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November 30, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Macroeconomic and Fiscal Developments, Outlook, and Reform in the West Bank and Gaza—Note by Fund Staff for the Ad-Hoc Liaison Committee (AHLC) Meeting on December 8, 2004**

Attached for the **information** of the Executive Directors is a note on macroeconomic and fiscal developments, outlook, and reform in the West Bank and Gaza, which has been prepared by the Fund staff for the AHLC meeting to be held in Oslo on December 8, 2004. At the time of circulation of this note to the Board, the Secretary's Department has not received a communication from the authorities of the West Bank and Gaza indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Toujas-Bernaté (ext. 36936) and Ms. Beidas (ext. 38922) in MCD.

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MACROECONOMIC AND FISCAL DEVELOPMENTS, OUTLOOK, AND REFORM IN THE WEST BANK AND GAZA

AD-HOC LIAISON COMMITTEE (AHLC) MEETING

OSLO, DECEMBER 8, 2004

INTERNATIONAL MONETARY FUND

MACROECONOMIC AND FISCAL DEVELOPMENTS, OUTLOOK, AND REFORM IN THE WEST BANK AND GAZA

I. ECONOMIC DEVELOPMENTS IN 2004

1. **Following the Palestinian economy's slight rebound in 2003, with real GDP growth estimated at 5 to 6 percent, real GDP growth in 2004 is estimated to fall to 3 percent.** On the one hand, economic activity in 2004 will be supported by the expected good harvest from the olive crop and the positive spillover from Israel, whose 2004 growth is estimated at 4 percent. On the other hand, growth in 2004 will be constrained by continued violence and closures in the West Bank and Gaza, further extension of the separation wall, and fewer Palestinian workers in Israel (Table 1).

2. **Along with slightly higher economic activity, employment improved but not sufficiently to curb the rising level of unemployment.** Employment increased by about 7 percent in the first half of 2004 compared to the same period last year, mainly in the manufacturing sector, other services, and, to a lesser extent, the construction sector.[1] Nonetheless, as the economy was unable to create enough jobs for the rapidly growing labor force, unemployment in the West Bank and Gaza increased from 24 percent at end-2003 to 29 percent at mid-2004. The unemployment situation is particularly acute in Gaza, where economic activity has been disrupted by incursions of the Israeli Army and by the closure of the Erez Industrial Zone that has reduced the flow of Palestinian workers to Israel from Gaza, contributing to an unemployment rate of about 40 percent.[2]

3. **Inflation has fallen in the last two years from almost 6 percent in 2002 to about 2 percent in the year ending September 2004**. This decline is partly due to the appreciation of the shekel against the dollar. Nonetheless, increasing transportation costs, partly reflecting the restrictions on the movement of goods and people within the West Bank and Gaza as well as higher oil prices, continue to exert upward pressures on prices.

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[1] These sectors constituted 60 percent of total employment.

[2] The number of Palestinians from Gaza working in Israel and industrial zones declined substantially to under 500 in the second quarter of 2004 from about 4,000 at the same time last year.

4. **The banking sector remained robust in the first three quarters of 2004.** Private sector deposits increased by almost 4 percent during this period. The Israeli raid on banks in the West Bank on February 25, 2004, in which $8.5 million was seized from bank vaults, has not significantly affected public confidence in banks. However, this event, together with slower economic growth, may have contributed to a lower level of deposit growth in the first half of 2004 than in 2003.[3] Bank credit to the private sector grew strongly by about 13 percent in the first three quarters of 2004 after being stagnant through 2001–03. This was partly due to greater demand for loans by creditworthy businesses and the increase in bankable projects, and partly to the Palestine Monetary Authority's (PMA) pressures on banks to enhance their financial intermediation role since only 29 percent of deposits are invested in the West Bank and Gaza. At the same time, nonperforming loans (NPLs) fell substantially from about 23 percent at end-2002 to 19 percent in the first quarter of 2004. This decline was largely due to better business performance, as well as restructuring and rescheduling of loans coupled with enhanced monitoring, recovery, and management of loan portfolios by banks. Another positive indicator for the banking sector was the significant decline in the number and value of checks with "insufficient funds" in the economy as a whole in 2004 compared with 2002.

II. Budgetary Operations in 2004

5. **The fiscal situation in 2004 has been very tight, especially during the fourth quarter of 2004, despite strong revenue performance.** Three factors have accounted for this situation. First, external budget support estimated at $345 million for the year is only about half the budgeted external financing of $650 million, which was endorsed at the G8 meeting in Dubai in September 2003 and the AHLC meeting in Rome in December 2003. Second, most of the external financing was disbursed during the first three quarters of the year. Third, there were repeated attachments by Israeli courts of tax revenues collected by the government of Israel on behalf of the Palestinian National Authority (PNA).[4] The combination of these factors, coupled with a substantial rise in the wage bill, has created acute difficulties in the payment of October salaries at the beginning of November 2004. Moreover, as the wage bill has become disproportionately large, nonwage expenditures are being squeezed. Important challenges in 2005 will include curbing the wage bill growth as planned by the PNA and ensuring full financing of the budget.

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[3] Banks reported in particular that a number of bank accounts have been transferred to Jordan since the Israeli raid.

[4] These attachments, made in the context of claims by Israeli families of victims of violence, amounted to NIS 154 million ($34.5 million) during the first three quarters of 2004, resulting in lower transfers of revenues than expected.

A. Revenue

6. **Budgetary revenues have been consistently strong, outperforming budget projections and reaching the pre-intifada level during the third quarter of 2004.** Gross revenue in the nine months from January to September 2004 amounted to NIS 3,155 million ($700 million), outperforming budget projections by 9 percent, and being over 30 percent higher than the same period last year (Figure 1 and Table 2). Total gross revenue is projected to reach 25 percent of GDP in 2004, a much higher level than the regional average of 15 percent of GDP for lower and middle income countries. This has occurred despite the severe disruption in economic activity in the West Bank and Gaza during the last four years. Clearance revenue was particularly strong (34 percent higher than last year), as VAT and customs grew by about 25 percent, while excise revenues doubled from the same period last year.[5] The buoyancy of the VAT can be largely attributed to its single rate and unified invoice system with Israel. The doubling in petroleum excises followed the takeover of the petroleum agency by the ministry of finance (MoF) in July 2003, which resulted in improvements in operations and governance (Figure 2).[6] Higher sales of petroleum products by the Palestinian Petroleum Authority were realized by eliminating monopoly profit margins and competing successfully with Israeli prices and smugglers. Domestic taxes during the first nine months (January–September 2004) were 14 percent higher than last year on account of improvements in tax administration. In addition, nontax revenues were slightly above $100 million during the period (a 40 percent increase from last year), of which about $28 million were profits of the Palestinian Investment Fund (PIF) transferred to the PNA budget. As a result of these developments, the structure of revenues has changed since last year, with a lower contribution of net VAT receipts to total revenue and a higher share of petroleum excises.[7]

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[5] Clearance revenues are indirect taxes collected by the Government of Israel on behalf of the PNA, and represent about two-thirds of total revenue.

[6] Excises on petroleum products, which are specific taxes, evolve with the volume of sales.

[7] The share of net VAT receipts in total revenues declined from 36 percent in 2003 to 31 percent during the period January–September 2004, while the share of petroleum excises increased from 17 percent to 21 percent during the same period. Indirect tax revenue continued to make up about 60 percent of total revenues.

Figure 1. Budgetary Revenues by Type, 1996–2004

(Including clearance revenues collected in 2001–02 but not transferred)
(Quarterly, in millions of NIS)

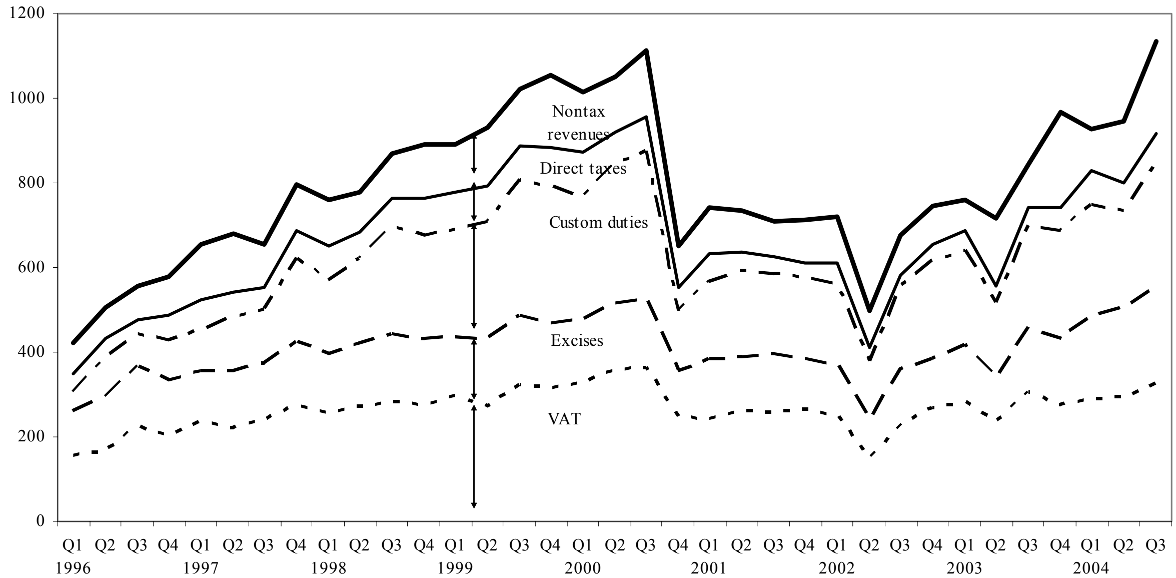
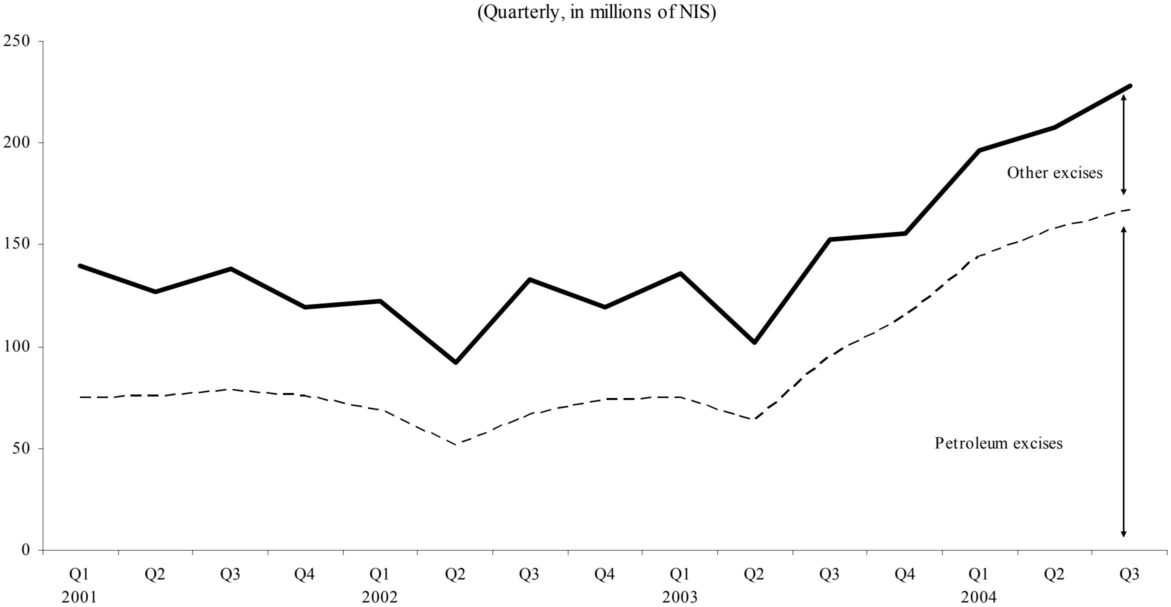


Figure 2. Excise Revenues, 2001–04

(Including clearance revenues collected in 2001–02 but not transferred)
(Quarterly, in millions of NIS)



B. Wage Bill and PNA Employment

7. **The wage bill has been rising continuously since the establishment of the PNA, and is now taking up more than two-thirds of current expenditure.** In 1997–2000, the annual increase in the wage bill reached 16 percent, accommodating a large increase in government employment well above population growth (see extract table on the right). In 2000–02, while revenues collapsed, the wage bill and government employment continued to grow, albeit at a slower pace, squeezing out nonwage and development expenditures, and requiring additional financing. This policy was partly aimed at providing income to part of the population in the context of increasing unemployment and poverty. More recently, the implementation in September 2003 of the long-awaited 1998 Civil Service Law contributed to a 15 percent wage increase for civil servants. This was, however, an important structural reform, which provides better control by the MoF over promotions and hiring and should have positive effects on the efficiency of the civil service in the longer run (see Box 1).

Wage Bill Developments, 1997–2003

(Average annual increases, in percent)

	1997–2000	2000–03
Wage bill (in NIS terms)	16.1	9.9
Civil service	17.7	10.2
Police and security	13.7	9.4
Employment	11.4	5.4
Civil service	12.5	6.5
Police and security	10.1	4.0
Average wages	4.2	4.3
Civil service	4.6	3.4
Police and security	3.3	5.2
Memorandum items:		
Inflation	4.6	3.7
Population growth	4.2	5.0

8. **While the increase in civil service employment has been mainly in social sectors in recent years, there has been a lack of control over large increases in the number of security personnel.** In 2003, the year-on-year growth of civil service employment was 3.9 percent (with about 2,800 new positions), while security personnel grew by 8.6 percent (with about 4,500 new positions). Although the civil service employment increase was within the budgetary appropriation, recruitment in the security services rose beyond the control of the MoF. Within the civil service, the growth in social sector employment[8] was higher than for other ministries. As a result, the share of health and education sectors in the total civil service employment increased from 58 percent at end-2002 to 60 percent at end-2003, and rose further during the first half of 2004 to 62 percent.

9. **More recently, the PNA hired 2,724 new civil service employees between end-December 2003 and end-August 2004,** well within the budgeted 3,500 additional positions. Social sectors employment grew by more (2,899) than the overall net increase, while employment in other ministries declined. There was also an increase in security

[8] Social sector employment is defined as the employees of the following ministries: education, health, social affairs and justice, and the High Judicial Council.

Box 1. West Bank and Gaza: Civil Service Reform Implemented in 2003

The main features of the Civil Service Reform are as follows:

- A compression of grades from 21 to 12—or from 12 to 8, if one excludes the top level of grades, which only few attained.
- An increase and expansion in the wage scale (from monthly wages of \$154–\$1,320 to \$240–\$2,147).
- The abolition of implicit bonuses in favor of a merit-based, transparent system with a scale from \$56 for the lowest grade to \$467 for the highest grade.
- The establishment of a minimum of four years time in grade, with no grade skipping, and favorable annual reports against pre-set job descriptions being required before a promotion.

The immediate impact of the implementation of the Civil Service Law has been a 15 percent increase in the civil service wage bill during the last quarter of 2003 onwards, but also the elimination of the possibility of an employee receiving two salaries. For instance, security personnel had been able to draw two salaries when on secondment to a high level official for protection. This is no longer possible. As a result, the number of PNA employees recorded in the payroll declined by about 2,500. All civil servants, previously under the aegis of the General Personnel Council (GPC), have been scanned, verified, and their payroll computerized by the payroll department of the MoF. The re-grading of all jobs according to years of experience and qualifications is expected to bring in professionalism to the civil service.

The MoF has better control over promotions and hiring. The GPC still receives nominations for promotion, but now submits these to the budget director at the MoF to ascertain the availability of allocations. These are then sent to the payroll director to set up the change and verify qualifications, and then to the financial control director for prepayment inspection. Once these three steps are completed, the minister of finance has the final say in whether to sign the promotion/appointment or not. Hence, the GPC has been stripped of its executive role.

personnel during the period by 550 (a 1 percent increase above 2003), due to reinstatement of personnel with prolonged absences.[9] However, the MoF is committed not to allow any

[9] Their personnel files were frozen until they reported back for duty, but these personnel had a right to be reinstated and their files were hence reactivated.

increase in security employment in 2004; the expectation is that the additional 550 positions at end-August will be eliminated by year end.

10. **As a result of the implementation of the Civil Service Law and other factors mentioned above, the wage bill in the months January–September 2004 increased in line with budget projections to $72 million per month,** about $13 million per month higher than last year. While the overall wage bill was in line with the budget, the wage bill for security personnel was not. It crept up gradually by 4 percent over budget due to higher employment and average wages. On the other hand, the civil service wage bill was consistently below budget by 2 percent.

C. Wage Bill Action Plan

11. **Faced with continued pressure for increasing employment, the authorities have developed a plan to contain the wage bill in the coming years.** The action plan, spanning the years 2005–06, aims at maintaining: (a) a stable security forces wage bill, with any salary increase fully offset by a decline in employment (except for some drift reflecting promotions); and (b) a stable civilian wage bill in relation to GDP. Assuming a continued increase in budgetary revenues slightly above nominal GDP, this plan would bring the ratio of the wage bill to revenue down from 98 percent in 2003 to 90 percent in 2006, thereby freeing additional resources for other expenditures.

12. **Containing the wage bill will be achieved through a combination of salary and employment restraint**. In particular, no further salary increase will be granted across the board (average salaries would increase only slightly reflecting promotions), and increases in civil service employment will be limited to social sector ministries, while employment in other ministries would decline as not all retirees will be replaced. The result of this policy would be a significant lower growth in the wage bill than in the past, at 3.5 percent per year. Compared with a scenario of no policy action, this plan would generate savings of up to $180 million in 2006.

13. **The wage bill action plan was adopted by the Council of Ministers for 2005–06**. For 2005, the plan will limit net recruitment well below the 2004 level, mostly in the ministries of education and health, and foresees no wage increase other than a 2 percent wage drift. The Council of Ministers has authorized the MoF to reflect these measures in the 2005 Budget.[10] However, the reduction in net recruitment hinges on the establishment of a unified pension plan for the West Bank and Gaza, and full coverage of security personnel, who do not have a pension plan yet, which has impeded their retirement.

[10] They have been included in the budget circular that was sent to ministries on June 28, 2004.

D. Nonwage Expenditures and Deductions

14. **Because of external financing shortfalls, the nonwage expenditure squeeze continues**. Operating expenses and transfers[11] as of end-September 2004 were 23 percent lower than budgeted, at $288 million, albeit some $45 million higher than during the same period last year. Operating expenditures were reduced the most, at 28 percent below budget, while transfers stood at 19 percent below budget. The World Bank's multi-donor Emergency Services Support Program (ESSP), designed to safeguard nonwage operating expenditure in education, health, and social welfare, contributed to protect social sectors from the overall nonwage expenditure squeeze.

15. **The PNA continues to cover utility bills on behalf of municipalities and outlays of other agencies, adding further difficulties to the budget.** Payment of these bills totaled $94 million at end-September 2004, much lower than the end-September 2003 total of $147 million. This primarily covered outstanding utility payments owed by municipalities and public agencies to Israeli providers, which, if unpaid, accrue interest penalties and run the risk of power cuts. Nevertheless, the lower payment of utility bills in 2004 is somewhat deceptive considering that fuel bills due by the Gaza electricity generating company and unpaid electricity bills have accumulated to NIS 350 million ($80 million) as of end-October 2004.[12] The MoF is still pushing for greater efforts by municipalities in utility bill collection, which have fallen behind since the beginning of the second intifada. However, the recent Israeli incursion in Gaza, coupled with the deterioration in the internal security situation throughout the West Bank and Gaza, has set back these efforts. These unpaid bills may result in additional deductions from clearance revenues by Israel in the coming months.

16. **VAT refunds were slightly above initial budget expectations, but some arrears on VAT refunds from previous years have not been cleared**. VAT refunds amounted to $14 million in January–September 2004, compared with an annual budget appropriation of $15 million. Following the passage of the budget, the objective was to clear as much as possible of the arrears on VAT refunds accumulated in previous years, which amounted to some NIS 240 million ($53 million or 1.4 percent of GDP). Almost 60 percent of these arrears are due to private sector contractors implementing donor projects, with the remaining

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[11] Operating expenses include travel, rent, water, and electricity bills not included in net lending, postal and telecommunications, fuel, stationary and supplies, maintenance, and other expenses. Transfers include transfers to households, social security payments—the 12.5 percent employer contribution to the pension fund on behalf of active civil servants, members of the Gaza Pension and Insurance Corporation—and retirement payments to West Bank pensioners.

[12] This includes NIS 250 million due to the Israel Electricity Company (IEC) and NIS 100 million due to fuel suppliers.

amount due to donors themselves. However, given the tight budget constraint, little progress has been achieved toward this objective.

E. Deficit and Financing

17. **External budget support amounted to $285 million in the first nine months of 2004, about 40 percent lower than projected in the budget, forcing the MoF to resort to larger domestic bank financing.** The main contributors continued to be the European Union and Saudi Arabia. Disbursements from the World Bank Trust Fund, established earlier this year, amounted to $107 million at end-September. After external budget support, the current deficit of $80 million at end-September 2004 was covered by additional domestic bank borrowing. Outstanding net bank borrowing by the treasury has risen to over $280 million at end-September (10 percent of GDP), from a stock of about $190 million at the end of last year. However, banks are now expecting repayments by the PNA during the last quarter of 2004.

External Budget Support in 2003–04

(In millions of U.S. dollars)

	2003	2004		
		Jan.–Sept.	Proj. Oct.–Dec.	Proj. Annual
Total budget support	261	285	60	346
Multilateral assistance	229	285	56	341
Arab countries 1/	132	78	31	109
Saudi Arabia	77	62	31	92
Kuwait	15	--	--	--
U.A.E.	21	--	--	--
Libya	1	11	--	11
Qatar	5	--	--	--
Bahrain	3	--	--	--
Algeria	9	--	--	--
Tunisia	--	2	--	2
Other	--	2	--	2
European Union	58	50	--	50
World Bank (ESSP)	39	51	15	66
World Bank Trust Fund	--	107	10	117
European Union	--	56	--	56
World Bank	--	20	--	20
Norway	--	12	--	12
Canada	--	7	--	7
United Kingdom	--	12	--	12
Japan	--	--	10	10
Bilateral assistance	32	--	5	5

Source: IMF staff estimates and projections.
1/ Assistance from Arab countries emanated from the Arab League summit held in March 2002. This commitment was successively renewed until September 2003.

18. **Additional arrears were accumulated in 2004.** Comprehensive data is not yet available on arrear accumulation this year. However, some categories of arrears are known. Arrears to the Gaza Pension and Insurance Corporation (GPIC) accumulated in January–October 2004 amounted to NIS 160 million ($35 million). In addition, as mentioned above, the MoF owed the IEC and the suppliers of fuel for the Gaza electricity generating company NIS 350 million ($80 million) as of end-October 2004.[13] Other arrears to domestic suppliers have also accumulated and may be in the range of NIS 200–300 million ($45–65 million).

[13] Deductions from the release in November 2004 of tax revenues previously attached by Israeli courts reduced this indebtness by NIS 175 million.

F. Projections for 2004

19. **Overall, the 2004 fiscal position relative to GDP is expected to slightly improve in comparison to 2003**. The higher gross revenue of 25 percent of GDP (versus 22 percent in 2003) will be almost fully absorbed by the higher wage bill of 23 percent of GDP (versus 21 percent in 2003). Nevertheless, the deficit before grants is likely to improve slightly from 15 percent of GDP in 2003 to below 14 percent in 2004 (about $510 million) and the deficit after grants would improve by about 3 percent of GDP. The narrower-than-budgeted deficit will result from higher-than-budgeted revenues and nonwage expenditures of about $120 million below budget, at $380 million.[14]

20. **Donor assistance at about $345 million for the year would leave much of the financing gap in the last quarter of 2004 uncovered.** Total external financing disbursements in 2004 are projected to be somewhat higher than in 2003, when they reached about $260 million. However, in 2003 the PNA benefited from transfers equivalent to about $180 million of previously withheld clearance revenues by Israel. A large part of these transfers were used to cover current expenditures, with the rest being used to repay arrears. In 2004, no such transfers have taken place as of end-October. Donor support this year was not as high as envisaged by the PNA, possibly because of the lack of progress in and uncertainty surrounding the peace process. The fiscal situation has become even tighter during the last quarter of 2004, as most of the external financing was disbursed during the first three quarters of the year. In addition, the Israeli incursion in Gaza throughout the month of October resulted in substantial damage to Gaza housing and infrastructure, particularly to power lines, water supply, and sewage facilities. The PNA was also faced with emergency humanitarian assistance to the displaced and injured population. These emergency expenditures were estimated at $12 million. Consequently, the MoF experienced difficulties in paying the October payroll and made an emergency appeal to donors, to assist in covering immediate expenditure needs. The Government of Israel provided some relief by releasing a net transfer of NIS 100 million ($22 million) in early November 2004 from the NIS 1.1 billion of withheld revenues attached by court orders.[15] However, much of the financing gap estimated for the fourth quarter at $160 million remains uncovered.

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[14] This amount, nevertheless, is expected to be about $55 million higher than the outcome in 2003.

[15] This net transfer consisted of a gross transfer of NIS 144 million from which NIS 45 million were deducted for payments to the IEC. In addition, the Government of Israel released NIS 130 million in mid-November, which went entirely to cover IEC bills.

III. Public Finance Reforms in 2004

21. **Despite the continuing difficulties in budget execution, steady progress in public finance reforms has been achieved in 2004.** First, several reforms were implemented to enhance public finance transparency and accountability: starting in April 2004, **salary payments of all PNA security personnel** were directly deposited into individual bank accounts instead of being made in cash; the first annual report of the **PIF** was published in April 2004 by internationally certified accountants, who valued all PIF assets as of end-2003 at $799 million;[16] and the preliminary statements of the **2003 budget accounts** were approved by the Council of Ministers and submitted to the Palestinian Legislative Council (PLC) in July 2004.

22. Second, other reforms were aimed at improving expenditure management and control: a **procurement department**—the Department of Supplies and Tenders—was established at the MoF assuming full jurisdiction over all purchases made by PNA ministries and agencies, including the security; and some progress was achieved in the areas of **internal and external audit**. Regarding external audit, a new draft law is going through its third reading in the PLC, which in effect abolishes the legal base of the General Control Institution (GCI) as it currently is, and foresees not only an improved method of working, but also a completely new supreme audit institution.

23. In addition, a revised **Income Tax Law** was passed in October. It unifies all taxation under one administration, establishes the principle of universal taxation, and is in line with international best practices. This should help in raising income tax collection, which so far has been lagging behind regional performance. Finally, the Council of Ministers approved a draft **Pension Law** in August 2004, which sets out the parameters, institutions, and management of a unified and sustainable public sector scheme for both the civil service and security.[17] This would pave the way for the retirement of security personnel who have reached retirement age, but could not retire because of the absence of a pension law covering

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[16] See *www.palestineinvestmentfund.com*. The PIF assets are the counterpart of tax revenues and investment income that were channeled to accounts outside the control of the MoF during 1995–2000. These tax revenues and investment income were estimated at about $900 million (see *"Economic Performance and Reform under Conflict Conditions"*, IMF, 2003). The gap between this estimated amount and the auditors' valuation of PIF assets as of end-2003 may reflect the decline in the market value of many PNA investments, particularly in high technology companies, between 2000 and 2003. The audit report also set forth an investment strategy, including 16 companies to be closed and an exit strategy for five others.

[17] A draft pension law for security personnel has been presented in parallel to the PLC and passed a second reading. The MoF is attempting to introduce parity between the civil service and security pension parameters in the two draft laws.

them. Moreover, the PNA Cabinet's decision on retiring civil servants older than 60 years continues to be implemented. All these reforms are detailed further in Attachment I.

IV. Outlook for 2005

A. Macroeconomic Outlook

24. **The macroeconomic outlook for 2005 will depend critically on the political situation**. Real GDP growth is projected at 2 percent in 2005 in a status quo scenario, which assumes the implementation of the Gaza disengagement towards the end of 2005, but no significant progress on the political front. This is below the estimated 2004 real GDP growth rate because of two key factors.

25. **First, the completion of the Israeli separation barrier will likely result in a substantial reduction in the number of Palestinian workers in Israel**. In addition, completion of the barrier will further displace people and farmers along the high yield agricultural land known as the "seam line" of the barrier, resulting in losses in employment in the agriculture sector and industrial establishments closed in by the wall.

26. **Second, any positive impact of the disengagement plan adopted by the Government of Israel will not be felt until late 2005 and will crucially depend on the nature of the plan.**[18] On the one hand, the Israeli disengagement may impact exports adversely if it does not provide for an effective border regime and a transportation link for goods and people between Gaza and the West Bank. On the other hand, the potential removal of internal closures and blockades within Gaza and the West Bank, limiting movement for Palestinian goods, would greatly reduce transactions costs. In addition, an orderly handover of the settlement infrastructure to Palestinian use would be significant for the revival of growth in Gaza.[19] Given the above uncertainties, the status quo scenario does not factor in any large impact of the disengagement plan, even beyond 2005.

B. The 2005 Budget

27. **In a context of weaker growth, the 2005 budget points to a gradual improvement and rebalancing of expenditures.** Gross revenue is expected to increase by 5 percent (1 percentage point higher than nominal GDP), given the revenue reforms mentioned above.

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[18] See the set of World Bank reports prepared for the AHLC meeting on the prerequisites for economic recovery in the West Bank and Gaza.

[19] This includes green houses as well as factories and other agricultural infrastructure. A World Bank technical paper on Gaza disengagement discusses the pertinent issues relating to settlements.

On the expenditure side, the full implementation of the wage bill action plan will slow down the growth of the PNA payroll and provide more room for other expenditures. The ratio of both the wage bill and nonwage expenditures to GDP will likely be broadly maintained only because real GDP growth is assumed to be low at 2 percent. The wage bill is expected to decelerate slightly in 2006 onward, while nonwage expenditures will probably pick up over the medium term to offset part of their decline relative to the wage bill in the last few years. In addition, the pension reform will result in additional pension contributions due by the PNA to the pension fund of $60 to 80 million, starting in 2005, as contributions will cover a much larger number of PNA employees, including security personnel. Lower payments of utility bills on behalf of municipalities, which would stem from the implementation of an Action Plan for the municipalities by the ministry of local government, are projected to contribute to narrowing total financing needs. This plan would aim at strengthening municipalities' capacity to collect utility bills from their inhabitants.[20]

28. **Overall, based on the above projections, the fiscal deficit before grants would decline from 14 percent of GDP in 2004 to 12 percent in 2005.** When excluding additional pension contributions due by the PNA following the pension reform, the reduction in the fiscal deficit in 2004 would be equivalent to 3 percent of GDP, representing a sizable adjustment. The financing needed to cover current budgetary operations would be close to $500 million, as compared to $650 million in the 2004 budget. Given the currently high level of PNA indebtedness to commercial banks, these financing needs would need to be largely covered with external financing. Early indications from donors in that regard will help the MoF to execute the budget more smoothly during 2005 than in the last few years.

29. **The fiscal position in 2005 and over the medium term remains subject to several risk factors.** The ability of the PNA to contain the wage bill will hinge greatly on the pension reform, which will allow the retirement of civil servants and security personnel who reached retirement age. Perpetuating a large number of ministries under emergency conditions would also continue to put pressure on budget expenditure. In addition, maintaining nonwage expenditure at their current low level may not be sustainable. Finally, continued strong revenue performance will depend on the overall security environment and may be eroded by larger-than-expected deductions by the Government of Israel to cover unpaid bills due by municipalities and other Palestinian agencies.

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[20] A limited introduction of prepaid electricity meters, financed by the Norwegian Government on a pilot basis in Gaza, will contribute to a higher rate of collection and is favored by the ministry of energy as the solution to the delinquency in payments of electricity bills.

Table 1. West Bank and Gaza: Macroeconomic Framework, 2000–07

	2000	2001	Est 2002	Est 2003	Proj. 2004	Proj. 2005	Proj. 2006	Proj. 2007
Income, employment, and inflation								
Real GDP growth (in percent)	-5.4	-15.3	-9.0	5.4	3.0	2.0	1.0	1.5
Real GNI growth (in percent)	-6.8	-20.1	-8.6	6.6	1.2	1.2	-0.3	1.4
Nominal GDP (in millions of U.S. dollars)	4,442	3,686	3,087	3,548	3,746	3,923	4,057	4,219
Growth rate	-1.7	-17.0	-16.2	14.9	5.6	4.7	3.4	4.0
Nominal GNI (in millions of U.S. dollars)	5,274	4,131	3,483	4,047	4,197	4,360	4,451	4,618
Per capita, nominal GDP (U.S. dollars)	1,410	1,117	889	973	979	978	966	960
Per capita nominal GNI (U.S. dollars)	1,674	1,252	1,003	1,109	1,097	1,087	1,059	1,051
Per capita nominal GNI (NIS)	6,827	5,267	4,754	5,038	4,934	4,890	4,768	4,730
Growth rate	-8.7	-22.9	-9.7	6.0	-2.1	-0.9	-2.5	-0.8
Nominal gross domestic investment	1,359	739	739	972	1,001	996	1,014	1,053
Government (in millions of U.S. dollars)	242	214	204	292	280	239	219	219
Growth rate	-23.8	-11.6	-4.6	43.3	-4.2	-14.6	-8.4	0.0
Private and other (in millions of U.S. dollars)	1,117	525	535	680	721	757	795	834
Growth rate	-20.6	-53.0	2.0	27.0	6.0	5.0	5.0	5.0
Unemployment (in percent of total labor force)	14.4	25.5	31.3	25.6	27.5	29.2	31.8	33.4
Employment (in '000)	596	507	486	589	592	599	598	605
In Israel	117	70	50	57	53	50	43	43
In West Bank and Gaza	479	437	436	532	539	549	555	562
Civil service 1/	115	122	125	130	133	135	136	138
Growth rate	11.0	6.3	2.2	3.8	2.3	1.5	1.1	1.1
Private sector 2/	364	315	312	403	406	415	419	425
Growth rate	4.1	-13.4	-1.1	29.3	0.9	2.0	1.0	1.5
Consumer price index 3/	2.8	1.2	5.7	4.4	2.5	2.0	2.0	2.0
			(In percent of GDP)					
Fiscal operations								
Revenue 4/	21.4	7.4	9.4	21.5	24.4	24.7	25.1	25.3
Current expenditures 5/	26.9	29.7	32.2	30.1	33.3	33.8	33.9	33.9
Total expenditures 6/	32.3	35.5	39.4	38.3	40.8	39.9	39.3	39.1
Current balance	-5.5	-22.3	-22.8	-8.6	-8.9	-9.1	-8.8	-8.6
Overall balance 5/	-10.9	-28.1	-30.0	-16.8	-16.4	-15.2	-14.2	-13.7
Budget support	1.2	14.4	15.1	7.4	9.2	...	...	...
Budget financing gap 7/	...	...	...	...	...	12.4	10.8	9.7
			(In millions of U.S. dollars)					
External current account								
Exports of goods and nonfactor services	867	560	465	465	500	531	563	596
Imports of goods and nonfactor services	3,404	2,671	2,489	2,800	2,963	3,045	3,113	3,212
Net factor income	833	445	396	499	452	437	393	399
Net transfers	586	1,365	1,426	1,276	1,355	1,379	1,339	1,299
Current account balance	-1,118	-301	-203	-561	-656	-699	-819	-917
			(In millions of U.S. dollars)					
Money and banking								
Deposits 8/	3,261	3,150	2,974	3,208	...	...	...	...
Growth rate	24.9	-3.4	-5.6	7.9	...	...	...	...
Demand deposits 8/	795	746	746	1,006	...	...	...	...
Time deposits 8/	2,466	2,404	2,229	2,202	...	...	...	...
Claims to the private sector 8/	927	860	859	861	...	...	...	...
Growth rate	1.6	-7.2	-0.1	0.2	...	...	...	...
Memorandum items:								
Population growth (percent)	4.3	4.7	5.2	5.1	4.9	4.8	4.7	4.6
Average NIS/U.S.$ exchange rate	4.08	4.21	4.74	4.54	4.50	4.50	4.50	4.50

Source: Ministry of finance; Palestinian Central Bureau of Statistics; and IMF staff estimates.

1/ PA employment only, end of period.
2/ Includes local governments and public enterprises.
3/ Percentage change of CPI over previous year (using 1990 as base).
4/ Excludes accrued clearance revenue not transferred by Israel in 2001and 2002, and transfers from accumulated stock in 2003 and 2004. Net of VAT refunds.
5/ Excludes net lending.
6/ Includes donor financed and PNA financed (from 2000 onward) capital expenditure.
7/ Includes current balance, PNA financed capital expenditure and net lending.
8/ End of period.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2001–07

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

					Prel.				
				Budget 6/	Jan.–Sept.	Rev. Proj.	Proj.	Proj.	Proj.
	2001	2002	2003	2004	2004	2004	2005	2006	2007
Revenue	275	296	762	855	700	933	985	1,034	1,086
Gross domestic	275	224	291	326	246	328	347	364	382
Tax revenues	183	141	167	171	144	192	...	...	...
Nontax revenues	92	82	124	154	102	136	...	...	...
Gross monthly clearance 1/	0	72	472	530	454	605	639	671	704
Expenditure	1,117	1,017	1,104	1,380	958	1,278	1,345	1,394	1,449
Gross wages	678	642	743	863	648	868	900	929	962
Civilian	426	404	456	547	400	539	564	587	607
Security	252	239	288	317	248	329	336	342	354
Nonwage expenditure	417	352	324	498	288	380	426	446	468
Operating	...	...	124	235	127	168	...	...	...
Transfers (including pensions)	...	...	201	264	160	212	...	...	...
PNA financed capital spending	22	23	36	19	22	30	19	19	19
Net lending 2/		0	173	125	104	149	110	60	30
VAT refunds	2	5	16	15	14	18	15	16	17
Balance	-845	-726	-531	-665	-376	-512	-485	-435	-410
External budget support	530	467	261	678	285	346	...	...	...
Balance, including budget support	-315	-259	-270	-3	-90	-166	...	...	...
Total other financing	315	259	270	3	90	166	...	...	...
Gross withheld clearance revenues 3/	0	82	300	188	-22	...	...	...	...
Net domestic bank financing	83	115	85	-13	192	...	...	...	...
Net change in arrears (- = repayment) and residual	232	65	-115	-188	-80	...	...	...	...
				(In percent of GDP)					
Gross revenue	7.4	9.6	21.5	25.0	...	24.9	25.1	25.5	25.7
Expenditure 4/	30.3	32.9	31.1	40.3	...	34.1	34.3	34.3	34.3
Wages	...	...	21.0	25.2	...	23.2	22.9	22.9	22.8
Nonwages	...	...	9.1	14.6	...	10.1	10.9	11.0	11.1
Net lending and VAT refunds	0.1	0.2	5.3	4.1	...	4.5	3.2	1.9	1.1
Deficit before grants	-22.9	-23.5	-15.0	-19.4	...	-13.7	-12.3	-10.7	-9.7
Deficit after grants	-8.5	-8.4	-7.6	-0.1	...	-4.4	...	...	...
Memorandum items:									
Exchange rate NIS/U.S.$ (period average)	4.21	4.74	4.54	4.51	4.51	4.50	4.50	4.50	4.50
Government employment (end of period) 5/	123,450	122,329	129,560	...	...	133,057	135,057	136,557	138,057
Of which									
Civilian	70,034	70,157	72,920	...	...	75,867	78,420	79,920	81,420
Security	53,416	52,172	56,640	...	...	57,190	56,637	56,637	56,637

Source: Ministry of finance; and IMF staff estimates.

1/ Includes payments deducted for dues owed to the Israeli water company, Mekorot, while the budget figure is on a net basis.
2/ Payments deducted at source by GOI from disbursements of withheld clearance revenue for owed bills by Palestinian municipalities.
3/ Monthly figures include deductions by GOI for utility bills, while the budget figure is on a net basis.
4/ Comprised of gross wages, nonwage expenditure, and PA financed capital spending.
5/ There is a break in the series between 2002 and 2003, due to computerization of the payroll and the elimination of double counting.
6/ Budget valued at actual exchange rate.

Public Finance Reforms in 2004

This attachment provides additional information on the most notable reforms in 2004, which are monitored by the local task force on financial accountability, chaired by the International Monetary Fund, and co-chaired by the European Union and the United States:

- **Starting in April 2004, salary payments of all PNA security personnel were directly deposited into individual bank accounts instead of being made in cash.** This has been a major breakthrough which has enhanced transparency and governance. Moreover, it has enabled security personnel to utilize for the first time banking services, particularly in obtaining credit.

- **The first annual report of the PIF was published** in April 2004 by the internationally certified accountants, Ernst & Young. Ernst & Young provided a consolidated balance sheet for all PIF assets valued as of end-2003 at $799 million. The report also set forth an investment strategy (beginning in January 2004), identifying 16 mostly inactive companies to be closed and an exit strategy for five others. The PIF is now considering the establishment of a Private Sector Restructuring Fund (in association with private sector investors) to help businesses which have been injured by the ongoing conflict to restructure their debt and jumpstart their operations.

- **The preliminary statements of the 2003 budget accounts were approved by the Council of Ministers and submitted to the PLC in July 2004**.

- **A procurement department—the Department of Supplies and Tenders—was established at the MoF assuming full jurisdiction over all purchases made by PNA ministries and agencies, including the security.** This aims to ensure that all procurement operations are made in accordance with the application of the general procurement law in order to guarantee competitive practices and transparency. Progress reports, specifying the number of contracts and their amounts by procurement method for each PNA agency have also commenced with the first issue in July 2004. On the security front, the company which used to have exclusive procurement rights with security agencies, has been recently outbid by other competitors in a substantial tender. The contract was awarded to sixteen different bidders at less than half the cost of a similar contract previously awarded.

- **Some progress was achieved in the areas of internal and external audit**. The internal audit charter was approved in April, training has commenced, and several audits have been completed. The new Internal Audit Department (IAD) was established in May and a director appointed, in accordance with the Council of Ministers' decision to bring together the financial control and internal audit departments in line ministries to the MoF, under two separate MoF departments. In terms of external audit, the legal basis for the GCI has been brought in full conformity with the Basic Law insofar as the independence of the appointment process for the head of the Council, the independence of the reporting process, and the coverage of all PNA activities (including the PIF and security) are concerned. The External Audit Law is going through its third reading in the PLC. This new draft in effect abolishes the legal base of the GCI as it currently is, as well as the post of the Auditor General. It not only foresees an improved method of working, but also a completely new supreme audit institution.

- **A draft Pension Law was approved by the Council of Ministers in August 2004 and has been sent to the PLC for passage.** The draft law, together with a detailed outline of the pension reform program, was prepared by a National Pension Committee with World Bank assistance. It sets out the parameters, institutions, and management of a unified and sustainable public sector scheme for both the civil service and security. At the same time, a draft pension law for security personnel has been presented to the PLC and passed a second reading. The MoF is attempting to introduce parity between the civil service and security pension parameters and will support the pension draft law for security services only if appropriately amended.[1] This would pave the way for the retirement of more than 1,600 security personnel who have reached (or exceeded) retirement age, but could not retire because of the absence of a pension law covering them. A Pension Project Coordination Unit has been established in the MoF, charged with overseeing the preparation and implementation of the new pension system.[2]

- **The PNA Cabinet's decision on retiring civil servants older than sixty years continues to be implemented**—in accordance with the Civil Service Law (and prior to the passage of a new pension law). A retirement report indicates that 368 civil servants were retired between December 2003 and June 2004, under the temporary "75 percent scheme".[3] There are no civil servants older than 60 years

[1] The unified law will apply to the under 45 years of age, while civil servants above this age will be grandfathered under existing regulations. The amendment to the security law would limit its application to those over 45, thereby providing retirement coverage for security personnel similar to civil servants, while those below 45 would be covered under the unified law. The level of benefits would also need to be negotiated.

[2] A head of the unit has already been appointed.

[3] The 75 percent scheme, which refers to a payment of 75 percent of the last annual salary, is an extraordinary cabinet decision, designed to encourage retirement of high ranking PNA officials with under 15 years of service (in the post Oslo PNA). It entails a one-off lump sum retirement benefit (linked to 75 percent of their last annual salary) and would cover some 400 officials already over 60 years of age.

in active service without an exemption.[4] As for security personnel, the MoF has been working with their agencies to draw up a list of those aged 60 years and over, with a view of possibly introducing the "75 percent scheme" on a voluntary basis.

- **A revised Income Tax Law was passed in October,** following its third reading at the PLC and has been sent back to the Council of Ministers, which is expected to incorporate it into the 2005 Budget Law and make it effective January 1, 2005. It compares favorably with international best practices and includes taxation of Palestinian income earned abroad. Three individual income tax rates have been introduced for individuals of 8, 12, and 16 percent with limited exemptions. However, there is only one 16 percent rate for corporations with no exemptions (except for a lower rate for life insurance). This is the first unified income tax law for both the West Bank and Gaza, which are currently operating under two different and sometimes inconsistent tax codes of Jordanian and Egyptian origin, respectively. Moreover, the MoF is working towards unifying all taxation under one administration, allowing for cross checking between indirect and direct taxes and greater follow up of delinquent files. This should help in raising income tax collection, which so far has been lagging behind regional performance. Implementing regulations for the new income tax law are being drafted.

[4] Eleven were granted one-year exemptions in 2004, while the number of exemptions granted prior to December 2003 was 950. The PNA confirms that exemptions are only granted for one year and that no further exemptions or renewals will be granted except for critical posts. The number of civil servants expected to reach 60 and retire during the remainder of 2004, under the normal pension scheme, is expected to be 155 in Gaza and 98 in the West Bank.