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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED GRANT

IN THE AMOUNT EQUIVALENT TO USD40 MILLION

TO THE

PALESTINE LIBERATION ORGANIZATION
(FOR THE BENEFIT OF THE PALESTINIAN AUTHORITY)

FOR A

PALESTINIAN NATIONAL DEVELOPMENT PLAN
DEVELOPMENT POLICY GRANT VII

JANUARY 14, 2016

Macroeconomic and Fiscal Policy Management Global Practice
Middle East and North Africa Region

WEST BANK AND GAZA

FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 30, 2015)

Currency Unit	New Israeli Shekel
USD1.00	3.88 NIS

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

AHLC	Ad-hoc Liaison Committee
AS	Assistance Strategy
DNA	Damage and Needs Assessment
DPG	Development Policy Grant
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GoI	Government of Israel
GRS	Grievance Redress Service
ICR	Implementation Completion and Results Report
IEC	Israel Electric Corporation
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
LGU	Local Government Unit
MoF	Ministry of Finance and Planning
MoH	Ministry of Health
MoU	Memoranda of Understanding
NDP	National Development Plan
NIS	New Israeli Shekel
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PDO	Program Development Objective
PEFA	Public Expenditure Financial Accountability Assessment
PENRA	Palestinian Energy and Natural Resources Authority
PER	Public Expenditure Review
PFM	Public Financial Management
PMA	Palestine Monetary Authority
PRDP	Palestinian Recovery and Development Plan
TFGWB	Trust Fund for Gaza and West Bank
UNRWA	United Nations Relief and Works Agency
VAT	Value-added tax
WBG	World Bank Group

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WEST BANK AND GAZA

PALESTINIAN NATIONAL DEVELOPMENT PLAN - DEVELOPMENT POLICY GRANT VII

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The Development Policy Grant VII was prepared by a core team consisting of Orhan Niksic (Senior Economist, Task Team Leader); Nur Nasser Eddin (Economist); Pierre Prosper Messali (Senior Public Sector Specialist); Samira Ahmed Hillis (Senior Social Protection Specialist); Bjorn Philipp (Senior Urban Specialist); Mei Wang (Senior Counsel); Nadi Yousef Mashni (Financial Sector Specialist); Maha Muhammad Bali (Program Assistant).

The team wishes to thank the Ministry of Finance and other PA staff for excellent collaboration during the preparation process.

SUMMARY OF PROPOSED GRANT AND PROGRAM

WEST BANK AND GAZA

PALESTINIAN NATIONAL DEVELOPMENT PLAN - DEVELOPMENT POLICY GRANT VII

Recipient	*Palestine Liberation Organization (PLO) (for the benefit of the Palestinian Authority)*
Implementation Agency	*Ministry of Finance and Planning of the Palestinian Authority*
Financing Data	*Terms: Grant from the Trust Fund for Gaza and West Bank (TFGWB)* *Amount: USD 40 million*
Operation Type	*Standalone*
Pillars of the Operation And Program Development Objective(s)	*(I) Improve public revenue performance and improve sustainability of public expenditures; (II) Improve transparency of public finances; (III) Facilitate the land registration process.*
Result Indicators	*PDO (1):* • *The stock of income tax debt estimated based upon official income tax filings that have been verified through MoF audits. Baseline (2015): NIS100 million; Target (2016): reduced by 15 percent.* • *The ratio of annual wholesale electricity bill payments to the Israel Electric Corporation made by JDECO, NEDCO, SELCO, HEPCO and TEDCO electricity distribution companies to amount collected by these DISCOs from end customers in the West Bank. Baseline (2014): 65 percent; Target (2016): at least 80 percent* • *The cost of health referrals to health service providers outside of the Palestinian public healthcare system. Baseline (2014): 1.2 percent of GDP; Target (2016): below 1.2 percent of GDP.* *PDO (2):* • *Annual information is available online on the amount of: (1) the transportation tax collected by the MoF on behalf of each LGU, (2) the service fees charged, (3) any deductions/intercepts for each LGU specifically, and (4) the transportation tax paid to each LGU in the first quarter of 2016. Baseline (2014): No; Target (2016): Yes* • *Access to information on commitments in the pipeline is provided by the Ministry of Health, Ministry of Transportation, Ministry of Interior, Ministry of Public Works and the Ministry of Local Government in the Integrated Financial Management Information System at the time a commitment is made. Baseline (2015): No; Target (2016): Yes.* *PDO (3):* • *The number of land titles picked up in the pilot area (monitored through data obtained from the Palestinian Land Authority)). Baseline (2015): 188 out of 5,000 issued. Target (2016): at least 100 percent higher.*
Overall risk rating	*High*
Climate and disaster risks *(required for IDA countries)*	*(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes* ***No X***
Operation ID	P156865

PROGRAM DOCUMENT
PALESTINIAN NATIONAL DEVELOPMENT PLAN –
DEVELOPMENT POLICY GRANT VII

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Grant VII (DPG) is a standalone operation aimed at supporting the Palestinian Authority (PA) in improving the management of public finances and improving the business environment.** Specifically, the DPG will support the PA's efforts in augmenting tax revenues and cutting inefficiencies in public spending in order to reduce the fiscal deficit amid declining donor aid. The DPG will also support the PA's effort to reform and further strengthen public finance management, and improve the business environment by facilitating land registration. The DPG VII will provide support to the PA's 2016 budget in the amount of USD40 million. The DPG VII builds upon the reform progress supported by the previous DPGs.

2. **As envisaged in the Assistance Strategy FY15-16 for the West Bank and Gaza, DPGs remain a key instrument aimed at supporting the PA's strategic priorities, advancing policy dialogue, and also providing essential financing for the PA's budget.** Due to the severity of the political situation, in particular in Gaza, and the impact of restrictions[1] on movement, access and trade on private sector investment and growth, real income per capita in the Palestinian territories has been shrinking for three years in a row. The PA's revenues have also been affected by the decline in Gross Domestic Product (GDP) and delays in the transfer of revenues collected by the Government of Israel (GoI) on behalf of the PA. Against this background, donor assistance, even though on a downward trend, continues to provide a lifeline to the PA's budget. It is important to stress that the financial significance of this operation is not only in that it provides USD40 million, but that it directly leverages the support of other donors through the Palestinian Recovery and Development Plan (PRDP) Trust Fund in the amount of roughly USD200 million per year. The operation also provides a positive signaling effect to other donors that provide assistance directly to the PA when such assistance is of utmost importance for the Palestinian economy and public finances.

3. **The preparation of this DPG is taking place against the backdrop of high political uncertainty and fragility following the failure of last year's peace talks.** The peace process between the GoI and the PA led by the United States Secretary of State Kerry resumed on July 29, 2013, giving fresh hope for peace, stability, and prosperity in the region. However, the talks broke down in April 2014, resulting in heightened uncertainty about the future and growing pessimism among the Palestinian population, including the business community. Soon after the peace talks failed, a conflict broke out in Gaza (July 2014) leaving the two parties further away from a peace deal. The PA then took steps towards international recognition and became a member of the International Criminal Court on April 1, 2015. Meanwhile, the GoI has continued with its settlement expansion policy and according to Peace Now, currently more than 40 percent of the

[1] The Government of Israel states that these restrictions are necessary for security purposes.

West Bank is directly controlled by settlers and is off limits to Palestinians.[2] Internal reconciliation efforts between Fatah and Hamas have not had much success either. The National consensus government that was formed in June 2014 after a reconciliation agreement was signed between both factions has failed to achieve its main mandate—the creation of a unified Palestinian government in the West Bank and Gaza.

4. **More than a year after the 2014 conflict, the situation in Gaza remains extremely difficult**. The reconstruction process has been much slower than anticipated due to restrictions on imports into Gaza and lower than expected aid. Aid disbursed through September 2015 amounts to USD1.23 billion, which represents 35 percent of pledges made at the Cairo conference for Gaza reconstruction in October 2014. The majority of disbursements made so far have supported United Nations Relief and Works Agency (UNRWA) activities, while less than 20 percent has been directed towards priority interventions defined by the Damage and Needs Assessment (DNA) that was conducted after the conflict. This represents a mere 5 percent of the overall needs outlined by the DNA. Forced to teach in overcrowded classrooms, many of which were damaged by the conflict, UNRWA's teachers have been threatening to go on strike. Most of Gaza's hospitals are also not fully operational due to lack of funds needed to fuel electrical generators, as currently Gaza only receives 8 hours of electricity per day.

5. **Amid heightened political uncertainty and inadequate progress on the removal of restrictions that hinder private sector investment and growth, the recovery from a recent recession has been very weak.** Growth has resumed following the recession caused by the conflict in Gaza in 2014, but the output level in the second quarter of 2015 was still below the pre-2014 conflict level. While picking up, as a result of the reconstruction effort in Gaza, without substantial improvement in the political climate, growth of the Palestinian economy is expected to remain around 3-4 percent over the medium term. This will result in some temporary recovery of per capita income in Gaza and its continued shrinking in the West Bank as overall population growth for West Bank and Gaza is around 3 percent. Naturally, the turmoil in the region only adds to the high degree of uncertainty related to the Palestinian conflict.

6. **Against this grueling background, progress on structural reforms has continued, though unevenly in some policy areas.** Emboldened by low fuel prices, the PA has made very good progress in reducing explicit and implicit energy subsidies (on fuel and electricity). As a way to contain the wage bill, the PA has implemented a zero net hiring policy effective since late 2013 and the Cabinet has subsequently committed to reduce the size of civil service. The PA is also making good progress in implementing a subset of required health reforms, but overdue pension reforms are still on hold. Furthermore, the PA has finalized a revenue strategy and started implementing it. However, additional tax policy and enforcement measures are needed to broaden what is currently a very narrow tax base by international comparison. Progress is being made in some areas of public finance management, but the procurement reform has stalled for some time and despite some renewed progress in recent months the new procurement system is not in operation yet. This operation has been used as a platform for continued policy dialogue and to support progress on reforms on all the above policy issues.

[2] Peace Now is an Israeli NGO that tracks settlement building in the Palestinian territories. Please see http://peacenow.org.il/eng/content/settlements-are-not-obstacle-peace

7. A quarter of Palestinians live in poverty, and if the current trend of low growth persists, poverty could be on the rise. The Palestinian Central Bureau of Statistics (PCBS) data show that almost 26 percent of Palestinians lived in poverty in 2011, according to the national poverty line.[3] However, the overall figure at the national level masks wide regional divergences. In Gaza, the poverty rate was 39 percent, which is more than twice that in the West Bank at 18 percent. This regional contrast was driven by the severe economic shock that hit Gaza following the internal divide, which led to a dramatic poverty increase in 2007, leaving one in two Gazans living below the poverty line. Notably, social transfers have continued to play a key role in reducing poverty levels, especially in Gaza. In 2011, and in the absence of all social programs, the official poverty headcount rate would have been 11 percentage points higher. If these social payments were to be reduced or discontinued, it is expected that a large number of households would fall back below the poverty line.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. Growth of the Palestinian economy has been severely constrained by various restrictions on movement, access and trade, as well as a high degree of political uncertainty. Restrictions substantially increase the cost of trade and make it impossible to import many production inputs into the Palestinian territories.[4] In addition to the restrictions on labor movement between the Palestinian territories, restrictions on movement within the West Bank have been shown to have a strong impact on employability, wages, and economic growth. Moreover, the GoI restrictions render much economic activity very difficult or impossible to conduct on about 61 percent of the West Bank territory called Area C. World Bank estimates show that giving Palestinian businesses access to conduct operations in Area C would boost the Palestinian economy by about a third and lower the PA's fiscal deficit by half.[5] The situation is even more difficult in Gaza where the blockade imposed since 2007 has significantly eroded the competitiveness of private businesses. Fully opening up Gaza could potentially increase its GDP by 229 percent, according to World Bank calculations.[6] As a result of the ongoing restrictions, private sector activity has been severely constrained and private investment levels, at 15 percent, are considered very low. Even though the economy witnessed strong growth between 2007 and 2011 due to large inflows of aid that fueled public and private consumption, the trend started to wane in 2012 due to a sharp drop in budget support and the economy has been stalling since.

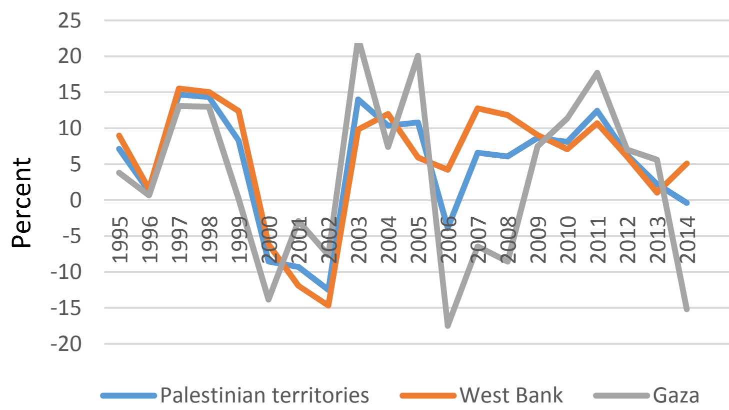
9. A substantial growth deceleration has caused real GDP per capita to shrink for three years in a row. Real GDP growth levels have significantly dropped from an average of 8 percent between 2007 and 2011 to 2.7 percent between the period 2012 and 2015, mainly as a result of the persistent restrictions and the decline in aid levels. Given that population growth in the Palestinian

[3] More recent poverty data is not available yet.
[4] These are goods on the "dual use lists," which may have both civilian and military applications. Consequently, a number of chemicals, fertilizers and machinery for metal processing cannot be imported into the Palestinian territories.
[5] Niksic, Orhan, Nur Nasser Eddin, and Massimiliano Cali, 2014. *Area C and the Future of the Palestinian Economy.* World Bank Studies. Washington, DC.
[6] See World Bank report to the Ad Hoc Liaison Committee (AHLC) Meeting, May 27, 2015.

territories is high at around 3 percent, this led to a decline in real per capita income levels from USD1,808 in 2012 to USD1,732 projected in 2015.

10. As a result of the conflict in Gaza, the Palestinian economy plunged into recession in 2014. The economy of the Palestinian territories contracted by 0.4 percent in 2014 mainly as a result of the conflict in Gaza which had a devastating impact on economic activity, infrastructure, and the livelihood of Gazans. Latest data by the PCBS shows that the Palestinian economy has started to recover in 2015 with growth amounting to 2.6 percent in the first three quarters of the year compared to the same period in 2014.

Figure 1: Real GDP Growth, 1995-2014



Source: Palestinian Central Bureau of Statistics

11. A slow recovery from the deep recession was underway in Gaza in 2015 with real GDP growing by 1.3 percent in the first three quarters of that year. The recovery has been mainly driven by a very strong rebound in construction activity which grew by more than 90 percent in 2015. Wholesale and retail trade also expanded by 4 percent. Notably, the GoI has been allowing exports of certain products from Gaza to the West Bank and some agricultural produce to Israel. Nonetheless, monthly flow of goods out of Gaza continue to only represent 6 percent of what they used to be before the blockade was imposed in 2007. [7]

12. Meanwhile, growth in the West Bank slowed in 2015. Real growth in the West Bank amounted to 3 percent in the first three quarters of 2015, which is a 2.1 percentage point drop from its level in 2014. The GoI's decision to suspend the transfer of taxes it collects on behalf of the PA from December 2014 until April 2015 contributed to the growth slowdown. During the period when revenues were suspended, short-term bank credit to the PA and its employees supported consumption, which was the main driver of growth in the West Bank during the first three quarter of 2015.

[7] Businesses in Gaza report that even though export restrictions have been relaxed, they are hesitant to invest in capacity expansion to reach export markets because of the extremely uncertain political outlook and the related likelihood of another conflict or restrictions being re-imposed.

Table 1: Key Macroeconomic Indicators and Projections, Palestinian territories 2012-2020

			Prel.	Projections					
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Output and prices				Annual percentage change					
Real GDP (2004 market prices)	6.3	2.2	-0.4	2.9	3.9	3.7	3.7	3.4	3.2
West Bank	6.0	1.0	5.1	1.8	3.0	2.8	2.7	2.6	2.6
Gaza	7.0	5.6	-15.2	6.5	6.5	6.5	6.5	5.8	5.0
CPI inflation (period average)	1.7	2.7	1.2	1.6	2.5	2.5	2.5	2.5	2.4
CPI inflation (end of period)	2.8	1.7	1.7	1.6	2.6	2.5	2.5	2.5	2.4
Investment and saving				In percent of GDP					
Gross capital formation, of which:	21.2	21.8	18.6	21.8	21.1	21.5	18.9	19.2	19.2
Public	3.5	3.3	3.6	4.0	6.1	6.1	3.5	3.5	3.5
Private	17.7	18.5	15.0	17.7	15.0	15.4	15.5	15.7	15.8
Gross national savings, of which:	5.0	9.5	7.8	10.7	9.1	9.1	8.7	8.7	7.9
Public	-6.0	-1.0	-2.3	-3.0	-2.5	-2.0	-1.6	-0.9	-0.5
Private	11.0	10.6	10.1	13.7	11.6	11.1	10.4	9.6	8.4
Saving-investment balance	-16.2	-12.3	-10.8	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Monetary sector				Annual percentage change					
Credit to the private sector	14.3	11.0	16.0	15.0	15.0	13.0	12.0	12.0	12.0
Private sector deposits	6.8	10.7	9.9	7.4	6.9	6.4	5.9	5.4	4.9
External sector				In percent of GDP					
Exports of goods and nonfactor services	16.7	16.7	18.0	18.2	17.8	17.7	17.7	17.8	17.7
Imports of goods and nonfactor services	56.1	54.8	61.1	60.3	59.9	59.7	56.8	57.8	57.8
Trade balance	-39.4	-38.1	-43.1	-42.1	-42.1	-42.0	-39.1	-40.0	-40.1
Net factor income	7.6	8.6	10.8	10.8	10.6	10.5	10.4	10.4	10.3
Net current transfers	15.6	17.3	21.3	20.3	19.6	19.0	18.4	19.1	18.5
Private transfers	8.7	7.1	13.2	13.4	12.8	12.5	12.1	12.5	12.1
Official transfers	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Current account balance (excluding official transfers)	-23.1	-22.4	-19.1	-17.9	-18.7	-19.0	-16.6	-17.1	-17.7
Current account balance (including official transfers)	-16.1	-19.1	-10.9	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Memorandum items:									
Nominal GDP (in millions of USD)	11235	12419	12744	12974	13260	13636	14101	13606	14061
Per Capita nominal GDP (USD)	2617	2809	2801	2771	2753	2753	2768	2597	2610
Unemployment rate	23	23	27	27	28	29	29	30	30

Sources: MoF, IMF and World Bank calculations.

13. **The unemployment rate has recently been declining in both Gaza and the West Bank, but it remains very high as 25 percent of the Palestinian labor force is still unemployed**.[8] In Gaza, the unemployment rate skyrocketed to more than 47 percent during the 2014 conflict. It has, however, been declining since and latest available data shows that it dropped to 41 percent in the first three quarters of 2015 as the reconstruction process started to slowly pick up and private firms have been rebuilding their capacity. Unemployment in the West Bank has also slightly declined from an average of 18 percent in 2014 to just below 17 percent in the first three quarters of 2015. Notably, the drop in unemployment in the West Bank could be explained by the increase in the number of West Bank workers in Israel which grew by about 8 percent reaching 113,200 in the third quarter of 2015.

14. **Inflation in the Palestinian territories remains low and stable, but with regional differences.** The Israeli currency is the legal tender in the Palestinian territories and hence inflation generally follows price trends in Israel. Between January and November 2015, it averaged 1.5 percent: 1.3 percent in the West Bank and 1.8 percent in Gaza. Inflation in Gaza started to rise following the crackdown of the tunnels with Egypt in the summer of 2013, as access to the cheaper Egyptian fuel, construction materials, and other commercial goods significantly deteriorated.

[8] Based on PCBS Labor Force Survey data.

15. Between January and October 2015, the Palestinian trade deficit declined by 5 percent relative to the same period in 2014, but at 31 percent of GDP it remains extraordinarily high.[9] The decline was driven by a 3 percent drop in imports due to a decline in imports from Israel - the Palestinian territories' main trading partner. The drop in imports from Israel is the result of reduced economic activity, but also a growing trend among Palestinian consumers to substitute products imported from Israel by those from other countries, as a result of which non-Israeli imports were up by 22 percent. Exports also grew by 6 percent between January and October 2015 (year-on-year). Nevertheless, their size in the economy has remained very low averaging about 15 percent in recent years due to the low productive capacity of agriculture and industry that is further held back by the Israeli restrictions.

16. On the fiscal side, it is noteworthy that the PA managed to achieve a sizable degree of fiscal consolidation over recent years. The reduction in the recurrent deficit (before grants) from 25 percent of GDP in 2007 to 10 percent of GDP in 2014 is commendable. It was achieved mostly through the reduction in the size of the wage bill and net lending to GDP. The wage bill peaked at 24 percent in 2006 and has since been reduced to 16 percent of GDP, largely thanks to strong GDP growth, but also due to hiring control and wage growth restraint. The relative size of net lending was also reduced from nearly 10 percent of GDP in 2007 to 2 percent of GDP in 2014. Furthermore, taking advantage of low fuel prices in 2014, the PA managed to reduce fuel subsidies by USD55 million (31 percent). In 2014, revenues increased sharply from 18.6 to 21.5 percent of GDP thanks to higher formal imports into Gaza from Israel, but also as a result of improvements in tax enforcement.

17. In 2015, the PA successfully managed the fiscal crisis resulting from the withholding of clearance revenues[10] early in the year. The GoI withheld clearance revenues from December 2014 until April 2015, leaving the PA without 70 percent of its revenues. Consequently, the PA resorted to severe cash rationing only paying partial salaries while delaying most other expenditures. Despite the sharp liquidity squeeze during the first four months of the year, public service delivery was well maintained and the PA's efforts in managing the fiscal crisis were successful.

18. The PA's revenues performed well during the first nine months of 2015.[11] Domestic tax collections grew by 10 percent year-on-year mainly as a result of a jump in value-added tax (VAT) receipts. VAT liabilities owed by some of the big corporations were collected in July and August causing this tax category to increase by 10 percent in 2015. In addition to the collection of arrears, the Ministry of Finance and Planning (MoF) has also focused efforts in 2015 on widening the tax base through adding more than six thousand taxpayers to the system. Clearance revenues also performed well in the first three quarters of 2015 growing by 9 percent year-on-year. This growth was mainly driven by a 17 percent increase in customs receipts, which are collected on non-Israeli imports according to the Paris Protocol.[12] Another factor that contributed to the growth

[9] Preliminary data published by the PCBS.

[10] Clearance revenues are VAT and import duties collected by the GoI on behalf of the PA and transferred on a monthly basis after deducting a 3 percent administrative fee, in addition to debt on utility bills and the cost of medical health referrals to Israeli hospitals.

[11] All year-on-year changes mentioned in this section are based on nominal NIS figures.

[12] The Paris Protocol is the protocol of economic relations that was agreed upon by the Government of Israel and the Palestine Liberation Organization, and signed in April 1994.

of clearance revenues is an 11 percent increase in collections from petroleum excise mainly due to larger imports of Israeli fuel into Gaza.

19. **Expenditures have so far increased in 2015, but they are expected to stay broadly in line with the budget.** The PA's expenditures grew by 3 percent during the first nine months of 2015, mainly due to an increase in transfers and spending on goods and services. Transfers grew by 5 percent following an increase in social spending in Gaza after the 2014 conflict.[13] Spending on goods and services also increased by 3 percent between January and September 2015 due to an increase in the cost of medical referrals outside the public health system.

20. **The wage bill was kept below its prorated budget target for the first nine months of 2015**. According to the MoF, the wage bill grew by 2 percent—lower than the 3.8 percent assumed by the budget. This is partly because the PA has placed a tight constraint on hiring in 2015 reducing net staffing by 86 employees.[14] According to Bank estimates however, the MoF has underestimated its wage bill commitments because the reported figure does not include the planned Cost of Living Allowance (CoLA), which has so far not been paid. It also does not include the full 5 percent increase for teachers, which was only disbursed for the month of May.[15]

21. **The PA's efforts in controlling other categories of expenditures are starting to show results.** For instance, net lending, which represents deductions by the GoI from clearance revenues to clear utility bills owed by Palestinian Local Government Units (LGUs) and distribution companies was reduced by 7 percent in the period between January and September 2015 compared to the same period in 2014.[16] Also, even though the overall cost of health referrals has increased so far in 2015 due to an increase in cases referred to hospitals in the West Bank and East Jerusalem, the cost of referrals to Israeli hospitals was reduced by 19 percent because the PA decided to focus initial reform efforts on this category of referral cases, given that it represents the highest unit cost.

22. **In spite of the reform efforts and the ensuing deficit reduction, the fiscal situation continues to be difficult and the PA continues to rely on arrears as a source of deficit financing.** The combination of strong revenue performance and reform measures that limited expenditure growth caused the recurrent deficit for the first nine months of 2015 to decline by 10 percent compared to the same period in 2014. However, donor aid for recurrent spending has declined from USD1.8 billion in 2008 to USD894 million in 2015, and although there has been a substantial fiscal adjustment in response, it has not been commensurate with the reduction in aid flows. Also, despite the recent improvement, revenue performance remains weak and particularly problematic is the low amount of revenues raised from Gaza compared to expenditures there.[17] The tax base in the West Bank also remains small due to inefficiencies in both enforcement and

[13] The need for social assistance in Gaza grew following the 2014 conflict, due to the acute humanitarian situation. As a result, 7058 new Gaza beneficiaries were added to the National Cash Transfer Program in 2015.
[14] 518 employees departed from the labor force in Gaza while 334 were hired in the West Bank. The number of employees in the National Fund and embassies increased by 98 employees. Net employment in the security and health sectors increased by 52 and 183 respectively, while it was reduced by 265 in the education sector.
[15] Even though the CoLA and the increase for teachers have not yet been fully disbursed, the MoF should include them in the wage bill figure on commitment basis since they were committed through the budget.
[16] This calculation is made after adjusting figures to exclude the deduction of NIS237 million made by the GoI from February 2015 clearance revenues.
[17] The PA reports that 13 percent of its revenues are generated from Gaza, while 43 percent of its expenditures are concentrated there.

policy. These problems are also aggravated by the recent economic decline. Thus, the PA continued to resort to arrears to finance the deficit. In the first nine months of 2015, the PA's total deficit amounted to USD996 million (10 percent of GDP). Aid received was USD593 million: USD530 million in budget support and USD63 million in investment project financing. As a result, the PA ended up with a financing gap of USD403 million. Although the PA has been clearing its old arrears, new arrears were generated in 2015, and hence, net accumulation of arrears amounted to USD417 million[18] during the first nine months of 2015 – slightly more than what was needed to close the financing gap. Excess financing in addition to clearance revenue advances by the GoI in September 2015 enabled the PA to reduce its net domestic bank financing by USD85 million.

Table 2: Central Government Fiscal Operations, 2012-2020

				Preliminary Estimates & Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Public finances (commitment basis)				In USD million					
Total net revenues	2075	2311	2744	2820	2918	3039	3169	3093	3228
Gross domestic revenues	729	852	871	883	899	933	971	945	984
Tax revenues	481	597	601	596	567	591	617	604	631
Nontax revenues	248	255	270	287	332	342	354	341	353
Clearance revenues	1459	1690	2049	2085	2143	2209	2281	2208	2276
Less tax refunds	113	231	176	148	124	103	83	60	32
Recurrent expenditures and net lending	3531	3694	4068	4109	4140	4207	4292	4103	4192
Wage expenditure	1769	1919	2050	2045	2055	2083	2115	2018	2054
Non-wage expenditure	1483	1565	1732	1790	1825	1873	1933	1862	1921
Net lending	278	211	286	274	259	251	244	223	218
Recurrent balance	-1455	-1383	-1324	-1289	-1222	-1168	-1123	-1010	-964
Development expenditures	243	187	263	250	604	610	217	210	217
Overall balance (before external support)	-1699	-1570	-1587	-1539	-1826	-1778	-1340	-1220	-1181
Financing	1699	1570	1587	1539	1826	1778	1340	1220	1181
External budgetary support	776	1255	1030	894	894	894	894	894	894
Development financing	156	106	203	250	604	610	217	210	217
Net domestic bank financing	127	-248	-142	220	110	107	104	95	93
Domestic arrears	686	462	504	171*	171*	167*	125*	21*	-23
Other	0	4	0	0	47	0	0	0	0
Residual	-46	-10	-9	4	0	0	0	0	0
Public finances (commitment basis)				In percent of GDP					
Total net revenues	18.5	18.6	21.5	21.7	22.0	22.3	22.5	22.7	23.0
Recurrent expenditures and net lending	31.4	29.7	31.9	31.7	31.2	30.9	30.4	30.2	29.8
Wage expenditure	15.7	15.5	16.1	15.8	15.5	15.3	15.0	14.8	14.6
Non-wage expenditure	13.2	12.6	13.6	13.8	13.8	13.7	13.7	13.7	13.7
Net lending	2.5	1.7	2.2	2.1	2.0	1.8	1.7	1.6	1.6
Recurrent balance (before external support)	-13.0	-11.1	-10.4	-9.9	-9.2	-8.6	-8.0	-7.4	-6.9
Overall balance (before external support)	-15.1	-12.6	-12.5	-11.9	-13.8	-13.0	-9.5	-9.0	-8.4
External budgetary support	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Domestic arrears	6.1	3.7	4.0	1.3	1.3	1.2	0.9	0.2	-0.2
Memorandum item:									
Nominal GDP (in millions of US$)	11235	12419	12744	12974	13260	13636	14101	13606	14061

Sources: MoF, IMF and World Bank calculations.
*To the pension fund.

23. The Palestinian banking sector is generally healthy. Data provided by the Palestine Monetary Authority (PMA) indicates that the sector's net assets grew by 3 percent so far in 2015. There is ample liquidity in the banking sector as evidenced by the loans-to-deposits ratio which

[18] About 44 percent of arrears accumulated in 2015 is to the private sector while the majority of the rest is to the pension fund.

stood at 57 percent as of June 2015. Private credit grew by 15 percent in 2015 with the majority of private lending comprising construction and consumption loans. This raises concentration risks that should be monitored, particularly given the continued growth of this credit category during the recent economic slowdown. Encouragingly, the ratio of non-performing loans to gross loans continues to be stable and low at less than 3 percent.

24. **The banking sector's credit exposure to the public sector remains a concern but the PMA has been closely monitoring the related risks and taking appropriate actions to mitigate them.** As of June 2015, the PMA reports that the Palestinian banking sector has provided USD1.26 billion in credit facilities to the PA, which represents about 10 percent of the sector's total assets and 91 percent of its equity. Credit to public sector employees has been growing since 2010 and it reached USD958 million by the end of June 2015. More than 40 percent of banks' lending portfolios constitute loans to the PA and its employees. This high credit concentration is a serious risk that can threaten the viability of the overall sector, particularly given the PA's precarious fiscal situation. As a result, the PMA has been regularly conducting stress testing in line with the Basel II principles to evaluate the banking system's stability. The PMA reports that the results of the June 2015 tests indicate that the banking sector is well capitalized with the tier 1 capital as a ratio of risk weighted assets at 18 percent, and is therefore able to withstand a wide range of economic, political, and liquidity shocks.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

25. **Without a political breakthrough, the economy will continue to operate below its potential and jobs created will not be sufficient to reduce unemployment and improve living standards.** In a baseline scenario that assumes no changes to the political environment or the Israeli restriction system and a stabilization in aid levels, real GDP growth is expected to be around 3-4 percent in the medium term. Given that population growth in the Palestinian territories is 3 percent, this implies little, if any, growth in real per capita income and an increase in unemployment. In the West Bank, real GDP growth is expected to have reached 1.8 percent in 2015 (full year data is not yet available), assuming regular monthly transfers of clearance revenues by the GoI. The pace of the reconstruction process in Gaza is expected to be slower than originally anticipated due to lower than needed aid and import restrictions on building materials. Therefore, the economy is expected to rebound only by 6.5 percent assuming continued construction activity.

26. **Inflation is expected to remain around 2-3 percent, but the West Bank and in particular Gaza remain vulnerable to increases in food and fuel prices**. The projected inflation figure takes into account the expectation of Israeli inflation not exceeding 1.6 percent and relatively stable prices at international commodity markets.

27. **The PA's revenues are expected to have increased as a percentage of GDP in 2015 and continue this trend in the coming years**. The MoF has been focusing efforts on increasing domestic revenues through widening the tax base. In fact, more than 6 thousand taxpayers were added to the system in the first three quarters of 2015. In addition, the PA has recently amended the Income Tax Law to enable the settlement of income tax violations through the execution court system, which should significantly expedite the process. Also, the income tax and VAT collection departments were recently merged and have started to operate as a single unit which will facilitate information sharing and increase coordination. The MoF is also in the process of revising the

Large Taxpayer Unit (LTU) criteria to raise the requirement for the yearly turnover amount from USD1.3 million to USD5.1 million in order to cover some of the larger companies operating in the local market. Finally, the MoF has already submitted to the Cabinet a proposal to revise administrative fees the government charges for service provision which will generate an additional USD54 million in yearly revenue. The abovementioned measures are expected to gradually increase the size of revenues in the economy over the medium term. Initially, revenues as a share of GDP are projected to have increased by 0.2 percentage points in 2015 and reached 21.7 percent (full year data is not yet available). This will be followed by additional growth in the following years until the relative size of PA revenues reaches 23 percent in 2020.

28. The size of the PA's spending in the economy dropped in 2015 according to preliminary estimates. The PA has been implementing a number of measures to control public spending including maintaining a zero net hiring policy since late 2013. To further control the wage bill, the Cabinet has recently approved a decision to reduce fuel and phone allowances for public employees by 25 percent. The wage bill is expected to have decreased by 0.3 percentage points of GDP in 2015 as a result of these measures. As for non-wage spending, the PA has been trying to control the cost of outside health referrals which have been the main driver of growth in this category of expenditure. Therefore, a referral manual that sets clear guidelines and procedures for the referral process has been developed by the Ministry of Health (MoH). Also, given that the highest unit cost for referral cases is charged by Israeli hospitals, recent efforts have focused on reducing the cost of referrals to Israel. In fact, the MoH has already managed to reduce the cost of this category of referrals by 19 percent year-on-year. Also, the PA has recently taken some steps to control net lending, including entering into Memoranda of Understanding (MoU) with Palestinian electricity distributors to ensure that fees collected are used to cover bills to the Israel Electric Corporation (IEC) (the main provider) and not to finance non-electricity related expenditures. In addition, the MoF has been working with the distribution companies and municipalities to reconcile the amount of electricity debt owed to/by them. Other actions were also taken to increase the collection rate, including installing additional prepaid meters. As a result of these measures, net lending has actually started to decrease and its share in the economy is expected to have slightly declined and reached 2.1 percent in 2015. Overall, the PA's expenditure is expected to have declined by 0.2 percentage points of GDP in 2015 and reached 31.7 percent.

29. Expenditure as a share of GDP will continue declining in the medium term as the PA continues with its efforts to rationalize spending. The cost of health referrals is expected to decline by 15 percent over the coming years as the PA starts implementing a master plan that has been prepared with assistance from the World Bank. Future efforts will also focus on further controlling net lending through implementing an action plan that is being developed by the Energy Authority and the MoF. The Bank will be providing technical assistance to the MoF in the preparation and implementation of this plan. Despite the difficult social context, the PA also intends to start tackling issues related to pension reform, based on the action plan that was prepared with the Bank's assistance in 2010. Measures to control the growth of the wage bill and civil service reform are also underway. The General Personnel Council has already finalized a review of all posts in each line ministry or agency, updated job descriptions, and produced job classifications. These job classifications will be used as criteria to determine allocations for staff costs to various ministries in the 2016 budget. Job forecasting has also been piloted in 10 ministries and the plan is to roll out this activity in all other ministries over the next two years. These efforts combined are expected to lead to a 2 percentage points decline in government spending in the medium term, which is projected at 29.8 percent of GDP in 2020.

30. As a result, the recurrent fiscal deficit is expected to have dropped in 2015 and is expected to continue this trend. World Bank estimates indicate that the recurrent deficit (before grants) will decline from 10.4 percent of GDP in 2014 to 9.9 percent in 2015 and continue declining in the medium term until it reaches 7 percent in 2020. The overall deficit (before grants) will also decline from 12.5 percent in 2014 to 11.9 percent of GDP in 2015. However, development spending is expected to significantly increase in 2016 and 2017 to finance Gaza reconstruction mostly through donor grants, and hence the overall deficit will rise to 13-14 percent of GDP in these two years. In the subsequent period, the overall deficit will start declining again until it reaches 8.4 percent of GDP in 2020 as capital spending decreases to its normal levels.

31. However, the financing need would remain large. In 2015, the financing need is projected to have amounted to USD1.29 billion, only to cover recurrent expenditures. A further USD250 million was needed to finance investment projects, bringing the total financing need for the 2015 budget to USD1.54 billion. Aid to the public sector for recurrent and capital spending in 2015 is expected to have amounted to USD1.1 billion, leading to a financing requirement after grants of around USD0.4 billion. This, as in previous years, is expected to have been financed through domestic sources mainly, including arrears to the pension fund (de facto borrowing from the pension fund) and borrowing from commercial banks especially since the PA had managed to reduce its debt to the local banking sector in 2014, creating room for additional borrowing in 2015.

32. The PA will continue to rely on grant assistance funding for recurrent and development budgets over the medium term. The deficit in the medium term is expected to be financed mainly through aid, arrears to the pension fund, and borrowing from local banks. Given that the private sector remains severely constrained, aid has been the main driver of growth and the latter has facilitated fiscal consolidation efforts in recent years. Further reduction in the level of aid would weaken an already sluggish aggregate demand, further reduce growth, and increase unemployment, which will in turn make it extremely difficult for the PA to pursue structural reforms and fiscal consolidation efforts. Therefore, it would be critical for the PA's reform agenda to continue to benefit from sustained and substantial financial support from donors. As indicated by the International Monetary Fund (IMF), the level of aid should increase, in particular that allocated to investment projects until constraints on private sector investment have been substantially relaxed. Predictability of donor aid is also important, as unpredictable aid flows introduce an additional layer of uncertainty to decision making, budget management, and prioritization of activities for the PA.

33. Due to the persistently high trade deficit, the 2015 current account deficit - including official transfers - is projected to stay at last year's level of 11 percent of GDP[19]. Constrained by the restrictions system, Palestinian export growth is expected to remain sluggish and the Palestinian territories will continue to heavily depend on imports to meet even some of the basic needs. Consequently, the current account deficit will remain high in the medium term. In addition to official transfers, current account deficit financing will continue to depend on informal private capital transfers and possibly further drawdowns of foreign exchange in cash and savings.

[19] Full year data is not yet available.

34. Public debt remains sustainable under the baseline scenario, but risks to debt sustainability have increased. [20] The increase in the average projected financing requirement (after the inclusion of donor grants) in the PA's budget from 1.6 percent of GDP to about 3 percent of GDP between 2015 and 2020 is the main driver behind the higher risk to debt sustainability. The PA's public debt consists of external debt (25 percent of total), borrowing from the domestic banking sector (25 percent), and domestic arrears to the public sector and to the pension fund (14 and 36 percent of the total, respectively). Under a baseline scenario, public debt is expected to reach 42 percent of GDP in 2015 – higher than the 40 percent limit prescribed by the Law on Public Debt. It is expected to continue rising until it peaks in 2019 and reaches 45.5 percent of GDP – up almost 5 percentage points of GDP from its 2014 level. According to the baseline scenario, debt will finally stabilize in 2020. Sensitivity analysis demonstrates that a shock equivalent to one standard deviation to the interest rate earned by domestic banks will raise the debt level to 50 percent of GDP by 2020. Shocks to growth, primary balance or a combined shock would make public debt unsustainable, raising its level to more than 60 percent of GDP. A one-time contingent liabilities shock equivalent to 10 percent of GDP (e.g., in the case of non-payments to utilities) will result in an immediate 10 percent increase in the debt level. A decline in donor aid would have a similar effect. On a final note, debt to the pension fund—largest component of the public debt—is in fact a contingent liability that could be substantially reduced, if not eliminated through parametric reforms of the pension system, to which the PA has committed in the Letter of Development Policy (Annex 2).

35. With continued reform efforts by the PA and anticipated inflows of donor aid, the macroeconomic policy framework is adequate. The banking sector is healthy and has proven repeatedly resilient to shocks and exchange rate risks are minimized through the use of the Israeli shekel, which is appropriate, given that the vast majority of Palestinian trade is with Israel. The most relevant risks are related to the sustainability of the fiscal account, many of them beyond the PA's control. Nevertheless, as long as private sector growth remains constrained by factors outside the PA's control, there is likely no feasible alternative in the Palestinian territories to a macro-fiscal framework that relies on large amounts of donor aid, in addition to reform efforts to boost revenues and curb public expenditure growth, but without causing politically and socially unbearable impacts on citizen welfare and social stability. This grant will contribute to the reduction in the PA's fiscal deficit and is expected to leverage 4-5 times larger amounts of grant assistance that will altogether substantially reduce the PA's fiscal deficit and improve debt sustainability prospects, along with ongoing and planned reform efforts by the PA.

2.3 IMF RELATIONS

36. West Bank and Gaza is not a member of the IMF and consequently there can be no IMF program. The IMF, however, has an office for West Bank and Gaza in Jerusalem and has had an active analytical and technical support program. The IMF has been providing technical assistance in the area of taxation, public finance management, statistics, and financial sector reforms. It also conducts regular macro-fiscal monitoring and publishes two reports a year in advance of the Ad Hoc Liaison Committee meetings, as well as other ad hoc reports.

[20] The debt sustainability assessment (DSA) contained here is entirely based on the DSA that was conducted by the IMF in preparation for the September 2015 AHLC meeting.

3. THE GOVERNMENT'S PROGRAM

37. **The PA's program is imbedded in the National Development Plan (NDP) 2014-2016.** The plan has three broad objectives: the first one is focused on growth, competitiveness, and job creation, the second one on improving governance and public institutions, and the third one on infrastructure development. Under the first objective, the PA's aims are to improve the business environment, facilitate investments in areas that can lead to significant job creation, improve external competitiveness of Palestinian enterprises, as well as to facilitate entrepreneurship among women and youth. Under the area of governance, the focus is on efficiency, effectiveness and transparency in public services, enhanced public service provision, enhanced capacity of local governments, enhancements in the security and justice systems, strengthened citizen participation in decision making, and improved functioning of Palestinian representation abroad. In the area of infrastructure, the focus is on improved efficiency and safety of transportation infrastructure, improved provision of energy, water, and sewerage services, environmental protection, and the development of a housing sector. In addition to the NDP, sector-specific strategies have also been developed. Thus, for instance, the government has finalized a revenue strategy that aims to significantly expand the tax base both through changes to tax policy and better enforcement. If fully implemented, the strategy could significantly improve the PA's fiscal position.

38. **The government has consulted various stakeholders in the process of drafting the NDP.** Formal consultations are an integral part of the NDP drafting process. Broad-based consultations were held with representatives of the private sector, civil society, and donors and their feedback has been reflected in the plan. Taking into account inputs received during consultation sessions, sector and cross-sector strategies were reviewed and updated by the Sector Strategy Teams, which included representatives of the private sector and civil society. Furthermore, all major donors to the PA were consulted during the strategy preparation process and were given an opportunity to comment on a draft NDP.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

39. **This operation has been designed to support the first two objectives of the NDP.** The first objective (focused on growth, competitiveness, and job creation) will be supported through the actions taken to facilitate the land registration process, currently deemed an obstacle to private investment. The second objective related to better governance in public institutions will be supported through the actions aimed at improving public revenue performance and improving sustainability of public expenditures, as well as the actions aimed at improving transparency of public finances.

40. **The Program Development Objectives (PDOs) respond directly to some of the key government needs and broader development goals and are as follows:** (1) improve public revenue performance and improve sustainability of public expenditures; (2) improve transparency of public finances; and (3) facilitate the land registration process. A substantial slowdown in economic growth combined with a significant reduction in donor aid over the past several years

have rendered deficit reduction a top policy priority for the PA, as the fiscal deficit became unfinanced. Although an impressive degree of consolidation has been carried out already, more needs to be done. At the same time, rapid reduction in the fiscal deficit is having a negative impact on aggregate demand and therefore a too sharp fiscal adjustment without a pickup in private investment is not desirable. This operation supports deficit reduction through gradual elimination of specific inefficiencies that do not contribute to the quality of services provided by the PA. Moreover, the operation provides essential budget financing and encourages other donors to provide budget support through the PRDP Trust Fund, administered by the World Bank. Sustainable and well-managed public finances, along with an improved business environment are also a precondition for economic growth, which in turn is crucial for sustainable job creation and poverty reduction.

41. **Lessons learned through previous DPGs, in particular those related to the need for strong government ownership and flexibility, have been taken into account in the preparation of this DPG.** The standalone operations have proved advantageous within a highly volatile security and political context that often leads to reprioritization of reforms. At the same time, the programmatic nature of certain reforms has not been neglected. For instance, this operation supports recent progress in complex reform efforts in the areas of net lending and health referrals, building on earlier stages of reforms that were supported through previous DPGs. This DPG is entirely based on the PA's reform program to ensure full ownership in all areas of reform. The choice of prior actions takes into consideration not only the PA's reform priorities, but also its technical capacity, as well as the social and even security risks that might be associated with certain reforms. Consequently, for instance, this DPG has not been designed to focus on pension reform or more ambitious pay and grading reforms in the Palestinian public sector, although both of these reforms remain important priorities on the path to fiscal sustainability. The dialogue on these reforms continues, and the PA has expressed commitment to tackle them over the medium term (see Annex 2, Letter of Development Policy). The Public Expenditure Review (PER) recently completed by the World Bank provides important analytical underpinnings for an action-oriented policy dialogue. Finally, it is important to note that the results the selected prior actions supported by this DPG are already visible in several areas.[21]

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Policy Area I: Improving public revenue performance and improving sustainability of public expenditures

Public Revenue Performance

42. **Tax revenues have grown impressively in recent years, but there is room for substantial further growth, in particular of domestically collected tax revenues**. Between 2012 and 2014, the PA's tax revenue receipts increased by 3 percentage points from 18.4 to 21.5 percent of GDP. Over this period, clearance tax revenues increased by 41 percent in nominal terms, while domestic tax revenues increased by 25 percent (nominal GDP increased by 13 percent over the same period). Clearance tax revenues increased primarily as a result of higher imports

[21] This is the case, in particular, with the reduction in the costs of health referrals to Israeli hospitals through better contracting practices and rule clarity, and with reforms to reduce net lending, which build upon the World Bank's earlier support through DPGs, analytical work, and technical assistance.

into Gaza from Israel (fuel in particular) and growth in customs revenues as a result of growth in imports from third countries, but also improved tax enforcement cooperation between the PA and the GoI. Growth in domestic revenues is the result of improvements in tax collection. Domestic, or internally collected revenues by the PA remain below potential, as documented by the IMF.[22] In 2014, domestic tax revenues amounted to 23 percent of all tax revenues, or 5 percent of GDP. The fact that imports amount to less than 50 percent of final consumption, while taxes on imports amount to around 77 percent of total tax revenues is a strong sign of substantial additional room for the collection of consumption taxes internally within the Palestinian territories. Likewise, income tax collection (personal and corporate) at around 1.5 percent of GDP in 2014 is also relatively low compared to other countries at a similar stage of development.

43. The PA has adopted a revenue action plan and has recently been conducting a number of activities to increase revenues. Although the Bank and the IMF deem that Palestinian tax rates are competitive and there may be some potential for further increase in the tax rates, the focus of the PA's efforts to increase tax revenues has been on widening the tax base through some policy changes and better tax enforcement. Amendments to the Investment Promotion Law in 2014, which were supported through DPG VI, eliminated some tax breaks that the earlier version of this law provided and which were generally deemed ineffective as an investment promotion tool. Currently, the focus of the PA is on tax enforcement.

44. This operation supports two specific actions taken by the PA, which aim to improve tax collection. The first prior action supports the introduction of amendments to the Income Tax Law to enhance the collection of predetermined tax debts by tax payers. Previously, these debts were supposed to be collected through the institution of the Administrative Governor and a collection committee, but neither of these institutions have been established. Consequently, efforts to collect tax debt are taking a very long time at the moment. After the amendments to the Income Tax Law became effective in early 2016, if a taxpayer does not pay a tax debt within the legally specified timeframe, a notice will be sent to the taxpayer ordering payment settlement within a 30-day period. If the taxpayer fails to settle the debt, the notice automatically becomes an execution order that will be settled through the execution court system. The result of these changes will be a substantially faster and more effective tax collection system. Furthermore, in order to strengthen the tax collection effort and to render it administratively more efficient, the PA is unifying the VAT and income tax collection departments. This institutional change will produce cost-efficiency, and will lead to improved information sharing for conducting tax audits and building a risk-based tax enforcement system. These actions, together with other activities the PA is conducting to improve tax collection, are expected to result in more effective domestic tax collection efforts and relatively higher domestic tax revenues, starting already in 2016.

Prior Actions Supported by the Operation

- *Action 1: The Council of Ministers has agreed upon and referred the draft amendments to the Income Tax Law to the President for issuance in order to improve income tax collection by allowing income tax payment violations to be settled through the Recipient's execution court system.*

[22] West Bank and Gaza, "Technical Memoranda on Investment Tax Incentives," Russel Krelove and Artur Swistak, the International Monetary Fund, 2013.

- *Action 2: The Ministry of Finance has issued an instruction to merge its existing value-added tax collection department and the income tax collection department into a single collection department to improve operational efficiency.*

Expected Results

- *The stock of income tax debt estimated based upon official income tax filings that have been verified through MoF audits is 15 percent lower in 2016 than it was in October 2015.*

Sustainability of public expenditures

45. The PA is implementing a number of measures to contain expenditure growth. Ideally, these measures should be even more ambitious, as further reduction of the recurrent fiscal deficit is needed to enhance the outlook for fiscal sustainability over the medium term, but additional action seems to be constrained by considerations related to weak aggregate demand growth, rising social tensions, heightened political uncertainty, and security risks. Nevertheless, the PA has committed itself to reducing the size of civil service through a policy of hiring controls in order to contain growth of the wage bill. It is conducting a number of reforms to reduce the size of the so called net lending, health referral costs, and non-essential discretionary spending. Aided by low fuel prices, the PA has also substantially reduced the fuel subsidy.[23]

46. This DPG is supporting the PA's efforts to reduce the size of net lending. Net lending is a line in the PA's recurrent expenditures that mostly comprises deductions made by the GoI from clearance revenues accrued to the PA on the account of unpaid electricity bills by Palestinian local governments and electricity distribution companies. The causes of net lending are complex and are related to substantial technical losses in the Palestinian electricity grid, electricity theft, inadequate collection of electricity bills, the diversion of electricity revenues by municipal governments to finance their budgets, and even overpricing of electricity by the Israel Electric Corporation, which supplies 88 percent of electricity consumed.[24] Although it has dropped substantially as a share of GDP in recent years, this expenditure has persisted for a number of years and it reached USD286 million in 2014 (2 percent of GDP). The PA has been trying to address this issue for a number of years, with limited success, and is now seeing some results. In 2014, the Bank completed a study which for the first time provided a systematic and in-depth assessment of the principal causes behind net lending increase in the electricity sector. Its findings and the subsequent dialogue have breathed new energy into the reform effort to reduce net lending. The PA is taking a number of actions that will result in higher payments of electricity bills to the Israel Electric Corporation, and therefore lead to a decline in net lending. Some of the activities are targeting improvements in electricity bill collection which increased from 81 percent in 2013 to 84 percent in 2015 for the

[23] The definition of net lending referred to here is not necessarily consistent with the standard GFS terminology.

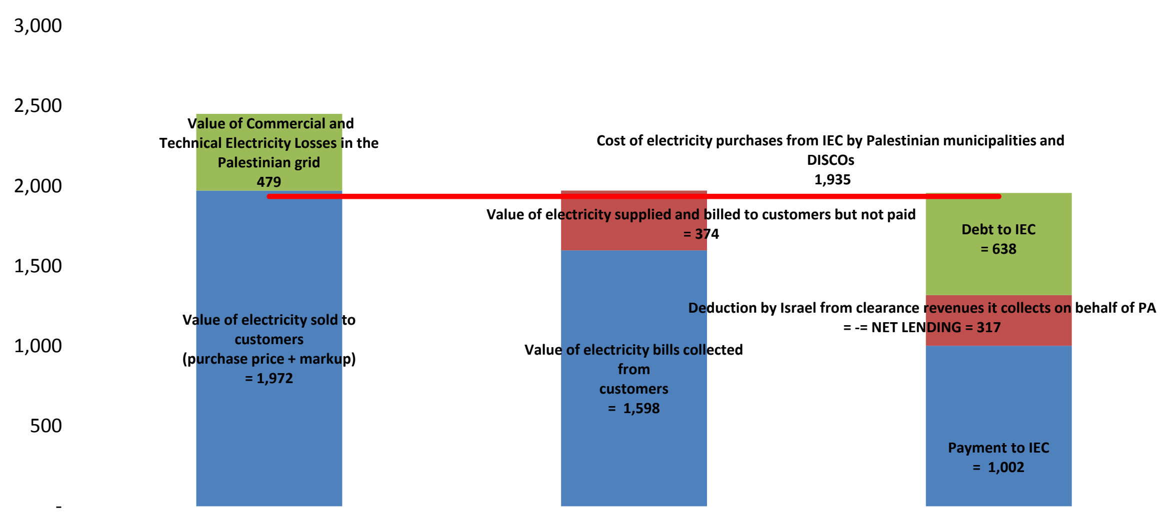
[24] Electricity prices charged by the IEC to Palestinian municipalities and electricity distribution companies, for instance, include some taxes for greening initiatives in Israel. The Palestinian entities take the electricity prices charged by the IEC as given and the PA has been attempting to centralize electricity purchases (currently conducting investments that will enable this) and to negotiate power purchase agreements with the IEC and other suppliers in order to reduce the cost of electricity purchased. Efforts are also underway to facilitate investments in electricity generation in both the West Bank and Gaza.

West Bank. Moreover, investments are being made that will substantially reduce technical losses, while other actions aim to incentivize local governments to stop diverting electricity revenues to finance their budgets and to pay their bills to electricity providers (primarily the IEC).

Box 1: Stakeholders involved in the net lending process

The Palestinian territories are highly dependent on energy imports from neighboring countries due to the lack of domestic energy sources. The Israel Electric Corporation (IEC) is the largest energy supplier providing 88 percent of electricity consumed in the Palestinian territories. Electricity distribution in the Palestinian territories is carried out by Palestinian municipalities, village councils, and Distribution Companies (DISCOs). These Palestinian entities have not been paying their electricity purchase bills to the IEC in full. The electricity distribution company in Gaza, for instance, does not pay any of the bills it owes to the IEC. In recent years, the degree of nonpayment of electricity bills to the IEC by the Palestinian distributors in the West Bank has also increased. There are several reasons for this, including significant technical losses due to the outdated electricity grid, electricity theft, and inadequate collection of electricity bills. Moreover, recent World Bank research shows that electricity bills collected from consumers are used by the distributors to finance expenditures rather than settle bills to the IEC. Outstanding payments owed to the IEC, including late payment fees, are either (1) deducted by the Israeli MoF from revenues that the GoI collects on behalf of the PA (clearance revenues) and are recorded in the PA's budget as "net lending", or (2) accumulated as debt owed to the IEC. Furthermore, the PA's MoF has not been fully transferring to LGUs the fees and taxes that it collects on their behalf to offset deductions made by the GoI from clearance revenues. This results in a rather complicated, opaque and distorted intergovernmental fiscal relations system. The dynamics of net lending is also shown on the example of the West Bank in the diagram below.

Electricity distribution operations of Palestinian municipalities and DISCOs (West Bank, 2013)



47. **The aim of the prior action supported by this DPG is to incentivize local governments to pay their electricity bills to electricity providers.** The prior action involves the signing of Memoranda of Understanding (MoU) between the Palestinian Energy and Natural Resources Authority (PENRA) on one side and Palestinian municipalities and electricity distribution companies on the other, wherein the municipalities and distribution companies commit themselves to paying 90 percent of what they collect from customers to electricity suppliers (10 percent is kept for operational costs). Furthermore, the MoUs specify debt obligations between the PA and local

governments. In addition, although not a party to these MoUs, the MoF of the PA has committed to regularly transmit the payment of taxes and fees it collects on behalf of municipalities to them, which so far has not been the practice.

Prior Action Supported by the Operation

- *Action 3: The Palestinian Energy and Natural Resources Authority has entered into and commenced the implementation of the memoranda of understanding with at least two (2) electricity distribution companies and at least one (1) municipality in order to coordinate and facilitate the payment of electricity bills to the Israel Electric Corporation by electricity distribution companies and municipalities.*

Expected Results

- *The ratio of annual wholesale electricity bill payments to the Israel Electric Corporation made by JDECO, NEDCO, SELCO, HEPCO and TEDCO electricity distribution companies to amount collected by these DISCOs from end customers in the West Bank amounts to at least 80 percent in 2016.*

48. This operation is also supporting the PA's efforts to reduce the cost of medical referrals outside of the public health system. Referrals are mostly made to Israeli hospitals and private healthcare facilities in the West Bank and Gaza, but also to Jordan and Egypt. The number of such referrals has increased from 8,123 in 2000 to 56,468 in 2014. The corresponding expenditure has also increased significantly from less than USD10 million in 2000 to as much as USD125 million in 2014. Notably, the highest unit cost for referral cases is charged by Israeli hospitals, so even though this category of referral cases represents only 11 percent of the total number of referred cases, the associated cost is about 47 percent of the total referral cost. According to an assessment conducted by the Bank, the rapid growth in referral costs cannot be explained by demographic or epidemiological factors alone, although the demographic transition and the increase in the incidence of non-communicable diseases may have played a minor role. Therefore, this high and increasing level of expenditure on outside referrals represents an inefficiency in health spending. The PA is unable to finance the growing costs of health referrals. Currently, unpaid bills to outside service providers amount to more than NIS72 million (USD18 million). While attempts to control the cost of health referrals have been made in the past, largely as a result of pressure from donors, the PA has started showing strong commitment to reform the referral system at the Cabinet level as of 2014. A number of reforms have been carried out since then and as a result of these reforms, the costs of referrals to Israel have finally started to drop in 2015.

49. This operation supports two specific reform actions which the PA has recently taken and the results of which are already visible. The first prior action pertains to the signing and implementation of the MoUs with three Israeli hospitals to regulate prices and other relevant contractual terms between the two parties in the referral process. In the past, patients were referred to Israeli and other institutions without a priori understanding about the treatments that were authorized and the cost of such treatments. Unsurprisingly, analytical work carried out earlier by the Bank and others found this practice to be one of the causes of referral cost growth. This is corroborated by the fact that costs per referral case charged by institutions with which MoUs were signed started coming down immediately once their implementation commenced. Now, hospitals with which the PA has signed the MoUs commit not to conduct any cost-inducing treatments without prior approval from the relevant department at the PA's Ministry of Health. This procedure allows the PA to eliminate expenditures on unnecessary treatments, which can be conducted more efficiently within the public health system in the West Bank and Gaza. The second prior action supported by this operation is the formal introduction of a referral manual and the mandated application thereof to the referral decision-making process. The manual, which was prepared with the assistance of international experts, sets clear criteria for referral decision making, substantially reducing room for discretion in the referral process, which has also been identified as a systemic weakness that results in referrals being made when not necessary and for treatments not covered by the public healthcare system. Adherence to the manual in referral decision making has been mandated through an instruction issued by the Minister of Health.

Prior Actions Supported by the Operation

- *Action 4: The Ministry of Health has entered into and commenced the implementation of the memoranda of understanding with at least three (3) Israeli hospitals to facilitate the health referral process between the Ministry of Health and Israeli hospitals.*

- *Action 5: The Minster of Health has issued an instruction mandating the health referral committees within the Ministry of Health to use a new Referral Manual for patient referrals outside the public health system.*

Expected Results

- *The cost of health referrals to health service providers outside of the Palestinian public healthcare system is lower than 1.2 percent of GDP in 2016.*

Policy Area II: Improving Transparency of Public Finances

50. The PA has made good progress in developing modern PFM systems, however, there still is room for improvement. Progress has been particularly effective in setting up a well performing Integrated Financial Management Information System (IFMIS) and the Government Financial Statistics (GFS) budget classification. Together with the development of the unified treasury system (Treasury Single Account and zero-balance account) overseen by the MoF in accordance with international practices, these reforms have allowed the MoF to commence devolving budget execution to line ministries. Over the years, the PA has also continued to make progress in improving the transparency and information quality pertaining to its fiscal reporting and some of these efforts were supported by previous DPGs. The PA's budget is published online, and monthly budget execution reports that follow GFS 2001 format are regularly prepared. The amount of detail in these reports has been increasing. The MoF has also already taken action to significantly improve information on the stock and age profile of arrears, which is important for both broader fiscal management and arrears management. Notably, this action was supported by the previous DPG operation.

51. **This operation supports the PA's efforts in improving the quality of information on intergovernmental fiscal relations between the PA and local governments.** Local governments have repeatedly complained about the lack of specific information on the amount of taxes that the PA collects on their behalf, and the amount of fees and specific deductions made by the PA before it remits these taxes to local governments. The absence of this information was an obstacle to the development of trust between the PA and municipal governments. Therefore, the previous DPG supported an action that requires the MoF to publish regular reports showing the amount of property tax it collects on behalf of LGUs, and also the amounts it remits back to them. This operation builds upon this action through expanding these reports to include data on transportation fees that the PA collects on behalf of LGUs. Namely, following the debt reconciliation process between the PA and local governments discussed above, access to this information would enable both the PA and municipal governments to track tax-related flows between the two and to regularly update information on debt stocks. Also, access to this kind of information will enable, among other things, the monitoring of net lending flows for each unit of local government separately. Overall, this action would improve transparency of intergovernmental fiscal flows and would contribute to trust-building between local governments and the PA. The relevant units within the MoF have been mandated to start producing regular annual reports that provide relevant information on transportation taxes that the PA collects on behalf of municipalities, as specified in the prior action below. These reports will be published on the MoF website.

Prior Action Supported by the Operation

- *Action 6: The Ministry of Finance and Planning has issued an instruction mandating its relevant units to produce yearly reports that include information on: (i) the amount of transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; (b) the amount of service fees charged by the Ministry of Finance and Planning and deducted from the transportation taxes collected on behalf of each local government unit; (c) the amount of any other deductions or intercepts on transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; and (d) the amount of transportation taxes transferred by the Ministry of Finance and Planning to each local government unit.*

Expected Results

- *Annual information is available online on the amount of: (1) the transportation tax collected by the MoF on behalf of each LGU; (2) the service fees charged; (3) any deductions/intercepts for each LGU specifically; and (4) the transportation tax paid to each LGU in the first quarter of 2016.*

52. **The operation also supports the PA's efforts in implementing a commitment system in a number of line ministries.** This system ensures that a budget allocation is secured for any expense prior to its contracting. It has already been piloted at the MoF and the Ministry of Education and is now being rolled out in several other line ministries, including the ministries of Health, Transportation, Interior, Public Works, and Local Government. This system will provide information on all outstanding and newly incurred commitments that will be paid at a later stage. Once this system is developed into a full commitment control system aimed at monitoring and

adjusting the flow of new commitments according to availability of financing, it will considerably reduce the possibility of generating new arrears.

Prior Action Supported by the Operation

- *Action 7: The Ministry of Finance and Planning has issued an instruction mandating the ministries responsible for health, transportation, interior, public works and local government to implement a Commitment Recording System.*

Expected Results

- *Starting January 2016, access to information on commitments in the pipeline is provided by the Ministry of Health, Ministry of Transportation, Ministry of Interior, Ministry of Public Works and the Ministry of Local Government in the IFMIS at the time a commitment is made.*

Policy Area III: Facilitating the Land Registration Process

53. Private sector growth, in particular its tradable side, has been severely constrained. Private investment has averaged around 15 percent of GDP over the past seven years, as compared with rates of over 25 percent in fast-growing middle income economies, and Foreign Direct Investment (FDI) has averaged a mere 1 percent of GDP, which is also very low in comparison to most fast growing economies. Much of this investment is channeled into internal trade and real estate development. With low level of investment and relatively sluggish growth, unemployment rates have remained very high in the Palestinian territories. While internal Palestinian political divisions have contributed to investor aversion, Bank studies have confirmed that Israeli restrictions on trade, movement and access are the binding constraints to investment.

54. Nevertheless, there is substantial room for the PA to improve some aspects of the Palestinian business environment and the government has recently made some progress in this direction. Despite significant improvement in some areas over the past year, the 2015 Doing Business Report shows that several aspects of the Palestinian business environment do not compare favorably with other countries at a similar level of income. Although the aspects of the Palestinian business environment which are assessed in the Doing Business report may currently not be the binding constraint to investment, the removal of those constraints would prepare the Palestinian economy for sustainable growth once the other constraints—primarily movement and access restrictions and political risks—are removed or ameliorated. Several actions have been taken in the past two years to improve the business environment, including enacting a new Leasing Law, an action that was supported by DPG VI.

55. Property registration has been identified as a significant obstacle to doing business in the Palestinian territories. The 2015 Doing Business Report ranks West Bank and Gaza at 99 on property registration out of 189 countries. An issue specific to land registration in the Palestinian territories is that only 30 percent of all land in the West Bank is registered with a clear title. Feedback received informally from property owners, refers to the relatively high cost of registration (in particular, a fee for issuance of a certificate of ownership title) as a main obstacle to registration and a discouragement for landowners to pick up their titles. Consequently, it is estimated that only about 6 percent of first time landowners pick up their land titles. Not having a land title has several negative consequences. For instance, it not only hinders the functioning of the land market, but also prevents the use of land titles for collateral, which reduces access to finance.[25] Furthermore, the absence of land titles hinders government efforts to collect property taxes, and thus deprives local governments from a significant source of potential revenues.

56. This operation supports an action taken recently by the PA to reduce the cost of land registration. Namely, to encourage land registration and more specifically to encourage first time land buyers to register land titles following land purchase, the PA has decided to waive the first time land registration fee. As a general trend, systematic land registration and the issuance of a title certificate to its rightful owner should be free of charge for landowners, and international experience has shown that fees are clearly a barrier to first time registration. The World Bank experience demonstrates that most successful large scale systematic registration projects waive fees for issuance of the title certificate and a few such projects charge a nominal fee. Previously, the Palestinian Land Authority (PLA) required the payment of 1 percent of the property value as assessed during settlement.

Prior Action Supported by the Operation

- *Action 8: The Cabinet of Ministers has approved a waiver for land titling registration fees and charges for first time land purchasers.*

Expected Result

- *The number of land titles picked up in 2016 in the pilot area (monitored through data obtained from the PLA) is at least 100 percent higher than it was in October 2015 (i.e. at least 376 land titles have been picked up by December 31, 2016).*

[25] The PA is ranked 116th on the access to credit criteria in the 2015 Doing Business Report. It has a zero score on the strength of legal rights index, which, among other things, measures legal firmness of collateral.

Table 3: Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
I.1 Improve Public Revenue Performance	
Action 1: The Council of Ministers has agreed upon and referred the draft amendments to the Income Tax Law to the President for issuance in order to improve income tax collection by allowing income tax payment violations to be settled through the Recipient's execution court system.	The analysis carried out by the Palestinian Authority in the context of its recently adopted Revenue Strategy clearly shows that the legal instrument to collect tax debts is weak and that the tax collection process is slow and ineffective.
Action 2: The Ministry of Finance has issued an instruction to merge its existing value-added tax collection department and the income tax collection department into a single collection department to improve operational efficiency.	The PA's Revenue strategy shows clear benefits of merging the collection departments for VAT and income tax.
I.2 Improve Sustainability of Public Expenditures	
Action 3: The Palestinian Energy and Natural Resources Authority has entered into and commenced the implementation of the memoranda of understanding with at least two (2) electricity distribution companies and at least one (1) municipality in order to coordinate and facilitate the payment of electricity bills to the Israel Electric Corporation by electricity distribution companies and municipalities.	In 2014, the Bank finalized an analytical report on net lending. The issue of net lending was also analyzed in the intergovernmental fiscal relations chapter of the recently completed Public Expenditure Review (still not published). These studies have shown that one of the main causes for net lending is the fact that local governments divert electricity revenues to finance broad expenditures in their budgets. Consequently, the PA's reform efforts, which were previously mainly focused on improving utility bill collection and reducing technical losses have been expanded to also tackle the revenue diversion issue by local governments.
Action 4: The Ministry of Health has entered into and commenced the implementation of the memoranda of understanding with at least three (3) Israeli hospitals to facilitate the health referral process between the Ministry of Health and Israeli hospitals. *Action 5:* The Minster of Health has issued an instruction mandating the health referral committees within the Ministry of Health to use a new Referral Manual for patient referrals outside the public health system.	These actions are underpinned by the analytical work conducted by the World Bank (including the recent PER and technical assistance on referrals), as well as the work of USAID, which has been providing technical assistance to the PA to reduce inefficiencies related to health referrals. The analytical work clearly showed that (1) weak contracting practices with external health service providers lead to inflation of referral costs (addressed through prior action #5) and (2) that the absence of clear criteria for referral decision making also contributes to the inflation of health referral costs.
II. Improve Transparency of Public Finances	
Action 6: The Ministry of Finance has issued an instruction mandating its relevant units to produce yearly reports that include information on: (i) the amount of transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; (b) the amount of service fees charged by the Ministry of Finance and Planning and deducted from the transportation taxes collected on behalf of each local government unit; (c) the amount of any other deductions or intercepts on transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; and (d) the amount of transportation taxes transferred by the Ministry of Finance and Planning to each local government unit. *Action 7:* The Ministry of Finance and Planning has issued an instruction mandating the ministries responsible for health, transportation, interior, public works and local government to implement a Commitment Recording System.	Analytical underpinnings for prior action #6 are found in the recently produced note on intergovernmental fiscal relations, which documents the lack of transparency in certain aspects of intergovernmental fiscal relations, but the extent to which the absence of this data represents a problem for fiscal planning and building trust between the local governments and the Palestinian Authority became obvious through the Local Government and Services Improvement Program-for-Results. As for prior action #7, the 2014 Public Expenditure and Financial Accountability (PEFA) report has identified weaknesses related to commitment recording and control. The Bank's technical assistance on arrears has also identified the absence of a solid commitment recording system as a weakness that among other causes contributes to the accumulation of arrears and hinders the MoF's cash planning efforts.
III. Facilitate the Land Registration Process	
Action 8: The Cabinet of Ministers has approved a waiver for land titling registration fees and charges for first time land purchasers.	The analytical underpinnings for this prior action are based on extensive international experience, which has shown that fees are clearly a barrier to first time registration. The waiver of fees is the only way to have a comprehensive and inclusive process. Otherwise, there will necessarily be people who cannot afford the cost of the registration and therefore, the process cannot be considered as being systematic. Specifically, these findings are corroborated in the analysis carried out related to the economic impact of 13 World Bank-financed land administration projects implemented in the Europe and Central Asia Region between 1997 and 2012.

4.3 LINK TO ASSISTANCE STRATEGY, OTHER BANK OPERATIONS AND THE WBG STRATEGY

57. **This operation is aligned with the World Bank Group's strategic goals of ending extreme poverty and enhancing shared prosperity in a sustainable manner, as well as with the new MENA Strategy.** This operation will contribute to the strategic goals by supporting reforms aimed at improving governance in the public sector by reducing tax avoidance and broadening the tax base, addressing issues that constrain efficient and effective uses of public finances in providing essential citizen services. Fiscal sustainability, efficient and transparent management of public finances should also contribute, along with specific regulatory reforms to improved business climate, to private sector growth and sustainable job creation.

58. **This operation is fully in line with the new MENA Strategy**. The prior actions supported by this operation will contribute to a fairer tax collection system that is based on the rule of law; the prior actions aimed at reducing the cost of health referrals and net lending will reduce important sources of expenditure inefficiencies in order to render public health and electricity provision systems sustainable and viable, and to make public finances more resilient to external shocks; the prior actions aimed at strengthening the PFM systems will further improve the transparency of public finances not only to provide the tool for better fiscal management and trust-building between local and central governments, but also improve the tools to hold the authorities accountable for the management of public finances; the prior actions aimed at facilitating land registration should contribute to private sector growth. Thus, all of these actions aim to contribute to a new social contract, one that creates private-sector jobs and improves public services while strengthening citizens' ability to hold the state to account. Moreover, resilience in the context of the West Bank and Gaza primarily means resilience to externally imposed growth and fiscal shocks (e.g., clearance revenue suspension flows). Efforts to strengthen the PA's fiscal position through revenue and expenditure reforms are essential for strengthening resilience to external shocks and for the ability to provide quality public services.

59. **This operation had been envisaged as one of the core operations under the Bank's Assistance Strategy for the West Bank and Gaza and designed to support both of its objective pillars**. This operation has been designed to support the Assistance Strategy FY15-16 for the West Bank and Gaza. The strategy, in turn, was designed to support the implementation of the PA's NDP in areas where the Bank has a competitive advantage over other donors. The operation was designed to directly support the achievement of both strategy pillar 1 outcomes: 1.1 Improved fiscal management with a focus on health and electricity sectors; 1.2 Increased transparency and accountability in service delivery. In addition, this DPG ventures into the second pillar of the strategy, which supports the creation of an enabling environment for private sector led growth by supporting the government's efforts to facilitate land registration. The preparation of this operation has taken into account lessons from the Implementation Completion and Results Report (ICR) for earlier DPGs (see Box 2). Furthermore, it is noteworthy that the DPG leverages four to five times its amount of budget support through the Bank-administered PRDP Multi-donor Trust Fund. Australia, France, Japan, Kuwait, Norway, and UK are currently active donors to this trust fund that supports the same policy areas identified in the DPGs. This significantly augments the DPGs' leverage in supporting the achievement of the objectives pursued by the Bank's strategy.

60. **The operation is directly linked to several TFGWB-financed projects and can indirectly benefit most of them.** The operation, for instance, supports the Utilities Management

Project, the Health System Resiliency Strengthening project, and the energy sector project currently under preparation.

61. **The Bank continues to administer the PRDP-TF, through which donors provide budget support based on the Bank's monitoring of the PA's progress in implementing the NDP reform program**. The PRDP-TF provides a key mechanism for donor coordination in support of implementing the PA's NDP. Collaboration with other donors, especially through the Trust Fund, helps focus the dialogue with the authorities on key issues considered critical for reform. This collaboration provides significant weight to common points in the reform agenda and therefore should be maintained and enhanced.

Box 2: Summary of Previous ICR Lessons

Since the establishment of the Trust Fund for Gaza and West Bank (TFGWB) in 1993, a wide range of lessons have been learned, enabling largely successful Bank engagement in a fragile political and security environment. The Bank has remained active in the Palestinian territories since 1993 and this operation is the seventh DPG since 2008. The preparation of this operation benefited from lessons learned in the ICRs for previous DPGs and the lessons of implementation experience drawn in the Interim Strategy Note (ISN) 2012-2014. Several important lessons have been drawn from the ICR for DPG V and earlier DPG ICRs. Below is the summary of some of the main ICR lessons:

- *Even in an environment of high risk, DPGs can be successful if the design adequately takes into account the risks and ensures government ownership of the reform program.* Client commitment to the program is a key for success under difficult circumstances. DPG IV was firmly embedded in the government's own medium-term economic program, which is the main reason the operation was relatively successful in achieving its intended development objectives, despite a challenging operating environment. Furthermore, the operation was designed with another important objective in mind: to provide indispensable financial assistance to ensure the provision of essential public services.
- *Even standalone operations can and should be designed with a medium-term agenda in mind*. While it would probably not be appropriate to design a programmatic DPG series given the high level of uncertainty in the Palestinian territories, this operation was designed with some medium-term objectives in mind and was used as a platform to support dialogue on the medium-term program and a tool to prepare a follow up operation. However, due to a rapidly-changing operating environment which can cause a drastic shift in priorities, it would be unrealistic for the Bank to commit to a medium-term program.
- *Political economy analysis of potentially controversial reforms should be carried out to minimize the likelihood of slippage.*
- *Technical challenges of implementing specific reforms ought to be taken into account in operation design.*

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

62. **The operation follows the PA's NDP and, as discussed in section 3 above, the PA has held wide consultations during the preparation of its new NDP.** The feedback received during the consultation process shaped the design of the NDP.

63. As noted above, the government has consulted various stakeholders in the process of drafting the NDP (see paragraph 38). During the preparation of this operation, the Bank has held consultations with the IMF as well as with all donors who provide financial support to the PA's budget and will continue to do so. As they have done with earlier DPGs, PRDP TF donors are expected to continue to rely on the DPG VII policy and results matrix as the sole criteria to evaluate the PA's performance in implementing the NDP for the purpose of quarterly disbursements under the PRDP TF. This has proven to be an efficient and effective way to leverage donor budget support around important structural reforms. Thus, the importance of the DPG program goes significantly above and beyond the operation itself. Furthermore, the Bank holds close consultation with the European Union, which provides the largest single contribution to the Palestinian budget through its direct financial support mechanism - PEGASE. After close consultations with the PA and donor partners operating in West Bank and Gaza, including the World Bank, and in the context of its budget support operation, the EU has developed an instrument to monitor progress against a set of institutional and policy reforms. The EU's budget support is not directly conditional on the implementation of these reforms, but the reform progress is expected to affect the level of budget support contributions from the EU.

64. A more formal aid coordination mechanism in the Palestinian territories was set up following a decision made at the December 14, 2005 meeting in London of the Ad Hoc Liaison Committee (AHLC). The aim behind this mechanism is to improve the effectiveness of aid coordination structures in providing coherent technical assistance and financial support based on national priorities to the Palestinian people in line with the OECD-DAC Paris Declaration on Aid Effectiveness. [26] At the local level, the donor coordination structure comprises the Local Development Forum, in addition to four strategy groups, each one supported by roughly five sector working groups.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

65. The prior actions supported under this operation are not expected to have any negative impact on poor and vulnerable groups in the Palestinian territories. For instance, measures aimed at improving tax revenue collection will not increase tax rates (rates were recently decreased) or increase the tax liability of the poor and vulnerable groups. They are aimed at improving the collection efficiency and reducing tax evasion by private enterprises and wealthier individuals.[27]

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[26] The AHLC is chaired by Norway and brings together in a meeting on a semi-annual basis several donors, as well as the PA and the Government of Israel. The Bank acts as the Secretariat to the AHLC, submitting a report prior to every meeting that provides an update on recent economic and fiscal trends, as well as on broader economic and institutional developments in the Palestinian territories. The Bank's report has often helped to set the agenda and frame the discussion at the AHLC meeting.

[27] Individuals with gross taxable annual income of less than NIS50,000, which is significantly above the household poverty line (NIS27,516) are within the 5 percent tax bracket and with allowances pay a maximum of NIS1,000 of tax.

66. Measures aimed at containing government expenditures and improving their efficiency will not cut any benefits to the poor. In fact, in its 2015 budget, the PA has increased the number of beneficiaries in its means tested cash transfer program. Likewise, the goal of other measures is to eliminate waste and financial leakages outside of the Palestinian economy (e.g., through payments for referral to other countries or payment of penalties to the GoI for outstanding electricity bills). Efforts aimed at reducing net lending will contribute to improved sustainability of the PA's finances and should ultimately augment the fiscal space for poverty reducing social and development spending. The efforts do not include plans to increase the electricity tariff, and currently there is a lifeline tariff that enables the most vulnerable segments of the Palestinian population to pay a significantly lower electricity tariff from that paid by other segments of the Palestinian population. Furthermore, the effort to reform the health referral system is not expected to have a negative social and poverty impact, as it aims not to deny any health services to the poorer segments of the Palestinian population, but to lower the cost of certain health services through more efficient contracting with external healthcare providers, as well as to render the referral process substantially more rule-based in order to ensure equal access to health referral services for all segments of the Palestinian population.

67. Over the medium term, the reforms supported by this operation are expected to translate into augmented fiscal space for essential poverty-reducing programs and improved prospects for employment opportunities in the private sector, which is particularly important for women and youth. As demonstrated in the recently finalized PER, measures aimed at increasing government revenues combined with measures to reduce inefficiencies in public expenditures will increase the fiscal space for essential poverty-reducing expenditure programs. Improved fiscal management is also an important requirement for economic growth and job creation and so is cheaper land registration and a better functioning land market. This would have a positive poverty and social impact, in particular on women and youth, whose participation in the labor market is currently low. The PA is giving particular emphasis to the creation of employment opportunities for these two social groups in its 2014-2016 NDP. Other PFM reforms supported by this operation are aimed at strengthening public finance management practices, which would strengthen accountability of public officials, increase efficiency and efficacy of public expenditures, all of which are important determinants of economic growth and development.

5.2 ENVIRONMENTAL ASPECTS

68. This operation will not have significant effects on the country's environment, forests and other natural resources. The environmental and natural resource implications are driven by the activities embedded in the design of an operation. None of the prior actions will have environmental impacts or risks.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

Fiduciary Aspects

69. The PA's Public Financial Management (PFM) system is considered adequate for the purpose of budget support operations, but weaknesses remain. In general, the system enables budget preparation, execution (including payment verification controls), and reporting. For example, an IFMIS that supports budget preparation and execution has been in place since 2009. It has also been fully rolled out to line ministries and is considered the official system to account for public financial resources. Also, all tax revenue is paid directly into a Treasury Single Account (TSA) and most operational payments and transfers are executed by line ministries in a devolved Treasury model, using the IFMIS. A key component in the MoF internal control framework is the function of the financial controller who is required to review and clear all transactions before they are processed for payment. An Internal Audit Department (IAD) was set up in 2004 with the dual mandate of performing the MoF internal audit and decentralizing the internal audit function to line ministries. In reality, however, the internal audit function is not yet fully operational nor decentralized due to capacity and financing constraints. The State Audit and Administrative Control Bureau (SAACB) was established in 2004 as the main body responsible for independent oversight and external audit over public sector bodies. The SAACB has made important improvements in its audit performance over the last few years and the newly adopted audit methodology is largely compliant with international standards. There are significant weaknesses related to delays in the production and audit of the 2011 annual accounts[28], as well as a lack of timeliness in preparing the 2012, 2013, and 2014 financial statements.

70. Therefore, the fiduciary risk related to the DPG and the proposed financing is considered to be High. To mitigate this risk, the Bank has engaged with the MoF in strengthening accounting and financial reporting in line with the government PFM strategy.

- Firstly, the Bank has conducted several Technical Assistance (TA) missions to the General Accounting Department at the MoF aimed at strengthening accountability of the PFM system in relation with continued budget support. Those missions focused on developing a framework for creating commitment control recording and control procedures, improving the cash planning, and controlling the generation of arrears. Also, the Bank has assisted in developing an accounting handbook which is in line with the International Public Sector Accounting Standards- cash basis (IPSAS). This handbook is expected to empower the MoF to: (i) make the line ministries implement the correct accounting procedures, as they are primarily responsible for accounting data entry into the IFMIS as part of a decentralized budget implementation system; (ii) enhance the quality and timeliness of the accounting and reporting data by establishing a quality control process in the duty of producing the main reporting and accounting documents; and (iii) develop accounting training and capacity building in order to ensure a sustainable framework for financial accountability.

- Secondly, other donors (primarily DfID, and the EU) have engaged the government on a series of activities to strengthen the credibility, reliability and accountability of the PFM system. The DfID focused on building up a *top-down* budget preparation approach consistent with setting up a multi-year fiscal framework (MTFF) and developing an overarching budget preparation procedure that could reflect realistic forecast of budget support pledged by the donors, in particular the main bilateral contributors; and (ii) EU focused on providing technical support to the SAACB in order to enhance its capacity in auditing the financial statements of the Palestinian Authority.

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[28] The 2011 accounts were issued by the MoF and sent for audit to the State Audit and Administrative Control Bureau (SAACB) at the end of the first half of 2015. At the time of preparation of this document, the audited statements were not yet issued. Thus the delay for issuing these accounts audited is near 4 years.

- Thirdly, the World Bank is monitoring the PA's revenues and uses of funds through the review and analysis of the monthly reports issued by MoF, which are made publicly available by the 15th of the following month. The Bank performs monthly analysis and review of these reports, any significant fluctuations in monthly reports are discussed with the MoF.

71. The expected outcomes of all these TA activities provided by the Bank and other donors are expected to eventually reduce the fiduciary risk, as long as the government takes effective decisions to expedite the issuance of the annual financial statements, resolve and clear disputed accounts balances, and ensure accountability of public officials. The Bank has discussed with the government the update of the 2013 (PEFA), and the government agreed to hold a workshop to introduce the latest updates in the PEFA methodology.

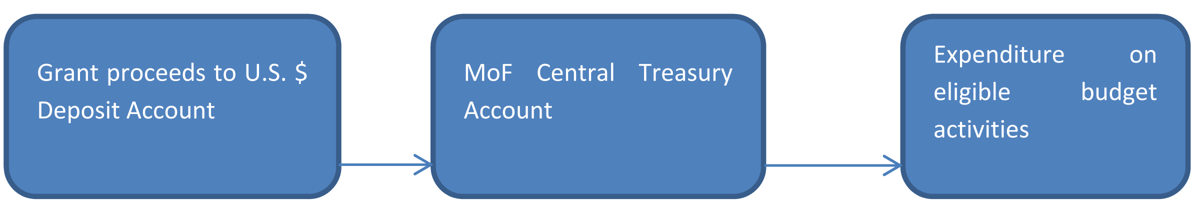
Flow of Funds and Auditing Requirements

72. The grant proceeds will be disbursed in a single tranche to a US Dollar Deposit Account that forms part of the PA's official foreign exchange reserves. The Deposit Account will be held at the Bank of Palestine (Ramallah), a public commercial bank.

73. The MoF will confirm to the Bank, within 15 days of disbursement, the receipt of the grant funds and that the grant proceeds have been credited to the Central Treasury Account to finance national budget expenditures, including the date and number of the Treasury Account in which the funds have been deposited as well as the exchange rate applied. A satisfactory confirmation letter for the disbursement under the previous DPG proceeds was timely submitted to the Bank by the MoF.

74. If any portion of the grant is used to finance ineligible expenditures as defined in the Grant Agreement, the Bank shall require the PA to refund the ineligible amount.

Flow of funds diagram



External Auditing of the Grant Deposit Account

75. The PA will hire an independent external auditor acceptable to the Bank to perform an audit of the Deposit Account. The audit will be conducted in accordance with International Standards on Auditing, by an auditor and with terms of reference acceptable to the Bank. The audit report will be approved by the MoF before it is submitted to the Bank. The audit report will be submitted to the Bank not later than six months after the withdrawal of the grant proceeds. For the previous DPG supplemental financing release to the Deposit Account, the MoF submitted acceptable audited financial statements in a timely manner.

76. The auditor will be required to:

- Validate the transfer and deposit transactions into the Deposit Account relating to the DPG proceeds;
- Verify the extent to which the Bank's requirements under the Grant Agreement are met, and whether the PA's procedures are adequate to achieve this result;
- Verify that no funds are kept in or paid into the Deposit Account other than those disbursed by the Bank for this particular operation;
- Ensure that the MoF follows adequate disbursement procedures as per PA and governmental standards including accuracy of the exchange rate prevailing at the date of conversion from US Dollar to New Israeli Shekel, and deposit to the Central Treasury Account within one week of the receipt of funds in the Deposit Account.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

77. The design of the monitoring and evaluation arrangements were built upon those developed under the earlier development policy grants. The results framework of the DPG was agreed with the authorities and developed in consultation with other development partners. As has been the practice, the results framework was developed not only to monitor progress under the DPG, but also to monitor the implementation of the Multi-Donor Trust Fund (a major source for donor funding to the budget) aligned to the NDP. Since both the DPG and the PRDP TF support the implementation of selected key objectives of the PA's strategy and aim to provide stable and predictable financial support to the PA budget, a shared results framework for both has provided additional leverage to reform implementation. The indicators used are direct measures of development objectives, the data is collected by the statistics agency and finance and line ministries, and enjoys full ownership across the government.

78. The monitoring arrangements have been institutionalized in the Palestinian Ministry of Finance. Based on the inputs from line ministries and other government agencies, the PA prepares quarterly reports on a regular basis to monitor the performance under both the DPG and the PRDP/NDP MDTF. The same arrangement is utilized to monitor progress against the PA's medium-term program. These reports are placed on the website of the MoF. The monitoring arrangements developed in the context of DPGs and PRDP TF have not only been used for the purposes of those operations, but there is evidence that these arrangements have contributed to building stronger institutional arrangements for monitoring PA's broader reform efforts.

79. Grievance Redress. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond.

80. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS

81. *The political and security situation in the West Bank and Gaza is very fragile,* as demonstrated by the 2014 outbreak of conflict in Gaza. The recent social unrest and civil service strikes also attest to the fragility of the political situation. The highly volatile political situation could deteriorate, with the consequence of stalled reforms. If the security situation relapses, private sector confidence and investment will decline, public revenues will fall, and government reforms may stall. The PA is not likely to be able to meet its medium-term fiscal goals without substantial economic growth. However, under the recent political uncertainties, the broad relaxation of movement and access restrictions imposed by the GoI in both Gaza and West Bank and restrictions on economic activity in Area C have slowed down. The international donor community is continuing to monitor the various restrictions on economic activity and their economic impact. What is critical at this juncture is that the PA has continued to implement structural reforms despite the highly difficult economic environment and fiscal pressures and remains committed to continued reforms.

82. *The macroeconomic risk is also high.* The outbreak of conflict in Gaza and most recently in the West Bank has remarkably affected the level of uncertainty, as well as business confidence. Also, the multilayered system of restrictions on movement, access and trade implemented by the GoI presents an ongoing binding constraint to private sector investment and economic growth. On the fiscal side, risks relate to the persistently high fiscal deficit financed mostly through donor grants that have been relatively unpredictable and on a declining path since 2008. Also, repeated suspensions of tax revenue payments for taxes collected by the GoI on behalf of the PA and the PA's lack of control over public finances and economic management in Gaza significantly add to the risks.

83. *Possible reduction in the level and predictability of donor assistance poses significant risks to the sustainability of the PA's macroeconomic and fiscal framework.* While the PA has charted a course toward lesser dependence on external aid and is actively undertaking the relevant reforms, it will take many years for the PA to achieve fiscal sustainability and that will only be possible if there is a political settlement that allows for strong private sector-led growth. Thus, a further reduction in the overall level of donor assistance or lack of its predictability is a significant source of risk to the PA's finances and the Palestinian economy as a whole.

84. *The fiduciary risks are also high, as discussed above.* In general, the PFM system enables budget preparation, execution and reporting, but weaknesses remain and materialize through significant delays in the issuance of the audited annual accounts mainly due to the lack of timely preparation of the financial statements by the MoF. To mitigate the risks, the Bank has assisted in developing an accounting handbook in line with the International Public Sector Accounting

Standards and is providing training and other technical assistance to help the PA follow the guidelines set in the accounting handbook. These efforts are expected to accelerate the preparation of financial statements and improve their quality. Currently, the Bank performs regular analysis of the PA's revenues and use of funds through reviewing the monthly reports issued by the MoF on its website. In addition, the Bank has worked with the MoF to strengthen accounting and reporting procedures according to the PA's PFM strategy. For instance, the Bank has conducted several technical assistance missions to the General Accounting Department focused on developing a framework for creating commitment control recording and control procedures, improving cash planning and controlling arrear generation. Other donors have also engaged with the PA on a series of activities aimed at strengthening its PFM systems.

85. *Finally, due to a high degree of fragility and ensuing political uncertainty, the risks to sustainability of sector strategies are rated as substantial.* Political instability may undermine the implementation of sector strategies. This risk is mitigated by the selection of prior actions, which have already been implemented and for which there appears to be a broad consensus.

86. The operation has been designed to minimize the likelihood and the potential impact of some of the abovementioned risks. This proposed seventh DPG sends a strong signal that the World Bank places great importance on progress in implementing the NDP and that it needs continued donor support. Most importantly, the operation leverages around USD200 million per year through the PRDP Trust Fund, which the Bank administers. This is particularly important since a reduction in donor aid has been identified as one of the important risks to the success of the operation. The IMF has joined the Bank in urging donors to augment their assistance to the PA. Another mitigating factor is related to the fact that the program supported by the operation has a simple design focused primarily on actions that have already been implemented or whose implementation is well underway. Moreover, the PA has strong ownership of this program which contributes to fiscal consolidation, and this is a mitigating factor for the risk related to sustainability of sector strategies and policies. On balance, the potential benefits of the operation justify the Bank's engagement despite the significant risks identified above.

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	H
2. Macroeconomic	H
3. Sector strategies and policies	S
4. Technical design of project or program	M
5. Institutional capacity for implementation and Sustainability	M
6. Fiduciary	H
7. Environment and Social	L
8. Stakeholders	M
Overall	H

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions	Results Indicators	Baseline	Target
Pillar I: (I.1) Improving Public Revenue Performance; (I.2) Improving Sustainability of Public Expenditures			
Prior action 1: *The Council of Ministers has agreed upon and referred the draft amendments to the Income Tax Law to the President for issuance in order to improve income tax collection by allowing income tax payment violations to be settled through the Recipient's execution court system.* ***Prior action 2:*** The Ministry of Finance has issued an instruction to merge its existing value-added tax collection department and the income tax collection department into a single collection department to improve operational efficiency.	The stock of income tax debt estimated based upon official income tax filings that have been verified through MoF audits.	The stock of income tax debt estimated based upon official income tax filings that have been verified through MoF audits in October 2015 amounted to NIS100 million.	The stock of income tax debt estimated based upon official income tax filings that have been verified through MoF audits is 15 percent lower in 2016 than it was in October 2015.
Prior action 3: The Palestinian Energy and Natural Resources Authority has entered into and commenced the implementation of the memoranda of understanding with at least two (2) electricity distribution companies and at least one (1) municipality in order to coordinate and facilitate the payment of electricity bills to the Israel Electric Corporation by	The ratio of annual wholesale electricity bill payments to the Israel Electric Corporation made by —JDECO, NEDCO, SELCO, HEPCO and TEDCO electricity distribution companies to amount collected by these DISCOs from end customers.	The ratio of annual wholesale electricity bill payments to the Israel Electric Corporation made by —JDECO, NEDCO, SELCO, HEPCO and TEDCO electricity distribution companies to amount collected by these DISCOs from end customers was equal to 65 percent in 2014	The ratio of annual wholesale electricity bill payments to the Israel Electric Corporation made by JDECO, NEDCO, SELCO, HEPCO and TEDCO electricity distribution companies to amount collected by these DISCOs from end customers in the West Bank amounts to at least 80 percent in 2016.

electricity distribution companies and municipalities. ***Prior action 4:*** The Ministry of Health has entered into and commenced the implementation of the memoranda of understanding with at least three (3) Israeli hospitals to facilitate the health referral process between the Ministry of Health and Israeli hospitals. ***Prior action 5:*** The Minster of Health has issued an instruction mandating the health referral committees within the Ministry of Health to use a new Referral Manual for patient referrals outside the public health system.	The cost of health referrals to health service providers outside of the Palestinian public healthcare system as a percentage of GDP.	The cost of health referrals to health service providers outside of the Palestinian public healthcare system was NIS569.6 million in 2014 (1.2 percent of GDP)	The cost of health referrals to health service providers outside of the Palestinian public healthcare system is lower than 1.2 percent of GDP in 2016

Pillar II: Improving Transparency of Public Finances			
Prior action 6: The Ministry of Finance has issued an instruction mandating its relevant units to produce yearly reports that include information on: (i) the amount of transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; (b) the amount of service fees charged by the Ministry of Finance and Planning and deducted from the transportation taxes collected on behalf of each local government unit; (c) the amount of any other deductions or intercepts on transportation taxes collected by the Ministry of Finance and Planning on behalf of each local government unit; and (d) the amount of transportation taxes transferred by the Ministry of Finance and Planning to each local government unit.	Information on the amount of transportation tax collected by the PA on behalf of municipalities.	No information on the amount of transportation tax collected by the MoF on behalf of municipalities is available online (August 2014)	Annual information is available online on the amount of: 1) the transportation tax collected by the MoF on behalf of each LGU; 2) the service fees charged; 3) any deductions/intercepts for each LGU specifically; and 4) the transportation tax paid to each LGU in the first quarter of 2016
Prior action 7: The Ministry of Finance and Planning has issued an instruction mandating the ministries responsible for health, transportation, interior, public works and local government to implement a Commitment Recording System.	Information on commitments in the pipeline in the Integrated Financial Management System (IFMIS) by the Ministry of Health, Ministry of Transportation, Ministry of Interior, Ministry of Public Works and the Ministry of Local Government.	Information on commitments in the pipeline is not available by the Ministry of Health, Ministry of Transportation, Ministry of Interior, Ministry of Public Works and the Ministry of Local Government (October 2015)	Starting January 2016, access to information on commitments in the pipeline is provided by the Ministry of Health, Ministry of Transportation, Ministry of Interior, Ministry of Public Works and the Ministry of Local Government in the IFMIS at the time a commitment is made.

Pillar III: Facilitating the Land Registration Process			
Prior action 8*:* The Cabinet of Ministers has approved a waiver for land titling registration fees and charges for first time land purchasers.	The number of land titles picked up out of 5,000 issued in the pilot area (monitored through the land registration project).	188 land titles out of 5,000 issued have been picked up in the pilot area (monitored through information collected from the PLA) up until October 2015	The number of land titles picked up in 2016 in the pilot area (monitored through the land registration project) is at least 100 percent higher than what it was in October 2015 (i.e. at least 376 land titles have been picked up by December 31, 2016).

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Palestinian National Authority
Ministry of Finance and Planning
Office of the Minister

السلطة الوطنية الفلسطينية
وزارة المالية والتخطيط
مكتب الوزير

No. : ..MoF/I.D.A/2246/2015

Date :..1/12/2015...................

الرقم : ....

التاريخ : ....

Dr. Jim Yong Kim
President
International Development Association
1818 H street N.W
Washington, D C. 20433

Subject: LETTER OF DEVELOPMENT POLICY

Dear President Kim,
Over the past decade, the Palestinian National Authority (PNA) has experienced progress in capacity building, economic development, and improvement in living conditions and security in the West Bank. Growth and prosperity, however, were fast-fleeting, and the West Bank and Gaza are witnessing continued decline in economic activity, since 2013. This decline in growth is mostly attributed to the continued and significant drop in donor support, combined with the unilateral dynamics of our relationship with Israel, where continued Israeli restrictions on trade, access and movement stifle the Palestinian potential for growth. These restrictions, particularly on "dual use" imports", have undermined private sector investment in productive capacity. Gross investment in machinery and equipment only amounted to 4% of GDP in 2014, barely sufficient for capital depreciation.

As a result of these factors, in addition to the latest attack on Gaza, which had devastating economic and fiscal impacts, the Palestinian economy continues to be in decline. Economic recovery in Gaza has been slow due to declining donor support and strict constraints on imports of construction material production inputs, constraining the much-needed investments for Gaza reconstruction efforts. Gaza exports in 2015 are only 6% of what they were in 2005.

Despite the ongoing challenges, the PNA has been working with local, national, and international partners to support the relief and reconstruction efforts of Gaza. The Government's 'National Early Recovery and Reconstruction Plan for, Gaza 2014-2016 (NERRP), which was presented at the donors' conference in Cairo on October 12, 2014, raised approximately USD 5 billion in donor pledges from the International community with approximately USD 2.8 billion earmarked for Gaza recovery and reconstruction. However, of the pledges dedicated to Gaza only $ 1.1 billion has been received so far.
Supporting the Palestinian private sector is essential to trigger a rebound in economic growth. This requires the removal of Israeli restrictions on access and movement, including access to land and natural resources in "Area C", which will enable us to benefit from its vast economic potential. Your staff has produced a remarkable study on potential benefits from development of area C .
Sustaining economic growth also requires lifting the blockade on Gaza and allowing movement of goods between Gaza and West Bank. Additionally, it is essential to restore full trade linkages between the West Bank and East Jerusalem and to allow for the development of East Jerusalem institutions and businesses.

Ramallah Tel: 00970-2-2978846/7/8 Fax: 00970-2-2978845 P.O. Box 795 Ramallah E-mail: minister@pmof.ps

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Ministry of Finance and Planning
Office of the Minister

السـلطة الوطنيـة الفلسـطينية
وزارة الماليــة والتخطيط
مكـتب الـوزيـر

No. : .... الرقـم : ....

Date : .... التاريخ : ....

Public Finance 2015

The first four months of the year were underscored by fiscal and economic challenges following the withholding of Palestinian clearance revenue (70 percent of total revenue) for five consecutive months (December 2014 through April 2015). The Palestinian Government was forced to make-do with only 30 percent of its revenues, obligating it to operate at only 50 percent of last year's operational expenditures, and paying only 60 percent of public employee wages.

In spite of these challenges, public service delivery was well maintained and the PNA's revenue mobilization strategy was launched in various West Bank cities. These efforts began to yield benefits during the second half of the year, where revenue performance and expenditure restraint exceeded both budget projections, and previous year performance. Gross revenues increased by 8.6% in Jan-Aug 2015 relative to Jan-Aug 2015, and exceeded its budget target by 7%. Expenditure restraint limited the growth of the wage bill—the largest expenditure item—to 2% during the January-August 2015 period. As a result of this achievement, the recurrent deficit fell by 3% during the same period compared to 2014, and fell below its 8-month budget target by 6%.

Ministry of Finance (MoF) projections indicate that gross revenues will outperform its 2015 budget target at the end of year by approximately 6%. Expenditures are expected to outgrow their budget target by a slight 2%, only due to one-off deductions by the Israeli government from clearance revenue to reduce the PNA debt to the Israeli electricity company(IEC), which raised the "net lending" expenditure item. Wage and non-wage expenditure projections for the full year are both expected to perform below budget targets. The combined efforts of revenue enhancement on the one hand, and expenditure control on the other, resulted in a better fiscal consolidation than budgeted, with the recurrent deficit expected to fall by 4.5% below budget targets. Fiscal policies on both the revenue and expenditure fronts include:

A. Revenues:
Against the backdrop of a decline in the rate of economic growth in the West Bank to 1.5% and a decline in inflation below 2%--both of which would tend to reduce revenues, gross revenues exceeded those of 2014, within the first eight months of 2015 and also exceeded their budget target. They amounted to NIS 7.85 billion in Jan-Aug 2015 whereas actual collections in Jan-July 2014 amounted to NIS 7.23billion, and the eight-month budget target was NIS 7.37billion. Similarly, total net revenues also outperformed last year's performance, and this year's budget target.
Progress in revenue performance was made as part of a long-term strategy for the modernization of revenue administration. The PNA began to implement a three-year Revenue Action Plan (RAP), which 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. Domestic tax revenues emerged as the best performing revenue base, increasing by 11.2% during the first eight months of 2015, when compared to performance during the same period in 2014.

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The results of these efforts have been tangible on a number of fronts:

(1) Amendments to the investment promotion law have been adopted by the cabinet, reducing tax incentives for new investments, limiting them to fewer sectors and limiting their duration.

(2) Raising tax awareness has been a priority, and MoF aims to continue to highlight the important of tax compliance to taxpayers. MoF was able to widen the tax base significantly. In 2012, the number of registered taxpayers stood at 151,212 by July 2015, this number was raised to 172,896 and is projected to further grow to 179,431 by the end of the year. This is an increase of 28,219 in the number of registrations in just 3 years.

(3) Field campaigns by MoF officials have been very diligent and have enhanced tax collection, as reflected in revenue and tax base expansion figures. Similar campaigns are done by custom officials to enforce tax payments by importers and avoid tax evasion.

(4) On the clearance revenue side, better information and data sharing through regular meetings with Israeli MoF officials, have enhanced cooperation and allows the PNA to better follow-up and control the clearing mechanism. Clearance revenue increased by 8.3% during the first eight months of 2015, compared to the same period of 2014, despite lower economic growth and lower inflation.

(5) On November 30, 2015, the Palestinian Cabinet adopted amendments to the income tax law allowing tax dues to be collected through the execution departments that are affiliated with the Court of First Degree. Prior to these amendments and according to the domanial property law, these debts were to be collected through the institution of the Administrative Governor and a collection committee, which never existed. Consequently, efforts to collect tax debt have been extremely time consuming and unsuccessful. The new amendments will facilitate the collection of tax dues because they enable the Director of the tax department, or any person authorised on his/her behalf, to request from the execution court to use the tax notice produced by the tax department as an execution order and collect the tax dues through the execution departments.

B. Expenditures:

Total expenditures and net lending have reached NIS 10.2 billion during Jan-Aug 2015, a growth of 6.3% above the same period of 2014. However, given that the eight-month budget target for total expenditures and net lending is around NIS 10.05 billion, expenditures have only exceeded the budget target by close to 2%. This excess over the budget is mostly due to the unilateral one off deductions by Israel on electricity bills, specifically during the month of February where over NIS 230 million in deductions were made, partly to reduce the PNA debt to IEC. Wages and non-wage expenditures are performing well within the budget, and efforts on containing the wage bill and reducing net lending have been rigorous.

The Wage Bill:

We realize the wage bill is still quite high by international comparison and that further reduction is necessary to bring it to sustainability. This, however, cannot he accomplished quickly without having to incur undesirable social, poverty, and political impacts. For immediate action on the issue, the PNA has restated its commitment to the net zero hiring policy for 2015 with a wage bill not to exceed 3.8. Another cabinet decision was taken this year to reduce the number of staff hired on special contracts by 15%.

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Net Lending:

At the highest level of government, officials were determined to reduce the electricity subsidy (net lending) to municipalities and refugee camps. 40% of consumers are not paying their electricity bills. An Inter-Ministerial Committee, chaired by the Prime Minister is focusing on a number of approaches to increase collection efficiency of distribution companies and municipalities, increase the compliance for the payment of the electricity bill by the Distribution Companies (DISCO's) and Local Government Units (LGU's), and enhance the infrastructure and legal framework for the energy sector.

Additionally, as of early 2015, the DISCO's were committed to paying the total IEC electricity bill, and in some cases, partial payment of the previous debt in addition to the current IEC statement.

We are also working with the Israeli side synchronize the billing and improve its delivery, provide full details for the invoices and improve the timeliness of their flow, and deal with the outstanding debt to the IEC. In this respect we have submitted to the Israeli MoF a draft memorandum of understanding which contains proposals to restructure the debt and establish a repayment schedule.

Health Referrals:
The PNA is committed to improving the performance of the medical referral system and ensuring that all Palestinians have access to quality health care services without suffering financial hardship while paying for them. Therefore, it has allocated its efforts on strengthening institutional capacity of the Ministry of Health (MoH) through improving mechanisms for health planning, policy development and systematized monitoring and evaluation systems.

The MoH, supported by Ministry of Finance, managed to adopt a new referral manual and procedures to organize the referral system and established a clear set of referral criteria within the MoH to enhance efficiency. Efforts have also been made to verify and audit the invoices received by the Israeli hospitals and negotiate and sign MOU's with the Israeli hospitals to organize relations.

Due to these actions the number of health referrals in 2014-2015 has declined due to more controlled referral systems to Israel with a reduction in the number of unauthorized and unnecessary referrals. The cost of health was reduced from a peak of NIS189 million in Jan-June 2014 to NIS 132 million during the same period of 2015. This is a significant reduction of NIS 57 million. Capacity of the MoH team in verifying and checking the invoices have been also improved.
Fuel Subsidies:
Fuel subsidies have been declining since the beginning of 2014, and throughout the year 2015. As such, subsidies declined from a monthly peak of NIS 70 million in June 2013, to no more than NIS 25 million monthly by end 2014. Following this performance, spending on these subsidies have continued to decline throughout the first eight months of this year, reaching NIS 405 million a reduction of 14.8% compared to the previous year, due to a retail pricing policy in the West Bank and Gaza which reduces the gap between buying prices from Israel fuel companies (including full Israeli taxation) and selling prices.

This improvement was enforced by government decision and commitment to minimize fuel subsidies to sustainable levels and to eventually eliminate them and by a cabinet decision to reduce phone and fuel subsidies to public employees by 25%.

Pension reform:

This government inherited a $ 1.5 billion unfunded liability in the Pension Fund. We have been making a regular payment of NIS 10 million each month, rising to NIS 20 million per month in 2016 in an effort to stabilize the Pension Fund until substantial reform is initiated.

We envisage a comprehensive reform of the Pension Fund focusing on three key areas: administration, parametric changes and structural reforms. We plan to initiate these reforms in 2016.

C. The Budget Deficit and Donor Aid

Despite the strong commitment to the reform agenda to reduce the budget deficit and improve financial management, budget support has declined steadily from $ 1.23 billion in 2013 to $ 1 billion in 2014 and an estimated $ 800 million in 2015. The coming years will also be challenging in terms of external aid due to the changing political environment, economic uncertainty and redirection of aids towards the distressed countries in the Middle East.

To overcome this unpredictable and declining behavior of external budget support, the PNA had to resort over the past several years to private sector arrears accumulation, which crowds out the private sector, and borrowing from commercial banks up to their prudential limits. Because of this risk, and forced credit by the private sector the government has taken measures to reduce both bank debts, and to repay old private sector arrears:

- In 2014, the PNA has made four rounds of payments to cover private sector arrears, totaling USD 81 million. Additionally, the PNA also repaid part of its commercial debt in 2014 where USD 140 million in domestic bank debt was repaid, and another USD 20 million of external debt was paid.
- Since July 2015, the PNA made several payments to the private sector, totaling USD 130 million.

In support of our reform agenda and the need to finance our funding gap of $ 400 million in 2015 in an orderly fashion, the PNA has requested from the donor community at the AHLC held this September in New York to increase their budget support to the level provided in 2013,($ 1.2 billion). This would cover our financing gap, fully financing our recurrent deficit, and will give us the flexibility in, not only eliminating any further accumulation of private sector arrears, but reducing them substantially with the objective of eliminating them altogether.

In addition to ongoing aid mobilization efforts, the PNA is also committed to continue and expand our reform efforts to reduce the recurrent fiscal deficit. We plan to continue the efforts we have been pursuing to increase government revenues, to contain the growth of public sector staff, to reduce energy subsidies, to reduce the cost of health referrals outside of the public healthcare system and reduce the size of net lending that is related to unpaid electricity bills to Israel by local governments and electricity distribution companies. In addition, we also plan to initiate parametric reforms of our pension system in order to render it sustainable and prevent it from becoming

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A new Public Procurement Law (PPL) and implementing regulation were enacted in April 2014, and a cabinet decision was adopted on June 16, 2015 which states the following:

- To include the Higher Council for Public Procurement Policies (HCPPP) to be an independent organization within the budget of 2015.
- To reduce the requested budget of the HCPPP to be in line with the actual needs of the Council.
- To shift qualified staff from various government departments to work in the HCPPP with consultation between the chairman of the council and the General Personnel Council and with the relevant government department.

The PNA is currently working on preparations and requirements needed for the Public Procurement Law (PPL) to be fully implemented, which is expected by the end of this year, 2015. All the institutional arrangements and other requirements should be finalized by that time.

Despite the difficult situation we are facing, the PNA is determined to move forward on the institutional reforms mentioned above. The World Bank has been assisting us both financially and through the provision of technical assistance in various areas. We are grateful for its continuing support and we are fully committed to maintaining this cooperation and achieving all the objectives we have prescribed in our reform efforts.

We kindly request that the World Bank provides us with a seventh Development Policy Grant of $ 40 million to assist the PNA in progressing further in this reform agenda.

Sincerely,

Shukry Bishara
Minister of Finance

H.A

Ramallah Tel: 00970-2-2978846/7/8 Fax: 00970-2-2978845 P.O. Box 795 Ramallah E-mail: minister@pmof.ps

ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

September 18, 2015

KEY ISSUES

Context: The Israeli-Palestinian peace process remains stalled, and prospects for a resumption of talks have receded, owing to continued Israeli settlement activities and Palestinian steps toward international recognition. Recent sporadic acts of violence in the West Bank highlight the fragility of the security situation. On the domestic political front, the difficult reconciliation process between the main Palestinian factions remains stalled and political uncertainty is on the rise. The reconstruction of Gaza is progressing but remains hampered by administrative delays and Israeli restrictions on the import of construction materials, as well as slow donor aid disbursement.

Outlook and risks: The economic outlook for the remainder of 2015 is highly uncertain, with numerous risks calling for a cautious policy stance. Assuming the political status quo with no change in restrictions and/or security conditions, real GDP growth for the West Bank and Gaza (WBG) economy is projected at 2.9 percent, implying stagnant per capita incomes after a drop last year. Main risks to the outlook include an escalation of political tensions and violence, fiscal slippages, and shortfalls in donor aid. Risks could be mitigated—and medium-term prospects enhanced—through progress on the peace front, an easing of Israeli restrictions, scaled-up donor aid, and improved economic collaboration at a technical level between the Palestinian Authority (PA) and the Government of Israel (GoI), including by seeking clarity on the level of the PA's outstanding electricity sector debts.

Key policy recommendations: Continued policy discipline is required to address fiscal pressures and a projected large financing gap in 2015. Measures should focus on limiting the wage bill increase, introducing new government administrative fees, implementing the envisaged withholding tax on dividends, and further reducing fuel subsidies. In addition, the PA needs to redouble efforts to mobilize donor aid, including by demonstrating a commitment to structural reforms. Over the medium term, the PA's focus should shift to a more viable financing model based on further fiscal consolidation and a re-orientation of government outlays toward productivity—enhancing investment in human capital and infrastructure.

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

Approved By
Juha Kähkönen and Steven Barnett

Discussions were held in East Jerusalem and Ramallah during June 10–18, 2015, and the report was updated with subsequent developments. The staff team comprised Christoph Duenwald (head), Jonah Rosenthal, Priscilla Toffano, Anna Unigovskaya (all MCD), Ragnar Gudmundsson (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Prime Minister Hamdallah, Finance Minister Bishara, Palestine Monetary Authority Governor Al Wazir, other senior officials, private sector representatives, and donors. The mission prepared a concluding statement and issued a press release. Neil Hickey, Cecilia Pineda, and Vanessa Panaligan contributed to producing this report.

CONTENTS

ANNEXES

CONTEXT

1. **The Israeli-Palestinian peace process remains stalled amid a fragile security situation.** Since the breakdown of peace talks in April 2014, Israeli-Palestinian relations have been deteriorating, and prospects for a resumption of peace talks have further receded. In this environment, the PA has taken further steps towards international recognition by joining the International Criminal Court (ICC) in April 2015 and Israel continues to expand settlements in the West Bank. Sporadic small-scale launches of rockets from Gaza into Israel and acts of violence in the West Bank in recent months are reminders of the fragility of both the Israel-Hamas truce following the 2014 war and of the security situation in the West Bank.

2. **On the domestic political front, the reconciliation between the main Palestinian factions—Hamas and Fatah—has stalled and political uncertainty is on the rise.** Hamas remains unwilling to relinquish its security presence near the border crossings and to transfer power to the PA in Gaza. The PA's decision not to pay the salaries of around 40,000 civil servants hired by Hamas since 2007 to administer Gaza constitutes another challenge. The rift between the two sides was further deepened with Hamas's objection to the PA's appointment of four new ministers in the consensus government in July 2015. Meanwhile, Hamas continues to operate a shadow government in Gaza, impeding efforts at reconstruction.

3. **Against this background, the reconstruction of Gaza—led by the Gaza Reconstruction Mechanism (GRM)[2]—is progressing but remains hampered by restraints on the import of construction materials.** The World Bank estimates that 35 percent of the $3.5 billion pledged for Gaza in Cairo in September 2014 had been disbursed as of August 2015.[3] While repairs of some 90,000 partially damaged dwellings have been completed, reconstruction of about 16,000 destroyed homes, along with the rehabilitation of infrastructure, has only just begun. In the meantime, Hamas has reportedly resumed taxation of imports, including construction materials entering Gaza, and the blockade of Gaza remains largely in place.[4] Overall, the humanitarian situation in Gaza remains deplorable, as highlighted in a recent UNCTAD report.[5]

[2] The GRM is a temporary agreement between the PA and the GoI brokered by the United Nations in September 2014 to enable construction and reconstruction work in Gaza following the war.

[3] See http://www.worldbank.org/en/programs/rebuilding-gaza-donor-pledges.

[4] In this report, "blockade" refers to the restrictions placed on the movement of goods and people between Gaza and Israel, and the closure of the Rafah crossing by Egypt.

[5] See http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1068.

RECENT ECONOMIC DEVELOPMENTS

4. **Economic activity is weak.** Overall growth in the WBG declined further from -0.4 percent in 2014 to -0.8 percent in the first quarter of 2015, reflecting a slowdown in the West Bank.

- In the West Bank, a four-month suspension in clearance revenue (CR) transfers by Israel triggered a slowdown in growth from 5 percent year-over-year in the fourth quarter of 2014 to 1.8 percent in the first quarter of 2015.[6] Growth in Q1 was supported by consumption (public and private) financed by bank credit and increased employment of Palestinians in Israel. Short-term bank credit to the government and public sector employees allowed consumption smoothing during the period of fiscal strains. At the same time, unemployment declined from 17.4 percent at end-2014 to 15.4 percent in 2015:Q2, supported by an increase in employment of Palestinians in Israel and settlements.

Real GDP Growth, 2012–15
(y-o-y percent change)

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

- In Gaza, reconstruction efforts started to produce a slow economic recovery in the first quarter of 2015, although real GDP still remained 8 percent below the level of the first quarter of 2014. Unemployment decreased modestly from 42.8 percent at end-2014 to 41.5 percent in 2015:Q2, with youth unemployment at close to 60 percent.

5. **Inflation is contained, while the real exchange rate is appreciating.** After briefly accelerating around the time of Ramadan, inflation slowed to 0.4 percent year over year in August, reflecting deflation in Israel and falling global commodity prices. Prices in the West Bank increased by 1.2 percent, while declining by 0.9 percent in Gaza. With inflation in the WBG generally higher compared with its trading partners, staff estimates that the real effective exchange rate increased by 0.9 percent over the 12-month period to July.

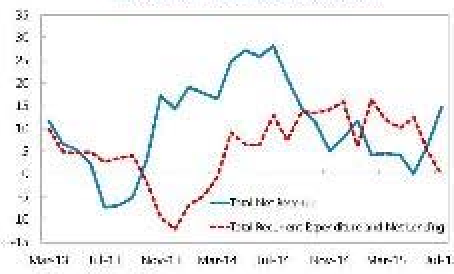
Effective Exchange Rate, 1996–2015
(Index Jan 1996=100)

Sources: Haver, INS, and IMF staff estimates.

[6] Note that PCBS data for 2015:Q1 remain preliminary and may be revised at a later stage.

6. Following a reduction in the overall deficit in 2014, fiscal pressures, as reflected in the accumulation of arrears, have increased in 2015. In early 2015, the authorities managed a fiscal crisis brought on by the Israeli suspension of CR by rationing wage spending and temporarily expanding bank financing, while accumulating arrears.[7] Even after CR resumed in April, economic conditions remained difficult and a significant fiscal deficit was recorded in the first seven months of 2015. CR grew by 6.1 percent year-over-year, supported by improved customs administration and exchange of information with Israeli tax authorities. Domestic tax and nontax revenue increased by 2.5 percent, supported by efforts to expand the tax base and to strengthen tax administration.[8] Meanwhile, recurrent expenditure increased by 4.6 percent, driven largely by net lending (payments by the PA to Israel for electricity, water, and sanitation services, which are deducted from CR), which increased by about 25 percent owing to an extraordinary deduction linked to old debts, while donor support declined by about 6 percent compared to the same period in 2014. The expanding deficit was financed by arrears, which increased on a net basis by about $350 million since the beginning of the year after accounting for repayment of earlier arrears,[9] while the stock of debt to banks was reduced. Debt to the Israeli Electricity Corporation (IEC), some of which is in dispute, stood at NIS 1.6 billion in August.

Revenue and Expenditure Growth, 2013–15



Source: Ministry of Finance.

7. Financial sector indicators are strong, but high exposure to the PA and its employees remains a major risk to stability. Nonperforming loans (NPLs) remain below 3 percent of total loans, and liquidity and capital ratios are high by international standards. However, loans to the PA and its employees comprised 41 percent of domestic bank credit at end-June. Credit to the private sector continued to grow robustly at 18 percent year over year in the second quarter of 2015, supported by an increase in private deposits, and directed mainly toward construction, real estate, and personal consumption. Recent stress tests by the PMA demonstrate the resilience of the banking system to a range of shocks.

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[7] While CR was suspended, the authorities temporary paid only 60 percent of wages, accumulating wage arrears, and expanded short-term borrowing from domestic banks. Once Israel resumed clearance transfers in April, the arrears were cleared and loans were repaid.

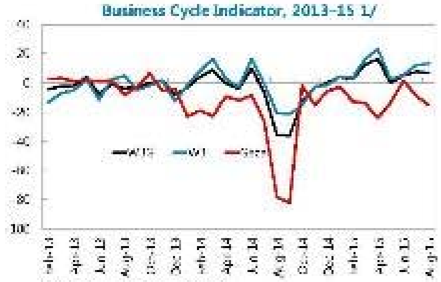
[8] For example, the number of registered taxpayers during January-July increased by 5,465 to reach 172,896. The full year target for 2015 is to increase the number of taxpayers by 12,000.

[9] This contrasts with the budget projection of $314 million of net arrears reduction during 2015.

OUTLOOK AND RISKS

8. The outlook for the remainder of 2015 is challenging and subject to considerable risks. Assuming the political status quo, with no change in restrictions and/or security conditions, growth in the West Bank is projected to slow to 1.8 percent in 2015 from 5 percent in 2014, reflecting the impact of increased uncertainty on private demand and reduced growth in Israel (Table 1). In Gaza, a rebound of 6½ percent is expected from a low base, assuming continued reconstruction activity, albeit constrained by administrative delays and limits on imports of construction materials. The Palestine Monetary Authority's (PMA) Business Cycle Indicator highlights the continued negative business sentiment in Gaza and a lack of momentum in the West Bank. Real GDP growth for the WBG economy is therefore projected at 2.9 percent, implying stagnant per capita GDP given the high rate of population growth. Inflation is projected to remain low, at less than 2 percent. Falling donor support and fiscal pressures will lead to a large financing gap, projected at $0.5 billion (or 3.7 percent of GDP). Absent new measures to reduce the fiscal deficit, the financing gap will likely be filled by domestic borrowing and arrears accumulation. The main risks to the outlook relate to heightened political and security tensions, a related lower than expected rebound in private investment, and fiscal slippages. The latter include the inability of the PA to withstand spending pressures, revenue shortfalls, and lower donor aid. Other risks relate to spillovers from developments in the global economy and the region, including due to financial linkages with neighboring countries (Box 2, Annex I). Previously reported risks (see IMF AHLC report from May 2015) related to the financial implications of litigation in U.S. courts have receded until the PA's appeal is decided in the *Sokolow vs. Palestine Liberation Organization* case.[10]

Business Cycle Indicator, 2013–15 1/

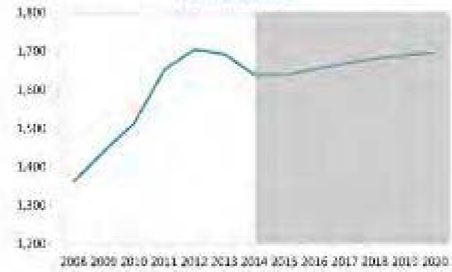


Source: Palestine Monetary Authority.
1/ Based on survey of managers of industrial firms in WBG. Values range between -100 and +100. Negative values denote pessimistic economic outlook.

[10] The judge in the Sokolow litigation recently ordered the PA to post a bond in the amount of $10 million following the PA's appeal of the earlier guilty verdict. The amount of the bond was much lower than many had expected.

9. **In the medium term, absent a political breakthrough, growth will remain below what is needed to durably reduce unemployment and improve living standards.** The high degree of political uncertainty implies a wide range of possible economic outcomes. In the baseline scenario, assuming the political status quo and unchanged Israeli restrictions, some decline in aid after the completion of Gaza reconstruction, and limited policy actions on the part of the PA, growth will hover around 3 percent, implying little if any growth in per capita incomes combined with a rise in unemployment. In Gaza, the reconstruction effort will continue in the medium term, supported by donors, but real GDP is not expected to reach its pre-war level until end-2017. In this scenario, the pace of fiscal consolidation will be insufficient to prevent arrears accumulation, including to the private sector, which in turn will hurt private demand and growth. A further deterioration in the political landscape or aid shortfalls would produce even worse economic outcomes. On the other hand, progress on the peace front and an easing of Israeli restrictions could dramatically improve economic outcomes. At the same time, even in the absence of a breakthrough on the peace front, improvements in Israeli-Palestinian economic cooperation at the technical level could prove beneficial.

Real GDP per Capita in WBG, 2008–20 (proj.)
(In 2004 U.S. dollars)



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

POLICY DISCUSSIONS

A. Fiscal Policy in 2015

10. **Discussions focused on the 2015 budget, which was approved with a significant delay in late June due to the disruptions in clearance revenue transfers.** The budget implies an expansion in the overall deficit from 12.4 to 18.4 percent of GDP, after factoring in a fourfold increase in development spending associated with Gaza reconstruction, and a reduction in the recurrent deficit from 10.4 percent in 2014 to 9.2 percent in 2015. Net revenue is projected to rise by 8.6 percent, reflecting plans to raise government fees in the second half of 2015 and higher dividends from the Palestinian Investment Fund. The projected increase in revenue also reflects efforts to expand the tax base and improve compliance, including with the help of the new income tax law introduced in April, which effectively lowers the income tax burden (Box 1). Recurrent expenditure is budgeted to rise by 3.6 percent, with the wage bill expanding by 3.8 percent on the basis of cost-of-living and legally mandated wage increases, combined with zero net hiring.[11] The budget foresees a sharp reduction in fuel subsidies ("fuel tax refund"), lower spending on goods and

[11] This assumes a 1.25 percent annual wage increase under the Civil Service Law, a 1.3 percent increase in the cost of living adjustment (on gross salary), a 5 percent increase in teachers' salaries accounting for 0.5 percent in the overall wage increase, and the allowance for promotions accounting for 0.7 percent of the wage increase.

services due to projected savings on the costs of health referrals,[12] and a 22-percent decline in net lending. The latter is based on efforts to improve payment discipline by municipalities and distribution companies, continue introducing prepaid meters to improve collections, and strictly implement a "deed of release"—a policy which prevents access to government services of citizens who are not current on their electricity bills.[13] With total donor support assumed at nearly $2 billion, the budget projects a financing gap of about $400 million, or about 3 percent of GDP. This is after assuming that about $300 million of arrears will be cleared using bank borrowing.

Budget 2015

	2013	2014		2015 Budget	
	NIS million	NIS million	% Change from 2013	NIS million	% Change from 2014
Net revenues	8,346	9,817	17.6	10,558	6.6
Recurrent expenditures and net lending	13,974	14,555	4.2	15,385	5.6
Wage expenditures	6,928	7,335	5.9	7,617	3.8
Nonwage expenditures	6,287	6,198	-1.4	6,658	7.6
Net lending	760	1,022	34.5	800	-21.7
Development expenditures	674	958	39.2	4,485	368.1
of which: Gaza reconstruction	--	--	--	3,380	--
Overall balance	-6,300	-5,675	-9.9	-8,912	57.0
Total financing	6,300	5,676	-9.9	8,912	57.0
External financing for recurrent expenditures	4,532	5,375	18.6	6,120	15.1
External financing for development expenditures	383	725	89.4	4,290	492.7
Domestic financing	746	1,311	75.7	-1,502	14.5
Net domestic bank financing	-895	-469	--	1,170	--
Arrears (net)	1,680	1,762	4.9	-1,170	--
Residual/Financing gap	-38	18		1,502	

Sources: Ministry of Finance; and IMF staff calculations.

11. Staff noted that current policies and a significant reduction in budget support implied a larger financing gap compared with the budget. Staff project that, the recurrent deficit will decline by 0.5 percentage points to 9.9 percent of GDP, compared to a budget forecast of 9.2 percent, leading to a financing gap of $0.5 billion after accounting for development spending and projected donor financing.[14] Staff viewed the budget's projections for domestic revenue, tax refunds, and net lending as optimistic, pointing to the likely negative effect on revenue of the new income tax law implemented from May. Moreover, given the significant fiscal risks, the financing gap could be substantially larger. Staff cautioned that if the financing gap were filled with arrears accumulation or bank borrowing, debt would rise, posing a risk to debt sustainability (Annex III), while further accumulation of arrears to the private sector would undermine efforts to improve

[12] Health referrals refer to health services that are provided in Israel to Palestinians and that are deducted monthly from clearance revenue. Monthly deductions have been reduced from a peak of about NIS 36 million to about NIS 14 million at present.

[13] Efforts are underway to normalize financial relations between the PA and municipalities and to settle outstanding debts. The PA is committed to transfer to municipalities the share of transportation fees and property taxes which it collects on their behalf ("earmarked revenue collection"). In return, they expect timely payment of electricity bills.

[14] Relative to the May 2015 AHLC report, staff revised downwards its projections of aid for Gaza distributed via the budget since it appears that a large share of aid is provided outside of the budget.

revenue collection.[5] However, with the benefit of two months' additional fiscal data since the mission, some of staff's concerns, especially on domestic revenue, are to some extent being allayed, although risks remain tilted to the downside.

12. To close the financing gap and avoid arrears accumulation, staff recommended a combination of fiscal adjustment and additional donor aid. The proposed measures include: a 2 percent limit on the wage bill increase, close to projected inflation; the introduction of a 10 percent withholding tax on dividends, which had been considered before being shelved; a front-loaded increase in government fees; and the immediate elimination of fuel tax refund (untargeted fuel subsidy which should be replaced by targeted cash transfers). Mindful that those measures alone would be insufficient to fill in the gap, not least because less than half of the year would remain to implement them, staff advised that additional donor aid would be needed to avoid arrears accumulation. Staff also emphasized the importance of adhering to the prudential limit on government borrowing from banks.

Fiscal Measures

	2015		
Measure	NIS million	USD million	% GDP
Identified financing gap in 2015	1808	485	3.7
Total proposed measures	584	157	1.2
Increase in fees	200	54	0.4
Introduction of a 10-percent tax on dividends	100	27	0.2
Wage bill	134	36	0.3
Elimination of fuel tax subsidy	150	40	0.3
Other unidentified measures/new financing	1224	329	2.5

13. The authorities expressed concern about the political feasibility of the proposed measures, and defended the introduction of the new income tax law. They were supportive in principle of the proposed restraint on the wage bill, emphasizing efforts since 2013 to reverse the escalation in wages observed during the previous administration. They pointed to ongoing measures to reduce the number of new hires, eliminate ghost workers, and rationalize the cost structure through mergers, economies of scale and performance based reviews. However, the authorities cited the difficult political situation and strong opposition from unions as constraining their actions. There was no appetite to introduce the tax on dividends at present, or to further reduce fuel subsidies beyond the target of NIS 25 million per month, as these help alleviate hardship in Gaza. On the other hand, the authorities indicated they would consider frontloading the increase in government fees. As regards the new income tax law, the authorities were more optimistic than staff about its net effect on revenue. They did not think that any losses would be incurred in 2015 as most of the income tax from large taxpayers had been prepaid in early 2015. They did not rule out the possibility of revenue losses in 2016 (estimating them at up to NIS 200 million), but believed enhanced tax compliance and measures on nontax revenue would offset them. They also noted a lack of progress in their discussions with Israel on the implementation of the Paris Protocol related to the proper assessment of transfers and fees owed to the PA by Israel, which in their view could significantly boost revenue.

[5] In this regard, the recently announced plan to proceed with clearance of $200 million of arrears to the private sector using bank borrowing is a positive step but will not in itself resolve the problem of arrears accumulation without additional fiscal measures to reduce the financing gap.

B. Fiscal Policy in the Medium Term

14. Staff reiterated that the existing financing model is not viable. In the medium term, growth-friendly fiscal consolidation, backed by more predictable aid, perhaps linked to deliverables, would improve economic outcomes, even in the presence of continued Israeli restrictions. Staff projects that, with a steady reduction in donor aid likely, fiscal consolidation of 4–5 percent of GDP is needed in the medium term to avoid arrears accumulation and improve the fiscal situation. Using international examples, staff outlined the lessons from successful fiscal consolidation efforts elsewhere, and outlined ways to make it more growth-friendly (Annex IV).

15. There are some encouraging signs that the PA, with the help of donors, is buying into this advice. Despite adverse circumstances, the authorities have managed to deliver lower deficits in the past few years, partly as a result of their successes in expanding the tax base, introducing a term limit for tax exemptions, and upgrading the system of health referrals by establishing the Health Information Management system with USAID assistance and the signing of MOUs with Israeli hospitals. Additionally, they pointed to ongoing efforts to stop electricity debt accumulation, including by instilling better control over municipalities' expenditure, consolidating transmission and purchasing systems, and eventually transferring responsibility for the management of utilities from local governments to commercial public corporations with assistance from the World Bank. The latter, however, would require infrastructure investments and become operational only in a few years. In the area of Public Financial Management (PFM), there has been some progress in improving reporting of intra government transfers and recording of arrears. The authorities also requested technical assistance to improve fiscal analysis and forecasting capacity of the macro fiscal unit at the MOF, which will be provided under a program financed by Belgium and supported by the Fund. Donors, such as the EU, are joining the World Bank in introducing results based frameworks to their budget support disbursements.

16. At the same time, there is a large unfinished fiscal reform agenda. While the authorities agreed with the staff about the need to tackle pensions and civil service reform to ensure medium term fiscal sustainability, they have not yet committed to specific actions in these areas. Lack of legal enforcement hinders tax administration reform. Public procurement reform has stalled, and the Public Procurement Council continues to face difficulties in exercising its role, despite receiving budgetary allocations in 2015. Despite progress in adopting a new accounting manual and better monitoring of arrears, many other PFM reforms remain to be implemented, as outlined in Box 1 of the IMF's May 2015 AHLC report. In particular, staff noted with concern that the 2011 audited financial statements have still not been approved, a delay that could set back the planned submission in 2015 of the audited financial statements for 2012 and 2013.

C. Financial Sector

17. The authorities and staff agreed that the financial sector is strong, but staff pointed to risks. These include high exposure of banks to the PA and its employees, as well as credit growth which outpaces growth of nominal GDP and is concentrated in a few sectors (Annex II). Additionally, staff noted risks stemming from currency mismatches in the banks' balance sheets and expressed concerns about whether the banking sector has sufficient capacity to manage the quickly rising volume of credit. The PMA responded that rapid credit growth reflected mostly financial deepening, emphasizing that supervisory standards are strict, loan-to-deposit ratios are low, and credit to the private sector is maintained within supervisory limits. At the same time, risks were being monitored closely, and work is continuing to further improve supervision and regulation, including with the help of technical assistance from the IMF, and to extend it to shadow banking. As discussed in the IMF's May 2015 AHLC report, the PMA has recently expanded its macro-prudential policy toolkit; is developing a bank resolution framework to include provisions for resolving foreign bank branches; and is providing inputs for the new central bank law with a view to ensuring stronger PMA independence. Additionally, beginning in 2015, banks started contributing to the deposit insurance fund (0.03 percent of eligible deposits per year), and work to expand the credit registry is ongoing.

18. **The authorities welcomed two positive developments on outstanding issues involving cooperation with the Bank of Israel (BOI).** First, they noted that an earlier cash surplus problem had eased without the need to expand the limit on cash conversion by the BOI, as cash shortages were observed in banks in early 2015.[16] Second, they welcomed Israel's decision to postpone by two years the implementation for Palestinians of the Locker Bill, which by limiting individual cash transactions in Israel to NIS 10,000 could negatively affect Israeli-Palestinian trade. The upgrade of the payment system started in May 2015 when the PMA introduced the National Switch to enable ATM connectivity between a number of large banks.

D. Structural Reforms

19. **There remains scope to improve the business climate.** Israeli restrictions, especially access to Area C and the near-total blockade of Gaza, remain major obstacles to an expansion of private sector activity.[17] However, there is significant scope for the PA to improve the business climate—to simplify procedures, improve legislation, and level the playing field for businesses. In particular, expeditious approval of the Secured Transactions Law, the Competition Law, and the New Companies Law would confer significant benefits. The World Bank is working with the authorities on the Secured Transactions Law, which is expected to boost private sector access to credit by formalizing the use of collateral. In general, the absence of a functioning legislature, vested interests in some cases, and the de facto jurisdictional divide between Gaza and the West Bank are, according to the authorities, among the obstacles preventing legislative initiatives from going forward. The World Bank and the Finnish Government are supporting land reform, where key challenges include gaps in the existing laws that require issuance of clear regulations and

[16] The PMA in the past expressed concerns about the limits set by the Bank of Israel on the amount of NIS cash transfers it accepts from Palestinian banks. These limits have been established at NIS 300 million per month in order to combat money laundering and financing of terrorism.

[17] The GoI emphasizes security concerns that restrict its ability to ease or lift restrictions in the WBG.

instructions; currently, only around 30 percent of land is registered, though progress has been made recently.

20. **Staff emphasized that stronger economic collaboration between the PA and the GoI would be conducive to improved economic outcomes.** The authorities and staff agreed on the importance of conducting meetings of the Joint Economic Committee that bring together the Palestinian and Israeli finance ministers to discuss and resolve outstanding issues linked to the implementation of the Paris Protocol. To stimulate a constructive dialogue between the two parties and enhance predictability of clearance revenue, staff emphasized the need to find a mutually acceptable solution concerning claims on outstanding electricity debts, building on ongoing discussions between the two finance ministries. In this regard, staff suggested an audit by a reputable international accounting firm leading to agreement on a repayment plan, an idea that resonated with the PA and donors.

STAFF APPRAISAL

21. **A deadlocked peace process and stalled domestic political reconciliation characterize the difficult context in which the WBG economy operates.** As a result, the economy operates well below its potential, resulting in declining, or at best stagnant, per capita incomes and persistently high unemployment. In Gaza, a humanitarian crisis continues to unfold, while sporadic violence in the West Bank is a reminder of the tenuous security situation and the risk of social unrest. In this environment, it is imperative that the PA maintains policy discipline and pursues economic reforms, and that donors raise the level of aid. On the part of Israel, easing restrictions and enhancing economic cooperation with the PA while ensuring consistent and predictable transfers of clearance revenue would contribute significantly to better economic outcomes in the WBG.

22. **Economic activity in 2015 and the foreseeable future is insufficient to generate adequate job opportunities.** The subdued pace of economic activity in the West Bank this year is the result of a slowdown in private demand linked to a drop in confidence following the suspension of clearance revenue transfers from January to April. The suspension also led to the accumulation of new arrears to the private sector. In Gaza, despite some encouraging signs that donor pledges are being disbursed, the pace of reconstruction still needs to gain momentum to strengthen growth and employment and improve the humanitarian situation. For 2015, staff projects a 1.8 percent rise in the West Bank's real GDP, while Gaza's economy should rebound by 6½ percent assuming continued construction activity. Beyond 2015, under the assumption of the political status quo, growth will remain modest and unemployment rates high. The main risks to the outlook are on the fiscal side and include higher than projected spending and revenue or donor aid shortfalls.

23. **Fiscal policies combined with developments year-to-date imply a large financing gap in 2015.** The continued net accumulation of arrears through the first seven months of 2015 is symptomatic of persistent fiscal pressures. The authorities are working to address these pressures. On the revenue side, they are contemplating a number of revenue enhancing measures, including raising government administrative fees, broadening the tax base by increasing the number of

registered taxpayers, carrying out risk-based audits, conducting voluntary disclosure and taxpayer awareness campaigns, and introducing a standardized reporting system for revenue collecting units. At the same time, amendments to the income tax law will likely result in revenue losses in the short term, even if they lead over time to additional revenue through greater compliance. On the expenditure side, while the authorities intend to adhere to a zero net hiring policy, the budget assumes a 3.8 percent increase in the wage bill, which is twice the projected inflation rate. In addition, a relatively large increase of 8 percent in nonwage spending (transfers and purchases of goods and services) is projected. Combined with a reduction in donor budget support relative to 2014, current fiscal policies imply a financing gap of nearly $500 million, or 3.7 percent of GDP, after factoring in an arrears repayment of roughly $300 million.

24. **A combination of fiscal measures and additional donor support is needed to fill the projected financing gap.** Fiscal measures, which are outlined below, can reduce the gap to some extent, but, absent scaled up donor aid, the gap will likely be closed by recourse to harmful arrears and additional bank lending, which raises the PA's indebtedness and threatens fiscal sustainability. Staff recommends the following measures:

- Limit the increase in the wage bill to 2 percent or less in 2015, in line with inflation. In particular, there may be merit in eliminating the automatic annual salary increase of 1.25 percent as a first step.
- New government administrative fees should be introduced in full and without delay.
- The previously envisaged 10 percent withholding tax on dividends should be implemented in order to offset revenue losses from the new income tax law and to contribute to a more progressive tax regime.
- Fuel subsidies should be further reduced, building on the good progress already made.

25. **In addition to containing the deficit, the PA needs to redouble efforts to mobilize donor aid.** The large financing gap projected for 2015 cannot be closed through measures alone, and scaled up donor budget support for the PA is urgently needed. To strengthen its credibility vis-à-vis donors, strong policies on the part of the PA will be needed. Beyond 2015, the PA's focus needs to shift to a more viable financing model based on further fiscal consolidation and a reorientation of government outlays towards productivity enhancing investment in human capital and infrastructure. For such efforts to succeed, continued and enhanced support from donors will be necessary, avoiding a substitution of aid away from the West Bank toward Gaza.

26. **Efforts to consolidate the fiscal position should be accompanied by fiscal structural reforms.** Despite some progress, further reforms in the PFM area are needed. Recent efforts to better account for the stock of arrears to the private sector, to track their accumulation in monthly fiscal reports, to assess contingent liabilities to the Pension Fund, and to reflect intra-governmental transfers in fiscal reports are welcome. However, staff noted with concern that the 2011 audited financial statements have still not been approved. In addition, implementation of the new

procurement law remains dependent on the establishment of the High Council for Public Procurement, which should proceed expeditiously. Going forward, efforts should focus on increasing the transparency and quality of fiscal reporting, finalizing and implementing a new accounting manual, developing a medium-term expenditure framework with realistic macroeconomic and financing assumptions, and drafting an Organic Budget Law that will provide an overarching regulatory framework for all public finance related matters. In the revenue area, the most pressing issue is the inadequate tax policy enforcement legislation, which urgently needs to be updated.

27. **Safeguarding financial stability remains a priority.** While the system is sound and well capitalized, exposure to the PA and its employees and the rapid rate of growth in credit to the private sector call for close monitoring by the PMA, not least considering the weak operating environment. Some of the credit growth may be explained by the success of the PMA's financial inclusion efforts, but the concentration of lending in a narrow range of sectors, along with a high share of loans supporting consumption and increased lending by shadow banking entities, warrants close monitoring.

28. **Given the uncertain prospects for a resumption of peace talks, economic collaboration at the technical level between the PA and the GoI takes on even greater importance.** As demonstrated by the fiscal crisis during the first four months of the year, predictability of clearance revenue is critical to allow for normal budget execution and to preserve economic and social stability. Efforts to enhance predictability and preserve stability would be bolstered by the resumption of regular meetings of the Joint Economic Committee. In that context, one issue that urgently requires a mutually acceptable solution concerns the claims of both the GoI and the PA on outstanding electricity debts. An audit by a reputable international accounting firm leading to agreement on a repayment plan is one option that should be considered. More broadly, an easing of Israeli restrictions in the West Bank and a lifting of the blockade of Gaza remain the two most important steps for improving economic prospects.

Box 1. New Income Tax Law

In April, the PA enacted a new income tax law which introduced new income tax brackets as follows:

Old law		Amended law	
Income, NIS	Tax rate %	Income, NIS	Tax rate,%
<30,000	exempt	<36,000	exempt
30,000-40,000	5	36,001-75,000	5
40,001-80,000	10	75,001-150,000	10
80,001-125,000	15	>150,000	15
>125,000	20		

The new law effectively lowers progressivity of the income tax and the marginal tax rate from 20 to 15 percent. Exceptions are given to monopolistic companies, particularly telecoms, for which the marginal tax rate of 20 percent remains unchanged. The effective tax rate for telecoms, however, is not expected to reach 20 percent on account of significant tax exemptions currently provided to telecoms.

Box 2. Economic Linkages Between the WBG and the Rest of the World (ROW)

The WBG is a small open economy with trade dominated by Israel. With the total value of exports plus imports at nearly 80 percent of GDP in 2014, the WBG is a fairly open economy, notwithstanding Israeli restrictions that raise transaction costs and hurt competitiveness of WBG products. Under the Oslo accords, a customs union was established between Israel and the WBG. The resulting tariff regime largely reflects Israel's preferences, which, together with geographic proximity and Israeli control of the WBG's border crossings, makes the economy of the WBG essentially a captive market for Israeli goods. In recent years, Israel accounted for more than 70 percent of all Palestinian imports and absorbed about 85 percent of Palestinian exports.[1] Other major trading partners include Arab countries and the EU. Exports are dominated by low value-added goods, such as construction materials, furniture, and foodstuffs. Major components of imports are energy, foodstuffs, and manufactured goods. As an oil importer, the WBG is also affected by movements in world oil prices. It is important to note that Israel's control of border crossings and ports makes it responsible for collecting foreign trade taxes on behalf of the PA.

The West Bank economy is supported by labor income from Israel. Israel issues work permits to Palestinians, the income from which supports consumption in the West Bank and reduces unemployment there. The number of work permits has varied over time, but has recently increased, prompted by growing Israeli demand for labor in the booming construction sector. As a result, labor income from Israel has increased to reach 10.2 percent of GDP in 2014, up from 6.5 percent in 2010. In 2014, Israel employed about 12 percent of workers from the West Bank. However, the employment is concentrated mainly in low-skilled sectors such as agriculture and construction, contributing little to the development of human capital, technology transfer, or long-term growth.

External transfers are an important source of budget and balance of payments financing. The WBG is a donor-dependent economy with annual external donor support to the PA accounting for about 10 percent of GDP over the past four years. Additional donor support is provided outside of the budget, which includes financing for the United Nations Relief and Works Agency (UNRWA) and, recently, Gaza reconstruction. At the same time, private transfers, mainly from the Palestinian diaspora, constitute about 10 percent of GDP. FDI inflows remain small, at only 1.4 percent of GDP on average over the past five years, reflecting weak business confidence and high country risk amid an uncertain political outlook.

Financial linkages of the WBG with the ROW are limited, apart from a heavy presence of Jordanian banks. The WBG uses the New Israeli Shekel as its currency, which ties monetary conditions to those in Israel. The banking system is dominated by branches of Jordanian banks. The largest Jordanian bank in the WBG, Arab Bank, holds almost one-third of total deposits, provides one quarter of domestic credit, and accounts for almost 30 percent of total banking assets. Capital markets, on the other hand, are less developed and not well integrated internationally, with stock market capitalization at less than 25 percent of GDP, and no interbank or government bond markets.

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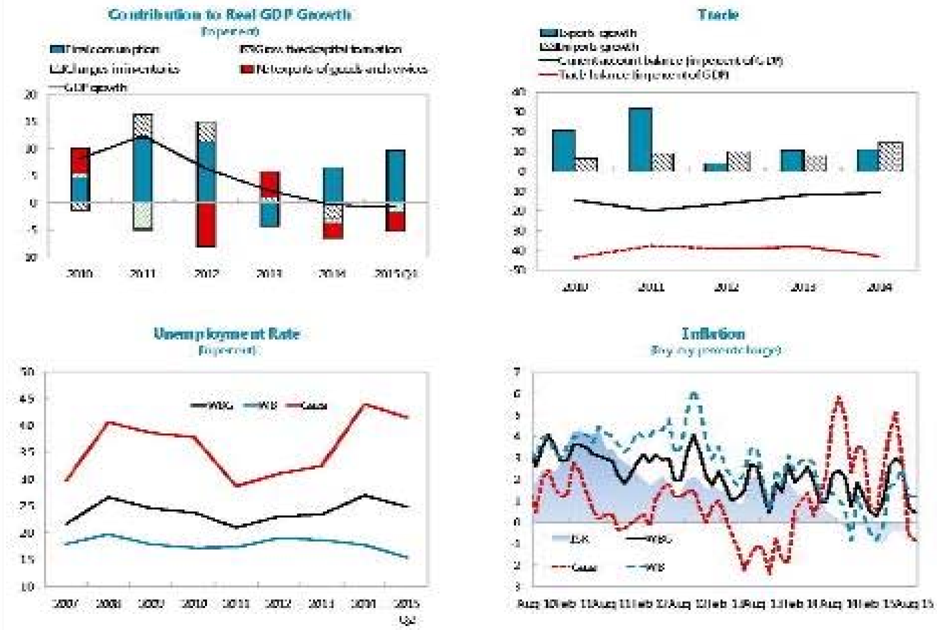
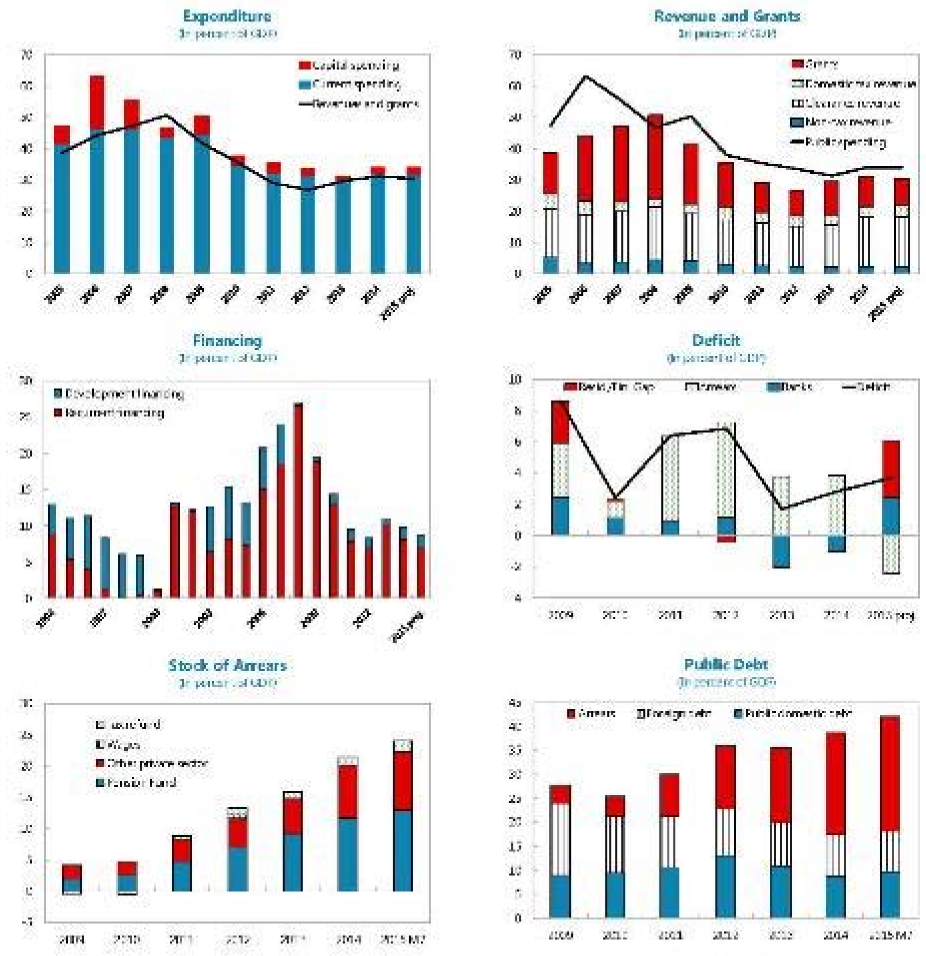
[1] These numbers, however, include some transit trade via Israel. Note that the figure for exports only reflects exports from the West Bank. Exports from Gaza to Israel resumed in 2015, but amount to only 6 percent of their pre-2007 levels, according to World Bank estimates.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2007–15



Sources: Palestinian authorities; and IMF staff calculations.

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



Sources: Palestinian authorities; and IMF staff calculations.

Figure 3. West Bank and Gaza: Financial Sector Indicators, 2000–15

Sources: Palestinian authorities; and IMF staff calculations.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2012–20

(Population: 4.6 million; 2014 est.)
(Per capita GDP: $2,801; 2014)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

			Est.	Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	6.3	2.2	-0.4	2.9	3.9	3.7	3.7	3.4	3.2
West Bank	6.0	1.0	5.1	1.8	3.0	2.5	2.7	2.6	2.6
Gaza	7.0	3.6	-15.2	6.5	6.5	6.5	6.5	5.5	5.0
CPI inflation rate (end-of-period)	1.7	2.7	1.2	1.6	2.5	2.5	2.5	2.5	2.4
CPI inflation rate (period average)	2.8	1.7	1.7	1.6	2.6	2.5	2.5	2.5	2.4
Investment and saving				(In percent of GDP)					
Gross capital formation, of which:	21.2	21.8	18.6	21.8	21.1	21.5	18.9	19.2	19.2
Public	3.5	3.3	3.6	4.0	6.1	6.1	3.5	3.5	3.5
Private	17.7	18.5	15.0	17.7	15.0	15.4	15.5	15.7	15.8
Gross national savings, of which:	5.0	9.3	7.8	10.7	9.1	9.1	8.7	8.7	7.9
Public	-6.0	-1.0	-2.3	-3.0	-2.5	-2.0	-1.6	-0.9	-0.5
Private	11.0	10.6	10.1	13.7	11.6	11.1	10.4	9.6	8.4
Saving-investment balance	-16.2	-12.5	-10.9	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Public finances 1/				(In percent of GDP)					
Revenues	18.4	18.6	21.5	21.7	22.0	22.2	22.5	22.7	23.0
Recurrent expenditures and net lending	31.4	29.7	31.6	31.7	31.2	30.9	30.4	30.2	29.8
Wage expenditures	15.7	15.4	16.1	15.8	15.5	15.2	15.0	14.5	14.6
Nonwage expenditures	13.2	12.6	13.6	13.8	13.8	13.7	13.7	13.7	13.7
Net lending	2.5	1.7	2.2	2.1	2.0	1.5	1.7	1.6	1.5
Recurrent balance (commitment before external support)	-12.9	-11.1	-10.4	-9.9	-9.2	-8.6	-8.0	-7.4	-6.9
Recurrent balance (cash, before external support)	-7.1	-7.3	-8.1	-12.4	-10.8	-9.7	-9.0	-8.5	-7.9
Development expenditures	2.2	1.3	2.1	2.3	4.6	4.5	1.5	1.6	1.5
(In millions of U.S. dollars)	243	167	262	300	604	610	217	219	217
Overall balance (commitment, before external support)	-15.1	-12.6	-12.4	-12.2	-13.8	-13.0	-9.5	-9.0	-8.4
Total external support, including for development expenditures	8.3	11.0	9.7	8.6	10.8	10.5	7.4	7.5	7.3
(In millions of U.S. dollars)	930	1,361	1,230	1,114	1,431	1,435	1,039	1,016	1,032
External support for recurrent expenditure (in millions of U.S. dollars)	774	1,255	1,027	894	894	894	894	894	894
In percent of GDP	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Financing gap (in millions of U.S. dollars) 2/	…	…	…	485	452	426	301	301	261
In percent of GDP	…	…	…	3.7	3.4	3.1	2.8	2.2	1.9
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	14.3	11.0	16.0	13.0	15.0	13.0	12.0	12.0	12.0
Private sector deposits	6.8	10.7	9.9	7.4	6.9	6.4	5.9	5.4	4.9
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-23.1	-22.4	-18.5	-18.0	-18.7	-19.0	-16.6	-17.0	-17.7
Current account balance (including official transfers)	-16.2	-12.3	-10.4	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Exports of goods and nonfactor services	16.7	16.7	18.0	18.2	17.9	17.7	17.7	17.5	17.7
Import of goods and nonfactor services	56.1	54.8	58.1	58.3	59.9	59.7	56.8	57.6	57.8
Net factor income	7.6	8.6	10.8	10.8	10.6	10.5	10.4	10.4	10.3
Net current transfers	15.6	17.3	21.3	20.3	19.6	19.0	18.4	19.1	18.5
Private transfers	8.7	7.1	13.2	13.4	12.8	12.5	12.1	12.5	12.1
Official transfers	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	11,235	12,419	12,744	12,974	13,260	13,636	14,101	13,606	14,061
Per capita nominal GDP (U.S. dollars)	2,617	2,809	2,801	2,771	2,753	2,752	2,768	2,397	2,610
Unemployment rate	23	23	27	27	28	29	29	30	30
Al Quds stock market index (annual percentage change) 4/	0.1	13.4	-7.1	-4.2	…	…	…	…	…

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

1/ Commitment basis.
2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.
3/ End-of-period; in U.S. dollar terms.
4/ For 2015, percent change since end-2014.

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

	2012	2013	2014	Budget 2015	Projections 2015	2016	2017	2018
	(In millions of shekels, unless otherwise stated)							
Net revenues	7,962	8,243	9,617	11,658	10,506	11,271	12,008	12,074
Gross domestic revenues	2,836	2,673	2,414	[illegible]	3,790	[illegible]	[illegible]	[illegible]
Tax revenues	1,977	2,157	2,148	[illegible]	2,220	2,167	2,231	[illegible]
Nontax revenues (accrual)	859	521	555	1,070	1,070	1,054	1,061	[illegible]
Of which: arrears	54	…	…			…	…	
Clearance revenues (accrual)	5,517	6,303	7,291	7,768	7,766	8,274	8,704	[illegible]
Of which: arrears	475	14	13					
Tax refunds 1/	454	834	473	400	330	490	410	240
Of which: arrears	254	27	117					
Recurrent expenditure and net lending (commitment)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Of which: arrears	1,868	1,611	2,251	-1,170	-1,170	-577	-507	-614
Wage expenditure (commitment)	6,532	6,528	7,395	7,612	7,517	7,587	8,210	8,668
Of which: arrears	612	383	573			…	…	
Nonwage expenditures (commitment)	5,709	5,643	6,153	2,668	6,555	7,092	7,407	7,914
Of which: arrears	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	525	557	614
Net lending	1,352	761	1,077	890	1,022	1,000	1,000	1,000
Development expenditures (commitment)	907	674	698	4,463	1,116	2,204	2,432	690
Of which: on Gaza reconstruction		…	75	3,050	579	1,545	1,582	…
Of which: arrears	124	65	251	…		…	…	
Recurrent balance (commitment, excl. development expenditure)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Overall balance (commitment)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Total financing	5,541	5,602	5,675	8,912	5,016	7,062	7,075	5,468
Net domestic bank financing	490	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
External debt repayment			-95		-41	-27	-154	-175
External financing for recurrent expenditures	2,566	4,552	3,675	3,120	3,330	2,462	2,585	3,662
External financing for development expenditures	301	381	733	4,290	330	2,004	2,153	592
Other domestic financing	…	…	…	…	…	…	…	…
Arrears accumulation (net)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	525	557	614
Of which: repayment			1,003	[illegible]	[illegible]	525	557	614
Residual financing gap 2/	-382	-65	15	1,590	1,906	1,747	1,702	1,640
	(In millions of U.S. dollars, unless otherwise stated)							
Net revenues	2,077	2,317	2,344	2,861	2,721	2,918	3,093	3,166
Gross domestic revenues	725	853	873	888	885	832	858	950
Tax revenues	[illegible]	557	631	599	596	567	590	612
Nontax revenues (accrual)	246	235	273	287	287	282	242	334
Of which: arrears	15							
Clearance revenues (accrual)	1,457	1,695	2,043	2,063	2,005	2,140	2,255	2,261
Of which: arrears	124	3	3					
Tax refunds	118	231	124	107	108	121	104	64
Of which: arrears	62	7	41	…		…	…	
Recurrent expenditure and net lending (commitment)	3,525	3,659	4,055	4,047	4,109	4,140	4,227	4,232
Of which: arrears	463	440	638	-314	-314	-150	-150	-150
Wage expenditure (commitment)	1,707	1,810	2,053	2,040	2,045	2,053	2,083	2,115
Of which: arrears	217	103	159					
Nonwage expenditures (commitment)	1,481	1,561	1,727	1,790	1,790	1,875	1,893	1,903
Of which: arrears	[illegible]	338	475	-314	314	-150	-150	-150
Net lending (commitment)	275	233	255	235	270	254	253	254
Development expenditures (commitment)	240	187	202	1,204	300	604	632	227
Of which: on Gaza reconstruction			75	800	100	400	400	
Of which: arrears	27	13	53					
Recurrent balance (commitment, excl. development expenditure)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Overall balance (commitment)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Total financing	1,456	1,565	1,585	2,552	1,506	1,825	1,775	1,540
Net domestic bank financing	127	-245	-391	334	314	100	100	104
External debt repayment			-13	…	-11	-12	-40	-44
External financing for recurrent expenditures	774	1,253	1,037	806	894	694	694	694
External financing for development expenditures	156	103	203	1,152	100	532	540	172
Arrears (net)	689	-165	-133	311	314	150	150	150
Of which: repayment			-251					
Residual financing gap 2/	-47	-31	5	406	485	462	425	355
Memorandum items	(In percent of GDP, unless otherwise stated)							
Revenues	18.4	18.5	21.5	22.1	21.7	22.1	22.1	22.5
Recurrent expenditure and net lending	31.7	29.7	33.9	31.2	31.7	31.2	30.3	30.4
Wage expenditure	15.7	15.8	16.1	15.5	15.8	15.5	15.4	15.0
Nonwage expenditures	12.2	12.5	13.5	12.5	12.6	13.5	13.7	12.7
Net lending	2.5	1.7	2.2	1.7	2.1	2.0	1.8	1.7
Recurrent balance (commitment) before external support	-12.5	-11.1	-11.4	-9.7	-9.9	-9.7	-9.2	-8.0
External financing for recurrent expenditures	6.5	10.1	8.1	6.5	6.9	5.7	5.5	6.0
Development expenditures (cash)	1.8	1.5	1.8	9.8	2.5	4.6	4.5	1.5
Overall balance (commitment)	[illegible]	[illegible]	[illegible]	18.4	[illegible]	13.8	[illegible]	[illegible]
Overall balance (cash)	-12.0	-8.7	-9.4	-20.7	-14.7	-14.3	-14.2	-12.5
Residual financing gap	-0.4	-0.1	0.0	3.1	3.7	3.4	3.1	2.5
Nominal exchange rate (NIS per U.S. dollar)	3.86	3.61	3.53	…	…	…	…	…
Nominal GDP (in millions of shekels)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Sources: Palestinian Ministry of Finance; and IMF staff projections.
1/ Includes fuel subsidies.
2/ [illegible]

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

	2012	2013	2014	2015	2016	2017	2018
				Projections			
	(In millions of shekels)						
Revenue	11,576	15,263	14,220	14,657	16,735	17,809	17,229
Taxes	7,035	7,426	8,852	9,438	9,986	10,738	11,526
Domestic taxes	1,832	2,157	2,149	2,220	2,192	2,354	2,526
Clearance taxes	5,627	6,103	7,331	7,768	8,274	8,794	9,311
Tax refund	-424	-834	-628	-550	-480	-410	-310
Grants	3,587	4,915	4,402	4,149	5,526	5,711	4,255
External budget support	2,986	4,532	3,676	3,330	3,452	3,558	3,659
External development support	601	383	726	820	2,074	2,153	596
Other revenue	954	921	966	1,070	1,284	1,361	1,447
Of which: dividends	120	116	121	124	161	171	182
Expenditures	14,530	14,009	15,494	16,424	18,521	19,176	18,462
Expense	13,593	13,336	14,356	15,307	15,987	16,747	17,572
Compensation of employees 1/	6,612	6,928	7,236	7,617	7,907	8,290	8,656
Use of goods and services	2,112	1,816	2,335	2,225	2,558	2,499	2,656
Grants 2/	1,072	760	1,022	1,022	1,000	1,000	1,000
Other expense 3/	3,597	3,832	3,864	4,442	4,052	4,958	5,256
Net acquisition of nonfinancial assets	937	674	938	1,118	2,534	2,429	890
Gross operating balance	-2,017	-73	-136	-650	608	1,062	-312
Net lending / borrowing (overall balance)	-2,954	-746	-1,274	-1,767	-1,926	-1,367	-1,252
Net financial transactions	2,954	746	1,274	1,767	1,926	1,367	1,252
Net acquisition of financial assets	...	...	...	...	...	...	...
Domestic							
Currency and deposits	...	...	...	...	...	...	...
Net incurrence of liabilities	3,136	785	1,256	41	221	336	358
Domestic	3,136	785	1,293	0	154	172	189
Loans	490	-895	-469	1,170	425	425	425
Net domestic bank financing	490	-895	-469	1,170	425	425	425
Other accounts payable	2,646	1,683	1,762	-1,170	-575	-597	-614
Arrears (recurrent)	2,043	1,628	1,424	-1,170	-575	-597	-614
Arrears (capital)	124	66	351	...	...	...	...
Arrears (clearance)	-479	14	13	...	...	...	...
Foreign	...	...	-38	-41	-67	-164	-176
Loans	...	...	38	41	57	164	178
Statistical discrepancy/financing gap	182	38	18	1,808	1,747	1,702	1,600
Memorandum items:							
Gross operating balance excl. grants (commitment)	-5,604	-4,988	-4,739	-4,799	-4,918	-4,649	-4,586
Gross operating balance excl. grants (cash)	3,082	3,374	3,528	5,660	5,297	5,246	5,212
Overall balance (NLB) excl. grants (commitment)	6,541	5,662	5,676	5,916	7,052	7,078	5,488
Overall balance (NLB) excl. grants (cash)	-3,691	-3,982	-3,954	-7,086	-7,651	-7,075	-6,102
Revenue (percent of GDP)	26.7	29.6	31.2	30.3	32.8	32.8	29.8
Expenditure (percent of GDP)	33.5	31.2	34.0	34.0	35.8	35.5	32.0
Expense (percent of GDP)	31.4	29.7	31.5	31.7	31.2	30.9	30.4
Wage expenditure (percent of GDP)	15.3	15.4	16.1	15.8	15.5	15.3	15.0
Nonwage expenditures (percent of GDP)	4.9	4.1	5.1	4.6	4.8	4.6	4.6
GOB (commitment) excluding grants (percent of GDP)	-12.9	-11.1	-10.4	-9.9	-9.2	-8.6	-8.0
GOB (cash) excluding grants (percent of GDP)	-7.1	-7.5	-7.3	-12.4	-10.3	-9.7	-9.0
External support (recurrent)	6.9	10.1	8.1	6.9	6.7	6.6	6.5
In millions of NIS	2,986	4,532	3,676	3,330	3,452	3,558	3,659
NLB (commitment) excluding grants (percent of GDP)	-15.1	-12.6	-12.4	-12.2	-13.8	-13.0	-9.5
NLB (cash) excluding grants (percent of GDP)	9.0	8.9	8.6	14.7	14.9	14.1	10.6
Total external support (in millions of shekels)	3,587	4,915	4,402	4,149	5,526	5,711	4,255
Nominal GDP (in millions of shekels)	43,322	44,813	45,586	48,328	51,210	54,261	57,752
Exchange rate	3.9	3.6	3.6	...	...	...	...

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, 2011–15

(In percent)

	Dec 11	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15
Capital adequacy (for all banks)												
Tier 1 capital to risk-weighted assets	22.9	22.2	21.5	21.2	21.0	21.5	21.1	20.1	20.0	20.0	15.8	15.0
Regulatory capital to risk-weighted assets	21.1	20.3	19.8	19.5	19.3	21.0	19.5	18.9	18.3	15.9	17.8	17.1
Capital adequacy (for local banks)												
Tier 1 capital to risk-weighted assets	24.5	22.7	21.2	20.9	20.5	[illegible]	20.4	[illegible]	16.1	16.0	[illegible]	15.6
Regulatory capital to risk-weighted assets	20.5	18.5	17.7	17.7	17.3	17.6	17.5	16.2	16.3	16.3	15.7	15.1
Asset quality 1/												
Nonperforming loans (percent of total loans)	2.7	3.1	3.2	3.1	2.9	2.9	2.5	2.5	2.7	2.5	2.7	2.5
Nonperforming loans net of provisions to capital	3.6	4.5	4.2	5.1	4.8	4.7	4.8	4.4	4.1	4.0	4.9	4.2
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	51.6	55.3	50.5	53.1	58.3	61.2	51.2	57.4	56.6	61.4
Earnings and profitability												
Return on assets (ROA)	1.9	1.5	2.0	2.0	2.0	1.9	1.8	1.5	1.7	1.7	1.8	1.6
Return on equity (ROE) 2/	17.0	16.2	19.0	15.5	15.8	15.5	18.5	17.5	17.2	15.1	15.7	15.6
Interest income to gross income	71.7	72.4	74.0	75.0	74.6	74.0	74.5	74.1	73.0	72.4	71.5	70.8
Non-interest expenses to gross income	57.2	55.4	52.8	55.5	54.1	54.6	55.0	58.2	59.0	50.1	59.2	61.0
Personnel cost to non-interest expenses	55.5	53.6	57.4	57.9	55.1	53.9	56.3	53.7	52.5	51.5	55.0	52.9
Liquidity												
Liquid assets to total assets	38.2	37.5	36.3	36.8	37.5	38.5	38.0	37.0	36.3	35.4	34.1	32.8
Liquid assets to current and savings deposits	74.4	71.5	59.0	58.4	71.1	74.0	72.0	71.1	58.1	56.9	52.9	61.0
Liquid assets to total deposits	46.9	45.5	44.6	45.0	45.8	46.1	46.5	45.7	[illegible]	43.2	41.8	40.0

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. Risk Assessment Matrix[1]
Potential Deviations from Baseline

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

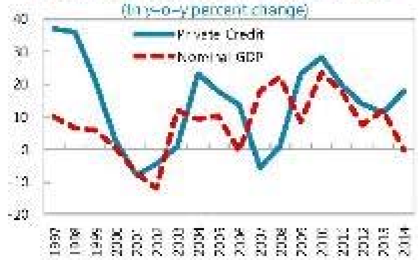
Nature/Sources of Main Threats	Likelihood of Realization in the Next Three Years	Expected Impact on Economy If Risk is Realized	Policy Recommendations to Mitigate Risks
Donor "fatigue" and reduced support from Arab donors due to falling oil prices	***Medium/Medium Term***	***High*** Budget support from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

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

Annex II. Rapid Credit Growth in the West Bank and Gaza (WBG): How Much Should We Worry?

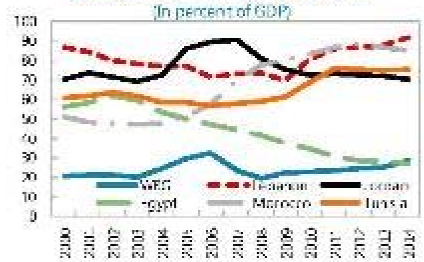
In recent years, the WBG has experienced high private sector credit growth, despite slowing economic activity. Bank credit to the private sector has risen annually by an average of 20 percent since 2009, almost double the rate of nominal GDP growth over the same period. Following 16 percent growth in 2014, credit has continued to expand at 18 percent year over year in the second quarter of 2015.

Growth of Private Credit and Nominal GDP
(In y-o-y percent change)



Sources: National authorities, and IMF staff calculations.

Domestic Credit to the Private Sector
(In percent of GDP)



Source: IMF Staff Calculations.

Part of this growth reflects catching up, but rapid credit expansion is often accompanied by a buildup of macro-financial risks. The WBG's credit expansion started from a low base, even by regional standards; while its 2014 credit-to-GDP ratio of 31 percent was slightly higher than that of Egypt, it was more than 50 percent lower than those in Jordan, Lebanon, and Morocco, and below the average level of countries in the MENA region. Hence, high private credit growth could reflect a catching-up process and the financial deepening associated with financial inclusion (Annex Box 1). On the other hand, it could indicate the emergance of a credit boom linked to looser lending standards, excessive leverage, and asset price bubbles, with attendant risks for macro-financial stability (Gourinchas and Obstfeld, 2012).

Statistical analysis of data on private credit, however, is inconclusive on the extent to which rapid credit growth has increased risks.

- **Analysis of credit gaps does not point to existence of a boom.** Credit booms are generally defined as extraordinary deviations ("gaps") in the actual credit from a long term trend or from an ad hoc threshold.[1] Borio and Lowe (2004) first documented the properties of the credit gap as a useful early warning indicator for banking crises. In this case, the analysis of the actual

[1] As a cautionary note, the short length and high volatility of the historical data for the WBG make it difficult to identify a conclusive credit trend.

credit—and its trending pattern—does not point to a problem because both the credit level and the credit-to-GDP ratio in WBG are consistent with their trends.[2]

Growth of Credit Relative to Trend
(In millions of US$, log transformation)

Sources: National authorities; and IMF staff calculations.

Credit Relative to Cubic Trend
(In percent of GDP)

Sources: National authorities; and IMF staff calculations.

- **The WBG does not significantly display the patterns of rapid credit expansion and contraction seen in a typical credit boom (see Dell'Ariccia and others, 2012).** As a middle-income economy with an under-developed financial system, the WBG has seen high growth in the credit-to-GDP ratio by absolute standards, but this growth could not be assessed as exceptionally strong or abrupt.[3]

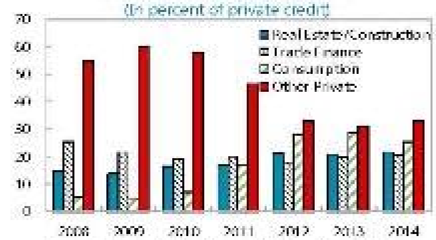
Nevertheless, economic analysis of private credit points to risks that need to be monitored. Lack of statistical evidence does not preclude the possibility of a credit boom, as statistical analysis is known to miss credit booms associated with financial crises (Mitra and others, 2011). In addition, even in the absence of a credit boom, there are risks that need to be monitored. These include high and increasing concentrations of credit, and possibly the insufficient capacity of bank supervisors to monitor a rapidly expanding loan portfolio.

[2] Two measures of credit (credit level and credit to GDP ratio) and two types of trends (the HP filter of log credit with a smoothing parameter set equal to 100 and the backward-looking rolling cubic trend, which incorporates two inflection points to allow for financial deepening and reversal) have been considered in this analysis.

[3] In a recent paper, Dell'Ariccia and others (2012) analyze 175 credit booms in a sample of 170 countries over the period 1960–2010 and find that: (i) most booms happen in middle income countries and under-developed financial systems; (ii) the median credit-to-GDP ratio at the start of a boom is 19 percent; and (iii) the median boom lasts three years, with the credit-to-GDP ratio growing at about 13 percent per year, or about five times its median growth in non-boom years.

Credit is concentrated in the West Bank and in three economic sectors. Eighty-four percent of private credit is extended in the West Bank and only 16 percent in Gaza. Credit is also concentrated in construction, trade, and, consumption. Loans to these three sectors account for almost 70 percent of domestic credit and 20 percent of GDP. The loan-to-deposit (LTD) ratio increased from 31 percent in 2008 to 55 percent in 2014 indicating that the rapid extension of loans did not always go hand in hand with the growth in deposits. At the same time, private credit has not exceeded 20 percent of total credit in any sector, an ad hoc concentration threshold set by the PMA as indicative of emerging vulnerabilities.[4]

Sectoral Distribution of Credit
(In percent of private credit)



Sources: National authorities; and IMF staff calculations.

Of concern is the rise of consumption loans, which have increased dramatically since 2008 and now account for a quarter of domestic credit, or 7 percent of GDP. Many of them are extended to employees of the PA, thereby adding to the already high direct exposure of the banking sector to the PA. The theoretical literature linking the financial sector to the real economy makes a distinction between the role of investment and consumption credit with some evidence that the former is associated with economic growth while the effect of the latter is more ambiguous (Beck and others, 2012). However, private investments in WBG increased from almost 16 percent in 2008 to 19 percent of GDP in 2014, seeming to exclude the crowding out of private investment by consumption (see Junius, 2013).

Worries arise about whether the banking sector has adequate capacity for managing the rising volume of credit. While total credit has more than doubled since 2009, banking sector growth has been unable to keep the same pace. In particular, the number of employees and bank branches has increased since 2007 by much less than bank credit. Although increased banking personnel productivity has been supported by the creation of the credit registry, understaffing in banks should be monitored to safeguard against a drop in credit quality.

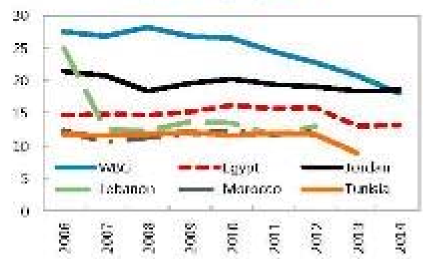
Evolution of Banking Sector Capacity
(In y-o-y percent change)

Sources: National authorities; and IMF staff calculations.

[4] PMA Regulation No. 5/2008 Article (1/6/5).

The PMA has been working to address the risks, but close monitoring needs to continue. The PMA has implemented a range of strong macroprudential policies, including countercyclical capital buffers, limits on real estate exposure, and monitoring of loan-to-value and loan-to-income ratios. Currently, the banking system is well capitalized by international standards, NPLs are below 3 percent, and liquidity is high. However, there has been a steady decline in capital adequacy. In addition, liquidity management by banks is constrained by the absence of a functioning interbank market, strained political relations with Israel, and a lack of access to capital markets. Furthermore, borrowers are reported to have currency mismatches between their loans and incomes, particularly in mortgages. Thus, even if recent private credit growth is a reflection of financial deepening rather than a boom, continuous vigilance is needed to monitor heightened risks in the context of a slowing economy.

Capital Adequacy Ratio

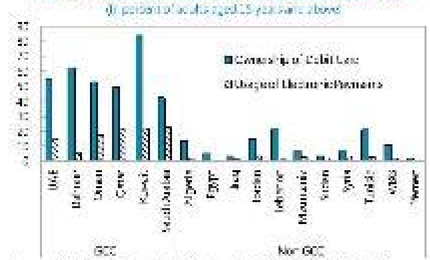


Source: Regional Economic Outlook.

Annex Box 1. Financial Inclusion in West Bank and Gaza[1]

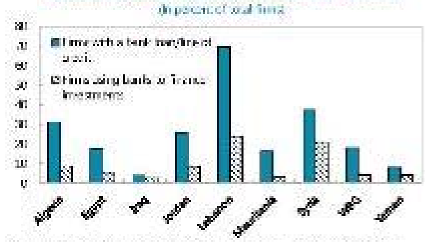
Financial inclusion is accelerating in the WBG, but there is a divergence between access to, and use of, bank credit. Financial inclusion is a process of increasing the efficiency, depth, breadth, and reach of financial systems, which is normally measured in terms of the number of individuals who own a bank account, have requested a loan in the past year, and make use of debit cards or electronic payments. The private credit-to-GDP ratio, a standard indicator of financial inclusion, has grown rapidly. Still, as of 2013, while 59 percent of adults had bank accounts, only 11 percent had credit accounts; based on a World Bank study, only 11 percent of adults had a debit card and a meager 2 percent made use of electronic payments.[2] The divergence between access to, and use of, bank credit could be attributed to religious reasons, according to the World Bank. Among firms, 18 percent had a line of credit and 4 percent used banks to finance investments, on par with Egypt, but below Lebanon and Jordan.

Financial Inclusion Indicators at the Individual Level
(In percent of adults aged 15 years and above)



Source: World Bank Financial Inclusion Report, 2014 and IMF staff calculations.
All data from 2011 or most recent available.

Financial Inclusion Indicators on the Firm Level 1/
(In percent of total firms)



Source: World Bank Financial Inclusion Report, 2014 and IMF staff calculations.
1/ Based on surveys of more than 130,000 firms spanning 2006 and 2013 conducted by the World Bank's enterprise unit.

The PMA has taken important steps toward enhancing financial inclusion. During the past decade, the PMA has aimed to reduce the population per branch. This indicator decreased from 16,900 people per branch in 2013 to 16,000 in 2014. In 2008, it established a Credit Bureau (CB) and in 2010 launched a credit scoring system linked to the credit registry, thereby supporting the rise of bank credit to the private sector. Later, it expanded the CB to include a database for SMEs and a Bounced Checks System. The PMA has also encouraged the use of ATMs and e banking services to lower the cost, and accelerate the execution of, transactions and reduce the use of cash. In 2013, the PMA launched the second phase of the International Banking Account System (IBAN) and, more recently, implemented the National Switch Payment System, vital for the development of retail ATM transactions. It also organized several banking awareness campaigns aimed at children and youth. In 2015, the PMA began formulating its first National Financial Inclusion Strategy.

Further progress, however, would require overcoming a number of challenges. Challenges include expanding banking services to the large informal sector, improving competition in the banking sector, and overcoming banks' discrimination against smaller customers. Improving competition can be achieved through adoption of innovative technologies, enhancing banks' business models so that they reach out to new clients, and strengthening the regulatory framework. To this end, the enactment of the Competition Law and the Secured Transaction Law and the utilization of the asset registry would enhance credit provision, particularly for SMEs, including by allowing collateralization of machines and equipment. This should be complemented by efforts to strengthen creditors' rights and speeding up the procedures for collateral enforcement.

[1] Source: PMA and World Bank (2014).

[2] See World Bank (2014).

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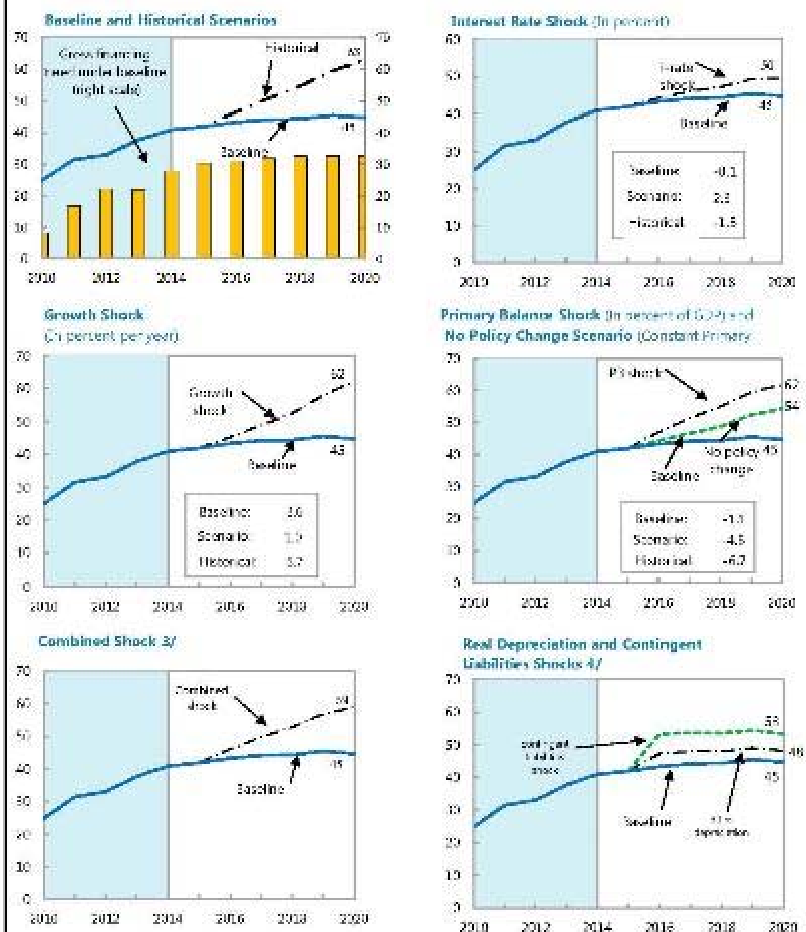
Annex III. Update of Debt Sustainability Analysis (DSA)

This DSA updates the DSA of May 2015. Since then staff assumed more sanguine view on the pace of fiscal consolidation in the medium-term to reflect continuing difficulties of the PA to contain current spending, including wages. A financing gap was raised from 1.6 percent of GDP on average over 2015–20 to about 3 percent, while macroeconomic projections of growth, prices and exchange rate changed only marginally.

The results of the DSA demonstrate that the risks to debt sustainability have increased. Public debt under the baseline scenario is on a rising path through 2019, stabilizing only at the end of the projected period.[1] At its peak, public debt is projected to reach 45 percent, up almost 5 percentage points of GDP from 2014. An interest rate shock could add 5 percentage points of GDP to the debt level at the end of the projected period, with public debt rising to 50 percent of GDP in 2020. The increase could be even more dramatic, with public debt rising to almost 60 percent of GDP or more and public debt becoming unsustainable, in case of shocks to growth, primary balance, or a combined shock. A one-time contingent liabilities shock equivalent to 10 percent of GDP (e.g., in case of non-payment to utilities) would elevate the level of debt immediately by about ten percentage points. A similar effect would occur with a fall in donor aid.

[1] Public debt refers to debt of the PA, including estimated arrears.

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 2016, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2010–20
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	24.9	31.5	33.1	37.8	40.0	41.9	43.5	44.1	44.3	45.5	44.7	-1.6
Of which: foreign-currency denominated	11.2	11.4	9.5	8.6	9.5	8.8	8.3	7.8	7.3	6.9	5.6	
2 Change in public sector debt	1.8	6.5	1.6	4.7	2.2	1.9	1.6	0.6	0.2	1.1	-0.8	
3 Identified debt-creating flows (4+7+12)	0.2	3.1	2.0	1.3	1.0	1.5	0.6	0.1	0.5	0.9	1.4	
4 Primary deficit	2.0	5.7	6.4	1.5	2.2	3.2	2.1	1.6	1.2	0.5	0.2	
5 Revenue and grants	35.5	29.0	26.7	29.6	31.2	30.3	32.8	32.8	29.8	30.2	30.2	
6 Primary (noninterest) expenditure	37.5	34.8	33.2	31.0	33.4	33.5	34.9	34.4	31.1	30.7	30.4	
7 Automatic debt dynamics 2/	-1.8	-2.5	-4.4	-0.2	-0.5	-1.8	-1.5	-1.5	-1.7	-1.4	-1.6	
8 Contribution from interest rate/growth differential 3/	3.0	2.1	4.0	0.9	0.1	1.8	1.5	1.5	1.7	1.4	1.6	
9 Of which: contribution from real interest rate	1.4	0.0	2.3	0.2	0.2	0.7	0.0	0.1	0.2	0.0	0.2	
10 Of which: contribution from real GDP growth	-1.6	-2.5	-1.7	-0.7	0.1	-1.1	-1.5	-1.5	-1.3	-1.4	-1.4	
11 Contribution from exchange rate depreciation 4/	1.2	0.5	0.4	0.7	0.5	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.6	3.4	0.5	3.5	1.5	0.4	0.8	0.8	0.7	2.0	0.7	
Public sector debt-to-revenue ratio 1/	70.2	108.4	123.7	127.7	131.3	138.3	132.0	134.5	148.6	150.5	148.0	
Gross financing need 6/	8.3	17.1	22.2	22.0	26.1	30.3	31.1	32.1	32.8	33.6	32.7	
in billions of U.S. dollars	0.7	1.7	2.7	2.5	3.3	4.1	4.4	4.8	5.2	5.5	5.8	
Scenario with key variables at their historical averages 7/						41.9	46.5	50.6	54.7	59.6	62.9	-4.2
Scenario with no policy change (constant primary balance) in 2015–2020						41.9	44.4	46.7	48.7	52.3	54.4	1.9
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.1	12.4	6.3	2.2	-0.4	2.9	3.9	3.7	3.7	3.4	3.2	
Average nominal interest rate on public debt (in percent) 8/	3.0	2.5	1.4	0.7	1.5	1.5	2.2	2.2	2.2	2.3	2.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.5	2.8	-7.7	-0.6	-0.9	-1.7	0.2	-0.1	-0.4	0.2	-0.4	
Nominal appreciation (increase in US dollar value of local currency, in percent)	8.8	3.2	4.5	7.2	6.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.5	0.0	9.2	1.3	2.1	3.0	2.0	2.2	2.5	2.1	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	-18.7	4.1	1.3	-4.3	7.3	3.1	8.3	2.3	-6.5	2.2	2.0	
Primary deficit	2.0	5.7	6.4	1.5	2.2	3.2	2.1	1.6	1.2	0.5	0.2	

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 $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = 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 $r - \pi(1+g)$ and the real growth contribution as $-g$.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
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.

Annex IV. Global Fiscal Adjustment: Some Lessons for the West Bank and Gaza

In recent years, the IMF has recommended medium-term fiscal adjustment in the WBG to stem accumulation of arrears, reduce aid dependence, and ensure public debt sustainability. Staff estimates that the required adjustment amounts to at least 4 percent of GDP. While significant, an adjustment of this magnitude is not uncommon. This annex summarizes lessons for the WBG that could be drawn from fiscal adjustment in other regions.

Fiscal adjustment, especially when large, is never an easy choice for a government. Regardless of whether the adjustment is revenue- or expenditure-based, there are losers in society, as some are bound to pay higher taxes while others see government subsidies decline and free services diminish. Because of this, fiscal reforms are politically difficult, and often implemented in dire economic circumstances. Typically, these occur when the economy is overheating and inflation picks up or when debt sustainability is compromised because of excessive deficits or financing constraints. Despite the challenges, many economically diverse countries enjoyed success with large fiscal adjustments of more than 5 percentage points of GDP over a span of two years.[1]

In the WBG, significant fiscal consolidation is needed. Its fiscal sustainability is at risk, it relies on fickle donor aid, and it has no market access. Residual fiscal financing gaps have typically been financed by accumulation of arrears and borrowing from commercial banks. Staff projects that, assuming unchanged donor aid and unchanged policies, the WBG could face a financing gap of about 4 percent of GDP over the next several years. Moreover, there are significant downside risks that could increase the projected financing gap by about 2 percentage points of GDP, including from demographic factors such as age pensions, which are not fully accounted for.[2] In addition, public debt has significantly increased, arrears have been creeping up, and debt sustainability is at risk. Hence, a fiscal adjustment of 4 percent of GDP or more is needed to prevent the accumulation of new arrears and the further erosion of private sector confidence.

In the current political and economic environment, the WBG will likely be more successful at gradual, rather than front-loaded, adjustment. Some front-loading, however, would be beneficial to avoid reform fatigue, a common pitfall, and to forestall the accumulation of arrears to the private sector. International experience suggests that both gradual and upfront adjustments could be successful, and that political and demand conditions dictate the speed of adjustment. A newly elected government with a strong public mandate would more likely resort to front-loaded adjustment, since gradual adjustments are more difficult to sustain politically. For instance, in the majority of cases (eight out of 12 cases) of large fiscal adjustments studied by Tsibouris and others where the countries faced financing constraints and had new political leadership, adjustment programs were front-loaded. In the WBG, however, weak demand conditions in an economy

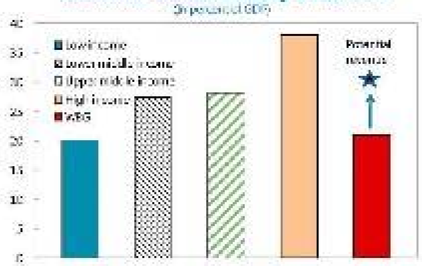
[1] See, for example, Tsibouris and others (2006) for case studies.

[2] The World Bank is currently conducting a study of the pension system in the WBG.

suffering from political uncertainty and Israeli restrictions, combined with lack of political unity, suggest a gradual approach to fiscal consolidation. To sustain the consolidation, however, given the significant share of aid in budget financing, continuous donor support will be required. Success will also critically depend on the support of Israel in providing steady transfers of clearance revenue and removing restrictions to allow more private sector activity.

Increasing revenue will play an important role in the WBG's fiscal consolidation. The choice between revenue- and expenditure-based fiscal consolidation is typically country specific.[3] Expenditure-based consolidation is preferred in countries where the size of the public sector is excessive. This has been the case in many OECD economies. Revenue-based consolidations have been more prevalent in emerging and developing economies with low revenue to GDP ratios. Revenue measures are also easier to implement compared to expenditure measures, especially if they are perceived as improving fairness, and if taxpayers perceive an improvement in the quality of public services. The WBG has significant potential to raise revenue by expanding the tax base, improving compliance, and raising nontax revenue (see Report to the AHLC, May 2015), and to improve fairness by making the tax system less regressive.[4] Moreover, total expenditure in the WBG does not appear excessive compared to other countries in the Middle East and North Africa region.

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



Source: IMF staff estimates.

Public Expenditure, 2014
(In percent of GDP)

Source: IMF staff estimates.

At the same time, expenditure measures can be implemented more quickly, and are necessary to address short-run financing constraints. The WBG and other countries have demonstrated that revenue measures often require improvements in tax administration that take time to implement, while clamping down on tax exemptions draws resistance from vested interests. This stymies reform, prompting expenditure cuts—often to investment—to address immediate fiscal concerns. For instance, in all cases of large revenue-based fiscal consolidation studied by Tsibouris and others (Brazil 1999–2003, Cote d'Ivoire 1993–2000, Jamaica 1998–2001, Nigeria 1990–2000, Russia 1999–2002, Zambia 1989–94) some type of expenditure measures were implemented to support fiscal adjustment. In Brazil, in particular, the annual practice was to curtail

[3] The distinction between the two types of consolidations is made for expositional purposes; in practice, a combination of the two types of measures is used.

[4] See Jewell and others (2015) for a discussion of fair taxation in MENA.

expenditure during the first part of the year, until revenue performance was ascertained. It is important, however, to avoid across-the-board cuts in order to ensure continuous delivery of public services at acceptable levels and thereby ensure public support for reforms.

In the WBG, the expenditure effort should focus on rationalizing the wage bill and transfers while strengthening the social safety net. Expenditure measures that are undertaken should be growth-friendly.[5] Although in the short-run expenditure consolidation may lower aggregate demand and thereby negatively affect growth, in the longer term this effect dissipates if the contractionary impact of lower public spending is mitigated by an expansionary private sector response. This response is more pronounced when cuts affect wages and transfers, and productive public investment spending is preserved or even increased (if there is fiscal space).[6] Moreover, cutting wages and transfers delivers sustainable nonreversible adjustment, unlike some low-quality measures which have only a transitory effect.[7] For instance, in all cases of large fiscal consolidation in Tsibouris and others, a combination of measures to contain wages, untargeted subsidies, or excessive social transfers was applied. In some cases, public investment were also reduced or reoriented towards social sectors, such as health and education (Cote d'Ivoire and South Africa). In the WBG, the level of public investment spending is small, compared to other MENA countries, while expenditure on wages is the highest in the region.

Capital Expenditure, 2014
(In percent of GDP)

Source: IMF staff estimates.

Wage Expenditure, 2014
(In percent of GDP)

Source: IMF staff estimates.

Furthermore, a recent study by the World Bank found that public sector wages in the WBG are significantly higher than private sector wages, and that the gap between public and private sector wages has been increasing over time, hurting competitiveness.[8]

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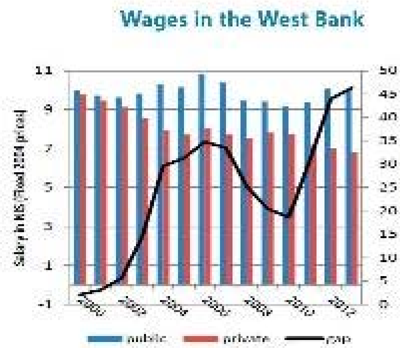
[5] See, for example, IMF (2015) and Kumar and others (2007).

[6] Staff finds that fiscal multipliers for public investment spending are higher than those for wages and transfers (see Cerisola and others, 2015).

[7] Examples of lower-quality measures include deferral of payments, savings on essential operations such as maintenance, sudden cuts in public investment, etc. These measures would ultimately lead to arrears, stalled projects, or lower long-term investment and growth.

[8] See "Causes behind the Palestinian Authority's Large Wage Bill and the Road to Its Sustainability" (forthcoming, World Bank).



Source: World Bank estimates.

There is also room to reduce untargeted subsidies on fuel which amounted to about 1 percent of GDP in 2014, and to limit increases in age related spending (for instance, by raising the retirement age).[9]

Fiscal reforms should be accompanied by wider structural reforms. To ensure sustainability, wage restraint should be accompanied by broader civil service reforms that raise productivity and link remuneration to performance. In Nigeria, wage increases without supporting civil service reform led to a reversal of fiscal consolidation achieved over 1990–2000 in follow-up years. Little progress on civil service reform was also among reasons for a similar reversal of reforms from 1989–94 in Zambia. As noted above, it is also important to prompt a strong, positive private sector response to fiscal consolidation in order to ensure success. This could be achieved not only by improving the fairness of the tax system and investing in infrastructure, but also by enhancing the business climate through improvements to the regulatory and institutional infrastructure. Promoting a business-friendly environment should be part of a complementary structural reform strategy. Countries, that underwent large fiscal adjustments, had to tackle labor (Canada, Finland, New Zealand, South Africa) and product (New Zealand, Zambia) market rigidities, trade restrictions (Brazil, Zambia), distortions in the energy sector (Russia), privatization of state-own enterprises (Russia, Brazil), inefficient tax system (Brazil, Cote d'Ivoire).

Successful implementation of a fiscal consolidation strategy is associated with sound PFM. Strong budget institutions are needed to understand the scale and scope of fiscal issues. This entails efforts to improve the quality of fiscal reporting, to build capacity for medium-term projections, and to deepen the analysis of long-term issues (such as an aging population). Fiscal consolidation requires the development of a medium-term fiscal framework that can provide guidance for annual budget allocations based on transparent fiscal objectives such as the reduction of the deficit or ensuring debt sustainability. Improvements in budget planning and execution, combined with

[9] See *Public Expenditure Review for the West Bank and Gaza* (forthcoming, World Bank).

transparency in the use of public resources, can boost trust in the government and make reform—especially if it involves an increase in effective tax levels—more acceptable to the public. Experience from other countries shows that the establishment of a strong macro-fiscal unit embedded in the ministry of finance can be an effective way of tackling the aforementioned challenges. In Tsibouris and others, in six out of 13 study cases large fiscal consolidations were accompanied by a transition to medium-term budget frameworks supplemented in some cases by strengthened legal frameworks for developing, implementing and monitoring annual budgets, and improved expenditure planning, accounting and reporting, and oversight.

Timing of reform matters. A supportive external environment often presents a good opportunity to launch reforms. For example, in Russia in the late 1990s, favorable oil price developments contributed to better revenue reform outcomes and mitigated negative effects of expenditure consolidation on growth. In the WBG now, strong export demand from trading partners (Israel and the EU for the WBG) and declining oil prices should help mitigate the negative effects on output of fiscal contraction; low fuel prices should also help oil-importers, such as the WBG, to lower fuel subsidies with minimal impact on consumers. At the same time, a challenging domestic environment should, in and of itself, push reforms forward. In the WBG, the detrimental effect of public sector arrears on the economy, and the impact of the ongoing fiscal crisis on the quality of public infrastructure and services, should be sufficient to motivate fiscal reforms.

A fiscal consolidation strategy needs to include a public communication strategy. Successful implementation of fiscal reforms requires public support. Governments successful at implementing fiscal consolidation design and implement a public communication strategy to educate the broader public about the conduct of the reforms and their goals. Messages emphasize how reforms are advancing equity by creating fiscal space for well-targeted social spending and growth-enhancing infrastructure, and leveling the playing field for businesses. Adequate attention is also given to safeguarding social safety nets and improving their targeting. A review of subsidy reform experiences by the Fund, for example, found that the likelihood of success almost tripled with strong public support and proactive public communications.[13]

External partners can play a key role in bringing about fiscal reform. Bilateral donors and international organizations—including the IMF—can serve as advisors and honest brokers to explain the pros and cons of reforms to the public, add credibility, and provide technical assistance to facilitate design and implementation. Notably, in nine out of 13 cases of large fiscal consolidation in Tsibouris and others, the countries have active programs with the IMF.

[13] See IMF (2011).

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

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

Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Nov. 9–20, 2014	Strengthening Large Taxpayer Unit	Nov. 2014
Nov. 23–Dec. 1, 2014	Public Financial Management Progress Review	Dec 2014
Mar. 8–19, 2015	Compliance Modeling in LTU and Tax Departments	Mar. 2015
Aug. 16–27, 2015	Revenue Administration	n.a.
Aug. 23–28, 2015	Work Program for Macro Fiscal Advisor	n.a.
Monetary and Financial Systems: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for eventual introduction of an independent currency for the WBGWBG economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012
Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk Based Banking Supervision *	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012
Oct. 31–Nov. 15, 2012	Strengthening the Stress Testing Framework, Consolidated and Cross Border Supervision and Contingency Crisis Management Framework	Nov. 2012
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013

Mar. 31–Apr. 11, 2013	Follow up on Risk Based Supervision Manual	n.a.
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	July 2013
Nov. 3–14, 2013	Implementing Risk Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk Based Supervision Manual	June 2014
Oct. 26–Nov. 6, 2014	Follow up on Risk Based Supervision Manual	n.a.
Jan. 18–29, 2015	Follow up on Risk Based Supervision Manual	n.a.
Mar. 8–18, 2015	Contingency Planning and Crises Preparedness*	May 2015
April 5–16, 2015	Follow up on Risk Based Supervision Manual*	April 2015
April 13–17,2015	Risk Assessment and Stress Testing*	May 2015
Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.		
Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	June 2014
May 21–June 3, 2014	Monetary and Financial Statistics	n.a.
Dec. 7–18, 2014	Price Index	Dec. 2014
Feb. 1–12, 2015	External Sector Statistics	April 2015
Feb. 22–26, 2015	National Accounts	Mar. 2015

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

ANNEX 4: PUBLIC FINANCIAL MANAGEMENT (PFM) AND FIDUCIARY ASPECTS

The proposed DPG VII will be executed through the PA's PFM system. This annex summarizes the current state of certain aspects of the system and ongoing reform efforts. The PA PFM system is considered to be reasonably adequate for the purposes of general budget support operations.

Implementation of Integrated Financial Management Information System (IFMIS)
The PA budget preparation and execution process has been supported by IFMIS since 2009. The IFMIS has been rolled out to all line ministries and is considered the official country system to account for public financial resources. Transactions are entered by line ministries with approval for the transaction by Financial Controllers who are decentralized to all line ministries. IFMIS modalities have been updated which has led to improvements in terms of consolidation of the financial statements, quality of financial reports and the orderly exchanges between line ministries and the MoF. The IFMIS has controls for payments against cash ceilings; however the insufficiency of commitment controls can lead to generation of arrears.

Treasury Single Account and Bank Funded Projects
All tax revenue is paid directly into the treasury account, and most operational payments and transfer expenditures are executed by line ministries in a devolved Treasury model, using IFMIS. Reconciliation between the Treasury subaccount and payment is made on a regular basis (daily for most expenditures). There are three main Treasury Accounts: (i) Clearance Revenue Account; (ii) a Donor Fund Account used to deposit budget support financing (e.g. DPG, Program for Results); and (iii) an account catering to domestic revenues and expenditures. Each TA has subaccounts with virtual ceilings which are consolidated each day to ensure zero balances in the subaccounts. All accounts are managed online and a daily cash report is produced. Currently, World Bank funds as well as all donor funds are not channeled through the Treasury Account, but rather through separate designated accounts held at the Bank of Palestine (Ramallah) for funds receipts and disbursements.

Financial and Commitment Control
A key component in the MoF internal control framework is the function of the financial controller. This is the traditional ex-ante model ("pre-audit") used by many ministries of finance. Each financial controller posted at the respective line ministry is required to review and clear all transactions, including those relating to Bank-financed projects, before they are processed for payment. Financial controllers are appointed by the MoF Accountant General. The financial control function is not driven by a risk-based guidelines and procedures. Currently, there is a functionality in IFMIS to enter and record budget commitments (called *budget request voucher*) but it is not mandatory and is not controlled by the financial controller. However, these last two years this functionality has been utilized on a pilot basis at the ministries of Education and Finance and the MoF has agreed to extend it to five other line ministries prior to further rolling-out the system. Such reform is supported by the DPG and could contribute to reduce the generation of new arrears if there is no cash available to process the disbursement at the time the expenditure is made.

Internal Audit
The Internal Audit Department (IAD) was created in 2004 within the MoF with the dual mandate of performing the MoF internal audit, and decentralizing the internal audit function from the MoF to line ministries. The scope of the Internal Audit Function across the Palestinian National Authority is governed by regulation No. 11/2011 (the Charter) issued in August 2011, which

clarifies roles and responsibilities of the IAD as well as reporting requirements. A Central Harmonization Unit (CHU) was established within the MoF pursuant to article No. 5 of Regulation 11/2011 issued by the Minister of Finance. According to the Regulation, the CHU is responsible for setting and updating the internal audit methodology as well as providing advice to the internal audit units in line ministries. The CHU also supervises the decentralization transition process and reports to the Internal Audit Committee. The IAD adopted the International Internal Auditing Standards (published by the Institute of Internal Auditors) that were customized to meet the country context. In practice, the internal audit and the CHU are not yet fully operational and decentralized due to capacity and financing constraints.

Accounting and Reporting

The fiscal year of the PA is January 1st to December 31st. The financial statements of the PA are prepared in accordance with cash basis IPSAS standards. However, IPSAS have not been completely applied, as noted by the SAACB in its 2010 qualified opinion, which identified certain missing information and/or explanations. Monthly bank reconciliations are performed at the level of line ministries through the IFMIS and are submitted to the MoF generally in a timely manner. Reconciliations on revenues are usually performed at the MoF level but their timeliness and accuracy are to be improved.

Although the monthly budget execution reports are produced and published on a timely basis, a major delay in the issuance of the annual accounts has accumulated recently. The last set of annual accounts relate to 2010.

State Audit and Administrative Control Bureau (SAACB)

The SAACB is the supreme audit institution responsible for independent oversight and external audit over public sector bodies in accordance with provisions of PA law. The organization in its current form was established in 2004. The SAACB has issued its opinion on the financial statements of the Palestinian Authority (PA) since 2008, the latest covering the year ended December 31, 2010. According to the 2013 PEFA report with regard to the "scope, nature and follow up of external audit", namely, performance indicator PI-26, the three dimensions of the indicator are rated at B or C levels (on an A-D scale basis).

The SAACB is a well-managed organization with a high degree of openness to its stakeholders, including the public and civil society. The SAACB has made important improvements in its audit performance over the last few years, and the newly adopted audit methodology is largely compliant with international standards. However, the new methodology is not yet evenly implemented across the various audit directorates within the organization. Before the new methodology was adopted, the quality of audit assignments could vary significantly. Taking into account the relatively strong foundations built over several years in combination with the SAACB's strong interest in bringing its audit practices further into line with the International Standards of Supreme Audit Institutions (ISSAIs) and its rich engagement with external partners, SAACB's prospects for further improvements are considered to be strong. External partners have provided support in areas of significance to the SAACB, and are likely to continue to assist SAACB in its efforts. However, the SAACB still needs to increase its efforts to institutionalize the new practices introduced through external support so that it can continue to improve in a sustainable manner.

SAACB effectiveness is affected by its operational environment. Specifically, the Ministry of Finance has not submitted to SAACB the final accounts for 2012 to 2014. In addition, the SAACB's legal audit mandate is broad in comparison to its actual resources. The SAACB is mandated to audit around 5,000 entities, including central and local government entities, non-governmental organizations (NGOs), as well as to conduct audits based on complaints from the public.

Procurement

The reform, which has been supported by the Bank, including through the DPG series, aimed at improving the accountability, integrity, and transparency of the system, as well as preventing corruption and increasing opportunities for the private sector. As part of these efforts, a new Public Procurement Law (PPL) and its implementing regulation, consistent with international best practices, were enacted in April 2014. The PPL represents a good balance between the current means of the country and internationally accepted practices. The PPL, which applies to all procurement activities by all entities using public funds (including municipalities), lays down an acceptable institutional and organizational set-up for public procurement; provides comprehensive provisions on procedural matters; sets out provisions on transparency and accountability; establishes a complaint/dispute review mechanism; and provides for routine dissemination of information on public procurement through a single portal procurement website. The PA also established, through Cabinet decision, the Higher Council for Public Procurement Policies (HCPPP), which is the entity mandated by the PPL for the development of the procurement system, including: policy setting, institution building, procurement documentation, guidelines and manuals, training and public awareness campaigns , as well as for oversight of all public procurement activity.

However, the efforts in finalizing the procurement reforms have recently stalled. As of the end of 2015, the PPL has not yet come into effect and HCPPP is not yet fully functional. As a result, the majority of shortcomings identified in the Country Procurement Assessment Report of 2014 remain unaddressed. In particular, the procurement system continues to suffer from: (i) inconsistent implementation of procurement processes resulting from a general lack of common guidelines, rules and technical standards; (ii) lack of a single central entity to ensure efficient oversight and clear and enforceable sanctions and enforcement mechanisms; (iii) an absence of routine reporting of procurement activities and dissemination of procurement information; (iv) no independent mechanism to investigate complaints by bidders about procurement processes; and (v) limited capacity of civil service staff working in public procurement.

Anti-Corruption Overview

Due to political reasons, the legislative council is not convening, the legislative branch therefore is having difficulty fulfilling its role as a monitoring institution over the government. This diminishes government accountability and increases the risk of unregulated corrupt practices.[29] In addition, the lack of access to information legislation negatively affects transparency and citizen engagements. A World Bank 2011 study summarizes the progress made and challenges ahead in this area as follows: First, the PA has made significant strides to improve economic governance over the past decade. Second, reform efforts have achieved varying degrees of success and the PA needs to prioritize and address the ongoing challenges. Finally, the PA should take a more proactive approach to investigating and prosecuting corruption, as well as communicating its anti-corruption activities to build public confidence in government accountability.[30] There is now an anti-corruption law and a fairly new Anti-Corruption agency. These two developments will need some

[29] http://www.transparency.org/country/#PSE

[30] Improving Governance and Reducing Corruption in West Bank and Gaza, the World Bank, May 2011.

time to have an impact on the corruption perception. Another positive note is that CSOs and media have increased their role.

Management of Foreign Exchange

As with previous DPGs, DPG proceeds will be deposited into the **Treasury Single Account** held at the Bank of Palestine. Bank of Palestine financial statements for the year ended December 31, 2014 were audited by Ernst &Young. The auditor expressed an unqualified opinion. The semi-annual reports for 2015 are published on Bank of Palestine's website[31].

Conclusion

Over the past decade, the PA has made significant progress in reforming PFM, and there is broad agreement between the PA and the international development community to continue to pursue these efforts. However, serious weaknesses remain that need continuous commitment from the PA, so that the technical assistance provided by the Bank and other development partners bears impact on the ground. The Bank is discussing with the government to update the 2013 PEFA during 2016 to confirm the current strengths and weaknesses in the PFM system.

[31] http://www.bankofpalestine.com/en/ir/financial-docs