Fiscal Challenges and Long Term Economic Costs

Economic Monitoring Report to the Ad Hoc Liaison Committee

March 19, 2013

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Acronyms

AHLC	*Ad Hoc* Liaison Committee
GDP	Gross Domestic Product
GoI	Government of Israel
IEC	Israel Electric Corporation
IMF	International Monetary Fund
IT	Information Technology
MENA	Middle East and North Africa
MoF	Ministry of Finance
MoH	Ministry of Health
NGOs	Non-Governmental Organizations
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PIF	Palestine Investment Fund
PMA	Palestine Monetary Authority
Q1/3	First / Third Quarter
USAID	United States Agency for International Development
VAT	Value Added Tax
WDR	World Development Report

Executive Summary

Recent reports to the *Ad Hoc* Liaison Committee (AHLC) have repeatedly noted the necessity of both sustainable economic growth and effective institutions as the underpinning of a viable state. The substantial achievements of the Palestinian Authority (PA) on institution building have been the subject of considerable analysis and reporting to this forum. Indeed these institutions have played a crucial role in enabling the positive economic growth in the Palestinian Territories in recent years. Yet prospects for sustainable economic growth remain constrained.

With the current economic slowdown, measures to increase tax revenues handicapped by external constraints, most notably Israeli restrictions[1], and any further increase in the PA's borrowing from local commercial banks considered unsafe for the stability of the banking sector, the provision of basic services by the PA is increasingly affected and there is a risk that gains in institution building may be eroded. Moreover, it is important to recognize that the fiscal challenges faced by the PA, coupled with a protracted stalemate in the political process, have negative impacts not only on short term economic growth, but also the competitiveness of the Palestinian economy over the longer term.

Following robust GDP growth in recent years, economic activity significantly slowed in 2012. This slowdown reflects in part the absence of further easing of Israeli restrictions, the withdrawal of fiscal stimulus due to a persistent shortfall in donor aid, and uncertainty created by the PA's fiscal challenges. Despite the fiscal stress, the PA has continued its reform efforts. Notable efforts include modernization of revenue administration, initiating rationalization of health sector spending, containment of the civil service wage bill within the budget target, improving efficiency and transparency of cash transfer program and public procurement system, and satisfactory performance of the banking sector.

Continued financial support by the donor community and reform efforts by the PA are therefore essential to manage the financing shortfalls of today. However, much greater attention must be given to the removal of obstacles to allow real Palestinian private sector-led growth. The Oslo Accords of 1993 anticipated an arrangement that would last for a five-year interim period during which a permanent agreement would be negotiated. They did not anticipate the lack of forward movement on the political process that has been experienced with its concomitant economic effects. This so called *status quo* belies a process whereby the continuation of restrictions and the absence of real opportunities to open up the Palestinian economy are actually having a lasting negative impact on its overall competitiveness. While some of the costs imposed by the current situation are transitory and could be expected to disappear with a peace agreement, others are posed to remain and are likely to require significant time and financial resources to be remedied.

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

The growth potential of a small economy depends to a large extent on its capacity to compete in global markets – yet, since 1994, the Palestinian economy has been steadily losing this capacity. In particular, the manufacturing sector, one of the key drivers of export-led growth, has largely stagnated between 1994 and the present and its share of Gross Domestic Product (GDP) has declined substantially. In the meantime, the agriculture sector has doubled its employment but sector productivity was roughly halved.

The share of exports of goods in the Palestinian economy, at around 7 percent in 2011 (from around 10 percent in 1996), is among the lowest in the world. Moreover, Palestinian exports are highly concentrated in low value added goods and services and they are exported to only a small number of countries, with more than 85 percent of them heading to Israel. Even with the removal of exogenous restrictions, the Palestinian economy is ill-positioned to benefit quickly and sufficiently from export opportunities and adjustments would require significant resources and time.

With low labor force participation and high rates and duration of unemployment, many Palestinians of working age do not have the opportunity to develop on-the-job skills. Furthermore, the concentration of the labor force in small enterprises for trade and services is not conducive to the development of skills that would render Palestinian workers competitive in the global economy. The growth in public sector employment has supported job creation but is not a sustainable solution in the medium and long term. The worrisome implication of these phenomena is that the long term employability prospects for the Palestinian labor force are being eroded. In addition to the economic implications, protracted unemployment, especially among youth, tends to weaken social cohesion.

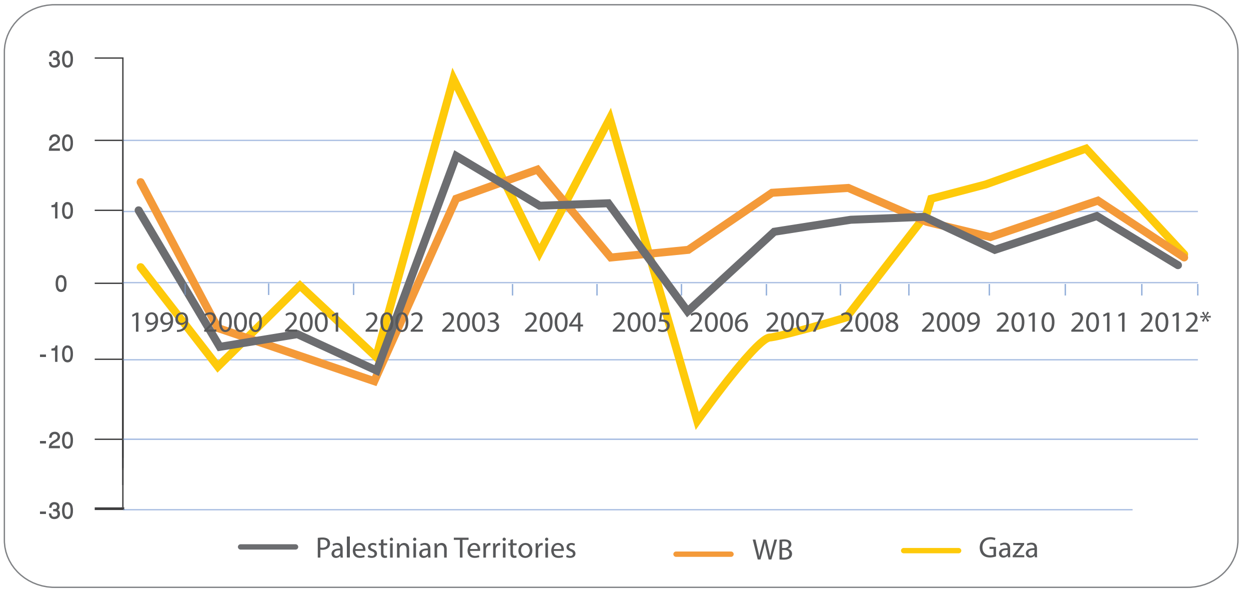
Poor performance of infrastructure sectors has also had a negative impact on the competitiveness of the Palestinian economy. The PA's worsening fiscal space for infrastructure spending has severely constrained the accumulation and management of physical infrastructure despite contributions from development partners. Restrictions on movement and access have also led to the deterioration of the quality of infrastructure as evidenced in various sectors such as water, transport, and telecommunications, with its negative impact most significant in Gaza.

In conclusion, continued financial support by the donor community, and increased reform efforts by the PA to manage the current fiscal challenges must remain a high priority. However, much bolder efforts to create the basis for a viable economy need to be made to prevent the continued deterioration that will have lasting and costly implications to economic competiveness.

A. Recent Economic Developments

1. **Following robust GDP growth in recent years, economic activity in the Palestinian Territories significantly slowed in 2012.** According to the Palestinian Central Bureau of Statistics (PCBS), real GDP growth for the first three quarters of 2012 was 6.1 percent down from an average of 11 percent in 2010 and 2011. The declining trend was witnessed in both the West Bank and Gaza. For instance, Gaza's economy was growing at an average rate of 15 percent between 2010 and 2011. However, growth dropped to 7.7 percent in the first three quarters of 2012. In the West Bank, real GDP growth averaged 9 percent between 2010 and 2011, but it declined to 5.5 percent during the first three quarters of 2012.

Figure 1: Real GDP growth rate 1999-2012



* Based on preliminary data for the first three quarters of 2012. Source: PCBS, National Accounts Data.

2. **The slowdown in growth in the West Bank during the first three quarters of 2012 reflects the absence of further easing of Israeli restrictions, the withdrawal of fiscal stimulus due a persistent shortfall in donor aid, and uncertainty created by the PA's fiscal stress.** In addition, the global economic slowdown, particularly in Israel, contributed to the declining trend in the West Bank. The public administration and defence sector, a key contributor to West Bank growth in 2011, shrank by 1 percent in the first three quarters of 2012 as a consequence of continued fiscal retrenchment. Construction output declined by 7 percent in 2012 because of the increasing amount of PA arrears to local contractors. Tradable sectors continue to be constrained by Israeli restrictions and therefore most of the recent West Bank growth resulted from an expansion of services. The services sector grew by 11 percent and contributed around 2 percentage points to the 5.5 percent growth in the West Bank during the first three quarters of 2012. The wholesale and retail trade sector expanded by 9 percent and accounted for more than 1.3 percentage points of West Bank growth in the same period.

3. **The decline in Gaza's growth in the first three quarters of 2012 is mainly attributed to the waning of the rebound effect and to a significant decline in the agriculture and fishing sector while the construction sector continues to grow, albeit at a slower pace.** The high growth rate in 2010 and 2011 reflected the low base from which it had rebounded and could be attributed to a combination of higher aid inflows, the easing of restrictions on entry of goods from Israel, and increased purchases through tunnels from Egypt. In the first three quarters of 2012, the rebound effect started to fade and the agriculture and fishing sector shrank by more than 37 percent when compared to the same period in 2011, offsetting much of the growth witnessed in other sectors. Farmers in Gaza cite unfavorable weather conditions and irregular water supply caused by frequent electricity blackouts as the main reasons behind the decline in agricultural output. The wholesale and retail trade sector in Gaza also declined by 3 percent in the first three quarters of 2012, reflecting a decrease in the output of the agriculture and manufacturing sectors. Most of the recent growth in Gaza was driven by the construction sector which expanded by 39 percent contributing almost 8 percentage points to Gaza's growth in the first three quarters of 2012. The construction sector continued to expand mainly as a result of the relaxation of the import restrictions by the GoI in 2010 and the increase in purchases of construction materials from Egypt through the tunnels. The services sector also contributed around 2 percentage points to Gaza's growth in the first three quarters of 2012 as it grew by 9 percent when compared to the same period in 2011.

Table 1: Contribution to GDP growth by economic activity, January-September 2012

Economic Activity	Palestinian Territories	West Bank	Gaza
Agriculture, Forestry and Fishing	-0.58	0.38	-3.31
Mining, Manufacturing, Electricity and Water	0.36	0.38	0.31
Manufacturing	0.17	0.26	-0.09
Electricity, Gas, Steam and Air Conditioning Supply	0.12	0.02	0.39
Construction	1.30	-0.89	7.53
Wholesale and Retail Trade	0.91	1.33	-0.31
Transportation and Storage	0.15	0.05	0.44
Financial and Insurance Activities	0.10	0.08	0.15
Information and Communication	0.42	0.56	0.02
Services	1.92	1.78	2.33
Accommodation and Food Service Activities	0.15	0.14	0.17
Public Administration and Defense	0.00	-0.06	0.19
Households with Employed Persons	0.00	-0.01	0.00
Financial Intermediation Services Indirectly Measured	-0.14	-0.15	-0.12
Customs Duties	0.53	0.70	0.05
VAT on Imports, net	1.09	1.32	0.44
Real GDP Growth Rate (%)	**6.06**	**5.48**	**7.70**

Source: PCBS and World Bank staff calculations.

4. **The World Bank estimates that growth in the fourth quarter remained approximately unchanged from that in the third quarter, while a further slowdown is expected in 2013.** While the official estimates by PCBS for the annual growth rate in 2012 are not available yet, Bank estimates put the overall growth in the Palestinian Territories at around 6 percent. A further slowdown in economic activity is expected in 2013, whereby the overall growth rate is projected to decline to 5.0 percent; 4.7 percent in the West Bank and 6.0 percent in Gaza. [2] This projection assumes no significant easing in movement and access restrictions within the Palestinian Territories. Controls on imports as well as exports are expected to be eased only modestly, and it is assumed that no significant easing of restrictions on economic activity in Area C will be made during 2013[3]. These restrictions pose a binding constraint to tradable sector growth and consequently to private sector-led growth. As foreign aid to the public sector is not expected to increase enough to offset the impact of restrictions on private sector growth, and space for new domestic borrowing is highly constrained, fiscal contraction is expected to cause growth to slow further.

5. **Unemployment in the Palestinian Territories continues to be alarmingly high with low labor force participation rates in both the West Bank and Gaza.** When compared to Q4 2011, the overall unemployment rate increased by 2 percentage points to reach 22.9 percent in Q4 2012. In the West Bank, unemployment increased to 18.3 percent even though the labor force participation rate decreased from 47.3 to 46.1 between Q4 2011 and Q4 2012. Gaza's unemployment rate continued to be amongst the highest in the world at around 32.2 percent in Q4 2012, up from 30.3 percent in Q4 2011. The labor force participation rate in Gaza slightly increased from 39.5 percent to 40.0 percent during the same period.

6. **Youth unemployment continues to pose a serious concern**. In the West Bank, only 40.3 percent of young Palestinians aged 15-29 were active participants in the labor force in Q4 2012, and 27.9 percent of those were unemployed. In Gaza, the youth unemployment rate was 48.9 percent with a participation rate of 34.2 percent. These figures indicate that Palestinian youth is highly discouraged from joining the labor force because of the lack of opportunities. For example, prior to the year 2000 when the second Intifada broke out, a large portion of Palestinian youth was employed in Israel as the latter's share in Palestinian Territories employment was around 21 percent. Nevertheless, since the breakout of the second Intifada, Israel's share in employment has declined to 12 percent[4].

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[2] These projections are prepared by the IMF in consultation with the World Bank, PCBS, and the PA.

[3] The 1995 Interim Agreement between the Palestine Liberation Organization (PLO) and the GoI defined Area C as "areas of the West Bank outside Areas A and B, which, except for the issues that will be negotiated in the permanent status negotiations, will be gradually transferred to Palestinian jurisdiction in accordance with this Agreement."

[4] This figure mainly includes workers from the West Bank as the number of Gaza workers allowed into Israel has remained insignificant since 2001.

Table 2: Labor force statistics, Q4 2012

	Palestinian Territories	WB	Gaza
Unemployment Rate	22.9	18.3	32.2
Underemployment	5.7	5.0	7.1
Labor Force Participation Rate	43.9	46.1	40.0
Youth Unemployment (Ages 15-29)	35.1	27.9	48.9
Youth Labor Force Participation	38.0	40.3	34.2

Source: PCBS Labor Force Survey.

7. **Looking ahead, the risk for high unemployment in the Palestinian Territories remains significant**. Private investment is unlikely to increase substantially given the ongoing Israeli constraints on trade, movement and access[5], and investment in Area C[6]. Consequently, the private sector will not be able to generate sufficient job opportunities to absorb increasing number of job seekers, including new labor market entrants. The public sector has been the employer of last resort; it employed around 22.9 percent of those in the labor force in 2012: 38 percent in Gaza and 16.3 in the West Bank. Nevertheless, its ability to generate more jobs is expected to significantly decrease given the PA's financial stress and the already large size of the public sector work force.

B. Fiscal Developments, 2012

8. **The PA's fiscal stress grew increasingly acute throughout 2012**. This is mainly due to higher than expected expenditures, lower than anticipated revenues, and a persistent shortfall in donor funding. Donor assistance for budget support has continued to decline since 2008 while the PA's needs for external support have not adjusted at the same pace. Total revenues were 6 percent lower than budget, while total expenditures and net lending were 12 percent higher than their forecasts in 2012. Consequently, the year-end recurrent deficit was 55 percent above its budget target amounting to NIS 5.6 billion (US$1.46 billion). The PA's development expenditures were NIS937 million (US$243 million). Thus, the total deficit including recurrent and development spending totaled NIS6.54 billion (US$1.7 billion). However, total external support received was much lower at NIS3.59 billion (US$932 million). Donor support to finance the recurrent budget deficit and development projects were NIS826 million (US$214 million) and NIS539 million (US$140 million) less than anticipated, respectively. This led the PA to increase domestic bank borrowing and accumulate significant arrears mainly to its private suppliers and the pension system. The PA's fiscal difficulties also caused frequent delays in the disbursement of civil servants' monthly wages which have been paid in tranches since June 2012. This prompted civil servants to embark on regular strikes since late 2012, which has led to a decline in the quality of public

[5] The GoI cities overriding security concerns that restrict its ability to continue to ease or lift restrictions on the Palestinian Territories.

[6] The GoI states that recently 25 projects in Area C were approved, some of them through 'Fast Track route'.

service delivery. If the current situation persists, it may erode the capacity of the PA's public institutions and jeopardize gains previously achieved in institution building.

9. **The PA's domestic tax revenues for 2012 were 9 percent lower than budgeted, mainly because tax revenues were lower than their budget target** due to a highly optimistic revenue forecast and slower than expected implementation of some tax reforms, particularly those concerning VAT. VAT collections for 2012 slightly declined in comparison to 2011 even though the PA raised the VAT rate from 14.5 percent to 15 percent in September[7]. The rate increase did not generate enough tax receipts to make up for the low compliance by private businesses. Some companies have not been paying their tax obligations, especially VAT, to offset unpaid bills owed to them by the PA. Several tax reforms aimed at improving compliance are underway, but did not yielded enough results to affect tax collections in 2012.

10. **The PA adopted several measures to boost income tax receipts**, **which grew by 40 percent in 2012 compared to the previous year, exceeding budget projections**. Such measures include improving tax compliance and raising the income tax rate on higher income categories from 15 to 20 percent[8]. Advance income tax payments received under the new bracket helped boost tax revenues in 2012. The PA also made efforts to collect tax arrears and liabilities from the largest corporations. In addition, 15 leading private sector companies agreed to voluntarily give up all tax exemptions granted to them by the Investment Promotion Law for a period of two years (2012 – 2013). Despite the recent improvement in income tax receipts, their share of GDP stood only at 1.7 percent by the end of 2012, about half the share collected by other countries in the region at a similar level of development. Therefore, it is important that the PA accelerates efforts to increase tax revenues in 2013 including improving tax compliance, widening the tax base, and finalizing the organization structure and staffing of the Large Taxpayer Unit.

11. **Non tax receipts for 2012 were slightly below their target despite higher than expected investment profits from the Palestine Investment Fund (PIF)[9]**. The PA received NIS119 million (US$31 million) in investment profits from the PIF in July, which is 25 percent higher than the amount that was originally projected in the budget. The additional profits were not able to fully make up for the shortfall in other non-tax revenues such as domestic fees and charges.

[7] The PA raised its VAT rate following a similar hike that took place in Israel because according to the Paris Protocol, the difference between the VAT rate applied in the Palestinian Territories and that in Israel must not exceed two percentage points.

[8] In the beginning of 2012, a new income tax bracket of 20 percent was applied on high income categories earning more than NIS 125 thousand per year.

[9] PIF was established in 2003 as an independent investment company aiming to strengthen the local economy through strategic investments, while maximizing long-run returns for its ultimate shareholder; the people of Palestine.

Table 3: Palestinian Authority revenues 2012: actual vs. budget

Revenue item (NIS million)	2012 (actual)	Budget	Percentage difference between budget & actual figures
Total net revenues	**7989.4**	**8,493**	**-5.9**
Gross domestic revenues	2806.4	3,087	-9.1
Tax revenues	1852.0	2,124	-12.8
Non-tax revenues	954.4	963	-0.9
Clearance revenues	5617.0	5,859	-4.1
Tax refunds (-)	434.0	454	-4.4

Source: Palestinian Authority Ministry of Finance

12. **Clearance revenues were 4 percent lower than their budget target for 2012, as the latter was founded on the assumption of finalizing an agreement with the GoI, which failed to materialize.** However, standing at NIS 5.62 billion (US$1.46 billion), clearance revenues were 10 percent higher than in 2011. Customs, VAT and petroleum excise tax all increased by 10, 15, and 8 percent, respectively when compared to the previous year. The growth in clearance revenues is a positive achievement for the PA, which has made a strong effort to ensure that it receives the VAT receipts and import duties it is owed. However, further cooperation and information sharing between the PA and the GoI are necessary to reinforce compliance and reduce tax leakage. The exchange of letters that took place between the PA and the GoI in July 2012 to streamline clearance revenue procedures has so far not led to a final agreement. The GoI made advance payments on clearance revenues in 2012 to help facilitate the payment of PA wages[10]. However, in December, the GoI withheld the transfer of clearance revenues collected for November and used them to clear electricity arrears owed by the Jerusalem District Electricity Company (JDECO) to the Israeli Electric Corporation (IEC)[11]. Clearance revenues collected for December and January were each transferred after delays. Given the importance of clearance revenues as the PA's main source of income[12], continued delays in their transfer would further exacerbate the PA's precarious fiscal situation. Therefore, it is important that the two sides find a mutually agreeable schedule to settle these arrears.

13. **In 2012, total expenditures and net lending amounted to NIS13.6 billion (US$3.53 billion) exceeding the budget by 12 percent due to significant unbudgeted growth in non-wage expenditures and net lending.** Non-wage expenditures were 16.5 percent above their budget target because transfer payments such as pensions and payments to local governments were 20 percent above their target. Higher than expected transfers are mostly related to unbudgeted pension

[10] During 2012, the GoI made three advance payments on clearance revenues in the total amount of NIS 900 million, to facilitate the payment of wages. The first payment was made in July in the amount of NIS180 million. The second payment was made in September in the amount of NIS260 million. The last advance payment was made in November in the amount of NIS450 million. However, there is a dispute over these revenues as the PA does not consider them advance payments; rather tax receipts already collected by the GoI but not yet transferred.
[11] There is a dispute over the PA's liability for these arrears as some of the areas covered by JDECO are not under the PA's jurisdiction.
[12] Clearance revenues represented 70 percent of the PA's total revenues in 2012.

payments to retirees in the security sector. In order to offset the increase in transfer payments, the PA decided to delay any major spending under minor capital expenditure category which ended the year 67 percent below their target.

14. **Despite the adoption of several measures to rationalize them, operational expenditures were 15 percent above their year-end budget target mainly due to higher than forecasted health spending.** Since early 2012, the PA has withdrawn car privileges from all PA employees ranking below heads of institutions and their deputies, and has cancelled all international travel allowances. It has recently also limited contractual employment. Nevertheless, these measures to control operational spending were not enough to offset the unanticipated growth in health expenditures. The Ministry of Health (MoH) reports that the fastest growing spending item on its budget is outside treatment referrals. The high and increasing level of outside referrals is not fiscally sustainable. Therefore, the MoH has initiated reform efforts to improve the equity and efficiency of the overall referral system, which will require sustained attention. For instance, the referral process has already been formalized and centralized under the authority of the General Directorate for Health Insurance. Additionally, the Directorate now applies clear and stringent criteria to determine the eligibility for outside medical referrals.

15. **The PA succeeded in its efforts to keep the wage bill, which represents 50 percent of current expenditures, on its budget target.** Estimates show that its share of GDP dropped by 0.4 percent in 2012. The PA introduced a hiring and promotions freeze for 2012 starting on August 25th, which contributed to limiting the net growth of the public labor force to 1,165 employees in 2012. This figure is significantly lower than the 3,000 cap previously applied for the full year. Overall, PA employment in 2012 rose by 1,888 new hires in the West Bank and decreased by 689 in Gaza.[13] Notably, more than half of PA employment took place in the security sector where 590 new employees were added to the payroll in 2012. The remaining new hires were mainly recruited in the education and health sectors where 530 and 189 additional workers were added, respectively. The PA's financing difficulties during 2012 caused frequent delays in wage payments to civil servants who have been receiving their monthly salaries in tranches since last June. These difficulties intensified by the end of the year when the GoI suspended the transfer of clearance revenues, which caused the PA to exit 2012 without paying full salaries for November. The financing difficulties have continued in 2013 as salary payments to civil servants are still being delayed. In an effort to contain the growth of the wage bill during 2013, the Cabinet has recently issued a decree limiting net hiring to zero in 2013.

16. **On the other hand, the PA has not been able to regain control over net lending[14] which has consistently exceeded forecasts since late 2011.** By the end of 2012, net lending was 168 percent above its year-end budget target because the Palestinian electricity distribution companies and municipalities had been accumulating large arrears to the Israeli Electric Corporation (IEC). The Israeli MoF therefore made higher than anticipated deductions from clearance revenues in 2012 to clear some of these arrears. These deductions are recorded as 'net lending' in the PA's budget and

[13] In addition, net employment for permanent deputies, the Palestinian National Fund and the embassies decreased, by 34 employees.

[14] Net lending mostly includes payments by the central government for utility bills owed by municipalities.

it largely explains the recent jump in this budget item. Reasons behind the mounting electricity arrears in 2012 can mainly be attributed to an increase in the incidents of nonpayment among Palestinian consumers. Electricity prices in the Palestinian Territories were raised in early 2012 following a similar increase in Israel.[15] These price increases were also compounded with an overall slowdown in economic activity, and have both triggered a significant increase in nonpayment. The PA's difficult fiscal situation has also contributed to the increase in net lending. A large number of civil servants who have faced frequent delays in their salary payments since June 2012 have been accruing arrears on their electricity bills. In addition, the inability of the MoF to make regular transfers to municipalities due to its liquidity difficulty compelled municipalities to withhold some payments to IEC.

Table 4: Palestinian Authority expenditures 2012: actual vs. budget

Expenditure item (NIS million)	2012 (actual)	Budget	Percentage difference between budget & actual figures
Total expenditures & net lending	**13593.0**	**12,114**	**12.2**
Wage expenditures	6812.1	6,813	-0.01
Non-wage expenditures	5709.0	4,901	16.5
Operational expenditures	2257.4	1,959	15.2
Transfers	3425.6	2,864	19.6
Minor capital expenditures	25.9	78	-66.8
Net lending	1072.0	400	168.0

Source: Palestinian Authority Ministry of Finance

17. **The combination of lower than expected revenues, higher than budgeted expenditures and a shortfall in donor aid during 2012 led to significant arrears accumulation and unanticipated borrowing from local banks.** The balance of the PA's arrears, accumulated in 2012, amounted to NIS2.23 billion (US$578 million), mainly owed to civil servants, private suppliers and the pension system. The PA's financial difficulties forced it to end the year with only partial payment of the November wage bill (due in December); thus ending the year with of NIS272 million (US$71 million) in salary arrears. The PA also accumulated additional arrears to its private sector suppliers in 2012 in the amount of NIS741 million (US$192 million). This raises the total stock of private sector arrears accumulated since 2009 to more than US$0.6 billion. The PA acknowledges the toll that this exacts on the overall economy and it has recently been making efforts to prioritize payments to the private sector and has borrowed an additional US$185 million from commercial banks for this purpose. Consequently, the percentage of private sector arrears declined from 54 percent of overall arrears in Q1 2012 to 33 percent by the end of the year. On the other hand, the PA continued to accumulate large arrears to the pension system because it views this debt as a long term commitment and

[15] The power utilities in the Palestinian Territories passed through entirely the higher purchase price from Israel onto their customers by increasing the tariffs. Municipalities that continue to supply electricity have different tariff structures and it is unclear to what extent they raised tariffs, but it does not appear that the full cost increase was passed through to customers.

not a present priority. Preliminary estimates suggest that the value of accumulated pension arrears exceeds US$1.3 billion. Finally, as a result of additional borrowing, the PA's stock of local debt increased to NIS5.1 billion (US$1.4 billion) or 14 percent of GDP as of the end of 2012, up from NIS 4.2 billion (US$1.1 billion) in 2011.

C. Banking Sector Developments

18. **The Palestinian banking sector continues to be well regulated by the Palestine Monetary Authority (PMA).** The PMA aims to be a full-fledged central bank and has steadily built its institutional capabilities to achieve this goal. It has strong oversight over all banks operating in the Palestinian Territories and implements an Anti-Money Laundering law in line with international standards, with technical assistance from the IMF and USAID. The PA has recently passed a new payments law which enables the PMA to introduce a national centralised system for the automated settlement and clearance of financial transactions. This system will enable banks to provide modern e-banking services including e-signature which will reduce the cost and time of daily financial procedures.

19. **Despite the recent economic and fiscal downturn, the performance of the Palestinian banking sector has remained strong.** The year-on-year growth of the sector's net assets was 7.5 percent in December 2012. The continuous improvement in the financial market's infrastructure carried out by the PMA has enabled a rise in the private credit-to-deposit ratio from 30 percent at the end of 2010 to 38 percent in December 2012. However, the sector's overall loan-to-deposit ratio continues to be lower than in most countries at around 56 percent as of December 2012, reflecting high level of perceived systemic risk. By the end of 2012, the percentage of non-performing loans to total credit remained low at 3.3 percent.

20. **However, the PA's stock of debt to local banks has been on the rise since 2008 and is becoming a source of concern.** Domestic credit facilities to the PA were around US$0.5 billion in 2008. This figure, however, has risen to around US$1.4 billion as of December 2012 - about 14 percent of the sector's total assets and 112 percent of its equity. Credit to the public sector and PA employees, combined, represented around 50 percent of the sector's gross credit, as of December 2012.

21. **The PMA has been carefully monitoring risks associated with the banking sector's high exposure to the PA through quarterly stress tests according to Basel II principles.** These tests have been carried out on all banks operating in the Palestinian Territories since March 2011. The results are used to evaluate the banking system's resilience to numerous economic, political and concentration shocks that can lead to delay of loan instalments by the PA in addition to loan delinquency by PA employees and private businesses. These shocks are tested in 9 different combinations and the banking sector's capital adequacy is evaluated under each. The latest stress tests' results indicate that the banking system as a whole is resilient to a variety of shocks and is well capitalised with the Tier 1 capital as a ratio of risk weighted assets at 22.1 percent by the end of December 2012. The Tier 1 ratio fell close to the required minimum of 8 percent only under 2 extreme scenarios. The first scenario assumes that 40 percent of the PA's loan instalments will be delayed, and that 50 percent of

loans to PA employees and 20 percent of private sector loans will default, among other shocks. The second scenario assumes that 30 percent of private sector loans will default, 20 percent of deposits will be withdrawn from the banking system within one month, and the fair value of Palestinian investments inside and outside the Palestinian Territories will decrease by 25 percent. In order to further strengthen the resilience of the banking sector, the PMA has ordered some of the larger and more exposed banks to raise their capital, increase their risk reserves, and diversify their portfolios. Individual banks are also instructed by the PMA to perform their own semi-annual stress tests using bespoke scenarios tailored to the specific characteristics of each.

D. Long-Term Economic Costs

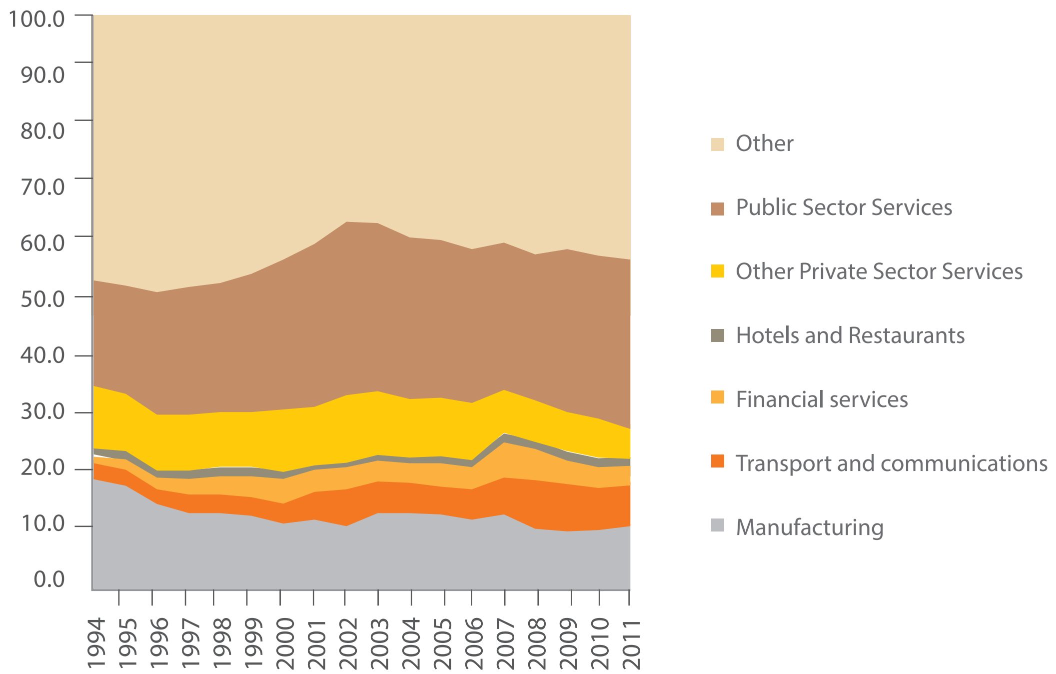
22. **While the PA is struggling to manage the current fiscal stress and donors are focusing on keeping the PA solvent to ensure the continued provision of services, it is important to recognize that a lack of progress on removing the multilayered system of restrictions has negative impacts not only on short term growth, but also the competitiveness of the Palestinian economy over the longer term.** While some of the costs imposed by the current situation are transitory and would disappear with a peace agreement along with other negative manifestations that affect the Palestinian Territories, others are posed to remain and are likely to require significant time and substantial financial resources to be remedied. Moreover, these costs are growing and will continue to do so until critical constraints for sustainable economic growth have finally been removed. The substantial amounts of financial assistance from the international community have been essential to mitigate the impact of those restrictions on the quality of life and stability in the Palestinian Territories, but aid cannot substitute for a poor business environment to unlock Palestinian growth potential. This section elaborates in more detail the nature and magnitude of the long term economic costs of the *status quo* on the structure of the Palestinian economy, its export competiveness, employability of the labor force, and the stock and quality of infrastructure.

I. Structure of the Economy

23. **The growth potential of a small economy depends to a large extent on its capacity to compete in global markets and increase the exports of goods and services, but the Palestinian economy has been losing this capacity.** The structure of the Palestinian economy has substantially deteriorated since the late 90's and current circumstances do not portend the return to strong and sustainable economic growth. In particular, the manufacturing sector, which is usually one of the key drivers of export-led growth, has largely stagnated between 1994 and the present. Its share in GDP has dropped from 19 percent in 1994 to 10 percent in 2011. To make things worse, the rapid decline in manufacturing has not been replaced by the growth of high value-added service exports such as Information Technology (IT) services and tourism. As Figure 2 below shows, over the period 1994 to 2011, there was some growth in the size of the transport and communications sector (which includes IT services), but almost entirely for the domestic market, and the growth in tourism, which is reflected in the hotel and restaurants sector, has been negligible despite its strong potential. Most service related growth was generated in the public sector, largely due to donor budget support.

24. **As the Figure 2 shows, in relative terms, most growth occurred in public sector services.** The share of public sector services in total output increased from 19 to 30 percent from 1994 to 2011. This has been clearly reflected in the quality and quantity of education, healthcare, social assistance, law and order and other services provided by the government. The problem is that the growth in public sector output and its capacity has not been accompanied by the expansion of sectors with potential to generate sustainable growth and revenues to continue the provision of those services over the medium and long term. Also, the current fiscal stress implies that any further expansion in the public sector is highly unlikely.

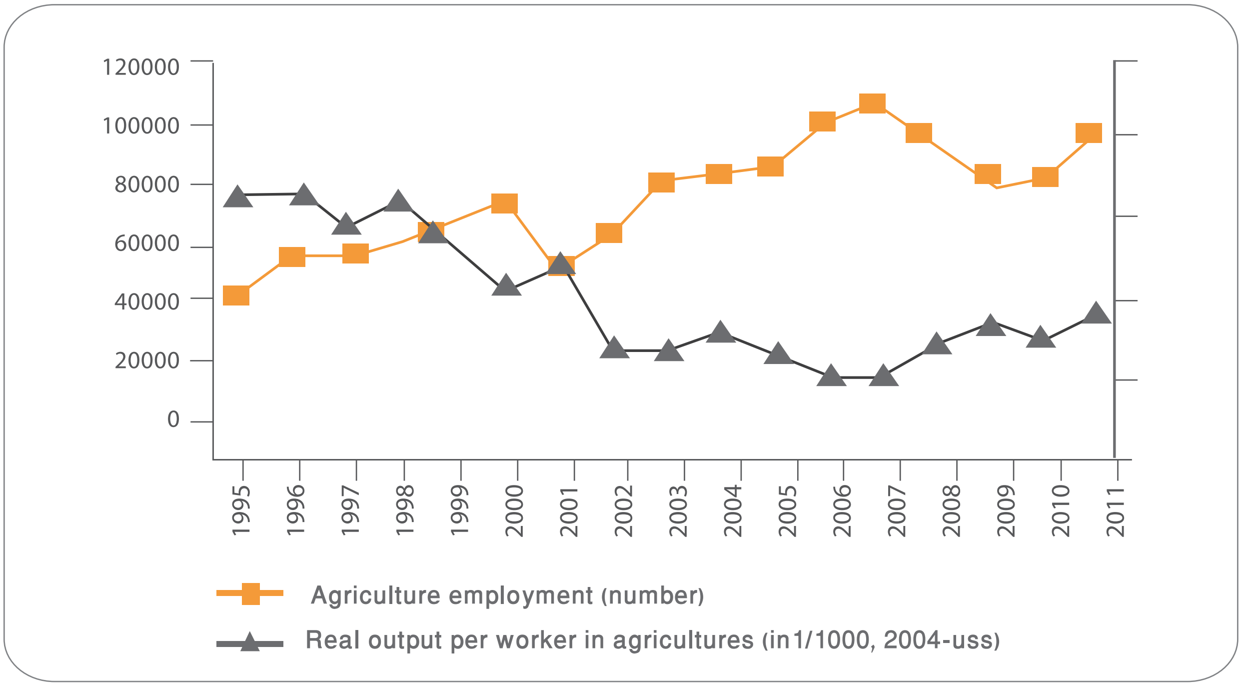
Figure 2: Changes in the structure of the Palestinian economy.



Source: Palestinian Central Bureau of Statistics, national accounts data.

25. **Another example of declining competitiveness lies within the agriculture sector.** Typically agriculture sector employment declines as a country develops and sector productivity increases, but the opposite has happened in the Palestinian Territories. Agriculture employment doubled between 1995 and 2011, increasing from 53,000 to 99,000 workers. At the same time, the share of the agriculture sector in the economy dropped from 13 percent to 6 percent. Agriculture sector productivity, measured by output per worker, was roughly cut in half over this period as Figure 3 below shows. As a result, the Palestinian economy depends to a very large degree on food imports, primarily from Israel while Israel, with similar climate and land quality, is able to meet most of its food needs from its own production.

Figure 3: Trends in agriculture employment and output per worker

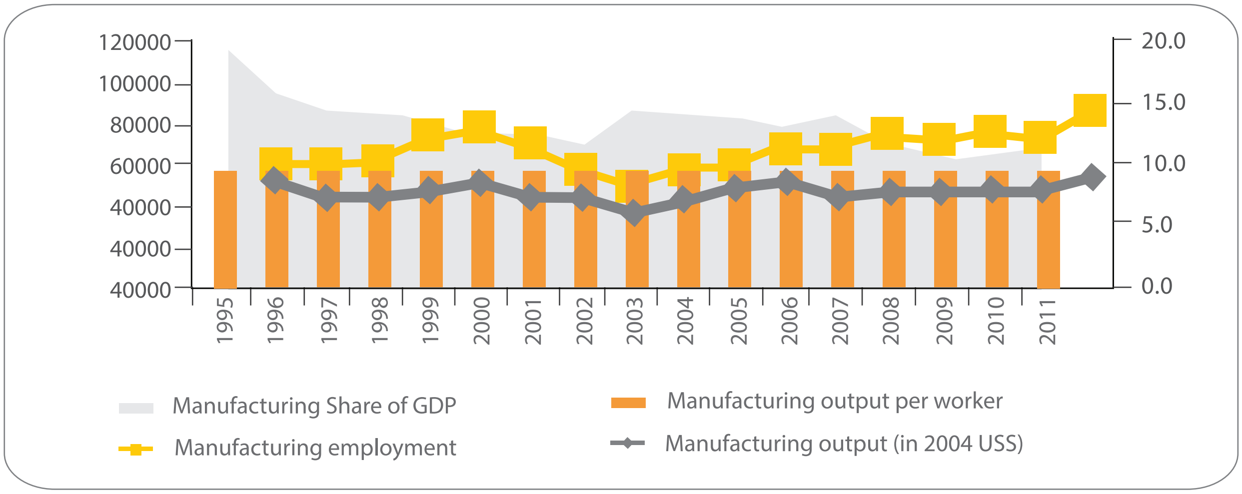


Source: World Bank Staff Calculation based on PCBS data

26. **Specifically, food exports are seven times smaller than the value of imported food products although food exports (at about US$100 million) make up a large share of total Palestinian exports (15 percent).** This should not be surprising: various restrictions on imports of agricultural inputs such as fertilizers, lack of access to water and infrastructure for irrigation, and restrictions on exports have resulted in highly inadequate investment in this sector. According to PCBS data, investments in essential agriculture machinery between 2000 and 2008 have been merely adequate to replace the retired old machinery. The agriculture employment and capital stock data clearly indicate that the competitiveness and productive capacity of the agriculture sector has been deteriorating continuously and it can be directly linked to protracted restrictions on imports of agricultural inputs (e.g. fertilizers), other trade restrictions and restrictions on access to land. The growth of sector employment merely may reflect the absence of better jobs elsewhere and the spread of subsistence agriculture, as a means of economic survival.

27. **As Figure 2 shows the Palestinian economy has also been deindustrialized over this period.** The share of manufacturing in GDP has dropped from 18 percent in 1995 to 11 percent in 2011. In real terms, manufacturing output remained largely stagnant over this period (Figure 4 below). Sector productivity, measured by output per worker, has also dropped slightly. With restrictions on imports of various technology, tools, and raw materials, the development of some industries within the manufacturing sector, such as metal processing, is nearly impossible. Consequently, manufactured products are mostly based on natural resource endowments with low value added, such as processed stone, low end furniture, packaging materials, ceramics, and other products characterized by the use of old technologies.

Figure 4: Recent evolution of the manufacturing sector: share in GDP, employment, and output



Source: World Bank staff calculations based on PCBS data

28. **Private investment, which is essential for maintaining competitiveness, has been low and much of it seems to have been channeled to the less productive non-tradable sector.** Private investment hovering at around 15 percent of GDP for the past seven years is very low compared to other fast growing economies and it has clearly not been adequate to put a dent in unemployment. Foreign Direct Investment (FDI) inflows, which are associated with productivity growth, averaged a mere 1 percent of GDP over the past 10 years. While a sectoral breakdown of private investment data is not easily obtainable, it is apparent that much of it is destined to less productive activities, in particular. in the non-tradable sector, such as internal trade activities, real estate development, etc. Investors make decisions that would be suboptimal if the Israeli restrictions on economic activity were not in place.

29. **An interesting case study is a pharmaceutical company, which decided to invest a significant share of its profits outside of its core business**. According to the company, growing the pharmaceutical business either to meet the demand in the local market, or in particular for the export market, has been made very difficult as a result of barriers to imports of technology and raw materials and barriers to export. To illustrate one of these barriers, obtaining a license from the Israeli Pharmaceutical Administration to import raw materials for drugs, requires as an initial step obtaining consent from a competing Israeli company that produces a similar drug and sells it to the Palestinian market.

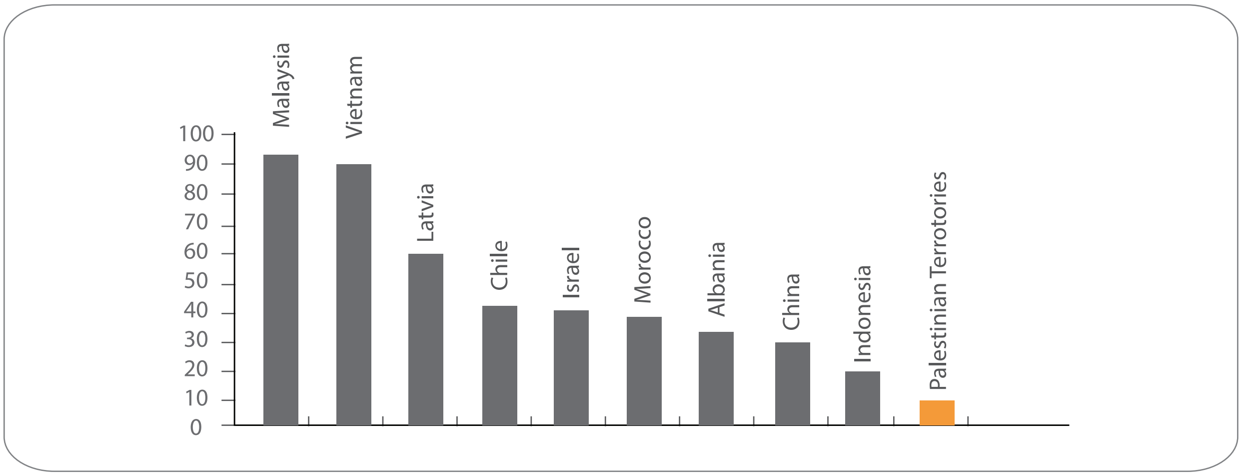
II. Exports Competitiveness

30. **With the decline of both the agriculture and manufacturing sectors, the Palestinian economy's capacity to export has deteriorated and this is evidenced in the size, structure, and the level of value added in its exports**. The share of exports of goods in the Palestinian economy has dropped from around 10 percent in 1996 to around seven percent in 2011 and this figure is among the lowest in the world. For the Palestinian economy, service exports are equally as significant as goods exports.

This is somewhat unusual and speaks more to the small size of goods exports rather than a strong performance in service exports. Goods and service exports together account for roughly 14 percent of GDP, which is in stark contrast with most fast growing economies, in particular small economies, whose share of exports to GDP is substantially higher (Figures 5 and 6 below).

Figure 5: Share of exports to GDP, a declining trend

Figure 6: Exports of goods and services in the Palestinian Territories compared to some fast-growing economics around the world (2011 data)



Sources: PCBS, World Bank databases.

31. **Furthermore, Palestinian exports are highly concentrated in low value added activities.** As Table 7 below shows, exports are dominated by commodities such as stone and primary agriculture products. The only significant technologically advanced exports are pharmaceuticals, but they only make up about 2 percent of total exports. Based on educational attainment, institutions quality, and endowments - all of which have been improving - one would expect to see a substantially higher level of technological sophistication in the Palestinian export sector. However, various restrictions on economic activity have gradually eroded the Palestinian capacity to export. While the data on

the structure of private investment is not available, it is evident from the export composition that little investment has been made to support exports and in particular manufacturing exports.

Table 5: The value and relative size of Palestinian major export product groups

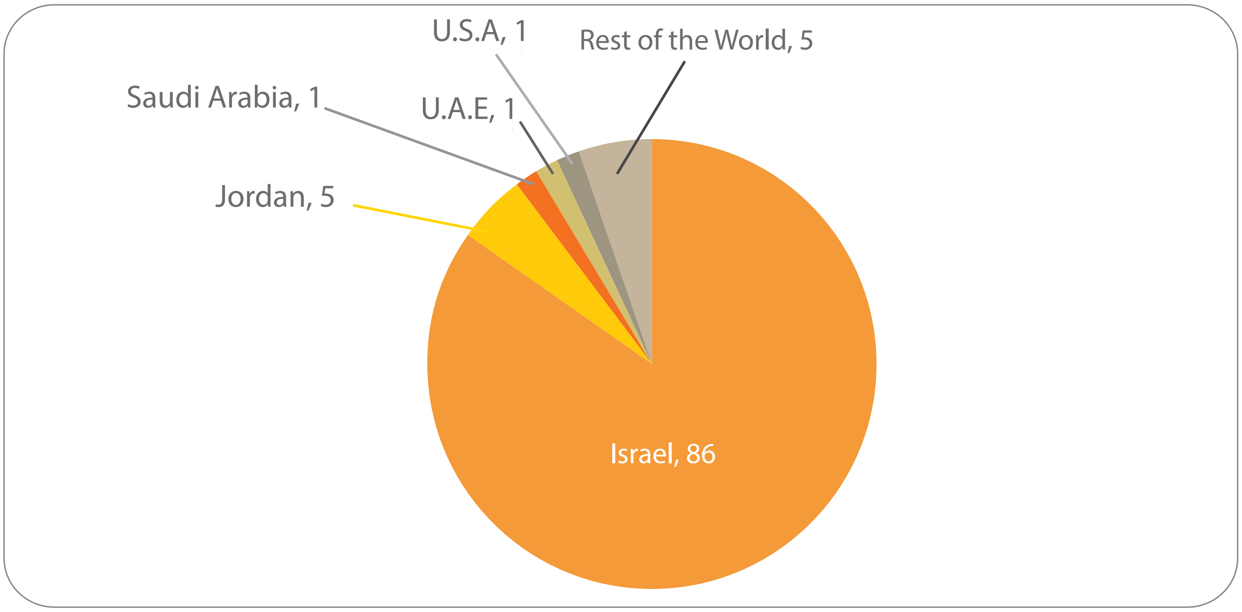
Description of Palestinian major export pruduct groups	Value (US$000)	Percent of total
Monumental or building stone (except slate), and articles with a flat or even surface.	92,146	12.8
Remelting scrap ingots of iron or steel.	56,915	7.9
Marble, travertine and alabaster and articles thereof, simply cut or sawn, with a flat or even surface	33,115	4.6
Plastics (Sacks and bags).	26,312	3.7
Cigarettes.	22,679	3.2
Sports boots.	22,655	3.1
Copper scrape.	16,822	2.3
Fresh Olive Oil	16,652	2.3
Medicaments in measured doses.	16,107	2.2
Wood Bedroom Furniture	13,962	1.9
Mattresses.	13,910	1.9
Yogurt	13,350	1.9
Pallets, box pallets and other load boards	12,353	1.7
Glazed ceramic flags and paving hearth or wall tiles, unglazed ceramic mosaic cubes	11,333	1.6
Aluminum bars, rods and profiles	11,054	1.5
Other polymers of ethylene in primary forms.	10,841	1.5
Cereals unmilled	9,063	1.3
Wood Seats and frames.	9,020	1.3
Bars and rods of iron or steel in coils or long size rolled.	7,428	1.0
Laminated wood panels and veneers coated with similar materials	7,224	1.0

Source: PCBS

32. **Another worrisome trend is that both imports and exports are concentrated on a small number of trading partners.** Israel accounted for as much as 86 percent of total Palestinian exports in 2011. The rest were concentrated in an additional four countries (Jordan, Saudi Arabia. UAE, and USA) and only five percent of exports was destined outside of these countries (Figure 8 below). This unusual concentration of exports in a few countries has persisted for many years. Imports are not concentrated as heavily, but with about 73 percent of total imports coming from Israel and only nine countries accounting for 90 percent of total exports, their concentration is also atypical.

33. **There is strong empirical evidence on the correlation between export diversification, both in terms of the number of products exported and destinations, and economic growth.** This is largely because heavy export concentration exposes countries to price and demand fluctuations for specific products or in case of geographic concentration to broader economic conditions in a destination country. Therefore, the Palestinian economy is ill positioned to benefit quickly and sufficiently from export opportunities even when exogenous export restrictions have been removed. As diversification of export products and destinations involves structural change and requires significant financial resources and time, the Palestinian economy is and would continue for quite a while to be heavily exposed to economic shocks in Israel.

Figure 7: Share of Palestinian Territories exports by country of destination for 2011.



Source: PCBS

III. Long term Employability of the Labor Force

34. **With low labor force participation and high rates and duration of unemployment, many Palestinians of working age do not have an opportunity to develop important on-the-job skills.** Based on the Labor Force Survey conducted by the PCBS, the unemployment rate in the Palestinian Territories in 2011 was 21 percent (19 percent of males and 28 percent for females). The average duration of unemployment is 12 months and it has almost doubled since the year 2000. However, the severity of the lack of jobs becomes more acute when one observes the labor force participation rate data, which shows that as many as 57 percent of individuals over the age of 15 are outside the labor force. Labor force participation rate for females is abysmally low at a mere 17 percent.[16]

[16] As clearly demonstrated in the World Bank's Education Sector Analysis, Impressive Achievements Under Harsh Conditions and the Way Forward to Consolidate Quality, low female labor force participation is not explained

35. **Furthermore, the concentration of the labor force in small enterprises operating in non-tradable sectors, which are characterized by low productivity, is not conducive to the development of skills that would render Palestinian workers competitive in the global economy[17].** For instance, on average a Palestinian enterprise employs only 3.5 workers[18]. Thus, an average Palestinian enterprise would be classified as a micro-enterprise based on European standards.[19] In manufacturing, an average enterprise employs only 4.5 workers; only 27 enterprises in the manufacturing sector employ more than 100 workers and would be considered medium sized by EU standards.[20] Thus, the majority of these small enterprises focus on activities where the potential for growth and expansion is very limited. Internal "souq-like" trade, which is characterized by a large number of micro enterprises accounts for around 40 percent of total employment.[21] Since a large number of workers are employed in the non-tradable sector, they are not exposed to competitive pressures that would force employers to invest in employee training to boost productivity. Moreover, small companies with three employees on average would not have the resources to invest in on-the-job training. The PA is neither in a position to invest significant resources in vocational training.

by educational attainment because 37 percent of the Palestinian female education has at least secondary degree. In recent years, educational attainment has been increasing and the transition rate of female students from elementary to secondary school is as high as 94 percent. The study shows that school enrolment has been increasing from year to year.

[17] Nevertheless, a certain percentage of the Palestinian labor force remains highly qualified and competitive by regional standards.

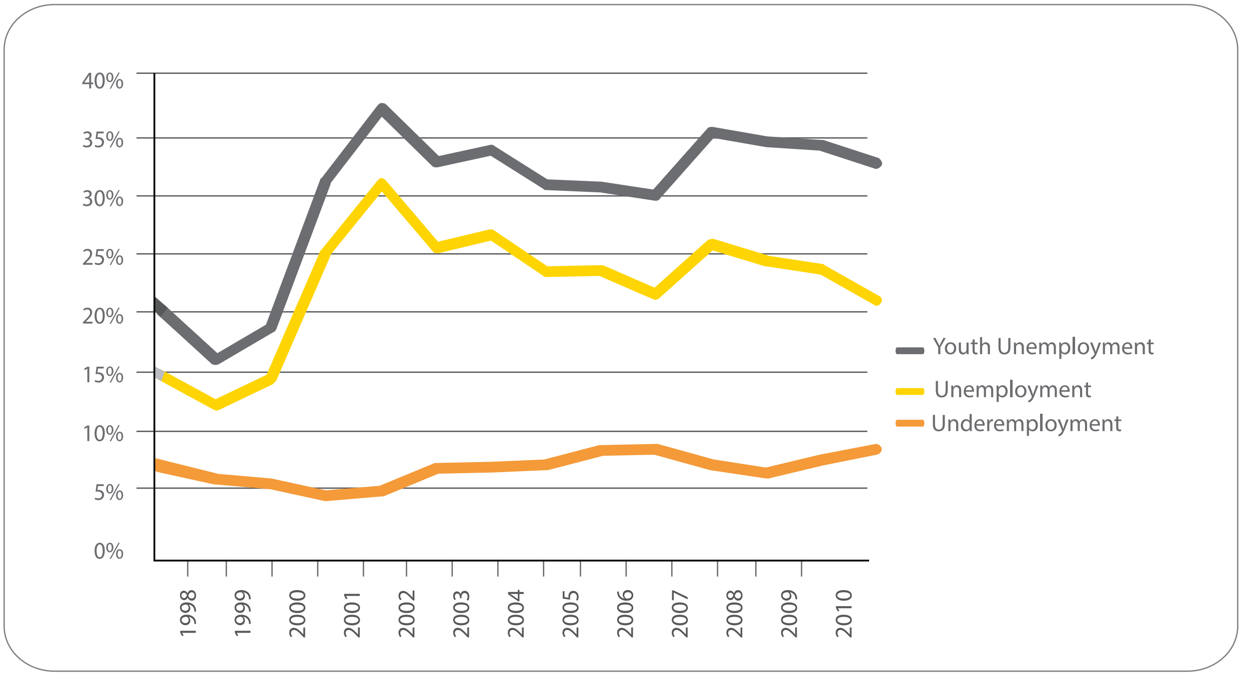
[18] Source: Palestinian Central Bureau of Statistics, Establishment Survey 2012, preliminary results.

[19] Source: Palestinian Central Bureau of Statistics, Establishment Survey 2012, preliminary results.

[20] Source: PCBS enterprise survey 2007.

[21] PCBS Economic Survey Data, 2009.

Figure 8: Unemployment and Underemployment in the Palestinian Territories, 1998-2010.

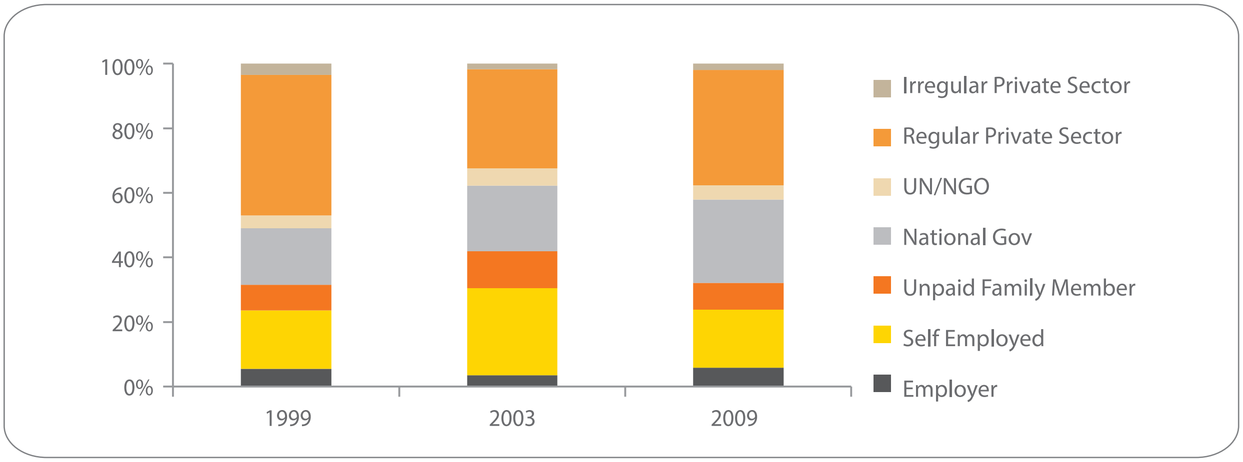


Source: PCBS

36. The growth in public sector employment has absorbed some of the labor market inflow, but it cannot provide a sustainable solution to the unemployment problem. From 1998 to 2009, the public sector share of employment has risen from 17 to 26 percent. The expansion of the public sector was largely driven by growth in health and social work, education, and public administration. In addition, college educated woman work overwhelmingly in the government or for international agencies and Non-Governmental Organizations (NGOs)[22]. Skills obtained in the public sector are often not compatible with those in the private sector.

[22] Toward Economic Sustainability of A Future Palestinian State: Promoting Private Sector – Led Growth, World Bank, April 2012

Figure 9: Employment by sector in the Palestinian Territories, all working age individuals (15-64 years old)



37. **Given that skills are at the core of improving individuals' employment outcomes, the absence of sufficient opportunities for obtaining marketable skills could have a damaging impact on the employability of the Palestinian labor force**. This is more worrisome when one considers that the availability of a skilled labor force is one of the key factors that any potential foreign investor would consider in deciding whether to invest in the Palestinian Territories even after a political solution has been realized. Investment and time would be required to develop a labor force that can work in high-value-added sectors and compete in the global market. The situation could be improved if the GoI were to allow a higher number of Palestinian workers in Israel, where high value added skills can be accumulated.

38. **In addition to these economic implications, protracted unemployment, especially among youth, tend to weaken social cohesion.** The World Development Report 2013 (WDR 2013) by the World Bank points out that in addition to improving the living conditions of job holders and to increasing the productivity of society, jobs can affect social values and norms, influencing how groups co-exist and mange tension. The WDR 2013 states that if people believe that job opportunities are available to them either now or in the future, their trust in others and their confidence in public institutions may increase.[23] Unemployment and job loss are also associated with lower levels of both trust and civil engagement, which are two indicators of social cohesion. Given the fragile situation in the Palestinian Territories, protracted unemployment, especially among youth, raises the potential for growth in social instability.

IV. Stock and Quality of Infrastructure

39. **The role of infrastructure is widely recognized to have a direct effect on productivity and growth.** At the macro level, infrastructure helps determine the success of manufacturing and agricultural activities. Investments in water, sanitation, energy, housing, and transport also improve

[23] The World Development Report 2013- Jobs, The World Bank

lives and help reduce poverty. New information and communication technologies promote growth, improve delivery of health and other services, expand the reach of education, and support social and cultural advances[24]. At the micro level - both households and firms - the availability and quality of infrastructure result in different decisions to invest and may influence key economic decisions such as business establishment location.

40. **The PA's worsening fiscal space for infrastructure spending has had a negative impact on the accumulation of physical infrastructure despite contributions from development partners.** Following the Oslo Accords of 1993, responsibility for managing infrastructure was transferred to the PA from the Israel Civil Administration. However, continuous PA fiscal constraints have left very little fiscal space for public investment. At 2-3 percent of GDP, the level of investment by the PA, including donor supported projects, has been very low. It is estimated that the current level of public investment is not enough even to offset depreciation and maintain the current level of infrastructure stock, let alone to reduce the cost of doing business and facilitate growth in the private sector.

41. **In addition, the quality of infrastructure in the Palestinian Territories has deteriorated, causing economic productivity loss.** Important concerns regarding the quality of infrastructure include limited access to key assets and resources such as water supply, roads and radio spectrum, and lack of financially and commercially oriented viable regional utilities such as electricity, water and wastewater, and transport. In addition, the restricted access to land in Area C has been a major constraint to the efficient development of transport infrastructure. Consequently, decisions to invest in transport, energy, or water infrastructure cannot be developed in optimal ways. Prevented from laying fiber-optic cables through Area C, telecoms are forced to make less efficient investments to serve their customers and will end up with sunk costs even if the restrictions of access to Area C were removed in the future.

42. **In the electricity sector, for example, chronic under-investment in past years has resulted in deteriorating performance of the sector**. Distribution network losses, one of the consequences of the dated grid system, remain high at around 24% compared to other Middle East and North Africa (MENA) countries such as Egypt (8%) or Jordan (12%)[25]. Investment in lower cost electricity production and fuel supply for electricity are also constrained, meaning that the Palestinian economy remains critically dependent on Israel for around 95% of supply. In the absence of cheaper power supply alternatives the PA is subject to Israeli pricing policies for electricity.

43. **The negative impact of ongoing conflict and Israeli restrictions on infrastructure development is most significant in Gaza[26].** Significant damage to utility networks, plants, equipment and other assets has resulted in considerable dislocation across infrastructure subsectors, reducing output, level of service and capacity and increasing costs. Restrictions on movement of people and

[24] Data.Worldbank.org/Infrastructure

[25] 24 percent is the median losses of the five Palestinian distribution companies based on data from Palestinian Energy Authority.

[26] The contested internal political environment in Gaza has also negatively affected infrastructure management and institutional development. This is particularly the case in the water, solid waste and road sectors while electricity sector appears to be spared to date.

goods have added to the difficulty of maintenance of existing infrastructure and general system development. The restrictions have also limited the options of the location of future infrastructure development. These negative impacts are more pertinent in the north of the Gaza Strip and areas near to the security buffer zone. It is estimated that significant resources are required to bring the level of infrastructure performance to a desirable level; approximately US$870 million for the water and wastewater sector; US$430 million for municipal services (internal roads, street lighting, solid waste management and public facilities); US$200 million for the electricity sector; and US$1 billion for the road sector.[27]

27 Draft Gaza Infrastructure Sector Assessment 2012, the World Bank

Conclusion

44. **As has been highlighted in this report, the PA is experiencing acute fiscal stress that could worsen in 2013 with declining donor support and uncertainty in the transfer of clearance revenues.** Therefore, it is imperative for the PA to continue on-going reforms to raise revenues and contain expenditures while maintaining the provision of basic services. Equally imperative is continued support from donors to the PA's budget. Financial support to the PA is crucial to sustain the commendable progress on institutional building that the PA has achieved to date.

45. **While urgent attention to the short-term financing shortfalls is essential, it is important to recognize that the continued existence of a system of closures and restrictions is creating lasting damage to economic competiveness in the Palestinian Territories.** The longer the current, restrictive situation persists, the more costly and time-consuming it will be to restore the productive capacity of the Palestinian economy. Without easing current restrictions, investments risk being put into low productivity activities that cannot be the drivers of sustainable economic growth in the future. The external competitiveness of the manufacturing sector, which is one of the key growth engines for small open economies, is likely to erode even further. Palestinian exports are yielding less development impact than they might, as they are focused largely on low value added products and services and the economy is currently ill-positioned to benefit from market diversification. The skills deficit caused by high levels of unemployment and low labor force participation rates would continue to accumulate and make a large part of the Palestinian labor force less competitive in high value added sectors. Bolder efforts need to be made to stem the deterioration and help put the economy on a sustainable growth path that will reduce its dependence on donor transfers.

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