The Palestine Economic Policy Research Institute (MAS)

Background Paper
RT (5)

The Performance of the PNA's FY 2018 Budget – compared with FY 2017 Budget and the Clearance Crisis

2019

The Performance of the PNA's FY 2018 Budget [1]– Compared with FY 2017 Budget and the Clearance Crisis

1- Background and Rationale[2]

A country's budget is a practical plan that that the Ministry of Finance (MoF) follows to serve the objectives of its development plans, which aims ultimately to achieve economic, financial and social goals. The budget is prepared by estimating the different budget items based on assumptions and guided by data. The financial instruments in the budget structure which are used as basic variables in the formulation of fiscal policy are listed under three main rubrics: Public Expenditures and related components (goods, services, wages, salaries, non-wages, social services, security, development, investment and current expenditures); Public Revenues and related components (collected from several domestic and foreign sources, and from various types of taxes and non-tax sources, fees and profits); Deficit, and how it is financed, and net lending, which is linked with revenues, foreign aid, and domestic and external borrowings to cover the financing gap.
The different internal restrictions and fundamental distortions undermines the PNA's Budget. For example, operating expenses and transfers (non-wages) make up third of the current budget expenditures, security 26%, education 20%, health 11%, social development 8%. This structural distortion in the distribution of expenditures, restricted spending on other sectors such as agriculture, which accounted for a mere 1%, considering that the security, health and education sectors are top priorities. In addition, growth of current expenditure has exceeded growth in revenues, which have created a gap that needs funding, either from external or internal lending sources. Lending, on the other hand, augments accumulated public debt.

In summary, MoF works diligently to prepare a budget that is in line with the economic and fiscal resources and that responds to political changes and domestic development. These policies aim at gradually creating an independent economy capable of generating the needed revenues. These efforts build upon previous efforts that began in 2010 and were embodied in the 2014 and 2015 budgets and their new procedural, policy and legal statements. Following 2015, the process of developing the budget became different, having to go through three main stages:

First, the preliminary stage, which represents the referential basis and the general

[1] The first PNA budget was developed in 1995 (which was not then based on a budget law). Since it was not built on a technically coherent basis, the first budget was tentative and improvised. Following the first legislative elections in 1996, the Palestinian Legislative Council (PLC) was formed and the Basic Law which (in its Articles 60 and 61) made the development of the public budget mandatory, and Law No. (7) of 1998, which regulated the public budget and financial issues, was issued. Afterwards, the PNA process of formulating the budget became part of a comprehensive financial policy. The policy sets the rules and procedures for designing the budget, stipulating compliance with the budget law and requiring the executive authority to submit the budget to the PLC under a law that is ratified at a specific date each year. However, following the 2007 political division which suspended the Legislative Council, the budget law is now presented by the Cabinet to the PNA President for ratification.

2 The sources of data used for this paper include: previous RT background papers, MoF and PMA data and reports, different MAS studies.

framework for policies, which involves identifying the economic and political environment and the various related indicators, determining the economic and social targets and assumptions of the budget; Second, the stage of defining the budget items entailing revenues and expenditures of the different centers of responsibility; Third, the stage of implementation and follow-up, which is the direct responsibility of the MoF, which ensures compliance with the limits set in the budget.

The preparation of the FY 2019 Budget takes place within a complex economic and political context, more than any previous era. The recent Clearance Crisis have further compounded the myriad of challenges posed by the Israeli occupation.

The most pressing challenges that beset preparing the budget is expenditures planning and forecasts under continuing revenues uncertainty. This uncertainty is the result of two factors: Israel's control over a large proportion of clearance revenues making up 65% of total PNA's revenues. One example of withholding Palestinian clearance revenues for a long period of time (84 months), for political reasons like the takeover of Hamas government, Non-member observer status in the UN in 2013, and many other pretexts, the latest of which, withholding clearance revenues since Feb 2019 (Table -2). Second, the uncertainty in the availability of foreign budget aid, depending on political conditions, which are following a downward trend in recent years.

The discussion of the budget has become an established tradition at MAS, each year. However, because of the latest clearance crisis, working with the FY 2019 Budget was suspended, as well, actual data of FY 2018 Budget was not available. This has delayed holding this discussion until it was possible to access data for both the FY 2018 and the FY 2019 emergency budget. Based on this, the FY 2018 Actual Budget will be compared with previous years' budgets, in light of the current clearance crisis 2019 and its impact on the preparation of the previous year's budget. In addition, the trends of the Emergency Budget or monetary plan until July 2019, will be presented.

Previous Budgets– Policies and Assumptions

The 2017 Budget was developed based on the same framework of financial reforms that was adopted in 2014-2015, basically: developing a revised guide of terms and concepts, setting ceilings for the medium-term budgets of the ministries and other public agencies within a framework of program budgeting and expenditure planning, creating projects' ID cards, and introducing a computerized system that integrates budgeting in the financial management system. A new framework was introduced in 2016, which was based on reforming management of public resources applying a newly created procedural manual for a medium-term of three years ceiling for program budgets set based on detailed data. Notably, the FY 2016 Budget Statement focused on developing gender-sensitive budget with more focus on vulnerable groups. The budget followed a conservative approach in stating assumptions and expectations about revenues, reducing spending and net lending, and increased dependence on domestic revenues by following a set of measures: horizontal expansion of the tax base, increasing tax obligation and combating evasion, and enhancing the relationship with the private sector. All these principles were maintained in FY 2018 Budget Statement.

In respect to previous budgets, the following points are noteworthy:

- Volatile financial sustainability[3]: The government's ability to implement fiscal policies (expenditures and revenues), without faltering or running a deficit, or accumulating budget debt over the years. To achieve this, there are standards[4] that should be followed, most importantly: a budget deficit should not exceed 3% of GDP, the overall public debt[5] (domestic and external) according to the Law of the Palestinian General Debt Law No. 24 of 2005. The budget deficit indicator shows a deviation of the conventional standard, as the public debt indicator has reached the maximum allowed ceiling.

  Under Palestinian circumstances this is considered somewhat acceptable[6], and consistent with the Palestinian General Debt Law of 2005 and other neighboring countries. However, what indicates a volatile financial sustainability is the increase in other current expenditures and net lending (excluding salaries) constituting around 40% of total public expenditures. Development expenditures constituted less than 6% in previous budgets, although it ranged between 10%-20% in previous years.

  The distortion, which is seen in most Palestinian public budgets, is that actual cash expenditures exceeds the budgeted expenditures, which is a negative indicator of the public fiscal sustainability. The latter represents the difficulty the government faces in meeting its obligations with limited options available for bridging the financing gap in light of the shrinking external aid.
- There is a correlation between the size of import revenues (from Israel and third countries) and economic growth, whereby the positive impact of economic growth on the size of imports translates into an increase in revenues. A slow growth is on the horizon, which means that this growth will not exceed current levels and cannot be expected to increase above that level. Therefore, the expected growth in revenues depends mainly on domestic revenues through improving tax collection and ensuring the private sector's tax obligation, even though domestic revenues contribute only 22% of total revenues. This situation calls for reconsideration of the applied tax policies, tax justice, and how to promote wider tax obligation which responds to the special needs of the Palestinian economy.

[3]Financial sustainability is also affected by political factors, especially donor countries support to the budget. According to the IMF, the stability of the debt-to-GDP ratio for at least five years is a condition for financial stability, which is ideally around 5%. This ratio indicates the country's financial ability to pay back debits without undertaking major fiscal policy compromises in the future

[4] Palestinian General Debt Law No. 24 of 2005, defines debt as any liability on the government, which should not to exceed 40% of GDP.

5 The debt-to- "nominal" GDP ratio was 18%. There are two major forms of public debt, branching into many, which are Internal Debt; government loans from local banks and other financial institutions. Second, External Debt; public borrowings from other Arab or International countries or institutions. A public deficit occurs when expenditures exceed revenues or when the difference between the two items equals zero. To cover the financing gap governments resort to borrowing from domestic or external sources. Based on this definition, the Palestinian public debt ratio was 18% of GDP. After adding other arrears and liabilities to the Pension Fund and public sector employees, the debt rises to 38% of GDP.

[6] The public debt-to-GDP ratio is 18% of GDP, after adding accrued arrears it rises to 38% of GDP, which is low or within acceptable levels compared with other neighboring countries. For example, in Jordan and Israel it stands at 94% and 62% respectively. However, Palestine's low ratio do not necessarily indicate a solid fiscal position in terms of the country's ability to borrow and pay back its liabilities, considering the limited Palestinian financial resources and the many other impediments that there are no room to mentioned here.

- ✧ The growth of domestic revenues, decline in external revenues (grants and aid), and strict austerity measures, are all indicators that the PNA is more capable of controlling and cutting expenditures than controlling revenues, giving that expenditures are controlled internally, contrary to external revenues which are dependent on donors or are channeled through Israel.
- ✧ The rise in the ratio of revenues to expenditures from 69% to 84% indicates good progress during these years, due to improved collection and rationalization of expenditures.

The FY 2018 Budget: Assumptions and Economic Indicators

The FY 2018 Budget came within political conditions[7] and expectations that are different from previous ones. This changing environment pertains to recent developments in the Palestinian reconciliation file, in addition to the deteriorating political situation following the USA new position on Jerusalem. These have together impacted expectations regarding Palestinian-Israeli trade relations, especially the possible instability in clearance revenues. In addition, international aid is forecast to decline, another indicator that the Palestinian economy is expected to shrink. Therefore, the Budget's scenario was built flexibly enough to accommodate the possibility of reconciliation and to serve its goals. For this purpose, it was structured differently. In addition to the Baseline Budget, which includes the expenditures of the southern governorates (Gaza Strip), it included the additional budgetary needs of Gaza of accommodating the salaries of 20,000 public servants and other additional expenditures, presented under the "Unified Budget".

The budget estimates were based on the following PCBS data and economic indicators:

- By the end of 2017 the GDP grew to 3.9%.
- The consumer price index (CPI) rose by 0.21% as a result of the increase in fuel prices and electricity tariffs.
- The unemployment rate in the West Bank and the Gaza Strip rose to 29.2%.
- The trade balance deficit rose to USD 5281 million in 2017 (USD 7816 in imports, USD 2535 in exports).

FY 2018 Budget: Key Policies and Assumptions

As mentioned earlier, the FY 2018 Budget policies were developed based on the Budget Statement of the FY 2014 and onward, which embodied a new framework and assumptions that aimed at consolidating the financial position of the PNA, reducing dependence on external aid. According to FY 2018 Budget Statement, the most important assumptions are:

- Reducing tax burden on individuals and start-ups and small enterprises, with the aim of achieving greater tax equity, while taking into consideration economic discrepancies between southern and northern governorates.
- The budget statement introduced corporate tax policies that aim at absorbing fresh graduates and encouraging banks and financial institutions to finance start-ups and small enterprises.

[7] FY 2018 Budget Assumptions and Policies- MoF.

- Incorporating the reconciliation's costs and additional budgetary needs and implementing new development projects in the Gaza Strip.
- Enhancing financial sustainability through expenditures rationing and cutting unnecessary expenditures, curbing borrowings as much as possible and directing it to development projects rather than to consumption or current expenditures, while ensuring debt servicing capacity.
- Continue reducing arrears as part of the FY 2018 Budget policies through issuing "promissory notes"[8], provided that an 80% cash reserve is secured. The issuance ceiling during FY 2018 will be NIS 600 million.
- Continue supporting the Palestinian Pension Authority, through raising the allocated funds from NIS 20 million (in 2017) to NIS 25 million.

- In addition, the Unified Budget addressed possible new financial burdens based on the following policies[9]:
    - ❖ Continue enforcing and expanding the tax system and ensuring that administrative development is pursued, in addition to enacting new amendments to the income tax brackets for corporates and individuals.
    - ❖ Introducing smart incentives and exemptions like considering a 150% of the minimum wage as acceptable expenditures in the income tax, reducing tax cut on the credit portfolio for SMEs.
    - ❖ Establishing a long-term lending fund administrated by the MoF, for implementing renewable energy projects, in which the government and the PMA contribute USD 10 million each, to reach a capital of USD 40 million.
    - ❖ Revising the Law on Landlords and Tenants, and standardizing applicable government fees in many sectors, including oil, courts and land sectors.
    - ❖ Reducing net lending by 20%, and adopting strict austerity policy including cutting or freezing public sector employees' allowances, as well as reforming the medical referral system and increased local provision of medical services.
    - ❖ Increasing pressure on Israel to demand for Palestinian financial rights, such as border crossing fees and collection fees (3%) that Israel deducts from revenues transferred to the PNA.

Assessment of the FY 2018 Budget Compared with FY 2017 Actual Budget

The above discussion presented the FY 2018 Budget in detail and identified its main policies, many of which are new ones that might have positive or negative outcomes. Although this cannot be decided now, it does not mean that these policies cannot be assessed at this stage. The available data and indicators provide an adequate basis for

[8]Promissory notes of NIS 12 billion were issued in 2016, and NIS 968 million of arrears were paid off. (FY 2018 Budget Statement).

[9]for more information, refer to MAS, 2018 (Background Paper RT (1)).

evaluating the budget and identifying pros and cons. Based on the Budget Statement and the above, the following observations are pertinent:

1. In Generally, drawing comparison between the FY 2018 Budget and previous budgets shows that growth in expenditures surpasses growth in revenues. It also shows that the revenue coverage to expenditure indicator has declined from 84% in the FY 2017 Budget to 80% in the FY 2018 Budget.
2. The government's commitment to strengthen the public-private sector partnership was not maintained in the FY 2018 Budget, which is shown in a 230% large decline in tax refunds. These refunds pump liquidity into the business market and provide for the private sector's expansion
3. The financial sustainability dilemma is still paramount, especially after incorporating additional budgetary needs of the southern governorates, and with the high ratio of current expenditures reaching 40% of the total.
4. Although the FY 2017 Budget has succeeded in reducing the salaries bill through applying strict measures, the same progress was not possible on the level of current expenditures and net lending. Achieving significant changes in both items requires the enactment of laws, policies and strict measures.
5. The FY 2018 Budget introduced policies and measures which are novel and in the right direction, among these: tax amendments, smart incentives and exemptions, standardization of applied fees, as indicated in the "necessary track" policies in the Baseline Budget. These policies are considered a quantum leap in terms of the distribution of the tax burden, adoption of a progressive tax approach, as well as enhancing the development of the small-scale private sector and increasing employment.

Generally speaking, from an economic growth perspective the continuing expenditure cutting policy, and reduction in investment incentives could lead unintentionally to economic stagnation in the future and does not stimulate demand in the economy. To measure the impact of this downward trend, economic studies needs to be carried out, to investigate to which extent spending can be reduced. Furthermore, this policy has implications on the quality of delivered services especially that the health, education and social services are already deteriorating and need improvement, which cannot be achieved without the necessary spending.

FY 2018 Budget Deviations: Estimated vs. Actual and in Comparison with FY 2017 Actual Budget

In the previous sections a comparison was drawn between FY 2018 Budget and actual budgets of previous years. In this section, we present FY 2018 actual performance compared with the estimated for 2018 and actual for 2017. This will help monitor significant variances and assess the expenditure and revenues plan in FY 2018 Actual Budget.

Revenues

- Actual revenues in 2018 were behind the estimated, less by 11% in net revenues and clearance revenues as well. This decline is ascribed to the smuggling phenomenon (especially diesel), and banning the entry of diesel to the Gaza Strip which have largely affected the fuels clearance. The overall decline in clearance revenues reached 8% in 2018 compared with 2017 (MoF, 2019).

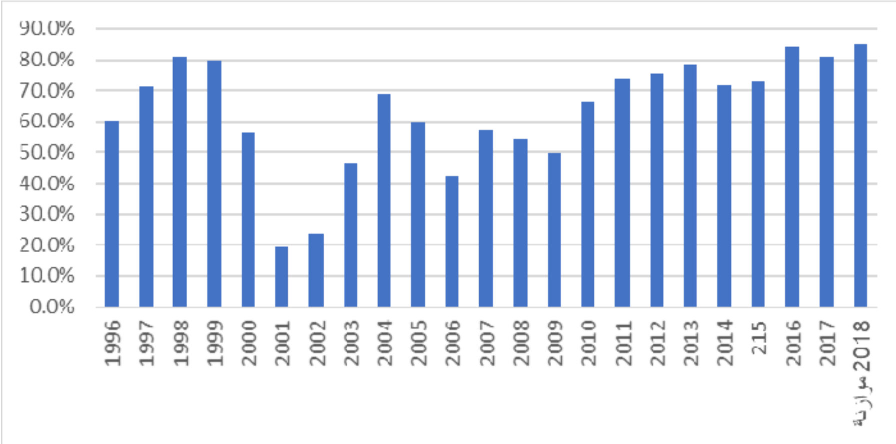
- External financing (aid and grants) declined as well by 13% compared to estimates (USD 100 million less), which has widened the financing gap by 19%, thus impacting the share of development expenditures negatively (about 60% of financing came from domestic sources), and the share of budget support. The overall decline in external financing reached 59% in 2018 compared with 2013, while it declined by 47% on average during that period. The decline in clearance revenues and external financing have resulted in a decline in total revenues by 5% in 2017.
- On the other hand, domestic revenues increased by 1% (USD 13 million) in 2018, which is within the expected because of the expansion of the tax base. Compared with 2017, the rise reaches USD 121 million, which goes in line with the budget's assumptions and policies focusing on increasing domestic revenues, which have led to a 9% increase compared with 2017.
- The actual budget shows a significant increase in the payment of tax refunds to the private sector of 229% (USD 119 million more than estimates).

Expenditures

- Actual expenditures were markedly less than estimates (USD 426 million), which is ascribed to cutting expenditures, especially salaries and wages, following the early retirement law (USD 390 million less in 2018). Note that other current expenditures were only USD 36 million less. The increase in net lending was slight (did not exceed USD 2 million).
- Overall, actual expenditures declined in 2018 by 7.6% compared with actual expenditures in 2017. This development was the result of cutting expenses and austerity and rationalization measures, especially employment freeze and the application of the Palestinian Law of Public Retirement (around 9,238 civil retirees, and 18,363 military retirees by the end of 2018).
- In sum, compared with the FY 2017 Budget, revenues and total current expenditures in the FY 2018 Actual Budget declined by 4% and 7% respectively, while the financing gap increased by 27% due to the decline in aid and grants by 7%. This highlights the huge impact that external financing, which shrank to the half, had on bridging the financing gap during recent years.
- On the other hand, the structural imbalance in the budget is evident in inflated current expenditures and net lending. Despite the development on the level of revenues, they have not exceeded expenditures. A small increase in expenditures must be offset by a double increase in expenditures. As Figure (1) shows, early-years Palestinian Budgets had no inflated current expenditures nor included the net lending item until 2010. In addition, revenues covered 80%, however, because of inflated current expenditures, this ratio declined and the deficit hiked since 2000.

This is a clear example of structural distortion in the budget, as mentioned earlier, which needs years to be rectified. Cutting current expenditures is a long-term plan, and usually would have adverse impacts on aggregate demand and stimulating economic growth.

Figure (1): Revenues to Expenditures Coverage Ratio, 1996-2018



FY 2019 Budget and the Clearance Crisis

The Occupation's latest decision to deduct around USD 138 million annually from clearance revenues, which represent the dues to Palestinian martyrs and prisoners' families, has put the PNA under an unforeseen financial pressure. The PNA had to replace the FY 2019 Budget with an Emergency Budget for Feb-July 2019. The Budget is financed from domestic sources, borrowings from local banks and pledges through the Arab Safety Net.[10]

The Emergency Budget was developed based on fiscal austerity measures with limited financial ceilings, while considering the following principles:

- Protecting low income earners
- Setting a minimum and maximum wage level and cutting the wage bill by 30%
- giving priority to marginalized and poor families
- Freezing employment and promotions
- Cutting operating expenses by 20%, and approving other current expenditures based on needs
- Commit in 2019 to FY 2018 development commitments
- Postponing paying the private sector arrears
- Reducing the public debt service (interests) to zero, which means stopping borrowing from local banks

The plan's sources of revenues are:

[10] Palestinian Minister of Finance called (during the emergency meeting of the Arab Finance Ministers chaired by Tunisia in 1/6/2019) for activating the Safety Net, to secure USD 100 million monthly as per the Arab League decision to support Palestine by providing USD 55 million a month, which is the minimum amount needed for fulfilling basic current expenditures, whether in the social, health or education sectors, as declared by the Palestinian minister of Finance.

- The borrowing ceiling from local banks should be less than USD 450 million until July 2019, i.e. USD 80 million a month.
- Issuing promissory notes of USD 100 million until July
- External aid estimated at USD 55 million a month
- Domestic revenues averaged USD 80 million

In summary, despite the slight contraction in the FY 2018 actual Budget, following 2014 the financial performance saw a marked improvement. However, revenues uncertainty has always affected having a good budget planning, which was compounded by the latest clearance crisis. Because of the crisis, the Palestinian government was not able to fulfill its obligations, or put the FY 2019 Budget into application, replacing it with the Emergency Budget, at a time the Actual Budget of 2018 was behind the FY 2017 Budget and behind estimates and projections. Have the structural distortions in previous budgets been rectified or reversed gradually, today's financial position would have been stronger

The current situation calls for revisiting the structure of the budget, especially the current and operational expenditures and net lending, and shifting toward a structural reform in these items, or at least controlling net lending which represents a huge burden on the budget. In addition, a structural reform is needed in the development expenditures which have depended historically on external financing, and did not exceed 6% of the budget compared with 40% of the budget allocated to current expenditures account (without salaries). On the other hand, a possible reform in revenue sources is increasing domestic revenues through the tax burden, improving tax collection, combating tax evasion and customs smuggling, and promoting trust and partnerships between the public and the private sectors.

Regarding the FY 2019 Emergency Budget, it is not possible to assess the Budget, which came as a result of the political conditions and clearance crisis[11] as it is suspended and inaccessible. Having an Emergency Budget does not mean controlling risks, especially the risk of financial sustainability, stability of the monetary system, and its ability to continue providing funds for more than six months, in addition to the deteriorating economic indicators, domestic demand and purchasing power, and the contraction in the budget's financial indicators evident in the growing current deficit and the accumulating debt, increasing public debt service which is costly to citizens. Most importantly, the government defaulted from meeting its full obligations, especially in terms of current expenditures.

Today, all these risks became a realty lived by Palestinians and policy makers. To control these risks, the structure of the budget should be analyzed carefully to cut any unnecessary current expenditures and boost investment development expenditures.

[11] Following the crisis, the PNA found itself obliged to deal with limited financial resources (around 35-40% of resources available before the crisis) which is a huge burden on the PNA in terms of meeting its liabilities and managing public resources.

Table (1): Palestinian Budgets, 2017-2018- (USD million)

Item	Actual 2017	Actual 2018	Baseline 2018	2018 Deviation between the actual and estimates	Ratio of deflection	Actual 2018 Vs. 2017
Net Public Revenues	**3495**	**3355**	3751	−396	−11%	−4%
Total Revenues	**3567**	**3526**	3803	−277	−7%	−1%
− Domestic revenues	**1151**	**1272**	1259	13	1%	10%
− Clearance Revenues	**2416**	**2254**	2544	−290	−11%	−7%
Tax refunds	**72**	**171**	52	119	229%	58%
Total Current Expenditures and Net Lending	**4358**	**4068**	4494	−426	−9%	−7%
−Wages and Salaries	2114	1798	2188	−390	−18%	−18%
Running costs	1978	2020	2056	−36	−2%	2%
−Net Lending	266	268	250	18	7%	1%
Current deficit before financing	**863**	**713**	743	−30	−4%	−21%
+ Development expenditure	366	363	530	−167	−32%	−1%
Total deficit before financing	**1229**	**1076**	1273	−197	−15%	−14%
Needed Funding	**1229**	**1076**	1273	−197	−15%	−14%
External Funding	**719**	**675**	775	−100	−13%	−7%
_ Budget support	544	515	600	−85	−14%	−6%
− financing development expenditure	175	160	175	−15	−9%	−9%
Financing gap (after external funding)	510	401	498	−97	−19%	−27%

Source: Ministry of Finance data - multiple years - cash basis

Table (2): dates and amounts of Palestinian clearance funds withheld in previous years

Due Date MONTH/YEAR	**Payment Date MONTH/YEAR**	**Duration of retention /a month**	**Held amount (USD million)***
7/1997	8/1997	1	87
12/2000	12/2002	24	500
3/2006	7/2007	16	1100
5/2011	5/2011	0.5	100
11/2011	11/2011	0.5	100
11/2012	21/1/2013	3	100
1/2015	4/2015	3	450
19/3/2019	Not defined	Five months so far	**All clearance**

Questions for Discussion

- Looking at the 2018 budget performance, can the deviation between the planned and actual 2018 and compared with 2017 be considered the start of the coming budgets' future trend?
- What budgetary structural reforms are workable? Considering net lending and operating expenses and non-wage expenditures?
- What possible adverse economic repercussions could a five-years austerity plan have?
- How successful was the Emergency Cash Budget? Was applying all its items possible? what is the next financial step following July?