INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

May 18, 2015

KEY ISSUES

Context: Since the breakdown of peace talks in April 2014, Israeli-Palestinian relations have been deteriorating. After the war in Gaza, Israel continued settlement expansion, and the Palestinian Authority (PA) took steps towards international recognition, including membership in the International Criminal Court. This prompted Israel to suspend the transfer of clearance revenue (CR), resulting in a major blow to the PA's finances.[2] Recently, such transfers resumed. Little progress has been achieved in the reconciliation between Hamas and Fatah, the rival Palestinian factions. This, combined with limitations on imports of construction materials into Gaza and shortfalls in donor aid relative to Cairo pledges, has stalled progress on Gaza reconstruction.

Outlook and risks: Economic prospects in 2015 are highly uncertain, and risks are elevated. Further interruptions in CR transfers or continued shortfalls in donor aid would lead to drastic fiscal retrenchment with adverse economic, and potentially social, consequences. In the medium term, without a sustainable political solution, growth will remain subpar and unemployment will rise, threatening social cohesion. On the other hand, if peace talks resumed and restrictions on trade were relaxed, economic prospects would brighten. In Gaza, the economic outlook depends on the availability of donor aid for reconstruction.

Key policy recommendations: While the resumption of CR transfers has reduced pressures, fiscal discipline is needed to instill confidence in highly uncertain times. Measures to contain the projected 2015 financing gap and avoid further arrears accumulation are needed, especially wage restraint and efforts to improve tax compliance. However, measures alone will not be sufficient, and additional aid is needed to cover the gap. Over the medium term, the key recommendation remains to move to a more viable financing model that combines lower deficits and a growth-friendly re-composition of expenditure with sustained donor aid, predictable revenue transfers, and an easing of Israeli restrictions.

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[1] The IMF provides technical services to the West Bank and Gaza, including policy advice in the macroeconomic, fiscal, and financial areas, as well as technical assistance, with a focus on tax administration, public expenditure management, banking supervision and regulation, and statistics. See www.imf.org/wbg for recent reports.

[2] Clearance revenues are revenues collected by Israel mainly in the form of indirect taxes on imported goods. These revenues are later transferred to the Palestinian Authority, and account for two-thirds of total revenues.

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Discussions were held in East Jerusalem and Ramallah during January 21–29, 2015, and the report was updated with subsequent developments. The staff team comprised Christoph Duenwald (head), Anja Baum, and Anna Unigovskaya, Ragnar Gudmundsson (IMF Resident Representative) and Hania Qassis (IMF Resident Representative Office). The mission met Deputy Prime Minister Mustafa, Finance Minister Bishara, Palestine Monetary Authority Governor Al Wazir, other senior officials, private sector representatives, and donors. The mission prepared a concluding statement (which was later published) and issued a press statement. Priscilla Toffano, Jonah Rosenthal, Cecilia Pineda, and Vanessa Panaligan contributed to producing this report.

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CONTEXT

1. **Israeli-Palestinian relations have worsened over the past year, the security situation remains fragile, and the future of the peace process is uncertain.** A ceasefire agreement between Israel and Hamas ended last summer's war in August 2014, but a permanent truce remains elusive. After a UN Security Council resolution calling for the establishment of an independent Palestinian state by end-2017 failed to pass, the PA applied for membership in the International Criminal Court (ICC) in early January, allowing the possibility for the court to investigate alleged Israeli war crimes and settlement activities. This prompted Israel to freeze the transfer of CR from December 2014 to March 2015, inflicting a major blow to the PA's finances. In April, a few weeks after the Israeli election, the withheld CR was released. The ICC formally accepted Palestine as a member on April 1, 2015. Prospects for a resumption of Israeli-Palestinian peace talks remain highly uncertain.

2. **Domestic politics continue to be marked by factional rivalry.** The national consensus government remains in place, but the reconciliation deal reached in June 2014 appears to be unraveling, with Hamas largely remaining in control of Gaza. A key issue of contention is the PA's decision not to pay the salaries of around 40,000 civil servants hired by Hamas since 2007 to administer Gaza. These civil servants have been on strike because of unpaid wages as their employment status in the unity government has not been resolved. Under these circumstances, prospects for national elections are uncertain.

3. **The reconstruction process in Gaza is moving far more slowly than expected.** This reflects limits on imports of construction materials, and unfulfilled donor pledges from the October 2014 Cairo conference amid a lack of progress in Fatah-Hamas reconciliation. Reconciliation is necessary for a recovery in Gaza to take place, including through effective implementation and suitable monitoring of the Gaza Reconstruction Mechanism brokered by the United Nations and agreed between the Government of Israel and the PA. While notable progress has been made recently with the provision of materials for the repair of individual homes, larger construction projects that are required for a job-creating economic recovery are still pending. Out of a total $3.5 billion pledged for the reconstruction of Gaza during the October 2014 Cairo Conference, only an estimated 27 percent had been disbursed as of mid-April 2015.[3, 4] Meanwhile, the blockade of Gaza largely remains in place.[5]

[3] Source: World Bank, which is monitoring the delivery of pledges, disbursement, and implementation progress. See http://www.worldbank.org/en/programs/rebuilding-gaza-donor-pledges.

[4] Out of the $3.5 billion pledged for Gaza at the Cairo Conference, $2.5 billion was new funding.

[5] In this report, "blockade" refers to the restrictions placed on the movement of goods and people between Gaza and Israel, and the closure of the Rafah crossing by Egypt. The nature of these restrictions has varied over time.

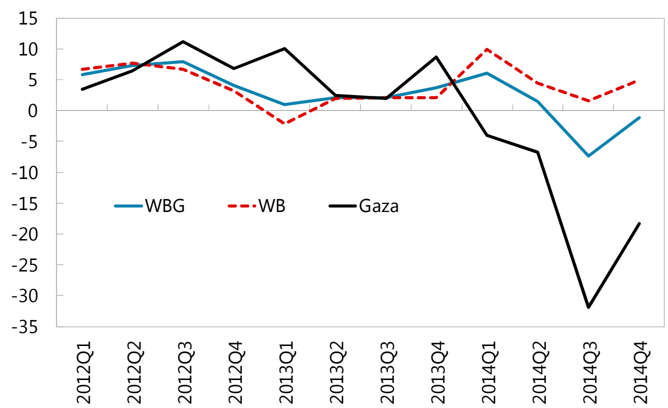
4. **Litigation risks add to uncertainties.** The Sokolow lawsuit in a New York court accuses the PA and the Palestine Liberation Organization (PLO) of financially supporting terrorist acts between 2001 and 2004. The PA rejected the accusations and pointed to jurisdictional shortcomings. The court has ruled in favor of the plaintiffs, and the PA might be required to place in an escrow account a significant portion of damages awarded while its appeal is considered. Given the large potential financial liability, this lawsuit raises concerns about the PA's financial viability.[6]

RECENT ECONOMIC DEVELOPMENTS

5. **Economic developments diverged sharply between the West Bank and Gaza (WBG) in 2014, reflecting the Hamas-Israel armed conflict in the summer.** The WBG's aggregate real GDP declined by 0.4 percent, the first contraction since 2006. In Gaza, real GDP contracted by 15 percent, whereas in the West Bank it rose by 5 percent.

- While growth in Gaza was already slowing before the war, economic activity collapsed during the war, with GDP contracting by 32 percent y-o-y in the third quarter of 2014. The contraction was concentrated in the construction sector, but agriculture and manufacturing also suffered major retrenchments. Following the war, the blockade remained largely in place and reconstruction proceeded very slowly. The unemployment rate peaked at 47 percent in the third quarter, before easing to 43 percent by year's end, four percentage points higher than a year earlier.

Real GDP Growth, 2012–14
(In y-o-y percent change)



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

- In the West Bank, growth rose from its 2013 level, driven mainly by exports, bank credit-fueled private consumption, and donor-financed public demand which rebounded from a fiscal crisis in early 2013. In the third quarter of 2014, however, growth decelerated to 1.5 percent y-o-y reflecting spillovers from the conflict in Gaza. The unemployment rate declined modestly to 17.4 percent at end-2014, with labor force participation increasing slightly to 46 percent.

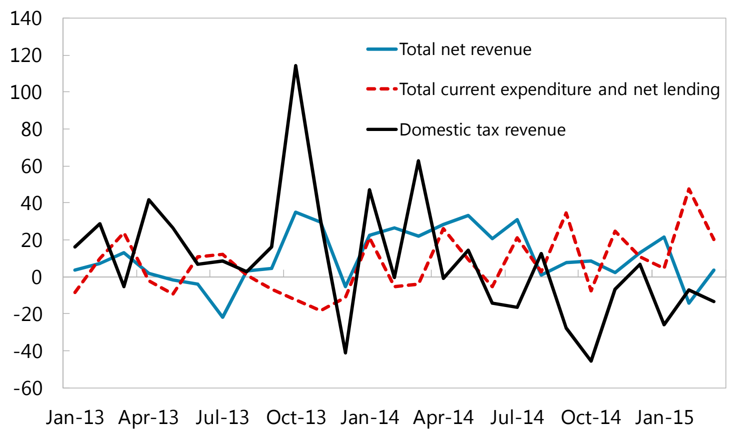
[6] In addition, there is a lawsuit against Arab Bank—which has a large presence in the West Bank and Gaza—filed at a New York federal district court in 2004 for having provided financial services to Hamas. A verdict against Arab Bank is expected to be appealed.

6. **Overall inflation in the WBG remained low, with higher inflation in Gaza.** Helped by lower fuel prices and deflation in Israel, inflation remained subdued at under 2 percent in the West Bank, despite the depreciation of the shekel in the second half of 2014. In Gaza, after a spike to 6 percent in August, notably due to the closure of tunnels and more expensive imports from Israel, inflation subsided to 3.4 percent in December. In early 2015, inflation is picking up, especially in Gaza.

7. **On the fiscal front, a modest reduction in the deficit was achieved in 2014, thanks to strong revenues.** The overall deficit declined from 12.6 percent of GDP in 2013 to 11.9 percent in 2014. The improvement in revenue was driven mostly by strong growth in CR (20 percent), helped by a sharp rise in fuel VAT and excise revenue collection and stepped-up tax administration efforts to combat under-invoicing. Although the authorities succeeded in raising the number of registered taxpayers by 7 percent, domestic income receipts remained depressed because of tax exemptions that had been agreed in previous years and took effect during 2014. Regarding expenditure, growth in current spending accelerated to 7.6 percent, with wages increasing by almost 6 percent, above the budgeted 5 percent. In part, this reflected the hiring of about 1,300 new employees, breaching the authorities' zero net hiring policy. Nonwage spending grew by 10 percent, reflecting strong growth in spending on goods and services. Net lending (expenditure that represents the PA's payment to Israel for electricity, water, and sanitation services, which is incurred by means of deductions from clearance revenue) increased by 35 percent. Development spending grew by 39 percent, with donors financing nearly 80 percent of the total, higher than in previous years.

Revenue and Expenditure

(Y–o–y growth, in percent)



Source: Ministry of Finance.

8. **The reduction in the deficit was insufficient to arrest arrears accumulation.** Donor aid in 2014 was lower than expected, reaching $1.2 billion, or about 80 percent of total projected official donor support for the year. This, combined with only a small reduction in the deficit and repayment of some bank debt, led to NIS 1.7 billion (3.7 percent of GDP) in new net arrears.[7] As a result, overall debt including arrears reached an estimated 39 percent of GDP. Moreover, the PA's direct and contingent liabilities to the Israel Electricity Company (IEC), some of which are in dispute, continued to increase, reaching NIS 1.8 billion at end-March 2015. Arrears to the Pension Fund constituted about 70 percent of the total new arrears, with the remainder to private suppliers.

[7] Arrears to some private sector suppliers were repaid.

9. **During January–March 2015, a significant fiscal deficit was recorded.** Fiscal operations were marked by a severe revenue shortage, caused by Israeli withholding of CR, accompanied by an expansion of spending commitments, which rose by 20 percent y-o-y, reflecting a spike in nonwage spending.[8] Domestic revenue underperformed, declining by 15 percent, despite improved collection efforts.[9] The authorities resorted to about $200 million of new borrowing from domestic banks, and accumulated wage and nonwage arrears.

10. **The banking system remains healthy under the circumstances, but there are vulnerabilities** (Figure 3)**.** Banks weathered the war in Gaza, thanks to good crisis preparedness by the PMA. In anticipation of disruptions, banks' risk reserves were raised, ATMs were filled, and their networks expanded, allowing banking operations to continue even during the conflict. After the war, the PMA lowered required reserves counter-cyclically, thereby boosting liquidity, while mandating the banks to reschedule loan repayments for Gazans to give borrowers time to recover from the war. As of end-December, financial soundness indicators remained strong (Table 4), notwithstanding some reduction in the capital adequacy ratio (CAR). Private credit growth remained surprisingly high given the economic strains. Worryingly, almost 43 percent of banks' loan portfolios constitute loans to the PA and its employees.

11. **Business and social indicators remain weak** (Figure 4)**.** The WBG scores favorably on human development and income inequality in comparison with other countries at its per capita income level. However, challenges remain in the business environment, in part reflecting the Israeli restrictions.[10] According to the 2015 Doing Business Report, the WBG ranks 143rd out of 189 countries, a downgrade from 139th in 2014.[11] Nevertheless, some progress has been made. The authorities recently eliminated the minimum capital requirement for registering a business, simplified business registration, and passed the financial leasing law.

OUTLOOK AND RISKS

12. **In 2015, staff projects a mild economic recovery with overall growth of 2.5 percent.** The CR freeze until April 2015 likely dampened private sector demand in the West Bank in the first quarter. On the assumption of steady CR transfers in the remainder of the year and a confirmation

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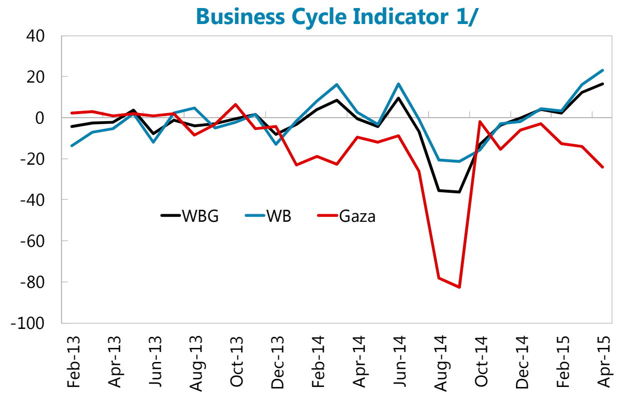
[8] The reasons for this increase are not yet understood and will be discussed with the authorities.

[9] The authorities link the decline to a one-off factor related to back payments of taxes in 2014 by two large taxpayers, a reduction in tobacco excise fees after phasing out of a subsidy for domestic tobacco in 2014, and lower domestic VAT from banks following the implementation in 2015 of a deposit insurance law by which banks have to contribute 0.03 percent of customers' deposits to the Palestinian Deposit Insurance Corporation, reducing their taxable income.

[10] The Government of Israel emphasizes security concerns that restrict its ability to ease or lift restrictions in the WBG.

[11] The World Bank Doing Business indicators should be interpreted with caution due to a limited number of respondents, limited geographical coverage, and standardized assumptions on business constraints and information availability.

of the recent improvement in the Business Cycle Indicator (text figure), growth should recover, supported by sustained low oil prices, averaging about 1 percent. In Gaza, staff projects growth to rebound to 7 percent from a low 2014 base, even though reconstruction will remain constrained as long as the national reconciliation process remains stalled and donor disbursements fall short of pledges. Business confidence in Gaza appears to have receded again. In these circumstances, and without additional reform measures, the fiscal financing gap will remain substantial at nearly $500 million.



Source: Palestine Monetary Authority.
1/ Based on survey of managers of industrial firms in WBG. Values range between -100 and +100. Negative values denote pessimistic economic outlook.

13. **Near-term risks to the baseline projection are significant** (Annex I)**.** Fiscal risks dominate, as the already large projected financing gap could further widen in case of shortfalls in transfers of CR, should Israel unilaterally decide to increase deductions to settle outstanding PA debts. In addition, donor aid might be diverted to other conflict-stricken countries or reduced. Expenditure overruns could occur because of the PA's inability to withstand pressure to raise wages and transfers (in particular, if it absorbs large numbers of additional civil servants in Gaza without a commensurate increase in revenue from Gaza) or to control net lending and health referrals. The potential large financial liabilities related to litigation in U.S. courts could threaten the WBG's financial stability. If they materialize, these risks would further undermine the already fragile financial position of the PA, leading to private sector arrears, a fall in demand, and in the extreme case, to a breakdown of essential government services and social instability. A fiscal crisis could spread to banks, which are heavily exposed to the public sector. Other risks relate to potential inward spillovers from developments in the global economy and neighboring countries, particularly if these lead to reduced aid.

14. **Beyond 2015, the high degree of political uncertainty implies a wide range of possible economic outcomes.** Under baseline assumptions, with the political status quo and continuing Israeli restrictions, unpredictable donor aid, and limited policy action, growth will remain insufficient to absorb the rising labor force, and unemployment will continue to rise. The fiscal position will remain fragile with some consolidation taking place but with a persistent financing gap in the medium term. In the absence of scaled-up donor grants, this implies an unsustainable accumulation of arrears. If Israeli-Palestinian relations deteriorated further, potentially leading to more restrictions, interruptions in CR, and less aid, economic outcomes would be even worse. On the other hand, a breakthrough in the peace process could yield a substantial economic dividend to the WBG.

15. **The authorities concurred with staff's analysis, suggesting that in current circumstances the viability of the PA is at risk.** They agreed with staff on the main risks, outlining their efforts at mitigation including by controlling spending, implementing administrative measures

to strengthen revenue, and safeguarding financial stability. However, they noted that a large shock—such as having to make a substantial payment related to the Sokolow case—would cripple the PA and threaten its very existence. They are also concerned about reputational and financial risks, including spillovers from neighboring countries.

POLICY DISCUSSIONS

A. Fiscal Policy in 2015

16. **Discussions focused on ways to manage the fiscal crisis triggered by Israel's earlier suspension of CR transfers.** Given limited available financing from domestic banks, which are already heavily exposed to the PA, and no new or front-loaded donor support, they resorted to strict cash rationing, paying only 60 percent of the wage bill in the months of January-April, and accumulating arrears. Staff agreed with the authorities' cash rationing strategy, but advised that reduced salary payments should be differentiated so as to minimize the impact on the poor. This advice was implemented in February, when the lowest-paid employees received 100 percent of their wages.

17. **The preliminary 2015 budget targets a higher deficit than in 2014, to account for scaled up donor-financed Gaza reconstruction.** The budget implies an overall deficit of 17.7 percent of GDP, factoring in a more than fourfold increase in development spending related to Gaza. The recurrent deficit, however, is projected to decline to 8.9 percent of GDP based on net revenue growth of 8 percent and recurrent expenditure growth of 3.5 percent. CR is projected to grow by 5 percent and domestic revenue by 6 percent. On the expenditure side, the wage bill is budgeted to rise by 3.8 percent on the basis of cost-of-living and mandatory 1¼ percent wage adjustments,[12] combined with a zero net hiring policy. At the same time, efforts will be made to rationalize spending on goods and services, budgeted to decline by 5 percent, and to reduce net lending by more than 20 percent. The cost of health referrals is expected to decline sharply due to enhanced control and audit measures. Tax refunds are projected to decline by 36 percent in line with a further reduction in fuel subsidies.[13] Development outlays, other than those that are earmarked for Gaza reconstruction, are projected to increase by almost 50 percent. In addition, the budget assumes $800 million of new spending on Gaza, which is expected to be fully financed by donors. Domestic financing of about $300 million is expected to be used to repay private arrears.

18. **In staff's view, the budget implies a financing gap of $0.5 billion**. Staff projects that the recurrent deficit will decrease marginally from 9.9 percent in 2014 to 9.3 percent in 2015, but that the overall deficit will increase from 11.9 percent to 14.7 percent, driven mainly by Gaza reconstruction outlays. Compared to the authorities' projections, staff assumes slightly lower growth

[12] The Palestinian law stipulates annual wage increase of 1.25 percent for public sector employees.

[13] The authorities are committed to contain subsidies at about NIS 25 million per month—a decline from peak of about NIS 70 million per month in mid-2013.

in revenue in line with lower GDP growth, and higher net lending.[14] Staff also projects lower Gaza reconstruction spending ($400 million), to account for recent experience with slower than expected donor disbursements. Overall donor budget support is projected to reach $1.5 billion, of which $0.9 billion will be for recurrent expenditure, $0.4 billion for Gaza reconstruction, and $0.2 billion for non-Gaza-related development spending. In the absence of policy measures or additional donor support, new arrears will be accumulated, leading to higher debt and posing risks to debt sustainability (Annex II).

19. **To close the financing gap and avoid new arrears accumulation, staff recommended a combination of policy measures and mobilization of additional aid.** Staff advised limiting wage growth to 2 percent, keeping real wages broadly constant. This may require a freeze on promotions and cuts in the cost-of-living adjustment, along with further cuts in fuel subsidies. Development spending, including in Gaza, should be linked to the availability of donor aid. On the revenue side, the authorities should continue to strengthen tax administration and consider the early introduction of the 10 percent tax on dividends they are considering, which would contribute to a less regressive tax system. Staff advised against tax rate reductions (such as in the corporate income tax rate) before administrative reforms to strengthen tax compliance are fully implemented. Staff conceded, however, that all these measures might not be sufficient to fully close the financing gap, and that additional donor aid would be needed.

20. **Because of substantial risks to baseline projections, staff recommended preparation of a contingency plan.** The contingency plan could include: a freeze on wages, allowances, and promotions; rationalization of transfers; immediate withdrawal of fuel subsidies; a further reduction in tax incentives; an increase in government fees; and an increase in dividends from the Palestinian Investment Fund.

21. **The authorities broadly agreed with staff's analysis of the baseline scenario and risks, but were guarded about the proposed measures.** They perceive fiscal measures on the expenditure side difficult to implement in the current political environment, citing continued pressure from labor unions as one constraint. By bringing more taxpayers into the tax net, they also viewed tax reductions as potentially revenue-enhancing. On the financing side, they saw limited scope for additional bank financing, and stressed the need for predictable and steady CR transfers and more donor aid to avoid further arrears accumulation.

B. Medium-Term Fiscal Policy

22. **Staff reiterated that the current fiscal financing model is not viable in the medium term.** To revamp the model, concerted actions are needed by the various stakeholders. The PA needs to deliver consistently lower recurrent deficits underpinned by credible and growth-friendly

[14] According to a recent World Bank study (Press Release) net lending is a structural problem, resolution of which depends partly on technological factors and might take time. The study proposes a detailed action plan to reduce non-payment for electricity services in the WBG.

fiscal consolidation. Donors need to ensure effective aid delivery in support of the PA's reform efforts, based on multiyear commitments and possibly linked to deliverables, helping the WBG overcome aid dependency. In this context, the mission presented its work on reducing aid dependence, which advocates better alignment of aid with national development goals and improved coordination among donors to enhance ownership (Annex III). Additionally, removal of Israeli restrictions and adherence to provisions of the Paris Protocol are prerequisites to allow the WBG economy to reach its growth potential.

23. **The mission advocated fiscal reforms in support of a move to a new financing model.** Staff presented analytical work showing that there is significant scope to raise revenue by means of expanding the tax base and eliminating leakages, for both domestic and CR (Annex IV). Reforms should draw on international best practices, which emphasize self-assessment, risk-based audits, strong enforcement, and tax administration along functional lines. In addition to the PA's own efforts, successful revenue mobilization will depend on cooperation with Israel and progress on integration of Gaza, which currently contributes very little to revenues. On the expenditure side, the authorities need to push through with comprehensive civil service, pension, and electricity sector reforms to put expenditure on a sustainable path. In addition, staff underscored the need to strengthen public financial management (PFM) in line with technical assistance recommendations (Box 1).

24. **The authorities pointed out that progress on fiscal structural reforms is underway.** On tax administration, they noted the strengthening of the large taxpayer unit, the plan to make greater use of risk-based auditing (with the help of IMF TA), and their intention to phase out costly and ineffective tax exemptions. On PFM, the authorities have been making progress on clearing the backlog of unaudited financial statements on the budget and finalizing a new accounting manual (with assistance from the World Bank). On civil service reform, they have recently reviewed and updated public sector job descriptions and classifications, and completed functional reviews to determine hiring needs in 2015. On electricity sector reform, the Palestinian Energy Authority in collaboration with the World Bank has developed an action plan targeting a reduction in net lending (see footnote 14). Finally, the authorities plan to establish a simplified tax regime for small and medium businesses, for which they requested IMF technical assistance, and to implement income tax reductions as a revenue-enhancing measure.

C. Financial Sector

25. **Staff commended the PMA for success in maintaining financial stability during trying times.** The PMA has strengthened its crisis preparedness and business continuity framework, which it credits with ensuring the stability of the banking system during the Gaza war. In response to risks, including geopolitical risks, the PMA significantly expanded its macro-prudential policy toolkit, including countercyclical capital buffers, dynamic provisioning, dynamic caps on loan-to-value ratios, and dynamic leverage ratios. The PMA also continues to improve its stress testing methodology, and is developing a bank resolution framework. The latter should include a mechanism that resolves foreign bank branches operating in the WBG given risks of spillovers to

their respective foreign parent banks. In 2014, the PMA launched a financial inclusion strategy to enhance access to credit on affordable terms to the population and SMEs. To that end, the credit registry has been expanded to include information about mortgages, lease financing, court judgments and retailers. Finally, a new central bank law that will provide for greater independence in the conduct of monetary policy is expected to be finalized in 2015.

26. **The authorities and staff agreed that the banking system is strong, but risks have increased.** At the time of the mission, the most important risk was the sustained withholding of CR by Israel, which could undermine confidence in the banking system given its high exposure to the PA and its employees. While supporting banks' bridge financing to the PA, the PMA also implemented a temporary mandatory rollover of banks' loans to government employees for the period of the CR shortfall. Staff noted that such measures should be unwound in due course. Staff also urged the PMA to closely monitor banks' asset quality in light of high credit growth, noting that financial sector indicators are generally backward looking. Apart from these various risks, the PMA expressed concerns about litigation risks and the potential impact on the WBG's financial system.

27. **New Israeli legislation aimed at limiting cash use could eventually have a negative impact on the WBG economy.** The bill limits the use of cash per transaction in Israel to NIS 10,000 with the objective of containing the underground economy in Israel and promoting the use of electronic means of payment. However, it could eventually reduce overall trade volumes given that Palestinians who do business in Israel tend to rely extensively on cash as a means of payment, and a full transition to noncash payment is likely to take time. The Israeli cabinet has authorized relevant ministers and officials to amend the bill in order to reduce the negative impact on the Palestinian economy. This should allow for a transition phase after the law is passed during which cash transactions of more than NIS 10,000 between Israelis and Palestinians are allowed. In addition, the PMA has been in discussions with the Bank of Israel on this issue and is expected to roll out a new National Switch that will help reduce the use of cash in the system in due course.

D. Structural Policies and Other Issues

28. **The authorities and staff agree that there remains scope for policy action to improve the business climate, notwithstanding Israeli restrictions.** The restrictions continue to place a severe constraint on private sector production and investment, particularly with Palestinian access to Area C remaining highly restricted. However, there is scope to simplify procedures, improve legislation, and level the playing field for businesses. Several regulations that are pending would improve the business climate. These include the Secured Transaction Law, the Competition Law, and the New Companies Law. The authorities noted that the absence of a functional legislature is an obstacle to fast progress in reforms. They pointed out that a major hindrance to business sector development remains the absence of clear property rights.

29. **Enhancing data quality, ensuring its integrity and timeliness, and improving data sharing among government agencies remain priorities.** Progress has been made in data collection, but addressing gaps, particularly in national accounts statistics and real estate market

indicators, and improving communications among key stakeholders are important steps to support economic analysis and policy formulation.

STAFF APPRAISAL

30. **After a contraction in the WBG's real GDP in 2014, various headwinds reduce the chances of a strong economic recovery in 2015.** The suspension by Israel of CR until April 2015 and resulting partial salary payments for civil servants is likely to have caused some pullback in private consumption and hurt business confidence in the first quarter. For the year as a whole, real GDP in the West Bank will therefore only rise modestly (by about one percent), while Gaza should experience a modest rebound of 7 percent from a low 2014 base as reconstruction continues albeit at a slow pace. Over the medium term, growth will remain insufficient to absorb the rising labor force and unemployment will continue to grow, unless there is an improvement in the political climate that would lead to a lifting of Israeli restrictions in the West Bank and the blockade of Gaza.

31. **Despite the difficult economic and political situation in 2014, the fiscal authorities stayed on the deficit reduction course of recent years.** Revenue performance was broadly satisfactory over the past year. Clearance revenue growth outpaced budget projections, helped by a sharp rise in fuel VAT and excise revenue. In addition, tax refunds declined markedly, reflecting lower fuel subsidies helped by declining global fuel prices. On the other hand, growth in spending was high, exceeding budget projections, and, regretfully, the authorities' zero net hiring policy was breached. The authorities also managed to reduce some previous arrears to the private sector, though the combination of higher spending and lower donor support nevertheless led to the accumulation of new arrears.

32. **While the authorities succeeded in cash rationing during the CR freeze earlier this year, they have been unable so far to reduce spending commitments.** With the temporary loss of two thirds of their revenues, the fiscal authorities operated nimbly on the basis of cash rationing, making partial salary payments while protecting the salaries of the lowest paid civil servants. They also secured bridge financing from commercial banks, although this pushed banks' exposure close to the prudential limits. At the same time, expenditure commitments rose quickly, and it is critical that they be clawed back later this year.

33. **The resumption of CR transfers has eased fiscal strains, but a large financing gap is projected for 2015 and fiscal risks are considerable.** Staff projects an overall fiscal deficit of almost 15 percent of GDP, nearly 3 percentage points higher than in 2014, and a financing gap of nearly $0.5 billion, assuming total external support of about $1.5 billion. To close the financing gap, measures should aim to: contain growth of the wage bill below budget targets; accelerate the reduction of poorly targeted fuel subsidies; means test and rationalize transfers for recipients outside the cash transfer program; and increase revenues by raising tax compliance through better enforcement. Development spending in Gaza should be linked to the availability of donor aid pledged at the Cairo Conference. Fiscal risks are significant and largely relate to further interruptions in CR transfers, shortfalls in donor aid, and a potential large financial liability related to the Sokolow

case. In light of the risks, preparation of a contingency plan, which could include a freeze on wages, is urgently needed.

34. **Measures alone will not be enough to close the financing gap.** Strong efforts by the PA can only go so far to contain the gap. Donors will need to boost their total aid envelope for the WBG, avoiding a substitution of aid away from the West Bank to Gaza. Israel needs to ensure consistent and predictable transfer of CR while addressing the restrictions that constrain the movement of labor and goods and access to resources. Over time, there is a need for a more sustainable financing model based on lower deficits, a pro-growth re-orientation of government spending, and sustained predictable donor aid.

35. **Moves towards a more sustainable fiscal position should be buttressed by renewed emphasis on fiscal structural reform.** Progress in this area is essential not only to promote gradual fiscal consolidation, but also to signal progress to donors and ensure their continued support, including for Gaza reconstruction. Strengthening public financial management is particularly important. In addition, there is significant potential for additional revenue over time, both through base broadening and reducing leakages. International experience suggests that better tax administration and a phase out of tax incentives will be central to a revenue mobilization effort. Eventually, revenue collection in Gaza will need to be stepped up.

36. **In a volatile environment, safeguarding financial stability will remain a priority.** The PMA's well-designed crisis management and business continuity framework was on display during the Gaza war. The PMA has also made considerable progress in the area of risk-based supervision and developing its macro-prudential policy toolkit. While the financial system is sound and well capitalized, private credit growth remains high for an economy that has been growing slowly. The high exposure of the banking system to the PA and its employees calls for vigilance, especially in light of the earlier suspension of CR transfers.

37. **Efforts to enhance data quality and strengthen the coordination between relevant institutions should be intensified.** The authorities should continue to improve the quality of the national accounts statistics and to enhance fiscal reporting, as this is essential to support macroeconomic forecasting, budget preparation, and policy design. Prompt implementation of the recommendations of recent TA missions is encouraged.

Box 1. Update on Public Financial Management

Progress on the PFM front has been slowing. With fiscal pressures diverting attention away from structural reforms, PFM capacity appears to have suffered in the last 18 months. Donors have demanded closer oversight by the international financial institutions, particularly in the context of donor money destined for Gaza, and the Fund and World Bank have collaborated closely to help the authorities get back on track in institution building and capacity development. A recent METAC (Middle East Technical Assistance Center) scoping mission found the following:

- The work on developing legal and regulatory PFM frameworks remains suspended. The idea of an organic budget law will be looked at in 2015. Work on accompanying financial regulations and manuals will follow accordingly.

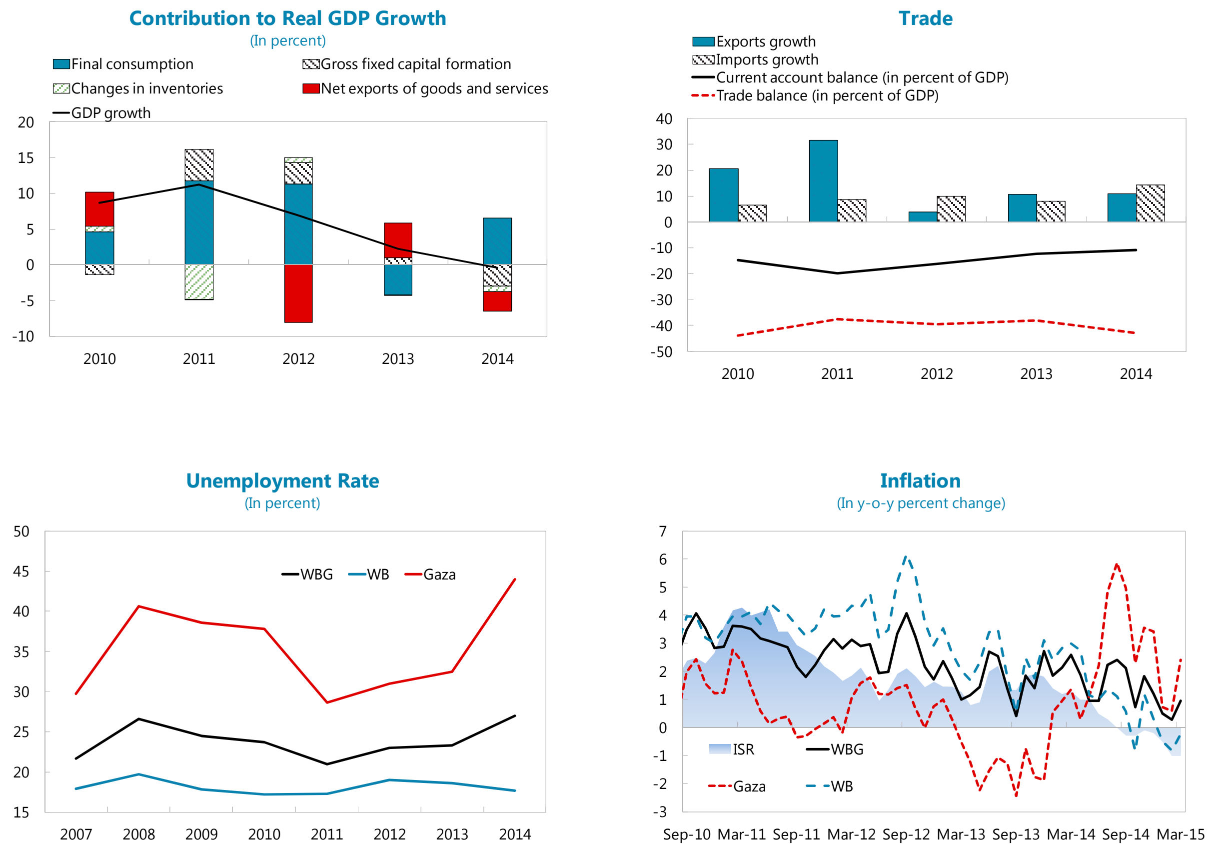
- The Medium-Term Fiscal Framework is being prepared by the Macro-Fiscal Unit (MFU), but adherence to its parameters in the budget preparation is not robust. Staffing the MFU remains a challenge, with a high turnover rate. Sustainability of the MFU after the transition from full donor support to PA/Ministry of Finance organizational integration remains a risk.

- Program budgeting practice is making slow headway. However, its full impact in meaningful resource reallocation and real service outcomes is some time away.

- Commitments identification and control are not in place. The Financial Management Information System (FMIS) procurement module may have to be adjusted and piloted before implementation. More robust cash management would be needed as well. Although there has been progress in budget execution by utilizing cash plans mostly for the purpose of cash rationing for selected spending, this has not contained the risk of increased payment arrears. There is ongoing work on finalizing an accounting manual whose implementation may start in mid-2015 and possibly take a couple of years.

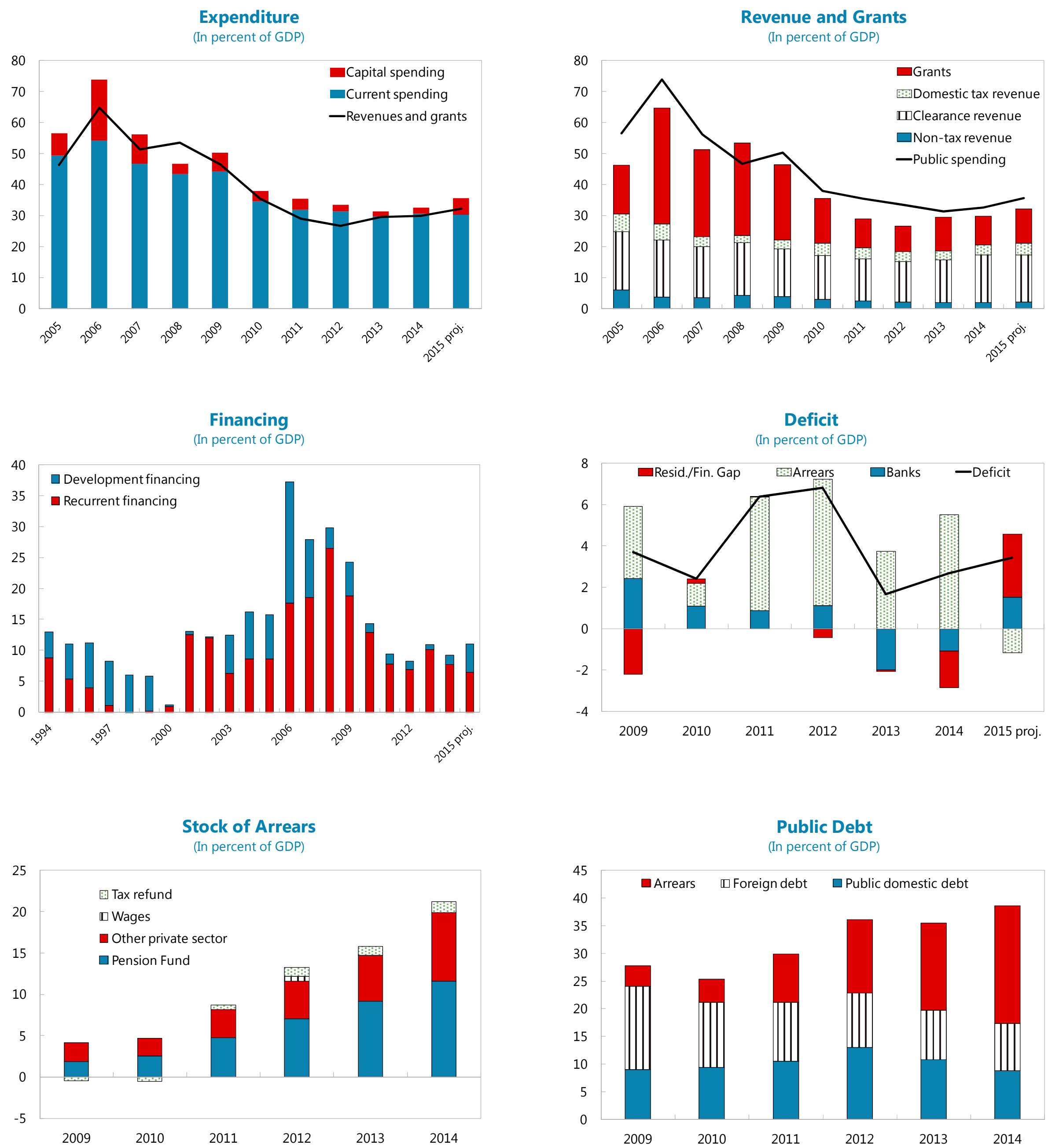
- There remains a backlog of outstanding financial statements (2011, 2012, and 2013). The 2011 financial statement, however, has been prepared and is being audited by the State Audit and Administrative Control Bureau (SAACB). Monthly fiscal reporting has controlled the 'residual' problem this year. But the extreme diligence required in manual production still makes reporting vulnerable to error. Quarterly updating of all monthly figures is recommended. Additionally, financing items should be made more detailed and transparent (i.e., separate net domestic bank financing into net repayments and change in deposits).

Figure 1. West Bank and Gaza: Recent Economic Developments, 2007–14



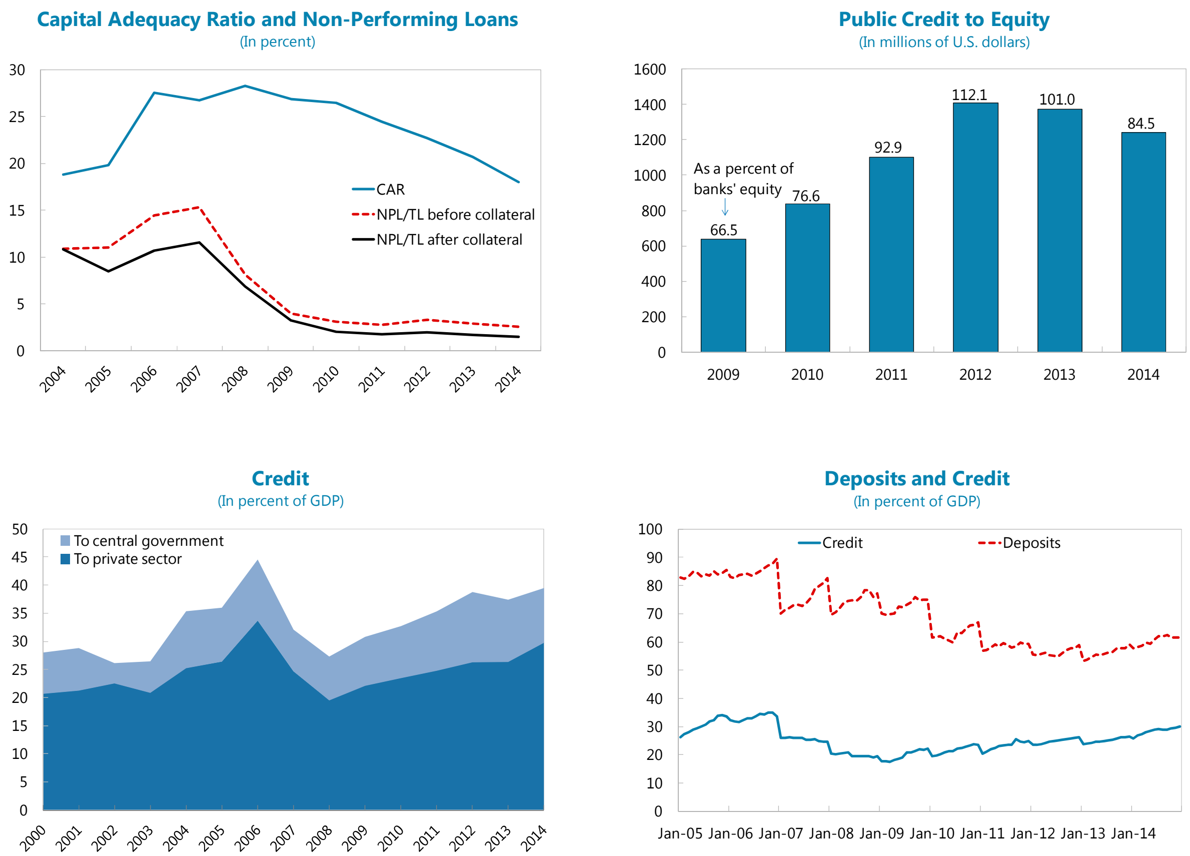
Sources: Palestinian authorities; and IMF staff calculations.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 1994–2015



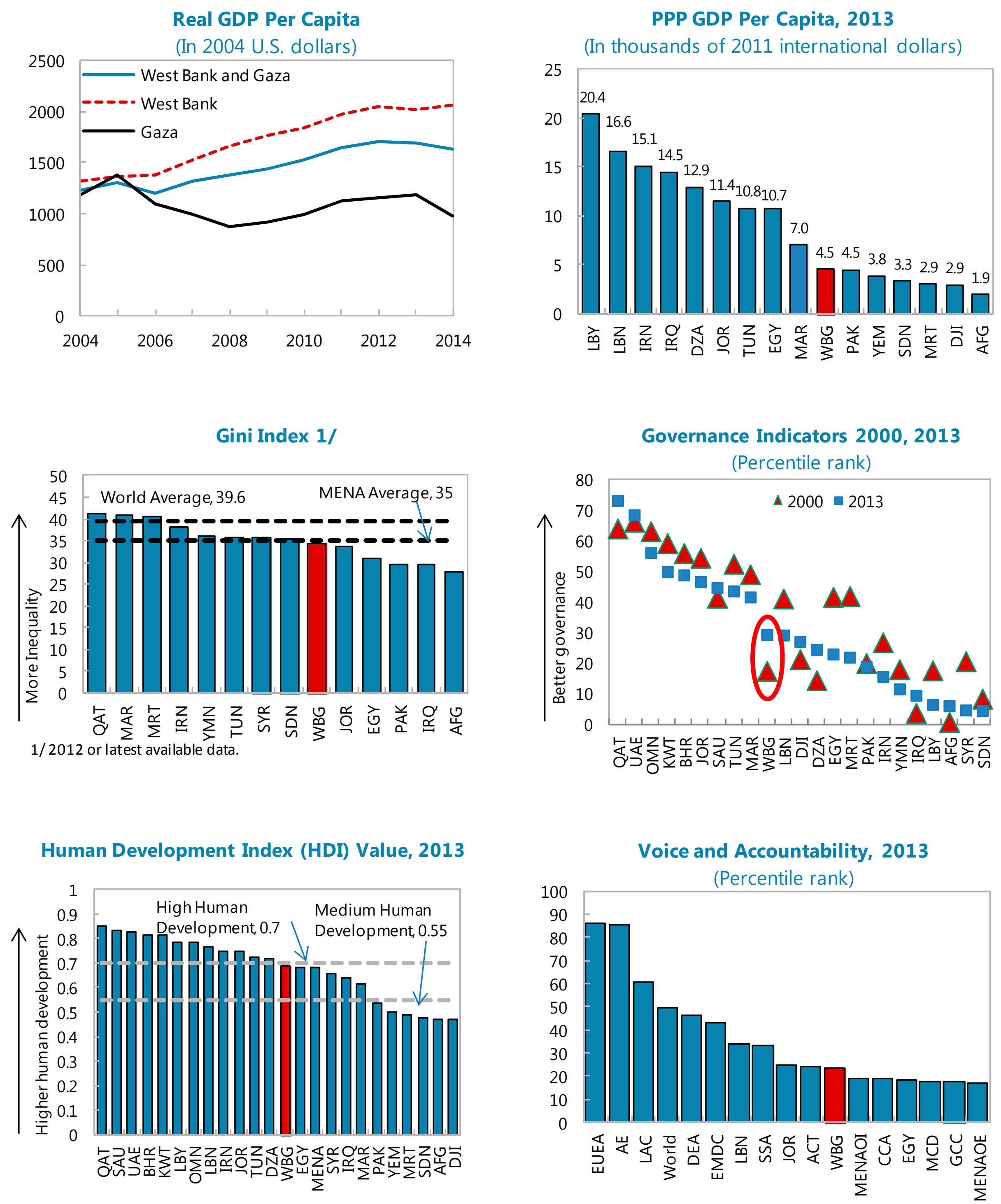
Sources: Palestinian authorities; and IMF staff calculations.

Figure 3. West Bank and Gaza: Financial Sector Indicators, 2004–14



Sources: Palestinian authorities; and IMF staff calculations.

Figure 4. West Bank and Gaza: Social and Governance Indicators



Sources: Palestinian Central Bureau of Statistics (PCBS); Regional Economic Outlook; World Bank World Development Indicators and Worldwide Governance Indicators; United Nations Development Programme (UNDP) Human Development Report 2014; and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators

(Population: 4.6 million; 2014 est.)
(Per capita GDP: $2,809; 2013)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

		Prel.	Est.	Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	6.3	2.8	-0.4	2.5	4.2	4.0	3.7	3.5	3.2
West Bank	6.0	1.0	5.1	1.1	3.1	2.8	2.8	2.6	2.6
Gaza	7.0	5.6	-15.2	7.0	7.5	7.5	6.5	6.2	5.0
CPI inflation rate (end-of-period)	1.7	2.7	1.2	1.5	2.5	2.5	2.5	2.5	2.5
CPI inflation rate (period average)	2.8	1.7	1.7	1.6	2.5	2.5	2.5	2.5	2.5
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	21.2	21.8	18.6	21.9	22.3	22.6	20.2	20.2	20.1
Public	3.5	3.3	2.8	7.0	6.8	6.5	3.7	3.6	3.6
Private	17.7	18.5	15.9	14.9	15.5	16.1	16.5	16.5	16.6
Gross national savings, *of which:*	5.0	9.5	7.8	13.3	12.4	12.4	11.8	11.2	10.5
Public	-6.0	-1.0	-2.2	-2.8	-1.2	-0.5	-0.1	0.3	0.6
Private	11.0	10.6	10.0	16.1	13.6	12.9	11.9	10.9	9.9
Saving-investment balance	-16.2	-12.3	-10.9	-8.6	-9.8	-10.2	-8.3	-9.0	-9.6
Public finances 1/				(In percent of GDP)					
Revenues	18.4	18.6	20.6	21.1	21.5	21.7	21.7	21.7	21.6
Recurrent expenditures and net lending	31.4	29.7	30.6	30.4	29.9	29.0	28.2	27.4	26.7
Wage expenditures	15.7	15.4	15.4	15.3	14.9	14.6	14.2	13.9	13.6
Nonwage expenditures	13.2	12.6	13.0	13.3	13.3	13.0	12.7	12.4	12.1
Net lending	2.5	1.7	2.1	1.8	1.6	1.4	1.2	1.1	1.0
Recurrent balance (commitment, before external support)	-12.9	-11.1	-9.9	-9.3	-8.4	-7.3	-6.4	-5.7	-5.0
Recurrent balance (cash, before external support)	-7.1	-7.5	-5.2	-11.7	-9.5	-8.3	-7.4	-6.6	-5.9
Development expenditures	2.2	1.5	2.0	5.3	5.2	5.0	2.3	2.3	2.3
(In millions of U.S. dollars)	243	187	251	700	717	737	358	381	405
Overall balance (commitment, before external support)	-15.1	-12.6	-11.9	-14.7	-13.6	-12.3	-8.7	-8.0	-7.3
Total external support, including for development expenditures	8.3	11.0	9.2	11.1	11.6	11.0	7.9	7.4	7.1
(In millions of U.S. dollars)	930	1,361	1,178	1,452	1,613	1,626	1,240	1,234	1,251
External support for recurrent expenditure (in millions of U.S. dollars)	774	1,255	984	851	1,000	1,000	1,000	1,000	1,000
In percent of GDP	6.9	10.1	7.7	6.5	7.2	6.8	6.4	6.0	5.6
Financing gap (in millions of U.S. dollars) 2/	...	...	...	483	327	263	209	176	126
In percent of GDP	...	...	...	3.7	2.4	1.8	1.3	1.1	0.7
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	14.3	11.0	16.0	15.0	15.0	13.0	12.0	12.0	13.0
Private sector deposits	6.8	10.7	9.9	7.4	5.7	6.0	6.2	6.3	6.3
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-23.1	-22.4	-18.6	-15.1	-17.0	-16.9	-14.7	-15.0	-15.2
Current account balance (including official transfers)	-16.2	-12.3	-10.9	-8.6	-9.8	-10.2	-8.3	-9.0	-9.6
Exports of goods and nonfactor services	16.7	16.7	18.0	18.5	18.4	18.4	18.6	18.7	18.9
Import of goods and nonfactor services	56.1	54.8	61.1	58.1	58.7	57.7	54.8	54.4	54.0
Net factor income	7.6	8.6	10.8	10.9	10.6	10.5	10.3	10.2	10.0
Net current transfers	15.6	17.3	21.3	20.1	19.8	18.7	17.6	16.5	15.5
Private transfers	8.7	7.1	13.6	13.6	12.6	11.9	11.2	10.5	9.9
Official transfers	6.9	10.1	7.7	6.5	7.2	6.8	6.4	6.0	5.6
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	11,235	12,419	12,744	13,118	13,881	14,731	15,656	16,649	17,708
Per capita nominal GDP (U.S. dollars)	2,617	2,809	2,801	2,802	2,882	2,974	3,073	3,178	3,287
Unemployment rate	23	23	27	27	27	28	29	30	30
Al Quds stock market index (annual percentage change)	0.1	13.4	-7.1	...	...	...	...	...	...

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

1/ Commitment basis.
2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.
3/ End-of-period; in U.S. dollar terms.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2012–18

	2012	2013	2014	Budget Prel. 2015	Projections 2015	2016	2017	2018
			(In millions of shekels, unless otherwise stated)					
Net revenues	7,989	8,348	9,817	10,597	10,509	11,421	12,319	13,126
Gross domestic revenues	2,806	3,078	3,114	3,300	3,274	3,517	3,769	4,037
Tax revenues	1,852	2,157	2,149	2,277	2,251	2,426	2,606	2,798
Nontax revenues (accrued)	954	921	966	1,023	1,023	1,091	1,163	1,239
Of which: arrears	59	...	...	...	...	...	...	...
Clearance revenues (accrued)	5,617	6,103	7,331	7,697	7,635	8,153	8,693	9,242
Of which: arrears	-479	14	13	...	...	...	...	...
Less tax refunds 1/	434	834	628	400	400	250	144	153
Of which: arrears	239	27	147	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	13,593	13,336	14,556	15,059	15,159	15,889	16,439	17,012
Of which: arrears	1,863	1,601	2,281	-1,200	-1,200	-575	-577	-578
Wage expenditures (commitment)	6,812	6,928	7,336	7,617	7,617	7,949	8,266	8,594
Of which : arrears	816	380	570	...	...	...	...	...
Nonwage expenditures (commitment)	5,709	5,648	6,198	6,642	6,642	7,089	7,373	7,668
Of which: arrears	1,046	1,221	1,712	-1,200	-1,200	-575	-577	-578
Net lending	1,072	760	1,022	800	900	850	800	750
Development expenditures (commitment)	937	674	938	4,370	2,660	2,749	2,836	1,381
Of which: on Gaza reconstruction	...	...	25	2,990	1,520	1,533	1,539	...
Of which: arrears	124	66	351	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-5,604	-4,988	-4,739	-4,462	-4,650	-4,468	-4,120	-3,886
Overall balance (committment)	-6,541	-5,662	-5,676	-8,832	-7,310	-7,217	-6,956	-5,267
Total financing	6,541	5,662	5,676	8,832	7,310	7,217	6,956	5,267
Net domestic bank financing	490	-895	-467	1,200	1,200	425	425	425
External debt repayment			-39	...	-42	-66	-158	-168
External financing for recurrent expenditures	2,986	4,532	3,676	4,582	3,234	3,832	3,848	3,856
External financing for development expenditures	601	383	726	4,180	2,284	2,348	2,408	925
Arrears accumulation (net)	2,646	1,680	1,762	-1,200	-1,200	-575	-577	-578
Of which: repayment			-1,004					
Residual/financing gap 2/	-182	-38	18	0	1,834	1,253	1,010	808
			(In millions of U.S. dollars, unless otherwise stated)					
Net revenues	2,072	2,312	2,627	2,788	2,765	2,980	3,201	3,404
Gross domestic revenues	728	853	833	868	861	918	980	1,047
Tax revenues	480	597	575	599	592	633	677	726
Nontax revenues (accrued)	248	255	258	269	269	285	302	321
Of which: arrears	15	...	...	...	...	...	...	...
Clearance revenues (accrued)	1,457	1,690	1,962	2,025	2,009	2,128	2,259	2,397
Of which: arrears	-124	4	3	...	...	...	...	...
Less tax refunds	113	231	168	105	105	65	37	40
Of which: arrears	62	7	39	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	3,525	3,693	3,895	3,962	3,989	4,146	4,272	4,412
Of which: arrears	483	443	610	-316	-316	-150	-150	-150
Wage expenditures (commitment)	1,767	1,919	1,963	2,004	2,004	2,074	2,148	2,229
Of which: arrears	212	105	152...	...	...	...	...	...
Nonwage expenditures (commitment)	1,481	1,564	1,658	1,748	1,748	1,850	1,916	1,989
Of which: arrears	271	338	458	-316	-316	-150	-150	-150
Net lending (commitment)	278	210	274	210	237	222	208	195
Development expenditures (commitment)	243	187	251	1,150	700	717	737	358
Of which: on Gaza reconstruction	...	...	25	800	400	400	400	...
Of which: arrears	32	18	94	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-1,453	-1,381	-1,268	-1,174	-1,223	-1,166	-1,071	-1,008
Overall balance (committment)	-1,696	-1,568	-1,519	-2,324	-1,923	-1,883	-1,808	-1,366
Total financing	1,696	1,568	1,519	2,324	1,923	1,883	1,808	1,366
Net domestic bank financing	127	-248	-125	316	316	111	110	110
External debt repayment			-10	---	-11	-17	-41	-44
External financing for recurrent expenditures	774	1,255	984	1,206	851	1,000	1,000	1,000
External financing for development expenditures	156	106	194	1,100	601	613	626	240
Arrears (net)	686	465	472	-316	-316	-150	-150	-150
Of which: repayment			-269					
Residual/Financing gap 2/	-47	-11	5	---	483	327	263	209
Memorandum items:			(In percent of GDP, unless otherwise stated)					
Revenues	18.4	18.6	20.6	21.3	21.1	21.5	21.7	21.7
Recurrent expenditures and net lending	31.4	29.7	30.6	30.2	30.4	29.9	29.0	28.2
Wage expenditures	15.7	15.4	15.4	15.3	15.3	14.9	14.6	14.2
Nonwage expenditures	13.2	12.6	13.0	13.3	13.3	13.3	13.0	12.7
Net lending	2.5	1.7	2.1	1.6	1.8	1.6	1.4	1.2
Recurrent balance (commitment) before external support	-12.9	-11.1	-9.9	-8.9	-9.3	-8.4	-7.3	-6.4
External financing for recurrent expenditures	6.9	10.1	7.7	9.2	6.5	7.2	6.8	6.4
Development expenditures (cash)	1.9	1.4	1.2	8.8	5.3	5.2	5.0	2.3
Overall balance (commitment)	-15.1	-12.6	-11.9	-17.7	-14.7	-13.6	-12.3	-8.7
Overall balance (cash)	-9.0	-8.9	-6.1	-20.1	-17.1	-14.6	-13.3	-9.7
Residual/financing gap	-0.4	-0.1	0.0	0.0	3.7	2.4	1.8	1.3
Nominal exchange rate (NIS per U.S. dollar)	3.86	3.61	3.74	...	...	...	...	...
Nominal GDP (in millions of shekels)	43,322	44,843	47,628	49,856	49,856	53,197	56,685	60,367

Sources: Ministry of Finance; and IMF staff projections.

1/ Includes fuel subsidies.

2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2012–18
(GFSM 2001)

	2012	2013	2014	Projections 2015	2016	2017	2018
	(In millions of shekels)						
Revenue	11,576	13,263	14,220	16,027	17,601	18,575	17,907
Taxes	7,035	7,426	8,852	9,486	10,329	11,156	11,887
Domestic taxes	1,852	2,157	2,149	2,251	2,426	2,606	2,798
Clearance taxes	5,617	6,103	7,331	7,635	8,153	8,693	9,242
Tax refund	-434	-834	-628	-400	-250	-144	-153
Grants	3,587	4,915	4,402	5,518	6,180	6,256	4,781
External budget support	2,986	4,532	3,676	3,234	3,832	3,848	3,856
External development support	601	383	726	2,284	2,348	2,408	925
Other revenue	954	921	966	1,023	1,091	1,163	1,239
Of which: dividends	120	116	121	128	137	146	156
Expenditures	14,530	14,009	15,494	17,819	18,638	19,274	18,393
Expense	13,593	13,336	14,556	15,159	15,889	16,439	17,012
Compensation of employees 1/	6,812	6,928	7,336	7,617	7,949	8,266	8,594
Use of goods and services	2,112	2,148	2,274	2,361	2,464	2,562	2,664
Grants 2/	1,072	760	1,022	900	850	800	750
Other expense 3/	3,597	3,500	3,923	4,281	4,625	4,810	5,003
Net acquisition of nonfinancial assets	937	674	938	2,660	2,749	2,836	1,381
Gross operating balance	-2,017	-73	-336	868	1,712	2,136	894
Net lending / borrowing (overall balance)	-2,954	-746	-1,274	-1,792	-1,037	-700	-486
Net financial transactions	-2,954	-746	-2,105	-1,792	-1,037	-700	-485
Net acquisition of financial assets	...	...	...	...	...	...	...
Domestic							
Currency and deposits	...	...	...	...	...	...	...
Net incurrence of liabilities	3,136	785	2,087	-42	-216	-310	-321
Domestic	3,136	785	2,126	0	-150	-152	-153
Loans	490	-895	-507	1,200	425	425	425
Net domestic bank financing	490	-895	-507	1,200	425	425	425
Other accounts payable	2,646	1,680	2,633	-1,200	-575	-577	-578
Arrears (recurrent)	2,043	1,628	2,281	-1,200	-575	-577	-578
Arrears (capital)	124	66	...	...	...	...	...
Arrears (clearance)	-479	14	...	...	...	...	...
Foreign	...	...	-39	-42	-66	-158	-168
Loans	...	...	-39	-42	-66	-158	-168
Statistical discrepancy/financing gap	-182	-38	18	1,834	1,253	1,010	808
Memorandum items:							
Gross operating balance excl. grants (commitment)	-5,604	-4,988	-4,739	-4,650	-4,468	-4,120	-3,886
Gross operating balance excl. grants (cash)	-3,082	-3,374	-2,457	-5,850	-5,043	-4,697	-4,465
Overall balance (NLB) excl. grants (commitment)	-6,541	-5,662	-5,676	-7,310	-7,217	-6,956	-5,267
Overall balance (NLB) excl. grants (cash)	-3,894	-3,982	-3,044	-8,511	-7,792	-7,533	-5,845
Revenue (percent of GDP)	26.7	29.6	29.9	32.1	33.1	32.8	29.7
Expenditure (percent of GDP)	33.5	31.2	32.5	35.7	35.0	34.0	30.5
Expense (percent of GDP)	31.4	29.7	30.6	30.4	29.9	29.0	28.2
Wage expenditure (percent of GDP)	15.7	15.4	15.4	15.3	14.9	14.6	14.2
Nonwage expenditures (percent of GDP)	4.9	4.8	4.8	4.7	4.6	4.5	4.4
GOB (commitment) excluding grants (percent of GDP)	-12.9	-11.1	-9.9	-9.3	-8.4	-7.3	-6.4
GOB (cash) excluding grants (percent of GDP)	-7.1	-7.5	-5.2	-11.7	-9.5	-8.3	-7.4
External support (recurrent)	6.9	10.1	7.7	6.5	7.2	6.8	6.4
in millions of NIS	2,986	4,532	3,676	3,234	3,832	3,848	3,856
NLB (commitment) excluding grants (percent of GDP)	-15.1	-12.6	-11.9	-14.7	-13.6	-12.3	-8.7
NLB (cash) excluding grants (percent of GDP)	-9.0	-8.9	-6.4	-17.1	-14.6	-13.3	-9.7
Total external support (in millions of shekels)	3,587	4,915	4,402	5,518	6,180	6,256	4,781
Nominal GDP (in millions of shekels)	43,322	44,843	47,628	49,856	53,197	56,685	60,367
Exchange rate	3.9	3.6	3.7	...	...	...	...

Sources: Ministry of Finance; and IMF 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 4. West Bank and Gaza: Financial Soundness Indicators, 2010–14
(In percent)

	Dec-10	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Capital adequacy (for all banks)											
Tier I capital to risk-weighted assets	23.3	22.9	22.2	21.5	21.2	21.0	21.5	21.1	20.1	20.0	20.0
Regulatory capital to risk-weighted assets	21.4	21.1	20.3	19.8	19.5	19.3	20.0	19.6	18.9	18.9	19.0
Capital adequacy (for local banks)											
Tier I capital to risk-weighted assets	26.5	24.5	22.7	21.2	20.9	20.5	20.7	20.4	18.3	18.3	18.0
Regulatory capital to risk-weighted assets	21.6	20.3	18.8	17.7	17.7	17.3	17.8	17.5	16.2	16.5	16.4
Asset quality 1/											
Nonperforming loans (percent of total loans)	3.1	2.7	3.1	3.2	3.1	2.9	2.9	2.8	2.6	2.7	2.5
Nonperforming loans net of provisions to capital	2.9	3.8	4.9	4.7	5.1	4.8	4.7	4.8	4.4	4.3	4.0
Coverage ratio (provisions as percent of nonperforming loans)	70.4	60.9	60.1	61.6	59.3	60.5	59.1	58.9	61.2	61.7	61.9
Earnings and profitability											
Return on assets (ROA)	2.1	1.9	1.8	2.0	2.0	2.0	1.9	1.9	1.8	1.7	1.7
Return on equity (ROE) 2/	21.1	17.0	16.2	19.1	18.5	18.8	18.7	18.6	17.8	17.2	17.2
Interest income to gross income	59.4	71.7	72.4	74.0	75.0	74.6	74.0	74.5	74.1	73.9	72.4
Non-interest expenses to gross income	55.0	57.2	55.4	52.8	53.5	54.1	54.8	55.0	58.2	59.9	60.1
Personnel cost to non-interest expenses	55.3	55.5	53.8	57.4	56.9	55.1	53.9	56.3	53.7	52.5	51.3
Liquidity											
Liquid assets to total assets	40.3	38.2	37.5	36.3	36.8	37.5	39.5	38.0	37.0	36.9	35.3
Liquid assets to demand and savings deposits	78.4	74.4	71.6	69.1	69.4	71.1	74.7	72.0	71.1	68.3	65.8
Liquid assets to total deposits	49.1	46.9	45.8	44.6	45.0	45.8	48.1	46.5	45.7	45.1	43.2

Source: Palestine Monetary Authority.
1/ Nonperforming loans includes loans more than 90 day overdue.
2/ Return on equity (ROE) is a ratio of income before extraordinary items and taxes to average Tier 1 capital.

Annex I. Risk Assessment Matrix[1]
Potential Deviations from Baseline

Nature/Sources of Main Threats	Likelihood of Realization in the Next Three Years	Expected Impact on Economy If Risk is Realized	Policy Recommendations to Mitigate Risks
Protracted period of slower growth in key advanced and emerging economies	***High/Medium/Short to Medium Term***	***Low*** A further slowdown in growth, higher unemployment, and worsening in the fiscal position. The WBG is sensitive to a slowdown in Israel. Austerity in donor countries could affect availability of aid for the PA.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Improve competitiveness of the economy via scaled-up investment in infrastructure, and education to support human capital development.
Pressures on the banking system mostly from a deteriorating domestic and regional environment.	***Medium/Short to Medium Term***	***Medium*** The WBG banks are heavily exposed to the PA and its employees. There are no direct linkages to global financial markets, but the considerable presence of Jordanian banks could pose major challenges in case of a crisis in the home country because of insufficient coordination in bank resolution across borders. The restriction on cash transfers by WBG banks to Israel is another source of risk.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Further strengthen the banking supervisory framework, including cross-border supervision and cooperation with the Central Bank of Jordan; (3) Broaden data coverage of the real estate market; and (4) Develop an early warning model and a contingency plan.
Resumption of hostilities between Hamas and Israel; Israeli retaliatory measures following ICC membership application; a surge in unrest in Gaza and the West Bank	***High/Short to Medium Term***	***Medium to High*** If the conflict resumes, the humanitarian and economic situation in Gaza would deteriorate further. Even if the truce holds, domestic unrest in the West Bank (e.g., due to a flare-up of violence in Gaza because of further deterioration of the humanitarian situation) could lead to a tightening of Israeli restrictions, and possible suspension of clearance revenue transfers. Some donors may withdraw support.	In the short run, economic policies can do little to mitigate these particular risks. At best, maintaining strong domestic policies could instill some element of confidence. The authorities should develop a contingency plan in case these risks materialize.

Nature/Sources of Main Threats	Likelihood of Realization in the Next Three Years	Expected Impact on Economy If Risk is Realized	Policy Recommendations to Mitigate Risks
Donor "fatigue" and reduced support from Arab donors due to falling oil prices	***Medium/Medium Term***	***High*** Budget support from Arab donors could decline due to a reduction in oil producers' income following the sharp decline in oil prices. The suspension of peace talks, if sustained, could lead other donors to reconsider their long-term commitment to supporting the PA, which could threaten fiscal sustainability. Budget support could also decline due to diversion of commitments to Gaza reconstruction.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Reduce aid dependency and support fiscal sustainability via pro-growth policies; and (3) Continue reforms to improve government institutions.
Risks to energy prices, with increased volatility due to uncertainty about the persistence of the oil supply shock and the underlying drivers of the price decline	***High/Medium Term***	***Low/Medium*** Increase in energy prices if passed to consumers will lead to lower demand and growth. Maintenance of subsidies, on the other hand, will further weaken already fragile fiscal position.	Phase out fuel subsidies and allow pass-through of energy prices to consumers, while strengthen targeted social transfers to support the poor.
Heightened risk of fragmentation/state failure/security dislocation in the Middle East	***Medium/Short Term***	***High*** Social and political unrest in the nearby region could spill over to the WBG and potentially divert donor money away from the WBG.	Economic policies can do little to mitigate these particular risks. At best, maintaining strong domestic policies could instill some element of confidence.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex II. Debt Sustainability Analysis (DSA)

Public debt continued to increase in 2014, reflecting growing arrears.[1] Since the end of 2013 public debt increased by about $300 million, reaching $5 billion or 39 percent of 2014 GDP, and almost reaching a 40 percent government-mandated threshold for public debt. During this period, net arrears grew by $420 million (after repayment of $260 million of arrears to private suppliers), reaching an estimated $2.4 billion.[2] Of those, about $330 million was new arrears to the Pension Fund and the remainder was arrears to private suppliers. Notably, arrears were used to substitute for expensive domestic financing, which declined since end-2013 by over $110 million, as authorities reduced bank overdrafts and short-term loans.[3]

At end-2014 arrears comprised half of total debt. Arrears of the Pension Fund comprised 36 percent of debt, constituting unfunded future fiscal liabilities, while arrears to the private sector, mostly for goods and services and tax refunds, comprised 14 percent of debt. *External debt*, comprised 25 percent of public debt and consisted of multilateral and bilateral concessional loans, which declined marginally since 2013. External disbursements continued on a loan by the European Investment Bank for construction of electricity stations. Arrears on external debt (principal) reached about $52 million at end-December. *Domestic debt* comprised 25 percent of total debt and remained dominated by short-term debt. However, during 2014 the authorities managed to rebalance it somewhat toward longer maturities, including by reducing overdrafts. Of total bank debt, arrears to banks are estimated at more than $152 million. Bank debt is normally extended at interest rates ranging from 4 percent on loans to 7–8 percent on overdrafts.[4] The authorities have also resorted to borrowing from the Palestinian Investment Fund ($23 million

Public Debt
(In millions of U.S. dollars)

	2012	2013	2014	2014 In percent of total
Public debt, including arrears	4,041	4,638	4,986	100
Domestic debt	1,467	1,349	1,233	25
Total Domestic debt (short term)	1,048	969	663	13
Of which: long term	337	298	465	9
Bank loans	719	661	631	13
Short term	382	363	166	3
Of which: long term	337	298	465	9
Overdraft	480	366	303	6
Short term	480	366	303	6
Petroleum Authority loans	178	225	181	4
Short term	178	225	181	4
Other public institutions loans	8	15	13	0
Short term	8	15	13	0
Palestinian Investment Fund	79	79	102	2
PMA	3	3	3	0
External debt	1,247	1,269	1,259	25
Of which arrears on external debt service				
Arab Financial Institutions	629	630	621	12
Al Aqsa Fund	522	524	517	10
Arab Fund for Economic & Social Development	57	58	57	1
Islamic Development Bank	50	48	47	1
International and Regional Institutions	339	343	348	7
World Bank	290	284	277	6
European Investment Bank	26	36	48	1
IFAD	3	3	3	0
OPEC	19	20	20	0
Bilateral loans and advances	280	296	290	6
Spain	92	96	84	2
Italy	33	35	31	1
China	5	5	5	0
Israel 1/	150	160	170	3
Arrears 2/	1,327	2,019	2,494	50
Pension fund	1,058	1,465	1,799	36
Private supliers 3/	269	555	695	14
Memo: Debt Palestinian entities to Israeli Electricity Company		375	466	

Sources: Palestinian authorities; and IMF staff estimates.
1/ Includes clearance advances.
2/ Excluding arrears on debt service, and for electricity to Israel Electric Corporation.
3/ Estimated arrears, includes payables.

[1] Public debt includes debt of the PA.

[2] Information on arrears reflects latest estimates by the Ministry of Finance and covers arrears to private suppliers and the Pension Fund. The authorities are working to refine these estimates. Arrears to private suppliers are overestimated to the extent that the available information does not allow to distinguish between payments due and payments past due.

[3] While providing savings in the short term, a policy of substituting bank debt with arrears to the private sector could undermine private sector liquidity and growth, and could endanger government revenue and fiscal position in the longer term.

[4] Most borrowing is in U.S. dollars and NIS, but there are loans from Jordanian banks in Jordanian dinars.

during in 2014). Separately, borrowing of the General Petroleum Corporation (a public company purchasing fuel from Israel) declined by $45 million during 2014.

The assumptions for the current Debt Sustainability Analysis (DSA) have changed since the last DSA in September 2014 to reflect updated medium-term projections and updated estimates for GDP in 2014.[5] They take into account:

- Slowing growth to 3.2 percent by 2020, averaging 3.5 percent over 2015–20 against 3.3 percent in the September 2014 DSA—a higher rate to reflect revised GDP growth in the West Bank.
- Stable exchange rate and inflation, as determined by Israeli monetary policy (same assumption as in the September 2014 DSA); and
- A financing gap, averaging 1.6 percent of GDP in 2015–20—a downward revision from 2.7 percent in the previous DSA—to reflect continued fiscal consolidation, better than projected GDP outcome in 2014, and assuming that Gaza reconstruction will be financed by donor aid. It is assumed that financing gaps are filled by a combination of arrears and domestic borrowing.

The results of the updated public DSA highlight risks (Table A1 and Figure A1). The DSA shows that public debt in the baseline scenario is sustainable in the medium term, but is sensitive to shocks. Debt is projected to rise slightly to 40 percent of GDP in 2015 before declining to 34 percent of GDP in 2020. This result is sensitive to several shocks. The shocks to growth, primary balance, or a combined shock will raise the debt level more to 53, 47, and 45 percent of GDP by 2020, respectively. A one-time contingent liabilities shock equivalent to 10 percent of GDP (e.g., in the case of non-payments to utilities) will elevate the level of debt immediately by about ten percentage points. A similar effect will occur with a fall in donor aid.

[5] See Report for September 2014 AHLC meeting.

Table A1. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2010–20

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	24.9	31.5	33.1	37.8	39.0	**40.9**	**40.4**	**39.5**	**38.1**	**36.6**	**34.9**	**-1.4**
	Of which: foreign-currency denominated	11.2	11.4	9.5	8.6	8.8	8.4	7.9	7.4	7.0	6.5	6.2	
2	Change in public sector debt	1.8	6.6	1.6	4.7	1.2	2.0	-0.5	-1.0	-1.3	-1.5	-1.7	
3	Identified debt-creating flows (4+7+12)	0.2	3.1	2.0	1.3	-0.1	1.9	-0.6	-1.3	-1.6	-1.7	-2.0	
4	Primary deficit	2.0	5.7	6.4	1.5	2.1	3.1	1.1	0.4	0.0	-0.2	-0.5	
5	Revenue and grants	35.5	29.0	26.7	29.6	29.9	32.1	33.1	32.8	29.7	29.1	28.7	
6	Primary (noninterest) expenditure	37.5	34.8	33.2	31.0	32.0	35.3	34.2	33.2	29.7	28.9	28.2	
7	Automatic debt dynamics 2/	-1.8	-2.6	-4.4	-0.2	-2.2	-1.3	-1.8	-1.7	-1.6	-1.5	-1.4	
8	Contribution from interest rate/growth differential 3/	-3.0	-2.1	-4.0	-0.9	-1.7	-1.3	-1.8	-1.7	-1.6	-1.5	-1.4	
9	Of which: contribution from real interest rate	-1.2	0.5	-2.3	0.0	-1.8	-0.3	-0.1	-0.1	-0.2	-0.3	-0.3	
10	Of which: contribution from real GDP growth	-1.8	-2.6	-1.7	-0.9	0.2	-0.9	-1.6	-1.5	-1.4	-1.2	-1.1	
11	Contribution from exchange rate depreciation 4/	1.2	-0.5	-0.4	0.7	-0.5	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	1.6	3.4	-0.5	3.5	1.2	0.1	0.1	0.3	0.3	0.2	0.3	
	Public sector debt-to-revenue ratio 1/	70.2	108.4	123.7	127.7	130.5	127.3	122.2	120.5	128.5	125.8	121.6	
	Gross financing need 6/	8.3	17.0	22.2	22.0	26.9	29.3	29.0	28.5	27.7	26.7	25.4	
	in billions of U.S. dollars	0.7	1.7	2.7	2.6	3.5	4.0	4.3	4.4	4.6	4.7	4.8	
	Scenario with key variables at their historical averages 7/						**40.9**	**41.4**	**42.1**	**42.6**	**43.1**	**43.5**	**-3.4**
	Scenario with no policy change (constant primary balance) in 2015-2020						**40.9**	**42.4**	**44.0**	**45.6**	**47.2**	**48.7**	**-1.9**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	9.2	11.9	6.3	2.8	-0.4	2.5	4.2	4.0	3.7	3.5	3.2	
	Average nominal interest rate on public debt (in percent) 8/	1.8	2.9	1.4	0.7	1.6	1.3	2.1	2.1	2.2	2.2	2.3	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.4	2.4	-7.7	0.0	-5.1	-0.8	-0.3	-0.3	-0.5	-0.7	-0.8	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.8	5.2	4.5	-7.2	6.8	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	7.2	0.5	9.2	0.7	6.7	2.1	2.4	2.4	2.6	2.9	3.1	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-17.9	3.7	1.3	-3.8	2.6	13.0	1.2	0.9	-7.3	0.8	0.6	
	Primary deficit	2.0	5.7	6.4	1.5	2.1	3.1	1.1	0.4	0.0	-0.2	-0.5	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

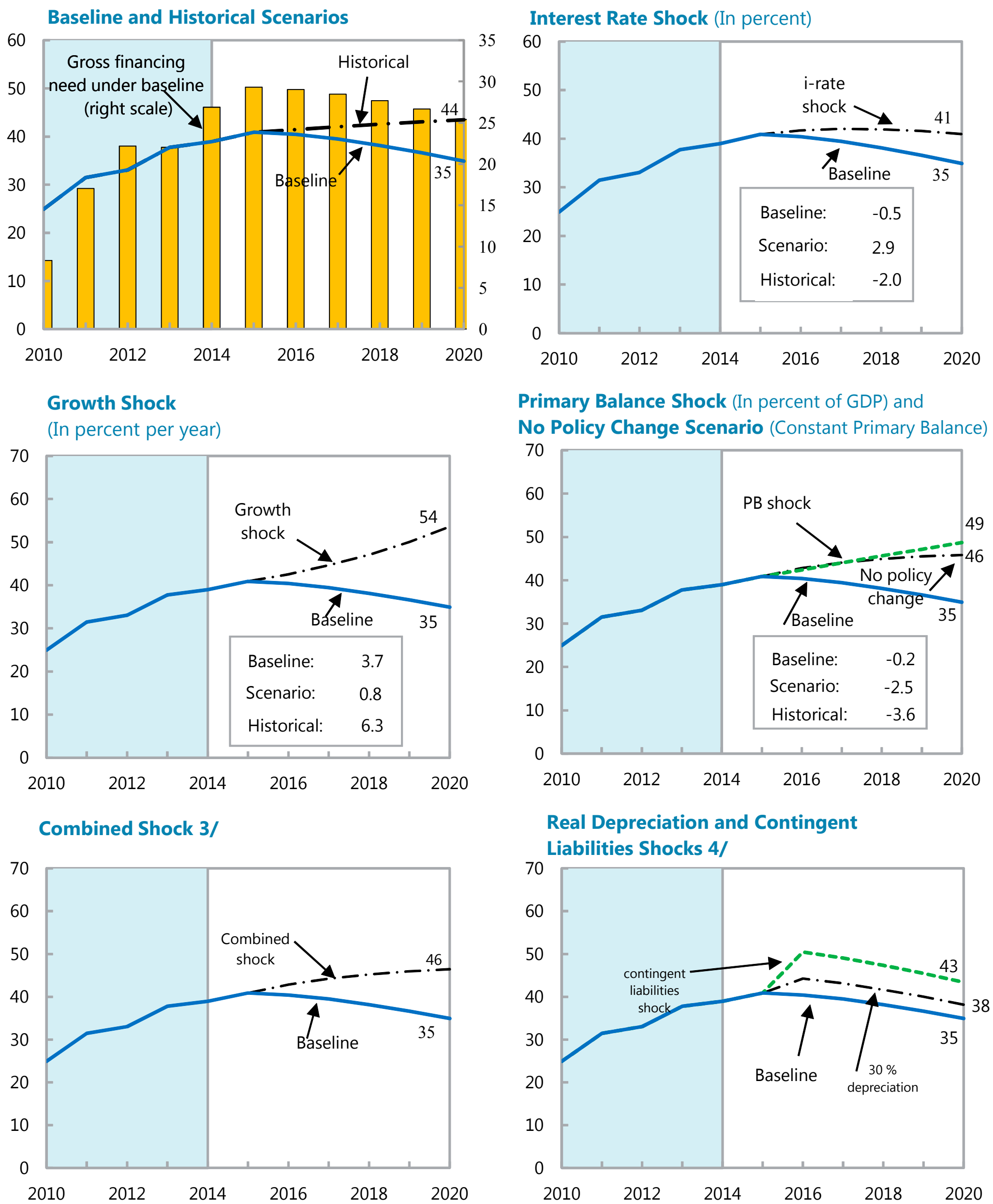
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. West Bank and Gaza: Public Debt Sustainability: Bound Tests 1/2/
(Public debt in percent of GDP)



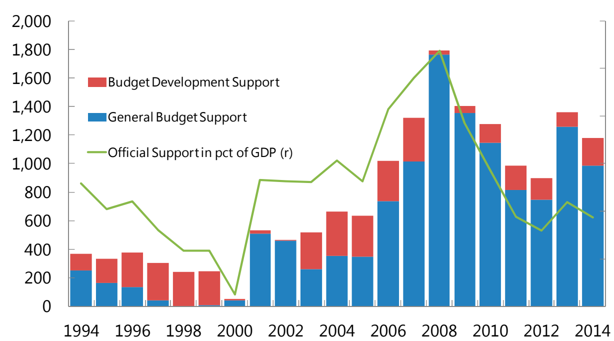
Sources: Palestinian authorities; and IMF staff estimates and projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex III. Toward a Reduction of Aid Dependency in the West Bank and Gaza (WBG)[1]

Aid Dependence in the WBG

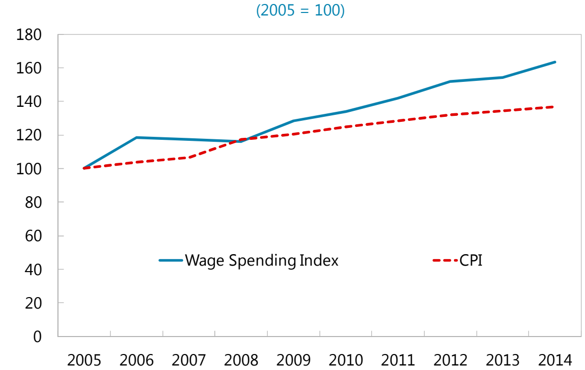
High recurrent government expenditure supported by donor aid has become the main driver for economic growth in the WBG, creating a situation of aid dependency. The PA has long been a large recipient of official donor aid.[2] While official support grew over time, it became increasingly volatile and channeled to recurrent expenditure. Official donor aid peaked at 32 percent of GDP in 2006, when half of it went to development support. Since then, aid has declined to about 10 percent of GDP and development support has become severely squeezed. Over the same period, public recurrent expenditure increased in real terms by 9 percent, reflecting primarily increases in wage spending that have persistently outpaced inflation and growth in net lending. With private sector investments constrained by a short political horizon and Israeli restrictions, the economy of the WBG is increasingly reliant on the public sector, which in turn has become dependent on external support to finance its day-to-day operations.

Total Official Donor Support, 1994–2014
(In percent of GDP and in millions of USD)



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

Developments in Wage Spending, 2005–14
(2005 = 100)



Sources: National authorities; and IMF staff calculations.

Both donors and the authorities are responsible for poor aid effectiveness. Although aid contributed to poverty reduction and growth, its volatile nature led to a gradual substitution away from development spending, which requires predictable multiyear commitments. When aid windfalls did occur, they tended to boost government consumption rather than investment.[3] In addition, donors' own priorities and development agendas limited alignment of aid with national development priorities. At the same time, the National Development Plan (NDP) planning and implementation process has been inadequate, with little prioritization, unrealistic targets, weak links

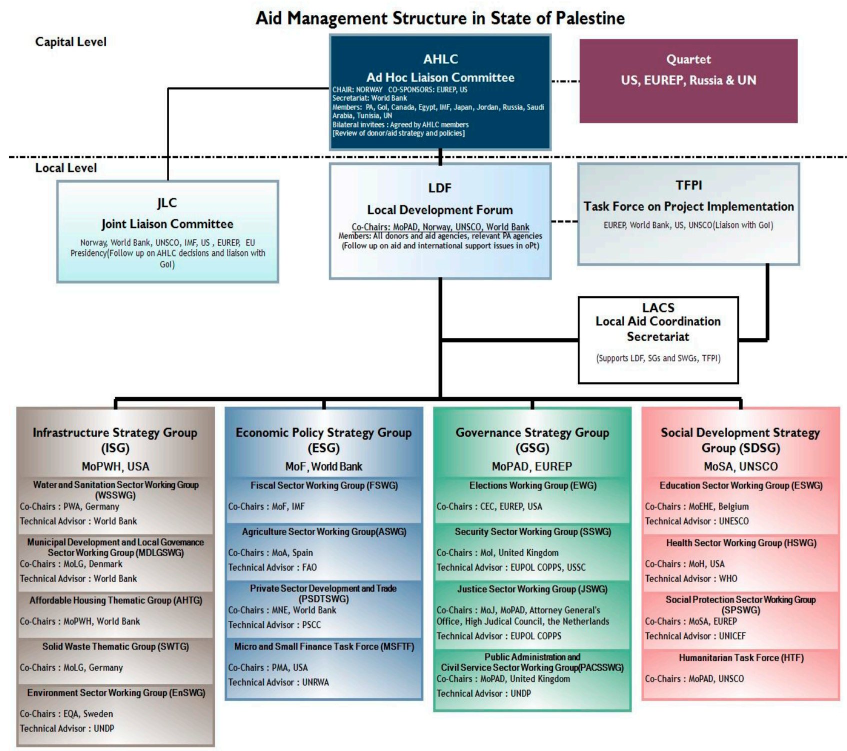
[1] Prepared by Anja Baum.

[2] Official donor aid refers to aid that goes through the fiscal budget. Official donor aid is divided into (general) budget support and development (budget) support. Together, official donor aid accounts for about 30 percent of total aid. The remaining 70 percent go to off-budget support.

[3] Public investment is often more negotiable than recurrent commitments, and thus frequently treated as a residual.

between economic policymaking and NDP strategies, and lack of program monitoring, which in turn provided little incentive for the donors to support the NDP.

The donor coordination mechanism is overly complex, with unclear responsibilities and involvement, and incomplete information on donor involvement. The Ad Hoc Liaison Committee and the Local Development Forum were set up with the goal to mobilize and prioritize donor aid. A complex system of donor strategy groups and agencies aims to coordinate donor assistance with national priorities. On the PA side, the Ministry of Planning and Development (MoPAD) coordinates the projects financed through the budget. It is also tasked to align off-budget support with the national development agenda. Off-budget aid, however, is highly fragmented, and information on its delivery and projects is scarce. This leads to increased costs, overlaps, and ineffective aid alignment to the national development agenda. In addition, unclear responsibilities and lack of coordination amongst PA branches in handling Gaza's reconstruction are resulting in inefficiencies and hindering progress.

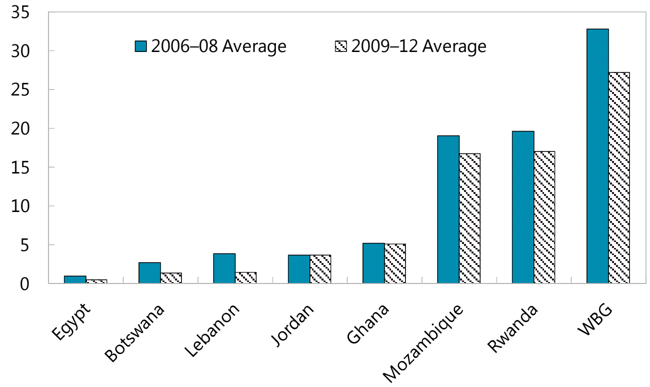


Source: LACS.

Reduction of Aid Dependency: Case Studies

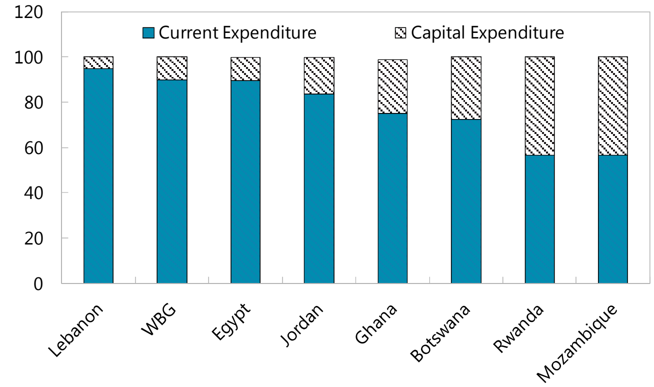
Several countries with similarly high aid flows have successfully reduced aid dependency. Examples include Ghana, Mozambique, Rwanda and Botswana. Ghana, Mozambique and Rwanda still receive very high aid flows today, but aid ratios to government spending have fallen in all three countries in recent years. Botswana was one of the poorest countries in the world at the time of its independence in 1966, when it relied on grants from Britain for development and most of its recurrent spending. Although aid provided critical resources in the early years of independence, its role declined over time, and by 2006/7 it accounted for less than 2 percent of GDP.

Net Official Aid
(In percent of GDP)



Sources: World Development Indicators; and IMF staff calculations.

Composition of Government Spending, 2009–12 Average
(In percent)



Sources: National authorities; and IMF staff calculations.

In all of the above-mentioned examples, capital expenditure, tied closely to the national development agenda and supported by donors, has been a national priority. All four countries allocate a considerably higher share of total expenditure to capital expenditures than the WBG (and also several other countries in the region). In Mozambique, official aid flows currently represent close to one third of public spending, and are largely tied to the implementation of a jointly-agreed development agenda, with results evaluated on a systematic basis. In Ghana, the establishment of the Multi-Donor Budgetary Support (MDBS) fund in 2005 led to the pooling of one third of all aid to Ghana in budget support, away from tied aid or off-budget project support, which helped the implementation of the medium-term national development framework coordinated by the government. In Botswana, two different phases of aid were observed: an initial emphasis on infrastructure development from 1970 to 1988, followed by a transition to technical assistance.

Several other common characteristics of successful countries include strong institutions to support aid ownership, private sector orientation, and increased revenue mobilization. Strong institutions, commonly observed in less aid-dependent countries, increase the likelihood of national ownership,[4] manifesting itself in clear articulation and prioritization of development targets. Ownership further facilitates an alignment of predictable donor support with the national development agenda. Further common characteristics across less aid-dependent countries are donor-supported capacity-building and support limited to a few key donors or pooled through the budget. Finally, donor-supported revenue mobilization has been successful in a number of countries. In Ghana, tax reforms coordinated and funded by donors through the MDBS helped to increase domestic revenues in line with rapid GDP growth. In Rwanda, tailored aid from the UK helped to triple tax revenues between 1998 and 2006.

[4] "Ownership" refers to the authorities' leadership role in devising and guiding development policies and strategies.

Lessons for the WBG Based on International Experience

The PA ownership should be improved by strengthening the development agenda and its implementation. The WBG's NDP should express a clear vision of medium- and long-term objectives, with an emphasis on realistic, feasible and growth-enhancing development targets. These should be discussed with donors from early drafting stages, describing the contribution of public policies and providing a roadmap for medium-term donor support. Furthermore, Gaza's reconstruction should be an element of the national development plan, supported by donors and with the aim of attaining a level of development comparable to the West Bank. A coherent set of policies to gradually increase private business activity and employment is crucial to increase resource mobilization from untapped areas of the economy and foster growth.

Aid should be aligned with national development goals. Donors should play an active role in the implementation of the NDP, aiming their support toward outlined projects and programs. In principle, a project not in the plan should be discussed beforehand and justified before funding is earmarked. In the context of yearly implementation plans, focusing on a few priority sectors could also prove successful in building momentum for reform and delivering tangible results. One such example might be a determined effort to enhance the provision of electricity by resolving issues linked to non-payment and net lending. Implementing ministries should have regular dealings with aid agencies, with oversight of all negotiations by the ministry coordinating aid. In order to ensure consistent donor involvement, setting up a monitoring, reporting and evaluation system for funded projects will be crucial.

Aid coordination is important to enhance ownership and to improve aid effectiveness. Control over policy design and implementation is weakened as a result of the fragmentation of systems for managing and negotiating aid, extensive entanglement between donor and government institutions, as well as insufficient information and public involvement in off-budget support. These factors make it difficult for the WBG authorities to devise their own policies and to guide bundled and sufficient donor support toward them. Donors should be transparent and accountable, by publishing details of their work in an internationally agreed form. In addition, donor coordination should be increased to reduce fragmentation and costs, especially for off-budget aid.

Capital spending and efforts toward revenue mobilization should be increased, supported by strong and predictable aid. The donor community and the PA should work closely together to support a gradual shift away from current toward development expenditure. Donor aid should not be reduced, but a redirection of focus toward the support of structural reforms, revenue mobilization, expenditure efficiency, and private sector development is urgently needed.

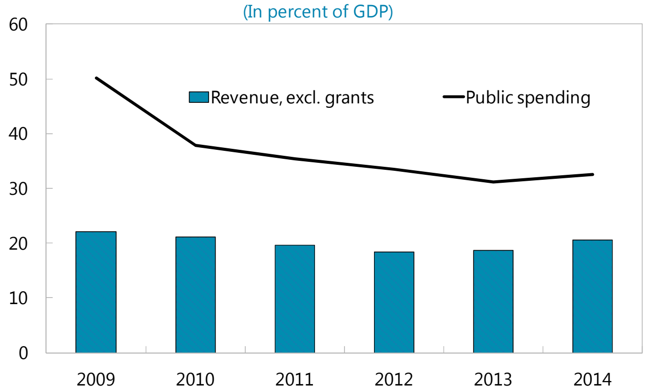
Annex IV. Revenue Potential in the West Bank and Gaza (WBG)[1]

Fiscal policies in the WBG in recent years have been associated with persistent financing gaps, increasingly filled by arrears accumulation. This has had an adverse effect on private demand and growth, and domestic debt has risen to worrisome levels. To turn the situation around, it is essential for the PA to reduce deficits in the medium term. In staff's assessment, significant potential exists for higher revenue to reduce deficits and financing gaps.

Revenue Mobilization is a Critical Issue in the WBG

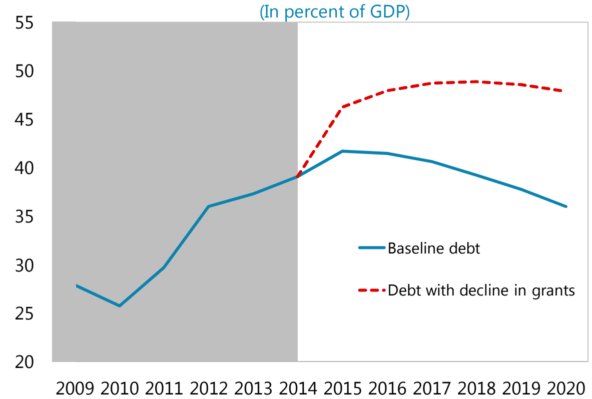
Fiscal consolidation has become a critical task for the PA. While the gap between revenue and spending has been shrinking in the past 6 years, it has remained large, standing in excess of 10 percent of GDP in 2014. Donor aid has helped to bridge the gap, but aid has been insufficient and as a result significant arrears to the Pension Fund and private suppliers have accumulated, reaching 19 percent of GDP at the end of 2014. Combined with borrowing from banks, this has pushed up the PA's debt, endangering its debt sustainability and increasing its vulnerability to shocks.

Revenue and Expenditure
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

Public Debt
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

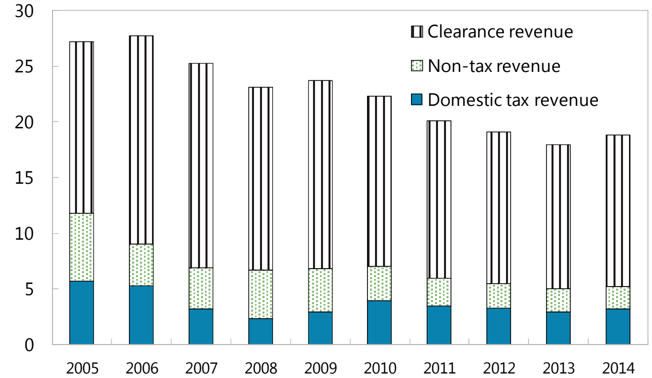
Revenue mobilization should be the key factor in reducing the deficits. Although the role of expenditure consolidation should not be underestimated, its drastic reduction could be problematic. In the special circumstances of the WBG, where private sector demand is constrained by Israeli restrictions, government spending has provided an important stimulus to growth. Additionally, there are significant needs in developing infrastructure and social sectors. Therefore, it is imperative that expenditure consolidation is complemented by revenue mobilization to bridge the financing gaps in the medium term.

The PA has become rightly focused recently on revenue mobilization in an effort to reduce deficits. In early 2014, a revenue strategy was launched, which followed an earlier revenue action plan compiled with donor assistance. Significant technical assistance has been provided by international financial institutions and bilateral donors, including on tax administration.

[1] Prepared by Anna Unigovskaya.

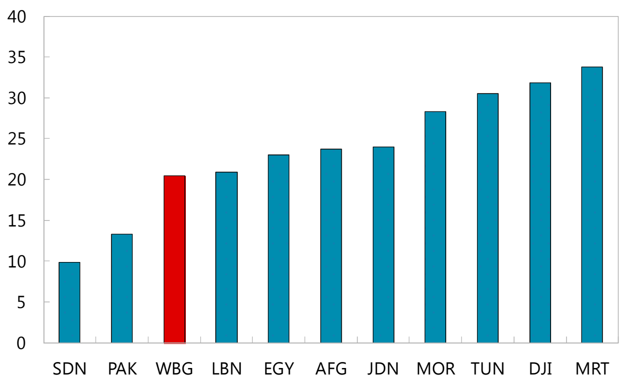
Data show that over time and in a cross-country context, revenue results have been unsatisfactory. Until recently, little progress was achieved in revenue mobilization, which contributed to an entrenching of aid dependency. Revenue declined in terms of GDP from 2005 to 2013 by 9 percent. A reversal of this trend occurred in 2014, mainly on account of an increase in CR. A cross country comparison shows that government revenue in the WBG is lower compared to most of the countries in the MENA region, and it is significantly lower than the average for the WBG's peer countries in the lower-middle-income group.

Revenue
(In percent of GDP)



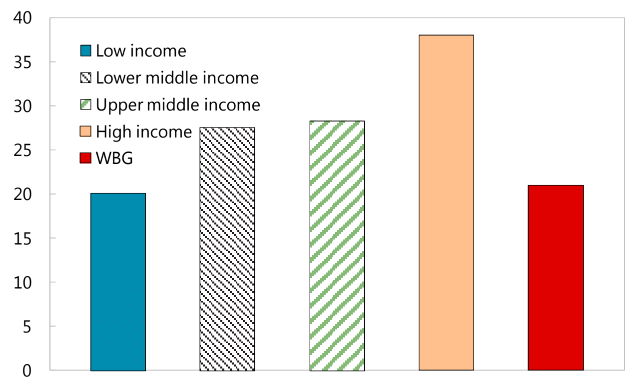
Sources: National authorities; and IMF staff estimates.

Total Revenue, 2013
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

Government Revenue Excluding Grants, 2013
(In percent of GDP)



Source: IMF staff estimates.

Main Principles of Successful Revenue Mobilization

The authorities should be guided in their revenue mobilization effort by lessons from international experience. The IMF reports "Revenue Mobilization in Developing Countries" (2011) and "Current Challenges in Revenue Mobilization: Improving Tax Compliance" (2014) highlight the main principles of successful revenue mobilization in countries with limited capacity. The main target for policymakers should be achieving maximum revenue collection at minimum cost, which is possible if tax compliance is voluntary and tax administration resources are utilized effectively. Voluntary compliance arises, in turn, if the cost of noncompliance for taxpayers is higher than the cost of compliance. Therefore, to mobilize revenue successfully, policymakers should strive to:

- Ensure fairness: there should be no preferential treatments of taxpayers through special tax exemptions, which raise the cost of tax compliance;

- Ensure a low cost of compliance by means of efficient tax information and taxpayer services and simplified procedures for small businesses;

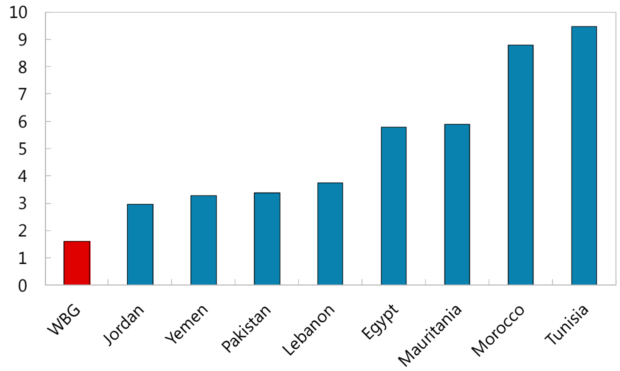
- Make noncompliance costly by means of expensive penalties for noncompliance and uniform enforcement;
- Ensure a high quality of public spending to gain taxpayers' trust, which will increase their willingness to comply;
- Use available tax administration capacity effectively. First, enhance the focus on large taxpayers, which often account for 80 percent of public revenue or more; consequently, the cost of administration per unit of revenue for large taxpayers is significantly lower than for small taxpayers. Second, exercise tax administration over segmented taxpayers (i.e. taxpayer with similar characteristics) to explore economies of scale. Third, harness effectively IT and banking information, and finally, conduct risk-based monitoring.
- Implement a legal framework and regulations governing tax administration to ensure uniform treatment of taxpayers, and proper conduct of tax authorities; and,
- Reduce tax rates only if tax administration is deemed sufficiently strong. Some cross-country examples suggest that lower taxes could improve compliance and overall tax intake by making tax compliance less costly (e.g. Russia). However, the cost of noncompliance must be sufficiently high to ensure positive results.

Calculation of Potential Revenue Intake

Significant potential exist for raising domestic tax revenue in the WBG, if the above-outlined principles of revenue mobilization are followed. Domestic revenue comprises currently about 4.6 of GDP, or 22 percent of total net revenue. On staff estimates, domestic revenue could potentially increase to 7 percent of GDP. To achieve this, the PA should target raising the tax base by means of eliminating exemptions, increasing the number of registered taxpayers and improving compliance. By the authorities' own estimates, they receive taxes from about 30 percent of the potential tax base, and tax avoidance is widespread. Additional income could be derived from tax increases; however, in the absence of a strong tax administration mechanism, caution is needed to ensure that tax increases do not amplify a non-uniform incidence of taxation. Consequently, actions to strengthen tax administration may be a necessary precondition.

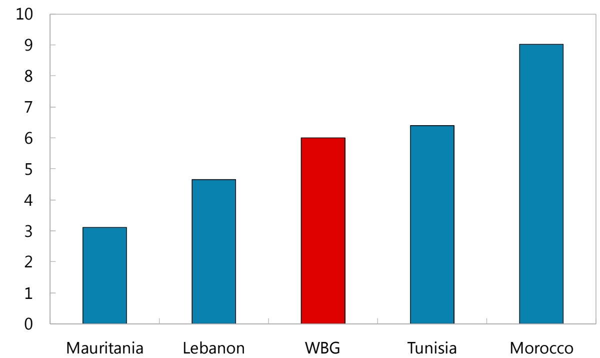
Most increases should come from better tax administration and phasing out tax incentives, as options to modify domestic taxes are limited. In line with the Paris Protocol under Oslo accords, which guide the economic relationship between the PA and Israel, the PA has limited options to independently set indirect taxes, such as VAT and customs taxes, but has freedom to set direct taxes. The PA has to set the VAT within a 2-percent range from the rate in Israel (currently 18 percent). It currently charges 16 percent, and an increase in the rate could be considered provided it does not undermine the competitiveness of products in the WBG. The CIT is assessed as competitive in the region (with a 20 percent maximum rate), but income incentives up to 1.5 percent of GDP represent a significant loss to revenue and should be eliminated. As for the PIT, progressivity could be improved; the maximum rate of 20 percent could increase to 30 percent for the top bracket. It is generally accepted that not much room exists to change excises, because of product competition with Israel and potential smuggling.

Income Tax Revenue in MENAP Oil Importers
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

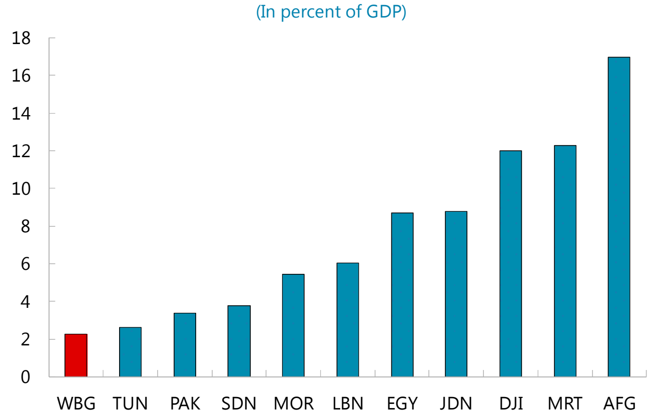
Value-Added Tax Revenue in MENAP Oil Importers
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

Significant potential also exists for raising nontax revenue, which includes fees for government services and incomes from public property and investments. Nontax revenue in the WBG is a little over 2 percent of GDP, the lowest in the MENA region. This reflects the fact that government fees have not been adjusted for the past 20 years, as well as a lack of clear rules regarding PIF income transfers to the budget. Staff estimates that the nontax revenue could nearly double, though, if collection also expands to Gaza. At the same time, it should be noted that exceptionally high nontax revenue, e.g. above 10 percent of GDP, should not be an explicit target, as it could be a sign of poor tax collection.

Non-Tax Revenue, 2013
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

Clearance revenue (CR) could also be significantly scaled up, but enhanced cooperation with Israel would be needed. CR is the most significant source of government income (two thirds of revenue), but it also is subject to risks, as recent experience demonstrates. Moreover, enhancements to CR will also dependent on cooperation with Israeli tax authorities. The main issues with clearance transfers relate to (i) underreporting of imports in Israeli customs, (ii) difficulty in collecting invoices for trade with Israel, which serve as a basis for the clearance mechanism (iii) losses on custom duties on goods of non-Israeli origin, which are reported as Israeli goods, and (iv) losses on direct taxes on employment of Palestinians in Israel, which are substantial due to the high number of Palestinian employees in Israel who work without permits (up to 30 percent of all workers employed in Israel). By authorities' estimates, underreporting in customs amounts to up to 65 percent of the value of goods. The authorities also contend that quality audits of importers are impeded by limited access to area C, where Israel maintains security and administrative control. Similarly, lack of border control and no information exchange with Israel on VAT leads to underreporting on VAT; authorities estimate that up to 50 percent of VAT invoices are not submitted. Additionally, some provisions under the Oslo accords are questioned by the authorities. These concern the fairness of a 3-percent fee for administration of clearance transfers and exit fees for Palestinians to cross the border to Jordan (both charged by Israel). All in all, annual losses on CR according to a study by UNCTAD are estimated at over $300 million, or 3.6 percent of GDP.[2]

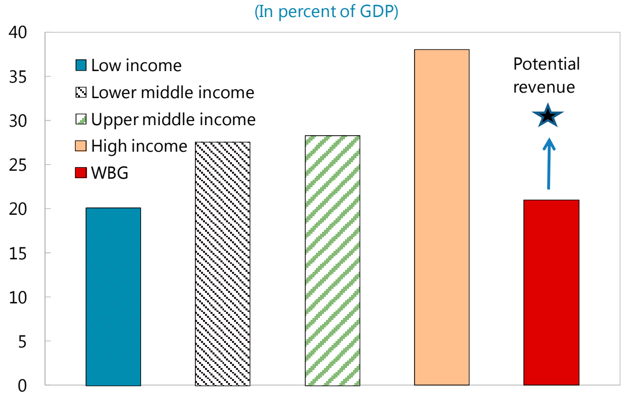
Gaza also could generate significant additional revenue. Domestic revenue from Gaza—tax and nontax—has not been received since 2006, when Hamas seized power in Gaza. At the same time, the PA spends a significant share of its budget on Gaza, including 40 percent of its wage bill (or 6 percent of GDP). To resume tax collection and to put an end to administrative separation of Gaza from the West Bank, reconciliation between rival political factions would be needed. Staff estimates that the loss to the PA budget from domestic revenue underperformance in Gaza currently amounts to about 2.2 percent of GDP, or a third of overall domestic collection in the West Bank (in line with the relative size of Gaza's economy). Moreover, significant losses to the PA's CR arise from inability to collect VAT invoices in Gaza.

Conclusion

Analysis by staff suggests that significant revenue potential exists for the WBG. Revenue could be increased by as much as 10 percentage points of GDP to reach the level of an average upper middle income country. This could be achieved gradually, if best practices are followed and political circumstances are favorable. At the initial stage, revenue potential could be realized from domestic revenues in the West Bank, a territory under control of the PA. With time, assuming progress on national reconciliation and improvement in relations with Israel, additional revenue could be derived from Gaza and enhanced clearance process. Realistically, however, short-term revenue gains are likely to be limited, and expenditure rationalization efforts continue to be needed to close the financing gaps.

Government Revenue Excluding Grants, 2013

(In percent of GDP)



Source: IMF staff estimates.

Revenue Potential (In percent of GDP)

	2014 Actual	Domestic Measures	Gaza	Clearance Measures	Total Potential
Total revenue	21.9	3.7	3.0	3.6	32.2
Tax revenues	19.9	2.5	2.0		24.4
Domestic tax revenues	4.5	2.5	2.0		9.0
Income tax	1.4	1.5	1.0		3.9
Value-added tax	2.0	1.0	1.0		4.0
Customs	0.6	0.0	0.0		0.6
Excises on beverages	0.0	0.0	0.0		0.0
Excises on tobacco	0.5	0.0			0.5
Property tax	0.0	0.0	0.0		0.0
Clearance revenue	15.4	0.0	0.0	3.6	19.0
Nontax revenues	2.0	1.1	1.0		4.1
Domestic fees and charges	1.9	1.0	1.0		3.9
Investments profits	0.1	0.1	0.0		0.2

[2] See "Palestinian Fiscal Revenue Leakage to Israel under the Paris Protocol on Economic Relations," UNCTAD (2014). It should be noted, however, that these estimates are considered excessive by the Israeli authorities, who have also expressed concern about revenue leakages from Israel to the West Bank.

Annex V. West Bank and Gaza: Technical Assistance by the IMF to the Palestinian Authority, 2011–15

The TA support has been in the areas of public financial management, revenue administration, banking supervision, and national accounts. There was also support to the recently established macro-fiscal unit within the MoF. The priorities over the medium term remain on public financial management, revenue administration, and banking supervision. There is need for intermittent review and assistance to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts expenditures side. It is expected that FAD and MCM will continue in providing TA, dependent on the authorities' commitment and progress, supported by METAC.[1]

Mission Date	Mission	Date of TA Report
Fiscal Sector: Since 2007, numerous reform components of a modern public financial management system have been put in place and steadily upgraded. Significant progress in PFM was made in drafting legal frameworks, adopting Single Treasury Account (STA), establishing debt management and cash planning units, modernization of budget classification and Chart of Accounts, developing computerized financial management information system (FMIS), strengthening accounting and reporting, activating internal audit departments in ministries, establishing an independent external audit agency, and establishing a macro-fiscal unit. A medium-term plan of reforms had been agreed upon in 2011 and further updated in 2012. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and STA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, the TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term work program, recommended by the FAD, will strengthen particularly the administration of income tax and VAT for the large and medium taxpayer segments and reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun more effective work. In the medium term, the FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.		
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
Jul. 3-7, 2011	Self Assessment Preparations and Progress with its Introduction in LTU	n.a.
Sep. 14–27, 2011	Tax Audits Procedures	Oct. 2011
Sep. 28–Oct. 30, 2011	Improving Compliance with Income Tax	Dec. 2011
Dec. 1–12, 2011	Public Financial Management Progress Review	Jan. 2012
Feb. 1–14, 2012	Tax Administration	n.a.
Apr. 15–22, 2012	Tax Revenues Clearance Procedures	May 2012

Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Nov. 9–20, 2014	Strengthening Large Taxpayer Unit	Nov. 2014
Nov. 23–Dec. 1, 2014	Public Financial Management Progress Review	Dec 2014
Mar. 8–19, 2015	Compliance Modeling in LTU and Tax Departments	n.a.
Monetary and Financial Systems: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for eventual introduction of an independent currency for the WBG economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012
Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk-Based Banking Supervision *	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012
Oct. 31–Nov. 15, 2012	Strengthening the Stress Testing Framework, Consolidated and Cross Border Supervision and Contingency Crisis Management Framework	Nov. 2012
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013
Mar. 31–Apr. 11, 2013	Follow up on Risk-Based Supervision Manual	n.a.
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	July 2013

Nov. 3–14, 2013	Implementing Risk-Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk-Based Supervision Manual	June 2014
Oct. 26–Nov. 6, 2014	Follow up on Risk-Based Supervision Manual	n.a.
Jan. 18–29, 2015	Follow up on Risk-Based Supervision Manual	n.a.
Mar. 8–19, 2015	Contingency Planning and Crises Preparedness*	May 2015
April 5–16, 2015	Follow up on Risk-Based Supervision Manual	n.a.
April 13–17,2015	Risk Assessment and Stress Testing	n.a.
Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.		
Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	June 2014
May 21–June 3, 2014	Monetary and Financial Statistics	n.a.
Dec. 7–18, 2014	Price Index	Dec. 2014
Feb. 1–12, 2015	External Sector Statistics	April 2015
Feb. 22–26, 2015	National Accounts	Mar. 2015

[1] METAC – Middle East Regional Technical Assistance Center.
n.a. – not applicable.
* The reports are classified confidential.