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Fiscal Challenges and Long Term Economic Costs

Economic Monitoring Report to the Ad Hoc Liaison Committee
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Executive Summary

Recent reports to the *Ad Hoc* Liaison Committee (AHLC) have repeatedly noted the necessity of both sustainable economic growth and effective institutions as the underpinning of a viable state. The substantial achievements of the Palestinian Authority (PA) on institution building have been the subject of considerable analysis and reporting to this forum. Indeed these institutions have played a crucial role in enabling the positive economic growth in the Palestinian Territories in recent years. Yet prospects for sustainable economic growth remain constrained.

With the current economic slowdown, measures to increase tax revenues handicapped by external constraints, most notably Israeli restrictions1, and any further increase in the PA's borrowing from local commercial banks considered unsafe for the stability of the banking sector, the provision of basic services by the PA is increasingly affected and there is a risk that gains in institution building may be eroded. Moreover, it is important to recognize that the fiscal challenges faced by the PA, coupled with a protracted stalemate in the political process, have negative impacts not only on short term economic growth, but also the competitiveness of the Palestinian economy over the longer term.

Following robust GDP growth in recent years, economic activity significantly slowed in 2012. This slowdown reflects in part the absence of further easing of Israeli restrictions, the withdrawal of fiscal stimulus due to a persistent shortfall in donor aid, and uncertainty created by the PA's fiscal challenges. Despite the fiscal stress, the PA has continued its reform efforts. Notable efforts include modernization of revenue administration, initiating rationalization of health sector spending, containment of the civil service wage bill within the budget target, improving efficiency and transparency of cash transfer program and public procurement system, and satisfactory performance of the banking sector.

Continued financial support by the donor community and reform efforts by the PA are therefore essential to manage the financing shortfalls of today. However, much greater attention must be given to the removal of obstacles to allow real Palestinian private sector-led growth. The Oslo Accords of 1993 anticipated an arrangement that would last for a five-year interim period during which a permanent agreement would be negotiated. They did not anticipate the lack of forward movement on the political process that has been experienced with its concomitant economic effects. This so called *status quo* belies a process whereby the continuation of restrictions and the absence of real opportunities to open up the Palestinian economy are actually having a lasting negative impact on its overall competitiveness. While some of the costs imposed by the current situation are transitory and could be expected to disappear with a peace agreement, others are posed to remain and are likely to require significant time and financial resources to be remedied.

The growth potential of a small economy depends to a large extent on its capacity to compete in global markets – yet, since 1994, the Palestinian economy has been steadily losing this capacity. In particular, the manufacturing sector, one of the key drivers of export-led growth, has largely stagnated between 1994 and the present and its share of Gross Domestic Product (GDP) has declined substantially. In the meantime, the agriculture sector has doubled its employment but sector productivity was roughly halved.

The share of exports of goods in the Palestinian economy, at around 7 percent in 2011 (from around 10 percent in 1996), is among the lowest in the world. Moreover, Palestinian exports are highly concentrated in low value added goods and services and they are exported to only a small number of countries, with more than 85 percent of them heading to Israel. Even with the removal of exogenous restrictions, the Palestinian economy is ill-positioned to benefit quickly and sufficiently from export opportunities and adjustments would require significant resources and time.

With low labor force participation and high rates and duration of unemployment, many Palestinians of working age do not have the opportunity to develop on-the-job skills. Furthermore, the concentration of the labor force in small enterprises for trade and services is not conducive to the development of skills that would render Palestinian workers competitive in the global economy. The growth in public sector employment has supported job creation but is not a sustainable solution in the medium and long term. The worrisome implication of these phenomena is that the long term employability prospects for the Palestinian labor force are being eroded. In addition to the economic implications, protracted unemployment, especially among youth, tends to weaken social cohesion.

Poor performance of infrastructure sectors has also had a negative impact on the competitiveness of the Palestinian economy. The PA's worsening fiscal space for infrastructure spending has severely constrained the accumulation and management of physical infrastructure despite contributions from development partners. Restrictions on movement and access have also led to the deterioration of the quality of infrastructure as evidenced in various sectors such as water, transport, and telecommunications, with its negative impact most significant in Gaza.

In conclusion, continued financial support by the donor community, and increased reform efforts by the PA to manage the current fiscal challenges must remain a high priority. However, much bolder efforts to create the basis for a viable economy need to be made to prevent the continued deterioration that will have lasting and costly implications to

economic competiveness.

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[1] The Government of Israel cities overriding security concerns that restrict its ability to continue to ease or lift restrictions on the Palestinian Territories.