POLITICISING PEGASE

Politicising the EU PEGASE Direct Financial Support Programme to structurally address the Palestinian fiscal unsustainability

ALESSANDRO FERRANTE
Sine Qua Non
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info@sinequanon-eu.com

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Contents

Abstract

The article deals with the EU's failure to bring long-term solutions to the permanent fiscal crisis facing the Palestinian Authority (PA). Under the Paris Protocol (economic and trade agreement between the PA and the Government of Israel), fiscal losses and fiscal leakages for the PA are taking place every year due to the inherent flaws of this treaty, resulting in a leakage of hundreds of millions of dollars each year. This creates a situation of fiscal atrophy which prevents the Palestinian administration from fully exploiting its fiscal revenue potential. In addition to this, repeated Israeli breaches of the Paris Protocol have been reported and have led to additional fiscal losses and fiscal leakages for the PA. Moreover, the paper also tackles the regressive components of the Palestinian tax structure which hamper growth and foster inequality among the Palestinian population. This set of fiscal issues partially contributes to the PA's fiscal unsustainability, evidenced by constant financing gaps. A major component of the EU's assistance to the PA is channelled via the PEGASE Direct Financial Support (PDFS), and it has substantially contributed to the recurrent expenditure of the Palestinian budget. Nonetheless, this instrument has failed to address the structural drivers of the PA's unsustainable fiscal position, notably by ignoring the recurrent fiscal losses and leakages which seriously undermine Palestinian public finances. Furthermore, the last PDFS action plan has adopted a more technocratic approach which mostly focuses on the PA's internal reforms. This approach is problematic because it is clear that these reforms will not be sufficient to achieve fiscal sustainability and because it ignores the regressive issues featured in the Palestinian tax structure. Given the increasingly worrying fiscal situation of the PA and the context of donor fatigue, the paper proposes an urgent revision of the PDFS approach and an intensification of the political content of this development program. New perspectives integrating the Israeli non-commitment to the Paris Protocol or the inherent flaws of this protocol should frame the overall approach of the next PEGASE action plan. In parallel, the paper proposes concrete policy measures which would bring long-term solutions to the PA's fiscal atrophy and foster progressivity within the Palestinian tax system.

Résumé

L'article porte sur la crise fiscale que traverse l'Autorité Palestinienne (AP), et sur l'échec de l'Union Européenne (UE) à y apporter des solutions durables. Les pertes fiscales de l'AP représentent chaque année plusieurs millions de dollars, et résultent en partie des failles inhérentes au Protocole de Paris (traité économique et social entre l'AP et le gouvernement israélien). Une partie des pertes fiscales résulte également des violations répétées de ce protocole par le gouvernement israélien. L'article montre comment certains éléments du régime fiscal mis en place par l'administration palestinienne freine la croissance et favorise les inégalités au sein la population. Ce lot de défis fiscaux contribue partiellement à l'insoutenabilité fiscale de l'AP, qui s'illustre à travers des déficits budgétaires constants.

La majeure partie de l'aide européenne à l'AP passe par le biais du programme PEGASE, qui a substantiellement contribué au financement de certaines dépenses récurrentes du budget palestinien. Néanmoins, ce programme ne n'est pas attaqué aux facteurs structurels qui sous-tendent l'instabilité fiscale de l'AP, en ignorant notamment les pertes fiscales chroniques, liées au protocole de Paris, dont pâtissent les finances publiques palestiniennes. De surcroit, le dernier plan d'action de PEGASE reflète une approche plus technocratique, qui se concentre principalement sur les réformes internes de l'AP. Cette approche est problématique car ces réformes seront insuffisantes pour restaurer une soutenabilité fiscale. Elle ne prend également pas en compte la nature régressive de la structure taxative mise en place par l'AP. Au vu de la situation fiscale palestinienne de plus en plus préoccupante, et du déclin de l'aide au développement, l'article propose de revoir l'approche de PEGASE et d'intensifier le contenu politique de ce programme de développement. De nouvelles hypothèses intégrant le non-respect israélien du protocole de Paris, ainsi que les défauts inhérents de ce protocole, devraient encadrer l'approche générale du prochain plan d'action de PEGASE. En parallèle, l'article propose des mesures concrètes qui apporteraient des solutions durables à l'atrophie fiscale de l'AP, et stimuleraient la progressivité au sein de la structure fiscale palestinienne.

Part I: State of Play - The permanent Palestinian fiscal crisis

Fiscal crisis under the Paris Protocol

In April 1994, the Protocol on Economic Relations (Paris Protocol)—part of the Gaza-Jericho Agreement—was signed, announcing a new era of economic and trade relations for the occupied Palestinian territory. Theoretically, the Protocol was intended as a five-year interim agreement but with the incapacity to reach a permanent political settlement by May 1999, it has continued, de facto, to govern Israeli-Palestinian economic and trade relations. As stated in the preamble, the Paris Protocol aimed at laying "the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities." However, over the two last decades, the Palestinian Authority (PA) has witnessed a gradual deterioration of its fiscal situation and last year marked one of its most intense fiscal crises.

In the years following the signing of the Paris Protocol, Palestinian public finances witnessed a positive trend. The recurrent fiscal deficit was only 1,5% of GDP and was balanced in 1999. There was no external budget support and foreign aid was restricted to development expenditures and humanitarian aid. However, the political events that followed the failure of the negotiations for a permanent status agreement in 2000 strongly undermined the PA's fiscal sustainability.[1] The second Intifada and the Israeli retaliations including severe restrictions on movement led to a prolonged economic downturn. Large fiscal deficits soon emerged, peaking at 30 percent of GDP in 2006. Important measures were undertaken by the PA to lower its total fiscal deficit, mainly by reducing the wage bill and net lending to GDP. The relative size of the PA's total fiscal deficit has gradually shrunk to reach 7.3% of GDP in 2018. Despite these impressive reduction efforts, financing gaps have occurred every year, even after external budget support, leading to an increasing public debt and recurrent payment arrears to the private sector (see table 1).

Structural factors, often intertwined, can explain the chronic fiscal unsustainability of the PA. The gradual deterioration of the real GDP growth in the West Bank since 2007 is one of the most visible structural factors. Peaking at $2,8 billion in 2008, the external aid has also progressively declined over the years and reached $676 million in 2018.[2] The massive trade deficit[3] and the inability to develop Area C due to Israeli annexation policies[4] have also been advanced as structural factors. Recurrent fiscal losses and leakages within the clearance system as well as repeated breaches of the Paris Protocol by the Government of Israel (GoI), have largely contributed to the unsustainability of the PA's fiscal situation. The regressive components within the Palestinian tax system also contribute to this precarious situation. These last fiscal elements are the main focus of this policy paper and are extensively analysed in the first section. In the second part, the paper argues that the EU instrument PEGASE Direct Financial Support (PDFS), which aims at delivering financial aid in order to sustain the viability of the PA's fiscal situation, has largely failed to address these elements and led to inefficient and ineffective results with respect to its own stated objective.

The relevance of clearance revenues, i.e. the transfers of all direct and indirect customs and tax revenues collected by the GoI on behalf of the PA, is clear. Approximatively 65% of the PA's total revenues are emanating

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1 Nashashibi, K., Palestinian Public Finance Under Crisis Management: Restoring Fiscal Sustainability, 2015 https://www.mas.ps/files/server/Lectures/%20FISCAL%20/Fiscal%20sustainability%20paper%20March%2031%202015.pdf

2 World Bank, Economic Report Monitoring to the AHLC, 30 April 2019, p.19. http://documents.worldbank.org/curated/en/942481555340123420/Economic-Monitoring-Report-to-the-Ad-Hoc-Liaison-Committee

3 World Bank, Unlocking the Trade Potential of the Palestinian Economy, 2017. http://documents.worldbank.org/curated/en/960071513228856631/Unlocking-the-trade-potential-of-the-Palestinian-economy-immediate-measures-and-a-long-term-vision-to-improve-Palestinian-trade-and-economic-outcomes

4 Nashashibi, K., Palestinian Public Finance Under Crisis Management: Restoring Fiscal Sustainability, 2015.

from this source. Furthermore, the recent political tension over the Martyrs Fund between the GoI and the PA shed light on this crucial policy issue. In March 2019, the GoI started to deduct $12 million from the clearance revenue on a monthly basis because this amount allegedly corresponds to the monthly payments emanating from the Martyrs Fund, which consists of transfers by the PA to the families of Palestinians killed, injured or jailed for involvement in political actions. In response to these unilateral deductions, the PA refused the entire clearance revenues as a sign of protest and it lasted approximately eight months. This sparked an intense fiscal crisis, with a financing gap exceeding $ 1 billion in the first half of 2019. In order to finance it, the PA had to accrue large arrears and resort to additional borrowing from the domestic banking sector, resulting in a significant increase of the banking sector's exposure to the PA. As of June 2019, the outstanding debt equalled to $ 1.6 billion.

TABLE 1. PERSISTENT FINANCING GAPS OVER THE YEARS

Year	2014	2015	2016	2017	2018	2019
Financing gap ($, million)	**357**	**650**	**330**	**420**	**404**	**810**

SOURCE: WORLD BANK, ECONOMIC REPORT MONITORING TO THE AHLC FROM 2014 TO 2020

Fiscal leakages and fiscal losses within the clearance system

One of the key components of the Paris Protocol is the establishment of a revenue sharing mechanism between Palestinian and Israeli authorities. By formalizing the pre-Oslo customs union trade regime, the Protocol legally enshrined taxing rights for both authorities and set up different administrative procedures, referred as the clearance system, to ensure the transfer of all direct and indirect customs and tax revenues collected by the GoI on behalf of the PA. The bulk of this revenue sharing mechanism is set out in the articles III, V, VI and VII of the Paris Protocol. These legal provisions entail the clearance of the VAT on bilateral trade, the purchase tax, the import taxes on goods imported from third countries, and the income taxes on labour in Israel and the settlements. However, the inherent flaws and the inadequate implementation of the Paris Protocol has led to recurrent fiscal leakages and fiscal losses in each layer of the clearance system. Fiscal leakages correspond to fiscal resources leaked to the Israeli treasury and fiscal losses correspond to fiscal revenues foregone because they have not been collected by both administrations. This section relies on the UNCTAD estimates for the fiscal losses and fiscal leakages due to their comprehensive nature. Nonetheless, other estimates have been produced by the World Bank as well as the Palestinian Ministry of Finance and can be found in the annex.

The clearance of the VAT on bilateral trade

Article VI of the Paris Protocol sets up the clearance bill mechanism to clear VAT on bilateral trade between Israeli and Palestinian businesses, based on the exchange of invoices. These official trade documents, presented under an Israeli form and a Palestinian form, support the movement of goods and services flowing between the two markets. More precisely, the invoices, issued by the Israeli and Palestinian tax authorities, are provided to the registered businesses, upon request. After each trade transaction, the seller generates an invoice to record it. They then give the original invoice to the buyer, send a copy to their respective tax administration, and keep another copy for internal bookkeeping. Eventually, paragraph five of article VI stipulates that "VAT on purchases by businesses registered for VAT purposes will accrue to the tax administration with which the respective business is registered".

Regarding VAT on bilateral trade, Palestinian and Israeli authorities both suffer from fiscal losses due to smuggling and fraud. Nonetheless, it is more prevalent on the Palestinian side because two thirds of Palestinian trade are with Israel while Palestinian territories represent only 6 percent of the Israeli trade. In addition to this, the PA has less control over its borders. According to the World Bank, "goods are brought from Israel to Area C of the West Bank, where the PA has no control. These goods are then gradually moved to Areas A and B where they are sold to wholesale and retail vendors without paying taxes to the PA."[5] The UNCTAD adds that only a fraction of the Palestinian imports enters through the four crossing points that were arbitrarily designated by the GoI for goods that are intended to enter the West Bank.[6] In addition to smuggling, both authorities acknowledge that forgery and manipulation of VAT clearance bills also represent sources of fiscal losses. More precisely, fraudulent clearance bills, which are not recognized by the respective authorities, are printed and used between merchants but cannot be used during clearance sessions. Importers and exporters also agree to underestimate the value of the transaction on the issued clearance bill to reduce VAT dues.

The second issue with respect to VAT on bilateral trade is that Palestinian businesses underreport VAT paid to Israel, creating a fiscal leakage for the Palestinian treasury. In other terms, Palestinian buyers do not always submit to the PA the invoice they receive from Israeli sellers at the time of the transaction to conceal sales on these goods, and hence, reducing their local VAT and income tax obligations. As a consequence, the PA is not able to claim for these VAT revenues during clearance sessions due to the absence of such invoices. Furthermore, according to the Paris Protocol, the PA cannot claim any clearance bill that is more than 6 months old, allowing the GoI to ignore any revenue related to such invoices even after being proven valid.

In a recent report, the UNCTAD has affirmed that an important share of the goods smuggled into Areas A and B are subject to import taxes, namely customs duties, purchase tax and VAT, in Israel. The estimated leakages of Palestinian public revenues into the Israeli treasury resulting from the evasion of import taxes amounted to $202 million in 2015, equivalent to 1.6% of Palestinian GDP at that time.[7] Concerning the undervaluation of imports from Israel, i.e., the difference between the real and declared values of imports from Israel, it was estimated that the PA lost $33.7 million worth of VAT revenues in 2015. It should be added that the cost incurred by the undervaluation of imports from third countries is much larger because these imports are subject to customs duties and purchase tax as well. For the year 2015, it represented $138,6 million.

The import taxes on goods imported from third countries

According to Article III (15) of the Paris Protocol, all revenues from taxes on imports, whether customs duties, purchase tax or VAT, from countries other than Israel, transiting through Israeli borders, must be transferred to the PA within 6 working days, as long as the destination principle is respected. In other terms, if the import declaration states that the final destination is the Palestinian territories, then the GoI is expected to transfer the PA its dues. Furthermore, the Protocol provides that "these tax revenues will be allocated to the Palestinian Authority even if the importation was carried out by Israeli importers when the final destination explicitly stated in the import documentation is a corporation registered by the Palestinian Authority and conducting business activity in the Areas".

Important fiscal leakages for the PA occur through the indirect importing process. Due to various factors, it is costly for Palestinian businesses to directly import products from third countries. First of all, numerous and variable restrictions, ranging from security checks to trade restrictions, negatively affect direct imports from third countries. Israeli ports apply a discriminatory policy against goods destined for the Palestinian market "in terms of searches, delays, and inspection, as opposed to goods destined for Israel."[8] Furthermore,

5 World Bank, Economic Report Monitoring to the AHLC, 19 April 2016, p.16. http://documents.worldbank.org/curated/en/780371468179658043/main-report

6 The four crossing points are the following: Tarqumia, Betunia, Sha'ar Ephraim and Al Jalameh.

7 UNCTAD, Economic costs of the Israeli occupation for the Palestinian People: Fiscal Aspects, 2019, p.8.

8 UNCTAD, Palestinian Fiscal Revenue Leakage to Israel under the Paris Protocol on Economic Relations, 2014, p.32.

Palestinian importers and officials are not allowed to enter Israeli ports, resulting in an exclusive Israeli control over import and shipping information. Regarding import licenses, Palestinian importers need to apply for a new licence every time they import goods while Israeli importers benefit from a one-year license. According to the UNCTAD, these import authorizations take sometimes weeks to be delivered to Palestinian dealers.[9] Eventually, the customs regulations governing direct imports are often revised by Israeli authorities and are only made available in Hebrew, creating additional difficulties for Palestinian traders.

Inevitably, due to this unfavourable context, Palestinian importers resort to indirect importing through Israel. They rely on Israeli middlemen to import merchandise from third countries because procedures are seen as cheaper, simpler and less time consuming to those governing direct imports. As mentioned earlier, the Paris protocol foresees such scenarios and stipulates that the PA is eligible to receive import taxes only if the Israeli importer explicitly mentions in the import declaration that the goods are destined to the Palestinian territories. In practice, however, goods that originate from third countries are imported to Israel as the final destination and then re-sold to Palestinian traders as Israeli goods. This is made possible by the fact that Israeli importers, contrary to Palestinian importers, are not legally obliged to declare that the imported good will only be sold in one particular area. These indirect imports that enter the Palestinian market as Israeli goods curtail tax revenues for the PA, since only VAT is collected on them while other import duties are retained by the GoI. That is a clear example of fiscal leakage. The UNCTAD estimates on fiscal leakage from all indirect import taxes amount to $129 million for the year 2015.

The income taxes and deductions on labour in Israel and in the settlements

Under Article V (3) of the Paris Protocol, the GoI must transfer to the PA 75 percent of income taxes collected from Palestinians working in Israel and 100 percent of income taxes paid by Palestinians working in the Israeli settlements. Furthermore, Article VII lays down the transfer to the PA of several deductions from the income of Palestinians working in Israel. More precisely, it includes the equalization levy, the pension contribution and the health stamp. The equalization levy has been established in order to keep the wage cost of Palestinian workers equal to Israeli workers given that the former pay lower contributions[10] to the Israeli national insurance system. The GoI is expected to transfer this levy to the PA, on a monthly basis, after deducting health services provided to Palestinian workers at the workplace in addition to two thirds of the administrative costs borne by the Israeli Employment Service when taking care of issues related to Palestinian workers. Secondly, the GoI has the legal obligation to transfer, on a monthly basis, to a relevant pension fund established by the PA, pension insurance deductions collected from wages of Palestinians working in Israel and their employers. Finally, the Protocol provides for monthly transfers to the PA of health insurance fees, or "health stamp", collected by the GoI from the salaries of Palestinians working in Israel. These transfers are explained by the fact that Palestinian workers are not entitled to health insurance services in Israel.

With respect to income taxes, there is an important lack of official oversight over the earnings of Palestinians working in Israel, enabling Israeli employers to underreport wages, and hence, to lower their tax obligations and other charges. The direct consequence for the PA is reduced income tax transfers by the GoI, averaging around $8 million in recent years. Furthermore, underreporting of income also leads to lower equalization fees and other deductions since they are computed on the basis of the salary, creating additional fiscal losses for the PA.

Other sources of fiscal leakages/losses

In the supplement to the Paris Protocol, it is added that "Israel will deduct 3% from each transfer to the

9 UNCTAD, Palestinian Fiscal Revenue Leakage to Israel under the Paris Protocol on Economic Relations, 2014, p.32.

10 Palestinians pay lower contributions because they are entitled to a basic insurance package that only cover work related injuries, employer bankruptcy, and the maternity leave allowance.

Palestinian side of import taxes and other indirect taxes, in order to cover Israel's administrative costs in collecting these taxes and in handling matters related to them". During the negotiation of the protocol in 1994, Palestinian clearance revenue equalled $624 million, resulting in $18 million of handling fees. However, as pointed out by the World Bank[11] and the UNCTAD,[12] the size of the clearance revenue has significantly increased, leading to an outdated fee. In 2014, handling fees collected by the GoI amounted to $63 million and were used to finance almost a third of the Israeli customs and VAT's total budget, even though the Palestinian share represent only 6 percent of the total imports dealt by this department. In 2017, the handling fees reached $70 million. The World Bank has estimated that the "3 percent fee should be reduced to 0.6 percent to become commensurate with the share of Palestinian imports in total imports handled by the Israeli customs and VAT department."[13]With this adapted rate, the PA could increase its revenues by $40 million to $50 million, money that is currently leaking into the Israeli treasury.

Furthermore, in 1996, the GoI began to collect a 3 per cent handling fee on Palestinian imports of fuels and petroleum derivatives such as gasoline, diesel and kerosene. These handling fees are contested by the PA because there are no administrative costs involved in direct imports. This contestation is underpinned by the fact that between 1994 and 1996, Israel used to transfer the excise tax on fuel separately from other clearance revenues and did not deduct a handling fee on the former transfer. Based on the data supplied by the Palestinian Central Bureau of Statistics, the UNCTAD estimates that, between 1996 and 2017, $224 million dollar were "unilaterally deducted in the form of fees imposed on Palestinian tax revenues accruing from direct fuel imports from Israel".[14] It also estimates that, due to the inappropriate handling fee rate, Palestinian fiscal leakage to the Israeli treasury in administrative and handling fees are estimated at $56 million, $24 million relating to petroleum excise, and $32 million to other import taxes.

TABLE 2. SUM OF FISCAL LEAKAGES AND FISCAL LOSSES FOR THE YEAR 2015 (UNCTAD METHODOLOGY)

Fiscal leakages/Fiscal losses	**2015 ($, million)**
Evasion of import taxes	**202**
Undervaluation of imports from Israel	**33,7**
Undervaluation of imports from third countries	**138,6**
Leakages through indirect imports	**129**
Reduced income tax transfers	**8**
Inappropriate handling fees	**32**
Handling fees fuel	**24**
Sum	**567,3**

SOURCE: UNCTAD, ECONOMIC COSTS OF THE ISRAELI OCCUPATION FOR THE PALESTINIAN PEOPLE: FISCAL ASPECTS, 2019

Breaches of the Paris Protocol by the GoI

The previous part illustrates the inherent flaws and/or the inadequate implementation of the Paris Protocol and the resulting harmful fiscal consequences for the PA. Nonetheless, the fiscal losses and fiscal leakages afflicting the PA under the Paris Protocol also emanate from the repeated legal breaches of this agreement

11 World Bank, Economic Report Monitoring to the AHLC, 19 April 2016, p.20.

12 UNCTAD, Economic costs of the Israeli occupation for the Palestinian People: Fiscal Aspects, 2019, p.8.

13 World Bank, Economic Report Monitoring to the AHLC, 19 April 2016, p.20.

14 UNCTAD, Economic costs of the Israeli occupation for the Palestinian People: Fiscal Aspects, 2019, p.9.

committed by the GoI. The following paragraphs evidence direct violations of international law made by the GoI and its inconsideration of the protocol's aim.

First of all, in order to create economic relations based on mutual interests, the Protocol established the Palestinian-Israeli Joint Economic Committee (JEC). The aim of this body is to ensure the proper implementation of the Paris Protocol and decide on problems that may arise. However, it is effectively subject to an Israeli security veto, which explains its insignificant role in governing the economic and trade relations between the GoI and the PA. The numerous and repeated unilateral Israeli decisions in terms of trade and taxation policies, leading to harmful consequences for the Palestinian side, are clear examples of the constant disrespect of the JEC by the GoI. The next paragraph illustrates different arbitrary decisions made by the GoI that have completely overridden the JEC, and more generally the protocol's aim.

Regarding the purchase tax, the Israeli government has repeatedly amended the relevant legislation after signing the Paris Protocol and has never consulted the PA beforehand. These unilateral measures contradict all the commitments vis-à-vis the JEC as well as articles II and III of the Protocol that establish any changes in import taxation policies shall be anticipated *ex ante* and in concertation between the two parties. For instance, in August 2000, Israel suddenly either phased out or reduced the purchase tax on a large number of goods. The negative effects of this measure only hit the Palestinian economy and treasury. According to the UNCTAD,[15] Palestinian businesses suffered great losses that amounted to $30 million. Other examples evidence Israeli arbitrary decisions in terms of trade and tax policies. From time to time, Israel has unilaterally raised the passenger exit fees at the Karamah/Allenby bridge. The sudden application of a 3% handling fee on Palestinian imports of fuels and petroleum derivatives was also a decision made by the GoI without consulting its Palestinian partner.

Secondly, the GoI has not fulfilled various revenue-sharing commitments covered by several articles of the Paris Protocol. With respect to the income tax deductions on Palestinians working in Israeli territories, the GoI has never established a monthly transfer mechanism of the equalization levies, the pension contributions and the health stamps to the PA. According to the World Bank,[16] the annual loss for the PA's treasury of the Israeli withholding of equalization levies and health stamps represent $25,2 million. Regarding the pension contributions, it is estimated that the GoI has accumulated, during the period that runs from 2006 to 2013,[17] $377 million euros. As a result, Palestinian workers have gradually withdrawn their pension contributions over the years. It should be mentioned that one of possible reason for GoI's failure to transfer these pension contributions is the absence of a Palestinian Pension Fund. Indeed, PA's attempts to establish a social security system have failed so far due to widespread opposition among the population. This opposition mainly stems from the general mistrust of the PA's capacity to secure public funds and the neoliberal nature of the proposed social security schemes.[18]

Two other revenue-sharing arrangements have been ignored by the Israeli authorities, the taxes collected by the GoI on behalf of the PA in Area C and the passenger exit fees at the Karamah/Allenby bridge. Under the Protocol on Economic Relations, Israel has the legal obligation to levy VAT and income tax in Area C on behalf of the PA and "transfer that revenue to the Palestinian treasury based on the principle of the place of final consumption and geographic location of income generation".[19] Until 2000, Israel collected VAT, income tax, property tax, and operational fees from the approximatively 2,000 Israeli commercial enterprises or individuals based in Area C. It has since stopped to transfer revenues and to provide any

15 UNCTAD, Palestinian Fiscal Revenue Leakage to Israel under the Paris Protocol on Economic Relations, 2014, p.21.

16 UNCTAD, Economic Report Monitoring to the AHLC, 19 April 2016, p.21.

17 Absence of data for the previous years.

18 https://al-shabaka.org/commentaries/palestinian-opposition-to-social-security-revolution-or-devolution/.

19 UNCTAD, Economic costs of the Israeli occupation for the Palestinian People: Fiscal Aspects, 2019, p.9.

information about the commercial activity in this area. The UNCTAD affirms, on the basis of the Palestinian government estimates, that the GoI has accumulated $320 million during the period 2001-2017, creating an important fiscal leakage for the Palestinian treasury. Regarding the passenger exit fees, the Protocol[20] provides that the two parties should share the revenues according to clear calculation methods. However, since 1994, the GoI has irregularly and partially transferred the revenues it collects on behalf of the PA. Based on Palestinian estimates, the accumulated exit fees leaked into the Israeli treasury from 2008 onwards amount to $145 million.[21]

Eventually, as evidenced by the recent crisis over the Martyrs Fund, the GoI partially or fully freezes Palestinian clearance revenue for political purposes. From 1997 to 2015, Israel withheld, either partially or fully, seven times these crucial revenues for the PA. The total amount of dues frozen during that period amounted to $2.4 billion. For instance, in November 2012, the GoI froze the clearance revenue for three months after UN General Assembly's recognition of Palestine as a state. In January 2015, it froze it again for three months in retaliation of the PA's attempt to join the international criminal court in the Hague. These obvious violations of the Paris Protocol undermine the PA's planning and administration and strongly weaken its ability to meet its financial obligations. Furthermore, it forces the Authority to accumulate arrears and resort to borrowing from domestic banks, thereby creating additional costs through the interest rates accruing on credit denominated in new Israeli shekels. Furthermore, it is important to point that that the Israeli treasury benefits from the interest paid on the withheld revenue on bank deposits in Israel. That is a clear fiscal leakage. The UNCTAD estimated the non-recurring fiscal leakages and losses from withholding clearance revenue by Israel from 1997 to 2015 and it amounts to $486.9 million.

Israeli compensations for Palestinian fiscal leakages and losses

From 2016, following several ministerial meetings with the PA, Israel started to make one-off payments to compensate for Palestinian fiscal leakages/losses in a very unstructured way.

The Israeli transfers for the year 2016 amounted to NIS1.2 billion in order to cover VAT receipts collected on imports to Gaza, refund on the 3 percent handling fee for Palestinian imports, accumulated Allenby bridge exit fees, and equalization as well as health fees paid by Palestinian workers in Israel over the years. In 2017, lump-sum payments, amounting to NIS465 million, were transferred to the PA in order to compensate for income tax collected from Palestinians working in Israel over a period of several months, health fees and equalization levies and VAT leakage. In 2018, the GoI paid NIS165 million to the PA covering health and equalization fees collected from Palestinian workers. The GoI reports that since June 2018, these transfers have been made on a monthly basis and it is hoped that a system can be put in place to ensure regular transfers going forward.

Using the 2019 exchange rate,[22] these transfers, equalling NIS1,83 billion, correspond to $529.5 million. The positive aspect of these compensations lies in the implicit Israeli recognition of the misfunctioning of the Protocol. Nonetheless, from a purely financial perspective, these compensations are clearly not sufficient. Apart from being sporadic and unpredictable, the Israeli financial settlements for the period 2016-2018 did not even cover the 2015 fiscal losses and leakages experienced by the PA. If the cost of the Israeli breaches is also taken into account, it becomes even more evident that Israeli transfers are far from being adequate.

20 Annex 1: Redeployment and Security Arrangements Protocol (Appendix 5, section G).

21 The Government of Palestine's report to the Ad Hoc Liaison Committee Meeting, Stopping Fiscal Leakages, September 2018. http://www.lacs.ps/documentsShow.aspx?ATT_ID=36702

22 31/12/2019 exchange rate.

PA's efforts to reduce the fiscal deficit: an expenditure-based approach[23]

The Authority has been through numerous reforms to reduce the budget deficit and enhance its fiscal space. Between 2006 and 2018, the relative size of the PA's total fiscal deficit fell from 30 percent of GDP to below 7 percent. This is the result of continuous efforts to streamline public expenditure, mainly by reducing the wage bill, hospital referrals and net lending.[24] With respect to the wage bill, the PA has enacted several measures over the years to contain it. In early 2012, car privileges and international allowances were cancelled for all PA employees ranking below heads of institutions and their deputies. The same year the PA introduced a hiring and promotion freeze which contributed to limiting the net growth of the public labour force. In 2013, it went further and established a "zero net hiring" policy. The year after the practice of paying transportation and supervision allowances for stay-at home staff was abandoned. The next important reforms related to the wage bill were the cuts of allowances and wage payments of PA employees in Gaza and the significant reduction of public servants due to early retirement measures since early 2017.

Concerning the cost of referrals, multiple actions have been undertaken to limit it. In late 2012, the medical referral process was strengthened by including health experts, who are not part of the public sector, within the medical referral committees. Furthermore, in that year, the referral process was centralized by transferring the billing department from Nablus to Ramallah under the direct authority of the General Directorate for Health Insurance. Due to the growing cost of referrals from Israeli medical institutions, instructions were given to restrain these to absolute necessities and with the Minister's prior approval. In addition to this, Memoranda of Understanding with six Israeli hospitals have been signed to regulate the pricing and contractual arrangements with them.

In order to control net lending, the PA has made various efforts to reduce electricity non-payments. Over the last decade, various capacity-building initiatives were undertaken such as the Palestinian Electricity Regulatory Council, institutional building and legal amendments to address non-payments or the Electricity Transmission Company Limited to handle consolidated supply of electricity.[25] Moreover, the PA entered into different Memoranda of Understanding with Palestinian electricity providers and municipalities to ensure that fees collected are used to pay bills to the Israeli Electricity Company (IEC) and not to finance non-electricity related expenditures. Eventually, actions have been led to enhance the collection rate such as additional prepaid meters and prevent consumption abuses such as civil service restrictions in case of accumulated unpaid bills.

Following the Public Expenditure and Financial Accountability (PEFA) report in 2013, significant progresses have been made regarding the Public Financial Management (PFM). For instance, budget preparation has been strengthened with the implementation of a budget circular with a detailed calendar in 2016. Also, the budget execution procedure has been toughened with the implementation of an annual cash plan and a commitment recording system that delivers comprehensive information on the stock and flow of arrears. Finally, the major delays in the production and audit of financial statements have been substantially reduced.

The persistent regressivity of the Palestinian tax system

On the revenue side, reforms have been more limited. In early 2014, the PA started to prioritize revenue reforms, tackling tax violations and widening the tax base. Between 2012 and 2017, more than 55,000 new taxpayers were added to the system. Improvements have also been made on updating public fees and

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23 The successive reforms listed in this section can be found in the Economic Reports Monitoring to the AHLC provided by the World Bank from 2013 onwards.

24 Net lending represents deductions by the GoI from clearance revenues it collects on behalf of the PA for unpaid utility bills by Palestinian public utilities and local governments.

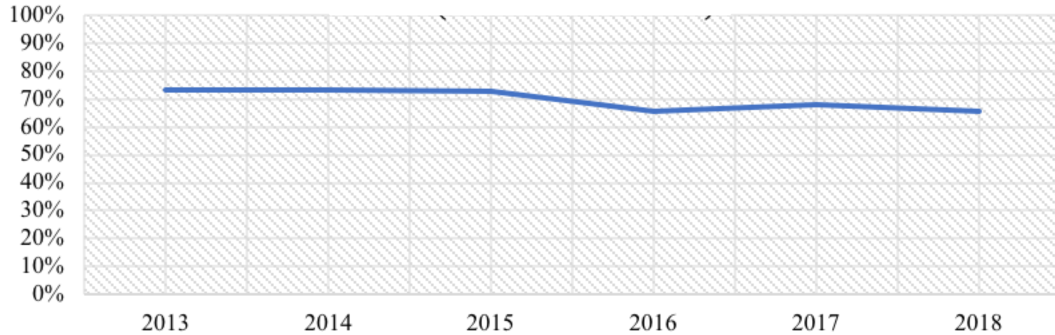
25 World Bank, Economic Report Monitoring to the AHLC, 25 September 2013, p.20. http://documents.worldbank.org/curated/en/313821468321846300/pdf/760240WP0GZ0AH0B0x374357B00PUBLIC0l.pdf

charges, evidenced by a rate hike on domestic customs on cars in mid-2016 or more recently the increase of the license fee for petrol stations. However, the PA's measures to address the regressive nature of the Palestinian tax system have failed to bring substantial change and have been marred by inconsistency.

The primary driver of regressive taxation within the Palestinian tax system is the overreliance on indirect taxes. These represent more than 90% of Palestinian tax revenues, mainly through the clearance mechanism described in the previous section.[26]

FIGURE1. THE PA IS STRONGLY RELIANT ON THE CLEARANCE REVENUE MECHANISM

Share of clearance revenue in PA's total net revemue, 2013-2018 (commitment basis)



The reliance on indirect tax revenues and the clearance mechanism, is not only a source of political instability but also a source of inequality. Indirect taxes charge the same rate to all citizens and do not operate distinctions among taxpayers. Furthermore, the VAT in the oPts does not include differentiated tax brackets for basic materials or luxury products with 16 percent being charged on all goods and services.

In addition to this, direct taxes are skewed in favor of the wealthy contributing to their minor importance in the PA's total revenues. The frequent rearrangement of the relevant tax legislation, often contradictory, have led to inconsequential results with respect to this structural issue. Regarding the Personal income tax (PIT),[27] on the basis of the 2011 Income Tax Law, a fourth tax bracket at 20 percent was added in 2012.[28] However, amendments in 2015 removed this fourth tax bracket, leaving the high personal income tax rate at 15 percent.[29] As a consequence, the contribution of PIT to total tax revenues has remained at very low rate, averaging 4.4% for the period 2011-2016.[30] The identical legislative processes applied to the Corporate Income Tax (CIT). The fourth bracket at 20 percent added by the 2012 amendment was abandoned few years later. The CIT in the oPts is currently fixed at a uniform rate of 15 percent, except for monopolies, banking and financial institutions, and telecom companies, which are taxed at 20 percent rate. It should be added that the last amendments to the Income Tax Law also reduced taxes on life insurance premiums from 10 percent to five percent for companies.[31] The contribution of CIT to total tax revenues decreased from 5.5% in 2012 to 3.6% in 2016, restraining considerably this source of revenue.

Lastly, income tax exemptions constitute another vector for regressive taxation within the Palestinian tax system. In 2014, amendments to the 2011 Investment Promotion Law disregarded the capital size as a condition to benefit from income tax exemption. New criteria have been established: export capacity

26 Fair Tax Monitor Report, 2018, p.25. https://maketaxfair.net/assets/FAIRTAXMONITOR-English-1.pdf

27 Tax imposed on Palestinian residents who have resided continuously in Palestine for at least 120 days during the year with a taxable income.

28 Fair Tax Monitor Report, 2018, p.18.

29 Fair Tax Monitor Report, 2018, p.18.

30 Fair Tax Monitor Report, 2018, p.23.

31 Fair Tax Monitor Report, 2018, p.24.

TABLE 3. CURRENT PERSONAL AND CORPORATE INCOME TAX IN THE OPTS

Personal Income Tax	
Income (NIS)	Tax Rate
1-36000	Exempt
36000-75000	5%
75001-150000	10%
More than 150000	15%

Corporate Income Tax	
Income	Tax Rate
Full tax base	15%
Other Companies (Franchises and Monopolies)	20%

SOURCE: FAIR TAX MONITOR REPORT, 2018

(40 percent of total sales); number of employees (25 at least); use of local inputs in production (70 percent of total inputs); and whether or not they are intervening in priority economic sectors like information and communication technology (ICT), tourism and manufacturing. If a firm meets any one of these conditions, it is entitled to income tax exemption for five years. These requirements favor large and privileged companies because more than 99 percent of firms are classified as SMEs that employ less than 10 people and sell only to local markets.[32] Therefore, the number of businesses potentially eligible for tax exemption only concern less than one percent of the Palestinian private sector.

Part II: EU Policy - The blind spots of the PEGASE Direct Financial Support

Context and structure of PEGASE

In February 2008, following the Paris Donor Conference and the Palestinian Authority's Palestinian Reform and Development Plan (PRDP) 2008-2010, the EU launched the PEGASE mechanism. It replaced the Temporary International Mechanism (TIM) which emerged in 2006 and aimed at directly delivering financial assistance to the Palestinian population. Most of the EU's assistance to the PA is channelled via the PEGASE Direct Financial Support (PDFS). Through this mechanism, the EU has contributed substantially to the recurrent expenditure of the national budget of the Palestinian Authority. The last evaluation of the PEGASE DFS, published in October 2018, concluded that "PDFS is much appreciated by the PA, both in its own right and as a catalyst for attracting contributions from other than European Development Partners."[33] More importantly, the mechanism is considered as a "lifesaver" by the PA according to the evaluation report.

Currently, it is composed of three main components: The Civil Service & Pensions (CSP) programme, the support to the Cash Transfer programme (CTP), and the East Jerusalem Hospitals (EJH) programme. The CSP programme aims to support the functioning of the PA administration and *in fine* insure the provision of essential public services to the Palestinian citizens. 5-6 payments per year are transferred to contribute to the salaries and pensions of around 58,000 PA civil servants and pensioners. For the years 2018, 2019, and 2020, the annual allocation amounts to EUR 85 million. Secondly, the PEGASE DFS supports the CTP, a Palestinian social program that reaches the poorest households in the West Bank and in Gaza, by contributing to the quarterly CTP payments to an average of 70,000 families (80% of which in Gaza). The aim of this PEGASE component is to ensure the continued assistance to Palestinian families living in extreme poverty, relying on PA social programs. It also strengthens the reform of the social protection system and the social cohesion among Palestinians. For the years 2018, 2019, and 2020, the annual allocations respectively amount to EUR 50 million, EUR 40 million, and EUR 40 million. The last main component, the EJH program, is a financial assistance program to 6 hospitals in East Jerusalem. These hospitals are considered as key due to their provision of quality range of tertiary healthcare, most of which is not delivered elsewhere in Palestine. Furthermore, the six EJH are the largest remaining Palestinian-run institutions in East Jerusalem. Due to the precarious fiscal situation of the PA, there is a chronic debt problem with these hospitals. In this regard,

32 Fair Tax Monitory Report, 2018, p.38.

33 Evaluation of 2016/2017 PEGASE Direct Financial Support to the Palestinian Authority, p.5. https://eeas.europa.eu/sites/eeas/files/pegase_evaluation_2017-2018_final_report.pdf

this component of PEGASE covers part of the debt to ensure access to quality health services to the entire Palestinian population.

The Depoliticisation of PEGASE and increasing emphasis on PA's internal reforms.

Following the Gaza War in 2008, the main objective of PEGASE was to support the implementation of the Palestinian Reform and Development Agenda by helping the PA to cope with its budget deficit, meet its financial obligations *vis-à-vis* civil employees, pensioners and vulnerable sectors and *de facto* maintain the functioning of the administration and the provision of essential public services to the population.[34] In 2014, a more political objective was ascertained to justify the relevance of PEGASE, i.e. "maintain the viability of the two-state solution by avoiding the fiscal collapse of the PA and sustain basic living conditions of the whole Palestinian people."[35] The political aim to maintain the viability of the two-state solution was sustained as the overall objective of PEGASE action documents of the years 2015, 2016 and 2017.

However, the last official document concerning PEGASE, the Multi-Annual Action Document for PEGASE 2018-2020,[36] has promoted a more technocratic and less political approach. The stated overall objective is now "to build effective and accountable institutions ready for statehood and enable inclusive social development (leaving no one behind)."[37] In fact, this change of tone did not go unnoticed. The last evaluation report[38] on PEGASE published in October 2018 noted that the Commission services had adopted a more technical and measurable approach to the intervention logic of PDFS. This shift, from a political to a pragmatic goal, as worded by the aforementioned evaluation report, is further evidenced by the increasing focus on PA's internal reforms.

The Multi-Annual Action Document for PEGASE 2018-2020 has introduced for the first time incentive-based allocations for the CSP programme. Based on the recommendation of the Special Report by the European Court of Auditors, tranches of the CSP disbursement have been made conditional on PA-led reforms, EUR 60 million in total. The PEGASE document has selected various areas where the PA is expected to bring achievements: budget and public procurement transparency; public administration reform;[39] effectiveness of control process. This technocratic shift aligns with the World Bank and IMF approaches that have continuously pushed for measures to reduce spending, increase revenues, and improve the efficiency of public management while neglecting the political drivers behind the PA's fiscal situation.[40]

The increasingly exclusive focus on the PA's internal reforms in the EU's development approach is unproductive for two major reasons. First of all, even though there is still room for large improvements, the PA has significantly reduced its budget deficit over the years. As mentioned earlier, the relative size of the PA's total fiscal deficit shrank from 30 percent of GDP in 2006 to below 7 percent in 2018. The relative size of the wage bill fell from 24 percent of GDP in 2006 to 11 percent in 2018 while net lending (*de facto* transfers to municipalities) from 7 percent of GDP in 2006 to 2 percent in 2018. Eventually, out of 16 public sustainability reform items identified by the World Bank's latest AHLC, the PA has achieved at least some

34 EU action document PEGASE DFS, 2010. https://ec.europa.eu/neighbourhood-enlargement/neighbourhood/countries/palestine_en

35 EU action document PEGASE DFS 2014, p.7. https://ec.europa.eu/neighbourhood-enlargement/neighbourhood/countries/palestine_en

36 EU multi-annual action document for PEGASE DFS 2018, 2019 and 2020. https://ec.europa.eu/neighbourhood-enlargement/neighbourhood/countries/palestine_en

37 EU multi-annual action document for PEGASE DFS 2018, 2019 and 2020, p.11

38 Evaluation of 2016/2017 PEGASE Direct Financial Support to the Palestinian Authority, p.13.

39 With a particular emphasis on payroll control.

40 UNCTAD, Report on UNCTAD assistance to the Palestinian People- Developments in the economy of the Occupied Palestinian Territory, September 2016, p.5. https://unctad.org/en/PublicationsLibrary/tdb64d4_embargoed_en.pdf

progress in 11 of them.[41] Despite these progresses, financing gaps continue to emerge every year, leading to a larger public debt and more arrears. Therefore, these numbers blatantly highlight that PA's internal reforms will not be sufficient to achieve fiscal sustainability. A similar conclusion is drawn by the UNCTAD, often praising PA's efforts and even declaring that its "chronic fiscal crisis is mainly caused by occupation."[42] The second reason is that the last PEGASE document did not tackle a major issue with respect to PA's internal reforms, namely the persistence of regressive taxation, the low contribution of PIT/CIT to the total tax revenues and the unequal tax exemptions. Reforms in these areas would bring higher revenues, enhance social justice, and reduce PA's dependency to the clearance revenue mechanism. Furthermore, it should be added that the World Bank[43] as well as the IMF[44] have stressed the need to address these issues and target high-earning individuals and companies.

The structural weaknesses of PEGASE's approach.

The PEGASE actions plans are articulated around key assumptions that frame the overall approach. From the fiscal perspective, there is one recurring assumption that strongly undermines the validity of the approach promoted by the EU in the program. It is assumed that "the Government of Israel respects its Oslo/Paris agreements' commitments, notably in terms of transfer of clearance revenues, and does not impose further restrictions."[45] Since 2015,[46] this wrong assumption has continuously been advanced, hampering the effectiveness and efficiency of PEGASE. The persistent disregard of the JEC, the multiple revenue-sharing commitments that have not yet been implemented or the freezing of clearance revenue transfers are clear evidences that the GoI does not respect its Oslo/Paris agreements' commitments. These repeated legal breaches incur important financial costs, representing hundreds of million US dollars accumulated over time, for the PA and permanently threatens its fiscal stability. As long as this context of constant infringements continues, the EU efforts to consolidate the PA's fiscal situation in the longer-term are vain.

The latter point has been acknowledged to a certain extent by the Commission services themselves. In the PEGASE action plans of 2015, 2016, and 2017, the freezing of clearance revenues was mentioned as a risk for the effectiveness of PEGASE DFS. Furthermore, it was recognized in the aforementioned documents that a mitigating measure could consist of tying EU aid effectiveness in Palestine directly to Israeli actions. This proposal followed the ECA recommendation in the previously mentioned 2013 report, which affirmed that Israeli actions negatively affect the performance of the EU instrument and advocate for bringing "Israel to take the necessary steps to help ensure that PEGASE DFS is effective".[47] Although the risk of Israeli actions has been acknowledged, the assumption of Israeli commitment to the Paris Protocol was maintained. The PEGASE action plan 2018-2020 has even abandoned the proposal to link EU co-operation effectiveness in Palestine directly to Israeli actions. This decision leaves further aside the prospects to include Israeli harmful actions within the PEGASE approach and *in fine* to adopt a (much necessary) political approach.

In addition to this flawed assumption, there is almost no mention in the PEGASE action plans of the recurrent

41 World Bank, Economic Report Monitoring to the AHLC, 26 September 2019, p.17.

42 UNCTAD, Report on UNCTAD assistance to the Palestinian People- Developments in the economy of the Occupied Palestinian territory, September 2016, p.5.

43 World Bank, Economic Report Monitoring to the AHLC, 26 September 2019, p.13.

44 IMF, Report to the Ad Hoc Liaison Committee, 2018, p.18. https://www.imf.org/en/Publications/CR/Issues/2018/09/17/west-bank-gaza-report-to-the-ad-hoc-liaison-committee

45 EU multi-annual action document for PEGASE DFS 2018, 2019 and 2020, p.9.

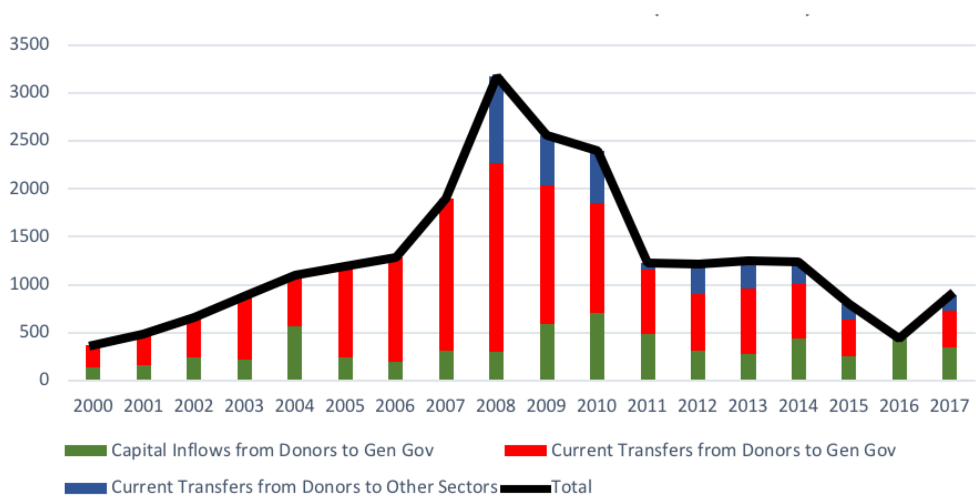
46 Prior to 2015, the PEGASE action documents relied on the following assumption: all actions under this special measure require that no additional restrictions are imposed by the Israeli Government.

47 European Court of Auditors, European Union Direct Financial Support to the Palestinian Authority, 2013, p.33, https://www.eca.europa.eu/Lists/ECADocuments/SR13_14/SR13_14_EN.pdf

fiscal losses and leakages taking place within the clearance system.[48] These represent a dramatic annual fiscal loss for the PA, amounting to approximatively 567 million US dollars for the year 2015. The inappropriate revenue sharing mechanisms laid down by the Paris Protocol prevents the PA from fully collecting legitimate VAT, purchase tax, and import taxes. This fiscal atrophy counteracts EU efforts to build robust institutions in Palestinian territories and favour social inclusion. Moreover, two other crucial observations need to be acknowledged. First, external donors, including the EU, are reducing their financial support, while the PA's fiscal situation remains unsustainable and is even worsening (see figure 2). Second, the increasing focus on PA's internal reforms does not bring substantial results in spite of the consistent narrowing of the PA's deficit-to-GDP ratio. Thus, in light of all the aforementioned elements, it is rational and urgent to tie the Palestinian fiscal situation to the clearance system functioning.

FIGURE 2. DECLINING TREND FOR DONORS AID IN THE OPTS

Donors Aid from 2000 to 2017 (million, $)



SOURCE: PALESTINIAN MONETARY AUTHORITY

The responses provided by the Commission and EEAS services to the criticisms found in the ECA report are quite illustrative of the current PEGASE approach. From 2008 to 2010, one of the PEGASE component, called Support for essential public services (SEPS), insured the delivery of fuel for the Gaza power plant at a cost of EUR 183,8 million.[49] Half of the PEGASE funding for fuel purchase was spent on VAT and excise duties. The ECA criticized the Commission on the grounds that the latter was unable to determine how far this amount was refunded to the PA by the GoI through the clearance mechanism. In response to this criticism, the Commission explained that "the issue of VAT and other taxes on fuel delivery with Israel extends much further than PEGASE and is part of an overall issue in relations between the EU and Israel."[50] It further admitted that this situation was one of a number of factors which led to the Commission ceasing to finance fuel deliveries. Moreover, as previously mentioned, the ECA criticized the Commission's overall approach with the GoI in the context of PEGASE due to its incapacity to bring Israel to take necessary steps to ensure the effectiveness of this EU program. The Commission and EEAS services responded that Israeli cooperation was actively requested, notably through numerous meetings with the Israeli Ministry of Defence. Nonetheless, these EU bodies acknowledged that effectiveness of such demarches could be

48 In November 2019, the multiannual PEGASE action plan 2018-2019 was amended. Due to the aggravated PA's fiscal situation, the document mentioned for the first time the need for "enhanced policy dialogue around fiscal leakages and Paris Protocol issues" (p.8).

49 European Court of Auditors, European Union Direct Financial Support to the Palestinian Authority 2013, p.27

50 European Court of Auditors, European Union Direct Financial Support to the Palestinian Authority, 2013, p.60

enhanced by involving the Member States more consistently on the matter.[51]

The answers provided by the Commission and EEAS are quite useful to grasp more precisely PEGASE's approach. It appears that PEGASE is only circumscribed to relief operations with low-political content, namely ensuring cash transfers to the poorest Palestinian households, financing PA's administration or protecting the access to quality health services to the Palestinian population. The Commission's decision to cease the financing of fuel deliveries to the oPt partially due to the high-political tensions around the fuel taxing rights further evidences the propensity to depoliticise PEGASE. Furthermore, even though the lack of Israeli cooperation is acknowledged, it never translates into a fundamental assumption from which the EU program could be shaped. This logic can be understood as a way to avoid highly political confrontations and maximise impact where it can be quickly achieved. Moreover, it partially fulfils PEGASE's mandate because the program effectively provides precious financial assistance and enables access to essential services to the Palestinian population, thereby trying to *leave no one behind*.

However, this logic does not fully address PEGASE's mandate and the deterioration of PA's fiscal situation strongly undermines the already precarious Commission's logic. First, as evidenced throughout the paper, despite the clear relevance of this EU program for the PA and the Palestinian people, the low-political and short-term nature of PEGASE prevents it from durably favouring *statehood* and enabling *inclusive social development* in the oPt. At most, this strategy, followed by other major international organisations such as the World Bank, could sustain the status-quo and avoid the collapse of the PA. However, the recent years have witnessed a gradual deterioration of PA's fiscal situation which almost collapsed last year after the Martyrs Fund crisis. The heavy financial consequences of last year's crisis, in conjunction with a continued donor fatigue, are going to intensify the unsustainability of Palestinian public finances and more generally further push the PA to the hedge. The current development approach adopted by major international organisations, including the EU, has become unsustainable as well and should be fundamentally revised.

Part III: Policy recommendations

The European Joint Strategy in support of Palestine 2017-2020 as a starting point

The European Joint Strategy in support of Palestine 2017-2020 aims at providing a framework through which European development partners can support the oPt and address the key developmental and political challenges facing these territories. Before setting out the areas of intervention and priorities, this EU strategic document brings out crucial observations about the Palestinian development context which should be further operationalised.

First and foremost, it is acknowledged that the Israeli occupation is the primary driver of poverty in Palestine with the limitations and restrictions that are imposed, notably through the transfer of tax revenues.[52] In addition to this, the continued occupation is explicitly held responsible for the de-development dynamic taking place in the oPt and the increasing need for relief type activities.[53] Regarding the EU's cooperation with these territories, there is a recognition that the results are mixed and that donors "have to a certain extent contributed to the management of the conflict rather than to the achievement of a lasting and

51 European Court of Auditors, European Union Direct Financial Support to the Palestinian Authority, 2013, p.61

52 European Joint Strategy in support of Palestine 2017-2020, p.24. https://ec.europa.eu/neighbourhood-enlargement/sites/near/

53 European Joint Strategy in support of Palestine 2017-2020, p.42

inclusive solution."[54] More importantly, the Joint Strategy document stresses that the insufficient European political response strongly limits EU's capacity to bring long-term development solutions.[55] On the basis of recommendations of the 2014 Final Report *Evaluation of the EU's Cooperation with the occupied Palestinian territory and support to the Palestinian people,* the document calls for a more decisive cooperation which incorporate complementary and effective political track involving Israel, a process referred as "triangulation."[56]

However, this legitimate and critical assessment of EU's cooperation with the oPt has not translated into a tangible course of action. Surprisingly, at the end of the Joint Strategy document, several areas of action were identified for the European development partners, including fiscal consolidation. Apart from promoting PFM reforms, expenditure cuts and revenue increases, the document did not provide any recommendations to address PA's fiscal losses arising from the clearance system and the repeated breaches of the Paris Protocol committed by the GoI. Furthermore, as evidenced earlier, the 2018-2020 PEGASE action plan deviated even further from the critical assessment found in the European Joint Strategy and maintained the conflict management approach. More generally, it deviates from key EU principles laid down in Article 21 of the Treaty of the European Union, "the Union's action on the international scene shall be guided by the principles which have inspired its own creation (...): democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity."

Adding political wings to PEGASE

The context of the oPt demands to find a complex equilibrium between political pressures and effective delivery of help. In other terms, a new PEGASE developmental approach should address structural issues through politicisation processes (long-term objectives) while avoiding strong confrontations with the GoI which could hamper the provision of essential services to the Palestinian population (short-term objectives).

As a first step, the assumptions structuring PEGASE action documents should be modified in order to prepare a more fertile conceptual framework for politicisation processes. It should be first acknowledged that the Israeli occupation is the primary driver of fiscal unsustainability in Palestine and therefore recognise PA's internal reforms will not be sufficient to stabilise the Palestinian fiscal situation. Secondly, the assumption that "the Government of Israel respects its Oslo/Paris agreements' commitments, notably in terms of transfer of clearance revenues, and does not impose further restrictions" should be removed. The repeated breaches of the Paris Protocol are extensively documented, and the recent freezing of PA's clearance revenues last year further evidences the irrelevance of this assumption. As a consequence of the two first elements, triangulation, namely a complementary and effective political track involving Israel, should be mentioned as a necessary condition to fulfil PEGASE objectives, and thus tying EU co-operation effectiveness in Palestine directly to Israeli actions. Moreover, it should be acknowledged that the inappropriate revenue sharing mechanisms laid down by the Paris Protocol prevents the PA from fully collecting legitimate VAT, purchase tax, and import taxes and creates a situation of fiscal atrophy. Eventually, the donor fatigue context should be recognised, accentuating the need for long-term solutions.

TABLE 4. PROPOSAL OF NEW ASSUMPTIONS FOR THE NEXT PEGASE ACTION PLAN

Current PEGASE Assumptions	Adjusted PEGASE Assumptions
The two-State solution remains the political aim supported by international peace building initiatives;	No further significant deterioration of the current political and security context;
No further significant deterioration of the current political and security context;	The Palestinian Authority continues to be committed to its statehood agenda and the reconciliation process;

The Palestinian Authority continues to be committed to its statehood agenda and the reconciliation process;	The Palestinian Authority remains committed to implementing the NPA strategy and related sector reforms;
The Palestinian Authority remains committed to implementing the NPA strategy and related sector reforms;	Israeli occupation is the primary driver of fiscal unsustainability in Palestine and thus Palestinian Authority's internal reforms will not be sufficient to stabilise the Palestinian fiscal situation;
Human resources and technical capacity to implement reforms are available;	The Government of Israel does not respect its Oslo/Paris agreements' commitments and uses the clearance revenue as a political pressure instrument;
The Government of Israel respects its Oslo/Paris agreements' commitments, notably in terms of transfer of clearance revenues, and does not impose further restrictions.	EU co-operation effectiveness in Palestine needs to be tied directly to Israeli actions;
	The revenue sharing arrangement under the Paris Protocol is malfunctioning and prevents the Palestinian Authority from fully collecting legitimate VAT, purchase tax, and import taxes;
	The context of donor fatigue is increasingly evident and accentuates the need for long-term solution.

More importantly, the second step consists of deploying concrete policy measures to rapidly tackle structural issues. A potential way forward could involve the integration of a new program within PEGASE that addresses the inappropriate revenue sharing mechanisms laid down by the Paris Protocol. This program would be composed of different policy measures which would subtly increment the political content of PEGASE programs and operate the shift towards a long-term solving approach. Here are several suggestions:

- asking EU officials to write an annual report which estimates the annual fiscal losses/leakages for the PA under the Paris Protocol
- finance a joint electronic system for VAT and customs between the PA and the GoI (without accepting the terms of the GoI which condition the use of such a system on Palestine's acceptance of a process by which goods destined for Palestine must enter through specified Israeli commercial crossings in the West Bank)
- establish an EU task force dealing with smuggling and fraud across the border which would partner with the Joint Economic Committee (JEC) in order to foster the revival of this institution (neglected by the GoI) and produce recommendations
- persuade Israel to lower the 3% handling fee on the clearance of revenues and to establish a monetary cap on the handling fee that is commensurate with the service provided by the Government of Israel

In addition to this, the EU should also tackle the regressive components of the Palestinian tax system in order to foster fiscal resilience and social justice in the oPt. Furthermore, direct taxation and tax exemptions are policy areas that do not depend on Israeli cooperation and thus significant results could be rapidly delivered. In 2018, different reforms were proposed by the Ministry of Finance and Planning to enhance tax progressivity, including the restoration of the top income tax bracket of 20 percent and the reduction of the CIT from 15 percent to 10 percent for SMEs with a net annual income inferior to NIS 3,500,000.[57] Nonetheless, these measures have not been implemented so far. Therefore, the EU should also use incentive-

57 Fair Tax Monitor Report, 2018, p.18.

based allocations in PEGASE to enhance tax progressivity in the oPt and push the PA to accelerate its pace of reforms in this regard. The following objectives, based on the results of the 2018 Fair Tax Monitor Report, could guide EU incentive-based allocations:

- increase the contribution of the CIT and the PIT to total tax revenues in order to decrease PA's dependency on indirect taxes and de facto the clearance mechanism
- increase the number of tax brackets to ensure better social equity and capture more revenue
- raise marginal tax rates on the personal income of high-income categories and for investment activities and reduce tax rates for low-incomes and SMEs
- redesign tax incentives to target fewer large investments and more SMEs, which account for more than 95 percent of businesses
- establish regular cost-benefit analysis on tax incentives to empirically assess their contribution to economic growth, labour and development
- review the current tax base to include non-traditional activities and non-productive and non-value-added activities that generate high and rapid profits, such as real estate transactions and speculations in financial market

Epilogue

As part of the coalition agreement between Likud party and Defense Minister Benny Gantz's Blue and White party, Benjamin Netanyahu pledged to annex parts of the occupied West Bank on 25 May 2020 starting as soon as July 1. As a response, Mahmoud Abbas declared that the Palestinian Authority is no longer bound by accords with Israel and the United States. The aim of this epilogue is to assess the potential impacts of this announcement on the paper's recommendations.

Concerning the PA's reaction, it is not the first time Abbas has threatened to terminate agreements with Israel, and it is unclear whether his declaration would be implemented or have any practical effect. With respect to the annexation, there are strong chances that it will take place. The growing uncertainty about Trump's re-election as well as the weak reactions from the rest of the international community constitute a favourable context for imminent annexation moves. The key question is more about whether or not the Israeli expansion will be implemented in the context of Trump's peace plan, or any other peace agreements. So far, it seems unlikely that the annexation moves would be accompanied with peace talks given the current political context. Even if it does, the renewed peace process could take years as evidenced by the Trump's peace plan which proposes a four-year negotiation window.

In light of the previous paragraph, it is likely that the annexation moves will not fundamentally disrupt the current structure organising economic and trade relationships between Israel and the Palestinian territories. Thus, the policy issues, including the ones related to the Paris Protocol, mentioned in the policy paper will remain relevant. However, in the case of significant changes with respect to the economic and trade structure, for instance the end of the Paris Protocol, the paper could still serve as a basis to negotiate better economic and trade terms for the Palestinians *vis-à-vis* Israel.

Eventually, the imminent annexation moves once again highlight the current impossibility to establish a political dialogue with the GoI based on international law which would uphold Palestinian fundamental rights. This factual observation should guide EU's position *vis-à-vis* Israel and the oPt. The paper provides different policy recommendations which could initiate this repositioning and build, to a very limited extent, the conditions for the protection of Palestinian fundamental rights and viable socio-economic development. Thus, these recommendations remain relevant, but the timing of implementation has been tightened by the imminent annexation moves. Therefore, the next PEGASE Direct Financial Support programme should rapidly integrate these recommendations and more importantly complement them with more confrontational measures vis-à-vis the GoI.

Annex 1: Alternative estimations of fiscal losses and fiscal leakages under the Paris Protocol for the PA

FIGURE 1. SUM OF FISCAL LEAKAGES AND FISCAL LOSSES FOR THE YEAR 2014 (WORLD BANK METHODOLOGY)

Fiscal leakages/Fiscal losses	**2014 ($, million)**
Evasion of import taxes	103,7
Undervaluation of imports from third countries	53
Leakages through indirect imports	30.6
Inappropriate handling fees	50,4
Sum	237,7

FIGURE 2. SUM OF FISCAL LEAKAGES AND FISCAL LOSSES FOR THE YEAR 2017 (PALESTINIAN AUTHORITY METHODOLOGY)

Fiscal leakages/Fiscal losses	**2015 ($, million)**
Evasion of import taxes	120
Leakages through indirect imports	31
Inappropriate handling fees	55
Handling fees fuel	26
Sum	232

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