HM Government

Economic aspects of peace in the Middle East

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September 2007

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Contents

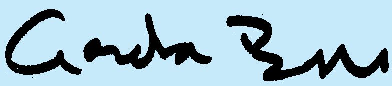
Foreword by the Prime Minister

It is my strong personal belief that economics, politics and security are inter-linked and that a strong and sustainable Palestinian economy is a vital component of a viable future Palestinian state. By giving ordinary Palestinians an economic stake in their future, we support the forces of peace and moderation.

That is why, with the support of Jim Wolfensohn (then the Quartet's Special Envoy) and G7 Finance Ministers, I commissioned Ed Balls and Jon Cunliffe to write this report in September 2005. At that time, it was widely felt that we were faced with a historic opportunity for progress in the Middle East Peace Process. Events in 2006 did not support such optimism. It is absolutely clear that sustainable political and economic progress in the Middle East Peace Process require the PA and the Israeli government to work together.

However, the formation of Salam Fayyad's government, the appointment of Tony Blair as the Quartet Representative to the region and the resumption of regular dialogue between President Abbas and Prime Minister Olmert point towards a better future. I retain my strong belief that political progress needs to be firmly supported by economic growth. As I have learnt from the dramatic changes seen over recent years in Northern Ireland, by providing moderates with a material stake in their own future, we increase the cost of returning to conflict. This will help initiate a virtuous cycle of progress, with ever-increasing prosperity leading towards greater security for Palestinians and Israelis alike.

I am very grateful to Ed and Jon for persevering with their task and I fully endorse their analysis and recommendations. I hope this report will inform policymakers and the business community alike on how they can best support the Palestinian economy, and provide a useful contribution to efforts to secure peace in the Middle East.



Gordon Brown
Prime Minister

Executive Summary

When this report was commissioned in September 2005, the challenge set was to identify the necessary conditions for economic progress in the Occupied Palestinian Territories (OPTs) and determine how the international community should offer support. The underlying rationale was that a viable Palestinian state, living in peace and security with Israel, requires the creation of a sustainable Palestinian economy. Conditions in the OPTs have deteriorated in the intervening two years, most recently following the Hamas takeover of Gaza, and this rationale, acknowledged by both the Israeli and Palestinian authorities, has become even more compelling.

The world economy has been transformed over the past 40 years. Many countries, including Israel, have benefited from the process of globalisation. The Palestinian economy, however, has been left behind. Its composition today is remarkably similar to that of 1967, with the private sector highly fragmented and unproductive relative to regional, and global, competitors. Developments since the outbreak of the second *intifada* in 2000 have further reduced economic opportunities, resulting in a 40 per cent fall in per capita GDP, during a time when much of the world was experiencing unprecedented growth.

The current economic outlook for the OPTs is bleak. Despite $10 billion in international aid since the formation of the Palestinian Authority in 1993, the Palestinian people are getting poorer and 65 per cent now live below the poverty line. For the Palestinians, further economic malaise will only increase humanitarian suffering. For the Israelis, economic deterioration in the OPTs can only increase security risks. For both sides, the current vicious cycle of poverty and unemployment contributing to instability and conflict, and in turn further poverty and unemployment, must be broken.

Sustainable economic growth in the OPTs can come only from the private sector, whose development is currently held back by a number of barriers. While these are numerous, five building blocks of an economic roadmap for sustainable progress have been identified. First, the economy needs to be stabilised by reducing public expenditure, specifically the public wage bill, which could be temporarily underpinned by donor-funded employment and investment programmes. Second, a stable relationship between the Palestinian and Israeli economies needs to be established to provide a reliable framework for private sector led growth. Third, flowing from this, the right balance must be struck between short-term security and allowing movement and access, to allow both prosperity and security for the future. Fourth, the Palestinian economy must diversify its trade links and improve its access to global markets. Fifth, the private sector needs to be supported by enhancing the investment climate.

Realising the economic roadmap requires adopting a number of recommendations, divided between those that can be implemented straight away and those that are conditional upon political progress. Seeing this through will not be easy. But the experience of other conflicts demonstrates the need for economic progress to go hand in hand with political progress. Above all, taking this work forward will require strong leadership from the Palestinians, the Israelis and the international community, working together to achieve the common goal: a strong, democratic, and viable Palestinian state living side by side, in peace and security, with Israel and its neighbours.

1 Origin of the report

1.1 When they met in December 2005, joined by the then Israeli and Palestinian Finance Ministers, Ehud Olmert and Salam Fayyad, G7 Finance Ministers acknowledged the urgent need to raise Palestinian living standards, particularly in light of high unemployment, increasing poverty and rapid population growth witnessed in the Occupied Palestinian Territories (OPTs). They agreed that there was an opportunity for the international financial community to support the regeneration of the Palestinian economy, building on the 2005 G8 Gleneagles goal of providing up to $9 billion over three years to stimulate Palestinian economic recovery[1].

1.2 With the support of James Wolfensohn, then the Quartet's special envoy for the region, Gordon Brown commissioned this report on the behalf of G7 Finance Ministers and, highlighting the critical role to be played by the private sector in future Palestinian growth, HM Treasury and the World Bank co-hosted a conference in London in December 2005 to promote private sector growth in the OPTs[2].

A greater stake in the future

1.3 It was keenly felt, based in part on the UK's experiences in Northern Ireland, that effectively targeted economic measures would provide Palestinian people with a real stake in the future by demonstrating an achievable path leading away from the current malaise. This would increase the cost of a subsequent return to violence. Improving security and economic performance would then provide an environment more conducive to productive political negotiations, thereby initiating a virtuous circle of progress.

1.4 A secure two-state solution requires a viable Palestinian state that offers prosperity and economic opportunities to its inhabitants, and peace and security to Israeli citizens. As in many conflict environments, substantive and sustainable economic progress in the OPTs will be dependent upon improvements to the political and security situation. However, the deterioration during 2006 of all Palestinian economic and social indicators demonstrates that the economic and security agendas cannot be separated from each other, or from the political process. Each needs to be carefully addressed in parallel if overall progress in the Middle East Peace Process is to be achieved.

Events in 2006 and 2007

1.5 It was originally intended to publish the report in spring 2006. However, this was delayed by events in the region. The Hamas government, which took office in March 2006, refused to move towards the three Quartet principles: non-violence; recognition of Israel; and acceptance of previous agreements and obligations, including the Roadmap. As a consequence, most of the international community was unable to establish direct contact with the Hamas government, ending direct budget support and instead establishing the Temporary International Mechanism (TIM) to channel record levels of aid directly to the Palestinian people. Israel ceased co-operation with the Palestinian Authority (PA) and suspended the transfer of Palestinian tax revenues, which ordinarily constitute more than half of the PA's revenues. The security situation also deteriorated, following the 25 June kidnapping of Corporal Shalit and the subsequent Israeli Defence Force incursions into Gaza.

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[1] www.fco.gov.uk/Files/kfile/PostG8_Gleneagles_MEPP.pdf

[2] The authors would like to thank all those who have provided advice and material to inform this report since it was commissioned in September 2005.

1.6 A National Unity Government was established on 17 March 2007 and, following Hamas' take-over of Gaza on 14 June, President Abbas established a new interim government under the internationally respected Salam Fayyad. The international community is now fully engaged with Dr Fayyad's government. Hamas' control of Gaza continues to restrict efforts to support economic development, including on consultation on this report. A viable Palestinian state, however, must include both the West Bank and Gaza and both territories are addressed in this work, though in current circumstances progress in Gaza will be more difficult.

1.7 The past 18 months have clearly demonstrated that sustainable political and economic progress requires both the PA and Israeli government to work together, which in turn requires a PA that is both based on the Quartet principles and committed to negotiations with Israel.

Looking to the future

1.8 The coming period, however, offers an important opportunity for progress. In recent months, many other actors have been involved in advancing the cause of Palestinian economic regeneration. These include:

1. Tony Blair, appointed as the Quartet Representative on 27 June, who has been tasked with:
    - Mobilising international assistance to the Palestinians, working closely with donors and existing coordination bodies; and
    - Developing plans to promote Palestinian economic development, including private sector partnerships, building on previously agreed frameworks, especially those concerning access and movement.
2. The European Commission, which is working towards:
    - Establishing and strengthening those Palestinian institutions and structures necessary for a sustainable and productive economy; and
    - Developing specific programmes to encourage economic development, including in the private sector.
3. Arab donors, who have provided significant funds to the PA and Palestinian NGOs.

1.9 Recent months have also seen encouraging political developments. President Abbas and Prime Minister Olmert continue to meet and make significant progress, including on the resumption of clearance revenue[3] transfers and payments of arrears accumulated during 2006, and a commitment to improve freedom of movement in the West Bank. The principal representatives of the Quartet (US, UN, Russia and EU) also continue to meet and US Secretary of State Rice remains heavily engaged, visiting the region regularly. Regional states also play a vital role, notably through the re-endorsed Arab Peace Initiative, announced at the Arab League Summit in March, and the historic follow-up visit by Jordanian and Egyptian Foreign Ministers, on behalf of the Arab League, to Israel.

1.10 Looking ahead, Tony Blair, the EC and other major donors, the G7 and international finance institutions, and the business community all have a vital role to play in supporting the economic aspects of the peace process, which will provide the

[3] The clearance revenue is taxes collected by the government of Israel on the behalf of the PA. It is mainly trade taxes and value-added tax on Palestinian imports.

foundation of sustainable political progress. Upcoming meetings this autumn will provide significant opportunities to advance this important cause[4].

Box 1.1 The Northern Ireland Experience

Experiences from across the world have demonstrated the importance of economic incentives in facilitating political progress, and the economic benefits that can arise from political settlement. While no two conflicts are the same, both the role external financial support played in sustaining employment during the 'Troubles' and the importance of mobilising the business community behind economic and political reform are key lessons to be drawn from the Northern Ireland Peace Process.

As with the Occupied Palestinian Territories, public sector expansion in Northern Ireland during the 1970s and 1980s provided short-term employment opportunities, helping protect workers against the strongly negative economic effect of the 'Troubles'. Though this may not have helped long-term productivity, it did provide essential support during this difficult period[5].

However, it was the private sector that played the critical role in fostering sustainable economic growth. Moreover, the correlation between private sector growth and political and security progress in Northern Ireland was, and continues to be, significant and mutually reinforcing. Economic growth in the provinces, which included an economic convergence between Catholics and Protestants, and between Northern Ireland and the Republic of Ireland, played a catalytic role in shifting political opinions and reducing economic incentives for violence.

Foreign direct investment, initially underwritten by the international community under the stewardship of George Mitchell, President Clinton's special economic advisor, lay the early foundations for sustainable private sector development. It also provided an insight into the longer-term economic benefits that would be possible with political stability, particularly to Northern Ireland's services sector.

Throughout the period, the Northern Irish private sector, supported by the international community, strongly articulated to voters the 'peace dividend' that would accrue from a political settlement, encouraging support for the peace process. Following both the IRA cease-fire in 1994 and the 1998 Good Friday Agreement, the level of investment in Northern Ireland grew substantially. Once political settlement reduced the political and security risks firms were facing, Northern Ireland attracted significant overseas private investment, further driving the private sector growth that underpinned sustained economic improvements in Northern Ireland, and creating a virtuous cycle so that by 1995 unemployment had declined to 11.5 per cent; and in the second quarter of 2007 stood at 4.2 per cent, lower than the UK average[6].

[4] The Ad-Hoc Liaison Committee, which serves as the principal policy-level coordination mechanism for development assistance to the Palestinian people, will meet on 24 September 2007. On 16 July 2007, President Bush called for an international meeting before the end of the year to discuss the Middle East Peace Process. A PA-led donor conference has also been scheduled for before the end of the year.

[5] The Portland Trust (2007): '*Beyond Conflict: Lessons from Northern Ireland, The Portland Trust, London, 2007*'

[6] Northern Ireland Department of Enterprise, Trade and Investment (2007): '*Monthly Labour Market Report July 2007*', DETINI, Belfast, July 2007. At 4.2% the March-May 2007 seasonally adjusted unemployment rate in Northern Ireland was lower than the UK average rate of 5.4%.

2 Context of the Palestinian economy

2.1 In the last 40 years, the global economy has changed dramatically, delivering profound benefits to many countries, including Israel. The Israeli economy, previously characterised by agriculture and low-value manufacturing, is now built on innovative and dynamic companies specialising in high-tech production for the world market. Israel has shown that it can adapt to the new economic environment: one that requires flexibility, continual investment in education and improvements to the business climate, and unconstrained access to global markets.

2.2 The Palestinian economy, in stark contrast, has changed very little. In 1967, agriculture was the dominant sector. Industry contributed less than 10 per cent of total GDP. The average industrial unit was a micro-enterprise of fewer than 5 employees and produced almost exclusively for the local market[7].

2.3 Forty years later, the economic fundamentals are unchanged. Though the importance of agriculture has declined, and wholesale, retail and repair sectors now employ the largest numbers, most establishments remain micro-enterprises. Over 90 per cent of private firms remain micro-enterprises and the majority are family run and unregistered[8].

Explaining the present situation

2.4 Following 1967, political developments, specifically the relationship with Israel, have determined the opportunities open to the Palestinian economy. The Israeli authorities first sought to integrate their economy with the Palestinian one. Bilateral trade and investment opportunities expanded, and further increased following the 1993 Oslo Accords, along with greater freedom of movement of labour. The Palestinian economy grew substantially during this period. Between 1996 and 1999, GDP in the West Bank grew by over 10 per cent, and in Gaza by 5.5 per cent, per annum, compared with 3.5 per cent growth in Israel. Unemployment in this period fell to 12 per cent, the regional average.

2.5 The integration of the two economies was characterised most clearly by high levels of Palestinian employment in Israel. In the third quarter of 2000, nearly a quarter of all employed Palestinians (136,000) were working in low-skilled jobs in Israel[9], providing Palestinian workers with on-the-job learning opportunities and remittances with which many thousands of Palestinian families were supported.

2.6 However, this relative growth in prosperity came at a cost. The links with the rapidly growing Israeli economy pushed up domestic Palestinian wages and reduced Palestinian competitiveness compared with its regional neighbours. This left the Palestinian economy increasingly dependent on Israel, and therefore highly vulnerable to a deterioration in the political peace process.

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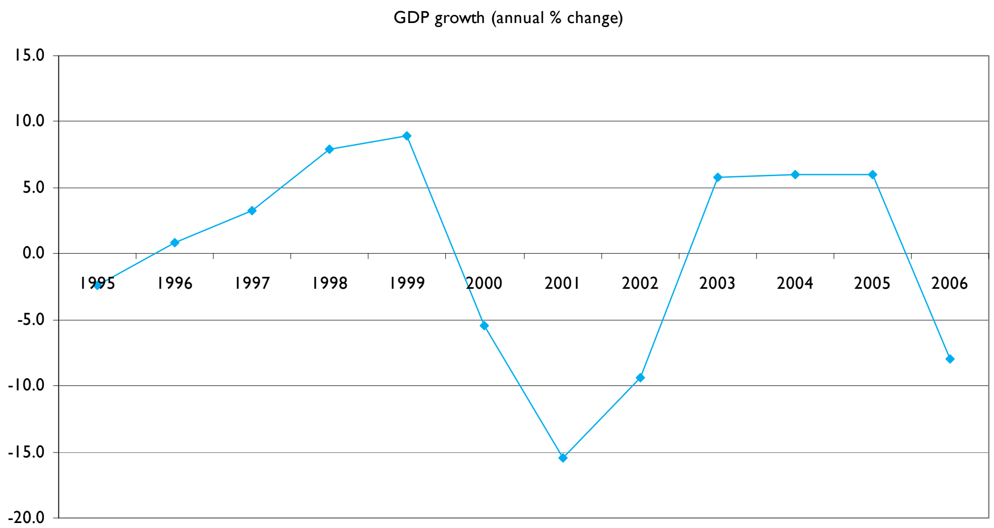
7 World Bank (2007): *'West Bank and Gaza Investment Climate Assessment'*, World Bank, Washington DC, 2007

8 World Bank (2006): *'West Bank and Gaza, Country Economic Memorandum'*, World Bank, Washington DC, 2006

9 World Bank (2006): *'West Bank and Gaza, Country Economic Memorandum'*, World Bank, Washington DC, 2006

Chart 2.1: Annual GDP growth 1995-2006: West Bank and Gaza



Source: *IMF/World Bank (2007): 'West Bank and Gaza – Economic Developments in 2006'*

Security, movement and access

2.7 This vulnerability was fully exposed following the onset of the second *intifada* in 2000 and the escalation of violence and terrorist attacks against Israel. In order to protect Israeli citizens from attack, Israel introduced restrictive controls on Palestinian movement within the OPTs and between the OPTs and Israel and other countries.

2.8 These controls, by limiting movement within the OPTs and preventing Palestinian access to the Israeli and global markets for both goods and labour, have had a devastating impact on the Palestinian economy. Between 2000 – 2002, the economy contracted by 35 per cent[10] and, though this period was followed by a degree of adjustment (see chart 2.1), by 2005 unemployment levels had reached 23 per cent and poverty levels had risen dramatically. The private sector proved unable to accommodate those previously working in Israel, leading the public sector to expand to prevent further unemployment, creating an unsustainable fiscal situation.

2.9 Real GDP fell during 2006 by between 5 – 10 per cent. Real per capita GDP, which fell by more than 10 per cent in 2006, is now almost 40 per cent lower than its level before the start of the second *intifada*. Further decreases in GDP during 2006 were prevented only by a substantial increase in external financing, which the IMF estimate reached almost $750 million, more than double the amount received in 2005. Arab donors channelled an estimated $290 million into the Office of the Palestinian President and the TIM directed a further $170 million to the Palestinian people[11].

2.10 Early 2007 saw a fall in clashes between Israeli security forces and Palestinian militants and improvements to the operation of the Karni crossing between Israel and Gaza. However, 2007 also saw an increase in movement and access restrictions within the West Bank and a rise in intra-Palestinian violence, culminating in the take-over of Gaza by Hamas militants and over 100 Palestinian deaths. The Eilat suicide attack of 29

[10] World Bank (2003) *Twenty-Seven Months – Intifada, Closures and Palestinian Economic Crisis*, World Bank, Washington DC, 2003

[11] IMF (2007): *'West Bank and Gaza: Fiscal Performance in 2006'*, IMF, Washington DC, 2007

January, which killed three Israelis, and the continued Qassam rocket attacks, highlight the continuing security concerns Israel faces.

Current state of the Palestinian economy

2.11 Therefore, and as a consequence of both these long-term and more recent developments, the current economic outlook in the OPTs is bleak. In 2005, the Palestinian population was just over half that of Israel, yet the Palestinian GDP was only 3 per cent of Israel's. The Palestinian private sector has failed to accommodate those who previously worked in Israel. While manufacturing in neighbouring Jordan has increased to 30 per cent of GDP, Palestinian manufacturing remains stagnant at 15 per cent of GDP[12].

2.12 With a small and fragmented domestic market, the Palestinian private sector's only hope for development involves dependable access to global markets, which is currently prevented by Israeli security measures. Moreover, domestic wages, driven up during the period of integration with Israel, remain too high relative to productivity for Palestinians to be globally competitive in labour-intensive manufacturing.

Table 2.1: Macroeconomic Indicators, 1995-2006

	1995	2000	2001	2002	2003	2004	2005	2006
Nominal GDP ($USD billion)	4.52*	4.44	3.75	3.16	3.62	4.08	4.48	4.39
Real GDP Growth (% change)	-2.4	-5.4	-15.4	-9.4	5.8	6.0	6.0	-5.0
Nominal GDP per capita ($USD)	1731	1861	1697	1469	1535	1636	1724	1764
Exports ($USD billion)	0.64	0.87	0.56	0.46	0.46	0.53	0.59	0.53
Exports (% growth)	-10	-2.2	-35.6	-17.9	0	15.2	11.3	-10.2
Imports ($USD billion)	2.73	3.40	2.70	2.54	2.84	3.28	3.60	3.48
Imports (% growth)	-2.0	-10.5	-20.6	-5.9	11.8	15.5	9.8	-3.3
External Trade Balance (% of GDP)	-46.2	-57.0	-57.1	-65.9	-65.7	-67.4	-67.2	-67.2

Note: * *1999*

Source: IMF and World Bank.

2.13 This situation is unsustainable. As table 2.2 shows, not only is unemployment already unacceptably high, but the Palestinian population is also growing rapidly. By 2050, the UN estimate that the population of the OPTs will equal that of Israel[13]. The UN Relief and Works Agency (UNRWA) estimate that the Palestinian economy would need to generate over 500,000 new jobs by 2015 to maintain unemployment at the pre-*intifada* level[14]. In the long term, these jobs cannot be found in the Palestinian public sector or else a profound fiscal crisis will ensue. They can only be provided through private sector development.

12 World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

13 UN World Populations Prospects: http://esa.un.org/unpp/

14 HM Treasury consultation with UNRWA.

Table 2.2: Social Indicators 1995-2006

	1995	2000	2001	2002	2003	2004	2005	2006
Unemployment (%)	18.2	14.3	25.2	31.3	25.6	26.8	23.5	23.6
Population (million)	2.78**	3.15	3.28	3.39	3.51	3.64	3.76	3.89
Population growth (annual %)	4.0**	4.3	3.6	3.5	3.5	3.4	3.3	3.3
Population Ages 0-14 (% of total)	45.8	46.5	46.4	46.2	46.0	45.7	45.5	N/A

** refers to 1999

Source: IMF and World Bank.

3 Barriers to Palestinian economic growth

Introduction

3.1 As described in chapter 2, the Palestinian economy is far poorer and less dynamic than the Israeli economy. Moreover, previous drivers of economic growth cannot be sustained. The high level of economic integration between the Palestinian and Israeli economies, witnessed prior to the *intifada*, is unlikely to be realised again, at least until much greater progress has been made on the political and security agendas. Nor can further expansion of the public sector underpin long-term economic growth. Over time, therefore, the dominance of the public sector must be reduced and private sector development supported to propel sustainable economic growth.

3.2 Reviving the private sector will be difficult and will take time. There may need to be a transition period during which substantial external financing continues to be required to support reform of the Palestinian public finances through reassigning current civil servants and security personnel to more productive activities. However, private sector regeneration will be possible, if political and security circumstances permit.

3.3 As annex A describes, provided Palestinian producers are allowed dependable access to global markets, there are many areas that could support future growth. In the short term, agriculture could provide a rapid contribution to the Palestinian economy, and there is significant export potential for higher-value agricultural produce, such as herbs and strawberries. Manufacturing, specifically of furniture and stone products, could also contribute substantially to economic growth in the medium term. In the long term, the development of high quality services such as tourism and information and communication technology (ICT) could underpin sustainable economic growth.

3.4 However, for any part of the Palestinian economy to develop, there are a number of barriers that must be addressed, which are described below in the following sub-sections:

- Security, movement and access;
- Public sector financial management;
- Infrastructure;
- Private sector productivity and competitiveness;
- Trade; and
- Human development.

3.5 These barriers can be brought together into five building blocks to an economic roadmap, described in chapter 4, and addressed through specific recommendations for action, which are listed in chapter 5.

Security, movement and access

3.6 Economic regeneration cannot occur in an insecure environment. This is especially true in the OPTs, where Israel's response to the Palestinian terrorist threat, the closure regime, exerts a heavy toll. The PA must fulfil its international obligations to prevent terrorist attacks on Israel. At the same time, as the Government of Israel has recognised, the long-term security of both Israelis and Palestinians in no small measure depends on Palestinian economic development. Striking the balance between Israeli security and Palestinian economic freedom poses a great challenge for Israeli policymakers and security officials, but it is one that cannot be avoided.

The impact of the closure regime

3.7 The closure regime, described in more detail in annex C, has three major economic impacts:

- It inhibits Palestinian producers from accessing potential markets – domestic, Israeli and international. Border crossings from the OPTs have long been inadequate. Even before the Hamas takeover in June 2007, all trade into and from Gaza had to pass through a single, unreliable crossing point at Karni, where all produce was inspected by Israeli security officials. Such processes either delay or prevent the movement of goods and make it both expensive and unreliable, thereby reducing Palestinian competitiveness. Domestic trade between Gaza and the West Bank and within the West Bank has also been increasingly curtailed (see chart 3.1 below) and only 10 per cent of Palestinian firms are able to sell directly to the international market[15];

- It constrains the mobility of people both within and into the OPTs. This reduces the flexibility of the Palestinian labour market and prevents engagement with international investors, particularly those from the Palestinian diaspora; and

- It reduces opportunities for Palestinians to work in Israel. Before the second *intifada*, 136,000 Palestinians worked in Israel every day. This has now fallen to 62,000, increasing unemployment and reducing remittances[16].

3.8 To address the impact of the closures regime, the Agreement on Movement and Access (AMA) was established in November 2005 between Israel and the Palestinian Authority. The AMA was facilitated by US Secretary of State Condoleezza Rice, European Union High Representative Javier Solana and the then Quartet Representative James Wolfensohn. The AMA, the full text of which appears in annex D, lists the specific steps that would 'promote peaceful economic development and improve the humanitarian situation on the ground[17]'.

3.9 After some positive steps, particularly the early effective operation of the Rafah crossing between Egypt and Gaza under the supervision of the EU Border Assistance Mission (BAM), implementation of the AMA stalled following the election of Hamas in January 2006. Since the Hamas take-over of Gaza, Rafah has remained closed. The crossings between Israel and Gaza have been open irregularly and only for humanitarian supplies. The Palestinian private sector in Gaza, unable to either export or import, is now near total collapse.

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[15] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

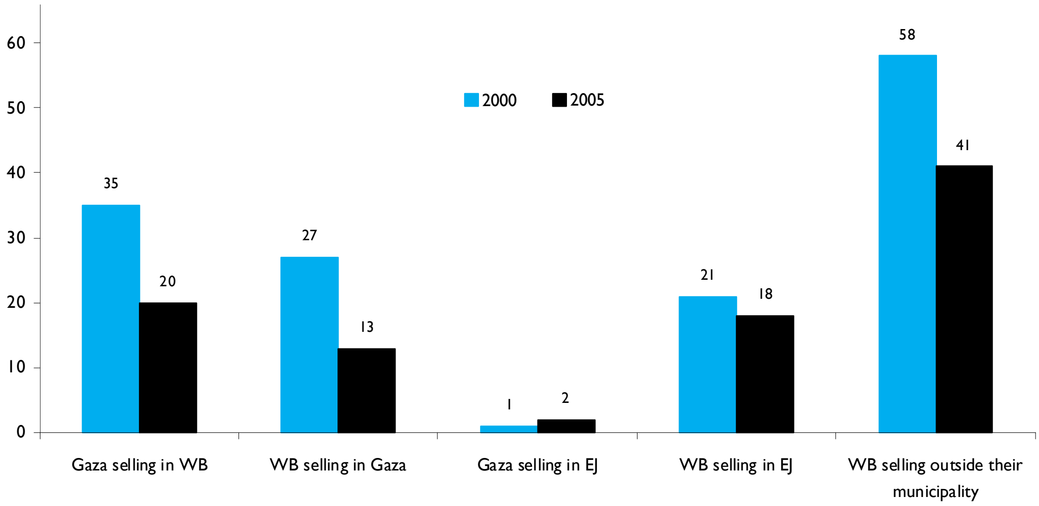
[16] IMF and World Bank (2007): *'West Bank and Gaza: Economic Developments in 2006'*, World Bank and IMF, Washington DC, 2007

[17] Opening sentence of the Agreement of Movement and Access, 15 November 2005. For the full text, please see annex D.

3.10 Moreover, movement within the West Bank remains highly restricted. In August 2007, the UN Office for the Coordination of Humanitarian Affairs (UNOCHA) reported 532 obstacles to movement in the West Bank – a 40 per cent increase on the AMA baseline of August 2005[18]. Many of these restrictions, according to the World Bank, have been put in place to facilitate movement between Israel and the Settlements, the population of which have nearly doubled since the Oslo Accords[19].

3.11 Renewed efforts to implement the agreed proposals of the AMA, including the lifting of movement restrictions in the West Bank, would enormously help the Palestinian private sector in both the West Bank and Gaza to recover and grow.

Chart 3.1 Percentage of firms selling out of their region



Key: WB - West Bank; EJ - East Jerusalem

Source: World Bank (2007): Investment Climate Assessment.

PUBLIC SECTOR FINANCIAL MANAGEMENT

3.12 Since the onset of the second *intifada* in 2000, the public sector has dominated the Palestinian economy, increasingly leading to macroeconomic instability. The formation of a Hamas-led government in March 2006 exacerbated, rather than created, this instability.

3.13 The Palestinian Monetary Authority, which has responsibility for banking regulations, has coped well since 2000 so macroeconomic instability is entirely a fiscal problem. The main contributors to instability are:

- a sharp decline in revenues, leading to increased reliance on external budget support; and

[18] UNOCHA (2007): *'Report No. 45 Implementation of the Agreement on Movement and Access (25 July – 7 August 2007)'*, United Nations, 2007

[19] World Bank (2007): *'Movement and Access Restrictions in the West Bank and Gaza: Uncertainty and Inefficiency in the Palestinian Economy'*, World Bank, Washington DC, 2007

- continued growth in spending, such that, at 50 per cent GDP, in 2005 the PA had the second highest central government expenditure-to-GDP ratio in the world[20].

3.14 Public employment has continued to grow despite the fiscal instability, as the PA has attempted to compensate for private sector decline. In 2006, the PA spent $656 million on wages and allowances (nearly 40 per cent of which went on the security services), compared with tax revenues of only $546 million. While the PA has prioritised wage payments, declining revenues have forced it into arrears, with only 50 - 55 per cent of government employees' normal incomes received on average in 2006[21]. Israel's resumed payment of clearance revenues to the PA and the payment of withheld funds should improve the situation. However, existing unemployment and high population growth (see table 2.2 above) mean that even without a bloated public sector the challenge of private sector job creation is immense. The need to absorb large numbers of public sector workers just makes it more difficult.

3.15 Beyond the wage bill, the overall economic deterioration has led to an increase of subsidies to public companies and also welfare payments. Subsidies to public companies reached $337 million in 2006[22], while welfare payments almost doubled between 2004 and 2005. In the longer term, the recently introduced public pension scheme will create further fiscal problems – when viewed as a ratio of average employee earnings, the PA pension scheme is among the most generous in the world[23].

3.16 The Palestinian private sector has been affected by the resultant weak fiscal position and build-up of payment arrears by the PA. These threaten to bankrupt those businesses that have lent the PA money, with knock-on effects on the financial system. Furthermore, the rapid build up of debt by the PA could cause servicing problems in the future. The World Bank has estimated that maintaining fiscal stability will require reducing the primary deficit from 25 per cent in 2005 to 12 per cent by 2010[24].

Achieving sustainable public finances

3.17 The biggest fiscal challenge facing the PA is reducing both the civilian and security elements of the public sector wage bill. Though both external financing and the private sector have an important role to play in absorbing excess public sector employment and redirecting it to more productive ends, crucial reforms to be carried out by the PA itself include:

- Proper enforcement of the 1998 Civil Service Law;
- Agreement over a sustainable wage bill over the medium term;
- Review of re-training facilities for retrenched public servants; and
- Security sector reform.

20 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

21 IMF (2007): '*West Bank and Gaza, Fiscal Performance in 2006*', IMF, Washington DC, 2007

22 IMF (2007): '*West Bank and Gaza, Fiscal Performance in 2006*', IMF, Washington DC, 2007

23 World Bank (2007): '*West Bank and Gaza Public Expenditure Review*', World Bank, Washington DC, 2007

24 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

INFRASTRUCTURE

3.18 Improving and maintaining Palestinian infrastructure will be essential to both provide public services and support the long-term development of the private sector, and there is a continuing need to restore what has been destroyed or damaged during the second *intifada*. The challenges here are significant. In 2003 the World Bank estimated that the cost of repairing damage since 2000 alone exceeded $1.7 billion. There has been further damage since 2003, particularly in Gaza.

3.19 However, even restoring infrastructure to pre-2000 levels will not be sufficient if a viable Palestinian economy is to be created. A broader investment programme is required to develop the infrastructure needed for long-term growth and development, and underpin the productive capacity of the economy.

3.20 Infrastructure projects can absorb large inflows of international financial assistance and, under the right conditions, will generate much-needed productive jobs. These will come directly, from the jobs created through construction and in particular maintenance of infrastructure facilities, and indirectly, via the broader employment opportunities that will be generated through boosting the productive capacity of the economy.

3.21 Previous experience with infrastructure projects, both in the OPTs and internationally, however, identifies a number of lessons that should be learned. First, it is important that the necessary institutional arrangements are in place to plan, regulate and provide the competitive framework for efficient and market-driven infrastructure development[25]. Second, long-term reliance upon donor funding, which has previously led to inefficiencies and misallocations of resources, should be avoided. Though this may be constrained in the short term by political risks, the PA should look to explore the increasing trend of leveraging funds from international business to build and operate projects. Third, maintenance costs must be factored in when planning infrastructure projects to ensure that the investment lasts. Finally, it should be noted that maintenance and operation expenditure is frequently a better use of funds than new investment.

3.22 Specific parts of the Palestinian economy are in particular need of both immediate, and longer term, investment in infrastructure. These include trade-related infrastructure, energy, housing and water.

Trade-related infrastructure

3.23 As acknowledged in Chapter 2, due to the small and fragmented Palestinian domestic market, private sector development in the OPTs will be conditional upon dependable access to global markets. The development of trade-related infrastructure will be integral to establishing alternative trading links for Palestinian producers, both within the immediate region, and more widely to Europe and the Gulf. James Wolfensohn, the Quartet's former Special Envoy to the West Bank and Gaza, identified three such projects[26], which remain clear priorities:

- a direct, permanent link between the West Bank and Gaza;
- the reconstruction of Gaza's airport; and
- the construction of a seaport in Gaza.

[25] World Bank (2005): '*West Bank and Gaza: Palestinian Recovery Program*' World Bank, Washington DC, 2005

[26] Chair's Summary, Meeting of the Ad Hoc Liaison Committee, London, December 14, 2005

3.24 The Palestinian road network presents different challenges in Gaza and the West Bank. Military conflict since the start of the *intifada* has caused extensive damage to roads in Gaza, which should be repaired. Within the West Bank, the trunk road network is in good condition. However, Palestinian access to these roads is restricted by the presence of Israeli settlements, the population of which have more than doubled since the signing of the Oslo Accords in 1993.

3.25 The economic implications of the Israeli settlements in the West Bank are profound. Each settlement requires a range of security measures to protect its inhabitants, which explains why the barrier is twice the length of the Green Line that officially separates Israel from the West Bank. The current barrier route around the major settlement blocks encloses between 8-10 per cent of the West Bank. In addition, the fences, checkpoints and permit regime associated with the settlements and outposts east of the barrier have a severe impact on Palestinian freedom of movement, and thereby on the Palestinian economy.

Energy

3.26 Electricity coverage and reliability in the West Bank and Gaza is high within the region, with 98 per cent of the population having access to electricity services. However, local producers currently meet only 10 – 15 per cent of total electricity demand and dependency on Israel will only increase as demand grows, with Palestinian electricity consumption projected to triple by 2016[27].

3.27 The OPTs do possess rights over the natural gas fields offshore from Gaza, the development and exploitation of which could offer economic and energy security benefits to both Israelis and Palestinians. The gas could meet Gaza's energy requirements, thereby replacing the more costly and less environmentally friendly diesel-fuelled generators that are currently used. Exporting the gas to Israel or elsewhere could also provide long-term, steady income from taxation and profits to the PA. British Gas Group, who own the exploration rights, estimate that the reserves, once developed, will generate around $1 billion in revenues for the PA over 15 years. 2006 and early 2007 saw strong progress in finalising terms of the contract and completing negotiations would be a major step forward.

3.28 The Palestinian Energy Authority has, with the support of the World Bank, committed to reducing its energy dependency on Israel. Achieving this will require significant investment in electricity generation facilities, along with sourcing electricity from alternative markets such as Egypt and Jordan. It will also require completing the negotiations about Gaza gas fields. More immediately, restoring production to the Gaza power plant, which was heavily damaged in June 2006, is a clear priority.

Housing

3.29 The lack of affordable housing in the West Bank and Gaza Strip is restricting development. The housing stock within the refugee camps is of particularly poor quality. Almost 70 per cent of Palestinians predict that they will require new housing in the next ten years[28], both in response to conflict-inflicted damage to the existing housing stock, and in response to rapid population growth.

3.30 Despite the evident need for more housing, the residential construction sector's contribution to Palestinian GDP has declined since the start of the second *intifada*, falling to $120 million in 2005 compared with nearly $200 million in 2001. In parallel, employment in the housing sector declined to just under 12 per cent of the total

[27] Paltrade and the Peres Center for Peace (2006): '*The Untapped Potential, Palestinian-Israeli Economic Relations: Policy Options and Recommendations*' Paltrade and the Peres Center for Peace, Tel Aviv and Al Ram, 2006

28 Palestinian Central Bureau of Statistics (2007): 'Population, Housing and Establishment Census' Palestinian Central Bureau of Statistics , Ramallah, 2007,

employed workforce, from nearly 20 per cent in 2000[29]. The expansion of domestic housing is constrained by unclear registration of land – although 90 per cent of land is registered in Gaza, only 26 per cent of land in the West Bank is registered[30].

3.31 There is clear scope for improving co-ordination between developers, financiers and housing co-operatives in the housing sector. Donors can play an important role helping the market work effectively for the poorer parts of the population, ensuring that access to land and credit and banking services such as mortgages are available to all. Several Gulf States, including Saudi Arabia and the UAE, have already provided generous funds for improved housing in both Gaza and the West Bank.

Water

3.32 Water is acutely important to the Palestinian economy, particularly the agricultural sector. Palestinians in the OPTs receive an average of less than 100 litres of water per capita per day for all uses, much less than the minimum of 150 litres per day recommended by the World Health Organisation, and the World Bank report that less than half of all the available water supply in the West Bank is obtained from locally owned or controlled sources.

3.33 Projected demographic trends indicate that this problem will only get more severe. The development of alternative domestic sources of water, including potential reuse of wastewater, and desalination of water from the Mediterranean, would decrease water-dependence and de-link the provision of essential water services from external control. However, new sources of Palestinian water need to be balanced against equitable reallocation of existing water resources in the OPTs, including ensuring more equitable access.

3.34 The development of independent water provision and distribution facilities should also be prioritised. Prior to the election of Hamas, plans had been created to develop the West Bank Water Department into a commercial water authority, with financial and technical assistance from the French government.

PRIVATE SECTOR PRODUCTIVITY AND COMPETITIVENESS

3.35 The World Bank's Investment Climate Assessment for the OPTs, based on a 2005 survey of the formal sector, found that the largest constraints to doing business are political, security and economic instability.

3.36 In many other ways, the Palestinian investment climate compares favourably with that of other regional countries[31]:

- Surveyed firms did not perceive corruption to be a major impediment to economic activity, relative to the rest of the region;
- Bureaucracy is relatively limited: only 7 per cent of OPTs managers' time is spent dealing with government regulations – compared with a regional average of 13 per cent; and
- The financial markets are relatively developed: over 85 per cent of surveyed firms have a bank account.

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29 HM Treasury consultation with The Portland Trust.

30 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

31 World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

3.37 However, there remain a number of other impediments to private sector development that need to be addressed. These concern the productivity of enterprises, access to finance, the role of government and institutions, and the administration of land.

Enterprise productivity

3.38 Palestinian manufacturing has traditionally concentrated on low-value, labour intensive intermediate goods produced for Israeli companies. In the past 20 years the Israeli economy has changed, and now specialises in producing high-tech, high-value exports, which do not demand the low-value, labour intensive inputs that Palestinian firms produce. As table 3.1 makes clear, wage levels are such that Palestinian manufacturers are struggling to compete internationally with global producers of labour intensive goods, including China, and the micro-scale of most Palestinian producers prevents them from achieving economies of scale[32].

Table 3.1: Average hourly wage for a semi-skilled garments worker (January 2005 $USD)

West Bank	Gaza	Israel	Egypt	Turkey	China
1.75	1.20	9.81	0.82	2.88	0.48

Source: World Bank (2006): West Bank and Gaza Country Economic Memorandum

3.39 The Palestinian manufacturing base would benefit from moving up the value chain. This requires a substantial increase in investment and an expansion of the Palestinian industrial base. Neighbouring Jordan, which has received more than $1 billion per year in foreign direct investment since 2000, demonstrates the region's potential.

Investing in future growth

3.40 Since the second *intifada*, investment in Palestinian enterprises has been minimal. World Bank surveys indicate that on average Palestinian machinery is 10 years old, with fewer than 50 per cent of enterprises carrying out any investment in 2005.

3.41 In the near term, investment in Palestinian industry will not come without external assistance. However, successful investment, underwritten by the international community, in a small pilot group of Palestinian businesses should provide a strong demonstration effect that will encourage other manufacturers.

3.42 Similarly, the expansion of industrial activity in the OPTs would benefit from support from the international community. This could be achieved by supporting the establishment of industrial estates. Previous experience, both in Gaza and around the world, suggests that such estates could, under the right circumstances, attract substantial investment from Palestinians, Israelis and the global business community.

3.43 A number of foreign governments, notably Turkey and Japan, continue to show interest in supporting industrial estates. Foreign involvement could help address the security and access issues that need to be resolved for the estates to work. However, for the foreseeable future it is likely that the elevated political risk will deter private foreign investment. To facilitate investment it will be important to establish a programme for providing political risk insurance for foreign investors, possibly underwritten by the international financial institutions.

[32] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

Access to finance

Improving access to credit

3.44 Recent surveys suggest that many Palestinian firms are not financially constrained[33] and commercial lending is low. However, this is mainly attributable to the elevated political risks to investment, rather than a well-functioning credit market. In the OPTs, credit amounts to only 28 per cent of GDP, low by regional comparison – see table 3.2 In 2002, the investment to output ratio in Palestinian enterprises was a mere one per cent - less than the level required to replace depreciated capital. A more normal investment to output ratio of 6 per cent, as experienced in the OPTs in 1994, would require improved access to financial resources and services[34].

Table 3.2: Regional financial indicators (as percentage of GDP)

	Credit to the private sector	Private sector deposits
WBG	28.4	74.3
Jordan	70.4	47.0
Egypt	43.5	76.7
Morocco	63.3	78.3
Tunisia	59.3	25.0
Israel	94.6	93.3

Source: IMF (2005): Macroeconomic Developments and Outlook

3.45 A number of Loan Guarantee Schemes, supported by both European and American donors, now exist, with the potential to guarantee over $250 million in loans. These schemes share the risk of banks' lending to SMEs. The current demand for loans is low as few enterprises have sufficient confidence to invest[35]. However, these schemes should provide a valuable service under more auspicious circumstances.

3.46 There are, however, still a number of constraints to the Palestinian credit market, including institutional factors, such as a complex legal framework, and inefficiency of contracts enforcement and creditor rights protection[36]. Banks have responded to the growing informalisation of economic activity by relying increasingly upon personal relationships and lending based upon specific collateral, such as clear land titles. With less than 30 per cent of land in the West Bank accurately surveyed and registered, this restricts access to credit.

Role of Government and Institutions

3.47 Almost all investment in the OPTs is either domestic or comes from the Palestinian diaspora. Political and security stability is a clear precondition for attracting

33 World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

34 The Portland Trust (2004): '*Beyond Conflict: The Economic impact of peace on Palestinians and Israeliis*', The Portland Trust, London, 2004.

35 In the first 6 months of operation, the EC scheme had guaranteed just over $1 million out of a potential $30 million.

36 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

foreign investment. However, the PA, with international support, also needs to undertake reforms and develop the capacity to create a more enabling business environment. Legal, institutional and pensions reform are clear priorities.

Legal reform

3.48 The PA made rapid progress on legal reform in the late 1990s. However, the Palestinian legal framework remains weak and the business environment uncertain. In 2005, the EC undertook a detailed study of the PA's financial and economic legal reform requirements, which include the full implementation of the Commercial Law, the Administrative Law and the Civil Law[37].

3.49 These priorities remain and technical assistance will be required to develop the capacity of those institutions responsible for drafting and implementing the laws. In addition, institutional arrangements should be made to ensure closer future collaboration between the private sector and the PA on the maintenance and development of the legal system, to ensure it remains responsive to private sector requirements.

Institutional reform

3.50 Private sector business membership organisations (BMOs) have grown rapidly over the past decade[38]. Some of them provide valuable services to their members, such as timely market information and promotional opportunities. The largest BMOs have also recently produced the Palestinian Private Sector Recovery and Resilience Plan with the aim of coordinating donor support for the private sector. They play an important role in creating and maintaining a supportive investment climate and need support to develop their capabilities.

Private pension reform

3.51 International experience suggests that the development of a funded pension system can not help the elderly, but also promote economic growth through the development of financial markets[39]. In recent years, a generous pension scheme for public sector workers has been introduced. However, there are no widely available pension schemes for private sector workers, who are therefore forced to rely on informal savings or family support in their retirement. This not only causes personal distress, but also limits the accumulation of private capital for domestic investment.

Land administration

3.52 Most Palestinian enterprises operate in residential areas. This reflects the high cost of industrial land. Industrial space in Ramallah, for example, costs between \$100 – \$200/square metre, which is close to European levels[40]. Such high prices are attributable to the scarcity of registered land, particularly in the West Bank where less than 30 per cent of land is registered.

3.53 The PA has previously demonstrated its commitment to improving the registration of land within area A of the West Bank (see map 3.1 below), for example through the establishment of the Palestinian Land Authority, a PA-run institution tasked with determining ownership of land under occupation, in 2003. Israel has responsibility for security in areas B and C, which currently occupy more than 80 per

[37] European Union (2006): *'Strengthening of the Palestinian Economic Legislative and Private Sector Institutional Frameworks,'* European Union Technical Assistance Office for West Bank and Gaza, Jerusalem, 2006

[38]. Examples organisations include the Palestinian Federation of Industries, the Wood Industry Union and the Textile Producers Union. World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

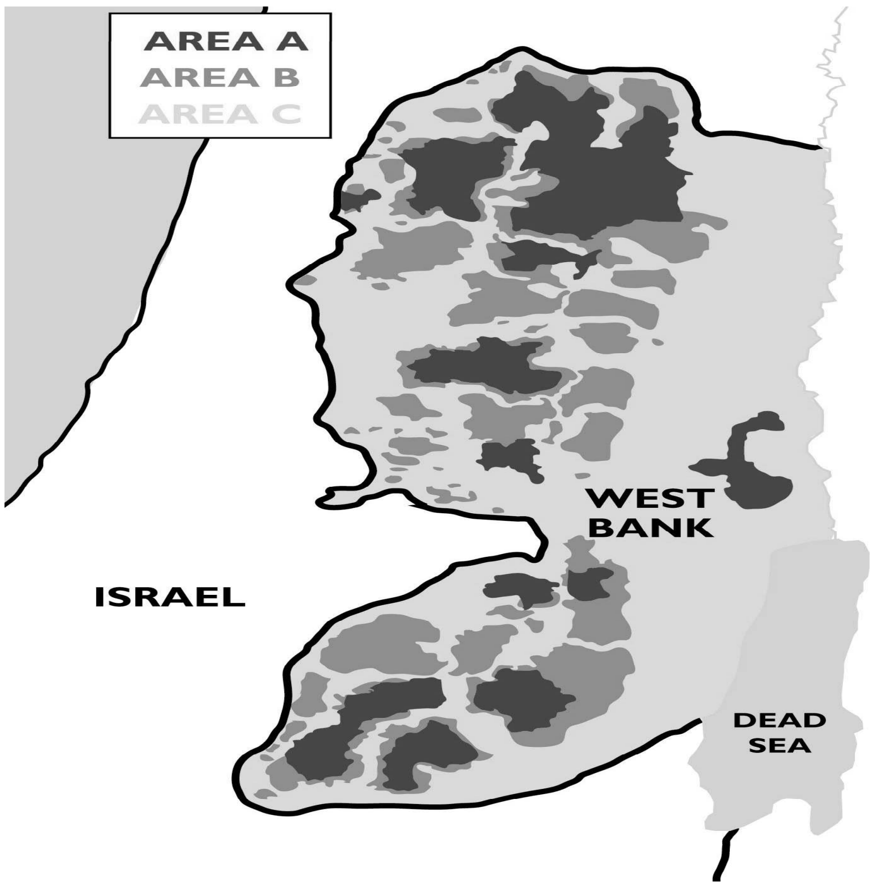
[39] Levant Consulting (2006): '*Developing a Pension Fund for the Private Sector in the West Bank and Gaza Strip*', Levant Consulting, Amman, 2006

[40] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

cent of the West Bank[41]. Palestinians often encounter difficulties obtaining building permits for these areas, which discourages economic activity.

3.54 Registering all available land in the West Bank and Gaza would provide a major boost to private sector activity. For example, further serviced industrial land could be developed, thereby allowing industry to move away from residential areas and take advantage of economies of scale.

Map 3.1 Administrative divisions within the West Bank as of 2000



Source: www.procon.org, created using information from B'tselem and Foundation for Middle East Peace

TRADE

3.55 The total value of global trade has more than doubled in the past decade to over $20 trillion[42]. This has benefited many countries in the Middle East. Jordan, for example, has seen the value of exports grow annually by 18 per cent since 2000[43]. However, trade

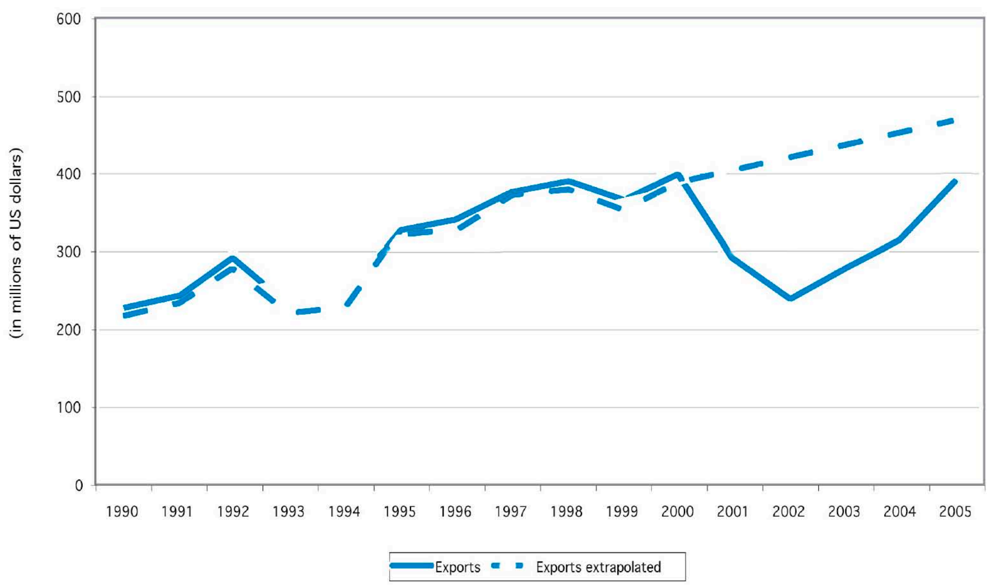
41 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

42 Source: HM Treasury,

43 IMF (2007): '*Jordan: 2006 Article IV Consultation and Fourth Post-Program Monitoring Discussions - Staff Report; and Public Information Notice on the Executive Board Discussion*', IMF Country Report No.07/128, Washington DC, 2007

performance in the OPTs has not kept pace (see chart 3.2 below). Palestinian exports have never risen above $400 million per year or 10 per cent of GDP. This represented a third of the value of Jordan's exports in 2000 but only a tenth in 2004[44].

Chart 3.2 Palestinian exports 1990 – 2005 (in million of current $USD)



Source: World Bank (2006): West Bank and Gaza Country Economic Memorandum.

3.56 As discussed in Chapter 2, the Palestinian private sector will only develop through dependable access to the global market. This is for three reasons. First, the Palestinian domestic market is too small and fragmented to support a vibrant private sector. Second, previously close integration with the Israeli economy has increased domestic wages, ensuring that Palestinian producers can only be competitive in high-value products, for which there is very limited domestic demand. Third, though geographical proximity will ensure the continual importance of the Israeli economy to Palestinian producers, political realities prevent the return to the very close integration of the two economies witnessed before the *intifada* for the foreseeable future, thereby requiring producers to look beyond the Israeli market.

3.57 However, as table 3.3 indicates, there are a number of barriers that currently restrict Palestinian producers from accessing all their potential markets.

The Paris Protocol

3.58 The current Palestinian trade regime is dominated by the Paris Protocol, which was established in 1994 to govern the economic relationship between Israel and the OPTs. The Protocol provides a customs union between the two economies[45] and, if properly implemented, would hold many benefits for Palestinian producers[46]:

- It provides for the efficient Israeli customs service to collect customs duties on behalf of the Palestinians, and remit them to the PA's budget;

[44] The current value of Jordan's exports in 2000 was $1.3 billion and in 2004 was $3.9 billion. www.intracen.org.uk.

[45] Though contrary to other customs unions Israeli retains control over all OPTS borders and airspace.

[46] World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

- It allows Palestinian goods, including agricultural products, duty free, quota free market access to Israel;
- It allows the PA to take advantage of Israel's preferential trade agreements, e.g. with the US; and
- It opens possibilities for deeper economic integration with Israel.

3.59 The Paris Protocol is currently deficient in a number of important respects, however. First, effective management of any customs union requires cooperation between the customs authorities, which has been limited; second, the Protocol envisaged the establishment of a joint Israeli-Palestinian institution ('the Joint Economic Committee') to update the protocols where necessary and settle disputes. The JEC has not convened since the outbreak of the *intifada* at the end of 2000. Finally, in the OPTs firms face high administration and standards barriers that prevent free access to the Israeli market.

Table 3.3: Percentage of exporters reporting an obstacle as major or severe

	West Bank	Gaza Strip
Movement and access for raw material	51.6	83.3
Movement and access for exporting goods	50.0	80.6
Production capacity to meet order quantities and delivery dates	40.6	36.1
Difficulty attaining visa and entry issues	33.0	50.0
Lack of export financing	31.6	25
Import regulations and non-tariff barriers in export markets	29.7	38.2
Information and contacts in external markets	23.9	31.4
Price competitiveness in export markets	14.6	13.9
Meeting export market packaging requirements	9.6	5.7
Meeting export market product requirements	8.2	8.3

Source: World Bank (2007): Investment Climate Assessment

Fully utilising the current trade regime

3.60 In addition to the Paris Protocol, the PA currently has trade agreements with amongst others, the European Union, the United States, the Greater Arab Free Trade Area (GAFTA), Jordan and Egypt[47]. Making the optimal use of these bilateral and regional trade agreements will be critical to driving forward Palestinian trade.

3.61 However, few Palestinian producers currently reach international standards (see table 3.4), limiting their ability to take full advantage of existing bilateral and regional agreements. Israeli authorities frequently do not recognise certifications from the

47 Economic Policy Programme (2006): '*Planning for Statehood: The Regulation of External Trade*', London and Ramallah, Economic Policy Programme, project funded by Department for International Development, 2006

Palestinian Standards Institute and security concerns prevent the Standards Institutions of Israel from checking manufacturing standards within the OPTs.

3.62 Established in 1996, the Palestinian Standards Institute (PSI) has responsibility for setting and accrediting standards for Palestinian products, and has created over 600 standards covering all productive sectors[48]. Improving the capacity of the PSI to develop and adopt internationally compatible standards would allow Palestinian exports to enter lucrative markets.

Table 3.4: Percentage of manufacturing sample with internationally recognized quality standard certifications

West Bank	Gaza Strip	East Jerusalem
18	19	5

Source: World Bank (2007): West Bank and Gaza Investment Climate Assessment.

3.63 It is currently difficult for Palestinian businessmen to travel and international buyers or dealers rarely visit the OPTs. To take advantage of opportunities in foreign markets, Palestinian businesses require reliable information on market requirements and institutions that promote Palestinian enterprise internationally. The Palestinian Trade Centre has previously provided these services, and should be supported in the future. Assistance to help Palestinian producers expand into third markets by pooling the risk of exploring overseas business opportunities could help further.

3.64 Entering the World Customs Organisation would also provide the Palestinian Department of Customs, which works under the President's Office as part of the Steering Group on Borders, with guidance, support and a valuable international forum[49], as it works towards maximising the efficiency and effectiveness of its customs regime. Expansion of ASYCUDA, the computerised customs management system that monitors and records trade and VAT transactions, could help streamline the processing of goods crossing Palestinian borders.

3.65 Fairtrade products have expanded their market share enormously recently with comparatively little assistance from donors. In the UK alone, 50 per cent of the public now recognise products certified by the Fairtrade Foundation and sales are growing by over 40 per cent year-on-year[50]. Donors including USAID have looked into establishing a similar 'Made in Palestine' brand and small quantities of Fairtrade 'Made in Palestine' olive oil are already produced. Though it would require significant external assistance to get established, it is likely that such a brand would be popular, particularly in the EU markets.

Improving access to foreign markets

3.66 In order to increase the diversification of exports beyond the Israeli market, Palestinian producers need to offer reliability, efficiency and choice to compete in the global economy. Meeting delivery schedules is particularly important for high-value goods, whose production and trade could be significant drivers of future Palestinian growth. There are a number of factors along the export routes that reduce Palestinian

48 http://www.paltrade.org/cms/

49 Economic Policy Programme (2006): '*Planning for Statehood: The Regulation of External Trade*', London and Ramallah, Economic Policy Programme, project funded by Department for International Development, 2006

50 Fairtrade Foundation (2007): Memorandum submitted to International Development Select Committee, Fairtrade Foundation, London, February 2007. http://www.publications.parliament.uk/pa/cm200607/cmselect/cmintdev/ucfairtrade/123403.htm

competitiveness.

- It takes Palestinian firms an inordinately long time to clear Israeli customs for both imports and exports – a median of 10 days for firms in the West Bank and 30 days for firms in Gaza[51];
- Palestinian produce is not allowed on scheduled passenger air services from Israel, and Israel does not have direct access to many of the most lucrative Gulf markets; and
- The Karni Crossing currently holds a monopoly over goods leaving Gaza, which has produced inefficiencies and corruption.

3.67 It is important that the private sector is involved in the operation of the border crossings, both to provide on-time and independent data about how the border terminals are operating, building on data already provided by the Palestinian Trade Centre for the Karni Crossing, and to carry out non-regulatory tasks, such as goods handling, the efficiency of which could be improved by private sector competition.

3.68 To facilitate Palestinian access to third markets, the World Bank have undertaken an extensive study on the feasibility of opening the Rafah Crossing between Gaza and Egypt as an alternative trade corridor, with goods being exported from Egypt to global markets either via road, sea or air. Opening Rafah would offer Palestinian producers greater opportunities for direct market access to Egypt and through to the Gulf; greater reliability and frequency of services; and greater choice. World Bank analysis suggests that it could also be achieved in a manner that satisfies all legitimate security concerns[52].

3.69 The Agreement on Movement and Access also calls for arrangements to make West Bank passages fully operational, thereby allowing direct exports to Jordan. King Abdullah II of Jordan, who has recently called for the reopening of the Damya crossing between Jordan and the West Bank, should be supported in his efforts to diversify Palestinian trade corridors. Japan, under their planned Corridor for Peace and Prosperity, is also looking to facilitate the transportation of Palestinian goods from the West Bank to Jordan.

HUMAN DEVELOPMENT

3.70 Nearly 50 per cent of the Palestinian population is under 14 years old and it is they who will determine the long-term development of the Palestinian economy. With universal access to basic education and 80 per cent enrolment for secondary education, Palestinians have good access to school education. Despite the difficult conditions experienced in recent years, access to basic and secondary education remains highly equitable with respect to gender, location, refugee status and income.

3.71 However, both short and long-term changes to the Palestinian education system are required to support private sector development. Particular focus needs to go on targeting and enhancing economic opportunities for the young, whose education and training has been most heavily constrained by the political and economic framework of

[51] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*', World Bank, Washington DC, 2007

[52] World Bank (2007): '*Developing the Rafah Trade Corridor*', World Bank, Washington DC, 2007

recent years. There is also a clear mismatch between the skills currently supplied by the Palestinian education system and those demanded by the labour market.

Improving the quality of education

3.72 Whilst coverage is broad, the depth and consistency of primary and secondary education could be improved, as was confirmed by the results of the National Tests in Arabic and Maths in 2005, which showed a marked deterioration from previous comparable exercises. UNRWA performance is consistently higher than that of PA schools, though much of this can be attributed to factors beyond the PA's control. However, some aspects of the UNRWA system could be employed advantageously in the PA system, including ensuring the principal and staff are accountable for monitoring and improving the learning outcomes in their schools, and embedding robust systems for the continuous professional development of teachers and educational leaders[53].

Investment in education

3.73 Education expenditure has increased over the past five years, though the PA's contribution has fallen to around one third of the total. In 2005, UNRWA accounted for 20 per cent of total expenditure, enrolling 25 per cent of students for basic education. Even before 2004, 46 per cent of the costs in PA schools were privately funded. In 2005 the Ministry of Finance cut by 50 per cent non-salary expenditure, the majority of which was already being spent on textbooks and operational expenses, and salaries now constitute over 90 per cent of the PA's education budget.

3.74 Capital expenditure on education infrastructure, which in the last decade has almost exclusively come from donor organisations, has not kept up with the expansion of student numbers. This has contributed to a general deterioration in the learning environment. Crowding is a widespread problem – school buildings are used with particular intensity in Gaza, where nearly three quarters of government and UNRWA schools operate double shifts. In addition, the recent damage afflicted by factional infighting to Gaza's universities should be repaired. A mechanism to coordinate donor funds for education and ensure long-term predictability in funding, drawing on the 'Education for All' initiative, should be considered[54].

Addressing the supply and demand of skills

3.75 Two thirds of students at the traditional universities, which have expanded three-fold in the past decade, study education, social sciences or the humanities[55]. This reflects current labour market realities. The Ministry of Education is presently the largest employer within the PA, itself the main source of employment in the West Bank and Gaza Strip. This has resulted in dramatic oversupply of applicants: there were 25,000 graduate applications for the 2,200 new teaching posts advertised by the Ministry of Education in 2005.

3.76 In contrast, there is little demand for the technical or vocational courses offered by the PA. Total enrolments increased from around 3,000 in 1999/2000 to 5,561 in 2004/2005, significantly below the target enrolment figure of 9000[56]. Currently, only the least able students are expected to enrol in these courses, which are expensive and do not provide the skills demanded by the labour market. In contrast, there is high demand for technical courses administered by UNRWA, which are more successful at getting their graduates into employment.

[53] World Bank (2006): '*West Bank and Gaza: Education Sector Analysis*', World Bank, Washington DC, 2006

[54] www.fasttrackinitiative.org

[55] World Bank (2006): '*West Bank and Gaza: Education Sector Analysis*', World Bank, Washington DC, 2006

[56] World Bank (2006): '*West Bank and Gaza: Education Sector Analysis*', World Bank, Washington DC, 2006

4 THE BUILDING BLOCKS OF AN ECONOMIC ROADMAP

4.1 Chapter 3 has identified the barriers to Palestinian economic growth and, from these, five key economic building blocks can be identified. These have to be put in place to arrest further deterioration and set an economic roadmap to what must be the goal of moderates everywhere - a vibrant Palestinian economy, trading with its neighbours, with the region and with the world, and providing employment and prosperity for all its citizens.

1) Stabilising the economy

4.2 A platform of stability is an absolute prerequisite for building a strong economy. Therefore, addressing the fiscal crisis, controlling the growth in public sector employment and starting to create productive jobs must be the first step.

4.3 Short-term stability will be improved by a regular stream of donor support, coordinated both among donors and with the Palestinian Ministry of Finance to allow for full integration with budgetary systems. However, a longer-term macroeconomic crisis can only be averted through a credible PA-led budget plan based on the uninterrupted transfer of clearance revenues and the reduction of public expenditure, specifically the wage bill.

4.4 It would not be realistic to expect the Palestinian private sector to provide many jobs in the short and even medium term. Internationally financed investment programmes may be needed to bridge the employment gap. These would provide a source of employment, training and hope for those currently unemployed or underemployed in either the civil or security service. Such programmes could also provide essential improvements to the Palestinian investment climate, thereby enhancing business productivity and providing a modern foundation for growth.

2) Establishing a stable relationship between the Palestinian and Israeli economies

4.5 Second, it is essential to create a stable and consistent framework for interaction between the Israeli and Palestinian economies. Businesses cannot thrive unless they can be confident that their inputs and exports are going to reach their destinations on time.

4.6 The flexibility and global reach of today's Israeli economy means that to prosper it does not need the Palestinian economy. However, to be viable, the Palestinian economy needs a dependable economic and trading relationship with Israel. Notwithstanding developments since 2000, the Palestinian economy is still highly dependent upon the Israeli market – the destination of over 90 per cent of Palestinian exports, many for re-export, and the source of over 70 per cent of Palestinian imports[57].

4.7 Political developments will determine what constitutes a sustainable level of integration between the two economies. Certainly, a return to the very close integration witnessed in the 1990s is not realistic in the foreseeable future, nor necessarily economically desirable. But without greater reliability in the economic relationship, especially concerning the movement of goods between the West Bank and Gaza, with

[57] World Bank (2007): *West Bank and Gaza Investment Climate Assessment*, World Bank, Washington DC, 2007

Israel, and through Israel to wider markets, the Palestinian economy cannot reach its potential. Though political leaders will be responsible for determining the outcome of the relationship, both the Palestinian and Israeli business communities, by working together, can help articulate the economic voice for stability.

3) Improving security to allow movement

4.8 Third, and as a crucial element of a stable relationship between the Israeli and Palestinian economies, the right balance must be struck between short-term security concerns and allowing movement and access, which is essential to promote both security and prosperity for the medium term. The threat that Israel faces is real and the restrictions have successfully prevented a number of intended terrorist attacks. This highlights the need for the PA, with the support of UN Security Coordinator General Dayton, to reform its large but poorly organised security services so that they can ensure physical security and control local gangs and militia.

4.9 However, the security restrictions seriously constrain Palestinian economic activity. Though targeted at extremists, they impact equally on the majority of moderate Palestinians. As the Government of Israel acknowledged in 2005 by signing the Agreement on Movement and Access, Israel's medium-term security can only be assured through Palestinian prosperity.

4) Encouraging Palestinian economic diversification

4.10 Fourth, the Palestinian economy must be able to trade with itself, with Israel and, most importantly, with the global economy. The OPTs have become increasingly an enclave economy, falling behind regional competitors. The lack of trade corridors limits access to foreign markets, of particular concern given the small size and fragmentation of the internal Palestinian domestic market.

4.11 Such isolation is not inevitable. The West Bank shares a border with Jordan and the Gaza Strip with Egypt. Trade corridors through these countries could allow Palestinian producers to build links with the rapidly growing Gulf economies, and access lucrative EU and Arab markets. Therefore, finding direct ways to encourage diversification, including through new trade agreements and new infrastructure, is critical.

5) Supporting the Palestinian Private Sector

4.12 Finally, the fifth building block, dependent upon all the others, is to develop and support a vibrant Palestinian private sector through encouraging investment and thereby increasing productivity. Globally, foreign direct investment is at record highs. However, it is not reaching the OPTs, where recent surveys have highlighted that, in addition to the security threat, absent or inadequate commercial legislation, incomplete land registration and weak institutions all present barriers to inward investment[58].

4.13 The traditional focus of Palestinian industry on producing low-value goods for Israeli manufacturing companies is not sustainable. High Palestinian wages reduce domestic competitiveness and the Israeli economy has moved beyond basic manufacturing. Palestinian businesses must, therefore, attract investment to increase productivity and move up the value chain. This will require a number of far-reaching changes to both the investment climate and the education system.

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[58] World Bank (2007): *'West Bank and Gaza Investment Climate Assessment'*, World Bank, Washington DC, 2007.

5 RECOMMENDATIONS FOR ACTION

5.1 This chapter contains recommendations for action which, taken together, address the barriers to economic growth identified in Chapter 3. If successfully implemented, they would put in place the five building blocks to the economic roadmap described in Chapter 4.

5.2 The recommendations are divided into two categories:

- Actions and policies that can be carried out immediately and would strengthen the OPTs even in the absence of further political progress. Some of these actions would have an immediate impact, while the impact of others would be more gradual; and

- Actions requiring political and security progress, and that would allow the OPTs to develop into a viable and self-sustaining economy.

5.3 Specific responsibility has not been allocated for implementing these actions. Just as a viable Palestinian state, offering prosperity, stability and economic opportunities to its inhabitants, and peace and security to Israeli citizens, is a goal shared by all moderate people, so must all actors work together to ensure the implementation of these recommendations. This includes: the Palestinian and Israeli leadership; Tony Blair and the Quartet; the European Commission; Arab Donors; the international financial institutions and the local and global business community.

1) STABILISING THE ECONOMY

Recommendations for immediate action

- Support the PA in developing a credible medium term financial management reform programme; including enhanced fiscal transparency, greater decentralisation of expenditure responsibility and reform of the accounting system;

- Implement the existing expenditure framework for the remainder of 2007, making the budget a credible instrument for policy and prioritisation;

- Develop a fiscal plan for 2008-10, ensuring a better allocation of public resources and aligning spending needs to realistic estimates of available revenues;

- Ensure the full and uninterrupted payment of Palestinian clearance revenues;

- Fulfil all pledges of financial support to the PA, including the Arab League commitment of $55 million per month and the G8's support for stimulating a global financial contribution of up to $3 billion a year for three years;

- Establish a coordinated funding mechanism for direct financial assistance to support PA reform and service delivery, in line with the Paris Declaration on Aid Effectiveness;

- Review the engagement of all multilateral organisations with Palestinian institutions and develop options for best delivering their mandate to the Palestinian population.

Recommendations dependent on political progress

- Invest in programmes for maintenance of infrastructure and on housing to stimulate economic growth and enable employment generation until significant private sector activity is restored;
- Explore the possibility of establishing a regional council to coordinate infrastructure development;
- Reduce the PA wage bill to a sustainable level, including through implementing the Security Sector Transformation plan;
- Reform and restructure the public sector pension fund.

2) ESTABLISHING A STABLE RELATIONSHIP BETWEEN PALESTINIAN AND ISRAELI ECONOMIES

Recommendations for immediate action

- Immediately cease all Israeli settlement and associated infrastructure expansion (including roads and water use), consistent with the Roadmap and international law;
- Revive the Joint Economic Committee to monitor and update the Paris Protocol;
- Support joint Palestinian and Israeli business-to-business forums, to ensure that they meet regularly to encourage economic cooperation;
- Improve trade access and extend the opening hours and capacity of West Bank crossings, especially at Tarqumiya.

Recommendations dependent on political progress

- Establish a mutual recognition agreement for product standards between Israel and the OPTs.

3) IMPROVING SECURITY TO ALLOW MOVEMENT

Recommendations for immediate action

- Undertake comprehensive Security Sector Reform (SSR) in the OPTs, including a development plan outlining immediate and longer term security improvements;
- Improve access for contract staff and potential investors in the OPTs, including from the Palestinian diaspora;
- Improve travel between West Bank towns through the removal of obstacles to movement;

- Use efficient scanning techniques that allow goods vehicles to cross the border between Israel and the OPTs and establish standards that can be monitored for performance;
- Operate continuous and predictable border crossings for goods and people into and out of Gaza;
- Examine options for improving access to Gaza, including the expansion of EUBAM to other Gaza Crossings and greater private sector involvement in border operations;
- Allow the passage of convoys for people and trade between Gaza and the West Bank.

Recommendations dependent on political progress

- Restart discussions on the issues of security arrangements, construction, and operation of Gaza airport;
- Establish full PA security control over those areas of the West Bank for which it has security responsibility (area A);
- Finalise plans, and where appropriate begin work, on investments supporting access and trade facilitation, including border crossings, a permanent Gaza – West Bank access corridor and Gaza airport.

4) ENCOURAGING PALESTINIAN ECONOMIC DIVERSIFICATION

Recommendations for immediate action

- Examine ways of improving Palestinian access to world markets, including regional and EU markets, for example through Jordan's Qualifying Industrial Zone model;
- Establish a mechanism for international support to assist Palestinian enterprises in upgrading outdated production techniques, re-skilling workforces and exporting to new markets; including 'Fairtrade' markets;
- Develop plans for energy security and regional integration to electricity markets;
- Join the World Customs Organisation and build capacity for bodies such as Palestinian Trade Centre and the Palestinian Standards Institute to deliver an effective and responsive trade support service.

Recommendations dependent on political progress

- Implement the World Bank's recommendations on opening up the Rafah Crossing as an alternative trade route through Egypt and extend to Kerem Shalom;
- Review the PA's options for free trade agreements with bilateral partners and accession to the World Trade Organisation;
- Restart the construction of the Gaza seaport.

5) SUPPORTING THE PALESTINIAN PRIVATE SECTOR

Recommendations for immediate action:

- Coordinate through existing infrastructure working groups a prioritised list for investment in infrastructure projects that will not compromise final status discussions;
- Put in place and follow a realistic timetable for registering all available land in the West Bank and Gaza, building on the existing work of the Palestinian Land Authority;
- Maintain momentum on negotiations to develop the Gaza Gas fields;
- Develop the West Bank Water Department into a commercial water authority;
- Restore the Gaza power plant to full production capacity.

Recommendations dependent on political progress

- Establish a programme for providing political risk insurance for foreign investors;
- Remove all barriers to immediate implementation of infrastructure projects where plans and financing are in place, including the West Bank Trunk Road and Solid Waste Facility projects;
- Establish industrial parks and special economic zones to help attract investment and boost employment, in line with the work of the Turkish and Japanese governments in this area;
- Support an investment unit to leverage finance and expertise for infrastructure development, including through private sector investment and public private partnerships;
- Increase capacity of institutions responsible for drafting and implementing the Commercial Law, the Administrative Law and the Civil Law; increase investments in construction and upgrading of educational facilities, including rebuilding damaged universities in Gaza;
- Investigate options for a common system of private sector pension provision;
- Improve the relationship between tertiary, vocational and technical training and labour market needs.

A SECTORAL ANALYSIS OF THE PALESTINIAN ECONOMY

INTRODUCTION:

A.1 This annex assesses each sector of the Palestinian economy and identifies specific opportunities for future development.

A.2 At a glance, the Palestinian economy is characterised by a large and diverse services sector, declining manufacturing industries with low productivity, and an agricultural sector, which, though contributing only a small proportion of GDP, is an important source of exports.

Agriculture

A.3 The successful development of the agricultural sector could make a rapid contribution to the Palestinian economy. Agriculture already accounted for 27 per cent of total value of exports in 2003 and there is great potential for enhanced production and export of high-value agricultural produce. The main exports are olive oil, citrus fruits, carnations, tomatoes and strawberries. Two thirds of agricultural exports currently go to Israel although direct exports to the European Union and Arab States are increasing.

A.4 13 per cent of the workforce currently works in agriculture, down from 20 per cent in the 1980s. However, agriculture accounts for 25-35 per cent of female employment and provides much needed rural employment.

A.5 The vast majority of cultivated land is found in the West Bank, most of which is rain fed. In contrast, Gaza irrigates two thirds of its agricultural land. Despite its small size, Gaza produced over 40 per cent by value of all exports from the OPTs in 2003.

A.6 The customs union between Israel and the PA benefits Palestinian farmers. Agricultural tariffs into the union are high, ranging from 40 per cent for milk to 120 per cent for dairy products, protecting Palestinian (and Israeli) farmers from global competition, and facilitating imports from Israel, which in 2003 were worth $1.6 billion[59]. However, under the right circumstances, a more liberal trade framework could enhance economic growth, development and poverty reduction in the OPTs, and facilitate their integration into the global economy.

Olive oil

A.7 Palestinian olive oil has an international reputation for quality and has excellent growth potential. Though most production is consumed domestically, in good years olive oil can account for 20 per cent of agricultural exports[60]. Significant new markets could be developed, particularly for the higher value extra virgin olive oil, in the Arab Gulf, the EU and North America. Consumers in these markets are likely to value not only the high quality of Palestinian olive oil, but also its wider attributes, for example the religious or cultural significance.

[59] World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

[60] World Bank (2006), '*Brief Overview of the Olive and the Olive Oil Sector in the Palestinian Territories*', World Bank, Washington DC, 2007

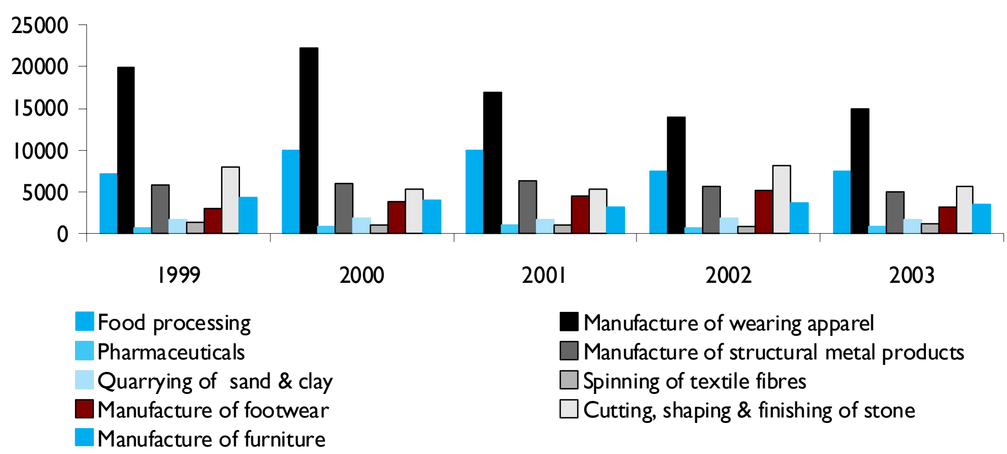
Industry

A.8 In the medium term, the industrial sector could provide many jobs. This will require improvements in productivity, a graduation up the value-chain to more lucrative products, and the development of well-targeted product marketing techniques.

A.9 The main Palestinian industries are textiles and footwear, food processing, stone cutting and furniture (see chart A.1 below). The industrial sector's share of GDP has decreased from 16 per cent in 1996 to 12 per cent in 2005. This decline is attributable to the deteriorating political and security environment and the liberalisation of Israel's economy, which has exposed Palestinian producers to foreign competition. Employment in the sector has declined from 14.1 per cent of workers in 1994 to 12.3 per cent in 2004. The largest decrease over this period was in the apparel sector, which decreased by 50 per cent.

A.10 Industrial exports as a share of total exports steadily increased in the 1990s to 70 per cent in 2000. Since then they have fluctuated substantially and in 2004 were at 51 per cent[61]. The majority of exports are low value added goods, for example stone and marble, which require little processing.

Chart A.1: Industrial Employment by sector



Source: World Bank (2006): West Bank and Gaza Country Economic Memorandum

A.11 Palestinian productivity is low and Palestinian enterprises are only more productive than neighbouring Egypt and Jordan in the pharmaceutical and food processing industries. Enterprise productivity is poor partly because managers and owners are reluctant to invest to improve efficiency. Only 50 per cent of firms in the West Bank and 25 per cent in Gaza invested in 2005. In addition, Palestinian firms are unable to take advantage of economies of scale: most production occurs in small, family run enterprises – only around 20 industrial establishments in the OPTs have more than 100 employees[62].

[61] World Bank (2007): 'West Bank and Gaza Investment Climate Assessment' World Bank, Washington DC, 2007

[62] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

A.12 Investment in human resources is also low. Fewer than 35 per cent of firms in the West Bank and 15 per cent of firms in Gaza invested in formal training in 2005. Palestinian producers face high input costs. Raw materials have the greatest share at 66 per cent over the period 1996-2004[63]. Labour costs, mirroring the cost structure in Israel, are higher than in most other neighbouring countries. The cost of utilities is also significant and much higher than in neighbouring countries.

Food processing

A.13 Palestinian productivity in food processing is regionally competitive and the industry presently contributes 23 per cent of gross value added, employing 10-15 per cent of the industrial workforce. Opportunities for growth exist in both the local market and export markets. The local market imported 46 per cent of processed food products in 2005; local producers could capture more of this market by reducing production costs and establishing a brand based on quality. There are also opportunities to develop exports, particularly to Israeli and Arab markets, where the Arab League tariff waiver provides an opportunity for growth [64].

Wood furniture

A.14 The wood furniture sector provides approximately 10 per cent of total industrial employment. While almost 50 per cent of businesses employ less than 5 people, leading factories employ more than 80 workers. Approximately 80 per cent of furniture is produced in Gaza[65]. Encouragingly, Palestinian producers have already begun moving slowly towards producing high quality products.

Services

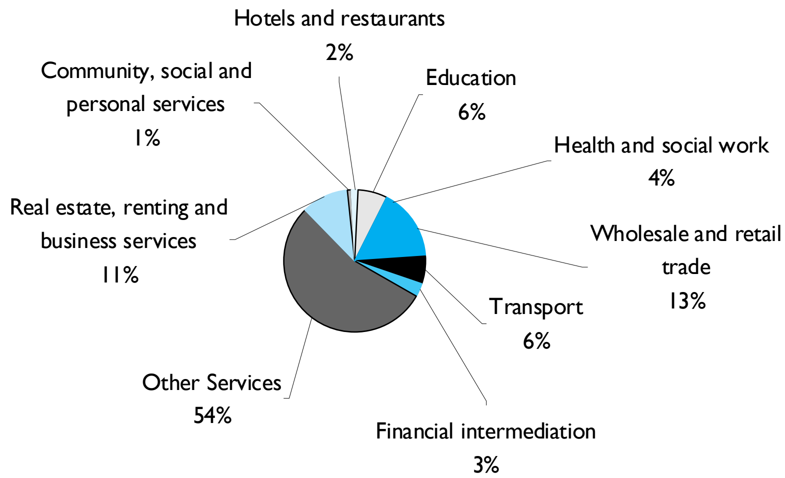
A.15 The services sector currently constitutes 48 per cent of Palestinian GDP. Its composition is illustrated in chart A.2 below. Palestinian services in general, and tourism and information communication technology (ICT) in particular, have significant development potential. However, with so many backward linkages to the rest of the economy, the development of the services sector will be dependent on the revitalisation of the economy as a whole.

63 Makhool, B., Muhannad H.,, and Shaker S., (2006):,'*Dynamics of the Palestinian Industrial Sector (1994-2004)*'

64 In 2006 one study estimated that closer cooperation between Israel and OPT could generate value-added of US$2-2.5 billion for Israel and US$1 billion for OPT. Paltrade and The Peres Center for Peace (2006), The Untapped Potential, Palestinian-Israeli Economic Relations: Policy Options and Recommendations

65 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

Chart A.2: Composition of the Palestinian services sector



Source: World Bank (2006): Country Economic Memorandum

Tourism A.16 The global tourism industry is currently worth nearly $700 billion per year and it is growing rapidly[66]. Within the global market, niche markets, including historical and religious places of special interest, are developing particularly rapidly.

A.17 At its height, between 1994 and 2000, tourism contributed about $225 million per annum to the Palestinian economy. However, with the security, access and movement implications of the second *intifada*, this had fallen to less than $50 million in 2005[67]. In 2005, neighbouring Jordan's tourist industry was worth an estimated $1.4 billion per year, indicating the potential of tourism in the OPTs. Like Jordan, the OPTs are richly endowed with religious and historical significance. They are home to 1,600 archaeological sites containing treasured artefacts and the birthplace of three great monotheistic religions.

ICT A.18 Growth in the Information and Communication Technology (ICT) sector accelerated after the Oslo Accords, accompanying the global development of the industry. The *intifada* had less of an immediate impact on the ICT sector than other parts of the economy, though since 2000 almost all foreign investment has been withdrawn. The ICT sector currently employs 4,400 people, with the Palestinian Telecommunications Company (Paltel) providing 55 per cent of all ICT jobs. Paltel was created in 1997, and together with its subsidiary mobile phone operator Jawwal, has monopoly control over the OPTs telecoms market.

[66] HMT calculations from UNWTO (2006), Tourism Market Trends.

[67] USAID (2006)*The Palestinian Tourism Cluster: Assessment Report 2006*, USAID, Washington DC, 2006

B SECURITY, MOVEMENT AND ACCESS

B.1 As previous chapters have made clear, security restrictions on the movement and access of Palestinian goods and services represent the greatest barrier to Palestinian economic growth. This annex provides further detail on the impact of these restrictions, often known as the closure regime. While it has unquestionably helped improve Israel's short-term security, the closure regime's impact on the Palestinian economy has been profound.

The impact of the closure regime

B.2 The closure regime has three major economic impacts:

- it denies Palestinian producers access to potential markets – international, Israeli and domestic. Restrictions either delay or prevent goods the movement of goods, making it both expensive and unreliable. This reduces the competitiveness of Palestinian firms;
- it reduces the mobility of people both within and into the OPTs. This reduces the flexibility of the Palestinian labour market and prevents international investors; and
- it prevents Palestinians from working in Israel, thereby increasing unemployment and reducing remittances. Before the second *intifada*, around 130,000 Palestinians worked in Israel every day. The current figure is about 62,000.

B.3 All Palestinian goods must leave the OPTs via Israel and fewer than 10 per cent of companies sell directly to the international market. It is, however, believed that many Palestinian goods sold to Israelis are subsequently exported under an Israeli label.

B.4 Conventionally, the Israeli market would represent a great asset to Palestinian producers. Not only is Israel a high-income country, with a GDP per capita of nearly $20,000, but through the Paris Protocol Israel and the OPTs are in a customs union. However, relatively few Palestinian manufacturers currently export to Israel – fewer than 40 per cent on average in the West Bank and fewer than 20 per cent in Gaza [68].

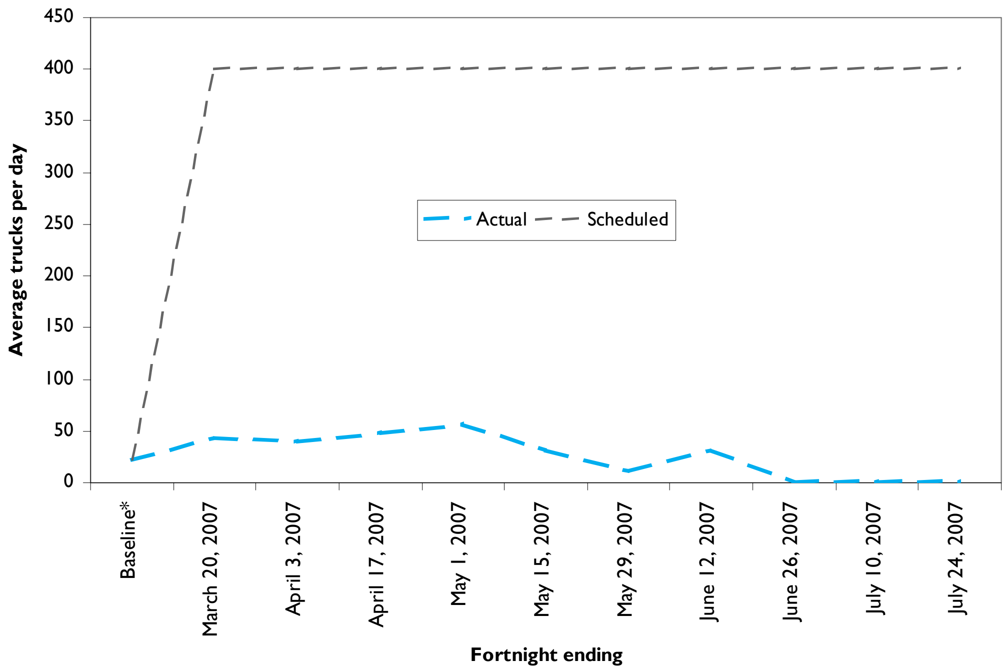
B.5 All goods leaving and entering the Gaza Strip, which has a population of more than 1.5 million people, must pass through the Karni Crossing. Even before the Hamas takeover of Gaza in June 2007, the opening of the Karni Crossing was both unpredictable and insufficient to meet market demand – see chart B.1[69]. According to the World Bank, corruption was present on both sides of the border and in 2006 bribes on the Israeli side of the border were reportedly running at between $2,000 - $6,000 per truck[70]. Since the Hamas takeover of Gaza, the Karni Crossing has been permanently closed.

[68] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

[69] Market demand was identified in the Agreement on Movement and Access as 150 trucks per day. Through-out 2006 an average of only 20 trucks passed through the Karni Crossing per day.

[70] World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

Chart B.1: Scheduled and actual number of trucks leaving Gaza



**January 2004 – January 2005*

Source: UNOCHA, 2007

B.6 It is easier to get goods out of the West Bank, though the completion of the barrier, which will cut off nearly 10 per cent of the West Bank, may make it more difficult. The barrier has made informal sales of goods and services from the West Bank to East Jerusalem and Israel increasingly difficult. It is estimated that the barrier will cost the Palestinian economy between 2-3 percentage points of GDP per annum[71].

B.7 The closures regime also restricts Palestinian access to the Palestinian market. In August 2007, there were 532 impediments to movement in the West Bank and Palestinian access to 1,200 kilometres of road was also partially or wholly restricted[72]. Some towns in the West Bank, including Jericho and Nablus, which were traditionally centres of business, are now almost entirely surrounded by security restrictions. As a consequence of all the impediments to movement in the West Bank, only 4o per cent of West Bank firms are able to sell outside of their immediate area, and less than 20 per cent of firms are able to trade between the West Bank and Gaza.

B.8 Finally, the closure regime has implications for the movement of people. It is difficult for Palestinians to move permanently between East Jerusalem and other cities within the West Bank, or between Gaza and the West Bank. Palestinians who travel abroad for work or education and do not regularly renew their residency permits can also risk losing their citizenship. In addition, it is hard for foreign nationals, especially those of Palestinian descent, to acquire a residency permit in the OPTs without an Israeli Identity Card. These restrictions reduce labour mobility and inhibit the flow of investment into the OPTs by the Palestinian diaspora, who currently provide almost all direct and indirect foreign investment in the OPTs.

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71 World Bank (2007): '*West Bank and Gaza Investment Climate Assessment*' World Bank, Washington DC, 2007

72 UNOCHA, various reports.

C PUBLIC SECTOR FINANCIAL MANAGEMENT

C.1 Stable management of the public finances provides an essential foundation for sustained economic growth. Chapter 3 identified the main problems facing the Palestinian public finances. This annex provides further detail.

C.2 Since the formation of the Hamas-led government in March 2006, the PA has faced an acute financial crisis, worsening an already precarious situation. However, it is important to stress that recent events have served to exacerbate, rather than create, the crisis. Even before the January 2006 Palestinian elections, many donors had suspended direct budget support, reflecting concern at unsustainable spending plans.

C.3 Growing public expenditure has powered the Palestinian economy since the start of the second *intifada*. Combined with falling or stagnant revenues, this has caused increasing fiscal instability. By the end of 2005, the PA was financing current expenditure through sales of Palestinian Investment Fund assets and bank lending secured against those assets. A fiscal crisis in 2006 was virtually inevitable. It is important to address the underlying reasons for this if long-term sustainability is to be achieved.

Revenues

C.4 Following its formation in 1994, the Palestinian Authority's revenues grew substantially, reaching a peak of US$95 million for September 2000. These increases are attributable to increases in clearance revenues and the rapid establishment of tax collection capacity within the OPTs[73]. During this time, the PA did not receive any external budget support.

C.5 However, by December 2000, three months into the second *intifada*, revenues had declined to only $49 million per month. In compensation, the PA became reliant upon substantial external budget support, peaking at $530 million for 2001. Since 2001, Palestinians have received more than $300 per capita per annum, the highest level of per capita foreign aid in the world. Domestic revenues recovered from the end of 2003 and annual revenues, including external financing, reached nearly $1.6 billion in 2005 (see table C.1 below).

C.6 In 2006, annual resources fell to $1.37 billion, which includes nearly $750 million in external budget support, most of which was channelled through the Office of the Palestinian President by either Arab Donors or the Temporary International Mechanism (TIM)[74].

[73] World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

[74] IMF (2007): '*West Bank and Gaza: Fiscal Performance in 2006*', IMF, Washington DC, 2007

Table C.1 Palestinian Authority Fiscal Indicators, 1995-2006

US$ million	1995	2000	2001	2002	2003	2004	2005	2006
Revenues								
Total	**510**	**939**	**275**	**296**	**763**	**954**	**1232**	**570**
o/w Gross Domestic	244	352	275	224	291	337	476	290
o/w Tax	144	241	183	141	167	191	231	206
o/w Non Tax	100	111	92	82	124	146	245	84
o/w Gross Clearance	266	587	0	72	472	617	757	280
Expenditure (including net lending and VAT refunds)								
Total	**578**	**1212**	**1119**	**1022**	**1292**	**1528**	**1994**	**1022**
Recurrent Expenditure	578	1199	1095	994	1067	1320	1594	1014
o/w Wages	304	622	678	642	743	870	1001	656
o/w Civil service	194	378	426	404	456	538	614	415
o/w Security service	110	244	252	239	288	333	387	241
o/w Non-wage Expenditure	274	577	417	352	324	449	593	358
PA-Financed Capital Expenditure	0	13	22	23	36	36	44	8
Balance	**-68**	**-274**	**-842**	**-721**	**-340**	**-402**	**-406**	**-453**
Net Lending	0	0	0	0	173	157	344	337
VAT Refunds	0	0	2	5	16	16	12	6
Overall Balance	**-68**	**-274**	**-844**	**-726**	**-529**	**-574**	**-762**	**-796**
External Budget Support	**68**	**54**	**530**	**467**	**261**	**352**	**349**	**747**

Source: IMF and World Bank

Expenditure

C.7 In contrast to revenues, PA expenditure grew inexorably until the end of 2005, when it reached $1.99 billion, at which point the PA had the second highest central government expenditure-to-GDP ratio in the world after Eritrea[75]. In 2006, expenditure decreased substantially to just over $1 billion, much of which was funded by the TIM[76]. Since June 2006, the TIM has distributed more than $400 million, thereby ensuring the continued delivery of vital services, including health and education.

C.8 As table C.1 shows, there are two main components to PA expenditure: the wage bill and non-wage recurrent expenditure:

Public wage bill

C.9 Public employment grew by at least 10 per cent per annum between 1995 and 2005, despite the collapse in public revenues after 2000. By the end of 2005, the wage bill took up 95 per cent of the PA's gross domestic revenues and PA salaries had dramatically diverged from private sector salaries in OPTs. The proportion of wages paid to the security services remained constant during this period at around 36 per cent[77].

C.10 After the formation of the Hamas government, wages were prioritised as resources fell. For most of 2006, it was possible only to pay partial salaries. Overall, and including allowances paid by the Office of the Palestinian Presidency and the Temporary

75 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

76 IMF (2007): '*West Bank and Gaza: Fiscal Performance in 2006*', IMF, Washington DC, 2007

77 IMF (2006): '*Macroeconomic Developments and Outlook*', IMF, Washington DC, 2006

International Mechanism, government employees received on average 50 – 55 per cent of their normal incomes, absorbing over $650 million - over $100 million more than the domestic revenues accrued to the PA during the year[78].

Non-wage expenditure

C.11 Aside from wages, welfare provision represents the PA's greatest recurrent expenditure and, over the years, the PA has implemented an array of welfare measures, including a fiscally unsustainable public pension scheme. The Ministry of Social Affairs is the primary provider of social safety nets, but additional programmes are offered by the Ministry of Detainees and Ex-Detainee Affairs, the Ministry of Labour and the Ministry of the Interior. Spending on transfers almost doubled between 2004 and 2005 to $375 million with the introduction of a new welfare system[79].

Achieving long-term fiscal stability

C.12 A viable Palestinian state means, in the long term, a self-sufficient state. Precedent suggests that, under improved circumstances, this is achievable. Until the start of the second *intifada*, the PA was not dependent upon external budget support and still managed a modest budget deficit of 1.3 per cent of GDP[80].

C.13 The PA needs to produce a credible plan for medium-term fiscal stability. Implementing this will almost certainly require external budget support. But without a credible plan and political commitment, donors will be reluctant to maintain high levels of financial support. Fiscal stability will also depend on the full repayment of all withheld Palestinian clearance revenues and continued regular transfers in the future.

C.14 Above all, however, restoring fiscal stability requires increasing revenues and decreasing expenditure. Raising domestic revenue significantly above the levels of 2006 will be difficult. The tax collection system is relatively efficient and further increases to the tax rate will deter private sector development. The challenge, therefore, will be to reduce domestic expenditure. Key priorities will be to improve financial management capacity and reduce the public sector wage bill.

Improving financial management

C.15 The transparency of public financial management has deteriorated since the formation of the Hamas-led government in March 2006, exacerbating (though not creating) the need for public financial management reform. Such reform is essential if the PA is to convince the Palestinian people, and the donor community, that it is capable of carrying out the difficult changes necessary to achieve fiscal stability. Key priorities should be to promote:

- Reform of the accounting system;
- Greater decentralisation of expenditure responsibility; and
- Enhanced financial transparency and programme coordination within a number of key public institutions.

Reducing the public wage bill

C.16 The PA will need to work towards the retrenchment or reassignment of non-performing civil servants. The 1998 Civil Service Law states that civil servants can be dismissed for failing to turn up to work for more than 15 consecutive days without an acceptable reason. The World Bank's Public Expenditure Review of March 2007

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78 IMF (2007): '*West Bank and Gaza: Fiscal Performance in 2006*', IMF, Washington DC, 2007

79 World Bank (2006): '*West Bank and Gaza, Country Economic Memorandum*', World Bank, Washington DC, 2006

80 World Bank (2007): '*West Bank and Gaza Public Expenditure Review*', World Bank, Washington DC, 2007

estimates that there are 11,500 people in this category, costing the PA $60 million per year.

C.17 The PA also needs to determine what represents a sustainable wage bill - and take action to achieve it. The World Bank estimate that, under improved political circumstances, the PA could sustain a monthly wage bill of $80 million - around the level that existed prior to the major civil service salary increases of July 2005.

C.18 Reforming the security sector, which currently employs over 85,000 people, including the 10,000 Hamas 'Executive Force', will represent particular challenges[81]. US Security Coordinator General Dayton has estimated that a thorough security sector reform would leave the PA with around 60,000 security personnel.

C.19 Though managing the wage bill will be an essential element to achieving fiscal stability, it will also present acute social protection challenges. Demobilising security personnel in particular will require careful handling to ensure a smooth transition to civilian life. There is likely to be a transition period, during which externally financed programmes will be needed to both stimulate economic growth and provide immediate employment opportunities outside of state employment. In the longer term, the expansion of vocational training programmes, created in partnership with, and responding to the needs of, the private sector, will be necessary if former public employees are to re-integrated into the labour force.

81 World Bank (2007): '*West Bank and Gaza Public Expenditure Review*', World Bank, Washington DC, 2007

D The agreement on movement and access

D.1 The following annex contains the full text of the Agreement on Movement and Access (AMA) between Israel and the PA. The AMA, which was facilitated by US Secretary of State Condoleezza Rice, European High Representative Javier Solana and the then Quartet Representative James Wolfensohn, was signed on 15 November 2005.

The Agreement on Movement and Access

D.2 To promote peaceful economic development and improve the humanitarian situation on the ground, the following agreement has been reached. It represents the commitments of the Government of Israel (GoI) and the Palestinian Authority (PA). Its implementation and further elaboration will be assisted by the Quartet Special Envoy for Disengagement and his staff and/or the United States Security Coordinator (USSC) and his staff.

Rafah

D.3 The parties have agreed to the attached statement of principles. Rafah will be opened as soon as it is ready to operate at an international standard in accordance with the specifications of this agreement and as soon as the 3rd party is on site, with a target date of November 25.

Crossing Points

D.4 The parties have agreed that:

- The passages will operate continuously. On an urgent basis, Israel will permit the export of all agricultural products from Gaza during this 2005 harvest season;
- The new and additional scanner will be installed and fully operational by December 31. At that time, the number of export trucks per day to be processed through Karni will reach 150, and 400 by end-2006. A common management system will be adopted by both parties; and
- In addition to the number of trucks above, Israel will permit export of agricultural produce from Gaza and will facilitate its speedy exit and onward movement so that quality and freshness can be maintained. Israel will ensure the continued opportunity to export.

D.5 To enhance operation, the parties agree that:

- When a new generation of x-ray equipment able to scan trailers as well as containers becomes available it will be used. Once it arrives in the country, testing will also be carried out with the assistance of the Quartet Special Envoy;
- The USSC will ensure continuing consultation, with unresolved implementation issues to be discussed as needed with the parties;
- The PA will ensure that the passages will be protected on the Palestinian side of the border and will train and upgrade the management of all crossings to

ensure efficiency and effectiveness. The PA will establish, without delay, a unified system of border management; and

- The management system that has been developed for Karni should, with suitable local variations, be adapted to the passages at Erez and Kareem Shalom. Israel also undertakes to put in place similar arrangements as appropriate that will make West Bank passages fully operational as soon as possible. A bilateral committee, with participation as needed of the Quartet Special Envoy and/or the USSC, will develop operational procedures for those passages.

Link between Gaza and the West Bank

D.6 Israel will allow the passage of convoys to facilitate the movements of goods and persons. Specifically:

- Establish bus convoys by December 15.
- Establish truck convoys by January 15.
- Work out detailed implementation arrangements in a bilateral committee of the Gobi and PA with participation as needed from the Quartet team and the USSC.

D.7 It is understood that security is a prime and continuing concern for Israel and that appropriate arrangements to ensure security will be adopted.

Movement within the West Bank

D.8 Consistent with Israel's security needs, to facilitate movement of people and goods within the West Bank and to minimize disruption to Palestinian lives, the ongoing work between Israel and the U.S. to establish an agreed list of obstacles to movement and develop a plan to reduce them to the maximum extent possible will be accelerated so that the work can be completed by December 31.

Gaza Seaport

D.9 Construction of a seaport can commence. The Gobi will undertake to assure donors that it will not interfere with operation of the port. The parties will establish a U.S.-led tripartite committee to develop security and other relevant arrangements for the port prior to its opening. The 3rd party model to be used at Rafah will provide the basis for this work.

Airport

D.10 The parties agree on the importance of the airport. Discussions will continue on the issues of security arrangements, construction, and operation.

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