Economic Monitoring Report
to the Ad Hoc Liaison Committee

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The World Bank

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I. Executive Summary

1. **Palestinians are getting poorer on average for the third year in a row.** As evidenced in previous World Bank reports, the competitiveness of the Palestinian economy has been progressively eroding since the signing of the Oslo accords, in particular its industry and agriculture. Even though donor aid had increased government-funded services and fueled consumption-driven growth during 2007 to 2011, this growth model has proved unsustainable. Donor support has significantly declined in recent years and, in any case, aid cannot sustainably make up for inadequate private investment. Thus, growth has started to slow since 2012 and the Palestinian economy contracted in 2014 following the Gaza war. In early 2015, GDP was still lower than it was a year ago. Due to population growth, real GDP per capita has been shrinking since 2013. Unemployment remains high, particularly amongst Gaza's youth where it exceeds 60 percent, and 25 percent of Palestinians currently live in poverty. Against the backdrop of weak economic growth, reduced donor aid, and temporary suspension of revenue payments by the Government of Israel (GoI), the Palestinian Authority's reform efforts have not been able to prevent another year with a financing gap. The persistence of this situation could potentially lead to political and social unrest. In short, the status quo is not sustainable and downside risks of further conflict and social unrest are high.

2. **Until there is a permanent peace agreement, the Palestinian economy will continue to perform below its potential.** Political instability constitutes a significant risk to private investors and is a key reason why private investment levels have remained very low for many years. If the status quo persists, private investment will not pick up and the private sector, which ought to be the main engine of sustainable growth, will continue to function far below its potential. The internal divide between the West Bank and Gaza also creates difficulties for private investors that have to deal with two separate regulatory frameworks and tax systems in the West Bank and in Gaza. However, the lack of political horizon should not lead the parties to complacency. Even before a final peace deal, there are many actions that can be taken that would improve socio-economic development for Palestinians. These actions are essential, not just for economic development, but also for peace, since the international evidence is clear that economic development is conducive to peace.

3. **Even without a final peace deal, there is substantial upside potential in the Palestinian economy if existing agreements are implemented and restrictions lifted.** For example, the Oslo agreement foresaw a gradual transfer of Area C to Palestinian control, but this has not happened. World Bank estimates show that granting Palestinian businesses access to economic activity in Area C (excluding the areas subject to final status negotiations) would boost the Palestinian economy by about a third and lower the PA's deficit by half. Similarly, the regular and predictable transfer of revenues collected by the GoI on behalf of the PA, and close cooperation with the PA to minimize tax leakages are critical to ensure fiscal predictability. On movement and access restrictions[1], the recent statements by Israeli officials about the importance of Palestinian economic development are most welcome if followed up by action and implementation of existing agreements. Finally, full implementation of the Paris protocol and expansion of the joint work between Israeli and Palestinian public institutions across a number of areas would help create a more predictable business and fiscal environment. The blockade on Gaza imposed by countries neighboring the Strip needs to be lifted in a way that protects legitimate security concerns of those countries. Israeli measures to let more goods leave Gaza are welcome and they have expanded since the last AHLC meeting, but more needs to be done: only six percent of what left Gaza prior to the blockade is currently being allowed out. In general, granting Palestinians access to production inputs and external markets and enabling unimpeded movement of goods, labor and capital, as stipulated in the Paris protocol, would drastically improve growth prospects of the Palestinian economy.

4. **Reforms by the PA of its revenues and expenditures ought to continue to improve fiscal sustainability and effective service delivery, even under the current political scenario.** The PA has made very good progress in reducing its fiscal deficit and it has recently launched some important reform initiatives in this area. Through continued efforts to address key sources of inefficiency and ineffectiveness, the PA could do a great deal to avert fiscal crises and stop financing its budgets by accumulating arrears to the private sector. Not only can the PA put its finances on a more sustainable footing through reforms, but it can also create adequate fiscal space to increase the currently very low level of investment in public infrastructure and to enhance service delivery. A top priority should be the reduction of the wage bill, which could lead to large savings of up to 5 percentage points of GDP, but there is also substantial room for cost savings to be made on other categories of expenditures as well as for increasing tax revenues beyond what has already been done. There is also potential to substantially increase tax collection in Gaza once the PA takes charge of tax collection efforts there. Within some sectors, overall expenditures are not very high compared to other countries, but access to and the quality of those public services are significantly below what they could be if certain expenditures were better prioritized and more efficiently managed. For instance, the PA has recently made very good progress in reforming the health referral process, but significant inefficiencies related to public health spending remain; the reduction of these inefficiencies could generate savings to be used to further reduce the deficit or alternatively to invest them in programs that will improve the quality of public health services. As detailed in the body of this report, similar issues exist in a number of other areas of expenditure management and intensified reform efforts are urgently called for to address them.

5. **Until private investment shoots up, donors need to increase aid provided to the PA, as the financing gap in the PA's budget cannot be closed through reforms**

alone. Despite having managed to reduce the budget deficit, the PA still has a large financing gap in its 2015 budget and it is likely to continue accumulating arrears to the private sector. While further reform efforts should be made by the PA to reduce the 2015 budget deficit in line with the IMF recommendations, donors are also called upon to augment their 2015 budget support as it would be unrealistic to expect that the gap can be closed through reforms alone. Even if the PA were able to fully close the financing gap in the 2015 budget, such sharp fiscal consolidation would be damaging to growth. Thus, fiscal consolidation has to happen gradually over a period of 2-3 years. Then, donors should be able to channel a larger share of their funds towards public investments in infrastructure, which are needed both to catalyze private investment and to improve the quality of public services. Furthermore, the financing of socioeconomic recovery in Gaza, following last year's war, almost entirely depends on donor aid.

6. **On a final note, slow donor aid disbursements and restrictions on imports are delaying the Gaza reconstruction process and both issues should be urgently dealt with.** Out of the USD3.5 billion of pledges made at the Cairo conference for Gaza reconstruction, USD1.23 billion has so far been disbursed, which puts the disbursement ratio at 35 percent. Funds already disbursed are USD881 million less than what was originally planned, mainly because payments by the largest donors remain lower than anticipated. The majority of disbursements made so far supported UNRWA activities, while less than 20 percent was used to finance interventions outlined by the Damage and Needs Assessment. Construction material imported into Gaza continues to be lower than what is needed, even though it has recently increased. Between August 2014 and August 2015, 1.6 million tons of construction material entered Gaza, which represents 6.7 percent of the total need.[2] There has also been a delay in finalizing the residential stream of the Gaza Reconstruction Mechanism (GRM), which means that totally destroyed homes are still not rebuilt, a year after the war ended, even though there has been good progress on partially destroyed homes.

7. **The main body of the report is organized in two chapters and an annex.** Chapter II focuses on the assessment of recent macroeconomic and fiscal developments in the Palestinian territories and the Palestinian Authority's (PA) related policies and actions. It also provides a near term macroeconomic and fiscal outlook. Chapter III draws on the just-completed public expenditure review providing insights into key issues related to public expenditure management as well as specific policy recommendations for reducing the PA's fiscal deficits and increasing the efficiency and efficacy of public spending. Finally, an annex summarizes the status of donor pledges from the Cairo conference on Gaza reconstruction.

http://documents.worldbank.org/curated/en/2015/09/25081078/economic-monitoring-report-ad-hoc-liaison-committee-vol-2-main-report