**Source: World Bank** **2 October 2013**

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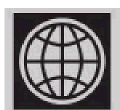
**Report No. AUS2922**

# West Bank and Gaza
# Area C and the Future of the Palestinian Economy

**October 2, 2013**

**Poverty Reduction and Economic Management Department**
**Middle East and North Africa Region**



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## Executive Summary

i. ***Restrictions on economic activity in Area C of the West Bank have been particularly detrimental to the Palestinian economy***. Area C constitutes about 61 percent of the West Bank territory and was defined under the Oslo Peace Accords as the area that would be gradually transferred to the Palestinian Authority within a period of 5 years, except for the parts to be agreed upon within the final settlement agreement.' The gradual transfer has not yet taken place and, in the meantime, access to this area for most kinds of economic activity has been severely limited. Yet, the potential contribution of Area C to the Palestinian economy is large. Area C is richly endowed with natural resources and it is contiguous, whereas Areas A and B are smaller territorial islands. The manner in which Area C is currently administered virtually precludes Palestinian businesses from investing there.
ii. ***Mobilizing the Area Cpotential would help afaltering Palestinian economy***. The Palestinian economy has experienced strong growth in recent years, fuelled by large inflows of donor budget support, some easing of the Israeli movement restrictions that intensified during the second intifada, and a PA reform program. By 2012, however, foreign budget support had declined by more than half, and GDP growth has fallen from 9 percent in 2008-11 to 5.9 percent by 2012 and to 1.9 percent in the first half of 2013 (with negative growth of - 0. 1 percent in the West Bank).

iii. ***This slowdown has exposed the distorted nature of the economy and its artificial reliance on donor-financed consumption***. For a small open economy, prosperity requires a strong tradable sector with the ability to compete in the global marketplace. The faltering nature of the peace process and the persistence of administrative restrictions as well as others on trade, movement and access have had a dampening effect on private investment and private sector activity. Private investment has averaged a mere 15 percent of GDP over the past seven years, compared with rates of over 25 percent in vigorous middle income countries. The manufacturing sector, usually a key driver of export-led growth, has stagnated since 1994, its share in GDP falling from 19 percent to 10 percent by 2011. Nor has manufacturing been replaced by high value-added service exports like Information Technology (IT) or tourism, as might have been expected. Much of the meager investment has been channeled into internal trade and real estate development, neither of which generates significant employment. Consequently, unemployment rates have remained very high in the Palestinian territories and are currently about 22 percent - with almost a quarter of the workforce employed by the Palestinian Authority, an unhealthy proportion that reflects the lack of dynamism in the private sector. While the unsettled political environment and internal Palestinian political divisions have contributed to investor aversion to the Palestinian territories, Israeli restrictions on trade, movement and access have been seen as the dominant deterrent.
iv. ***Area C is key to future Palestinian economic development.*** The decisive negative economic impact of Israeli restrictions has been analyzed in many reports produced by the World Bank and other development agencies over the past decade, and Israel's rationale for them - that they are necessary to protect Israeli citizens - is also well-known. Within this setting, Area C is particularly important because it is either off limits for Palestinian economic activity, or only accessible with considerable difficulty and often at prohibitive cost. Since Area C is where the majority of the West Bank's natural resources lie, the impact of these restrictions on the Palestinian economy has been considerable. Thus, the key to Palestinian prosperity continues to lie in the removal of these restrictions with due regard for Israel's security. As this report shows, rolling back the restrictions would bring substantial benefits to the Palestinian economy and could usher in a new period of increasing Palestinian GDP and substantially improved prospects for sustained growth.
v. ***This report examines the economic benefits of lifting the restrictions on movement and access as well as other administrative obstacles to Palestinian investment and economic activity in Area C.*** It focuses on the economic potential of Area C and does not prejudge the status of any territory which may be subject to negotiations between Palestinians and Israelis. We examine potential direct, sector-specific benefits, but also indirect benefits related to improvements in physical and institutional infrastructure, as well as spillover effects to other sectors of the Palestinian economy. The sectors we examine are agriculture, Dead Sea minerals exploitation, stone mining and quarrying, construction, tourism, telecommunications and cosmetics. To do so, we have assumed that the various physical, legal, regulatory and bureaucratic constraints that currently prevent investors from obtaining construction permits, and accessing land and water resources are lifted, as envisaged under the Interim Agreement. We then estimate potential production and value added, using deliberately conservative assumptions - and avoid quantification where data are inadequate (as with cosmetics, for example, or for tourism other than that of Dead Sea resorts). It is understood that realizing the full potential of such investments requires other changes as well - first, the rolling back of the movement and access restrictions in force outside Area C, which prevent

the easy export of Palestinian products and inhibit tourists and investors from accessing Area C; and second, further reforms by the Palestinian Authority to better enable potential investors to register businesses, enforce contracts, and acquire finance.

### Direct Benefits

*vi.* ***Neglecting indirect positive effects, we estimate that the potential additional output from the sectors evaluated in this report alone would amount to at least USD 2.2 billion per annum in valued added terms - a sum equivalent to 23 percent of 2011 Palestinian GDP.***[2] The bulk of this would come from agriculture and Dead Sea minerals exploitation.

- In the case of ***agriculture***, the key issues are access to fertile land, and the availability of water to irrigate it. We have omitted from our calculations the 187,000 dunums that fall under the control of Israeli settlements. To irrigate the 326,400 dunums of other agricultural land notionally available to Palestinians in Area C would require some 189 MCM of water per year. Current Palestinian allocations under the Oslo Accords are 138.5 MCM, or 20 percent of the estimated availability - a share to be revisited at Final Status negotiations. Irrigating this unexploited area as well as accessing additional range and forest land could deliver an additional USD 704 million in value added to the Palestinian economy - equivalent to 7 percent of 2011 GDP.
- The Dead Sea abounds in valuable ***minerals***, principally large deposits of potash and bromine. Israel and Jordan together derive some USD 4.2 billion in annual sales of these products, and account for 6 percent of the world's supply of potash and fully 73 percent of global bromine output. Demand for both these products is projected to remain strong, with the Dead Sea a cheap and easily exploited source. There is no reason to suppose that Palestinian investors along with prospective international partners would not be able to reap the benefits of this market, provided they were able to access the resource. Taking as a benchmark the average value added by these industries to the Jordanian and the Israeli economies, the Palestinian economy could derive up to USD 918 million per annum - equal to 9 percent of 2011 GDP, almost equivalent to the size of the entire Palestinian manufacturing sector.
- Area C is also rich in stone, with estimated deposits of some 20,000 dunums of quarryable land. Palestinian stone ***mining and quarrying*** is already Palestinian territories' largest export industry with exports based on the famous "Jerusalem Gold Stone". However, this is a struggling industry, due to an inability to obtain permits to open new quarries, and with most existing quarries in Area C unable to renew their licenses. If these restrictions are lifted, we estimate that the industry could double in size, increasing value added by some USD 241 million - and adding 2 percent to 2011 Palestinian GDP.
- The ***construction*** industry is in acute need of additional land to expand housing and make it more affordable. Areas A and B are already very densely populated and built-up. UNOCHA analysis suggests that less than one percent of the land in Area C is currently available to Palestinians for construction; permit data also shows that it is almost impossible to obtain permission to build in Area C. Less than 6 percent of all requests made between 2000 and 2007 secured approval. This situation applies not only to housing but to public economic infrastructure (roads, water reservoirs, waste treatment plants) and industrial plant, and to the access roads and utility lines needed to connect Areas A and B across Area C. These factors have led to much suppressed growth in the construction sector and to an average increase in housing prices in the West Bank over the past two decades that is some 24 percent above what would otherwise be expected. We estimate that lifting the tight restrictions on the construction of residential and commercial buildings alone (excluding infrastructure projects) could increase West Bank construction sector value added by some USD 239 million per annum - or 2 percent of 2011 Palestinian GDP.
- Area C has major global ***tourism*** potential, but for Palestinians this remains largely unexploited due to a large degree to current restrictions on access and investment, in particular around the Dead Sea. Palestinian Dead Sea tourism development was envisaged in the Interim Agreement, but has not yet emerged. If current restrictions are lifted and investment climate in the West Bank improves, it is reasonable to assume that, in due course, Palestinian investors would be able to create a Dead Sea hotel industry equivalent to Israel's, producing value added of some USD 126 million per annum - or 1 percent of 2011 Palestinian GDP. Investments to develop other attractive tourism locations in Area C could generate substantial additional revenues.
- The development of the Palestinian ***telecommunications*** sector is also constrained by Area C restrictions, which prevent the construction of towers for mobile service and have impeded the laying of landlines and ADSL cable. Only limited 2G frequencies have been provided to the two Palestinian mobile operators, while access to the 3G spectrum has not been granted at all. Importation of equipment has also been difficult. As a result, Palestinian telecommunications costs are high, and coverage and service quality are less than optimal. The 3G restrictions in particular threaten the industry's very viability, particularly since Israeli competitors have been allowed to develop infrastructure in Area C. We estimate that removing today's restrictions would not only remove a serious threat to the viability of this industry, but also add some USD 48 million in value to the sector - equal to 0.5 percent of Palestinian 2011 GDP.

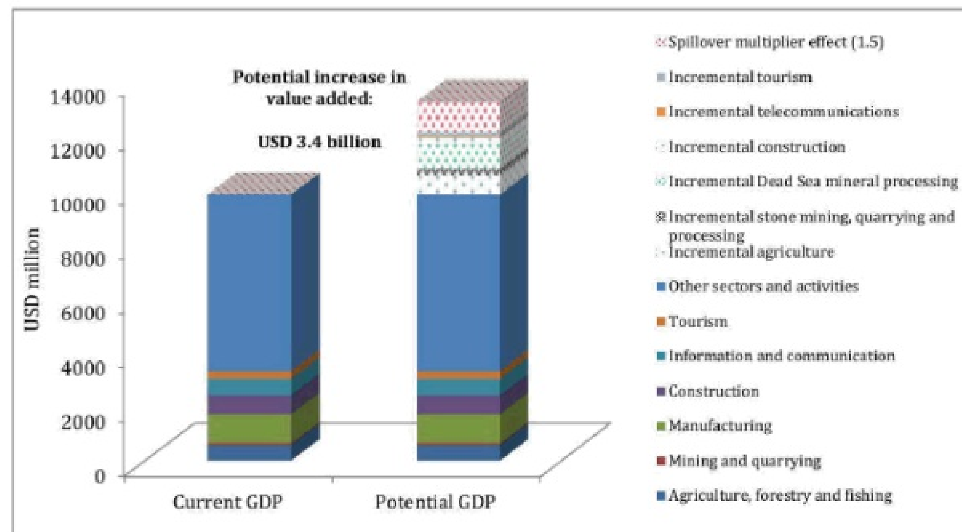
### Indirect Benefits

*vii.* ***In addition to the direct benefits discussed in Chapter 2, the indirect benefits of removing the restrictions in Area C would be significant.*** Indirect costs and benefits can be divided into those related to physical and institutional infrastructure, and spillover-related costs and benefits. The first set of costs and benefits are driven by the impact of Israeli restrictions on the quality and cost of infrastructure; the impact of the restrictions in this instance is difficult to measure, and no attempt to do so is made here. Nonetheless, the effects are considerable and are alluded to below. The second set derives from the fact that sectors are linked, with one using the outputs of another as production inputs - and those effects can be quantified.

*viii.* ***The quality and cost of infrastructure are impacted considerably by the restrictions present in Area C.*** All Palestinian industries are to some extent dependent on the quality of transportation, electricity, water, and telecommunications infrastructure. Transportation infrastructure is particularly problematic as Palestinian use of roads in Area C is highly restricted, and travel times can be inordinate; the Palestinian Authority has also been unable to develop roads, airports or railways in or through Area C. Restrictions in Area C have impeded the development of "soft" institutional infrastructure such as banking services, which are hamstrung by the inability to open and service branches, and the inability in practice to use land in Area C as collateral. Insecurity and the difficulty of policing Area C also deter investors. These impediments create significant uncertainty and reduce the expected returns on potential investments.

*ix.* ***Addressing the constraints on the evaluated sectors would have sizeable effects on the demand for output in other related sectors.*** Despite the relative lack of diversification of the Palestinian economy and the undeveloped nature of its domestic supply chains, these linkages are important. The potential spillover effects for the rest of the Palestinian economy emanating from the expansion of these sectors was calculated by using data on inter-sectoral linkages produced recently by the Palestinian Central Bureau of Statistics. The overall multiplier effect emerging from this exercise is 1.5 - a figure calculated without reliance on a general equilibrium model, and very probably an underestimate.3 Applying this multiplier, the total potential value added from alleviating today's restrictions on access to, and activity and production in Area C is likely to amount to some USD 3.4 billion -- or 35 percent of Palestinian GDP in 2011.

**Figure I: Growth generated through the lifting of restrictions in selected sectors could increase potential Palestinian value added by USD 3.4 billion**

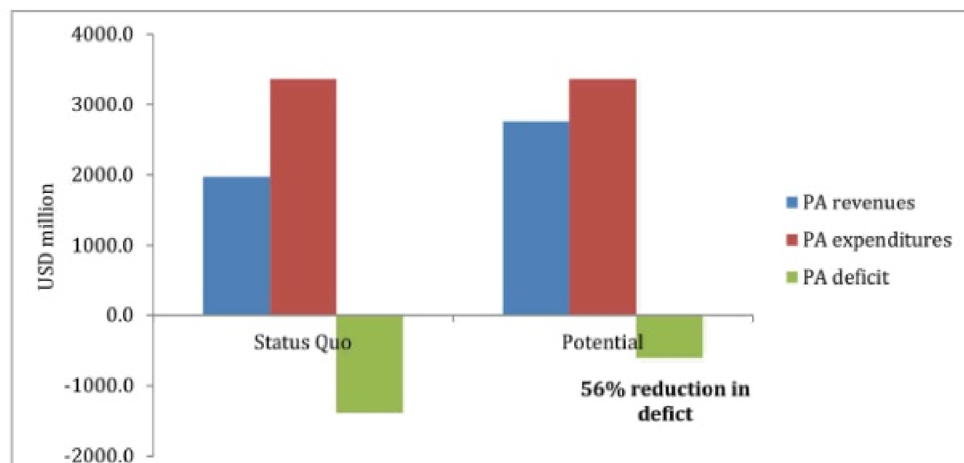



*Source:* Palestinian Central Bureau of Statistics (PCBS) National Accounts data (2011) and World Bank staff calculations.

*x.* ***Tapping this potential output could dramatically improve the PA's fiscal position.*** Even without any improvements in the efficiency of tax collection, at the current rate of tax/GDP of 20 percent the additional tax revenues associated with such an increase in GDP would amount to some USD 800 million. Assuming that expenditures remain at the same level, this extra resource would notionally cut the fiscal deficit by half - significantly reducing the need for donor recurrent budget support.4 This major improvement in fiscal sustainability would in turn generate significant positive reputational benefits for the PA and would considerably enhance investor confidence.

*xi.* ***The impact on Palestinian livelihoods would be impressive.*** An increase in GDP equivalent to 35 percent would be expected to create substantial employment, sufficient to put a significant dent in the currently high rate of unemployment. If an earlier estimated one-to-one relationship between growth and employment was to hold, this increase in GDP would lead to a 35 percent increase in employment. This level of growth in employment would also put a large dent in poverty, as recent estimates show that unemployed Palestinians are twice as likely to be poor as their employed counterparts.

**Figure II: If the output potential associated with lifting the restrictions materializes, the fiscal deficit of the PA is reduced by 56 percent and the need for external budget support greatly declines**




*Source: Ministry of Finance of Palestinian authority fiscal data (2012) and World Bank staff calculations.*

*xii.* ***Access to Area C will not cure all Palestinian economic problems - but the alternative is bleak.*** Without the ability to conduct purposeful economic activity in Area C, the economic space of the West Bank will remain crowded and stunted, inhabited by people whose daily interactions with the State of Israel are characterized by inconvenience, expense and frustration.

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[1] The Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip ("Oslo 2"_ 9/28/95).

[2] Sensitivity of these estimates to different assumptions on key variables is shown in ANNEX 1.

[3] A general equilibrium model would capture third round effects, the effects of infrastructure development in Area C and other indirect effects, which our calculation did not capture. Such a model would also capture price effects, which in the short and medium term would have a negative impact on demand, but would adjust in the long run, which allows for capacity adjustments.

[4] In reality, the lifting of restrictions on Area C would probably lead to an increase in public investments to develop infrastructure there. These investments would increase public expenditures, but they would also contribute to growth and the net effect is uncertain. Thus, for the sake of this report no change in the level of public expenditures associated with the lifting of Area C restrictions was assumed.

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