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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Contents Page

I. EXECUTIVE SUMMARY

The Palestinian economy is facing serious risks, with a slowdown in growth and rise in unemployment in both Gaza and the West Bank. During 2008–10, the West Bank's real GDP grew by an annual average rate of 9 percent, reflecting sound economic management and reforms supported by donor aid, and an easing of Israeli internal barriers. However, growth declined to 5 percent in 2011 and the first quarter of 2012, while unemployment rose to 19 percent in the first half of 2012 from 16 percent in the same period last year. The economic slowdown reflects continued fiscal retrenchment combined with severe financing difficulties, declining donor aid especially from regional donors, and slower easing of restrictions on movement and access. In Gaza, after a rebound in its real output by over 20 percent on average in 2010–11 following the easing of tight restrictions, growth has declined to 6 percent in the first quarter of 2012, and unemployment has risen to 30 percent from 28 percent in the same period last year. Looking ahead, with persisting restrictions, financing difficulties with aid shortfalls, and stalemate in the peace process, there is a high risk of a continued economic slowdown, a rise in unemployment, and social upheaval.

The Palestinian Authority (PA)'s severe financing difficulties in 2011 and so far in 2012 have led to a substantial rise in domestic payment arrears and debt to commercial banks. Steady institution-building and prudent fiscal management by the PA during 2008–10 enabled a significant improvement in the quality of spending and a sharp reduction in recurrent budgetary aid from $1.8 billion to $1.1 billion. However, in 2011 and so far in 2012, donor aid for recurrent spending and development projects has been lower than needed to finance the already tight budgets. The consequent liquidity difficulties have been compounded by shortfalls in revenue in the context of a decline in economic growth and slower-than-expected implementation of clearance and domestic tax administration measures, as well as higher pension payments. Domestic payment arrears, including to the private sector and public pension fund, are estimated to have risen by about $0.3 billion in the first half of 2012. The stock of government debt to domestic banks has increased to $1.2 billion (12 percent of GDP) at end-June 2012 from $1.0 billion at end-2010.

Given the high risk of continued aid shortfalls, it is important for the PA to promptly implement a contingency plan to cover the financing gap, which as of mid-September is projected at $0.4 billion for 2012. The PA already announced in mid-August a freeze in new public sector employment and promotions for the remainder of the year. The contingency plan should complement these measures by a reduction in the cost of living adjustment for public sector employees. 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. Any measures to alleviate the impact of the September fuel price increases should be offset by cuts in other non-essential spending, given the severe financing constraint. Development projects should only be implemented if there are matching funds from donors, to prevent the diversion of aid away from essential recurrent spending. While domestic revenue measures are unlikely to start bearing fruit before the end of the year, nevertheless it is important to press ahead with the prompt implementation of the IMF technical assistance recommendations to improve tax administration, notably through enhancing compliance and widening the tax base.

Joint PA-Government of Israel (GoI) measures to raise clearance revenue should be implemented promptly to support the fiscal adjustment efforts. Given that clearance revenue, which is collected by the GoI on the PA's behalf, represents 70 percent of the PA's total tax revenue, the PA-GoI understanding reached in July 2012 to enhance the efficiency of the clearance revenue mechanism through joint PA-GoI measures has the potential to raise budgetary revenue and reduce the PA's reliance on aid over time. To ensure a sustainable rise in the Palestinian economic and revenue base, economic cooperation should be broadened to include an easing of restrictions on movement and access.

Along with its efforts to address the immediate financing difficulties, 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. As set out in the IMF staff reports for the Ad Hoc Liaison Committee meetings in 2011, IMF staff considers that the PA is able to conduct the sound economic policies expected of a future Palestinian state, given its solid track record of reforms and institution building. A milestone reached in April 2012 was the WBG's subscription to the IMF's Special Dissemination Standards (SDDS). This is the outcome of the PA's efforts to enhance the quality and transparency of economic and financial statistics, which compare favorably with those of IMF member countries that maintain high data management and dissemination standards. It is essential that the PA continues to build on its track record by taking measures toward comprehensive pension and civil service reforms, further strengthening the social safety net, completing the commercialization of electricity distribution, and enhancing the legal and regulatory framework facing businesses.

Additional aid is essential to sustain orderly reforms and fiscal adjustment. The delays in wage payments have already raised social tensions, and there is an increased public anxiety that, even with additional austerity measures by the PA, much needed social spending would be cut and wage payments delayed. It is thus critical that the PA's efforts be complemented by the prompt disbursement of additional aid to help cover the 2012 financing gap. It is also important for the PA and donors to work closely to develop a donor coordination framework to enhance the predictability of aid, especially from regional donors.

To stem the risks of a continued economic slowdown, a rise in unemployment, and a deepening fiscal crisis—which are bound to fuel social upheaval—urgent and concerted actions are needed by the PA, the GoI, and the international community. The PA should do its utmost to prudently manage the current fiscal crisis and continue to lay the foundation for sustainable growth and financial self-reliance. However, the economic and financial base that allows the PA to operate in a sustainable manner and build institutions, and its ability to ensure broad-based public support for its reforms, would be seriously eroded without sustained donor aid, including for public investment, and without an easing of Israeli controls on the WBG's external trade and access to the West Bank's Area C. The easing of these controls would relax a key constraint on private sector growth and employment, raise the WBG's economic and budgetary revenue potential, and help ensure a sustained rise in Palestinians' living standards.

II. Recent Economic Developments

1. **Real GDP growth in the West Bank and Gaza (WBG) declined from a yearly average of 10 percent in 2010–11 to 6 percent in 2012 due to persistent restrictions on movement and access, lower donor aid, and fiscal retrenchment.**

- In 2010–11, the annual average real GDP growth of Gaza (whose GDP covers about 30 percent of the WBG's total GDP) exceeded 20 percent, reflecting largely a rebound from the relaxation of Israeli restrictions on a range of imports following a period of tight restrictions.[2] The growth was driven mainly by services and construction, while agriculture and manufacturing continued to be constrained by the virtual ban on exports.[3] Gaza's growth slowed to 6 percent in the first quarter of 2012, as the waning of the rebound effect was compounded by a contraction in agriculture due to unfavorable weather conditions and electricity and fuel shortages.

- In the West Bank, real GDP growth declined from 7 percent in 2010 to 5 percent in 2011, reflecting lower donor aid (especially from Arab donors), the global economic slowdown, and the absence of further easing of restrictions on internal movement and exports.[4] Growth in the first quarter of 2012 continued at about 5 percent, driven mainly by services but with a contraction in manufacturing, agriculture, and construction.

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[2] Since mid-2007, Gaza has been under the control of Hamas. The restrictions have been imposed by the Government of Israel (GoI) due to its security concerns.

[3] In 2011–12, some exceptions were made to the Gaza export ban, notably to pre-approved shipments to non-Israeli markets of limited quantities of apparel and of some agricultural and horticultural products.

[4] According to the UN Office for the Coordination of Humanitarian Affairs (OCHA), the number of obstacles on movement within the West Bank declined from 626 at end-2009 to 500 at end-August 2010, but increased to 523 at end-2011 and 542 by end-July 2012. The GoI reports that 13 checkpoints remain in the West Bank, which it regards as "normally open", i.e., the checkpoints are active only when there are security warnings or other exceptional circumstances. For details on the obstacles and non-trade barriers to the access of goods from the West Bank to Israel, see the World Bank's report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza, published on www.worldbank.org.

2. **Reflecting the decline in growth, the WBG unemployment rate rose to 22 percent in the first half of 2012, from 20 percent in the same period last year.**

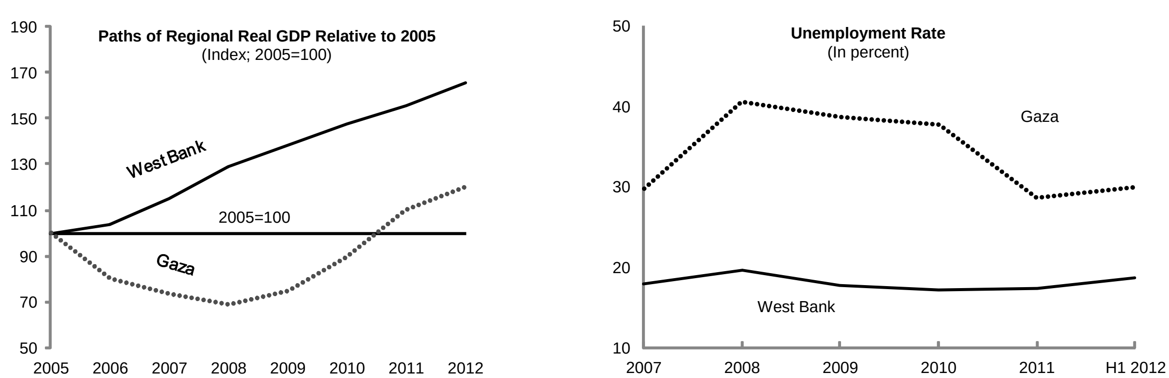
- The West Bank's unemployment rate was virtually unchanged at about 17 percent in 2010 and 2011, and rose to 19 percent in the first half of 2012. The persistence of high unemployment reflects the skewed nature of growth, both sectorally and regionally, with the expansion of the labor-intensive sectors, in particular agriculture and manufacturing, constrained by the trade restrictions, and with investment highly restricted in Area C, which covers about 60 percent of the West Bank. Youth unemployment in the West Bank has changed little in recent years, remaining at about 26–27 percent from 2006 to 2011, and increased to 28 percent in the first half of 2012. While the number of people from the West Bank allowed to work in Israel has been rising, as a share of total employment it has remained in the range of 12 to 14 percent since 2002 (compared to 21 percent prior to the Intifada in 2000).

- Following the relaxation of Gaza's tight restrictions, its unemployment rate declined from 38 percent in 2010 to 29 percent in 2011. Since then the unemployment rate edged up to 30 percent in the first half of 2012. Youth unemployment also increased from 44 percent in 2011 to 45 percent in the first half of 2012. The tight restrictions on the movement of Gazans into Israel, where prior to 2000 about 13 percent of Gaza's employed were working, remains an important constraint on the expansion of employment. Some significant steps were taken toward relaxing Gaza's trade restrictions as part of the package agreed by the Quartet Representative and Israel (see Appendix, Section C). Nevertheless, the virtual ban on Gaza's exports to its main potential markets (the West Bank and Israel) continues to constrain output and employment in agriculture.

Figure 1. Economic Developments in the West Bank and Gaza

Despite Gaza's recent rapid growth its GDP is today only slightly above its 2005 level.

The unemployment rate has risen in the West Bank and in Gaza in the first half of 2012.



Sources: Palestinian Central Bureau of Statistics; and IMF staff projections.

3. **While the WBG's overall inflation has remained contained in the 2 to 3 percent range during 2011 and the first half of 2012, petroleum products' prices have risen rapidly.** At end-August 2012, Gaza's inflation (at 1 percent) was well below that in the West Bank (5 percent) due to the sharp rise in the availability of consumer goods in Gaza since the relaxation of restrictions in mid-2010. In the West Bank, inflation rose from 3 percent in July to 5 percent in August, reflecting rising food and petroleum products' prices. Petroleum products' prices, reflecting prices in Israel, rose by between 7 percent (for kerosene) and 11 percent (for regular gasoline) in August 2012. While September price data are not yet available, in September petroleum prices rose further following increases in prices in Israel and the rise in the VAT rate from 14.5 percent to 15.5 percent on September 1. The PA subsequently announced that it will reduce the VAT rate from 15.5 percent to 15 percent (as of October 1) and the prices of some petroleum products (diesel, cooking gas, and kerosene) back to their August levels (as of September 12).

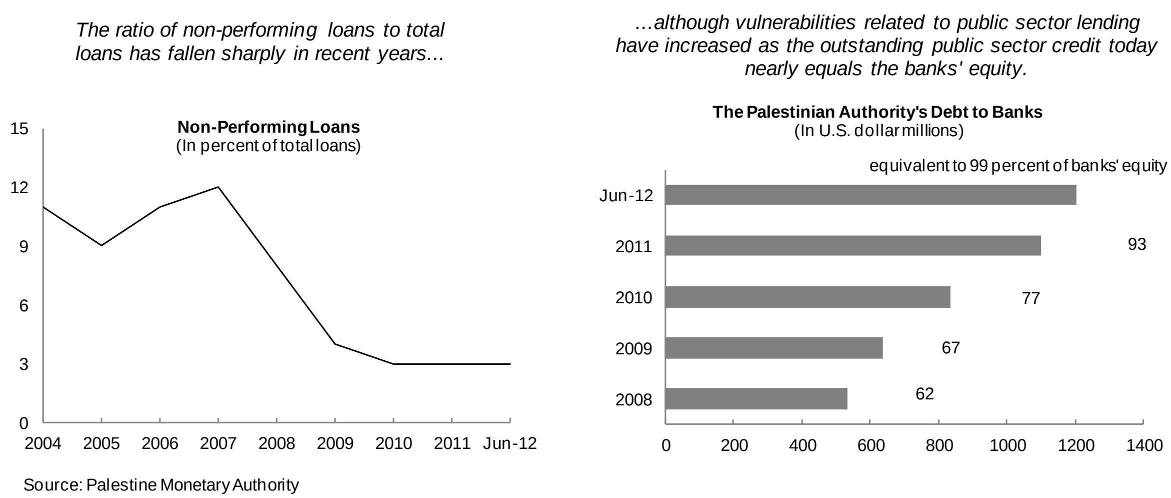
4. **The WBG's banking system continues to perform well, with limited exposure to global markets and conservative practices in private sector lending. However, the Palestinian Authority (PA)'s debt to domestic banks continues to rise.**

- Significant improvements in financial market infrastructure—including a credit registry with a modern credit scoring system—have enabled a rise in the private credit to deposit ratio from 33 percent at end-2010 to 41 percent at end-June 2012 (Appendix, Section A).[5] The rise in private sector credit, in the year ending in June 2012, was sharper in Gaza (about 44 percent) than in the West Bank (7 percent), reflecting Gaza's increased consumer credit demand as restrictions on imports were relaxed. The share of non-performing loans in total loans has fallen steadily, from 8 percent at end-2008 to about 3 percent at end-June 2012 (Figure 2). This fall has been facilitated by the continued strengthening in 2011–12 of the credit registry and the credit scoring system, with Fund technical assistance, which has helped support the channeling of bank loans to creditworthy borrowers. However, there is a risk of a future rise in that ratio if the PA does not reduce its stock of arrears to its private sector suppliers, many of whom might be liquidity-constrained and otherwise unable to service their bank debts.
- Private sector deposits remained broadly unchanged in the West Bank and Gaza, reflecting the economic growth slowdown. In Gaza, consumers have continued to withdraw cash to satisfy pent up demand after the relaxation of import restrictions, in the context of Israeli controls on the entry of cash into Gaza.

[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.

- The PA's debt to commercial banks rose from $0.5 billion in 2008 (62 percent of banks' equity) to $1.1 billion at end-2011 (91 percent of banks' equity) and $1.2 billion (99 percent of banks' equity) by end-June 2012. One indirect implication of the PA's financing difficulties has been temporary delinquencies by public sector employees on loan payments, following delays in the payment of their wages. In addition, the risk of wage payment delays has led to a precautionary demand for bank loans, and a rise in bank credit to PA employees from $0.3 billion at end-2010 to $0.6 billion by mid-2012, equivalent to about a quarter of WBG banks' private sector loans. The PA's persisting domestic payment arrears and wage payment delays could lead to liquidity difficulties by private sector suppliers and public sector employees, which in turn could lead to a rise in banks' non-performing loans.

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



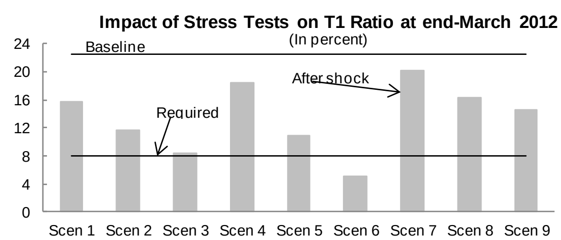
5. **Stress tests conducted by the Palestine Monetary Authority (PMA) indicate that the WBG's banking system is resilient to a broad range of shocks, including to a rise in banks' exposure to the PA (Box 1).** Key variables in these tests include the rising credit exposure of banks to the PA and government employees, as well as to businesses supplying goods and services to the PA. The PMA has been providing guidance and training to banks in the application of stress-testing techniques. Starting in January 2012, the PMA has required all banks to conduct their own stress tests on a semi-annual basis, with scenarios tailored to their own conditions and constraints, and to submit the first set of results to the PMA by end-2012. The PMA is planning to conduct in the fall of 2012 workshops and seminars to assist banks' staff 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.

Box 1. Stress Tests of the Banking System

Since January 2011, the PMA has been conducting stress tests for the West Bank and Gaza (WBG)'s banking system and individual banks. These tests, which starting in September 2012 will be undertaken on a quarterly basis, consist of an assessment of the impact of credit, liquidity, market, and operation shocks on banks' financial position, capital adequacy, and liquidity. Given the high direct exposure of banks to the Palestinian Authority (PA) and its employees, two key sets of tests consist of delayed payments of loans from the government and delinquencies on PA employee loans.

The PMA stress tests conducted in spring 2012 indicate that the WBG's banking system 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 at 24 percent at end-March 2012. The PMA has tested nine combinations of the shocks described in the table below, in the context of a macroeconomic scenario which assumes slightly negative real GDP growth. The after-shock Tier 1 ratio fell below the required minimum of 8 percent only under an extreme Scenario 6 which in effect assumes a shock that would directly impact private sector production and incomes, leading to the inability of borrowers to repay their loans, and a significant withdrawal of deposits. Specifically, it makes 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. An alternative extreme "political shock" scenario leads to the inability of public sector workers to repay their loans, along with an adverse impact on bank deposits. The latter Scenario 3 lowers the ratio to the required 8 percent. That scenario assumes a 40 percent delinquency rate on loans to the PA, 50 percent delinquency rate of loans to PA employees, a loss of 20 percent in the fair value of domestic investments, and a 20 percent withdrawal of deposits. The PMA is planning to conduct additional stress tests in the fall of 2012 that 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.

Shocks
- 20 to 40 percent of government loans suffer delayed payments
- 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 35 percent decline of fair value of investments
- 5 to 20 percent of deposits withdrawn within one month
- 1 to 5 largest borrowers become delinquent
- 1 to 5 largest depositors withdraw deposits



6. **The PMA and the Bank of Israel (BoI) have continued joint efforts aimed at facilitating cooperation between Palestinian and Israeli commercial banks.** These efforts were stepped up in 2009, when large shekel cash surpluses had accumulated at Palestinian banks due to Israeli banks' refusal to accept cash deposits on concerns about legal implications. The two parties have been working to address that problem through a special arrangement whereby the excess shekel cash is regularly deposited at Israeli banks' accounts with the BoI. In addition, the PMA and the BoI continue to work 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.

III. FISCAL POLICY IN 2012–13

A. Fiscal Developments in 2012

7. **In 2012, lower-than-expected-revenues and higher-than-expected-expenditures, especially on transfers and net lending, have put pressure on the budget. Combined with shortfalls in donor aid for both recurrent and development spending, these have resulted in substantial arrears accumulation and borrowing from commercial banks.**

- In January–June 2012, total net revenue (after tax refunds) was 7 percent lower than budgeted due to several factors:

    - Implementation of the action plan to strengthen domestic tax administration was uneven across tax categories (Box 2, Section 1). Measures to improve income tax compliance were implemented as planned in early 2012, which, in combination with a prepayment of taxes, resulted in a 45 percent rise in income tax revenue (compared to the first half of 2011). However, those related to improvements in VAT collection, notably improvements in the Large Taxpayers' Unit organization, staffing, and management, were stepped up only in mid-2012. In addition, there was a continued decline in businesses' compliance with the payments of domestic taxes, especially for VAT. Cash revenue collection has been adversely affected by 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. Over time, these revenue losses will be partly offset by the rise in the VAT rate from 14.5 percent to 15 percent (projected to yield an additional $2 million per month in revenue), in line with the rise in the rate in Israel, which took effect on September 1, 2012.

- o Clearance revenue was 6 percent lower than budgeted in the first half of 2012 due to delays in the implementation of joint Israeli-Palestinian measures to strengthen collection and minimize leakages. An understanding between Israel's Finance Minister Steinitz and Prime Minister Fayyad to facilitate their implementation was finalized in July 2012.

- o Non-tax revenue was 12 percent lower than the budgeted pro-rated amount for the first half of 2012. However, the amount for 2012 as a whole is projected to be in line with the budget, given the transfer in July of $30 million in dividends from the Palestine Investment Fund (PIF) to the Treasury.

➢ The wage bill on a commitment basis has been in line with the budget. The wage bill in the 2012 was budgeted to increase by 6.8 percent, reflecting the yearly wage adjustment, wage drift, and a limited increase in net PNA employment (not exceeding 3,000 employees.) In the first half of 2012, net PNA employment increased by 965 employees (123 in health, 947 in education, and 484 in security, with a net decline of 589 in other sectors).

➢ Non-wage recurrent expenditures on a commitment basis were 9 percent higher than expected, with higher-than-budgeted pension transfers more than offsetting lower operational spending and minor capital expenditures (Table A).

➢ Net lending expenditures (mostly payments by the central government for utility bills owed by municipalities) were 37 percent above the budgeted levels, reflecting higher-than-expected deductions by Israel from clearance revenue as a result of increases in electricity prices and repayment of debt due to the Israeli Electricity Company (IEC). Moreover, the inability of the MoF to remit to some municipalities their share of tax revenue due to its liquidity difficulties prompted them to withhold some payments to the IEC.

Table A. Non-Wage Expenditure in 2011–12

		Total	Operational Expenditure	Transfers	Minor Capital Expenditure
			(Commitment basis; in millions of NIS)		
2011					
	Budget	**5,043**	1,864	3,089	90
	Outturn	**5,015**	1,792	3,165	58
2012	Jan–June				
	Pro-rated Budget	**2,451**	980	1,432	39
	Outturn	**2,660**	951	1,699	9

Source: Ministry of Finance.

- At $400 million (NIS 1,511 million), donor recurrent budgetary aid disbursed in the first half of 2012 was about 20 percent lower than envisaged in the budget. In addition, development budgetary aid (i.e., aid channeled through the Treasury) amounted to $48 million—compared to $117 million committed for development projects, and $150 million planned in the 2012 budget. Of the $93 million cash spending on development projects, $45 million was covered by the treasury (compared to only $25 million envisaged in the budget), while $24 million (equivalent to about NIS 91 million) accumulated as arrears.

- The shortfalls in aid for recurrent and development spending, lower revenue, and higher-than-budgeted non-wage expenditures 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 $290 million (or NIS 1,097 million) in arrears to the pension fund, private sector suppliers, development projects, and on tax refunds (Table B). The financing difficulties also led to an increase in net domestic financing by $42 million, yielding a stock of debt to banks of $1.2 billion (12 percent of GDP) as of end-June 2012.

- Financing difficulties continued in July and August 2012. In July, there was two-week delay in the payment of 40 percent of public sector wages (about $60 million out of a total wage bill of $150 million). The payment was finally enabled by the disbursement by Israel of a clearance revenue advance of $45 million.

Table B. Composition of Net Arrears Accumulation 2009–12

	2009	2010	2011	2012 Jan–Jun
	(In millions of NIS)			
Contributions to the pension fund:				
of which: employee's share 1/	171	185	374	277
government's share	355	172	573	301
Nonwage expenditures 2/	460	92	353	245
Net lending	77	-103	0	0
Development projects 3/	118	88	270	91
Tax refund	-140	-39	368	182
Total	**1,040**	**394**	**1,939**	**1,097**

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

Box 2. Measures to Raise Budgetary Revenue

I. Raising domestic tax revenue

In 2011–12 the PA made progress in enhancing domestic tax revenue collection through a comprehensive action plan to reform tax administration with technical assistance from the IMF, DFID, and USAID. An important objective of the plan has been to expand the tax base and improve compliance, notably for the income tax and VAT. 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.

Raising income tax revenue has been a key aim of the PA. Several measures were taken in 2012 which raised the income tax revenue to the equivalent of 2 percent of GDP in the first half of 2012 (on annualized basis) from 1.6 percent of GDP in the first half of 2011. This is a significant improvement, although it is still well below the share in other developing countries (3 to 4 percent of GDP for Algeria, Jordan, Lebanon, and Pakistan).

An important revenue measure has been the increase, effective in January 2012, in the top corporate income tax rate from 15 percent to 20 percent. The rate increase was complemented by measures to expand the tax base and improve compliance, which was crucial given the low compliance rate (estimated at below 40 percent). Toward that end, the implementation of the first stage of the plan started in early 2012, aimed at improving tax compliance by large taxpayers. The latter included 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. One additional measure which helped raise income tax revenue in early 2012 was a two-year suspension of income tax exemptions for 13 companies. In the remainder of 2012 and 2013, the MoF intends to apply the above tax administration measures to raise domestic VAT collection, which has remained at about 0.8 percent of GDP in the first half of 2012, about the same level as in the first half of 2011. Such measures will help ensure that the rise in the VAT rate (from 14.5 percent to 15 percent following a change in VAT in Israel) will be supported by a wider VAT base and better payment compliance.

II. Raising clearance revenue

While measures to raise domestic tax revenue are key to moving toward fiscal sustainability, it is important to put their revenue impact in broader perspective. The PA's domestic tax revenue represents only one fourth of its total tax revenue, with the remainder three fourths coming from clearance revenue. Thus it would take a 30 percent increase in domestic taxes to match just a 10 percent improvement in the yield of clearance revenue. This underscores the importance of the understanding in July 2012 between Minister Steinitz and Prime Minister Fayyad to implement the understandings reached in 2011 at the technical level between the Israeli and Palestinian ministries of finance:

- Ensuring that the assessment of clearance revenue owed to each side is 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 would have equal access to data collected through shared electronic interfaces. The data-sharing would allow a better appraisal and tracing of the extent and sources of tax leakages.
- Enhancing control and tracing by both sides of merchandise destined to the WBG to ensure better compliance of taxpayers with unified invoice requirements. This will involve agreement, inter alia, on new procedures to electronically trace imports ("e-tagging"), and establishment of bonded warehouses for WBG imports entering through Israeli ports.
- Review current revenue-sharing practices to ensure that they are in line with the Paris Protocol. One practice to be reviewed at the outset relates to the review of exit fees levied by the GoI on Palestinian passengers crossing the Allenby Bridge, to ensure that the revenue is equally shared between the two sides.

Table C. Fiscal Indicators for 2011–13
(In millions of U.S. dollars, unless otherwise indicated)

	2011	2012				2013
		Jan–Jun Est.	Jul–Dec Proj.	Jan–Dec Proj.	Budget	Proj.
Total net revenues	2,046	1,035	1,085	2,120	2,235	2,257
Gross domestic revenues	738	363	398	761	812	774
Tax revenues	483	252	246	498	559	492
Nontax revenues	256	111	152	263	254	283
Gross clearance revenues	1,424	725	761	1,485	1,542	1,619
Tax refunds	116	53	74	126	119	137
Total recurrent expenditures (commitment basis):	3,325	1,665	1,735	3,400	3,188	3,468
Wage expenditures	1,783	893	903	1,796	1,793	1,886
Non-wage expenditures	1,402	700	732	1,431	1,290	1,451
Net lending	140	72	100	172	105	132
Total recurrent expenditures (cash basis)	2,962	1,448	1,952	3,400	3,188	3,668
of which: non-wage expenditures (cash basis)	1,143	820	611	1,431	1,793	1,651
Recurrent balance (commitment basis)	-1,279	-631	-650	-1,280	-953	-1,212
Recurrent balance (cash basis)	-783	-397	-898	-1,295	-953	-1,412
Development projects (commitment basis)	370	117	115	232	350	300
Development projects (cash basis)	295	93	139	232	350	300
Overall balance (cash basis, including development expenditures)	-1,078	-490	-1,037	-1,526	-1,303	-1,712
Financing	1,078	490	1,037	1,526	1,303	1,712
External support for recurrent and development expenditures	940	445	698	1,143	1,303	1,712
External support for recurrent expenditures disbursed or indicated	771	398	543	941	1,003	1,412
External support for development expenditures	169	48	155	202	300	300
Domestic financing	137	42	-42	---	---	---
Residual	1	3	380	383	---	---
Memorandum items:						
GDP	9,982	10,425	10,425	10,425	9,771	11,349
Domestic tax revenue (percent of GDP)	4.8	2.4	2.4	4.8	5.7	4.3
Clearance revenue (percent of GDP)	14.3	7.0	7.3	14.2	15.8	14.3
Wage expenditures (commitment basis), percent of GDP	17.9	8.6	8.7	17.2	18.3	16.6
Net lending (including subsidies; percent of GDP)	1.4	0.7	1.0	1.7	1.1	1.2
External financing for recurrent budget (US$ billion)	0.77	0.40	0.54	0.94	1.00	1.41
Recurrent balance (commitment basis), percent of GDP	-12.8	-6.0	-6.2	-12.3	-9.8	-10.7
Recurrent balance (cash basis), percent of GDP	-7.8	-3.8	-8.6	-12.4	-9.8	-12.4
Net expenditure arrears accumulation (US$ billion)	0.36	0.22	0.22	0.43	---	-0.2
of which: non-wage arrears	0.26	0.14	0.14	0.29	---	-0.2
Net expenditure arrears accumulation (percent of GDP)	3.6	2.1	2.1	4.2	---	-1.8
Total interest payments (US$ million)	69	13	30	42	42	42
Domestic payments	63	8	29	38	38	38
External payments	5	5	0	5	5	5
Total principal payment (US$ million)	-151	85	97	182	182	182
Domestic payments	-157	78	80	158	158	158
External payments	5	7	17	24	24	24

Sources: Ministry of Finance; and IMF staff estimates.

Table D. Fiscal Indicators for 2011–13
(In millions of NIS, unless otherwise indicated)

	2011	2012				2013
		Jan–Jun Est.	Jul–Dec Proj.	Jan–Dec Proj.	Budget	Proj.
Total net revenues	7,321	3,931	4,124	8,055	8,493	8,576
Gross domestic revenues	2,642	1,378	1,513	2,891	3,087	2,943
Tax revenues	1,727	957	935	1,892	2,124	1,869
Nontax revenues	915	422	577	999	963	1,074
Gross clearance revenues	5,095	2,754	2,890	5,644	5,859	6,152
Tax refunds	416	201	279	480	454	519
Total recurrent expenditures (commitment basis):	11,897	6,327	6,592	12,919	12,114	13,180
Wage expenditures	6,381	3,394	3,431	6,825	6,813	7,166
Non-wage expenditures	5,015	2,660	2,780	5,439	4,901	5,514
Net lending	501	273	382	655	400	500
Total recurrent expenditures (cash basis)	10,597	5,504	7,416	12,919	12,114	13,940
of which: non-wage expenditures (cash basis)	4,089	3,117	2,323	5,439	6,813	6,274
Recurrent balance (commitment basis)	-4,576	-2,396	-2,468	-4,864	-3,621	-4,604
Recurrent balance (cash basis)	-2,803	-1,507	-3,412	-4,920	-3,621	-5,364
Development projects (commitment basis)	1,325	444	436	880	1,330	1,140
Development projects (cash basis)	1,054	353	527	880	1,330	1,140
Overall balance (cash basis, including development expenditures)	-3,858	-1,860	-3,939	-5,800	-4,951	-6,504
Financing	3,858	1,860	3,939	5,800	4,951	6,504
External support for recurrent and development expenditures	3,364	1,691	2,653	4,344	4,951	6,504
External support for recurrent expenditures disbursed or indicated	2,759	1,511	2,065	3,576	3,811	5,364
External support for development expenditures	605	181	587	768	1,140	1,140
Domestic financing	490	159	-159	---	---	---
Residual	4	10	1,446	1,456	---	---
Memorandum items:						
GDP	35,717	39,613	39,613	39,613	37,129	43,127
Domestic tax revenue (percent of GDP)	4.8	2.4	2.4	4.8	5.7	4.3
Clearance revenue (percent of GDP)	14.3	7.0	7.3	14.2	15.8	14.3
Wage expenditures (commitment basis), percent of GDP	17.9	8.6	8.7	17.2	18.3	16.6
Net lending (including subsidies; percent of GDP)	1.4	0.7	1.0	1.7	1.1	1.2
External financing for recurrent budget (NIS billion)	2.8	1.5	2.1	3.6	3.8	5.4
Recurrent balance (commitment basis), percent of GDP	-12.8	-6.0	-6.2	-12.3	-9.8	-10.7
Recurrent balance (cash basis), percent of GDP	-7.8	-3.8	-8.6	-12.4	-9.8	-12.4
Net expenditure arrears accumulation (NIS billion)	1.30	0.82	0.82	1.65	---	-0.8
of which: non-wage arrears	0.93	0.55	0.55	1.09	---	-0.8
Net expenditure arrears accumulation (percent of GDP)	3.6	2.1	2.1	4.2	---	-1.8
Total interest payments (NIS million)	246	48	113	161	161	161
Domestic payments	226	31	112	143	143	143
External payments	19	17	1	18	18	18
Total principal payment (NIS million)	-541	322	368	691	691	691
Domestic payments	-560	296	304	600	600	600
External payments	20	26	65	91	91	91

Sources: Ministry of Finance; and IMF staff estimates.

8. **The financing gap for 2012 is projected at about $0.4 billion, which will make it difficult for the PA to make essential payments, including for wages.** Assuming that fiscal performance in the remainder of 2012 is broadly in line with that in the first half of the year, the recurrent deficit is projected at $1.3 billion. The donor aid envisaged for 2012 at $0.9 billion is not sufficient to cover the deficit and will result in a financing gap of $0.4 billion for 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. There is thus a high risk that the persistence of that gap will result in cuts in essential spending.

9. **The authorities are planning to take fiscal measures in the remainder of 2012 to reduce the financing gap:**

- Halting new public sector employment and promotions, and better targeting employee allowances, including bonuses and travel allowances.

- Postponement of lower priority non-wage spending, including development projects for which there are no matching funds from donors. The budgetary cost of the reduction in domestic petroleum prices relative to those in Israel will be offset by cuts in non-essential expenditures (in ministries other than covering health, education, and social services).[6]

- Further strengthening of the Public Financial Management System to better align commitments with cash availability, thus stemming arrears accumulation. 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 involve 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.

- Stepping up implementation of the action plan to strengthen domestic tax administration reform, notably through the establishment of a unified revenue administration, expanding the coverage of the Large Taxpayer Unit, and the computerization of taxpayers’ records to reduce tax evasion.

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[6] These cuts are envisaged to stem from: (i) lower expenditure commitments related to travel, rent, and general administration, including lower spending on transportation and petroleum products; and (ii) progressive deductions from salaries of high-level public sector employees.

B. Fiscal Outlook for 2013

10. **The preparation of the 2013 budget is underway, with the aim of sending budget circulars to line ministries by end-October 2012.** The MoF has set preliminary targets for broad fiscal line items. These will be fine-tuned to take into account updates in the macroeconomic outlook, indications of donor aid, and completion of a plan for the repayment of domestic debt, including arrears to the private sector and the pension fund. The key line items are set out below:

- The increase in the wage bill is set at a maximum of 5 percent, which includes a cost of living adjustment, an automatic yearly increase, and any increase in net employment.
- Recurrent nonwage expenditures will decline by about 1 percent of GDP, corresponding to a virtual freeze in NIS terms. The MoF will be assessing the scope to reduce transfers through better streamlining of social payments, taking advantage of the strengthening of the social safety net. Operational spending will also be reviewed with the aim of reducing lower priority items.
- Net lending is projected to decline by about 0.5 percent of GDP, reflecting continued commercialization of electricity distribution in the West Bank, scheduled to be completed by end-2012.
- Revenues are conservatively projected to grow by 6 percent over 2012, maintaining the ratio to GDP at about 20 percent. The projection is conservative in that it does not include the impact of the rise in the VAT rate from 14.5 to 15 percent, nor does it assume any additional revenue yield from enhanced clearance revenue administration. The cautious approach is warranted by two key factors: (i) there is a risk of a decline in cash tax collection and compliance due to the continued build up of arrears and delays in wage payments; and (ii) there is significant uncertainty regarding the pace of implementation of the clearance revenue measures, which depend on joint PA-GoI measures. Under an optimistic outlook, the potential revenue gain from these two sets of measures would be substantial: the VAT rate increase, assuming no offsetting fall in compliance, would yield about NIS 100 million per year (0.25 percent of GDP) in additional revenue, (NIS 25 million from domestic tax and NIS 75 million from clearance revenue). While there is uncertainty on the yield from clearance revenue, even a modest improvement could yield substantial gains. To illustrate, a 10 percent improvement in collection could yield about NIS 420 million (1 percent of GDP) in additional revenue in 2013.
- One key item that the authorities are in the process of finalizing relates to the amount of domestic payment arrears to be repaid over the medium term. The pace of repayment will depend crucially on the amount of donor aid that could realistically be counted on to finance the recurrent budget deficits over the medium term. Given the uncertainty on likely aid, the authorities' preliminary 2013 outlook envisages the repayment of $200 million in arrears for 2013 and 2014, and $100 million in 2015.

The arrears repayment path will be updated once indications of donor support are firmed up.

- On the basis of the above expenditure and revenue targets, the recurrent budget deficit on a commitment basis is projected to decline from about 12.3 percent of GDP in 2012 to 10.7 percent in 2013, or about $1.2 billion. The overall financing needs—assuming the repayment of $0.2 billion in arrears, and $0.3 billion for development projects—are projected at $1.7 billion for 2013, compared to $1.5 billion for 2012.

IV. Medium-Term Outlook and Structural Reforms

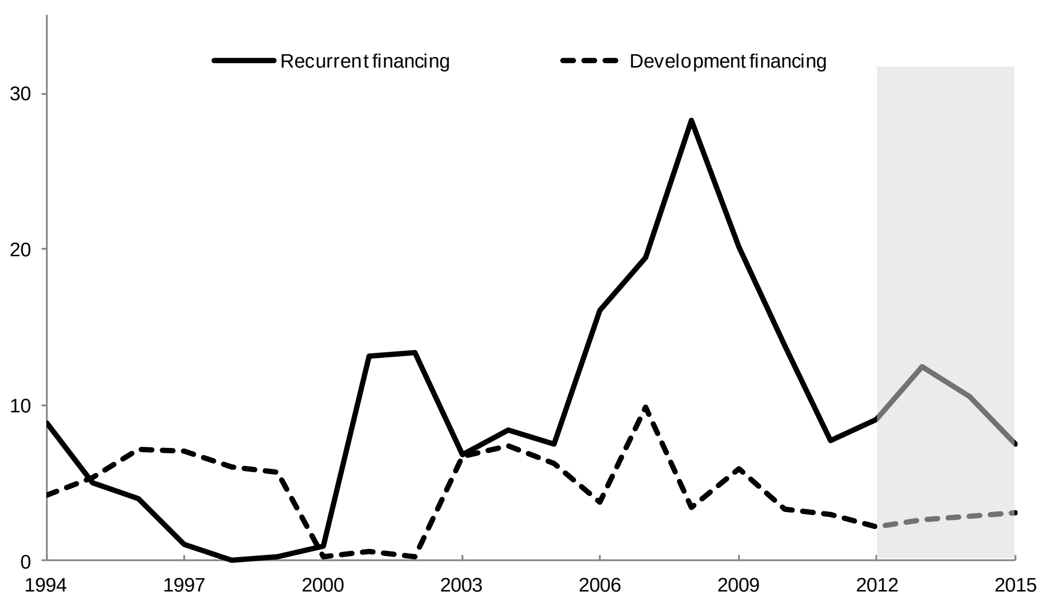
11. **The macroeconomic framework has been revised to take into account the risk that restrictions on movement and access will persist over the medium term.** While the framework underpinning the Palestinian National Development Plan for 2012–14 assumed an easing of restrictions, in fact there was little change in their scope or intensity since early 2011. Given the persisting stalemate in the peace process and the absence of indications that the restrictions will be phased out in the foreseeable future, the economic growth outlook for 2013–15 has been revised downward. The expected pickup in Israel's economic growth in 2013 will favorably affect the WBG's economic activity through increased Israeli import demand but the impact will be limited by the persistence of Israeli restrictions, especially the tight restrictions on exports from Gaza. The impact of changes in the global and regional economic outlook will continue to affect the WBG mainly through its trade with Israel, given its limited direct access and in view of the weak financial links with the rest of the world. Given the significant downside risks and the dim political outlook, the following two scenarios were developed:

- The "baseline growth" scenario, which envisages limited easing of internal restrictions on movement and access. In the West Bank, it is assumed that there will be a limited relaxation of controls on internal movement and access to Israeli markets, and a modest improvement in access to "Area C". For Gaza, controls on imports of private investment inputs will be eased modestly. The scenario assumes that the social and political conditions will be stable enough to enable the PA to implement a prudent fiscal policy and stepping up structural reforms (Box 3) leading to a sustained reduction in the recurrent budget deficit. This is aided by donors disbursing 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 persisting restrictions in the WBG might lead to faster deterioration in the macroeconomic environment than under the baseline scenario, inhibiting trade and private investment. In addition, this scenario assumes that donor aid would be below what would be required to finance the deficit, leading to further substantial arrears accumulation. Adverse macroeconomic environment would result in slower revenue growth. This, along with rising emergency spending, would reduce the pace of fiscal consolidation, even with continued restraint on public sector wages and employment.

12. **In the baseline scenario, the reduced catch up effect following the brisk recovery of recent years, in the context of limited relaxation of movement and access, is projected to reduce real GDP growth from an average of 8 percent in 2011–12 to 5 percent over the medium term, with a modest fall in unemployment from 21 percent to 18 percent by 2015.** The recurrent deficit would decline to 11 percent of GDP in 2013 and to 7 percent of GDP by 2015. The shift of spending away from wages and subsidies would continue at a measured pace. This in turn would allow a gradual 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

13. **In the lower-growth scenario, real GDP growth would remain at an average of about 2 percent over the medium term and the unemployment rate would remain above 25 percent.** Emergency spending and arrears accumulation would slow the pace of fiscal adjustment, with the recurrent deficit rising above 13 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 tighten substantially the liquidity situation of the private sector, leading to a rise in banks' nonperforming loans. Living standards would decline, 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
	Baseline Growth Scenario					Lower Growth Scenario		
Output and Investment								
Real GDP (percentage change)	9.9	6.2	5.6	5.2	4.8	3.0	2.0	1.0
West Bank	5.2	5.0	5.0	4.6	4.3	2.6	1.6	1.0
Gaza	23.0	9.0	7.0	6.5	6.0	4.0	3.0	1.0
Real GDP per capita (percentage change)	6.7	3.1	2.6	2.2	1.8	0.1	-0.9	-1.8
West Bank	2.5	2.3	2.3	2.0	1.6	-0.1	-1.0	-1.5
Gaza	18.8	5.3	3.4	3.0	2.5	0.5	-0.4	-2.3
Gross capital formation (in percent of GDP)	18.5	18.0	18.6	19.0	19.4	16.6	16.3	16.1
of which: public investment (in percent of GDP)	3.0	2.2	2.6	2.9	3.0	1.3	1.5	1.7
	(In percent of GDP)							
Public finances 1/								
Revenues	20.5	20.3	19.9	20.3	21.4	19.8	19.9	20.0
Recurrent expenditures and net lending	33.3	32.6	30.6	29.3	28.2	31.7	32.4	33.3
Recurrent balance (before external support)	-12.8	-12.3	-10.7	-9.0	-6.7	-12.0	-12.5	-13.3
Expenditure arrears accumulation	3.6	0.0	-1.8	-1.6	-0.8	4.2	6.8	8.6
Capital expenditures	3.0	2.2	2.6	2.9	3.0	1.3	1.5	1.7
(In millions of U.S. dollars)	295	232	300	350	400	150	175	200
External recurrent budgetary support	7.7	9.0	12.4	10.6	7.5	10.2	8.9	6.5
(In billions of U.S. dollars)	0.8	0.9	1.4	1.3	1.0	1.1	1.0	0.8
Total external support, including capital expenditures	9.4	11.0	15.1	13.4	10.5	11.5	10.4	8.2
(In billions of U.S. dollars)	0.9	1.1	1.7	1.6	1.4	1.3	1.2	1.0
	(In percent of GDP)							
External sector								
Exports of goods and nonfactor services	18.7	18.8	19.8	21.2	22.3	16.3	14.3	12.7
Import of goods and nonfactor services	63.9	58.3	56.3	56.1	56.1	55.6	54.8	56.8
Current account balance (excluding official transfers)	-36.7	-30.7	-26.8	-24.3	-22.4	-30.9	-32.3	-36.1
Current account balance (including official transfers)	-27.3	-19.7	-11.7	-10.9	-11.8	-19.4	-21.9	-27.9
Memorandum items:								
Unemployment rate (average in percent of labor force)	21	21	19	18	18	23	25	27

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

Box 3. Structural Reforms

A sustained reduction in the recurrent deficit over the medium term will require stepping up the implementation of key structural reforms:

- *Targeting social assistance.* Enhancing the efficiency of targeting social assistance, which represents one fifth of all non-wage wage expenditures, has the potential to generate substantial budgetary savings provided there is a pickup in economic growth and a rise in household incomes. In March 2012, the Ministry of Social Affairs (MSA) started a review of its database of poor and vulnerable households, including through on-site visits and a proxy means testing, with the aim of ensuring that only eligible households are included. The review was finalized in August 2012. Looking forward, it is important for the PA to ensure that all cash assistance programs are merged into the "single payment modality" program that uses the MSA's database.

- *Phasing out electricity subsidies.* The PA has succeeded in substantially reducing electricity subsidies since the launching of the Palestinian Development Plan in 2007, from the equivalent of 11 percent of GDP in 2007 to 1 percent of GDP in 2011. In addition to providing better incentives for electricity users to pay their bills, an important contributor to this decline has been the transfer of a large share of electricity distribution in the West Bank from municipalities to commercially-run companies, and the installation of pre-paid meters. To ensure continued reductions in subsidies, it is important to press ahead with the PA's action plan to complete the transfer of distribution by end-2012. This process should be complemented by a rigorous application of the "lifeline electricity tariff", to ensure that a "lifeline" amount of household consumption is billed only at cost for households in the social safety net.

- *Steps to reform the public pension system.* To restore the viability of the public pension fund, it is important for the PA to press ahead with the implementation of the pension reform action plan agreed with the World Bank in July 2010. The first phase of the plan includes amendments to the Public Pension Law which would index pensions to CPI inflation, raise the retirement age, and eliminate lump payments at retirement. The implementation of these measures promptly in 2013, as currently planned, will require approval of the amendments by the Council of Ministers, and then by the President, by end-2012.

- *Steps toward civil service reform.* While the wage bill's share of GDP has declined from 27 percent in 2007 to 18 percent in 2011, it remains well above the 10–15 percent that is typical of countries at a similar stage of development. Furthermore, reducing that share only through restraint on wage rates and employment is not sustainable, especially given that the WBG's average public sector real wage rate has already declined by about 3 percent since end-2007. Steps toward a comprehensive civil service reforms are needed to ensure a sustainable decline in the wage bill and rise in public sector efficiency. One step that could be implemented promptly in 2012, in line with World Bank recommendations, is a comprehensive review of employees' qualifications and performance to pave the way for a new incentive structure with a wider pay scale.

- *Strengthening the legal and regulatory framework.* Prompt enactment of the New Companies Law, the New Industry Law, and the Movable Assets Law 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. The laws have been approved by the Cabinet, and are awaiting Presidential approval. A new Procurement Law has been signed by the President in late 2011 to improve efficiency, accountability, and transparency in the acquisition of goods and services by the government. However, its implementation requires two measures to be taken promptly: (i) the establishment of a council to oversee procurement activities and compliance with the law and (ii) enactment of regulations supporting the legal framework for public procurement.

V. STAFF APPRAISAL

14. **The WBG economy's outlook is facing mounting risks due to the convergence of serious challenges on several fronts**:

- *Worse-than-expected revenue and expenditure outturns, with lower aid.* The WBG's strong economic recovery during 2008–10 was aided by the PA's institution-building and development efforts, its sound economic and fiscal management, and the reestablishment of law and order in the West Bank. Restraint on the public sector wage bill, reduced utility subsidies, prioritized expenditures, and transparent government finances enabled a sharp decline in the fiscal deficit and reduction in the budget's external financing requirements. However, since 2011 substantial liquidity difficulties emerged as aid declined to below the level necessary to finance already tight budgets. In the first half of 2012, these difficulties were compounded by shortfalls in tax revenue and higher-than-budgeted pension payments, leading to a financing gap of $0.4 billion for the year. An important contributor to the tax revenue shortfalls has been the reduction in tax compliance, including through the practice by some taxpayers of offsetting tax payments due against arrears owed to them by the government. The liquidity difficulties have led to the accumulation of further domestic payments arrears, delays in the payment of public sector wages, advance payments of clearance revenue by Israel, and borrowing up to the commercial banks' limits.

- *Slowdown in the economic recovery.* Along with the PA's institution-building and support from the donor community, the relaxation of many of the West Bank's internal obstacles on movement and access, as well as the easing of Gaza's tight restrictions, have contributed significantly to the WBG's economic recovery during 2008 to 2010. However, that impetus to growth has waned in the West Bank in 2011 and so far in 2012, given the absence of further significant easing of restrictions. Core impediments on the expansion of private sector activity and investment remain, including on access to the West Bank's "Area C", export restrictions, and import controls on private investment inputs in the WBG.

- *Political uncertainties.* In addition to the above factors, the stalemate in the peace process and an increasingly uncertain domestic and regional political environment are bound to further inhibit private sector confidence and investment. The absence of concrete indications that restrictions will be lifted any time soon, or of a rise in donor aid that will address the PA's fiscal difficulties, have also dimmed the economic growth outlook and prospects for a reduction in unemployment, thus raising the potential for social tensions.

15. **In view of the high risk of continued donor aid shortfalls for the remainder of the year, it is important for the PA to implement a contingency plan of fiscal measures to cover the 2012 financing gap, which is projected at $0.4 billion as of mid-September 2012.** It is hoped that higher donor aid would reduce that gap. However, the PA should prepare for the worst case scenario with a plan to cap expenditure commitments to fully cover the financing gap. This will prevent a situation where the PA is forced by continued aid shortfalls to take drastic measures at short notice, such as curtailment of social spending or an indefinite delay of wage payments. The PA has already announced in mid-August a freeze in new public sector employment and promotions for the remainder of the year. The contingency plan should complement the latter measure by a reduction in the cost of living adjustment (to a maximum of 1.5 percent). 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. Any measures to alleviate the impact of the September fuel price increases should be offset by cuts in other non-essential spending, given the severe financing constraint. Development projects should only be implemented if there are matching funds from donors, to prevent the diversion of aid away from essential recurrent spending. It is particularly important to protect spending on the social safety net, in the health and education sectors, as well as operational expenditure deemed essential for the functioning and building of PA institutions. While domestic revenue measures are unlikely to start bearing fruit before the end of the year, nevertheless it is important to press ahead with the prompt implementation of the IMF technical assistance recommendations to improve tax administration, notably through enhancing compliance and widening the tax base. Enhancing tax administration is especially important in view of the reduced compliance especially from the practice of offsetting tax payments against government arrears.

16. **Concerted actions are needed by the PA, GoI, and donors to contain significant risks to the economic outlook.** Persistence of restrictions on movement and access and donor aid shortfalls would dampen investor confidence and economic activity, reducing private employment and household income growth. The consequent erosion in living standards and rise in unemployment would reduce public support for reforms and make it more difficult for the PA to reduce spending and raise revenue, leading to a rising budget deficit and further buildup of arrears on wages and other essential payments. This in turn would raise social tensions and heighten political uncertainties, reinforcing the adverse impact on confidence, investment, and growth.

- The Fayyad-Steinitz understanding of July 2012 to enhance clearance revenue collection and minimize leakages has the potential to enhance the PA's fiscal situation, given that it covers the bulk of the PA's budgetary revenue. Given the pressing fiscal difficulties, it is important to start implementation as soon as possible. Concrete steps that could be implemented in the remainder of 2012 include: (i) assessment of clearance revenue owed to each side on the basis of comprehensive trade data compiled by the GoI; and (ii) enhancement of control and tracing by both sides of merchandise destined to the WBG to improve tax compliance and reduce smuggling.

- Beyond its potential to raise revenue for the PA, the Fayyad-Steinitz understanding has raised expectations of broader economic measures by the GoI to support the Palestinian economy. These expectations were reinforced by several additional supportive actions by the GoI in 2012, including the disbursement of a clearance revenue advance of $45 million to facilitate the payment of the July wage bill. Nevertheless, the relaxation of restrictions on movement and access remain the key area of enhanced Palestinian-Israeli cooperation which could have an immediate and far-reaching positive economic and fiscal impact and accelerate the PA's state building process. Fully tapping the West Bank's economic and budgetary revenue potential and reinvigorating its growth will require a broad-based removal of impediments on exports to Israel, of imports of machinery and equipment, as well as enabling Palestinian economic activity in Area C. In Gaza, a lasting recovery in private sector activity and employment will require a removal of the tight restrictions on exports and private sector imports of investment inputs.

- The shortfalls and delays in donor aid continue to impose a significant cost on the PA in terms of interest payments and additional premia required by private suppliers of goods and services and commercial banks. Of particular concern are the pervasive adverse repercussions of domestic payment arrears accumulation. One worrisome consequence has been the reduction in tax revenue collection stemming from the offsetting of tax payments due against government arrears. In addition, the delays in wage payments have already raised social tensions, and there is an increased public anxiety that, even with additional austerity measures by the PA, much needed social spending would be cut and wage payments delayed. It is thus critical that the PA's efforts be complemented by the prompt disbursement of additional aid to help cover the 2012 financing gap. It is also important for the PA and donors to work closely to develop a donor coordination framework to enhance the predictability of aid. Enhancing aid predictability is especially important for regional donors, whose disbursements have been carried out on an ad hoc basis, with little planning and fallen well short of past commitments.

17. **Looking beyond the immediate economic difficulties, it is important for the PA to step up structural reforms to raise economic efficiency and sustain orderly fiscal adjustment:**

- While the public sector wage bill has declined substantially since 2008, this was accomplished mainly through a blanket restraint on total public sector employment and on overall wage rate increases. To ensure that such a decline continues over the medium term, along with an increase in the quality and efficiency of public sector services, it is important for the PA to take steps in the remainder of 2012 toward a comprehensive civil service reform. These should include a comprehensive review of employees' qualifications and performance as a basis for a new incentive structure with a wider pay scale.

- Given that social assistance represents about one fifth of all non-wage expenditures, it is important for the PA to take steps to enhance the efficiency of its targeting. One important step to be completed by end-2012, in line with World Bank advice, is to ensure that only households that meet the eligibility criteria are provided for under the social safety net.

- 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 approval by the Council of Ministers of amendments to the Public Pension Law which would allow, starting in 2013, the indexing of pensions to CPI inflation, raising the retirement age, and eliminating lump-sum payments at retirement.

- Electricity subsidies have diminished substantially in recent years due to improved incentives for municipalities and households to pay their electricity bills, as well as progress in commercializing electricity distribution in the West Bank. 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. It is important to apply as rigorously as possible the "lifeline" electricity tariff, which bills electricity at supply cost to eligible households, especially given the recent significant rise in electricity prices.

- The PMA has made good progress in 2012 in assessing bank vulnerabilities by conducting its own stress tests, as well as by guiding banks to conduct their own tests, taking into account their own conditions and constraints. It is important for the PMA to develop an action-plan to reduce the banks' vulnerabilities—in particular to the risks of a possible downturn in economic activity 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.

- While restrictions on movement and access are a key impediment to the development of the private sector, the investment climate and the economy's growth potential would benefit from a further strengthening by the PA of the legal and regulatory framework. To ensure that incentives and regulations are in line with international practice, it is important to promptly enact the laws that help ensure a level playing field in the legal treatment of private and public companies, and improve access to bank financing (including through the new Companies Law, New Industry Law, and the Movable Assets Law) and enable the implementation of the procurement law to improve the efficiency, accountability, and transparency in the acquisition of goods and services by the government.

Table 1. Selected Economic Indicators, 2009–15

(Population: 4.2 million; 2011 est.)
(Per capita GDP: $2,394; 2011)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 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	9.9	6.2	5.6	5.2	4.8
West Bank	7.1	6.8	5.2	5.0	5.0	4.6	4.3
Gaza	8.4	19.5	23.0	9.0	7.0	6.5	6.0
CPI inflation rate (end-of-period)	4.3	2.8	2.7	3.3	2.5	2.5	2.5
CPI inflation rate (period average)	2.8	3.7	2.9	3.0	2.9	2.5	2.5
Investment and saving			(In percent of GDP)				
Gross capital formation, *of which:*	18.3	18.5	18.5	18.0	18.6	19.0	19.4
Public	6.0	3.3	3.0	2.2	2.6	2.9	3.0
Private	12.4	15.2	15.6	15.8	15.9	16.1	16.4
Gross national savings, *of which:*	6.3	7.9	-8.8	-1.7	6.9	8.1	7.6
Public	9.1	3.3	1.6	2.4	2.6	2.9	3.0
Private	-2.7	4.6	-10.4	-4.0	4.2	5.2	4.6
Saving-investment balance	-12.0	-10.6	-27.3	-19.7	-11.7	-10.9	-11.8
Public finances 1/			(In percent of GDP)				
Revenues	23.8	22.6	20.5	20.3	19.9	20.3	21.4
Recurrent expenditures and net lending	47.5	36.8	33.3	32.6	30.6	29.3	28.2
Wage expenditures	21.8	19.3	17.9	17.2	16.6	16.2	15.8
Nonwage expenditures	20.1	14.7	14.0	13.7	12.8	12.1	11.6
Net lending	5.6	2.8	1.4	1.7	1.2	1.0	0.8
Recurrent balance (commitment, before external support)	-23.7	-14.3	-12.8	-12.3	-10.7	-9.0	-6.7
Recurrent balance, cash (before external support)	-20.4	-13.4	-7.8	-12.4	-12.4	-10.6	-7.5
Development expenditures	6.0	3.3	3.0	2.2	2.6	2.9	3.0
(In millions of U.S. dollars)	400	274	295	232	300	350	400
Overall balance (before external support)	-29.6	-17.6	-15.8	-14.5	-13.3	-11.8	-9.8
External recurrent budgetary support (in billions of U.S. dollars)	1.4	1.1	0.8	0.9	1.4	1.3	1.0
Total external support, including for development expenditures	26.1	15.3	9.4	11.0	15.1	13.4	10.5
(In billions of U.S. dollars)	1.8	1.3	0.9	1.1	1.7	1.6	1.4
Financing gap (in billions of U.S. dollars)	...	...	...	0.4	...	...	...
Monetary sector 2/			(Annual percentage change)				
Credit to the private sector	22.9	31.2	23.8	16.0	15.4	15.0	14.6
Private sector deposits	5.7	9.9	4.1	3.7	3.6	3.4	3.3
External sector			(In percent of GDP)				
Exports of goods and nonfactor services	13.5	13.8	18.7	18.8	19.8	21.2	22.3
Import of goods and nonfactor services	65.3	55.5	63.9	58.3	56.3	56.1	56.1
Net factor income	7.9	7.2	6.7	6.3	6.1	6.0	5.8
Net current transfers	31.9	23.9	11.2	13.5	18.6	18.0	16.2
Private transfers	5.7	8.6	1.8	2.5	3.6	4.6	5.7
Official transfers	26.1	15.3	9.4	11.0	15.1	13.4	10.5
Current account balance (excluding official transfers)	-38.1	-25.9	-36.7	-30.7	-26.8	-24.3	-22.4
Current account balance (including official transfers)	-12.0	-10.6	-27.3	-19.7	-11.7	-10.9	-11.8
Memorandum items:							
Nominal GDP (in millions of U.S. dollars)	6,720	8,331	9,982	10,425	11,349	12,253	13,174
Per capita nominal GDP (U.S. dollars)	1,708	2,058	2,394	2,428	2,567	2,693	2,813
Unemployment rate (average in percent of labor force)	25	24	21	21	19	18	18
Al Quds stock market index (annual percentage change)	11.6	-0.7	-2.7	…	…	…	…

Sources: Palestinian authorities; and IMF staff estimates and projections.

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	2012			Projections		
				Budget	Jan-Jun	Proj.	2013	2014	2015
				(In millions of U.S. dollars, unless otherwise stated)					
Total net revenues	**1,597**	**1,884**	**2,046**	**2,235**	**1,035**	**2,120**	**2,257**	**2,489**	**2,820**
Gross domestic revenues	585	702	738	812	363	761	774	881	1,087
Tax revenues	301	431	483	559	252	498	492	531	587
Nontax revenues (accrued)	284	270	256	253	111	263	283	350	500
Nontax revenues (cash)	284	270	219	253	96	248	283	350	500
Clearance revenues (accrued)	1,103	1,259	1,424	1,542	725	1,485	1,619	1,755	1,890
Clearance revenues (cash)	1,090	1,242	1,490	1,542	708	1,485	1,619	1,755	1,890
Clearance revenues (net arrears)	13	16	-66	---	16	---	---	---	---
Tax refunds	91	76	116	119	53	126	137	147	156
Total recurrent expenditures and net lending (commitment)	**3,190**	**3,076**	**3,325**	**3,188**	**1,665**	**3,400**	**3,468**	**3,586**	**3,709**
Wage expenditures (commitment)	1,467	1,613	1,783	1,793	893	1,796	1,886	1,980	2,079
Wage expenditures (cash)	1,423	1,564	1,679	1,793	820	1,796	1,886	1,980	2,079
Wage expenditures (net arrears)	44	50	105	---	73	---	---	---	---
Nonwage expenditures (commitment)	1,349	1,227	1,402	1,290	700	1,431	1,451	1,487	1,525
Nonwage expenditures (cash)	1,142	1,156	1,143	1,290	556	1,431	1,651	1,687	1,625
Nonwage expenditures (net arrears)	207	71	259	---	144	---	-200	-200	-100
Net lending (commitment)	374	236	140	105	72	172	132	118	105
Net lending (cash)	355	263	140	105	72	172	132	118	105
Net lending (net arrears)	20	-28	---	---	---	---	---	---	---
Recurrent balance (commitment, before external support)	**-1,592**	**-1,192**	**-1,279**	**-953**	**-631**	**-1,280**	**-1,212**	**-1,097**	**-888**
subtract: nontax revenue arrears	---	---	36	---	15	15	---	---	---
add: expenditure arrears (net)	270	93	363	---	217	---	-200	-200	-100
subtract: net clearance due (+) or repaid (-)	13	16	-66	---	16	---	---	---	---
add: arrears on tax refunds due (+) or repaid (-)	-36	-3	103	---	48	---	---	---	---
Recurrent balance (cash, before external support)	**-1,371**	**-1,118**	**-783**	**-953**	**-397**	**-1,295**	**-1,412**	**-1,297**	**-988**
Development expenditures (commitment)	**430**	**299**	**370**	**350**	**117**	**232**	**300**	**350**	**400**
Development expenditures (cash)	**400**	**275**	**295**	**350**	**93**	**232**	**300**	**350**	**400**
Development expenditures (arrears)	**30**	**23**	**76**	**---**	**24**	**---**	**---**	**---**	**---**
Overall balance (cash, including development expenditures)	**-1,771**	**-1,393**	**-1,078**	**-1,303**	**-490**	**-1,526**	**-1,712**	**-1,647**	**-1,388**
Total financing	**1,771**	**1,393**	**1,078**	**1,303**	**490**	**1,526**	**1,712**	**1,647**	**1,388**
Net domestic bank financing	176	97	137	---	42	---	---	---	---
Other domestic financing	---	---	---	---	---	---	---	---	---
External financing for recurrent expenditures	1,355	1,146	771	1,003	398	941	1,412	1,297	988
External financing for development expenditures	400	129	169	300	48	202	300	350	400
Net external debt	-4	---	---	---	---	---	---	---	---
Residual	-156	20	1	---	3	383	---	---	---
Memorandum items:				(In percent of GDP; unless otherwise stated)					
Revenues	23.8	22.6	20.5	22.9	9.9	20.3	19.9	20.3	21.4
Recurrent expenditures and net lending	47.5	36.9	33.3	32.6	16.0	32.6	30.6	29.3	28.2
Wage expenditures	21.8	19.4	17.9	18.3	8.6	17.2	16.6	16.2	15.8
Nonwage expenditures	20.1	14.7	14.0	13.2	6.7	13.7	12.8	12.1	11.6
Net lending	5.6	2.8	1.4	1.1	0.7	1.7	1.2	1.0	0.8
Recurrent balance (commitment) before external support:	-23.7	-14.3	-12.8	-9.8	-6.0	-12.3	-10.7	-9.0	-6.7
Recurrent balance (cash) before external support	-20.4	-13.4	-7.8	-9.8	-3.8	-12.4	-12.4	-10.6	-7.5
External support (recurrent)	20.2	13.8	7.7	10.3	3.8	9.0	12.4	10.6	7.5
in millions of U.S. dollars	1,355	1,146	771	1,003	398	941	1,412	1,297	988
Development expenditures (cash)	6.0	3.3	3.0	3.6	0.9	2.2	2.6	2.9	3.0
Overall balance (cash)	-26.4	-16.7	-10.8	-13.3	-4.7	-14.6	-15.1	-13.4	-10.5
Total external support (in millions of U.S. dollars)	1,755	1,276	940	1,303	445	1,143	1,712	1,647	1,388
Nominal exchange rate (average; NIS per US dollar)	3.9	3.7	3.6	3.8	3.8	3.8	...	...	...
Nominal GDP (in millions of U.S. dollars)	6,720	8,331	9,982	9,771	10,425	10,425	11,349	12,253	13,174

Sources: Ministry of Finance; and IMF staff estimates.

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

	2009	2010	2011	2012 Budget	2012 Jan–Jun	2012 Proj.	Projections 2013	Projections 2014	Projections 2015
				(In millions of shekels, unless otherwise stated)					
Total net revenues	**6,282**	**7,028**	**7,321**	**8,493**	**3,931**	**8,055**	**8,576**	**9,456**	**10,718**
Gross domestic revenues	2,301	2,617	2,642	3,087	1,378	2,891	2,943	3,348	4,130
Tax revenues	1,185	1,608	1,727	2,124	957	1,892	1,869	2,018	2,230
Nontax revenues (accrued)	1,115	1,009	915	963	422	999	1,074	1,330	1,900
Nontax revenues (cash)	1,115	1,009	785	963	366	944	1,074	1,330	1,900
Clearance revenues (accrued)	4,338	4,695	5,095	5,859	2,754	5,644	6,152	6,669	7,181
Clearance revenues (cash)	4,286	4,634	5,330	5,859	2,692	5,644	6,152	6,669	7,181
Clearance revenues (net arrears)	52	61	-235	---	62	---	---	---	---
Tax refunds	357	285	416	454	201	480	519	560	593
Total recurrent expenditures and net lending (commitment)	**12,543**	**11,473**	**11,897**	**12,114**	**6,327**	**12,919**	**13,180**	**13,626**	**14,094**
Wage expenditures (commitment)	5,768	6,017	6,381	6,813	3,394	6,825	7,166	7,525	7,901
Wage expenditures (cash)	5,596	5,832	6,007	6,813	3,117	6,825	7,166	7,525	7,901
Wage expenditures (net arrears)	171	185	374	---	277	---	---	---	---
Nonwage expenditures (commitment)	5,304	4,575	5,015	4,901	2,660	5,439	5,514	5,652	5,793
Nonwage expenditures (cash)	4,490	4,312	4,089	4,901	2,114	5,439	6,274	6,412	6,173
Nonwage expenditures (net arrears)	815	263	926	---	546	---	-760	-760	-380
Net lending (commitment)	1,471	880	501	400	273	655	500	450	400
Net lending (cash)	1,395	983	501	400	273	655	500	450	400
Net lending (net arrears)	77	-103	---	---	---	---	---	---	---
Recurrent balance (commitment, before external support)	**-6,261**	**-4,445**	**-4,576**	**-3,621**	**-2,396**	**-4,864**	**-4,604**	**-4,170**	**-3,376**
subtract: nontax revenue arrears	0	0	130	---	55	55	---	---	---
add: expenditure arrears (net)	1,063	345	1,300	---	824	---	-760	-760	-380
subtract: net clearance due (+) or repaid (-)	52	61	-235	---	62	---	---	---	---
add: arrears on tax refunds due (+) or repaid (-)	-140	-9	368	---	182	---	---	---	---
Recurrent balance (cash, before external support)	**-5,391**	**-4,170**	**-2,803**	**-3,621**	**-1,507**	**-4,920**	**-5,364**	**-4,930**	**-3,756**
Development expenditures (commitment)	**1,691**	**1,114**	**1,325**	**1,330**	**444**	**880**	**1,140**	**1,330**	**1,520**
Development expenditures (cash)	**1,573**	**1,026**	**1,054**	**1,330**	**353**	**880**	**1,140**	**1,330**	**1,520**
Development expenditures (arrears)	**118**	**88**	**270**	---	**91**	---	---	---	---
Overall balance (cash, including development expenditures)	**-6,964**	**-5,195**	**-3,858**	**-4,951**	**-1,860**	**-5,800**	**-6,504**	**-6,260**	**-5,276**
Total financing	**6,964**	**5,195**	**3,858**	**4,951**	**1,860**	**5,800**	**6,504**	**6,260**	**5,276**
Net domestic bank financing	691	363	490	0	159	---	---	---	---
Other domestic financing	---	---	---	---	---	---	---	---	---
External financing for recurrent expenditures	5,328	4,276	2,759	3,811	1,511	3,576	5,364	4,930	3,756
External financing for development expenditures	1,573	482	605	1,140	181	768	1,140	1,330	1,520
Net external debt	-16	---	---	---	---	---	---	---	---
Residual	-613	74	4	---	10	1,456	---	---	---
Memorandum items:				(In percent of GDP; unless otherwise stated)					
Revenues	23.8	22.6	20.5	22.9	9.9	20.3	19.9	20.3	21.4
Recurrent expenditures and net lending	47.5	36.9	33.3	32.6	16.0	32.6	30.6	29.3	28.2
Wage expenditures	21.8	19.4	17.9	18.3	8.6	17.2	16.6	16.2	15.8
Nonwage expenditures	20.1	14.7	14.0	13.2	6.7	13.7	12.8	12.1	11.6
Net lending	5.6	2.8	1.4	1.1	0.7	1.7	1.2	1.0	0.8
Recurrent balance (commitment) before external support:	-23.7	-14.3	-12.8	-9.8	-6.0	-12.3	-10.7	-9.0	-6.7
Recurrent balance (cash) before external support	-20.4	-13.4	-7.8	-9.8	-3.8	-12.4	-12.4	-10.6	-7.5
External support (recurrent)	20.2	13.8	7.7	10.3	3.8	9.0	12.4	10.6	7.5
in millions of U.S. dollars	1,355	1,146	771	1,003	398	941	1,412	1,297	988
Development expenditures (cash)	6.0	3.3	3.0	3.6	0.9	2.2	2.6	2.9	3.0
Overall balance (cash)	-26.4	-16.7	-10.8	-13.3	-4.7	-14.6	-15.1	-13.4	-10.5
Total external support (in millions of shekels)	6,901	4,758	3,364	4,951	1,691	4,344	6,504	6,260	5,276
Nominal exchange rate (NIS per US dollar)	3.9	3.7	3.6	3.80	3.80	3.80	...	...	...
Nominal GDP (in millions of shekels)	26,424	31,073	35,717	37,129	39,613	39,613	43,127	46,561	50,061

Sources: Ministry of Finance; and IMF staff estimates.

Table 4. Central Government Budget, 2009–15
(GFSM 2001, in millions of U.S. dollars)

	2009	2010	2011	2012			Projections		
				Budget	Jan-Jun	Proj.	2013	2014	2015
	(In millions of U.S. dollars, unless otherwise stated)								
Revenue	**3,352**	**3,160**	**2,986**	**3,538**	**1,480**	**3,646**	**3,968**	**4,136**	**4,209**
Taxes	1,314	1,614	1,790	1,981	924	1,857	1,974	2,139	2,320
Domestic taxes	301	431	483	559	252	498	492	531	587
Clearance taxes	1,103	1,259	1,424	1,542	725	1,485	1,619	1,755	1,890
Tax refund	-91	-76	-116	-119	-53	-126	-137	-147	-156
Grants	1,755	1,276	940	1,303	445	1,526	1,712	1,647	1,388
External budget support	1,355	1,146	771	1,003	398	1,324	1,412	1,297	988
External development support	400	129	169	300	48	202	300	350	400
Other revenue	284	270	256	253	111	263	283	350	500
o/w Dividends	12	149	160	25	---	30	---	---	---
Expenditures	**3,620**	**3,374**	**3,695**	**3,538**	**1,782**	**3,631**	**3,768**	**3,936**	**4,109**
Expense	3,190	3,076	3,325	3,188	1,665	3,400	3,468	3,586	3,709
Compensation of employees 1/	1,467	1,613	1,783	1,793	893	1,796	1,886	1,980	2,079
Use of goods and services	466	493	501	516	250	516	541	568	597
Grants 2/	374	236	140	105	72	172	132	118	105
Other expense 3/	883	733	901	774	450	916	910	919	928
Net acquisition of nonfinancial assets	430	299	370	350	117	232	300	350	400
Gross Operating Balance	**163**	**84**	**-339**	**350**	**-185**	**246**	**500**	**550**	**500**
Net lending / borrowing (overall balance)	-267	-215	-709	---	-302	15	200	200	100
Net financial transactions	-267	-215	-709	---	-302	-369	200	200	100
Net acquisition of financial assets	---	---	---	---	---	---	---	---	---
Domestic									
Currency and deposits	---	---	---	---	---	---	---	---	---
Net incurrence of liabilities	423	195	708	---	300	-15	-200	-200	-100
Domestic	427	195	708	---	300	-15	-200	-200	-100
Loans	176	97	137	---	42	---	---	---	---
Net domestic bank financing	176	97	137	---	42	---	---	---	---
Other accounts payable	251	97	571	---	258	-15	-200	-200	-100
Arrears (recurrent)	235	90	430	---	250	-15	-200	-200	-100
Arrears (capital)	30	23	76	---	24	---	---	---	---
Arrears (clearance)	13	16	-66	---	16	---	---	---	---
Foreign	-4	---	---	---	---	---	---	---	---
Loans	-4	---	---	---	---	---	---	---	---
Statistical Discrepancy	*-156*	*20*	*1*	---	*3*	*383*	---	---	---
Memorandum items:									
Gross operating balance excl. grants (commitment)	-1,592	-1,192	-1,279	-953	-631	-1,280	-1,212	-1,097	-888
Gross operating balance excl. grants (cash)	-1,371	-1,118	-783	-953	-397	-1,295	-1,412	-1,297	-988
Overall balance (NLB) excl. grants (commitment)	-2,022	-1,490	-1,649	-1,303	-747	-1,512	-1,512	-1,447	-1,288
Overall balance (NLB) excl. grants (cash)	-1,771	-1,393	-1,078	-1,303	-490	-1,526	-1,712	-1,647	-1,388
Revenue as % of GDP	49.9	37.9	29.9	36.2	14.2	35.0	35.0	33.8	31.9
Expenditure as % of GDP	53.9	40.5	37.0	36.2	17.1	34.8	33.2	32.1	31.2
Expense as % of GDP	47.5	36.9	33.3	32.6	16.0	32.6	30.6	29.3	28.2
Wage expenditure as % of GDP	21.8	19.4	17.9	18.3	8.6	17.2	16.6	16.2	15.8
Nonwage expenditures as % of GDP	6.9	5.9	5.0	5.3	2.4	4.9	4.8	4.6	4.5
GOB (commitment) excluding grants as % of GDP	-23.7	-14.3	-12.8	-9.8	-6.0	-12.3	-10.7	-9.0	-6.7
GOB (cash) excluding grants as % of GDP	-20.4	-13.4	-7.8	-9.8	-3.8	-12.4	-12.4	-10.6	-7.5
External support (recurrent)	20.2	13.8	7.7	10.3	3.8	12.7	12.4	10.6	7.5
in millions of U.S. dollars	1,355	1,146	771	1,003	398	1,324	1,412	1,297	988
NLB (commitment) excluding grants as % of GDP	-30.1	-17.9	-16.5	-13.3	-7.2	-14.5	-13.3	-11.8	-9.8
NLB (cash) excluding grants as % of GDP	-26.4	-16.7	-10.8	-13.3	-4.7	-14.6	-15.1	-13.4	-10.5
Total external support (in millions of shekels)	1,755	1,276	940	1,303	445	1,526	1,712	1,647	1,388
Nominal GDP (in millions of shekels)	6,720	8,331	9,982	9,771	10,425	10,425	11,349	12,253	13,174
Exchange Rate	3.9	3.7	3.6	3.8	3.8	3.8	…	...	…

Sources: The Ministry of Finance, West Bank and Gaza; and Fund staff projections.

1/ Wage expenditures.
2/ Grants to local governments related to purchase of water and electricity.
3/ Includes transfers (social benefits) and minor capital.

Table 5. Central Government Budget, 2009–15
(GFSM 2001, in millions of shekels)

	2009	2010	2011	2012			Projections		
				Budget	Jan-Jun	Proj.	2013	2014	2015
	(In millions of shekels, unless otherwise stated)								
Revenue	**13,183**	**11,786**	**10,685**	**13,443**	**5,622**	**13,855**	**15,080**	**15,716**	**15,994**
Taxes	5,167	6,019	6,406	7,529	3,510	7,056	7,502	8,126	8,818
Domestic taxes	1,185	1,608	1,727	2,124	957	1,892	1,869	2,018	2,230
Clearance taxes	4,338	4,695	5,095	5,859	2,754	5,644	6,152	6,669	7,181
Tax refund	-357	-285	-416	-454	-201	-480	-519	-560	-593
Grants	6,901	4,758	3,364	4,951	1,691	5,800	6,504	6,260	5,276
External budget support	5,328	4,276	2,759	3,811	1,511	5,032	5,364	4,930	3,756
External development support	1,573	482	605	1,140	181	768	1,140	1,330	1,520
Other revenue	1,115	1,009	915	963	422	999	1,074	1,330	1,900
o/w Dividends	12	149	160	95	---	114	---	---	---
Expenditures	**14,234**	**12,586**	**13,222**	**13,444**	**6,771**	**13,799**	**14,320**	**14,956**	**15,614**
Expense	12,543	11,473	11,897	12,114	6,327	12,919	13,180	13,626	14,094
Compensation of employees 1/	5,768	6,017	6,381	6,813	3,394	6,825	7,166	7,525	7,901
Use of goods and services	1,831	1,840	1,792	1,959	951	1,959	2,057	2,160	2,268
Grants 2/	1,471	880	501	400	273	655	500	450	400
Other expense 3/	3,473	2,735	3,223	2,942	1,709	3,480	3,457	3,492	3,525
Net acquisition of nonfinancial assets	1,691	1,114	1,325	1,330	444	880	1,140	1,330	1,520
Gross Operating Balance	**639**	**313**	**-1,212**	**1,329**	**-705**	**935**	**1,900**	**2,090**	**1,900**
Net lending / borrowing (overall balance)	-1,051	-800	-2,537	-1	-1,149	55	760	760	380
Net financial transactions	-1,051	-800	-2,537	---	-1,149	-1,401	760	760	380
Net acquisition of financial assets	---	---	---	---	---	---	---	---	---
Domestic									
Currency and deposits	---	---	---	---	---	---	---	---	---
Net incurrence of liabilities	1,664	726	2,533	---	1,139	-55	-760	-760	-380
Domestic	1,680	726	2,533	---	1,139	-55	-760	-760	-380
Loans	691	363	490	---	159	---	---	---	---
Net domestic bank financing	691	363	490	---	159	---	---	---	---
Other accounts payable	988	363	2,043	---	980	-55	-760	-760	-380
Arrears (recurrent)	922	336	1,538	---	951	-55	-760	-760	-380
Arrears (capital)	118	88	270	---	91	---	---	---	---
Arrears (clearance)	52	61	-235	---	62	---	---	---	---
Foreign	-16	---	---	---	---	---	---	---	---
Loans	-16	---	---	---	---	---	---	---	---
Statistical Discrepancy	*-613*	*74*	*4*	---	*10*	*1,456*	---	---	---
Memorandum items:									
Gross operating balance excl. grants (commitment)	-6,261	-4,445	-4,576	-3,622	-2,396	-4,864	-4,604	-4,170	-3,376
Gross operating balance excl. grants (cash)	-5,391	-4,170	-2,803	-3,622	-1,507	-4,920	-5,364	-4,930	-3,756
Overall balance (NLB) excl. grants (commitment)	-7,952	-5,559	-5,901	-4,952	-2,840	-5,744	-5,744	-5,500	-4,896
Overall balance (NLB) excl. grants (cash)	-6,964	-5,196	-3,858	-4,952	-1,860	-5,800	-6,504	-6,260	-5,276
Revenue as % of GDP	49.9	37.9	29.9	36.2	14.2	35.0	35.0	33.8	31.9
Expenditure as % of GDP	53.9	40.5	37.0	36.2	17.1	34.8	33.2	32.1	31.2
Expense as % of GDP	47.5	36.9	33.3	32.6	16.0	32.6	30.6	29.3	28.2
Wage expenditure as % of GDP	21.8	19.4	17.9	18.3	8.6	17.2	16.6	16.2	15.8
Nonwage expenditures as % of GDP	6.9	5.9	5.0	5.3	2.4	4.9	4.8	4.6	4.5
GOB (commitment) excluding grants as % of GDP	-23.7	-14.3	-12.8	-9.8	-6.0	-12.3	-10.7	-9.0	-6.7
GOB (cash) excluding grants as % of GDP	-20.4	-13.4	-7.8	-9.8	-3.8	-12.4	-12.4	-10.6	-7.5
External support (recurrent)	20.2	13.8	7.7	10.3	3.8	12.7	12.4	10.6	7.5
in millions of NIS	5,328	4,276	2,759	3,811	1,511	5,032	5,364	4,930	3,756
NLB (commitment) excluding grants as % of GDP	-30.1	-17.9	-16.5	-13.3	-7.2	-14.5	-13.3	-11.8	-9.8
NLB (cash) excluding grants as % of GDP	-26.4	-16.7	-10.8	-13.3	-4.7	-14.6	-15.1	-13.4	-10.5
Total external support (in millions of shekels)	6,901	4,758	3,364	4,951	1,691	5,800	6,504	6,260	5,276
Nominal GDP (in millions of shekels)	26,424	31,073	35,717	37,129	39,613	39,613	43,127	46,561	50,061
Exchange Rate	3.9	3.7	3.6	3.8	3.8	3.8	…	…	…

Sources: The Ministry of Finance, West Bank and Gaza; and Fund staff projections.

1/ Wage expenditures.
2/ Grants to local governments related to purchase of water and electricity.
3/ Includes transfers (social benefits) and minor capital.

APPENDIX

A. Reforms by the Palestine Monetary Authority

The Palestine Monetary Authority's (PMA) 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.

1. **In 2010–12 the PMA has strengthened the supervision and regulatory framework and advanced toward the implementation of Basel II/III 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 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 2009: (i) an increase in the minimum capital requirement to $50 million (from $35 million) with a compliance deadline of end-2010; 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. Since March 2011 the PMA has conducted quarterly stress tests of individual banks and the banking system to assess the robustness of the banks and the system to plausible shocks. The PMA has also provided training on stress testing to banks' staff and advises banks on the design of their stress tests. The implementation of Basel II/III requirements continues along a road map adopted by the PMA and supported by the World Bank. The PMA is reviewing bids submitted by external consultants to implement Basel requirements. In January 2012, the PMA introduced regulations for licensing and managing of Specialized Lending and Financial Companies, including microfinance institutions, approved in 2011. It also introduced the regulation on Incentives and Compensation to enhance the governance, stability, and robustness of the financial system. The PMA, through its consumer relations and market conduct department, has issued the Basic Account regulations, ATM service regulation, and electronic banking regulations all aimed at further increasing inclusion and consumers' awareness, safety, and security of transactions.

2. **The PMA have established a modern payment infrastructure including bounced-checks tracking, credit scoring, and electronic payment systems.** The bounced-checks 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 awaiting the Cabinet's approval. 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. The PMA agreed with the Palestine Stock Exchange to bring under the RTGS transactions settled through central securities depository. The PMA is currently updating, with World Bank assistance, instructions for RTGS operations and its oversight framework. In addition the PMA is working to implement a national switch project for domestic electronic transactions. This will allow settling transactions domestically. It also established an international bank account number (IBAN) for the West Bank and Gaza and registered it with the international payment system (i.e. SWIFT) in July 2012. The IBAN will simplify and lower the costs of international transactions for the WBG based businesses. The transactions will bypass intermediaries and follow so called "straight through processing" (i.e., a direct route between the transacting parties). The PMA expects that banks will start using the IBAN by the fall of 2012.

3. **The PMA and the Bank of Israel (BoI) have continued joint efforts aimed at facilitating cooperation between Palestinian and Israeli commercial banks.** These efforts were stepped up in 2009, when large shekel cash surpluses had accumulated at Palestinian banks due to Israeli banks' refusal to accept cash deposits on concerns about legal implications. The two parties have been working to address that problem through a special arrangement whereby the excess shekel cash is regularly deposited at Israeli banks' accounts with the BoI. In addition, the PMA and the BoI continue to work 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.

4. **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 currently being formulated and discussed by the PMA. 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 has started preparing its Monetary Operations Department for open market operations and the issuance of government securities and PMA Certificates of Deposits, including Sukuk certificates.

B. 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.

1. **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.

2. **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, public debt and since 2011 public investments. 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 SAACB is finalizing an audit of 2010 financial statements submitted to the SAACB in September 2011.

3. 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 as well as regulations and manuals that have been drafted during the last few years as part of the reforms to improve institutionalization of public finance reforms and accountability. 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.

- Appoint the head of the macro fiscal unit and continue to develop the 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.

C. Economic Measures Agreed By the Quartet Representative and Israel

On February 4, 2011, the Quartet Representative and the GoI agreed on a package of measures to support the WBG's development. The package includes a series of initial, practical steps that need to be taken promptly. To expand Palestinian private sector activity and raise revenue to the PA in a sustainable manner, it is essential to build on those steps by lifting the remaining restrictions on movement and access. Below is a summary of progress made in the measures' implementation as of end-August 2012.

1. **Relaxing Gaza's export restrictions**

Pre-agreement situation: Since the onset of the tight restrictions in 2006, the GoI imposed tight restrictions on exports from Gaza. The GoI occasionally permitted the export of limited quantities of flowers and strawberries destined to EU markets.

Agreed measures and progress:

- *Starting on April 1, 2011*, the GoI announced that it would permit the export of textiles, furniture, and agricultural products from Gaza to international markets (but not to Israel or the West Bank). By mid-March 2011, the GoI has permitted the export to EU markets of limited quantities of cherry tomatoes and sweet peppers, in addition to flowers and strawberries to EU markets. In 2012, agricultural exports to the EU exceeded 2011 levels.

  Progress: As of end-August 2012 export of textile and furniture to international markets has been approved but has involved very small volumes. Gaza exporters have traditionally relied on Israeli and West Bank markets and developing new international contacts has proven difficult. Four truckloads of furniture were exported to Amman, Jordan for an exhibition and a trade fair, and 4000 items of knitwear were exported to the UK in June 2012. A transport mechanism to export tomatoes and potatoes to Jordan was tested in July 2011 but so far no commercial loads of potatoes have been exported and only a few truckloads of tomatoes were exported to Jordan in the spring of 2012. Insufficient progress related to this export option is a result of the high cost of transferring products through the Kerem Shalom crossing, the high cost of freight by sealed trucks (required to comply with Israeli phyto-sanitary protection applied to potatoes) from Kerem Shalom to the Allenby Bridge, and seasonal price variations in Jordan.

- *By end-April 2011,* the GoI will decide on whether to allow PA-approved Gaza producers to transfer textiles and furniture to pre-approved West Bank purchasers.

  Progress: In late 2010 GoI indicated that export to the West Bank would be allowed to fill orders to PA institutions. As of end-August 2012 no exports had been completed. Several tenders for school furniture were won by a Gaza firm which approached GoI for permission to transfer. The GoI has already approved one of these tenders for transferring school furniture to the West Bank and another one is under consideration. Gaza manufacturers have been reluctant to submit tenders because of the GoI no transfer policy to the West Bank.

- *Once a merchandise security scanner is installed, expected by mid-2011,* the GoI will increase the quantities, and potentially the range, of goods exported to all markets except Israel and the West Bank.

  Progress: A reconditioned, high-resolution gantry scanner was installed by the GoI Crossing Point Administration at the goods crossing on the Israel-Gaza border in May 2012. As of end-August 2012 there has been no significant change in export rules or volumes resulting from this installation and the Palestinian counterparts have not been notified of any expected changes in the foreseeable future.

- *The GoI has agreed to consider, in due course, further relaxation of export restrictions.*

  Progress: Measures not yet implemented as of end-August 2012.

2. Relaxing Gaza's import restrictions

Pre-agreement situation: From 2006 to mid-2010, the GoI allowed into Gaza mostly humanitarian goods and limited quantities of consumer goods on a "positive list". Since mid-2010, it has applied a "negative" or "controlled goods" list, which in effect lifts restrictions on imports of consumer goods, as well as on input materials destined to pre-approved, internationally-supervised investment and construction projects. However, the policy has maintained import restrictions on a broad range of investment inputs for the private sector, including construction inputs, as well as machinery and equipment considered to have potential dual military/civilian use.

Agreed measures and progress:

- The GoI has agreed to discuss with the Office of the Quarter Representative and the United Nations the implementation of a pilot arrangement, *to start on April 1, 2011,* to allow PA-approved Gaza businesses to import limited quantities of construction inputs.

  Progress: Discussions began in February 2011 and the pilot arrangement was approved in September 2011. It allowed for 10 approved factories to import cement, steel bar and aggregate for specified re-building of bomb damaged structures. It required over-sight by an international engineering company to ensure that volumes imported matched volumes used in construction. It was expected to start in late-October 2011 subject to the security situation. Raw materials were imported in mid-November 2011 by which time most of the 10 factories had been re-built using materials available on the open market. Many of the 10 rebuilt factory owners had not provided the plans and specifications allowing for effective monitoring. There has been no general relaxation of import restrictions on construction materials.

- *In progress since February 2011*: The GoI had agreed to pre-approve 20 new internationally supervised construction projects in Gaza including in the health, housing, infrastructure, and environmental areas. The funders of these projects were preparing to implement them in coordination with the GoI.

  Progress: New projects have been approved since February 2011 but the recently high growth rates are mostly attributed to the tunnel trade and only a small portion can be attributed to these international projects.

3. **Enhancing energy supply to the West Bank and Gaza**

Pre-agreement situation: Since 2006, Gaza had depended for its electricity mostly on an inefficient oil-based power station with obsolete equipment. Power outages had been frequent. Prior to September 2010, the plant was dependent on the provision of fuel purchased by the PA, but the subsidy was gradually phased out as payment of electricity bills by Gaza consumers improved.

Agreed measures and progress:

- *By June 2011*: The GoI agreed to conclude preliminary discussions with the PA on the development of the Gaza Marine offshore gas field. The development of this field will provide natural gas to both the Gaza Strip and the West Bank.

  Progress: The GoI and the PA exchanged a set of letters regarding the development of the Palestinian offshore gas field known as Gaza Marine. The GoI has given its non-objection to the development of the field and is currently in discussion with the PA and the private sector consortium that was awarded the concession agreement about moving ahead with implementation.

- The GoI has agreed to approve the upgrading of the existing power station in Gaza and the construction of a second one following the submission of the PA plans. It has also agreed to the use of the gas from the Gaza Marine field (once developed) by the two plants, and to review requests to provide electricity to Gaza from Israeli sources.

  Progress: The GoI has continued to facilitate the entry of materials and staff to maintain the existing Gaza power plant. It also approved the entry of Qatari gas and 30 million liters of Egyptian fuel for the Gaza power plant.

4. **Improving the collection of clearance revenue**

A key fiscal objective of the PA had been to raise clearance revenue toward its full potential through joint steps with the GoI, including through enhanced information-sharing and monitoring by PA officials of imports at crossing points/gateways. The GoI agreed to schedule regular meetings with the PA to identify and agree on measures to raise and streamline the transfer of revenue to the PA.

Progress: In July 2012, Minister Steinitz and Prime Minister Fayyad signed the understanding to implement the understandings reached in 2011 at the technical level between the Israeli and Palestinian ministries of finance:

- Ensuring that the assessment of clearance revenue owed to each side is 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 would have equal access to data collected through shared electronic interfaces. The data-sharing would allow a better appraisal and tracing of the extent and sources of tax leakages.

- Enhancing control and tracing by both sides of merchandise destined to the WBG to ensure better compliance of taxpayers with unified invoice requirements. This will involve agreement, inter alia, on new procedures to electronically trace imports ("e-tagging"), and establishment of bonded warehouses for WBG imports entering through Israeli ports.

- Review current revenue-sharing practices to ensure that they are in line with the Paris Protocol. One practice to be reviewed at the outset relates to the review of exit fees levied by Israel on Palestinian passengers crossing the Allenby Bridge, to ensure that the revenue is equally shared between the two sides.