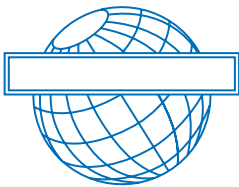


# MEMBERSHIP

*September 22, 2014*



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## A

AHLC	Ad Hoc Liaison Committee
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GoI	Government of Israel
IEC	Israel Electric Corporation
MoF	Ministry of Finance
MoSA	Ministry of Social Affairs
NCTP	National Cash Transfer Program
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PMA	Palestine Monetary Authority
USD	United States Dollar
VAT	Value Added Tax

## E S a

- a. The conflict and humanitarian tragedy in Gaza has made an already struggling Palestinian economy worse and put further stress on the fiscal situation of the Palestinian Authority (PA). To return to a sustainable growth path, action is needed in three areas: (i) providing access to imports and exports into, out of and between the West Bank and Gaza; (ii) re-integrating the governance framework between the West Bank and Gaza under the Palestinian consensus government; and (iii) additional funding from the international community to facilitate continued reforms and the re-construction of Gaza's economy.
- b. Political uncertainty and restrictions on movement and access are the main reasons why the Palestinian economy is unable to take off. Private investment in the Palestinian territories remains far from sufficient to fuel adequate rates of economic growth and to create enough jobs to allow unemployment to fall. The lack of a comprehensive peace agreement leads to a vicious cycle of economic decline and conflict. The impact of this political instability on the Palestinian investment climate has been severe, resulting in uncertainty, increased costs for businesses and investors, and the fragmentation of Palestinian economic space and markets. There are positive aspects in the investment climate, such as a stable financial sector and low incidence of bribery; and firm performance indicates potentially competitive productivity levels. These positive aspects imply that the Palestinian private sector could respond effectively once movement and access is allowed.
- c. While impacting the West Bank adversely, the effect of political uncertainty and restrictions has been particularly severe in Gaza. In the past decade, employment in the manufacturing sector fell from an already low 9 percent to 5 percent as main markets (Israel and the West Bank) were lost. Firms are unable to invest in capital goods – making Gaza's labor force productivity lower than in the West Bank. Gaza's energy crisis is also a binding constraint, second only to political instability. In the recent conflict, the only power plant in Gaza was targeted and it is now out of commission, making an already serious situation even worse.
- d. Growth in the Palestinian territories, already decelerating since 2012 slowed down further to less than 2 percent in 2013; and the economy entered into recession in 2014. The closures of the illicit tunnels with Egypt hit Gaza hard, as they were its main trade channel. The economic decline has resulted in growing unemployment – as a share of the labor force, one in six in the West Bank is unemployed, and nearly every second person in Gaza. As international experience and recent history in Gaza shows, such a dire situation may fuel further violence.
- e. Even without the additional expenditures resulting from the Gaza conflict, the PA would face a



channeled through the PA, preferably as budget support. For such support to be effective it has to be accompanied by (i) allowing access in and out of Gaza, while protecting legitimate security concerns of neighboring governments; and (ii) the PA establishing a strong governance framework under the consensus government.

g. In summary, the following elements are critical for a sustainable Palestinian economic future:

- For the international community, continued budget support to strengthen the PA's fiscal position will be essential to sustain reforms and enable provision of services to the Palestinian population, including those in Gaza.
- For the PA, strong efforts are needed to address governance challenges in Gaza both to support recovery and reconstruction efforts and to provide a unified business climate.
- For the Government of Israel (GoI), sincere efforts are needed to allow better and faster movement of people and goods in, out and among the Palestinian territories, while taking into account legitimate security concerns of the GoI.

## I. C a E , G

- 1. There is growing consensus that private sector led growth is the only sustainable future for the Palestinian territories.** Growth would also enhance the PA's revenue base and its ability to invest in physical and human capital within a sustainable fiscal framework. For now the private sector is stifled by political uncertainty, the divide between Gaza and the West Bank; and most importantly restrictions on movement and access.
- 2. Political uncertainty restricts the Palestinian private sector to low capital intensity, small-size and low productivity.** During the last seven years, there has been no significant growth in capital investment or in employment. Palestinian firms' capital intensity is among the lowest in the region. For instance, more than three out of four firms choose not to apply for a loan, even though they would be eligible. The costs and uncertainty associated with following special procedures for obtaining movement permits, entry for goods on the dual use goods lists, and visas for investors, technical experts, or workers add another layer of complexities. This has led private enterprises towards informality with an estimated 100,000 extremely small businesses (with 1 to 2 workers) that are unregulated, but has also restricted access to finance. The proportion of formal firms with more than 20 workers is just 11 percent, compared to 35 percent in comparable lower-middle income countries.
- 3. Fragmented legal and regulatory business environments impede private sector development.** The de jure legal and regulatory environment and de facto administrative practices for Palestinian firms differ among the Gaza Strip, Areas A and B of the West Bank (under the PA's security and administrative control), and Area C of the West Bank and East Jerusalem (under Israeli control). Business registration, licensing and permits, banking, taxation, investment incentives, courts, and enforcement of contracts are all affected by the

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- The emergence of a technology-based entrepreneurship network, although nascent, shows a potential for growth, especially as it links up and gains support from broader regional initiatives.
- Few Palestinian firms report petty corruption in the form of informal payments to officials in their business operations.





## II. RECENT DEVELOPMENTS

### a. Quarterly Economic Performance

8. **The Palestinian economy buckled under the burden of the constraints discussed above and entered into recession in 2014.** Following a period of sustained economic recovery between 2007 and 2011 (when growth exceeded 8 percent on average), the economy has increasingly struggled. The downturn started in 2012 when growth decelerated to about 6 percent as a result of a steep drop in foreign aid. With domestic revenue generation



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Table 2· Palestinian Authority's Revenues, January – June 201

(NIS million)	Jan–Jun 2013	Jan-Jun 2014	Y-o-Y change	Prorated 2014 budget	Percentage difference budget & actual
Gross domestic revenues	1672.4	1754.6	4.9	1663.0	5.5
Tax revenues	1137.8	1251.1	10.0	1164.5	7.4
Non-tax revenues	534.5	503.5	-5.8	498.5	1.0
Clearance revenues	2810.2	3667.6	30.5	3272.5	12.1
Tax refunds (-)	384.8	369.6	-4.0	280.0	32.0
Fuel	331.0	324.7	-1.9	240.0	35.3
Other	53.9	44.9	-16.7	40.0	12.3

Source: Palestinian Authority Ministry of Finance (MoF)

- 17. Domestic tax collection may struggle to keep up during the second half of this year.** In the first quarter of 2014, domestic tax revenues grew by 24 percent in comparison to the same period in 2013. The PA introduced an 8 percent discount on early VAT payments in 2014 on top of the property and income tax incentives that apply to tax receipts in the first 90 days of the year. As a result, a number of large companies and major banks pre-paid their tax obligations. Growth in domestic tax revenues in the first quarter can, therefore, be mainly attributed to advance payments rather than a significant widening of the tax base. Starting in April, 2014 and following the expiration of the early payment tax incentives, domestic revenue started to slow down. The second quarter's collections were 49 percent less than in the first quarter and were also 27 percent lower than the prorated budget target. This is an indication that stronger effort needs to be carried out by the PA to continue to widen the tax base and enhance compliance.
- 18. Energy subsidies, in the form of tax refunds, are also hampering revenue efforts.** They were 32 percent over budget during the first half of 2014. These subsidies are probably



by the World Bank reveals that the underlying problems lie with the deteriorating efficiency of the electricity distributors, increasing electricity losses, and decreasing collection from customers, particularly in the West Bank. According to the Israeli Electricity Company (IEC), debt owed by the PA on the account of unpaid electricity bills amounted to NIS 1.7 billion as of August 2014.<sup>7</sup> Recently intensified reform efforts by the PA such as (i) the creation of an inter-ministerial special committee to monitor and address net lending issues; and (ii) the adoption of a decision to impose penalties on electricity distributors not paying their bills to IEC are encouraging and deserve strong support from the international community. Effective and direct collaboration between the PA and the GoI is important to ensure a successful and sustainable implementation of some of these reforms.

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**rundown of arrears to the private sector.** While recurrent spending increased by 11 percent year-on-year through June, due to higher nonwage expenditures as arrears to the private sector were repaid. Wage spending was kept within its budget target.

21. **The wage bill has been kept on a tight leash.** It remained 1.4 percent below its prorated budget target due to a delay in paying some allowances. This offset the increase that resulted from the growth in the net number of employees which totaled 830 in the first half of 2014.<sup>8</sup> The PA reports that this increase is only temporary and it is caused by the fact that new recruitments usually take place earlier in the year while most retirements and other departures occur towards the end of the year. The PA has put in place a zero net hiring policy in late 2012 and has maintained it since. Even so, the wage bill absorbs about half the recurrent budget, and, at 17 percent of GDP, remains high by international standards.

22. **Transfers, the second biggest recurrent expenditure item, were also kept below their midyear target.** They were about 12 percent below expectations because the Ministry of Social Affairs (MoSA) lacked funds to increase the number of new households benefiting from the National Cash Transfer Program (NCTP), as it had earlier planned. However, the conflict in Gaza has created an urgency and transfer payments in July 2014 were twice as high as in June.

23. **In addition, the PA has provided immediate assistance to alleviate the impact of the war in Gaza.** A large number of injured during the recent conflict in Gaza were treated in East Jerusalem and Israeli hospitals. While the exact cost of these treatments is not clear yet, it will be covered by the budget of the PA. Furthermore, the PA also provided fuel for generators to meet urgent needs for electricity during and immediately after the conflict. The PA also committed to temporarily extend financial assistance to an additional 20,000 poor people in Gaza, who were affected by the recent conflict.

24. **Also, with past arrears to suppliers beginning to be cleared, cash spending on goods and** . This was particularly the case at the Ministry of Health, where about NIS190 million in arrears accumulated in previous years on health referrals were cleared in the first half of 2014.

<sup>7</sup> This amount is disputed by the PA.

<sup>8</sup> Specifically, 1100 employees were hired in the West Bank while 289 departed from the PA's labor force in Gaza. In addition, employment in the national fund and in the number of deputy positions was reduced by 326 while it was increased by 345 in the embassies.





### III. Background, a Roadmap, and Recommendations for Gaza

28. **Future reconstruction efforts will have to address not only the emergency needs but also the pre-existing constraints to economic development.** Following the cease fire agreement, the PA and the international community are rapidly moving to provide humanitarian aid and immediate recovery support. Based on a rapid needs assessment, the PA with the help of development partners has developed the Palestinian National Early Recovery and Reconstruction Plan to provide a roadmap covering the current humanitarian crisis to long-term development. This will be presented to a donors' aid conference scheduled on October 12, 2014.
29. **Strong PA leadership in recovery efforts in Gaza is essential.** Following a PA-led damage and needs assessment, the reconstruction efforts should also be led by the PA. In some instances the PA already has experience with implementing projects in Gaza through PA agencies there. For example, the PA's agencies in the water, municipal and electricity sectors have good implementation capacity. In other sectors, the PA may decide to contract out the implementation to others. In this context, the international community would want clear assurances that resources reaching Gaza are used in an efficient manner and only for the purposes intended.
30. **The governance challenge will only be addressed in the medium and long term if**



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