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West Bank and Gaza
Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth

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Executive Summary

i. Sustained economic growth, widely recognized as a key part of the Palestinian state building project will depend upon the establishment of a dynamic, private sector led economy. While the Palestinian Authority (PA) has had considerable success in building the institutions of a future state, it has made less progress in developing a sustainable economic base. Following a deep contraction in the first half of the decade there has now been five years of economic growth.
However, the Government of Israel's (GOI's) security restrictions continue to stymie investment and the recent growth has largely been driven by donor aid. This situation is unsustainable and aid levels have already begun to fall. For a future Palestinian state to be viable, it is necessary that a private sector led economy is able to generate the jobs needed by a rapidly growing population and the resources required by the government to provide services. This paper reviews some of the most important issues facing the Palestinian economy and identifies steps that can be taken now to set the stage for private sector led growth .
ii. With the advent of the second Intifada, West Bank and Gaza (WB&G) suffered a severe economic contraction and by the end of 2006, real per-capita GDP was 23 percent below its peak in 1999. In 2007, the international community embraced the new PA cabinet and pledged more than US$7.5 billion in aid. The improved security situation led the (GOI) to relax some of its restrictions, which also provided a boost to the economy. The return of growth has led to a fall in poverty in the West Bank, where poverty headcounts fell from 23 percent in 2004 to 16 percent in 2009. But the continuing closure in Gaza has meant that the poverty rate has actually increased from 30 to 33 percent during this same period.
iii. Despite the easing of some restrictions, most of the constraints on movement of people and access to resources have remained in place, constraining investment and productivity growth. Consequently, most of the recent economic growth can be attributed to the large inflow of aid, which has funded government expenditures. This has skewed the economy towards the public sector and non-tradables. Public administration, defense and other mostly public services such as health, education, electricity and water grew from less than 20 percent of GDP in 1994 to more than 27 percent in 2010. Meanwhile, the industrial and agriculture sectors declined from 13 to 10 percent and 9 to 6 percent respectively. The importance of aid cannot be overstated and by 2008 current transfers had risen to about US$3.4 billion, double what they were in 2006.
iv. The PA has become increasingly dependent upon this donor assistance to fund its basic operations. This not only leaves it vulnerable to reductions in aid, but also means that the PA has few resources to devote to long-term development issues. In 1999, the PA recurrent budget had a small surplus and all aid was directed toward development projects. In 2002, at the height of the second Intifada, external budget support was still less than US$500 million. But by 2009, the need for budget support to cover recurrent expenditures had increased to US$1.6 billion, despite the improved security and resumption of growth. The high levels of budget support were seen by donors as temporary measures to help the new PA government deal with crisis and have begun to decline. However, they are still large and in 2010 budget support was nearly US$1.15 billion. But even this large amount did not cover the full recurrent deficit, forcing the PA to borrow from the local banking sector and accumulate arrears at an unsustainable rate.[1]
v. The establishment of a Palestinian state and a comprehensive peace agreement can be expected to lead to rapid growth and more tax revenues for the PA. However, it is unlikely that even with significant growth the PA will be able to support an administration of the current size. Therefore, it is important that the PA take steps to reduce costs, raise revenues and move towards fiscal sustainability. Such efforts will help address the current fiscal crisis, free up resources for long term development and establish the ground work for fiscal sustainability.
vi. The PA is already taking actions to increase revenues through widening the tax base and improving tax administration, though progress has been slow. However, in 2010, the PA's gross domestic revenues were around 27 percent of GDP, which is not too different from neighboring countries. In 2009, total government revenues in Jordan and Egypt were 23.3 percent and 27 percent of GDP respectively.[2]
Therefore, there will be a limit to how much additional revenue can be raised given the already substantial level of collections and low level of economic activity. More important will be efforts to slow the growth of the PA's spending. About three quarters of total expenditures goes for wages and transfer payments, which include large pension commitments. Electricity and water subsidies to municipalities were only about 8 percent of the budget in 2010 and have been dropping, leaving less than 20 percent of the budget for operational and minor capital expenditures. Clearly, the only way for the PA to make substantial savings is to address the growth of the wage bill and transfer payments.
vii. Substantial savings will only come from comprehensive civil service reform. It is unlikely that the PA will be able to shed workers until strong private sector growth resumes. But in light of the difficulty and time it takes to implement significant reform, the PA should begin the process of identifying what it truly needs to effectively provide services and establishing

a coherent system to manage its workforce. The PA's pension system is one of its largest obligations; it is insolvent and effectively operating as a pay-as-you go system. It is imperative that the PA deals with this issue before the current employees retire and the system goes into crisis.

viii. No matter what steps the PA takes, it is unlikely to reach fiscal sustainability until there is a political settlement that allows the private sector to experience rapid and sustained growth. The major constraints to private sector activity are the tight Israeli restrictions, and growth will not be sustainable until Palestinians have access to resources and are allowed to move freely. However, there are a number of areas where the PA can focus its attention to not only improve current performance, but to lay the groundwork for a future state. The ongoing political and fiscal crises absorb the PA's attention, and there has been little recent progress on improving the conditions for private sector growth. But given the sector's importance for both the present situation and a future state, it is imperative that the PA focus more on the issue.

ix. WB&G is a small and open economy. Therefore its future development will depend upon increasing trade, particularly in exporting higher value added products. A future Palestinian state should seek to emulate Asian countries that have managed to sustain high levels of economic growth by adopting an outward orientation and integrating into world supply chains. In contrast, many of WB&G's Middle-Eastern neighbors have focused on the domestic markets and experienced slower growth. Given WB&G's lack of natural resources, but well educated and entrepreneurial population, it is likely that high value added services could play an important role in its growth, thus the service sector should not be neglected as the PA develops its policies.

x. Increasing trade depends upon efficient trade facilitation beginning with the adoption of an appropriate trade policy. It is important that the PA decide what type of policy it expects a future state to adopt. This will help the guide the institution building agenda, allow the private sector to plan and also support the negotiators as they discuss the parameters of a future political solution. A well balanced customs union between a future Palestinian state and Israel could hold a lot of promise for both countries. However, the current quasicustoms union does not work well. There is no free movement of labor and Palestinian goods have difficulty accessing the Israeli economy. It is therefore unlikely that such a system would be acceptable option in . But moving to a nondiscriminatory trade policy would limit free access to Israel, WB&G's leading trading partner. Thus, a system of free trade agreements between a future Palestinian state, Israel and neighboring countries might be the most promising option. It could be envisioned that in such a situation, Israeli manufacturers could tap skilled but inexpensive Palestinian labor to export, including to the Arab world. This would provide Israeli firms a competitive advantage and help build up Palestinian business through a transfer of knowledge.

xi. Whatever system is chosen, it is important that the PA begin to develop the necessary trade infrastructure, including the institutional infrastructure. The PA needs to establish a clear border management system that is designed primarily to facilitate trade and does not militarize the border. It should move rapidly to develop the capacity of its customs agency, both to prepare for a future state and to increase current revenues. At the same time it is necessary to begin developing the supporting legislative framework by enacting legislation that covers customs, health and safety standards, intellectual property rights, competition policy and other areas important to trade.

xii. Both firm level surveys and macro economic data indicate that there is relatively little private sector investment in WB&G. Though the Israeli restrictions remain the biggest constraint, there is also much that the PA can do to create a business environment that will attract the needed investment. To overcome the perceptions of risk resulting from years of conflict and attract the necessary high level of investment, the PA should strive to build a business environment that is among the best in the world and not merely on par with its neighbors. One of the most important steps the PA can take is to rapidly expand land registration in the West Bank.[3] In the Palestinian controlled areas, vacant land suitable for development is scarce. What land is available is difficult to access because ownership is heavily fragmented and only a small portion is registered and titled. Consequently, one of the most important steps that the PA can take to spur investment is to increase the amount of land that is registered and legally titled. Likewise, it is important that the PA completes the registry of public lands in Areas A and B and plans for adding public land in Area C to the registry when the time comes. Increasing available land will also help develop the housing market, which could be a significant driver of growth, especially if political developments encourage a large number of Palestinians from outside return.

xiii. The legal and regulatory environment in WB&G is not adequate to attract the needed foreign and domestic investment. The current system of laws stems from different periods of Palestinian history, and consist of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws as well as Israeli Military Orders, which differ between Gaza and the West Bank. This disparate group of laws leaves significant gaps and contains many internal inconsistencies. Thus, reforming the current collection of legislation governing business is critical to improving the investment climate. The most pressing new laws are the secured transactions law, companies law, competition law, leasing law, tenants law and laws around land and housing.

xiv. A well functioning labor market that provides workers with appropriate skills is also critical to increasing the productivity and competitiveness of Palestinian businesses. There are no indications that PA labor regulations impede labor market flexibility and the high level of unemployment is mostly due to the low level of economic activity resulting from the restrictions. However, rising government wages and high wages earned by unskilled workers in Israel do distort the Palestinian labor market and affect competitiveness. A much more important issue is the skill level of Palestinian workers. Despite the large pool of unemployed workers, the Palestinian private sector consistently reports that it is unable to find workers with the skills that it needs. This is particularly a problem for exporters of high value added goods and services. If the Palestinian economy is going to integrate into world supply chains, it is critical that the education system prepares students for the modern workplace. Education must go beyond basic literacy and provide students with the high-level cognitive skills (such as analysis, problem solving, and communication) and behavioral skills (such as discipline and work effort) required by competitive industries. This will require the PA to accelerate education reforms in WB&G.

Endnotes

[1] These figures do not include any funds going to the government in Gaza. Thus, they understate the true aid dependency of WB&G.

[2] IMF Regional Economic Outlook, 2010

[3] The Gaza Strip does not face the same types of challenges in terms of access to land. Since the evacuation of the Israeli settlements in 2005, the entire Gaza Strip is under Palestinian control. In addition, the land law in the Gaza Strip is the Egyptian law which makes all property sales binding only once registered in the Land Registry. As a result, less than 2 percent of land in Gaza has not been registered and titled.

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