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# Economic Monitoring Report to the Ad Hoc Liaison Committee

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## The World Bank

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### I. Executive Summary

1. **The Palestinian economy is not growing enough to raise living standards and reduce high unemployment.** The economy has witnessed a sharp deceleration in economic growth, from over 8 percent during 2007-11 to 3 percent during 2012-15. The sharp decline in growth has stifled the economy's ability to create jobs for a growing youth population. Successful reform efforts and strong economic growth helped bring the relative size of the Palestinian overall fiscal deficit down from 24.6 percent of GDP in 2008 to 13 percent in 2010. However, despite these efforts at fiscal consolidation, the deficit to GDP ratio has remained stuck in the 10 - 13 percent range since 2010 -- on the back of a large wage bill and weak revenue performance. The economy has long suffered from the restrictions[1] and political instability that continue to constrain private sector activity. In addition, the decline in donor funding from 32 percent of GDP in 2008 to 6 percent in 2015 has significantly contributed to the recent economic weakening. The internal divide between the West Bank and Gaza, which has created a dual regulatory framework, has also negatively impacted economic activity and the tax base.

2. **In 2015, the economy bounced back from the 2014 recession but economic growth was barely enough to keep up with population growth.** The 2014 Gaza war pushed the Palestinian economy into recession due to the devastating impact it had on economic activity and the livelihood of Gazans. From a very low base, economic growth was 6.8 percent in Gaza in 2015 — with the reconstruction, wholesale and retail trade sectors being the main drivers. While it is positive that Gaza returned to economic growth, with the current pace of reconstruction, and with a lingering internal divide between Gaza and the West Bank, the Gaza economy is not expected to rebound to prewar levels before 2018. Overall growth in the Palestinian economy was limited to 3.5 percent due to a growth slowdown in the West Bank from 5.3 percent in 2014 to an anemic 2.5 percent in 2015 in the face of a significant decline in foreign aid and the liquidity squeeze caused by the Israeli decision to suspend the transfer of the Palestinian Authority's (PA) taxes during the first four months of 2015. Given that population growth in the Palestinian territories is around 3 percent, economic growth witnessed in 2015 was not enough to increase per capita incomes.

3. **Even though only a political resolution would allow the Palestinian economy to reach its full potential, easing the restrictions and implementing existing agreements could significantly improve the economic outlook.** In general, granting Palestinians access to production inputs and external markets and enabling unimpeded movement of goods, labor and capital, as anticipated in the political agreements, would drastically improve growth prospects of the Palestinian economy. For example, the Oslo Accords envisioned a gradual transfer of Area C to the PA's control. This hasn't happened yet, and the World Bank estimates that granting Palestinian businesses access to Area C would increase Palestinian GDP by a third. Also, the Paris Protocol allows for the expansion of the quota of goods that the PA can apply its own import and customs policy to and import from third countries, depending on the Palestinian market's needs. These quotas, however, have not been revised since 1994 even though Palestinian needs have significantly increased over the years, resulting in supply shortages. The blockade imposed on Gaza since 2007 continues to weigh on the economy. Also, the closure of the Rafah crossing has further exacerbated the situation. Israeli measures to allow more goods out of Gaza have expanded since the last AHLC meeting and are a step in the right direction. However, more needs to be done as only 11 percent of what left Gaza prior to the blockade is currently being allowed out. Freeing up movement of people and goods in a way that meets legitimate security concerns of neighboring countries is essential to improve Gaza's growth prospects.

4. **The PA suffers from substantial revenue losses under the current revenue sharing arrangements outlined by the Paris Protocol and other subsequent agreements.** The agreements defined specific arrangements through which the Government of Israel (GoI) collects VAT, import duties and other income, or the so called clearance revenues, on behalf of the PA and shares it with the latter on a monthly basis. Some of these arrangements have become outdated and others have not been implemented as envisaged by the agreements, resulting in fiscal losses for the PA. The quantified annual loss (excluding revenues collected by the GoI in Area C that could not be quantified due to data constraints) amounts to USD285 million, or 2.2 percent of Palestinian GDP. The majority of the quantified loss from incomplete implementation of the Paris Protocol results from tax leakages on bilateral trade with Israel in addition to undervaluation of Palestinian imports from third countries. In addition to costs related to incomplete implementation of the Paris Protocol, some of the measures need to be updated. For instance, while the three percent handling fee charged by the GoI may have been appropriate at the time the agreement was signed, the current amount significantly outstrips costs incurred by the GoI to handle Palestinian imports.

5. **In addition to the annual losses, considerable revenues owed to the PA and to Palestinian workers are not remitted.** The stock of revenues currently retained by the GoI is estimated at USD669 million, or 5.3 percent of Palestinian GDP. This amount mainly includes pension contributions collected over the years from Palestinians working in Israel and their employers. Under the agreement, it was anticipated that these contributions would be transferred to a dedicated pension fund that is yet to be established by the PA, and are to be used to pay pension allowances for these workers once they retire. The overall amount also includes deductions made by the GoI from the salaries of Palestinian workers in Israel over the years. These deductions were expected to have been transferred to the PA on a monthly basis to finance health services and social benefits for these workers and their families. Finally, revenues retained by the GoI include Allenby Bridge exit fees that have not been shared with the PA as intended under the original agreed upon sharing formula.

6. **Resolving outstanding issues related to the revenue sharing arrangements will significantly ease the PA's fiscal stress, improve the economic outlook, and might facilitate progress on the political front.** The Israeli and Palestinian Ministers of Finance have recently met and it was agreed that the GoI will transfer to the PA about USD128 million to offset some of the PA's losses accumulated over the years. This recent agreement is highly encouraging as a first step. The revival of the Joint Economic Committee (JEC) that was established in 1994 with the objective of following up on the implementation of the Paris Protocol would help in resolving outstanding issues.

7. **Closing the fiscal gap will also require sustained action by the PA and the donors.** The PA ought to carry on with its efforts to enhance public revenues as they continue to be lower than potential. On the domestic front, low tax collection in Gaza is an important reason behind suboptimal revenues, as it shaves 3-4 percentage points off the PA's revenues as a share of GDP. Weak compliance in the West Bank and generous tax holidays also reduce revenues by about 4 percentage points. Reforms by the PA to enhance revenues and rationalize expenditures ought to continue, even under the challenging economic and political conditions. The World Bank's report to the ABLC in September 2015 provided recommendations on how to rationalize public spending and improve its quality. With such continued fiscal reforms by the PA, donors need to do their share and support the

reforms through budget support based on progress by the PA on key measures such as those found in the European Union's results framework for budget support, the IMF's recommendations and the World Bank's budget support framework.

8. **Slower than expected aid continues to hamper Gaza reconstruction, but as additional pledges materialize, the current import mechanism will also need to be adjusted.** Out of the USD3.5 billion pledged at the Cairo conference for Gaza reconstruction, USD1.4 billion has so far been disbursed, which puts the disbursement ratio at 40 percent. Since the September 2015 AHLC report, disbursements have increased by USD179 million• USD159 million in additional disbursements and USD20 million as a result of updating figures. Funds already disbursed are USD1.3 billion less than originally planned mainly because payments by some of the largest donors remain lower than anticipated. At the current pace, pledges will fully materialize by mid-2019; almost two years behind schedule. As donor pledges materialize and as larger recovery projects start to advance, the import mechanism will need to be adjusted to enable the entrance of the required materials and accelerate approval procedures, while taking into account legitimate Israeli security concerns. Despite recent progress, construction material imported into Gaza continues to be lower than needed. At the current import rate, it will take about two years to import materials needed to rebuild and repair all housing units impacted by the war. As a result of lower than needed funding and construction materials, only 9 percent of totally damaged houses and 45 percent of partially damaged houses have so far been rebuilt, and 14,800 families continue to be displaced.

9. **The main body of the report is organized in four chapters and an annex.** Chapter II focuses on recent economic developments and provides a near term macroeconomic outlook. Chapter III discusses the PA's finances in 2015 and 2016. Chapter IV reviews money and banking, while Chapter V takes a comprehensive look at the implementation of the revenue sharing arrangements between the PA and the GoI. Finally, an annex summarizes the status of donor pledges from the Cairo conference on Gaza reconstruction.

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[i] According to the Government of Israel these restrictions are imposed to protect the security of Israeli citizens.