The Underpinnings of the Future Palestinian State: Sustainable Growth and Institutions

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Economic Monitoring Report to the Ad Hoc Liaison Committee

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Acronyms

AHLC	Ad Hoc Liaison Committee
BoI	Bank of Israel
EU	European Union
GDP	Gross Domestic Product
GoI	Government of Israel
ICT	Information and communications technologies
IIRS	Israel Internal Revenue Service
IMF	International Monetary Fund
MoF	Ministry of Finance
MoNE	Ministry of National Economy
MoPAD	Ministry of Planning and Administrative Development
MoSA	Ministry of Social Affairs
NEDCO	Northern Electricity Distribution Company
NIS	New Israeli Shekels
PA	Palestinian Authority
PalTrade	Palestine Trade Center
PCBS	Palestinian Central Bureau of Statistics
PERC	Palestinian Electricity Regulatory Council
PFM	Public financial management
PMA	Palestine Monetary Authority
PNCTP	Palestinian National Cash Transfer Program
PSI	Palestine Standards Institution
UN OCHA oPt	United Nations Office for the Coordination of Humanitarian Affairs in the occupied Palestinian territory
VAT	Value-added tax
WB&G	West Bank and Gaza

Executive summary

a. The viability of a future Palestinian state will be determined by the strength of its institutions and its ability to sustain economic growth.

b. **If the Palestinian Authority (PA) maintains its current performance in institution-building and delivery of public services, it is well-positioned for the establishment of a state at any point in the near future**.

c. Implementation of the PA's reform agenda accelerated significantly in the first half of 2010. Spending remained within budget targets and improved collection rates resulted in higher than projected domestic tax revenue. In the first half of 2010, tax revenues were nearly 15 percent above budget projections and 50 percent higher than in the same period in 2009.

d. Progress on major reform initiatives strengthened the PA's fiscal position and included: (a) the merger of the European Union and World Bank funded social safety net programs into a Palestinian National Cash Transfer Program; (b) the approval of an Action Plan for Public Pension Reform; (c) the reduction of implicit electricity subsidies through the activation of the regulator and the northern West Bank distribution company; and (d) significant improvement in public resource management systems.

e. The West Bank economy continued to grow in the first half of 2010 and the real growth rate, combined with Gaza, is likely to reach the projected 8 percent for the year. Some of the increase in economic activity can be attributed to improved investor confidence and the partial easing of restrictions by the Government of Israel (GoI). The main driver of growth, however, remains external financial assistance.

f. Anecdotal evidence provides some positive signs that private investment is beginning to pick up in certain sectors. Managers in banks and loan guarantee programs have indicated that they are being approached by more entrepreneurs seeking financing for long-term projects. Between 2008 and 2009 alone, the number of newly registered enterprises jumped by more than 38 percent with declared capital in 2009 more than double of that in 2008 and, encouragingly, results from the first half of 2010 indicate that this year will be similar to 2009.

g. **Sustainable economic growth in the West Bank and Gaza, however, remains absent**. Significant changes in the policy environment are still required for increased private investment particularly in the productive sectors, enabling the PA to significantly reduce its dependence on donor aid.

h. The obstacles facing private investment in the West Bank are manifold and myriad, as many important GoI restrictions remain in place: (a) access to the majority of the territory's land and water (Area C) is severely curtailed; (b) East Jerusalem -- a lucrative market -- is beyond reach; (c) the ability of investors to enter into Israel and the West Bank is unpredictable; and (d) many raw materials critical to the productive sectors are classified by the GoI as “dual-use” (civilian and military) and their import entails the navigation of complex procedures, generating delays and significantly increasing costs.

i. It is still too early to assess whether the recent partial relaxation of the Gaza blockade has revived its moribund economy. In any case, the impact on the private sector will be limited while the ban on exports continues.

j. Despite its improved fiscal performance and expenditure control within budget ceilings, the PA faces a shortfall in projected donor financing, possibly as high as US$300-400 million by the end of the year.

k. **Unless action is taken in the near future to address the remaining obstacles to private sector development and sustainable growth, the PA will remain donor dependent and its institutions, no matter how robust, will not be able to underpin a viable state.**

A. Introduction

1. **In its last meeting on April 13, 2010, the Ad Hoc Liaison Committee (AHLC) renewed its pledge to assist in implementing the program of the 13th Palestinian Government for building a viable Palestinian state, with a focus on developing a sustainable economy and building robust state institutions[1].** In August 2009, the Palestinian Government presented this two-year program, entitled "Palestine: Ending the Occupation, Establishing the State," laying out in it the vision, foundational principles, and national goals for the future Palestinian state, as well as institution-building and sector priorities. In August 2010, the 13th Government has documented the achievements of the first year of its program, as well as remaining challenges for the second year, in "Homestretch to Freedom: The Second Year of the 13th Government Program." In this document, the Government states that it "will continue to work in all sectors to improve institutional performance, public service delivery, quality of life, and economic prosperity" (page 3).

2. **The dual pillars of a sustainable economy and robust institutions are the focus of the current report.** The report's first section will attempt to shed some light on the current state of the Palestinian economy, with a focus on recent developments in private investment and continuing obstacles to further development in this area. The second section will turn to an update on important institutional developments, in particular those that impact the fiscal strength of the Palestinian Authority (PA). The report posits that the continued absence of sustainable growth in the West Bank and Gaza (WB&G) risks putting in jeopardy the substantial progress made in building institutions able to respond to the needs of citizens. This risk remains present despite the PA's best attempts at strengthening its fiscal position.

3. **As the update on recent economic developments below shows, the Palestinian economy continues to grow in 2010, but this growth remains driven by the PA's spending that is financed by donor assistance.** In order for growth to be sustainable, it must be led by the private sector, which in turn means that the constraints to private sector development must be minimized. Though the Government of Israel (GoI) has eased movement and access restrictions between urban centers within the West Bank, Palestinians continue to lack access to the resources of Area C of the West Bank, and the link between the remainder of the West Bank and East Jerusalem has been severed. For Gaza, the GoI has implemented an important easing of the blockade that falls short, however, of allowing for exports.

4. **In parallel with economic growth, reforms in several important areas such as the electricity sector, pensions, and the social safety net have led to a fiscally stronger PA.** Most of these reforms were long in the making and represent significant milestones for the PA that bode well for further progress in institution-building. The quest for robust state institutions, however, must also take into account the fiscal sustainability of institutions. In this regard, the virtuous cycle of sustainable growth and robust institutions cannot be ignored nor the link between the two underestimated.

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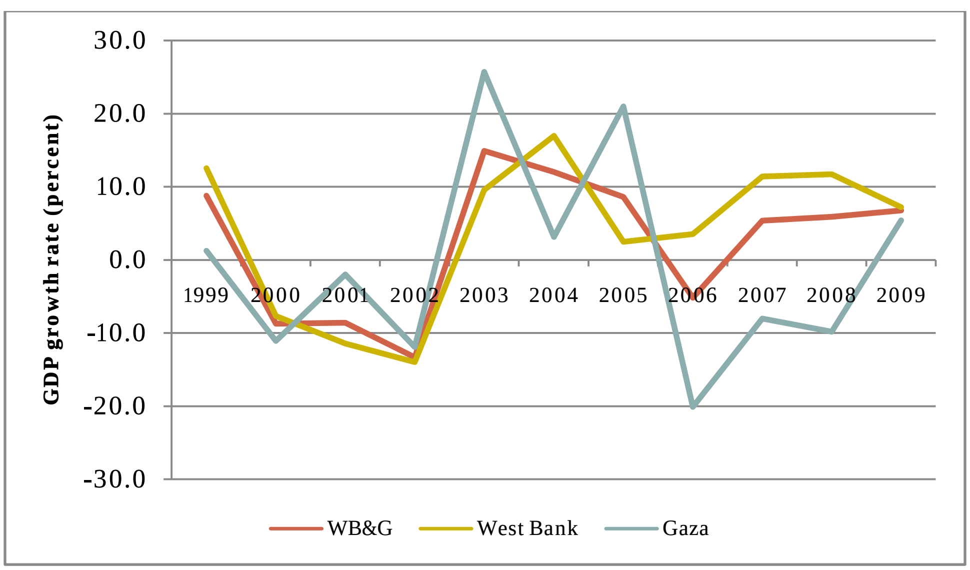
1 See "Meeting of the Ad Hoc Liaison Committee, Madrid, 13 April 2010, Chair's Summary".

B. Potential for sustainable growth

B.I. Recent economic developments

5. **In the first half of 2010, the economy of WB&G continued to rebound and the International Monetary Fund (IMF) projects that real Gross Domestic Product (GDP) growth will reach 8 percent in 2010.** First quarter 2010 estimates by the Palestinian Central Bureau of Statistics (PCBS) show a real GDP growth rate of 11.5 percent for WB&G compared to the first quarter of 2009. In the West Bank, growth was about 10 percent, while initial first quarter 2010 estimates by PCBS indicate the real GDP growth in Gaza was 15 percent compared to the first quarter of 2009 and nearly 8 percent compared to the fourth quarter of 2009. In addition, PCBS now estimates that real growth in Gaza in 2009 was 5.4 percent. The large increase between the first quarter of 2009 and first quarter of 2010 in Gaza is partly due to the Israeli military operation (Operation Cast Lead, December 27, 2008 -- January 18, 2009) that reduced economic activity during the first months of 2009, i.e. reduced the base for comparison. However, the continuing growth reflects a combination of large inflows of humanitarian assistance, the thriving tunnel operations that allowed entry of goods despite the Israeli blockade, as well as the recent easing of the blockade by the GoI (see more below). The growth in Gaza has meant that, for the first time since 2005, per capita income increased in Gaza in 2009, whereas per capita income has been on the rise in the West Bank since 2006 (see Figure 2).

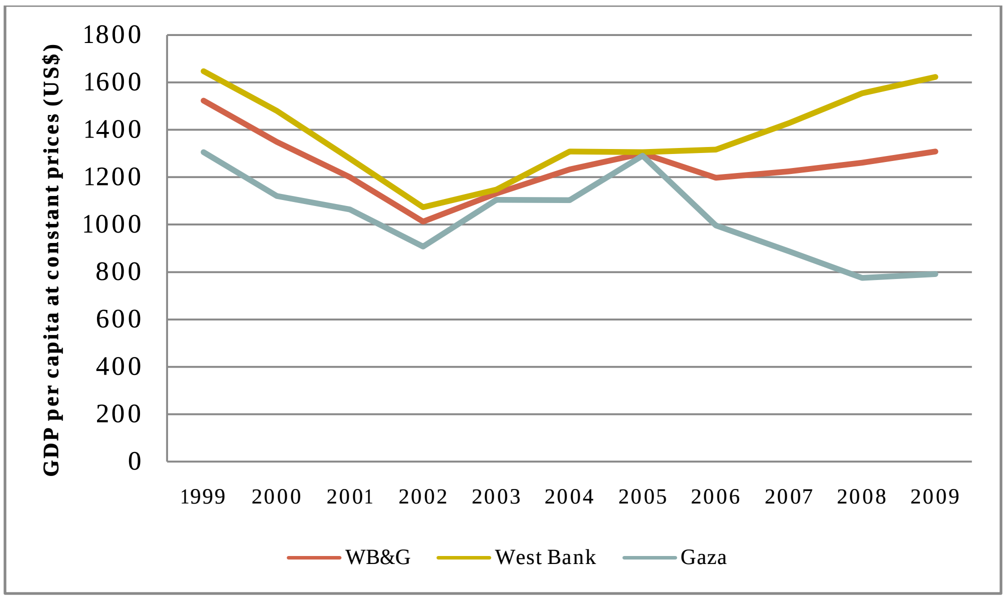
Figure 1: Real GDP growth rate, 1999-2009 (percent)



Source: Palestinian Central Bureau of Statistics

6. The resurgence of growth and the expectation of a fourth year of real per-capita growth can be partly attributed to increasing investor confidence and easing by the GoI of some restrictions, but still appears to be largely driven by continuing large amounts of donor aid. This donor aid has allowed the PA to maintain high levels of government spending, thereby stimulating the economy. In the first half of 2010, the PA received more than US$525 million in budget support, coming on top of nearly US$1.4 billion in 2009 and US$1.8 billion in 2008. This has allowed the PA to increase expenditures on a commitment basis by nearly 27 percent between 2007 and 2009, i.e. from US$2.5 billion to US$3.19 billion. The 2010 budget calls for expenditures to fall only slightly in dollar terms to US$3.17 billion, i.e. close to 46 percent of GDP.

Figure 2: GDP per capita, 1999-2009 (constant US$)



Source: Palestinian Central Bureau of Statistics

7. Donor-funded PA government spending is driving GDP growth, as suggested by the sectors showing the largest increases in output. Public administration and defense has the largest quarter on quarter growth and if health and education services are added, these government-supported sectors account for more than a third of the increase in both the West Bank and Gaza. Other growing sectors are construction, financial intermediation, and wholesale and retail trade, which grew quarter on quarter by 19, 22, and 8 percent, respectively. Manufacturing grew by only 3 percent and remains well below its high point in 1999. Initial estimates suggest that agricultural output increased by more than 20 percent quarter on quarter, but given that agriculture is only about 5 percent of GDP, this large increase has little overall effect. Similarly, though output in the hotels and restaurants sector more than doubled -- demonstrating an increase in tourism -- this sector is only 1.5 percent of GDP so the large increase has little effect on the overall economy. In sum, the main source of growth appears to be government spending that is leading to increased consumption, which is driving trade, services, and construction.

8. **Another important driver of growth has been the increase in the number of West Bank Palestinians employed in Israel and its settlements.** PCBS estimates that this number rose from about 70,000 in the first quarter of 2009 to nearly 83,000 in the first quarter of 2010, including workers with and without Israeli permits. Of those, as many as 23,000 workers are employed in Israeli settlements in the West Bank[2]. Much of the jump in employment took place in the beginning of the year as there is a reported increase of nearly 10,000 between the last quarter of 2009 and first quarter of 2010. This increase has provided an important boost to the West Bank economy, as wages received in Israel are more than double those received in the West Bank private sector. The Israeli Central Bureau of Statistics estimates that income earned in Israel and its settlements by Palestinians increased from US$168 million in the first quarter of 2009 to US$238 million in the first quarter of 2010 (and this is probably an underestimation). Much of this increase took place in the first quarter of 2010 alone, when income earned in Israel rose by more than 24 percent.

9. **Unemployment has dropped in the West Bank but not in Gaza.** In the West Bank, unemployment fell from 15.9 percent in the second quarter of 2009 to 15.2 percent in the second quarter of 2010. In Gaza, during the same period, the unemployment rate rose from 36 percent to about 39 percent. The labor force participation rate continues to be low in WB&G. In the second quarter of 2010, it remained about 37 percent in Gaza, and in the West Bank it held generally steady at around 43 percent.

B.I.a. Private investment

10. **The sustainability of growth in WB&G depends upon increasing private investment, and anecdotal evidence[3] indicates that private investment is beginning to pick up in certain sectors.** However, the increase in private investment remains well below what is needed to replace donor aid as the main source of growth. Nonetheless, managers in banks and loan guarantee programs have indicated that they are being approached by more entrepreneurs seeking financing for long- term projects. Indeed, the outstanding credit to resident customers was more than 24 percent higher in June 2010 than it was at the end of 2009, though the majority of it is going to support trade and consumer services. Only a small share is going to manufacturing, tourism, or agriculture (see Figure 3). There are also plans for two private equity funds targeting small and medium enterprises to begin operation within the year[4]. The managers of the funds believe they have already identified a small pipeline of viable projects.

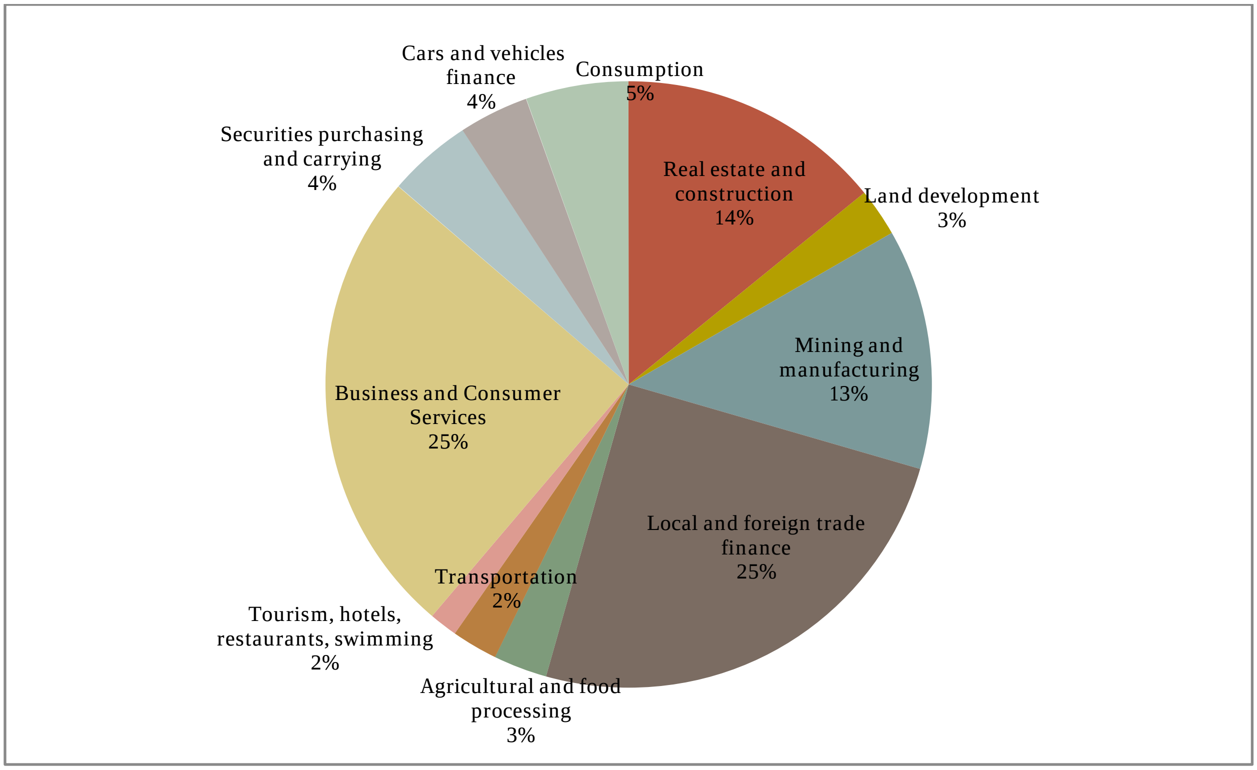
[2] Figure based on interviews with PA officials.

[3] Unfortunately, no current estimates of private or public investment in West Bank or Gaza are available.

[4] Siraj Fund, with a capital of US$80 million; and the Palestine Growth Capital Fund, a cooperation between the Palestine Investment Fund and Abraaj Capital, with a capital of US$50 million.

While limited in size, the fact that such funds are willing to begin operations in the West Bank signals an improvement in the environment and an increase in optimism.

Figure 3: Distribution of outstanding credit portfolio among economic activities in 2009

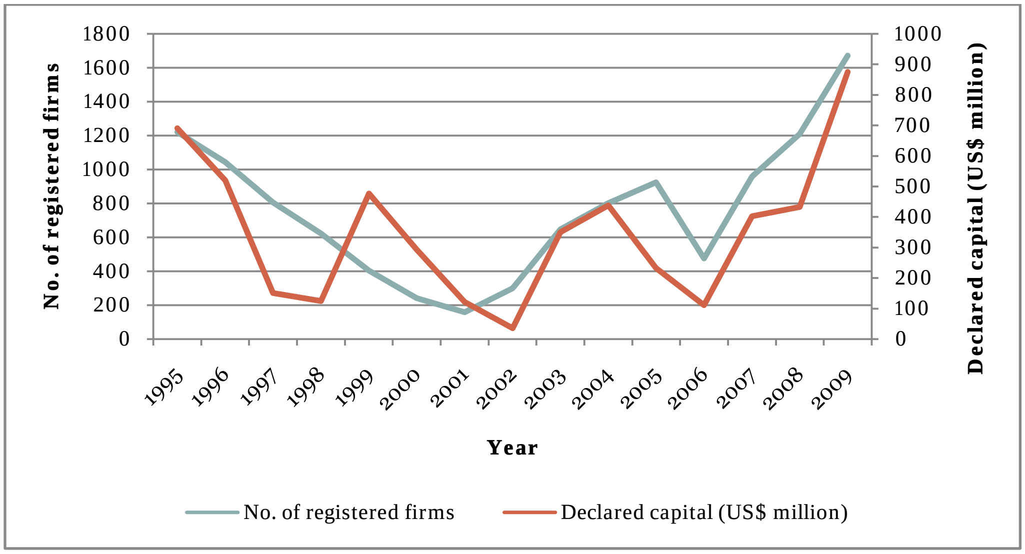


Source: *Palestine Monetary Authority Statistical Bulletin*, various issues.

11. **There has been a steady increase in the number of new enterprises registered in the West Bank[5] since the sharp drop observed in 2006, but again overwhelmingly in the commerce and services sectors, while other sectors lag.** Between 2008 and 2009 alone, the number of newly registered enterprises jumped by more than 38 percent with declared capital in 2009 more than double of that in 2008 (see Figure 4). Results from the first half of 2010 indicate that this year will be similar to 2009. While not all of the newly registered enterprises will have actually begun operating, the number paying the fees to register is a good indication of increased economic activity and investor confidence. The sectoral pattern of operation of the new enterprises mirrors output growth by sector: they are overwhelmingly in commerce and services, while industry, agriculture, and tourism lag. Nonetheless, there is a clear growth trend in industry between 2006 and 2009, with its share in the declared capital of newly-licensed firms rising steadily from 1.9 to 8.2 percent (unpublished data of the PA Ministry of National Economy).

5 Similar data are currently not available for Gaza.

Figure 4: Newly-registered firms in the West Bank, 1995-2009

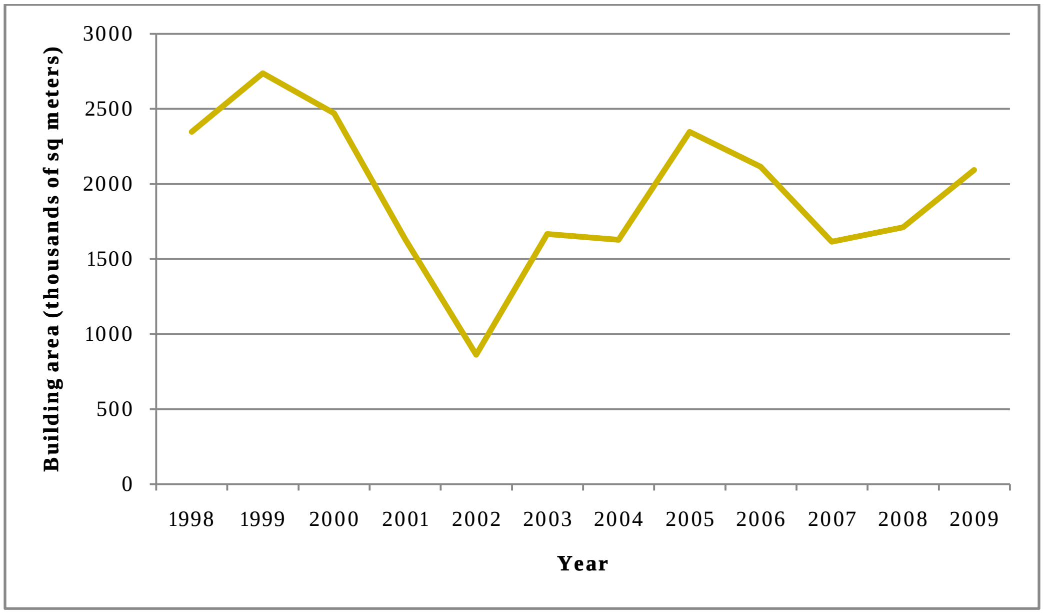


Source: Ministry of National Economy -- unpublished data

12. **In addition to growth in the number of newly registered businesses, there has been a recovery in the number of new building licenses issued and the amount of licensed area in the West Bank.** After a sharp decline between 1999 and 2002, building began to recover in 2003, faltering again in 2006 (Figure 5). The amount of licensed area is estimated to have fallen by nearly a third between 2005 and 2007. In 2008 and 2009 there was a steady recovery that appears to be accelerating in 2010. Nearly three quarters of the new licenses are for residential building. Combined with the fact that a large share of mortgages are provided to employees of the PA and international organizations, this once again highlights the importance of aid in driving growth.

13. **For Gaza, the recent relaxation of the blockade, while important, is too recent for it to have significantly impacted private sector activity.** Managers of enterprises report that they are only just beginning to receive limited amounts of raw materials, spare parts, and other imports needed to resume production. However, as indicated by data on the industry and construction sectors, there has been an increase in activity over the past year to service the local economy (Table 1). This is the result of firms having had time to adapt and from increased access to goods imported from Egypt. With the relaxation of the Israeli blockade, it is expected that private sector activity will continue to pick up. However, without the ability to export, its scope to grow and provide employment is limited.

Figure 5: Newly-licensed building area in the West Bank, 1998-2009 (thousands of square meters)



Source: Palestinian Central Bureau of Statistics Building License Surveys

Table 1: Gaza -- Status of key sectors during three periods

Sector	Indicator	Before Closure (14 June 2007)	During the Closure 2008	June-July 2010	Notes
Industry	No. of working establishments	3,900	117	1,365 *See notes*	15% of establishments are working with 30-60% capacity; 20% operating with around 20% capacity; 65% of industrial establishments are closed
	No. of workers	35,000	2,000	6,000	
Construction	No. of working establishments	125	8	50	(Current scope includes small maintenance works)
	No. of workers	50,000	100	1,500	

Source: Palestinian Federation of Industries and Palestinian Contractors' Union, as reported in PalTrade 2010a

B.II. Constraints to private sector development

14. **Despite the pick-up in private sector activity reported above, the obstacles facing potential private investors in WB&G remain manifold and myriad, primarily resulting from restrictions put in place by the GoI.** This section, without attempting to be exhaustive, lays out some of the main impediments to private sector development – impediments that need to be addressed both by the GoI and the PA. Potential investors find that exports from Gaza remain restricted; access to the majority of the West Bank's land and water is severely curtailed; East Jerusalem – a lucrative Palestinian market – is beyond reach; their own entry to Israel or WB&G is by no means guaranteed; and the entry of a range of raw materials deemed by Israel to be of dual civilian/military nature entails complex procedures and delays. A significant example is in the telecommunications sector, where Israel retains control of the electromagnetic spectrum, hampering operations of the Wataniya Telecommunications Company, which was launched without the required range of frequencies. In that particular sector, furthermore, the PA has yet to establish an independent regulator despite the passage of the relevant law. Indeed, leaving the restrictions imposed by Israel aside, the PA also needs to take action if it wishes to improve the investment climate, diminish uncertainty, and support private investment.

B.II.a. Selective easing of Gaza blockade

15. On June 20, 2010 the GoI announced its decision to ease the blockade on Gaza by allowing the unrestricted import of goods intended for civilian use while maintaining restrictions on items it defines as military or dual military/civilian, as well as on exports and the passage of people[6]. The official list of military and dual-use items was released by the Israeli authorities on July 5, and it includes 15 categories of general items (e.g. fertilizers, glass, fiber-based raw materials, drilling equipment), as well as 19 types of construction materials, which are limited to specific projects approved by the PA and implemented under the supervision of international organizations (UN OCHA oPt 2010a). The easing of the blockade meant that 2,973 truckloads entered Gaza during June, and 3,780 during July 2010 (UN OCHA oPt). Already the June figure represents the highest number of truckloads since May 2009 and is clearly a positive development, though even the July figure remains a fraction of the monthly average of truckloads that entered Gaza during the first five months of 2007 (i.e. prior to the blockade).

16. Since the loosening of the Gaza blockade began in June, tunnel activity is reported to have declined[7]. Most consumer goods that are now being allowed to enter through the

[6] On movement of the population, the announcement states that the policy of permitting the entry and exit of people for humanitarian and medical reasons and that of employees of international organizations that are recognized by the GoI will be streamlined. In addition, "as conditions improve, Israel will consider additional ways to facilitate the movement of people to and from Gaza" (Israel Ministry of Foreign Affairs MFA Newsletter, June 20, 2010).

[7] Based on interviews with Gaza businessmen and residents.

crossings with Israel are no longer brought through the tunnels. However, construction material, chemicals, and other goods that are not allowed to cross from Israel continue to come through the tunnels. Fuel, which is cheaper in Egypt, is also brought through the tunnels in large quantities. In June, new items allowed to enter Gaza through the crossings with Israel were limited to consumer goods and did not include raw materials (with some exceptions, e.g. automotive spare parts and agricultural and fishing materials). More recently, the GoI has allowed in other raw materials such as textiles, wood, drinks concentrate, and empty tin cans. At the same time, exports from Gaza continue to remain prohibited, which, combined with the restrictions on entry of some raw materials and inputs, precludes the revival of the private sector.

B.II.b. Lack of access to Area C[8] resources

17. **The Israeli authorities have implemented a series of measures that improved the freedom of movement of West Bank Palestinians between most urban centers (especially in the north) but no significant improvement took place in the access of Palestinians to areas beyond the Security Barrier, and to land and rural communities in the Jordan Valley (UN OCHA oPt 2010b).** During the period April 2009 – March 2010, the measures implemented by the GoI included the removal of obstacles[9]; the transformation of six key checkpoints into "partial" checkpoints staffed on an *ad hoc* basis; the relaxation of controls at some permanent checkpoints; the lifting of permit requirements for vehicles driving to and from Nablus; and the opening of three sections of roads for Palestinian use. These measures have significantly reduced the travel time between many Palestinian cities and towns. Yet these measures did not improve access of West Bank ID holders with entry permits to East Jerusalem, who remain limited to three of the 16 checkpoints along the Security Barrier. In addition, while the Israeli military removed some 80 roadblocks that impeded vehicular access for limited numbers of farmers to agricultural land in Area C, no improvement was observed regarding access to much larger agricultural areas in the Jordan Valley.

18. **In addition to its vast potential for agricultural development, the Jordan Valley has great potential for industrial development, as well as comparative advantages in the fields of tourism, transportation, and logistics (Gal et al. 2010).** The present situation severely handicaps Palestinian economic activity in the Jordan Valley, as most of the Jordan Valley is Area C, comprised of Israeli closed military areas or firing zones, or settlement areas, and so is almost completely off limits to Palestinians. Yet Palestinians could develop the Jordan Valley as a powerhouse of export-oriented high value-added agriculture. According to one study, an

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[8] The West Bank is divided into 3 areas: 2 areas are under Palestinian control and correspond to all major population centers (Area A) and most rural communities (Area B). The third area, Area C, is under Israeli control for both security and civilian affairs related to territory, including land administration and planning. The future of Area C is part of final status negotiations between Israel and the Palestinians.

[9] The total number of closure obstacles documented by the United Nations Office for the Coordination of Humanitarian Affairs in the occupied Palestinian territory (UN OCHA oPt) in March 2010 stood at 505, down from 626 in March 2009 (UN OCHA oPt 2010b).

appropriate mix of new irrigation and growing technologies with “old” greenhouse growing technologies and some open-field crops would enable Palestinians to develop, on approximately 50,000 *dunum*[10] in the Jordan Valley, an export-oriented high-value vegetable, flower, and herb industry valued at around US$1 billion per year (Gal et al. 2010). This study further posits that, taking into account the agricultural nature of the Jordan Valley, its industrial development would concentrate on food processing and other industries related to agriculture. Furthermore, a major facet of the economic development of the Jordan Valley would be the upgrading of west-east transportation routes. Tourism development would include the Dead Sea, Jordan River, and Jordan Valley slopes and mountains, as they offer a unique combination of health, leisure, sport/adventure, ecological, agro, and religious tourism destinations in a single area.

19. **Yet, according to the PCBS 2007 Census of Economic Establishments, the number of operating establishments in the Jericho and Al-Aghwar Governorate (corresponding to the Jordan Valley) was only 1,389, while the number of employees in these establishments was only 3,865 – less than 2 percent of the West Bank total of 82,871 establishments and 210,000 employees.** Thus, in spite of its vast agricultural potential, limitations on access and water scarcity have turned the Jordan Valley into the least-cultivated governorate by Palestinians: only 4 percent of the area of the Jericho and Al-Aghwar Governorate was cultivated in 2006, compared to the overall Palestinian average of 25 percent. Although the Jericho and Al-Aghwar Governorate constitutes 10 percent of total Palestinian territory, its share in total Palestinian cultivated land is only 2 percent.

20. **Given the fundamental importance of land to economic activity and development, the impact of continued Israeli control of Area C – fully 59 percent of the West Bank -- cannot be underestimated.** Land is a common means of storing wealth and a powerful economic asset; provides a foundation for economic activity in sectors as varied as agriculture, industries, housing, and tourism; as well as being a key factor in the functioning of credit markets. Thus, the effects on the Palestinian economy of the current territorial distribution are manifold. The physical access restrictions are the most visible, but perhaps not the most pernicious (World Bank 2008). The land use and planning regulations in effect in Area C tend to limit development within the confines of existing villages, with too little suitable space for demographic growth, causing irrational land use and unsound environmental management. Predictably, economic activity in Area C is limited primarily to low intensity agriculture. High intensity agricultural, industrial, housing, tourism, and other investments are hindered by the inability to obtain construction permits from the Israeli authorities and the limited amount of titled land available[11].

21. **Over 120 official Israeli settlements were built in the West Bank, as well as approximately 100 outposts (i.e. settlements built without official authorization, but with the support and assistance of government ministries) between 1967 and May 2010 (B’Tselem 2010)**. Israel has also established some 13 industrial areas near settlements, the major ones

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10 1 *dunum* = 1,000 square meters

11 In 1967, only 30 percent of West Bank land was registered, and systematic land registration was discontinued until 2006.

being Mishor Adumim, situated east of the Ma'ale Adumim settlement, and Barkan, adjacent to the Ariel settlement. Unfortunately, the full extent of the settler economy in the West Bank is not known since the Israeli Central Bureau of Statistics does not publish GDP statistics broken down by region (Swirski 2008b). Nonetheless, a one-time glimpse into the economic activity of settlements is provided by the 2006 Annual Report of the Israel Internal Revenue Service (IIRS) which included, for the first time, information on all Israeli corporations by administrative district[12]. On the basis of the figures published by the IIRS, it appears that many of the settlers depend for their livelihood on jobs within Israel, and not in the settlements themselves. Indeed, only 4,600 persons, i.e. 1.3 percent of those employed in industry in Israel, are employed in Israeli industrial areas in the West Bank. The exceptions to this rule are the settlements in the Jordan Valley of the West Bank that have developed a specialized agricultural production, primarily for export. Although their population is quite small, most settlers in the Jordan Valley are farmers who cultivate large areas of land and use most of the water resources in the area.

22. Hand-in-hand with access to land, access to water is a key ingredient for all sectors of the economy and for agriculture in particular. Palestinians extract about 20 percent of the "estimated potential" of the aquifers that underlie both the West Bank and Israel (World Bank 2009)[13]. Israel extracts the balance, and in addition overdraws on the "estimated potential" by more than 50 percent. This over-extraction by deep wells combined with reduced recharge has created risks for the aquifers and a decline in water available to Palestinians through shallower wells. On a per capita basis, water withdrawals for Palestinians in the West Bank are about one quarter of those available to Israelis, and have declined over the last decade. By regional standards, Palestinians have the lowest access to fresh water resources. Declining availability of agricultural water in particular carries significant opportunity losses in terms of output and employment. Though the potential exists for expansion of irrigated areas, the dwindling water availability, with almost no new or replacement water sources receiving permits, has meant that this potential simply cannot be realized. An upper bound estimate of the cost to the economy of the foregone opportunity in irrigated agriculture is as high as 10 percent of GDP and 110,000 jobs (World Bank 2009).

B.II.c. Severed link to East Jerusalem[14]

23. **East Jerusalem has historically been the center of the West Bank economy and society and its separation from the rest of WB&G has had a profound economic effect.** It cuts off nearly 10 percent of the West Bank population and since the East Jerusalem population has a higher level of income than the West Bank in general, it is a significant loss of market for West Bank enterprises and jobs for West Bank residents. In addition, it prevents access to the

12 The purpose of the analysis was to help assess the impact of the July 2006 Second Lebanon War on economic activity in the northern district of Israel, i.e. the one bordering on Lebanon.

13 According to the GoI, today this share stands at 70 percent for Israel, 30 percent for Palestinians.

14 The future of East Jerusalem is part of final status negotiations between Israel and the Palestinians.

Jerusalem holy sites for many Palestinians, significantly disrupting the tourism industry. The separation of East Jerusalem has forced a reorientation of markets so that many institutions and businesses in East Jerusalem have shifted operations and refocused their attention only on Jerusalem. Likewise, many enterprises in the rest of the West Bank have either attempted to open separate operations in East Jerusalem or given up the market. The cutoff of the East Jerusalem market, combined with the blockade of Gaza, has reduced the size of the already small Palestinian market. This in turn makes it difficult for firms to achieve minimum efficient scale, thereby increasing costs and lowering productivity.

24. **Perhaps the biggest impediment to trade is the requirement to abide by Israeli standards for Palestinian products entering the Palestinian market in East Jerusalem.** Palestinian firms are unable to obtain Israeli health and safety certifications. Consequently, pharmaceuticals and most food products are prevented from entering East Jerusalem. A few food producers have been allowed to continue to sell in East Jerusalem but the GoI has given notice that this is only temporary and unless the producers receive Israeli certification they will be forbidden to sell in East Jerusalem in the future. Other products must receive the Israeli quality certificate known as "Teken", which is also difficult for Palestinian producers to obtain. It reportedly requires a site visit by Israeli inspectors and Israelis are prevented by Israeli law from traveling to PA-controlled areas.

25. **In addition to the certification issue, shipments to East Jerusalem from the West Bank are generally required to go through the commercial crossings, adding substantial costs and delays**. For many small shipments, it is not cost-effective to hire a full truck, which firms find is necessary in order to go through the crossings. In addition to the cost of transport and damage caused by the back-to-back system at crossings, there are other impediments. For example, some shippers claim that they must present value-added tax (VAT) receipts even for goods destined to VAT exempt international organizations. One IT firm claims that this requirement has reduced the company's sales by nearly a third as it can no longer provide goods to international organizations in East Jerusalem.

26. **The inability of people without Jerusalem residence permits to enter East Jerusalem also makes it hard for firms located in the rest of the West Bank to provide services such as IT support, repairs, or consulting services**. This has greatly affected the service sector since many lucrative clients, especially among international organizations, are located in East Jerusalem. It must also be noted that the companies that have exclusive distribution rights for imported goods in the West Bank are prevented by the GoI from selling in East Jerusalem. Residents there must buy from the Israeli distributor, which deprives Palestinian firms of a lucrative market. Because of the access difficulties, some businesses in the remaining West Bank have resorted to opening branches in East Jerusalem though it is only a short distance away and could easily be serviced from the main establishment if there were free access. But many other firms report that while they will sell to East Jerusalem clients when the opportunity arises, they have effectively given up on the East Jerusalem market because of the high costs entailed[15].

[15] Based on interviews with Palestinian businesses and business organizations.

27. **Finally, the disruption caused by the separation of East Jerusalem to individual lives is well illustrated in a survey of 1,115 Palestinian households in the Jerusalem Governorate conducted by International Peace and Cooperation Center[16].** The survey found that about 9 percent of respondents had changed their place of residency because of the Separation Barrier and 19 percent indicated that the number of family members residing in the household had increased as family members started sharing houses located in East Jerusalem to avoid the loss of their residence permits. In addition, about 61 percent of the respondents deemed that their income decreased because of the Barrier, 26 percent declared that employment of household members was affected, and 29 percent stated that the Barrier changed the location of a family member's work place. The impact on markets is indicated by the fact that 61 percent of respondents said that the Barrier has affected their shopping patterns, with the vast majority having shifted from shopping in the suburbs on the other side of the Barrier to East Jerusalem.

B.II.d. Curtailed entry of visa holders and "dual-use" items

28. **One of the major factors limiting investment in WB&G is the difficulty and uncertainty of obtaining visas for foreign investors and technical staff as well.** The GoI controls entry into the PA territories and issues visas and entry permits. Potential investors from countries with visa agreements with Israel can expect to be allowed entry to Israel as well as the PA territories, and those from countries with no such agreements can expect to receive visas upon submission of their application. While this process usually works, it does not always: many times, entry is denied to those whose countries have visa agreements, and visa applications are rejected for others -- and often no reason is given (PalTrade 2010b). Other times potential investors are given visas that only allow them to be in PA-controlled areas, effectively cutting them off from East Jerusalem and Israel. Yet other times, internationals who enter Israel through Ben Gurion Airport are requested to sign a commitment statement in which they agree not to enter PA-controlled areas. Even more problematic is obtaining multiple entry visas or work permits for individuals working with Palestinian firms. Yet it is possible for investors to gain entry, as evidenced by the large number of permits approved for the 2010 Palestine Investment Conference, held June 2-3, 2010 in Bethlehem (including many permits for citizens of countries that have no diplomatic relations with Israel). There is therefore a high level of uncertainty in terms of obtaining and renewing entry permits and visas, which in turn leads many private investors to report that they are discouraged from attempting new projects.

29. **Another important factor hampering private sector investment that appears to be becoming an even larger impediment are restrictions on importing "dual-use" items into WB&G[17].** Dual-use items are items that have both civilian use as well as potentially other

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[16] The survey covered households within the municipal boundaries but outside the Barrier, households inside the Barrier, and households outside the municipal boundaries but within the Jerusalem Governorate.

[17] Some of the information in this section is based on a presentation made by the United States Agency for International Development at the September 2, 2010 meeting of the Private Sector and Trade Sector Working Group. The relevant report is as yet unpublished.

harmful use to which they could be diverted after import into WB&G. Israeli restrictions on dual-use chemicals and fertilizers have been in place for decades but in 2002 the Israeli military began limiting access to chemicals and fertilizers further by lowering the maximum concentration levels allowed. Since 2002, the GoI has progressively added materials, machinery, and equipment (including telecommunications equipment) to the list of items considered “dual-use”. To control their import by Palestinian businesses into the West Bank, the GoI has established a system of bureaucratic controls that require the GoI to authorize their transfer to the West Bank. Under this system, the permitting process must be repeated for every truckload of dual-use item, even for the same type of goods.

30. **While it is critical to Israel’s security needs to control access of dangerous items, the current restriction regime imposes a significant cost on Palestinian businesses, particularly as it appears to be getting tighter.** For example, The GoI has reduced the allowed concentrations of nitrogen, phosphorus, and potassium in fertilizers three times in the last seven years, most recently in 2009, which has forced farmers to seek more expensive and less effective alternatives. In another example, since January 2010, a West Bank firm that specializes in lining and coating metal pipes for infrastructure projects funded by donors, has been unable to obtain a license to transfer uncoated and unlined pipes in the most popular size and is in danger of losing large contracts. Although a system for clearance is apparently in place, the greatest obstacle facing businesses is the lack of transparency and predictability. Firms and investors are unable to plan because the list of dual use items is hard to obtain and items can be added without notice. Furthermore, the lack of transparency means businesses are unable to determine the anticipated timing of permit issuance, nor, if they are denied, how to appeal. Consequently, private investors are discouraged from investing in areas that might be affected, including the information and communications technologies (ICT) sector, arguably one of the most heavily affected by the dual-use restrictions. This is particularly problematic for the Palestinian economy as this is a high value-added sector that many see as holding great potential in WB&G. In some ways, the ICT sector is less affected than other sectors by physical impediments, but the increasing dual-use restrictions effectively eliminate much of this advantage.

B.II.e. Challenges facing the banking sector

31. **The Palestinian banking system remains highly conservative and well regulated by the Palestine Monetary Authority (PMA).** It was relatively untouched by the upheavals in the world financial markets and remains stable. It is slowly expanding the number of branches and services it offers including recently introducing electronic point of sales. Because of previous regulatory changes requiring banks to keep at least 45 percent of their liabilities within WB&G, banks have been more aggressive in providing credit facilities. This factor, along with the increase in economic activity, explains the more than 25 percent jump in outstanding credit facilities between December 2009 and June 2010.

32. **However, the Palestinian banking sector faces a number of serious challenges, one of which is its large and growing exposure to the PA.** At the end of June 2010, credit facilities to the PA stood at US$813 million, up from US$627 in December 2009. Credit to the public sector accounted for more than 32 percent of outstanding credit facilities and over 10 percent of total assets in the banking sector. In addition, many banks have very large exposure to PA employees to whom they have extended mortgages and consumer loans secured by salary transfers. If the PA's fiscal position deteriorates and it cannot service its debt or make regular salary payments, the banking sector will be seriously affected. The banks and their regulators are well aware of the risks and are seeking ways to diversify. However, given the state of the economy, there are few options.

33. **The Palestinian banking sector continues to face challenges resulting from the political situation, but the PMA and Bank of Israel (BoI) are collaborating closely to facilitate cooperation between Palestinian and Israeli commercial banks.** In 2009, large shekel cash surpluses had accumulated at Palestinian banks due to Israeli banks' refusal to accept these cash deposits on concerns about possible legal ramifications. Consequently, Palestinian banks were faced with holding excess cash, causing them to not only lose revenue on the idle funds but also driving up their insurance rates. However, this issue was resolved in July 2010 through a special arrangement whereby the excess shekel cash is regularly deposited at Israeli banks' accounts with the BoI. In Gaza, there continues to be an unstable supply of cash. Previously there was a shortage of shekels while US dollars were plentiful. This was followed by a period when Gaza branches had excess shekels that needed to be shipped to the West Bank. With the recent increase in economic activity this has again reversed and banks reported a shortage of shekels that would make paying salaries to PA employees difficult. The PMA and BoI are currently working on ways to ensure the regular transfer into Gaza of cash amounts adequate to fully cover commercial banks' needs, without pre-set limits on quantity or currency composition. Through an informal agreement reached in 2009, NIS 50 million was allowed to enter Gaza per month[18]. Since July 2010, however, cash amounts beyond this NIS 50 million per month limit have been transferred, as well as the replacement of NIS 31 million in tattered bank notes with new notes.

B.II.f. Improvements to the business environment

34. **Though Israeli economic restrictions remain the main constraint to private sector investment, the PA needs to continue efforts to provide an investment climate that limits uncertainty and supports private investment.** The PA's Ministry of National Economy (MoNE) has made improving the investment climate a priority and has taken a number of steps, but there remains significant work to be done. Amongst these steps is the recent drafting of a number of new laws to improve the investment climate. These laws have been passed by the

[18] This informal agreement does not cover the entry of Jordanian Dinars or US dollars.

Council of Ministers and are awaiting signature by the President[19]. Among the important new laws waiting to be adopted are:

i. **New Companies Law:** This new law modernizes how companies are registered and regulated. Among other things, it will reduce the minimum capital requirement for registration, which will make it easier to establish new enterprises.

ii. **New Investment Law:** This legislation changes the way investment incentives are given, including adding new sectors that are eligible for incentives.

iii. **New Industry Law:** This law will change the way industry is regulated and supported by the PA.

iv. **Movable Assets Law:** This law establishes a movable assets registry in the MoNE, which will help enterprises access finance by allowing them to use movable assets as collateral.

35. **In addition to adopting new legislation, the PA has also faced challenges in effectively implementing legislation it has adopted, such as the 2009 telecommunications law that requires the establishment of an independent regulator.** To date, the regulator has not been established and the Ministry of Telecommunications and Information Technologies has indicated that it does not expect the regulator to be established in the near future. This is despite that fact that PALTEL remains the monopoly provider of fixed line service and internet gateway as well as controlling the largest mobile operator. The PA's inability to establish effective regulation of this market will discourage new entrants and hinder development of the sector. In addition, it sends a cautionary signal to businesses in other sectors that the PA is unable to effectively implement difficult legislation or effectively regulate markets. Therefore, establishing the independent telecommunications regulator should rank as one of the PA's highest priorities.

36. **In addition to drafting legislation, the MoNE is initiating other activities to create a more conducive investment climate.** For example, the MoNE has created a Recognized Importer Card, which aims to improve government services for large importers. It recently took steps to activate the Palestinian Council for Consumer Protection and form a national committee for the implementation of labeling requirements in the Palestinian market. More importantly, the PA has recognized the importance of improving the capabilities of the Palestine Standards Institution (PSI). Raising the quality of Palestinian products and providing them with internationally recognized standards certificates is essential in order to expand access to Israeli and other markets. Consequently, the PA is making this a priority and has entered into an agreement with the European Union (EU) to support the PSI.

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[19] Since the Palestinian Legislative Council does not meet, all laws are adopted as presidential decrees, subject to revision by the Legislative Council once it does meet.

C. Progress towards robust institutions

37. The September 2009 World Bank economic monitoring report to the AHLC[20] states that the PA's institution-building performance is generally satisfactory, having demonstrated its competence in the provision of basic services, so that the PA is well-positioned for the establishment of a Palestinian state at any point in the near future. This report reaffirms this assessment, and highlights the need for institution-building to go hand in hand with sustainable growth, so as to solidify the progress made to date. The PA allocated in 2009 (as it did in 2008) the largest shares of public spending to the Ministries of Interior and National Security, Education, and Health (see Table 2). Together, these three Ministries absorb over half of the PA's total public spending, and over 80 percent of spending on wages and salaries. This spending pattern demonstrates the PA's commitment to providing security and delivering education and health services to the population.

38. In order for the PA to continue its demonstrated focus on providing security and basic services, it must remain fiscally viable, which in turn requires continued growth as well as progress on its reform agenda. Prior to 2000, WB&G did not face fiscal deficits in recurrent expenditures, though they did rely on donor funding for investment. Clearly, the sharp drop in GDP experienced since 1999 has had a severe impact on the PA's fiscal position. By the same token, the recent upward trend in GDP bodes well for the strengthening of this position, though the sustainability of this growth remains in question, as described above. In addition to economic growth, the PA is focusing on a reform agenda that will further reduce its dependence on donor assistance for recurrent expenditures. This reform agenda for fiscal strengthening spans several areas, including the electricity sector, pensions, and the social safety net, and has recently achieved important milestones, as will be described further below.

C.I. The PA's fiscal position

39. **The PA is broadly on track to achieve its deficit target in 2010.** Although there has been an underperformance in dividend receipts, the PA has increased domestic tax revenues and reduced non-wage expenditures below budget projections, while achieving the target for the wage bill. However, budget support is currently estimated to be US$300-400 million less than projected in the budget. Since the PA is probably close to the limit of its ability to borrow from local banks, this shortfall could lead the PA to accumulate large amounts of arrears. If expected development funding also does not materialize, then the arrears could become even larger. Consequently, if new sources of donor support are not quickly identified, economic growth and confidence in the PA itself could suffer.

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[20] World Bank. September 22, 2009. "A Palestinian State in Two Years: Institutions for Economic Revival."

Table 2: Palestinian Authority 2009 expenditures, percentage share

	Total Expenditure	Wages & Salaries	Operational Expenditure	Transfer Expenditure	Capital Expenditure	Development Expenditure
Ministry of Interior and National Security	28.0	43.0	14.7	8.7	28.8	22.2
Ministry of Education	16.7	27.8	4.3	6.7	6.4	3.2
Ministry of Health	11.5	9.7	42.3	0.6	1.1	2.7
Ministry of Social Affairs	7.9	0.7	0.5	26.9	0.3	4.4
Retirees Pension Allowances	6.7	0.0	0.0	25.3	0.0	0.0
Ministry of Prisoners Affairs	2.9	0.3	0.2	10.4	0.0	0.0
Ministry of Local Government	2.5	0.3	0.2	3.5	1.0	21.3
Financial Reserves	2.0	0.0	0.0	7.6	0.1	0.0
President's Office	1.8	1.0	7.6	0.2	3.3	1.0
Ministry of Public Works and Housing	1.8	0.6	0.3	3.5	1.0	7.3
Public Debt Service	1.7	0.0	11.4	0.0	0.0	0.0
Ministry of Finance	1.7	1.5	2.9	0.4	1.1	5.5
Embassies	1.5	1.4	4.3	0.3	6.1	0.2
P.L.O. Institutions	1.0	1.2	0.9	0.4	0.4	2.2
The Ministry of Awqaf and Religious Affairs	1.0	1.6	0.2	0.5	0.1	0.5
General Personnel Office	0.9	1.6	0.1	0.5	0.1	0.0
Development Expenditures	0.9	0.0	1.0	0.2	37.5	0.0
Sub-total	90.7	90.7	90.7	95.7	87.2	70.5
Other[a]	9.3	9.3	9.3	4.3	12.8	29.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
Memorandum item *Share of type of expenditure in total expenditure*	*100.0*	*50.2*	*15.0*	*26.6*	*1.7*	*6.5*

Source: Ministry of Finance Table 6B "Expenditures by Function (Commitment Basis) Jan – Dec 2009" available at http://www.pmof.ps/news/plugins/spaw/uploads/files/accounts/2010/01/table6b_eng.pdf

Note: Spending entities are ranked in descending order by share of total 2009 expenditure.

[a] Includes all other spending entities.

40. **The recurrent budget deficit in the first half of 2010 was almost NIS 2.5 billion or 6 percent above budget projections.** Total expenditures and net lending were about 3.8 percent below budget projections. However, total revenues were around 9 percent short of expectations, mostly due to lower than expected clearance revenues and non-tax revenues. In addition, the PA continued to fund some development projects with resources from the Central Treasury Account, even though it has not yet received donor support for the projects as called for in the budget. Development expenditures amounted to NIS 470 million, while development financing is reported at only NIS 92 million. This shortfall in development financing, combined with the recurrent deficit, forced the PA to increase domestic bank financing by NIS 454 million and to accumulate arrears of almost NIS 383 million. About NIS 312 million of these arrears were non-wage arrears, mostly owed to the private sector, including some NIS 100 million in tax refunds. The PA recognizes that arrears to the private sector undermines its credibility and budget execution controls and is an issue that must be addressed[21].

41. **Thanks to strong efforts by the PA to mobilize domestic resources, tax revenues in the first half of 2010 were nearly 15 percent above budget projections and 50 percent higher than in the same period in 2009.** VAT continues to be the largest source of domestic revenue. However, income and property tax saw the largest year on year increase, 60 and 53 percent, respectively. Unfortunately, non-tax revenues, while nearly 18 percent higher than in the same period of 2009, were 38 percent below the pro-rated budget target. Non-tax revenues are mostly dividends, and as such lumpy and unpredictable. No investment profits were received by the PA during the first half of the year, but the Palestine Investment Fund provided a US$40 million dividend in August. Thus, it is still possible that the PA could make up much of the shortfall in non-tax revenues. However, the PA currently estimates that it will receive around NIS 170 million less in non-tax revenues than projected in the budget. The largest single source of revenue for the PA is the tax clearance revenues collected by the GoI. In the first half of 2010, they were nearly 10 percent below budget projections, though still 11 percent higher than in the first half of 2009. The lower than expected clearance revenues can partly be explained by the decline in fuel shipments to Gaza as well as the substitution of cheaper petroleum products imported from Egypt for more expensive Israeli fuel in Gaza.

42. **A factor constraining potential VAT receipts is that the PA does not receive any VAT for most items imported into Gaza or for goods that leak into the West Bank.** For the PA to receive the VAT collected by the GoI it must present VAT invoices to the Israeli authorities. Since the PA is not able to monitor entry of goods into Gaza, it cannot obtain the required documentation. However, as the GoI is able to fully account for the amount and value of all goods entering through the Gaza crossings, efforts should be made to address this surmountable problem and the VAT could be remitted accordingly. In the West Bank, the situation is similar: because the PA has no presence at the commercial crossings, commercial quantities of goods can slip into the West Bank without proper documentation being provided to the Palestinian authorities. As the flow of commercial goods into Gaza increases following the loosening of the blockade, the foregone revenue will increase.

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[21] See Ministry of Finance second quarter and midyear 2010 fiscal report on the Ministry's website.

43. **Wage expenditures met the budget target, and non-wage expenditures were almost 11 percent less.** In the first quarter of 2010 there was a change in budget classification to align with the IMF's Government Finance Statistics. This entailed taking out the transportation allowances from the wage bill and reclassifying it under operational expenditures. At the same time, contractual employees were taken out of transfer expenditures and reclassified under wages. Overall, the Ministry of Finance (MoF) estimates that this reduced the wage bill by about NIS 35 million on an annual basis. However, in the first half of the year, other unbudgeted adjustments were made to the wage bill, including: a) in February 2010, workers in the health sector received "danger pay" with some retroactivity to 2009; and b) in April 2010, a "supervisory allowance" was provided to all supervisors. Despite these adjustments, the wage bill in NIS terms achieved the budget target in the first half of the year, though it could be higher in the second half. Nonetheless, the unbudgeted increases in pay and allowances are a worrying sign given the PA's commitment to controlling growth of the unsustainable wage bill.

44. **For the PA to achieve its deficit target it is essential that spending restraint be maintained to make up for the shortfall in revenues.** Operational expenditures were almost 12 percent below budget and 11 percent lower than in the first half of last year. Transfers remained at similar levels to last year and more than 7 percent below the budget target. The PA has been moving forward on its reforms in the electricity sector, and net lending[22] is nearly 33 percent lower than in the first half of 2009. But it is running some 10 percent or nearly NIS 48 million more than in the budget. However, given recent structural reforms in the electricity sector (see further below), the PA still projects that it will achieve the budget target for net lending by the end of the year.

[22] "Net lending" refers to a phenomenon in the electricity sector which arises due to the non-collection (by utilities and municipalities) of electricity bills, and the diversion of utility revenues to fund municipal operations, forcing the central government to fund payments to the Israel Electricity Company for bulk purchases of electricity in order to avoid service disruption.

C.II. Strengthening the fiscal position

C.II.a. Social safety net

45. **The Ministries of Social Affairs and Finance have facilitated the merger of the EU-funded Special Hardship Case program with the World Bank-funded Social Safety Net Reform Project into a Palestinian National Cash Transfer Program (PNCTP).** The PNCTP became a reality on the ground on June 26, 2010 when a first combined quarterly payment was made to 63,906 households. The PNCTP participating households were selected using the same targeting modalities ("proxy means testing" formula) and receive the same benefit levels regardless of the funding source. This is a significant step forward, as PNCTP targeting efficiency has improved significantly and regardless of the funding source PNCTP households will receive the same benefits at the same time.

46. **The Ministry of Social Affairs (MoSA) is committed to ensuring the PNCTP's financial sustainability as well as ascertaining that all poor households below a certain welfare threshold participate in the program.** In order to minimize the exclusion of these poor households, MoSA is carrying out an in-depth verification process of over 90,000 poor households currently outside the program, of which about half are likely to fall below the poverty line and be eligible for cash benefits. This exercise will enable the MoSA to have a complete distribution of household poverty levels throughout the West Bank and ensure that the poorest households benefit from the PNCTP. MoSA has also intensified its efforts to certify Gaza households using the same methodology currently applied in the West Bank. This is necessary in order for MoSA to have a complete distribution of household poverty levels throughout the West Bank and Gaza and subsequently establish benefit levels accordingly.

47. **Based on MoSA's recent efforts to re-certify PNCTP households, about 8,900 households were found to be no longer eligible for cash benefits, but discontinuing benefits is of course a politically difficult undertaking.** Thus, MoSA has been actively exploring other means of providing support to these households, as they are still in need of assistance, by directing them to micro-finance, food aid, vocational training, or other social assistance programs. In addition, MoSA has made arrangements to pay a flat rate of NIS 250 during a transitory year (July 2010-June 2011) as a means of transitioning the households out of the PNCTP.

C.II.b. Public pension system

48. T**he PA's public pension system is a generous pension system with early retirement provisions and high benefit accrual rates that has been undergoing slow reform for over a decade.** Pension reforms began as early as 1998 when the PA began the gradual integration of the two civil service schemes that it had inherited from Jordan for West Bank civil servants and

from Egypt for Gaza civil servants. A new scheme was enacted in 2005 by the Unified Pension Law. In 2009, the MoF issued a decree requiring all ministries to comply with the career paths and promotions defined in the civil service regulations, in order to avoid artificial end-of-career salary increases that have a negative effect on pension liabilities. Nevertheless, budgetary pension expenditures accounted for 4 percent of GDP in 2009, which is higher than the average burden in the region, despite the fact that the Palestinian population tends to be younger.

49. **In May 2010, the Palestinian Pension Authority developed an Action Plan for Public Pension Reform that was approved by the Council of Ministers in July.** The Action Plan outlines immediate measures to be taken in 2010-11 and additional measures for 2011-13. Amongst the immediate measures is the elimination of early retirement, i.e. PA employees who retire early will not have the right to receive pension benefits until they reach the mandatory age of 60 for civil servants and 50 for security personnel. In addition, gradually increasing the retirement age over the next five years from 60 to 65 for the civil service and from 50 to 55 for security personnel is one of the medium-term measures to be adopted by June 2013. While these actions will not have a substantial impact on the PA budget in the short run, they put the PA on the path to addressing the fiscally unsustainable pension system.

C.II.c. Electricity distribution and net lending

50. **The Palestinian Electricity Regulatory Council (PERC), established in February 2010, has been activated and has prepared the drafts of necessary regulations to transfer the electricity distribution from local governments to commercially run distribution companies.** Among the regulations approved by the Council of Ministers is the financial assistance for a temporary period of time for those municipalities and village councils that stand to lose from relinquishing their revenues from electricity sales.

51. **On July 19, 2010, electricity bills were issued by the Northern Electricity Distribution Company (NEDCO) to consumers in Nablus – representing a significant milestone.** Though established in 2008, NEDCO only recently became operational, primarily since the local governments that are most reliant on electricity fees had not been willing to turn over electricity distribution to the new company. However, NEDCO is now responsible for billing, collection, and the IT database of the electricity services in Nablus. In addition, NEDCO plans to next operate the electricity services in Jenin, followed by the cities of Tulkarm and Qalqilya, and by August 2011 about 85 percent of electricity services in the northern West Bank.

52. **Together, the activation of PERC and NEDCO represent significant steps in the reform of the electricity sector and should help the PA end the practice of net lending for electricity in the West Bank.** In addition to these major steps, the PA continues to distribute pre-paid meters, deduct overdue electricity bills from PA employees, and take other steps to increase electricity bill collection rates. It must be noted, however, that though significant progress on

the issue of net lending has taken place in the West Bank, actions required to reduce net lending in Gaza have been hampered by the current political situation.

C.III. Improving public finance management

53. **The PA continues to make progress in improving the system through which it manages public resources – the public financial management (PFM) system.** The progress has been particularly notable since the formation of the Caretaker Government of Prime Minister Salam Fayyad in 2007. A central objective has been to ensure that government resources are managed in a transparent and accountable manner. During 2010, a number of further advances have been made to improve the quality of budget formulation, budget execution, and reporting.

54. **The formulation of the 2011 budget will feature a number of significant new developments.** 2011 is the first year for the new three-year Palestinian strategy document. The MoF and the Ministry of Planning and Administrative Development (MoPAD) are working closely together to ensure that the 2011 budget is an effective first step in implementing the plan. This is both at the level of the fiscal framework and in the determination of expenditure priorities.

55. **In preparing the 2011 budget, the MoF will also use a budget module that has been developed as a new component of the computerised accounting system.** The module will provide up to date information on budget execution in the current year and will thus improve the basis for budget decisions. It will also facilitate a more timely completion of the budget document, with the MoF intending to have the budget in place by January 2011 – at least two months earlier than recent years. In conjunction with the new budget module, the MoF is introducing a new budget classification for the 2011 budget, with the economic classification based on the IMF's Government Financial Statistics Manual 2001. This is another important step towards meeting international standards for budget management.

56. **The transformation of the budget execution systems since 2007 has been extremely impressive.** These reforms have strengthened the MoF's control of expenditures, and steadily increased the quality of accounting, while allowing greater responsibility for financial management to be devolved to line ministries. During 2010, the most significant developments have been:

i. A commitment control system has been introduced to provide MoF with more control over expenditures. The system is already being used by MoF to restrict commitments by line ministries in view of the major shortfall in budget support. This is an option that MoF did not have in earlier periods and it should help in reducing any buildup in expenditure arrears.

ii. The MoF has developed a report on the PA debt stock that is included as a feature of the monthly fiscal reports. Preparing the report has been a challenging task as much of the source data were destroyed during Israel's recent military operation in Gaza (Operation Cast Lead, December 27, 2008 -- January 18, 2009).

iii. The audit of the 2008 financial statements is also expected to be completed in the coming weeks.

57. **Developments have also occurred in the tax administration system**. These changes have improved the effectiveness of enforcement activity since mid-2009 and in conjunction with the stronger economy there has been a noticeable increase in the taxes being collected. Further reforms are being prepared, including the establishment of a large taxpayers' center in the coming months.

58. **Good progress has been made in recent years in improving the PFM system and some difficult reforms have been successfully introduced.** Looking forward, the nature of the challenge will change as many of the essential features of a sound PFM system are now in place. Instead of developing new systems the focus should increasingly turn towards deepening the understanding of the recent reforms in both the MoF and line ministries, and using the reformed systems to improve the value for money Palestinians receive from government expenditure. Particular areas for focus include:

i. Creating a unit in the MoF for fiscal analysis and projections;

ii. Increasing the quality of budget formulation by developing the analytical capacity in the MoF, MoPAD, and line ministries to monitor the effectiveness of expenditures and feed this assessment into future budget decision-making;

iii. Continuing to strengthen the link between the cash plan and the commitment control system to reinforce the control of expenditures. This is particularly challenging – but also extremely critical - given the uncertainty of budget support flows; and

iv. Using the opportunities provided by the new accounting system to continue to improve the quality and range of reports on fiscal operations.

C.III.a. Public procurement

59. **The PA has re-emphasized its commitment to the enactment of a new public procurement law and regulations.** A PA inter-ministerial working group is currently revising the 2010 draft of the Palestinian Public Procurement Law, including taking into account revisions proposed by the World Bank. The draft Law is seen as largely reflecting the essence of internationally recognized practices as embodied in legal compendiums such as the UNCITRAL Model Law on Procurement. As such, the draft Law provides a good starting point for crafting

of an enhanced version which would close existing gaps, address some inconsistencies, and improve the structure and drafting of the text. Particular areas for improvement include: (a) clarity on the institutional and organizational set-up; (b) need for comprehensive and up-to-date provisions on procedural matters; and (c) further development of the provisions on transparency and accountability. The finalization of the draft Law is expected in autumn of 2010.

60. **A sound procurement system plays a key role across all sectors in achieving good governance in WB&G, and the enactment of a good procurement law is a crucial, but only first step, in the development of a complete procurement system.** Other critical components of the procurement system need to be put in place. Those include regulations for the Law, standard bidding documents and general conditions of contract, systematic capacity- building and professionalization of the procurement workforce, establishment of the Procurement Policy Unit, and preparation of a strategy for introducing e-procurement. The PA is committed to these further steps and foresees their implementation in the next two years.

D. Conclusion

61. The twin pillars of sustainable growth and robust institutions for the future Palestinian state must be a joint undertaking of the PA, GoI, as well as the international community. As this report has laid out, all three have played their role in the recent growth that has taken place in WB&G: the GoI by easing movement and access restrictions, and the donors by funding the PA's spending. All three actors continue to have important roles to play for this recent growth to transform into sustainable growth, and for the sustainable growth to support further progress for robust institution-building. For the GoI, further actions to improve the conditions on the ground and allow a real take-off in private sector development are necessary. For the PA, a continuation on the path of improving the business environment is key, as are the measures it is taking to strengthen its fiscal position and thereby bolster its institutions. And for the donor community, continued generosity is of the essence to consolidate the substantial gains made by the PA and allow it to reduce its reliance on external support without compromising basic service delivery to the Palestinian population.

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