
Fiscal Crisis, Economic Prospects

The Imperative for Economic Cohesion in the Palestinian Territories

*Economic Monitoring Report to the Ad Hoc Liaison Committee
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Executive Summary

The *Ad Hoc Liaison Committee* (AHLIC) meeting of September 2012 comes at a time of deepening fiscal crisis for the Palestinian Authority (PA), coupled with worrying signs of economic slowdown, reduced donor aid, and few positive prospects in the broader political environment.

The PA is making credible efforts to tackle the crisis and continue to build its institutions. Indeed, a year ago the World Bank reported to this forum on its assessment of the institution building efforts of the PA noting that "In areas where government effectiveness matters most – security and justice; revenue and expenditure management; economic development; and service delivery – Palestinian public institutions compare favorably to other countries in the region and beyond." That report also noted that the institutions of the PA "...are reasonably effective, both by any absolute standard one might have, and especially in comparison to other countries, in the region or elsewhere." The institutional assessment of one year ago remains valid today. However, that report also warned of the need for sustainable economic growth driven by private sector investment. This issue is the focus of this report.

The PA is facing a very serious fiscal situation with its budget deficit higher than expected while external budget support has been falling. Debt to the local banking sector is almost at its limit and further credit from the private sector is unlikely to be forthcoming given the current high level of arrears. It is imperative therefore that donors maintain their support to the PA's budget, and that the PA continues to move on key reforms to raise domestic revenues and control expenditures. However, even with such measures, the real prospects for progressing on a path towards sustainable Palestinian economic growth will be challenging absent fundamental and significant changes that remove the impediments caused by the dissection of the Palestinian territories – impediments which constrain investment, raise costs and hinder economic cohesion.

As reiterated in past World Bank reports, the sustainability of growth in the Palestinian territories depends upon increasing private investment. However, restrictions put in place by the Government of Israel (GoI)¹ continue to stand in the way of potential private investment and remain the major impediment to sustainable economic growth. Most notably, the continued geographical fragmentation of Area C, (envisaged under the Oslo Accords as a temporary arrangement), poses a binding constraint to real economic growth, essential to support the future Palestinian state. Area C's significance, as the only contiguous land in the West Bank connecting 227 separate geographical areas (A and B), is the key to economic cohesion and is the most resource abundant space in the West Bank holding the majority of the territory's water, agricultural lands, natural resources, and land reserves that provide an economic foundation for growth in key sectors of the economy.

Preliminary analysis illustrates, in a number of potentially lucrative sectors, how the current system of restrictions, both physical and administrative hinders or prevents Palestinian private investment. The analysis highlights myriad challenges which can be tackled – whether with respect to land and water access, regulatory and procedural issues, in addition to the more frequently recognized physical barriers.

Continued financial support by the donor community, and increased reform efforts by the PA, to be fully effective, should also be combined with stronger action by the GoI to significantly ease remaining obstacles that currently prevent the Palestinian private sector from becoming the real engine of sustainable growth – the only medium term solution to exit from protracted fiscal crisis.

¹The GoI cites overriding security concerns that restrict its ability to continue to ease or lift restrictions on the West Bank and Gaza.