# RECENT EXPERIENCE AND PROSPECTS OF THE ECONOMY OF THE WEST BANK AND GAZA[1]

## STAFF REPORT PREPARED FOR THE MEETING OF THE AD HOC LIAISON COMMITTEE

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## I. Executive Summary

**The economy of the West Bank and Gaza (WBG) has entered a difficult phase, with a slowdown in growth and persisting high unemployment in the West Bank.** The West Bank's real GDP growth has slowed to 5.7 percent in 2011 (compared to a yearly average of 9 percent in 2008–10), and unemployment remains unchanged at 17 percent. There is a high risk that growth will dampen further due to fiscal retrenchment, declining aid and consequent severe liquidity difficulties, the global economic slowdown, as well as the lack of easing of restrictions on movement and access since 2011 due to Government of Israel (GoI)'s security concerns. In Gaza, growth continued its sharp recovery, surging by about 20 percent in 2011, underpinned by the lifting of restrictions on consumer goods and inputs on internationally-supervised projects. However, with continued controls on imports of private investment inputs and on exports, Gaza's growth is likely to wane and unemployment to remain at around 30 percent. The persistence of high unemployment reflects the skewed nature of growth, both sectorally and regionally, with the labor-intensive sectors still constrained by the restrictions, especially on exports.

**The Palestinian Authority (PA) has faced severe liquidity difficulties in 2011, leading to the accumulation of substantial domestic payment arrears.** Donor aid was substantially less than envisaged to finance the recurrent budget ($0.8 billion compared to the budgeted $1.0 billion) as well as the development budget ($0.2 billion compared to the budgeted $0.5 billion). These shortfalls, in addition to lower-than-expected tax revenue in the context of a slowdown in economic growth, led to the accumulation of $0.5 billion in domestic payment arrears to the private sector and to the public pension fund. There was also an increase in net domestic bank borrowing by about $140 million, raising the stock of government debt to the banking system to a total of $1.1 billion (11 percent of GDP).

**The 2012 draft budget continues fiscal consolidation started in 2008, with a further reduction in the recurrent deficit by 3 percentage points of GDP. However, there remains a substantial financing gap, projected at $0.5 billion.** There is little scope to cover that gap through further arrears accumulation to the private sector or borrowing from commercial banks, given the existing large stock of debt to businesses and banks. Therefore there is a high risk that the persistence of that gap will result in cuts in essential spending, including wages and social transfers. Concerted efforts are needed by the three parties (PA, GoI, and donors) to cover that gap.

**It is important for the PA to implement a plan to cover the financing gap.** That plan should be implemented as soon as possible, given that the 2012 aid outlook is highly uncertain even as of March 2012. Given that the wage bill represents half of total recurrent expenditures, controlling its growth should be part of the plan, including limiting the wage bill increase by reducing cost of living adjustment (e.g., to a maximum of 1.5 percent), with no new net hiring. In the non-wage area, it is important to press ahead with measures to strengthen further the commitment controls system to stem arrears accumulation. Development projects should only be implemented if there are matching funds from donors, to prevent the diversion of aid from essential recurrent spending. On the revenue side, it is important to complement the recent income tax increases with the prompt implementation of measures to improve tax administration, notably through enhancing compliance and widening the tax base.

**The PA should also continue to build on the solid track record established since 2008 in reforms and institution-building in the public finance and financial areas.** As set out in the IMF staff reports for the Ad Hoc Liaison Committee meetings of April and September 2011, IMF staff considers that, given that record, the PA is able to conduct the sound economic policies expected of a future Palestinian state. The PA has also made major strides in raising the quality and transparency of economic and financial statistics, which now compare favorably with those of IMF member countries that maintain high data management and dissemination standards. This has enabled the WBG to meet the requirements of the IMF's Special Dissemination Standards (SDDS) in January 2012. Looking forward, it is important for the PA to employ its enhanced institutional capacity to press ahead with measures to further raise public sector efficiency and phase out reliance on recurrent aid, notably through comprehensive civil service and pension reforms, further strengthening of the social safety net, and completion of the transfer of electricity distribution from municipalities to commercial companies.

**Raising budgetary revenue in a sustainable manner will require the PA and the GoI to work closely together to enhance clearance revenue collection and minimize leakages.** Clearance revenue collected by the GoI on behalf of the PA represents about 70 percent of total budgetary revenue, and thus even a small increase in its yield could significantly reduce the financing gap. In this regard, it is important that the agreements reached between the technical teams of the Palestinian and Israeli ministries of finance be promptly approved at the Israeli ministerial level. Practical measures that could be implemented in the spring of 2012 include the assessment of potential clearance revenue owed to the PA on the basis of comprehensive data compiled by the GoI on trade between Israel and the WBG.

**It will be very difficult for the PA to cover the 2012 financing gap through austerity alone, without the prompt pledging and disbursement of additional aid.** The shortfalls and delays in disbursements are bound to curtail essential spending, even with further adjustment efforts by the PA. They also impose a significant cost on the PA in terms of interest payments and additional premia required by private suppliers of goods and services. Sustained donor aid during 2008–10 supported the successful implementation of the Palestinian Reform and Development Plan presented at the Paris Donors' Conference in December 2007 and was essential to sustain orderly reforms and fiscal adjustment. The latter in turn enabled the PA to reduce the aid needed to finance the recurrent budget deficit, from \$1.8 billion in 2008 to \$1.1 billion in 2010. Timely and adequate aid will allow sustained reforms and adjustment which in turn will enable early self-reliance by the PA for its recurrent spending, with donor aid increasingly focused on growth-enhancing development projects.

## II. Recent Economic Developments

1. **The West Bank and Gaza (WBG)'s real GDP growth in 2011 continued at a high pace of about 9.5 percent, underpinned by Gaza's strong recovery, but with a slowdown in the West Bank (Figure 1).**

- Gaza's growth of about 20 percent in 2011 reflected the continued recovery in output following the relaxation of Israeli restrictions on imports of consumer goods, and on inputs for internationally-supervised investment projects, in addition to increased imports from Egypt. Growth has been mainly concentrated in the services and construction sectors, while agriculture and manufacturing continued to be constrained by the persisting ban on exports. Despite the strong recovery over the past two years, Gaza's real GDP has only in 2011 reached its 2005 level. The overall ban on exports from Gaza has been maintained, with some exceptions made to pre-approved shipments to non-Israeli markets of limited quantities of agricultural and other products.[2]

- In the West Bank, growth slowed to 5.7 percent in 2011 (compared to an average of 9 percent in 2008–10), with a weakening of activity in agriculture. The slowdown reflects continued fiscal retrenchment, declining donor aid (especially from Arab donors), the global economic slowdown, as well the absence of further easing of restrictions on internal movement and exports.[3] The WBG's exports to Israel are estimated to have declined by a cumulative 24 percent over 2008–11, reflecting restrictions on exports to Israel.[4]

2. **The unemployment rate was unchanged in the West Bank, and remains very high in Gaza, even with the recent decline.**

- In the West Bank, unemployment has remained unchanged since 2010 at about 17 percent. The limited impact of economic growth on unemployment reflects the skewed nature of growth, both sectorally and regionally, with the labor-intensive sectors still stifled by the restrictions, and economic activity still highly restricted in

[2] In February 2011, the Quartet Representative and the Government of Israel agreed on a package of trade and other measures to support the WBG's economic development. Measures to substantially relax exports from Gaza are yet to be implemented.

[3] According to the UN Office for the Coordination of Humanitarian Affairs (OCHA), the number of obstacles on movement within the West Bank increased from 500 at end-August 2010 to 517 at end-June 2011 and further to 523 at end-December 2011.

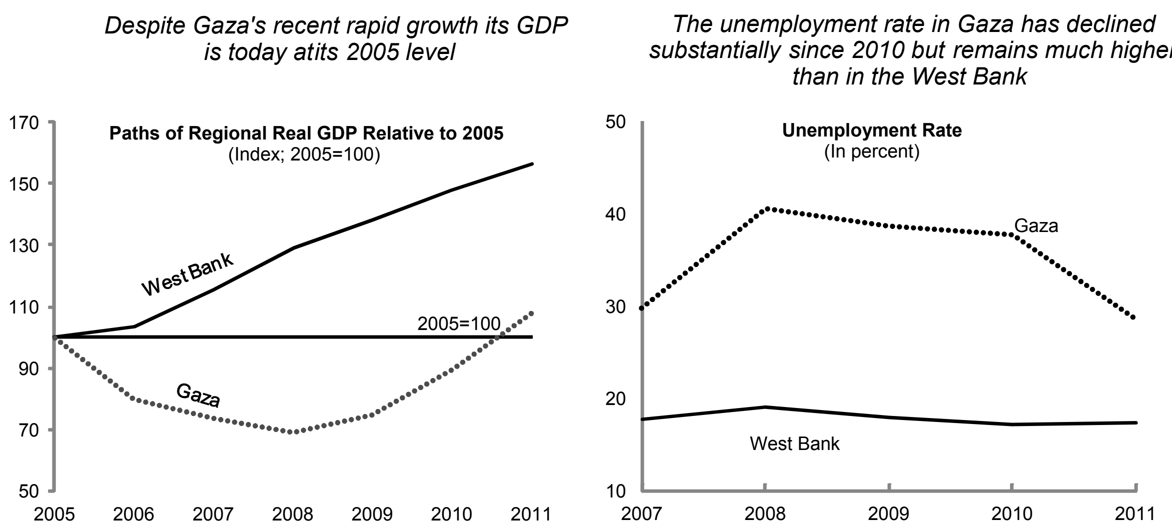
[4] For details on the obstacles and non-trade barriers to the access of goods from the WBG to Israel, see the World Bank's report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza," published at www.worldbank.org.

about two-thirds of the West Bank (so called "Area C"). Youth unemployment in the West Bank remained high at about 26 percent, in 2011. While the number of people from the West Bank allowed to work in Israel has been rising, as a share of the labor force it has remained virtually unchanged since 2001, remaining in the range of 10 to 12 percent (compared to 19 percent prior to the Intifada in 2000).

- Gaza's unemployment rate declined from 38 percent in 2010 to 29 percent in 2011, aided by increased employment in internationally supervised projects since the relaxation of restrictions in mid-2010. However, youth unemployment remained high at about 47 percent. The ban on the movement of Gazans into Israel, due to Israel's security concerns, where prior to 2000 about 13 percent of Gaza's labor force was employed, remains an important constraint on the expansion of employment.

- The slow expansion of private sector employment continues to be a key impediment to the reduction of employment in the public sector, which employs about one fourth of the total labor force.

Figure 1. Economic Developments in the West Bank and Gaza




Source: Palestinian Central Bureau of Statistics

3. **The inflation is estimated at about 3 percent in 2011.** The WBG's CPI inflation rate (in NIS) was 2.7 percent at end-2011, about the same as at end-2010. In Gaza prices declined by 0.2 percent reflecting the sharp rise in the availability of consumer goods as restrictions were relaxed, as well as lower prices of petroleum and other products imported from Egypt. Gaza's deflation has tempered the impact of the rise in the West Bank's CPI of 3.7 percent that partly reflects rising fuel prices.

4. **The commercial banking system continues to perform well, although rising exposure to the Palestinian Authority (PA) is a source of concern (Figure 2).**

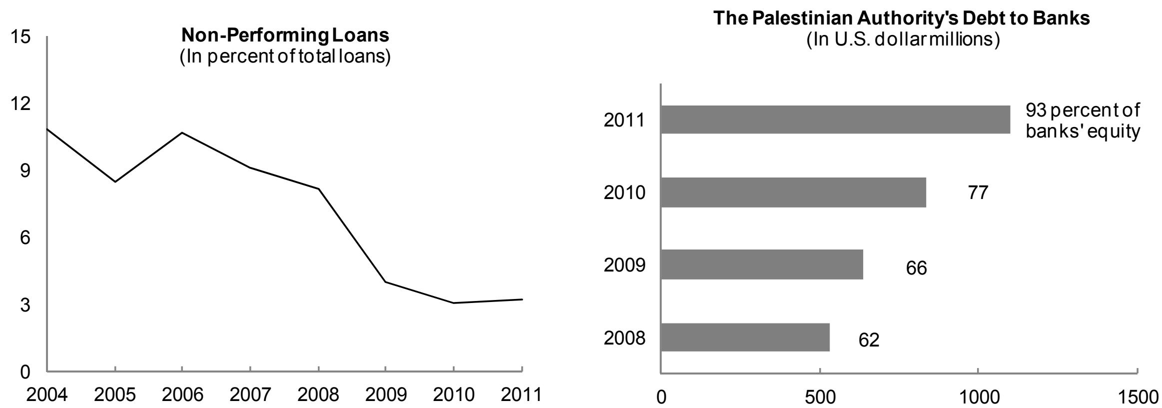
- Exposure to global markets continues to be limited, with conservative practices in private sector lending. Significant improvements in financial market infrastructure continued in 2011, including the establishment of a credit registry (Appendix, Section C).[5] Private sector credit rose by 21 percent in the West Bank and 38 percent in Gaza, in line with improved economic conditions. The share of non-performing loans in total loans continued to fall, from 8 percent at end-2008 to 3 percent at end-2011. However, going forward, there is a risk that the PA will be unable to quickly reduce its arrears to private sector suppliers, which in turn could lead to the inability of these suppliers to settle their bank debts, leading to a rise in banks' non-performing loans.
- Private deposits in the West Bank grew by 7 percent in 2011, reflecting private income growth and continued expansion of bank branches. In contrast, deposits in Gaza fell by 7 percent owing to large cash withdrawals to satisfy pent up demand after the relaxation of import restrictions, especially given persisting controls on the entry of cash into Gaza.
- The PA's debt to commercial banks rose to $1.1 billion at end-2011, equivalent to about 93 percent of banks' equity. One indirect implication of the PA's liquidity difficulties has been temporary delinquencies by public sector employees on loan payments, following delays in the payment of their wages. Loan payments resumed with the resumption of wage payments. However, the risk of wage payment delays has contributed to a rise in demand by the PA employees for bank loans. Bank credit to the PA employees increased from $0.33 billion at end-2010 to $0.51 billion at end-2011.

[5] While government institutions and governance in Gaza have been outside the PA's control since Hamas's takeover of Gaza in mid-2007, the Palestine Monetary Authority has maintained prudential regulation and supervision of commercial banks in Gaza.

Figure 2. Banking Sector Developments in the West Bank and Gaza

*The ratio of non-performing loans to total loans has fallen sharply in recent years...*

*...although vulnerabilities related to public sector lending have increased as the outstanding public sector credit today nearly equals the banks' equity.*




Source: Palestine Monetary Authority

5. **The Palestine Monetary Authority (PMA) conducted stress tests of banks and the banking system to assess their robustness to plausible shocks, including to a rise in banks' exposure to the PA (Box 1)**. In the fall of 2011, the PMA issued regulations that specify methodologies and procedures for the conduct of stress tests in line with Basel II principles. Key variables in these tests include the rising credit exposure of banks to the PA and government employees, as well as to businesses supplying goods and services to the PA. The results so far indicate that the WBG's banking system is resilient to a broad range of shocks. Such resilience was boosted in mid-2011 by the PMA's prudential measures, including an increase in capital requirements. In 2012, the PMA will be organizing workshops and training for bankers to assist them in conducting individual stress tests, and to provide guidance in strengthening their financial positions, especially through: (i) application of risk mitigation tools, (ii) diversification of credit and foreign investment portfolios, (iii) strengthening of the capital base; and (iv) securing long-term financing. It is important that the new stress tests incorporate scenarios in which persisting PA domestic payment arrears give rise to liquidity difficulties by private sector suppliers, leading them to default on bank loans.

### Box 1. Stress Tests of the Banking System

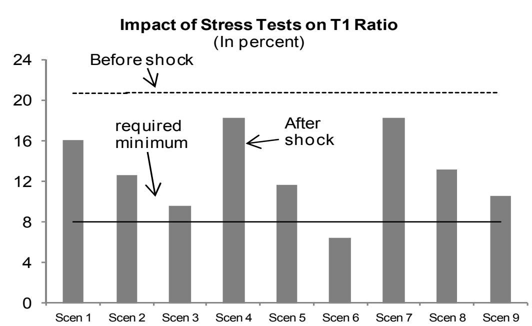
**In 2011, the Palestine Monetary Authority (PMA) conducted stress tests for the West Bank and Gaza (WBG)'s banking system and individual banks**. Stress tests consisted of an assessment of the impact of credit, liquidity, market, and operation shocks on banks' financial position, capital adequacy, and liquidity. Special attention has been given to an assessment of risks from banks' exposure to the Palestinian Authority (PA) and to the PA employees.

**The PMA's stress tests indicate that the WBG's banking system as a whole is resilient to a broad range of shocks**. The system is currently well capitalized, with the Tier 1 capital as a ratio of risk weighted assets (the "before shock" Tier 1 ratio) at 25 percent as of end-2011. The PMA has tested nine combinations of the shocks described in the table below. These shocks are consistent with a macroeconomic scenario which assumes slightly negative real GDP growth (and thus worse than the "lower growth" scenario set out in Section IV of this report, which assumes positive, albeit low, real GDP growth). The after-shock Tier 1 ratio fell below the required minimum of 8 percent only under an extreme "scenario 6" with the following assumptions: (i) 30 percent of private sector loans become delinquent; (ii) fair value of shares falls by 35 percent; and (iii) 20 percent of total deposits are withdrawn within one month.

**The PMA's stress tests for individual banks are broadly in line with those for the banking system.** The results indicated vulnerability in some banks, which have been taking steps to address weaknesses, including by raising paid-in equity and diversifying the sectoral allocation of their loan portfolios. In January 2012, the PMA has required all banks to conduct their own stress-tests, with scenarios tailored to their own conditions and constraints. Banks will hitherto be required to submit to the PMA the results of these tests on a semi-annual basis. Since March 2012, workshops have been organized by the PMA to guide banks in the techniques of stress-testing.

**Shocks**

- 20 to 40 percent of government loans become classified
- 25 to 50 percent of PNA employees loans become delinquent
- 10 to 30 percent of private sector loans (excluding PNA employees loans) become delinquent
- 5 to 20 percent of deposits withdrawn within one month
- 1 to 5 largest borrowers become delinquent
- 1 to 5 largest depositors withdraw deposits
- Fair value of shares and stocks declines by 5 to 35 percent



## III. Fiscal Developments in 2011–12

### A. Fiscal Developments in 2011

6. **The PA's expenditure commitments were in line with the budget, in 2011. However, shortfalls in donor funding for both recurrent spending and development projects, as well as lower-than-expected tax revenue, resulted in substantial arrears accumulation and borrowing from commercial banks.**

- Total net revenue (after tax refunds) was about 9 percent lower than budgeted due to several factors, in addition to lower-than-expected economic growth:

  - Compliance with the payments of domestic taxes declined, especially for businesses. This could reflect taxpayers' offsetting the amounts owed to them by the government (including overdue bills for goods and services and tax refunds) through non-payment of taxes.

  - Clearance revenue was lower than expected due to: (i) a reduction by the Government of Israel (GoI) in early 2011 of excise and purchase taxes on petroleum products; and (ii) a substitution of petroleum products imported into Gaza from Israel with cheaper products from Egypt.

  - Non-tax revenue was also lower than envisaged, reflecting: (i) the partial repayment of license fees to the Palestinian Telecommunications Group, following the cancellation of a license agreement; and (ii) lower-than-budgeted dividend payments from the Palestine Investment Fund (PIF).

- The wage bill for 2011 was about 1 percent higher than budgeted (or by about NIS56 million) reflecting primarily retroactive salary payments to employees appointed in the education sector in late 2010. The increase in wage rates was as budgeted consisting of: (i) an adjustment of 3.5 percent to compensate for 2010 inflation; and (ii) the 1.25 percent automatic yearly increase. The number of public sector employees rose on a net basis by 2,653 employees, consisting of an increase of 2,177 in education, 1,325 in security, 199 in health, and a reduction of 1,048 in other sectors.

- Non-wage recurrent expenditures on a commitment basis were lower than budgeted largely because of the compression of operational expenditures (Table A). The application of the computerized accounting system, which now links the Ministry of Finance (MoF) with all line ministries, facilitated the compression of some expenditures taking into account the priorities set in the budget.

Table A. Non-Wage Expenditure in 2011

| | Total | Operational expenditure | Transfers | Minor capital expenditure |
|---|---|---|---|---|
| | | (Commitment basis; in millions of NIS) | | |
| Budget | **5,043** | 1,864 | 3,089 | 90 |
| Outturn | **5,015** | 1,792 | 3,165 | 58 |

Source: Ministry of Finance.

- Net lending (mostly payments by the central government for utility bills owed by municipalities) continued its declining trend, from NIS 880 million in 2010, to NIS 501 in 2011. The decline reflects: (i) increased payments by the Gaza Electricity Distribution Company (GEDC) for fuel used by the Gaza Electricity Generating Company (GEGC); and (ii) the introduction by the PA in late 2010 of a program whereby automatic monthly deductions (totaling about NIS 13 million) are made from Gaza employees' wages to cover a "notional" electricity bill.

- Donor aid to finance the 2011 recurrent budget was significantly lower than envisaged in the 2011 budget. Only \$0.8 billion was disbursed compared to \$1.0 billion that the budget anticipated. In addition, development budgetary aid (i.e., channeled through the Treasury) was only \$169 million—compared to \$370 million committed for development projects, and to \$500 million in the 2011 budget. Of the \$295 million cash expenditures on development projects, \$126 million was covered by the treasury, while \$76 million (equivalent to about NIS 270 million) accumulated as arrears.

7. **Spending commitments were kept at budgeted levels. Nevertheless, the shortfalls in aid, lower-than-expected revenue, and financing from the Treasury of development projects, have led to substantial arrears accumulation and borrowing from domestic banks.** Available revenue was far from sufficient to cover expenditure commitments, contributing to the accumulation of NIS 1938 million (or about \$538 million) in arrears including to the pension fund, private sector suppliers, and development projects (Table B). The liquidity difficulties also led to an increase in net domestic financing by \$137 million, yielding a stock of debt to banks of about \$1.1 billion as of end-2011. Liquidity management was also hampered by the temporary withholding of the transfer of clearance revenue by the GoI to the PA's budget in May and November 2011.

Table B. Composition of Net Arrears Accumulation 2009–11

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| (In millions of NIS) | | | |
| Contributions to the pension fund: | | | |
| of which: employee's share 1/ | 171 | 185 | 374 |
| government's share | 355 | 172 | 573 |
| Nonwage expenditures 2/ | 460 | 92 | 353 |
| Net lending | 77 | -103 | 0 |
| Development projects 3/ | 118 | 88 | 270 |
| Tax refund | -140 | -39 | 368 |
| **Total** | **1,040** | **394** | **1,938** |

Source: Ministry of Finance.
1/ Item classified under "wage expenditures".
2/ Including to private sector suppliers.
3/ Item classified under "development projects".

8. **The strengthening of the Public Financial Management System (PFM) has helped the PA better manage the severe liquidity difficulties (Appendix, Section D).** The PFM improvements since mid-2007 have helped prioritize and raise the quality of public expenditures, and enhanced transparency and accountability. In particular, expenditure management was enhanced since 2010 through the integration of the Commitment Control System (CCS) into the Financial Management Information System (FMIS). The MoF, with IMF technical assistance, has set out a medium-term program to further strengthen the PFM. An important objective for 2012 is to ensure that line ministries do not make expenditure commitments that exceed amounts under "purchase orders" authorized by the MoF's General Accountant. This will require the integration into the FMIS of the "procurement module", with expenditure commitments recorded at the time a purchase order is entered into the system, as opposed to when the first payment is made for that purchase. This will help in better aligning commitments with cash availability, thus stemming arrears accumulation. Other important objectives to be met by end-2012 include a strengthening of the budget preparation process, as well as ensuring that all fiscal data are reported in accordance with GFSM 2001 methodology.

## Table C. Fiscal Indicators for 2010–12 in millions of U.S. dollars

(In millions of U.S. dollars, unless otherwise indicated)

| | 2010 | 2011 | | 2012 |
|---|---|---|---|---|
| | | Year | Budget | Proj. |
| Total net revenues | 1,927 | 2,046 | 2,149 | 2,173 |
| Gross domestic revenues | 745 | 738 | 812 | 788 |
| Tax revenues | 474 | 483 | 512 | 535 |
| Nontax revenues | 270 | 256 | 300 | 254 |
| Gross clearance revenues | 1,259 | 1,424 | 1,442 | 1,508 |
| Tax refunds | 76 | 116 | 105 | 123 |
| | | | | |
| Total recurrent expenditures (commitment basis): | 3,076 | 3,324 | 3,232 | 3,268 |
| Wage expenditures | 1,613 | 1,783 | 1,709 | 1,838 |
| Non-wage expenditures | 1,227 | 1,401 | 1,363 | 1,322 |
| Net lending | 236 | 140 | 160 | 108 |
| | | | | |
| Total recurrent expenditures (cash basis) | 2,956 | 2,961 | 3,232 | 3,268 |
| of which: non-wage expenditures (cash basis) | 1,156 | 1,143 | 1,363 | 1,322 |
| | | | | |
| Recurrent balance (commitment basis) | -1,149 | -1,279 | -1,084 | -1,094 |
| Recurrent balance (cash basis) | -1,083 | -783 | -967 | -1,094 |
| | | | | |
| Development projects (commitment basis) | 299 | 370 | 500 | 350 |
| Development projects (cash basis) | 275 | 295 | 500 | 350 |
| Overall balance (cash basis, including development expenditures) | -1,358 | -1,078 | -1,467 | -1,444 |
| | | | | |
| Financing | 1,358 | 1,078 | 1,467 | 1,444 |
| External support for recurrent and development expenditures | 1,277 | 940 | 1,467 | 910 |
| External support for recurrent expenditures disbursed or indicated | 1,146 | 771 | 967 | 610 |
| External support for development expenditures | 130 | 169 | 500 | 300 |
| Domestic financing | 84 | 137 | --- | --- |
| Residual | -3 | 1 | --- | 534 |
| | | | | |
| Memorandum items: | | | | |
| GDP | 8,331 | 9,809 | 9,163 | 10,532 |
| Domestic tax revenue (percent of GDP) | 5.7 | 4.9 | 5.6 | 5.1 |
| Clearence revenue (percent of GDP) | 15.1 | 14.5 | 15.7 | 14.3 |
| Wage expenditures (commitment basis), percent of GDP | 19.4 | 18.2 | 18.7 | 17.5 |
| Net lending (including subsidies; percent of GDP) | 2.8 | 1.4 | 1.7 | 1.0 |
| External financing for recurrent budget (US$ billion) | 1.15 | 0.77 | 0.97 | 0.61 |
| Recurrent balance (commitment basis), percent of GDP | -13.8 | -13.0 | -11.8 | -10.4 |
| Recurrent balance (cash basis), percent of GDP | -13.0 | -8.0 | -10.6 | -10.4 |
| Net expenditure arrears accumulation (US$ billion) | 0.09 | 0.36 | --- | --- |
| of which: non-wage arrears | 0.07 | 0.26 | --- | --- |
| Net expenditure arrears accumulation (percent of GDP) | 1.1 | 3.7 | --- | --- |
| Total interest payments (US$ million) | 45 | 69 | --- | 69 |
| Domestic payments | 36 | 63 | --- | 63 |
| External payments | 10 | 5 | --- | 5 |
| Total principal payment (US$ million) | 25 | -151 | --- | -151 |
| Domestic payments | -7 | -157 | --- | -157 |
| External payments | 33 | 5 | --- | 5 |

Sources: Ministry of Finance; and IMF staff estimates.

## Table D. Fiscal Indicators for 2010–12 in millions of NIS
(In millions of NIS, unless otherwise indicated)

| | 2010 | 2011 | | 2012 |
|---|---|---|---|---|
| | | Year | Budget | Proj. |
| Total net revenues | 7,188 | 7,321 | 7,951 | 8,042 |
| Gross domestic revenues | 2,778 | 2,642 | 3,004 | 2,916 |
| Tax revenues | 1,769 | 1,727 | 1,894 | 1,978 |
| Nontax revenues | 1,009 | 915 | 1,110 | 938 |
| Gross clearance revenues | 4,695 | 5,095 | 5,335 | 5,579 |
| Tax refunds | 285 | 416 | 388 | 454 |
| Total recurrent expenditures (commitment basis): | 11,473 | 11,897 | 11,960 | 12,090 |
| Wage expenditures | 6,017 | 6,381 | 6,325 | 6,800 |
| Non-wage expenditures | 4,575 | 5,015 | 5,043 | 4,890 |
| Net lending | 880 | 501 | 592 | 400 |
| Total recurrent expenditures (cash basis) | 11,127 | 10,597 | 11,960 | 12,090 |
| of which: non-wage expenditures (cash basis) | 4,312 | 4,089 | 5,043 | 4,890 |
| Recurrent balance (commitment basis) | -4,284 | -4,576 | -4,009 | -4,048 |
| Recurrent balance (cash basis) | -4,039 | -2,803 | -3,579 | -4,048 |
| Development projects (commitment basis) | 1,114 | 1,325 | 1,850 | 1,295 |
| Development projects (cash basis) | 1,026 | 1,054 | 1,850 | 1,295 |
| Overall balance (cash basis, including development expenditures) | -5,065 | -3,858 | -5,429 | -5,343 |
| Financing | 5,065 | 3,858 | 5,429 | 5,343 |
| External support for recurrent and development expenditures | 4,763 | 3,364 | 5,429 | 3,366 |
| External support for recurrent expenditures disbursed or indicated | 4,276 | 2,759 | 3,579 | 2,256 |
| External support for development expenditures | 487 | 605 | 1,850 | 1,110 |
| Domestic financing | 312 | 490 | --- | --- |
| Residual | -10 | 4 | --- | 1,977 |
| Memorandum items: | | | | |
| GDP | 31,073 | 35,105 | 33,902 | 38,967 |
| Domestic tax revenue (percent of GDP) | 5.7 | 4.9 | 5.6 | 5.1 |
| Clearence revenue (percent of GDP) | 15.1 | 14.5 | 15.7 | 14.3 |
| Wage expenditures (commitment basis), percent of GDP | 19.4 | 18.2 | 18.7 | 17.5 |
| Net lending (including subsidies; percent of GDP) | 2.8 | 1.4 | 1.7 | 1.0 |
| External financing for recurrent budget (NIS billion) | 4.28 | 2.76 | 3.58 | 2.26 |
| Recurrent balance (commitment basis), percent of GDP | -13.8 | -13.0 | -11.8 | -10.4 |
| Recurrent balance (cash basis), percent of GDP | -13.0 | -8.0 | -10.6 | -10.4 |
| Net expenditure arrears accumulation (NIS billion) | 0.35 | 1.30 | --- | --- |
| of which: non-wage arrears | 0.26 | 0.93 | --- | --- |
| Net expenditure arrears accumulation (percent of GDP) | 1.1 | 3.7 | --- | --- |
| Total interest payments (NIS million) | 169 | 246 | --- | 254 |
| Domestic payments | 132 | 226 | --- | 234 |
| External payments | 37 | 19 | --- | 20 |
| Total principal payment (US$ million) | 95 | -559 | --- | -559 |
| Domestic payments | -28 | -579 | --- | -579 |
| External payments | 123 | 20 | --- | 20 |

Sources: Ministry of Finance; and IMF staff estimates.

## B. Fiscal Outlook for 2012

9. **The MoF has prepared a draft budget for 2012 based on a decline in non-wage spending in nominal terms, yielding a reduction in the recurrent budget deficit by 3 percentage points of GDP to $1.1 billion, or 10.4 percent of GDP.** The budget continues the downward trend in the deficit, which declined steadily as a share of GDP from 21 percent in 2008 to 13 percent in 2011. Nevertheless, as of end-February donor aid for 2012 is projected at only $0.6 billion, yielding a financing gap of $0.5 billion. The PA has been engaged in intensive dialogue with civil society and private sector representatives to elicit views and ensure support for additional measures that could cover as much as possible of the 2012 financing gap. The draft budget has the following key features:

- Domestic tax revenue is conservatively projected to rise by 0.2 percent of GDP—to about 5 percent of GDP. The following measures to raise domestic tax revenue are envisaged for 2012: (i) steps to improve the administration of the income tax and VAT, in line with the recommendations of the IMF's technical assistance (Box 2); and (ii) the introduction of an additional income tax bracket of 20 percent (on income exceeding NIS 200,000). In addition, as an outcome of the dialogue between the PA and the private sector, several large businesses have volunteered to forego until end-2013 income tax exemptions granted under the Investment Promotion Law. The revenue gains from these measures are conservatively projected for 2012, given the uncertainty surrounding the pace of improvement in tax compliance. These gains are likely to rise gradually over the medium term as the implementation of tax administration measures bears fruit.

- Clearance revenue is also conservatively projected to be broadly unchanged at about 14 percent of GDP. There is ample scope to raise the clearance revenue collection through the implementation of the set of measures to improve collection and reduce leakages, as agreed at the technical level between the Palestinian and Israeli ministries of finance. Given that clearance revenue represents about 70 percent of total revenue, it would take only a 5 percent increase in clearance revenue to reduce the 2012 financing gap by $75 million. In contrast, it would take a 50 percent increase in domestic income tax revenue (which represents only 7 percent of total revenue) to yield the same result. No yield from clearance revenue measures is assumed in the budget given the uncertainty regarding their approval at the Israeli ministerial level.

- The wage bill is envisaged to increase by 6.6 percent, consisting of: (i) a rise by 3 percent in wage rates to compensate for 2011 inflation; (ii) the 1.25 percent automatic yearly increase, and a 0.8 percent increase for promotions; and (iii) 1.5 percent increase for 3,000 new employees.

- Recurrent nonwage expenditures are envisaged to decline by about 3 percent in nominal terms, equivalent to a reduction by about 2 percentage points of GDP. This decline will be enabled by: (i) further strengthening of the social safety net, including the streamlining of social transfers; (ii) containing increases in operational expenditures to what is strictly necessary for the operation of the ministries, eliminating several "non-essential" ministerial units, reducing travel and other allowances, and minimizing contractual hires. In addition, continued strengthening of the PFM system will allow better prioritization of spending, while tighter commitment controls and cash management will help contain arrears accumulation.

- Net lending is projected to decline by 0.4 percent of GDP, reflecting continued commercialization of electricity distribution and measures to improve the incentives to municipalities and households to pay electricity bills.

- The budget envisages no net domestic bank borrowing except for short-term loans. While the repayment of arrears is envisaged to start in 2013, for 2012 any higher-than-budgeted revenue will be used to repay domestic payment arrears, provided donor aid is adequate to cover the budgeted deficit.

- In 2011, donor aid to finance development expenditure was limited to $169 million, which fell well short of the development spending commitments of $370 million. The MoF has thus budgeted a conservative amount of $350 million for 2012, $50 million of which is envisaged to be financed by the Treasury and $300 million by donor aid. The MoF intends to proceed with development projects only as matching donor funds become available.

- As of end-February 2012, donor aid indicated by donors for disbursement in 2012 amounted to $0.6 billion. Given the recurrent deficit of $1.1 billion, the financing gap for 2012 is projected at $0.5 billion.

## Box 2. Measures to Raise Domestic Tax and Clearance Revenues

### I. Raising domestic tax revenue

**The Palestinian Authority (PA) has been implementing a comprehensive reform of tax administration with technical assistance from the Fund, DFID, and USAID.** In 2011, the authorities have started the implementation of an action plan, developed with assistance from the Fund, aimed at expanding the tax base and improving compliance. Key measures in that plan for 2012 include the establishment of a unified revenue administration with a strengthened Large Taxpayer Unit (LTU), and the computerization of taxpayers' records to reduce tax evasion.

**Improving the administration of the income tax needs special attention, given the very low compliance rate for that tax (estimated at below 40 percent).** The West Bank and Gaza (WBG)'s income tax revenue as a share of GDP is one of the lowest in the region, estimated at about 1.5 percent (compared to for example a share of 3–4 percent of GDP for Algeria, Jordan, Lebanon, and Pakistan). Improving income tax compliance and widening the base, is a crucial complement to an increase in the tax rates. In this regard, a "first stage" plan for implementation in 2012–13 was developed, with Fund technical assistance, to improve income tax compliance by large tax payers through several measures, including better enforcement of penalties, reforming the tax filing and assessment processes, more rigorous and frequent audits, and improvement in the LTU's organization, staffing, and management. The objective of the plan is to expand the coverage of the LTU from 50 percent to 70 percent of large taxpayers by 2013. Since early 2011, the staff of the income tax department has been receiving training on the effective application of the recently developed manual on income tax operating procedures.

### II. Raising clearance revenue

**Given that, as stipulated by the Paris Protocol, clearance revenue is collected by the Government of Israel (GoI) on behalf of the PA, improving its collection requires close coordination and cooperation between the two sides.** In 2011, the staff of the Palestinian and Israeli Ministries of Finance (MoF) reached understandings in principle on several measures aimed at strengthening collection and minimizing leakages of clearance revenue, including by reducing the current serious underreporting of imports. These understandings need approval at the Israeli ministerial level to be put into practice:

- The assessment of clearance revenue owed to the PA should be made on the basis of the data compiled by the GoI on trade between Israel and the WBG, in line with the Paris Protocol. Both sides should have equal access to data collected through shared electronic interfaces.
- Discontinue the current practice of settling unpaid electricity bills (owed by the Gaza Electricity Distribution Company and by Palestinian municipalities to the Israeli Electricity Company) through automatic deductions by the Israeli MoF from clearance revenue owed to the PA. Instead, to raise efficiency and transparency, the Israeli electricity company should send electricity bills to the Palestinian MoF which will be responsible for their settlement.
- It is important that PA officials be present at border crossings to enable close monitoring of imports into the West Bank and improve the collection of invoices for VAT and other taxes and fees.
- Several practices of revenue sharing should be reviewed to ensure that they are in line with the Paris Protocol. In particular, exit fees levied by Israel on Palestinian passengers crossing the Allenby Bridge should be equally shared between the two sides.

## IV. MEDIUM-TERM OUTLOOK AND STRUCTURAL REFORMS

10. **The macroeconomic framework underpinning the Palestinian National Development Plan (PNDP) has been revised to take into account the risk of slower easing of restrictions and of shortfalls in donor aid over the medium term.** The pace of easing of restrictions on movement and access has been a key determinant of the pace of economic growth. The impact of the global economic slowdown is expected to continue to be tempered by the substantial trade restrictions, in particular on exports, as well as the weak global links of the domestic financial system with the rest of the world. Nevertheless, the projected growth slowdown in Israel in 2012 will adversely affect the WBG's growth through reduced import demand from Israel, given that over two thirds of the WBG's trade is with Israel. Two scenarios were developed to assess the outlook:

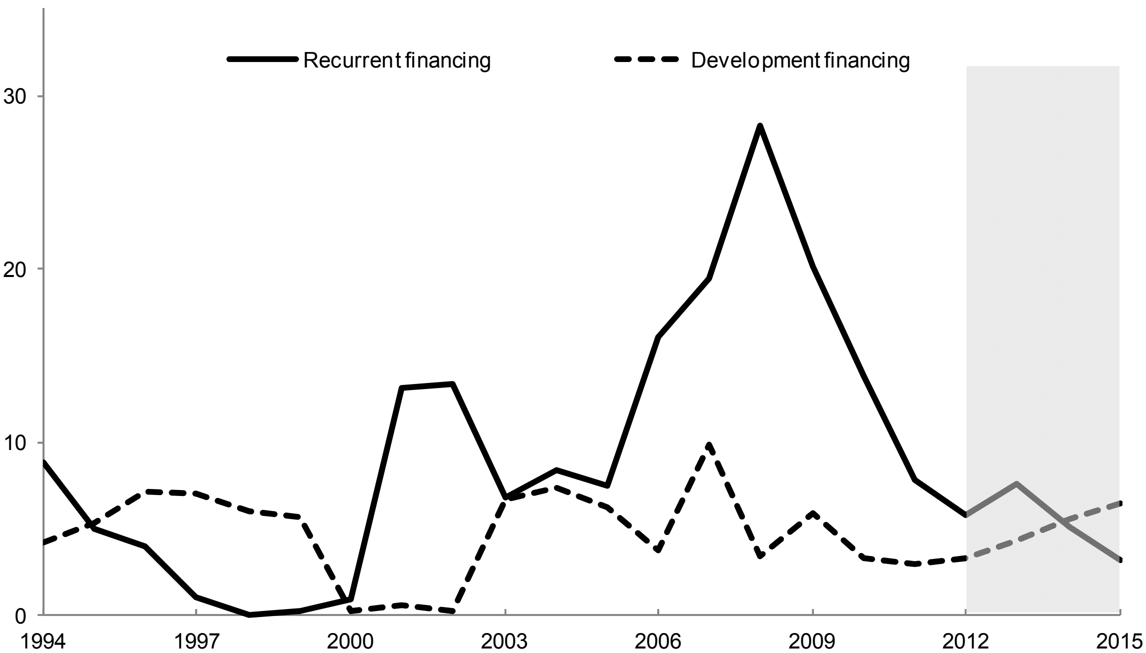
- The "higher growth" scenario, which envisages a significant easing over the medium term of trade and other restrictions, including on foreign direct investment, which would outweigh the impact of the PA's fiscal retrenchment on private sector activity and investment. Given the long-standing restrictions to which the economy has been subjected, there is ample scope for a vigorous recovery over the medium term as controls are phased out and the WBG's resources are fully tapped.[6] In Gaza, the further easing of restrictions will allow: (i) steadily rising imports of investment inputs required by the private sector; and (ii) a gradual increase in trade with the West Bank and in exports. In the West Bank, lifting of remaining internal restrictions will be complemented by a phasing out of obstacles on trade, in particular with Israel and East Jerusalem, as well as on access to "Area C". The PA implements a prudent fiscal policy and structural reforms to enable a sustained reduction in the recurrent budget deficit. Donors disburse adequate aid on time to cover the narrowing budget deficit as well as public investment and reconstruction needs.

- The "lower growth" scenario was developed based on the assumption that restrictions in the WBG will not be eased, inhibiting trade and private investment. Slower revenue growth, along with rising emergency spending, would reduce the pace of fiscal consolidation, even with continued restraint on public sector wages and employment. In addition, donor aid would be below what is required to finance the deficit, leading to substantial arrears accumulation.

[6] For an analysis of the WBG's potential for high growth in case of easing of restrictions, and of the "growth performance gap", see the IMF staff's analysis in the Appendix, Section B, of the IMF Staff Report for the Ad Hoc Liaison Committee in New York, September 18, 2011, published on www.imf.org/wbg.

11. **The expansion of private sector activity and external trade in the higher growth scenario would gradually raise real GDP growth from 6 percent in 2012 to 8 percent by 2015, with a fall in unemployment from 21 percent in 2011 to 12 percent by 2015.** The recurrent deficit would decline to 7.2 percent of GDP in 2013, with a continued shift of spending away from wages and subsidies. This in turn would allow a shift in donor aid from budget financing to development projects (Figure 3).

Figure 3. Composition of Donor Aid
(Percent of GDP)



Source: Ministry of Finance, and IMF staff estimates and projections

12. **In the lower-growth scenario, real GDP growth would remain at an average of about 4 percent over the medium term and the unemployment rate would remain above 20 percent.** Emergency spending and arrears accumulation would slow the pace of fiscal adjustment, with the recurrent deficit rising above 11 percent of GDP by 2015 (Table E). Arrears accumulation would average above 6 percent of GDP per year. Given the already high stock of arrears to the private sector, most businesses would be unlikely to provide goods and services on credit, and would insist on cash payment. Arrears would thus likely be borne by other essential spending, including wages and social benefits. The rising arrears in turn are bound to substantially tighten the liquidity situation of the private sector, leading to a rise in banks' nonperforming loans. Living standards would stagnate, given the yearly population growth rate of about 3 percent.

## Table E. Comparison of Higher and Lower-Growth Scenarios

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | Higher Growth Scenario | | | | | Lower Growth Scenario | | |
| Output and Investment | | | | | | | | |
| Real GDP (percentage change) | 9.5 | 6.2 | 7.0 | 7.4 | 8.0 | 3.9 | 3.7 | 3.3 |
| West Bank | 5.7 | 5.0 | 6.0 | 6.0 | 7.0 | 3.5 | 3.2 | 3.0 |
| Gaza | 20.2 | 9.0 | 9.0 | 10.0 | 10.0 | 5.0 | 5.0 | 4.0 |
| Real GDP per capita (percentage change) | 6.3 | 3.1 | 3.9 | 4.3 | 5.0 | 0.9 | 0.7 | 0.4 |
| West Bank | 3.0 | 2.3 | 3.3 | 3.6 | 4.3 | 0.8 | 0.5 | 0.4 |
| Gaza | 16.2 | 5.5 | 5.7 | 6.3 | 6.6 | 1.5 | 1.5 | 0.6 |
| Gross capital formation (in percent of GDP) | 18.2 | 19.2 | 21.0 | 22.9 | 24.5 | 17.7 | 17.3 | 16.8 |
| *Of which:* public investment (in percent of GDP) | 4.1 | 4.3 | 5.3 | 6.5 | 7.3 | 3.2 | 3.9 | 4.6 |
| | (In percent of GDP) | | | | | | | |
| Public finances 1/ | | | | | | | | |
| Revenues | 20.9 | 20.6 | 21.9 | 22.4 | 23.0 | 20.2 | 20.3 | 20.4 |
| Recurrent expenditures and net lending | 33.9 | 31.0 | 29.1 | 27.1 | 25.8 | 30.8 | 31.1 | 31.6 |
| Recurrent balance (before external support) | -13.0 | -10.4 | -7.2 | -4.7 | -2.9 | -10.6 | -10.9 | -11.2 |
| Expenditure arrears accumulation | 3.7 | 0.0 | -0.4 | -0.4 | -0.4 | 4.2 | 6.7 | 8.5 |
| Capital expenditures | 3.0 | 3.3 | 4.3 | 5.5 | 6.5 | 2.2 | 3.0 | 3.6 |
| (In millions of U.S. dollars) | 295 | 350 | 500 | 700 | 900 | 250 | 350 | 450 |
| External recurrent budgetary support | 6.6 | 5.3 | 7.6 | 5.1 | 3.2 | 6.3 | 4.3 | 2.9 |
| (In billions of U.S. dollars) | 0.6 | 0.6 | 0.9 | 0.6 | 0.4 | 0.7 | 0.5 | 0.4 |
| Total external support, including capital expenditures | 9.6 | 8.6 | 11.9 | 10.6 | 9.7 | 8.5 | 7.3 | 6.5 |
| (In billions of U.S. dollars) | 0.9 | 0.9 | 1.4 | 1.3 | 1.3 | 1.0 | 0.9 | 0.8 |
| | (In percent of GDP) | | | | | | | |
| External sector | | | | | | | | |
| Exports of goods and nonfactor services | 16.2 | 16.4 | 18.2 | 20.2 | 22.5 | 17.3 | 17.3 | 17.4 |
| Import of goods and nonfactor services | 56.5 | 55.3 | 59.8 | 63.3 | 66.4 | 55.8 | 54.6 | 53.8 |
| Current account balance (excluding official transfers) | -19.0 | -18.0 | -21.0 | -22.6 | -23.8 | -18.0 | -17.0 | -16.5 |
| Current account balance (including official transfers) | -9.4 | -9.4 | -9.1 | -12.0 | -14.1 | -9.5 | -9.8 | -10.0 |
| Memorandum items: | | | | | | | | |
| Unemployment rate (average in percent of labor force) | 21 | 18 | 15 | 13 | 12 | 20 | 22 | 24 |

Sources: Palestinian authorities and IMF staff estimates.
1/ Commitment basis, unless otherwise stated.

13. **To ensure a steady reduction in the recurrent deficit, it is important to step up the implementation of key structural reforms, to build upon the progress already made (Box 3):**

- *Streamline and better target social assistance.* The authorities should continue to integrate all social transfers into the social safety net, to ensure that only those in the database of targeted households receive assistance. The database should be updated regularly to ensure that it includes only households below the poverty line.

- *Eliminating electricity subsidies.* The authorities should press ahead with the implementation of the action plan to complete by end-2012 the transfer of electricity distribution from local governments to private electricity companies.

- *Reforming the public pension system.* The comprehensive public pension reform agreed with the World Bank in July 2010 needs to be implemented promptly. This will require, as a first step in 2012, prompt approval by the Council of Ministers, and then the President, of measures to index pensions to inflation, raise the retirement age, and eliminate lump sum payments at retirement.

- *Initiating civil service reform.* The authorities should complete by end-2012 the plan for a comprehensive civil service reform, in collaboration with the World Bank. In the meantime, during 2012, a comprehensive review of employees' qualifications and performance should be undertaken to pave the way for a new incentive structure with a wider salary scale.
- *Strengthening the legal and regulatory framework.* The New Companies Law, the New Industry Law, and the Movable Assets Law have been approved by the Cabinet, and are awaiting Presidential approval. Prompt enactment of these laws is important to ensure a level playing field in the legal treatment of public and private companies, and to facilitate access to bank finance by enabling the use of movable assets as collateral.

### Box 3. Structural Reforms Implemented Since 2010

**Significant structural reforms were implemented since 2010 to facilitate the move toward fiscal sustainability:**

- *Targeting social assistance.* In 2010, several cash assistance programs in the West Bank have been merged into one central program with a single payment modality. The eligibility for the payments under the program is verified through on-site visits and a proxy means test to identify households below the poverty line. Another key social safety net measure has been the implementation since July 1, 2011 of the "lifeline electricity tariff" for households in the social safety net, for which a "lifeline" amount of household electricity consumption is billed only at cost.
- *Reducing electricity subsidies.* Two important steps were taken since 2010: (i) the transfer of about two-thirds of electricity distribution in the West Bank from municipalities to private companies; and (ii) the installation of about 150,000 pre-paid meters in the West Bank, which will further improve electricity bills payment. An action plan was prepared to complete the transfer of distribution from municipalities to private companies by end-2012.
- *Steps to reform the public pension system.* The comprehensive public pension reform action plan was adopted in July 2010. In May 2011, the authorities reached agreement with the World Bank on legislative amendments (including to the Public Pension law) to enable parametric changes to the pension system. The amendments were submitted to the Council of Ministers in the fall of 2011.
- *Steps toward civil service reform.* This reform is to reduce the wage bill and raise public sector efficiency. In mid-2011, the authorities started a comprehensive review of employees' qualifications and performance. The review will include a careful assessment of personnel needs in key sectors, including health and education.
- *Strengthening the legal and regulatory framework.* The Ministry of National Economy has taken measures in 2011 to reduce the red tape faced by new small- and medium-sized businesses, including streamlining registration procedures. A new Procurement Law has been signed by the President in late 2011, which will improve efficiency, accountability, and transparency in the acquisition of goods and services by the government.

## V. Appraisal

14. **The substantial reduction in donor aid since early 2011, as well as the absence of relaxation of restrictions on movement and access, are posing serious risks to the Palestinian economy's outlook:**

- Economic growth in 2008–10 has been supported by a combination of steady reforms, donor aid, and easing of restrictions. Aid was essential in supporting the PA's institution-building and development efforts, and the reestablishment of law and order in the West Bank, all of which were crucial for bolstering private sector confidence and expansion. Furthermore, the reduction in the PA's fiscal deficit has allowed a reduction in external financing requirements for the recurrent budget from the equivalent of 21 percent of GDP in 2008 to 14 percent of GDP in 2010. However, in 2011 aid declined to well below the level necessary to finance an already tight budget. The resulting liquidity difficulties were compounded by shortfalls in tax revenue. This led to substantial arrears to businesses and the pension fund, posing a serious risk to the PA's institution-building program and private sector growth.
- In addition to the contribution of donor aid, growth was supported by the removal since 2009 of a large number of roadblocks in the West Bank, as well as the expansion of capacity at crossing points with Israel. Similarly, the easing in Gaza in mid-2010 of controls on imports of consumer goods and inputs for internationally-supervised projects led to a surge in growth. However, in 2011 there was no significant relaxation of restrictions in the WBG. Continued easing of controls on trade and other economic activities is essential to ensure that the growth momentum is sustained, at least to offset the impact of the PA's fiscal retrenchment and declining aid on private sector activity and investment.
- The persistence of aid shortfalls and restrictions has dimmed the WBG's economic growth outlook and prospects for a significant reduction in unemployment. Investors' incentives have been further adversely affected by the lack of progress in the peace process and associated higher risk of social unrest.

15. **While the 2012 draft budget continues fiscal consolidation started in 2008, with a further reduction in the recurrent deficit by 3 percentage points of GDP, there remains a substantial financing gap, projected at $0.5 billion (as of end-February 2012).** There is little scope to cover that gap through further arrears accumulation to the private sector or borrowing from commercial banks, given the existing large stock of debt to businesses and banks. Therefore there is a high risk that the persistence of that gap will result in cuts in essential spending, including wages and social transfers. Concerted efforts are needed by the three parties (PA, GoI and donors) to help cover that gap:

- It is important for the PA to implement a contingency plan to cover the financing gap. That plan should be implemented as soon as possible, given that the 2012 aid outlook is highly uncertain even as of March 2012. Given that the wage bill represents over half of total recurrent expenditures, controlling its growth should be part of the plan, including limiting the wage bill increase by reducing cost of living adjustment (e.g., to a maximum of 1.5 percent), with no new net hiring. It is essential that the PA continues to do its utmost as early as possible to cover the financing gap by further reducing its expenditures and enhancing domestic revenues. This will prevent a situation where the PA is forced by continued aid shortfalls to take drastic measures at short notice, such as a sudden curtailment of social transfers or payment of only a portion of the wage bill. In the non-wage area, it is important to press ahead with measures to strengthen further the commitment controls system to stem arrears accumulation. Non-wage expenditures should be carefully prioritized, making full use of the cash management system, to ensure that in case of continued aid shortfalls, non-essential expenditures take the brunt of the cuts. Development projects should only be implemented if there are matching funds from donors, to prevent the diversion of aid away from essential recurrent spending. On the revenue side, it is important to complement the recent income tax increases with the prompt implementation of the IMF technical assistance recommendations to improve tax administration, notably through enhancing compliance and widening the tax base. The MoF is considering the above measures as part of the contingency plan to be incorporated into the 2012 budget, to be finalized by end-March 2012.

- Raising budgetary revenue in a sustainable manner will require the PA and the GoI to work closely together to enhance clearance revenue collection and minimize leakages. Clearance revenue collected by the GoI on behalf of the PA represents about 70 percent of total budgetary revenue, and thus even a small increase in its yield could significantly reduce the financing gap. In this regard, it is important that the agreements reached between the technical teams of the Palestinian and Israeli ministries of finance be promptly approved at the Israeli ministerial level. Practical measures that could be implemented in the spring of 2012 include the assessment of potential clearance revenue owed to the PA on the basis of comprehensive data compiled by the GoI on trade between Israel and the WBG.
- It will be very difficult for the PA to cover the 2012 financing gap through austerity alone, without the prompt pledging and disbursement of additional aid. There is also a need for an enhanced donor coordination framework to enhance the predictability of aid, which has varied widely by donor in recent years. For example, while the EU countries' disbursements have generally been predictable, in line with yearly plans, many of the regional donors' disbursements have been made on an ad hoc basis with little advance planning.

16. **Along with the concerted efforts set out above to address the severe liquidity difficulties, it is essential for the PA to step up key structural reforms in order to raise economic efficiency and fully eliminate longer-term reliance on recurrent aid:**

- The wage bill represents over half of total recurrent expenditure, and is the area where, over time, substantial budgetary savings could be achieved while raising the quality and efficiency of public sector services. While the share of the wage bill in GDP has declined in recent years due to across-the-board limits on increases in wage rates and new employment, at about 18 percent it is still significantly higher than the 10-15 percent that is typical of countries at a similar stage of development. A comprehensive civil service reform is essential to sustain the reduction in the wage bill without reducing the PA's effectiveness.
- In the short term it is difficult for the PA to compress non-wage expenditures, given that the bulk of these consist of social transfers and pension payments. However, substantial budgetary savings could be derived over the medium term through the strengthening of the social safety net. In that regard, it is important for the PA to continue to streamline social payments to ensure that all transfers are made on the basis of the database of poor households developed in collaboration with the World Bank.
- Containing the growth of non-wage expenditures over the medium term will also require the implementation of the action plan to reform and restore the viability of the pension system. This requires the prompt implementation of bold measures, including indexing the pensions to the CPI, rather than to wages, and raising the retirement age.
- Electricity subsidies, reflected in the "net lending" component of the budget, have declined substantially due to improved incentives for municipalities and households to pay their electricity bills. To ensure that these subsidies are fully phased out over the medium term, it is essential to complete the commercialization of electricity distribution in the West Bank by end-2012, as envisaged in the PNDP. It is important to apply as rigorously as possible the "lifeline" electricity tariff, which bills electricity at supply cost, to eligible households.
- It is important for the PMA to press ahead with its action-plan to reduce banks' vulnerability to the slowdown in economic growth and increased exposure to the public sector. That plan should incorporate remedial actions that are warranted by the stress tests' results—including raising certain banks' paid in capital and reducing their exposure to specific sectors. Prompt implementation of remedial measures is especially important given: (i) the recent substantial rise in bank credit to the PA; and (ii) the risk that the PA will be unable to quickly reduce its arrears to private sector suppliers, which in turn could lead to the inability of these suppliers to settle their bank debts, leading to a rise in banks' non-performing loans.

# Table 1. Selected Economic Indicators, 2009–15

(Population: 4 million; 2010 est.)
(Per capita GDP: $2,058; 2010)
(Poverty rate: 18 percent in the West Bank and 38 percent in Gaza Strip; 2010 est.)

| | | | Est. | Projections | | | |
|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| Output and prices | (Annual percentage change) | | | | | | |
| Real GDP (2004 market prices) | 7.4 | 9.8 | 9.5 | 6.2 | 7.0 | 7.4 | 8.0 |
| West Bank | 7.1 | 6.8 | 5.7 | 5.0 | 6.0 | 6.3 | 7.0 |
| Gaza | 8.4 | 19.5 | 20.2 | 9.0 | 9.0 | 10.0 | 10.0 |
| CPI inflation rate (end-of-period) | 4.3 | 2.8 | 2.7 | 2.3 | 2.0 | 2.0 | 2.0 |
| CPI inflation rate (period average) | 2.8 | 3.7 | 2.9 | 3.8 | 2.1 | 2.0 | 2.0 |
| Investment and saving | (In percent of GDP) | | | | | | |
| Gross capital formation, *of which:* | 18.3 | 18.5 | 18.2 | 19.2 | 21.0 | 22.9 | 24.5 |
| Public | 6.3 | 4.4 | 4.1 | 4.3 | 5.3 | 6.5 | 7.3 |
| Private | 12.0 | 14.1 | 14.2 | 14.9 | 15.7 | 16.5 | 17.2 |
| Gross national savings, *of which:* | 6.3 | 7.9 | 8.8 | 9.8 | 12.0 | 10.9 | 10.4 |
| Public | 9.1 | 3.7 | 1.6 | -1.8 | 4.3 | 5.5 | 6.5 |
| Private | -2.7 | 4.2 | 7.2 | 11.6 | 7.6 | 5.4 | 4.0 |
| Saving-investment balance | -12.0 | -10.6 | -9.4 | -9.4 | -9.1 | -12.0 | -14.1 |
| Public finances 1/ | (In percent of GDP) | | | | | | |
| Revenues | 23.8 | 23.1 | 20.9 | 20.6 | 21.9 | 22.4 | 23.0 |
| Recurrent expenditures and net lending | 47.5 | 36.8 | 33.9 | 31.0 | 29.1 | 27.1 | 25.8 |
| Wage expenditures | 21.8 | 19.3 | 18.2 | 17.5 | 16.7 | 16.0 | 15.3 |
| Nonwage expenditures | 20.1 | 14.7 | 14.3 | 12.5 | 11.7 | 10.8 | 10.4 |
| Net lending | 5.6 | 2.8 | 1.4 | 1.0 | 0.7 | 0.3 | 0.1 |
| Recurrent balance (commitment, before external support) | -23.7 | -13.8 | -13.0 | -10.4 | -7.2 | -4.7 | -2.9 |
| Recurrent balance, cash (before external support) | -20.4 | -13.0 | -8.0 | -10.4 | -7.6 | -5.1 | -3.2 |
| Development expenditures | 6.0 | 3.3 | 3.0 | 3.3 | 4.3 | 5.5 | 6.5 |
| (In millions of U.S. dollars) | 400 | 274 | 295 | 350 | 500 | 700 | 900 |
| Overall balance (before external support) | -29.6 | -17.0 | -16.0 | -13.7 | -11.5 | -10.2 | -9.3 |
| External recurrent budgetary support (in billions of U.S. dollars) | 1.4 | 1.1 | 0.6 | 0.6 | 0.9 | 0.6 | 0.4 |
| Total external support, including for development expenditures | 26.1 | 15.3 | 9.6 | 8.6 | 11.9 | 10.6 | 9.7 |
| (In billions of U.S. dollars) | 1.8 | 1.3 | 0.9 | 0.9 | 1.4 | 1.3 | 1.3 |
| Financing gap (in billions of U.S. dollars) | … | … | … | 0.5 | … | … | … |
| Monetary sector 2/ | (Annual percentage change) | | | | | | |
| Credit to the private sector | 22.9 | 31.2 | 17.4 | 19.4 | 22.7 | 22.4 | 22.9 |
| Private sector deposits | 5.7 | 9.9 | 4.0 | 11.9 | 15.7 | 15.4 | 15.9 |
| External sector | (In percent of GDP) | | | | | | |
| Exports of goods and nonfactor services | 13.5 | 13.8 | 16.2 | 16.4 | 18.2 | 20.2 | 22.5 |
| Import of goods and nonfactor services | 65.3 | 55.5 | 56.5 | 55.3 | 59.8 | 63.3 | 66.4 |
| Net factor income | 7.9 | 7.2 | 6.7 | 6.4 | 6.1 | 5.9 | 5.6 |
| Net current transfers | 31.9 | 23.9 | 24.1 | 23.2 | 26.5 | 25.2 | 24.3 |
| Official transfers | 26.1 | 15.3 | 9.6 | 8.6 | 11.9 | 10.6 | 9.7 |
| Current account balance (excluding official transfers) | -38.1 | -25.9 | -19.0 | -18.0 | -21.0 | -22.6 | -23.8 |
| Current account balance (including official transfers) | -12.0 | -10.6 | -9.4 | -9.4 | -9.1 | -12.0 | -14.1 |
| Memorandum items: | | | | | | | |
| Nominal GDP (in millions of U.S. dollars) | 6,720 | 8,331 | 9,809 | 10,532 | 11,551 | 12,639 | 13,892 |
| Per capita nominal GDP (U.S. dollars) | 1,708 | 2,058 | 2,353 | 2,453 | 2,613 | 2,777 | 2,967 |
| Unemployment rate (average in percent of labor force) | 25 | 24 | 21 | 18 | 15 | 13 | 12 |
| Al Quds stock market index (annual percentage change) | 11.6 | -0.7 | -2.7 | … | … | … | … |

Sources: Palestinian authorities; and IMF staff estimates.

1/ Commitment basis.

2/ End-of-period; in U.S. dollar terms.

# Table 2. Central Government Budget, 2009–15
## (In millions of U.S. dollars)

| | 2009 | 2010 | 2011 | | Projection | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Budget | Year | 2012 | 2013 | 2014 | 2015 |
| | | | (In millions of U.S. dollars, unless otherwise stated) | | | | | |
| **Total net revenues** | **1,597** | **1,927** | **2,149** | **2,046** | **2,173** | **2,529** | **2,836** | **3,193** |
| Gross domestic revenues | 585 | 745 | 812 | 738 | 788 | 997 | 1,153 | 1,338 |
| Tax revenues | 301 | 474 | 512 | 483 | 535 | 597 | 653 | 738 |
| Nontax revenues (accrued) | 284 | 270 | 300 | 256 | 254 | 400 | 500 | 600 |
| Nontax revenues (cash) | 284 | 270 | 300 | 219 | 254 | 400 | 500 | 600 |
| Clearance revenues (accrued) | 1,103 | 1,259 | 1,442 | 1,424 | 1,508 | 1,666 | 1,830 | 2,015 |
| Clearance revenues (cash) | 1,090 | 1,242 | 1,558 | 1,489 | 1,508 | 1,666 | 1,830 | 2,015 |
| Clearance revenues (net arrears) | 13 | 16 | -116 | -66 | --- | --- | --- | --- |
| Tax refunds | 91 | 76 | 105 | 116 | 123 | 135 | 147 | 159 |
| **Total recurrent expenditures and net lending (commitment)** | **3,190** | **3,076** | **3,232** | **3,324** | **3,268** | **3,358** | **3,428** | **3,591** |
| Wage expenditures (commitment) | 1,467 | 1,613 | 1,709 | 1,783 | 1,838 | 1,930 | 2,026 | 2,128 |
| Wage expenditures (cash) | 1,423 | 1,564 | 1,709 | 1,678 | 1,838 | 1,930 | 2,026 | 2,128 |
| Wage expenditures (net arrears) | 44 | 50 | --- | 105 | --- | --- | --- | --- |
| Nonwage expenditures (commitment) | 1,349 | 1,227 | 1,363 | 1,401 | 1,322 | 1,348 | 1,362 | 1,443 |
| Nonwage expenditures (cash) | 1,142 | 1,156 | 1,363 | 1,143 | 1,322 | 1,398 | 1,412 | 1,493 |
| Nonwage expenditures (net arrears) | 207 | 71 | --- | 259 | --- | -50 | -50 | -50 |
| Net lending (commitment) | 374 | 236 | 160 | 140 | 108 | 80 | 40 | 20 |
| Net lending (cash) | 355 | 263 | 160 | 140 | 108 | 80 | 40 | 20 |
| Net lending (net arrears ) | 20 | -28 | --- | --- | --- | --- | --- | --- |
| **Recurrent balance (commitment, before external support)** | **-1,592** | **-1,149** | **-1,084** | **-1,279** | **-1,094** | **-829** | **-591** | **-398** |
| subtract: nontax revenue arrears | --- | --- | --- | 36 | --- | --- | --- | --- |
| add: expenditure arrears (net) | 270 | 93 | --- | 363 | --- | -50 | -50 | -50 |
| subtract: net clearance due (+) or repaid (-) | 13 | 16 | -116 | -66 | --- | --- | --- | --- |
| add: arrears on tax refunds due (+) or repaid (-) | -36 | -11 | --- | 103 | --- | --- | --- | --- |
| **Recurrent balance (cash, before external support)** | **-1,371** | **-1,083** | **-967** | **-783** | **-1,094** | **-879** | **-641** | **-448** |
| **Development expenditures (commitment)** | **430** | **299** | **500** | **370** | **350** | **500** | **700** | **900** |
| **Development expenditures (cash)** | **400** | **275** | **500** | **295** | **350** | **500** | **700** | **900** |
| **Development expenditures (arrears)** | **30** | **23** | **---** | **76** | **---** | **---** | **---** | **---** |
| **Overall balance (cash, including development expenditures)** | **-1,771** | **-1,358** | **-1,467** | **-1,078** | **-1,444** | **-1,379** | **-1,341** | **-1,348** |
| **Total financing** | **1,771** | **1,358** | **1,467** | **1,078** | **1,444** | **1,379** | **1,341** | **1,348** |
| Net domestic bank financing | 176 | 84 | --- | 137 | --- | --- | --- | --- |
| Other domestic financing | --- | --- | --- | --- | --- | --- | --- | --- |
| External financing for recurrent expenditures | 1,355 | 1,146 | 967 | 771 | 610 | 879 | 641 | 448 |
| External financing for development expenditures | 400 | 130 | 500 | 169 | 300 | 500 | 700 | 900 |
| Net external debt | -4 | --- | --- | --- | --- | --- | --- | --- |
| Residual | -156 | -3 | --- | 1 | 534 | --- | --- | --- |
| Memorandum items: | | | (In percent of GDP; unless otherwise stated) | | | | | |
| Revenues | 23.8 | 23.1 | 23.5 | 20.9 | 20.6 | 21.9 | 22.4 | 23.0 |
| Recurrent expenditures and net lending | 47.5 | 36.9 | 35.3 | 33.9 | 31.0 | 29.1 | 27.1 | 25.8 |
| Wage expenditures | 21.8 | 19.4 | 18.7 | 18.2 | 17.5 | 16.7 | 16.0 | 15.3 |
| Nonwage expenditures | 20.1 | 14.7 | 14.9 | 14.3 | 12.5 | 11.7 | 10.8 | 10.4 |
| Net lending | 5.6 | 2.8 | 1.7 | 1.4 | 1.0 | 0.7 | 0.3 | 0.1 |
| Recurrent balance (commitment) before external support: | -23.7 | -13.8 | -11.8 | -13.0 | -10.4 | -7.2 | -4.7 | -2.9 |
| Recurrent balance (cash) before external support | -20.4 | -13.0 | -10.6 | -8.0 | -10.4 | -7.6 | -5.1 | -3.2 |
| External support (recurrent) | 20.2 | 13.8 | 10.6 | 7.9 | 5.8 | 7.6 | 5.1 | 3.2 |
| in millions of U.S. dollars | 1,355 | 1,146 | 967 | 771 | 610 | 879 | 641 | 448 |
| Development expenditures (cash) | 6.0 | 3.3 | 5.5 | 3.0 | 3.3 | 4.3 | 5.5 | 6.5 |
| Overall balance (cash) | -26.4 | -16.3 | -16.0 | -11.0 | -13.7 | -11.9 | -10.6 | -9.7 |
| Total external support (in millions of U.S. dollars) | 1,755 | 1,277 | 1,467 | 940 | 910 | 1,379 | 1,341 | 1,348 |
| Nominal exchange rate (average; NIS per US dollar) | 3.9 | 3.7 | 3.7 | 3.6 | 3.7 | ... | ... | ... |
| Nominal GDP (in millions of U.S. dollars) | 6,720 | 8,331 | 9,163 | 9,809 | 10,532 | 11,551 | 12,639 | 13,892 |

Sources: Ministry of Finance; and IMF staff estimates.

# Table 3. Central Government Budget, 2009–15
## (In millions of shekels)

| | 2009 | 2010 | 2011 | | Proj. | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Budget | Year | 2012 | 2013 | 2014 | 2015 |
| | | | (In millions of shekels, unless otherwise stated) | | | | | |
| **Total net revenues** | **6,282** | **7,188** | **7,951** | **7,321** | **8,042** | **9,356** | **10,495** | **11,815** |
| Gross domestic revenues | 2,301 | 2,778 | 3,004 | 2,642 | 2,916 | 3,689 | 4,267 | 4,949 |
| Tax revenues | 1,185 | 1,769 | 1,894 | 1,727 | 1,978 | 2,209 | 2,417 | 2,729 |
| Nontax revenues (accrued) | 1,115 | 1,009 | 1,110 | 915 | 938 | 1,480 | 1,850 | 2,220 |
| Nontax revenues (cash) | 1,115 | 1,009 | 1,110 | 785 | 938 | 1,480 | 1,850 | 2,220 |
| Clearance revenues (accrued) | 4,338 | 4,695 | 5,335 | 5,095 | 5,579 | 6,165 | 6,773 | 7,455 |
| Clearance revenues (cash) | 4,286 | 4,634 | 5,765 | 5,330 | 5,579 | 6,165 | 6,773 | 7,455 |
| Clearance revenues (net arrears) | 52 | 61 | -430 | -235 | --- | --- | --- | --- |
| Tax refunds | 357 | 285 | 388 | 416 | 454 | 498 | 545 | 590 |
| **Total recurrent expenditures and net lending (commitment)** | **12,543** | **11,473** | **11,960** | **11,897** | **12,090** | **12,424** | **12,683** | **13,286** |
| Wage expenditures (commitment) | 5,768 | 6,017 | 6,325 | 6,381 | 6,800 | 7,140 | 7,497 | 7,872 |
| Wage expenditures (cash) | 5,596 | 5,832 | 6,325 | 6,007 | 6,800 | 7,140 | 7,497 | 7,872 |
| Wage expenditures (net arrears ) | 171 | 185 | 0 | 374 | --- | --- | --- | --- |
| Nonwage expenditures (commitment) | 5,304 | 4,575 | 5,043 | 5,015 | 4,890 | 4,988 | 5,038 | 5,340 |
| Nonwage expenditures (cash) | 4,490 | 4,312 | 5,043 | 4,089 | 4,890 | 5,173 | 5,223 | 5,525 |
| Nonwage expenditures (net arrears ) | 815 | 263 | 0 | 926 | --- | -185 | -185 | -185 |
| Net lending (commitment) | 1,471 | 880 | 592 | 501 | 400 | 296 | 148 | 74 |
| Net lending (cash) | 1,395 | 983 | 592 | 501 | 400 | 296 | 148 | 74 |
| Net lending (net arrears ) | 77 | -103 | --- | --- | --- | --- | --- | --- |
| **Recurrent balance (commitment, before external support)** | **-6,261** | **-4,284** | **-4,009** | **-4,576** | **-4,048** | **-3,067** | **-2,188** | **-1,471** |
| subtract: nontax revenue arrears | --- | --- | --- | 130 | --- | --- | --- | --- |
| add: expenditure arrears (net ) | 1,063 | 345 | --- | 1,300 | --- | -185 | -185 | -185 |
| subtract: net clearance due (+) or repaid (-) | 52 | 61 | -430 | -235 | --- | --- | --- | --- |
| add: arrears on tax refunds due (+) or repaid (-) | -140 | -39 | --- | 368 | --- | --- | --- | --- |
| **Recurrent balance (cash, before external support)** | **-5,391** | **-4,039** | **-3,579** | **-2,803** | **-4,048** | **-3,252** | **-2,373** | **-1,656** |
| **Development expenditures (commitment)** | **1,691** | **1,114** | **1,850** | **1,325** | **1,295** | **1,850** | **2,590** | **3,330** |
| **Development expenditures (cash)** | **1,573** | **1,026** | **1,850** | **1,054** | **1,295** | **1,850** | **2,590** | **3,330** |
| **Development expenditures (arrears)** | **118** | **88** | **---** | **270** | **---** | **---** | **---** | **---** |
| **Overall balance (cash, including development expenditures)** | **-6,964** | **-5,065** | **-5,429** | **-3,858** | **-5,343** | **-5,102** | **-4,963** | **-4,986** |
| **Total financing** | **6,964** | **5,065** | **5,429** | **3,858** | **5,343** | **5,102** | **4,963** | **4,986** |
| Net domestic bank financing | 691 | 312 | --- | 490 | --- | --- | --- | --- |
| Other domestic financing | --- | --- | --- | --- | --- | --- | --- | --- |
| External financing for recurrent expenditures | 5,328 | 4,276 | 3,579 | 2,759 | 2,256 | 3,252 | 2,373 | 1,656 |
| External financing for development expenditures | 1,573 | 487 | 1,850 | 605 | 1,110 | 1,850 | 2,590 | 3,330 |
| Net external debt | -16 | --- | --- | --- | --- | --- | --- | --- |
| Residual | -613 | -10 | --- | 4 | 1,977 | --- | --- | --- |
| Memorandum items: | | | (In percent of GDP; unless otherwise stated) | | | | | |
| Revenues | 23.8 | 23.1 | 23.5 | 20.9 | 20.6 | 21.9 | 22.4 | 23.0 |
| Recurrent expenditures and net lending | 47.5 | 36.9 | 35.3 | 33.9 | 31.0 | 29.1 | 27.1 | 25.8 |
| Wage expenditures | 21.8 | 19.4 | 18.7 | 18.2 | 17.5 | 16.7 | 16.0 | 15.3 |
| Nonwage expenditures | 20.1 | 14.7 | 14.9 | 14.3 | 12.5 | 11.7 | 10.8 | 10.4 |
| Net lending | 5.6 | 2.8 | 1.7 | 1.4 | 1.0 | 0.7 | 0.3 | 0.1 |
| Recurrent balance (commitment) before external support: | -23.7 | -13.8 | -11.8 | -13.0 | -10.4 | -7.2 | -4.7 | -2.9 |
| Recurrent balance (cash) before external support | -20.4 | -13.0 | -10.6 | -8.0 | -10.4 | -7.6 | -5.1 | -3.2 |
| External support (recurrent) | 20.2 | 13.8 | 10.6 | 7.9 | 5.8 | 7.6 | 5.1 | 3.2 |
| in millions of U.S. dollars | 1,355 | 1,146 | 967 | 771 | 610 | 879 | 641 | 448 |
| Development expenditures (cash) | 6.0 | 3.3 | 5.5 | 3.0 | 3.3 | 4.3 | 5.5 | 6.5 |
| Overall balance (cash) | -26.4 | -16.3 | -16.0 | -11.0 | -13.7 | -11.9 | -10.6 | -9.7 |
| Total external support (in millions of shekels) | 6,901 | 4,763 | 5,429 | 3,364 | 3,366 | 5,102 | 4,963 | 4,986 |
| Nominal exchange rate (NIS per US dollar) | 3.9 | 3.7 | 3.7 | 3.6 | 3.7 | … | … | … |
| Nominal GDP (in millions of shekels) | 26,424 | 31,073 | 33,902 | 35,105 | 38,967 | 42,738 | 46,763 | 51,400 |

Sources: Ministry of Finance; and IMF staff estimates.

# APPENDIX

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

*Clearance revenues, collected and transferred to the Palestinian Authority (PA) by the Government of Israel (GoI), are a major source of budgetary revenue. Given the already precarious liquidity situation, and the fact that there is little scope for a further increase in the PA's domestic debt, a prolonged interruption of clearance revenue transfers would trigger a crisis.*

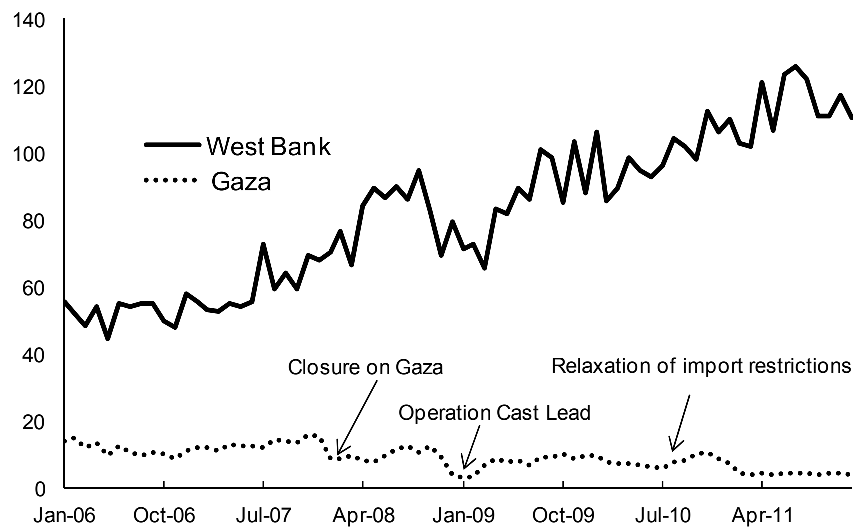
1. **The clearance revenue mechanism was established by the 1994 Oslo Accords, and set out in the Protocol of Economic Relations (the "Paris Protocol").** Israel and the West Bank and Gaza (WBG) form a customs union and their authorities levy and collect direct and indirect taxes. Indirect taxes (including customs duties, excise taxes, and VAT) are shared between the GoI and the PA on the basis of the "destination principle", with a monthly reconciliation of accounts. Direct taxes are shared on the basis of "services principle", which recognizes that most Palestinians working in Israel reside in the PA's territories, and thus benefit from services provided by the PA. According to the Paris Protocol, Israel is bound to transfer to the PA 75 percent of income taxes collected from Palestinians working in Israel and 100 percent of taxes collected from Palestinians working in the settlements. Israel levies a three percent collection and processing fee on all gross clearance revenues.

2. **Clearance revenues are recorded using a unified invoice system.** Any sales transaction between an Israeli and a Palestinian trader must be recorded in a uniquely numbered and coded invoice. Both sides are responsible for the collection of invoices from importers in their jurisdiction and for entering the information in an electronic database, which is the basis for transfers of revenues. Transfers of revenues take place monthly after reconciliation of accounts.

3. **The share of clearance revenue in total budgetary revenue has risen over time, and its regional composition has changed (Figure 1).** The share of clearance revenue in total revenue increased from an average of 62 percent in the 1990's, to about 70 percent in 2011. This has made the PA's budget more vulnerable to delays or suspensions of clearance revenue. The share of clearance revenue from Gaza diminished markedly from 18 percent in 2006, prior to the intensification of restrictions in mid-2007 (following Hamas' takeover of Gaza) to 7 percent in 2010. In 2011, there was a further decline in that share to 4 percent, reflecting the replacement of fuel imported from Israel with fuel imported from Egypt, and a reduction, enacted by the GoI in February 2011, in excise taxes on petroleum products.

[1] Prepared by Udo Kock and Hania Qassis. An earlier version is on the IMF Resident Representative website www.imf.org/wbg.

Figure 1. Clearance Revenue: Regional Composition
(In millions of U. S. dollars)




Source: Ministry of Finance

4. **The transfer of clearance revenues was suspended or delayed by the GoI on several occasions (Table 1).** In addition to past suspensions, in 2011 the GoI delayed the transfer of clearance revenues by about three weeks in May (after the PA signed a reconciliation agreement with Hamas) and again in November (after the PA's application for membership at the UN). The delays worsened the liquidity shortage faced by the PA and delayed the payment of salaries to public sector employees. In addition, because of the nonpayment of salaries, some WBG commercial banks experienced delinquencies on loans owed by PA employees. Repeated delays are bound to raise uncertainty among the Palestinian population, and undermine private sector and public employees' confidence in the ability of the PA to meet its financial obligations on time.

Table 1. History of Suspension of Transfer of Clearance Revenue by the Government of Israel

| Suspension period | Reason for suspension | Amounts withheld (In U.S. dollar millions) | Compensating donor mechanisms |
|---|---|---|---|
| Aug-Sep 1997 | Intensification of hostilities | 78 | Short-term credit facility from the EU. |
| Dec 2000-Dec 2002 | Second Intifada | 500 | Special Cash Facility from the EU, loans from the Islamic Development Bank, and the Emergency Services Support Project financed by IDA and European donors administered by the World Bank. |
| Mar 2006-Jul 2007 | Hamas' electoral victory and formation of government. | 1,100 | Temporary International Mechanism funded allowances for civil servants and expenditures for basic services outside of budget. |

Source: IMF staff reports various issues.

5. **A suspension of clearance revenues today would have a more disruptive impact on financial and economic conditions in the WBG than in the past.** First, the stock of domestic bank debt and domestic payment arrears is much higher today than at the onset of past episodes of suspension, and thus there is little scope to offset the suspension through further debt accumulation. Second, today clearance revenues represent a larger share of the PA's total revenues than in the past. Finally, donor aid has been diminishing in recent years, and since 2011 has not been adequate even to cover normal budgetary requirements. Furthermore, several donors, including the US and EU, are facing increasingly tight constraints on their aid budgets. This makes it less likely that donors would be as forthcoming as in the past to compensate the PA for the loss in clearance revenue. Thus a prolonged interruption of clearance revenue transfers would trigger a crisis.

## B. Impediments to Private Investment in the West Bank and Gaza[2]

*Political uncertainty and the restrictions on movement and access are a key barrier to private investment in the West Bank and Gaza (WBG). Nevertheless, the Palestinian Authority (PA) can still support a business-friendly environment by enhancing macroeconomic stability, ensuring sound fiscal management, and taking measures supportive of the private sector.*

6. **Low investment costs, a stable investment climate, and a level-playing field among businesses are essential for high rates of private investment.** The empirical evidence indicates that private investment rates tend to be especially high in countries with solid legal and regulatory frameworks, adequate infrastructure, low crime and corruption, and little red tape[3]. These features tend to reduce uncertainty facing investors and raise rates of return. A competitive business environment stimulates productivity, efficiency, and innovation. In the WBG, a sustained increase in private investment is essential to ensure high rates of growth and reduce the high rates of unemployment.

7. **Private investment growth has been very volatile (Figure 2).** The annual growth of real private sector investment has fluctuated between +50 and –30 percent since 1994. As a share of GDP, private investment rose to over 26 percent in 1999, before declining to a low of 11 percent in 2006. It then picked up in 2008 but fell to about 14 percent in 2011.

*What are the barriers to private investment in the WBG?*

8. **Political uncertainty and restrictions on the movement of goods and people are key impediments to private sector investment.**[4] The uncertainty induces entrepreneurs to

[2] Prepared by Bahrom Shukurov, based on earlier work by Rina Bhattacharya.

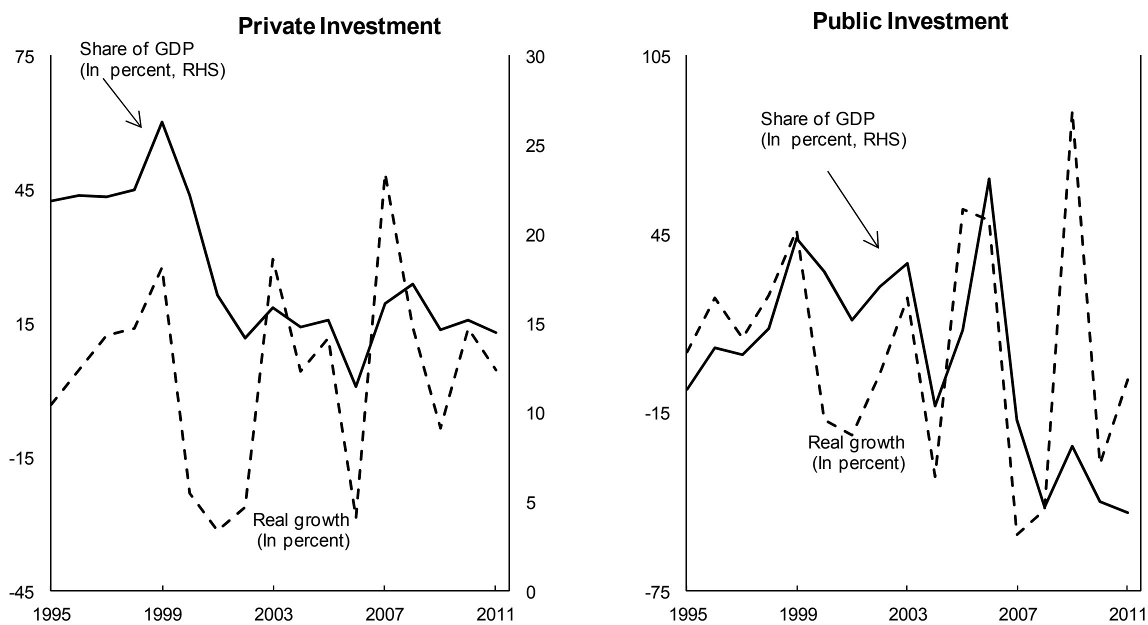
[3] "*Promoting Private Investment for Development*" (2006), Organization for Economic Cooperation and Development.

[4] For a comprehensive analysis of the impact of uncertainty and restrictions on movement and access on private investment incentives in the West Bank and Gaza, see "Private Investment under Uncertainty in the West Bank and Gaza Strip" by Oussama Kanaan, Chapter 3 in "*The Economy of the West Bank and Gaza Strip: Recent*

(continued)

postpone investments and discourages investments especially in commodity-producing sectors such as manufacturing and agriculture. The restrictions and barriers adversely affect the profitability of investment through their adverse impact on the average level of demand, and by increasing the volatility of demand. Costs are raised through higher transportation costs, difficulties in importing inputs, and through adjustment costs while adapting to fluctuating demand conditions. The adverse effects on the profitability of investment are particularly strong in the export sector, given the barriers on exports to Israel, while import controls have raised the relative profitability of import-substitution.

Figure 2. Private and Public Investment




Source: Palestine Central Bureau of Statistics and staff estimates.

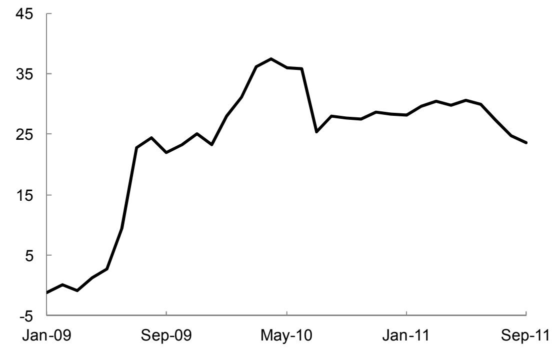
9. **Strengthening the WBG's infrastructure is also important to raise private investment.** In the WBG public and private investment are likely to be complementary—higher public spending on infrastructure will most likely 'crowd in' private sector investment. Much of the public infrastructure in the West Bank will need to be established in "Area C", in which Palestinian investment is restricted. Restrictions on investment in that area, in addition to limited aid for development projects, limit public investment in infrastructure, with an adverse impact on the productive capacity and growth potential of the Palestinian economy.

10. **The PA has taken steps to ease constraints on investment.** In particular, the supervisory and regulatory framework has been enhanced, and access to bank financing by creditworthy investors has been facilitated by the establishment of the credit registry

*Experience, Prospects, and Challenges to Private Sector Development*", Middle Eastern Department, IMF, Washington D.C.

(Figure 3). Efforts are now focused on strengthening the legal framework facing businesses, and ensuring its enforcement.

Figure 3. Private Credit Growth
(In percent, end of period)




Source: PMA.

11. **Other factors.** The perception of corruption as a constraint on private sector development in the West Bank is declining according to the survey conducted by the World Bank in 2011[5]. While the use of personal and family ties, and petty bribery, are still significant, large scale corruption has been diminishing. The 2010 Transparency International Global Corruption Barometer reports that about 60 percent of respondents indicate corruption has been declining. An internal West Bank survey conducted by the statistical office indicates that Palestinian entrepreneurs were most satisfied with fairness of the police, effectiveness of the courts, licenses and permits issuance, and labor laws (Table 2).

Table 2. Satisfaction with Public and Private Services
Among Business Owners in the West Bank, Q4 2011

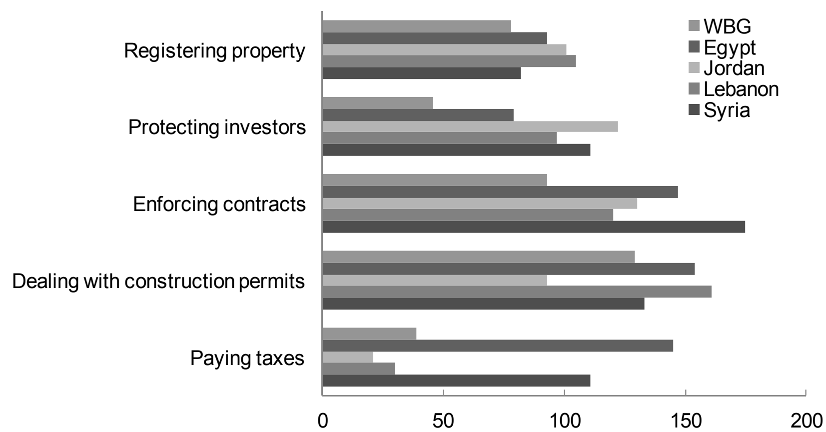
| Services | Satisfaction rate |
|---|---|
| | (In percent of total) |
| Fairness of the police | 91 |
| Telecommunications | 89 |
| Effectiveness of the courts | 80 |
| Licenses and permits | 75 |
| Labor laws | 74 |
| Water supply | 72 |
| Electricity supply | 71 |
| Transport and Communications | 70 |
| Provision of necessary permits and licenses | 69 |
| Tax administration | 69 |
| The quality of roads | 64 |
| Internet Service | 63 |
| Tax rate | 61 |
| Access to industrial areas | 56 |
| Access to information | 34 |
| Provision of information to enterprises | 34 |
| Promotion of policies for development of institutions | 33 |
| Access to governmental consulting and training | 26 |

Source: Palestinian Central Bureau of Statistics

[5] "*West Bank and Gaza: Improving Governance and Reducing Corruption*" (2011). World Bank, Wash., DC.

12. **The WBG ranks higher than its neighbors in several areas related to "business climate".** The 2012 *Doing Business* report ranks the WBG above Egypt, Jordan, Lebanon, and Syria on registering property, protecting investors, and enforcing contracts as well as on dealing with construction permits and ease of paying taxes (Figure 4).

Figure 4. Doing Business Rankings for WBG and Neighbors
(Lower number=better ranking)




Source: World Bank Doing Business 2012.

*How can the PA support private investment?*

**The PA can support private investment by:**

- ***Further strengthening the legal environment and enforcing existing laws.*** Another useful measure would be to complete the land registry to ensure clear titles to land and property. Improving land policy and registering all land would provide a major boost to private sector activity. Strengthening lenders' rights and their enforcement would encourage banks to lend to riskier projects. Cooperation with MIGA to provide SMEs with political risk guarantees would also have a favorable impact.

- ***Developing public infrastructure.*** The composition of government spending should continue to shift from wages and subsidies toward investments in physical infrastructure and human capital.

- ***Promoting competitiveness.*** Measures to strengthen the competitiveness include: (i) strengthening institutions such as the Palestinian Standards Institute and the Palestinian Trade Center to enhance investors' access to external markets; (ii) simplifying export and import procedures; (iii) improving access to trade finance, including through microfinance institutions; and (iv) establishing an independent regulator for the telecommunication sector.

## C. Reforms by the Palestine Monetary Authority

*The Palestine Monetary Authority (PMA)'s steady reforms, implemented with IMF technical assistance, have resulted in rigorous regulation and on-site and off-site supervision of banks in the West Bank and Gaza (WBG). The PMA uses a broad range of prudential instruments, including reserves ratios, capital requirements, liquidity ratios, as well as limits on credit concentration, outside placements, and currency exposure.*

13. **In 2010–11 the PMA has strengthened the supervision and regulatory framework and advanced toward the implementation of Basel II standards.** In January 2010, a unit was established in the Supervision Department to implement the Fair Lending Regulations and conduct financial literacy campaigns. In May 2010, the PMA issued Basel II compliant regulations governing the disclosure of information by financial institutions. In early 2011, President approved regulations for licensing and supervision of Specialized Lending and Financial Companies, including microfinance institutions. In August 2010, the PMA adopted regulations governing mergers and acquisitions in line with best practices. These regulations have already been applied to bank mergers. The PMA has also applied Basel standards and procedures when liquidating two banks in 2010. To further strengthen the banking system's capital base, the PMA introduced two measures in December 2010: (i) an increase in the minimum capital requirement to $50 million (from $35 million); and (ii) new "counter-cyclical" reserve requirements according to which banks should add 15 percent of their net (after tax) income to their Tier I capital as an additional "bad times" buffer. In May 2011, the PMA established a Consumer Awareness and Market Discipline department to monitor closely developments in the mortgage and housing markets. In March and June 2011, the PMA conducted stress tests of individual banks and the banking system to assess the robustness of the banks and the system to plausible shocks. Full implementation of Basel II standards is expected by mid-2013.

14. **The PMA established a modern payment infrastructure including bounced-checks tracking, credit scoring, and electronic payment systems.** The bounced-check tracking, in operation since 2009, has contributed to the decline in bounced checks by an estimated 25 percent. The credit scoring system, which was integrated into the credit registry in July 2010, is considered by banks to have been an important facilitator of the rise in the WBG's bank credit to the private sector. A bank deposit insurance scheme, developed with World Bank assistance, is expected to be ready by mid-2012. The PMA installed the electronic payment system in November 2010. It includes a Real Time Gross Settlement system (RTGS) and a Clearance House. The payment system raised bank payments' efficiency and reduced liquidity risk.

15. **The PMA and the Bank of Israel (BoI) have continued to facilitate cooperation between Palestinian and Israeli commercial banks.** In 2009, large shekel cash surpluses had accumulated at Palestinian banks due to Israeli banks' refusal to accept cash deposits on concerns about legal implications. That problem was addressed in July 2010 through a special arrangement whereby the excess shekel cash is regularly deposited at Israeli banks' accounts with the BoI. The PMA and the BoI are currently working on devising practical ways to ensure the timely and regular transfer into Gaza of cash amounts adequate to cover fully commercial banks' needs, without pre-set limits on the amount of U.S. dollars or Jordanian Dinars.

16. **A new Banking Law to strengthen the financial sector's legal framework was enacted in November 2010.** A new central bank law, which guarantees the independence of the PMA, is expected to be submitted to the cabinet for approval by end-March 2012, before Presidential approval. An Anti-Money Laundering (AML) law, prepared with technical assistance from the IMF and USAID, has been in force since October 2007. Since 2008, the PMA has been monitoring banks' compliance with a Basel committee compliant corporate governance code. The PMA is preparing its Monetary Operations Department for open market operations and the issuance of government securities and PMA Certificates of Deposits, including Sukuk certificates, with technical assistance from the Fund.

## D. Reforms in Public Financial Management

*Since 2007, the Palestinian Authority (PA) has made wide-ranging reforms to its Public Financial Management (PFM) system. The reforms have allowed the PA to control expenditures, apply rigorous budget preparation and execution practices, and establish fiscal transparency and accountability in line with international standards.*

17. **In mid-2007, the PA was faced with a PFM system that had been severely degraded by sanctions and mismanagement.** The Ministry of Finance (MoF) had to tackle a number of exceptional challenges, including aid inflows that bypassed it, fragmented banking arrangements, weak budget procedures, and lack of fiscal reporting. The government took prompt steps to establish a Central Treasury Account which centralized all revenue, expenditure, and recurrent aid inflows under the MoF's control. By early 2008 all budget procedures were restored, expenditure controls and cash management strengthened, and fiscal accounts developed in line with best practice. These measures allowed the preparation of an emergency budget in 2008–09 that was the basis for generous donor support in 2008-09.

18. **Major strides in PFM reforms have been taken by the PA since 2008, enabling an improvement in the quality of budgetary expenditures and their prioritization:**

- In 2008, a Financial Management Information System (FMIS) was developed to link the MoF to line ministries. The FMIS, rolled out to all line ministries in 2009, increased the ministries' ownership of financial management, and enhanced the quality of budget execution. At the same time a new web-based budget information system was developed and implemented by mid-2009. The new system enhanced communication between the ministries during annual budget preparations, in particular by facilitating the compilation of budget submissions and preparation of final budget documents. Since mid-2010, the FMIS has allowed the preparation of budgets based on ministries' program objectives, taking into account information on budget execution, which has helped ensure that those line ministries' requests for budget allotments are in line with the overall budget ceiling set by the MoF. In parallel, a new chart of accounts and budget classification consistent with GFSM 2001 were integrated into the FMIS.
- To make public finances transparent and encourage feedback by civil society, in 2008 the MoF started publishing on its website monthly data on expenditures, revenue, external aid, and public debt. The data are published fifteen days after the end of each month, along with quarterly reports on budget execution. A macro-fiscal unit was established at the MoF in November 2011 to prepare fiscal assessments and projections based on a medium-term macroeconomic framework.
- To stem expenditure arrears accumulation, the MoF integrated in 2010 the Commitment Control System (CCS) into the FMIS. The purpose of the CCS is to cap expenditure commitments by line ministries at "purchase orders" levels authorized by the MoF's General Accountant. Prior to the development of the CCS, line ministries tended to make commitments at budgeted levels not accounting for cash availability. A key objective of the MoF since 2011 has been to enforce the matching of commitments with cash availability to minimize arrears accumulation.
- In 2009, the MoF established procedures to enable regular external audits of its annual financial statements, in line with best international practice. The Supreme Audit and Administrative Control Bureau (SAACB) audited the 2008 financial statements in 2010 with assistance from Deloitte and Touche. The SAACB audited 2009 financial statements in 2011. The MoF submitted the 2010 financial statements to the SAACB in September 2011.

19. The MoF, with IMF technical assistance, has set out a medium-term program to further strengthen the PFM, with the following key objectives for 2012:

- Ensure that line ministries do not make expenditure commitments that exceed amounts under "purchase orders" authorized by the MoF's General Accountant. This will require the integration into the FMIS of the "procurement module", with expenditure commitments recorded at the time a purchase order is entered into the system, as opposed to when the first payment is made for that purchase.

- Further strengthen the legal and regulatory framework underpinning the budget process, including through the preparation and adoption of a new organic budget law. This will involve defining the framework of the commitment control system, and introducing a new budget classification structure to further enhance the budget's preparation and execution.

- Develop the macro fiscal unit to enable MoF staff to complement the monthly fiscal reports, currently posted on the MoF website, with timely analyses of fiscal performance along with policy implications. These analyses would be steadily expanded to allow forecasting of key fiscal variables, taking into account a medium-term macroeconomic framework.