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Government Expenditure Reduction Strategies: What Policies Does the Government Have Available for Fiscal Consolidation

The Palestine Economic Policy Research Institute (MAS) regularly publishes applied and scientific studies, in addition to brief research papers, as part of an annual series of roundtable sessions on important economic topics of interest to the public and decision-makers. The policy briefs outline the key recommendations of selected scholastic activities, in order to disseminate this information and maximize the benefits derived from this series of sessions. This Policy Brief was prepared with the support of Heinrich Boll Stiftung (HBS Jordan and Palestine).

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Prepared by: Palestine Economic Policy Research Institute (MAS)

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1. Background: Structural Fiscal Constraints

The budget serves as the Palestinian Ministry of Finance's (MoF) practical plan to achieve the economic, financial, and social objectives outlined in the development plans. The budget structure comprises three main categories of financial tools:

- Public expenditures, encompassing spending on goods and services, wages, salaries (including simi-salaries and non-salaries), net lending, social services, security, and current, development, and investment expenditures.
- Public revenues (derived from various local and external sources, including tax and non-tax revenues, fees, and profits).
- Deficit management strategies, including net lending, revenue collection, external assistance, and domestic and external borrowing to bridge the financing gap.

The Palestinian budget encounters various internal constraints and negative structural developments. One significant constraint is the allocation of a considerable portion of the current expenditure (two-thirds), reaching 68% in recent years, to the health and education sectors. The security sector alone accounted for as much as 28% of public expenditure, receding to around 22%, thus further limiting spending on other sectors such as the agriculture sector, while sectors like health, education, and security have been prioritized.

Despite the persistent policy of reducing expenditures over the past decade, the challenges of managing current and operational expenditures, controlling net lending, and implementing necessary structural changes remain unresolved. One of the significant challenges is the burden posed by uncontrolled net lending, which puts a strain on the budget. Furthermore, there is an urgent need to reform development expenditures, which have historically heavily relied on external funding sources. These challenges facing managing the public budget are further exacerbated by the continuous Israeli procedures and the substantial withholding of clearance revenues by Israel for different security pretexts.

2. The Challenges: Managing a Rolling Financial Crisis

Palestine continues to face a severe financial crisis due to the significant gap between realized revenues and high expenditures. The government is making concerted efforts to bridge this gap using available resources and implementing policies aimed at achieving financial reform and reducing expenditures. These policies encompass measures such as reducing the payroll bill, controlling healthcare costs (especially external medical referrals), implementing net lending reduction strategies, and introducing various tax strategies in addition to other reforms. However, the financial crisis continues to persist in 2023, as indicated by the inability to fully pay salaries and the significant net lending amount.[1]

(1) According to the data of the Public Budget Law No. (19) of 2022, the total public expenditure and net lending amounted to approximately (19.1) billion shekels. The revenues were estimated at about (15.5) billion shekels, and external financing was approximately (1.8) billion shekels (subject to donor commitments). However, a financing gap of about (1.8) billion shekels persisting, in addition to the arrears of the private sector, loans of the Palestinian National Authority from various funds, and the public debt.

Structural financial sustainability lies at the center of challenges, related above all to political factors, especially in terms of budget support from donor countries. The International Monetary Fund (IMF) considers maintaining the public debt-to-GDP ratio stable for a period of five years as an indicator of financial stability, which usually should not exceed 5%. This means that the country can bear debt without the need for major adjustments in fiscal policy in the future to achieve a balance between revenues and public expenditures. Conversely, throughout the history of Palestinian budgets, there has been a persistent issue of overspending on actual cash expenditures beyond planned expenditures.

The growth rate of expenditures has consistently outpaced that of revenues, exacerbating the situation. Revenue growth is heavily reliant on clearance tax revenues, which contributes to reduced financial independence and increased dependence. New challenges have emerged over the past three years, including: the decline in external aid to the public budget, whether from foreign donor countries or Arab countries, and Israel's continued withholding and deduction of funds from tax revenues. This is a result of enforcing Israeli discriminatory legislation that allows for the deduction of funds equivalent to the amounts paid by MoF to the families of martyrs and prisoners.

Public expenditures include: salaries and wages, social contributions, operating expenses, medical referral expenses, capital expenses, interest, and net lending, noting an increase in expenditure pressure. Specifically, there is a rise in salaries, medical referral expenses, and operating expenses, on the account of social contributions.

Considering these significant indicators, it is necessary to explore the causes of these crises and identify additional policies and solutions that can contribute to addressing this chronic crisis. This can be achieved through careful consideration of ways to reduce expenses and adopt optimal policies considering the available resources and capabilities. Therefore, we focus on potential policies for reducing public spending with the aim of alleviating the long-standing financial gap.

Here it can be said that the PA has greater control over expenditures than revenues, and based on this principle and these data, it is necessary to explore the causes of these crises and identify best practices. Also, there is potential for structural changes in revenue sources through measures such as reviewing the tax burden, improving tax compliance, combating customs and tax evasion more effectively, and fostering trust and partnerships between the private and public sectors.

3. Required Policies and Interventions

On the expenditure side, the only possible policy includes parallel measures in:

- Reduce the payroll bill and reform the public pension system;
- Intensify efforts to resolve the net lending dilemma through an austerity policy;
- Controlling public spending on health and reducing medical referral expenses through the localization of medical services in Palestine.

1. **Vigorous implementation of the reform plan addressing the payroll bill, announced by the MoF by:** regulating government positions; developing a bylaw on early retirement for public sector servants; and restructuring government entities and public servants to adapt them to the demands of the digital economy era.
2. **Developing a Plan to Eliminate or Reduce Net lending,** through developing strict laws and standards for local authorities; and implementing modern technological methods for the collection of electricity and water bills by establishing a specialized institutional unit in collaboration between the MoLG and the MoF. The unit's primary role will be to monitor and address all matters related to net lending.
3. **Reassessing healthcare service fees and health insurance fees** by raising them to an appropriate level, particularly for unaffected categories. This can be achieved by categorizing beneficiaries into three groups and establishing a fee schedule for each category, aimed at improving coverage and increasing the MoH's revenue. Additionally, the plan includes gradual localization of the healthcare services by reducing external medical referrals, which can be achieved through investments in healthcare projects within specialized departments of government hospitals.