Investing in Palestinian Economic Reform and Development

Report for the Pledging Conference

Paris, December 17th, 2007

The World Bank

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EXECUTIVE SUMMARY

The course of the Palestinian economy since the Second Intifadah has left per capita GDP in 2006 ($1,130) at 40% less than in 1999, and has altered an already-fragile economy from one driven by investment and private sector productivity, to one sustained by government and private consumption, and donor aid.

Reversing this downward cycle requires parallel actions by the Palestinian Authority (PA), Israel and the donors. Reform and development of the Palestinian economy and its institutions must proceed immediately. To succeed, these reforms must be implemented with determination by the PA, underwritten by donors and supported by Israeli actions. In the same vein, Israeli policies that impact the Palestinian economy and Palestinian actions on security to reinforce these policies must proceed in parallel.

The PA's Palestinian Reform and Development Plan (PRDP) for 2008-10 represents a process around which the PA, Israel and the donor community can coalesce. The PRDP is an important document that envisions a sequence of steps centering on control of expenditures with medium-term reforms across sectors to bring the PA back to financial sustainability. In addition, the PRDP is a promising effort by the PA to link policy-making, planning and budgeting, and to deliver a Palestinian-owned plan for allocating resources.

The PRDP is regarded as succeeding insofar as it is addressing the entirety of the Palestinian population. The Gaza Strip represents about 40% of the population, and an essential part of the Palestinian territory and economy. Any effort at economic recovery and development must address the impacts of the current closure regime and the aftermath of the illegal takeover of Gaza. The continued entry of humanitarian goods has mitigated the impact of the closures on Gaza's population, but has not been sufficient to offset the collapse of the private sector there.

The Expenditure Control Policy of the PRDP

The PRDP, with a gap for recurrent and capital expenditures of around $1.8 billion in 2008, seeks to stabilize the PA's fiscal situation through donor budgetary assistance, while containing recurrent spending and, as the economy improves, shifting resources progressively towards development spending. This expenditure control policy would extend to the largest spending categories, including the public sector wage bill and net lending.

Wages for civil service and security personnel account for almost half of total government expenditures and have increased by nearly 57% since 2004 New policies will reduce the wage bill from 27% of GDP in 2007 to 22% of GDP by 2010. This is a considerable effort in light of the need to compensate for the scarcity of private sector jobs, but is still insufficient to bring the civil service in line with actual requirements. Within the public sector, the security services represent approximately 44% of the wage bill. Reform of the security sector is linked to a political framework that includes the rebuilding of institutions, support to disarmament, demobilization and reintegration, and measures to improve the rule of law. Regardless of the ultimate structure of the security services, some early steps can be taken, including an accounting of their numbers, the removal of "non- - - 2
compliant" officers, and exploring options for officers nearing or past retirement age. Outside of the security sector, health and education represent other areas of reform over the three year period. These sectors have seen significant accomplishments over the years, but there remains a scope for efficiency gains and cost savings.

Any practical discussion on expenditure control and reform must be supported by a viable pension system. Taking this into the account, the PA has included pension reform in the PRDP, with a planned institutional review of current pension schemes in 2008. Some early steps can be taken, including addressing the unregulated private sector pension system. Also, the PA is exploring a policy of a 'flat rate coverage system' to cover the poorest in the WB&G. This can be explored, with a costing of different options in comparison with the likely savings from a revised pension system. These steps, along with an adequate focus on safety nets, can facilitate any necessary steps the PA would take to recalibrate the pension system to one that is consistent with the PRDP's expenditure control policy.

Another key fiscal reform is the reduction in net lending, which is the second largest expenditure after the wage bill. The PA has already initiated critical steps in this regard. Moving forward, these initiatives are of greatest impact if accompanied by other reforms over time, including: (a) creating electricity suppliers that are financially sustainable and able to collect payments from customers; (b) transferring electricity supply from municipalities to electricity distribution companies, complemented with a system to fix municipal finances; and (c) introducing a well-targeted social protection system to ensure access to electricity for the poorest segments of the population.

The Development Investment Agenda

The PRDP also presents a coherent development plan that reflects a frank assessment of the PA's absorptive capacity for project implementation. The development agenda contains priority investments in governance, social, economic and private sector, and infrastructure development worth $1.644 billion over three years. The development budget increases progressively over this three year period (from $427 million in 2008 to $667 million in 2010), reflecting pragmatic assumptions by the PA of its own absorptive capacity.

As the PRDP is a rolling process, additional analysis will be needed to ensure that the development projects are properly costed and sequenced. Moreover, the economic development projects are vital for creating an environment for investment and trade. Once these priorities are clearly set, it will be necessary to determine the mandates and resource needs- including for capacity building- of relevant institutions such as the Land Authority, Customs, General Administration of Crossings and Borders, etc. Programs aimed at increasing production and exports will need to be designed carefully to ensure access of goods and to account for the impacts of movement and access restrictions.

Implementing the PRDP

The realization of the PRDP relies on parallel commitments by the PA, Israel and donors, but also on a proper design of the implementation mechanisms. In terms of channels of assistance, the PA has expressed the need for donor aid to cover the entirety of - - 3

the PRDP, with primary focus on recurrent expenditures to ensure the PA's viability. Also expressed was the need for direct assistance into the MOF's Single Treasury Account (STA), given the priority for financing recurrent expenditures and the PA's successful efforts to reconstitute key parts of the public financial management system. In addition to these, other aspects of implementation must be addressed, including: (a) monitoring and evaluation of the PRDP that is clear, practical and that encompasses all of the Palestinian Territories; (b) identifying innovative ways, reflective of the PRDP's commitments, to ensure that Gaza is not confined to humanitarian assistance alone; and (c) exploring, over time, ways of improving the existing intergovernmental fiscal relations.

Scenarios Facing the Palestinian Economy

The PA's macroeconomic framework assumes: (a) the successful advancement of reforms, including law and order; (b) sufficient donor funding; and (c) a gradual easing of movement and access restrictions subject to Israeli security concerns. It does not assume a resolution of the situation in Gaza. Therefore most of the growth would be in the West Bank, driven by Government investment and consumption, both of which are linked to aid. Successfully reaching the PRDP goals will lead to modest growth, averaging 5% per year, which– given current demographics and distribution of income- will barely affect poverty levels.

An economic scenario analysis shows that the successful implementation of Palestinian commitments alone, with partial donor funding and continued movement and trade restrictions, will fall well short of the intended targets. Achieving 5% growth rates will depend critically on the commitment of the international community to fill the total fiscal gap over the next three years, as well as on the revival in the private sector as a result of concrete steps by Israel on settlement growth, and movement and access restrictions. Even with full funding but no relaxation in the closure regime, growth will be slightly negative, at around -2% per year. If the required aid also fails to materialize, income will decline even more, and the already high and growing poverty levels will rise dramatically.

Alternatively, a scenario where the PRDP is implemented and fully funded by donors and where private sector activity and trade is revived will accelerate growth considerably. Embedded in this scenario is a recovery in Gaza driven by the resolution of the current stalemate, and the removal of movement and trade restrictions affecting both the West Bank and Gaza.

Under every foreseeable scenario, the short-term viability of the Palestinian economy will be driven by aid. Even under the most optimistic scenarios significant aid will continue to be required for the medium-term. Clearly, the ability of the private sector to resume its place as a driver for growth will have a major bearing on the sustained health of the Palestinian economy and thus its aid requirements, which will therefore be even larger in the absence of improvements in movements and access restrictions.

FULL REPORT:

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