Economic Monitoring Report to the Ad Hoc Liaison Committee

September 25, 2013

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
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Acronyms

AHLC	*Ad Hoc* Liaison Committee
DFID	UK Department for International Development
EU	European Union
GDP	Gross Domestic Product
GoI	Government of Israel
IEC	Israel Electric Corporation
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
MENA	Middle East and North Africa Region
MoF	Ministry of Finance
MoH	Ministry of Health
MoNE	Palestinian Ministry of National Economy
MoSA	Ministry of Social Affairs
NCTP	National Cash Transfer Program
NIS	New Israeli Shekel
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PEA	Palestinian Energy Authority
PEFA	Public Expenditure and Financial Accountability
PETL	Palestinian Electricity Transmission Company Limited
PFM	Public Financial Management
PIF	Palestine Investment Fund
PLO	Palestine Liberation Organization
PMA	Palestine Monetary Authority
USAID	United States Agency for International Development
USD	United States Dollar
VAT	Value Added Tax
WB&G	West Bank and Gaza
WHO	World Health Organization

A. Executive Summary

a. The *Ad Hoc* Liaison Committee (AHLC) meeting of September 2013 comes at a time of deteriorating economic conditions in the West Bank and Gaza and continuing fiscal challenges for the Palestinian Authority (PA). However, the renewed talks between the Government of Israel (GoI) and the PA, and proposed plans for a substantial economic package aimed to boost private sector investment, could reverse the current trend, if coupled with a significant easing of restrictions by the GoI, continued reforms by the PA, and a commitment of ongoing financial support from the international community.

b. The economic situation has deteriorated since the last report in March, 2013. For the first time since 2002, economic output in the West Bank contracted during the first quarter of 2013, and almost one out of three participants in the labor force in Gaza was unemployed during the first half of 2013. Lower than anticipated growth contributed to the PA's revenues falling below the budget target. A sizeable financing gap of approximately USD320 million is forecast by the end of 2013 despite an increase in donor budget support in the first half of 2013 compared to the same period last year. Absent additional donor assistance, the PA will need to find ways to close the financing gap either through relatively costly borrowing from domestic commercial banks or accumulating further arrears to the pension system and private sector. The latter would, however, have negative consequences for liquidity, growth and subsequently tax revenues. In addition, the provision of public services may be negatively affected by unrelenting fiscal challenges. The economic situation, however, stands to gain from potential agreements in the context of the resumed political negotiations and the intention to bring large scale private investment to the West Bank and Gaza.

c. As noted in previous reports, the most significant impediment to economic viability in the Palestinian Territories is the multi-layered system of restrictions imposed by the GoI. The system of restrictions constrains investment, raises costs for doing business, and hinders economic cohesion. Restrictions on access and movement also negatively affect the PA's capacity to deliver public services. While some actions have recently been taken by the GoI to relax certain restrictions, stronger measures to significantly ease pervasive remaining obstacles that currently prevent private sector led economic growth are warranted.

d. In addition, the PA will need to make continued efforts on the reforms which are within its control to strengthen its fiscal position and enhance its capacity to deliver essential public services. The PA has already made substantial achievements on institution building. The impressive human development outcomes in the West Bank and Gaza are good indicators of reasonably well-functioning public institutions. On the other hand, in recent years fiscal space available for the delivery of essential public services has gradually diminished mainly due to slowed economic growth and decreased donor aid. Therefore, pressing on with reforms to strengthen the PA's fiscal position is essential to ensure the necessary fiscal space to boost growth and provide essential public services to the Palestinian people.

e. In particular, reforms to enhance domestic revenues, controls over the civil service wage bill, outpatient referrals and broader health expenditures, and deficits in the electricity sector, and rationalization of the social safety net program and the public pension system are expected to yield high returns for strengthening the PA's fiscal position and enhancing its capacity to provide essential public services. These reforms will require strong political commitment, effective change management, and relevant technical and financial resources. The reform efforts by the PA, to be fully effective, should be combined with better cooperation by the GoI. Moreover, continued financial support by the donor community would be essential to ensure that necessary fiscal space is available for providing basic services to the Palestinian people.

B. Recent Economic Developments

1. **Following robust growth in previous years, economic activity in the Palestinian Territories deteriorated in 2013, particularly in the West Bank**. Growth over the last few years has mainly been driven by large inflows of donor aid that enabled the expansion of the public sector, resulting in consumption driven growth. Decomposition of recent growth trends indicates that the contribution of government funded services to the economy has been on the rise while the share of the tradable sectors has declined mainly due to the ongoing Israeli restrictions on movement, trade, and access to Area C, East Jerusalem and Gaza. However, this growth model has proven unsustainable. The significant decline in donor aid that was witnessed in 2012, in addition to insufficient easing of Israeli restrictions on economic activity, had an immediate effect on the economy as the overall growth rate in West Bank and Gaza (WB&G) declined from an average of 11 percent in 2010-2011 to 6 percent in 2012.[1] The economic situation has further deteriorated in 2013 and Palestinian Central Bureau of Statistics (PCBS) reports that growth in WB&G during the first quarter of the year declined to 2.7 percent when compared to Q1 2012. Growth was driven by economic activity in Gaza which grew by 12 percent while output in the West Bank actually contracted by 0.6 percent.

Figure 1: Real GDP Growth Rates 1999 – Q1 2013

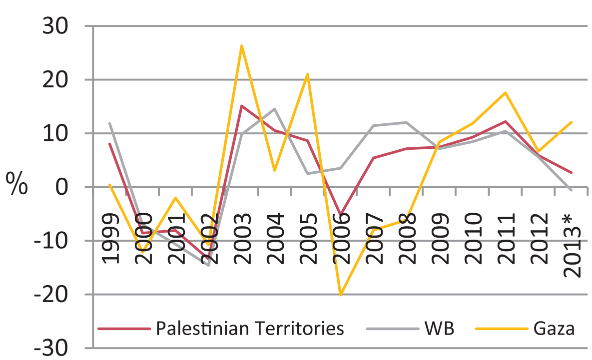
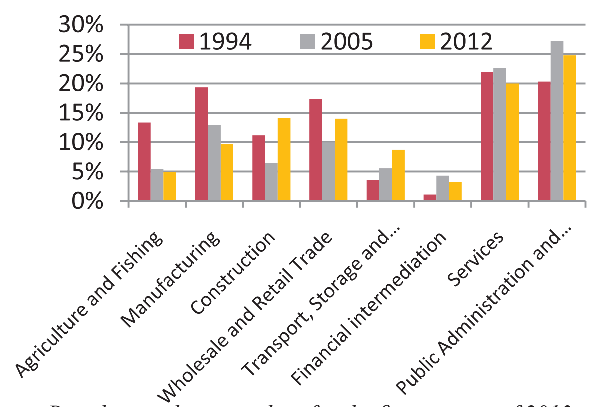


Figure 2: Structure of the WB&G economy changed drastically away from the tradable sectors



Source for figures 1 & 2: PCBS National Accounts Data; Based on preliminary data for the first quarter of 2013

2. **Growth in Gaza in Q1 2013 was mainly attributed to large inflows of donor aid directed towards construction projects that were initiated in late 2012.** These aid inflows enabled the construction sector to expand by 46 percent when compared to the same period in 2013, making it the main driver of growth in Q1 2013. Specifically, the construction sector accounted for more than 80 percent of Gaza's growth during this period as it contributed about 10 percent to the 12 percent total growth. However, since most construction material is brought into Gaza from Egypt through the tunnels, recent measures by the Egyptian authorities to reduce tunnel activity are expected to result in a significant decline in the construction sector's output over the coming months. This will likely, in turn, cause an overall decline in growth in Gaza especially given the important role that this sector has played in driving growth in

1 The Government of Israel cities overriding security concerns that restrict its ability to continue to ease or lift restrictions on the Palestinian Territories.

recent years. The public administration and defense sector was the second biggest contributor to Gaza's growth in Q1 2013 as it expanded by more than 13 percent and contributed 2.4 percentage points to overall growth during this period. Growth in these sectors was offset by a decline in other economic activities including agriculture and manufacturing which have both contracted by 2 and 1 percent, respectively.

3. **Economic output in the West Bank contracted during Q1 2013 mainly due to insufficient easing of Israeli restrictions, the withdrawal of fiscal stimulus and high levels of uncertainty[2].** The public administration and defense sector shrank by 1 percent in Q1 2013 on year-on-year basis as a consequence of fiscal retrenchment implemented in the face of irregular transfer of clearance revenues[3] by the GoI earlier in the year and a reduction in levels of donor aid in recent years. Furthermore, the fiscal difficulties caused a delay in civil servants' wage payments during the months of January and February, 2013, which created high levels of uncertainty that negatively affected consumption patterns in the economy. This, in addition to the ongoing restrictions, which constrain private investment, placed a toll on various economic sectors. For instance, the services sector, which had played a significant role in growth in the West Bank in 2012 contracted by 3 percent in Q1 2013 and negatively contributed to West Bank's growth by 0.5 percent. The wholesale and retail trade sector also contracted by 7 percent during Q1 2013, pulling down growth in the West Bank by 1 percent. Agriculture output also declined by 11 percent in Q1 2013.

Table 1: Contribution to GDP Growth by Economic Activity, January-March 2013

Economic Activity	WB&G	WB	Gaza
Agriculture, Forestry and Fishing	-0.3	-0.4	-0.1
Mining, Manufacturing, Electricity and Water	0.7	0.9	0.4
Manufacturing	0.8	1.1	0.0
Electricity, Gas, Steam and Air Conditioning Supply	0.1	0.1	0.4
Construction	3.3	1.2	9.6
Wholesale and Retail Trade	-0.9	-1.0	-0.7
Transportation and Storage	-0.1	-0.2	0.2
Financial and Insurance Activities	0.2	0.3	0.2
Information and Communication	-0.3	-0.5	0.0
Services	-0.4	-0.5	0.0
Accommodation and Food Service Activities	0.0	0.0	0.1
Public Administration and Defense	0.7	-0.1	2.9
Households with Employed Persons	0.0	0.0	0.0
FISIM	-0.2	-0.3	-0.2
Customs Duties	0.4	0.5	0.0
VAT on Imports, net	-0.4	-0.5	-0.1
(%) Real GDP Growth Rate	**2.7**	**-0.6**	**12.2**

Source: PCBS and World Bank staff calculations

2 All growth figures mentioned in this paragraph is on year-on-year basis.

3 Clearance revenues are VAT and import duties that are collected by the GoI on behalf of the Palestinian Authority, and they are considered the PA's main source of income.

4. **Unemployment in WB&G continues to be persistently high due to weak private sector activity.** The overall unemployment rate reached 22 percent in the first half of 2013. Notably, this rate masks wide regional divergence as unemployment in the West Bank, at 19 percent, is almost 11 percentage points lower than in Gaza at 30 percent. Consistently high unemployment is mainly attributed to low private investment that continues to be restrained by the ongoing Israeli restrictions. Private investment hovering at around 15 percent of GDP for the past seven years is very low by international standards. Thus, the Palestinian economy has clearly not been able to generate sufficient job opportunities and absorb enough new labor market entrants to improve the unemployment situation. Lack of opportunities in the private sector causes the public sector to be viewed as the employer of last resort as it currently employs 23.6 percent of persons employed in WB&G[4]. This rate is high, even by regional standards. Israel has recently increased the number of work permits for Palestinians from the West Bank from 35,000 to 45,000, but this was still not sufficient to put a dent on unemployment. Thus, unless the restrictions on economic activity imposed by the GoI are substantially relaxed to allow growth in private investment, unemployment in WB&G is expected to remain high.

Table 2: Labor Force Statistics January - June 2013

Indicator	WB&G	WB	Gaza
Unemployment Rate	22.3	18.6	29.5
Underemployment Rate	6.1	5.4	7.5
Labor Force Participation Rate	43.2	44.7	40.5
Youth Unemployment (Ages 15-29) Rate	34.9	28.6	46.6
Youth Labor Force Participation Rate	36.7	38.8	33.3
Female Unemployment Rate	34.5	26.3	51.0
Female Labor Force Participation Rate	16.9	17.7	15.4

Source: PCBS Labor Force Surveys for Q1 and Q2 2013

5. **Both high youth unemployment and low female labor force participation rates are serious concerns**. In the West Bank, 29 percent of young Palestinians aged 15-29 years were unemployed in the first half of 2013. Youth unemployment is especially acute in Gaza where almost one in every two young Palestinians is unemployed. The persistence of this trend raises alarm as the skills of those unemployed have deteriorated overtime, and hence, it has become extremely difficult for them to find good jobs. This has caused the majority of Palestinian youth in WB&G to drop out of the labor market which has, in turn, caused the youth labor force participation rate to remain low at 37 percent. Equally alarming is the lack of female participation in the labor force. At 17 percent, participation rates for females in WB&G are much lower than the Middle East and North Africa regional average of 26 percent, which is one of the lowest regional rates in the developing world[5]. The extremely low female participation rate in WB&G is partly due to social norms that constrain women's ability to work outside their homes. However, according to some earlier analysis, it is also attributable to safety and mobility constraints associated with the Israeli restrictions on movement.[6]

4 According to the Labor Force Survey by PCBS

5 Coping With Conflict? Poverty and Inclusion in the West Bank and Gaza, World Bank, 2013

6 World Bank (2010), "Checkpoints and Barriers: Searching for Livelihoods in West Bank and Gaza."

Figure 3: Youth unemployment and unemployment in WB&G remain high

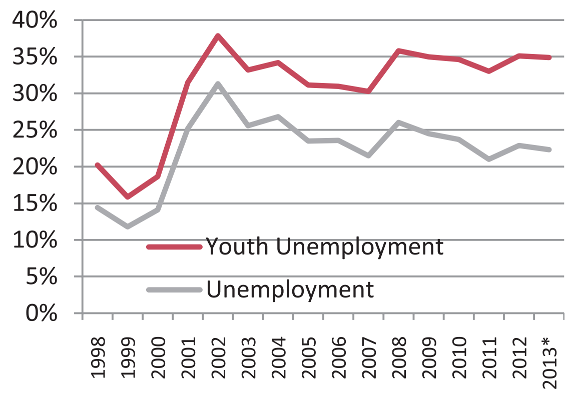
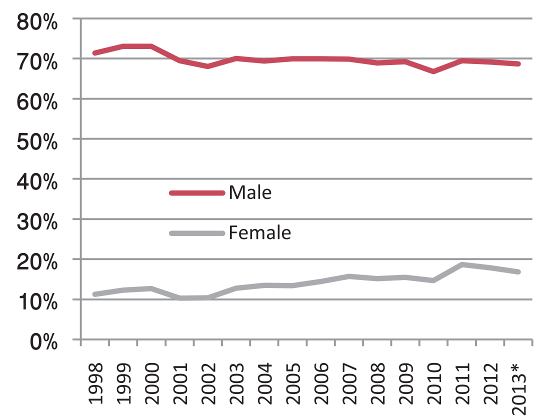


Figure 4: Female participation rate in the labor market has been extremely lower than the male labor force participation rate



Source for figures 3 and 4: PCBS labor force surveys for Q1 and Q2 2013
**Based on average data for Q1 and Q2 2013*

6. **The projected slowdown of the Palestinian economy to 4.5 percent in 2013 is expected to have a negative impact on the labor market outcomes and poverty, but recent developments in Gaza are of particular concern.** Recent moves by the Egyptian authorities on trade through tunnels are having an impact on the availability of access to imported goods (including fuel and construction materials).[7] Fuel shortages are being experienced and the prices of imported goods are allegedly on the rise although not observable in July price indices. There is therefore likely to be a significant impact on the economic growth, employment and poverty levels in Gaza if other measures are not taken to lift restrictions. As the PA provides social assistance to poor households in Gaza, these developments are expected to increase the demand for such services and exert additional pressure on the PA's finances.

C. Fiscal Developments, January-June 2013

7. **Despite keeping overall spending within the prorated budget target, the PA faced a challenging fiscal situation in the first half of 2013 mainly due to a worse-than-expected outturn for revenues and lower than needed external support.** In particular, receipts from clearance revenues[8], which represent more than two thirds of the PA's total income, were much lower than anticipated. On the other hand, although some expenditure categories exceeded their budget target for the first half of 2013, the PA managed to keep overall spending in line within budget through placing control on the big-ticket spending items such as wages and transfers. Nevertheless, lower than expected revenues caused the recurrent budget deficit to increase by 30 percent above the prorated annual budget target, amounting to NIS2.52 billion. The PA also reported development expenditures of NIS458 million in the first half of 2013, and therefore, the overall deficit totaled NIS2.98 billion. Total external financing received amounted to NIS2.41 billion and was NIS572 million short of what was needed to cover the overall deficit. As in previous years, the PA resorted to domestic sources to finance the gap, and accrued more than NIS1.39 billion in domestic arrears during the first half of 2013 - mainly owed to the private sector and to the pension fund. Notably, the amount of

7 Given the informal nature of this trade, quantitative estimates on import reduction were not available to the authors of this report.
8 Clearance revenues are VAT and import duties that are collected by the GoI on behalf of the PA.

arrears accumulated was higher than what was needed to offset the shortage in external aid. The excess financing enabled the PA to reduce its net domestic bank financing[9] by almost NIS602 million in the first half of 2013.

a. Revenues

8. **Despite the efforts to enhance revenue collection, the PA's total revenues for the first half of 2013 were 12 percent lower than their prorated target largely due to slower than expected growth of clearance revenues and higher than anticipated tax refunds. On the other hand, the PA's domestic revenues achieved their budget target.**

9. **Clearance revenues, which are the PA's main source of income, totaled NIS2.8 billion in the first half of 2013 and were 12 percent lower than anticipated in the budget.** Notably, the GoI had delayed the transfer of clearance revenues in the months of January and February 2013. Starting March, however, these monthly transfers have been on track, which helped reduce uncertainty related to the PA's cash planning. Lower than expected performance was witnessed across the board for all clearance revenue categories including customs, VAT and petroleum excise which were 16, 12 and 7 percent lower than forecasts, respectively. Clearance revenues only grew by 2 percent between January and June 2013 compared to 13 percent projected in the budget for the full year. [10] The underperformance is partly due to the fact that the budget forecast was highly optimistic as it assumed clearance revenue will grow more than that of nominal GDP. Furthermore, growth in the West Bank - where the majority of clearance revenues are collected - significantly declined in Q1 2013 which in turn had a negative impact on revenue growth. Historical trends show that growth in clearance revenues is usually higher in the second half of the year, which suggests that their performance may slightly improve in the coming months. Nevertheless, they are still expected to end the year about 4.5 percent below the budget target.

10. **The PA's domestic revenues reached the mid-year target as higher than expected receipts from domestic taxes made up for the relatively poor performance of non-tax revenues.** Domestic tax revenues were almost 4 percent above their prorated budget target amounting to NIS1.15 billion. These revenues were also 19 percent higher than in the first half of 2012. Income tax collections exceeded their budget target for the first half of 2013 by 12 percent. This is mainly due to the PA's efforts to widen the tax base, enhance compliance and collect tax arrears from the largest corporations. Several banks made income tax advance payments which also helped boost domestic tax receipts. Moreover, the first half of the year is usually marked by large income tax and property tax payments that benefit from receiving a discount when paid earlier in the year. VAT collections were 10 percent above budget projections and 26 percent higher than in the first half of 2012 because the PA raised the VAT rate from 14.5 percent to 15 percent in September 2012, and again to 16 percent last June[11]. The PA has also been making efforts to improve compliance among private businesses that have not been paying their VAT obligations to offset unpaid bills owed to them by the PA. Several major corporations made advance VAT payments in the first half of 2013 which contributed to the above-budget performance of this item. Furthermore, receipts from excise on tobacco grew by 70 percent when compared to the first half of 2012 because the PA had gradually raised this tax following similar hikes in Israel, the last of which was in May 2013.

9 Net domestic bank financing represents net change in the PA's bank balances including deposits and borrowing.

10 Clearance revenues grew by 2 percent in the first half of 2013 while, according to PCBS, import growth was much stronger during this period amounting to 6 percent. This is because import data includes car imports whose tax duties are mostly classified in the PA's fiscal reports as domestic revenues, and are not included in clearance revenues.

11 The VAT was raised on both occasions following similar hikes in Israel because according to the Paris Protocol, the difference between the VAT rate applied in the Palestinian Territories and that in Israel must not exceed two percentage points.

11. **Non-tax revenues were 6 percent lower than their prorated annual target mainly due to lower than anticipated investment profits from the Palestine Investment Fund (PIF)[12].** The PA expected to receive about NIS80 million from PIF during the first half of 2013, while the actual amount of profits disbursed was NIS63 million. The PA reports that it is unlikely that additional profits will be received from the PIF in the second half of the year and therefore, non-tax revenues are expected to be significantly lower than their 2013 target.

12. **The PA's tax refund payments significantly exceeded their prorated budget target by 73 percent during the first half of 2013**. This is mainly attributed to an increase in fuel tax refunds (i.e. subsidies) which grew from a monthly average of NIS40 million in Q1 2013 to about NIS70 million in May and June. The PA's fuel tax refunds were raised in an effort to reduce the cost of transportation for the Palestinian public, especially given the recent economic decline. This, however, has placed pressure on the already tight budget and the PA is therefore considering gradually reducing these refunds in the coming months.

Table 3: Palestinian Authority Revenues January-June 2013: Actual *vs*. Budget

Revenue item (NIS million)	January-June 2013 (actual)	Half year Budget	Percentage difference between budget & actual figures
Total net revenues	**4069.4**	**4603.5**	**-11.6**
Gross domestic revenues	1654	1646	0.5
Tax revenues	1146.7	1107	3.6
Non-tax revenues	507.3	539	-5.9
Clearance revenues	2810.2	3185.5	-11.8
Tax refunds (-)	394.8	228	73.2

Source: Ministry of Finance and WB staff calculation

b. Expenditures[13]

13. **Total expenditures for the first half of 2013 were in line with the mid-year budget target, amounting to NIS6.59 billion. Thanks to the implementation of several policy and institutional measures, the PA managed to keep its largest spending items such as wages and transfers below targets, which compensated for overspending in other expenditure categories namely social contribution payments, use of goods and services and net lending**.

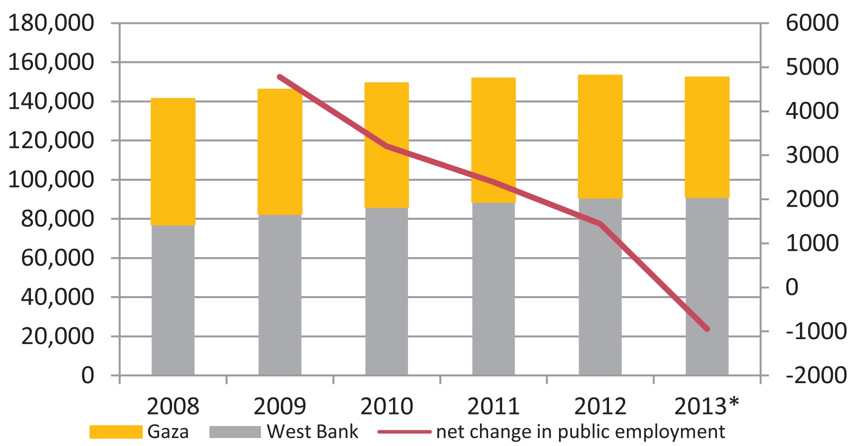
14. **The wage bill, which accounted for more than half of the PA's current spending between January-June 2013, was more than one percent lower than the prorated target, amounting to NIS3.44 billion**. It grew by 1.8 percent compared to the same period in 2012, which is in line with budget projections that assume a maximum increase of 2.1 percent in the wage bill in 2013. This is a departure from the previous year's policy when the budget had set the growth of the wage bill at 6.8 percent. The PA managed to cap the growth of the wage bill in the first half of 2013 through several measures. First, it adopted a zero net hiring policy aimed at limiting new recruitments to ensure they do not exceed the number of

12 PIF is the Palestinian territories sovereign wealth fund.

13 Since January 2013, the PA has started presenting its fiscal data in line with the IMF's Government Financial Statistics guidelines (GFSM 2001). The PA's contribution to the pension system which was previously included under transfers is now presented separately under social contributions. Domestic and external interest payments which were previously accounted for under operational expenditures are now presented under a separate item and the remaining part of operational expenditures is now presented as the use of goods and services.

retirement-related and other types of departures from the PA. The PA's employment figures as of the end of June 2013 indicate that the PA has restricted hiring beyond this policy as net employment was actually reduced by 956 during the first half of the year. While 1,249 employees departed from the public labor force in Gaza 304 were hired in the West Bank.[14] The number of employees in the security sector was reduced by a total of 807 on a net basis, while net employment in the education and health sectors declined by 595 and 386 workers, respectively. Second, the PA placed a freeze on salary payments for all employees who reside abroad for non-work related reasons. Finally, the PA devalued the USD/NIS exchange rate that is used to calculate the salaries of high ranking employees which are denominated in USD, as the previously used exchange rate did not accurately reflect the market's rate[15]. Lower than anticipated wage expenditures in the first half of 2013 can be attributed to employment reduction and also to a decision by the PA to reduce the cost of living allowance to 0.75 percent compared to 3 percent in previous years.

Figure 5: Net change in public employment has been declining due to a reduction in public employment in Gaza, while the number of public employees in the West Bank has been on the rise



Source: PA MoF
*Data is for the first half of 2013

15. **Transfers - the PA's second biggest current spending item - were more than 3 percent lower than the prorated annual budget target even though they were projected to grow by 7 percent in 2013.** Based on information provided by the PA on the major categories of transfers and the budgeted amount for each, it appears that the bulk of the savings comes from lower payments at the Ministry of Social Affairs (MoSA). The PA reports that this is related to the fact that the number of new households that MoSA added to the National Cash Transfer Program (NCTP) during the first half of 2013 was lower than expected. Therefore, cash assistance payments recorded under transfers was below their targets.

16. **Other items on the PA's budget including the payment of social contributions and the use of goods and services exceeded the mid-year targets**. Social contributions, which include the PA's contribution to the pension fund, were 5 percent above forecast due to unbudgeted pension payments to around 700 employees at the Ministry of Education. Expenditures categorized under the use of goods and services only slightly exceeded their budget as a result of overspending at the Ministry of Interior and National Security. The PA reports that

14 Employment in the national fund and the embassies was also reduced by a total of 11 employees.

15 The previously used exchange rate was set at USD 1 = NIS 4.4, while the market rate averaged USD 1= NIS 3.68 in the first half of 2013.

this ministry had accumulated large arrears on its operational spending in 2012, some of which were cleared in 2013. These arrear repayments were not anticipated in 2013 which explains the jump in this item compared to its prorated budget target.[16]

17. **The PA has not been able to regain control over net lending[17] which has consistently exceeded forecasts since late 2011.** In the first half of 2013, it was 114 percent higher than anticipated. This is mainly because the 2013 budget target for net lending is unrealistic as it assumes that this item will be cut in half in comparison to its 2012 level, even though no related reforms are expected to be finalized to address the underlying issues. Furthermore, there has been a rise in the incidence of nonpayment of electricity bills among Palestinian consumers, given recent liquidity shortages in both the public and the private sectors and the rise of electricity prices that took place in 2012, and more recently in 2013. The increase in nonpayment has led to mounting electricity arrears owed by the Palestinian municipalities and distribution companies (DISCOs) to the Israeli Electric Company (IEC). These arrears are cleared through deductions made by the Israeli Ministry of Finance (MoF) from the PA's clearance revenues, and are recorded in the PA's budget as net lending. The Israeli MoF has so far not fully cleared all electricity arrears owed by the Palestinians municipalities and the DISCOs and it is estimated that about NIS963 million in electricity debt is still outstanding, as of August 29, 2013. It is therefore expected that net lending will continue to increase throughout the year and hence exceed its budget target by more than 80 percent.

Table 4: Palestinian Authority Expenditures January-June 2013: Actual *vs*. Budget

Expenditure item (NIS million)	January-June 2013 (actual)	Half year Budget	Percentage difference between budget & actual figures
Total expenditure & net lending	**6589.5**	**6546**	**0.7**
Wages	**3436**	**3478**	**-1.2**
Social contributions	**319.9**	**304**	**5.2**
Use of goods and services	**959.4**	**953**	**0.7**
Transfers	**1476**	**1527.5**	**-3.4**
Minor capital	**9.3**	**38.5**	**-75.8**
Interest	**68.4**	**95**	**-28.0**
Net lending	**320.5**	**150**	**113.7**

Source: Ministry of Finance and WB staff calculation

18. **Increased external financing in the first half of 2013 was not sufficient to cover the PA's recurrent and development needs, and therefore, it has continued to depend on domestic arrears as a major source of financing**. The PA's total deficit during the first half of 2013 was NIS2.98 billion while total aid received during that period amounted to NIS2.41 billion (NIS2.26[18] billion in budget support and NIS144 million in development financing). The PA had accumulated more than NIS1.39 billion in domestic arrears during the first half of 2013 even though external financing was only NIS572 million short of what was needed to cover the PA's recurrent and development needs. Almost NIS473 million or 34 percent

16 Notably, these arrear repayments show as commitments in the PA's monthly fiscal tables when they should have been recorded as cash expe - ditures.
17 Net lending mostly includes payments by the central government for utility bills owed by municipalities.
18 This amount includes USD200 million from the US that was delayed from 2012 and USD120 million from Saudi Arabia.

of these arrears are owed to the private sector, which raises the total stock of private sector arrears accumulated since 2009 to more than USD685 million. The PA has also continued to accumulate large arrears to the pension system during the first half of 2013 in the amount of NIS320 million. Preliminary estimates suggest that the value of total accumulated pension arrears is about USD992 million[19]. Arrear accumulation - in excess of what was needed to cover the shortage in external aid - enabled the PA to reduce its net domestic bank financing by almost NIS602 million, yielding a stock of debt to local banks of USD1.3 billion as of end-June 2013. This indicates that the PA has adopted a policy that prioritizes the reduction of domestic debt over the repayment of arrears. While this policy might enable the PA to create a buffer for future domestic bank borrowing, it could very likely have negative consequences on private sector liquidity and growth, which could ultimately reduce public revenue generation and weaken the PA's fiscal position.

18. **The PA's fiscal situation is expected to remain problematic throughout the year.** Expenditure is projected to exceed year-end budget target mainly due to higher than anticipated payments on the account of net lending. Furthermore, recent projections estimate that the outturn for revenues will be worse-than-expected primarily due to a lower than anticipated clearance revenues and higher than budgeted fuel tax refunds. Consequently, the total deficit is expected to be 22 percent higher than 2013 budget, amounting to USD1.69 billion[20]. However, only around USD1.3 billion in donor funding has so far been identified – USD1.15 billion in recurrent budget support and USD180 million in external development financing[21]. Part of the financing shortfall may be covered through additional local borrowing especially since the PA was able to reduce its debt to the domestic banking sector in the first half of the year. Nevertheless, space available for domestic borrowing will not be enough to fully cover the PA's needs and a financing gap of approximately USD320 million is expected for 2013, even if all donor pledges are realized. Consequently and as in previous years, the PA may resort to other sources of domestic financing to cover the gap including arrear accumulation to the private sector, the pension system and possibly on the salaries of public servants.

D. The Banking Sector

19. **The Palestine Monetary Authority (PMA) continues to effectively regulate the banking sector.** Since its establishment in 1995, the PMA has made continuous effort to enhance its institutional capacity and build the capabilities of a central bank. Over recent years, the PMA has successfully implemented regulatory and structural measures aimed at building a modern banking system. It has adopted regulations in line with international standards including those related to loans classification, licensing procedures, good governance, capital adequacy, risk management and others. It applies an effective anti-money laundering law that was prepared in line with international standards, with technical assistance from the IMF and USAID[22]. The PMA also carries out efforts to enhance the infrastructure of the banking sector. Recently, a Deposit Insurance Law that was previously approved by the PMA's board of directors was signed by the President. The law requires the establishment of the Palestine Deposit Insurance Corporation which aims at compensating depositors against the loss of

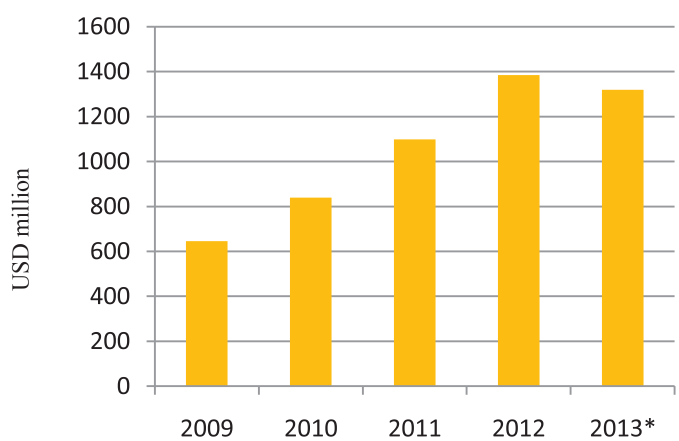
19 This figure refers to partial information as there are a number of pension schemes for which there are no exact data, funds or reconciliations so the actual arrears to the entire pension system are likely to be higher.
20 These projections are prepared by the IMF in cooperation with the World Bank and the PA MoF
21 This includes USD150 million from the US which was announced in August, 2013
22 IMF 2012, Recent Experience and Prospects of the Economy of the West Bank and Gaza: Staff Report Prepared for the Meeting of the Ad Hoc Liaison Committee.

insured deposits up to USD10,000 placed with member institutions in the event of a member institution's failure. This system will strengthen public confidence in banks, and hence, mobilize more savings and deposits which will in turn contribute to enhancing the soundness of the overall sector. Almost 93 percent of overall depositors in licensed banks operating in WB&G will be ensured under this law.

20. **The performance of the Palestinian banking sector is strong.** The year-on-year growth of the sector's net assets was 14 percent in June 2013; while the sector's net income grew by 22 percent when compared to the same period last year. The continuous improvement in the financial market's infrastructure carried out by the PMA has raised the private credit-to-deposit ratio from 30 percent at the end of 2010 to 37 percent by mid-2013. However, the sector's overall loan-to-deposit ratio continues to be lower than in most countries at around 54 percent as of June 2013, reflecting high level of perceived systemic risk. By the end of the first half of 2013, the percentage of nonperforming loans to total credit remained low at 3 percent.

21. **The decline in the banking sector's credit exposure to the PA in 2013 has slightly reduced related risks, though the latter remain elevated.** As of June 2013, the PMA reports that the Palestinian banking sector has provided USD1.3 billion in credit facilities to the PA, down from USD1.4 billion by the end of 2012. This represented about 13 percent of the sector's total assets and 105 percent of its equity. Credit to the public sector and PA employees, combined, represented around 48 percent of the sector's gross credit, as of June 2013.

Figure 6: PA Domestic Debt, 2009 – June 2013



Source: PA MoF
** Data is as of June 2013*

22. **The PMA has been carefully monitoring the risk emerging from the banks' high exposure to the PA and its employees through conducting stress tests since March 2011.** The PMA conducts these tests on the overall sector each quarter while it also orders each bank to carry out its own tests based on bespoke scenarios twice a year. These tests are designed according to Basel II principles and are used to evaluate the banking system's resilience to numerous economic, political and concentration shocks. The PMA reports that the results of the June 2013 tests indicate that the banking sector is well capitalized with the Tier 1 capital as a ratio of risk weighted assets at 21 percent. This ratio exceeded the minimum requirements specified by Basel II principles under all but two extreme scenarios. The first scenario relates

to an economic shock that could lead to a significant decline in the fair value of Palestinian investments inside and outside WB&G, a 30 percent default rate for private sector loans and withdrawal of about 20 percent of deposits from the banking system. The second scenario relates to a political shock which assumes that 40 percent of PA loan installments are delayed while 50 percent of loans to public servants default, among other things. Notably, the current stress testing methodology that the PMA uses to evaluate banks' resilience considers the impact of each type of shock on the sector's capital adequacy separately. Therefore, the results do not account for scenarios that compound multiple shocks, which is more likely to be the case in reality. The PMA acknowledges this shortcoming in its stress testing methodology and is currently working to improve it.

E. Priority Reform Agenda towards Fiscal Strengthening

23. **In recent years, the PA has made strong efforts to strengthen its fiscal position to create adequate fiscal space available for essential public service and has achieved progress in a number of areas**. While the multi-layered system of restrictions imposed by the GoI is clearly the most significant impediment for the PA to boost economic growth and achieve fiscal sustainability, the PA has pressed on with various reforms which are within control to strengthen its fiscal position. For instance, the relative size of the wage bill, which is the largest spending item in the PA's budget, has been reduced from 26 percent of GDP in 2006 to a projected 16 percent in 2013. The substantial achievements of the PA on institution building have played a crucial role and Palestinian public institutions for revenue and expenditure management and economic development compare favorably to other countries in the region and beyond, as the Bank reported to this forum in 2011. The impressive human development outcomes in the West Bank and Gaza are good indicators for the well-functioning public institutions[23].

24. **However, continued fiscal difficulties have gradually reduced fiscal space available for service delivery, and thus, pressing on with the priority reforms to strengthen the PA's fiscal position will be important**. Otherwise, the continual provision of high quality public service delivery will be constrained. The reform measures briefly described in this section are considered important for further strengthening of the PA's fiscal position, and thus warrant continued efforts by the PA and support from international community. Additionally, cooperation by the GoI is essential to ensure that the reforms reach their potential.

a. Revenues

25. **The PA has been making efforts to strengthen domestic revenue performance.** Several measures have been taken to raise income tax revenue to 1.7 percent of GDP in 2012 from 1.5 percent in 2011. In February 2013, the PA adopted a comprehensive multi-year revenue action plan that aims at merging all tax departments including income tax, VAT, customs and other direct and indirect taxes under a single administration and has already merged the customs and VAT administrations. The proposed measures in the action plan are highly relevant and important for enhancing effectiveness and efficiency of the PA's revenue administration.

23 Bank, W. (2011). Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza. West Bank

26. **Moving forward, the PA will need to focus its efforts on measures that help quickly enhance revenues.** In particular, enhancing compliance by large taxpayers thorough the newly established Large Taxpayer Unit will be important to boost revenue collection in short term because large taxpayers are the largest contributors to tax revenues. The PA should also seek to expand the tax base by reforming the existing tax exemptions which are too generous particularly when compared to others in the region. This will require amendments to the investment promotion law to limit tax holidays to only a few specific investments/ sectors with clear criteria, as advised by the IMF. The PA should also focus on accelerating the implementation of self-assessment mechanisms. In a self-assessment system, taxpayers calculate their own liabilities, file returns, and pay any tax they have assessed. If they fail to make accurate assessments and pay incorrect amounts, they run the risk of being detected, audited, and penalized. The system makes better use of audit tools, and can reduce the number of disputes, thus lowering the costs for the government and the taxpayer.

27. **Cooperation by the GoI is essential to boost revenues for the PA and some progress has been made in recent months**. Tax clearance revenues collected by the GoI and transferred on a monthly basis to the PA are the latter's main source of income constituting two thirds of total revenues. The PA reports that current receipts from clearance revenues are below their potential due to fiscal leakages that could be substantially reduced if more information is shared by the GoI. The first source of fiscal leakage is related to goods that are directly imported to WB&G from outside of Israel and which are cleared by the Israeli customs. The customs duties, VAT, and excise tax on these direct imports accrue to the PA. However, the PA believes that there is widespread undervaluation and that Israeli Customs rarely questions declarations of WB&G bound goods. Thus the PA had requested that Israeli Customs provides real time information from its information system to the PA's ASYCUDA[24] system as this data will allow PA Customs to develop a risk management system to improve tax collection on imports. Encouragingly, an agreement was recently reached between the two parties whereby this data is now being sent by the Israeli Customs on a daily basis to the Palestinian Tax Authority. However, this agreement does not entail data exchange on imports from Israel to WB&G, to which the majority of fiscal leakages relate[25]. Discussions between Israeli and Palestinian tax authorities are underway around this issue and it is hoped that a more comprehensive agreement on data sharing is reached between the parties.

b. Wage Bill

28. **Efforts by the PA in recent years have managed to control the public sector wage bill; however, its current level of about 16 percent of GDP remains high by international standards.** In the past, growth in the civil service and wages was often driven by social considerations with the civil service being considered an employer of last resort. However, the PA has recently taken measures such as a hiring and promotions freeze and adoption of a 'zero net hiring policy' to contain wage bill expenditure. These measures, combined with others, have dropped the public sector wage bill from 26 percent of GDP in 2006 to 17 percent in 2012, and a further drop to 16 percent is expected in 2013. However, the wage bill still constitutes the single largest component of the PA budget at over 50 percent of recurrent expenditure.

24 Automated System for Customs Data

25 With this type of imports, the VAT accrues to the PA. But, to obtain these funds from the GoI, the PA must present its own copies of the VAT receipts that were issued by the Israeli traders to the Palestinian importers. Since the PA does not exercise control over borders, it is difficult to collect the receipts from Palestinian merchants who do not forward these receipts to the Palestinian Customs to avoid paying VAT. The Israeli MoF has the information on how many tax invoices have been issued by Israelis to Palestinian traders and could send the information to the Palestinian MoF and remit the funds. This information would allow PA tax authorities to follow up and ensure that they collect VAT for such indirect imports when they are sold in the PA- controlled areas. According to sources from the Israeli government, discussions are underway to find a solution to this problem as well and some alternative solutions are being proposed.

29. **Future reform efforts need to focus on modernizing the civil service system and addressing issues related to administrative structures and the way that staff is rewarded for performance.** Although the number of PA ministries, departments, and agencies is not particularly large compared with many other governments, there are likely duplication of mandates, and overstaffing which need to be further reviewed. Given this, the PA may undertake a functional review for the overall machinery of government in order to better align mandates, structures and staffing. Furthermore, the evaluation system of civil servants is not well regarded by staff as it does not reward performance, and promotion is largely based on seniority. Therefore, the PA may proceed with the development and roll-out of a more performance based annual staff assessment. Actions required to improve the civil service system are extensive and wide ranging. Therefore, strong leadership and dedicated management over a number of years are warranted if it is to succeed.

c. Health Expenditure

30. **Health expenditures have risen sharply in the Palestinian territories.** Total health expenditures accounted 4 percent of GDP in 2011. Salaries and outside referrals are the two main categories of health expenditure. As of 2007, salaries constituted 55 percent and other operational spending including referral spending, medicines, and supplies made up 45 percent.

31. **In particular, health expenditures related to outside treatment referrals have grown more than ten times between 2000 and 2011.** Outside referral treatment is usually at the tertiary care level for those services that are not available in Ministry of Health (MoH) facilities. The number of referrals increased from 8,123 in 2000 to 56,468 in 2011. The corresponding expenditure has also increased significantly from less than USD10 million in 2000 to as much as USD125 million in 2011. This high and increasing level of expenditure on outside referrals is not fiscally sustainable. Currently, unpaid bills to outside services providers are estimated to be around NIS72 million (USD18 million)[26]. As arrears from the PA have accumulated several hospitals within and outside the Palestinian territories have stopped accepting referrals from the MOH. According to an assessment conducted by the World Bank, this 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. Thus, there is a large scope for efficiency improvements.

32. **The MoH has already initiated reform measures to deal with the growing referral expenses.** For instance, in late 2012, the medical referral process was strengthened by expanding the membership of the medical referral committees to include health experts from outside the public sector. The referral process has also been centralized by moving the billing department from Nablus to Ramallah under the direct authority of the General Directorate for Health Insurance. Furthermore, ministerial instructions were given to make referrals to medical institutions in Israel only when absolutely necessary and with the Minister's prior approval[27].

33. **Even though these measures are encouraging, a more comprehensive reform plan is warranted to tackle deeper institutional issues**. The weaknesses and consequent challenge of the health referral system cannot be addressed by one or two focused interventions or

26 Based on the World Bank Technical Assistance
27 This is due to the fact that the cost of health referrals to Israel is higher for most medical treatments than referrals to Jordan or Egypt.

policies. They need a comprehensive and integrated set of policy reforms and interventions tackling the different aspects of the problem. Key future reform areas include; a) strengthening the referral process by standardizing the process, consolidating information flows and databases, and strengthening capacity for accurate diagnosing and appropriate referring; b) developing and implementing a strong framework for strategic purchasing of referral services; c) reorganizing the supply of tertiary care to rationalize tertiary-level referrals and improve equity in the access to these services; and d) revising and rationalizing the benefit package to make it more sustainable.

d. Net Lending (Electricity Arrears)

34. **Net lending related to electricity arrears poses a significant problem to the PA's fiscal position.** Palestinian electric utilities, municipalities, and village councils continue to accrue arrears to the Israel Electric Corporation (IEC), due to non-payment of electricity as a result of a combination of technical losses, theft, and poor bill collection rates. This debt is cleared through deductions made by the Israeli Ministry of Finance (MoF) from the PA's clearance revenues, and is recorded in the PA's budget as net lending. Non-payment for electricity services has been rising since 2010; 57.4% of the total electricity bill owed to IEC was deducted from PA's clearance revenues in 2010 and 62.6% of 2013's total electricity bill. The PA's total expenditure accounted for NIS6.6 billion as of July 2013, out of which NIS393.8 million were paid for outstanding debt for electricity and water services. Non-payment for electricity alone accounted for 98.8% of the total net lending amount in 2013, which is 5.9% of PA's total expenditure for the year. In addition to these deductions, electricity debt still owed by the PA to IEC but not yet deducted amounted to NIS922 million, as of July 2013[28].

35. **Preliminary analysis indicates that prior to 2011 Gaza was mainly responsible for electricity net lending with monthly non-payment of approximately NIS40 million** whilst the remaining NIS5 million were attributed to non-payment for electricity services in the West Bank. Only NIS2-3 million a month was paid towards electricity services in Gaza, as part of an initiative where due amounts for electricity services are automatically deducted from public sector and electricity distribution companies' employees' salaries. Part of the problem is that electricity is supplied across more than 230 connection points, and the Palestinian Energy Authority (PEA) has no means of controlling this supply, or understanding what payments have been made across each connection point. The Palestinian MoF stated that the recent consolidation of municipalities and the establishment of new utilities have improved collection rates by allowing greater control and transparency over electricity supply. However, payments have more recently deteriorated again, with electricity arrears reaching NIS807 million in November 2012 alone. Most recent data reveals that electricity arrears have risen - with the majority of this increase attributed to non-payment in the West Bank.

36. **Along with Gaza, the majority of non-payment occurs in municipalities and village councils that lie outside the control of the four distribution companies, in refugee camps, and by some government authorities.** Recent reversals in the trend of improved payments for electricity have been attributed to economic slowdown, energy price increase, delays in payment of civil servants' wages, in addition to deterioration in consumer behavior and increased electricity theft. It is important to note that in addition to the fiscal burden that the electricity sector places on the PA, the sector faces its own significant challenges - including lack of security of supply, poor network reliability, high system losses, and affordability of both electricity and fuel, which all affect net lending indirectly.

28 According to the Israeli Ministry of Foreign Affairs

37. **The PA has made several efforts to contain the rise in electricity non-payment.** The PEA, in collaboration with development partners, has taken some measures including; a) establishing the Palestinian Electricity Regulatory Council, which introduced a unified electricity tariff; b) consolidating supply of electricity from IEC through 4 major substations to reduce the more than 230 existing connection points; c) rolling out pre-paid meters within the jurisdiction of the 5 DISCOs to reduce electricity non-payment and theft; and d) establishing the Palestinian Electricity Transmission Company Limited (PETL) to manage consolidated supply of electricity. The PEA has developed new energy efficiency and renewable energy strategies, which, with careful implementation, could potentially contribute to a reduction in net lending through further control over electricity supply. The PEA is also seeking to negotiate a single power purchase agreement with IEC in order to stabilize electricity pricing and provide stronger contractual control over electricity supply. Recently, the PEA has also taken steps to address non-payment through institutional building and legal amendments.

38. **However, stronger efforts need to be made to improve the financial performance of the electricity sector.** While each of the initiatives mentioned above may have a positive effect on net lending, none will directly improve payment for electricity services and mitigate net lending entirely. Currently, a comprehensive assessment of non-payment for electricity services is being conducted with an objective to more precisely understand and analyze the sources and reasons for non-payment for electricity and to develop a detailed action plan[29].

39. **Cooperation with the GoI is critical for the PA to reduce net lending associated with non-payment for electricity services.** As the principle supplier of electricity to the Palestinian Territories it is critical that the IEC and the PEA work together to resolve issues of non-payment. IEC maintains the only comprehensive data on power supply to the Palestinian Territories, including information on payment/non-payment for each connection point, source, amount, and date of payment and consumption, as well as outstanding debt. A large number of connection points between the Palestinian Territories and Israel fall outside the control of Palestinian distribution companies, and therefore the PEA has little information on the status of payment for many of these connections. Further analysis and understanding of sources and causes of non-payment for electricity will therefore rely heavily on the IEC for provision of this data. Actions to address non-payment will also likely require cooperation between the PEA and GoI, for example, by ensuring greater control and transparency of electricity supply through a long-term power purchase agreement between GoI and PEA, or by allowing IEC to better plan low-cost electricity supply by common development of electricity sector master plans.

e. Social Assistance Spending

40. **The PA's National Cash Transfer Program (NCTP) is recognized as among the most effective in the region[30].** The PA provides cash transfers through the NCTP that is managed by the Ministry of Social Affairs (MoSA). The program currently covers 104,030 households: 48,508 in the West Bank and 55,522 in Gaza. Several independent assessments have confirmed that the NCTP demonstrates good practice regarding the creation of use of a unified registry of beneficiaries, its comprehensive coverage, application of a robust proxy means test formula to determine the eligibility of beneficiary, and effective use of monitoring and evaluation system to inform budgetary decisions and reshape programs[31]. It is also said

29 By the World Bank

30 The 2012 Middle East and North Africa Development Report, " Inclusion and Resilience: The Way Forward for Social Safety Nets in the Middle East and North Africa", the World Bank, 2012

31 DFID, 2013 and EU, 2013

to be the only program in the region where social safety net transfers have the greatest impact on the welfare of the poorest quintile and have a higher impact on poverty than is observed in other well-performing programs.

41. **There is, however, pressure on the system and the MOSA is currently reviewing beneficiary eligibility to further prioritize those who are most needy to ensure that its limited resources are spent efficiently and effectively.** Some households were previously admitted into the NCTP on a temporary basis and were supposed to have graduated. However, the MoSA was not able to remove them from the program due to social and political considerations, and therefore created a 'vulnerable household' category to accommodate them in the system. The vulnerable household category covers families who are headed by a female or an elderly person above 60 years of age, or a person who is chronically ill or disabled. This category of beneficiaries has been growing and receiving cash assistance to the exclusion of extremely poor households which are on waiting lists. In an effort to deal with this issue, since the beginning of 2013, the MoSA has started applying a proxy means test formula to determine the eligibility of vulnerable households to receive assistance. It has also limited the growth of beneficiaries in the vulnerable category to a maximum of 19,200. Given that the objective of the NCTP is to mitigate extreme poverty, it is essential that efforts continue to ensure that the vulnerable families are eventually graduated from this program into others that are specifically designed to address the diverse and specialized needs of vulnerable groups.

f. Public Pension System

42. **The public pension system is a significant burden on the PA's public finances.** Contribution to the public pension system represents one of the PA's largest obligations and the system is insolvent. Currently, it is effectively operating as a pay-as-you-go system, where current contributions fund the cost of existing retirees instead of building up mandatory savings to support future retirees. The PA has managed to only make enough payments to the system to cover current retirees and has consistently been accumulating arrears towards the mandatory pension funds. Preliminary estimates suggest that the value of accumulated arrears is USD992 million[32] and growing. In July 2010, the PA formally adopted a reform plan that commits it to improving the pension administrative systems, implementing a number of parametric changes to reduce costs, and studying ways to improve the long term viability of the public pension system. Along with the implementation of administrative reforms, parametric reforms are needed before current employees begin to retire into the system. However, little progress has been made on these reforms, without which the public pension system will continue to be a weighty burden and a significant liability for the future.

g. Public Financial Management

43. **The PA's Public Financial Management (PFM) system has seen significant improvement over recent years.** In 2013 a Public Expenditure and Financial Accountability (PEFA) assessment was carried out by a multi-donor team to review the overall PFM system. The assessment provided a baseline for measuring progress since a previous similar assessment in 2007 as part of a broader Public Expenditure Review. Overall, the report underscored despite a challenging political and financial context the efforts of the PA to improve the overall

32 This figure refers to partial information as there are a number of pension schemes for which there are no exact data, funds or reconciliations so the actual arrears to the entire pension system are likely to be higher

functioning of the PFM system and to strengthen the capacity of the Ministry of Finance. The most significant progress has been witnessed in areas such as comprehensiveness and transparency of the budget, control and audit.

44. **However, actions are needed for some structural improvements and the PA has committed to dealing with weaknesses identified.** These relate to the budget preparation procedures, including strengthening the link between budget and development planning, cash planning including uncontrolled accumulation of arrears, commitment control and some accounting issues with regard to international standards (IPSAS). Responding to the weaknesses identified, the Ministry of Finance has already taken measures in the areas of cash planning and debt management. Increased technical assistance for capacity building and a more integrated strategy from development partners would be useful to support the PA's reform efforts.

45. **The PA has also continued to achieve progress in reforming its public procurement system.** This is a key reform that aims to improve accountability, integrity, and transparency of the public finance system. After the adoption of a new procurement law in December 2011, the Higher Council for Public Procurement Policies (the Council) was subsequently established on September, 2012, with representation from the public and private sectors. In addition to its oversight role, the Council is the entity which is mandated by law for the development of procurement systems, including institution building, procurement documentation, guidelines and manuals, training courses and public awareness campaigns. The PA is now in the process of allocating financial and institutional resources to operationalize the Council. In February 2013, the PA prepared a set of draft implementing regulations to the procurement law. With finalization of these regulations, a sound working legal framework for a modern public procurement system will be in place. Furthermore, the Council is preparing the national standard bidding documents and the procurement manual, which would ensure streamlined and consistent procurement practices in compliance with the law and regulations. Future action should focus on conducting training in all line ministries to prepare staff for implementing the new procurement law, the establishment of the single website procurement portal where all procurement and contract award notices would be published, and the operationalization of the complaint handling and dispute review mechanism.

F. Conclusion

46. **As has been highlighted in this report, the broad economic situation and the PA's fiscal position are showing worrying trends with a financing gap of about USD320 million projected by year end.** In particular, the economic output in the West Bank contracted during Q1 2013 for the first time since 2002, and unemployment in Gaza has reached almost 30 percent during the first half of 2013. Despite efforts to enhance revenue collection, the PA's total revenue for the first half of 2013 was lower than the prorated target. To close the projected financing gap, the PA is likely to resort to accumulating arrears to the private sector or increasing domestic borrowing, both of which have negative consequences on private sector liquidity, growth and the PA's fiscal position. Additionally, the quality of service delivery will eventually be affected by continued fiscal challenges.

47. **The restrictions imposed by the GoI continue to be the most significant impediment to economic growth, nonetheless the PA will need to make continued efforts on various reforms which are within its control to strengthen its fiscal position and improve the business environment.** The downward trend in economic growth shows that the current growth model based on donor aid to offset the restrictions imposed by the GoI is not sustainable. Therefore, cooperation with the GoI is essential in implementing measures that will promote private sector led economic growth. While the PA's substantial achievements on institution building have played a crucial role in managing revenue and expenditure management and economic development, continued attention to reform is essential. Moving forward, the reforms described in this report would be important for further strengthening the PA's fiscal position. Moreover, support from donors to the PA's budget should continue to allow these reforms to be implemented, which will in turn strengthen the fiscal position - a pre-condition for providing basic services to the Palestinian people. The need for donor aid will diminish only with a broad relaxation of restrictions by the GoI to enable export-led growth in the Palestinian Territories.

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