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Economic Monitoring Report

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I. Executive Summary

1. **Palestinians are getting poorer on average for the third year in a row.** As evidenced in previous World Bank reports, the competitiveness of the Palestinian economy has been progressively eroding since the signing of the Oslo accords, in particular its industry and agriculture. Even though donor aid had increased government-funded services and fueled consumption-driven growth during 2007 to 2011, this growth model has proved unsustainable. Donor support has significantly declined in recent years and, in any case, aid cannot sustainably make up for inadequate private investment. Thus, growth has started to slow since 2012 and the Palestinian economy contracted in 2014 following the Gaza war. In early 2015, GDP was still lower than it was a year ago. Due to population growth, real GDP per capita has been shrinking since 2013. Unemployment remains high, particularly amongst Gaza's youth where it exceeds 60 percent, and 25 percent of Palestinians currently live in poverty. Against the backdrop of weak economic growth, reduced donor aid, and temporary suspension of revenue payments by the Government of Israel (GoI), the Palestinian Authority's reform efforts have not been able to prevent another year with a financing gap. The persistence of this situation could potentially lead to political and social unrest. In short, the status quo is not sustainable and downside risks of further conflict and social unrest are high.

2. **Until there is a permanent peace agreement, the Palestinian economy will continue to perform below its potential.** Political instability constitutes a significant risk to private investors and is a key reason why private investment levels have remained very low for many years. If the status quo persists, private investment will not pick up and the private sector, which ought to be the main engine of sustainable growth, will continue to function far below its potential. The internal divide between the West Bank and Gaza also creates difficulties for private investors that have to deal with two separate regulatory frameworks and tax systems in the West Bank and in Gaza. However, the lack of political horizon should not lead the parties to complacency. Even before a final peace deal, there are many actions that can be taken that would improve socio-economic development for Palestinians. These actions are essential, not just for economic development, but also for peace, since the international evidence is clear that economic development is conducive to peace.

3. **Even without a final peace deal, there is substantial upside potential in the Palestinian economy if existing agreements are implemented and restrictions lifted.** For example, the Oslo agreement foresaw a gradual transfer of Area C to Palestinian control, but this has not happened. World Bank estimates show that granting Palestinian businesses access to economic activity in Area C (excluding the areas subject to final status negotiations) would boost the Palestinian economy by about a third and lower the PA's deficit by half. Similarly, the regular and predictable transfer of revenues collected by the GoI on behalf of the PA, and close cooperation with the PA to minimize tax leakages are critical to ensure fiscal predictability. On movement and access restrictions[1], the recent statements by Israeli officials about the importance of Palestinian economic development are most welcome if followed up by action and implementation of existing agreements. Finally, full implementation of the Paris protocol and expansion of the joint work between Israeli and Palestinian public institutions across a number of areas would help create a more predictable business and fiscal environment. The blockade on Gaza imposed by countries neighboring the Strip needs to be lifted in a way that protects legitimate security concerns of those countries. Israeli measures to let more goods leave Gaza are welcome and they have expanded since the last AHLC meeting, but more needs to be done: only six percent of what left Gaza prior to the blockade is currently being allowed out. In general, granting Palestinians access to production inputs and external markets and enabling unimpeded movement of goods, labor and capital,

[1] According to the GoI, the restrictions are imposed to protect the security of Israeli citizens.

as stipulated in the Paris protocol, would drastically improve growth prospects of the Palestinian economy.

4. **Reforms by the PA of its revenues and expenditures ought to continue to improve fiscal sustainability and effective service delivery, even under the current political scenario.** The PA has made very good progress in reducing its fiscal deficit and it has recently launched some important reform initiatives in this area. Through continued efforts to address key sources of inefficiency and ineffectiveness, the PA could do a great deal to avert fiscal crises and stop financing its budgets by accumulating arrears to the private sector. Not only can the PA put its finances on a more sustainable footing through reforms, but it can also create adequate fiscal space to increase the currently very low level of investment in public infrastructure and to enhance service delivery. A top priority should be the reduction of the wage bill, which could lead to large savings of up to 5 percentage points of GDP, but there is also substantial room for cost savings to be made on other categories of expenditures as well as for increasing tax revenues beyond what has already been done. There is also potential to substantially increase tax collection in Gaza once the PA takes charge of tax collection efforts there. Within some sectors, overall expenditures are not very high compared to other countries, but access to and the quality of those public services are significantly below what they could be if certain expenditures were better prioritized and more efficiently managed. For instance, the PA has recently made very good progress in reforming the health referral process, but significant inefficiencies related to public health spending remain; the reduction of these inefficiencies could generate savings to be used to further reduce the deficit or alternatively to invest them in programs that will improve the quality of public health services. As detailed in the body of this report, similar issues exist in a number of other areas of expenditure management and intensified reform efforts are urgently called for to address them.

5. **Until private investment shoots up, donors need to increase aid provided to the PA, as the financing gap in the PA's budget cannot be closed through reforms alone.** Despite having managed to reduce the budget deficit, the PA still has a large financing gap in its 2015 budget and it is likely to continue accumulating arrears to the private sector. While further reform efforts should be made by the PA to reduce the 2015 budget deficit in line with the IMF recommendations, donors are also called upon to augment their 2015 budget support as it would be unrealistic to expect that the gap can be closed through reforms alone. Even if the PA were able to fully close the financing gap in the 2015 budget, such sharp fiscal consolidation would be damaging to growth. Thus, fiscal consolidation has to happen gradually over a period of 2-3 years. Then, donors should be able to channel a larger share of their funds towards public investments in infrastructure, which are needed both to catalyze private investment and to improve the quality of public services. Furthermore, the financing of socioeconomic recovery in Gaza, following last year's war, almost entirely depends on donor aid.

6. **On a final note, slow donor aid disbursements and restrictions on imports are delaying the Gaza reconstruction process and both issues should be urgently dealt with.** Out of the USD3.5 billion of pledges made at the Cairo conference for Gaza reconstruction, USD1.23 billion has so far been disbursed, which puts the disbursement ratio at 35 percent. Funds already disbursed are USD881 million less than what was originally planned, mainly because payments by the largest donors remain lower than anticipated. The majority of disbursements made so far supported UNRWA activities, while less than 20 percent was used to finance interventions outlined by the Damage and Needs Assessment. Construction material imported into Gaza continues to be lower than what is needed, even though it has recently increased. Between August 2014 and August 2015, 1.6 million tons of construction material entered Gaza, which represents 6.7 percent of the total need.[2] There has also been a delay in finalizing the residential stream of the Gaza Reconstruction Mechanism (GRM), which means that

[2] The amount of materials that entered Gaza through August 2015 is based on GoI estimates.

totally destroyed homes are still not rebuilt, a year after the war ended, even though there has been good progress on partially destroyed homes.

7. **The main body of the report is organized in two chapters and an annex.** Chapter II focuses on the assessment of recent macroeconomic and fiscal developments in the Palestinian territories and the Palestinian Authority's (PA) related policies and actions. It also provides a near term macroeconomic and fiscal outlook. Chapter III draws on the just-completed public expenditure review providing insights into key issues related to public expenditure management as well as specific policy recommendations for reducing the PA's fiscal deficits and increasing the efficiency and efficacy of public spending. Finally, an annex summarizes the status of donor pledges from the Cairo conference on Gaza reconstruction.

II. Recent Developments

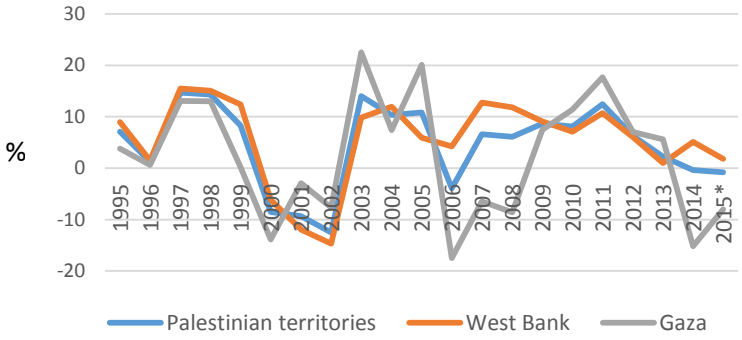
a. Economic Growth

8. **The economy of the Palestinian territories is unsustainable under the current paradigm.** Due to long lasting restrictions on movement, access and trade, private sector activity has been severely constrained and private investment levels are amongst the lowest in the world. The situation is even more difficult in Gaza where the blockade has significantly eroded the competitiveness of private businesses. Even though the economy witnessed strong growth between 2007 and 2011 due to large amounts of aid, the trend started to wane in 2012 due to a sharp drop in budget support. Aid levels increased again in 2013, but growth continued to decline, providing further evidence that this growth model has exhausted its potential. Therefore, it is imperative that, until a final peace agreement is reached, serious efforts are made to look at medium term measures that can reverse current negative trends and put the Palestinian economy on a path to sustainable growth.

9. **The Palestinian economy has been in recession since 2014.** The economy of the Palestinian territories contracted in 2014 mainly as a result of the war in Gaza which had a devastating impact on economic activity, infrastructure and the livelihood of Palestinians living there. The recovery to the pre-recession economic output level in Gaza is still underway, and according to the Palestine Central Bureau of Statistics (PCBS), real GDP for the Palestinian territories is 0.8 percent lower in the first quarter of the year compared to the same period in 2014.

10. **Gaza's economy continues to suffer from the impact of the 2014 war, but a slow process of recovery has started.** A comparison of figures for the first quarter of 2015 with those for the same period in 2014 indicates that year-on-year growth in Gaza amounted to minus 8 percent. However, the economy of Gaza grew by about 7 percent in the first quarter of 2015 compared to the fourth quarter of 2014, so some recovery is underway. This was mainly driven by a significant rebound in construction activity which has grown by more than 75 percent (from a very low base) since the war ended. As expected, activity in the wholesale and retail trade sectors also expanded by 22 percent quarter-on-quarter. The productive sectors including agriculture and manufacturing have also started to show signs of recovery albeit at a much slower rate. Notably, the GoI has been allowing exports of certain products from Gaza to the West Bank and some agricultural produce to Israel. On a monthly basis, Gaza exports are now at 6 percent of what they used to be before the blockade was imposed in 2007. Businesses in Gaza report that even though export restrictions have been relaxed, they are hesitant to invest in capacity expansion to reach export markets because of the extremely uncertain political outlook and the related likelihood of another war or restrictions being re-imposed.

Figure 1: Real GDP Growth, 1995-Q1 2015



Source: Palestine Central Bureau of Statistics.
* Data for 2015 is for the first quarter.

11. **Estimates indicate that West Bank GDP expanded by 1.8 percent in the first quarter of 2015 despite a liquidity squeeze that was caused by the GoI's decision to suspend the transfer of taxes it collects on behalf of the PA.** However, growth was the result of a statistical adjustment rather than an expansion in economic activity as gross value added actually contracted by 2 percent, while there was a strong increase in recorded import taxes as a result of a shift in the structure of imports.[3] The sectors that were most affected by the liquidity squeeze were manufacturing and construction which contracted by 11 and 8 percent, respectively, in the first quarter of 2015 compared to the same period in the previous year. Output of the agriculture sector also dropped by 2 percent year-on-year. Wholesale and retail trade was also negatively affected by the liquidity strain.

12. **The unemployment rate has recently been declining in both Gaza and the West Bank, but a quarter of the Palestinian labor force is still unemployed**.[4] In Gaza, the unemployment rate skyrocketed to more than 47 percent during the 2014 war. It has, however, been declining since and latest available data shows that it dropped to 42 percent in the first half of 2015 as the reconstruction process started to slowly pick up and private firms have been rebuilding their capacity. Unemployment in the West Bank has also slightly declined from an average of 18 percent in 2014 to 16 percent in the first half of 2015. Notably, the drop in unemployment in the West Bank could be explained by the increase in the number of West Bank laborers in Israel which grew by 7 percent reaching 112,200 in the second quarter of 2015.

13. **Poverty in the Palestinian territories reached 25 percent in 2014.**[5] The overall rate, however, masks wide regional divergence. Poverty in Gaza was 39 percent which is almost 2.5 times higher than that in the West Bank at 16 percent in 2014. And, according to the United Nation's Relief and Works Agency (UNRWA), almost 80 percent of Gaza's population is currently aid dependent.

14. **Inflation in the Palestinian territories remains low and stable, but with significant regional differences.** Between January and August 2015, it averaged 1.4 percent. In the West Bank, it was 0.9

[3] With the closure of illegal trade tunnels between Egypt and Gaza, legal imports into Gaza have increased substantially and so has the amount of taxes on imports. Furthermore, imports from third countries into the Palestinian territories have also been growing. This growth in taxes (commitment basis) was recorded in the national accounts data (production approach), resulting in apparent GDP growth.
[4] Based on PCBS Labor Force Survey data.
[5] Based on latest available preliminary estimates by the Bank.

percent while it was higher in Gaza at 1.8 percent. Inflation in Gaza started to rise following the crackdown of the tunnels with Egypt in the summer of 2013, as access to cheaper Egyptian fuel, construction material and other commercial goods significantly deteriorated.

15. **During the first quarter of 2015 the Palestinian trade deficit declined by 6 percent relative to the same period in 2014, but at 38 percent of GDP it remains extraordinarily high.**[6] The decline was driven by a four percent drop in imports during the first quarter of 2015 (year-on-year), and a 3 percent increase in exports. The drop in imports can be explained by a decrease in imports from Israel (which represent 58 percent of total imports) by 24 percent. The drop in imports from Israel is the result of reduced economic activity, but also a growing trend among Palestinian consumers to substitute products imported from Israel by those from other countries, as a result of which non-Israeli imports were up 22 percent. Despite the recent increase, the size of exports in the economy has remained very low averaging about 15 percent in recent years due to the low productive capacity of agriculture and industry that is held back by the Israeli restrictions. As a result of the reduction in the trade deficit, the current account deficit is estimated to have shrunk by as much as 18 percent.

16. **The Palestinian economy is expected to slightly recover throughout the remainder of the year while real per capita income will continue to shrink.** The overall growth rate in the Palestinian territories is projected at 2.9 percent in 2015. The West Bank economy is expected to grow by 1.8 percent, which implies a reduction in real GDP per capita due to population growth of about 3 percent. This projection for sluggish growth assumes that the GoI will continue making stable monthly transfers of clearance revenues. It also takes into consideration a reduction in budget support to the PA and weak confidence due to high political uncertainty and also assumes no major changes in the overall restriction system in the West Bank. The pace of the reconstruction process in Gaza is expected to be slower than originally anticipated due to lower than needed aid, import restrictions on building materials and coordination issues within the PA. (See Annex 1 for further details on Gaza reconstruction). As a result, real GDP growth projections for Gaza have been revised downwards to 6.5 percent in 2015.[7]

b. Public Finance

17. **Despite the PA's commendable efforts in managing the fiscal crisis resulting from the withholding of clearance revenues in early 2015, the fiscal situation remains precarious and expenditure growth is a concern**. The Government of Israel (GoI) withheld clearance revenues from December 2014 until April 2015, leaving the PA without 70 percent of its revenues. Consequently, the PA resorted to severe cash rationing only paying partial salaries while delaying most other expenditures and accumulating large arrears to the private sector and the pension fund and increasing its borrowing from local banks. Despite the sharp liquidity squeeze during the first four months of the year, public service delivery was well maintained and the PA's efforts in managing the fiscal crisis were successful. However, the fiscal situation remains difficult even after the resumption of clearance revenues due to significant expenditure growth, particularly on transfers and goods and services.

2015 Budget

18. **In June, the PA passed the 2015 baseline budget with a financing gap of USD0.4 billion**. Budget finalization was delayed due to uncertainty caused by the suspension of clearance revenues and the PA initially passed an emergency budget in March 2015. After the resumption of clearance revenues in April, the PA approved the 2015 regular budget which was signed by the president on June 30. The

[6] Preliminary data published by PCBS.
[7] GDP projections for 2015 were produced by the IMF.

baseline budget assumes that total net revenues will increase by 9 percent while expenditure growth will be limited to about 3.6 percent. Particularly, the wage bill is expected to grow by 3.8 percent to account for an annual increase of 1.25 percent, a Cost of Living Allowance (CoLA) of 2 percent in addition to a 5 percent raise for teachers with the enforcement of a zero net hiring policy. However, the PA is taking additional measures and it aims to cap wage bill growth at three percent. Spending on goods and services is expected to decline by 4.6 percent, whereas transfers are expected to increase by 17.8 percent due to higher social spending in Gaza following the 2014 war. Notably, the PA plans to reduce net lending by 21.7 percent in 2015. Based on the above, the recurrent deficit is projected to decrease by 7 percent year-on-year and amount to USD1.19 billion. The overall deficit, however is expected to be much higher at USD2.39 billion due to large development spending for Gaza reconstruction. The budget projects total aid in 2015 to be USD1.99 billion (USD838 million in budget support and USD1.15 billion in development spending) leading to a financing gap of about USD0.4 billion. Notably, the budget assumes that the PA's total stock of arrears will be reduced by USD314 million in 2015 and that net domestic borrowing will increase by the same amount.

Table 1: Palestinian territories / Central Government Fiscal Operations 2012-2015

	2012	2013	2014	2015 Budget	2015 F
Public finances (commitment basis)			In USD million		
Total net revenues	2072	2312	2744	2861	2821
Recurrent expenditures and net lending	3525	3694	4068	4050	4109
Wage expenditure	1767	1919	2050	2045	2045*
Non-wage expenditure	1481	1565	1732	1790	1790
Net lending	278	211	286	215	274
Recurrent balance	-1453	-1382	-1324	-1189	-1288
Development expenditures	243	187	263	1204	250
Overall balance (before external support)	-1696	-1569	-1587	-2393	-1538
Financing	1696	1569	1587	2393	1538
External Financing	930	1362	1230	1990	1144
Budgetary support	774	1255	1027	838	894
Development financing	156	106	203	1152	250
Residual/Financing gap after external financing	766	207	356	403	394
Domestic Financing	813	221	352	0	326
Net domestic bank financing	127	-248	-131	314	-85
Domestic arrears	686	465	493	-314	411
Other	0	4	-10	0	0
Residual/Financing gap after total financing	-47	-14	4	403	68
Public finances (commitment basis)			In percent of GDP		
Total net revenues	18.4	18.6	21.5	22.1	21.7
Recurrent expenditures and net lending	31.4	29.7	31.9	31.2	31.7
Wage expenditure	15.7	15.5	16.1	15.8	15.8
Non-wage expenditure	13.2	12.6	13.6	13.8	13.8
Net lending	2.5	1.7	2.2	1.7	2.1
Recurrent balance (before external support)	-12.9	-11.1	-10.4	-9.2	-9.9
Overall balance (before external support)	-15.1	-12.6	-12.5	-18.4	-11.9
External budgetary support	6.9	10.1	8.1	6.9	6.7
Domestic arrears	6.1	3.7	3.9	-2.4	3.2
Memorandum item:					
Nominal GDP (in USD million)	11235	12419	12744	12974	12974

Source: MoF, IMF and World Bank.

Note: The PA has recently taken some measures that aim to keep wage bill growth below budget. If implemented, the 2015 wage bill could end up lower than forecasted here.

19. Bank staff projections are in line with the PA's regarding the size of the financing gap, but not its contributors. Bank staff project the recurrent deficit to be USD1.29 billion which is larger than what is in the PA's budget due to higher than expected expenditure, particularly on net lending.[8] Compared to the PA's projections, staff foresees development spending in 2015 to be significantly lower due to the slow pace of the reconstruction process in Gaza (See Annex 1 for further details). This is expected to lead to an overall deficit that is smaller than what is in the PA's budget, amounting to USD1.54 billion. Total aid to the PA's treasury is expected to be USD1.1 billion, leading to a financing gap of USD0.4 billion. In contrast to the budget, which assumes a substantial reduction in the stock of arrears, and based on the trend during the first eight months of the year, it is expected that the stock of arrears to the private sector and the pension fund will grow during 2015 in order for the PA to close the financing gap. The Bank assesses that additional measures will be needed to boost revenues and control expenditures, but more donor aid is also urgently needed to buffer the negative impact of drastic fiscal consolidation on the economy.

Fiscal performance January – August 2015[9]

20. After a sluggish performance earlier in the year, domestic tax revenues finally picked up in July and August due to collection of tax arrears. VAT liabilities owed by some of the big corporations were collected in July and August causing domestic tax revenues for the first eight months of 2015 to grow by 11 percent year-on year. Some tax items, however, performed below previous year's levels. For instance, receipts from excise on tobacco between January and August 2015 dropped by 24 percent year-on-year as customers have been shifting to imported cigarettes and rolled tobacco sold in the informal market due to the elimination of the tobacco subsidy. Collections from property tax also declined by 4 percent. The contraction in economic activity has also affected consumer spending and hence, tax collection.[10] The Ministry of Finance (MoF) has so far in 2015 added 5,465 new taxpayers to its tax base and collections from income tax have increased by 2 percent through August, year-on-year. The PA's decision to reduce the income tax rate from 20 to 15 percent and also to widen the exempted bracket from NIS30 thousand to NIS36 thousand per year, effective since May 2015, has negatively affected income tax collections. Efforts so far conducted by the MoF to strengthen revenue performance and increase the number of taxpayers are commendable, and more needs to be done. Ongoing efforts to widen the tax base should be carried out in a more targeted manner that focuses on increasing the number of files in the Large Taxpayers Unit (LTU). The MoF should also accelerate its efforts to strengthen tax enforcement and impose strict financial penalties on evaders. In addition to the West Bank, efforts to enhance revenue collection from Gaza will need to be pursued once governance arrangements over the territory are clarified.

21. Despite being withheld earlier in the year, clearance revenues performed well between January and August 2015. The GoI withheld clearance revenues for the months of December 2014, January, February and March 2015 and released them on April 20 after making an extraordinary deduction of NIS237 million to clear electricity debt the GoI claims is owed by the PA, on top of the usual monthly deductions[11]. Since then, the GoI has resumed the monthly transfer of these revenues, and between

[8] Recent statements by the Ministry of Finance officials corroborate the World Bank's higher projection for expenditures on net lending.

[9] Fiscal data for August is preliminary and may be revised.

[10] National account statistics produced by the PCBS show a growth in consumption, however, this growth does not square with a drop in imports—a close proxy for consumption—nor with the output of specific economic sectors on the production side so we assume that there is an error in the estimate of consumption by the PCBS.

[11] The PA contests the unilateral deductions by the GoI and states that the majority of the electricity debt is owed by the Jerusalem District Electricity Company (JDECO) which is privately owned, and hence the debt should not be deducted from public funds. Israel, however, rejects the PA's claims.

January and August 2015 they grew by 8 percent year-on-year on a commitment basis and exceeded their prorated budget target. This growth was mainly driven by a 17 percent (year-on-year) increase in customs, which are only collected on non-Israeli imports according to the Paris protocol. Another factor that contributed to the growth of clearance revenues is an 8 percent increase in collections from petroleum excise mainly due to larger imports of Israeli fuel into Gaza. Notably, it is not entirely clear what part of clearance revenue growth is due to actual increase in imports from third countries and what is due to the PA's efforts in combating under invoicing through tax cooperation and information sharing with the GoI, which results in higher export values recorded by the authorities.

22. **Expenditure growth in the first eight months of 2015 was high amounting to 6 percent and it was mainly driven by an increase in transfers which grew by 14 percent.** The main reason behind the growth in transfers is the increase in social spending provided to poor households through the National Cash Transfer Program (NCTP), particularly in Gaza. The humanitarian situation in Gaza following the 2014 war got increasingly acute and the need for social assistance grew. As a result, 6809 new Gaza beneficiaries were added to the NCTP in 2015.

23. **According to the MoF, spending on the use of goods and services also increased by 11 percent between January and August 2015.** The majority of the increase in spending was at the Ministry of Health (MoH) due to an increase in the cost of medical referrals outside the public system. The MoH has been trying to control the issue of referral costs and given that the highest unit cost for referral cases is charged by Israeli hospitals, recent efforts have focused on reducing the cost of referrals to Israel[12]. In fact, the MoH has successfully managed to reduce the cost of this category of referrals by 19 percent. Nevertheless, the overall cost of referrals continues rise due to an increase in the number and cost of cases referred to Palestinian hospitals in the West Bank and East Jerusalem. Hence, the urgent need for a comprehensive strategy that sets clear guidelines and procedures for the overall referral process. In addition, reforming the extremely generous Health Insurance System (HIS), which is the primary source of hemorrhage, should be a priority.

24. **The MoF figures indicate that the wage bill was kept below its prorated budget target for the first eight months of 2015, but the PA seems to have underestimated its wage bill commitments.** According to the MoF, the prorated wage bill grew by 2 percent—lower than the 3.8 percent assumed by the budget. Figures reported by the MoF on the wage bill do not include the planned Cost of Living Allowance (CoLA) and the increase for teachers which have so far not been fully paid. If those are added, the increase in the wage bill would reach about 5 percent. Notably, there was a net increase in the number of PA employees by 169 as of August 2015.[13] Despite the increase in staffing, the PA has restated its budget commitment to implement the net zero hiring policy for 2015 and it states that the net increase is temporary and is caused by the fact that hiring usually happens earlier in the year while retirements and exits take place towards the end.

25. **The PA's efforts to reduce net lending[14] are starting to show results.** Net lending increased by 17 percent in the first eight months of 2015 compared to the same period in 2014, but due to extraordinary

[12] The MoH has already negotiated the price list of services provided with several major Israeli hospitals. It was also agreed with these hospitals that invoices will be audited and scrutinized by the MoH before any deductions are made from clearance revenues to cover the cost. Furthermore, several hospitals committed to admitting Palestinian patients only when valid referral documents produced by the MoH are presented in order to eliminate self-referrals.

[13] 429 employees departed from the public labor force in Gaza while 500 were hired in the West Bank. Net employment in the national fund and embassies was increased by 98. Employment in the security, health and education sectors increased by 94, 209, and 130 employees, respectively.

[14] Net lending represents deductions by the GoI from clearance revenues it collects on behalf of the PA for unpaid utility bills by Palestinian public utilities and local governments.

deductions made by the GoI from February clearance revenues. If figures are adjusted to assume standard deductions from February revenues, net lending would have declined by 17 percent due to the PA's efforts, which is a commendable achievement. The PA has recently taken some steps to control net lending including entering into Memorandums of Understanding (MoU) with Palestinian electricity providers to ensure that fees collected are used to cover bills to the Israeli Electricity Company (IEC) and not to finance non-electricity related expenditures. In addition, the MoF has recently finalized an exercise to reconcile the amount of electricity debt owed to/by the distribution companies and municipalities. Other actions were also taken to increase the collection rate including installing additional prepaid meters and passing a resolution preventing consumers from obtaining clearance to some civil services, including renewing a driver's license, applying for a visa, and obtaining travel permission, if they have accumulated unpaid bills. The MoF in cooperation with the Energy Authority currently aims to build upon these actions and produce a comprehensive action plan that aims to gradually reduce net lending until it is fully eliminated.

26. **The PA continues to rely on arrears as a source of deficit financing.** The PA's total deficit amounted to USD866 million between January and August 2015. Aid received was USD563 million: USD506 million in budget support and USD57 million in development financing. As a result, the PA ended up with a financing gap of USD303 million. Although the PA has been clearing its old arrears, new arrears were generated in 2015 and hence, net accumulation of arrears amounted to USD411 million[15] during the first eight months of 2015 – more than what was needed to close the financing gap. Excess financing enabled the PA to reduce its net domestic bank financing by USD85 million.

c. Money and Banking

27. **The Palestinian banking sector is generally healthy**. Data provided by the Palestine Monetary Authority (PMA) indicates that the sector's net assets grew by 3 percent so far in 2015. There is ample liquidity in the banking sector as evidenced by the loans-to-deposits ratio which stood at 57 percent as of June 2015. Banks in general are risk averse which is explained by the high political uncertainty in the country. Private credit grew by 15 percent in 2015 with the majority of private lending comprising construction and consumption loans. This raises concentration risks that should be monitored particularly given the continued growth of this credit category during the recent economic slowdown. Encouragingly, the ratio of non-performing loans to gross loans continues to be stable and low at less than 3 percent.

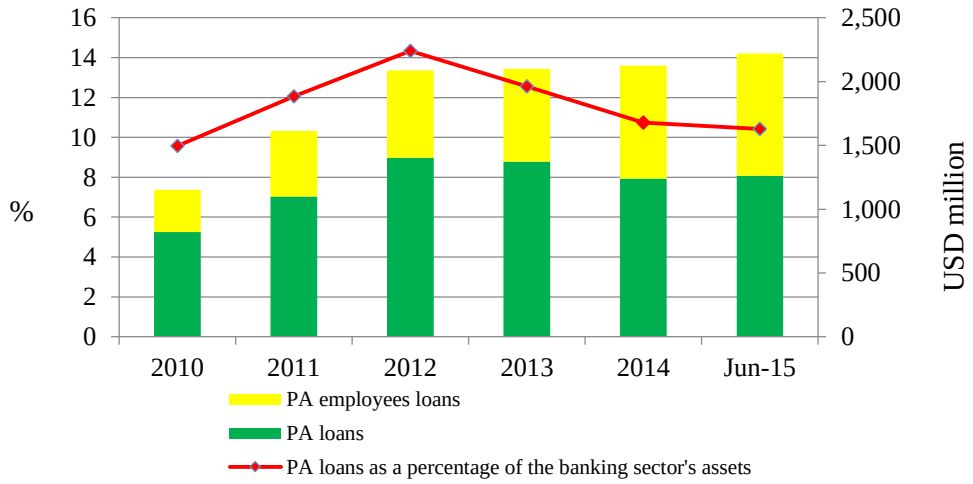
28. **Recent regulatory developments by the PMA** include the drafting of a new central bank law and the launch of a financial inclusion strategy. The proposed central bank law is expected to provide greater independence for the PMA in conducting monetary policy, and would form the legal basis for the potential establishment of a central bank in the future. Following a series of consultations with stakeholders to discuss the draft law, the PMA is currently in the process of incorporating feedback received, with a goal of finalizing the central bank law before the end of 2015. In addition to drafting the new central bank law, the PMA recently also made progress in the development of the financial inclusion strategy, initiated back in 2014. Concrete steps taken by the PMA to facilitate greater financial inclusion include the expansion of the credit registry beyond the basic credit history to include information on financial leasing, mortgage history, and court judgment.

29. **The banking sector's credit exposure to the public sector remains a concern but the PMA has been closely monitoring the related risks and taking appropriate actions to mitigate them.** As of

[15] About 40 percent of arrears accumulated in 2015 is to the private sector while the majority of the rest is to the pension fund.

June 2015, the PMA reports that the Palestinian banking sector has provided USD1.26 billion in credit facilities to the PA, which represents about 10 percent of the sector's total assets and 91 percent of its equity. Credit to public sector employees has been growing since 2010 and it reached USD958 million by the end of June 2015. More than 40 percent of banks' lending portfolios constitute loans to the PA and its employees. This high credit concentration is a serious risk that can threaten the viability of the overall sector, particularly given the PA's precarious fiscal situation. As a result, the PMA has been regularly conducting stress testing in line with Basel II principles to evaluate the banking system's stability. The PMA reports that the results of the June 2015 tests indicate that the banking sector is well capitalized and is able to withstand a wide range of economic, political and liquidity shocks.

Figure 2: Following a decline since 2012, PA debt increased again in 2015 after the suspension of clearance revenue while credit to PA employees has been on the rise all along



Source: Palestine Monetary Authority.

30. The recent war in Gaza did not have a significant negative impact on the financial sector. Several risk mitigating measures were adopted by the PMA over the past year to ensure stability of the banking sector in light of the prevailing risks, including the continuous refinement of the stress testing methodologies.[16] With support from the World Bank, the PMA is currently engaged in the design of a partial credit guarantee facility to help offset part of the political risks associated with lending in Gaza. The proposed facility aims to partially mitigate risks resulting from lending to the private sector in Gaza.

III. State building through better public expenditures – a reform agenda for the PA

31. There is substantial scope to improve the fiscal situation of the PA and improve the quality of public spending. While it is clear that economic growth through lifting of the restrictions would be essential to sustainably improve the fiscal situation of the PA, there are a number of measures that the PA can take to improve its fiscal position. In addition, the upcoming public expenditure review by the World Bank discusses a number of reforms that would improve equity and efficiency of public spending. This section will discuss the following reforms, some to reduce the deficit and others to

[16] Preparations are also underway to implement dynamic provisioning.

improve the quality of spending: (1) increasing revenues; (2) reducing the wage bill; (3) improving efficiency of the health spending; (4) overhauling the inequitable and expensive public pension system; (5) fixing the intergovernmental fiscal relations system and (6) strengthening public investment management capacity.

32. **No effort to substantially improve Palestinian public finances will be successful without a strong and sustainable rebound in economic growth.** Without strong economic growth that leads to job creation in the private sector and a substantial increase in the tax base for the Palestinian Authority, it is difficult to imagine the degree of fiscal consolidation that is required to place Palestinian public finances on a sustainable footing—even with current level of donor aid. As an illustration of the importance of growth for deficit reduction under the same reform effort, it is noteworthy that, *ceteris paribus*, the wage bill to GDP ratio could be lowered by an additional five percentage points of GDP (or more than half a billion dollars) over a four year period with a seven percent average growth as opposed to two percent average growth (based on modeling conducted by the World Bank).[17]

33. **In spite of the difficult economic and political situation, the PA has already implemented impressive reforms.** The reduction in the recurrent deficit from 25 percent of GDP in 2007 to 10 percent of GDP in 2014 is impressive and praiseworthy. It was achieved mostly through the reduction in the share of the wage bill and net lending to GDP. The wage bill peaked at 24 percent in 2006 and has since been reduced to 16 percent of GDP, largely thanks to strong GDP growth, but also due to hiring control and wage growth restraint. Net lending has been a significant source of fiscal burden for the PA. Fortunately, its relative size dropped from nearly 10 percent of GDP in 2007 to 2 percent of GDP in 2014. Analysis shows that it is possible to substantially further reduce net lending. Other categories of recurrent spending have fluctuated in the 13-14 percent range in recent years. Until 2014 when clearance revenue performance started improving, government revenues did not contribute substantially to deficit reduction.

a. Revenue Reforms

34. T**ax revenues remain substantially below potential**. The revenue to GDP ratio in the West Bank and Gaza is significantly below the world average and relevant comparators. An important reason behind the low level of revenue for the general government in the Palestinian territories is the very small amount of revenues collected by local governments, amounting to a mere 2 percent of GDP. Inadequate municipal revenues contribute to the PA's deficit by increasing the need to finance local government operations through transfers.[18]

[17] Palestinian GDP grew on average at the rate of 8 percent between 2007 and 2011 and the same rate of growth would be achievable again over the medium term if restrictions on movement and access were removed.

[18] Currently, there are no significant mandatory transfers to lower levels of government, but the PA indirectly finances municipal budgets through deductions the GoI makes from taxes it collects on behalf of the PA for unpaid utility bills that local government units owe to Israeli suppliers (this process is called net lending).

Table 2: General government revenues/GDP, selected regions

Comparator	General government revenue/GDP
Emerging and developing Europe	36.9
World average	31.6
Emerging and developing economies	28.6
West Bank and Gaza w/ higher Gaza contribution*	***27.1***
West Bank and Gaza actual	***23.5***

Source: Economy Watch database, www.economywatch.com and World Bank staff calculations.
Note: *Assuming Gaza contribution/Gaza GDP = West Bank contribution/West Bank GDP.

35. **More efforts are needed to further expand the tax base and reduce tax holidays**. Significant potential exists for increasing central government revenues by increasing the tax base, which is still relatively narrow. In particular, the tax base for internally collected direct and indirect taxes is small as a result of tax legislation that provides relatively excessive tax holidays (e.g., the investment promotion law that has recently been somewhat improved), as well as weaknesses in tax enforcement capacity, as a consequence of which many individuals and companies are not even registered to pay taxes. Improvements in tax enforcement require further capacity building (including recruitment of additional staff) of the Large Tax Payers' Unit in order to strengthen targeted audit activity and dispute management capacity. By reducing tax holidays and improving tax collections, the PA could generate sufficient additional revenues (worth 2-3 percentage points of GDP) to end its reliance on arrears for deficit financing. Furthermore, in addition to the effort to enhance tax revenues, the PA could generate about USD50 million in additional revenues by updating the pricing on a number of public fees and charges, which have not been updated for a number of years and its plans to do this are welcome. In sum, recent efforts by the PA to improve tax collections are welcome, but need to be intensified and accelerated.

36. **Inadequate tax receipts from Gaza are another important reason behind suboptimal tax collection.** As a result of the internal division between Fatah and Hamas, only about 12 percent of the PA's current tax revenues come from Gaza while as much as 43 percent of the PA's spending is in Gaza. Thus, tax collection effectiveness is significantly lower in Gaza than in the West Bank, which takes almost four percentage points off the share of general government revenue to GDP.

b. Oversized wage bill

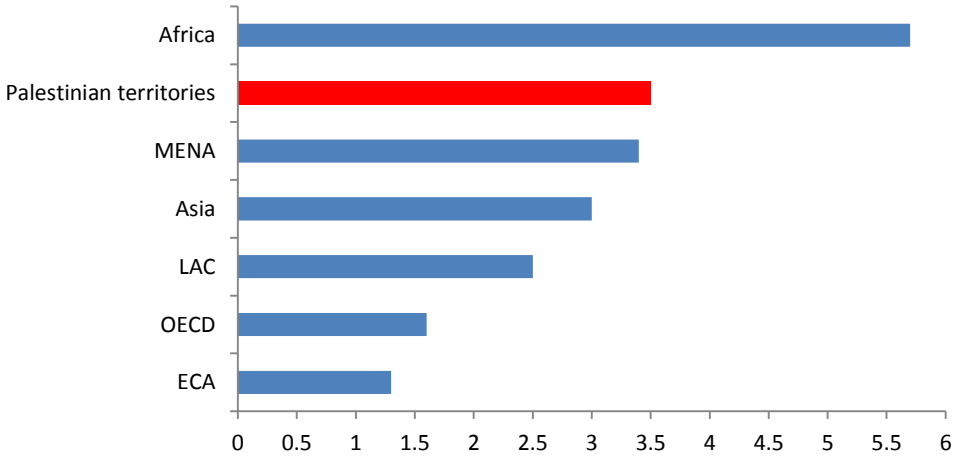
37. **On the expenditure side, the PA's very large wage bill remains a major drag on the sustainability of public finances.** At 16 percent relative to GDP, the wage bill of the general government in the Palestinian territories is among the very largest in the world. For comparison purposes, the expected wage bill of a country at a level of development that is similar to that of the Palestinian territories would be below 10 percent of GDP. The wage bill of local government units is quite small compared to other countries due to a relatively low degree of *de facto* decentralization, as local governments do not provide many services which are within their jurisdiction *de jure*.

38. **It is not the number of public sector employees that is the major contributor to the PA's oversized wage bill, but the relatively high average salary of the PA's employees.** Even if one were to add the employees recruited by the *de facto* authority in Gaza to the PA's wage bill, central government employment would still be below five percent of the Palestinian population, which puts West Bank and

Gaza significantly below many countries in the world and close to the average for middle income countries (5.3 percent).[19] While the overall numbers do not appear excessive, some sectors have large numbers of staff compared to international benchmarks. This is in particular the case with the Palestinian security sector. With close to 65 thousand staff, the PA's security sector is not so large by the standards of the Middle East, but is very large by global standards. Furthermore, the number of administrative employees in the public health sector, for instance, is quite large (35 percent of total) and the availability of health workers in the Palestinian territories surpasses many countries with similar income levels and countries in the region.

39. **Relative to GDP, the average public sector wage in the Palestinian territories is high.** The average yearly public wage in the Palestinian territories was USD11,059 in 2013 according to payroll data provided by the MoF. When measured as a multiple of per capita GDP, it amounts to 3.5. This ratio is higher than the MENA average of 3.4 and exceeds the ratios in other regions including Asia, Europe and Central Asia, Latin America and the Caribbean, in addition to OECD countries. Relatively higher average public wages in the West Bank and Gaza can be explained by the PA's pay practices. One reason is that the PA implemented two large salary increases over the last decade. The first one took place in 2004 when average pay was increased by 8.4 percent following enactment of the 2003 Civil Service Law. In early 2006, average wages were increased by a further 12.3 percent. The increases significantly exceeded inflation in these two years, which led to a real increase in wages without a commensurate increase in revenues to fund them. Furthermore, promotion policies in the civil service overall, but in particular in the security sector, which result in "top heavy" hierarchical structures have also contributed substantially to growth in the average wage. The total security force comprises one-third officers and two-thirds Non Commissioned Officers (NCOs) and soldiers. This represents a disproportionately large officer corps. In other countries, structures are flatter with broader spans of control in the hierarchy.

Figure 3: Average Public Salary (as a multiple of GDP per capita) in the Palestinian territories compared to MENA and most other regions



Source: World Bank staff calculations and World Bank 1999.
Note: While African countries have significantly higher public pay/per capita GDP, the average number of public sector employees per capita is much lower in Africa than in the Palestinian territories. `

[19] LABORISTA database, ILO.

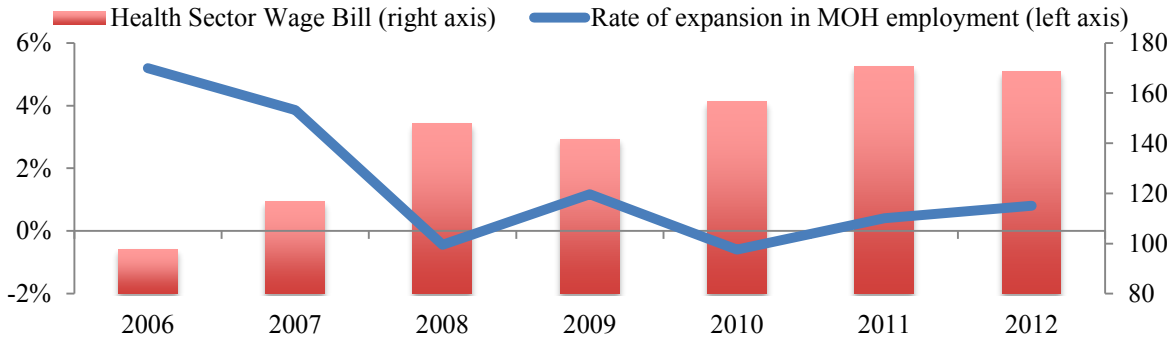
40. Serious reform efforts will need to continue to contain the wage bill. First, staff increases, which have been the norm up until 2012, will have to be contained for several years. Empowering the MoF to determine the overall wage bill ceiling and its allocation among different units of government based on pre agreed criteria, as well as authority to approve any new hiring, would strengthen the PA's ability to control wage bill growth. Second, wage growth will have to be contained until the wage gap between the public and private sectors is substantially reduced (currently average wages are 18 and 50 percent higher in the public sector than in the private sector for West Bank and Gaza, respectively). Folding most allowances now paid on top of base salary into base salary would also enhance control over wage inflation. These interim solutions will need to be followed up by deep reforms of pay and grade scales. The re-integration of the Gaza service delivery functions into the regular PA agencies would present a good opportunity to begin rationalizing the civil service.

c. Getting more value for money in the health sector

41. Although small by international standards, public health spending is on the rise, while the quality of public healthcare has not substantially improved. Consequently, patients rely on out-of-pocket spending to meet their health needs. This kind of spending is relatively high amounting to around 5 percent of the Palestinian GDP and it is still growing. This is in spite of the fact that public spending on health almost quadrupled during the last decade. It stood at USD488 million in 2012, representing 4.8 percent of GDP, which is higher than the MENA average of 2.6 percent and the Lower Middle Income Countries' average of 1.7 percent of GDP. In addition to the inefficiencies outlined below, it is noteworthy that political uncertainty, recurrent conflict, and restrictions on the movement of people and goods have important implications on planning and management of health services and thus hinder the overall efficiency of the system.

42. A significant factor contributing to the rise of healthcare expenditures is the rise of the health sector wage bill. The MoF reports that the health sector wage bill increased from USD97.8 million in 2006 to USD176.8 million in 2013. The overall wage bill also increased in this period, and not always in line with the expansion of the Ministry of Health (MoH) workforce. For instance, the largest increase in the health sector wage bill, amounting to 26 percent, took place between 2007 and 2008 and in 2011 it also increased by 9 percent. These increases were almost entirely due to pay raises and not workforce expansion, which in fact slightly contracted in 2011. Thus in addition to staff increases, salary raises contributed significantly to the growth of the PA-financed health sector wage bill.

Figure 4: MOH wage bill, Palestinian territories, 2006-2012

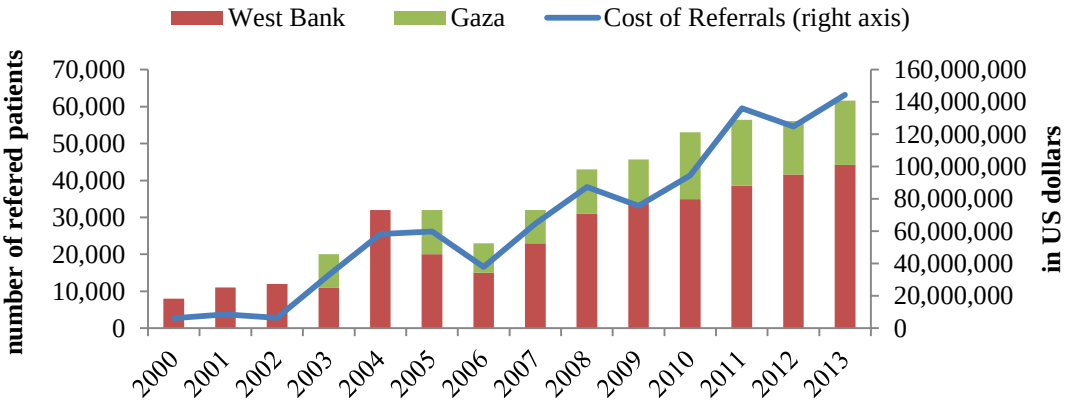


Source: MoF 2014.

43. **Another driver of higher spending is the inefficient system of medical referrals outside of the public healthcare system, which the PA has started to reform with some success already.** In recent years, a large and increasing number of patients requiring tertiary-level care are referred to a mix of private (for profit) and nonprofit service providers outside of the public health system. Many referrals are justified and they pertain to the conduct of complex medical procedures for cancer and cardiac patients, but a significant number of referrals currently made may not be necessary and the costs of referrals could be reduced through better control systems. A recent World Bank study audited the appropriateness of outside medical referrals and concluded that a significant majority of documentation on specific referral decisions lacked accurate information.[20] A set of guidelines with clear criteria for referral decisions has recently been developed and put to use by the Ministry of Health in order to reduce unwarranted discretion in the referral process described above.

44. **Another issue with the system has been that a large proportion of patients circumvents the referral system**. A World Bank initiated audit showed that 35 percent of patients received referrals directly from the higher medical committee without going through the referral system and over 10 percent received a referral without any reference. Of the 10 percent of referrals with proper documentation, the medical audit revealed that only 60 percent were medically justified. Currently the Ministry of Health (MoH) is preparing a strategy that defines which services it would like to invest in internally and which services it would like to purchase from other service providers within the Palestinian territories, as well as neighboring countries.

Figure 5: Trends in Medical Referrals, Palestinian territories, 2000-2013



Source: MoH 2014.
Note: No data were available for referrals from Gaza for 2000-2002 and 2004.

45. **Another factor contributing to high health costs is pharmaceutical expenditure which accounted for 47 percent of non-salary public expenditures in 2013.** Expenditure on drugs has shown large fluctuations increasing by 29 percent between 2010 and 2011, mirroring and partially driving the increasing overall public expenditures in health. A further discrepancy exists between the cost of drug tenders and overall pharmaceutical spending over the years. The MoH pays relatively high prices for pharmaceuticals, and import restrictions and large arrears owed to suppliers hamper its ability to negotiate better prices. Pharmaceutical companies factor in the cost of delayed payments in their

[20] Approximately 90 percent of all audited referral files lacked a reason for referral; 73 percent did not have a clinical summary; and 35 percent lacked an explanation of the initial diagnosis. Furthermore, 31 percent of the referral files lacked sufficient information to determine whether the case was referred for inpatient or outpatient services.

pricing. In addition, MoH officials and NGO representatives claim that restrictions by the Israeli government on pharmaceuticals that can be imported limit the choices available and, in some instances, force Palestinians to buy from Israeli companies at high prices. The review compared the top 20 tenders by cost from the 2013 Center for Medical Services list with international benchmark prices based on the WHO's International Drug Price Indicator Guide. The conclusion was that Palestinian territories are typically overpaying for drugs.

46. The health insurance system is not sustainable. The system is characterized by a significant imbalance between the government health insurance (GHI) revenues and expenditures, which have been growing. In 2012, public expenditure on health reached USD 488 million and GHI revenues were USD31 million, representing a financing gap of USD457 million, five times the size it was in 2000.

47. The PA can substantially improve the value for money and quality of healthcare services through reform. In addition to reforming the referral system which is already underway, it will be important to reform the health insurance system, rationalize staffing and improve pharmaceutical procurement.

d. A pension system in need of urgent reform

48. The pension system is expensive and covers a small share of the elderly population. Total pension expenditure was NIS1,089 million[21] in 2013, or around 3 percent of GDP. Even though this is close to the MENA average of 3.6 percent, it is considered extremely high in the Palestinian context given the demographic profile, with only 3 percent of the population currently above the age of 65, and only about a third of that population receiving pension benefits. For instance, as of September 2014, the system had 154,986 active contributors, including 86,359 civil servants, 65,277 security personnel, and 3,350 private sector employees.[22] Together, these represent around 16 percent of the total labor force, and 7 percent of the working-age population (ages 15 to 64). On the other hand, the system provides benefits - whether for old-age, disability, or survivorship - to 46,596 beneficiaries who represent only 1 percent of the total population. This coverage rate is very low compared to the share of pension expenditure in the Palestinian economy. Countries with similar low coverage ratios such as Paraguay and Ghana have much lower pension spending as a percentage of GDP.

49. Even though the system covers a small share of the population, the PA is unable to meet its obligations under the law. The Palestinian pension system is, *de jure*, a funded, multi-pillar system, but it is, *de facto*, run as a pay-as-you-go system. The PA has been making regular payments to pay current pension benefits, while making only sporadic contributions towards the funded pillar of the pension system, and consequently accruing considerable arrears. Contributions transferred by the PA to the Palestinian Pension Authority (PPA)[23] have increased since 2014, but they are still well below the amounts stipulated by the Unified Pension Law. Since May 2011, the PA has transferred to the PPA NIS70 million per month to make pension payments, even though its monthly commitment by law is about NIS96 million. Since November 2014, the MoF has started to also transfer an additional NIS10 million per month in contributions. Even though this is commendable, it has not been enough to cover the monthly commitments and the MoF therefore continues to accrue significant monthly arrears to the pension system. In total, arrears accumulated to civil servant schemes over the years are estimated at

[21] Based on December 2013 data (the amount includes regular and lump-sum payments).
[22] The first NGO joined the pension system in October 2011. By the end of 2013, 38 NGOs had joined the pension scheme. Low coverage in the private sector is mostly due to high informality, unemployment, and under-employment.
[23] According to the UPL enacted in 2005, all pension schemes should be centralized in the PPA. Centralization has been improved, but there are still a few constraints. The main ongoing challenge with the accounting systems of all pension schemes is that in practice the PA transfers to the PPA less than what is required by the UPL.

USD1.8 billion (July 2015 estimate). No information is yet available on arrears accumulated to the security services schemes.[24]

50. The combination of high benefits and low coverage raises important equity concerns. The fact that the system provides generous and unsustainable retirement benefits for those few Palestinians of retirement age who had worked in the public sector, while leaving out those who have not been employed or have worked in the private sector makes the system rather inequitable. Future pension costs are projected to continue increasing and, at some point, they will start crowding out spending on other key areas including social assistance, healthcare, and education. Thus, the system is expected to become not only less sustainable without reforms, but also less equitable if it reduces fiscal space for expenditures that disproportionally benefit poorer segments of the Palestinian population.

Figure 6: Pension Expenditure and % of Elderly Population

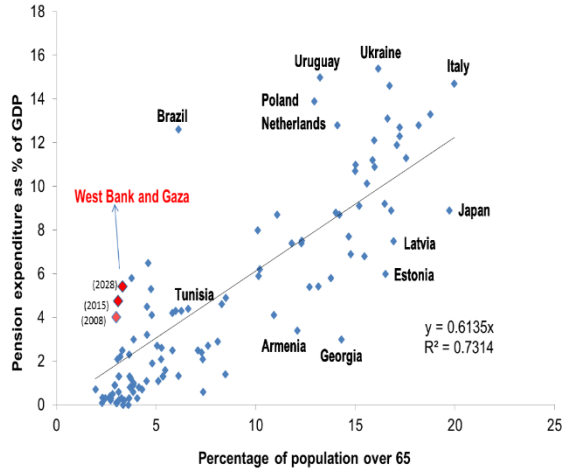
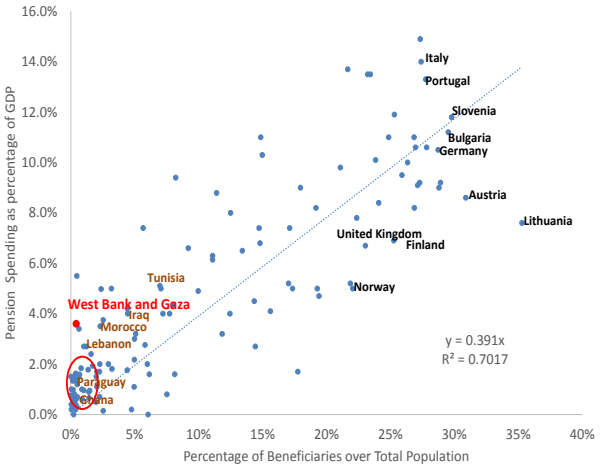


Figure 7: Pension Expenditures and % of Beneficiaries over total Population



Source: HDNSP Pensions Database.

51. Thus, the Palestinian public pension system is not sustainable as currently designed and implemented and there is an urgent need for deep reforms. Reform efforts would need to: a) consolidate the currently fragmented pension system and make the system not only, *de facto*, pay-as-you go, but also, *de jure*, by changing the pension law in order to: a) increase the retirement age; b) tighten the criteria for disability and survivorship pensions; d) render the pension level more in line with international practices to make it affordable.

[24] A joint committee that includes members from the MoF and the PPA was set up a few years ago to calculate the total amount of arrears owed to the pension system. The committee has so far focused its work on civil servant schemes and it plans to expand its work to include the security services schemes soon.

e. Inadequate local government revenues and indirect costs of municipal coping mechanisms

52. Local governments fulfill a fraction of their mandates mostly due to inadequate and partly unpredictable revenue sources. The size of most local government units (LGU) in the West Bank and Gaza is relatively small and their revenues are insufficient to fulfil many of the LGU's functional mandates. Local government expenditures account for 6 percent of expenditures, which is only a fraction of what is observed in other countries around the world. LGUs are assigned 27 different functions, but the large majority of the LGUs (around 80 percent) on average exercise only 12 of those. The main reason for this is inadequate LGU revenues as a consequence of which most LGUs run budget deficits. The reasons for inadequate LGU revenues is not only related to inadequate tax assignments and relatively inefficient tax collection, but it is also due to the fact that transfers from the central to local governments are irregular and relatively small in size. At present, there are no formalized and regular grants or transfers available from the PA to supplement the shortage of LGUs' own-source revenues. The criteria applied to decide on the distribution of transfers are not always clear either. This opens room for arbitrary allocations, which may not best serve government policy objectives, such as the reduction in inequality and poverty. For instance, poorer Palestinian municipalities have much lower revenues and consequently much lower expenditures per capita than wealthier ones. Furthermore, unpredictable transfer allocations also limit the ability of LGUs to plan their budgets.

53. Many LGUs rely on utility revenues (mostly electricity) to finance their operational expenditures, rendering the utility sector unsustainable. This behavior represents a significant source of fiscal burden on the Palestinian Authority because the GoI deducts most of the unpaid bills by distribution companies and LGUs from the indirect taxes it collects on behalf of the PA and it ends up costing the PA in excess of USD200 million per year. In addition to paying for unpaid electricity bills, the PA also pays an 11 percent late payment fee. The practice results in inadequate investments in maintenance and upgrading of the electricity sector, which leads to significant technical losses that amount to another USD200 million in purchased, but lost electricity.

54. Ensuring solvency of Palestinian public utility service provision, among other things, requires efforts to increase municipal revenues, including transfers. The Bank's analysis shows that some municipalities critically depend on revenues from electricity to cover their operational expenditures. Thus, in addition to efforts to increase municipal own revenues and reduce unnecessary expenditures, it is recommended that a formal and transparent government transfer be instituted to enable poorer municipalities to stop diverting electricity and other utility revenues to finance their operational and sometimes also development expenditures.

55. A sound utility sector and sound municipal finances also require the transfer of responsibility for the management of utility services away from LGUs to dedicated public corporations. Utility management requires skills and governance structures that are most often not found in government units, in particular in local governments. Moreover, without direct access to utility revenues, LGUs would no longer be tempted to divert them to finance operational expenditures. Finally, the transfer of these functions to dedicated public corporations would reduce the fragmentation of service provision, leading to some efficiency gains.

f. Low level of public investments and an underdeveloped public investment management system

56. The Palestinian economy suffers from low levels of public investment. In 2006 and 2007, public investment spending amounted to 5.6 percent and 5.7 percent of GDP, respectively, but the level was reduced gradually to an average of 2 percent between 2012 and 2014. While total public investment is

slightly higher, in the range of 4 percent (i.e., including local governments and off-budget public investment), public investment is still low compared to well-performing developing countries and significantly below Palestinian needs, especially if the Palestinian population continues to grow at an annual rate of 3 percent. Low level of public investment results in poor quality of infrastructure such as roads and electricity transmission networks and poor sanitation services, in particular in Gaza. Poor public infrastructure is visible in the West Bank and it is very conspicuous in Gaza.

57. **However, to effectively increase the level of public investments, it will be necessary to build the key features of a functioning public investment management system.** The PA currently lacks an adequate legal framework and institutional capacity for public investment management. First, the PA lacks a clear definition of public investment needs that is based on expenditure on fixed capital assets and related equipment costs. Furthermore, the PA needs to build a legal and institutional framework for public investment management to ensure that core functions starting with project identification, evaluation and appraisal, procurement, implementation monitoring and finally ex-post evaluation are effectively executed.[25] Furthermore, public investment should be separated from the wider development project categorisation which, particularly in the case of international development partner (IDP) funded projects, can include significant operational and service delivery spending. Despite significant progress in recent years in bringing IDP funded projects into the PA budget, in many sectors the major share of these remains off-budget. A plan should be made to work with donors and bring all IDP funded projects into the budget. Finally, since there is a need to substantially increase investments at the local government level to improve the infrastructure services whose provision sits within local government domain, an effort should be made to consolidate public investment management by local government units and to improve the oversight of local government investments. The responsibilities and functions of the Ministry of Local Government (MoLG) with respect to the oversight and reporting of public investment by local governments should be fully elaborated and the required analytical capacities put in place.

[25] Regulations issued under the organic budget law and detailed guidelines for the main requirements of the public investment management system (PIM) will need to be developed. Responsibility for PIM procedures and oversight of the capital investment program should be consolidated within the MoF for both PA and IDP financed capital projects.

Annex I: An overview of disbursement and implementation of pledges made at the Cairo Conference on Palestine "Reconstructing Gaza", Cairo 12th October, 2014

58. **The Cairo Conference on Palestine "Reconstructing Gaza" was convened to address urgent needs in Gaza after the 2014 war**. On October 12th 2014, Egypt, Norway and the Palestinian Authority (PA) convened the Cairo Conference on Palestine "Reconstructing Gaza" to respond to the humanitarian needs of the Palestinian people in the aftermath of the Gaza war that took place in July and August 2014, and to enable early recovery and the reconstruction of the Strip.

59. **The World Bank is leading a stocktaking exercise to track the disbursement of Cairo Conference pledges to support Gaza**. At the request of Norway, as chair of the Ad-Hoc Liaison Committee (AHLC), and the Palestinian Authority (PA), the World Bank has been leading a stocktaking exercise to overview the disbursement and implementation progress of support to Gaza pledged at the conference. The Bank's findings are updated regularly and presented in the World Bank's report to the AHLC twice a year.[26]

60. **This stock-take updates the disbursement figures from the May 2015 AHLC report. The main findings are that:**

a) Since the May 2015 AHLC report, disbursements have increased by USD262 million (27 percent). This mainly reflects additional disbursements (USD141 million), additional information from Turkey and UAE (USD82 million), and amendments of previous figures (USD39 million).

b) While USD1.229 billion has been disbursed this is almost USD0.9 billion less than the amount projected by donors during 2014 and 2015 when indicating the timing of their disbursements at Cairo. It is important that disbursements are accelerated.

c) Almost half of the USD3.5 billion in pledges made at the Cairo Conference have not been allocated to specific activities or projects.

d) Only USD227 million of the allocated disbursements relate to the Gaza Detailed Needs Assessment (DNA) and Recovery Framework. The PA should work with donors to allocate funds towards priority areas.

e) We have not been able to include information on actual expenditure in this report and would encourage donors to share this information so it can be included in future updates.

Pledges of support to Gaza announced at Cairo Conference

61. **USD3.5 billion was captured as support to Gaza during Cairo Conference, of which USD2.5 billion is new funding.** A review of total pledges captured at the Cairo Conference shows that participant countries and agencies pledged approximately USD5 billion to the Palestinian territories over the period 2014-2017, of which USD3.5 billion is intended to support Gaza over the same period.[27] About 72 percent of the support to Gaza captured at the conference is new funding committed by

[26] Findings can also be found online at (http://www.worldbank.org/en/programs/rebuilding-gaza-donor-pledges)

[27] Figures for pledges announced at Cairo Conference were revised due to some inaccuracies in recording original pledges and for the use of inflated commodity prices for the valuation of in-kind contributions. Check Glossary for terms and definitions.

participants to support Gaza recovery and reconstruction after the 2014 war.[28] The remainder, as shown in figure 9, is a reallocation of existing commitments, or assistance that was already disbursed during the war.[29]

Figure 8: Total pledges announced at Cairo Conference (in million)

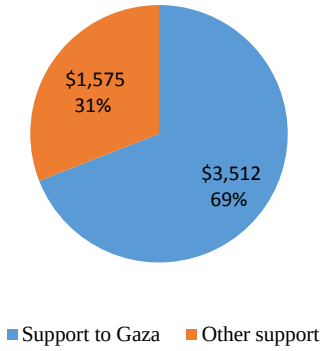
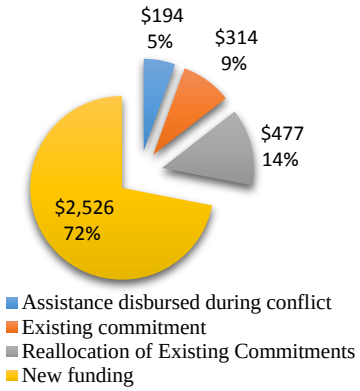


Figure 9: Support to Gaza classification (in million)



Disbursement progress of support to Gaza announced at Cairo Conference

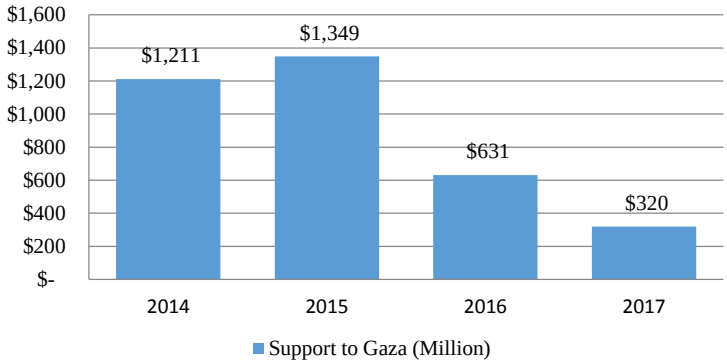
62. **As of August 31st, 2015, USD1.229 billion of support to Gaza announced at the Cairo Conference was disbursed, and disbursement efforts need to be accelerated.** Since the May 2015 AHLC report, total disbursements have increased by USD262 million. This mainly reflects additional disbursements (USD141 million), additional information from Turkey and UAE (USD82 million), and amendments of previous figures (USD39 million). As a result, almost a year after the 2014 war, total disbursement of pledges to support Gaza is estimated at USD1.229 billion,[30] and hence, the overall disbursement ratio of support to Gaza announced at Cairo Conference reached 35 percent.[31] However, this is USD881 million less than the expected disbursements in 2014 and the first eight months of 2015 based on information provided at the conference. Figure 10 shows the expected flow of funding to Gaza over the period 2014-2017 and more than 70 percent of total support was expected to be disbursed over the period 2014-2015.

63. **Even though 23 out of 54 participants have already fully delivered their pledges, disbursement by the largest donors remains lower than anticipated.** Based on data provided by participant countries, 23 participants have already fully delivered their original pledge announced at the conference to support Gaza. However, their overall disbursements (USD228 million) represent only 6.5 percent of total support to Gaza. Pledges from the top seven donors combined represent around 78 percent of total support to Gaza announced at the conference for the period 2014-2017 (USD2.7 billion).[32] Total

[28] Check Glossary for more details about classification of support to Gaza.
[29] Classification of funding may be subject to change in cases where donors have not yet verified their figures.
[30] Support to Gaza figure refers to pledges made at Cairo Conference and therefore does not reflect all support spent in Gaza after 2014 war.
[31] This estimate may change once further data is collected from donors who have not yet provided information about disbursements and allocations of pledges.
[32] The top seven donors are Qatar, Saudi Arabia, European Union, USA, Kuwait, Turkey and UAE.

disbursements so far by the top 7 donors amounted to USD742 million –27 percent of their total original pledges.[33]

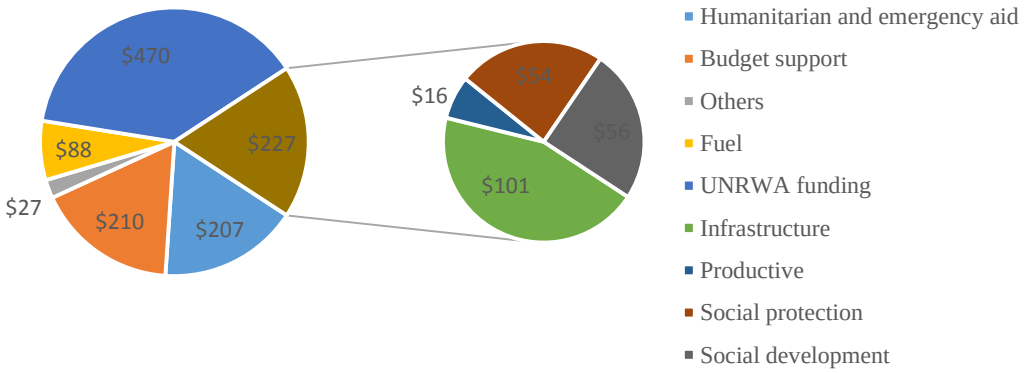
Figure 10: Expected flow of support to Gaza



64. Out of the USD1.229 billion that has been disbursed, only USD227 million was disbursed on priority interventions outlined in the Gaza DNA and Recovery Framework, which represents 5.8 percent of total recovery needs.[34] By analyzing donors' interventions in Gaza financed through pledges announced at the Cairo Conference, the World Bank in a joint effort with the National Office for Reconstructing Gaza (NORG) concluded that only USD227 million of actual disbursements as of August 31st, 2015 are attributed to the recovery framework outlined in the DNA across five sectors impacted by the 2014 war. An overall view of actual disbursements made so far by donors is shown in figure 11. USD470 million (38 percent) of actual disbursements made so far by donors financed UNRWA's activities and programs. On top of the funding directed to UNRWA, USD207 million was disbursed by donors to finance emergency aid operations and provide humanitarian aid to people in distress in Gaza. Another USD210 million supported the Palestinian budget either directly through the Single Treasury Account (STA) or through EU- PEGASE mechanism and World Bank PRDP trust fund. In addition, USD27 million- Others financed ongoing programs and projects in Gaza, while USD88 million was used to purchase fuel.

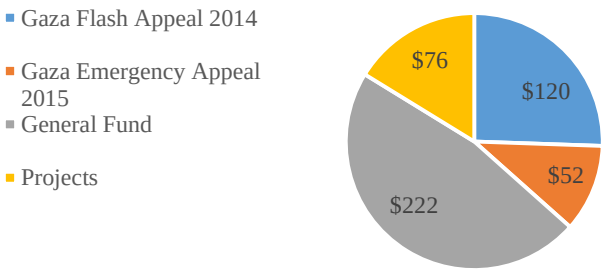
[33] This figure may change once further data is collected from donors who have not yet provided information about disbursements and allocations of pledges.
[34] All recovery interventions undertaken by UNRWA are classified under a separate category- UNRWA funding.

Figure 11: Actual disburesements of support to Gaza announced at Cairo Conference by category (in million)



65. **Almost 38 percent of actual disbursements by donors supported UNRWA's activities, but this still falls short of the funding requested by the Agency.** Figure 12 shows the distribution of UNRWA funding among its General Fund, Gaza Flash Appeal 2014, Emergency Appeal 2015 and UNRWA projects. According to UNRWA, there remains a deficit of USD493 million for the emergency shelter program supporting families whose homes were impacted during 2014 war.[35]On top of the unprecedented financial distress faced by UNRWA this year, the Agency claims it incurred USD7.5 million in additional costs in 2014 alone, which is equivalent to the cost of building four UNRWA schools, as a result of Israeli requirements on access and monitoring of imported materials into Gaza.[36] The additional costs include extra staffing, transit and logistical cost resulting from Israeli requirements on access and monitoring of imported materials.[37]

Figure 12: Funding received by UNRWA as part of Cairo Conference pledges (in million)



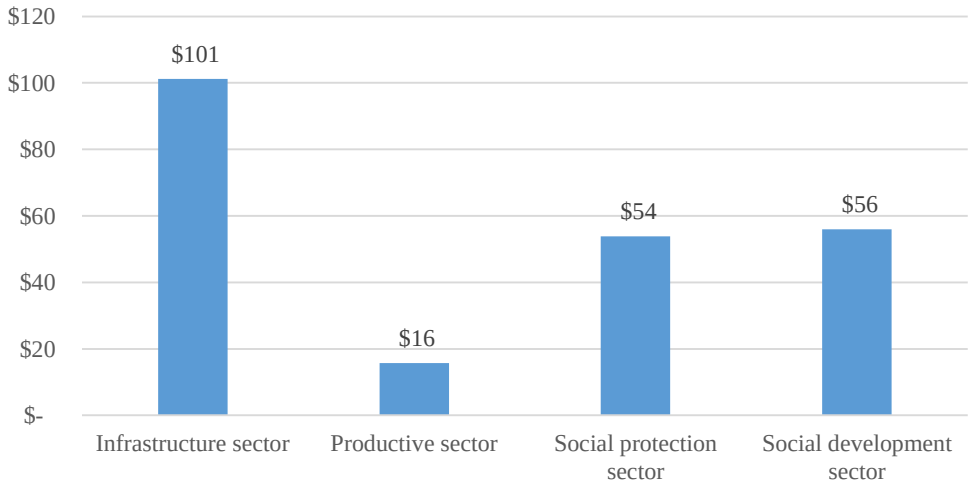
[35] UNRWA donor Communiqué 21st of August to September 3rd, 2015
[36] UNRWA, department of external relations and communications, Gaza Headquarters.
[37] Israel allows goods into the Gaza Strip except for items it defines as "dual use" materials, which are only permitted to enter for approved projects by international organizations. Since 2010, Israel has permitted construction materials to enter for approved UNRWA projects. Imports of construction materials by UN Agencies into Gaza remain subject to a lengthy and cumbersome approval process imposed by Israeli authorities.

Total disbursements of Cairo Conference pledges to finance recovery interventions outlined in the Gaza DNA and Recovery Framework

66. The Gaza DNA and Recovery Framework lays out the economic and human costs of the conflict and the set of strategies to help Gaza recover (see Table 3 below). Each recovery framework proposal was identified by the National Consensus Government of the Palestinian territories and has the support of local and international partners that took part in the assessment process. The PA will use these recovery framework interventions to mobilize and direct international support, including the remaining donor funds that were pledged at the Cairo Conference in October 2014 but have not yet been disbursed.[38]

67. **Based on interventions outlined in the DNA, actual disbursements, excluding UNRWA funding, financed a mere 5.8 percent of the overall recovery needs.**[39] USD227 million of actual disbursements[40] as of August 31st, 2015 financed interventions outlined in the DNA. The infrastructure sector attracted the highest funding of USD101 million, followed by the social development and social protection sector, which received USD56 million and USD54 million, respectively. While the productive sector received the lowest share with funding of USD16 million.[41]

Figure 13: Financing of DNA and Recovery Framework (in million)



68. **The Palestinian Authority needs to work with donors to mobilize the remaining funds that were pledged at the Cairo Conference but not yet been disbursed or allocated towards interventions outlined in the recovery framework**. Out of the USD3.5 billion of funds announced at the Cairo Conference, USD1.229 billion has been disbursed so far and another USD550 million of undisbursed pledges are allocated to specific projects and programs leaving USD1.73 billion to still be allocated.[42] It is key that the PA works with donors to direct these finds towards to priority areas outlined in the DNA.

[38] Detailed Needs Assessment and Recovery Framework, State of Palestine: Gaza, August 2015.
[39] Total recovery needs in Gaza DNA and Recovery Framework are estimated at USD3.875 billion.
[40] Support to Gaza figure refers to pledges made at Cairo Conference and therefore does not reflect all support spent in Gaza after 2014 war.
[41] A more detailed breakdown of the disbursement figures for each sector is provided on the World Bank website http://www.worldbank.org/en/programs/rebuilding-gaza-donor-pledges
[42] Based on data collected from donors.

Table 3: Summary table of damage, losses and recovery needs (Gaza Detailed Needs Assessment and Recovery Framework) (USD million).[43]

Sector	Subsector	Damage	Losses	Recovery Needs
Infrastructure	Housing	780	-	930
	Energy	58	924	238
	Water	33	94	156
	Transport	42	-	54
	Explosive Ordinance Disposal			5
	Subtotal	**913**	**1,018**	**1,383**
Productive	Agriculture	266	284	297
	Non-Agriculture Productive	144	136	301
	Tourism	8	-	1
	ICT	-	31	3
	Subtotal	**418**	**451**	**602**
Social Protection	Livelihoods and social protection	5	52	763
	Subtotal	**5**	**52**	**763**
Social Development	Health	24	149	383
	Education	35	16	150
	Culture	1	2	13
	Subtotal	**60**	**167**	**546**
Governance	Governance	32	-	581
	Subtotal	**32**	**-**	**581**
	Total	1,428	1,688	3,875

[43] *Ibid.*

Glossary:

Currency: Total pledges announced at Cairo Conference are in USD million. All original pledges in other currencies were converted into USD using the historical currency exchange rates obtained from (www.oanda.com) dated October 9th 2014. For donors with pledges in currencies other than USD, actual disbursed amounts may slightly differ from figures in table due to fluctuations in exchange rates. Disbursed amounts in other currencies were converted to USD based on historical exchange rate to reflect accurate progress in disbursement.

Pledges defined: The output of the pledging exercise in Cairo Conference was a combination of two types of pledges; pledges by donors of total support for the Palestinian territories for the period 2014-2017 and pledges by donors of support to Gaza only over the same period. [44] The difference in pledges reporting by donors at Cairo Conference required a classification of total support figures to better reflect support to Gaza for the period 2014-2017 and to allow tracking disbursement of support to Gaza over that period.

Support to Gaza: Funds pledged during the Cairo Conference intended to support Gaza recovery and reconstruction.[45]

Support to Gaza classification

Total support to Gaza that was announced at Cairo Conference is classified into 4 main categories:

Humanitarian assistance disbursed during conflict and prior to Cairo Conference that was part of the pledge declared at the conference.

Existing commitments by donors that were planned and programmed for Gaza for the period 2014-2017 prior to conflict and were part of the pledge.

Reallocation of existing commitment by donor to support Gaza in response to the conflict.

New funding announced at Cairo Conference to support Gaza recovery and reconstruction.

Disbursement defined: Disbursement of support to Gaza does not necessarily reflect actual expenditures made on purchasing project-related goods and services but that a donor funds have been made available for use by the relevant implementation agency.[46]

Disbursement ratio of support to Gaza: This is the ratio of the amount disbursed of support to Gaza, as per the disbursement definition above, to the amount pledged to support Gaza at the Cairo Conference.

[44] The pledging exercise at Cairo Conference took two forms; some participant countries declared all their commitments to the Palestinian territories over the period 2014-2017 while other participant countries declared Gaza specific funds only in their pledge.

[45] Support to Gaza figure refers to pledges made at Cairo Conference and therefore does not reflect all support spent on Gaza after 2014 war.

[46] When a pledge (part of pledge) is disbursed that means that funds were received and secured by implementation agency and donor had fulfilled the pledge committed at Cairo Conference.