

**Palestinian National Authority**

**Ministry of Finance**

**Fiscal Developments: Second Quarter & Midyear Report 2011**

**Macro-Fiscal Unit**

**15/08/2011**

## 1. Budget execution highlights:

- The current budget deficit for the first half of 2011 is above the budget target, mainly due to shortfall in revenues. Projections for the full year indicate that budgetary operations can remain within the budget ceilings provided there is restraint in non wage expenditure and an increase in revenues.
- Total net revenues are still below the budget target due to the shortfall in every item of its components.
- Investment profits of NIS 85.5 million were received from Palestinian Investment Fund (PIF) in April.
- The wage bill is largely on track with budget targets, except for a NIS 100 million overage (1.6% of the wage bill) due to allowances paid during Q1 11 not foreseen in the budget and underestimation of the wage bill.
- Non wage expenditures are running below budgetary appropriations. Provided transfers and operational expenditures during the second half of the year do not exceed an 43% increase over their spending level in the first half, savings obtained would offset some of the revenue shortfalls.
- Reducing net lending by transferring all electricity supply and distribution to distribution companies established is still on track to meet the budget target.
- Total net accumulation of arrears during the first half of 2011 reached NIS 1030 million including development expenditures arrears of NIS 173.7 million and tax refund arrears of NIS 222 million. Payment arrears to the private sector have accumulated to NIS 612 million –including tax refund arrears of NIS 222 million- during the first half of the year, due to a large external financing shortfall. Arrears to the private sector undermine PNA credibility and budget execution control.
- The external budget support shortfall can mostly be attributed to a drop in Arab countries budget support. Even with a strong pick up in Arab financial contributions, the external financing gap may reach NIS 1.1 billion before year end.

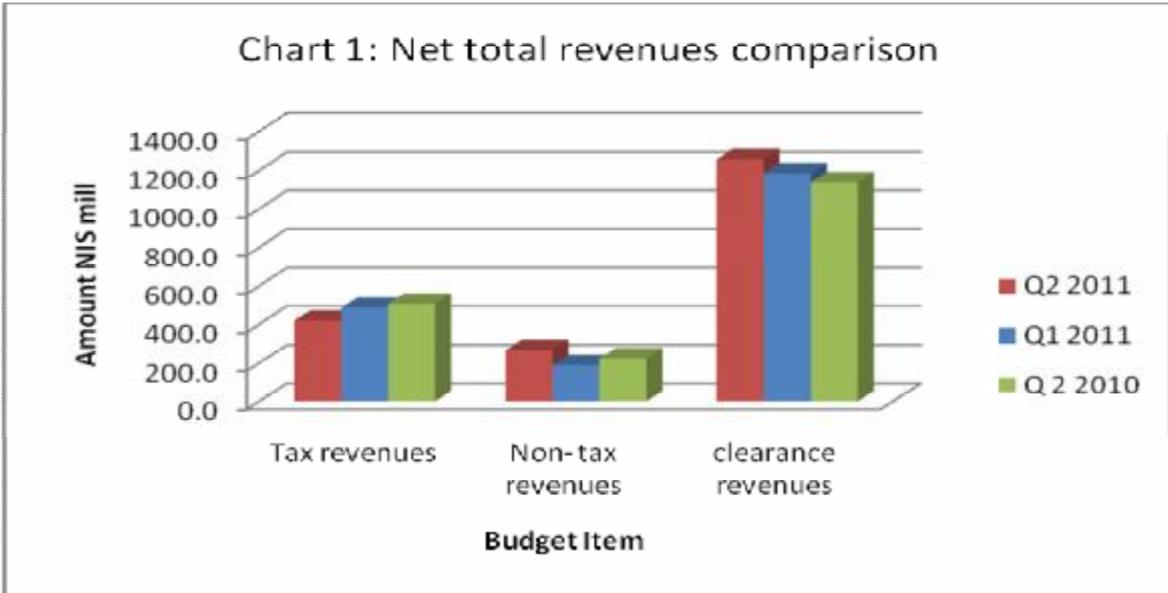
Table 1. Consolidated Fiscal Operation Analysis of Q2 2011 on Commitment Basis

Budget Classification	Q2 2011	Change from Q1 2011	Change from Q2 2010	First half 2011	Change from first half 2010	FY 2011 Approved Budget	1st half 11 as share of approved Budget
	NIS mill.	%	%	NIS mill	%	NIS mill.	%
Gross revenues	1942.5	4.3	-0.3	3,804.4	5.1	8339	45.6
· Tax revenues	418.8	-13.9	-17.6	905.5	-5.0	1894	47.8
· Non- tax revenues	267.2	40.9	19.1	456.8	14.6	1110	41.2
· Clearance revenues	1256.5	6.0	10.5	2,442.2	7.7	5335	45.8
· Tax refunds	108.6	-32.8	129.8	270.2	113.2	388	69.6
Total Expenditures and Net lending	2930.5	8.2	-1.5	5,638.7	-1.9	11960	47.1
· Wage Expenditures	1653.7	2.7	9.7	3,263.4	8.9	6325	51.6
· Non- wage Expenditures	1128.6	20.1	-8.1	2,068.1	-6.6	5043	41.0
- Operational Expenditures	498.2	6.4	4.5	966.3	15.7	1864	51.8
- Transfers	605.2	29.9	-16.4	1,071.0	-20.4	3089	34.7
- Minor Capital	25.2	355.2	-11.8	30.7	-11.0	90.4	34.0
· Net lending	148.2	-6.8	-37.3	307.2	-42.8	592	51.9
Current Balance	-1096.5	8.8	-12.3	-2,104.4	-6.7	-4009	52.5
Development expenditures	415.6	93.0	97.4	631.0	57.7	1850	34.1
Balance	-1512.1	23.6	11.1	-2,735.3	3.0	-5430	50.4
Financing	1512.1	23.6	11.1	2,735.3	3.0	5430	50.4
· Budget Support	436.1	-25.5	-63.5	1,021.9	-48.1	3580	28.5
· Development	65.8	-22.8	-57.5	151.0	-24.6	1850	8.2
· Net Domestic Bank Financing	576.6	-388.7	-599.3	376.9	25.5	0	Not applicable

## 2. Revenue

Gross PNA revenue, amounting to NIS 1.94 billion in Q2 11, increased by 4% over Q1 11 (NIS 1.86 billion, tables 1 and 5) . The first half of the year is usually marked by large income tax payments which benefit from receiving a discount when paid early. Nevertheless, when measured against Q2 10, gross PNA revenues decreased during Q2 11 by 0.3%, while the first half of 2011 increased over the same period in 2010 by 5.1%.

With domestic tax revenues below budget expectations by around NIS 40 million, the large gap in non tax revenue (NIS 285 million) and clearance revenues shortfall (NIS 400 million), overall revenue may incur a NIS 725 million shortfall. This would be essentially due to budgetary overestimation of these revenues and the slowdown of the economy.



Domestic tax revenue in Q2 11 declined to NIS 419 million from the peak it had reached in Q1 11 of NIS 487 million and decreased by 14% from Q2 10 (table 5). As mentioned above, most income tax payments accrue early in the year. In 2011, income taxes amounted to NIS 187 million in Q1 11 (the highest level attained on record) and fell to NIS 97 million in Q2 11. Domestic VAT increased (from NIS 132 million in Q1 to NIS 185 million in Q2) while excises on tobacco remained static at around NIS 82 million.

During the first half of 2011, domestic tax revenues decreased by 11% over the first half of 2010 (Chart 2). The slowdown in the economy from a growth rate of 15.6% in the WB in Q1 10 to a 3.3% in Q1 11 made it harder for the PA to increase revenues to reach the budget target even with the administrative reforms in MoF tax departments.

Non tax revenue, Domestic fees and charges amounted to NIS 182 million in Q2 11, a 19 % decrease over Q1 10. This decrease was mostly due to not receiving the exit taxes paid by Palestinians at the Allenby Bridge<sup>1</sup> owed for the first six months of 2011. In Q1 11 the amount collected from September- December 2010 were transferred to the PA amounted to NIS 15 million (table 5). In June, the Israeli Border's Authority agreed with MoF to transfer the amount of exit tax for the first six month of 2011.

Recording the monthly revenues of Jawwal to non-tax refunds commitments in the financing part of the fiscal tables (1-4), is the method adopted in reporting the refund of the \$ 70 million to Jawwal Telecommunication Company.

Investment profits amounted to NIS 85.5 million were received by the PNA during the first half of 2011 as dividends from the PIF. This would bring non tax revenues for the full year to about NIS 815 million. Historically the collections for licenses and fees increases in the third quarter each year, leading to gains in the non tax revenues towards achieving the budget target.

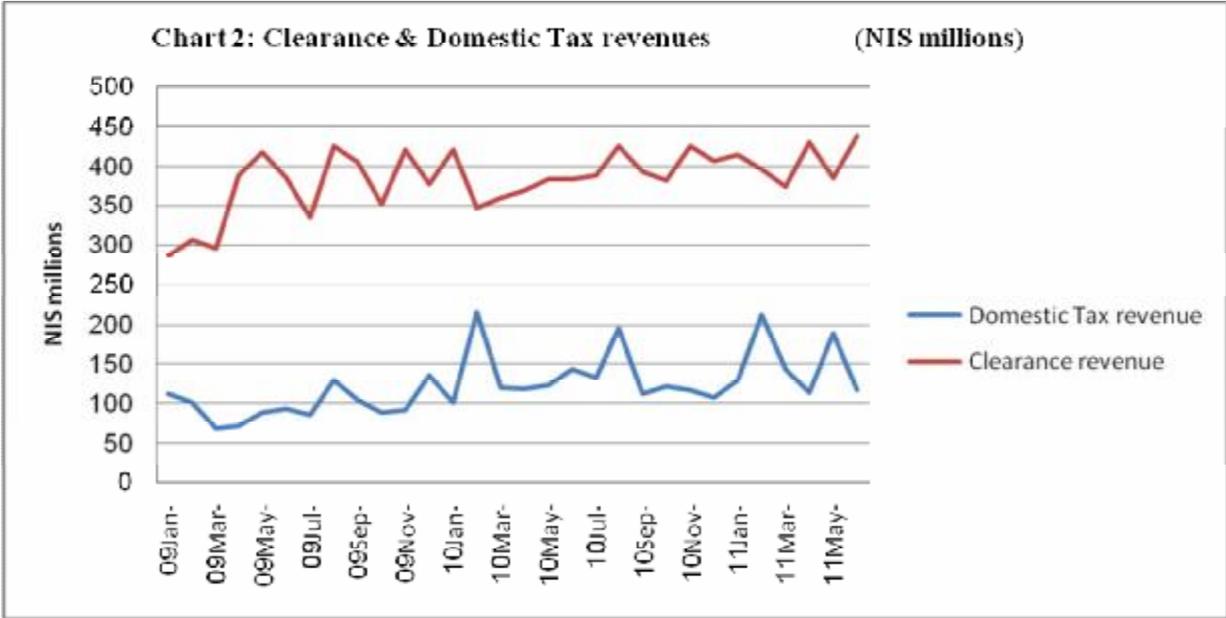
Overall, there may be a NIS 285 million shortfall in non tax receipts relative to the budget target which overestimated license fees and investment income.

Tax refunds have been running at about NIS 36 million per month during Q2 11, amounted to NIS 109 million during Q2 11 on a commitment basis, which increased over Q2 10 by 130%, reaching to 70% of its budget target. This is due to the payments of some tax refund arrears carried from 2010. However, on a cash basis, only NIS 48.5 million was disbursed, due to the large shortfall in external budget support. While tax refunds may not fully recover by year end,

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<sup>1</sup> These exit taxes are collected by the Israeli authorities and shared (by half) with the PNA. However, they are not remitted on a systematic basis and a transfer mechanism needs to be established.

unless a sharp increase in external financing takes place, these arrears will be carried into 2012.



Clearance revenue: Monthly monitoring of clearance revenue from the three major tax components, over the last three months may indicate a stronger economic activity during Q2 11<sup>2</sup>.

Clearance revenue in Q2 11 increased by 6% over Q1 11 to NIS 1.26 billion (tables 1 and 5). Compared to Q2 10, the increase in clearance revenue was even higher, 10.5%; this is basically due to increase in both import tax and VAT (Chart 3 & Table 4 in this report).

Clearance revenue received during the first half of 2011 increased by 7.7% over the same period in 2010 to NIS 2.44 billion. During the first half of 2010, excise taxes on petroleum products received from Gaza have actually declined from a monthly average of NIS 15 million in 2010 to almost NIS 0.3 million in June 2011. This may be explained by two factors related to Gaza: the decrease of petroleum excise (BLUE) from the Israeli side in February. Moreover, people in charge in Gaza stopped using the Israeli fuel for Gaza Electricity Generating Company, and they substitute it by cheaper petroleum products imported from Egypt through tunnels.

<sup>2</sup> Monthly Clearance session reports, MoF.

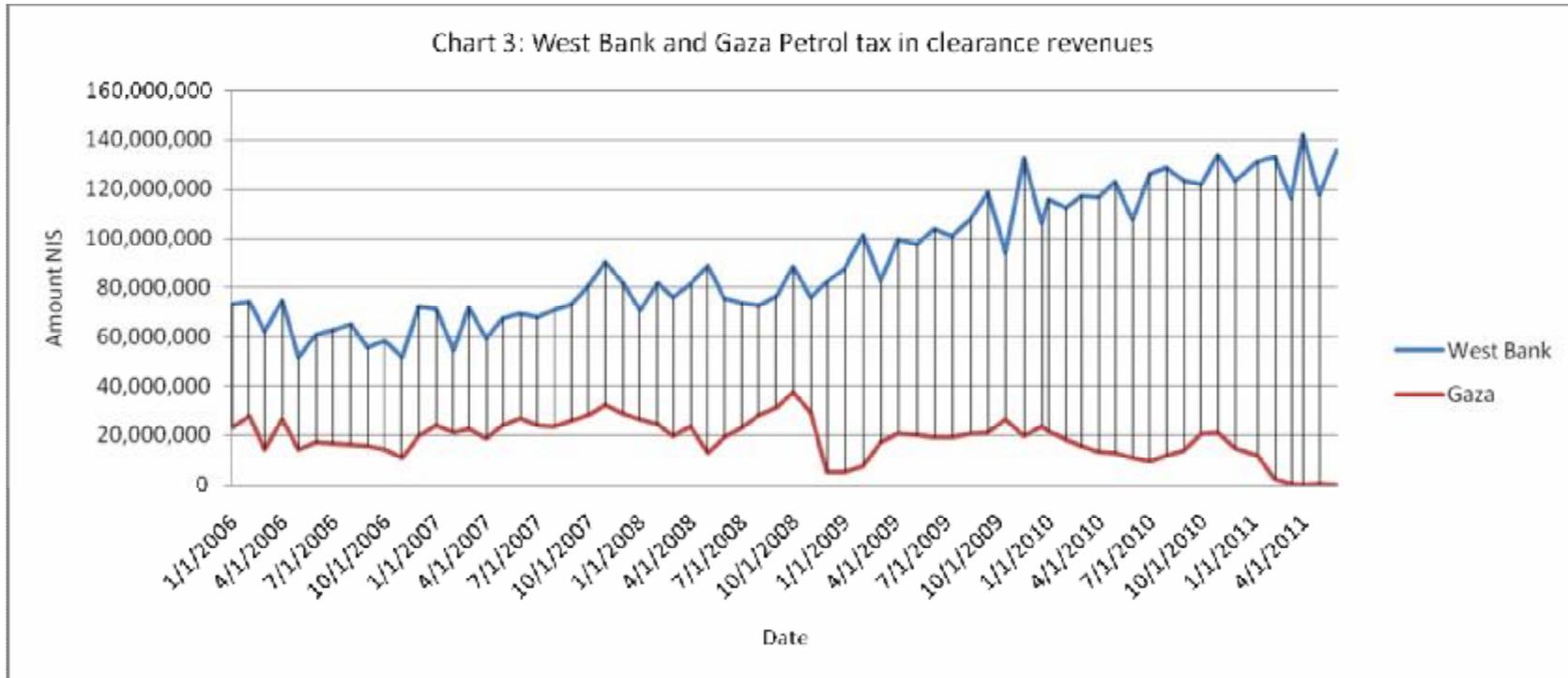
This would bring clearance revenues for the full year to about NIS 4.9 billion. Overall, there may be a NIS 400 million shortfall in clearance revenues relative to the budget target due to the slowdown of the economy during the first half of 2011 as opposed to the projected growth rate in 2011 budget and an overestimation of the budget target.

From the table and chart below (Table 4, Chart 4) we can see that the gap between the revenues collected from Gaza and West Bank is getting wider due to the decrease in petroleum excise received from Gaza (for the reasons mentioned above) and the Israeli siege on Gaza.

**Table 2: Clearance revenues breakdown Gaza & West Bank Jan 2011- Jun 2011, NIS**

	Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11	Total
<b>Import tax</b>	149,305,783	136,009,012	132,180,100	142,771,575	132,921,744	171,339,922	864,528,136
<b>Petrol tax</b>	143,187,257	135,456,991	117,281,385	142,640,157	118,383,465	136,543,476	793,492,731
West Bank	131,141,348	132,965,519	116,538,039	142,237,882	117,800,694	136,237,977	776,921,459
Gaza	12,045,909	2,491,472	743,346	402,275	582,771	305,499	16,571,272
<b>VAT tax</b>	127,553,204	120,818,298	126,388,818	144,840,240	132,421,239	129,882,567	781,904,366
<b>Purchase tax</b>	(4,129,433)	3,573,090	(2,089,577)	1,970,564	2,124,614	2,039,988	3,489,246
<b>Grand Total</b>	<b>415,916,811</b>	<b>395,857,391</b>	<b>373,760,726</b>	<b>432,222,536</b>	<b>385,851,062</b>	<b>439,805,953</b>	<b>2,443,414,479</b>

**Chart 3: West Bank and Gaza Petrol tax in clearance revenues**



### 3. Expenditures and net lending

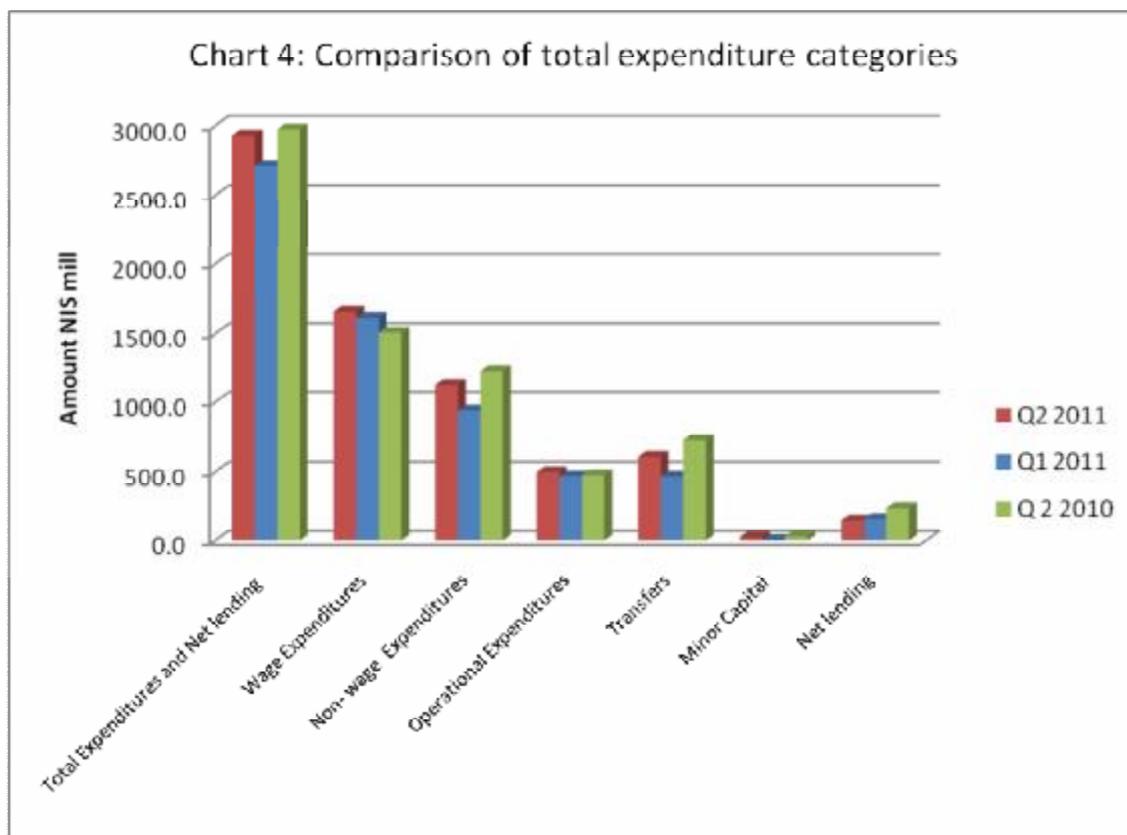
Total PNA expenditure and net lending on a commitment basis of during Q2 11 were 8% higher than expenditures during the first quarter (NIS 2.93 billion, table 1). When comparing the first half of 2011 to the same period in 2010, expenditures during January-June 2011, (NIS 5.64 billion) have fallen below the expenditure level during the first half of 2010 (NIS 5.75 billion). When projected on an annual basis (NIS 11.27 billion), total recurrent expenditures and net lending would fall slightly below the budgetary target (NIS 11.96 billion).

The PNA wage bill on a commitment basis in Q2 11 of NIS 1.65 billion was slightly higher than in Q1 11 (NIS 1.61 billion). When compared to Q2 10 the wage bill increased by 9.7%. This was moderately higher than what was programmed in the budget, which was predicated on a 6% salary increase, including the 3.5% cost of living allowance, 1.25% which is the annual increase and a 1.25% increase in employment planned for 2011.

Projecting the wage bill for the full year 2011, results in a NIS 6.5 billion wage bill, exceeding the budget target by 2.8% (NIS 200 million). There are several reasons for this overage:

A number of allowances and salary adjustments, which were not foreseen in the 2011 budget, took place during the first half of the year. The wage bill of the first half 2011 includes most of the budgeted retroactive payments to employees appointed at the end of 2010 who didn't start receiving their salaries due to the long recruiting procedure. The January 2011 wage bill included a NIS 12 million payment for 2010 Jerusalem allowances to employees, retroactively to the beginning of 2010. In January and February, a payment of NIS 5.5 million was made to health and education sectors' employees for overtimes and replacements.

Wage expenditure in cash (Tables 3 and 4) in Q2 11 of NIS 1.56 billion which is less than the commitments by about NIS 93 million which are arrears to the Pension Fund.



Non wage expenditures of NIS 1.13 billion in Q2 11, on a commitment basis, increased by 20% over Q1 11, with most increases occurring under transfers (tables 1 and 2). However, non wage expenditures during the first half of 2011 declined by 7% relative to the first half of 2010.

Projections of non wage expenditure for the full year would indicate that this spending may fall below the budget target of NIS 5.04 billion by about NIS 300 million. It is essential that this spending restraint takes place so as to make up for some of the projected shortfalls in revenue.

Non wage expenditure in cash (Tables 3 & 4) in Q2 11 of NIS 855 million was lower than commitments by NIS 274 million, with payment arrears mostly affecting the government contribution to the Pension Fund, as well as some arrears to private sector suppliers.

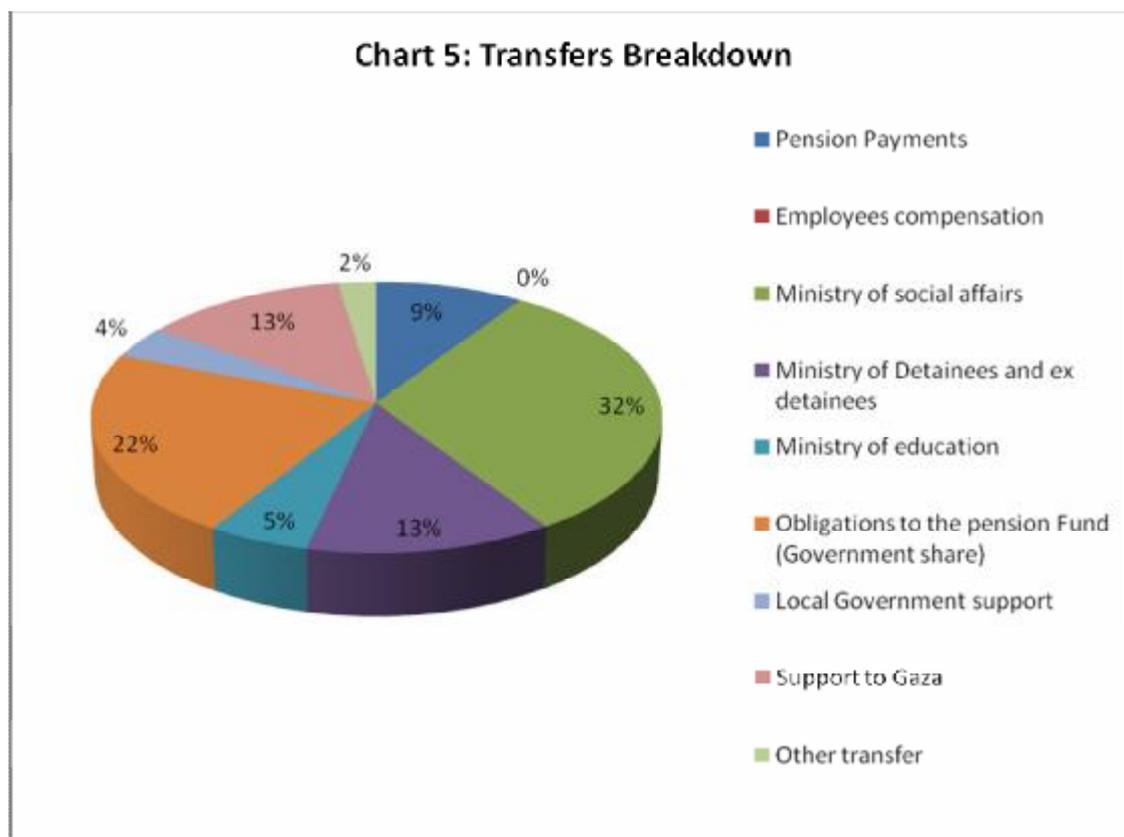
Operational expenditures of NIS 498 million in Q2 11 (Table 2) increased relative to Q1 11 (NIS 468 million) and relative to Q1 10 by 4.5%. However, when comparing the first

half of 2011 to the same period in 2010, there was an increase of 16%. During the first half of 2011, arrears of operational expenditures to the private sector are estimated at NIS 217 million.

Operational expenditures will be on track with the budget target, when Projected on an annual basis.

Transfers in Q2 11 of NIS 605 million were also higher than in Q1 11 (NIS 466 million, table 2) but when compared to Q2 10 transfers declined by 16.4% (NIS 724 million). Transfers in the first half amounted to NIS 1.07 billion declining by 20.4% over the same period of 2010. For the full year 2011, transfers are projected at about NIS 2.8 billion, a decrease of NIS 289 million from the budget target.

Item	Amount (NIS)
<b>Pension Payments</b>	98,598,254
<b>Employees compensation</b>	171,033
<b>Ministry of social affairs</b>	334,850,342
<b>Ministry of Detainees and ex detainees</b>	135,458,908
<b>Ministry of education</b>	55,666,628
<b>Obligations to the pension Fund (Government share)</b>	235,293,395
<b>Local Government support</b>	41,437,914
<b>Support to Gaza</b>	136,070,428
<b>Other transfer</b>	25,350,626
<b>Total</b>	1,062,897,529



Minor capital expenditure picked up to about NIS 25 million in Q2 11 from its very low level in Q1 11 (NIS 5.5 million). Given the shortfall in external budget support, it is not expected that this spending will exceed NIS 30 million per quarter during the second half. Minor capital expenditures will be on track with the Projected budget target.

Net Lending expenditure of NIS 148 million in Q2 11 declined from the previous quarter (NIS 159 million) by 7%. Compared to Q2 10, there was a NIS 89 million reduction (37%). During the first half of 2011, net lending amounted to NIS 307 million, a 43% decline from net lending during the first half of 2010. Considering that a declining trend in "net lending" has been firmly established, MoF expects that its budget appropriation of NIS 592 million for 2011 will be met.

Major efforts are now taking place to pressure Tulkarm and Anabta to join NEDCO before the end of this year 2011. It is worth mentioning that in July 2011 Gaza paid to the PNA around NIS 110 million for electricity.

Development expenditure channeled through the PNA treasury amounted to NIS 416 million in Q2 11, following an outlay of NIS 215 million in Q1 11. This is a 58% increase over the amount spent during the first half of 2010 (NIS 400 million). The amount spent in the first half of 2011 was mainly on ongoing project and not for new projects since bidding for new projects stopped from October 2010.

However, external financing for these development projects fell short of actual commitments. Of the first half of 2011 commitments for development expenditures of NIS 925 million, only NIS 151 million were financed from abroad (Tables 1 and 7).

#### 4. Deficit and financing

The recurrent fiscal deficit in Q2 11 of NIS 1.1 billion was higher than in Q1 11 by 9%, which was entirely due to a spurt in non-wage expenditures in May 2011 (table 1 &2). Nevertheless, the recurrent deficit during the first half of 2011 (NIS 2.1 billion) was lower than during the first half of 2010 (NIS 2.26 billion) but exceeded the budget deficit target by about NIS 200 million. Projections for the full year 2011 indicate that the budget target of NIS 4.01 billion will be hard to attain given the shortfall in revenues and the undiminished spending levels.

Financing of the budget deficit in Q2 11 through external budget support amounted to NIS 436 million, a substantial decrease over the support received in Q1 11 (NIS 586 million, table 7). Cumulatively the shortfall in external budget support during the first half is NIS 770 million. This has been of particular concern, considering that some western donors (PEGASE, Norway) had front loaded their budget support for the year at the request of the PNA. Arab donors contributed NIS 277 million during the first half of 2011, about 27% of total budget support during . The Arab countries contribution to budget support had fluctuated in the 30- 44 % range over the last three years. The depreciation of the US dollar stated in the budget (US dollar 1 = NIS 3.7) to (US dollar 1 = NIS 3.48) has resulted an additional loss of funds. Most donors denominate their aid in US dollars.

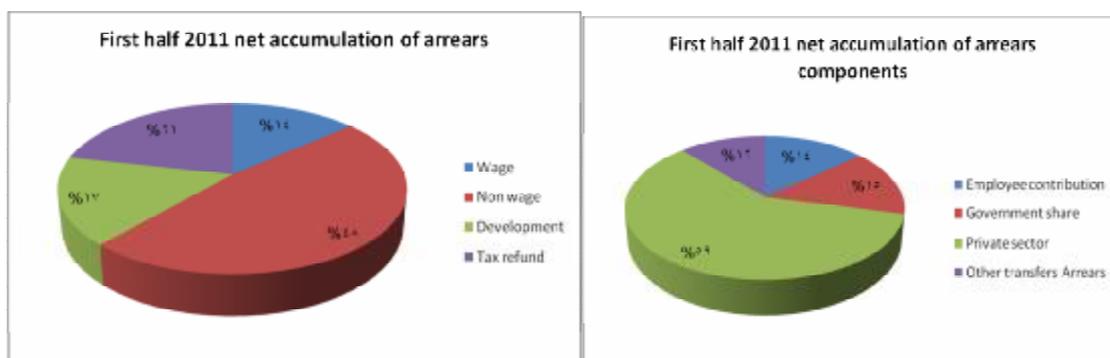
Even with a strong pick up in Arab financial contributions, the external financing gap may reach NIS 1.1 billion before year end.

The shortfall in external financing, coupled with a higher than targeted budget deficit mentioned above during the first half of the year, resulted in additional borrowing from the banking system by NIS 862 million. This has raised the public debt to commercial banks to NIS 3.82 billion (table 8).

Payment arrears to the private sector have accumulated to NIS 612 million –including tax refund arrears of NIS 222 million- during the first half of the year. Nevertheless, arrears to the private sector undermine PNA credibility and budget execution control, an issue which needs to be addressed. Total net accumulation of arrears during the first half of 2011 reached NIS 1030 million including development expenditures arrears of NIS 173.7 million and tax refund arrears of NIS 211 million.

Table 4: First half 2011 net accumulation of arrears			
Budget Item	NIS mill	Components	NIS mill
Wage	142	Employee contribution	142
Non wage	493	Government share	155.5
Development	173	Private sector	611.7
Tax refund	221.7	Other transfers Arrears	120.5
Total	1029.7		1029.7

Chart 6.



## Appendix 1: Institutional Development

- Regarding Pension Reform, a revised action plan to amend the public pension system has been approved by the Council of Ministers .A presidential decree with the necessary adjustments is expected to be issued.
- During this quarter a consultancy firm financed by the EU finalized an assessment to the Gaza Electricity Distribution Company (GEDCO). PEA & MOF shall continue to implement the recommendations of this study that has been approved by GEDCO & PEA.
- A two year technical assistance for the implementation of the institutional development and electricity sector reform has been launched. This assistance is financed by the EU and aims to give assistance to all distribution utilities in addition to PERC.
- The Council of Ministers has approved a new electricity tariff to be applicable to all Palestinian areas beginning July 2011. The new tariff Increases charges with levels of consumption, so as to protect the poorer segments of the population
- PEA has awarded two contracts for the supply of 214,000 prepaid meters, and the first shipment of these meters is expected to be in October/November 2011.
- The Budget department is in the process of preparing the new budget for the year 2012.
- The Financial Statement for 2009 is still in the last stages of auditing and will be released in the coming months.
- All zero balance accounts are functional, and around 369 accounts were closed by the second quarter of 2011, an increase of around 14 accounts closed over the first quarter of 2011.