MEDIUM-TERM MACROECONOMIC AND FISCAL FRAMEWORK
FOR THE WEST BANK AND GAZA

REPORT FOR THE DONORS' CONFERENCE

Paris, December 17, 2007

MEDIUM-TERM MACROECONOMIC AND FISCAL FRAMEWORK FOR THE WEST BANK AND GAZA[1]

EXECUTIVE SUMMARY

Following the passage of the 2007 emergency budget, the Palestinian Authority (PA) has initiated a number of fiscal reforms. Despite political uncertainty and a difficult security situation, a prudent fiscal policy is being pursued, including through a strict government employment policy and a tightening of nonwage spending commitments. The medium-term macroeconomic and fiscal framework adopted by the authorities builds on the improved fiscal performance in the second half of 2007. It aims at steadily reducing the recurrent budget deficit by an average of 3.7 percent of GDP per year during 2008–10. The fiscal adjustment will rely on sustained reduction in recurrent expenditures and net lending, in particular through: (i) a freeze in the wage rate and on new employment (except for health and education); (ii) measures to lower subsidies for utility bills; and (iii) continued improvements in the public finance management system. The staff considers that the contemplated adjustment is ambitious but also achievable, especially given the track record since June 2007.

Sustained fiscal adjustment by the PA will be facilitated by solid private sector growth. The West Bank and Gaza (WBG)'s growth is heavily reliant on trade with Israel and the free movement of goods and people within the territories. In addition, the revival of private investment will require a major reconstruction effort. Thus it is essential that Israeli restrictions on movement and access be relaxed. Donor assistance will also need to be scaled up, both to finance the recurrent budget deficit (an average of $1.3 billion per year over 2008-10) and for the public investment program (an average of $550 million per year). With these expectations, real GDP would then grow by an average of 5 percent per year over 2008–10. Given the population growth of 4 percent per year and rapid rise in the labor force, real income per capita would rise only slightly, and the rate of unemployment would not decline significantly. A more ambitious relaxation of restrictions by Israel and greater assistance by donors will be needed to substantially raise living standards.

Close cooperation among all three parties, the PA, the government of Israel, and donors, is thus critical to the success of the medium-term strategy. From the perspective of any one of the parties, going forward presents some risks, especially given past experiences of disappointed hopes at similar junctures. However, the alternative of not moving ahead implies a continued downward spiral for the WBG economy, with rising unemployment and poverty, which would ultimately be costly to the WBG and to Israel.

[1]This report was prepared by a team composed of Oussama Kanaan, Henry Ma, Bright Okogu, Joël Toujas-Bernaté, and Roman Zytek.

I. RECENT ECONOMIC DEVELOPMENTS

1. **The Palestinian economy is beginning to emerge from the very difficult phase it entered in early-2006.** In 2006, GDP is estimated to have fallen by about 8 percent in real terms, leaving real GDP per capita almost 40 percent below its 1999 level. The contraction reflected the destruction of physical infrastructure during the Israeli incursion into Gaza, the limited financing for government spending as a result of financial sanctions, and increased uncertainty about the Palestinian territories' prospects. The ending of financial sanctions since June 2007 has eased the liquidity situation of the Palestinian Authority (PA) and improved private sector confidence. This has led to some rebound of economic activity in the West Bank, offsetting the contraction in the first half of 2007. However, the tight closures around Gaza since June 2007 have led to a significant decline in private sector activity there. Taking into account the negative impact of Gaza's isolation, real GDP growth for the West Bank and Gaza (WBG) is projected to be zero in 2007.

2. **Unemployment and poverty remain high, especially in Gaza.** The unemployment rate was about 33 percent in Gaza and 19 percent in the West Bank in the third quarter of 2007. According to the United Nations Development Programme, in July 2007, 70 percent of households in Gaza and 56 percent in the West Bank lived below the poverty line. The situation in Gaza is expected to remain dismal as long as primary border crossings allow only imports of humanitarian aid and basic commodities, and are virtually sealed for exports.

3. **Inflation is low, at about 3 percent in the year to September 2007.** Price increases in the WBG largely mirror inflation developments in Israel, and have been dampened by the appreciation of the New Israeli Shekel (NIS) since 2006. While inflation has been tempered by the decline in Palestinian consumers' income, particularly in Gaza, prices continue to be pushed up by high transport costs due to restrictions on the movement of goods. More recently, increases in world prices of wheat and petroleum have contributed to large price increases for some basic products.

4. **Despite the difficult economic environment, bank deposits continued to grow**, largely reflecting remittances from the Palestinian diaspora. Deposits increased by 19 percent in the year to September 2007, raising the deposits-to-GDP ratio to about 100 percent. While total credit increased by 8 percent in the West Bank in the 12 months to September 2007, it contracted by about 33 percent in Gaza, reflecting relatively depressed investment in that region. The share of nonperforming loans in total bank loans, after increasing in 2006, remained stable at about 14 percent in 2007.[2] Overall, risks to banks' balance sheets persist, especially following Gaza's isolation and its likely adverse impact on asset quality.

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[2] The increase in the NPL ratio in 2006 reflected in particular the defaults by many PA employees who were not paid their full salary.

5. **The Palestine Monetary Authority (PMA) has strengthened prudential and regulatory standards.** It has been coordinating closely with the Bank of Israel to ensure continued smooth financial relations between Israel and the WBG in a difficult political environment. These efforts have intensified following the decision by two Israeli banks (Bank Hapoalim and Discount Bank) to stop acting as clearing institutions (in NIS) for Palestinian banks in Gaza. A new Anti-Money Laundering law has been adopted, while the new banking and PMA laws are being finalized and are expected to be enacted during the first half of 2008. The PMA continues to make considerable progress on internal reform and capacity building with technical assistance from the IMF, the World Bank, and other providers.

II. Fiscal Developments in 2007

6. **The PA is emerging from a liquidity crisis that followed the formation of the Hamas-led government in early 2006.** In 2006, budgetary resources fell by over a third compared to 2005, despite a doubling of external budgetary assistance, leading to a severe contraction in cash spending. The decline in resources reflected: (i) the withholding by Israel of the indirect taxes (i.e., “clearance revenues”) it collects on behalf of the PA; (ii) the reduction of commercial banks’ loan exposure to the PA; and (iii) the fall in domestic revenues due to the contraction in economic activity. The Public Finance Management System (PFMS) became fragmented as donors disbursed through channels outside the control of the Ministry of Finance (MoF), and some previous PFMS reforms were reversed. The wage bill rose, as did nonwage expenditures for the emergency needs of the population and the cost of energy and utilities. On a commitment basis, the fiscal deficit reached $1.2 billion, or 26 percent of GDP. About $0.9 billion in expenditure arrears were accumulated, owed to government employees, who received only 60 percent of their regular salaries in 2006, as well as to the pension fund and private sector suppliers.

7. **Liquidity difficulties continued in the first half of 2007**. Clearance revenues continued to be withheld, while domestic revenues remained subdued. Expenditure commitments increased at a faster pace than in 2006, reflecting the rise in the wage bill due to a surge in government employment (largely security personnel), and an increase in net lending due to the higher cost of petroleum imports and nonpayment of utility bills. Domestic financing from commercial banks remained unavailable, and past commercial bank loans had to be repaid through liquidation of government assets. Despite higher than expected external financing amounting to $560 million, the stock of arrears accumulated since January 2006 rose by another $400 million to reach $1.3 billion (27 percent of GDP) by end-June 2007.[3]

[3] The stock of arrears accumulated before end-2005 is not known with full certainty, but includes at least $240 million due to the General Pension and Insurance Corporation.

8. **The PA's fiscal situation has improved since the appointment of the new government led by Prime Minister Salam Fayyad in June 2007**, reflecting positive developments for budgetary revenues as well as expenditures:

- Israel resumed transferring clearance revenues in July, enabling the full payment of wages since then in all of the West Bank and Gaza. Most of the stock of clearance revenues collected between February 2006 and July 2007 (net of deductions for payments of utilities and of transfers to the PA made during this period) has been transferred, with a final monthly installment expected in December.

- Total revenues have picked up owing to the rebound in economic activity in the West Bank. This has more than offset the noncollection of domestic revenue from Gaza (about 20 percent of total domestic revenue). Furthermore, the impact of Gaza's economic slowdown on clearance revenues has been moderated by the relocation of some major traders from Gaza to the West Bank.

- On the expenditure side, the wage bill contracted (by an estimated 8 percent in NIS terms) in July due to the permanent retrenchment of about 20,000 security employees. While no cuts in nonwage expenditures or net lending were made, positive revenue developments have stemmed the accumulation of expenditure arrears.

- Expenditure control has been aided by the reestablishment of the Single Treasury Account (STA) at the MoF and by the restoration of pre-2006 cash controls. In July 2007, a mission from the IMF's Fiscal Affairs Department reviewed the MoF's public finance management system. Its assessment was that the MoF is once again ready to receive donor funds directly through the STA.

9. **Nevertheless, the fiscal deficit for 2007, projected at 28 percent of GDP, remains extremely high and is unsustainable**. It has been possible to finance it this year only because of exceptional factors, including the transfer of clearance revenues from amounts withheld in 2006. While the strict employment policy put in place is essential for fiscal sustainability, it will need to be supplemented by measures to contain net lending and further tighten controls on nonwage spending commitments.

West Bank and Gaza: Central Government Fiscal Operations (Commitment Basis), 2005-10
(in millions of US dollars, unless otherwise stated)

	2005	2006	2007	2008	2009	2010
			Projection			
Total revenues	1,233	1,149	1,186	1,289	1,418	1,578
Total recurrent expenditures and net lending	1,994	2,310	2,553	2,521	2,567	2,624
Recurrent balance before external budgetary support	-762	-1,161	-1,367	-1,232	-1,149	-1,046
External budgetary support	349	738	907	1,361	1,328	1,250
Recurrent balance after external budgetary support	-413	-423	-460	129	179	204
Other financing	413	423	460	-129	-179	-204
Net expenditure arrears (+)	0	884	30	-125	-175	-200
Net revenue arrears (-)	137	-427	430	0	0	0
Palestinian Investment Fund and banks	477	-26	0	0	0	0
Net external debt	0	0	0	-4	-4	-4
Residual	-202	-8	0	0	0	0
Memorandum item						
Recurrent balance before external budgetary support (as percent of GDP)	-17	-26	-28	-24	-20	-17

Sources: Ministry of Finance, and IMF staff estimates and projections.

III. The Macroeconomic and Fiscal Framework

10. **Any realistic outlook for the Palestinian economy needs to take into account several special factors that have in the past dominated its growth and development**:

- The WBG has always been heavily reliant on trade with Israel, both for its growth as well as public finances. Since 1967, over 75 percent of its exports and imports of goods and services have gone to or come from Israel.[4] In addition, remittances from WBG workers employed in Israel represented over 25 percent of Gross National Income until the number of worker permits was curtailed in 2002. The resulting pattern of economic growth has been greatly influenced by the intensity of Israeli restrictions on movement and access of goods and people across WBG's borders. This has been compounded by internal restrictions that hinder movement within the WBG. Furthermore, about two thirds of the PA's budgetary revenues comes from taxes collected by Israel on behalf of the PA.

- The PA's economic strategy as set out in the 1993 Oslo Accords aimed at fostering private sector-led, outward-oriented growth. In the absence of a domestic currency, fiscal policy has been its only macroeconomic management tool. That policy has been dominated in recent years by the need to contain the erosion in living standards and rising unemployment stemming from the recurrent border closures, intensified trade restrictions, and internal turmoil. Since the late 1990s, the PA has at times adopted lax

[4] This reflected Israel's much larger economy (with a GDP about twenty times as large as that of the WBG), its long border with the WBG, weak transport links with Jordan and Egypt, and the lack of a functioning seaport and airport.

policies by absorbing large numbers of new employees (Box 1) and granting significant wage increases, as well as increasing direct and indirect social transfers. As a result, a large share of government resources has been diverted from institution building toward emergency assistance, social transfers and subsidies, and the use of government employment as a de facto social safety net.

- Donor assistance was expected to be geared toward public investment to strengthen the WBG's weak productive base and infrastructure. However, a large part of donor assistance has ended up financing the PA's recurrent budget deficit. The budget's external financing requirements grew with the rising trend of government employment, and were especially large during periods of tight trade restrictions and when clearance revenues were withheld by Israel. Public investment has also been slowed by the restrictions on the flow of raw materials, capital goods, and personnel.

11. **Against this background, the PA's macroeconomic framework for 2008–10 is based on all parties (the PA, the government of Israel, and donors) working together constructively to foster sustainable growth in the WBG**. It assumes:

- An improvement in the trade environment as a result of a modest relaxation of the restrictions to the levels that prevailed in 2000.[5] Restrictions around Gaza would be sufficiently relaxed to allow the unhindered flow of humanitarian assistance and inputs for public investment projects. The resulting improved confidence and better trade conditions would lead to a recovery of trade and private investment, and enable an acceleration in the public investment program.

- The PA would pursue a prudent fiscal policy based on a tight expenditure stance. The expansion of private sector activity noted above would enable a sustained reduction in the budget deficit based on a strict government employment policy and a wage freeze, as well as lower implicit subsidies to cover municipalities' utility payments.

- Donors would scale up their financial assistance to the PA to cover both the recurrent budget deficit and larger public investment.

[5] Restrictions on the employment of Palestinian workers in Israel are assumed to persist.

Box 1. Government Employment and Wages

The wage bill accounts for about half of the PA's budget expenditures and exceeds its tax and nontax receipts. The PA public sector consists of the central government, municipalities, and public enterprises (mostly utilities managed by municipalities). The majority of government employees are paid from the central government budget. Government employment rose from just 20,000 in 1993, to about 164,000 by mid-2007, or from 4 percent to 18 percent of the WBG labor force. The PA security force accounted for about 50 percent of government employment in the first half of 2007. In 2006, the PA spent 27 percent of GDP on wages and salaries, which was slightly more than it collected in taxes, compared to less than 10 percent of GDP in 1993 and the 5–10 percent of GDP typically spent on the government payroll in most developing and industrialized countries.

PA employment has been heavily influenced by political and economic developments. Though the rapid increase in public sector employment in 1993–95 was warranted by the formation of the PA government, the expansion in the public payroll since 1999 resulted from the PA's becoming the "employer of last resort" as a direct response to the sharp deterioration in the labor market during the second Intifada. During 1999–2002, the number of permits for Palestinian workers in Israel and Israeli settlements fell from 136,000 to 49,000. More jobs were lost due to economic dislocations resulting from the tightened restrictions on movement of goods and people within the WBG. Facing an increase in the unemployment rate from under 12 percent in 1999 to 32 percent of the labor force in 2002, the PA increased its payroll by 80 percent (66,000 employees) during 1999-2007.

The strong growth in PA employment was accompanied by a surge in compensation. The average wage in the public sector rose by a cumulative 27 percent during 2003–07, compared to a cumulative price increase of 12 percent and a cumulative increase in the average wage in the private sector of 14 percent. Wages for security personnel increased by 28 percent in 2005 alone.

12. **Under the baseline scenario with the above assumptions and policy expectations, real GDP growth would increase from near zero in 2007 to 3.5 percent in 2008, 5 percent in 2009, and 6 percent in 2010** (Table 1). The rise in donor-funded and private sector investments would gradually offset the impact of fiscal consolidation as well as lay the foundations for longer-run sustainable growth. The share of public consumption in GDP would decline by 6 percentage points over 2007–10, making room for a steady rise in public investment (6 percentage points) and private investment (2 percentage points). Reflecting the gradual relaxation of trade restrictions, real export growth would conservatively average only 6 percent, while real import growth would be somewhat higher at 7 percent, reflecting strong demand for raw materials and capital goods.[6]

[6] The impact of the gradual relaxation of trade restrictions on export volumes is conservatively projected given the uncertainty on the speed of recovery of the export sector, especially following several years of slump and continued lack of a functioning seaport and airport.

13. **This moderate economic recovery would result in only a slight rise in living standards and little change in unemployment**. With population and the labor force both growing by about 4 percent per year, real income per capita would rise by only about 1.5 percent per year over 2008–10, while the rate of unemployment would remain at a high rate of about 23 percent. Living standards would therefore not improve significantly.

14. **Alternative scenarios were developed to assess the implications of pessimistic and optimistic assumptions and policy decisions**.

- Under the pessimistic scenario, Israeli restrictions would remain unchanged, inhibiting trade and private investment, and hindering the implementation of the donor-financed public investment program. The consequent depressed economic conditions and rising unemployment would prevent fiscal consolidation, leading to expenditure arrears accumulation and a widening recurrent financing gap. Real GDP per capita would decline by an average of 2 percent per year in 2008–10. Under these conditions, social unrest could erupt and disrupt public services delivery.

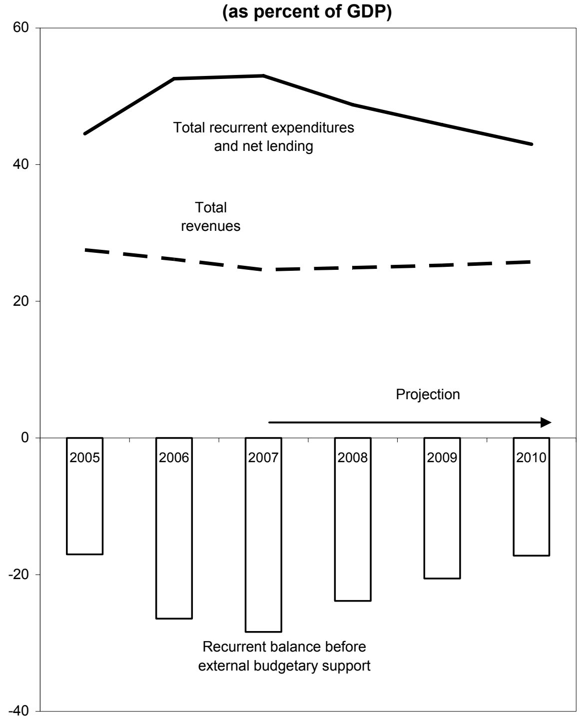
- In an optimistic scenario, Israeli restrictions would be eased to the levels of the early 1990s, enabling the flow of goods and people across the WBG's borders. This would result in a marked rebound in private and public investment, with real GDP increasing by an average rate of 8 percent per year over 2008–10, and living standards steadily improving. In such a scenario, the fiscal adjustment could be more significant and rapid, as public employment and social transfers could more easily be reduced.

15. **Fiscal consolidation over the medium term, underpinned by the above macroeconomic framework, is a core component in the Palestinian Reform and Development Plan (PRDP)**. The PRDP envisages a sustained reduction in the recurrent budget deficit, from 28 percent of GDP in 2007 to 17 percent of GDP in 2010, about the same level as in 2005 (Figure 1). Revenues would rise modestly through better compliance and improvements in tax administration. While all categories of expenditure would fall as a share of GDP, the savings would largely come from containing the wage bill and net lending. No recourse to domestic bank financing is envisaged. Significant external financial support will remain necessary, to fully cover the recurrent fiscal deficit and to pay for arrears reduction. An average of $1.3 billion per year would be needed to cover the recurrent deficit, and another $550 million per year to cover the public investment program, with the composition shifting toward public investment over time (Table 2).

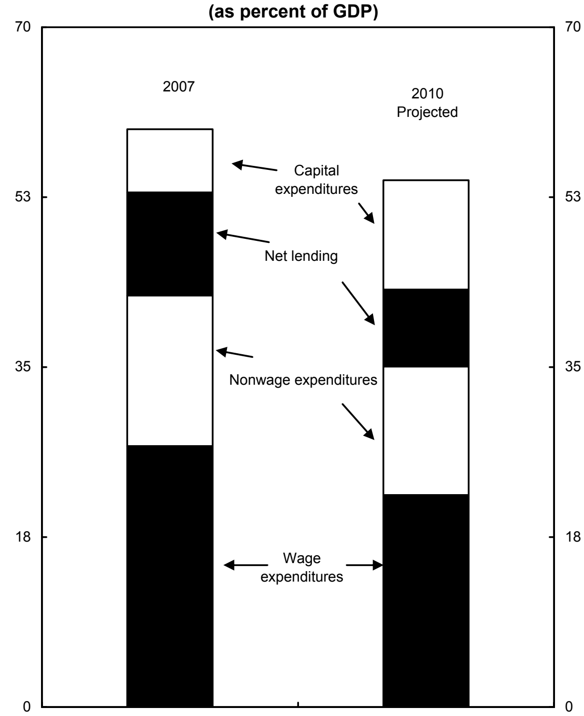
Figure 1. West Bank and Gaza: Fiscal Developments

Substantial fiscal adjustment is envisaged, with a shift toward capital expenditures.

Fiscal Indicators
(as percent of GDP)

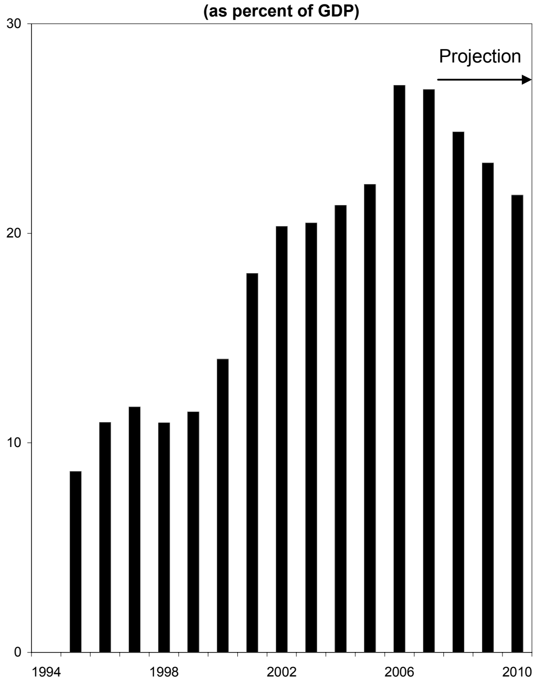


Public Expenditures, 2007 and 2010
(as percent of GDP)

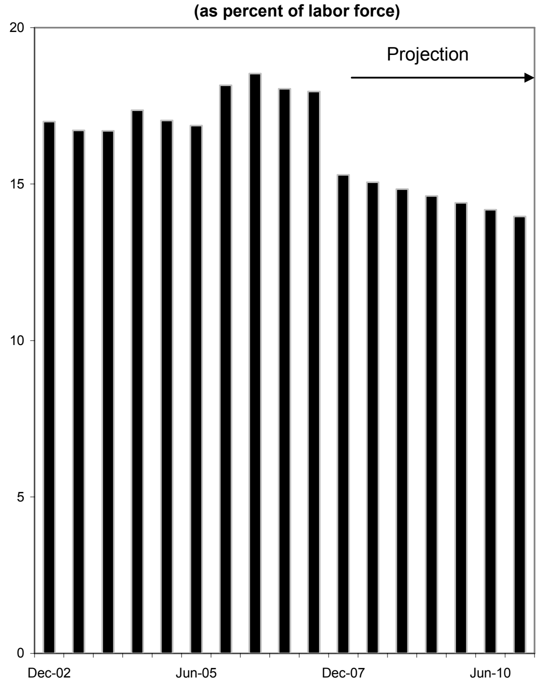


The rise in the PA's employment and wage bill was reversed in 2007.

Palestinian Authority Wage Bill, 1994-2010
(as percent of GDP)



Palestinian Authority Employment, 2002-10
(as percent of labor force)



Sources: Ministry of Finance and IMF staff estimates.

West Bank and Gaza: Medium-Term Fiscal Outlook, 2005-10
(In percent of GDP; unless otherwise stated)

	2005	2006	2007	2008	2009	2010
			Projection			
Revenues	28	26	25	25	25	26
Recurrent expenditures	45	53	53	49	46	43
Wage expenditures	22	27	27	25	23	22
Nonwage expenditures	14	17	15	15	14	13
Net lending	8	9	11	9	8	8
Recurrent balance	-17	-26	-28	-24	-20	-17
Externally financed capital expenditures	6	4	6	8	10	11
(millions of US dollars)	287	173	306	427	550	667
Overall balance	-23	-30	-35	-32	-30	-28
External support for recurrent budget	8	17	19	26	24	20
(millions of US dollars)	349	738	907	1,361	1,328	1,250

Sources: Ministry of Finance; and IMF staff estimates and projections.

16. **Fiscal adjustment is predicated on a fall in recurrent expenditures by 3-4 percentage points of GDP per year**, based on the following measures:

- A freeze will be placed on the wage rate and on new employment, except for the net additional recruitment of up to 3,000 health and education personnel per year. This implies a steady fall in the share of PA employment in the total labor force from about 18 percent in mid-2007 to 14 percent by 2010.

- Nonwage real expenditures will be held constant. A strengthening of cash management and spending commitment controls (Box 2) would allow higher quality and better prioritization, and help prevent arrears accumulation.

- To curb net lending, a range of measures will be implemented to improve the incentives of municipalities and households to pay their electricity bills (Box 3). At the same time, assistance will be targeted to cushion the impact of stricter payment enforcement on the poorer groups.

- An arrears-reduction plan will be adopted to repay about $500 million in wage arrears and arrears to the private sector and pension fund over 2008–10. This would still leave about $400 million in unpaid 2006 expenditure arrears.

- The revenue-to-GDP ratio (already one of the highest in the region) is envisaged to increase slightly, taking into account the impact of: (i) the rise in private income in the West Bank and consequent improved compliance; (ii) the noncollection of domestic revenues from Gaza; and (iii) improvements in tax administration (Box 4).

Box 2. The PA's Plan for Reforming Public Financial Management

Further reforms to the Public Finance Management System (PFMS) will help in implementing the fiscal consolidation strategy. The government will continue to build on the restoration of cash controls and the reestablishment of the Single Treasury Account (STA), and will further reform the PFMS, focusing on budget implementation, expenditure control, and cash management.

A major change in the PFMS is planned to take effect in early 2008, with the establishment of a new General Accountant department in the Ministry of Finance (MoF), accompanied by a new accounting system. The General Accountant will supervise treasury, cash and debt management, budget execution, payroll, and accounting and reporting. The new accounting system will cover the entire expenditure cycle, starting with planned commitments by line ministries, authorization by the General Accountant for envelopes of commitments, up to final payment by treasury. This new system will initially cover the MoF, the Ministry of Education, and the Ministry of Health, and will be expanded to all other ministries in the course of 2008. It will allow for decentralizing budget execution to line ministries, while ensuring continued effective control by the MoF over total expenditure. With line ministries' increased responsibility in allocating resources, public spending is expected to become more efficient and better targeted. The new accounting system will also allow for more comprehensive and timely reporting on fiscal operations.

The new structure and system are also expected to improve the alignment of spending with available resources, through a strengthening of cash management and planning. Line ministries will provide monthly reports of commitment and cash spending plans to the General Accountant; the General Accountant's cash management unit will prepare cash forecasts, which in turn will guide the General Accountant's directives to line ministries about spending envelopes for the coming period. As a result, the risks of accumulating new arrears will be minimized. Moreover, ministries' cash balances with banks will be cleared daily, promoting more efficient overall cash management.

Work is ongoing to integrate the investment budget into the overall PA budget, in particular to ensure: (i) the channeling of all project-related disbursements through subaccounts to the STA; (ii) the consolidation of the information on future investment provided by the donors into a comprehensive database of development projects that is routinely updated; and (iii) the monitoring of the implementation of all projects, in close coordination with the Ministry of Planning, and the preparation of periodic reports on the status of projects financed from the PA's own resources.

Box 3. Net Lending

Net lending refers to the PA's financial support to municipalities and other public entities, chiefly to cover utility expenses. These outlays are recorded as "net lending" because they are notionally eventually payable by these entities and therefore accumulate as assets on the PA's balance sheet. Net lending is conducted in two ways: (i) the PA provides cash to these entities (45 percent of total net lending in 2006-07); and (ii) the Government of Israel deducts from the clearance revenues due to the PA to cover Palestinian municipalities' overdue utility payments, 80 percent of which are owed to the Israel Electricity Company (IEC).

During the first half of 2007, net lending amounted to $273 million, consisting of $131 million in direct outlays and $142 million in deductions. The largest outlays were: (i) deductions for overdue payments to the IEC ($126 million); (ii) rebates to the Palestinian Petroleum Agency for part of the taxes it incurs on purchases of petroleum products ($74 million); and (iii) purchases of fuel for the Gaza Power Plant ($47 million).

The large sum for electricity reflects poor collection from end-users, averaging 70 percent in the West Bank and only 15–20 percent in Gaza, and persistent failures by municipalities, which are tasked with collecting from customers, to fully remit their collections to the IEC, due to their own spending needs. Hence, deductions from clearance revenues to cover unpaid bills have been mounting, reducing the PA's fiscal resources and control.

Accordingly, the PA's planned measures to contain the growth of net lending for electricity are aimed at both improving compliance by end-users and ensuring prompt remittance by municipalities.

- Consumers will be required to produce certificates of payment compliance in order to obtain vehicle licenses, tax refunds, and other government services, and PA employees will be subject to salary deductions for unpaid bills. The use of prepaid meters will be expanded to eventually cover about 300,000 customers in 3 years, to prevent the accumulation of unpaid bills and encourage electricity savings. To ensure that these measures do not adversely affect the poor and vulnerable, the PA plans to establish a targeted social safety net program. In the interim, prices will be discounted for specific sectors, such as refugee camps or households with low electricity consumption.

- Discussions will be held with municipalities to generate broad support for the reforms and to agree on strategies for prompt remittance of collections. Eventually, the municipalities' power distribution functions will be moved and consolidated into two distribution companies that will be partly owned by the PA, but privately operated to ensure efficiency and sufficient investment. Finally, municipal financing will be reformed to enhance municipalities' access to resources and reduce their need for withholding remittances.

The PA's efforts will focus only on the West Bank initially, which accounts for about 45 percent of deductions from clearance revenues for electricity based on historical data; hence, savings expected from the above measures will be relatively limited. Meanwhile, net lending for consumption of electricity in Gaza and for all other utilities will continue and will likely increase, particularly if world oil prices rise further. Reflecting the above measures, net lending to the Jerusalem Electricity Company and on electricity use in the West Bank would be cut by 50 percent in 2008, and 70 percent by 2010. Net lending would total about $477 million (8 percent of GDP) by 2010. Without such measures, total net lending would rise to about $580 million by 2010 (9.5 percent of GDP).

Box 4. Tax Administration Measures

At about 25 percent of GDP in 2006–07, the WBG's revenue-to-GDP ratio is one of the highest in the region, and also ranks high when compared to other countries with similar levels of income per capita. Nevertheless, given the severity of the fiscal crisis, the MoF intends to further strengthen tax collection through several administrative and technical measures. In particular, the computerization of taxpayers records will be strengthened, to allow better follow-up of compliance. Efforts will initially focus on some key strategic economic sectors; later, the creation of a unified revenues administration, including a Large Taxpayers Unit, will be further studied and implemented. A preparatory step to that end will be completing the computerization of tax administration under the PATACS project. Starting in 2008, the strengthening of control and supervision at border crossings, coupled with the computerized customs system, will help improve the monitoring and control of the tax base related to international trade.

17. **The preparation of the 2008 budget is under way on the basis of the above fiscal framework.** To guide the MoF's allocation of the framework's 2008 expenditure envelope, each line ministry and agency is providing detailed inputs on (i) its core objectives for the next three years, with a special focus on 2008; and (ii) the financial resources required for the fulfillment of those objectives. The Cabinet is expected to approve the budget by end-2007.

Assessment

18. **Staff considers that the contemplated fiscal adjustment is ambitious but also achievable.** Its credibility is enhanced by the fact that important measures have already been implemented in a difficult political environment, in particular the retrenchment of security personnel and tightening of expenditure commitment controls.

19. **The adjustment will require the prompt implementation of the structural reforms set out in the PRDP.** These will involve:

- A full-fledged civil service reform to raise public sector efficiency. The reform should guide the magnitude of needed retrenchment across sectors and apply an appropriate salary scale. It should also be supported by reforms aimed at delivering a leaner and more cost-effective PA security force. While the staff understands the difficulty of further retrenchment given the political circumstances, further cuts would be desirable as private sector growth picks up.

- The streamlining and efficient targeting of social transfers toward the truly needy. The authorities will need to utilize the ongoing work by the World Bank to implement a social safety net based on a reliable database of needy households.

- Measures to improve the collection of electricity bills. The World Bank has offered to facilitate their implementation through assistance in the areas of electricity sector reform, a review of municipalities' public finances, and steps to protect the poorer groups as payment enforcement is tightened.

- A comprehensive reform of the public pension system to restore its viability (Box 5).

Box 5. Fiscal Aspects of Public Pensions

Pension benefits for public sector retirees are the largest single source of social protection.* In 2008, about $165 million (3.2 percent of GDP) is expected to be paid to about 17,000 public sector retirees (civilian and security), of which $125 million would come from the central government budget.

Until 2005, there were two pension schemes covering civil servants. In the "Gaza" scheme, employees contributed 10 percent and the government 12.5 percent of basic wages to the Gaza Pension and Insurance Corporation (GPIC). The "West Bank" scheme required a 2 percent contribution from employees, which is not paid to any fund, and pension benefits are financed directly from the government budget. This scheme was closed to new entrants in 2001, and all newly hired civil servants have been added to the "Gaza" scheme. The security services were excluded from the public sector pension system until 2005.

In 2005, a Unified Pension Law (UPL) was adopted, but it has not yet been enacted. It was intended to launch a new two-pillar system (defined benefit and defined contribution) to cover all employees (civilian and security), and to be governed by a new and independent pension agency. This law mandates employee contributions of 10 percent and government contribution of 12 percent of basic salaries. Employees aged over 45 as of mid 2005 remain under their respective previous pension system. In addition, a new Security Services Pension Law was enacted in 2005, which provides pension coverage to all security personnel aged over 45 at that time. Like the Gaza system, it requires a 10 percent employee contribution and a 12.5 percent government contribution.

The government has made only sporadic contributions to GPIC, and had accumulated more than $300 million of arrears on employee and government contributions due to GPIC by end-2006. Nevertheless, GPIC has continued to pay pension benefits consistently by depleting its assets. By May 2007, with about $120 million of assets attached by court decisions in the U.S., GPIC was insolvent. Since then, the PA has been providing GPIC with just enough resources to continue paying benefits (about $3.3 million per month or $40 million on an annual basis). This remains lower than total contributions (employee and government contributions, for both civilian and security personnel) which the government should transfer or put aside in 2008, and which will amount to about $150 million.

All current pension schemes, including the UPL, are considered generous by international standards, with replacement rates at 90 to 100 percent of final salaries, liberal early retirement provisions, and future increases in pension benefits tied to wages, as opposed to inflation. In order to reduce future government liabilities and limit its fiscal burden, the system will need to be reformed by adjusting the parameters, rolling back early retirement provisions, and limiting acquired rights. It will also require changes in the legislation to ensure that financial assets are safeguarded for the benefit of pension plan participants.

* The World Bank's Public Expenditure Review (February 2007) discusses public sector pensions.

20. **The fiscal framework is subject to several downside risks**. In particular: (i) the required austerity measures could prove politically challenging, especially if tight Israeli restrictions on movement and access persist; (ii) the uncertainties regarding the situation in Gaza could result in unanticipated emergency and humanitarian spending; and (iii) available donor assistance could turn out to be less than required to fully finance the recurrent budget or public investment program.

21. **Close cooperation among all three parties (the PA, the government of Israel and donors) is therefore critical to the success of the medium-term strategy.** From the perspective of each of the parties, going forward presents some risk, especially given past experiences of disappointed hopes at similar junctures. However, the alternative implies a continued downward spiral for the Palestinian economy.

22. **For its part, the IMF will intensify its work in the WBG**, with a focus on the macroeconomic, fiscal, and financial areas. In particular, the IMF could play a role in the context of a possible new budget support instrument, notably by regularly reporting to donors on the macroeconomic and fiscal situation, and on the implementation of public finance reforms. Such an instrument should ensure well-coordinated and predictable financing from donors to allow smooth budget execution. Technical assistance from the IMF will also be stepped up, including in the areas of public expenditure management, banking supervision and regulation, and macroeconomic statistics.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2005–10

(Quota: N/A)
(Population: 3.94 million; 2006)
(Per capita GDP: US$1,130; 2006)
(Poverty rate: 58 percent, 2006)
(Main Exports: Manufactured goods, food and live animals, and chemicals; 2006)

	2005	2006	2007	2008	2009	2010
			Projection			
			(Annual percentage change)			
Output and prices						
Real GDP (1997 market prices)	6.0	-8.0	0.0	3.5	5.0	6.0
CPI inflation rate (end of period)	2.3	3.3	3.9	2.9	2.4	2.6
CPI inflation rate (period average)	3.6	3.6	1.5	3.2	2.4	2.6
			(In percent of GDP)			
Investment and saving						
Gross capital formation, of which:	24.1	19.3	22.5	25.5	28.1	30.2
Public	7.4	4.2	6.5	9.0	11.1	12.6
Private	16.7	15.1	16.0	16.4	17.0	17.6
Gross national savings, of which:	4.0	10.8	13.5	22.0	20.3	17.9
Public 1/	-2.8	-5.7	-3.2	10.7	13.0	14.2
Private	6.8	16.5	16.7	11.3	7.3	3.7
Saving-Investment balance	-20.1	-8.6	-9.0	-3.4	-7.8	-12.3
			(In percent of GDP)			
Public finances 2/						
Revenues	27.5	26.1	24.6	24.9	25.3	25.8
Recurrent expenditures and net lending	44.5	52.6	53.0	48.7	45.8	42.8
Wage expenditures	22.4	27.1	26.9	24.8	23.4	21.8
Nonwage (including minor capital expenditures)	14.5	17.0	15.5	14.9	14.1	13.2
Net lending	7.7	8.6	10.6	9.0	8.3	7.8
Recurrent balance (before external budgetary support)	-17.0	-26.4	-28.4	-23.8	-20.5	-17.1
Externally financed capital expenditures	6.4	3.9	6.3	8.3	9.8	10.9
Externally financed capital expenditures (millions of U.S. dollars)	287	173	306	427	550	667
Overall balance (before external budgetary support)	-23.4	-30.4	-34.7	-32.1	-30.3	-28.0
External support for recurrent budget 3/	7.8	16.8	18.8	26.3	23.7	20.4
External support for recurrent budget (millions of U.S. dollars) 3/	349	738	907	1,361	1,328	1,250
			(Annual percentage change)			
Monetary sector 4/						
Credit to the private sector	27.4	7.9	-0.6	9.3	12.5	14.1
Private sector deposits	2.6	6.2	19.0	9.3	10.5	11.1
			(In percent of GDP)			
External sector						
Exports of goods and nonfactor services	13.1	12.1	11.6	11.3	11.2	11.3
Import of goods and nonfactor services	80.3	79.1	79.7	79.9	79.6	78.8
Net factor income	12.0	12.2	11.8	10.8	9.7	8.7
Net transfers	35.0	46.2	47.3	54.4	50.9	46.6
Official transfers	14.2	20.7	25.2	34.6	33.5	31.3
Current account balance (excluding official transfers)	-34.3	-29.3	-34.2	-38.0	-41.3	-43.6
Current account balance (including official transfers)	-20.1	-8.6	-9.0	-3.4	-7.8	-12.3
Memorandum items:						
Nominal GDP (millions of U.S. dollars)	4,478	4,393	4,820	5,172	5,610	6,123
Nominal GNI (millions of U.S. dollars)	5,017	4,929	5,390	5,729	6,154	6,656
Per capita nominal GDP (U.S. dollars)	1,190	1,130	1,200	1,247	1,312	1,389
Unemployment rate (average in percent of labor force)	23.5	23.6	22.4	23.1	23.1	22.7
Exchange rate of New Israeli Shekel per US$ (period average)	4.49	4.46	4.15	...	…	…
Al Quds stock market index (annual percentage change)	306.6	-46.4	...	...	…	…

Sources: Palestinian authorities, World Bank, and IMF staff estimates.

1/ The large increase in gross public savings in 2008 is due in large part to the substantial inflow of external resources related to external support for the recurrent budget and external financing for capital expenditures.

2/ Commitment basis.

3/ External financing in 2006 includes only documented amounts.

4/ End of period; 2007 data are as of end-September.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2005-10

	2005	2006	2007 Jan-June Est.	2007 Year Proj.	2008 Projection	2009 Projection	2010 Projection
	(in millions of US dollars, unless otherwise stated)						
Total revenues	**1,232**	**1,149**	**572**	**1,186**	**1,289**	**1,418**	**1,578**
Gross domestic revenues	476	378	178	336	363	399	447
Clearance revenues (accrued)	757	771	394	850	926	1,018	1,130
Clearance revenues (cash)	894	344	258	1,280	926	1,018	1,130
Clearance revenues (net arrears accumulation)	-137	427	136	-430	0	0	0
Total recurrent expenditures and net lending (commitment basis)	**1,994**	**2,310**	**1,294**	**2,553**	**2,521**	**2,567**	**2,624**
Wage expenditures (commitment)	1,001	1,189	665	1,295	1,285	1,311	1,337
Wage expenditures (cash)	1,001	658	369	1,295	1,360	1,411	1,437
Wage expenditures (net arrears accumulation)	0	532	296	0	-75	-100	-100
Nonwage expenditures (commitment) 1/	649	745	356	747	770	789	810
Nonwage expenditures (cash)	649	392	253	717	820	864	910
Nonwage expenditures (net arrears accumulation)	0	353	104	30	-50	-75	-100
Net lending	344	376	273	512	466	467	477
Recurrent balance (commitment basis, before external budgetary support)	**-762**	**-1,161**	**-722**	**-1,367**	**-1,232**	**-1,149**	**-1,046**
add: expenditure arrears (net accumulation)	...	884	399	30	-125	-175	-200
subtract: net clearance withheld (+) or transferred from past collections (-)	-137	427	136	-430	0	0	0
Recurrent balance (cash basis, before external budgetary support)	**-625**	**-704**	**-459**	**-907**	**-1,357**	**-1,324**	**-1,246**
add: external budgetary support 2/	349	738	562	907	1,361	1,328	1,250
Recurrent balance (commitment basis, after external budgetary support)	**-413**	**-423**	**-160**	**-460**	**129**	**179**	**204**
Recurrent balance (cash basis, after external budgetary support)	**-276**	**34**	**103**	**0**	**4**	**4**	**4**
Capital expenditures	**287**	**173**	**177**	**306**	**427**	**550**	**667**
Overall balance (cash basis, including capital expenditures)	**-563**	**-139**	**-74**	**-306**	**-423**	**-546**	**-663**
Total other financing	**563**	**139**	**74**	**306**	**423**	**546**	**663**
Advances and other payments by Palestinian Investment Fund (PIF)	173	146	57	70	0	0	0
Net domestic bank financing	304	-171	-86	-70	0	0	0
External financing for capital expenditures	287	173	177	306	427	550	667
Net external debt	0	0	0	0	-4	-4	-4
Residual	-202	-8	-75	0	0	0	0
Memorandum items:							
Revenues, as percent of GDP	27.5	26.1	11.9	24.6	24.9	25.3	25.8
Recurrent expenditures and net lending, as percent of GDP	44.5	52.6	26.8	53.0	48.7	45.8	42.8
Wage expenditures, as percent of GDP	22.4	27.1	13.8	26.9	24.8	23.4	21.8
Nonwage expenditures, as percent of GDP	14.5	17.0	7.4	15.5	14.9	14.1	13.2
Net lending, as percent of GDP	7.7	8.6	5.7	10.6	9.0	8.3	7.8
Recurrent balance (commitment basis) before external budgetary support, as percent of GDP)	-17.0	-26.4	-15.0	-28.4	-23.8	-20.5	-17.1
External budgetary support, as percent of GDP	7.8	16.8	11.7	18.8	26.3	23.7	20.4
Overall balance, as percent of GDP	-12.6	-3.2	-1.5	-6.3	-8.2	-9.7	-10.8
Total external support for the budget (recurrent and capital)	636	911	739	1,213	1,788	1,878	1,917
Nominal GDP	4,478	4,393	4,820	4,820	5,172	5,610	6,123
Number of public employees (thousands; end of period)	151	167	164	150	153	156	159

Sources: Ministry of Finance, and IMF staff estimates.

1/ Including minor outlays for domestically financed capital expenditures.

2/ External financing in 2006 includes only documented amounts.