INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

STAFF REPORT PREPARED FOR THE SEPTEMBER 2013 MEETING OF THE AD HOC LIAISON COMMITTEE[1]

September 11, 2013

KEY ISSUES

Context: The political environment remains highly challenging, but recent developments provide a basis for optimism. U.S.-sponsored efforts have resulted in renewed direct peace negotiations between the Israelis and Palestinians. This development could facilitate the launch of an economic plan, which is being designed by Office of Quartet Representative Tony Blair. The specifics of this plan have not yet been divulged, but it contains ambitious macroeconomic objectives.

Outlook and risks: Recent years' worrisome trends in the economy—slowing growth, high unemployment, and large fiscal deficits—have continued. Under the assumption of status quo, medium-term economic prospects are dim and there are downside risks. On the other hand, if there is a breakthrough in the peace negotiations and the supporting economic package is implemented, the economic outlook would improve.

Key policy recommendations: While there has been some relief from the fiscal liquidity crisis experienced recently, fiscal risks in 2013 are again on the rise and measures are needed to fill the projected financing gap and contain these risks. Beyond the immediate challenges, the broader viability of the West Bank and Gaza's public finances is in doubt if the current model of financing persistently large deficits with unpredictable aid flows is maintained. The fiscal deficit should be reduced significantly over time and government spending made more growth-friendly. At the same time, the economy would benefit from increased donor aid during a transitional period, and a broad-based and sustained easing of restrictions, not linked to specific projects, by Israel.

[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 macroeconomic statistics (Annex III). See www.imf.org/wbg for recent staff reports.

Approved By
Juha Kähkönen and Ranil Salgado

Discussions were held in East Jerusalem and Ramallah during June 24–July 2, 2013. The staff team comprised Christoph Duenwald (head), Karsten Junius, Udo Kock (Resident Representative), Marcin Sasin, and Anna Unigovskaya (all MCD). The mission met Prime Minister Hamdallah, Deputy Prime Minister Mustafa, Finance Minister Bishara, Palestine Monetary Authority Governor Al Wazir, Minister of Planning and Administrative Development Ramadan, Palestine Central Bureau of Statistics President Awad, other senior officials, private sector representatives, and donors. The mission also held seminars for the authorities on its background analytical work, prepared a concluding statement, and issued a Press Statement.

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POLITICAL CONTEXT

1. **In the past few years, the West Bank and Gaza (WBG) has seen a gradual decline of its economic fortunes and an increase in political uncertainty**. The appointment in 2007 of a new government with an ambitious reform and institution-building agenda marked the beginning of three years of high growth, lower unemployment, and shrinking fiscal deficits. The economy benefited from some relaxation of Israeli restrictions, the 2007 Annapolis conference and subsequent political efforts that culminated in direct peace negotiations in 2010, and an aid surge. The breakdown of these negotiations in late 2010 ushered in almost three years of economic decline and political stalemate. This turn of fortune, combined with increasingly unpredictable donor aid, has reached a point where the early achievements in economic institution-building are being threatened. Popular support for much-needed fiscal adjustment measures is weak and the business community has raised concerns over the high cost of doing business and some recently implemented revenue-enhancing measures.

2. **The resumption of direct peace negotiations with Israel raises chances that economic conditions could improve, but there is a risk that the protracted nature of the peace process and the uncertainties about the associated economic package impede policy action**. The resumption of direct negotiations in late July may be accompanied by an ambitious plan to jumpstart the Palestinian economy. The plan is being developed by the Office of the Quartet Representative (OQR) Blair and was announced by U.S. Secretary of State Kerry in May. The plan's feasibility and potential impact will have to be assessed once its content has been announced. The envisaged large-scale (foreign) investment projects require upfront and far-reaching relaxation of restrictions by Israel. At this time, Israel has not indicated that it will ease restrictions further, and there may be local implementation constraints. A positive sign is the recent resumption of direct discussions between Israeli and Palestinian officials about improving the clearance revenue mechanism.[2] That said, the Palestinian Authority (PA) should guard against inaction when weighing the possibility of a positive economic impact of the peace negotiations against the need to implement unpopular measures to address the worsening economic and fiscal outlook.

3. **The newly appointed economic team faces more uncertainty**. Rami Hamdallah was inaugurated on June 6th to succeed Salam Fayyad as Prime Minister. The cabinet also includes a newly appointed minister of finance and a newly created post of Deputy Prime Minister for Economic Affairs. The Prime Minister resigned in late June, but, at the request of President Abbas, continues as caretaker and later agreed to form a new government, which has yet to be completed. The new economic team operates in a highly uncertain environment as a result of the government's caretaker status, uncertainty about the peace process, and lack of clarity about the status and content of the economic plan that can only yield results if fully enabled by Israel. Although the WBG's relative economic isolation limits spillovers from regional political turmoil, regional events add to uncertainty. The ousting of Egyptian President Morsi has weakened his political allies in Gaza and led to intensified

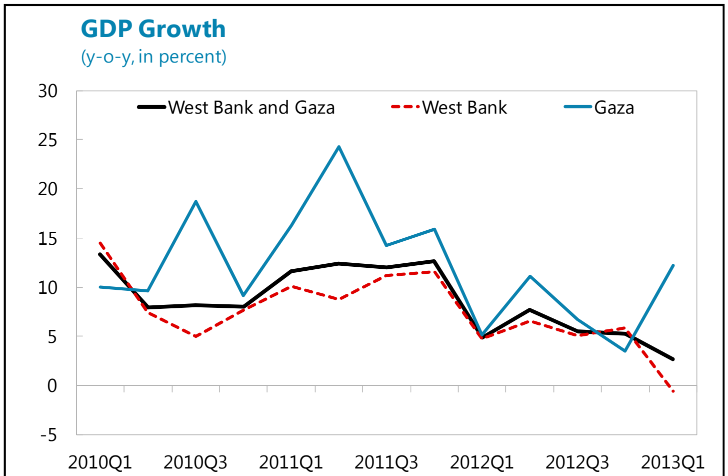
[2] Clearance revenues are revenues collected by Israel in the form of indirect taxes on imported goods. These revenues are later transferred to the Palestinian Authority.

disruptions in tunnel trade between Egypt and Gaza. Prospects for Palestinian reconciliation, meanwhile, remain dim.

RECENT DEVELOPMENTS AND MACRO OUTLOOK

A. Recent Economic Developments

4. GDP growth is slowing (Figure 1, p. 24). The now-familiar growth pattern—private and public consumption directed towards nontradable services—was again in evidence in 2012, but with a difference: after averaging a strong 11 percent per year in 2010–11, supported by some relaxation of Israeli restrictions and strong external demand, real GDP growth dropped sharply to 5.9 percent.[3,4] Broadly unchanged Israeli restrictions in 2012 and political uncertainty undermined economic activity, aggravated by shortfalls in donor support and associated accumulation of public sector arrears to the private sector. Strong growth in consumption pushed up imports, while slowing growth in Israel reduced export growth, resulting in a large negative contribution of net exports. On the production side, services and construction were the main contributors to growth, while the contribution of manufacturing was small and that of agriculture was negative. In the first quarter of 2013 real GDP growth declined to 2.7 percent year-on-year in the WBG, reflecting a private consumption-driven slowdown in the West Bank, linked to the PA's earlier financing difficulties.[5] In contrast, growth in Gaza has picked up in response to scaled up reconstruction efforts. But this source of growth is being disrupted as a result of political developments in Egypt and the related closure of the tunnels that have been used to circumvent the blockade of Gaza.[6]



Source: Palestinian Central Bureau of Statistics.

[3] Growth in the West Bank declined from an average of 9.4 percent in 2010–11 to 5.6 percent in 2012 and in Gaza from 14.7 percent to 6.6 percent.

[4] As discussed in "Growth in the Palestinian Economy," *Selected Issues*, the Israeli restrictions on movement and access directly and indirectly constrain private investment and increase costs of doing business. For example in Area C—which makes up 60 percent of the West Bank—construction is severely restricted. The system of road blocks, checkpoints and closures, results in a fragmentation of the West Bank, which raises the cost of doing business and reduces economies of scale.

[5] Delays with clearance revenue transfers resulted in the accumulation of arrears by the PA, including back wages. The West Bank generates about three quarters of GDP of the Palestinian economy.

[6] The precise economic impact of disruptions in tunnel trade is difficult to estimate. However, in 2011, the most recent data available, almost four times as much construction material reached Gaza through the tunnels as through official imports through Israeli crossings and the overall volume of the tunnel trade is estimated at four times the volume of

(continued)

5. The unemployment rate is high. As a result of the slowdown in growth, labor market conditions in the WBG have remained very difficult. In the second quarter of 2013, the unemployment rate in the WBG stood at nearly 21 percent (17 percent in the West Bank and 28 percent in Gaza). Youth unemployment in the WBG has reached a staggering 33 percent.

6. Inflation remains subdued. Inflation developments in the WBG are largely driven by inflation in Israel, with any margins (typically positive) mainly reflecting differing consumption baskets. Following an uptick in September 2012 related to an increase in fuel prices and VAT, CPI inflation had been slowing down from an average of 2.8 percent in 2012 to 1.5 percent on average in the first five months of 2013. In June–July, however, it picked up again (to 2.6 percent), in part reflecting a one percentage point increase in the VAT rate effective June 1. Inflation developments have diverged in the West Bank and in Gaza, with the latter recently recording price declines in part reflecting, until recently, the proliferation of cheap imports via tunnels from Egypt as well as higher imports of consumer goods and foodstuffs from Israel.[7]

7. Social and business indicators are mixed (Figure 2, p. 25). Although real per capita incomes have risen, other indicators point to challenges on the social front. As of 2011, about 26 percent of Palestinians lived below the poverty line (13 percent below the extreme poverty line).[8] The overall figure masks a significant difference between poverty rates of 18 percent in the West Bank and 39 percent in Gaza Strip, where conditions worsened after the blockade imposed in 2007. However, the WBG is ranked 110 out of 186 countries in UNDP's 2012 Human Development Index, which compares favorably with other countries in the region.[9] On business indicators, the WBG has managed to improve governance, but only ranks 135th out of 185 in ease of doing business.

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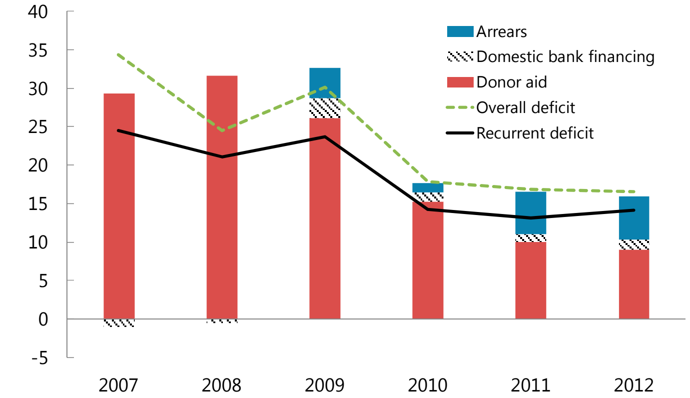
the officially registered trade. (See: Peres Center for Peace and Peace Research Institute Oslo, cited in: Reham Al Wehaidy, "Assistance to the Palestinians — challenges and opportunities", paper presented at the United Nations Seminar on Assistance to the Palestinian People, FAO, Rome, 27-28 February 2013.) Besides the serious economic impact of the disruption of trade and crossings between Egypt and Gaza there is also a humanitarian impact.

[7] The recent intensified crackdown on tunnel trade by the new government in Egypt may push up prices in Gaza later this year.

[8] In 2011, the poverty line and extreme poverty line stood at NIS 2,293 (USD 637) and NIS 1,832 (USD 509) respectively

[9] See: Palestinian National Authority: *The National Strategy to Achieve the MDGs by 2015* at http://www.mopad.pna.ps/en/index.php?option=com_content&view=article&id=246:the-national-strategy-to-achieve-the-mdgs-by-2015. A significant share of health and education services is provided by UNWRA, the UN relief agency for the Palestinian people.

8. On the fiscal front, progress in reducing the recurrent fiscal deficit stalled in 2012 (Figure 3, p. 26). In 2012, due to a combination of lower revenues (partly reflecting lower growth), higher net lending (partly as a result of deduction from clearance revenue of outstanding electricity debts to Israeli suppliers), and unbudgeted pension spending, the recurrent deficit increased to 14.2 percent of GDP.[10] Combined with lower-than-expected aid disbursements, the higher deficit led to large arrears accumulation and increased borrowing from domestic banks.[11]



Source: Palestinian authorities.

9. Partly reflecting the worse macroeconomic situation, the PA's fiscal position has started to diverge substantially from both the 2013 budget targets and the staff's projections presented in the March 2013 report. In the final months of 2012 and in early 2013, difficult government liquidity conditions began to take on crisis proportions, reflecting shortfalls in donor aid and incomplete transfer of clearance revenues from Israel, which account for two-thirds of total revenue. The cash crunch manifested itself in a sharp run-up of domestic arrears to the private sector, public sector employees (delays in wage payments), and the Pension Fund, and increased reliance on domestic bank financing.[12] This put at risk the hard-won institutional gains of recent years. Following additional aid inflows, and a resumption of clearance revenue transfers, fiscal pressures eased somewhat in March–April 2013, but since then, they are once again beginning to build up. Relative to our projections in the March 2013 staff report:

- Prorated revenues underperformed in January–June 2013, mainly on account of a shortfall in clearance revenues, which grew at about 2 percent against the IMF's March 2013 projection of 10 percent for the year as a whole, and increased fuel tax refunds;
- Recurrent expenditures were roughly as expected; savings on the wage bill and operational spending compensated for overruns in net lending, as problems with electricity and water fee collections continued;
- Development spending was low at less than 83 percent of prorated staff projections, and only 26 percent was donor financed, adding to financing pressures.

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[10] The recurrent deficit is defined as revenue less recurrent spending.

[11] For a detailed discussion, see the March 2013 IMF staff report.

[12] Government debt to banks stood at 112 percent of banks' equity at end-2012, but has since declined to 105 percent (end-June 2013).

Fiscal Projections and Outcomes in the First Half of 2013
(In millions of NIS)

	2013 Projections		2013	
	Budget	IMF March	H1 Act.	H1 Act. Relative to IMF March (In Percent) 1/
Net revenues	9,207	8,733	4,069	47
Gross domestic revenues	3,292	3,010	1,654	55
Clearance revenues (accrued)	6,371	6,179	2,810	45
Less tax refunds	456	456	395	87
Recurrent expenditures and net lending	13,092	13,656	6,589	48
Wage expenditures	6,956	7,090	3,436	48
Nonwage expenditures	5,836	6,066	2,833	47
Net lending (commitment)	300	500	321	64
Development expenditures	1,295	1,295	458	35
Overall balance	-5,180	-6,218	-2,978	48
Total financing	5,180	6,218	2,978	48
External financing for recurrent expenditures	4,070	3,756	2,269	60
External financing for development expenditures	1,110	1,127	143	13
Domestic financing	---	1,336	567	42
Net domestic bank financing	272	---	-602	...
Arrears	-272	-272	1,393	...
Residual/financing gap	---	1,608	-225	...

1/In line with normal seasonality patterns for revenue and expenditure, about 50 percent of total revenue for the year and 48 percent of current expenditure would be expected in the first half of 2013.

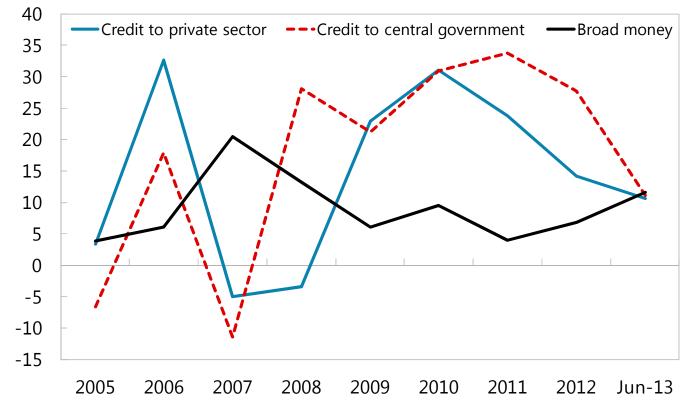
10. Public debt has increased considerably, posing risks to debt sustainability and raising financial system risks (Annex I). Slowing progress in reducing recurrent deficits, in combination with falling donor support, led to growing arrears to the private sector and continued reliance on short-term domestic bank financing. As a result, domestic public debt (including arrears) is estimated to have grown sharply from 26 percent in 2010 to 38 percent of GDP by mid-2013, quickly approaching the 40 percent threshold stipulated in the law and threatening debt sustainability. Worryingly, arrears, which undermine payment discipline and pose risks to government revenue, comprise about percent of public debt.[13]

11. With donor support declining in 2011/12, the current account deficit (including official transfers) deteriorated sharply, increasing from about 11 percent in 2010 to 29 percent in 2012. Despite falling external budget support, the trade deficit has not declined: imports continued to outpace exports, which in turn were affected by a slowdown in demand from Israel, the destination of more than 85 percent of Palestinian exports. According to estimates from the Palestinian Central Bureau of Statistics, the drawdown of cash and foreign deposits was the main source of current account financing. Competitiveness of the WBG's products remained low, in large part because Israel's restrictions result in high transaction costs and limited access to foreign markets. Merchandise exports (excluding from East Jerusalem) comprised only 7 percent of GDP in 2012 and consisted mostly of labor- and resource-intensive goods, such as building stone, garments, footwear and furniture.

[13] The stock of arrears is estimated as a sum of annual net arrears accumulation. An unknown amount of arrears has been settled against private sector tax obligations. Some of the arrears are to Israeli utilities.

12. Credit growth to the private sector is decelerating to more moderate rates after an exceptionally strong expansion in 2009-11, reflecting cyclical developments. In June 2013, annual credit growth to the private sector was 10.6 percent. This is still higher than nominal GDP growth, implying continued financial deepening. However, credit growth is well below the rates witnessed after the introduction of the credit registry in 2008 that reduced information asymmetries between lenders and borrowers. The PMA continues to pursue its predominantly regulatory role, while supporting banks' liquidity in special cases (Box 1).

Money and Credit
(12-month growth, in percent)



Source: Palestinian Central Bureau of Statistics and Palestinian Monetary Authority.

13. The banking sector remains healthy, supported by tight regulation and banks' risk averse behavior, while high interest rate margins sustain profits (Figure 4, p.27). The ratio of Tier 1 capital to risk-weighted assets (CAR) is sound at 21.2 percent even though it declined in the year to June 2013 when bank assets grew faster than bank capital. Nonperforming loans (NPLs) are close to 3 percent for the third consecutive year, while more than 60 percent of NPLs are provisioned for. Bank profitability is relatively high compared to neighboring countries, mainly as a result of high interest rate margins resulting from limited competition in the banking sector. The introduction of explicit deposit insurance, funded by mandatory contributions from banks and with deposits up to US$10,000 now covered, has added to financial system stability.

14. Despite the banking sector's resilience, stress tests indicate vulnerability mainly reflecting high exposure to the PA and its employees. Banks' direct and indirect exposure to the PA is high: as of June 2013, such credit accounted for 48 percent of banks' total loan portfolios. Moreover, the credit risk related to lending to the PA has increased as indicated by the rising volume of payment arrears. As discussed in the *Selected Issues* chapter on "Determinants of Private-Sector Credit Growth in the West Bank and Gaza," this leads to a high concentration of commercial banks' credit risk and additionally might affect banks' ability to lend to the private sector. The June 2013 Palestine Monetary Authority (PMA) stress tests of commercial banks' balance sheets show that banks' Tier I capital to risk-weighted assets ratio would remain above 10 percent in seven out of nine scenarios. However, the capital adequacy ratio would fall to well below 10 percent in the case of severe political or economic shocks. In these scenarios, banks seem especially vulnerable to a decrease in the fair value of investments held outside the WBG—reflecting the large share of net foreign assets in total assets—and to a decline in the quality of loans to the PA and its employees. The results of the stress tests are reported for the aggregate of banks, and some banks—including systemic banks—have exposure to the PA that is far above the average.

Box 1. Monetary Policy Framework

The PMA assumes several functions of a central bank but does not issue its own currency. In line with its main objective to secure the stability of the banking and monetary system, the PMA has set up a tight system of banking regulation, supervision and licensing and regularly conducts stress tests as well as on- and off-site inspections of commercial banks. At the end of 2012, the PMA introduced a deposit insurance scheme, covering deposits of up to US$10,000. Since 2008, it successfully operates a credit registry that currently covers 145,000 bank customers and 55,000 customers of microfinance institutions. Reserves management—helped by the World Bank's Reserves Advisory Management Program (RAMP)—is one of the main tasks of the PMA's operations. All New Israeli Shekel (NIS) are deposited with commercial banks in Europe. The PMA further acts as a financial agent for the PA.

The PMA does not refinance banks or act as lender of last resort, but provides liquidity support to banks in certain cases. Those arise mainly when commercial banks in WBG have excess NIS cash, which they cannot fully exchange for US dollars (USD) in the short term in order to meet the USD-demand of their clients. As the WBG is mainly a cash based economy, while most payments for imports have to be wired by commercial banks on behalf of their customers, banks regularly face a shortage of transferable funds despite high amounts of banknotes in their vaults. In those cases and on the initiative of banks, the PMA provides funds in the form of deposits in banks' accounts. Those deposits are fully secured by foreign currency swap deposits. Hence, the liquidity support banks receive from the PMA is structured and priced as foreign exchange swaps.

Available policy tools are limited and mainly used for prudential purposes. Without a domestic currency, the PMA has no control over the domestic money supply and little influence on domestic interest rates and inflation. Because of the lack of a domestic money market, domestic government securities, and a yield curve, it does not conduct open market operations. However, the PMA can influence the economy through its prudential regulations and related policy tools such as (i) (multiple) reserve requirements, (ii) remuneration of mandatory and voluntary reserves, and (iii) placement of reserves at commercial banks to support liquidity. After a period of applying different reserve requirements for each of the currencies in circulation (USD, Jordanian dinar (JOD), NIS and euro), the PMA currently imposes a uniform requirement of 9 percent on all deposits. It allows banks to keep up to 20 percent of required reserves in the payment system to increase liquidity.

The credit channel is therefore the main transmission channel of monetary policy. As a result of the limited set of policy instruments, monetary policy has virtually no influence on exchange rates, interest rates and asset prices. However, it can influence the credit supply to the private sector by altering the incentives for bank lending and for the composition of banks' loan portfolios.

B. Outlook and Risks

15. **The near-term outlook is challenging**. In a baseline scenario assuming limited policy actions by the PA, no broad-based easing of Israeli restrictions, and total donor aid for recurrent and development spending at US$1.3 billion, GDP growth is expected to continue to slow in 2013, to 4.5 percent, weighed down by political uncertainty and fiscal retrenchment. With weak growth unemployment is expected to rise further. Given current global commodity trends, inflation is projected to be benign and to remain slightly above Israeli inflation, at 2.5 percent. Fiscal consolidation of about 1½ percentage points of GDP is projected for 2013, largely resulting from expenditure measures, while a financing gap of roughly 3 percent of GDP (US$0.3 billion) remains. This projection reflects a slight scaling up of donor budget support to US$1.15 billion (relative to the budget assumption of US$1.1 billion), and a downward revision (from US$0.3 billion to US$0.18 billion)

of development support based on slow project implementation this year. Absent additional donor support, the gap would likely be covered by further arrears accumulation and domestic bank borrowing.

16. Further growth deceleration is expected in the medium term, unless the political context improves significantly. Absent a broad-based and sustained easing of Israeli restrictions, clarity on the political front, and reforms to improve the investment climate, production and private demand will remain subdued. Public consumption will need to adjust downward somewhat, in the face of binding financing constraints, especially given that donors will continue to face their own fiscal pressures and competing demands for aid to other parts of the region. External demand will remain subdued, reflecting modest growth in Israel (which in turn has strong links to Europe). Fiscal deficits are projected to decline, though not enough to eliminate financing gaps. All in all, real GDP growth is expected to average 3¼ percent over 2014–18, with a declining trend in both the West Bank and Gaza. Unemployment will continue to rise over the medium term as employment growth is insufficient to absorb new labor market entrants.

17. Downside risks to the outlook are significant, mainly because of political factors that in turn could affect aid disbursements (Annex II). For the immediate future, donors are unlikely to adjust aid disbursements, although this will also depend on how the ongoing peace talks evolve. If direct negotiations fail and the PA takes diplomatic steps against Israel, some donors could scale back support. There may also be rising concerns about the PA's financial stability, especially if the PA were unable to close the financing gap or if the new government loosens the fiscal policy stance, which could imply further arrears accumulation and have a destabilizing effect on private demand and growth. In this context, the high exposure of Palestinian banks to the PA and its employees poses another risk. In addition, banks, while not significantly exposed to developments in the euro zone, face the risk of higher borrowing costs in case of a crisis in Jordan, the home country of a large share of the commercial banks and the destination of a large share of their deposits. There are also risks emanating from developments in the region, especially in Egypt, with an impact that is difficult to assess. The disruption of tunnel trade with Egypt has potentially serious effects on Gaza's economy, particularly if there is no compensating easing of import restrictions by Israel. More generally, the heightened political and security risks in the region further increase uncertainty for the WBG. Of particular concern is the risk that an escalation of the Syrian conflict leads to higher world oil prices, with attendant negative effects on the Palestinian economy. Other risks relate to financial instability and close trade linkages with Israel, which is exposed to shocks from Europe. An unquantifiable, but critical, risk is social instability, which would surely rise over time with persistently high and rising unemployment.

18. However, there are also upside risks. If the peace negotiations progress well and the supporting economic package is implemented, over time additional investment and aid would be forthcoming, boosting growth and employment and potentially easing the government's fiscal constraints. Short of a game-changing breakthrough, the WBG's economic situation could be boosted by PA policy actions along the lines discussed in the next section (including implementing a growth-friendly fiscal consolidation and boosting the business climate). Of course, the economic benefits of such policies would be much larger if leveraged by successful peace negotiations and a full-scale lifting of Israeli restrictions. Staff estimates that reforms supported by a moderate easing of restrictions could boost growth by about three percentage points over the next three years, raise investments to levels seen in the past (about 16 percent of GDP), and stabilize unemployment (*Selected Issues* chapter on "Growth in the Palestinian Economy").

19. The authorities agreed with staff's assessment of the outlook and risks. They emphasized that the outlook is largely determined by external factors, especially Israeli restrictions and donor financial support, which are beyond their control. Lack of prospects for private sector development, in their view, and strong political opposition make it difficult to reduce public employment. They argued that the unpredictability of donor support and clearance revenue transfers hindered fiscal planning, and consequently obscured the growth outlook.

POLICY DISCUSSIONS

A. Fiscal Policy in 2013

20. The 2013 budget targets look increasingly out of reach (Box 2). The budget targets a recurrent deficit of 9 percent of GDP (5 percent of GDP less than in 2012) and an overall deficit of 12 percent (4½ percent of GDP less than in 2012). Financing relies on US$1.4 billion of donor support—US$1.1 billion for budget support, and US$0.3 billion in development support, taking into account additional donor pledges at the March 2013 AHLC meeting—and US$0.1 billion in domestic bank financing to repay wage arrears. Based on developments in the first half of 2013, these targets now look out of reach. Indeed, staff projects an overall deficit of US$1.7 billion (15 percent of GDP), about 3 percentage points higher than the budget, yielding a financing gap of US$0.3 billion. Absent additional donor financing, this gap will again be covered by arrears accumulation and borrowing from the commercial banks. The authorities agreed with staff's revised fiscal projections, although they expressed some optimism about additional donor financing from Arab countries.

21. Staff urged the PA to take measures to contain the mounting fiscal risks. Staff noted that to fill the financing gap and to counter the downside risks—including aid shortfalls, interruptions in clearance revenue transfers, and deductions from clearance revenues to settle utilities' debts—the authorities should take measures now, especially on the expenditure side. Such measures could include a wage and promotions freeze, rationalization of allowances for civil servants and continuing the rationalization of medical referrals, and more generally, careful vetting of all discretionary spending. In addition, net lending needs to be reduced, and this requires additional measures to improve municipal water and electricity bill collections, including through the continued installation of prepaid meters, and, over time, a broader reform of the sector. Further improvements in targeting of cash transfers should ensure that the most vulnerable segments of the population receive benefits. The authorities should also build on recent improvements in public financial management by further strengthening commitment controls and cash management.

Box 2. 2013 Fiscal Position: Budget and Staff Projections

The key elements of the 2013 budget are as follows:

- An overall balance (commitment basis) of about 12 percent of GDP, nearly 4½ percentage points of GDP lower than in 2012, with a zero financing gap.
- Real GDP growth and inflation of 5 percent and 2.8 percent, respectively, are assumed.
- Revenue is to increase by 1.1 percentage points of GDP. Domestic tax revenue is to grow at 19 percent, driven mainly by an increase in excises on tobacco, following a similar move by Israel. Nontax revenue is to grow at 13 percent to reflect improvements in administration of nontax revenue, including via the General Directorate of Property Tax (for fee collection), and improved investment income. Clearance revenue is expected to grow at 13 percent based on nominal GDP growth of about 8 percent and the full impact of last year's increases in VAT and excises.
- Recurrent expenditure is to decline by 4.1 percentage points of GDP, of which 2 percentage points are on account of a sharp cut in net lending, and about 1 percent each are on account of wages and non-wage spending. Wage growth is projected to be contained at 2.1 percent. A net hiring freeze and a new requirement for collection of wages in person are to generate savings in the wage bill.
- Transfers are to increase by 7 percent, while the much smaller allocation for operational spending is projected to decline by 7 percent.
- Development spending is expected to be mostly donor-financed, with government share limited to less than 15 percent.

Based on results in the first half of the year, staff believes these targets are mostly out of reach:

- Growth in clearance revenue (accounting for two-thirds of total revenue) is projected at 4.5 percent, far below the budgeted 13 percent increase. In addition, tax refunds, which comprise mainly fuel tax refunds, appear to be underestimated in the budget by as much as 0.9 percent of GDP.
- On the expenditure side, a budgeted reduction in net lending is also unlikely without additional measures to improve municipal water and electricity bill collections. As regards development spending, both implementation and donor support appear to be overly optimistic.
- Staff projects an overall deficit of US$1.7 billion (15 percent of GDP, compared to a budgeted deficit of US$1.4 billion) and a remaining financing gap of US$0.3 billion (3 percent of GDP, compared to a zero financing gap in the budget).

22. There is also room to strengthen revenue collection. This should take place along three dimensions: first, the PA's ambitious Revenue Action Plan (RAP), which aims to establish a fully integrated revenue administration of income tax, VAT, customs, and other direct and indirect taxes, should be fully implemented (Box 3). Staff encouraged the authorities to give priority to strengthening the Large Taxpayer Unit (LTU)—including by increasing its staffing—as the agency best suited to start improving taxpayer compliance through the introduction of taxpayer self-assessment. Second, staff warned that current tax incentives are overly generous and prone to abuse, create distortions, complicate tax administration, and sacrifice tax revenue (Box 4). The tax incentives should be scaled back by simplifying and reducing the tax exemption periods, refocusing the incentives on investment rather than profitability, and by narrowing their scope. Third, with fuel prices on a downward trend, fuel subsidies in the form of higher refunds of fuel excises should not be renewed in coming months. Staff also stressed the need for full and consistent implementation of the July 2012 Steinitz-Fayyad understanding, the main objective of which is full sharing of data pertaining to clearance revenue, given the critical importance of such revenues for the PA.

Box 3. Revenue Administration Reforms

As part of a long-term strategy for the modernization of revenue administration, in February 2013 the PA began to implement a three-year Revenue Action Plan (RAP). The RAP aims to expand the tax base and improve compliance by establishing a fully integrated revenue administration of income tax, VAT, customs, and other direct and indirect taxes. There will be broad technical assistance support from DFID, USAID, EU, and the IMF.

The RAP has set nine priorities: (i) train staff; (ii) update laws and regulations; (iii) adopt a new computerized taxpayer system (Revenue Management System, RMS); (iv) implement a taxpayer awareness program; (v) adopt integrated revenue administration and a matching functional organization; (vi) reform the Large Taxpayer Unit (LTU); (vii) initiate taxpayer identification and registration units; (viii) improve taxpayer services; and (ix) initiate a taxpayer investigations program.

The efforts are moving on a broad front:

- Training is done across activities. For now, the focus is on running the RMS productively. Other areas will come online as resources and the timing dictate. These areas include awareness campaign for the staff, one-stop shop, taxpayer awareness, self-assessment, audits, and appeals processes.
- The RMS Phase I module went live in August. In the meantime, data migration work from previous Israeli Tax Authority information system is proceeding. The Phase II modules (registration, collections, audits, appeals) continue to be constructed.
- A Tax Procedures Code has been drafted and is under review by the Finance Minister. The Code must then be approved by the Cabinet and signed by the President.
- Taxpayer awareness component is ready to move forward. The component funding is being secured from the EU and the project is expected to begin in 2014.
- To modernize the revenue administration organization, an Integration Law was drafted and approved. The Law was signed by the President but has not yet been published officially without which many RAP activities will remain on hold.
- An LTU director was appointed to oversee the integration of VAT and income tax procedures. The large taxpayer selection criteria are being discussed but no decisions have been made yet. The proposed criteria would expand the LTU’s coverage, potentially increasing the number of large taxpayers from 300 to around 500. Staffing shortage is a serious impediment to increasing the workload. Self-assessment work, with large taxpayers by end-2013 and others in 2014, will start when more staff capacity is acquired.
- Identification of non-registered taxpayers with tax obligations and efforts to bring them into compliance have made progress. Job descriptions, business process mapping, and some staff training were done. The next step will be publication of the Integration Law.

Box 4. Tax Incentives

Efforts to improve revenue collection are being undermined by excessive tax exemptions and holidays. The authorities are interested in reforming tax incentives, but vested interests and political considerations have so far kept them in place, even in the face of serious fiscal stress. The end-March 2013 deadline for granting new incentives under the current Investment Promotion Law was recently postponed to December. By July, more than 80 companies (about 60 of which fall under the LTU) received new tax breaks.

Tax exemptions are granted on the basis of the 'Law on the Encouragement of Investment in Palestine' (enacted in 1998 and revised in 2011). Projects in the following sectors and sub-sectors are entitled to tax incentives: industrial; tourism; agriculture; information technology; health; education; mortgage finance and investment if providing development finances and guarantees; real estate development; and environmental recycling. Eligible projects are entitled to an income tax holiday for the following periods: seven years for investments between US$250,000 and US$1 million; nine years for investments between US$1 million and US$5 million; 11 years for investments greater than US$5 million. For information technology projects, the period of the holiday (three to 10 years) depends on the number of local professional employees. Eligible projects are also entitled to an exemption from customs duties (but not VAT). Additional exemptions will be available within Industrial Estates and Free Zones. The Council of Ministers can also grant tax incentives to other sectors or subsectors and extend the term of the current exemptions.

Current tax incentives in WBG are overly generous and unnecessarily complex, and their success is questionable. Their cost is estimated at between 0.4 and 1.5 percent of GDP, and is bound to rise further in the future. Tax incentives are often granted to highly profitable ventures that would have been undertaken anyway. They are prone to abuse, cause distortions, and complicate tax administration. In light of the goal to improve revenue, they should be rationalized and limited to a few very specific investments/sectors focusing on investment rather than profitability, with clear criteria and a single time period of no more than five years, with the longer-term goal of eliminating all tax holidays. All tax incentives should be included in the tax law, and have a sunset clause. A tax expenditure statement detailing the estimated and actual cost of all tax incentives should be included in the budget.

23. **The authorities agreed with the staff's analysis, but did not appear ready to commit to the recommended measures.** Although improving the LTU is part of the authorities' RAP, they were not convinced that reforms to the LTU should move ahead of other revenue reforms. They noted that withdrawal of tax incentives may face resistance from vested interests, that powerful unions may resist any further wage measures, and that difficulties of accessing Area C and Gaza would thwart their efforts to improve utilities' collections. To address the risks, they would prefer Israel to commit to unconditional regular clearance revenue transfers and donors to provide more aid.

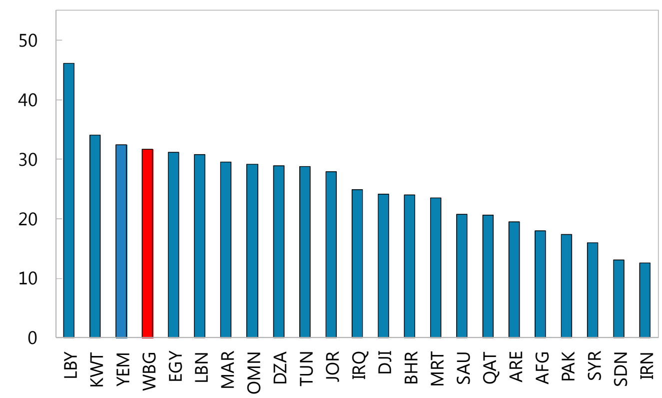
B. Medium-Term Fiscal Policy

24. **The WBG's current fiscal financing model raises serious concerns about the medium-term viability of the PA's finances** (*Selected Issues* chapter on "The Medium-Term Viability of the West Bank and Gaza's Fiscal Financing Model"). Persistently large recurrent deficits are financed mainly by donor aid, creating aid dependency. While the WBG has certainly benefitted from the generous support of the international community, aid flows have at times been unpredictable, undermining the PA's ability to prepare and implement medium-term expenditure plans. Efforts have

tended to focus on crisis management brought on by lower-than-budgeted aid or interruptions in clearance revenue transfers, rather than on long-range planning. The PA has relied on domestic bank financing and arrears to private sector suppliers and, on a few occasions, public sector workers.

25. Donor aid has largely been used to finance current fiscal deficits, rather than build up the economy's productive capacity (Box 5). Public spending has been tilted towards wages, pensions, and transfers, rather than investment in education and public infrastructure. The WBG is among the MENA countries with the highest current spending-to-GDP ratio, of which about half is wage spending. At the same time, badly needed development spending has been declining, and in 2012 comprised less than 3 percent of GDP. Such a skewed allocation of fiscal resources has nudged the economy toward domination by the nontradable service sector, while inadequate infrastructure has created additional obstacles to private sector development. That said, many of the WBG's economic problems are rooted in the longstanding conflict with Israel and solving the conflict would do more than any other measure on its own.

Current Expenditure
(In percent of GDP)



Sources: World Economic Outlook; and Palestinian authorities.

26. An analysis of financing requirements and sources suggests that the current model is not sustainable. Even in a baseline scenario, which assumes only a modest reduction in arrears, medium-term financing gaps are substantial. The financing gaps imply that arrears clearance is contingent on the gaps being filled; for the purposes of staff's debt sustainability analysis, it is assumed that domestic borrowing fills the gaps. Once negative shocks are applied to this baseline—for instance a sharp reduction in aid—financing gaps increase still further. In such a grim illustrative scenario, the experience from other countries suggests that economic activity would likely grind to a halt as the government would need to eventually cut spending drastically as financing sources dry up. In addition, while in the baseline public debt is sustainable, this ceases to be so once negative shocks are applied.

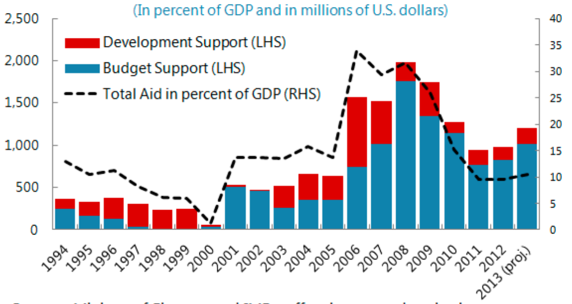
27. To restore medium-term fiscal sustainability, given aid dependency, joint efforts by the PA, donors, and Israel are needed. The PA would need to reduce its financing requirements over the medium term and improve the composition of its spending in exchange for stepped-up aid as part of multiyear commitments. Indeed, staff urges donors to provide additional and more predictable financing to support credible reforms in the short term and shift aid to project support over time. On the Israeli side, broad-based and comprehensive relaxation of Israeli restrictions is needed to lift the Palestinian economy, and the transfer of clearance revenue should be automatic rather than discretionary.

Box 5. Donor Aid for the Palestinian Authority: How Much and What Was it Used for?

The PA has long been a large recipient of official donor aid, but over time aid flows have become increasingly volatile and tilted towards budget support. Since its establishment in 1994, the PA has received more than US$15 billion in aid from bilateral and multilateral donors (15 percent of GDP per year), with annual per capita aid averaging US$340. Official aid flows to the PA have also become more volatile and tilted towards budget support. Before 2001, roughly one third came in the form of budget support; after 2007 this was more than 80 percent. The boom in budget support came at the expense of development support.

Total Budget and Development Support, 1994–2013 (proj.)

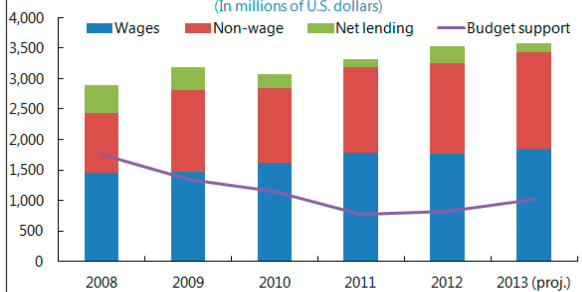
(In percent of GDP and in millions of U.S. dollars)



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

Budget Support and Recurrent Spending, 2008–13 (proj.)

(In millions of U.S. dollars)



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

Since 2008, budget support has been used mainly to finance recurrent spending. This is despite ambitious public investment plans envisaged in the Palestinian Reform and Development Plan (PRDP, 2008–10) and the Palestinian National Development Plan (PNDP, 2011–13). Under these two development plans, recurrent budget deficits were to be financed by budget support from donors. The PA received a total of US$6.5 billion for this purpose (including projections for 2013), about US$0.5 billion more than programmed. Actual recurrent deficits, however, were much larger and hence budget support fell US$1.8 billion short of financing needs, which resulted in arrears accumulation and bank borrowing. Still, on average, budget support covered roughly one third of total recurrent spending. For private-sector development and the buildup of public infrastructure, the PRDP and PNDP envisaged ambitious donor-financed investment plans, totaling US$4.4 billion; however, only US$1.2 billion in PA-implemented projects was covered by donors, resulting in more arrears accumulation and delays and sometimes cancellation of investment plans.[1]

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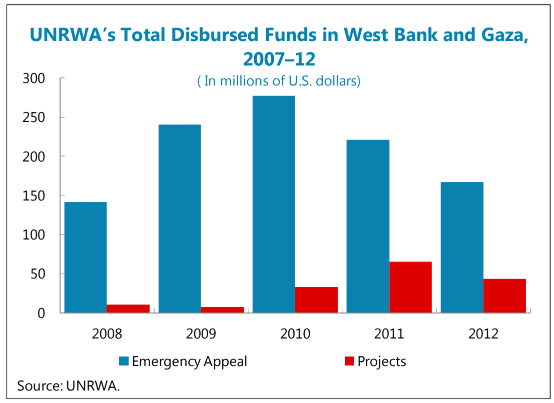
[1] This amount covers development support by donors that is channeled through the PA's budget. It does not capture potentially sizable donor aid for projects implemented directly by donors outside the PA's budget. Some of these projects have been implemented through local and international NGOs, to which donors gave US$393 million in the period 2010–12, according to the Ministry of Planning and Administrative Development.

Box 5. Donor Aid for the Palestinian Authority: How Much and What Was it Used for? (concluded)

Donors also provide substantial funding for the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNWRA), which tilts overall donor aid further towards recurrent spending. In the period 2008–12, UNRWA spent US$1.2 billion on cash transfers, job creation, food assistance, and health, education and other services for Palestinian refugees in the WBG. UNWRA's budget is almost exclusively funded by Western donors, who distribute their aid budgets for WBG between budget support, UNWRA, NGOs, and their own development projects.



28. Specifically, staff recommends the following approach to make the PA's finances sustainable:

- *Lower recurrent deficits over time*. To signal to donors its commitment to medium-term fiscal prudence, the PA could aim to consistently deliver lower recurrent fiscal deficits. In doing so, the PA should take a growth-friendly approach featuring a mix of spending and revenue measures anchored in a credible medium-term plan. On the spending side, the focus could be on reforming the generous pension system, health care (especially the referral process for treatment abroad), and reducing the wage bill (a hiring and wage freeze, and rationalization of allowances for high-income public sector workers), followed by comprehensive civil service reform. Given the likely impact of these reforms, the authorities will have to make good use of the existing targeted cash transfer system with a possible need for additional allocation of resources. On the revenue side, efforts could focus on domestic revenues, including income tax, tax exemptions, and compliance.
- *Improve the composition of spending*. The PA, together with its development partners, could prepare a plan to reorient government spending toward investment and away from current spending. Such a shift could be facilitated by shrinking deficits, with donors redirecting aid from budget support to support for projects that invest in education, health, and infrastructure. Institutional reforms also need to be stepped up to support private-sector development.
- *Increase the support from Israel and the international community*. Donors should support new comprehensive reforms that will help the PA transition to viable public finances with additional aid. The aid should be based on multiyear commitments and possibly linked to PA deliverables. Israel could provide increased support by lifting the restrictions that constrain private-sector

activity while ensuring uninterrupted transfers of clearance revenues.[14] Indeed, improvements to clearance revenue collections are largely outside of the control of the PA.

29. Although staff messages on medium-term fiscal viability resonated with the authorities, the degree of traction is uncertain. The authorities accepted the mission's analysis, but expressed concern that the proposed measures were politically unpalatable and that continuous donor support will be needed in lieu of rigorous policy action. Interlocutors from western donor countries were hesitant about the idea of scaled up aid to allow the PA to implement difficult reform measures. These donors highlighted fiscal pressures at home and competing demands for aid (such as Egypt and Syria) as important constraints on stepped-up aid to the PA. The Israeli officials also welcomed staff's analysis and recommendations, but gave no indication that an easing of restrictions was forthcoming. They did note that meetings between the Palestinian and Israeli ministries of finance had resumed discussing improvements in the clearance revenue mechanism.

C. Financial Sector

30. Staff discussed with the PMA and commercial banks recent trends in financial stability. Staff stressed that the banking sector continues to perform well, but expressed concerns in three areas: first, the potential risks stemming from the banks' increasing exposure to the PA and its employees; second, the risk of crowding out; and third, the consumption orientation of the majority of loans and the potential to increase credit for investment purposes. Banks and PMA emphasized the need for especially conservative banking practices, given political uncertainties and the lack of an own currency and a lender of last resort. The Israeli restrictions on movement and access, and the inability of the Palestinian authorities to enforce laws in large parts of the West Bank (Area C), also limit viable business opportunities for banks.

31. Banks and the PMA shared staff's concerns about banks' rising exposure to the PA. They stressed that banks' increasing direct and indirect exposure to the PA threatens the viability of the banking system if indebtedness were to increase and the underlying fiscal position of the PA were to deteriorate further. The PMA noted its careful monitoring of risks through quarterly stress tests. Staff urged the PMA to consider additional regulatory capital requirements for banks given the concentrated credit risk related to lending to the PA.

32. Domestic and foreign commercial banks only partly shared staff's concern that the high and volatile exposure to the PA would risk crowding out. Most banks referred to the high liquidity in the banking system, the still-high NFA amounting to US$4 billion or 38 percent of bank assets (mostly held as deposits at Jordanian banks) that potentially could be used for domestic lending, and the limited alternative opportunities to lend to the private sector, where many potential investment projects would depend on loosening of the Israeli restrictions. However, most banks also confirmed

[14] The Government of Israel cites security concerns that restrict its ability to ease or lift restrictions in the West Bank and Gaza.

that they would have to redouble efforts to lend to the private sector to support profitability if the PA were to repay a large share of its loans.

33. Banks noted the risks stemming from the bias of their credit portfolio towards consumer and private real estate, and stressed their desire to boost lending to SMEs. Some also mentioned a certain saturation of the consumer loan market, and noted that from a risk perspective it might not be advisable to increase consumers' and banks' exposure to the real estate sector. In this connection, banks and the PMA expressed the desire to boost lending to SMEs. One problem with diversifying loan portfolios is the lack of reliable information about potential borrowers to assess business plans. Banks have assisted SMEs with their financial reporting, while some banks reported positive experiences with loan-guarantee funds that reduce the risk for SME lending as well. In April 2013, the PMA issued a regulation for the promotion of lending to SMEs. To further improve lending conditions, staff stressed the importance of signing the Movable Assets Law and of further strengthening creditor rights, by, for example, speeding up court procedures.

D. Structural Issues

34. The National Development Plan 2011–13 has not been implemented as planned (*Selected Issues* chapter on "Growth in the Palestinian Economy"). The building of economic state institutions has largely gone according to plan, but the envisaged accelerated removal of constraints on the Palestinian economy did not materialize. As a result, the macroeconomic goals of the plan have not been achieved. The causes of this delay are largely outside the PA's direct control. However, several key reforms that have been under the control of the PA have also languished. In particular, there has been no meaningful progress in the reform of the pension system, where parametric changes must be implemented to bring entitlements into line with resources,[15] and in civil service reform, which is necessary to reduce the PA's inflated wage bill. As a result, donor engagement in both areas has weakened. Several draft laws that would help improve the business climate continue to await presidential signature (such as the Movable Assets Law and Companies Law), which is held back by the absence of a functioning legislature and the consequent lack of a proper consultative process for new legislation. Additional areas in need of reform include the energy sector, where comprehensive reform is needed to durably reduce net lending; the health sector, where the costs of medical referrals to hospitals outside the West Bank and Gaza (which have reached US$150 million per year) need to be streamlined; and the provision of social assistance, where further improvements in delivery efficiency are needed.[16] As the authorities begin to prepare for the National Development Plan 2014–16, these issues should be tackled with renewed vigor.

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[15] Preliminary estimates from the World Bank suggest that the value of total accumulated pension arrears is about $1.4 billion, although this is based on partial information so that actual arrears to the entire pension system are likely to be higher.

[16] The two latter reforms are being supported by the World Bank's recently approved the fifth Development Policy Grant (US$40 million).

35. Higher growth is a necessary condition for durably reducing unemployment (*Selected Issues* chapter on "The Link Between Growth, Employment, and Unemployment in the West Bank and Gaza"). While higher growth rates are crucial to lower unemployment, the right mix of reform and relaxation of restrictions can help boost job creation in more than one way**.** By far the biggest impact would come from a broad-based relaxation of Israeli restrictions—that is not linked to specific projects—which would support growth and also reduce rigidities in labor and products markets that hold back job creation. Expanding employment opportunities in Israel, including for workers from Gaza, would also contribute significantly.[17]

36. Notwithstanding the overarching importance of a relaxation of restrictions, the PA can also help create a more employment-friendly economic environment. Taking into account that generous public sector wages and benefits and high public sector employment could crowd out private sector employment, the PA could undertake a review of the Civil Service Law of 1998 (amended in 2005) with a view to bringing the provisions more into line with private sector conditions.[18] This would strengthen the competitiveness of the private sector which is not sufficiently productive to support high wages in manufacturing goods with low value added. There is also evidence that reform of product and labor markets can boost job creation.[19] Related, the PA can contribute by removing impediments to private sector growth. And while school enrolment rates in WBG compare favorably with rates elsewhere in the region, there are indications that many graduates lack the skills required by private sector employers. By redirecting public expenditure from consumption to investment, the PA can further underpin job creation and help bring about a reduction in unemployment.

37. The PA could take additional measures to improve the investment climate. There is scope to reduce the often burdensome procedures, as well as update and clarify the incomplete and complex economic legislation. Several draft laws that await presidential signature (such as the Movable Assets Law and Companies' Law) could be advanced, and the PA could undertake a review of other laws with a view to ensuring their business friendliness. Efforts to improve access to credit, in particular for SMEs, should continue. The competitiveness of Palestinian enterprises would benefit from better business-supporting services and institutions, such as collection of market intelligence, facilitation of business contacts, promotion of the Palestinian brand, and implementation of internationally recognized standards.

[17] An encouraging recent development is Israel's decision to increase the quota of Palestinian workers from the West Bank who are allowed to enter Israel.

[18] There is cross country evidence that public sector employment crowds out private sector employment, with the effect potentially stronger in the Middle East. See A. Behar and J. Mok, 2013, "Does Public-Sector Employment Fully Crowd Out Private-Sector Employment?" *IMF Working Paper* 13/146.

[19] The following factors are found to be positively correlated with employment elasticities: labor market flexibility, product market flexibility, macroeconomic stability (as measured by low volatility of output and prices), the relative size of the service sector, and the share of urban population. The size of government and trade openness are found to be negatively correlated with employment elasticity, among others. See E. Crivelli, D. Furceri, and J. Toujas-Bernaté, 2012, "Can Policies Affect Employment Intensity of Growth? A Cross-Country Analysis," IMF Working Paper 12/218.

STAFF APPRAISAL

38. The West Bank and Gaza's economic prospects are dim under a status quo baseline, and there are downside risks. The economic slowdown evident in 2012 was confirmed in the first quarter of 2013. Reflecting weak growth, the unemployment rate has remained high, and inflation muted. The banking sector continues to perform well in the circumstances, with low non-performing loans and strong capital adequacy ratios and profitability. Absent a substantial easing of Israeli restrictions and clarity on the political front, economic growth will remain subdued and unemployment will rise over time. For 2013, we project GDP growth of 4½ percent, slowing further in subsequent years. Inflation is projected to remain benign at a small margin above Israeli inflation, at 2.5 percent. Downside risks mostly relate to potential shortfalls in donor aid, increased political uncertainty, and external economic shocks, including higher oil prices.

39. However, there are also upside risks. Successful peace negotiations, combined with implementation of a supporting economic package, could lead to additional investment and aid, boosting growth and employment and potentially easing the government's fiscal constraints.

40. The authorities should take measures to contain fiscal risks in 2013. Fiscal risks are once again on the rise, and budget targets appear out of reach. Staff projects an overall deficit of 15 percent of GDP, with a financing gap of US$0.3 billion (3 percent of GDP). Absent additional donor support, the gap would likely be covered by further arrears accumulation and domestic bank borrowing, adding risks for some banks. The PA should take fiscal measures to reduce the financing gap and counter the risks. On the expenditure side, a wage and promotions freeze and rationalization of allowances are needed. Reduction in net lending requires additional measures to improve municipal water and electricity bill collection, and further down the road, broader reform of the sector. On the revenue side, the planned administrative reforms should be implemented, giving priority to strengthening the Large Taxpayer Unit, which is best suited to start improving taxpayer compliance through the introduction of a self-assessment approach. In addition, tax incentives need to be scaled back and the recently increased tax refunds (which are akin to subsidies) relating to purchases of fuel should not be renewed in coming months.

41. The financial sector is performing well under the circumstances, but the PMA should be mindful of increased risks to financial stability. In particular, there is concern about the high exposure of commercial banks to the PA and its employees. This concentration of credit to a single borrower raises credit risk and potentially leads to crowding out of credit to the private sector in banks that have lower liquidity ratios. To increase incentives for private sector lending, especially to small and medium-sized enterprises, and to internalize the higher credit risk of the PA, (i) the PMA could consider raising regulatory capital requirements (for instance, by imposing a positive risk weight for PA debt held by commercial banks when calculating CARs), (ii) the Movable Assets Law should be signed and adopted, and (iii) court procedures should be streamlined such that collateral can be seized more easily.

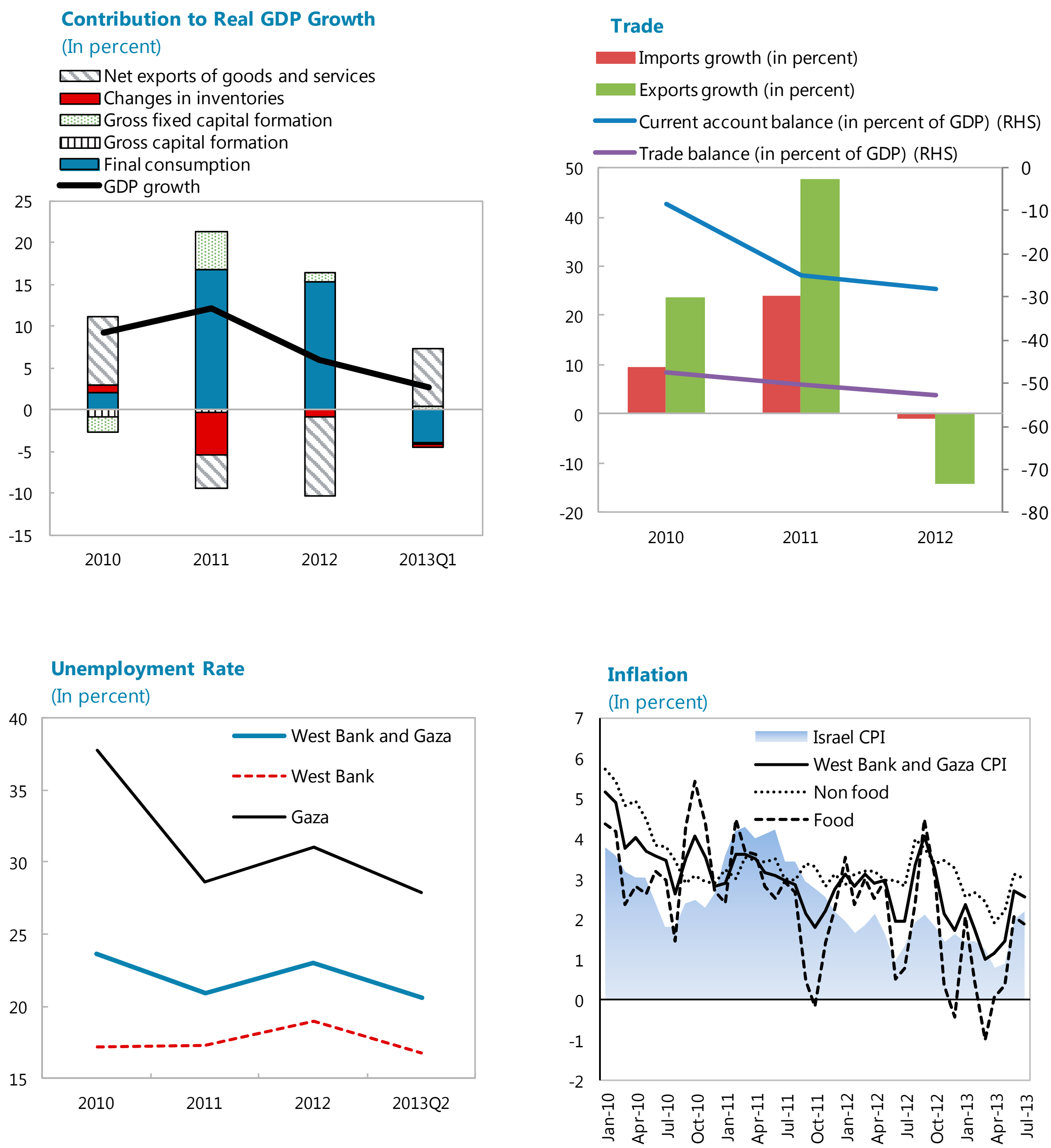
42. The PA's finances are not viable over the medium term if the current model of financing large deficits with unpredictable aid flows is maintained. Under the baseline projection, even assuming steady financing sources, substantial financing gaps remain as result of large financing requirements (mainly the fiscal deficit). With negative shocks—for instance a sharp fall in aid—financing gaps would increase still further and public debt would become unsustainable. In addition, public spending is tilted towards wages, pensions, and transfers, rather than towards much-needed investment in education and public infrastructure, leaving in place obstacles to private sector development. This would lead to disappointing growth and employment outcomes, threatening social stability.

43. While a coordinated approach among the PA, Israel, and donors to address these problems would be ideal, the PA should not wait for others before taking action. In particular, resolving these problems requires actions by the PA to reduce financing needs and to redirect government spending from consumption to investment. Recurrent fiscal deficits should be reduced gradually with a mix of mainly spending and some revenue measures anchored in a credible medium-term plan. Critical elements on the expenditure side would be reforming the pension system and health care (especially the referral process for treatment abroad), and reducing the wage bill (a promotion and wage freeze and rationalization of allowances for high-income public sector workers, followed by comprehensive civil service reform). Expanding the well-targeted Cash Transfer Program will help cushion the impact for the most vulnerable. The authorities should also build on recent improvements in public financial management by further strengthening commitment controls and cash management. Together with development partners, the authorities could prepare a plan to reorient spending toward investment and away from current spending, and, over time, redirecting aid from budget support to projects that invest in education, infrastructure, and private sector development. On the revenue side, efforts could focus on reducing tax exemptions and improving compliance.

44. At the same time, obstacles to economic growth need to be removed, which would generate a virtuous feedback loop to the public finances. First and foremost, this will require a broad-based and sustained easing of Israeli restrictions, not linked to specific projects and underpinned by clear progress in the peace process. The recent disruptions in Egyptian tunnel trade make an easing of Israeli import restrictions even more urgent. Avoiding further arrears of the PA to the private sector, reorienting public spending to investment, and strengthening the business environment by updating and harmonizing legislation, simplifying burdensome procedures, promoting competitiveness, and easing the entry of firms would also help unleash the private sector.

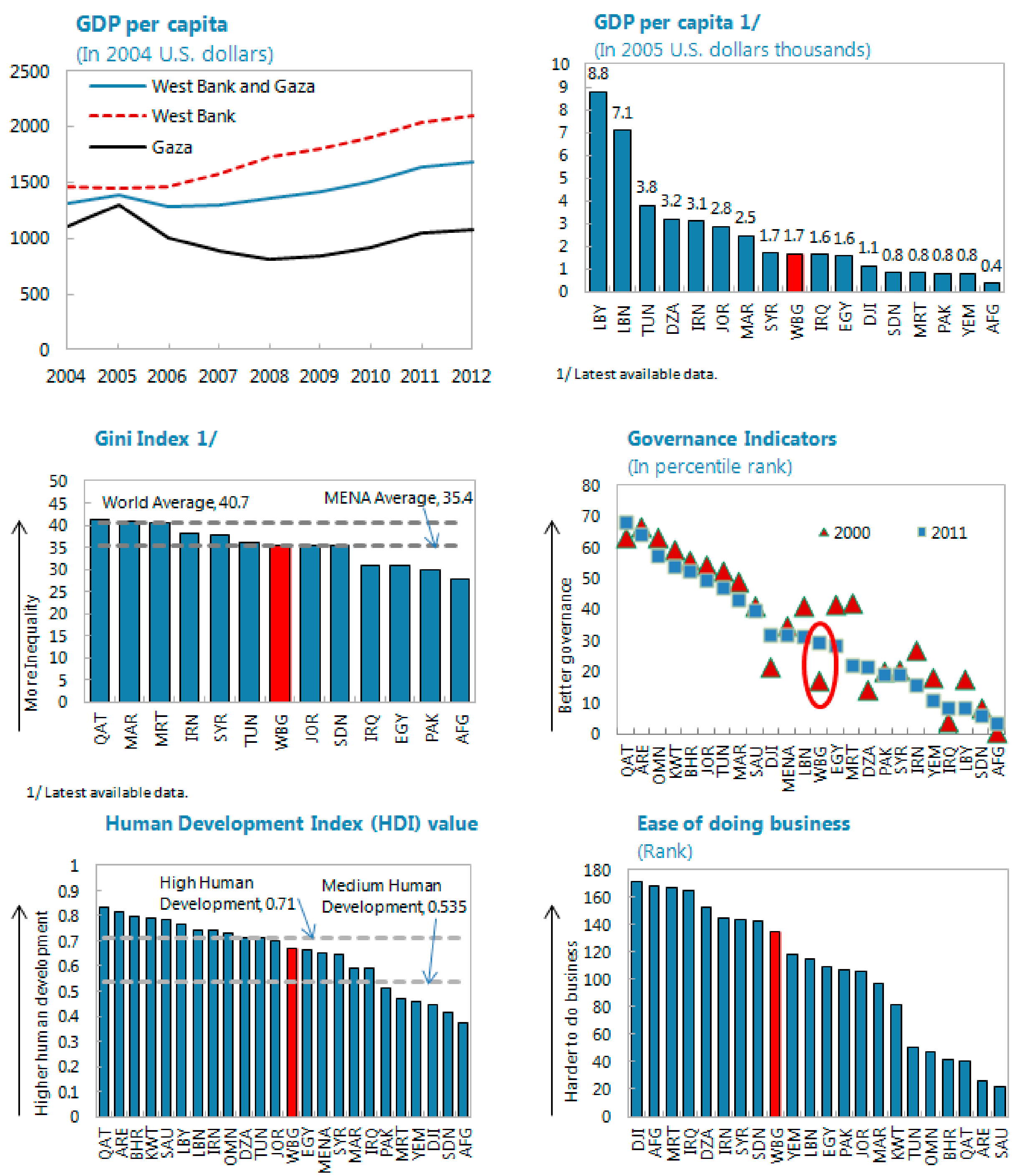
45. While resolution of the longstanding conflict with Israel would do more on its own than any other measure to strengthen the Palestinian economy, there is a need to act under any scenario. The PA needs the continued support and cooperation of the international community. A game-changing breakthrough on the political front would of course alleviate many of the economic and fiscal problems. In the interim, however, it is important to press ahead with the reforms outlined above, supported by the international community and guided by the common objective of a more vibrant and robust Palestinian economy. Donors should support the transition to viable public finances with additional aid based on multiyear commitments, given past aid volatility. Israel should lift restrictions that constrain private sector activity, and ensure uninterrupted transfers of clearance revenues.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2010–13



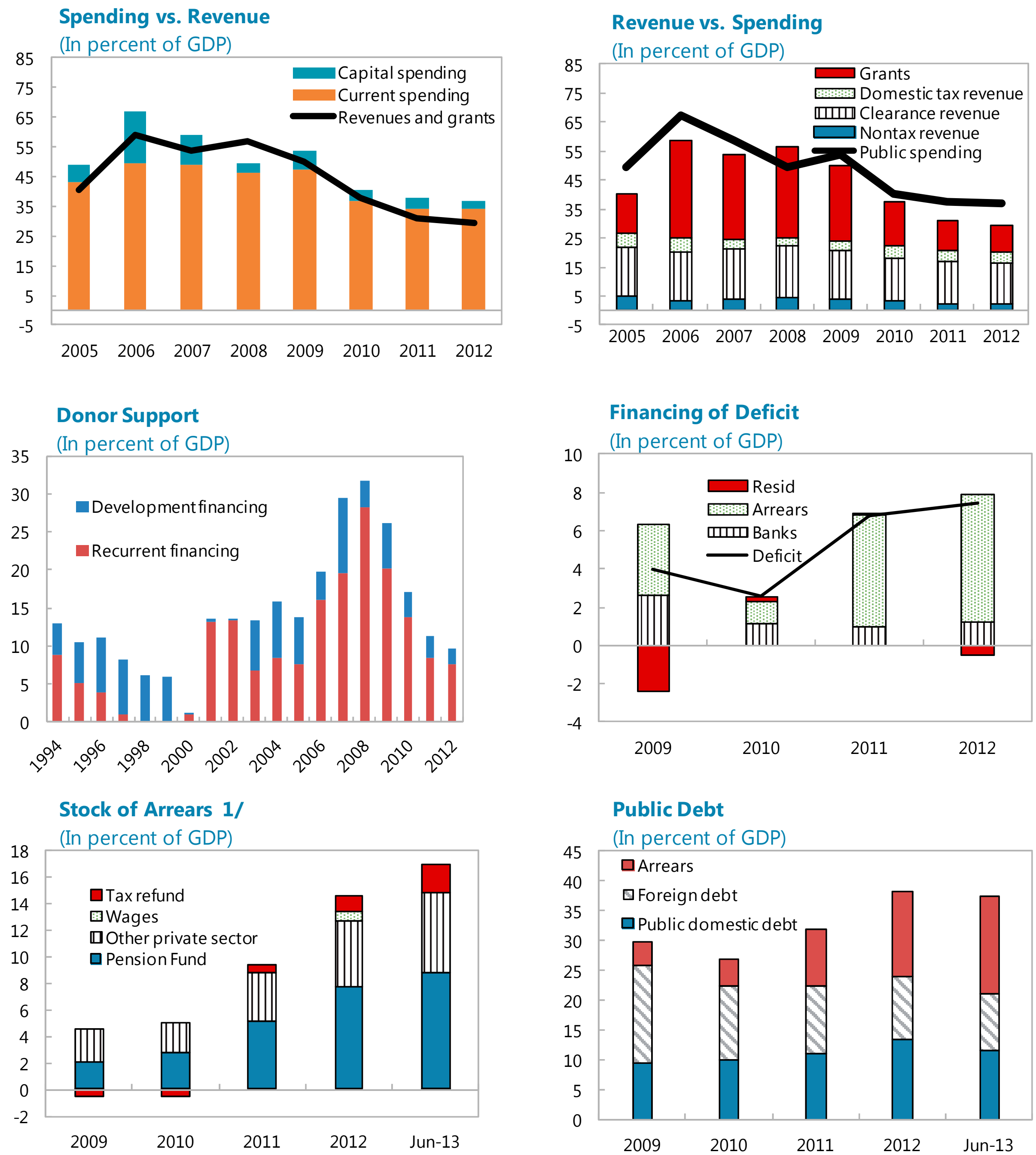
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Figure 2. West Bank and Gaza: Social and Governance Indicators



Sources: Palestinian Central Bureau of Statistics (PCBS); World Bank World Development Indicators and Worldwide Governance Indicators; United Nations Development Programme (UNDP) Human Development Report 2012; and World Bank Doing Business Report 2012.

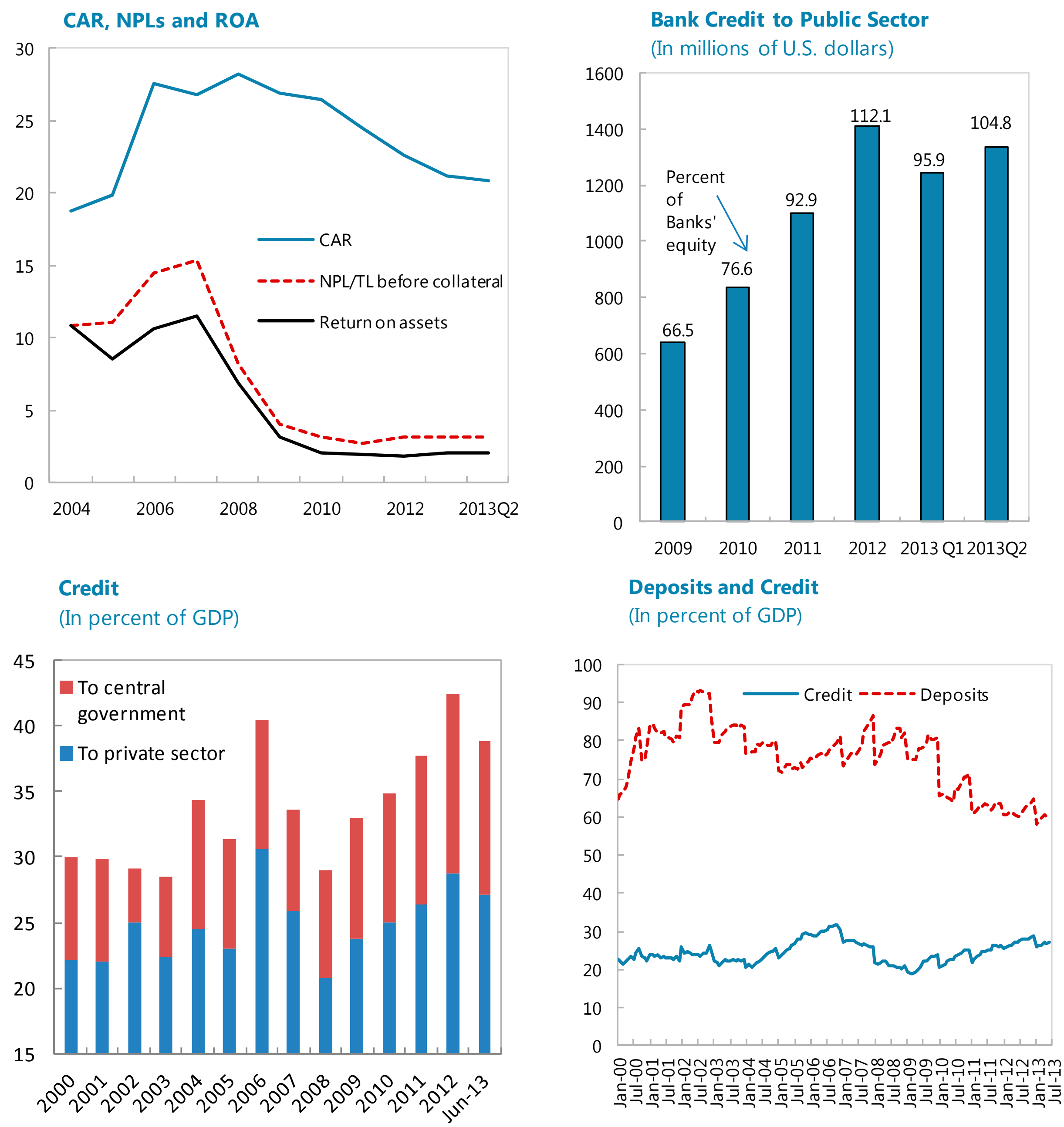
Figure 3. West Bank and Gaza: Fiscal Sector Indicators, 1994–2013



1/ Excludes arreas on external debt service.

Source: Ministry of Finance.

Figure 4. West Bank and Gaza: Financial Sector Indicators, 2000–13



Sources: Palestinian authorities; and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2010–18

(Population: 4.4 million; 2012 est.)
(Per capita GDP: $2,389; 2012)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

			Est.	Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	9.3	12.2	5.9	4.5	4.0	3.5	3.0	3.0	3.0
West Bank	8.4	10.4	5.6	3.4	3.3	2.9	2.6	2.6	2.6
Gaza	11.9	17.6	6.6	7.5	6.0	5.0	4.0	4.0	4.0
CPI inflation rate (end-of-period)	2.8	2.7	1.7	2.4	2.8	2.8	2.8	2.8	2.8
CPI inflation rate (period average)	3.7	2.9	2.8	2.5	2.7	2.8	2.8	2.8	2.8
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	18.5	17.3	13.7	12.5	11.6	10.6	9.8	9.0	8.2
Public	3.6	3.8	3.8	4.3	3.8	3.7	3.6	3.4	3.3
Private	14.9	13.5	9.9	8.1	7.8	6.9	6.2	5.6	5.0
Gross national savings, *of which:*	7.9	-6.4	-15.2	-10.0	-9.4	-7.6	-6.3	-5.7	-5.2
Public	-0.5	-4.7	-6.6	-2.4	-2.9	-2.3	-1.8	-1.4	-0.9
Private	8.4	-1.6	-8.6	-7.6	-6.6	-5.3	-4.5	-4.4	-4.3
Saving-investment balance	-10.6	-23.6	-28.9	-22.4	-21.0	-18.2	-16.1	-14.7	-13.5
Public finances 1/				(In percent of GDP)					
Revenues	22.6	20.9	20.2	18.9	19.1	19.1	19.2	19.2	19.2
Recurrent expenditures and net lending	36.8	34.0	34.4	31.4	30.0	28.9	28.0	27.1	26.3
Wage expenditures	19.3	18.2	17.2	16.3	15.6	15.0	14.6	14.1	13.6
Nonwage expenditures	14.7	14.3	14.4	13.9	13.4	13.1	12.8	12.5	12.2
Net lending	2.8	1.4	2.7	1.3	1.0	0.8	0.7	0.5	0.4
Recurrent balance (commitment, before external support)	-14.3	-13.1	-14.2	-12.5	-10.9	-9.8	-8.9	-8.0	-7.1
Recurrent balance (cash, before external support)	-13.4	-8.0	-7.8	-12.8	-11.7	-10.6	-9.6	-8.6	-7.7
Development expenditures	3.6	3.8	2.4	2.4	2.4	2.4	2.4	2.3	2.2
(In millions of U.S. dollars)	298	370	243	269	293	315	336	347	358
Overall balance (commitment, before external support)	-17.8	-16.9	-16.5	-14.9	-13.3	-12.2	-11.2	-10.2	-9.3
Total external support, including for development expenditures	15.3	10.1	9.1	11.7	9.7	9.1	8.6	8.1	7.7
(In millions of U.S. dollars)	1,275	984	930	1,330	1,196	1,211	1,225	1,232	1,240
External support for recurrent expenditure (in millions of U.S. dollars)	1,146	815	774	1,150	1,000	1,000	1,000	1,000	1,000
Financing gap (in millions of U.S. dollars)	...	...	...	323	435	395	355	305	249
In percent of GDP	...	...	...	2.8	3.5	3.0	2.5	2.0	1.5
Monetary sector 2/				(Annual percentage change)					
Credit to the private sector	31.1	23.8	14.2	12.9	12.4	11.8	11.3	11.4	11.4
Private sector deposits	9.9	4.1	6.9	9.4	8.0	7.5	7.0	6.5	6.0
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-24.3	-32.0	-36.4	-32.5	-29.1	-25.7	-23.1	-21.3	-19.7
Current account balance (including official transfers)	-10.6	-23.6	-28.9	-22.4	-21.0	-18.2	-16.1	-14.7	-13.5
Exports of goods and nonfactor services	13.8	15.4	16.3	16.4	17.0	17.6	18.1	18.6	19.1
Import of goods and nonfactor services	55.5	59.1	63.1	59.6	56.9	53.7	51.3	49.7	48.3
Net factor income	7.2	7.3	7.0	6.8	6.7	6.5	6.4	6.4	6.3
Net current transfers	23.9	12.7	10.9	13.9	12.3	11.4	10.7	10.0	9.4
Private transfers	10.2	4.4	3.3	3.8	4.2	3.9	3.7	3.4	3.2
Official transfers	13.7	8.3	7.6	10.1	8.1	7.5	7.0	6.6	6.2
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	8,344	9,775	10,255	11,377	12,379	13,327	14,226	15,165	16,151
Per capita nominal GDP (U.S. dollars)	2,061	2,345	2,389	2,574	2,720	2,846	2,954	3,062	3,173
Unemployment rate	24	21	23	24	25	27	28	29	30
Al Quds stock market index (annual percentage change)	-0.7	-2.6	0.1	...	...	...	...	...	...

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

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

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2010–16

	2010	2011	2012	2013		Projections		
				Budget	Staff	2014	2015	2016
	(In millions of shekels, unless otherwise stated)							
Net revenues	7,028	7,321	7,989	9,207	8,085	8,762	9,379	9,996
Gross domestic revenues	2,617	2,642	2,806	3,292	3,047	3,366	3,615	3,873
Tax revenues	1,608	1,727	1,852	2,214	2,129	2,254	2,437	2,626
Nontax revenues (accrued)	1,009	915	954	1,078	918	1,112	1,178	1,247
o/w arrears	---	130	59	---	---	---	---	---
Clearance revenues (accrued)	4,695	5,095	5,617	6,371	5,870	6,289	6,706	7,116
o/w arrears	61	-235	-479	---	-147	---	---	---
Less tax refunds	285	416	434	456	832	893	942	993
o/w arrears	-9	368	239	---	---	---	---	---
Recurrent expenditures and net lending (commitment)	11,473	11,897	13,593	13,092	13,431	13,777	14,188	14,616
o/w arrears	345	1,300	1,863	-272	-272	-371	-368	-367
Wage expenditures (commitment)	6,017	6,381	6,812	6,956	6,956	7,165	7,380	7,602
o/w arrears	185	374	816	-272	-272	---	---	---
Nonwage expenditures (commitment)	4,575	5,015	5,709	5,836	5,925	6,162	6,408	6,665
o/w arrears	263	926	1,046	---	---	-371	-368	-367
Net lending (commitment)	880	501	1,072	300	550	450	400	350
o/w arrears	-103	---	---	---	---	---	---	---
Development expenditures (commitment)	1,114	1,325	937	1,295	1,010	1,084	1,160	1,234
o/w arrears	88	270	124	---	---	---	---	---
Recurrent balance (commitment, excl. development expenditure)	-4,445	-4,576	-5,604	-3,885	-5,346	-5,015	-4,809	-4,620
Overall balance (committment)	-5,559	-5,901	-6,541	-5,180	-6,356	-6,099	-5,969	-5,854
Total financing	5,558	5,901	6,541	5,180	6,356	6,099	5,969	5,854
External financing for recurrent expenditures	4,276	2,915	2,986	4,070	4,319	3,706	3,681	3,668
External financing for development expenditures	482	605	601	1,110	676	727	777	827
Net domestic bank financing	363	334	490	272	272	425	425	425
Arrears	363	2,043	2,646	-272	-125	-371	-368	-367
Residual/Financing gap	74	4	-182	---	1,214	1,613	1,454	1,301
	(In millions of U.S. dollars, unless otherwise stated)							
Net revenues	1,883	2,046	2,072	2,488	2,153	2,365	2,548	2,725
Gross domestic revenues	701	738	728	890	811	908	982	1,056
Tax revenues	431	483	480	598	567	608	662	716
Nontax revenues (accrued)	270	256	248	291	244	300	320	340
o/w arrears	---	36	15	---	---	---	---	---
Clearance revenues (accrued)	1,258	1,424	1,457	1,722	1,563	1,697	1,822	1,940
o/w arrears	16	-66	-124	---	-39	---	---	---
Less tax refunds	76	116	113	123	221	241	256	271
o/w arrears	-2	103	62	---	---	---	---	---
Recurrent expenditures and net lending (commitment)	3,073	3,325	3,525	3,538	3,576	3,718	3,855	3,985
o/w arrears	93	363	483	-74	-72	-100	-100	-100
Wage expenditures (commitment)	1,612	1,783	1,767	1,880	1,852	1,934	2,005	2,072
o/w arrears	50	105	212	-74	-72	---	---	---
Nonwage expenditures (commitment)	1,226	1,402	1,481	1,577	1,578	1,663	1,741	1,817
o/w arrears	71	259	271	---	---	-100	-100	-100
Net lending (commitment)	236	140	278	81	146	121	109	95
o/w arrears	-28	---	---	---	---	---	---	---
Development expenditures (commitment)	298	370	243	350	269	293	315	336
o/w arrears	23	76	32	---	---	---	---	---
Recurrent balance (commitment, excl. development expenditure)	-1,191	-1,279	-1,453	-1,050	-1,424	-1,353	-1,307	-1,259
Overall balance (committment)	-1,489	-1,649	-1,696	-1,400	-1,692	-1,646	-1,622	-1,596
Total financing	1,489	1,649	1,696	1,400	1,692	1,646	1,622	1,596
Net domestic bank financing	97	93	127	74	72	115	115	116
External financing for recurrent expenditures	1,146	815	774	1,100	1,150	1,000	1,000	1,000
External financing for development expenditures	129	169	156	300	180	196	211	225
Arrears	97	571	686	-74	-33	-100	-100	-100
Residual/Financing gap	20	1	-47	---	323	435	395	355
Memorandum items:	(In percent of GDP, unless otherwise stated)							
Revenues	22.6	20.9	20.2	21.3	18.9	19.1	19.1	19.2
Recurrent expenditures and net lending	36.8	34.0	34.4	30.3	31.4	30.0	28.9	28.0
Wage expenditures	19.3	18.2	17.2	16.1	16.3	15.6	15.0	14.6
Nonwage expenditures	14.7	14.3	14.4	13.5	13.9	13.4	13.1	12.8
Net lending	2.8	1.4	2.7	0.7	1.3	1.0	0.8	0.7
Recurrent balance (commitment) before external support	-14.3	-13.1	-14.2	-9.0	-12.5	-10.9	-9.8	-8.9
External financing for recurrent expenditures	13.7	8.3	7.6	9.4	10.1	8.1	7.5	7.0
Development expenditures (cash)	3.3	3.0	2.1	3.0	2.4	2.4	2.4	2.4
Overall balance (committment)	-17.8	-16.9	-16.5	-12.0	-14.9	-13.3	-12.2	-11.2
Overall balance (cash)	-16.7	-11.0	-9.8	-12.6	-15.2	-14.1	-12.9	-11.9
Residual/Financing gap	0.2	0.0	-0.5	0.0	2.8	3.5	3.0	2.5
Nominal exchange rate (NIS per US dollar)	3.73	3.58	3.86	...	...	...	...	...
Nominal GDP (in millions of shekels)	31,148	34,977	39,541	43,204	42,728	45,873	49,053	52,182

Sources: Ministry of Finance; and IMF staff projections.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2010–16
(GFSM 2001)

	2010	2011	2012	Projections			
				2013	2014	2015	2016
	(GFSM 2001; in millions of shekels)						
Revenue	11,786	10,841	11,576	13,080	13,195	13,837	14,491
Taxes	6,019	6,406	7,035	7,167	7,651	8,201	8,749
Domestic taxes	1,608	1,727	1,852	2,129	2,254	2,437	2,626
Clearance taxes	4,695	5,095	5,617	5,870	6,289	6,706	7,116
Tax refund	-285	-416	-434	-832	-893	-942	-993
Grants	4,758	3,520	3,587	4,995	4,432	4,458	4,495
External budget support	4,276	2,915	2,986	4,319	3,706	3,681	3,668
External development support	482	605	601	676	727	777	827
Other revenue	1,009	915	954	918	1,112	1,178	1,247
o/w Dividends	149	160	120	115	140	148	157
Expenditures	12,586	13,222	14,530	14,441	14,862	15,348	15,850
Expense	11,473	11,897	13,593	13,431	13,777	14,188	14,616
Compensation of employees 1/	6,017	6,381	6,812	6,956	7,165	7,380	7,602
Use of goods and services	1,840	1,792	2,112	2,157	2,221	2,288	2,357
Grants 2/	880	501	1,072	550	450	400	350
Other expense 3/	2,735	3,223	3,597	3,768	3,941	4,120	4,308
Net acquisition of nonfinancial assets	1,114	1,325	937	1,010	1,084	1,160	1,234
Gross Operating Balance	313	-1,056	-2,017	-351	-582	-352	-125
Net lending / borrowing (overall balance)	-800	-2,381	-2,954	-1,361	-1,667	-1,511	-1,359
Net financial transactions	-800	-2,381	-2,954	-1,361	-1,667	-1,511	-1,359
Net acquisition of financial assets	---	---	---	---	---	---	---
Domestic							
Currency and deposits	---	---	---	---	---	---	---
Net incurrence of liabilities	726	2,377	3,136	147	54	57	58
Domestic	726	2,377	3,136	147	54	57	58
Loans	363	334	490	272	425	425	425
Net domestic bank financing	363	334	490	272	425	425	425
Other accounts payable	363	2,043	2,646	-125	-371	-368	-367
Arrears (recurrent)	336	1,538	2,043	-272	-371	-368	-367
Arrears (capital)	88	270	124	---	---	---	---
Arrears (clearance)	61	-235	-479	-147	---	---	---
Foreign	---	---	---	---	---	---	---
Loans	---	---	---	---	---	---	---
Statistical Discrepancy/Financing gap	*74*	*4*	*-182*	1,214	1,613	1,454	1,301
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,445	-4,576	-5,604	-5,346	-5,015	-4,809	-4,620
Gross operating balance excl. grants (cash)	-4,170	-2,803	-3,082	-5,471	-5,385	-5,177	-4,987
Overall balance (NLB) excl. grants (commitment)	-5,559	-5,901	-6,541	-6,356	-6,099	-5,969	-5,854
Overall balance (NLB) excl. grants (cash)	-5,196	-3,858	-3,894	-6,481	-6,470	-6,337	-6,220
Revenue (percent of GDP)	37.8	31.0	29.3	30.6	28.8	28.2	27.8
Expenditure (percent of GDP)	40.4	37.8	36.7	33.8	32.4	31.3	30.4
Expense (percent of GDP)	36.8	34.0	34.4	31.4	30.0	28.9	28.0
Wage expenditure (percent of GDP)	19.3	18.2	17.2	16.3	15.6	15.0	14.6
Nonwage expenditures (percent of GDP)	5.9	5.1	5.3	5.0	4.8	4.7	4.5
GOB (commitment) excluding grants (percent of GDP)	-14.3	-13.1	-14.2	-12.5	-10.9	-9.8	-8.9
GOB (cash) excluding grants (percent of GDP)	-13.4	-8.0	-7.8	-12.8	-11.7	-10.6	-9.6
External support (recurrent)	13.7	8.3	7.6	10.1	8.1	7.5	7.0
in millions of NIS	4,276	2,915	2,986	4,319	3,706	3,681	3,668
NLB (commitment) excluding grants (percent of GDP)	-17.8	-16.9	-16.5	-14.9	-13.3	-12.2	-11.2
NLB (cash) excluding grants (percent of GDP)	-16.7	-11.0	-9.8	-15.2	-14.1	-12.9	-11.9
Total external support (in millions of shekels)	4,758	3,520	3,587	4,995	4,432	4,458	4,495
Nominal GDP (in millions of shekels)	31,148	34,977	39,541	42,728	45,873	49,053	52,182
Exchange Rate	3.7	3.6	3.9	...	...	...	...

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, 2010–13
(In percent)

	Dec-10	Dec-11	Dec-12	Mar-13	Jun-13
Capital adequacy (for all Banks)					
Tier I capital to risk-weighted assets	23.3	22.9	22.2	21.5	21.2
Regulatory Capital to Risk Weighted Assets	21.4	21.1	20.3	19.8	19.5
Capital adequacy (for local Banks)					
Tier I capital to risk-weighted assets	26.5	24.5	22.7	21.2	20.8
Regulatory Capital to Risk Weighted Assets	21.6	20.3	18.8	17.7	17.6
Asset quality 1/					
Nonperforming loans (percent of total loans)	3.1	2.7	3.1	3.2	3.1
Nonperforming loans net of provisions to capital	2.9	3.8	4.9	4.7	4.9
Coverage ratio (provisions as percent of nonperforming loans)	70.4	60.9	60.1	61.6	60.0
Earnings and profitability					
Return on assets (ROA)	2.1	1.9	1.8	2.0	2.0
Return on equity (ROE) 2/	21.1	17.0	16.2	19.1	18.6
Interest income to gross income	59.4	71.7	72.4	74.0	74.9
Non-interest expenses to gross income	55.0	57.2	55.4	52.8	53.5
Personal Cost to non-interest expenses	55.3	55.5	53.8	57.4	56.6
Liquidity					
Liquid assets to total assets	40.3	38.2	37.5	36.3	36.8
Liquid assets to demand and savings deposits	78.4	74.4	71.6	69.1	69.3
Liquid assets to total deposits	49.1	46.9	45.8	44.6	45.0

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. West Bank and Gaza: Debt Sustainability Analysis

Public debt of the WBG consists of domestic banking sector debt, external long-term debt, and arrears. *Domestic debt* is mostly short-term debt (76 percent of domestic debt) extended by the banks at interest rates ranging from 4 percent on loans to 7–8 percent on overdraft.[1] *External debt* consists of concessional multilateral and bilateral long-term debt. Al Aqsa Fund and The World Bank are the largest lenders. Bilateral loans were extended to finance infrastructure projects and were used for on-lending to domestic companies. Arrears comprise the largest share of public debt.[2] Half of the arrears are to the Pension Fund and create unfunded future fiscal liabilities; the rest are mostly arrears for goods and services and tax refunds to private sector and Israeli utilities.[3]

Public Debt as of End-June 2013

	In Millions of U.S. Dollars	In Percent of Total
Public debt, including arrears	4,265	100
Domestic debt	1,320	31
o/w long term	311	7
Bank loans	648	15
o/w long term	311	7
Overdraft	461	11
Petroleum Authority loans	202	5
Other public institutions loans	8	0
External debt	1,093	26
Of which arrears on external debt service	*100*	*2*
Arab Financial Institutions	626	15
Al Aqsa Fund	522	12
Arab Fund for Economic & Social Development	57	1
Islamic Development Bank	47	1
International and Regional Institutions	338	8
World Bank	287	7
European Investment Bank	29	1
IFAD	3	0
OPEC	20	0
Bilateral loans	129	3
Spain	91	2
Italy	33	1
China	5	0
Arrears 1/	1,852	43
Pension fund	972	23
Tax refund	223	5
Other private sector	657	15

Sources: Palestinian authorities; and IMF staff estimates.
1/ Excluding arrears on external debt service.

Public debt has increased dramatically in the past two years, as falling aid and insufficient fiscal consolidation led to scaled-up domestic borrowing and accumulation of arrears on goods and services and external debt service. Since end-2010, public debt of the WBG increased from almost US$2.3 billion to an estimated US$4.3 billion in mid-2013, or from 26 percent to 38 percent of GDP. Although public debt is still marginally below the limit of 40 percent of GDP prescribed by the Law on Public Debt, resurgence of arrears suggests that even the current level of debt is high for the WBG.

The results of the public Debt Sustainability Analysis (DSA) show that debt is sustainable in the medium term, but sensitive to shocks (Table A1 and Figure A1). The DSA is based on macroeconomic assumptions of: (i) slowing growth (to 3 percent by 2018); (ii) stable exchange rate and inflation, as determined by Israeli monetary policy; and (iii) a worsening financing gap,

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

[2] This is an estimate, derived by adding up annual flows. It does not account for arrears that might be settled against tax obligations, and may not be fully comprehensive.

[3] According to Israeli accounts, electricity arrears, including those of municipalities and the PA, stood at about NIS 900 millions in June.

averaging 2.7 percent of GDP in 2013–18 to reflect declining aid and slow pace of fiscal consolidation. It is assumed that financing gaps are filled by domestic bank debt at prevailing interest rates, which are about 4 percent above the inflation rate. Because debt in terms of GDP will remain stable throughout the projection period under these assumptions, public debt in the baseline scenario is sustainable; however, this result is sensitive to a range of shocks. Sensitivity analysis demonstrates that a shock equivalent to a one standard deviation to the interest rate will raise the debt to 40 percent of GDP, the public debt threshold level, by 2018. The shocks to growth, primary balance, or a combined shock will raise the debt level even more to 52, 48, and 47 percent of GDP by 2018, 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 the same amount. A similar effect would occur with a fall in aid. Indeed, as discussed in more detail in "The Medium-Term Viability of the West Bank and Gaza's Fiscal Financing Model," in *Selected Issues*, a substantial reduction in donor aid would make the WBG's debt unsustainable.

Table A1. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2008–18

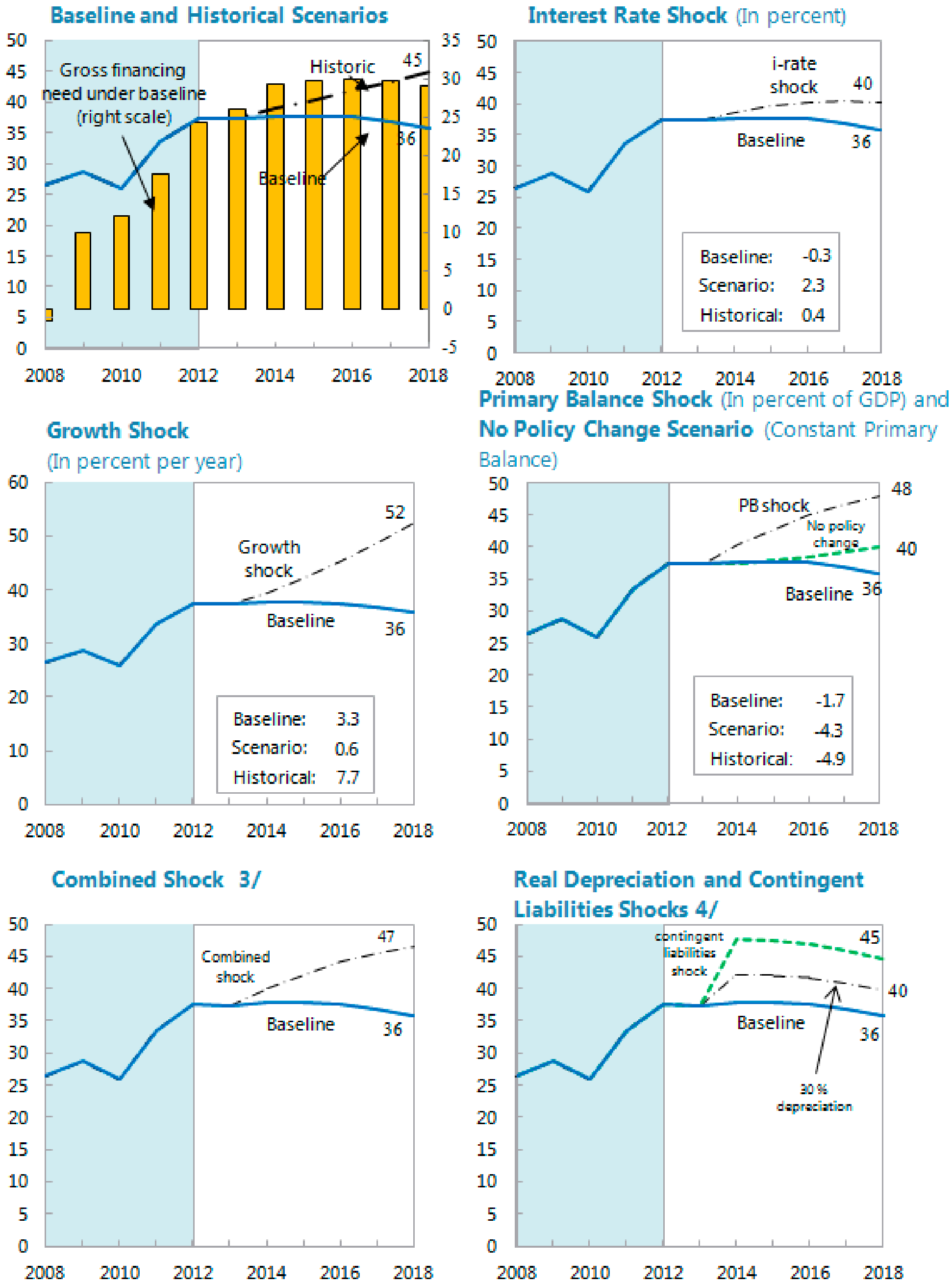
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	26.4	28.7	25.9	33.5	37.5	**37.4**	**37.7**	**37.7**	**37.5**	**36.8**	**35.8**	**-1.1**
o/w foreign-currency denominated	17.5	15.5	11.8	12.0	10.3	9.5	8.9	8.3	7.8	7.3	6.9	
2 Change in public sector debt	0.2	2.3	-2.8	7.6	4.0	-0.1	0.4	0.0	-0.2	-0.7	-1.1	
3 Identified debt-creating flows (4+7+12)	-10.8	1.5	-2.4	3.5	4.4	0.5	1.2	0.8	0.5	0.0	-0.4	
4 Primary deficit	-8.1	3.1	2.2	6.4	6.9	2.6	2.9	2.2	1.7	1.1	0.6	
5 Revenue and grants	56.8	49.9	37.8	31.0	29.3	30.5	28.6	28.1	27.6	27.2	26.7	
6 Primary (noninterest) expenditure	48.6	53.0	40.0	37.4	36.2	33.1	31.5	30.3	29.3	28.3	27.3	
7 Automatic debt dynamics 2/	-2.7	-1.6	-4.6	-2.9	-2.4	-2.1	-1.7	-1.4	-1.2	-1.1	-1.1	
8 Contribution from interest rate/growth differential 3/	-0.3	-3.1	-4.0	-2.5	-3.3	-2.1	-1.7	-1.4	-1.2	-1.1	-1.1	
9 Of which contribution from real interest rate	1.5	-1.5	-1.7	0.3	-1.5	-0.5	-0.3	-0.2	-0.1	-0.1	0.0	
10 Of which contribution from real GDP growth	-1.8	-1.7	-2.3	-2.8	-1.7	-1.6	-1.4	-1.2	-1.1	-1.1	-1.0	
11 Contribution from exchange rate depreciation 4/	-2.3	1.5	-0.7	-0.5	0.8	...	...	...	...	...	...	
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/	11.0	0.8	-0.3	4.1	-0.5	-0.6	-0.8	-0.8	-0.7	-0.7	-0.6	
Public sector debt-to-revenue ratio 1/	46.5	57.5	68.4	108.2	128.0	122.5	131.7	134.4	135.7	135.6	134.0	
Gross financing need 6/	-1.4	10.0	12.2	17.7	24.4	26.0	29.4	29.8	30.0	29.8	29.1	
in billions of U.S. dollars	-0.1	0.7	1.0	1.7	2.5	2.9	3.5	3.8	4.0	4.3	4.4	
Scenario with key variables at their historical averages 7/						**37.4**	**38.9**	**40.4**	**42.0**	**43.4**	**44.8**	**-3.1**
Scenario with no policy change (constant primary balance) in 2013-2018						**37.4**	**37.5**	**37.8**	**38.5**	**39.3**	**40.1**	**-1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.1	7.4	9.3	12.2	5.9	4.5	4.0	3.5	3.0	3.0	3.0	
Average nominal interest rate on public debt (in percent) 8/	4.0	3.9	1.6	1.6	2.0	2.1	2.6	2.9	3.0	3.2	3.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.7	-5.8	-6.3	1.5	-4.8	-1.3	-0.7	-0.5	-0.2	-0.1	0.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	14.5	-8.8	5.2	4.5	-7.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	-1.8	9.8	7.9	0.1	6.8	3.4	3.2	3.3	3.3	3.3	3.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	-11.1	17.0	-17.5	4.9	2.3	-4.4	-0.9	-0.5	-0.4	-0.5	-0.4	
Primary deficit	-8.1	3.1	2.2	6.4	6.9	2.6	2.9	2.2	1.7	1.1	0.6	

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 II. West Bank and Gaza: Risk Assessment Matrix[1]

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
Global oil shock triggered by geopolitical events (driving oil prices to $140 per barrel)	***Low/Short term***	***High*** The WBG is highly dependent on energy imports. Social pressures for costly mitigating measures would increase, particularly if second-round effects become prominent, and worsen an already difficult fiscal outlook.	(1) Implement full pass-through to consumers including for electricity tariffs; (2) Follow up efforts to improve collection at the local level; and (3) Use the existing targeted cash transfer scheme to support the poor.
Protracted period of slower European growth (larger-than-expected deleveraging or negative surprise on potential growth)	***High/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—itself a small open economy exposed to external shocks, and the main trading partner and an important source of remittances. 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 virtually no direct linkages to global financial markets, including the euro zone. There is a considerable presence of Jordanian banks which could face higher borrowing costs in case of a crisis in the home country.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Further strengthen the banking supervisory framework; and (3) Develop an early warning model and a contingency plan.
Domestic political developments and/or renewed violence in Gaza	***Medium to High/Short to medium term***	***Medium to High*** Deterioration in relations with Israel (for example, due to a flare-up of violence in Gaza, a failure to jumpstart the peace process, or Hamas-Fatah reconciliation) could lead to weakening of security	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.

		cooperation, a tightening of restrictions, and possible suspension of clearance revenue transfers. Some donors may withdraw support. This would hurt growth and further undermine already weak public finances.	
Donor "fatigue"	***Medium/Medium term***	***High*** Failure of the resumed peace process could lead some donors to reconsider their long-term commitment to supporting the PA, which could threaten fiscal sustainability.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Support fiscal sustainability via pro-growth policies; and (3) Continue reforms to improve government institutions.
Spillovers from unrest in Egypt and elsewhere in the region	***Medium to High/Short term***	***High*** Social and political unrest in the nearby region could spill over to the WBG. Sustained tunnel trade disruption would have a large economic impact on Gaza.	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 of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

Annex III. West Bank and Gaza: Technical Assistance by the IMF to the Palestinian Authority, 2010–13

Technical assistance (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 Ministry of Finance. The priorities over the medium term remain public financial management, revenue administration, and banking supervision. There is a need for occasional review and assistance to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts expenditures side accounting. It is expected that FAD and MCM will continue to provide TA, dependent on the authorities' commitment and progress, supported by the Middle East Regional Technical Assistance Center (METAC).

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 was 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, the Integration Law was signed by the president, and the Large Taxpayer Unit, 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.		
Aug. 26–Sep. 6, 2010	Public Financial Management Progress Review	Oct. 2010
Oct. 17–30, 2010	Completing the Foundations of Modern Revenue Administration	Dec. 2010
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
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
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
Monetary and Financial Sector: The TA efforts have focused on supporting 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 Palestinian 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 towards the possibility of issuance of a national currency.		
Oct. 16–28, 2010	Support to the Palestine Monetary Authority Credit Registry	Oct. 2010
Oct. 29–Nov. 4, 2010	Reserve Management *	Nov. 2010

Nov. 23–Dec. 2, 2010	Developing the Government Securities Market *	Dec. 2010
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	n.a.
Statistics: The TA efforts have focused on implementing and aligning 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 in the West Bank and Gaza joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed to improve 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.		
Feb. 2–18, 2010	Balance of Payments Statistics - IIP	n.a.
Apr. 14–27, 2010	Monetary and Financial Statistics	Apr. 2010
Sep. 19–30, 2010	Report on the Government Finance Statistics Mission	Jan. 2011
Dec. 5–16, 2010	External Sector Statistics	Jun. 2011
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.
n.a.: not applicable. * The reports are classified confidential.		