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Palestine Economic Policy Research Institute

Background Paper

Roundtable (1):

**The FY 2016 Budget
and the Recent Developments**

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Background and Rationale

Countries depend on fiscal and monetary policies to reach development goals. One important tool of fiscal policy is the government budget with its revenues and expenditures components. Given the specific Palestinian context, which puts constraints on the utilization of some policies (especially in the case of monetary policies which are completely absent), the general budget remains the only tool to achieve the economic goals. Budget policies, however, are further constrained by different determinants, particularly the external factors including Israeli restrictions and international aid that affect the revenue side, making budget planning a very difficult task.

It was in 1995 that the Palestinian National Authority (PNA) developed its first budget (which was not then based on a budget law). 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 general budget mandatory and Law No (7) of 1998 (which regulated the general budget and financial issues) were issued. Afterwards, the process of building the budget became a part of a comprehensive financial system. The system set the rules and procedures for building the budget, stipulating compliance with the budget law and requiring the executive branch to submit the budget to the PLC under a law that is ratified at a specific date each year. However, following the 2007 political divide which suspended the Legislative Council, the budget law is now presented to the PA President for approval.

The process of building the 2016 budget comes, as usual, amid an uncertain economic and political context. The Ministry of Finance has prepared the budget believing that it helps achieve the envisioned economic and fiscal objectives, with the ultimate goal of gradually making the budget dependent on the local economy in generating a significant part of revenues. The 2016 effort is complementary to previous efforts that began in 2012 and were embodied in the 2015 budget and its procedures and policy and legal outlines.

The process of developing the general budget and establishing the follow-up procedures is now different, having to go through three main stages. First, in the preliminary stage, which represents the general framework for policies, the planners identify the economic situation and the various indicators that determine the difference between the status quo and the targets. In the second stage, revenues and expenditures are defined through specific actions. The Ministry of Finance instructs stakeholders to estimate their needs. All of the sub-items provided are then assembled to constitute the general budget, to be presented as a bill before competent authorities for ratification. In the third stage, – implementation and follow-up – the Ministry of Finance takes all procedures to ensure commitment to the set targets in the budget.

As budgetary issues have always taken center stage, the Palestine Economic Policy Research Institute (MAS) has decided to dedicate its first roundtable for the year 2016 to this issue, bringing in the process different concerned parties to discuss the methods the PNA has put in place to develop the general budget and the economic and social implications for such methods. Part of the effort included updating information and identifying administrative and legal changes in the Palestinian budget and drawing a comparison between the 2016 budget and previous budgets in terms of targets and actual figures.

Fiscal Changes in the Actual Budgets since 2010

Tables 1 and 2 and Figure 1 show the changes in the main items of the actual budgets during the previous six years:

- ✧ The current deficit before financing dropped from 15% of GDP to 10.7% of GDP in 2015;
- ✧ Current expenditure and net lending fell from 36% of GDP in 2010 to 31.5% in 2015. This decline in ratio, however, does not mean a drop in the value of expenditures, which indeed rose by USD 619 million. The increase is, however, reasonable given the steady growth in the population, which requires additional allocations for health and educational services, as well as additional expenditure in all government functions, particularly security;

- ✧ Net public revenue grew from 20.7% of GDP in 2010 to 22.7% in 2015. In absolute figures, this seemingly small rise meant adding USD 905 million to the treasury;
- ✧ As Figure 1 below shows, the changes were initiated in 2013, gained importance in 2014, and paid off in 2015.

In short, current expenditure and net lending rose by USD 619 million and net revenue increased by USD 905 million owing to the policy of cutting down expenditure and improving revenues, together with a relatively stronger control and more effective implementation.

Table 1: PA Revenues and Expenditures as % of GDP– Actual Budgets

Item	(in USD millions)					
	2010	2011	2012	2013	2014	Approximate actual budget 2015*
Net public revenues	1,845.40	2,177.00	2,240.10	2,319.90	2,749.90	2,750
As % of GDP (current prices)	20.70%	20.80%	19.86%	18.59%	21.50%	22.70%
Total current expenditure and net lending	2,927.3	2,960.1	3,047.1	3,250.7	4,077.3	3,819
As % of GDP (current prices)	32.84%	28.28%	27.02%	26.06%	31.94%	31.52%
Total deficit before financing	1,354.70	1,077.60	1,018.00	1,099.20	1,589.90	1,293
As % of GDP (current prices)	15.20%	10.30%	9.03%	8.81%	12.50%	10.70%
GDP (current prices)	8,913.10	10,465.40	11,279.40	12,476.00	12,765.83	12,115.90

Sources: Data for 2010-2013 were obtained from the Palestine Monetary Authority (PMA).

Data for 2014-2015 were obtained from the actual budget of the Ministry of Finance.

Figures for GDP 2010-2013 were obtained from the Palestinian Central Bureau of Statistics (PCBS).

* Actual budget for the first nine months of the year and estimates for the last three months of the year.

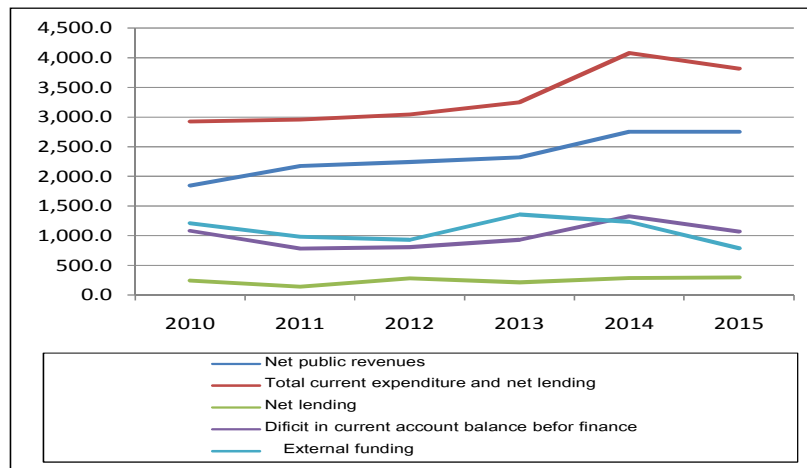
Table 2: Year-over-year Changes in the Actual Items
(in USD millions)

Item	2010	2011	2012	2013	2014	2015
Net public revenues	296.8	331.6	63.2	79.7	430.0	0.1
Total revenues	252.6	262.8	99.2	252.3	383.7	-25.3
- Local revenues	108.4	8.1	13.7	136.3	20.7	-24.3
Tax revenues	137.5	43.3	0.8	114.0	4.8	-6.6
Nontax revenues	-29.1	-35.3	12.9	22.3	16.2	-18.0
- Clearance revenues	144.2	254.7	85.5	116.0	363.0	-0.9
(Minus) tax rebates	-44.2	-68.8	36.0	172.6	-46.2	-25.4
Total current expenditure and net lending	-262.7	32.8	87.1	203.6	826.6	-258.1
- Salaries and wages	96.1	114.8	-120.2	256.1	241.1	-149.0
- Other current expenditures	-228.1	21.4	70.0	13.5	510.1	-118.4
- Net lending	-130.7	-103.4	137.3	-66.0	75.1	9.6
Current deficit before financing	-559.5	-298.8	23.9	123.8	396.3	-257.9
+ Developmental expenditure	86.9	21.7	-83.5	-42.6	94.3	-39.2
Total deficit before financing	-472.6	-277.0	-59.6	81.2	490.7	-297.1
External financing	-191.5	-227.0	-51.2	425.9	-124.9	-445.6
- Budget support	-223.5	-317.2	-37.2	474.1	-221.5	-325.1
- Developmental expenditure	32.0	90.2	-14.0	-48.2	96.6	-120.5

Sources: Palestine Monetary Authority (PMA), 2010-2013

Ministry of Finance, 2014-2015

Figure 1: The basic components of the budget
(Actual in USD millions)



Source: Table 2.

The Budget Structure and the Change in the Role of the Ministry of Finance

The budget is the practical plan that the Ministry of Finance should implement to fulfill the development aims designed to achieve the national economic, financial, and social goals. This requires studies and estimations by the Ministry of Finance in order to assign values to different budgetary items based on available data and assumption-supported estimates. To achieve this, the Ministry uses the basic financial instruments inherent in the structure of the budget. In accordance with the budget structure, there are three main instruments. First, there are public expenditures (on goods, services, wages, salaries, non-wages, social services, security services, as well as current, developmental and investment expenses). Second, there are public revenues and their components (from several local and external sources, taxes, non-tax fees, and dividends). Finally, there are the deficit, the public debt, and net lending in addition to their sources of funding (local revenues and foreign aid, as well as borrowing from domestic and external sources). Net lending is a new term that might be exclusive to the Palestinian context. The item became part of the Palestinian general budget when some Palestinian consumers started to default on paying utility bills. Lacking the needed practical measures to force bill payers to pay their debts to the Israeli electricity and water providers, the PA found itself in a situation where it had to pay the bills to the Israeli utility companies.

The Ministry of Finance plays a primary role in preparing the general budget and following up on its implementation. This role has undergone some developments over the years in that the Ministry is no longer only a receptacle of demands that flow in from the various units, where they are negotiated and subjected to modifications, the extent of which depended on the power, influence and negotiation skills of the respective stakeholder (minister, head of security service, etc.), irrespective of the availability of supporting documents, justifications or programs and plans that derive from actual needs and macroeconomic policy framework. This has changed in the last decade, and the Ministry has gradually developed a well-defined, reliable, legal/administrative methodology. Now, the Ministry of Finance links the process of developing the budget (within a new structural framework, an effective legal/administrative context, and well-defined instructions and control procedures) to the national development plans and national policies/programs in the service of the national economy.

Recent Developments in the Palestinian Budget

The changes in the way in which the Palestinian budget is built started in 2010 together with changes in the technical and administrative structure. That year, the Palestinian budget shifted its presentation from item-based to program-based budgeting (performance budgeting), a change consistent with the development of the planning process in all sectors of the economy. The program-based budget was partially introduced in 2012, and in 2013 the new methodology was completely introduced into the

system. The recent changes, highlighted below, were a quantum leap that responded to the Palestinian development plans requirements:

- ❖ Compelling units (ministries and public agencies) to adopt program-based plans together with spending policies, and integrate objectives and outputs within the claims. This was well-represented in the 2013, 2014, and 2015 budget statements;
- ❖ For the first time, the budget was built on a medium-term (three-year) period, with a computerized financial system built specifically for this purpose in 2015 to be used by all units. The new system will facilitate the process, provide accurate information, and help prepare the necessary reports;
- ❖ For the first time, the Ministry of Finance discusses the financial issues with units and requires such units to support their claims with documents on the actual needs. This is a prior control on spending and a departure from improvised estimates;
- ❖ The 2013 budget statement was the first to present the Palestinian fiscal policy, but the statement provided only broad outlines. The 2014 budget statement was, however, more specific in defining the objectives of the general budget, linking the general budget to the 2014-2016 national development plan. The statement provided for the government's commitment to an austerity plan by freezing public employment and cutting expenditure. The statement also stressed that the government would develop a plan to increase revenues, improve tax collection by expanding the tax base, develop revenue management, and change the tax structure, making all units report to a central department. According to the statement, the government would operate a new computerized system that links all files and staff to facilitate and improve collection;
- ❖ Target estimates became more realistic and conservative than before. The government could learn a lesson from its past experience, with the worsening of the economic situation as a result of the stalled political process in the Gaza Strip, the continued Israeli restrictions, and uncertainty about international aid. Thus, the 2016 budget statement came with a very conservative growth rate (1% contraction) at a time when the economy was expected to grow by 3%. This reservation is the basis for the estimates and gives sufficient justification to take a conservative financial policy based on cutting expenditures in the first place;
- ❖ The second part of the statement focused on the way in which ceilings are set and the conditions and procedures taken to determine such ceilings. For the first time, ceilings are determined for three years, and this is coupled with planning for spending on projects totally or partially funded. Now the plans are built on the outputs expected from the projects, which are, in turn, directly linked to expenditure ceilings. In previous budgets, planning was poor, with the individual ministries preparing a list of projects to be financed and claim allocations from the Ministry of Finance, which left many projects without funding.

Table 3: PA Revenues, Expenditures and Sources of Funding – Actual Budgets

(in USD millions)

Item	2010	2011	2012	2013	2014	Approximate actual budget 2015*	2015 Budget	2016 Budget
Net public revenues	1,845.4	2,177.0	2,240.1	2,319.9	2,749.9	2,750	2,733.0	2,869.0
Total revenues	1,927.7	2,190.5	2,289.7	2,542.0	2,925.8	2,901	2,835.0	2,982.0
- Local revenues	693.5	701.6	715.3	851.5	872.3	848	844.0	870.0
Tax revenues	439.0	482.3	483.2	597.2	602.0	595	569.0	562.3077
Nontax revenues	254.5	219.2	232.1	254.4	270.6	253	254.0	307.4359
- Clearance revenues	1,234.2	1,488.9	1,574.4	1,690.5	2,053.5	2,053	1,992.0	2,112.0
(Minus) tax rebates	82.3	13.5	49.6	222.1	175.9	151	103.0	113.0
Total current expenditure and net lending	2,927.3	2,960.1	3,047.1	3,250.7	4,077.3	3,819	3,868.0	3,901.0
- Salaries and wages	1,563.1	1,677.9	1,557.7	1,813.8	2,054.9	1,906	1,953.0	1,965.0
- Other current expenditures	1,120.9	1,142.3	1,212.2	1,225.7	1,735.9	1,617	1,710.0	1,718.0

Item	2010	2011	2012	2013	2014	Approximate actual budget 2015*	2015 Budget	2016 Budget
- Net lending	243.3	139.9	277.2	211.2	286.3	296	205.0	218.0
Current deficit before financing	1,081.9	783.1	807.0	930.8	1,327.2	1,069	1,135.0	1,032.0
+ Developmental expenditure	272.8	294.5	211.0	168.4	262.7	224	1,150.0	350.0
Total deficit before financing	1,354.7	1,077.6	1,018.0	1,099.2	1,589.9	1,293	2,285.0	1,382.0
External financing	1,210.3	983.3	932.1	1,358.0	1,233.1	787	1,900.0	995.0
- Budget support	1,131.5	814.3	777.1	1,251.2	1,029.7	705	800.0	750.0
- Developmental expenditure	78.8	169.0	155.0	106.8	203.4	83	1,100.0	245.0

Sources: Palestine Monetary Authority (PMA), 2010-2013
Ministry of Finance, 2014-2015

* Actual for the first three quarters of the year, while figures for the last quarter are projected according to the targets of the previous three quarters. The actual figures for the first three quarters and the targets for the fourth quarter are then calculated for the 2015 full year.

Note: In calculating the actual figures, the estimated budget was based on a USD/NIS exchange rate of 3.9 shekels for 2015 and 3.57 shekels for 2014.

Estimated and Actual Budget for 2015 (actual for the first 9 months and estimated for the last 3 months)

In building the 2015 budget, the planners had to deal with many challenges, particularly the problems that followed the 51-day war on Gaza and the Israeli military escalation in the West Bank. This was further worsened by withholding clearance revenues for four months before releasing them in March 2015. This situation created serious economic and financial challenges which forced the PA to reconsider its budgeting methodology to improve revenues and cut down spending through revenues/expenditure policy reforms which involved expanding the tax base, amending the Investment Promotion Law, and settling outstanding financial issues. On the expenditure side, the budget envisioned limiting the increase in salary expenses to 1.25% or less and that in on non-salaries to no more than 7%. A plan was put to reduce net lending, mainly through installing water and electricity pre-payment meters. The planners also envisioned reducing the current budget deficit by 6% after it fell by 5% in 2014 and by 4% in 2013. The financing gap of USD 25 million a month was also considered through austerity measures.

The budget estimates are based on assumptions and indicators agreed upon by the professional staff in the Ministry of Finance, and the targets they set are expected to be achieved. However, deviations are bound to occur, as in all countries, and are likely to be greater in the Palestinian context where the budget and revenues are dependent on unstable external factors, especially the uncertainty of the external support to the budget. This is also further compounded by internal factors, particularly the failure of units to keep their spending within ceilings set in the budget. The next section of the paper highlights these deviations through comparing the estimated budget at the beginning of 2015 and the actual budget at the end of the year.

The deviation figures are shown in Table 4 below. Clearly, the gaps in the 2015 budget are marginal and insignificant compared to previous years. The gap on the revenue side was only USD 17 million less than expected. Obviously, the planners have avoided the mistakes reported in the previous budgets (before 2012), hence the accuracy in estimates. In the process of building the budget, the planners were more conservative in their assumptions and expectations about revenues; they were so conservative that the actual revenues in 2014 were USD 159 million higher than expected. In 2015, the estimates were more accurate, with local revenues only USD 3 million higher than targets.

The deviation in the current expenditure and net lending was only 1% (or USD 48 million) lower than targets though net lending increased by USD 10 million (i.e., the deviation, excluding net lending, was only USD 38 million). The USD 39 million decline in other current expenditure items has offset the increase in other items, particularly salaries, which increased by USD 47 million. Such figures

reveal how crucial the procedures meant to control current expenditures through austerity measures are; they are also an indication of the PA ability to control spending. However, few questions still need answers: Can austerity measures put an end to the budget deficit crisis? Is there a likelihood of more expenditure cuts? These questions require more scrutiny by the Ministry of Finance decision-makers.

The actual data indicate a significant fall in the total deficit before financing, with the figure dropping by USD 993 million (from USD 2,285 million to USD 1,292 million). This positive deviation had never happened in previous budgets. While the budget set a target of USD 1,150 million for developmental expenditure, the actual figure was only USD 223 million. Such conservative targets are mainly due to the PA's lack of confidence in external funding allocated to developmental expenditure. While the budget expected USD 1,900 million as external funding, the actual figure was only USD 787 million, which made developmental expenditure figures very conservative. In financial and accounting terms, the decline in the deficit was favorable, but in socio-economic terms, it was adverse as it reduces investment and negatively affects the aggregate demand and employment.

In short, the improvement in the financial performance of the government in the 2015 actual budget was primarily a result of cutting spending and increasing revenues, particularly clearance. In 2014, current expenditure and net lending accounted for 31% of GDP, and in 2015 they fell by 0.5%. Meanwhile, the wages ratio also fell from 16.1% of GDP to 15.7%. In 2010 current expenditure and net lending ratio reached 36% of GDP. Then it started to drop gradually until it settled at 31%. On the other hand, the total deficit before financing fell from 10.4% of GDP in 2014 to 8.8% in 2015. These are important financial developments in the budget planning (See Tables 3 and 4).

FY 2016 Budget

Policies, Targets and Changes

According to the 2016 budget statement, the budget was developed within a new framework of financial reforms with policies and procedures for a medium-term of a three-year period within a detailed program-based budget. The effort started in 2015: 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 programs and spending planning, creating project ID cards, and introducing a computerized system that integrates budgeting in the financial management system.

Equally important were the new administrative arrangements that were based on a newly created procedural manual with instructions to all units to prepare their claims for 2016-2018. Starting from 2016, three-year ceilings for budgets will be set based on detailed data about the resources available to finance investment projects and public services. Within the framework of financial and economic policies, the Ministry of Finance makes estimates and prepares the results to be presented to the Council of Ministers.

The budget statement has focused on the issues of gender and vulnerable groups, thus making public services available to everyone. The planning policies now consider programs and projects that provide services to Palestinian women and vulnerable groups.

The 2016 budget statement (presented by the Council of Ministers) included legal articles aimed at controlling spending. Under the new procedures, borrowing from the banking sector is not allowed for purposes other than bridging the financing gap; and units are not allowed to go into overdraft from any local bank or financial institution. The statement cited legal articles restricting public employment and public expenditure.

Targets/Assumptions

The FY 2016 budget is complementary to the 2015 budget. It comes in an unfavorable context of weak economic performance and unstable political climate, which in turn negatively impacts the financial position of the PNA and the process of preparing the budget. Therefore, the assumptions of the 2016 budget were confined to two broad goals:

- ✧ Cutting expenditure across all budget items and controlling net lending through financial and administrative reforms in the electricity and water sectors. The budget translated this goal into real plans;
- ✧ Increasing local revenues through raising non-tax revenue collection and expanding the local tax base. The Ministry of Finance seeks to achieve this in 2016-2018 through expanding the tax base, raising local fees, and imposing new fees.

Comparing these goals to the estimated budget (see Tables 1 and 3) identified by Ministry of Finance brings about the following set of observations:

- ✧ **Revenues:** Estimating revenues in the 2016 budget saw departure from the trend reported in previous years. The increase in net revenues for 2016 was estimated at NIS 464 million, down from NIS 908 million in 2015. The focus was on improving domestic revenues by 50% (NIS 232 million and the remainder of the target is collected from clearance revenues). Obviously, the increase will depend on the local economy. Local revenues do not exceed 30% of total revenues, and they are expected to contribute more than 50% (or an increase of 20%). This requires a lot of efforts such as raising staff awareness and significantly improving tax collection efficiency (see Table 4);
- ✧ **Expenditure:** Controlling expenditures makes estimates of revenues more accurate, assuming units stick to ceiling set in advance. The 2015 and 2016 budgets signal downward spending trend, with figures of expenditure relative to GDP falling steadily, which is also evident when considering the medium-term budget up to 2018. The data also suggest a stable wage bill, with a constant fall relative to GDP. The cherry on top, however, is net lending which is expected to be NIS 304 million lower than the 2015 figure. The net lending targets are based on the envisioned reforms in the water and electricity sectors (see Table 4);
- ✧ **Deficit and Finance:** Changes in spending, revenues, and funding projections would naturally change the deficit figures. The deficit before financing is expected to drop to NIS 4,023 million, a decline of NIS 147 million from 2015. The total deficit is expected to increase from NIS 5,042 million in 2015 to NIS 5,388 million in 2016 due to improvement in developmental expenditure, which increased from NIS 900 million to NIS 1,365 million in 2016, with the same average value for the last two years. According to the 2016 budget law (Article III), the Palestinian treasury will allocate NIS 409 million for developmental spending and donors will appropriate NIS 956 million for the same purpose (see 2016 budget statement and Table 4).

2016 Budget Expectations

The last section of the paper provides a summary of the 2016 budget expectations. According to the second budget statement (Economic and political context influencing the preparation of the 2016-2018 budgets), the revenue is expected to rise by 10% in 2016, while current expenditure and net lending are expected to fall by 2% from 2015, thus dropping from NIS 1,114 million to NIS 800 million. Meanwhile, the current fiscal deficit is expected to fall by 18% to NIS 3.76 billion due to a decline in net lending and an increase in revenues. However, the total deficit is expected to rise by 15% (to NIS 8.24 billion) due to a 72% increase in developmental expenditure. The PA expects donors to finance NIS 3.12 billion of the deficit by way of developmental expenditure funds that are expected within the Gaza reconstruction program.

Table 4: PA Revenues, Expenditures and Sources of Funding, 2014-2016 – Cash Basis

(in USD millions)

Item	2014	2015	2016
Net public revenues	9,817	10,725	11,189
Total revenues	10,445	11,312	11,630
- Local revenues	3,114	3,307	3,393
Tax revenues	2,149	2,322	2,193
Nontax revenues	966	985	1,199
- Clearance revenues	7,331	8,005	8,237
(Minus) tax rebates	628	587	441
Total current expenditure and net lending	14,556	14,895	15,212
- Salaries and wages	7,336	7,433	7,662
- Other current expenditures	6,197	6,308	6,700
- Net lending	1,022	1,154	850
Current deficit before financing	4,738	4,170	4,023
+ Developmental expenditure	938	872	1,365
Total deficit before financing	5,676	5,042	5,388
External financing	4,402	3,071	3,881
- Budget support	3,676	2,748	2,925
- Developmental expenditure	726	323	956

Source: Ministry of Finance, 2016

Questions for Discussion

- Have we reached the limit of economic growth? Or are there still margins for positive growth rates?
- What are the main sources the budget focuses on to increase revenues?
- What are the main items targeted by the austerity policy? Can we tighten spending further?