Two Years after London: Restarting Palestinian Economic Recovery

Economic Monitoring Report to the Ad Hoc Liaison Committee

September 24th, 2007

The World Bank
www.worldbank.org/ps

Acronyms

AHLC	Ad-Hoc Liaison Committee
AMA	Agreement on Movement and Access
CG	Consultative Group
COGAT	Coordinator of Government Activities in the Palestinian Territories
EC	European Commission
EU	European Union
GDP	gross domestic product
GNP	gross national product
GoI	Government of Israel
ICA	Investment Climate Assessment
IMF	International Monetary Fund
LACS	Local Aid Coordination Secretariat
MENA	Middle East and North Africa
MOF	Ministry of Finance
MOP	Ministry of Planning
MTEF	Medium-Term Expenditure Framework
MTIT	Ministry of Telecommunications and Information Technology
NGO	non-governmental organization
ODA	official development assistance
PA	Palestinian National Authority
PCBS	Palestinian Central Bureau of Statistics
PRDP	Palestinian Reform and Development plan
PER	Public Expenditure Review
PLC	Palestinian Legislative Council
PMA	Palestinian Monetary Authority
PWA	Palestinian Water Authority
QR	Quartet Representative
SWG	Sector Working Group
TA	technical assistance
UNRWA	United Nations Relief and Works Agency
UNSCO	Office of the United Nations Special Coordinator
VAT	Value-Added Tax
WB&G	West Bank and Gaza

Table of Contents

Acknowledgements 1

Executive Summary 2

1. Introduction 7

2. Events since London 8

2.1 Economic and Fiscal Events 8

2.2 A Note on the Gaza Strip 14

3. Progress since the 2005 AHLC: Revisiting the Preconditions 17

3.1 Movement and Access and the 'Private Sector Potential' 17

3.2 Palestinian Governance 24

3.3 The Donor Response and Strategies 29

4. The Way Forward 34

Acknowledgements

This Economic Monitoring Note derives as much from its economic analysis as from the consultative process through which it was prepared. To ensure that the report reflects to the extent possible the views of all involved parties, approximately two months of intensive consultations were carried out with a vast spectrum of Palestinian, Israeli and international officials and agencies. Where possible, their inputs have been incorporated into the analysis. And where the World Bank's analysis and conclusions differed, every effort was made to reflect these varying views in the footnotes to the text.

We are grateful for the inputs and guidance of H.E. Prime Minister Salam Fayyad and the Ministries of Finance and Planning, as well as the Office of H.E. President Mahmoud Abbas. In addition, the feedback of the following institutions is gratefully acknowledged: Palestinian Investment Fund (PIF), Palestinian Monetary Authority (PMA), PLO Negotiations Affairs Department (NAD), Palestinian Federation of Industries (PFI), PalTrade, Palestinian Private Sector Coordination Council (PSCC), Palestinian Shippers' Council (PSC), various Palestinian private sector leaders in Gaza, Palestinian Central Bureau of Statistics (PCBS), Palestinian Center for Policy and Survey Research (PSR), and the Public Administration and Civil Service Reform Project Team (PACSR).

The inputs and feedback of the Israeli authorities also greatly benefited this report. We are grateful to the Ministry of Foreign Affairs, the Ministry of Justice, and the Office of the Coordinator of Government Activities in the Territories (COGAT) for their cooperation throughout the drafting of this report.

Last but not least, we gratefully acknowledge the inputs and feedback of the following international and donor agencies, and NGOs, with particular thanks to the International Monetary Fund (IMF) and the UN Office of the Coordinator of Humanitarian Affairs (OCHA) who provided significant analysis for this report. In addition, we note with appreciation the inputs of the European Commission (EC), EU Temporary International Mechanism (TIM), UK Department for International Development (DfID), Office of the Quartet Representative, U.S. Consulate General, U.S. Agency for International Development (USAID), Norwegian Representative's Office, Canadian International Development Agency (CIDA), UN Special Coordinator (UNSCO), UN Relief and Works Agency (UNRWA), Portland Trust, Development Alternatives Inc. (DAI), International Crisis Group (ICG), Oxfam International, B'Tselem, Bimkom, and Campaign for the Right of Entry/Re-Entry.

Executive Summary

1. At the 2005 AHLC meeting in London, the World Bank issued a report examining progress over the previous year, and reiterating the already-known preconditions for growth without which donor assistance would not yield lasting results. These are: (1) a drastic improvement in the security environment; (2) dismantling restrictions on the movement of Palestinian people and goods; and (3) clear progress on Palestinian reform and institution-building. In recognition of these widely accepted preconditions, the AHLC called for parallel and reinforcing actions by the Palestinian Authority (PA), the Government of Israel (GoI) and the donors.

2. This report evaluates the progress made since London in meeting the preconditions for a virtuous cycle of growth, and the changing circumstances in which these preconditions continue to apply. It also seeks to reflect some of the lessons learned over the past few years in the hope of influencing the concrete policies that are necessary, looking forward to the proposed Donor Conference in December, to revive the Palestinian economy and the overall peace process.

Economic and Fiscal Events

3. The decline of the Palestinian economy since the Second *Intifada* has left per capita GDP at $1,129 in 2006, about a third less than its level of $1,612 in 1999. The emerging recovery in 2003-2005 was again reversed in 2006 as a result of the fiscal crisis following the Palestinian Legislative Council (PLC) elections.

4. More troubling than the negative growth rates over the past few years is the changing composition of the economy, as GDP is being increasingly driven by government and private consumption from remittances and donor aid, while investment has fallen to exceedingly low levels, leaving little productive base for a self-sustaining economy.

5. Furthermore, the West Bank and Gaza (WB&G) faces an expanding labor force and a shrinking private sector. Thus, the public sector has become the only alternative for jobs. With few options at its disposal, and despite an unsustainable wage bill, the PA has resorted to absorbing workers as a way to alleviate poverty. At the same time, many workers have been hired as part of a trend to bolster political support. As a result, public sector employment has grown by 60% since 1999 and by 2006 stood at about 157,800. The current Caretaker Government has sought to roll this back by not paying 31,000 civil servants and security personnel hired illegally since the end of 2005. However, the PA may find it politically challenging to reduce the workforce any further.

6. Thus, while the public sector has expanded, the economy's productive capability has begun to hollow out making it increasingly donor dependent. While borrowing, remittances and increased aid outside key institutions of the PA managed to prevent a collapse in GDP in 2006, output in the productive sectors declined. Public investment to maintain or add infrastructure has nearly ceased and in the last two years almost all government funds have been used to pay salaries and cover operating costs. The IMF estimates that already-low private investment declined by over 15% between 2005 and 2006.

7. Adding to this, unpredictability of the border crossings and chechpoints has prevented Palestinian businesses from importing inputs and exporting products in a timely and planned manner. In response, enterprises have closed and large amounts of financial and human capital have fled. The pace of capital flight has reached an all-time high in the last two years with almost no foreign direct investment and most local capital being kept abroad or invested in real estate or short term trading activities.

8. The social impacts of the past few years are no less significant. Health indicators have seen a steady drop over the last three years. Chronic diseases have surged 31% since 2005. Chronic malnutrition among children under five jumped 3% between 2004 and 2006. The number of households with safe drinking water has also dropped by over 8% between 2000 and 2007. The quality of education and enrollment are also declining. The increasing insecurity, especially in the Gaza strip, is impacting the performance of students: failure rates in mathematics and Arabic are nearly 80% and 40%, respectively. Furthermore, the continuing conflict is perpetuating an internal cycle of violence, fragmenting social cohesion and affecting psychosocial well-being. A 2006 survey concluded that nearly three quarters of Palestinians suffer from severe depression. Women, who historically play a key role as income providers, are increasingly relegated to the informal market as a result of movement and access restrictions. Their participation in the labor market, at 15.2%, is amongst the lowest in the world. Also, since September 2000, youth have been caught literally and figuratively in the crossfire of the conflict. Nearly 75% of the injured during the second *Intifada* were between 10 to 29 years old. Youth also suffer from high rates of unemployment (60%).

9. The PA has sought to deliver services to an increasingly dependent population, and to compensate for a dwindling private sector. The PA's longstanding fiscal crisis deepened in 2006 as a result of GoI's withholding of Palestinian clearance revenues and the aid boycott, resulting in a deficit of over $1 billion. Yet, wages and non-wage operating costs, transfers, and spending on utilities and energy continued to grow despite the drop in funding. The PA's financial position continues to deteriorate at an increasing rate in 2007. In the first half of 2007, the deficit was $100 million a month. Even after Israel's decision in June 2007 to release withheld clearance revenues, the wage bill currently exceeds government revenues. This is further impacted by the PA's limited ability to increase domestic revenues given the loss in value-added tax (VAT) and customs duties from the suspension of Gaza trade.

10. As such, nearing the end of 2007, the PA finds itself with a large deficit, a significant stock of arrears and falling revenues. External assistance has been unusually high in 2007; nearly $450 million has been received in the first half of the year. Looking forward, the PA forecasts a need for at least $1.62 billion in donor assistance per year to close the fiscal gap, of which 94% will go to meet recurrent expenditure needs as opposed to development aid.

A Note on Gaza

11. From the outset, Gaza has been hit harder by closures and economic crises. Gaza's economic backbone and private sector vitality risks collapse if the current closure policy after Hamas' June 14th takeover of the Strip continues. Recent calls by various parties for the entry of solely humanitarian goods are a necessary but insufficient condition for the survival of the Gaza economy. However, a sustainable solution must include commercial imports and exports, considering that over 54% of employment in Gaza is private sector-driven (representing more than 100,000 jobs). Of these, 35,000 workers - 18,000 skilled - operate the industrial sector. According to the Palestinian Private Sector Coordination Council (PSCC), the current restrictions have led to the suspension of 90% of Gaza's industrial operations.

12. The likely lay-off of over 30,000 industrial workers, resulting from the current restrictions, would translate into an unprecedented private sector-driven unemployment level of about 44% in Gaza. The impacts of these closures will become more difficult to reverse. Most Gaza industries are export-oriented and have purchase and supply contracts with Israeli and other firms. Gaza manufacturers import 95% of their inputs. About 76% of their furniture products, 90% of their garments and 20% of their food products are exported to Israel, and some to the West Bank. Employment in construction and building has also been impacted by the suspension and

cancellation of most construction projects due to lack of construction materials. Also, 5,000 Gazan farmers depend on the export of cash crops. Israeli and other suppliers and purchasers needing to maintain their operations will soon cancel contracts and seek alternative supply chains elsewhere.

13. At the same time, the Hamas control of Gaza is incurring a direct negative impact on the economy. Without delving into the political context of the current stalemate, it is evident that Hamas also bears responsibility for creating a political and logistical environment in which all sides can reengage in Gaza. Furthermore, it must be noted that attacks on the crossings continue to take place, greatly undermining any efforts to shield Gaza's population and private sector from the impacts of the current situation.

Progress since the 2005 AHLC: Revisiting the Preconditions

Movement and Access

14. The main challenge for Palestinian economic recovery remains the comprehensive restrictions on movement and access imposed by GoI, which go beyond concrete and checkpoints to a complex matrix of restrictive policies and administrative procedures that combine to stunt Palestinian economic growth. Beyond movement within and across the Palestinian Territories, these policies and procedures also restrict access to domestic and international markets, water and other natural resources, and donor-financed projects for approximately 60% of the West Bank (Areas C).
15. While there is consensus on the legitimacy of Israel's security concerns, it is difficult to reconcile this with the clear correlation between access restrictions and the protection and expansion of Israeli settlement activity in the West Bank. The commitments entered into by Israel under the 2005 Agreement on Movement and Access (AMA) remain as unfulfilled as they are critical. The AMA must be implemented immediately; the loosening of restrictions on people and products is a long-term source of stability, not a consequence of it.

Palestinian Governance

16. The combined shocks of the last two years have endangered many Palestinian institutional gains. The refusal of the Hamas-led PA to meet the Quartet conditions, and the international reaction to the PLC elections have marginalized the legislative branch as a potential multi-party platform for policy-setting and for balance with the executive branch. Also, efforts at imposing law and order, reforming the executive and judicial branches of government and conducting the normal day-to-day operation of government have been frustrated by factional fighting and paralysis of the PLC.

17. However, the formation of the June 14th Emergency Government and later the Caretaker Government has opened the door to return to a path of reform. In terms of law and order, the resumption of high-level security coordination between the Caretaker Government and the GoI offers an opportunity for coordinated approaches.

18. On the fiscal front, the Caretaker Government has begun to reverse the impacts of 2006-07 and the legacy of its past spending practices. The PA has successfully rehabilitated parts of the Public Financial Management system, including reconsolidating the Single Treasury Account (STA), preparing a budget for 2007 and reversing some staffing additions of early 2005 and onward. The preparation of the 2008-10 Palestinian Reform and Development Plan will begin to address longstanding disconnects in policy-making, planning and budgeting processes.

19. Moving forward, the Government's prospects for success will depend on the credibility of its national policy agenda, including pragmatic plans to put the PA on the path to fiscal sustainability. These include re-linking PA institutions between the West Bank and Gaza, reforming its human resources, tackling intergovernmental fiscal relations and the spiraling municipal needs and rationalizing spending in the social sectors to ensure the sustainability of these services to the population. Reform of the pension system is a key priority in this regard. The August 27th, 2007 decree modifying previous pension laws does not tackle an insolvent pension system with substantial implicit liabilities for the PA. The PA's success will also depend on sufficient and predictable external assistance, including budget support, and a strong recovery of private economic activity. Both Israel and donors have a role to play.

The Donor Response and Strategies

20. Aid flows into the WB&G have been considerable, but remain fragmented and focused on bilateral arrangements with donors based on short-term political positions rather than a collective, longer-term view on broader economic and governance fundamentals. Thus, aid has not been governed by a longer-term Palestinian development agenda, nor has it been matched by parallel actions by the PA and the GoI to create an environment where funds translate into sustainable growth.

21. Aid has been reactive and lacking levers to encourage or enable institution-building or to create powerful incentives to reform. In addition, the hollowing out of the Palestinian economy has risked reversing the benefits of over $10 billion in past aid, and has diverted funds to recurrent expenditures and basic lifeline humanitarian support rather than to an investment in building effective Palestinian institutions and infrastructure.

22. Donors have long been aware of this issue, hence the establishment of multilateral financing mechanisms and new aid coordination bodies at the last AHLC in London. However, the effectiveness of these structures was undermined by the aid boycott. Going forward, these aid coordination bodies must be revitalized. The presence of the new Quartet Representative, and his leveraging of these structures, could strengthen them considerably. Also, donor commitment to the Palestinian Reform and Development Plan 2008-10 will be a key test of their support of Palestinian-driven institution-building, recovery and growth.

The Way Forward

23. Moving forward, the restoration of growth and peace will require all sides not only to return to the preconditions for economic recovery, but to take actions collectively and in parallel, in view of the longer-term benefits and not only the short-term costs. Experience over the past 15 years has shown that only parallel actions on the issues outlined in this report will lead to tangible results.

24. The viability of the PA is a precondition for a lasting recovery and peace. For the PA to be viable, it must restore law and order and become fiscally self-sufficient. Continued donor investment in and through PA institutions must be based on economic considerations and bolster a commitment by the Government to the reforms noted in this report, not be conditioned on it. Similarly, the PA's reform agenda must clearly and realistically reflect a finite horizon of aid dependency.

25. GoI actions on Palestinian movement and access must also reflect a clear policy on settlement activity, and a view of the removal of these restrictions as a major catalyst for stability, and not a consequence of it. In addition to the private sector, Israeli restrictions also impede the functions of the Palestinian public sector. The PA is obliged to administer a series of isolated territories despite complex obstacles in coordinating government policy, administrative procedures, service delivery and law enforcement.

26. However, any discussion on economic recovery and peace is incomplete without the Gaza Strip. Gaza represents about 40% of the population and a quintessential part of the Palestinian territory, economy and identity. Thus, any serious options for a private-sector led and export-oriented Palestinian economy must include Gaza. Without it, the collective investments and commitments advocated in this report are unlikely to materialize due to continued uncertainties about the sustainability and inclusiveness of Palestinian institutions.

27. Whether practical or not under the current circumstances, the need for these parallel steps is evident. These are the fundamentals of economic growth, and draw on the basics that guide all economies. Without them, all well-intentioned and creative solutions, policies and investments are undermined. The implication of this view is that all parties will need to expend more resources and assume more risks than they have done in the past. Perhaps this is best referred to as an investment in peace. The costs are subjective to each side, and are beyond the scope of this report. But the benefits of success make this an investment worth making.

1. Introduction

1. ***On December 14th, 2005, the members of the Ad-Hoc Liaison Committee (AHLC) gathered in London to take stock of progress since the previous meeting in Oslo, and to chart a path for Palestinian economic development*** to underpin a lasting peace in the region[1]. There, the World Bank issued a report examining progress over the previous year, and reiterating the already-known preconditions for growth without which donor assistance would not yield lasting results. These are: (1) a drastic improvement in the security environment; (2) dismantling restrictions on the movement of Palestinian people and goods; and (3) clear progress on Palestinian reform and institution-building. These were outlined in a matrix of Indicators of Economic Revival to anchor these preconditions in a qualitative analysis.

2. ***Much analysis has been devoted to the events since 2005. And deservedly so, as their impacts on a frail Palestinian economy are clear and acute.*** However, they also represent a new digression since the Second *Intifada* that masks the persistent challenge facing the three partners to Palestinian recovery and the peace process. The key remains the parallel fulfillment by the Palestinian Authority (PA), the Government of Israel (GOI) and the donors of commitments and investments towards viable Palestinian institutions and a healthy private sector.

3. ***The path of Palestinian economic recovery has been at risk long before the events of the last two years, with a confluence of policies and actions that have unraveled many successes, and that are stripping the Palestinian economy of any capacity of self-sufficiency and growth.*** In 1968, an average Israeli citizen was 10 times wealthier than an average Palestinian in the West Bank and Gaza (WB&G). Today, Israeli per capita GDP is more than 20 times that of the Palestinians. Two-thirds of Palestinians are below the poverty line. Even within the Palestinian Territories, Gaza is witnessing a dramatic drop in incomes and well-being, amplifying an economic rift. To claim that this growing rift among two worlds separated by a wall is a result of intentional Israeli or donor actions, or that Palestinian and Israeli development are a 'zero-sum' game, would be false. What is true, however, is that the investment in peace and prosperity has been far from complete.

4. ***The calling together of the AHLC coincides with a time of new momentum for the restoration of Palestinian recovery, and for a revisiting of the practices of the past.*** The continued commitment of donors to the Palestinian people is evident, and the current positive steps taken by the Israeli and Palestinian Governments towards a return to the peace agenda are commendable. As such, the AHLC offers an opportunity to explore the preconditions for a return to sustainable development driven by Palestinian institutions.

5. ***The good news is that all sides are aware of what is needed. The less positive news is that this involves much financial and political capital. The precondition for success is that parallel actions must be taken by all sides to trigger a virtuous cycle of growth and peace.*** This fact is embedded in the view that the actions of one side directly impact the success of the others. Hence, the previous and politically simpler concept of sequencing will need revisiting. The success of Palestinian reform and political stability relies on immediate and free movement and access, a healthy private sector, and predictable donor assistance. The impact of donor assistance depends on critical PA reforms. Israel's facilitation of Palestinian movement requires realistic assurances of law and order. Another precondition relates to the situation in Gaza, without which a discussion of Palestinian restoration would at best be incomplete if not temporary.

6. ***This report evaluates the progress made since 2005 in creating the preconditions for a virtuous cycle of growth*** without which actions will yield few lasting results.

1 See Annex 1 for the Statement of the 2005 AHLC Chair.

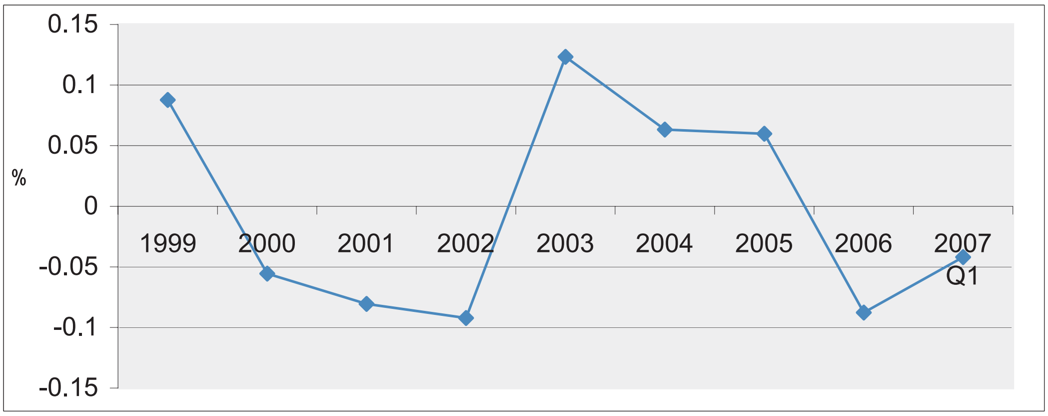
2. Events since London

2.1 Economic and Fiscal Events

7. ***The past two years since the London AHLC have witnessed a sequence of events that have at best retarded - and at worst, reversed - the precarious course of Palestinian institutional development and economic growth.*** The international response to the victory of Hamas in Parliamentary elections in early 2006 heralded an almost instant drop in services and incomes, and a polarizing effect on the populations of Gaza and the West Bank as access to incomes, donor assistance and crossings diverged (See Annex 6 for a summary of events since January 2006). At the same time, Gaza saw the brunt of Israeli restrictions and military action after the abduction of an Israeli soldier in the summer of 2006. Since London, Palestinians killed in conflict-related incidents rose from 210 in 2005 to 673 in 2006, and another 146 by June 2007. This does not include a new figure - 400 Palestinians dead in 2007 from internecine fighting between Palestinian factions – more than double those killed by the conflict with Israel. Over the same period, Israel witnessed 25 deaths in 2006 and 6 deaths in 2007, from various attacks including Qassam Rockets which have exceeded 2,700 since 2004. Palestinians injured over the two years reached more than 4,200, and Israelis injured more than 500.[2]

8. ***The decline of the Palestinian economy triggered by the Second Intifada in 2000 and compounded by recent events has left per capita GDP at $1,129 by the end of 2006, about a third less than it is level of $1,612 in 1999.*** The emerging recovery in 2003-2005 was again reversed in 2006 as a result of the fiscal crisis, and movement and access restrictions, following the Hamas victory in the PLC elections (Figure 1). GDP contracted by nearly 8.8% in 2006, and by a further 4.2% in the first quarter of 2007. This trend appears to be continuing in the second half of 2007.

Figure1: Economic Growth 1999-2007



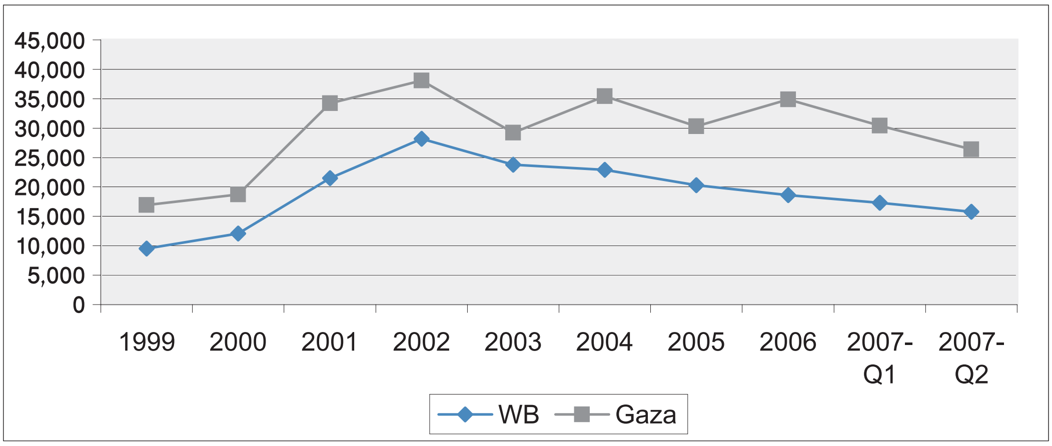
Source: PCBS and World Bank Staff Calculations

9. ***More troubling than the negative growth rate is the changing composition of the economy, as GDP*** is being increasingly driven by government and private consumption from remittances and donor aid, while investment has fallen to exceedingly low levels, leaving little of the productive base needed for a self-sustaining economy.

10. ***From the outset, Gaza has been hit harder by closures and economic crisis.*** Since Israel's disengagement from Gaza in September 2005, its borders have been closed for extended periods, inhibiting trade and the movement of people. Unemployment in Gaza rose from 30.3% in 2005 to almost 35% in 2006 (Figure 2), while unemployment in the West Bank actually fell

2 Source: OCHA, oPt Protection of Civilians Summary, June 2007.

Figure 2: Official Unemployment WB and Gaza

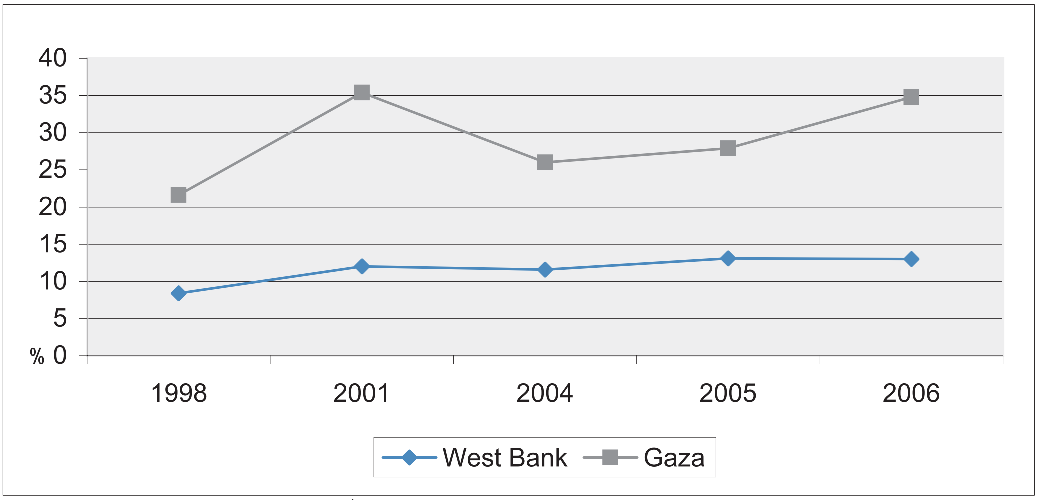


Source: PCBS Labor Force Servey

from 20.3 to 18.6%. In the first half of 2007, unemployment fell in both regions. But these figures are misleading. First, as a result of the fiscal crisis and its impacts on both public sector employees and private sector contractors, employment did not always translate into a regular salary payment. Furthermore, Gaza's unemployment rates were mitigated by temporary employment programs by UNRWA and others, which inject badly-needed funds but also conceal structural problems in the job market. Also, official unemployment data excludes workers who turn to unpaid family labor or seasonal agriculture to make up for lost jobs.[3] Thirdly, the figures do not include many discouraged workers who have left the labor market because they can not find employment. PCBS estimates that adding discouraged and underemployed workers would raise the 2006 unemployment rate in the West Bank to 28% and over 39% in Gaza.

11. ***A better measure of the extent of the crisis is the poverty rate, which has dramatically increased in the last two years.*** Despite large inflows of aid, the percentage of Gazans who live in deep poverty has been steadily increasing, rising from 21.6% in 1998 to nearly 35% in 2006.[4] With the continued economic decline in 2007 and the implementation of even more strict closures on Gaza the current poverty rate is almost certainly higher. This rate reflects actual consumption, which implies that without remittances and food aid the poverty rate is closer to 67%. The increase in poverty in the West Bank has been lower but still significant (Figure 3).

Figure 3: Deep Proverty 1998-2006

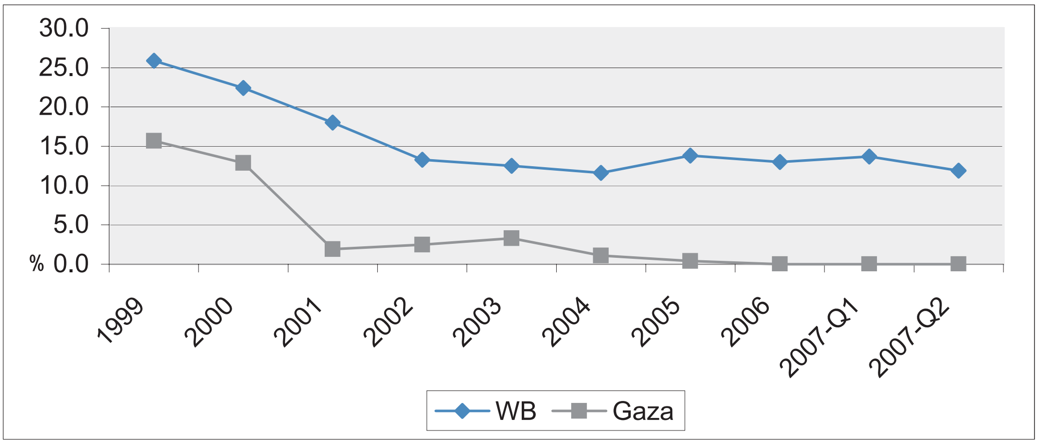


Source: PCBS unpublished estimates based on 6th Palestinian Expenditure and Consumption Servey

3 In 2006 PCBS estimates that 11.1% of employed workers were unpaid family members.
4 PCBS constructed the deep poverty line to reflect a budget for food, clothing and housing. For a family of six the deep poverty line in 2006 was NIS 1,837.

12. ***Adding to the downturn in the Palestinian economy is the reduction in the number of workers allowed in Israel.*** Population growth in WB&G is around 3.3% per annum; making it one of the highest rates in the world and creating an ever larger labor force. Israeli closure policies and political instability have discouraged investment in WB&G, making Palestinian private sector absorption of the labor force impossible. As such, the large surplus of Palestinian labor flocked to the Israeli economy where, throughout most of the last 40 years, they have received relatively higher wages than in WB&G. However, since the *Second Intifada*, Israel has been steadily reducing the number of permits for Palestinians to work in Israel, with the expressed goal of eliminating them in the near future[5]. The number of Palestinians working in Israel or its settlements has thus declined by nearly 55% since 1999.[6] The share of the work force employed in Israel has fallen from 23% to less than 10%[7]. All of these are from the West Bank as Gaza is now completely closed and no workers from Gaza are allowed into Israel (Figure 4). The loss of these relatively high paying jobs has been a devastating blow to the Palestinian economy and is a major factor in the growing poverty.

Figure 4: Share of WB&G Labor Force in Israel or Settlements



Source: PCBS 2006 Labor Force Servey

13. ***The WB&G faces an expanding labor force and a shrinking private sector. Thus, the civil service and security forces have become the only alternative for jobs.*** With few options at its disposal, and despite an unsustainable wage bill, the PA has resorted to absorbing workers as a way to alleviate poverty. At the same time, many workers have historically been hired to bolster political support. As a result, the public sector has grown by 60% since 1999 and in May 2007 stood at 168,319. The Caretaker Government has sought to roll this back by not paying 31,000 workers hired illegally since the end of 2005. However, the PA may find it politically challenging to reduce the work force any further. Unless the economy improves and the private sector is energized by a removal of movement and access restrictions, there remains little alternative to public sector jobs.

14. ***The economy's productive capability is diminishing making it increasingly donor dependent.*** GDP did not decline as much as expected after donors suspended direct aid to

5 The Israeli Ministry of Justice asserts that "The report notes that Palestinian links to the Israeli economy have driven up labor costs, without referring to the need to examine alternatives to these links, such as Palestinian employment in other regional states. In some of its previous reports, the World Bank began to recommend that Palestinian economy and labor look outside the Israeli market, and suggested that these options be examined. However, these states have systematically refused to employ Palestinians or establish joint industrial areas. It is strongly suggested that this report to the donors follow up on this broader and more realistic economic view, and enhance these recommendations." This assertion, however, does not address the impacts of Israel's policies on the mobility of Palestinian labor and on its growing dependence on Israeli labor markets since 1967. As such, a phased approach is required for such fundamental structural changes, matched with removal of restrictions against labor mobility.

6 These are PCBS figures taken from the 2006 Labor Force Survey. The number of workers includes both those that have permits to work in Israel and those that are working illegally.

7 The Israeli Coordinator of Government Activities in the Palestinian Territories (COGAT) has disputed this figure, noting that 42,000 Palestinians were allowed to work in Israel or the settlements by August 2007, up from 24,000 in May 2005.

the Hamas–led PA in 2006 (See Table 1). A combination of borrowing, remittances and increased aid that circumvented the PA allowed consumption to remain strong. PCBS estimates that despite the crisis, household consumption dropped by only 0.6% in 2005 and 2006. Nevertheless, output in the productive sectors declined in 2006[8]. The construction sector was the hardest hit, falling by nearly 13%. Industry fell by over 6% and services by nearly 4%. The IMF estimates that the public sector declined by 10 percent.

15. ***Investment has fallen to precariously low levels, endangering the prospects for long-term growth.*** Public investment to maintain or add infrastructure has nearly ceased and in the last two years almost all government funds have been used to pay salaries and cover operating costs. Already-low private investment is estimated by the IMF to have fallen by over 15% between 2005 and 2006. A recent World Bank Investment Climate Assessment found that less than a quarter of private sector firms made any investments in 2005/2006 and that manufacturing equipment were on average over 10 years old. Managers had access to finance, but were operating at less than 50% capacity, and saw few opportunities for investment under the current closure regime. Gross capital formation in the private sector fell by over 60% between 1999 and 2005 (See Table 1). The lack of investment in public infrastructure and private firms is eliminating any residue of the Palestinian productive base, making the economy more aid-dependent. When conditions improve, large investments will be needed just to rehabilitate assets let alone create new wealth.

Table 1: Composition of Real GDP in WB&G

	1999	2000	2001	2002	2003	2004	2005	2006
	(percentage change)							
Real GDP	8.9	-5.4	-15.4	-9.4	5.8	6.0	6.0	**-8.0**
Consumption	8.3	-1.9	-6.7	-7.7	4.5	8.6	5.6	**-4.8**
Private	8.3	-4.4	-5.4	-8.5	6.0	8.5	5.6	**-3.8**
Public	8.4	9.4	-11.6	-4.3	-1.6	9.5	5.7	**-9.4**
Investment	33.9	-27.0	-44.6	9.4	18.0	0.6	2.0	**-24.8**
Private	36.0	-26.5	-52.1	8.7	16.9	0.4	1.4	**-15.0**
Public	25.5	-29.4	-9.9	11.1	20.6	1.2	3.3	**-47.1**
Exports	3.7	-6.8	-34.7	-13.0	-4.0	13.5	8.2	**-11.6**
Imports	19.1	-13.9	-18.1	-2.0	4.8	9.9	4.4	**-8.5**
Change in inventories	62.3	-73.5	-8.9	-36.7	--	--	--	**--**
Real GDP/capita	4.4	-9.3	-18.7	-12.6	2.1	2.5	2.5	**-10.9**
Real GDI/capita	3.4	-7.4	-8.1	-7.2	-3.8	0.9	1.8	**-3.2**

Source: PCBS and IMF Staff Estimates.

16. ***The unpredictability of the border openings has prevented firms from importing inputs and exporting products in a planned and profitable way.*** In response, enterprises have closed and large amounts of financial and human capital have fled. The pace of capital flight reached an all-time high in the last two years. Investors have always been wary of investing in WB&G, with almost no foreign direct investment in the past few years and most local capital is kept abroad or invested in real estate or short term trading activities. Now local entrepreneurs are closing existing operations and moving them to neighboring countries. This capital and the entrepreneurial and technical talent that go with it are irreplaceable and unlikely to return unless conditions dramatically improve.

17. ***Despite the economic downturn, bank deposits continue to grow reflecting the continued inflows of aid and remittances.*** Private sector deposits increased by about 8% in 2006, and 6% in early 2007, compared to 2% in 2005. While a breakdown between businesses and

8 The exception was agriculture where a large olive harvest allowed agriculture to post a 7% gain.

households is not available, this expansion seems to reflect continued inflows from abroad, which are being used for consumption rather than investment. No comprehensive data are available on remittances, but interviews with commercial banks indicated that private inflows from abroad picked up in 2006 and continued to grow in 2007. Despite the crisis, banks continued to extend credit to the private sector, albeit at a much slower pace than in 2005.

18. ***Trade data indicate a significant decline in exports from WB&G but a smaller fall in imports.*** Most trade takes place with Israel and much of that is done informally and not reported. While trade data are not readily available, the Palestinian Monetary Authority (PMA) publishes estimates that indicate a significant economic slowdown. In 2006 imports declined by 10% but exports fell by close to 16%. The fall in trade in Gaza overshadowed the decline in West Bank. For most of 2006 and 2007 the borders there have rarely been open. Since the June 2007 events, these borders have been completely shut and there have been no commercial imports or exports.

19. ***The social impacts of the current crisis are no less significant, but are often overlooked.*** Health indicators in the WB&G have seen a steady drop over the last three years. Chronic diseases have surged 31% since 2005. Chronic malnutrition among children under five jumped 3% between 2004 and 2006. Ten out of every 100 children under 5 are stunted (13% in the Gaza strip and 8% in the West Bank).[9] The number of households with safe drinking water has also dropped by more than 8% between 2000 and 2007.[10] In the education sector, school enrolment is high but declining. The quality of education is also suffering because schools lack textbooks and other materials. The increasing insecurity, especially in the Gaza strip, is having a devastating effect on the performance of students: failure rates in mathematics are nearly 80% and 40% in Arabic.[11] In the West Bank, closures and restrictions on movement and access, especially due to the Separation Barrier are preventing many students and teachers from reaching their schools.

20. ***Furthermore, the continuing conflict is perpetuating an internal cycle of violence, fragmenting social cohesion and affecting psychosocial well-being.*** A 2006 survey concluded that nearly three quarters of Palestinians suffer from severe depression as a result of the current situation.[12] Women, who historically play a key role as income providers, are increasingly relegated to the informal market as a result movement and access restrictions. Their participation in the labor market, at 15.2%[13], is amongst the lowest in the world. Also, since September 2000, youth have been caught literally and figuratively in the crossfire of the conflict. Nearly 75% of the injured during the second *Intifada* were between 10 to 29 years old.[14] Youth have also been active participants in the *Intifada* and have therefore suffered both violence and imprisonment with its consequent impact on mental health and physical disability. They also suffer from high rates of unemployment (60 percent[15]) and are excluded from formal mechanisms of decision making.

The Fiscal Spiral

21. ***The PA's longstanding fiscal crisis deepened further in 2006 as a result of Israel's withholding of Palestinian clearance revenues and the aid boycott, resulting in a deficit of over $1 billion.*** Many donors cut off direct aid to the PA, but continued providing funds through the EU TIM, the Office of President Abbas, and other mechanisms. The IMF estimates that external aid towards recurrent operations reached $740 million in 2006;

9 Palestinian Family Health Survey, 2006.
10 PCBS, "Special Report on the 59th Anniversary of the Nakba," May 14, 2007.
11 UN News Service, "With Education Standards in Gaza Plummeting, UN Launches New Action Plan," 5 September 5, 2007
12 Near East Consulting, "Depression in the Occupied Palestinian Territories," Sept 2006.
13 PCBS, Labor Force Survey, April – June 2007.
14 PCBS, "Palestinian Youth: Facts and Figures," 2001. http://www.unfpa.org/adolescents/opportunities/palestina/docs/facts+figures%20Palestine.pdf
15 PCBS, Labor Force Survey April – June 2007.

over double the amount in 2005. Yet, total resources for recurrent expenditures fell by a third. About $0.9 billion in expenditure arrears were accumulated, including $385 million in arrears on net wages (excluding those related to pensions and other wage deductions), $175 million in arrears on pension contributions (employees' and government's contributions), and $200 million in arrears to the private sector (including Israeli suppliers and unpaid domestic tax refunds).

22. ***Of an estimated $770 million in Palestinian clearance revenues collected by Israel in 2006, only about $344 million was released to the PA due to deductions to for the payment of utilities.*** In addition, domestic revenues fell from $476 million in 2005 to around $395 million in 2006. Tax revenues remained about the same despite the fall in economic activity and government strike.

23. ***The PIF's assets continued to be depleted with about $190 million being used to pay dividends and to finance the PA in 2006.*** This was largely used to pay for fuel imports and cover debt service obligations to banks. Banks, fearing foreign anti-terrorism laws, sharply reduced lending to the PA and liquidated PIF assets held as collateral.

24. ***Non-wage operating costs, transfers, and spending on utilities and energy continued to grow despite the decrease in funding.*** The fiscal crisis meant that spending had to be prioritized, wages being the highest. However, as of the second quarter of 2006, wages could only be partially paid. Overall, including TIM payments, civil servants received about 60-65 percent of their wages. Yet these payments absorbed nearly half of the available resources. Social benefits and spending on utilities and energy took up the rest. Payments to cover production and consumption of energy and utilities, including subsidies of domestic petroleum products, reached almost $400 million.

25. ***The PA's underlying financial position has continued to deteriorate at an increasing rate in 2007.*** In the first half of 2007 the deficit was likely above $100 million a month. The largest expense is the wage bill, which on a commitment basis grew by nearly 20 percent in 2006 (See Annex 3).[16] Despite the Government's recent efforts to limit the growth in the public sector, the payroll remains at an unsustainable level. Even taking into account Israel's decision in June to release withheld clearance revenues[17], and even with a recovery of domestic tax revenues, the wage bill due now exceeds total government revenues. This implies that all non-wage expenditures such as energy and infrastructure would have to be covered from other sources.

26. ***The PA has only a limited ability to increase domestic revenues.*** PIF assets have been depleted and the PIF cannot be expected to maintain its previous level of funding. There is room for increased efficiency in tax collection, but this will not offset the loss in VAT and customs duty from the suspension of Gazan trade[18]. Thus, with deteriorating domestic revenues, most of the clearance revenues will go towards funding recurrent costs, and the PA will continue to accumulate arrears.

27. ***Nearing the end of 2007, the PA finds itself with a large current deficit and a significant stock of arrears.*** External assistance has been unusually high in 2007; about $560 million in the first half of the year. In the absence of equal or greater amounts of assistance, the year 2008 may herald an extremely precarious fiscal situation for the PA, with a large deficit, a substantial stock of arrears and falling domestic revenues. Looking

16 To some extent this reflects the full-year effect of wage increases granted in 2005 but it is also due to the increased number of government workers.

17 The GOI decided to release the withheld clearance revenue and resume monthly transfers with a first installment of NIS 500 million on July 2nd through the Single Treasury Account. The total stock of revenues collected as of July, net of deductions for payments of utilities (and net of the transfers made) was preliminarily estimated at NIS 2.7 billion. Of that amount, close to NIS 400 million has been attached by Israeli courts. The Israeli MoF agreed to release monthly installments of NIS 370 million until the stock of withheld revenues is fully repaid. Regular monthly transfers started in early August.

18 It is unclear how the drop in Gazan trade will affect tax revenues from West Bank enterprises. On the one hand, Gaza is an important market for a number of West Bank enterprises. On the other, many West Bank enterprises are reporting an increase in business as Israeli and other firms shift away from Gazan enterprises.

forward, the PA forecasts a need for at least $1.62 billion in donor assistance per year to achieve fiscal sustainability[19]. Of this amount, 94% will need to go to meet recurrent expenditure needs, as opposed to development assistance. The PA will soon unveil a three-year Palestinian Reform and Development Plan (PRDP 2008-10) based on a Medium Term Expenditure Framework (MTEF) approach. The will begin to address longstanding disconnects in policy-making, planning and budgeting processes. Its success will depend partly on the credibility of the reform agenda and pragmatic plans to achieve fiscal sustainability. However, these steps must be matched with predictable donor assistance and a growing private sector that will provide a larger tax base and alternatives to public sector employment. The removal of movement and access restrictions, and the ability of the Palestinian private sector to exploit its trade potential, will both increase the PA's revenues and allow it to reduce its expenditures.

2.2 A Note on the Gaza Strip

28. ***It is difficult to make definitive statements on Gaza without appearing to encroach on the politics of the current Hamas-PA conflict*** following the June violent takeover of Gaza by Hamas militants. However, all actors have expressed a desire to shield Gaza's 1.5 million people from the effects of the current standoff. Unfortunately, action on one relates to progress on the other. Similarly, any practical discussion on reducing the hardships on Gaza's population must confront the current policy of restricting entry of all but humanitarian commodities and consumables as a way to affect a political outcome.

29. ***Thus, the calls for the entry of solely humanitarian goods are a necessary but insufficient condition for the survival of the Gazan economy, which is already in dire straits after two years of restrictions.*** A sustainable solution must include commercial imports and exports at the very least at levels similar to those pre-crisis which were already deemed insufficient and not meeting the minimum targets set in the AMA.

30. ***Without prejudice to the legality of the events of June 2007, or of the position of the Caretaker Government, the observable fact is that any economic backbone and private sector vitality in Gaza risks collapse if the current closure policy continues.*** As a policy measure, this is a blunt instrument that can neither be regulated nor fully reversed. At best, it risks amplifying the economic disparities across borders.

31. ***In 2005 the Bank had already warned of dire impacts on the Palestinian economy if commercial trade continued to be impeded.*** Unfortunately, these projections are gradually being realized. PCBS notes that the percentage of Gazans who live in deep poverty has been steadily increasing, rising from 21.6% in 1998 to nearly 35% in 2006.[20] With the continued economic decline in 2007 and the recent closures on Gaza the current poverty rate is almost certainly higher. This rate reflects actual consumption, which implies that without remittances and food aid the poverty rate is closer to 67%. The increase in poverty in the West Bank has been lower but still significant.

32. ***In Gaza, the impact of two years of closures since disengagement and the most recent restrictions on imports and exports create a new extreme scenario.*** Over 54%[21] of employment in Gaza is private sector-driven, representing more than 100,000 jobs. Of these, 35,000 workers- 18,000 skilled- operate the industrial sector. Recent data on Gaza's GDP are not readily available, but Gaza contributed $1.3 billion to Palestinian GDP in 2003 (44%), of which the private sector is the main economic driver. According to the Palestinian Private Sector Coordination Council (PSCC), the current restrictions have led to the suspension of 90% of Gaza's industrial operations, including

19 Ministry of Finance, Budget Directorate.
20 PCBS constructed the deep poverty line to reflect a budget for food, clothing and housing. For a family of six the deep poverty line in 2006 was NIS 1,837.
21 Q1 2007 as reported by PCBS Labor Force Press release, July 2007

domestic and export-oriented manufacturing and agriculture, and services[22]. They can access neither the inputs for production nor the crossings to export what they would produce. Also observable is the emergence of a black market for consumer goods, and price hikes. Employment in construction and building has also been impacted by the suspension and cancellation of most construction projects, including USD $160 million in projects funded by UNRWA, UNDP, and others due to lack of construction materials.

33. ***The likely lay-off of over 30,000 industrial workers alone[23] resulting from the restrictions would lead to an unprecedented private sector driven-unemployment level of about 44% in Gaza. Recent employment generation schemes may reduce this figure, but these are temporary fixes that do not alter the emerging structural crisis in Gaza's labor market.*** Interestingly, the continued payment of civil servant salaries in the Strip- a welcome event- will still generate income to drive some degree of local demand for finished goods. Therefore, the end result would be a closure regime that serves little in the short-term, but would in the medium-term hollow out the Gazan economy of any residual production potential, transforming it into a consumer economy driven by public sector salaries and humanitarian assistance- both directly and indirectly financed by the donors.

Table 2: Industrial Decline in Gaza

	June 2005 (pre-disengagement)	Week 1, July 2007
Number of Working Establishments[1]	3,900	780
Number of Employees[1]	35,000	4,200
Exports from Gaza (truckloads)[2]	748	0

Source: PalTrade Presentation to PSCC, July 2007.
1 Source: original data from Industrial associations in Gaza reported to PalTrade
2 Source: PalTrade

34. ***The impacts of the closures will become less reversible with time.*** Most Gazan industries are export-oriented and have purchase and supply contracts with Israeli and other firms[24]. Gazan manufacturers import 95% of their inputs. About 76% of their furniture products, 90% of their garments and 20% of their food products are exported to Israel, and some to the West Bank. By mid July, the Palestinian Shippers' Council estimated an accrued $3,000,000 in storage and demurrage fees, with 1,600 containers worth over $130,000,000 waiting at the freight terminals and the ports.[25] Naturally, Israeli and other suppliers and purchasers must maintain their operations and will soon cancel contracts and seek alternative supply chains elsewhere[26], lest they also risk bankruptcy.[27] Experience has shown that the repair of business relationships, and the return of capital and skilled labor, takes time. And in the case of Israel and the Palestinian Territories, such business relationships are an important pillar of an eventual scenario of peace and cohabitation. Sadly, informal estimates suggest that nearly 100 enterprises have moved from Gaza within the last two years.[28]

35. ***The agriculture sector has also been badly hit. Nearly 5,000 farmers depend on the export of cash crops for Gaza.*** Production in 2007 was expected to be around $12m all of which will be lost due to the border closures. In addition, the agriculture sector is completely dependent upon imports of fertilizer, pesticides, packaging material and other inputs. Without these inputs

22 At the time of writing this report, PSCC figures showed that 780 of 3,900 industries maintained operations in Gaza, and 4,200 of 35,000 remained employed.
23 This does not include labor in the agriculture, construction and service sectors.
24 Private Sector Coordination Council (PSCC), Effect on Private Sector in Gaza, July 12, 2007.
25 Palestinian Shipper's Council, Importers in Gaza: Edge Towards Crisis, July 2007. Palestinian firms are fully dependent of Israeli ports. 80% of Gaza importers use Ashdod port. The remaining 20% use Haifa port or Ben Gurion airport.
26 At the time of this note, 1,000,000 finished garments and 400 containers of furniture were in storage, awaiting export to Israel.
27 According to PFI, as of July the confirmed business losses were $20.6 million, in addition to stoppage of $160 million in construction contracts.
28 From interviews with local private sector organizations, government officials and development agencies. One organization has a confidential list of over 70 enterprises that have moved operations out of Gaza.

private sector organizations estimate suggest that agriculture output will decline by fifty percent in 2007.

36. ***To arrive at a speedy and workable solution, it is important to analyze the dynamics of the closure regime.*** While the Karni Crossing has been closed since June, a pre-screened set of goods has been entering through the Sufa and Kerem Shalom Crossings. However, unlike Karni these crossings lack the infrastructure and the capacity to accommodate all goods, primarily inputs (e.g., piped products such as CO2 gas, steel, stone, etc.).[29] Thus, only limited types of goods enter. The reason cited for the closure of Karni by the GOI relates to the lack of security and logistics counterparts on the Gazan side.[30] However, the fact that creative ways have been found for the other crossings would imply that options exist for Karni. Gazan private sector officials have sought the PA's approval to explore a workable solution for the operation of the Crossing, and continue to seek a PA policy and dialogue with GOI for the entry of commercial goods into Gaza.

37. ***In addition, the goods allowed in have excluded inputs for manufacturing operations in Gaza.*** Finished goods are allowed to enter, but not those that would trigger commercial activity. Recently, the GOI allowed finished books to enter Gaza for use by UNRWA students, but excluded paper to produce the goods in Gaza. Similarly, World Bank surveys of Gazan industrialists indicate that while soda drinks are allowed to enter Gaza, the CO2 required to produce them in Gazan factories are forbidden. Notebooks are entering, but not the paper to make notebooks locally. Many other cases abound, including inputs for tissue paper, bottled water, etc. This issue must be addressed urgently at the level of the joint security committees of the PA and GOI.

38. ***A recent trial export of seven truckloads of potatoes out of Kerem Shalom into Israel on August 28th was a welcome first step.*** It is also a testament to the possibility, if the political will exists, to allow for the movement of commercial supplies in some form or another. At the same time, the costs and organizational complexities of that shipment also attest to the need for a quick opening of the Karni Crossing as it can accommodate a greater flow of goods than the other crossings.

39. ***At the same time, the Hamas control of Gaza is incurring a direct negative impact on the economy.*** Without delving into the political context of the current stalemate, it is evident that the current position in Gaza is also a function of Hamas' political and de facto security policies. Hence, it is a party that also bares responsibility for creating a political and logistical environment in which all sides can reengage in Gaza. It must be noted that attacks on the crossings continue to take place, greatly undermining any efforts to shield Gaza's population and private sector from the impacts of the current situation.

40. ***The demographic trends in Gaza need to be recognized, not only in terms of unshackling commerce but also in terms of donor assistance.*** It is noteworthy yet often overlooked that 50% of the Gaza's population is under the age of 15 and will soon be thrust into a barely-existing labor market. Thus, the work of donors and the PA to create the basis for sustainable jobs in Gaza is as critical as ever. Clearly, there are practical and legitimate concerns by the international community on the *modus operandi* of donor-financed project implementation in Gaza, including the flow of funds. However, recent effective steps by the PA to develop 'direct payment' mechanisms to contractors and laborers in Gaza offer a critical window for donors to explore.

29 In rare cases, Karni has accommodated up to 400 truckloads per day. Gazan private sector representatives state that both Sufa and Kerem Shalom can accommodate up to 120 truckloads per day.

30 Israel maintains its no-contact policy with Hamas.

3. Progress since the 2005 AHLC: Revisiting the Preconditions

41. ***At the 2005 AHLC Meeting, the World Bank suggested the need for progress in lifting Israeli closures, Palestinian governance and security, and donor coordination as prerequisites for Palestinian economic recovery.*** The following section takes stock of the progress on these preconditions since the AHLC meeting, and revisits the previous recommendations to assess their continuing validity. This section is not intended to offer a complete analysis of all of the relevant sectors or reforms, many of which fall outside of the mandate and competency of the World Bank. Rather, the goal is to provide sufficient analytical background to assist the PA, GOI and donors in the hope of informing the concrete policies that are necessary, looking forward to the proposed Donor Conference in December, to revive the Palestinian economy, and the overall peace process.

3.1 Movement and Access and the 'Private Sector Potential'

Summary: **The main challenge for Palestinian recovery remains the comprehensive restrictions on movement and access imposed by Israel, which go beyond concrete and checkpoints to a set of collective policies that combine to stunt economic growth. Beyond movement within and across Palestinian Territories, these policies also restrict access to domestic and international markets, land, water and other natural resources, and donor-financed projects for 60% of the West Bank (Areas C). While there is consensus on the legitimacy of Israel's security concerns, it is difficult to reconcile this with the clear correlation between access restrictions and the protection and expansion of Israeli settlement activity in the West Bank. The commitments entered to by Israel under the 2005 Agreement on Movement and Access (AMA) remain as unfulfilled as they are critical. The AMA must be implemented immediately. Moving forward, the full implementation of the AMA must be seen as an important step towards stability, not a consequence of it.**

42. ***The Agreement on Movement and Access (AMA) signed in November 2005 sought to unshackle the movement of Palestinian goods and people (See Annex 5).*** But the main challenge for Palestinian businesses remains the closure regime.[31] The World Bank's 2006 Investment Climate Assessment (ICA) revealed that shrinking market access and hindered movement are the main constraints for Palestinian enterprises, as uncertainties in the delivery of inputs and products hike up costs. That, combined with increasingly limited available markets, has stunted the investment potential of Palestinian entrepreneurs.

43. ***While the Israeli economy has evolved from agricultural and low-value manufacturing to high-end, high-technology products, the WB&G remain unindustrialized,*** with most businesses having fewer than 5 employees. And even under these circumstances, the prospects for relatively competitive low-end Palestinian goods are grim. The Palestinian links to the Israeli economy have driven up labor costs, making it an anomaly, a third word economy with first world wage rates.

31 The closure system effectively partitions the West Bank into a northern, a central and a southern economic zone, bounded on three sides by the Separation Barrier and to the east by a Jordan Valley that is increasingly difficult for Palestinians to access.

44. ***As such, Israel's review of the current restrictions regime is critical, including recognition that these restrictions go beyond concrete walls and checkpoints,*** towards a confluence of policies that combine to stunt the prospects of Palestinian self-sufficiency. And the term 'access' goes beyond the physical movement of person or good- it includes access to a wide range of resources needed for sustenance and growth.

45. ***It is recognized that Israeli security concerns are valid and undeniable.*** The impacts of Qassam rocket attacks on Sderot, and other past or potential attacks on Israel, are not disputed. However, as noted by the UK Economic Secretary to the Treasury at a June 19 speech, "… a viable economic roadmap will not be possible unless a better balance can be struck between short-term security on one hand and on allowing movement and access on the other, necessary to promote both security and prosperity for the medium term…"[32] This implies a revision of Israel's approach to security as a balance between short and long-term gains, matched with PA policies that recognize the potentially devastating impacts of short-term breaches in security that have halted previous attempts at reconciliation, and that have also impacted Palestinian economic recovery.

46. ***Analysis of movement and access restrictions suggests that they primarily serve to expand and protect settlement activity***[33] and the movement of settlers and other Israelis in and out of the West Bank. There are currently 149 settlements in the West Bank, including East Jerusalem, and roughly 100 "illegal outposts" that lack Israeli government approval, but that nevertheless remain.[34] The approximately 450,000 settlers living there are 63% more than at the time of the Oslo Accord period in 1993.[35][36] Some 38% of the West Bank has been confiscated for current or future settlements, outposts, closed military areas, municipal boundaries, and settlement regional jurisdiction.[37]

47. ***The result of this is that a vast amount of Palestinians cannot access homes and services, land, domestic and international markets, water and other natural resources, and even donor finance in areas C.*** These are analyzed in greater detail below.

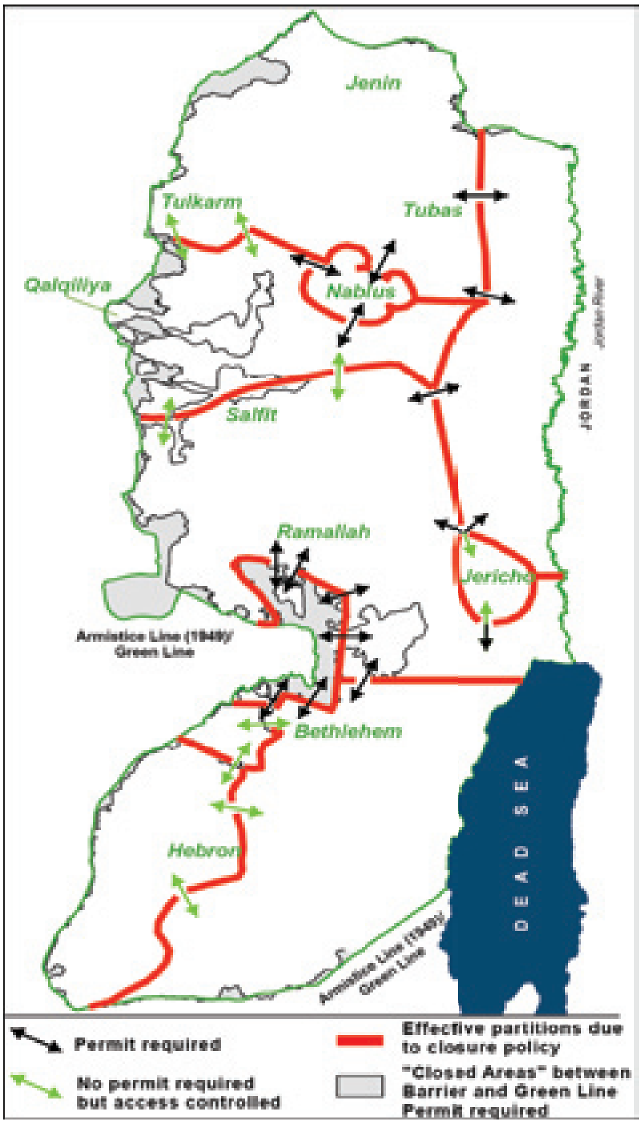
Access through the Separation Barrier and to the Seam Zone

48. ***To provide security for Israel and settlements and closed areas in the West Bank, Israel has constructed the Separation Barrier,***[38] three-quarters of which departs from the 1949 Armistice Line into the West Bank[39], creating a "seam zone" - a closed military area between the barrier and the Green Line- that consumes 8.5% the West Bank. As a further defense measure, Israel requires a "buffer zone" of 150-200 meters east of the wall.[40][41] Another 3.4% of the West Bank to the east of the Barrier is completely or partially surrounded, creating small Palestinian enclaves where permits are needed even by those living there.[42] The Barrier and Seam Zone have thus created additional Palestinian lands that are inaccessible to Palestinians. Eventually,

32 Lecture by the Economic Secretary to the UK Treasury, Ed Balls MP, on "Towards a Middle East Economic Roadmap" given at the Royal Society of Arts, London, June 19, 2007.
33 COGAT asserts that these restrictions are also based on security considerations, and 'not necessarily' the growth of settlements in the West Bank, adding that many of the restrictions would be removed once the security environment improved.
34 PCBS Settlements Annual Report, "Israeli Settlements in the Palestinian Territory," July 2007.
35 OCHA, Humanitarian Impact of Israeli Settlements and other Infrastructure in the West Bank, June 2007.
36 COGAT disputes these figures. They assert that there are 120 settlements in the Judea & Samaria region, accounting for 275,248 inhabitants. However, these figures do not include parts of municipal Jerusalem, which is the basis for OCHA's calculation.
37 Ibid. page 9.
38 Bimkom – Planners for Planning Rights and B'Tselem, "Under the Guise of Security – Routing the Separation Barrier to Enable the Expansion of Israeli Settlements in the West Bank", (December 2005).
39 COGAT has noted that this is a temporary barrier for security purposes. The Barrier, and the security zones, are to be re-declared periodically based on the security environment.
40 UN OCHA, "Preliminary Analysis of the Humanitarian Implications of the April 2006 Barrier Projections".
41 COGAT asserts that the buffer zone serves critical security requirements, ensuring that no new construction is higher than the Barrier and therefore undermines its protective nature.
42 B'Tselem, "Separation Barrier", www.btselem.org.
43 Recent figures from OCHA's Humanitarian Impact of Israeli Settlements and other Infrastructure in the West Bank, June 2007 (p. 46) assert that 60,500 residents of 42 villages will be in the Seam Zone.

about 50,000 residents of 38 villages will be in the Seam Zone[43] or the enclaves created by it[44]. About 61,000 Palestinian residents of East Jerusalem- as well as half a million Palestinians within 1 km outside of the Barrier- will be separated from family and trade networks, and municipal services.[45]

Figure 5: Breakup of Economic Space West Bank Fragmentation Map



Source: OCHA oPt, 2007

Access to Domestic Markets

49. ***Israel's withdrawal from Gaza on September 12, 2005 resolved the internal movement restrictions there. However, access between the West Bank and Gaza and movement within the West Bank remain restricted.*** In the West Bank, a confluence of policies, administrative practices, and physical impediments have fragmented the territory into ever smaller and more disconnected cantons (see figure 5).

50. ***In addition to a two-tiered road system where 1,661 km is reserved for Israelis and settlers[46], the UN estimates that the number of fixed physical impediments (checkpoints, roadblocks and gates) has gone from 376 in August 2005 to 541 in July 2007***. Likewise, flying checkpoints have increased from 272 in June 2005 to 524 in June 2007. [47] The Israeli authorities assert that there are only 442 impediments, of which 71 are manned[48]. Whatever the number may be, these impediments, along with the permit policies in pace, present a critical constraint to the survival of the Palestinian economy. These administrative obstacles, rooted in military orders associated with the occupation of WB&G, have created uncertainty, raised transaction costs, and have shrunk markets. World Bank analysis suggests that, between 2000 and 2006, the number of Palestinian enterprises in the West Bank that sell to customers outside their local metropolitan area declined by 30%.[49]

51. ***GOI has recently committed to removing some impediments and providing several hundred permits to categories of Palestinian businessmen.*** While this is a welcome initiative, incremental steps are unlikely to

44 COGAT asserts that only 7,000 Palestinian residents are within the Seam Zone.
45 The Israeli Ministry of Justice has noted that this section only addresses the "…negative impact of the Security Fence on the Palestinian economy. However, it does not make mention of the fact that the Security Fence allows Israel to ease checkpoints and restrictions on movement within the West Bank. Furthermore, the relative security the fence provides, and its clear assistance in lowering terrorist activities, allows for an environment where mutual trust can be regained, and economic projects re-started, including foreign investments…"
46 COGAT notes that the Israeli authorities have invested NIS 1 billion in 'fabric of life' roads intended to provide adequate and effective solutions for Palestinians impacted by the current closures.
47 See the OCHA website for movement monitoring notes that track impediments; URL: www.ochaopt.org.
48 COGAT also notes that, of these 71 manned checkpoints, half are in areas bordering Israel, and the other half are in high security areas in the West Bank.
49 See West Bank and Gaza Investment Climate Assessment, World Bank, March 2007 URL: www.worldbank.org/ps

lead to sustainable improvements as they have historically lacked permanence, and have been withdrawn or replaced by other restrictions. Moreover, economic recovery will remain elusive if large areas of the West Bank are inaccessible for economic exploitation and restricted movement remains the norm for the most Palestinians, their products, and their investment funds.

52. ***While East Jerusalem has historically been a hub of Palestinian economic and social activity, administrative obstacles, settlement expansion and the Barrier are severing it from the WB&G.*** The World Bank's analysis shows that the percentage of West Bank firms selling into East Jerusalem dropped from 21% to 18% between 2000 and 2005.[50] Gazan businesses are almost entirely shut out of the Jerusalem economy. There are also humanitarian impacts to this, involving a 50% drop in access by WB&G residents to critical tertiary health care in East Jerusalem's six hospitals.

53. ***Moreover, much of the Jordan Valley- a source of valuable agribusiness and tourism potential- has been off-limits to most Palestinians*** per military orders issued in August 2006. Despite the reversal of some orders in May 2007, Palestinians who do not have residency permits still cannot enter the Jordan Valley by vehicle.[51]

54. ***This stranglehold is augmented by recent practices on the issuance of temporary visas to eligible foreign nationals*** for family, tourism, humanitarian, investment and academic visits. Many documented cases abound regarding citizens from North America, Latin America, and the European Union being denied visas or issued ones for extremely short duration. These effectively discourage individuals from traveling to the Territories to tour, visit or work. A June 2007 survey by the Campaign for the Right of Entry/Re-Entry found that 30% of applicants were denied visa extensions to the West Bank. Also, foreign nationals continue to face difficulties in acquiring residency, particularly for family reunification. The same NGO noted that 500,000 to 750,000 applicants to Family Reunification may be forced to leave the West Bank as a result. This has had a direct impact on the Palestinian economy by reducing consumption and investment, as well as by eliminating the injection of foreign expertise and skills to upgrade the productivity of local businesses.52

Access to Israeli and International Markets

55. ***Gaza's post-2005 disengagement economy has seen a sharp reduction in external access.*** With the exception of aggregates and fuel through Nahal Oz, Gaza has a single access point at the Karni/Al-Montar Border Crossing to sustain nearly 1.5 million people. Even prior to the June 2007 events in Gaza, the operation of Karni was suboptimal from a trade perspective. Throughout 2006, its openings were erratic and involved varying hours, and inefficient screening[53]. Despite the AMA provision for continuous operations and for 150/day truck exports by January 2006 and 400/day truck exports by end 2006, an average of 16 trucks crossed daily in 2006. By end July 2007, the average had increased to 32 a day[54]. Since June 2007, Karni is no longer used except for limited imports of grains and animal feed[55]. Currently, the Sufa and Kerem Shalom are being used for the import of humanitarian goods into Gaza. These crossings are neither well equipped nor prepared to handle any large trade capacity, and are not opened regularly.

50 Ibid.

51 COGAT informed the World Bank that the key obstacles to movement and access in the Jordan Valley had been resolved, comprising the opening of the Tayseer, Beka'ot and Hamra Crossings, and the ability of Palestinians to enter the Jordan Valley 'on foot'.

52 In response, COGAT noted that foreigners from countries with visa agreements with Israel are able to enter freely, unless there are 'security or other prohibitions', adding that there are also 54,000 foreigners who entered with visas prior to the 2000 change in policy, and who now reside illegally in the WB&G. COGAT also added that 800 permits were allocated for 'senior businessmen' to enter the WB&G, although 697 were issued based on demand. Another 14,000 permits were allocated towards applications by local traders with Israel. However, COGAT confirmed that since 2000, family reunification has been frozen based on a decision of the Israel High Court of Justice.

53 According to the World Bank and OCHA, Karni was closed for most of 2006. The Israeli authorities dispute this figure, noting that Karni was closed for 104 out of 203 operating days. COGAT also asserts that the improvements made in the Karni Crossing added 210,000 jobs to Gaza's economy over the course of one year.

54 Paltrade, Al Montar/Karni Terminal Movement Monitoring Monthly Report- August 14, 2007.

55 Since the incidents at Gaza, the Israeli Customs Authority cancelled the customs code for all products to Gaza, so goods destined there can no longer be imported through Israeli ports.

56. ***West Bank trade with and through Israel is administered by six "back-to-back" commercial crossings.***[56] Once the Barrier is complete, all trade with and through Israel will have to pass through them.[57] The crossings will have a total capacity of around 2,000 trucks per day (4,000 if operated with two shifts) for both imports and exports.[58] Beyond this, most Palestinian trade to international markets goes through Israeli ports (Haifa, Ashdod, or Ben Gurion Airport).

57. ***As such, Palestinians are dependent on Israel for access to markets.*** Alternative trade routes are effectively non-existent, thus inhibiting the 'healthy competition' in routes that virtually all economies enjoy. Palestinian traders must turn to Israeli middlemen and service providers to facilitate imports and exports, making them vulnerable to changes in border policies. For example, recent requirements at Ashdod Port for Palestinian goods to be held for 48 hours caused many goods to miss sailings and remain at the port for several days. Air cargo originating in the Territories cannot be shipped on passenger airlines out of Ben Gurion, thereby limiting the frequency of services for high-value, time-sensitive goods. The only remaining possibilities for trade route alternatives are either from Gaza to Egypt through Rafah, or from the West Bank to Jordan through Allenby. Even before the events in Gaza, there had been no progress on a Palestinian port or airport as planned under the AMA.

58. ***Until the June events in Gaza, efforts were underway to open Rafah as an export gate for Palestinian products to and through Egypt***. World Bank analysis had shown this to be logistically and financially competitive with Israeli ports, and critical for Palestinian goods to take direct advantage of favorable treatment in Arab and other markets. Since November 2005, Rafah was successfully operated by the PA, with third party monitoring by the EU Border Assistance Mission (EUBAM) with additional scrutiny through CCTV cameras accessible to Israeli security. The crossing was fully operational until the abduction of an Israeli soldier near the Gazan border, after which it would open only intermittently. And after June 2007, the topic of exports through Rafah would be suspended indefinitely. However, the underlying economics of the Rafah crossing continue to hold, and its opening for exports remains a key step in the optimization of a Palestinian trade route.

59. ***By the same token, the West Bank economy is larger than Gaza's, and producers there also need direct access to the world market.*** An efficient and reliable crossing to and through Jordan would provide similar advantages of direct market access from the West Bank. Given that the Damieh Crossing with Jordan has been closed since September 2005 and can no longer be used for Palestinian trade, the only option for Palestinians for direct access to international markets is Allenby Bridge. But Israel's removal of access restrictions on Palestinians into the Jordan Valley is a necessary precondition to develop a Jordan trade corridor.

Access to Donor Finance-Development in Area C

60. ***The Oslo Accords grant the GoI military and civilian control over Area C,*** representing about 60% of the West Bank, and which represents the only fully contiguous area there-. This area surrounds and divides Areas A[59] (full PA military and civilian control) and B (PA civilian control, GOI military control). Area C also represents a key resource to accommodate the natural expansion of Palestinian demographics and economic base needs.

56 The main commercial crossings are Jalameh (north of Jenin), Bisan/Bardala (northern Jordan Valley), Irtah/"Sha'ar Efrayim" (south of Tulkarem; referred to as Taybeh), Beitunya (southwest of Ramallah), Tarqumia (northwestern Hebron district), and Terminal 300 (near Bethlehem).

57 Recently, the UN and other agencies were informed of new Israeli requirements once the Barrier is complete for moving aid goods through a fewer number of crossings using a 'back-to-back' system. This will raise costs as twice as many trucks will be needed, and as goods will have to be palletized. OCHA predicts a resulting tenfold increase in costs. Furthermore, local staff of all agencies will soon be restricted from entering the Seam Zone without permits, or from driving there for the conduct of their business.

58 According to a briefing by the Israeli Civil Administration to the Economic Advisor to the Palestinian President on January 22, 2007. Later, COGAT informed the Bank of plans to hand over management of the crossings to a civilian firm, and implement new inspection mechanisms, in order to enhance efficiency. COGAT also noted recent statistics by the Israeli and Jordanian Bureaus of Statistics and the Israel Airports Authority noting an increase in trade of 1.3% between the West Bank and Israel, and of 7.7% with Jordan.

59 Area A covers about 17 percent of the West Bank.

61. ***Alas, the extent of land in Area C available to Palestinians is very limited, transforming most of the West Bank into a geographic oddity*** where many Palestinian towns in Areas A or B cannot access agricultural land in Area C, and where Palestinian population densities are often double that of parts of Area C slated for settlement use.

62. ***Given the lack of space and the difficulties in obtaining a permit in Area C, many families are building without permission, resulting in house demolitions by the Israeli military.*** Donor projects in area C face similar constraints. Obtaining permits for Area C, whether for private, humanitarian or developmental purposes, is time consuming if not unattainable.[60] Any projects in any village in Area C require both a permit and a masterplan prepared by the Israeli authorities for that area. Yet, the Israeli Civil Administration has not yet prepared master plans for most towns.[61] Consequently, most NGOs report not having received construction permits since 2005. Particularly in the Jordan Valley, the lack of construction permits prevents several communities from developing or upgrading utilities (electricity, water) and social infrastructure (schools, clinics). According to the Oslo Agreements, solid infrastructure requires approval by the Israeli authorities, but humanitarian programs and temporary structures do not. Yet, several agencies have reported being forced to remove infrastructure for basic services (electricity, water, schools clinics), including temporary structures. Approximately 82 structures in area C were destroyed in the Jordan Valley in 2006[62].

63. ***A Task Force for Project Implementation (TFPI), comprising the UN, USAID, EC and the World Bank, undertook a survey and tour of some villages in Area C.*** One village surveyed, Al Jiftlik, had a masterplan. However, only 55% of its residents are located inside the masterplan, leaving 2,000 of the 5,500 inhabitants without electricity.[63] Another case is Furush Bet Dajan, which despite a population of 1,200 has no master plan and has thus been unable to develop since the 1990s. There is no electricity, and the main road needs paving. An application for a temporary clinic (i.e. in a container) has been pending for seven months (with funding from JICA). These are only two of many cases.

Access to Resources: Water, Telecommunications and Electricity

64. ***The Palestinian recovery formula is not complete without increased access to water, telecommunications, energy and other resources for domestic, industrial, and agricultural use.*** Palestinian use of water in the West Bank - most of which lies in Area C- is limited to 17% of total water in the aquifers. Israel uses the remaining 83% either through its settler population or pumping from the shared aquifers for consumption in Israel. This is despite the fact that 10%-14% of Palestinian GDP comes from agriculture, as opposed to 3% of Israel's GDP. Only 10% of Palestinian agriculture uses irrigation; the rest is rain-fed. Israel irrigates more than 50% of its land[64]. In the Jordan Valley, Palestinian allocations from wells are restricted with rare approvals for new wells and or increasing outputs from existing wells dug before 1967. Gaza, on the other hand, relies on wells that are increasingly infiltrated by seawater due to over-pumping by all parties. As

60 The Israeli Civil Administration requires an Israeli Masterplan to grant a permit for any construction or development project, but has not completed Masterplans for the vast majority of villages in Area C.

61 COGAT has responded to this assertion that once a Masterplan is developed, permits are usually given without delay. However, this does not resolve the absence of Masterplans for many villages in Area C. Recently, 16 Masterplans were prepared by the Israeli authorities, of which 10 were cleared for further review by IDF Central Command.

62 OCHA update to the Task Force for Project Implementation, 2007.

63 COGAT notes that many of those left outside the masterplan are not permanent residents of Jiftlik, but seasonal migrants from nearby Tubas. Nevertheless, this implies an inability of Palestinians to move and reside freely within the Jordan Valley.

64 Sources: PWA Statistics; World Health Organization, Health Conditions of, and Assistance to, the Arab Population in the Occupied Arab Territories, including Palestine, 58th World Health Assembly, May 17, 2005; and PLO Negotiations Affairs Department, Presentation on Water and the Two State Solution, July 2007.

a result, the UN estimates that Gaza will have no drinking water in the next 15 years[65]. Yet, regardless of the final resolution on water rights, the scarcity of this common resource requires the Palestinian Water Authority (PWA) to minimize water losses and rationalize its use of potable water. As such, the PWA must develop alternatives such as infrastructure for water treatment and reuse, and improved irrigation techniques in Palestinian agriculture.[66]

65. ***The same principle applies for telecommunications, where several impediments face the sector.*** This includes the PA's inability, under the Oslo Agreements, to have its own international gateways, to access the needed frequency spectrum, or to easily expand infrastructure in Area C. In addition, Palestinian operators claim that several Israeli mobile operators that, under the Oslo agreements are allowed to serve Israeli settlements in the West Bank, have been able to expand coverage more easily, and have as a result captured 20% of the Palestinian market. However, internal factors have also impacted the sector, including the need to strengthen governance and regulatory oversight in the sector for existing operators and to allow new entrants into the market. Effective competition between telecommunications operators can provide a very strong tax base, but will require a transparent system to generate tax revenues, as well as a clear policy to deal with unauthorized operators.[67]

66. ***In terms of energy, three-quarters is consumed by households and the service sector; illustrating the weakening industrial backbone of the Palestinian economy.*** Yet since 1999, energy demand increased annually by 6% in the West Bank and 10% in Gaza. Energy supply struggles to keep up with domestic demand. Nearly all energy is provided by electricity and petroleum products purchased from Israel.[68] The only substantial domestic energy resource is Gaza's offshore Marine gas field which is currently unexploited[69]. In the West Bank, the electricity system consists of isolated distribution systems operated by municipalities and village councils, with little generation or transmission capacity. In Gaza, electricity is partly provided by the Gaza Power Plant (GPP).

67. ***Thus, the WB&G will need to diversify energy sources beyond Israel which itself needs to meet its future energy needs.*** The West Bank is landlocked but borders Jordan which can serve as a source of energy. Gaza has substantial offshore gas, can receive supplies by sea, and borders Egypt which can become a major supplier. All this requires outside investment which is difficult given the constraints caused by Palestinian access restrictions. At the same time, the PA has to address incentives for electricity retailers, especially the municipalities and councils, to collect bills from their customers. Otherwise, the PA will continue to dedicate about 20% of its total budget to meeting outstanding amounts owed to the Israeli Electric Corporation (IEC). However, any increase in bill collection is tied to the ability of a typical Palestinian family to earn income- a cycle previously addressed as directly linked to movement and access.

65 Unfortunately, plans to enhance water availability and wastewater reuse in Gaza have been delayed by the suspension or postponement of several donor projects. Examples of key projects include: USAID's $140 million for the Gaza Seawater desalination plant and the Gaza North-South carrier, and KfW's approx Euro 70 for the Central Wastewater Treatment Plant. The World Bank-financed North Gaza Emergency Sewage Treatment Plant is facing delays due to the lack of entry of urgent supplies and equipment to complete the work. Wastewater reuse is at risk, and all poorly treated sewage generated from 70 million cubic meters of water supply is now pumped into the sea.

66 In a formal response on this issue, the Government of Israel asserts that "…all actions relating to water issues are undertaken according to the 1995 Water Agreement between Israel and the Palestinians. Israel fulfills all of its obligations and more (diverting 60 million cubic meters instead of 23 to the Palestinians), and has offered the Palestinians to assist in countering water shortages in various ways." GOI adds that since 1967, the water quantity drawn by Israel from the Mountain aquifer is diminishing in favor of the Palestinians. Thirdly, GOI notes that it has offered the PA several options to access more water, including a donor-financed desalination plant to be built in Hadera, Israel that would then sell desalinated water to the Palestinians. Lastly, GOI notes that it has reduced by 50% the use of potable water in Israeli agriculture, while the Palestinian side has not, thus raising the need for potable water.

67 Sources: (1) Findings of recent World Bank Technical Assistance to the Ministry of Telecommunications and IT, and (2) World Bank, West Bank and Gaza Infrastructure Assessment, December 2004.

68 The PA imports a small amount of electricity from Egypt to Gaza and has negotiated an agreement to import some power from Jordan to Jericho in the West Bank.

69 Discussions towards a gas production deal have been underway through the concessionaire, British Gas.

3.2 Palestinian Governance

Summary: The combined political and financial shocks of the last two years have endangered many Palestinian institutional gains. The refusal of the Hamas-led PA to meet the Quartet conditions, and the international reaction to the PLC elections have marginalized the legislative branch as a forum for multi-party policy making and legislation and as a mechanism for oversight of the executive branch. Also, efforts at imposing law and order and reforming the judiciary were overtaken by factional fighting and a paralysis of the PLC. The recent resumption of high-level security coordination between the Caretaker Government and the GOI offers an opportunity for a coordinated approach to law and order.

On the fiscal front, the PA has little time to reverse the fiscal and institutional impacts of 2006-07 and the legacy of its past spending practices. The PA has successfully rehabilitated parts of the Public Financial Management system. The preparation of a three-year Palestinian Reform and Development Plan (PRDP) will begin the process of addressing longstanding weaknesses and disconnects in policy-making, planning and budgeting processes. Its success will depend partly on the credibility of the national policy agenda, including pragmatic plans to improve the PA's performance in delivering services to the Palestinian public and putting it on the path to fiscal sustainability. But, its success also depends on sufficient and predictable external assistance and a strong recovery of private economic activity. Both GOI and donors have a role to play.

68. ***As mentioned earlier, the PA currently faces a large current deficit, a significant stock of arrears, and a precarious horizon of aid dependence.*** While this was amplified by the events of the past two years and the drastic drop in local and aid resources, the PA and the international community have long recognized for governance reform on several fronts, including law and order, judicial reform, public sector management, and others. This report covers some of the areas of priority.

Law and Order, and Judicial Reform

69. ***Internal security, access to justice and corruption were regarded by the PA and donors as key reform priorities in 2005. They were also decisive issues in the 2006 PLC elections. Ironically, progress on these areas has since been impossible as a result of the prevailing environment.*** Israel's incarceration of 46 PLC members, and the ongoing factional rivalry, left the PLC unable to muster a quorum and the PA in a state of policy and legislative paralysis. New aid channels fragmented the PA's Public Financial Management System, also constraining the PA's service delivery functions including security.

70. ***During 2006 and 2007, several attempts at establishing organizational arrangements to lead and coordinate security sector reform faltered.*** At the time of the Unity Government, the Presidency sought to establish an Office of National Security as a step towards consolidation of the various security apparatuses. However, these efforts foundered amid the factional fighting that culminated in the declaration of a State of Emergency. The PA's efforts to reform the justice sector has been similarly disappointing, due to continued lack of clarity in the respective roles of the Ministry of Justice and the High Judicial Council (HJC) in the administration of courts and other issues.

71. ***There have been recent positive steps by the Caretaker Government to impose law and order in the West Bank, and to begin the process of disarming militias. This was matched by incremental steps by Israel, including the reinstatement of security coordination with the PA, the granting of amnesty to a select number of militants, and the release of mostly-Fatah militants.*** However, these steps will need to be expanded in depth and scope in order to create comprehensive incentives for disarmament. The revived GOI/PA Joint Security Committee

- one of the more positive events since the Second *Intifada* - must lead to tangible gains on the ground for the entire population and not just a subset, lest it leads to further factional tensions. Efforts by the PA Ministry of Interior to restructure and unify the security services are most likely to succeed if the ultimate structure is seen as fully representative and divorced from any affiliations that have embroiled it in factional fighting in the past. And also here, Israel has a key role to play in restricting further incursions into Palestinian territory, and attacks on PA security organizations that provide a powerful disincentive to disarm.

72. ***The Caretaker Government has also taken some positive steps on Judicial Reform, but these can only be complete once a broader solution is found to reintegrate Gaza.*** There have been recent observable improvements in coordination between the new Ministry of Justice and the Higher Judicial Council, with clear consensus on sector reform priorities. This is best illustrated by the recent arrangements for joint management of justice sector capacity building projects. Of course, justice derives its value by its reach and scope. Hence, these steps are regarded as necessary but insufficient conditions in the absence of a resolution to the situation in Gaza. At the same time, the strengthening of formal and credible judicial systems can counteract the emergence of tribal and other systems for conflict resolution.

Rebuilding the Public Financial Management System

73. ***The PA Public Finance Management (PFM) system became increasingly fragmented in 2006*** due to the decision of donors and banks not to transact with the government. The Single Treasury Account was suspended, and without a proper budget framework and adequate control, transparency and accountability were substantially reduced. The new situation in Gaza has brought a number of new challenges and risks for the PFM system. The fact that the vast majority of administrative capacity for budget preparation as well as the main database servers of the MoF are in Gaza is a particular concern.

74. ***However, the Caretaker Government has made successful strides in rehabilitating some of the basic elements of the PFM system,*** [70] including: (a) reconsolidating the Single Treasury Account (STA), following the Arab Bank's account suspension in 2006 and the creation of separate accounts in the Bank of Palestine; (b) preparing a budget for the remainder of 2007 and beginning work on a budget for 2008;[71] (c) reversing some of the staffing additions of 2005 and onward. Initially, 31,000 of the 170,000 civil and security personnel - half of whom were recruited prior to the 2006 PLC elections - were removed by MOF subject to a closer review of their status; (d) investigating the PA's bank accounts in the West Bank and Gaza after the State of Emergency, and reopening accounts in the West Bank but allowing for direct payments to contractors and beneficiaries in Gaza[72]. This will allow for a workable solution for donors to ensure that urgent services continue in Gaza, through an 'acceptable' flow of funds; (e) preparing financial statements for 2006, despite the fragmentation of 2006 and the need to consolidate the aid data from the President's Office, the various donors, etc.[73]; and (f) reestablishing the MOF's control systems. Prior to 2006 the MOF set up a unit to manage central payments and deployed MoF officers in line ministries. The MoF also developed a separate internal audit function.

70 These issues were identified by a World Bank mission in early 2007, and further analyzed and articulated by an IMF mission in July that assessed the PA's PFM system.

71 Since 2005 and to date, the authorities are the using 1/12 monthly budgeting The Organic Budget Law allows the 1/12 mechanism for the first three months of the year only. However, the Palestinian Legislative Council (PLC) provided repeated approvals for its extension since early 2006.

72 The only exception has been for the Ministry of Education to pay those supervising end of year exams last June (where specific instructions were given to the bank as to the nature of payments that could be accepted), for the Courts dealing with trust money, and the pension fund.

73 The World Bank's 2006 Public Expenditure Review (PER) noted the lack of audited financial statements, with the last aggregate financial statement in 2004. Please visit www.worldbank.org/ps.

On a Path of PFM Reform

75. ***The current crisis provides an opportunity to take a longer term and more strategic view of Palestinian finances.*** Throughout 2005 and prior to the crisis, the PA was running an average monthly deficit in excess of $60 million, nearly 60% above its average monthly revenues. The 2007 budget prepared by the MOF now projects an average monthly deficit of about $130 million.

76. ***The Ministry of Planning, in collaboration with the Ministry of Finance, is preparing a three-year Palestinian Reform and Development Plan (PRDP) 2008-10 based on the international standard Medium-Term Expenditure Framework (MTEF) approach.*** This will begin the process of addressing longstanding weaknesses and disconnects in policy-making, planning and budgeting processes, with a view to delivering a Palestinian-owned plan for allocating resources to national policy priorities. The PRDP will be submitted to the AHLC in December 2007.

77. ***This PRDP is a welcome reform step in and of itself.*** The processes by which the PA produced its annual recurrent budget have so far been disconnected from the planning processes that yielded the Medium Term Development Plan (MTDP). Clearly, the success of the PRDP relies as much in the process as in the end result. Recognizing the time required to fully implement a new MTEF methodology, it is critical to begin the process of allowing greater participation and consultation across the PA and with NGOs and other service providers. The PRDP will set out an overall Palestinian national policy agenda, provide estimates of government revenues, provide estimates of the amount of capital and recurrent expenditure required to finance the policy agenda and, hence, provide an estimate of external financing required over the medium-term. The PA will also use this process to identify necessary reform in the policy, planning and financial management systems over the medium-term in order to realize the full benefits of the MTEF approach. As such, donors can assist in balancing incentives for a quick reform plan that shows progress by the Caretaker Government, with one that is pragmatic, locally-owned and sustainable.

78. ***Thus, to add to the PA's challenges, an unavoidable reality and politically difficult measures must be embedded in the fiscal framework for 2008-10.*** Areas include the wage bill, the collection of utility fees, the subsidization of petroleum products, and social transfers. To succeed, the PA's efforts must be matched by significant amounts of external assistance and a strong recovery of private economic activity. As such, a commitment from the donor community to provide budget support over the medium-term, and to comply with the provisions of the Paris Declaration on Aid Effectiveness more generally, will be critical to the success of the MTEF initiative.

Short-Term Reforms of the Public Sector

79. ***In the near-term, the PA should continue consolidating all funds around the STA, to allow the PA to effectively manage its cash and budget planning, and to set the stage for a coherent and manageable budget support operation linked to reforms.*** An optimal configuration would be the merger of the STA, PLO, Office of the President, TIM and other donor accounts. In addition, MOF can continue to strengthen confidence by resuming timely fiscal reports for the remainder of 2007. The 2006 report should be subject to external audit.

80. ***Another short-term priority is to re-link institutions in the West Bank and Gaza.*** This is an acute need given that budget preparation and the accounting system have historically been centralized in Gaza. The MOF is taking steps to create parallel systems, which is a reasonable step. However, it does not provide confidence in terms of the long-term stability of the system, nor of the broader issue of the role of Palestinian institutions. At the end of 2004[74],

74 This is the last date at which reliable records of the number of public sector workers employed by individual PNA organizations located in the West Bank and Gaza Strip are available.

44% of public sector employees were located in Gaza. While some ministries distribute staff equally across the two areas, others do not. For example, about 75% of Ministry of Justice employees were located in Gaza and, in the case of the Ministry of Planning, the reverse applies. The impact on the PA's conduct of business is clear. For example, the Minister of Justice in the Caretaker Government has had to draw on resources from various governmental and non-governmental organizations. If the separation persists, there will be pressure to recruit new employees and hence add further to the public sector wage bill. And even in ministries where the distribution of employees was roughly equal (e.g., MOF) there are still disparities in staffing levels among directorates.

Longer-Term Reforms of the Public Sector

81. The path to a sustainable fiscal footing also requires an early start on longer-term reforms. In consultation with the World Bank[75], IMF and others, the PA has identified a number of priorities that will have a proportional impact on the budget. These include:

82. ***Human Resources Management (HRM), and Civil and Security Service Reform.*** While there is ample evidence of efforts by the Cabinet formed immediately after the PLC elections in 2006 to effect organizational changes based on political rather than technical considerations,[76] this issue has long preceded Hamas' victory in the PLC elections. Prior to the elections, the PA had already approved public sector pay increases[77], promotions[78] and hiring that reversed earlier commitments to contain the wage bill.[79] In the current environment, aggressive reforms (e.g., staff retrenchment and/or demobilization and reintegration of security personnel) may risk further destabilization. But there remains a menu of critical yet less dramatic steps, including a moratorium on recruitment and wage rises, and/or restrictions on overtime payments to only those in front-line delivery in the Ministry of Health. Other options can also yield immediate savings. For example, the World Bank's 2006 Public Expenditure Review suggested that a roll-back of the 2005 salary increases may save the PA about $300 million annually over two years. A voluntary retirement packages to civil and security servants may save the PA about $400 to $700 million over five years.

83. This menu would need to be accompanied by steps to tackle deeper structural problems of overstaffing and poor performance (e.g., upgrading HRM systems and procedures to facilitating payroll and performance audits, launching a pay and grading review). Unfortunately, the severing of public institutions between the West Bank and Gaza is likely to lead to more hiring to compensate for the loss of accessible staff.

84. ***Local Government, Intergovernmental Fiscal Relations and Municipalities.*** WB&G has one of the more vibrant local government sectors in the region, as municipalities and village councils enjoy a relatively high degree of financial, administrative and operational autonomy from the central government. Yet the second intifada has heralded the problem of spiraling municipal financial arrears, heavy reliance on utility service surcharges for revenues, and an alarming shift of expenditures away from capital investments toward administration and wages. There is a need to consolidate the legal framework for decentralization, to ensure greater coordination among national and local agencies, and to rationalize the rising number of local governments. More encouraging are the

75 The World Bank Public Expenditure Review, 2006, www.worldbank.org/ps.

76 An analysis of the 10th Cabinet's 210 formal decisions up to September 2006 revealed that 32% relate to appointments or promotions of civil servants, 21% relate to changes in organizational structures of government and 18% directly reverse previous government decisions. The remaining decisions relate to various administrative matters; none of them set out policies or programs.

77 Average pay increases under the new Civil Service Law in July 2005: security services, 28%; civil service – 13%. These large pay increases awarded to the public sector were significantly out of line with the general labor market, and in particular, wage levels at the lower grades now exceed those in the private sector.

78 Between May-October 2005, 14% of category 2 employees and 10% of category 1 employees were promoted.

79 The wage bill increased to $1 billion in 2005 from $871 million in 2004; a rise of approx. 15%.

recent attempts to improve revenue recovery by introducing pre-paid metering for utility services and the establishment of the Municipal Development and Lending Fund (MDLF) which acts as a financial intermediary in the sector and can, over time, become an important policy instrument in promoting reforms through performance-based grants to municipalities.

85. ***Health, Education and Social Services.*** The functions of the public sector were severely undermined by the financial boycott, as unpredictable finances and the public sector strike contributed to the drop in public services, particularly in the West Bank. In the education sector, 35 school days were lost. In the health sector, facilities stopped providing services beyond emergency treatment between August 2006 and May 2007. Nevertheless, the social ministries showed remarkable resilience in cushioning citizens from the impact of the boycott. For example, the Ministry of Education implemented measures to compensate for the loss of classroom time caused by the strike. Ultimately, the 2007 Tawjihi (12th grade) exams were conducted successfully, though results in the West Bank show a slight decline in the percentage of students passing the exam in 2006-2007 compared with 2005-2006.[80]

Box 1: Municipal Development & Lending Fund (MDLF)

The genesis of the MDLF dates back to 2002 when the Ministers of Local Government, Finance and Planning agreed on the need to establish a more rationalized and transparent approach to intergovernmental fiscal transfers, aid coordination in the municipal sector, and financial management at the local level. They also sought to create a policy instrument to instill fiscal discipline and increased accountability and transparency in budget preparation and reporting at the local level. With support from the European Union, Denmark, Agence Français de Développement, GTZ, KFW and the World Bank, the MDLF was established in 2005 to: (i) introduce a rules-based framework for intergovernmental fiscal transfers; (ii) mobilize PA and donor aid for capital investments and emergency assistance at the municipal level; (iii) improve aid coordination in the sector and develop a municipal finance database; and (iv) promote innovation through new programs and learning exchanges based on global best practice. Despite its emergence during a period of uncertainty and crisis, the MDLF has proven to be resilient and responsive to many of the most urgent needs of municipalities by channeling emergency and development assistance to them through various programs over the past two years. Over time and as the political situation stabilizes, the MDLF aims to restore financial solvency at the municipal level through the use of performance-based grants intended to help municipalities graduate to credit worthy status and thus be able to attract financial from the commercial banking sector.

86. This is not surprising given the accomplishments within the health and education systems over the years. The expansion and access in the education sector is comparable with most middle-income countries, although quality varies widely. Health indicators are generally higher than others in MENA. However, there is scope for savings across these sectors, which represent very large shares of the wage bill, often at the expense of pharmaceuticals, medical supplies and operations and maintenance. As for social services, some are operating in a limited form despite the recent financial crisis. Yet reforms are needed in this sector. PA public sector pension schemes are among the most generous in the world, Moreover, the PA's pension fund obligations have in recent years been left unpaid in favor of monthly salary payments, leaving the PA in arrears to the Gaza Pension Corporation (GPIC) and further endangering the system[81].

80 59% of students passed this year in contrast to 63% of students in the previous year.

81 In January 2005 a Security Services Pension Law was approved covering all security personnel 45 years and above. The Law's provisions were over-generous and unsustainable. Subsequently, a Unified Pension Law (UPL) covering civil service and security employees under 45 came into force in May 2005 was also unsustainable and added to the PA's liabilities. On August 23rd, 2007 a Presidential decree modified these laws, making minor changes in the security services law but retaining fiscally unattainable provisions that increase the PA's implicit liabilities as guarantor. For example, the bylaws allow workers to collect a pension at 55 with only 15 years of service. They also link pensions to current salary scales rather than indexing these to the cost of living. Thirdly, the bylaws now cover the entire formal sector (including the private sector) under the same unaffordable parameters, including PLC members and other elected officials.

Reforms would include revising the Unified Pension Law to ensure sustainability. The pension law for security services, passed in 2005, is excessive and simply unaffordable. The August 27th, 2007 decree modifying these laws creates a pension system that is insolvent from the start, and increases the implicit liabilities of the PA which is the guarantor. Beyond pension reform, there is scope for significant savings through better social safety net program coordination and targeting. Currently the West Bank & Gaza uses several ad-hoc programs often operating independently of each other and covering overlapping beneficiaries.

3.3 The Donor Response and Strategies

Summary: **With more than 40 donors, aid flows into the WB&G have been considerable, including in the last two years where many donors sought creative ways to assist despite their boycott of the PA. Yet, aid remains fragmented and focused on bilateral arrangements with donors based on individual political positions rather than a collective longer-term view on broader economic and governance fundamentals. This has undermined aid effectiveness and created a "shopping list" approach to development planning where projects are more aligned with the donor's requirements than with local priorities.**

Furthermore, aid has not been matched by parallel GOI and PA actions to create an environment where funds translate into sustainable growth. Aid has been reactive, and has not fully enabled institution-building or created incentives to reform. The hollowing out of the Palestinian economy has risked reversing the benefits of over $10 billion in past aid, and has diverted funds to recurrent expenditures and basic humanitarian support rather than to an investment in Palestinian institutions and infrastructure. Donors have long been aware of this issue, hence the establishment of multilateral financing mechanisms and new aid coordination bodies. Going forward, these aid structures must be revitalized. The presence of the new Quartet Special Envoy, and his leveraging of these coordination structures, could strengthen them considerably. Also, donor commitment to the Palestinian Reform and Development Plan 2008-10 will be a key test of the support to Palestinian-driven recovery and growth.

87. ***Looking back, donor assistance can be said to have slowed the pace of Palestinian economic deterioration in bad times, and contributed to growth in good times.*** When permitted by the prevailing circumstances, donors abided by their collective understanding of the links between economic opportunities and the peace process, and on their role in building Palestinian institutions to underpin this peace. However, in reality donor funds have mostly gone to offsetting the impacts declines rather than underwriting growth (See Table 3 and Figure 6).

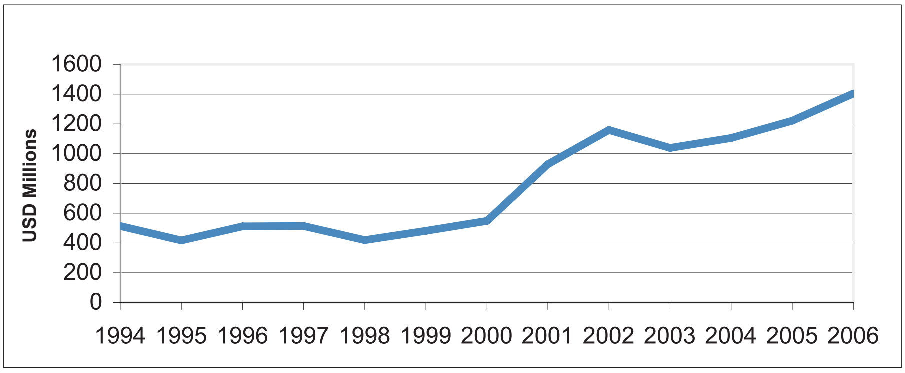
Table 3: Aid Disbursements grants and loans (in USD)[4]

Type of Aid	2002	2003	2004	2005	2006
Development[1]	$310,931,454	$448,917,192	$368,106,060	$381,358,856	$252,777,407
Humanitarian Aid[2]	$351,431,666	$339,063,715	$377,034,035	$490,987,126	$412,890,057
Budget support[3]	$497,200,000	$250,980,000	$361,080,000	$349,000,000	$738,210,000
Total	$1,159,563,120	$1,038,960,907	$1,106,220,095	$1,221,345,982	$1,403,877,464

Sources:
1- Development disbursements from Ministry of Planning PAMS database. Some humanitarian aid may be misclassified in this category, particularly in the health sector.
2- Humanitarian aid disbursements from Ministry of Planning PAMS database and includes UNRWA support and is adjusted by inputs from some key donors.
3- Budget support disbursements from Ministry of Finance and IMF.
4- These figures were compiled by the World Bank based on Ministry of Planning, Ministry of Finance, IMF, and donor data. The accuracy of these figures may be in question due to the lack of harmonized and consistent reporting on aid disbursements.

88. ***A 1999 joint report by the Government of Japan and the World Bank estimated that donor assistance since Oslo had contributed an additional 6-7% per annum to the growth of Palestinian GNP per capita***[82]. At the same time, the downturn of the economy since the Second *Intifada* was matched with a large injection of donor funds. In reality, these donor funds seem to have prevented a complete collapse in the economy, and mitigated the effects of the drop in GDP, employment, etc. As such, the amount of donor funds in recent times can be regarded as the quantification of the costs of mobility restrictions and other external shocks.

Figure 6: External Assistance to the WB&G



Sources: 1994 - 1997: Report on Aid Effectiveness, WB and Japan, 1999; 1998 - 2001: Four Years of Intifada and Economic Crisis, WB; 2002-2006: WB compilation of MOP, MOF, and IMF data

89. ***From the outset, the objective was to move from humanitarian assistance and basic services to setting long-term infrastructure for Palestinian-driven development supported by local institutions.***[83] However, from a technical perspective, the actual course has been erratic and bound by a series of shocks that prevented local institutions from achieving any lasting momentum. Strategies and policies were delayed, and predictable signals of donor commitment to reform were suspended.

90. ***The past two years have been a particularly challenging episode in donor-PA relations.*** Political considerations led to the near cessation of direct relations between most bilateral donors and the PA, with only some multilateral agencies and a few donors continuing direct contact and project administration.[84]

91. ***The impact of the donor boycott on the PA has been discussed at length.*** Despite collective efforts to provide humanitarian assistance and basic services to the population, the PA was forced to operate at about 66% of its 2005 expenditures[85]. The alternative mechanisms employed by donors centered on direct implementation or the Office of the President as a counterpart. The EU TIM injected badly-needed funds directly to beneficiaries. Arab funds were also paid directly to the OoP for disbursement. While the OoP made a valiant effort in managing these funds, their best efforts could not substitute for years of capacity and systems development at the Ministry of Finance.

82 Aid Effectiveness in the West Bank & Gaza, World Bank/Government of Japan, 1999, AHLC Report, p. 1.

83 World Bank analysis shows that growth rates are twice as high in countries with effective institutions. There, assistance of 1%of GDP produces a sustained increase of 0.5% in GDP growth, reduces poverty by 1%, and increases private investment by 1.9%. But in the absence of good policies and institutions, aid has little or no effect on long-term economic growth, and negative effects on private investment (World Bank 1998a).

84 Some donors maintained contact with the PA government officials at a technical level and allowed the continuation of ongoing projects. Others allowed only humanitarian projects. Some countries altered their policies somewhat with the formation of the unity government. Overall, the particulars of donor policy during this period were by no means homogeneous and varied over time.

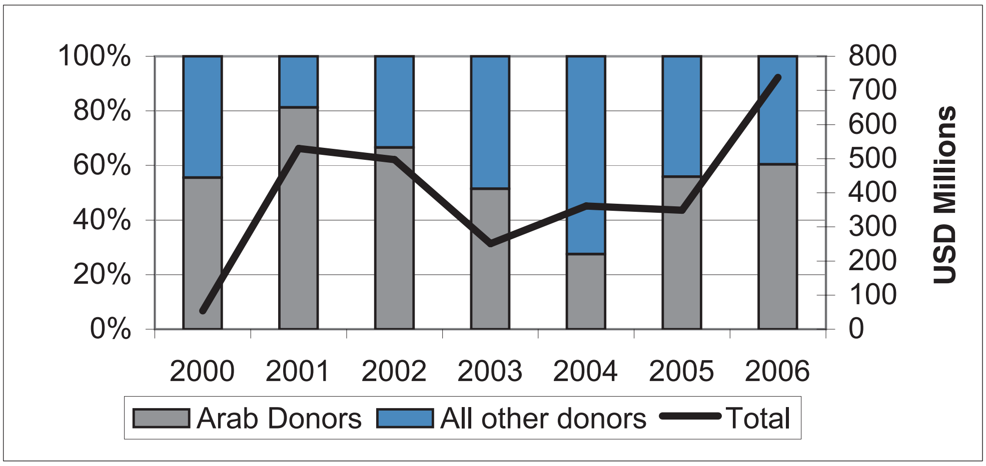
85 West Bank and Gaza: Fiscal Performance 2006, IMF, March 2007.

Aid Trends

92. ***Despite the boycott and Israel's freezing of clearance revenues, total donor assistance reached a record $1.4 billion*** in 2006, over half of which was in a form of budgetary support[86]. Arab donors provided nearly $600 million in budgetary support from January 2006 – June 2007, a quarter of which was transferred in 2007. The EU TIM provided over $520 million through July 2007 in essential supplies and running costs for health, education and social services (through the World Bank run ESSP program, or Window I), power and fuel for sanitation and health services (Window II), and allowances for some public servants and social hardship cases (Window III).

93. ***Thus, 2006 saw a doubling of budgetary support to $738 million. While budget support is in itself desirable as it relies on local prioritization and implementation, the aid given in 2006-07 flowed away from the PA and from development projects.*** This trend, combined with the hollowing out of the Palestinian economy's productive base, risks thrusting the WB&G into a protracted period of aid dependence for recurrent spending and humanitarian assistance. The injection of massive budget support did not offset the effects of the frozen clearance revenues, nor the reductions in tax revenues resulting from a depressed economy. Equally damaging was the fact that the doubling of external budget support was accompanied by a comparably sharp decline in aid for development projects (See Figures 7 and 8). For the 2008 budget, about 94% of the required donor funds will go towards recurrent expenditures as opposed to development assistance.

Figure 7: Budget Support to the WB&G

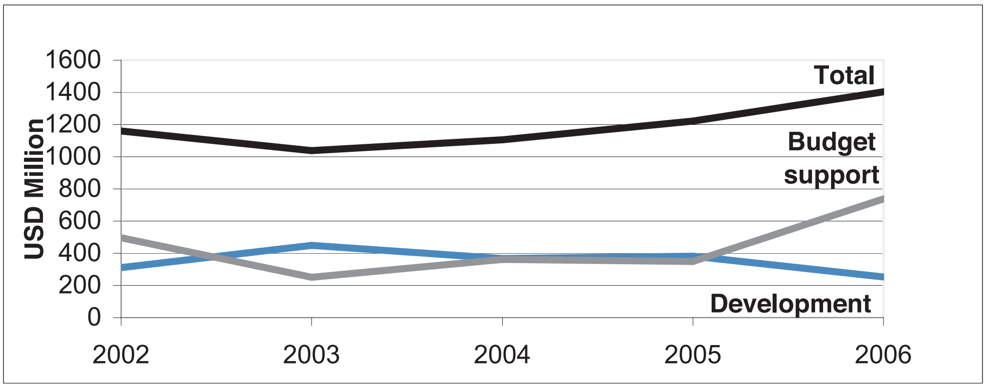


Source: MOF and IMF data

94. ***According to the Ministry of Planning, development aid dropped by at least one third from its $381 million level in 2005***[87]. Coming at a time of little to no public investment, and a very limited appetite for private investment under an excessive movement and access regime, this has and will continue to diminish any residue of productive capital in the economy. Thus, the sheer amount of donor money injected into the economy may have buffered any catastrophic effects of the boycott and restrictions, but it did not trigger any development 'multiplier effect' that is the normal standard for aid elsewhere.

86 This includes direct financing to the Office of the President, the PA, and the EU TIM.
87 These figures are only estimates and are subject to error due to lack of harmonization in classification of aid projects and other inconsistencies.

Figure 8: Budget Support versus Develpment Assistance



Source: Budget support from MOF and IMF; Development figures from MOP; Total is a compilation from MOF, IMF, MOP, and donors and includes budget, development, and humanitarian aid.

PA Management of Donor Assistance

95. ***The 'bypass financing routes' used by most donors undermined the PA's ability to plan or allocate funds.*** The lack of donor contact with PA officials in the Ministries of Planning, Finance, and others limited the latter's influence on funding decisions. While this approach may have been a practical response to political constraints, it was neither cost-effective nor aligned with the PA's broader priorities.

96. ***While this problem was particularly acute in 2006, the lack of PA ownership in planning and prioritization is a longer standing issue.*** At the core of this issue is the PA's Medium Term Development Planning (MTDP) process which intended to provide a framework for the prioritization and selection of projects. However, there was no actual commitment to the MTDP within the PA or among donors, including the need to abide by the MOP's mandate to endorse projects and programs, and provide accurate and comprehensive information on their activities to the MOP's database.

97. ***The Palestinian Reform and Development Plan 2008 – 10 to be presented to the AHLC in December intends to marry budgetary and development planning,*** and will be an impetus for greater Palestinian ownership. As such, donor support to this process and to a predictable flow of aid would be an unmistakable signal of an underlying commitment to Palestinian institution-building[88]. Also, donors should actively support the MOP's efforts towards a Palestinian Harmonization and Aid Effectiveness Action Plan.

Developments in Aid Coordination

98. ***Recognizing the challenges described above, a new aid coordination structure was approved at the London AHLC in 2005, creating the Local Development Forum and four strategy groups to coordinate aid at the local level and report to the AHLC.*** The key features of this new formula were the leadership of the PA and its partnership with donors in four Strategy Groups (economic development, governance, infrastructure, and social and humanitarian issues). Unfortunately, the boycott of the PA made it difficult to fully implement this structure. Three out of the four Strategy Groups actually convened, in addition to a number of sector working sub-groups[89]. There were however gaps in either PA or donor representation in various groups and, more importantly, the ability of these groups to engage in a meaningful strategic

88 The PA's recognition of the need to interface with donors is imbedded in the PRDP preparation process, whereby PA sub-teams were created on economic development, infrastructure, governance and social and humanitarian policy. The setup of these teams mirrors the structure of the Local Strategy Groups.
89 Donors operating in the WB&G are signatories to the March 2005 Paris Declaration on Aid Effectiveness, which requires reciprocal actions by the partner and donors to improve partner ownership of development agenda, donor alignment with partner priorities, and harmonization among donors.

planning and coordination. Some plans were presented, including the PA's 2007 Operational Plan, a recovery plan for 2007, and the Private Sector Recovery and Resilience Plan. With the exception of the latter, which did influence some donor initiatives, there was little donor engagement with these plans.

99. ***There has been substantial progress since June 2007 in reactivating these strategy groups with the full participation of the PA, and with the first meeting of the Infrastructure Group on September 11, 2007.*** Moving forward, the sustained value-added of these groups will depend on the active participation of donors, PA ministries, and the new Quartet Representative. As most donors operating in the WB&G are signatories to the Paris Declaration on Aid Effectiveness, this would be a continuation of commitments and practices observed elsewhere.

4.The Way Forward

100. ***Sadly, lost within this story are some important strides by the PA, Israel and the donors over the years to enable Palestinian economic recovery.*** The PA's past reforms in public financial management, municipal governance, education and health were impressive. The commitment of donors to support the Palestinian people throughout a series of unprecedented political crises is also notable, as is Israel's efforts to balance peace with a legitimate goal of protecting its citizens.

101. ***Moving forward, the restoration of growth and peace will require all sides not only to return to the now well-known preconditions for economic recovery, but to take actions collectively and in parallel, with a view to longer-term benefits and not only the short-term costs.*** Experience over the past 15 years has shown that only parallel actions on the recommendations of this report will lead to tangible results. The interactions among PA, GOI and donor policies are tied to such an extent that there is no recourse but to parallel steps and reforms- the absence of one greatly undermines the success of the other.

102. ***There is little doubt that parallel actions in a situation of conflict and political uncertainty are risky and politically costly. But experience to date has provided no substitute.*** The viability of the PA is a precondition for a lasting recovery and peace. For the PA to be viable, it must take bold steps to restore law and order and become fiscally self-sufficient. To date, it has not been able to do without predictable access to its clearance revenues, predictable donor financing over the medium-term, and a revitalized private sector that can generate tax revenues and absorb current and future labor. The PA's first priority of security and the disarming of militias is challenged by the absence of alternative jobs and the uncertainty about a future peace arrangement, making most unwilling to give up the only tangible item at their disposal - the gun.

103. As such, continued donor investment in and through PA institutions must bolster a commitment by the Government to carry out key reforms noted in this report, not be conditioned on it. Similarly, the PA's reform agenda must clearly and realistically reflect a finite horizon of aid dependency. Clearly, donors must expect reasonable assurances of transparency and due diligence in the use of their funds, as well as a reform trajectory. Yet, the complexity of the current situation may have shifted most donor requirements, creating scenarios where political conditions for aid may lead the PA to adapt in a way that is inconsistent with the economic conditions for aid (e.g., wage bill containment versus security sector consolidation). Of course, donors are not oblivious to this fact, which is consistent with the Paris Declaration on Aid Effectiveness that nearly all have adopted. But they have not been able to fully practice what they promote without efforts by the PA to ensure internal political stability, or by GOI to create the environment for a shift away from humanitarian support.

104. ***Israel's actions on Palestinian movement and access must also reflect a clear policy on settlement activity, and a view of the removal of these restrictions as a major catalyst for stability, and not merely a consequence of it.*** In addition to the private sector, Israeli restrictions also impede the functions of the Palestinian public sector. The PA is obliged to administer a series of isolated territories despite complex obstacles in coordinating government policy, administrative procedures, service delivery[90], and law enforcement. Even in the delivery of basic services, the PA is unable to exploit economies of scale as a means of controlling the cost of service delivery.[91] As such, the movement restrictions

90 Government authority and administrative procedures in the West Bank and Gaza continue to be based on a plethora of laws, regulations and military orders issued by a succession of occupying forces. Progress towards eliminating discrepancies and replacing these legal instruments with unified laws and regulations has been hampered by territorial fragmentation.

91 Fragmentation of communities creates demand for more schools and healthcare facilities than is ordinarily required to serve a similar-sized population that is free to travel across a similar-sized territory.

have shaped the Palestinian Territories into a series of micro-territories each requiring their only health facilities, waste sites, etc. Thus, the case for the removal of restrictions is clear, and requires a revision of Israel's approach to security as a balance between short and long term gains, in parallel with PA policies at disarmament of militias and reform of the security services, recognizing the devastating impacts of short-term breaches in security on previous attempts at reconciliation, and on the Palestinian economy itself.

105. ***Of course, any discussion on economic recovery and the prospects for peace is incomplete without the Gaza Strip.*** Gaza represents about 40% of the population, and a quintessential part of the Palestinian territory, economy and identity. Thus, any serious options for a private-sector led and export-oriented Palestinian economy must include Gaza. Without it, the collective investments and commitments advocated in this report are unlikely to materialize due to continued uncertainties about the sustainability and inclusiveness of Palestinian institutions.

106. ***Whether practical or not under the circumstances, the need for these parallel steps is evident.*** These are the fundamentals of economic growth, and draw on the basics that guide all economies. Without them, all well-intentioned and creative solutions, policies and investments are undermined. As the past years have shown, there is no prosthetic for an economy whose basic building blocks- people, natural resources and entrepreneurial spirit- are unable to move freely. The implication of this view is that all parties will need to expend more resources and assume more risks than done in the past. Perhaps this is best referred to as an investment in peace. The costs are subjective to each side, and are beyond the scope of this report. But the benefits of success make this an investment worth making.