

West Bank and Gaza: Report to the AD HOC Liaison Committee



WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE¹

September 13, 2022

KEY ISSUES

The Palestinian economy is facing formidable challenges. The fiscal situation, high political, security and social tensions, rising inflation, movement and access restrictions and an unfinished structural agenda all weigh on the medium-term outlook. Under unchanged policies, debt is unsustainable and per capita GDP is projected to decline. The situation is particularly dire in Gaza with persistently high unemployment and poverty.

Overcoming these challenges will require transformational reform with efforts required from the Palestinian Authority (PA), Israel, and the donor community. A comprehensive and joint effort would strengthen macroeconomic stability and pave the way for faster economic growth, job creation and poverty alleviation.

This IMF report focuses on fiscal reform policies and banking sector issues.

Following our [May 2022 Report](#) that laid out the broad contours of a reform scenario, this report discusses fiscal reform options in more depth. It also focuses on correspondent banking relations and the issue of excess cash in Palestinian banks.

Key recommendations

- Improve the quality of spending by implementing ambitious reforms centered on the wage bill and net lending, and raise domestic tax revenue via base broadening.
- Seek understandings with the Government of Israel to resolve fiscal files and reduce impediments to the movement of goods and people and on investment, including in Area C.
- Implement additional reforms to improve the business environment and tackle structural impediments to growth.
- Intensify oversight of banks, continue to push for alternative arrangements to replace current shekel correspondent banking relations, and advance digital payments to reduce excess physical shekel cash.

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 financial management, public expenditure management, banking supervision and regulation, and statistics. See www.imf.org/wbg for previous AHLC reports and Annex III for a list of TA provided.

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In person discussions were held during August 16–28, 2022 in Ramallah and Jerusalem. The team comprised Messrs. Tieman (head) and Ioannou, and Ms. Coulibaly (all MCD), Mr. Laursen, Ms. Qassis, and Mr. Ajamieh (Resident Representative office). Ms. Ma provided research assistance and Ms. Pineda assisted with the preparation of the report. The mission met with Prime Minister Mohammad Shtayyeh, Finance Minister Shukry Bishara, Palestine Monetary Authority Governor Feras Milhem, Minister of National Economy Khalid Al-Esseily, PCBS President Ola Awad, and other members of the Palestinian economic team, as well as Israeli officials and representatives of the Palestinian private sector, donors, and international organizations.

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RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. The Palestinian Economy Continues to Recover...

1. The economy experienced a strong rebound from the COVID-19 pandemic in 2021, but unemployment edged up and remains very high, in Gaza in particular. After a sharp recession in 2020, real GDP grew by 7.1 percent in 2021 as COVID vaccinations took off and COVID-related movement restrictions were eased (Figure 1). Private consumption contributed 5½ percentage points to growth, helped in part by higher employment of Palestinian workers in Israel and the settlements. Growth in Gaza, however, was just 3.4 percent as reconstruction efforts following the May 2021 conflict advanced only slowly. Even as employment grew by 8 percent during the year, the unemployment rate increased to 26.4 percent in 2021, as the easing of lockdowns drew discouraged workers back into the labor market. The unemployment rate in Gaza remained stubbornly high at over 45 percent, reflecting restrictions on movement of people and goods, and is closely associated with high prevalence of poverty.²

2. High frequency indicators point to a modest slowdown of the economic recovery in the first half of 2022, while inflation is rising. Industrial production trended downward in late 2021 and early 2022 before recovering in recent months, while business confidence in the West Bank has been on an overall declining trend, even preceding the Russian invasion of Ukraine (Figure 2). After registering modest deflation in 2020, average inflation rose to 1.2 percent in 2021 supported by strong demand and higher prices of Palestinian imports from Israel. Inflation increased in early 2022 to reach 3.9 percent y-o-y in July due to supply chain constraints and higher fuel and food prices, in part related to Russia's war in Ukraine.

3. The economy's current account deficit remains elevated mainly due to structural factors. Imports make up almost 57 percent of GDP, more than three times the size of exports. Both exports and imports rebounded strongly in 2021 in real terms, but the trade balance worsened despite modest gains in the terms of trade. The real exchange rate appreciated by more than 10 percent.³ Despite the deterioration of the trade balance, the external current account deficit decreased to 8.2 percent of GDP in 2021 reflecting higher net income inflows, mainly from Palestinian workers in Israel and the settlements, and increased transfers to non-governmental sectors. Still, the external current account deficit remains very high and mainly reflects structural factors, including lack of access to productive resources (e.g., economic activity in Area C, access to land and water for agriculture) and restrictions on the movement of goods, which hinders production and access to international markets.

4. Meanwhile, the political and security context continues to be fragile. Tensions around the Al Aqsa mosque and Israeli settlements, evictions and demolitions in East Jerusalem and the

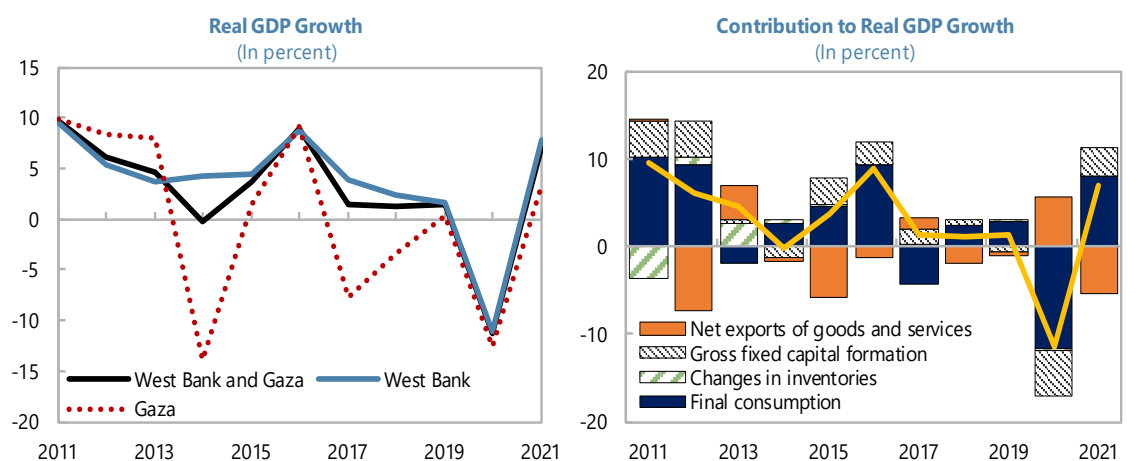
² In 2021, poverty stood at 61 and 13 percent in Gaza and the West Bank respectively, using the national poverty line ([World Bank, 2022](#)).

³ No external sector assessment was undertaken.

West Bank and the stalemate in the Gaza Strip are constant sources of pressure that could erupt with little warning, as demonstrated by the three-day hostilities between Israel and Gaza in early August. The difficult social and economic conditions of Palestinians is made worse by rising food prices and partial payment of public sector salaries. Elections for the Palestinian Legislative Council (the parliament) and president remain indefinitely postponed, while local elections in most West Bank municipalities in December 2021 and March 2022 have led to considerable gains for independent candidates. Meanwhile, the Israeli coalition government agreed to cautious economic confidence building measures in lieu of peace talks, but has now collapsed and new elections are scheduled for November.

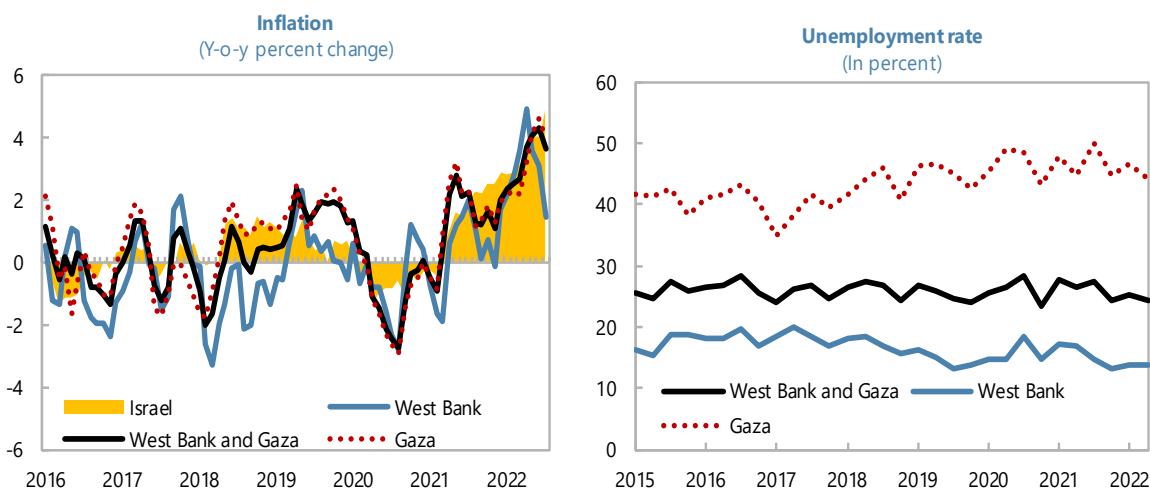
Figure 1. West Bank and Gaza: Recent Economic Developments, 2011–22

The Palestinian economy recovered strongly in 2021... driven by consumption and investment.



Inflation was modest in 2021 but picked up in 2022H1.

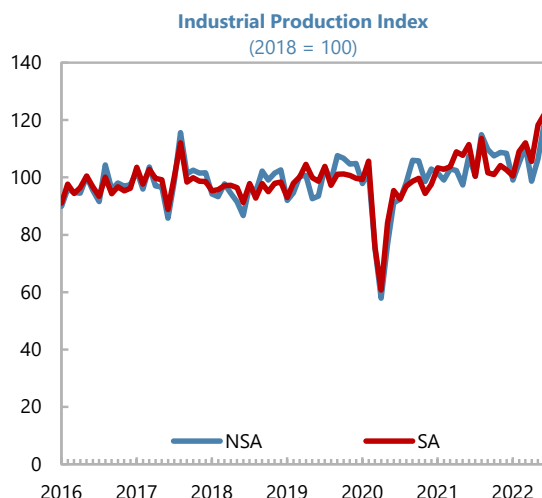
Unemployment remained stubbornly high, particularly in Gaza.



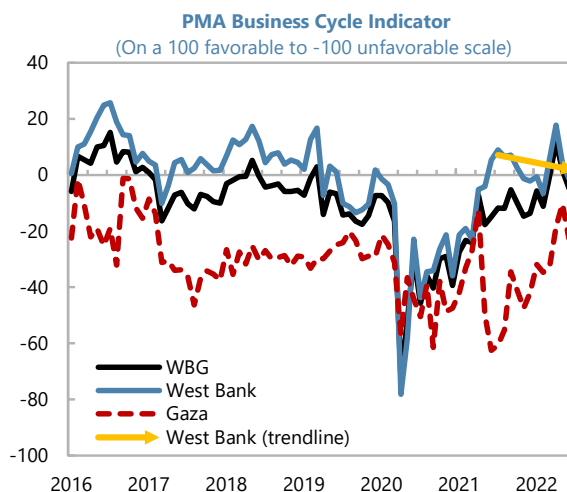
Sources: Palestine Central Bureau of Statistics (PCBS); Haver Analytics; and IMF staff estimates.

Figure 2. West Bank and Gaza: High Frequency Indicators, 2015–22

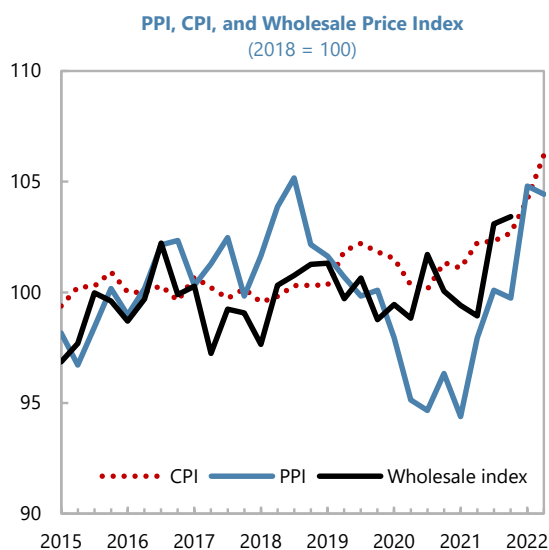
Industrial production trended downward in 2021H2 but has rebounded in recent months...



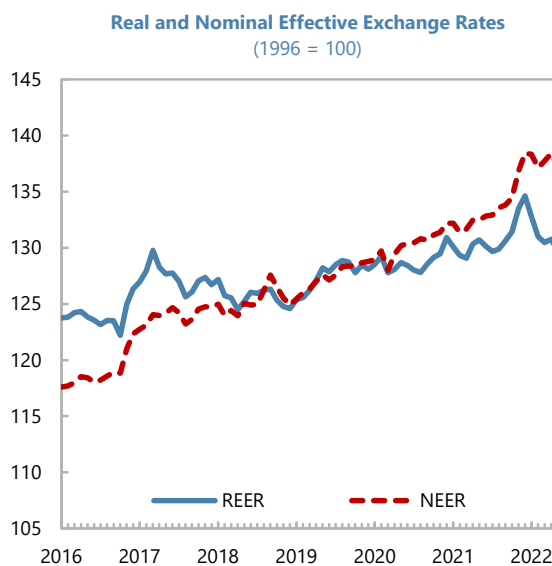
...while business confidence in the West Bank has been uneven but has overall declined since mid-2021.



Producer, wholesale, and consumer prices all increased fast...



... and the real and nominal effective exchange rates depreciated slightly.



Sources: PCBS; Palestine Monetary Authority (PMA); Haver Analytics; and IMF staff estimates.

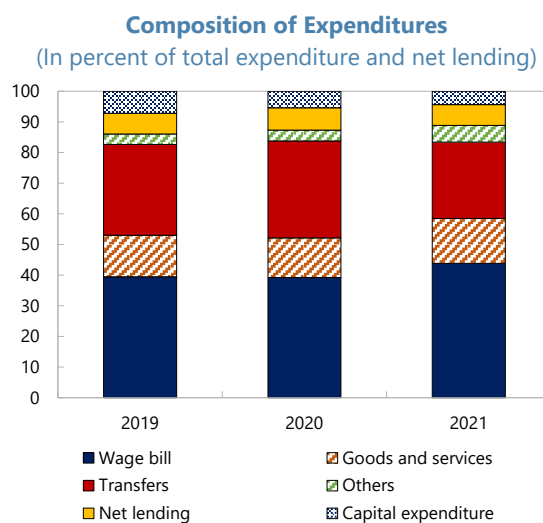
5. The outlook for 2022 points to a slowdown of the economy amid rising inflation concerns.

Growth was 5.7 percent (y-o-y) in 2022Q1 and is projected to decline to 4 percent, driven by lower consumption and investment due to lower real incomes as prices rise,⁴ continued fiscal weaknesses, and increased uncertainty related to the war in Ukraine—while direct spillovers from Russia and Ukraine (merchandise trade, tourism) are limited, indirect exposures, particularly on food and fuel imports via Israel, are substantial.⁵ Inflation is projected to rise to 4.9 percent in 2022, the highest since 2010, driven by higher food, fuel, and construction material prices, while moderated by substantial shekel appreciation. Over the medium term, growth is expected to slow to its estimated potential rate of 2 percent, which remains constrained by Israeli restrictions on the movement of goods and people and gaps in the business environment.

B. ...But the Fiscal Situation Remains Difficult...

6. Despite a difficult environment, the authorities contained the 2021 fiscal deficit to pre-pandemic levels.

The fiscal deficit declined to 5.2 percent of GDP in 2021. The deficit excluding grants—a better indicator of fiscal effort—came in at 7.0 percent of GDP. Contributing to this outcome was a 15.9 percent increase in revenues,⁶ well above nominal GDP growth, restraint in recurrent spending, and a cut in development spending to 1.3 percent of GDP, its lowest level on record. With budget grants down 40 percent from 2020, government debt (including arrears) increased from 34.5 percent of GDP in 2019 to 50.4 percent of GDP at end-2021 (20.6 percent of GDP excluding arrears and promissory notes, see Figure 3).⁷



Sources: MoF; and IMF staff estimates.

7. The deficit led to the net accumulation of new domestic arrears of 4.7 percent of GDP.

Prudential limits on bank lending and the lack of access to international capital markets constrained budget financing options. Arrears consist of outstanding obligations to suppliers, private contractors, and the pension fund. In addition, the policy of partial payment of public sector salaries (while exempting the lowest earners from the

⁴ See the World Bank September 2022 AHLC Report (forthcoming) for a detailed analysis of the impact of rising food prices on poverty.

⁵ Direct imports from Ukraine and Russia together are limited to 1.2 percent of imports. Imports of wheat and flour (direct plus through Israel) from Ukraine and Russia comprise 59 percent of wheat and flour imports. Fuel imports are almost wholly from Israel, which itself imports about 38 percent of its oil imports from Russia (UN COMTRADE 2018–19).

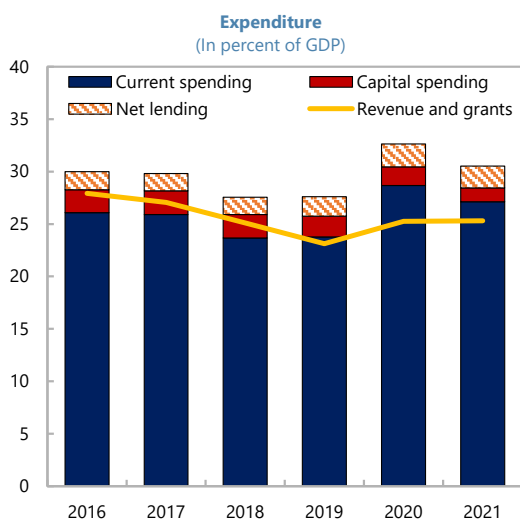
⁶ See IMF staff's [May 2022 AHLC Report](#) for further details.

⁷ The 50.4 percent of GDP end-2021 debt stock number includes promissory notes, which the authorities do not record as part of their debt (Annex II).

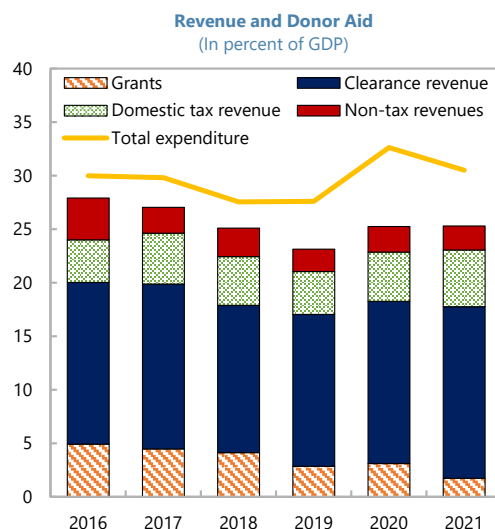
haircut), in place since November 2021, has led to wage arrears. Staff estimates the end-2021 arrears stock at 27.8 percent of GDP.⁸ However, there is considerable uncertainty over the size of these arrears, and the published end-2021 stock of arrears stood at 16.7 percent of GDP.

Figure 3. West Bank and Gaza: Fiscal Sector Indicators, 2016–21

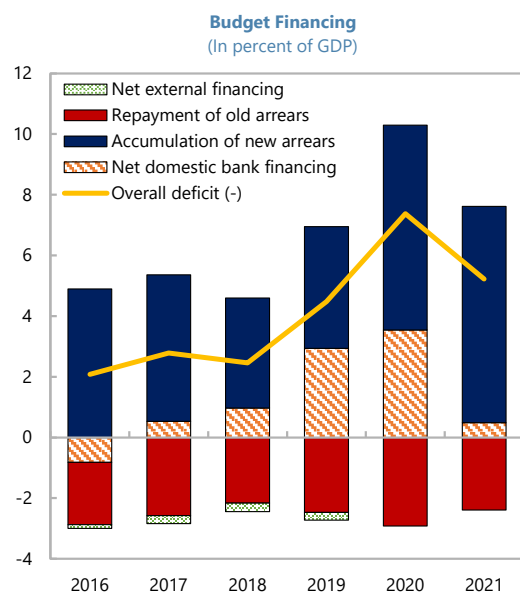
Expenditure has grown considerably relative to pre-COVID-19 levels...



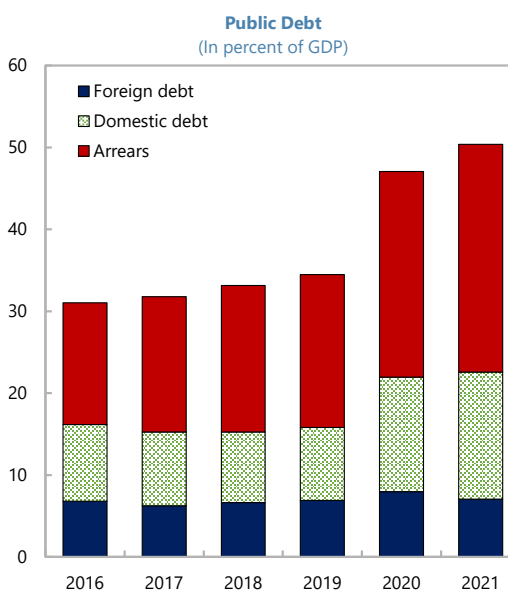
... outpacing revenue gains even as grants continued to decline.



High deficits are largely financed with domestic arrears...



... pushing public debt to record highs.



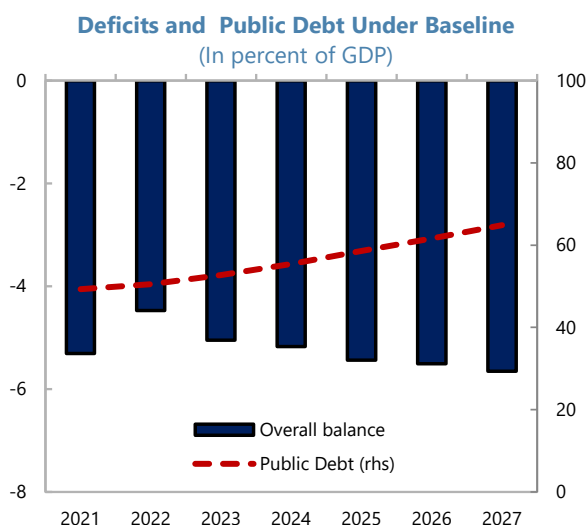
Sources: Ministry of Finance (MoF); and IMF staff estimates.

⁸ These estimates exclude penalties and interest on pension fund arrears, which remain under negotiation.

8. Fiscal performance in the first half of 2022 points to a continuation of 2021 trends.

Domestic revenues continue to perform well, as do clearance revenues (CR, taxes collected by Israel on behalf of the PA), mainly due to tax administration gains, higher fuel prices, and increased economic activity. The authorities continue to manage tight fiscal constraints by paying partial salaries to public sector employees, sharply reducing social transfers, and containing development spending. The fiscal deficit (on a commitment basis) in the first half of 2022 came out at 0.4 percent of GDP, compared to 2.4 percent of GDP over the same period in 2021, while the full year deficit is projected at 3.5 percent of GDP.

9. Under unchanged policies public finances remain unsustainable. Government debt (including arrears) would reach 58 percent of GDP by 2027. Although liabilities to the pension fund will only come due over the long term, debt sustainability analysis (Annex II) highlights risks associated with high gross financing needs and shocks. A significant part of the problem is structural. The PA raises virtually no revenue from Gaza and East Jerusalem, while it spent about a third of its budget in these areas in 2021, and neither does it raise any significant revenue from Area C in the West Bank. Moreover, the PA and Israel disagree on the amounts that the Government of Israel (GoI) should transfer to the PA under the Paris Protocol (fiscal leakages) and unilateral Israeli deductions for so-called “prisoner payments”.⁹ Lastly, donor grants are not projected to increase over the medium term.¹⁰



Source: IMF staff estimates.

C. ...While the Banking Sector Has Generally Been Stable...

10. The banking sector has remained generally stable (Table 3 and Figure 4).¹¹ At end-June 2022, banking sector capital (16.7 percent of risk-weighted assets) remained adequate and profitability (10.4 percent return on equity) had recovered to above its pre-pandemic level, while non-performing loans (NPLs) remained steady at 4.2 percent of total loans. Liquid assets increased, and comprised 47 percent of short-term liabilities at end-June 2022, but liquidity management continued to be hampered by the limit imposed on the transfer of physical shekel cash from the West Bank to Israel. As a result, banks held excess shekel cash of NIS 5 billion (equivalent to 7.2 percent of assets) at

⁹ The Israeli Palestinian Prisoners Law from 2018 mandates withholding CR of an amount equivalent to the GoI's estimate of PA payments to families of Palestinians imprisoned or killed for alleged terrorist offences under Israeli law.

¹⁰ The temporary uptick in 2023 is due to the assumption that the EU donor grants for 2022 and 2023 will both be paid out in that year.

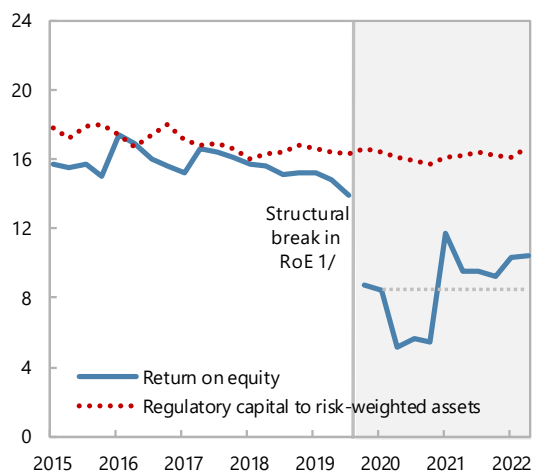
¹¹ The Palestinian banking sector consists of 13 private banks. The two largest banks together have a market share of 46 percent. Banking sector assets comprise 116 percent of GDP.

end-June 2022. The GoI renewed letters of immunity and indemnity to the two Israeli banks that offer correspondent services to Palestinian banks until March 2023, ensuring correspondent banking relations (CBRs) continue uninterrupted.

Figure 4. West Bank and Gaza: Financial Sector Developments, 2015–22

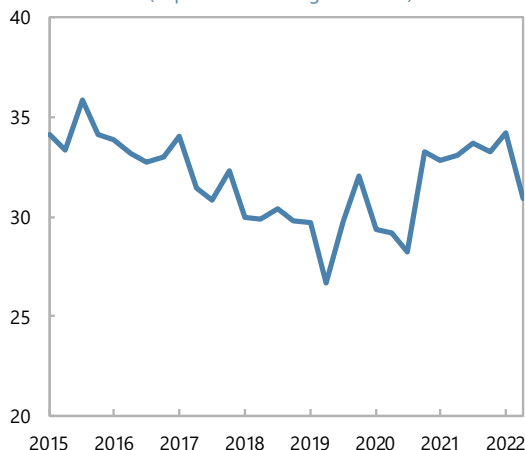
Capital remains adequate and profitability is above pre-pandemic level.

Capital Adequacy Ratio and Profitability
(In percent)



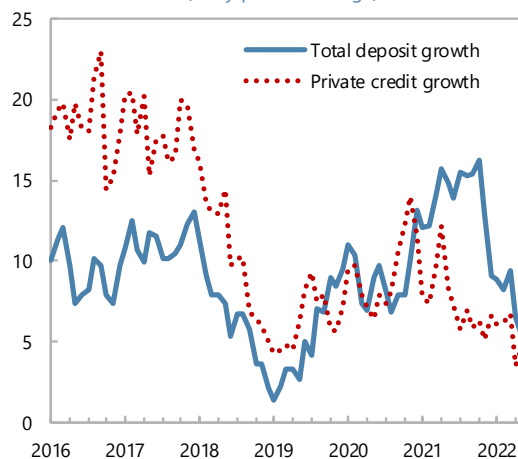
... raising bank liquid assets to total assets.

Liquid Assets
(In percent of total gross assets)



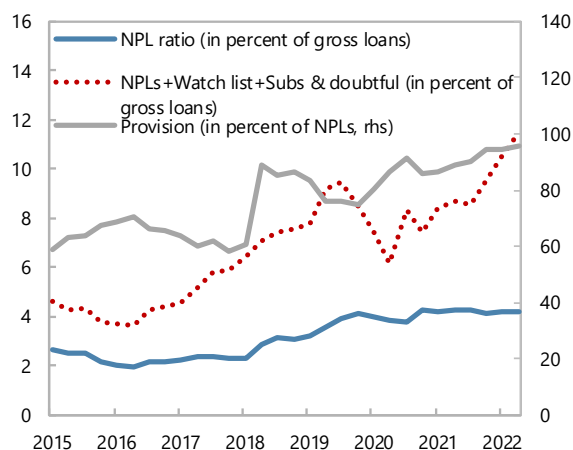
Deposit growth outpaced private credit growth until 2022Q1...

Deposit and Credit Growth
(Y-o-y percent change)



Non-performing loans rose only modestly, while provisioning increased.

Non-Performing Loans and Provisions



Sources: PMA; and IMF staff estimates.

1/ Return on equity (ROE) follows the 2019 IMF Financial Soundness Indicators Compilation Guide for 2019Q4 onwards. Figures for earlier years follow the 2006 Guide and are thus not comparable.

D. ...And Significant Risks Are Ever Present.

11. Political and socioeconomic conditions present clear downside risks. Frustration with the lack of progress on the peace process, unemployment, poverty, and dissatisfaction with domestic politics may lead to civil unrest or another confrontation with Israel. Renewed COVID-19-related movement restrictions and Russia's war in Ukraine present further risks. If these risks were to materialize, food and fuel price hikes could accelerate and confidence, investment and growth could be negatively affected (Annex I). Without fiscal buffers and with little scope for monetary easing, the authorities would not be able to significantly ease the burden. Still, they might attempt to cushion fuel and electricity retail prices, which would lead to higher fuel and electricity subsidy outlays.

12. The fiscal situation brings about risks to the banking sector and real economy.

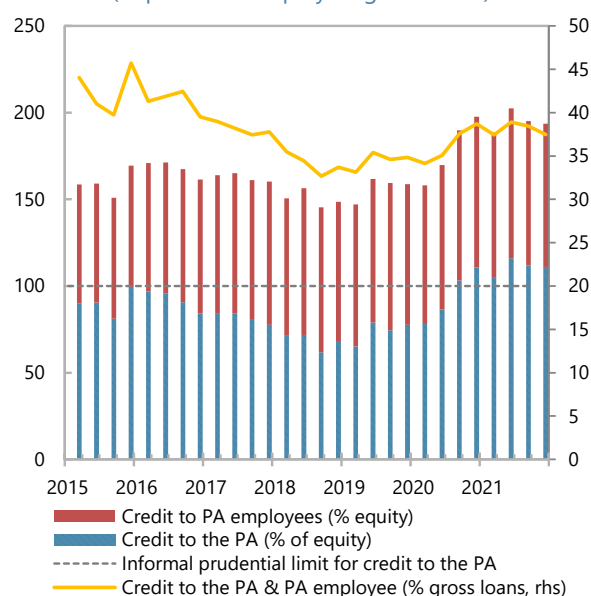
Banks are highly exposed to the PA.¹² An unchanged fiscal trajectory or downside shocks impacting PA debt (Annex II) would increase credit risk on this exposure, lowering the quality of bank assets, and could ultimately endanger financial stability. If banks came under pressure, the authorities' ability to provide liquidity support would be limited. Meanwhile the large and increasing stock of PA arrears to suppliers and public sector employees presents risks to the real economy.

13. The threat of disruption of shekel correspondent banking relations and asset quality deterioration comprise other banking sector risks.

Pending the development of alternatives to current CBR arrangements (1132)

any disruption to existing shekel CBRs would have serious economic impact due to the Palestinian and Israeli economies' interconnectedness and the widespread use of the shekel in the Palestinian territories. Furthermore, the cessation of COVID-19-related forbearance measures in 2022 could expose bank asset quality weakness—particularly in SMEs and consumer loans. The Gaza loan portfolios may also deteriorate because of difficult conditions on the ground and the destruction of physical infrastructure during the May 2021 conflict. Still, the high NPL coverage ratio of 96 percent provides a significant buffer.

Credit to the PA and PA Employees
(In percent of equity or gross loans)



Sources: PMA; and IMF staff calculations.

¹² Banks direct exposure stood at 21 percent of total loans (some 11 percent of assets or 111 percent of equity—above the informal 100 percent prudential limit) at end-2021, while loans to PA employees added an additional 16 percent of loans (8 percent of assets) in indirect exposure and there is further indirect exposure through loans to PA suppliers. Direct exposure fell to 104 percent of equity at end-February 2022.

14. The authorities broadly agree with staff's views on the outlook and risks. They note the increased burden inflation puts on the population. They concur that the current fiscal outlook poses risks and requires reform and noted that most of the fiscal leakages would be resolved if Israel abided by the provisions of the Paris Protocol. Against this background, they stress the 2021 deficit was contained despite the fragile political and socioeconomic situation, on the back of good revenue performance that has continued into 2022.

A NEED FOR REFORM

Boosting growth and putting public finances on a sustainable path will require ambitious reforms spanning several years and close cooperation between the PA, the GoI and donors. IMF staff's [May 2022 AHLC Report](#) laid out the broad parameters of a macro-fiscal reform scenario and how each stakeholder could contribute. This report does not revisit the reform scenario but rather builds on it by providing more details on reforms needed to achieve these objectives. Taken together, the sustained and deliberate implementation of the reforms outlined below would help restore debt sustainability, boost long-term economic growth, and reduce unemployment and poverty.

A. Fiscal Reform

15. The 2022 budget envisages considerable spending cuts, but the underlying policies to achieve these results remain under discussion. The budget foresees a fiscal deficit of 3.8 percent of GDP. The lower deficit is driven almost exclusively by lower recurrent spending, notably on transfers, goods and services, net lending, and wages. These spending cuts, together with projected increases in donor support for projects, are used to triple development spending to 3.9 percent of GDP in the budget. However, the policies to yield these expected savings have not yet been formulated and implemented. Accordingly, staff has not included the budgeted savings and additional development expenditure in its baseline scenario.

West Bank and Gaza: Central Government Fiscal Operations (Percent of GDP, accrual basis) 1/

	2020	2021	2022	
		Act.	Budget	Proj.
Total revenues and grants, net	25.3	25.3	26.2	25.8
Total revenues	22.1	23.5	23.4	24.1
Domestic tax revenues	4.7	5.5	5.7	5.9
Clearance revenues	15.1	16.0	15.6	16.5
Tax refunds	0.7	1.0	0.9	1.3
Nontax revenues	2.4	2.2	2.2	2.3
Earmarked collections	0.6	0.8	0.8	0.8
Grants	3.1	1.8	2.8	1.6
Total expenditure	32.6	30.5	30.0	29.2
Wages and salaries	12.9	13.4	13.0	13.3
Goods and services	4.2	4.5	3.8	4.3
Interest	0.4	0.7	0.8	0.7
Transfers	10.4	7.6	5.9	6.7
Minor capital	0.2	0.2	0.3	0.2
Net lending	2.2	2.1	1.5	2.0
Earmarked spending	0.6	0.8	0.8	0.8
Development expenditure	1.8	1.3	3.9	1.3
Overall balance (including grants)	-7.4	-5.2	-3.8	-3.5

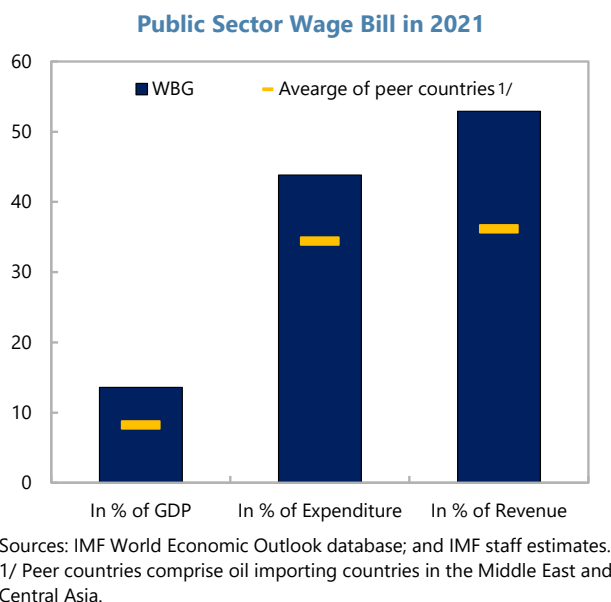
Sources: Palestinian authorities; and IMF estimates and projections.

1/Based on staff's projected GDP.

16. Any reforms will have to be carefully sequenced and communicated to increase the chance of success. The approach should be to first focus on "stop gap" measures that can be implemented in the short term, followed by a gradual and carefully sequenced implementation of ambitious medium term reforms. The reforms will require strong political commitment over the medium term and should be accompanied by effective communications on their need.

Wage Bill

17. The public wage bill contributes considerably to fiscal pressures and will require deep reform. The wage bill accounted for 44 percent of total spending and 57 percent of total revenues (excluding grants) in 2021. The main cause lies in relatively high public sector wages (incl. allowances), caused by high past salary increases, often out of sync with inflation and private-sector wage trends.¹³ In addition, automatic promotions based on seniority rather than performance have led to a top-heavy grading structure with more staff at senior levels than in other countries. Although pockets of overstaffing exist, the overall size of the public sector is not unduly large by international standards, even when employees in Gaza are included.¹⁴



18. The authorities are working with the World Bank to identify reform proposals. Agreeing on and implementing wage bill reform policies will take time, and hence potential savings will mostly materialize gradually over time. Policy options could include:

Short Term

- Continue the current temporary policy of paying partial salaries to public sector employees while exempting the lowest earners, until policy reforms generate substantial savings on the wage bill.
- Temporarily suspend all recruitment in the public sector and subsequently limit it by hiring at most 1 staff for each staff that leaves the service. Meet employment needs in specific sectors by shifting staff across departments.
- Suspend the next salary and allowance increases for employees above a certain grade.
- Suspend all promotions for civilian and security personnel for the remainder of 2022.

¹³ See the [World Bank 2016 public expenditure review](#). The PA implements an annual mandatory step increase of 1.25 percent, in addition to about 3–4 percent in other increases. At end-2022Q1, the average public sector salary was 32 percent above the average private sector salary.

¹⁴ The security sector accounts for almost 10 personnel per 1,000 inhabitants, compared with a global average of some 4.5/1,000 (World Bank May 2022 AHLC Report). The health and education sectors also have larger numbers of staff than other countries in the region (e.g., higher doctor-patient ratio).

Medium Term

- Reform the system of allowances and integrate them into base pay.
- Cease the practice of automatic salary increases and reform salary grades for new recruits.
- Consider early retirement incentives, provided these are well targeted (e.g., security personnel, staff with long employment records) and cost effective, and do not undermine the viability of the pension system.
- Undertake a functional review of the civil service, including in Gaza, and implement broad-based civil service reform aligned with a new vision of about the role of government. The key objectives would be to align staffing to the functions and needs of the public. Reforms would include modernizing human resource management (e.g., merit-based promotions, performance-based annual assessment), restructuring or merge public institutions and moving positions as needed, and adopting digital technologies.

19. The authorities consider the wage bill as the biggest challenge for public finances. They plan to shrink public sector employment and hence significantly lower the wage bill through a new early retirement scheme for both civil servants and security personnel. They also underscored the importance of containing subsequent hiring and instead plan to rely on rotation of existing staff to open positions. The authorities are planning to include some allowances into base pay and remain committed to restoring payment of full salaries as the situation allows. They have set up high-level committees to further develop these reform proposals.

Net Lending

20. Net lending constitutes a considerable fiscal drag. Net lending comprised 2.1 percent of GDP in 2021. It refers to the system by which Israel deducts payments (including for delay fines and addressing outstanding debt) for electricity, water and sewage services provided to Palestinian consumers through local government units (LGUs) and Palestinian distribution companies (DisCos) from the clearance revenue it collects on behalf of the PA.¹⁵ As LGUs and DisCos are formally responsible for the collection and payment of these bills, in effect net lending represents debt of the LGUs and DisCos to the PA (hence the terminology) and the associated deductions constitute transfers from the central government to LGUs/DisCos. By far the biggest component of net lending consists of electricity provision to Gaza, followed by electricity to West Bank, water provision and finally sewage services.

21. Net lending distorts incentives and reflects weaknesses in intergovernmental relations. The current setup does not provide accountability to the LGUs and DisCos and thus encourages a culture of nonpayment. For example, LGUs use some of their collections to pay for other expenses (education, health, local projects) and distribution companies have been known to pay shareholder

¹⁵ The Palestinian Electricity Law No 13 from 2009 provides that municipal electricity distribution services be integrated into five licensed electricity DisCos (which are owned by the municipalities). However, many municipalities never joined the DisCos, resulting in a web of highly inefficient overlapping distribution infrastructures.

before paying their Israeli suppliers. It also results in extensive and untransparent cross claims, when the PA withholds earmarked revenues it collects on behalf of LGUs as a partial offset for the Israeli deductions.¹⁶

22. Net lending is made worse by widespread problems with the electricity network.

Inadequate investment in maintenance and upgrading of the grid have led to considerable technical losses. Non-technical losses are also significant mainly due to theft, metering errors, lack of access to meters in Area C, and unbilled accounts. High prices by the Israeli supplier further contribute to weaknesses.¹⁷ These problems are particularly prominent in Palestinian refugee camps, where metering is lacking and non-collection is rife, and Gaza, from which the PA receives no utility revenue. The water and sewage networks suffer from similar issues.

23. Reducing net lending will require reforms along several fronts over many years. Policy options include:

Short Term

- *Strengthen transparency.* Deductions by the GoI should be clearly broken down by service and recipient, and reported online well-ahead of reconciliation meetings with the PA to allow for audit and reconciliation before deductions are made. So should deductions by the PA from LGU's earmarked revenues.

Medium Term

- *Gradually replace offsets with fixed transfers.* This would incentivize LGU collection and would improve transparency in intergovernmental relations.
- *Professionalize utility distribution services.* In line with World Bank recommendations, complete the move towards integrated DisCos by merging remaining municipal distribution services into the existing DisCos, and ensure cost recovery. Promote similar arms-length arrangements for water and sewage service. These measures would reduce inefficiencies and improve governance.
- *Improve LGU administrative capacity and increase LGU own revenue sources.* Strengthened administrative capacity (including liquidity and cash management) would allow LGUs to handle larger own-revenue streams and be more accountable to local residents. These efforts should be accompanied by reforms to increase LGU resources and at the same time limit the potential drain of LGUs on PA resources (through, e.g., review or approval of LGU budgets by the PA and a prohibition of borrowing by LGUs). The authorities may need to consider broader reform of LGUs by merging smaller units.

¹⁶ Earmarked revenues include municipal property taxes, and license and road fees and comprised some 3 percent of total revenue in 2021.

¹⁷ The Israeli Electricity Company charges its bulk tariff for medium or low voltage customers instead of an export wholesale price that would remove non-applicable components of the tariff.

24. The authorities see net lending a major challenge and are making efforts to reduce the fiscal drain. They note that a large part of the problem relates to the Gaza Strip—which is entirely beyond their control—, Area C—where they have no enforcement powers—, and refugee camps, with collection rates elsewhere generally high. Still, specific action can help. The authorities have, for instance, established a specialized unit to develop a database with crossclaims and a procedures manual for handling them. To be comprehensive, such database will require more timely information from Israel on bills and deductions. Israeli cooperation will also be required for enforcement (e.g., of disconnection on nonpayment) in Area C and allowing the construction of large-scale solar generation facilities, both of which would mitigate the problem. More ambitious reform of LGUs or forcing holdout LGUs to join electricity DisCos is politically sensitive and could proceed only in tandem with increased LGU resources. Still, the authorities are starting a pilot enabling five municipalities to collect property tax themselves, expecting this will boost ownership and collection.

Tax Revenue

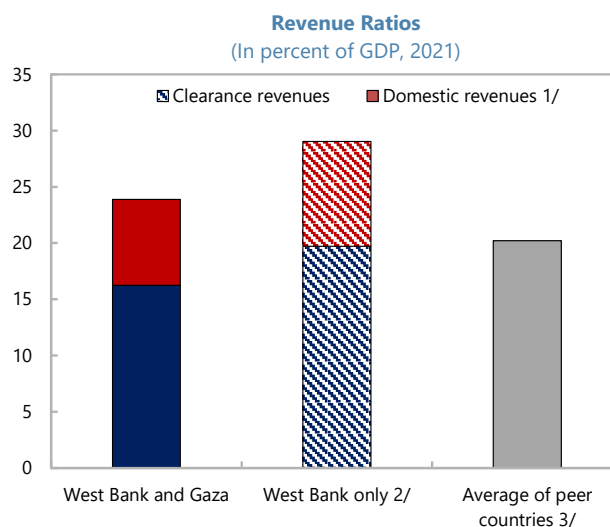
25. The authorities have formulated an ambitious strategy to boost domestic revenue.

Even as tax revenue collection is already well-above peers, the strategy appropriately focuses on broadening the tax base through combating tax and customs evasion. A key priority is combating underreporting among liberal professions

(e.g., doctors, lawyers) (Box 1). To achieve this goal, the authorities are seeking to strengthen banks' information exchange with tax authorities. While it is best practice for the tax authority to collect certain tax-related information from financial institutions, the specific modalities and procedures need to be carefully drafted to ensure appropriate safeguards, provide checks and balances to prevent overreach, and minimize the burden on banks. The tax strategy envisages a new VAT law that was recently approved by cabinet, as well as a new customs law and amendments to the 2011 income tax law. The strategy may also involve additional tax expenditures

("sectoral transformation" —see Box 1),

contrary to past advice to review and trim exemptions. It will be important to prioritize and sequence the envisaged revenue reform in order to not overburden implementation capacity and increase the chances of success.



Box 1. Revenue Strategy 2022–25

The goal of the authorities' revenue strategy is to boost domestic tax revenues. The main elements of the strategy include:

- Identifying and registering unregistered taxpayers (horizontal expansion).
- Strengthening coordination with the customs police to curb tax evasion.
- Establishing a revenue risk management department.
- Developing a risk-based tax audit strategy.
- Requiring business taxpayers to use cash registers.
- Strengthening coordination with relevant government agencies to exchange information.
- Electronically linking the public sector and the private sector, particularly the banking sector, to facilitate exchange of information on taxpayers.
- Developing and promoting the use of the electronic portal for taxpayers.
- Developing legislation and regulations governing e-commerce.
- Fully integrating the tax and customs administrations by completing the networking of the various computerized systems (including a comprehensive taxpayer database) and creating a customs and tax inspection department.
- Automating all customs and tax procedures and offering electronic services to taxpayers, including e-invoicing.
- Strengthening integrity and fighting of corruption

The strategy also emphasizes "sectoral transformation" of the tax system. Specifically, the authorities plan to offer attractive tax rates on specific sectors (e.g., education, e-commerce, real estate, health, liberal professions, agriculture, tourism) to encourage their development.

26. Cooperation between the PA and the GoI will be required to boost revenue and improve transparency. Systematic changes going beyond one-off payments to resolve or at least reduce fiscal leakages—estimated at about 1.8 percent of 2022 GDP—will be paramount. The launch of the e-VAT pilot in March is a good first step to tackle the VAT leakage. Under the pilot, traders on both sides can issue transaction receipts digitally. While the system is compulsory for Palestinian traders, participation for Israeli traders remains voluntary for now, resulting in modest take up. Going forward, there is a need to move more decisively toward bringing all Israeli traders and hence all purchases into the system. Revisiting the handling fee in light of significantly increased trade volumes over the past two and a half decades would be opportune.¹⁸ Exempting fuel imports from excise and VAT rather than the current practice of charging and subsequently refunding the tax to the PA subject to the 3

Main Fiscal Leakages, 2022	
	Annual flows, percent of 2022 GDP
Total	1.8
VAT ¹	0.8
Allenby crossing fees	0.1
Handling fee	0.5
of which: Fuel	0.2
Other	0.4

Source: IMF staff estimates.

¹ Losses largely due to missing invoices.

¹⁸ The 3 percent handling fee currently finances a disproportionately high share of the Israeli customs and VAT department's total budget when compared to the share of Palestinian imports out of total imports handled by the department.

percent handling fee would comprise an important first step in this regard. Regarding the Allenby (King Hussein) bridge exit fees, the GoI has unilaterally increased the exit fees three times but has not shared the increased revenues with the PA. In addition, there is a need for increased transparency through publishing detailed reports on the amounts deducted by Israel, for instance on the GoI's website. Easing access for Palestinian business to Area C in the West Bank and transferring the tax revenue on economic activity in Area C (outside the settlements and military locations) in line with the Paris Protocol would have a further strong impact on revenues. Lastly, revenues withheld unilaterally by Israel because of prisoner payments present a considerable fiscal drag.¹⁹ Other solutions should be found to support needy families, which should be accompanied by the cessation of these deductions and the release of the stock of withheld funds.

27. The authorities view their revenue strategy as underpinning the recent good revenue performance and expect its gradual further implementation to continue to boost revenue.

They are discussing various options to organize the exchange of bank account information with the tax authorities, building on the advice of a recent IMF revenue administration TA mission. The authorities strongly support faster progress on resolving the outstanding fiscal files, noting that they find the nature of some of the CR deductions intransparent and hence arbitrary. They would like to see the e-VAT coverage expand quickly to include all trade and the handling fee reduced, with fuel purchases exempt from it, and the transfer of customs authority to proceed. They believe that intensified discussion between the Israeli and Palestinian Ministries of Finance could help advance these fiscal issues. The authorities also explained that, due to political circumstances, obtaining better fiscal data from Gaza remains elusive.

Other Fiscal Issues

28. Reform of the healthcare, public pension and fuel subsidy systems present other potential areas for reform. Any such reforms should be gradual and go hand-in-hand with increased social support for the most vulnerable households and increased development spending, and should be communicated clearly in order to minimize the potential for social unrest.

- Public health spending is driven by high wages (60 percent of the Ministry of Health's budget), outside medical referrals (90 percent of non-wage spending), and high pharmaceutical costs.²⁰ Inefficiencies, duplication of service, doubtful or fraudulent claims, and emphasis on tertiary rather than primary care have all played a role. Moreover, the Government Health Insurance (GHI) system is underfunded, posing considerable financial risks to the PA.²¹

¹⁹ Since 2019 Israel has withheld an estimated US\$580 million (2.9 percent of 2022 GDP) in clearance revenues related to prisoner payments.

²⁰ See [World Bank PER](#) (2016) and [AHLC Report](#) (May 2022).

²¹ The GHI scheme was established in 1994. It offers health insurance, including on non-contributory basis for those facing hardship. Over the years, the share of non-contributory participants increased resulting in lower revenues and higher spending for the GHI, increasing pressures on the PA budget.

- The public pension system for civil servants and security personnel is fragmented and complex, comprising four different schemes.²² All schemes provide generous benefits, with some featuring replacement rates up to 100 percent of final salary, broad eligibility criteria, and early retirement options from age 45. Legally, the unified (Scheme II) pension system is a fully funded system, but the government has been unable to make the full required contributions and hence the current pension fund assets are insufficient to meet future obligations, rendering the system unsustainable. In practice the system operates as a PAYG system, with the PA paying current pension outlays, through the pension fund or, for security personnel, directly to beneficiaries.
- The PA sets the retail sale price for each fuel type in the Palestinian territories. Fuel subsidies cover losses the General Petroleum Authority incurs from selling in Palestinian territories at below its purchase price. The PA covers these losses through a fuel tax refund, which in 2021 totaled 0.4 percent of GDP. Amidst rising fuel prices, the fiscal burden has increased to 0.6 percent of projected 2022 GDP in the first half of the year, as the PA sought to contain the passthrough of import prices to consumers.

29. Improved public financial management should support fiscal policies. The World Bank's 2018 PEFA report notes weaknesses related to the budget calendar, setting of binding expenditure ceilings, and effectiveness of commitment controls. A gradual move toward a medium-term budgetary framework, including multi-annual commitment controls, consistent with a medium term macro-fiscal framework would address these issues. This would also facilitate improving public investment management, including by developing a prioritized medium-term public investment plan. In tandem, the authorities should strive to improve cash management. They are enhancing transparency and accountability by improving the timeliness of the audit of financial accounts by the State Audit and Administrative Control Bureau, which issued its 2018 and 2019 reports and is on track to complete the 2020-21 audit by year end. The authorities should undertake a comprehensive stock taking of arrears and adopt a strategy for their gradual clearance, based on clear and transparent criteria. Such a strategy could include both cash payment of arrears and securitization and could benefit from IMF technical assistance. The improvements in the budget planning and execution process discussed above should also help prevent the accumulation of new arrears.

30. The authorities expressed some reservations about the feasibility of these reforms in the current context. They agree with the need to first reduce and then eliminate their reliance on arrears financing and subsequently bring down the amounts owed to suppliers and employees. They note however that this is contingent on achieving fiscal consolidation and increasing donor contributions. They explained that a significant part of arrears to suppliers is to the health sector, and that they are containing health care costs by limiting outside medical referrals, negotiating to cut pharmaceutical prices, and developing a national health care price list. They do not believe the

²² The Pension Law (Public Pension Law No 7) of 2005 combined (grandfathered) pension schemes inherited from Egypt (for Gaza civil servants) and Jordan (for the West Bank civil servants) as scheme I (10 percent scheme) and scheme IV (2 percent scheme) respectively. Scheme II (7 percent scheme) was created for all public-sector employees (civilian and security) who were aged less than 45 on September 1, 2006. All newly hired public sector employees became members of this scheme. Scheme III (also known as security services scheme) was mainly for security forces aged more than 45 as of September 1, 2006. Schemes I, III, and IV are closed to new entrants and are being phased out. Scheme II is young, and most contributors have not yet reached retirement age.

current environment is right for wholesale pension reform, reiterating that arrears to the pension fund do not have an immediate impact on the real economy. In addition, they do not see the scope for reducing fuel subsidies at a time when wholesale fuel prices have increased significantly, but note that they are planning to improve targeting and that the fiscal situation may compel them to reduce fuel subsidies going forward. Lastly, the authorities noted that while a medium-term budget framework exists in principle, it is not operational given volatile macroeconomic environment.

B. Financial Sector Issues

31. The Palestine Monetary Authority (PMA) should intensify supervisory and regulatory oversight. This is particularly important in light of banks' continued high exposure to the PA (¶13) and the possible emergence of asset quality weakness now that COVID-related loan moratoria and regulatory forbearance have been discontinued. To tackle these risks, the PMA should further strengthen its risk-based supervision, informed by multi-factor stress tests developed with IMF assistance and the recommendations of the IMF TA on onsite risk-based banking supervision. The PMA should also continue to reinforce its bank resolution, crisis management and financial safety net toolkits, in line with ongoing IMF TA, and operationalize its emergency liquidity assistance framework. In anticipation of the possibility of higher NPLs, the PMA will need to improve data collection on rescheduled and restructured loans and ensure that all banks abide by provisioning requirements. With respect to macroprudential policies, the PMA has recently introduced a leverage ratio of 4 percent and continues to enforce concentration limits.

32. Maintaining shekel correspondent banking relations is essential for financial and economic stability. CBRs rely on letters of immunity and indemnity issued by the GoI to the two Israeli correspondent banks, who demand such assurances in light of perceived ML/FT risks. The PMA has worked closely with the Bank of Israel (BoI) to set up an alternative mechanism comprising either two publicly-owned clearing and settlement companies (one in Israel and one in WBG that would serve as intermediaries between Israeli and Palestinian banks), or a single publicly-owned Israeli company that would connect directly to the Palestinian banks. While considerable progress has been made, the PMA and the BoI have yet to decide which of these two options to implement. In addition, there is uncertainty about the continuation of ancillary correspondent banking services such as trade finance and foreign exchange services, currently provided by some of the correspondent banks. The PMA is also leading the efforts to strengthen the anti-money laundering and combating the financing of terrorism (AML/CFT) framework in the Palestinian territories, including through recent amendments to the AML/CFT law that criminalize terrorism financing (TF) and a decree that transcribes TF-related UN security resolutions into national legislation in line with international best practices. The PMA has received some IMF technical support to prepare for their upcoming MENAFATF onsite evaluation, and stands ready to act on its recommendations.

33. The build up of excess physical shekel cash in the Palestinian banking system also requires attention (Box 2 and SIP). While not *prima facie* a financial stability risk, it represents a drag on bank profitability, as well as a security risk associated with frequent cash transports and storage outside of overfull vaults. In order to reduce physical excess cash, the PMA is promoting digital means of payment. It has reduced interchange fees on domestic point of sale terminal

transactions and licensed five digital payments service providers, allowing them to provide e-wallets.²³ Early indications suggest that unbanked citizens also use these services, thus boosting financial inclusion. An Israeli measure requiring Israeli employers to pay their Palestinian workers electronically should help significantly reduce the problem further. Strengthening cross-border payment infrastructure more generally would also contribute. Still, the Bol should consider periodically increasing the regular limit on the amount of physical shekel cash it accepts, in line with estimates of accumulated shekel coins and notes through real economic activity.

Box 2. Excess Cash

Palestinian banks hold excessively large amounts of physical shekel cash. Banks elsewhere typically manage the amount and currency composition of cash they hold in their vaults through transactions with other commercial banks and central banks. However, the two Israeli banks that offer correspondent services to Palestinian banks no longer offer them cash services, and the Bol has set limits on the amounts of shekel cash it accepts from Palestinian banks, citing ML/FT concerns. Excess shekel cash is defined by the PMA as shekel cash in banks' vaults exceeding 6 percent of short-term shekel deposits.¹

The main sources of physical shekel cash inflows into WBG comprise Palestinian workers in Israel and the settlements who are mostly paid in cash, and (mainly Arab) Israelis who use cash to buy real estate, pay university tuition fees and shop in the West Bank to benefit from lower prices, in part because of a scarcity of electronic points of sale terminals and high interchange fees imposed on shekel transactions with Israeli payment cards in the West Bank. Staff estimates suggest that shekel cash inflows from these sources comprised some NIS 21.2 billion in 2021. Including informal imports into WBG (paid in cash), the total net 2021 physical cash inflows are estimated at NIS 19.8 billion, against a Bol regular cash shipment limit of NIS 18 billion.

¹ The PMA requires banks to hold 3 percent of their deposits in each currency at each branch, in cash, in vaults, in addition to holdings of 3 percent of deposits needed to meet daily customer cash withdrawal needs. The PMA's reserve requirement of 9 percent of deposits in all currencies must be met separately.

34. The authorities broadly agree with staff's recommendations. Nevertheless, they do not see a significant risk of higher NPLs, but if this were to happen, they would ensure banks abided by provisioning requirements. The authorities underscored the importance of the MENAFATF mutual evaluation. They expressed disappointment that the on-site visit was postponed due to the security environment in early August and are eager to have the visit take place as soon as possible. Their main ML/TF concern relates to the nonfinancial sector and they welcome IMF TA to address any potential deficiencies. The authorities see the alternative mechanism for CBRs as feasible but are unclear about the timeline envisaged by their Israeli counterpart. They expressed concern about a plan under which the Israeli CBR company would connect only to selected Palestinian banks, as this would compromise the level playing field and could be seen to undermine the PMA's bank licensing authority. They are eager to address the excess cash problem by promoting digital payments through the reduction of interchange and credit card fees, and see significant scope for reducing the inflow of physical shekel cash once Israeli authorities require Israeli employers to pay their

²³ See the accompanying Selected Issues Paper on Excess Cash in the Palestinian Banking System for details.

Palestinian workers electronically. They agree that the Bol should increase its limit on regular cash shipments in line with economic activity.

C. Structural Reform

35. Reforms of structural policies are critical to spur activity in domestic sectors, especially for those less impacted by movement and access restrictions. The recent adoption of the companies law modernized business registration and licensing and strengthened minority investor protection. This should be followed by adopting and implementing long-standing commercial legislative reform of the consumer protection law and insolvency and debt settlement regimes. Changes to the cabinet-approved competition law may also be needed to ensure the independence and strengthen the prerogatives of the competition department. Digitalization of government services could help bring about a broader digital transformation of the economy, which would also reduce the impact of movement and access restrictions. However, this would require reaching an understanding with the Gol to allow Palestinian operators to use 4G and 5G telecommunication spectra. Lastly, the authorities should proceed with the reform of the judiciary and create courts dedicated to financial and commercial cases to ensure speedy and consistent application of the law and protection of property rights.

36. Addressing labor market rigidities and improving education are equally important. The informal labor market is large, spurred by inflexible labor contracting and, at NIS 1,880 (or 87 percent of the average private sector wage), a high minimum wage. While the Palestinian labor force is well educated, the unemployment among the young is very high, driven by skills mismatch. Education reform centered on vocational training is key to tackle this issue. An improved STEM curriculum and incentives for employers to hire young graduates for on-the-job training should also be considered.

37. Still, the most important structural reform to boost growth would be the easing of Israeli restrictions on the movement of goods and people and on investment. These restrictions are twofold. First, movement, access and investment restrictions, including in Area C, which hamper growth. Second, trade restrictions in the form of costly non-tariff barriers which harm exports. At its most extreme, the Gaza blockade has stifled growth and essentially transformed the Strip into a closed economy. Staff has previously estimated that granting Palestinian businesses access to and allowing them to invest in Area C (excluding the areas subject to final status negotiations) and easing trade restrictions could boost growth by as much as 4 percentage points per year to 6 percent. The Gol decision to increase the number of permits for Palestinian workers in Israel and the settlements is a welcome step in this regard.

38. The authorities agree on the necessity for reforms in the PA's purview. They see the need to reduce unemployment and informality, while improving education and pursuing commercial legislative reform. They underscored, however, that Israel has an important role to play by allowing better Palestinians to access to Area C and reducing trade restrictions.

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39. The post-COVID recovery of the Palestinian economy is underway, but the fiscal outlook remains precarious and risks abound. Against the backdrop of repeated political and security shocks, a weak fiscal position, and higher inflation, the economy is continuing its recovery, supported in part by increased employment of Palestinian workers in Israel and the settlements. Yet, unemployment remains stubbornly high, especially in Gaza where it is a major contributor to poverty. Without a change in policies, public debt will continue its unsustainable increase, largely financed through arrears, and per capita GDP will decline over the medium term. Moreover, the outlook is subject to considerable downside risks. The PA's fiscal situation creates risks to the banking sector through its high PA exposure and the real economy through arrears financing. Other risks include a resurgence of the COVID pandemic, disruptions to shekel CBRs, a worsening of the political and security situation or sharper-than-expected increases in food and fuel prices, which could trigger renewed unrest.

40. The authorities are acutely aware of the challenges this brings. The 2022 budget appropriately features considerable spending cuts and an increase in development expenditure aimed at boosting the economy's long-term growth potential, while bringing down the deficit. The specific policies currently in the process of being formulated will be crucial to achieve these outcomes. They should include addressing the oversized wage bill and tackling net lending, while reform to health, pension and fuel subsidy expenditure should also be considered. Meanwhile, financial sector policies should focus on intensifying supervisory and regulatory oversight, strengthen the AML/CFT regime by addressing MENAFATF recommendations once they come out, and, together with the BoI, operationalize the alternative correspondent banking mechanism and work towards resolving the excess cash problem. Structural reform should focus on legislative commercial reform, addressing labor market rigidities and improving education to spur private sector growth and job creation.

41. Lasting improvements in economic prospects require transformational reform by the PA, Israel, and donors. A coordinated effort centered on PA spending reform, Israeli-Palestinian agreement on the resolution of the outstanding fiscal files (fiscal leakages), relaxation of Israeli restrictions on the movement of goods and people and on investment, including in Area C, and modest additional donor support would help restore public debt sustainability and unleash the potential for private-sector-led economic growth, thus reducing unemployment and poverty.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2019–27
 (Per capita GDP: \$3,045; 2020 est.)
 (Poverty rate 14 percent in the West Bank and 53 percent in Gaza Strip; 2017 est.) 1/

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Output, employment and prices	(annual percentage change)								
Real GDP (2015 market prices)	1.4	-11.3	7.1	4.0	3.5	2.4	2.0	2.0	2.0
West Bank	1.6	-11.0	7.8	3.8	3.6	2.5	2.2	2.2	2.2
Gaza	0.4	-12.6	3.4	5.0	3.0	1.9	1.5	1.5	1.5
Unemployment rate (period average)	25.4	25.9	26.4	25.7	25.0	24.5	24.2	24.1	24.0
CPI inflation rate (end-of-period)	1.3	0.1	1.3	5.7	3.8	2.5	2.2	2.3	2.0
CPI inflation rate (period average)	1.6	-0.7	1.2	4.9	3.4	2.7	2.5	2.2	2.0
	(in percent of GDP)								
Gross capital formation	26.8	24.3	25.8	27.7	25.4	23.6	22.0	20.6	19.7
Gross national savings	16.4	12.1	17.5	17.5	17.2	13.3	11.9	10.6	9.8
Saving-investment balance	-10.4	-12.3	-8.2	-10.2	-8.2	-10.3	-10.2	-10.1	-10.0
Public finances 2/	(in percent of GDP)								
Total revenues and grants	23.1	25.3	25.3	25.8	26.9	26.0	26.0	26.0	26.0
Revenues	20.3	22.1	23.5	24.1	24.4	24.5	24.5	24.6	24.6
Grants	2.9	3.1	1.8	1.6	2.4	1.6	1.5	1.5	1.4
Total Expenditure	27.6	32.6	30.5	29.2	29.9	30.1	30.3	30.4	30.6
Current expenditures and net lending	25.6	30.8	29.2	27.9	28.6	28.7	28.9	29.1	29.2
Development expenditures	2.0	1.8	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Overall balance (commitment, before external support)	-7.3	-10.5	-7.0	-5.1	-5.5	-5.6	-5.8	-5.8	-5.9
Overall balance (commitment)	-4.5	-7.4	-5.2	-3.5	-3.1	-4.0	-4.3	-4.4	-4.5
Financing gap/discrepancy (in millions of U.S. dollars)	45	0	1	943	902	1130	1228	1287	1374
Identified financing	4.2	7.4	5.2	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
Financing gap / Residual	0.3	0.0	0.0	5.0	4.7	5.6	5.9	5.9	6.1
Total external support	2.9	3.1	1.8	1.6	2.4	1.6	1.5	1.5	1.4
Public debt 3/	34.5	47.1	50.4	49.7	49.5	51.1	53.1	55.3	57.7
Monetary sector 4/	(annual percentage change)								
Credit to the private sector	5.3	5.6	5.6	6.0	6.5	6.8	6.5	6.0	5.5
Private sector deposits	10.0	13.9	8.3	6.5	7.5	8.1	7.5	7.0	6.5
External sector	(in percent of GDP)								
Current account balance (excluding official transfers)	-13.3	-14.5	-9.3	-11.1	-9.8	-11.1	-10.9	-10.8	-10.6
Current account balance	-10.4	-12.3	-8.2	-10.2	-8.2	-10.3	-10.2	-10.1	-10.0
Exports of goods and services	15.5	15.4	17.6	17.8	17.1	16.9	16.6	16.4	16.1
Import of goods and services	53.5	51.9	56.8	58.7	57.7	57.4	56.9	56.6	56.3
Primary income account, net	17.7	16.0	18.8	18.9	18.8	19.0	19.0	19.2	19.4
Secondary income account, net	9.9	8.3	12.1	11.7	13.6	11.3	11.1	11.0	10.8
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	17,134	15,532	18,037	19,677	21,059	22,146	23,164	24,159	25,146
Per capita nominal GDP (U.S. dollars)	3,443	3,045	3,451	3,678	3,847	3,956	4,047	4,131	4,210
Al Quds stock market index (annual percentage change)	-0.6	-10.4	-5.8	...	...	...	...	...	...

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

1/ Using the national poverty line.

2/ Commitment basis.

3/ Data beginning in 2021 include the estimated stock of promissory notes.

4/ End-of-period; in U.S. dollar terms.

Table 2a. West Bank and Gaza: Central Government Fiscal Operations, 2019–27 1/
(In percent of GDP, unless otherwise indicated)

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Revenue and grants	23.1	25.3	25.3	25.8	26.9	26.0	26.0	26.0	26.0
Tax revenue	17.7	19.1	20.5	21.1	21.4	21.4	21.4	21.5	21.6
Direct taxes	1.2	1.2	1.2	1.3	1.3	1.3	1.5	1.6	1.8
Indirect taxes	3.3	3.5	4.3	4.6	4.6	4.6	4.5	4.4	4.2
VAT on domestic purchases	1.8	2.0	2.1	2.3	2.3	2.3	2.1	2.0	1.9
Excises	0.4	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Customs duties	1.1	1.0	1.6	1.7	1.8	1.8	1.8	1.8	1.8
Clearance revenues 1/	14.2	15.1	16.0	16.5	16.5	16.5	16.5	16.5	16.5
Income Tax	0.4	0.1	0.4	0.5	0.5	0.5	0.5	0.5	0.5
VAT on imports	3.5	3.4	3.5	3.5	3.5	3.6	3.6	3.6	3.6
Petroleum Excise	4.3	4.4	4.4	4.5	4.5	4.5	4.5	4.5	4.5
Customs	6.0	7.2	7.7	7.8	7.8	7.9	7.9	7.9	7.9
Other	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Tax refunds	1.0	0.7	1.0	1.3	1.0	1.0	1.0	1.0	1.0
Non-tax revenues	2.1	2.4	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Earmarked revenues 2/	0.5	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Grants	2.9	3.1	1.8	1.6	2.4	1.6	1.5	1.5	1.4
External budgetary support	2.9	2.3	1.0	1.0	1.7	0.9	0.8	0.8	0.7
Total expenditure and net lending	27.6	32.6	30.5	29.2	29.9	30.1	30.3	30.4	30.6
Current spending	23.8	28.7	27.1	25.9	26.6	26.7	27.0	27.1	27.2
Wages and salaries	10.9	12.9	13.4	13.3	13.4	13.5	13.6	13.8	13.9
Goods and services	3.8	4.2	4.5	4.3	4.0	4.0	4.0	4.0	4.0
Interest payments	0.3	0.4	0.7	0.7	0.8	0.8	0.8	0.8	0.8
Domestic	0.3	0.3	0.7	0.6	0.7	0.7	0.8	0.8	0.8
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers	8.2	10.4	7.6	6.7	7.5	7.5	7.5	7.5	7.5
Social assistance	3.0	3.8	2.3	1.4	2.3	2.3	2.3	2.3	2.3
Transfers to the pension fund	5.4	6.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Other transfers	-0.2	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Earmarked payments 2/	0.5	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Development spending	2.0	1.8	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Net lending	1.9	2.2	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Overall balance	-4.5	-7.4	-5.2	-3.5	-3.1	-4.0	-4.3	-4.4	-4.5
Financing	4.2	7.4	5.2	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
Net domestic financing	4.5	7.4	5.2	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
Net domestic bank financing	2.9	3.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Accumulation of new arrears	4.0	6.8	7.1	0.0	0.0	0.0	0.0	0.0	0.0
Arrears repayment (old)	-2.5	-2.9	-2.4	-2.0	-2.1	-2.1	-2.1	-2.1	-2.1
Net external financing	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Borrowing, net	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual/Financing gap	0.3	0.0	0.0	5.0	4.7	5.6	5.9	5.9	6.1
Memorandum items:									
Overall balance (before external support)	-7.3	-10.5	-7.0	-5.1	-5.5	-5.6	-5.8	-5.8	-5.9
Domestic revenues 3/	5.5	6.4	6.7	6.9	7.2	7.2	7.2	7.3	7.3
Central government debt (incl. arrears)	34.5	47.1	50.4	49.7	49.5	51.1	53.1	55.3	57.7
Foreign debt	6.9	8.0	7.1	6.5	6.0	5.7	5.5	5.3	5.1
Domestic debt	27.6	39.1	43.3	43.2	43.4	45.3	47.6	50.0	52.6
of which : Stock of promissory notes 4/	n.a.	n.a.	2.0	1.0	0.5	0.0	0.0	0.0	0.0
of which : Stock of arrears	18.6	25.1	27.8	...	...	...	...	...	...
of which: Arrears to the pension fund	11.6	14.1	14.2	...	...	...	...	...	...
Nominal GDP (in billions of shekels)	61.1	53.5	58.3	63.6	68.0	71.5	74.8	78.0	81.2

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

1/ Revenue collected by Israel on behalf of and transferred to the Palestinian Authority.

2/ Earmarked revenues and payments are collections from taxes and revenues due to local government units.

3/ Revenues administered by the Palestinian authorities. Excludes clearance revenues.

4/ Data beginning in 2021 include the estimated stock of promissory notes.

Table 2b. West Bank and Gaza: Central Government Fiscal Operations, 2019–27 1/

(In millions of U.S. dollars, unless otherwise indicated)

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Revenue and grants	3,964	3,923	4,563	4,847	5,209	5,253	5,435	5,635	5,862
Tax revenue	3,024	2,970	3,701	3,964	4,149	4,323	4,481	4,658	4,855
Direct taxes	210	187	224	238	251	269	307	345	399
Indirect taxes	557	546	774	865	899	934	940	951	957
VAT on domestic purchases	304	306	371	429	443	457	445	438	425
Excises	63	86	108	104	108	112	116	120	125
Customs duties	186	150	290	327	344	360	373	387	401
Clearance revenues 1/	2,433	2,350	2,888	3,097	3,193	3,323	3,444	3,579	3,726
Income Tax	63	22	81	86	88	92	96	99	103
VAT on imports	602	534	627	668	688	718	744	774	805
Petroleum Excise	737	687	798	849	875	914	947	984	1,025
Customs	1,034	1,112	1,388	1,477	1,522	1,589	1,647	1,712	1,782
Other	-4	-4	-6	18	19	9	10	10	11
Tax refunds	175	114	184	236	195	203	210	217	226
Non-tax revenues	358	370	402	426	439	457	474	490	510
Earmarked revenues 2/	92	98	142	148	153	159	165	170	177
Grants	490	486	318	308	468	314	315	317	319
External budgetary support	498	354	186	182	338	179	175	172	168
Total expenditure and net lending	4,731	5,068	5,506	5,502	5,806	6,066	6,334	6,581	6,882
Current spending	4,071	4,452	4,891	4,879	5,164	5,398	5,642	5,865	6,137
Wages and salaries	1,866	2,001	2,413	2,510	2,592	2,720	2,852	2,982	3,138
Goods and services	643	657	807	806	772	804	833	862	897
Interest payments	53	56	125	129	149	157	177	181	186
Domestic	48	50	119	122	142	150	169	174	178
Foreign	5	6	6	7	7	7	7	8	8
Transfers	1,402	1,615	1,371	1,253	1,462	1,522	1,577	1,631	1,698
Social assistance	511	591	420	261	440	458	474	491	511
Transfers to the pension fund	932	936	899	938	967	1,006	1,043	1,079	1,123
Other transfers	-42	88	51	54	56	58	60	62	64
Other	16	27	33	34	35	37	38	39	41
Earmarked payments 2/	92	98	142	148	153	159	165	170	177
Development spending	341	277	242	252	260	270	280	290	302
Net lending	319	339	374	371	382	398	412	426	444
Overall balance	-767	-1,145	-943	-655	-597	-813	-899	-946	-1,020
Financing	722	1,145	942	-288	-305	-317	-329	-340	-354
Net domestic financing	766	1,145	942	-288	-305	-317	-329	-340	-354
Net domestic bank financing	504	551	88	92	95	99	102	106	110
Accumulation of new arrears	686	1,049	1,285	0	0	0	0	0	0
Arrears repayment (old)	-424	-454	-431	-380	-400	-416	-431	-446	-464
Net external financing	-44	0	0	0	0	0	0	0	0
Borrowing, net	-44	0	0	0	0	0	0	0	0
Residual/Financing gap	45	0	1	943	902	1,130	1,228	1,287	1,374
Memorandum items:									
Overall balance (before external support)	-1,257	-1,631	-1,261	-963	-1,066	-1,127	-1,214	-1,263	-1,339
Domestic revenues 3/	949	989	1,216	1,293	1,395	1,458	1,511	1,569	1,640
Domestic tax revenues (percent change)	-9	-8	28	16	8	6	5	5	5
Clearance revenues (percent change)	8	-7	15	12	7	5	5	5	4
Total expenditure and net lending (percent change)	5	7	9	0	6	4	4	4	5
Grants (millions of US dollars) 4/	490	486	318	308	468	314	315	317	319
of which: budget support	498	354	186	182	338	179	175	172	168
Central government debt (incl. arrears)	6,057	7,751	9,372	9,046	9,550	10,268	11,073	11,924	12,941
Foreign debt	1,211	1,312	1,313	1,179	1,167	1,156	1,146	1,136	1,136
Domestic debt	4,846	6,439	8,059	7,868	8,383	9,112	9,928	10,788	11,804
of which: Stock of promissory notes 5/	n.a.	n.a.	372	179	89	0	0	0	0
of which: Stock of arrears	3,277	4,137	5,171	...	...	...	...	...	...
of which: Arrears to the pension fund	2,046	2,327	2,636	...	...	...	...	...	...
Nominal GDP	17,134	15,532	18,037	19,677	21,059	22,146	23,164	24,159	25,146

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

1/ Revenue collected by Israel on behalf of and transferred to the Palestinian Authority.

2/ Earmarked revenues and payments are collections from taxes and revenues due to local government units.

3/ Revenues administered by the Palestinian authorities. Excludes clearance revenues.

4/ Excludes off-budget support through the UNRWA.

5/ Data beginning in 2021 include the estimated stock of promissory notes.

Table 2c. West Bank and Gaza: Central Government Fiscal Operations, 2019–27 1/

(In billions of shekels, unless otherwise indicated)

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Revenue and grants	14.1	13.5	14.7	16.4	18.3	18.6	19.4	20.3	21.1
Tax revenue	10.8	10.2	12.0	13.4	14.5	15.3	16.0	16.8	17.5
Direct taxes	0.7	0.6	0.7	0.8	0.9	1.0	1.1	1.2	1.4
Indirect taxes	2.0	1.9	2.5	2.9	3.2	3.3	3.4	3.4	3.5
VAT on domestic purchases	1.1	1.1	1.2	1.4	1.6	1.6	1.6	1.6	1.5
Excises	0.2	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.5
Customs duties	0.7	0.5	0.9	1.1	1.2	1.3	1.3	1.4	1.4
Clearance revenues 1/	8.7	8.1	9.3	10.5	11.2	11.8	12.3	12.9	13.4
Income Tax	0.2	0.1	0.3	0.3	0.3	0.3	0.3	0.4	0.4
VAT on imports	2.1	1.8	2.0	2.3	2.4	2.5	2.7	2.8	2.9
Petroleum Excise	2.6	2.4	2.6	2.9	3.1	3.2	3.4	3.6	3.7
Customs	3.7	3.8	4.5	5.0	5.3	5.6	5.9	6.2	6.4
Other	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Tax refunds	0.6	0.4	0.6	0.8	0.7	0.7	0.8	0.8	0.8
Non-tax revenues	1.3	1.3	1.3	1.4	1.5	1.6	1.7	1.8	1.8
Earmarked revenues 2/	0.3	0.3	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Grants	1.7	1.7	1.0	1.0	1.6	1.1	1.1	1.1	1.2
External budgetary support	1.8	1.2	0.6	0.6	1.2	0.6	0.6	0.6	0.6
Total expenditure and net lending	16.9	17.4	17.8	18.6	20.4	21.5	22.6	23.7	24.8
Current spending	14.5	15.3	15.8	16.5	18.1	19.1	20.2	21.2	22.1
Wages and salaries	6.7	6.9	7.8	8.5	9.1	9.6	10.2	10.8	11.3
Goods and services	2.3	2.3	2.6	2.7	2.7	2.8	3.0	3.1	3.2
Interest payments	0.2	0.2	0.4	0.4	0.5	0.6	0.6	0.7	0.7
Domestic	0.2	0.2	0.4	0.4	0.5	0.5	0.6	0.6	0.6
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers	5.0	5.6	4.4	4.2	5.1	5.4	5.6	5.9	6.1
Social assistance	1.8	2.0	1.4	0.9	1.5	1.6	1.7	1.8	1.8
Transfers to the pension fund	3.3	3.2	2.9	3.2	3.4	3.6	3.7	3.9	4.0
Other transfers	-0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Earmarked payments 2/	0.3	0.3	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Development spending	1.2	1.0	0.8	0.9	0.9	1.0	1.0	1.0	1.1
Net lending	1.1	1.2	1.2	1.3	1.3	1.4	1.5	1.5	1.6
Overall balance	-2.7	-3.9	-3.0	-2.2	-2.1	-2.9	-3.2	-3.4	-3.7
Financing	2.6	3.9	3.0	-1.0	-1.1	-1.1	-1.2	-1.2	-1.3
Net domestic financing	2.7	3.9	3.0	-1.0	-1.1	-1.1	-1.2	-1.2	-1.3
Net domestic bank financing	1.8	1.9	0.3	0.3	0.3	0.3	0.4	0.4	0.4
Accumulation of new arrears	2.4	3.6	4.2	0.0	0.0	0.0	0.0	0.0	0.0
Arrears repayment (old)	-1.5	-1.6	-1.4	-1.3	-1.4	-1.5	-1.5	-1.6	-1.7
Net external financing	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Borrowing, net	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual/Financing gap	0.2	0.0	0.0	3.2	3.2	4.0	4.4	4.6	5.0
Memorandum items:									
Overall balance (before external support)	-4.5	-5.6	-4.1	-3.3	-3.7	-4.0	-4.3	-4.6	-4.8
Domestic revenues 3/	3.4	3.4	3.9	4.4	4.9	5.2	5.4	5.7	5.9
Domestic tax revenues (percent change)	-8.8	-7.7	27.7	15.6	8.3	5.7	4.6	4.8	4.6
Clearance revenues (percent change)	7.7	-6.7	15.3	12.2	7.0	5.2	4.6	4.8	4.1
Total expenditure and net lending (percent change)	4.7	3.5	1.9	4.5	9.6	5.6	5.4	4.8	4.6
Central government debt (incl. arrears)	21.1	25.2	29.4	31.6	33.7	36.5	39.8	43.2	46.8
Foreign debt	4.2	4.3	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Domestic debt	16.8	20.9	25.2	27.5	29.5	32.4	35.6	39.1	42.7
of which: Stock of promissory notes 4/	n.a.	n.a.	1.2	0.6	0.3	0.0	0.0	0.0	0.0
of which: Stock of arrears	11.4	13.4	16.2	...	...	...	...	...	...
of which: Arrears to the pension fund	7.1	7.6	8.3	...	...	...	...	...	...
Nominal GDP	61.1	53.5	58.3	63.6	68.0	71.5	74.8	78.0	81.2

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

1/ Revenue collected by Israel on behalf of and transferred to the Palestinian Authority.

2/ Earmarked revenues and payments are collections from taxes and revenues due to local government units.

3/ Revenues administered by the Palestinian authorities. Excludes clearance revenues.

4/ Data beginning in 2021 include the estimated stock of promissory notes.

Table 3. West Bank and Gaza: Financial Soundness Indicators, 2017–22
(In percent)

	Dec-17	Dec-18	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22
Capital adequacy													
Tier I capital to risk-weighted assets	15.5	16.0	15.6	15.5	15.2	15.0	13.9	14.1	14.3	14.6	14.3	14.3	14.9
Regulatory capital to risk-weighted assets	16.6	16.8	16.6	16.4	16.1	15.9	15.7	16.0	16.2	16.4	16.1	16.1	16.7
Asset quality 1/													
Nonperforming loans (percent of total loans)	2.3	3.0	4.1	4.0	3.9	3.7	4.2	4.2	4.2	4.3	4.2	4.2	4.2
Nonperforming loans net of provisions to capital	5.2	2.2	5.7	4.4	3.1	1.9	3.8	3.7	2.9	2.6	1.5	1.5	1.1
Coverage ratio (provisions as percent of nonperforming loans)	58.4	86.2	75.0	80.4	86.2	91.7	86.1	86.4	89.0	90.3	94.4	94.6	95.7
Loan to deposit ratio	67.0	69.0	67.5	69.5	69.9	70.4	66.6	66.9	65.8	64.6	65.1	65.2	65.4
Earnings and profitability 2/													
Return on assets (ROA)	1.5	1.5	1.3	1.1	0.8	0.8	0.8	1.4	1.3	1.3	1.2	1.4	1.4
Return on equity (ROE)	16.1	15.2	8.7	8.4	5.2	5.7	5.4	11.7	9.5	9.5	9.3	10.3	10.4
Interest income to gross income	70.9	72.1	72.5	71.6	72.2	73.9	74.4	72.0	71.5	72.3	72.8	71.3	73.5
Non-interest expenses to gross income	62.0	63.3	63.4	63.5	65.7	64.1	63.7	59.5	59.6	59.5	59.8	59.5	59.0
Liquidity													
Liquid assets to total assets	32.3	29.8	32.0	29.3	29.2	28.3	33.2	32.8	33.0	33.7	33.2	34.2	30.9
Liquid assets to total deposits	41.6	38.6	40.9	37.7	37.2	36.9	42.1	41.9	41.9	42.7	42.0	42.9	39.2
Liquid assets to short-term liabilities	43.0	42.2	45.5	43.0	42.2	41.4	47.5	46.3	46.8	47.4	47.2	48.4	47.3

Source: PMA.

1/ Nonperforming loans includes loans more than 90 day overdue.

2/ ROA and ROE follow the 2019 IMF Financial Soundness Indicators Compilation Guide for 2019Q4 onwards. Figures for earlier years follow the 2006 Guide and are thus not comparable.

Annex I. Risk Assessment Matrix¹

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
Domestic Risks			
The PA's fiscal trajectory remains unaltered.	High	High Large fiscal deficits persist, financed by an increasing stock of arrears. Cascading arrears cause all-round liquidity shortages, damaging growth and financial stability. Debt (including arrears) is unsustainable.	Pursue gradual fiscal consolidation, centered on expenditure reform. Take stock of arrears and devise a strategy to clear them. Ensure the banking system remains well capitalized.
Fiscal crisis spilling over to the banking sector	Medium/High	High The PA's fiscal trajectory, if unchecked, could hurt banks' asset quality given the banking sector's high direct and indirect exposure to the PA, potentially undermining financial stability and harming economic growth.	Ensure that the banking system remains well capitalized. Gradually reduce banks' exposure to the PA. Strengthen bank supervision and crisis management capacity.
Reduced financial services by Israeli correspondent banks	High	High Loss of Israeli-Palestinian correspondent bank relations would lead to trade and financial disruption which would encourage a further shift into cash/informality. As a result, WBG's financial system would suffer, harming growth.	Work with Israeli counterparts to operationalize an alternative CBR mechanism and strengthen cross-border payment systems. Strengthen the AML/CFT framework and build implementation capacity, including with possible technical assistance.
Escalating social tensions due to lack of opportunities or prospects for peace and rising food and fuel prices.	High	High Unemployment, poverty, frustration with the lack of progress on the peace process and dissatisfaction with domestic politics and the rise of food and fuel prices may lead to the escalation of civil unrest or another confrontation with Israel. This would	Sound macroeconomic management and economic reform could help instill confidence and alleviate economic strain at the margin. Provide targeted and temporary support, provided the fiscal situation allows it. However,

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.

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
		undermine growth and intensify the humanitarian crisis in Gaza.	economic policies can do little to mitigate discontent with the political situation and the lack of progress on peace.
Israel tightens restrictions on movement of good and people further	Medium	High In response to unrest or renewed conflict, Israel may shut the border to people and constrain goods traffic further. Economic growth would be hit hard and quickly. Many Palestinian guest workers would lose their income, lowering transfers into WBG.	The authorities could try to seek additional grants to be able to partially compensate the population for the associated additional hardship.
Donor support remains low or declines further	High	Medium Donor support remains at its current low level or declines further. This would make the implementation of a reform agenda more difficult. Given that donor grants already stand at historic lows, the impact of a further decrease would worsen the baseline only modestly.	Pursue a comprehensive reform agenda that improves the macroeconomic situation. Entice donors to contribute to this turn around through increased grants.
Global Risks			
Local COVID-19 outbreaks.	Medium	Medium/High Outbreaks of more contagious vaccine-resistant COVID variants force new lockdowns or inhibit commerce. This results in extended supply chain disruptions, slower growth and job losses, adversely impacting public finances, and could undermine bank asset quality.	Provide targeted support to those in need by shifting spending away from lower priority areas. Strengthen banking sector crisis management capacity.
Intensifying spillovers from Russia's war on Ukraine and commodity price shocks.	High	Medium/High Further sanctions resulting from the war and related uncertainties exacerbate trade and financial disruptions and commodity price volatility. This may lead to price and real sector volatility, food insecurity, social unrest, and acute food and energy crises.	Provide targeted and temporary support, provided the fiscal situation allows it.

Annex II. Debt Sustainability Analysis¹

West Bank and Gaza's government debt is unsustainable under unchanged policies.² Its debt continues to rise over the medium term reaching almost 62 percent, a level that poses considerable challenges given the country's narrow revenue base, uncertainties over the flow of clearance revenues, and weak economic growth hindered by Israeli restrictions including on the mobility of labor, goods and capital. High gross financing needs pose a significant challenge. Moreover, West Bank and Gaza is subject to considerable shocks which can further worsen debt sustainability. A combined macro-fiscal shock and a political unrest shock would push debt above 80 percent of GDP by 2027, while gross financing needs would increase by almost 9 percent of GDP by 2027 relative to the baseline.

Structure of Public Debt

1. Government debt continued to grow in 2021 but at a slower pace than in 2020, thanks to the economic recovery. After surging by more than 12 percentage points in 2020 due to the COVID-19 pandemic and spending policies (e.g., vaccine purchases, support to vulnerable groups, reinstatement of full wages for about 6,000 civil servants in Gaza), gross public debt³ increased by 3.3 percentage points in 2021 reaching 50.4 percent of GDP.⁴ The lower growth rate was driven by the economic recovery. Staff estimates suggest that the increase in nominal GDP by 9 percent in 2021 contributed to a reduction in the stock of debt (excluding promissory notes) by 3.9 percent of GDP in 2021, while the change in the numerator added 5.2 percent of GDP to the stock of debt, in line with the recorded deficit.

2. Most of the government debt is domestic, with arrears accounting for well-over half of total debt.

- Domestic debt (including arrears and promissory notes) represented 86 percent of total debt at end-2021. Arrears are the largest component of domestic debt, representing more than double the amount of bank debt. About half of the arrears were to the pension fund and represented unfunded liabilities. Formal debt to the banking sector increased only modestly in 2021 as banks sought to comply with the informal prudential limit the PMA set for direct exposure to the PA.

¹ Prepared by Iacovos Ioannou.

² This DSA uses the 2021 Market Access Countries DSA template developed by the IMF; it is based on preliminary data at end-2021, and estimated and actual 2021 debt flow data. Methodological differences related to the treatment of new debt (short term vs. long term; domestic vs foreign), the calculation of interest payments (interest rates depending on maturity and variable over time) and the resulting estimation of gross financing requirements account for the modest deviations in debt indicators over the medium term relative to the staff report tables.

³ Debt coverage includes accounts payable and pension liabilities in line with the IMF's *Public Sector Debt Statistics: Guide for Compilers and Users* (2013).

⁴ The change in debt incorporates an increase due to the inclusion of promissory notes (estimated at 2.0 percent of GDP) in the stock of debt. Excluding the stock of promissory notes, gross public debt increased by 1.3 percentage points of GDP.

- External debt represented about 14 percent of total debt. Some 86 percent of foreign debt is long term. The biggest creditor is the Al Aqsa Fund (39 percent of external debt), followed by the World Bank and the Qatar National Bank (each with about 20 percent). Bilateral creditors (Italy, Spain) account for about 12 percent of external debt.

3. There is considerable uncertainty about the stock of debt. This uncertainty exists mainly for two reasons. First, the stock of arrears is not audited. The government typically accumulates arrears to suppliers, contractors and

the pension fund.⁵ In addition, the policy in place since November 2021 of paying only partial salaries to public sector employees has led to the accumulation of wage arrears of 1.2 percent of GDP at end-June 2022. The pension fund and the PA are in the process of reconciling arrears claims regarding late payment penalties and interest. Pending a mutual agreement, staff has excluded interest and penalties from the stock of arrears. The second source of

uncertainty stems from promissory notes (PNs). The authorities issue PNs to suppliers and contractors to clear arrears, but they do not record these PNs as debt, essentially treating them as an instrument to extinguish a liability.⁶ Staff's preliminary estimates suggest that the total stock of PNs at end-2021 was two percent of GDP but there is considerable uncertainty surrounding this estimate. In 2022, the PA paid banks \$160 million (0.9 percent of GDP) to eliminate the stock of PNs held by banks. The transaction was made possible after the PA secured bank loan in equivalent amounts and similar maturities from the banks holding the PNs. The authorities also indicated that they would cease issuing PNs altogether. The outstanding stock of PNs is expected to be paid off fully by end-2024.

4. Arrears are assumed to be the main source of new financing. Domestic bank financing is assumed to be limited because banks have high exposure to the PA preventing them from extending significant amounts of new loans. The government is also not able to issue securities in domestic or international markets. Reflecting these limited financing options, the authorities have been accumulating new arrears on a regular basis to cover deficits. Accordingly, the DSA assumes that the authorities will continue to rely on arrears as the main source of new financing. While

West Bank and Gaza: Total Debt Liabilities of the PA
(In percent of GDP)

	2019	2020	2021
Gross debt liabilities	34.5	47.1	50.4
Domestic debt	27.6	39.1	43.3
Loans and overdrafts	8.9	14.0	13.5
Promissory notes 1/	...	...	2.0
Arrears 1/	18.6	25.1	27.8
External debt	6.9	8.0	7.1

Sources: Ministry of Finance; and IMF staff estimates

¹ Figures are estimates due to insufficient official data.

⁵ Expenditure arrears are defined as the difference between spending on a commitment and cash bases. Arrears to the pension fund (both for civil servants and security personnel) comprise required government and employee contributions that the government does not transfer to the pension fund.

⁶ Initially, most PNs had a very short maturity (e.g., three months), but over time it has increased. At end-2021, the majority of PNs had a maturity of less than one year but a portion was long term, with the longest maturity being 24 months.

arrears to suppliers and contractors do not formally bear interest, for the purpose of the DSA these arrears are assumed to accrue interest of 5 percent (i.e., a similar rate to bank loans) annually. To further capture the uncertainty surrounding the level and terms of debt, the DSA includes a contingent liability shock in which the debt stock in 2022 is 5 percent of GDP higher than currently projected.

Macroeconomic Outlook

5. The macroeconomic outlook will remain difficult under unchanged policies. The economy is expected to weaken over the medium term, with annual growth falling to 2 percent. Inflation is expected to rise in the near term and gradually converge to near 2 percent, broadly in line with Israel's inflation target. Public finances should improve in the near term as the authorities unwind some of the COVID-19 stimulus. Nevertheless, over time, they will worsen under unchanged policies with the fiscal deficit rising to 4–4½ percent of GDP. There are considerable fiscal risks associated with the baseline forecast. These include the possibility of political unrest that would harm growth, higher than currently expected deductions of clearance revenues related to prisoner payments, and a stock of arrears that may be larger than currently estimated.

Debt Sustainability

6. Under the baseline scenario, gross public debt is projected to increase to about 62 percent of GDP by 2027. Both the level of debt and its rate of increase—about 11 percentage points of GDP over six years—would increase risks, especially when considering gross financing needs and institutional and policy constraints. West Bank and Gaza has a narrow revenue base, a considerable share of the revenues collected on its behalf by Israel is subject to deductions which are often unpredictable, and donor support has been declining for years. Limited fiscal policy instruments, lack of financing options, social tensions which make reforms more difficult, and restrictions on the movement of goods and people which obstruct economic growth further complicate debt management.

7. West Bank and Gaza is vulnerable to frequent shocks that could further worsen the debt outlook. A growth shock would push the level of public debt to 76 percent of GDP by 2027 while a combined macro-fiscal shock—which adds a temporary fiscal deterioration to the growth shock—results in a public debt level of 82 percent of GDP by 2027. Similarly, a contingent liability shock that captures a one-time upfront increase in the stock of debt related to arrears in conjunction with lower growth and higher funding costs for the government, pushes debt to 77 percent of GDP by 2027. Finally, a “political unrest” shock, which aims to mimic the shocks that West Bank and Gaza experienced in recent years, suggests that even a temporary but sizeable shock can lead to a sharp deterioration in the debt outlook. High financing needs would make it difficult for the authorities to manage shocks of this magnitude given also limited policy tools and buffers. As a result, the economy is likely to experience sharp downturns if faced with large shocks with unforeseen political and social consequences.

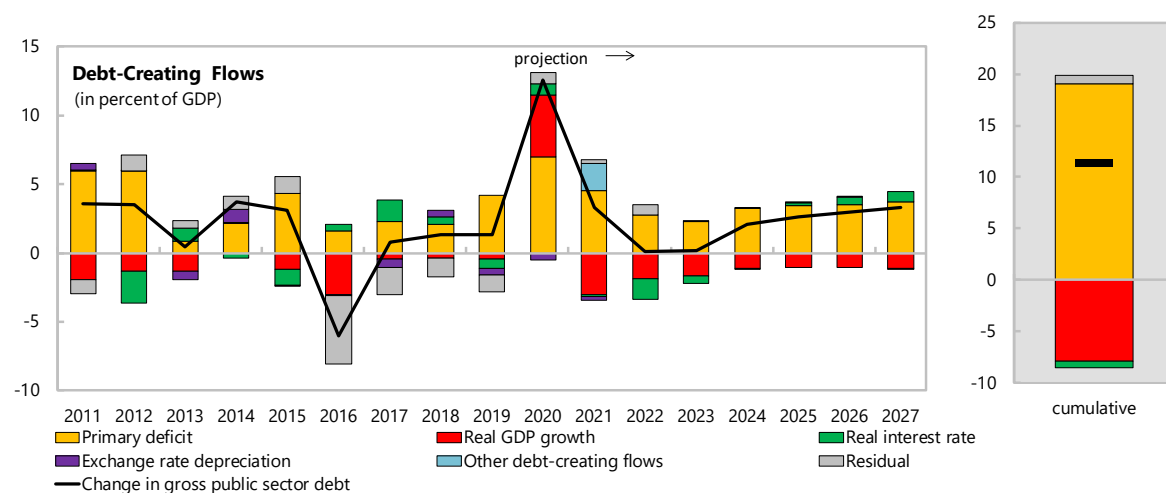
Figure 1. West Bank and Gaza: Public Sector Debt Sustainability Analysis—Baseline Scenario
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections							As of December 31, 2021		
	2011-2019 ^{2/}	2020	2021	2022	2023	2024	2025	2026	2027				
Nominal gross public debt	32.0	47.1	50.4	50.5	50.7	52.8	55.4	58.4	61.7	Sovereign Spreads			
Public gross financing needs	9.5	17.1	17.4	16.0	15.1	14.9	19.3	19.1	19.9	EMBIG (bp) 3/			
Real GDP growth (in percent)	4.1	-11.3	7.1	4.0	3.5	2.4	2.0	2.0	2.0	5Y CDS (bp)			
Inflation (GDP deflator, in percent)	1.9	-1.3	1.8	4.9	3.4	2.7	2.5	2.2	2.0	Ratings			
Nominal GDP growth (in percent)	6.1	-12.5	9.0	9.1	7.0	5.2	4.6	4.3	4.1	Moody's			
Effective interest rate (in percent) ^{4/}	1.4	0.9	1.6	1.8	2.3	2.7	3.0	3.2	3.4	S&Ps			
										Fitch			
										Foreign	Local		
										n.a.	n.a.		
										n.a.	n.a.		
										n.a.	n.a.		

Contribution to Changes in Public Debt

	Actual			Projections							cumulative 2022-27	debt-stabilizing primary balance ^{9/}
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027			
Change in gross public sector debt	1.3	12.6	3.3	0.1	0.1	2.1	2.7	3.0	3.3	11.4		-0.8
Identified debt-creating flows	2.0	11.8	3.1	-0.6	0.1	2.0	2.6	3.0	3.3	10.5		
Primary deficit	3.3	7.0	4.5	2.8	2.3	3.3	3.5	3.5	3.7	19.0		
Primary (noninterest) revenue and gr	26.3	25.3	25.3	25.8	26.9	26.0	26.0	26.0	26.0	156.7		
Primary (noninterest) expenditure	29.6	32.3	29.8	28.6	29.2	29.3	29.4	29.6	29.7	175.7		
Automatic debt dynamics ^{5/}	-1.2	4.7	-3.4	-3.4	-2.2	-1.2	-0.8	-0.6	-0.4	-8.6		
Interest rate/growth differential ^{6/}	-1.2	5.3	-3.2	-3.4	-2.2	-1.2	-0.8	-0.6	-0.4	-8.6		
Of which: real interest rate	-0.1	0.8	-0.1	-1.5	-0.6	0.0	0.2	0.5	0.8	-0.6		
Of which: real GDP growth	-1.1	4.5	-3.0	-1.8	-1.7	-1.2	-1.0	-1.1	-1.1	-7.9		
Exchange rate depreciation ^{7/}	0.0	-0.5	-0.3	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Please specify (1) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Promissory notes	0.0	0.0	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual, including asset changes ^{8/}	-0.7	0.9	0.2	0.7	0.1	0.0	0.0	0.0	0.0	0.9		



Source: IMF staff.

^{1/} Public sector is defined as central government.

^{2/} Based on available data.

^{3/} Long-term bond spread over German bonds.

^{4/} Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

^{5/} Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

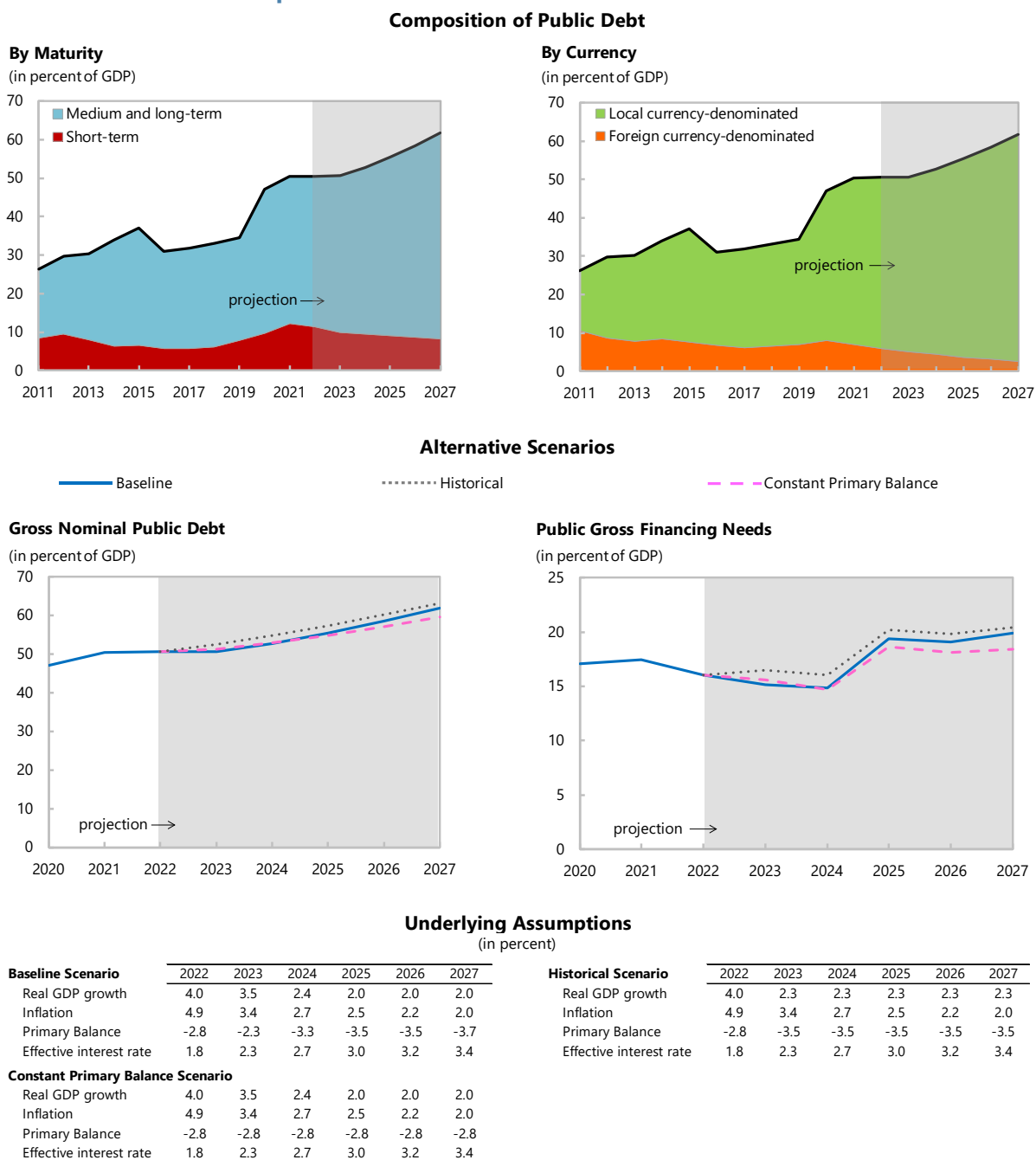
^{6/} The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

^{7/} The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

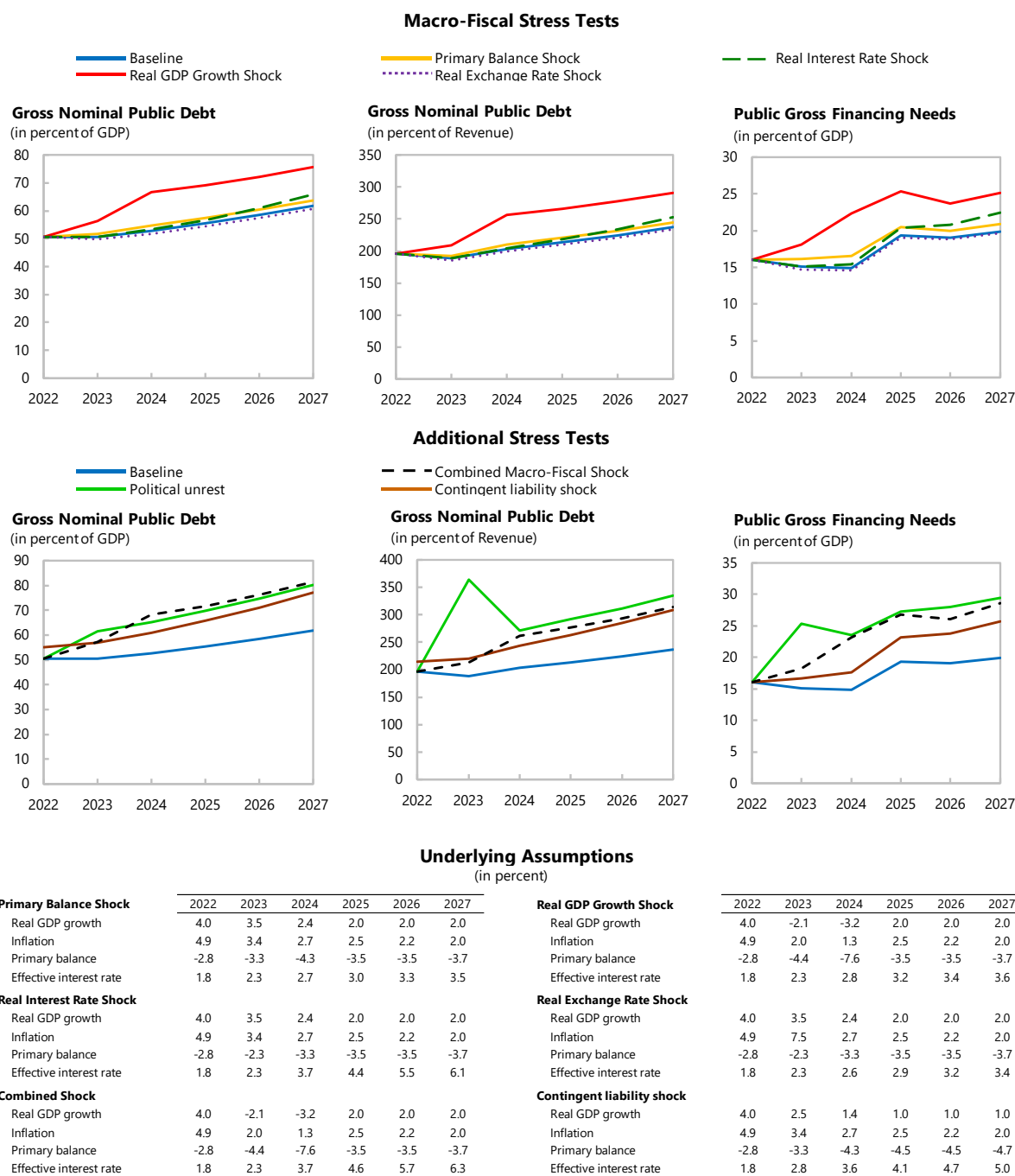
^{8/} Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

^{9/} Debt stabilizing primary balance in 2025.

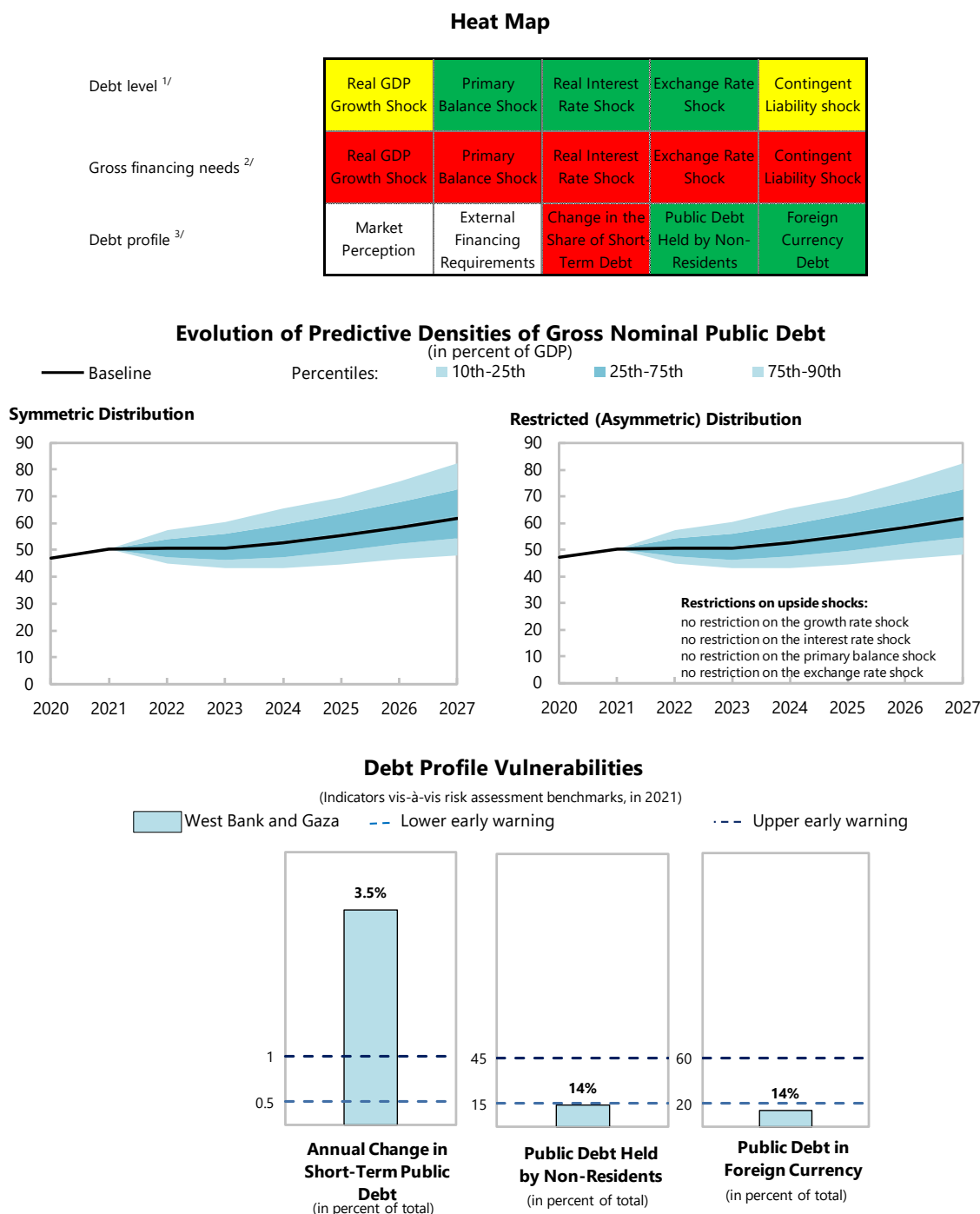
Figure 2. West Bank and Gaza: Public Debt Sustainability Analysis
—Composition of Public Debt and Alternative Scenarios



Source: IMF staff.

Figure 3. West Bank and Gaza: Public Debt Sustainability Analysis—Stress Tests

Source: IMF staff.

Figure 4. West Bank and Gaza: Public Debt Sustainability Analysis—Risk Assessment

Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

Annex III. IMF Technical Assistance to the Palestinian Authority, 2017–22

The IMF has provided TA to West Bank and Gaza (WBG) on public financial management (PFM), revenue administration, banking regulation and supervision, stress testing, anti-money laundering and combating the financing of terrorism (AML/CFT), national accounts, and external sector statistics. Technical support was also provided to the Ministry of Finance (MoF)'s macro-fiscal and large taxpayer units in 2018–19. Priorities for capacity building over the medium-term include banking supervision, the development of the national payments system, and AML/CFT. Periodic review and assistance to improve the quality of external sector and national accounts statistics are also needed. LEG, MCM and STA will continue to provide TA on these topics, with support from METAC. FAD is re-assessing current fiscal sector TA needs and priorities, together with the authorities but stands ready and tentatively plans to deliver TA on key critical areas, including expenditure reform, taxation, macro fiscal planning and cash management in 2022–23.

Mission Date	Mission	Date of TA Report
Fiscal Sector: IMF Fiscal TA's key objectives in 2017–19 were to consolidate the progress made in PFM in 2007–16, strengthen budget preparation and macro-fiscal forecasting, and boost revenue mobilization by helping modernize tax administration. Technical support was also provided to the MoF's macro-fiscal and large taxpayer units in 2018–19. FAD TA has resumed in 2022, after a three-year hiatus. Planned areas of focus of CD in the next two years comprise wage bill reform, net lending (within the context of the broader fiscal relations between the PA and municipalities), medium term budgeting and multi-annual commitment controls, cash management and revenue administration.		
April 3–13, 2017	Budget Preparation and Macro-Fiscal Forecasting	May 2017
April 30–May 11, 2017	Customs Risk Management	May 2017
August 27–31, 2017	Operationalization of the PFM reform strategy	September 2017
September 4–13, 2017	Budget Preparation and Macro-Fiscal Forecasting	October 2017
November 27–December 7, 2017	Budget Preparation and Macro-Fiscal Framework	December 2017
April 8–19, 2018	Supporting the Development of the Macro-Fiscal Unit's Capacity	June 2018
August 12–19, 2018	Supporting the Development of the Macro-Fiscal Unit's Capacity	January 2019
October 28–November 8, 2018	Supporting the Development of the Macro-Fiscal Unit's Capacity	November 2018
February 17–28, 2019	Supporting the Development of the Macro-Fiscal Unit's Capacity	April 2019
March 10–21, 2019	Revenue Administration/Large Taxpayer Office	March 2019

Mission Date	Mission	Date of TA Report
February 18–25, 2022	Training on Improving Tax Compliance in Digital Economy	n.a.
March 14–17, 2022	Virtual Regional Workshop on Public Sector Debt Statistics	n.a.
May 10–June 7, 2022	Review of Revenue Administration Reform Strategies	n.a.
June 1–14, 2022	Strengthening Quarterly Macro Fiscal Reporting	n.a.
Monetary and Financial Systems: In 2017–18, TA efforts focused on implementing IFRS9 and preparing for and facilitating the transition to Basel III. MCM TA priorities during 2019–22 were informed and guided by the findings and the recommendations of the Financial Sector Stability Review conducted in 2018 (and the associated technical assistance roadmap). During 2019–22, TA centered on bolstering crisis management arrangements, strengthening banking resolution provision and tools, and improving stress-testing to better reflect specificities of WBG's financial sector and test for multi-factor shocks. TA will also be provided in 2022–23 on AML/CFT ahead of and after the MENAFATF evaluation.		
May 19–22, 2017	Workshop to develop the CFT legal framework of West Bank and Gaza (in Amman, Jordan)	n.a.
September 24–October 3, 2017	Implementation of IFRS9	December 2017
February 25–March 8, 2018	Implementation of IFRS9	March 2018
March 14–23, 2018	Financial Stability/Stress-Testing	March 2018
July 1–5, 2018	Implementation of IFRS9	November 2018
September 23–27, 2018	Basel III	n.a.
October 17–November 1, 2018	Financial Sector Stability Review (FSSR)	May 2019
March 3–7, 2019	CFT framework	n.a.
March 24–28, 2019	Basel III	n.a.
December 3–12, 2019	FSSR Follow-up: Contingency Planning for Crisis Preparedness and Management*	July 2020
January 3–31, 2021	FSSR Follow-Up: Financial Institution Restructuring & Resolution*	October 2021
April 26–May 6, 2021	Macro Stress-Testing	n.a.
June 18–September 29, 2021	Macro Stress-Testing*	n.a.
May 3–7, 2021	FSSR Follow-Up: Financial Institution Restructuring & Resolution*	October 2021
January 9–February 6, 2022	Developing a Crisis Management Plan*	n.a.
March 2–17, 2022	Bank Resolution Law Reform*	n.a.
March 21–April 29, 2022	National Payment Systems*	n.a.

Mission Date	Mission	Date of TA Report
May 8–11, 2022	AML/CFT*	n.a.
June 26–July 5, 2022	Strengthening On-Site Risk Based Supervision	n.a.
Statistics: TA on statistical issues has focused on implementing and aligning existing statistical compilation and dissemination systems with the latest international statistical standards for national accounts and external sector statistics (ESS) datasets. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, the MoF, and the PMA are on par with those of countries that maintain good data management and dissemination standards, but additional work is needed to improve data consistency in ESS and produce quarterly and annual chain-linked national accounts.		
May 7–11, 2017	National Accounts	n.a.
November 12–16, 2017	Price Indexes	March 2018
December 17–21, 2017	National Accounts	October 2018
March 11–15, 2018	National Accounts	July 2018
June 24–28, 2018	National Accounts	October 2018
July 22–August 2, 2018	External Sector Statistics	October 2018
December 16–20, 2018	Price Statistics	April 2019
February 10–14, 2019	National Accounts	April 2019
December 13–15, 2019	National Accounts	February 2020
June 8–11, 2020	Residential Property Price Indices	August 2020
August 9–13, 2020	Compilation of Input-Output Tables	September 2020
February 21–25, 2021	Re-Chain Linking the National Accounts	April 2021
August 22–September 2, 2021	Institutional Sector Accounts – Sequence of Accounts	November 2021
February 27–March 10, 2022	Institutional Sector Accounts – Sector Accounts	April 2022
June 26–July 7, 2022	Balance of Payments	n.a.
July 24–August 4, 2022	Annual National Accounts	n.a.
n.a. – not applicable or not yet available. * Reports classified as confidential or strictly confidential.		