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Report on UNCTAD assistance to the Palestinian people

Report on UNCTAD assistance to the Palestinian people: developments in the economy of the Occupied Palestinian Territory

Note by the UNCTAD secretariat

Executive summary

With the persistence of Israeli restrictions on mobility in the Occupied Palestinian Territory,* loss of land and productive resources and bleak political prospects, gross domestic product (GDP) decelerated, and poverty and unemployment increased in 2012. These conditions are expected to deteriorate further. The Palestinian fiscal crisis deepened, owing to less aid and Israel's withholding of Palestinian revenue, posing risks to the whole economy. The crisis is exacerbated by the leakage of Palestinian fiscal revenues from smuggling and lost tax on imports via Israel. Stemming this leakage, estimated at $300 million annually, would expand Palestinian fiscal policy space, with a broader, positive impact on the economy, employment and poverty.

UNCTAD continues to respond positively to the emerging needs of the Palestinian people. However, securing extrabudgetary funding remains critical to achieving the Doha Mandate of supporting the efforts towards building an independent Palestinian State.

* The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the United Nations Secretariat concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delineation of its frontiers or boundaries. In accordance with the relevant resolutions and decisions of the General Assembly and Security Council, references in this report to the Occupied Palestinian Territory or territories pertain to the Gaza Strip and the West Bank, including East Jerusalem. Use of the term 'Palestine' refers to the Palestine Liberation Organization (PLO), which established the Palestinian Authority. References to the 'State of Palestine' are consistent with the vision expressed in Security Council resolution 1397 (2002) and General Assembly resolution 67/19 (2012).

I. Adverse economic and political horizons

1. The strains on the Palestinian economy have intensified since 2012. GDP growth slowed to 6 per cent in 2012, down from double-digit growth in the previous two years, while unemployment soared to 27 per cent. Structural constraints on economic development have worsened due to the prolonged Israeli restrictions on the movement of Palestinian people and goods, the expansion of settlements, the growing inability of Palestinian producers to access their productive resources, the decline in aid flows and pervasive political and economic uncertainty. The deepening fiscal crisis triggered political unrest in the Occupied Palestinian Territory, and hopes for a political settlement dimmed further. Economic growth is projected to decline further in the short to medium term. The present constraints will continue to have an adverse impact on unemployment and poverty, and the limited on Palestinian fiscal space.

A. Constraints on demand and supply

2. The projected decline in economic performance is a natural result of the increasingly binding constraints on both the supply and the demand sides of the economy. The feeble economic performance reflects the impact of the fiscal crisis and lower aid flows on aggregate demand. On the supply side, growth is sharply constrained by the blockade on Gaza, mobility and access restrictions and the construction of the separation barrier in the West Bank, isolation of the whole economy from international markets, inflated production costs that cripple competitiveness and deteriorating political horizons.

3. Previously, the effects of these restrictions had been masked by significant donor support, which enabled the Palestinian Authority to inject fiscal stimulus into the economy. The decline in accustomed aid inflows and the ensuing fiscal crisis have begun to reveal the full impact of the Israeli occupation on the Palestinian people and their economy.

4. The deceleration of economic activities was pronounced in Gaza, where GDP growth fell from 21 per cent in 2011 to 6.6 per cent in 2012. This decline, concentrated in the agricultural and fishing sectors, was due to the Israeli military operation on Gaza in November 2012, acute energy and water shortages,

unfavourable weather and the Palestinian Authority's fiscal crisis (World Bank, 2012). Growth in Gaza remains exceptionally weak in light of the low base of economic activity over the last seven years, the unemployed and underemployed human, physical and natural resources. Economic retraction reflects the continued restrictions on imports and exports and the increasing difficulties of the informal tunnel trade with Egypt. Even in the West Bank, previously higher economic growth slowed to 5.6 per cent, mainly because of the contraction of the construction sector (4.2 per cent) (Palestinian Central Bureau of Statistics (PCBS), 2013).

5. As a result of the economic blockade of Gaza, its share in the economy of the Occupied Palestinian Territory fell from one third to about one fourth between 2004 and 2012. Had Gaza maintained its 2004 share in the Palestinian economy, its 2012 GDP would have increased by almost 40 per cent to reach $2.5 billion, instead of the observed $1.8 billion. During the same period, the real GDP per capita in Gaza relative to that of the West Bank fell from 75 per cent to a mere 50 per cent. These numbers suggest that the ongoing blockade cost Gaza half of its real GDP, but this would be a significant underestimation, since the West Bank's economy has been operating much below its potential because of multiple occupation constraints.

B. Occupation and settlement make development unattainable

6. Since its occupation of the West Bank and Gaza in 1967, Israel has established about 150 settlements in the West Bank, including East Jerusalem, and some 100 unauthorized outposts. These were built on Palestinian land by Israeli settlers, numbering 520,000 in 2012.[1] Since then, more settlements and the expansion of existing ones in the Occupied Palestinian Territory have been approved. Housing constructions starts in settlements spiked 176 per cent in the first quarter of 2013 compared with 2012.[2] Construction of the separation barrier inside the West Bank continues; once completed, 80 per cent of the settler population in the West Bank and East Jerusalem will be living not only on the east side of the 1967 borders but farther to the east of the barrier, annexing more Palestinian land. Approximately 540 internal checkpoints, roadblocks and other physical obstacles continue to impede Palestinian movement within the West Bank and separate the Palestinian communities in segregated Bantustans, disconnected from domestic and international markets.

7. Palestinian farmers in the Jordan Valley are forced to use longer roads and pass through checkpoints, which increases the transportation cost by almost $2 million and therefore reduces the competitiveness of Palestinian products. Furthermore, the industrial sector faces inflated land cost as a result of the artificial scarcity of land induced by lack of access to Area C, which is under direct jurisdiction of the Israeli military.[3] This raises the cost of land in Areas A and B, partly under the jurisdiction of the Palestinian Authority, by an additional 30–150 per cent above similar land in Area C (World Bank, 2012). In addition, the debilitated Palestinian infrastructure limits the growth and reduces the competitiveness of the industrial sector. Collectively these supply constraints lead to lower output, higher unemployment and additional fiscal pressure due to the smaller tax base and increased need for greater public employment and social spending.

8. Another example of the impact of occupation on Palestinian development is the telecommunication sector. Palestinian mobile operators are not allowed to build towers in Area C, and are therefore forced to resort to contracts with Israeli firms. This escalates the costs and undermines the competitiveness of Palestinian providers. Consequently, Palestinian companies lose more than 30 per cent of their customer base, which is obliged to subscribe through Israeli suppliers. Lack of jurisdiction in Area C also means that the Palestinian Authority cannot protect or repair the telecommunication infrastructure. Theft and vandalism cost Palestinian operators over $1.2 million annually, in addition to losses incurred by the Palestinian landline operator of about $6 million. Such forced diversion to Israeli suppliers pervades most aspects of Palestinian economic life and is not limited to the telecommunication sector.

9. The overall pattern of economic growth in the Occupied Palestinian Territory has favoured the non-tradable sector, with a decline in agriculture and an expansion in services, which recorded the highest growth rate. In contrast, growth in the construction sector weakened in response to the decline in mortgage lending, the Palestinian Authority's fiscal crisis and the accumulation of arrears to the private sector.

10. Between 1995 and 2012, agriculture contribution to GDP decreased from 12–4.9 per cent. In 2012 the sector value added further declined by 13 per cent while the number of workers it employs fell by 2 per cent, indicating a drop in labour productivity. Agriculture has been disproportionately impacted by the loss of land and water resources and the expansion of Israeli settlements. In the Gaza Strip, limited growth was concentrated in the non-tradable goods sector, mainly transport and storage, construction, hotels and restaurants and the services sector, while the more dynamic and employment-intensive agricultural sector shrank 33 per cent, and the manufacturing sector failed to recover (PCBS, 2013). In the West Bank, growth followed the same pattern whereby services, wholesale and retail trade accounted for most of the observed growth.

11. Although the services sector accounts for the largest share of Palestinian GDP and employment, it has the lowest productivity per worker except for the sharply constrained agricultural sector. In 2012, productivity in the services sector stood at half of that of manufacturing and one third of construction. The corresponding comparative productivity figures are even worse for the besieged agricultural sector; standing at 42 per cent and 29 per cent of manufacturing and construction productivity, respectively.

12. Efforts of the Palestinian Authority to promote development under occupation have reached their limit; progress is impossible without rolling back occupation and its heavy economic losses. Arresting the ongoing economic deterioration and preserving the Palestinian Authority’s achievements in building institutional capacities requires continued donor support to ease fiscal constraint. However, Palestinian economic development and fiscal autonomy will continue to be an illusion as long as the current occupation constraints on development remain in place.

C. High unemployment, inflation, lower wages and poverty

13. Table 1 shows that unemployment rose to 27 per cent in 2012. Unemployment and participation rates are worst among young Palestinians, with one out of two unemployed in Gaza. Prolonged episodes of high unemployment will inevitably produce long-lasting socioeconomic costs because the large-scale deskilling of workers renders some of them not just unemployed but unemployable. The unemployment rate, high as it is, understates the severity of the socioeconomic conditions for reasons such as declining real wages, low labour productivity, high dependency rates, long duration of unemployment spells, which doubled from 2000 to reach 12 months in 2012, and the low participation rate, which was below 44 per cent in 2012.

Table 1
Economy of the Occupied Palestinian Territory: key indicators[a]

	1995	*1999*	*2002*	*2005*	*2009*	*2010*	*2011[a]*	*2012[a]*
Macroeconomic performance								
Real GDP growth (percentage)	6.0	8.8	(13.3)	8.6	7.4	9.3	12.2	5.9
GDP (million dollars)	3 220	4 179	3 433	4 634	6 720	8 331	9 775	10 255
Gross national income (GNI) (million dollars)	3 699	4 932	3 656	4 992	7 252	8 930	10 484	10 973
Gross national disposable income (million dollars)	4 099	5 306	4 708	6 120	9 393	10 921	11 730	12 090
GDP per capita (dollars)	1 400	1 493	1 125	1 410	1 815	2 185	2 489	2 534

GNI per capita (dollars)	1 608	1 763	1 199	1 519	1 959	2 342	2 670	2 711
Real GNI per capita growth (percentage)	0.7	4.1	(-16.7)	7.5	2.2	5.4	9.0	3.6
Population and labour								
Population (millions)	2.34	2.96	3.23	3.51	3.94	4.05	4.17	4.29
Unemployment (percentage)[b]	32.6	21.7	41.2	29.0	30.1	30.0	25.8	26.7
Total employment (thousands)	417	588	452	603	718	744	837	858
Public sector	51	103	125	145	181	179	188	195
Israel and settlements	68	135	42	56	73	78	84	83
Fiscal balance (percentage of GDP)								
Revenue net of arrears/clearance withheld	13.2	23.9	8.5	29.5	23.8	22.6	20.9	20.2
Current expenditure – commitment basis	15.3	22.6	29.0	43.0	47.5	36.9	33.1	32.4
Total expenditure – cash basis	25.6	29.9	35.4	49.2	50.1	41.5	31.3	29.1
Overall balance – cash basis	(12.3)	(6.1)	(27.0)	(19.7)	(26.3)	(18.9)	(10.4)	(8.9)
External trade								
Net current transfers (million dollars)	400	374	1 052	1 128	2 141	1 991	1 246	1 116
Exports of goods and services (million dollars)	499	684	380	613	905	1 152	1 510	1 670
Imports of goods and services (million dollars)	2 176	3 353	2 519	2 864	4 385	4 626	5 775	6 467
Trade balance (million dollars)	(1 677)	(2 670)	(2 139)	(2 250)	(3 480)	(3 474)	(4 266)	(4 797)
Trade balance (percentage of GDP)	(52.1)	(63.9)	(62.3)	(48.6)	(51.8)	(41.7)	(43.6)	(46.8)
Trade balance with Israel (million dollars)	(922)	(1 598)	(886)	(1 945)	(2 558)	(2 818)	(3 203)	(3 712)
Trade balance with Israel (percentage of GDP)	(28.6)	(38.2)	(25.8)	(42.0)	(38.1)	(33.8)	(32.8)	(36.2)
Palestinian Authority trade with Israel/total Palestinian Authority trade (percentage)[c]	92.3	68.6	53.5	82.7	73.9	77.5	68.8	67.3
Palestinian Authority trade with Israel/total Israeli trade (percentage)[c]	4.3	3.7	1.8	2.5	2.9	2.8	2.7	2.9

Sources: PCBS, Palestinian Authority Ministry of Finance, International Monetary Fund (IMF), International Labour Organization (ILO), Israel Central Bureau of Statistics.
Note: Except for the population figures, data regarding key indicators exclude East Jerusalem, given that PCBS has no access to the city.
[a] Preliminary estimates.
[b] ILO's 'relaxed definition' of unemployment includes discouraged workers.
[c] Palestinian and Israeli trade data refer to goods, and non-factor and factor services.

14. The long-term trend of the sectoral distribution of employment mirrors that of GDP, leaning towards the non-tradable sector; transport, storage and communication, services and construction sectors dominate job creation. Between 1995 and 2012, the share of manufacturing in employment declined from 13–12 per cent. Agriculture and construction shares also declined from 18–12 per cent and from 19–14 per cent, respectively. During the same period, the share of services rose from 50–62 per cent (PCBS, 2013). Employment in the tradable goods sectors has been shrinking under occupation because it is disproportionately affected by the closure policy, restrictions on market access, the inflated cost of doing business and the dearth of imported inputs and technology.

15. Real wages in the Occupied Palestinian Territory deteriorated further in 2012 as nominal wages growth failed to keep pace with inflation. Real wage was 10 per cent lower than its level in 2006, although productivity in 2012 and was 7 per cent above its 2004 level. This supports Larudee's (2012) findings, which suggest that the fruits of the growth achieved during the post-2007 period were unequally shared between wage earners and profits. Further, the improvement in unit labour cost, from lower wages and higher productivity, was not translated into enhanced competitiveness, as shown by the weakness of exports and the increasing reliance on imports (table 1).

16. Poverty deepened as a result of 3 per cent inflation in 2012, lagging nominal wages and high unemployment. Recent statistics indicate that 26 per cent of Palestinians lived below the poverty line in 2011, with a poverty rate of 18 per cent in the West Bank and 30 per cent in Gaza. The poverty gap is deeper in Gaza, indicating that not only poor households in Gaza are far below the poverty line, but also that inequality among Gaza's poor is much higher.

17. According to PCBS (2013), the poverty rate would have been 18 per cent higher without the Palestinian Authority's social assistance to the poor. This highlights the degree at which the Palestinian poor are vulnerable to the ongoing fiscal crisis and the decline in donor aid. IMF (2013) estimates a budget-financing gap of $700 million in 2013. This would expose the limited social expenditures on the poorest households to greater risks in the future. It is imperative, therefore, that donors meet their obligations towards the Palestinian people to sustain not just current expenditure, but also development and social spending.

D. Closure policy undermines human capital formation

18. The recurrent Israeli mobility restrictions compound the unemployment crisis by constraining workers' ability to reach their work sites and by increasing the difficulty, time length and cost of their movements. They have to use low-quality and long detour roads to reach their work places. These additional costs lower workers' net gains from employment, distort resource allocation patterns and reduce the market's ability to match skills with firms' needs For instance, travel time between Bethlehem and Ramallah has more than doubled as a result of the Israeli prohibition of Palestinian commuters to take the short road that passes through East Jerusalem (The Applied Research Institute – Jerusalem, 2012).

19. Moreover, movement barriers aggravate unemployment by lowering the profitability and viability of Palestinian firms as a result of inflated transaction costs, heightened uncertainty, small-scale production inefficiency and measures limiting producers' access to imported technology and inputs. According to Calì and Miaari (2012), closure has significant negative effects on hourly wages and workers' ability to find employment. Further, it reduces school attendance rates and increases child labour, thereby lowering human capital accumulation.

E. Squeezed tradable goods sector, persistent trade deficit and dependence

20. The large, persistent Palestinian trade deficit worsened in 2012 (table 1), rising 12.5 per cent from $4.3 billion to $4.8 billion between 2011 and 2012. Exports growth was too weak to keep up with the 10 per cent increase in imports. At $1.7 billion, exports barely covered one quarter of the import bill. The 7 per cent share of goods export in GDP is among the lowest in the world. These exports originate almost entirely from the West Bank as Gaza remains under tight blockade. The small, weak export sector is characterized by low value added, low technological content, and weak forward and backward linkages to

other economic sectors.

21. The trade deficit grew from 44-47 per cent in 2012 as a percentage of GDP. The structurally high deficit is directly related to the forced erosion of the Palestinian productive base for the tradable goods sector and the weakened competitiveness of what remained of it by inhibiting production costs. This undermined the ability of producers to penetrate foreign markets or even compete domestically. The weakness of the export sector cannot be separated from the inability of Palestinian produces to access the land and natural resources in Area C. The two export-oriented sectors, manufacturing and agriculture, have collapsed and their combined share in GDP has fallen sharply since the establishment of the Palestinian Authority in 1994 from 31 per cent to only 15 per cent in 2011.

22. The decline in the tradable goods sectors has cultivated both economic and aid dependence. Given the small size of the domestic market, economic progress requires rebuilding the export sector. According to UNCTAD (2011a), such revitalization requires significant public investment – supported by the international community – to repair the infrastructure of the Occupied Palestinian Territory and an unhindered access to external markets, other than Israel, and the implementation of policies to offset the negative impact of the strong new Israeli shekel on Palestinian competitiveness.

23. Another salient feature of Palestinian foreign trade is the forced dependence on the Israeli economy. Restrictions and the high cost of trade with the rest of the world have left Israel as the only viable foreign market for Palestinian exports and imports. This maintains a long-standing skewed concentration of Palestinian trade with Israel, which is the source of most of the restrictions imposed on the Occupied Palestinian Territory. This structural dependence continued in 2012 as Israel accounted for 70 per cent of Palestinian imports, and absorbed more than 80 per cent of its exports, leaving a bilateral trade deficit of $3.7 billion, equivalent to 77 per cent of the total Palestinian trade deficit and 37 per cent of GDP.

F. The mirage of Palestinian fiscal sustainability

24. As indicated earlier, the restrictive measures imposed by the occupation authorities have reinforced the Palestinian fiscal crisis from both the revenue and expenditure sides. On the revenue side, the weak economic activities, fragile private sector and below-potential output levels have reduced the tax base and restricted the Palestinian Authority's capacity to raise revenue. On the expenditure side, the ensuing economic decline and associated high poverty and unemployment rates have put pressure on the Palestinian Authority to increase its spending on social services and transfers to mitigate the large-scale impoverishment and recurrent humanitarian crises. In the meantime the suffocated private sector is incapable of job creation and has thus forced the Palestinian Authority to act as an employer of last resort to absorb a portion of the growing labour force.

25. Nonetheless, the Palestinian Authority has carried out fiscal measures in the context of the 2008–2011 Palestinian Reform and Development Plan (PRDP). The measures were aimed at improving budget preparation and control processes, integrating the accounting system across line ministries, raising tax rates and the capacity and efficiency of collection, eliminating net lending, instituting a hiring freeze, and improving overall Palestinian Authority financial and procurement procedures. In 2012, the Palestinian Authority raised the top income tax rate from 15–20 per cent, suspending some corporate income tax exemptions, and improving the thoroughness of audits. Consequently, the income tax ratio to GDP rose from 1.4–1.7 per cent between 2011 and 2012, and the VAT rate was increased from 14.5–15 per cent, in line with the change of rate in Israel.

26. In 2012 the Palestinian Authority suffered its most serious fiscal crisis since 2006. Revenues were below projections, donor aid fell, Palestinian Authority payments arrears to the private sector continued to accumulate and loans from domestic banks rose to $1.4 billion (68 per cent of revenue). As a result, the Palestinian Authority was often unable to pay the salaries of its employees on time and to meet its obligations to creditors. This undermines political confidence in the Palestinian Authority, increases the exposure of the domestic banking system and the private sector and erodes the significant institutional capacity built since the establishment of the Palestinian Authority in 1994. Furthermore, the critical economic situation faced by many households led to popular protests in the West Bank in late 2012 and public calls for abrogation of the Protocol on Economic Relations between Israel and Palestine, known as the Paris Protocol,[4] widely deemed to be responsible for the Palestinian economic policy predicament.

27. The same year, lower-than-expected revenue and higher-than-budgeted spending gave rise to a $1.7 billion budget deficit (17 per cent of GDP) on commitment basis; on cash basis, the deficit was 9 per cent of GDP. The difference between the commitment and cash basis reflects the arrears accumulated by the Government during the year. With only $770 million of donor budget support (22 per cent below budget target), the Palestinian Authority had no option but to borrow and accumulate arrears to finance its deficit. In 2012, it borrowed $300 million from domestic banks, raising its debt to $1.4 billion, and it accumulated unpaid wages and arrears of $570 million to the private sector.

28. Public expenditure (commitment basis) was $3.5 billion, 8 per cent above budget, with non-wage current expenditure above the budget target by 16 per cent, while net lending to cover municipalities' utility bills was 270 per cent above the budgeted level (Ministry of Finance, 2013). Development expenditure was a mere $243 million (7 per cent of recurrent expenditure, or 2.4 per cent of GDP).

29. While public revenue rose 1.4 per cent to slightly more than $2 billion in 2012, as a percentage of GDP it declined from 20.9–20.2 per cent. The monetary increase stemmed mainly from a 10 per cent surge of imports, which increased tax revenues cleared by Israel on behalf of the Palestinian Authority by 2.5 per cent to $1.5 billion. However, revenue from sources other than taxes fell slightly, ending the upward trend that had started with the PRDP.

30. Clearance revenue is the largest source of Palestinian public revenue, as it accounts for 70 per cent of total revenue, and covers 84 per cent of the public wage bill and 45 per cent of current expenditure. It is composed of revenue from tariffs and value added taxes (VATs) on Palestinian imports transiting Israel, which Israel collects on behalf of, and then transfers to, the Palestinian Authority. This arrangement gives Israel leverage over the Palestinian Authority, leaving it hostage to political pressure. Fiscal vulnerability has developed from Israel's repeated delaying or withholding of clearance revenue over the years. The latest episode of delayed clearance revenue, an average of $120 million a month, occurred following the successful bid for the recognition of the State of Palestine as a nonmember observer State by the United Nations in November 2012. This was combined with a unilateral deduction of $121 million to settle outstanding electricity arrears of Palestinian municipalities to Israel Electric Corporation As a result, the Palestinian Authority was able to pay public employees only half of their November salaries by recourse to foreign aid and borrowing from domestic banks (Portland Trust, 2013). As in the past, costly economic disruption was inevitable, although Israel eventually transferred the revenue to the Palestinian Authority.

31. The disappointing results of the Palestinian Authority's attempts at fiscal reform are testimony to the futility of autonomous economic policymaking under occupation. Achieving fiscal independence and ending structural dependence on aid will continue to be a mirage as long as Gaza remains under blockade, access and movement restrictions in the West Bank persist, public and private investment in Area C are restricted and sovereignty is denied.

G. The real economy and the ramifications of the fiscal crisis

32. The worsening of the Palestinian Authority's fiscal crisis threatens to spill over to all economic sectors through the banking system, which is highly exposed to the Palestinian Authority directly and indirectly through Palestinian Authority arrears to private suppliers and public employees, and high rates of private credit to households. Khalidi (2012) points to the increased financialization of the Palestinian economy, as reflected by the ratio to GDP of credit to the private sector, which reached an all-time high of 29 per cent in 2011, several points above the average for comparable economies. In recent years, while Palestinian private credit grew by 13 per cent annually, real per capita GDP was growing at less than one sixth of that rate. Furthermore, credit extended by the banking system to public-sector employees more than doubled to $700 million, accounting, together with the Palestinian Authority's debt, for almost half of the banking sector's gross credit, while public debt to domestic banks currently accounts for more than 110 per cent of total bank equity (IMF, 2013).

33. When the Palestinian Authority is unable to pay public employees and private supplier their dues, they are also unable to pay back their bank loans or obtain additional credit to meet their business and consumer needs. This triggers a vicious circle of negative feedback loops between the banking sector, the private sector and the economy. Without significant relaxation of occupation constraints and an increase in donor support, the Palestinian Authority will have no choice but to resort to increasingly risky borrowing from the banking system or cut essential social spending at the risk of renewed popular unrest. For example, in November 2012, the Palestinian Authority could not pay its $22 million bill to the East Jerusalem Hospital Network. As a result, hospitals were unable to pay the salaries of their employees and their dues to medical suppliers, and resorted to cutting expenses, laying off staff and

postponing care deemed non-urgent (Portland Trust, 2013).

H. Donor support is necessary but not sufficient

34. Although the donor community has provided significant support to the Palestinian people in the recent years, it remains true that as fiscal pressure on the Palestinian Authority mounts, it is inevitable that the dependence on unpredictable and unsustainable aid flows will deepen. UNCTAD (2006) has long affirmed that aid – essential as it has been for relief, sustaining the Palestinian Authority and preserving the economy from collapse – is not a substitute for sovereignty over land, borders, trade and economic policymaking.

35. Aid has been and continues to be a necessary but not sufficient condition for halting Palestinian economic decline. Aid should be combined with requests urging Israel to shoulder its obligations under international law and to take concrete steps to relieve the pressure placed on the Palestinian people. In a typical developing country, donor fatigue could be justified. However, in the Palestinian case, the main cause of donor fatigue is occupation, not the delivery of aid to a people denied the opportunity to develop and to freely exercise its right to self-determination.

II. Palestinian revenue leakage continues

36. As part of its ongoing examination of the obstacles to trade and development in the Occupied Palestinian Territory, UNCTAD will publish later in 2013 an in-depth assessment of Palestinian revenue leakage from taxes on imports as well as of the fiscal loss incurred by smuggling goods from Israel to the Occupied Palestinian Territory. Palestinian trade taxes consist of purchase tax and VAT, levied on all imports, whether they originate from Israel or elsewhere, as well as additional excise tax and custom duties on imports from sources other than Israel. The Paris Protocol stipulates that trade between Palestine and Israel be exempted from custom duties, but subject to VAT and purchase tax.

37. The study will not cover all aspects of Palestinian fiscal leakage to Israel and will be limited to a very specific source of leakage, which stems from the loss of taxes on imported or smuggled goods from Israel. As such, the study will not provide an estimate of substantial fiscal losses from other sources that remain to be investigated, such as the following:

(a) Leakage of revenue from taxes levied by Israel on the incomes of Palestinians working in Israel and settlements (under the Paris Protocol, Israel is required to transfer social security tax revenue to the Palestinian Authority);

(b) Seigniorage revenue loss from using the new Israeli shekel in the Occupied Palestinian Territory,[5] estimated to be 0.3–4.2 per cent of GNI (UNCTAD, 2009);

(c) Revenue loss from underpricing imported goods in invoices, owing to the lack of Palestinian control over borders and access to proper trade data;

(d) Revenue loss related to lack of control over land and natural resources;

(e) Financial resources loss related to goods and services imported through the Palestinian public sector, such as petroleum, energy and water;

(f) Loss of customs revenue on goods finished in Israel but with less than 40 per cent of Israeli content as required by the rules of origin established by the World Trade Organization;

(g) Fiscal loss as a result of the smaller tax base caused by the decimation of the productive base and loss of natural resources to occupation.

A. Leakage from direct and indirect imports and smuggling

38. The term ‘fiscal leakage’ refers here to Palestinian fiscal revenues destined for the Palestinian Authority, as stipulated by Paris Protocol, but retained by the Israeli Treasury instead. The following discussion focuses on leakage from Palestinian imports from Israel or products smuggled into the Occupied Palestinian Territory from Israel.

39. According to the Paris Protocol, any product that has been wholly produced in Israel or has more than 40 per cent of Israeli value added is exempted from Palestinian customs duties, but not from VAT or purchase taxes. However, it has been argued that not all Palestinian imports from Israel are goods produced in Israel or meet the rule of origin (UNCTAD, 2011b; World Bank, 2002). A significant portion of these imports are produced in a third country, cleared as Israeli imports before being sold in the Occupied Palestinian Territory as if they had been produced in Israel. They are known as indirect imports, to differentiate them from direct imports that meet the rule of origin. A number of estimates have been proposed to quantify the value of the indirect imports. Based on data from the Bank of Israel (2010), UNCTAD assumes that 39 per cent of recorded imports from Israel originate from the Israeli commercial sector, and could therefore be considered indirect imports.

40. Customs revenue from these indirect imports is collected by the Israeli authorities but not transferred to the Palestinian Authority, as they are not labelled as being destined for the Occupied Palestinian Territory and are imported by Israeli importers and resold to Palestinian consumers. Further, the Palestinian Treasury does not receive from Israel the purchase taxes on all imports from Israel.[6] The third element of fiscal leakage from imports from Israel is the VAT revenue that is applied to the leaked purchase tax and customs duties on indirect imports. The estimation of the value of these three sources of leakage was based on PCBS data regarding all Palestinian imports from Israel at the eight-digit level of the Harmonized System codes. The upper half of table 2 presents a summary of the estimated results. It is estimated that some $115 million per year of revenue from direct and indirect imports from Israel were not transferred to the Palestinian Authority in 2010 and 2011.

41. Smuggling is another source of significant fiscal revenue loss. Where the smuggled goods are produced in Israel, the Palestinian Authority loses VAT and purchase tax revenue. However, where goods are produced in a third country, tariff revenue is also leaked along with VAT and purchase tax revenue. The magnitude of smuggling is estimated by using customs control data augmented by interviews with senior officials from the Ministry of Finance, Customs and Tax Administration. According to these officials, smuggled goods are in the range of 5–35 per cent of imports from Israel, owing to the uncontrolled borders and the lack of Palestinian Authority control over Areas B and C. Records of customs controls, for example, show that there were 11,967 unsuccessful smuggling attempts between 2009 and 2011. The value of would-be smuggled goods caught by the Palestinian Authority in 2010 and 2011 was $240 million. This figure does not take into account the smuggling of spoiled or out-of-date goods, which would substantially increase the losses to the Palestinian economy.

42. The lower half of table 2 provides a summary of estimated revenue leakage from smuggling. Data for 2010 and 2011 suggest that it amounts to about $190 million per year. It should be noted that this is a conservative estimate, because it assumes that all the smuggled goods are Israeli products and therefore not subject to customs duty, and also assumes the lower end of the range quoted by experts for the magnitude of smuggling.

43. By adding up the leakage from total imports and smuggling from Israel, the estimated total leakage from these items alone is more than $300 million per year. Had these revenues been transferred to the Palestinian Authority, Palestinian tax revenue would have increased by 17 per cent, covering 18 per cent of the public wage bill. Indeed, the fiscal crisis as currently defined would not have developed. These estimates are moderate, as they do not account for the total aggregate of economic losses accumulated through the other fiscal leakage sources, which are not covered by the study but should be pursued vigorously by further technical investigations.

Table 2
Estimation of revenue leakage from imports from Israel and smuggling
(million dollars)

	2010	2011	Average
Revenue leakage from direct and indirect imports from Israel			
1. Value of taxable imports from Israel	506.0	516.1	511.0
2. Of which indirect imports from Israel (39% of total – row 1)	197.3	201.3	199.3
3. Purchase tax revenue from taxable imports from Israel	43.0	47.1	45.0
4. Customs duties on indirect imports from Israel (average 23% of row 2)	44.0	47.8	45.9
5. VAT revenue on leaked purchase tax and customs duties	23.3	25.4	24.4
Revenue leakage from direct and indirect imports from Israel (3+4+5)	**110.3**	**120.3**	**115.3**
Leakage from smuggling			
1. Value of total imports of goods from Israel	2 873.3	2 938.5	2 905.9
2. Value of smuggled goods (25% of row 1)	718.3	734.6	726.5
3. Leaked revenue from trade tax on smuggled goods (average 8.8% of row 2)	63.2	64.6	63.9
4. Leaked VAT revenue from smuggling (16% of sum of rows 2 and 3)	125.0	127.9	126.5
Revenue leakage from smuggling (3+4)	**188.2**	**192.5**	**190.4**
Total leakage (direct and indirect imports and smuggling)	**298.5**	**312.8**	**305.6**

B. Employment and output cost of fiscal leakage

44. The cost of financial resource leakage exceeds the nominal value of lost revenues. There are additional outputs and employment costs that the economy would have been able to generate had the lost financial resources been available to expand the fiscal space. To evaluate the costs of the estimated fiscal leakage, UNCTAD's macroeconometric model of the Palestinian economy was simulated to assess the economic performance under alternative scenarios, which assume that the leakage did not occur and the leaked resources were collected by the Palestinian Authority to finance either transfer payments to the poor or an export promotion programme.

45. Three alternative scenarios were simulated:

(a) The baseline scenario reflects economic performance under the present conditions using actual historical data, including fiscal leakage;

(b) The transfer payment scenario also uses historical data, but assumes no fiscal leakage, and therefore an increase in tax revenue of 17 per cent equivalent to the estimated leakage, which is used to increase expenditure on transfer payments;

(c) The export promotion scenario is similar to scenario (b), but assumes that the increase in revenue is allocated to promote Palestinian exports.

46. Table 3 shows that capturing the leaked revenue would expand the fiscal policy space available to Palestinian policymakers and the ability to provide fiscal stimulus. While the transfer scenario would increase real GDP in 2004 dollars by about $205 million (3 per cent) above the baseline in 2012, the export promotion scenario would increase GDP by $280 million, or 4 per cent. As for the impact on employment, the transfer and export promotion scenarios would increase employment over the baseline scenario by 3,300 and 9,200 jobs, respectively.

Table 3
Estimated economic and employment cost of Palestinian fiscal leakage

	2010	2011	2012
Tax revenue and fiscal leakage (million dollars)			
Total tax revenue	1 690.0	1 905.0	1 940.0
Fiscal leakage	300.6	312.8	319.7
Leakage/tax revenue (percentage)	17.8	16.4	16.5
Impact on real GDP (millions of 2004 dollars)			
Baseline scenario	5 754.4	6 423.1	6 763.4
Transfer payment scenario	5 856.4	6 570.5	6 968.9
Impact (million dollars)	102.0	147.4	205.4
Impact (percentage)	1.8	2.3	3.0
Export promotion scenario	5 903.4	6 640.0	7 041.9
Impact (million dollars)	148.9	216.9	278.5
Impact (percentage)	2.6	3.4	4.1
Impact on employment (thousand jobs per year)			
Baseline scenario	685.8	787.0	809.5
Transfer payment scenario	687.5	789.3	812.7
Impact – thousand jobs	1.6	2.3	3.3
Impact – percentage	0.2	0.3	0.4
Export promotion scenario	690.9	794.4	818.7
Impact – thousand jobs	5.1	7.4	9.2
Impact – percentage	0.7	0.9	1.1

C. Recommendations for stemming fiscal leakage

47. The estimated costs to the Occupied Palestinian Territory of the $300 million leaked annually to Israel is equivalent to 17 per cent of total tax revenue, in addition to 4 per cent in lost GDP and about 10,000 jobs per year. The analysis also shows that these costs are compounded over time as the economy grows and that there is a need for measures to stem the fiscal leakage and remedy the information asymmetry between the two sides, as well as measures to expand the operations and control of Palestinian Customs, and to reconsider the revenue clearance arrangement in place.

48. UNCTAD recommends the following measures to contain fiscal resources leakage:

(a) The Paris Protocol should be replaced with a balanced framework consistent with the needs for Palestinian fiscal independence, structural transformation prerequisites and sovereign economic policymaking for the following reasons:

(i) Palestinian resource leakage is rooted in the trade relations between the Occupied Palestinian Territory and Israel enshrined in the Paris Protocol, which deprives the Palestinian Authority of policy independence, border control and the ability to collect accurate data on external trade;

(ii) The Protocol curtails the Palestinian Authority's ability to conduct industrial policies and limits Palestinian fiscal space by forcing the Palestinian Authority to adhere to Israel's tariff schedule, which is not compatible with the vastly different Palestinian economy;

(b) Israel's cooperation should be sought to allow the Palestinian Authority:

(i) To gain full and accurate access to all data related to imports from or via Israel when the final destination of goods is the Occupied Palestinian Territory;

(ii) To have access to data related to imported Israeli products subject to purchase taxes and the companies that supply them, and due purchase tax revenue should be transferred to the Palestinian Authority as agreed in the 1999 Wye River Memorandum;

(iii) To abolish the time limit that prevents the Palestinian Authority from claiming due revenue from imports with transaction dates of more than six months, since its access to trade data is neither complete nor timely;

(iv) To reduce trade dependence on Israel by removing barriers to trade with countries other than Israel. This will not only give Palestinian shippers access to cheaper, more competitive sources, but will also increase fiscal revenue without necessarily laying additional burdens on Palestinian consumers since taxes on imports from third countries will be offset by less expensive imports;

(v) To obtain access for Palestinian customs brokers to Israeli ports and borders in order to follow up on customs procedures and clear goods destined to the Occupied Palestinian Territory. This will raise the efficiency of Palestinian trade, reduce costs and enhance the Palestinian Authority's control over external trade and related data;

(c) The Palestinian Authority should secure the financial and human resources necessary for strengthening customs administration capacity, including the important role of the customs police, as a strategic institution essential for sovereignty, fiscal sustainability, security and the ability to implement pro-development trade and industrial policies. Palestinian Customs should acquire the capacity to deal with complex and changing trade regimes in the context of prolonged occupation and beyond.

III. UNCTAD assistance to the Palestinian people

A. Framework and objectives

49. UNCTAD has been engaged with Palestinian development efforts for nearly three decades, contributing to consensus building, research and policy analysis, and technical cooperation activities to strengthen Palestinian public and private-sector institutional capacities. UNCTAD's multifaceted programme of technical assistance to the Palestinian people draws on the entire expertise of UNCTAD and is carried out in close cooperation with the State of Palestine, the Palestinian private sector, civil society organizations, United Nations agencies and international organizations.

50. The programme highlights the interrelatedness of trade, finance and enterprise development, with technical assistance offered under four clusters:

(a) Trade policies and strategies;

(b) Trade facilitation and logistics;

(c) Finance and development;

(d) Enterprise, investment and competition policy.

51. Given the peculiar context of the Occupied Palestinian Territory, and the unprecedented challenges faced by the Palestinian people, the contribution of UNCTAD has become more relevant under conditions of prolonged occupation, even as donor support has been lagging.

52. In recognition of the relevance of UNCTAD's contribution to Palestinian development, member States have strengthened the scope of this programme in paragraph 31(m) of the Doha Mandate, which calls on UNCTAD to assess the economic development prospects of, and examine the obstacles to trade and development in, the Occupied Palestinian Territory. The Doha Mandate also stresses the need to strengthen the programme with adequate resources and effective operational activities.

53. In 2012, through a selective and flexible mode of operation, UNCTAD made progress in supporting the Palestinian people to preserve the human and institutional capacities needed both to cope with the present situation and for the functioning of a sovereign Palestinian State as envisaged by the relevant United Nations resolutions. However, progress towards achieving the programme's objectives has been affected by adverse field conditions, especially in view of the difficulties encountered by UNCTAD staff in accessing the field through Israeli entry points and infringement of their privileges and immunities under the 1946 Convention on the Privileges and Immunities concerning the performance of their official duties.

B. Operational activities under way

54. Throughout 2012, UNCTAD continued to strengthen the institutional capacity of the Palestinian private sector with the implementation of the project 'Developing Palestinian Trade Facilitation Capacity', funded by the Canadian International Development Agency. The project aims at building the knowledge base of the Palestinian Shippers Council by consolidating its institutional capacity, increasing awareness among Palestinian shippers (exporters and importers) on trade facilitation best practices and building local capacities for the provision of advisory services and training. Much was achieved in 2012, including a stronger Council structure; the recruitment of local and international experts to contribute to the development of a comprehensive three-year strategy; and organizational structure, job profiles and business portfolios for the services the Council will provide to its members, including a business case projecting cost-recovery and the Council's long-term financial and functional sustainability. UNCTAD worked closely with international experts to set up the structure and guidelines for the legal and training units, both relevant to trade facilitation topics.

55. UNCTAD support to Palestinian Customs continued in 2012 by maintaining close contact with the Palestinian Authority and donors with the aim of approving a new technical cooperation project to consolidate previous achievements and a complete handover of the Automated System for Customs Data Analysis, commonly known as ASYCUDA, to the Palestinian Authority. The project was expected to commence in 2013, with funding from the European Commission. However, project implementation has been delayed pending further consideration of the implications of the changes introduced by the Commission to the provisions in its funding agreements with international organizations.

56. In 2012, UNCTAD trained staff from PCBS and economic ministries and agencies in both Geneva and Ramallah on forecasting, evaluating and interpreting socioeconomic data and assessing alternative policy scenarios. This led to the establishment of a forecasting unit in the Bureau staffed by professionals trained by UNCTAD on the adoption of its macroeconometric model of the Palestinian economy to produce PCBS official economic forecasts, which are used for planning and negotiation purposes by the Ministry of Finance and other entities.

57. In cooperation with the Division for Palestinian Rights of the United Nations, UNCTAD in 2012 hosted and trained Palestinian staff from the Ministry of National Economy to broaden their knowledge of the United Nations system in Geneva and provided them with the opportunity to attend the 2012 Trade and Development Board meetings. The training also exposed them to the work of other United Nations agencies based in Geneva.

58. During 2012 and early 2013 UNCTAD staff delivered a number presentations and participated in several workshops in Doha, Geneva, Jerusalem, Ramallah and Rome on the Palestinian economy and the development of the Palestinian private sector. '

C. Coordination, harmonization and resource mobilization

1. In 2012, UNCTAD undertook several missions to the Occupied Palestinian Territory and met with relevant Palestinian Authority officials, and members of the civil society and private sector, to discuss areas of coordination and ensure harmonization at all levels and to follow up on projects, both ongoing and in the pipeline. UNCTAD also continued to strengthen its relations with relevant Palestinian Government ministries and agencies, particularly through advisory services, capacity-building and training. Further, UNCTAD maintained close contact with the United Nations Country Team, United Nations agencies and donor countries, particularly those operating in the Occupied Palestinian Territory.

2. Notwithstanding the expanded Doha Mandate, UNCTAD contributions to the Palestinian people remain constrained by the inadequacy of resources. To maintain and build upon previous achievements, it is imperative to mobilize additional resources to meet the special needs of the Palestinian economy, including the provision of advisory services and delivery of technical cooperation support.

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Notes

[1] *B'Tselem*, http://www.btselem.org/settlements/statistics.

[2] *Jerusalem Post*, 10 June 2013 (http://www.jpost.com/Diplomacy-and-Politics/Settler-housing-startsspike-176-percent-in-1st-quarter-of-2013-315986). See also Office for the Coordination of Humanitarian Affairs (OCHA), 2012.

[3] According to the 1993 Oslo Accord, the West Bank is divided into Areas A, B and C, representing 18 per cent, 21 per cent and 61 per cent of the West Bank area, respectively. Israel retains extensive control in Area C, including over security, planning and zoning. Area A is under civil and security control of the Palestinian Authority. Area B is supposed to be under Palestinian civil control and joint Israeli-Palestinian security control.

[4] Signed in Paris in April 1994 and annexed to the Israeli-Palestinian interim agreements of that year.

[5] Seigniorage is net public revenue derived from issuing a currency, i.e. the difference between the face value of currency issued and its production and circulation costs. A government can raise seigniorage revenue without inflationary consequences if the increase in money supply is in line with economic growth and demand for money.

[6] Unlike VAT, which is imposed on most products, a purchase tax is imposed on the consumption of some products: those that are imported or produced domestically. According to the Paris Protocol, the purchase tax on Palestinian imports from Israel that are subject to this tax should be transferred to the Palestinian Authority.