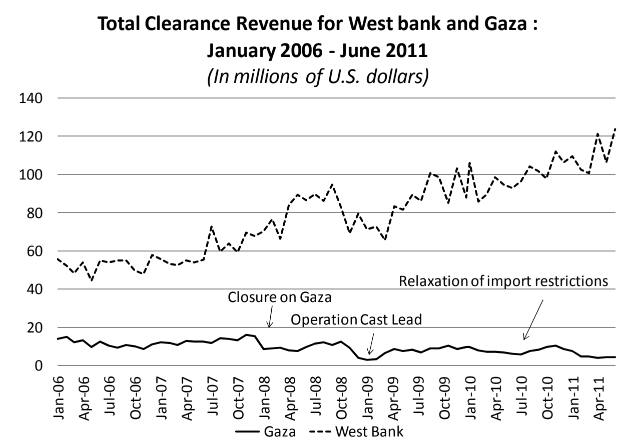
West Bank and Gaza: Recent Developments in Clearance Revenues[1]

Clearance revenues are a major source of budgetary revenue for the Palestinian Authority (PA). The PA is vulnerable, however, to the suspension of the transfer of these revenues by the Government of Israel (GoI). This note reviews recent trends in volume, composition, and origin of clearance revenues, and identifies the possible consequences of a prolonged suspension of transfers by the GoI. Under the current circumstances a prolonged suspension of clearance revenues could trigger a severe fiscal crisis with very serious economic ramifications. A background section at the end of the note provides information on the origins of the current transfer arrangement and past episodes of suspension of transfer of clearance revenues.

Clearance revenues from the West Bank have almost doubled since 2006, while revenues from Gaza have declined by 30 percent. Total clearance revenues reached $1.3 billion in 2010, of which $1.2 billion from trade with the West Bank. Clearance revenues from the West Bank jumped in 2007 and 2008, after the advent of Prime Minister Fayyad's government and the relaxation of the restrictions on movement and access. After 2008 the growth in clearance revenues was more gradual. VAT revenues from the West Bank grew only 4.4 percent in the period 2008-2010 (negative in real terms) while import duties grew 19.6 percent. Revenues from petroleum taxes on fuel imports to the West Bank increased by 48 percent in that period, accounting for 60 percent of the total increase. Clearance revenues from Gaza have fallen dramatically since the imposition of the closure after Hamas took control of the territory in mid-2007, from $157 million in 2007 to less than $100 million in 2010.



The 2011 budget assumes a further increase of clearance revenues but there have been some shortfalls early in the year. Through June clearance revenues were 8½ percent below the budget target (NIS450 million on an annualized basis). This is partially explained by an 8 percent reduction in petroleum excises and purchase tax by the GoI in February, which caused a shortfall of roughly NIS16 million per month. Clearance revenues from Gaza

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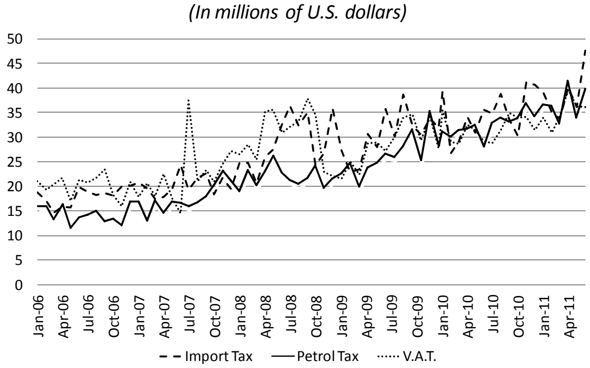
[1] Prepared by Udo Kock and Hania Qassis, June 2011; updated and revised October 2011. This note should not be reported as representing the views of the IMF. The views expressed in this note are those of the authors and do not necessarily represent those of the IMF or IMF policy. The note describes work in progress by the authors and is published to elicit comments and to further debate.

declined further in the first quarter of 2011 after the authorities ordered to substitute fuel imported from Israel with fuel imported from Egypt, which causes an estimated loss of about NIS9 million per month. The estimated combined annualized revenue loss in 2011of these two events is about NIS280 million. The budget includes an unspecified yield from efforts to find practical solutions with the GoI for clearance revenue leakage. Discussions between the staff of the Palestinian and Israeli Ministries of Finance have resulted in understandings in principle on several measures aimed at strengthening collection and minimizing leakages of clearance revenues.[2]

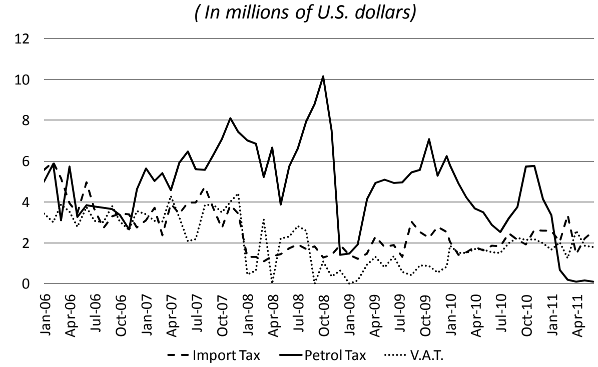
Nominal Clearance Revenue for West Bank: January 2006 - June 2011

(In millions of U.S. dollars)



Nominal Clearance Revenue for Gaza : January 2006 - June 2011

(In millions of U.S. dollars)



West Bank and Gaza : Clearance Revenue, 2006-2011 *

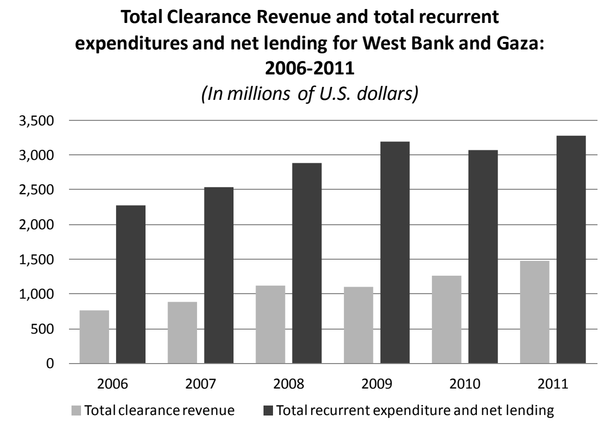
	2006	2007	2008	2009	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2010 Year	2011 Q1	2011 Q2	2011 Budget
	(In millions of U.S. dollars, unless otherwise stated)											
Total clearance revenue	768	881	1,091	1,120	306	308	325	346	1,286	329	366	1,442
WB	631	724	979	1,029	282	287	303	317	1,190	312	353	…
Gaza	137	157	112	90	25	20	22	29	96	17	13	…
Import tax	264	286	365	390	100	106	114	119	439	116	130	…
WB	216	243	347	365	95	101	107	112	415	108	124	…
Gaza	48	43	18	25	5	5	6	7	24	8	6	…
Value Added Tax	281	307	381	353	98	98	101	106	403	104	118	…
WB	242	266	365	344	93	93	95	99	381	99	112	…
Gaza	40	41	16	9	5	5	6	6	22	5	6	…
Petrol tax (excise tax)	220	283	341	374	108	102	109	121	440	110	116	…
WB	171	210	263	316	93	92	100	105	390	106	115	…
Gaza	49	73	78	57	15	10	9	16	50	4	0	…
Local purchase tax	3	5	4	4	1	1	1	1	4	-1	2	…
Memo Items												
Share of Gaza clearance revenues	18	18	10	8	8	7	7	8	7	5	3	…
Clearance revenue as a percentage of GDP	17	17	17	17	…	…	…	…	16	…	…	15
Clearance revenue as a percentage of total net revenues	67	69	63	69	69	64	62	73	67	72	69	67
Clearance revenue as percentage of total recurrent expenditures	34	35	38	34	41	39	44	43	42	44	43	45
Clearance revenue as a percentatge of wage expenditures	64	69	76	76	77	77	81	84	80	72	76	84
Clearance revenue (annual percentage change)												
WBG	…	15	24	3	37	10	4	13	15	7	19	12
WB	…	15	35	5	34	13	6	15	16	11	23	…
Gaza	…	15	-29	-19	95	-17	-12	2	6	-31	-37	…

* From 2006-2010 West Bank and Gaza clearance revenue based on estimates. 2011 is based on actual data.

Sources: Ministry of Finance, and IMF staff estimates.

[2] See for details paragraph 14 in the Staff Report Prepared for the Meeting of the Ad Hoc Liaison Committee (New York, 18 September, 2011).

Clearance revenues are an even more important revenue source today than in the early years of the PA. Clearance revenues have grown faster than domestic revenues (tax and non tax) since the early years of the PA, with domestic revenues growing from 8.9 percent to 10 percent of GDP and clearance revenues growing from 14.1 percent to 17 percent of GDP in 2010. As a result, by 2010 the share of clearance revenues had increased to 67 percent of total revenues (on a commitment basis), from 61 percent of total revenues (on a cash basis) in the first three full years of PA operations (1996-98). Because in recent years the PA has successfully constrained the growth of current spending, clearance revenues in 2011 finance a projected 45 percent of current spending, compared to 34 percent in 2006. The increased reliance on clearance revenues has made the PA more vulnerable to unilateral suspension of transfers by the GoI.



In May 2011 the GoI delayed the transfer of clearance revenues in response to the signing of the reconciliation agreement between Fatah and Hamas. The GoI withheld the transfer of clearance revenues for the month of April (NIS 352 million, about $100 million), which prevented the PA from paying salaries to its 150,000 employees. Donors did not step in to provide bridge financing and banks were unwilling to expand their exposure for the purpose of paying salaries. Banks provided some relief for the budget by extending financing for non-wage spending, but without clearance revenues the PA was unable to pay salaries. As a result of the non-payment of wages, banks experienced some delinquencies on loan payments, and the Palestinian Monetary Authority asked banks to waive penalties for late payments for government employees. The suspension was lifted after three weeks, allowing the PA to resume salary payments.

A prolonged suspension of clearance revenues will have a highly disruptive impact on financial and economic conditions in WBG. The PA is now more dependent on clearance revenues than during the 2006-07 episode to cover wage and other recurrent spending. The impact of a prolonged suspension depends largely on whether alternative sources of financing can be made available. Although donors stepped in during both the 2000 and the 2006 suspension of transfers, it is uncertain if they would do so again. Donors are already providing budget support to the PA ($1.1 billion in 2010, compared to $0.7 billion in 2006 and $0.2 billion in 2000) and they are experiencing their own financial difficulties, as they face competing demands for aid from other countries, as well as domestic pressures for budget cuts. Bank financing may also not be available to fully compensate for suspended transfers as bank’s exposure to the PA is much higher than during previous episodes.

Commercial banks' exposure to the PA is currently estimated around $1 billion, all of which is short term including in the form of overdraft facilities that can be withdrawn at short notice. Also, the PMA has since 2007 implemented steady institutional reforms that have resulted in rigorous regulation and banking supervision which restrict a further expansion of bank credit to the PA. Under these circumstances, with limited or no alternative sources of financing available, a prolonged suspension of clearance revenue transfers will prevent the PA from making wage and non-wage payments, which would cause a severe fiscal crisis with very serious economic repercussions.

Background

The clearance revenue mechanism came into effect as part of the 1994 Oslo accords, as agreed in the Protocol of Economic Relations (also called the 'Paris Protocol'). Under the Paris Protocol it is envisaged that Israel and the PA form a customs union and that each side levies and collects direct and indirect taxes for a shared pool. For indirect taxes the allocation is on the basis of the destination principle, with transfers made on a monthly basis after reconciliation of accounts. For direct taxes the allocation is based on the services principle, which recognizes that most Palestinian workers commute to Israel and hence consume social services at home and therefore the direct taxes paid should accrue to the PA. The Paris Protocol stipulates that Israel transfer 75 percent of income taxes collected from Palestinians working in Israel and 100 percent collected from Palestinians working in the settlements. Israel levies a three percent collection and processing fee on all gross clearance revenues.

Revenues are transferred using a unified invoice system. Any sales transaction between an Israeli and a Palestinian trader must be supported by a special invoice with a unique identification number ("I" invoices for Israeli merchants trading with Palestinian importers and "P" invoices for Palestinian merchants trading with Israeli importers). Both sides are responsible for the collection of invoices from importers in their jurisdiction and enter the information in an electronic database, which is the basis for the transfer of revenues. The amounts are agreed in monthly meetings between the two sides.

The main components of clearance revenues are customs duties, Value Added Tax, and petroleum excises, which account each for roughly one third of the total. In addition, a small amount of clearance revenues is from other direct and indirect taxes such as the income tax and the purchase tax. Revenues from Gaza have declined dramatically since the imposition of the blockade in 2008. Before the closure 18 percent of clearance revenues originated from goods imported into Gaza, compared to an estimated 4-5 percent today. About half of the clearance revenues from Gaza are petroleum excises.

While the economic implications of the recent suspension were limited, previous prolonged episodes have caused serious disruptions to the budget, and set back reforms and achievements in institution building. There have been three earlier episodes of suspension:

Summer of 1997: The transfer of clearance revenues was suspended during the closure of WBG. The EU made available a short-term credit facility to ensure the PA could continue its operations, and Israel transferred the withheld revenues later in the year.

December 2000 – December 2002: The transfer of clearance revenues was suspended in response to the outbreak of the second intifada in September 2000, arguing that terrorist activities may have been supported out of the PA budget. The withheld funds were deposited in an account at the Bank of Israel and accumulated to about $500 million. Transfers were resumed in December 2002 after political pressure from the U.S. and assurances from the PA to reform internal auditing of expenditures. Donors responded to the suspension with increased budget support, with the EU, Arab donors and a World Bank trust fund leading the way. The PA also relied heavily on domestic bank financing, which helped limit the accumulation of payment arrears to the private sector, and it received advances from the Palestinian Monetary Authority (PMA). Nonetheless, significant arrears accumulation was inevitable, which further aggravated the economic downturn.

March 2006 – July 2007: The transfer of clearance revenues was suspended after Hamas won the elections and formed a government. Transfers were resumed in July 2007 after the appointment of a new government led by Prime Minister Fayyad. Although donors stopped direct aid to the Hamas led PA government, they provided direct support to Palestinians through mechanisms outside the control of the government, including direct payment of allowances for civil servants and non-wage expenditures for basic services through the Temporary International Mechanism (TIM). Contrary to the previous episode of suspension domestic bank financing was unavailable as banks feared a full-blown financial crisis. They were unwilling to roll-over loans and the PA was forced to sell government assets to meet its obligations. Accumulation of payment arrears was significant, including for salaries, and many PA workers defaulted on their debt servicing obligations.

Characteristics of Previous Episodes of Suspension of Transfer of Clearance Revenues

	1997	2000	2006
Suspension period	August - September 1997	December 2000 - December 2002	March 2006 - July 2007
Reason for suspension	Increase in terror attacks on Israeli civilians.	Outbreak of the second intifada in September 2000.	Hamas victory in March 2006 followed by formation of Hamas government.
Amounts witheld	$78 million (est.)	$500 million	$1,1 billion (est.)
Compensating donor mechanisms	Short-term credit facility from the EU.	Special Cash Facility from the EU, loans from Arab donors through the Islamic Development Bank, and the Emergency Services Support Project (ESSP) financed by IDA and European donors and administered by the World Bank.	Temporary International Mechanism (TIM) to channel donor money outside the PA directly to payment of allowances for civil servants and non-wage expenditures for basis services.
Reason for ending suspension	Political pressure from the U.S.	Political pressure from the U.S. and assurances from the PA to reform internal auditing of expenditures.	Appointment of a new government led by Prime Minister Fayyad.

Source: Various IMF staff reports.