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# Fiscal Crisis, Economic Prospects

The Imperative for Economic Cohesion in the Palestinian Territories

**Economic Monitoring Report to the Ad Hoc Liaison Committee**  
**September 23, 2012**



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## Acronyms

3G/4G	Third / Fourth Generation of Mobile Telecommunications Technology
AHLC	<i>Ad Hoc</i> Liaison Committee
ARIJ	The Applied Research Institute - Jerusalem
BoI	Bank of Israel
DOP	Declaration of Principles
FISIM	Financial Intermediation Services Indirectly Measured
GDP	Gross Domestic Product
GoI	Government of Israel
ICA	Israeli Civil Administration
IEC	Israel Electric Corporation
IMF	International Monetary Fund
MoF	Ministry of Finance
MoNE	Palestinian Ministry of National Economy
NCTPS	National Cash Transfer Payments System
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PIF	Palestine Investment Fund
PLO	Palestine Liberation Organization
PMA	Palestine Monetary Authority
Q1/2	First / Second Quarter
USAID	United States Agency for International Development
VAT	Value Added Tax
WB&G	West Bank and Gaza

### Executive Summary

The *Ad Hoc* Liaison Committee (AHLC) meeting of September 2012 comes at a time of deepening fiscal crisis for the Palestinian Authority (PA), coupled with worrying signs of economic slowdown, reduced donor aid, and few positive prospects in the broader political environment.

The PA is making credible efforts to tackle the crisis and continue to build its institutions. Indeed, a year ago the World Bank reported to this forum on its assessment of the institution building efforts of the PA noting that “In areas where government effectiveness matters most – security and justice; revenue and expenditure management; economic development; and service delivery – Palestinian public institutions compare favorably to other countries in the region and beyond.” That report also noted that the institutions of the PA “...are reasonably effective, both by any absolute standard one might have, and especially in comparison to other countries, in the region or elsewhere.” The institutional assessment of one year ago remains valid today. However, that report also warned of the need for sustainable economic growth driven by private sector investment. This issue is the focus of this report.

The PA is facing a very serious fiscal situation with its budget deficit higher than expected while external budget support has been falling. Debt to the local banking sector is almost at its limit and further credit from the private sector is unlikely to be forthcoming given the current high level of arrears.

It is imperative therefore that donors maintain their support to the PA’s budget, and that the PA continues to move on key reforms to raise domestic revenues and control expenditures. However, even with such measures, the real prospects for progressing on a path towards sustainable Palestinian economic growth will be challenging absent fundamental and significant changes that remove the impediments caused by the dissection of the Palestinian territories - impediments which constrain investment, raise costs and hinder economic cohesion.

As reiterated in past World Bank reports, the sustainability of growth in the Palestinian territories depends upon increasing private investment. However, restrictions put in place by the Government of Israel (GoI)<sup>1</sup> continue to stand in the way of potential private investment and remain the major impediment to sustainable economic growth. Most notably, the continued geographical fragmentation of Area C, (envisaged under the Oslo Accords as a temporary arrangement), poses a binding constraint to real economic growth, essential to support the future Palestinian state. Area C’s significance, as the only contiguous land in the West Bank connecting 227 separate geographical areas (A and B), is the key to economic cohesion and is the most resource abundant space in the West Bank holding the majority of the territory’s water, agricultural lands, natural resources, and land reserves that provide an economic foundation for growth in key sectors of the economy.

Preliminary analysis illustrates, in a number of potentially lucrative sectors, how the current system of restrictions, both physical and administrative hinders or prevents Palestinian private investment. The analysis highlights myriad challenges which can be tackled – whether with respect to land and water access, regulatory and procedural issues, in addition to the more frequently recognized physical barriers.

Continued financial support by the donor community, and increased reform efforts by the PA, to be fully effective, should also be combined with stronger action by the GoI to significantly ease remaining obstacles that currently prevent the Palestinian private sector from becoming the real engine of sustainable growth – the only medium term solution to exit from protracted fiscal crisis.

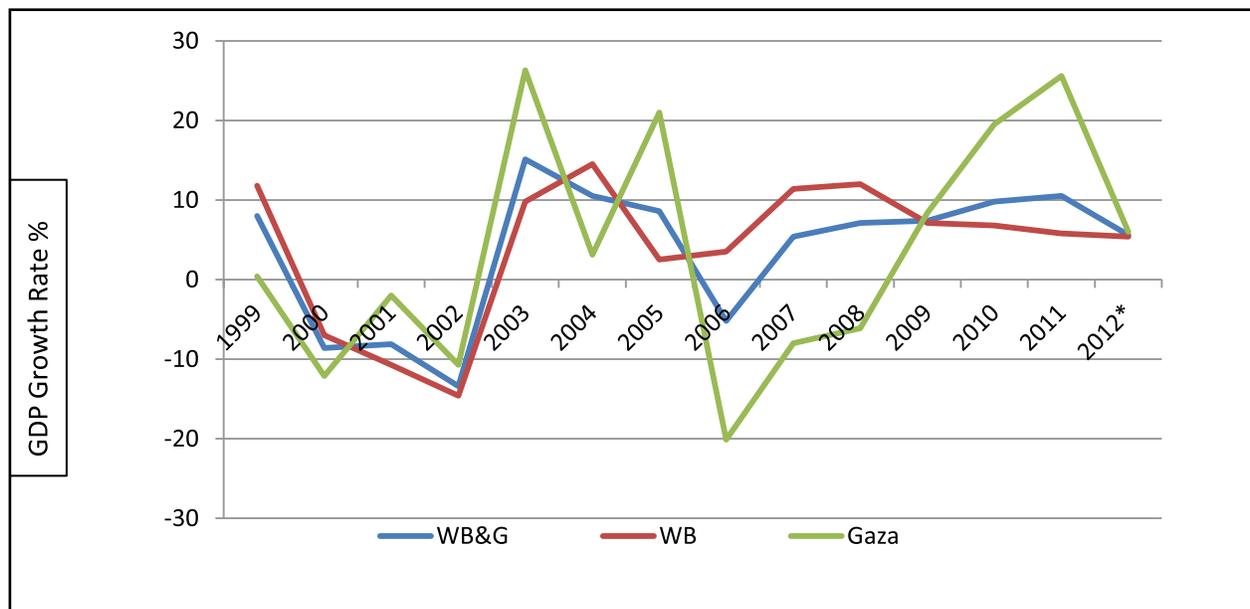
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1 The GoI cites overriding security concerns that restrict its ability to continue to ease or lift restrictions on the West Bank and Gaza.

## 1. Economic Developments

1. **Economic growth in West Bank and Gaza (WB&G) slowed in the first quarter (Q1) of 2012.** The real growth rate is estimated to have reached 5.6 percent<sup>2</sup>, more than three percentage points lower than the Q1 2011 growth figure and almost one percent lower than the growth forecast contained in the PA's budget. This decline is attributed to a major slowdown in Gaza, where real growth decreased from 21.3 percent to 6 percent on a year-on-year basis. In the West Bank economic activity in Q1 2012 was broadly unchanged from its 2011 level and real Gross Domestic Product (GDP) growth was 5.4 percent. Overall, economic growth in the Palestinian territories continues to be restrained by Israeli restrictions, a shortfall in donor aid in addition to uncertainty caused by the PA's fiscal crisis. It is expected that growth for the full year of 2012 will be around 6 percent – 5 percent in the West Bank and 9 percent in Gaza.<sup>3</sup>

Figure 1. Real GDP Growth Rate 1999-2012



\* Based on preliminary data for the first quarter of 2012, Source: PCBS, National Accounts

2. **The slowdown in Gaza during Q1 of 2012 was mainly attributed to a major decline in the agriculture and fishing sector, which offset much of the growth witnessed in other sectors.** This sector shrank by 43 percent in Q1 2012 due to frequent power outages resulting from the lack of fuel in Gaza. The electricity blackouts led to shortages in the supply of water to most agricultural facilities hindering their performance. Public administration and defense is another sector that contributed to the slowdown in Gaza, shrinking by 5 percent due to fiscal retrenchment. The manufacturing sector continues to be severely constrained by Israeli restrictions on exports, and therefore did not witness any growth during Q1 2012.
3. **Nevertheless, other sectors in Gaza expanded and the highest growth levels were witnessed in the construction, and hotels and restaurants sectors.** In Q1 2012, the construction sector is estimated to have grown by 40 percent compared to Q1 2011, contributing around 4.4 percent to total growth in Gaza. This reflects the sector's continued recovery following the relaxing of Israeli import restrictions

<sup>2</sup> Only the first quarter national accounts data were available during the reporting period.

<sup>3</sup> This is a projection prepared by the International Monetary Fund (IMF) in consultation with PCBS, the World Bank, and the PA MoF.

on construction materials for donor supervised projects since 2010, in addition to increasing imports of construction material from Egypt through the tunnels. Hotels and restaurants grew by 89 percent and accounted for approximately one third of Gaza's growth in Q1 2012.

4. **In the West Bank, growth in Q1 2012 was broadly unchanged from its 2011 level.** Most of the growth was from an expansion of services, which contributed around 2.2 percentage points of the 5.4 percent total growth in Q1 2012. Wholesale and retail trade grew by 12 percent and contributed more than 1 percent to total growth. The continuous expansion witnessed in the non-tradable sectors reflects the importance of donor aid in driving the Palestinian economy. The PA's national accounts data add as many as 3 percentage points to total growth in Q1 2012. This can be attributed to the PA's ongoing efforts in enhancing its VAT collections which increased by 19 percent in Q1 2012 over Q1 2011. Notably, public administration and defense, a key contributor to growth in the West Bank during 2011, shrank by around 1 percent in Q1 2012, due to fiscal retrenchment. Construction slowed by 9 percent in Q1 2012, mainly due to the increasing amount of PA arrears to local contractors. The manufacturing and agriculture sectors continue to be restrained by Israeli restrictions and both contracted by 4 and 7 percent respectively on a year-on-year basis.

Table 1: Contribution to GDP Growth by Economic Activity - Q1 2012

Economic activity	WB	Gaza	WB&G
Agriculture, Forestry and Fishing	-0.31	-3.72	-1.31
Mining, Manufacturing, Electricity and Water	-0.33	0.68	-0.03
Manufacturing	-0.46	0.00	-0.33
Construction	-0.90	4.38	0.65
Wholesale and Retail Trade	1.14	0.25	0.88
Transportation and Storage	0.16	0.68	0.31
Financial and Insurance Activities	0.15	0.18	0.16
Information and Communication	0.76	0.02	0.54
Services	2.24	4.25	2.83
Public Administration and Defense	-0.12	-1.23	-0.45
Households with Employed Persons	-0.01	0.00	-0.01
FISIM	-0.39	-0.14	-0.31
Customs Duties	0.10	0.02	0.08
VAT on Imports, net	2.91	0.57	2.23
<b>Real GDP growth rate (%)</b>	<b>5.40</b>	<b>5.96</b>	<b>5.57</b>

Source: PCBS and World Bank staff calculations

5. **The recent slowdown in economic growth is also reflected in higher unemployment levels.** Overall unemployment in WB&G was 20.9 percent in the second quarter of 2012 compared to 18.7 percent during the same period in 2011. In the West Bank, unemployment increased from 15.4 percent in Q2 2011 to 17.1 percent in Q2 2012 even though the labor force participation rate remained almost unchanged at about 45 percent. In Gaza, unemployment remains alarmingly high at 28.4 percent with a low labor force participation rate of 40.3 percent. Unemployment amongst females in WB&G grew from 28.6 percent in Q2 2011 to 29.5 percent in Q2 2012.

6. **A serious concern in WB&G is the high level of youth unemployment that is accompanied by low youth participation in the labor force.** In Gaza, only 34 percent of young Palestinians aged 15-29 were active participants in the labor force in Q2 2012, and 43.5 percent of those were unemployed. In the West Bank, youth unemployment was 25.9 percent with a participation rate of 39.3 percent. Employment in the public sector continues to be high whereby 21.9 percent of those in employment are civil servants: 37.9 percent in Gaza and 14.9 percent in the West Bank. Reports by the GoI state that the overall permit quota for Palestinian workers in Israel was recently raised by 10,250 permits. However, even though the number of people from the West Bank allowed to work in Israel has been increasing, its share of total employment has remained around 12 percent since 2002 compared to 21 percent in 2000.

Table 2: Labor Force Statistics Q2 2012

	WB&G	WB	Gaza
Unemployment Rate	20.9	17.1	28.4
Underemployment	8.3	9.1	6.8
Youth Unemployment (Ages 15-29)	32.0	25.9	43.5
Youth Labor Force Participation	37.3	39.3	34.0

Source: PCBS Labor Force Survey

## 2. The Palestinian Authority's Deepening Fiscal Crisis<sup>4</sup>

7. **During the first half of 2012, the PA continued to face an increasingly difficult fiscal situation** due to higher than expected expenditure, lower than anticipated revenue and a continued decline in donor funding. The recurrent deficit for the first half of 2012 was 32 percent above the budgeted target amounting to New Israeli Shekels (NIS) <sup>5</sup>2.4 billion (US\$632 million). Total expenditure and net lending were 4.5 percent above budget while total revenues were 7 percent below their target. The PA reported development expenditures of NIS444 million. Thus, the total financing need, for both recurrent and development expenditure, amounted to NIS2.84 billion (US\$749 million). However, total external support received was only NIS1.7 billion (US\$446 million). Consequently, the PA had to incur additional arrears in the amount of NIS1.1 billion (US\$290 million) during the first half of 2012, 42 percent of which is owed to the private sector. It is estimated that the PA's total stock of private sector arrears accumulated since 2009 now stands at about US\$500 million. The PA also made additional local borrowing in the amount NIS613 million during the first half of 2012, raising its overall local debt to NIS4.8 billion (US\$1.2 billion).
8. **In the first six months of 2012, gross domestic revenues were NIS1.4 billion (US\$364 million) and almost 11 percent lower than called for by the budget.** They only grew by 1 percent when compared to the same period last year, even though the budget calls for them to increase by 17 percent. Tax revenues for the first half of 2012 were 10 percent lower than their budget target. However, their performance improved when compared to the same period last year, whereby income tax collections grew by 45 percent, property tax receipts increased by 6 percent and VAT collections were almost unchanged. The rise in domestic tax receipts can be attributed to the PA's efforts in widening the tax base and enhancing the collection of tax arrears and liabilities from the largest corporations. The PA reports that advance income tax payments under the new 20 percent bracket that was applied in the beginning of the year also boosted tax receipts.<sup>6</sup> Additionally, fifteen private sector companies agreed to voluntarily give up all tax

<sup>4</sup> All figures cited in this section are on commitment basis.

<sup>5</sup> Between January to June 2012, the average New Israeli Shekel (NIS) exchange rate to the US\$ was 1 US\$=NIS 3.79.

<sup>6</sup> The income tax rate on upper income categories was raised from 15 to 20 percent in January 2012.

exemption privileges granted by the Palestinian investment promotion law for a period of two years. Despite all these efforts, the PA reports that tax revenues will not be able to achieve their projected end of year target. As for non-tax receipts, they were 12 percent lower than their half year budget target and 8 percent lower than in the first six months of 2011. Nevertheless, this item is expected to meet its end of year budget target given that US\$30 million in investment profits were received from the Palestine Investment Fund (PIF) in July.

9. **Clearance revenues performed well throughout the first half of 2012 despite not meeting their optimistic budget target.** They totaled NIS2.8 billion (US\$727 million), and were 6 percent below their budget target but 13 percent higher than the same period last year. Receipts from customs, VAT and petroleum excise tax all increased by 9, 20, and 10 percent, respectively when compared to the first half of 2011. This growth in clearance revenues is an achievement for the PA, which has been making strong efforts to reduce leakage in the VAT and import duties collection process. Notably, the GoI advanced the payment of NIS180 million of clearance revenues to the PA in late July, in addition to NIS250 million in mid September to facilitate the payment of wages. These advance payments will be gradually deducted by the Israeli MoF from the PA's future clearance revenue transfers over the coming months.

Table 3: Palestinian Authority revenues January-June 2012: Actual vs. Budget

Revenue item (NIS million)	January-June 2012	Half year budget	Percentage difference between budget & actual figures
<b>Total net revenues</b>	<b>3931.2</b>	<b>4246.5</b>	<b>-7.4</b>
Gross domestic revenues	1378.3	1543.5	-10.7
Tax revenues	956.7	1062	-9.9
Non-tax revenues	421.6	481.5	-12.4
Clearance revenues	2753.5	2929.5	-6.0
Tax refunds	200.6	227	-11.6

Source: Palestinian Authority Ministry of Finance

10. **It is important that the PA accelerates reform efforts to increase domestic revenues.** A medium term agenda should concentrate on strengthening revenue administration and broadening the tax base. In the area of tax administration, the focus should be on integrating the administration of VAT and income tax and implementing self assessment as advised by the International Monetary Fund (IMF). It is also key that cooperation between the GoI and the PA takes place to enhance the performance of clearance revenues, especially given their importance as the PA's main source of income representing around two thirds of total revenues. Encouragingly, it has recently been reported that the PA and the GoI have reached an understanding through an exchange of letters for expanding trade between the two parties and streamlining clearance revenues' procedures. According to statements made by the parties, the Israeli Customs Authority will start sharing real time data on direct imports to the Palestinian territories, as well as information on VAT receipts issued by Israeli traders to Palestinian importers. In addition, advanced technologies will be employed to facilitate and monitor trade between the two parties, and special bonded warehouses will be established on the Palestinian side to allow Palestinian Customs to assume responsibility on the clearance of direct imports to the PA from third countries. Such measures could substantially reduce tax leakage and increase clearance revenues. Thus, it is hoped that both parties will implement the agreement starting 2013, as planned.
11. **In the first half of 2012, total expenditures and net lending amounted to NIS6.3 billion (US\$1.7 billion) and were 4.5 percent above their budget target, mainly due to an unexpected increase in non-wage expenditures and net lending.** On the other hand, the wage bill, which represents 54 percent

of current expenditure, was kept slightly below its budget target which calls for a 6.8 percent increase in 2012. In the first half of 2012, net growth of the public labor force was 965 employees. Overall, PA employment rose by 1,420 new hires in the West Bank and decreased by 414 in Gaza.<sup>7</sup> Notably, the PA continued to increase employment in the security sector where 484 new employees were added to the payroll system during the first six months of 2012. In the education and health sectors, 478 and 65 new workers were added, respectively.<sup>8</sup>

12. **Non-wage expenditure for the first half of 2012 exceeded the budget by 9 percent, amounting to NIS2.7 billion (US\$702 million).** Transfers, which include pensions and payments to local governments, were 19 percent above their budget target even though the budget calls for these payments to decrease by 10 percent. The majority of the higher than target transfers is related to unbudgeted pension payments to retirees in the security sector. In order to offset the increase in transfer payments, the PA had to place tight control on operational and minor capital expenditures. As a result, operational expenditures were 3 percent lower than their target. The PA has adopted policy measures to keep its operational expenditures under control<sup>9</sup>. As for minor capital expenditures, the PA decided to delay any major spending in this area during the first half of 2012. As a result, minor capital expenditures were 76 percent lower than their projected target.
13. **In comparison to last year, progress achieved on net lending seems to be slowing down.**<sup>10</sup> In the first half of 2012, net lending was 37 percent higher than projections even though it is expected to decrease by 20 percent throughout the year. It was also 23 percent higher than the same period in 2011. The increase in net lending is mainly due to higher than usual deductions from clearance revenues by the Israeli Electric Corporation (IEC) to clear electricity arrears owed by the PA. These deductions are reported as net lending which explains some of the recent increase shown in this item. Additionally, the Ministry of Finance (MoF) reports that there has been an overall decline in electricity payments from municipalities to the PA. This is because the PA has not made regular transfers to the municipalities due to the lack of funds. If municipalities fall out of the routine of regularly paying their utility bills, previous progress achieved on net lending could be lost, and it may be very difficult for the PA to regain control over this item.

Table 4: Palestinian Authority expenditures January - June 2012: Actual vs. Budget

Expenditure item (NIS million)	January-June 2012	Half year budget	Percentage difference between budget & actual figures
<b>Total expenditures &amp; net lending</b>	<b>6327.2</b>	<b>6057</b>	<b>4.5</b>
Wage expenditures	3394.4	3406.5	-0.4
Non-wage expenditures	2659.7	2450.5	8.5
Operational expenditures.	951	979.5	-2.9
Transfers	1699.5	1432	18.7
Minor capital expenditures	9.2	39	-76.4
Net lending	273.1	200	36.6

Source: Palestinian Authority Ministry of Finance

<sup>7</sup> In addition, net employment for permanent deputies, the Palestinian National Fund and the embassies decreased by 41 employees.

<sup>8</sup> Figures cited for the education and health sectors include net employment for new hires in these sectors.

<sup>9</sup> These measures include withdrawing car privileges from all PA employees ranking below heads of institutions and their deputies. Also, air travel has been limited to economy class, and other transportation and supervisory allowances have been rationalized.

<sup>10</sup> Net lending refers to subsidies provided to municipalities by the central government mostly for electricity bills that were not paid to the Israel Electric Corporation.

14. **The PA should continue to move on with key fiscal reforms to contain its expenditures.** Arguably, major savings can only be found by addressing large spending items such as the wage bill, social transfers, and the public pension system. The wage bill, which represents the largest recurrent expenditure, needs to be firmly contained. Recent unconfirmed announcements by the PA to freeze all public hiring and promotions would be a welcome short term measure. However, a more comprehensive long term agenda should focus on structural reforms for the civil service system. The PA should also continue to reform transfer expenditures, more than half of which are social payments. To ensure that its limited resources are being efficiently used, the PA should attempt to consolidate all programs for social payments into the National Cash Transfer Payment System (NCTPS) and cover the extreme poor households only. The insolvent public pension system poses another area where reform has faltered. Reform efforts should be restarted particularly given the scale of liabilities -- preliminary estimates suggest that the value of accumulated pension arrears exceed USD 1 billion<sup>11</sup>.
15. **It is likely that the PA's fiscal situation will worsen by the end of 2012. Recent projections illustrate that the recurrent deficit for 2012 will amount to US\$1.28 billion – about US\$327 million above the US\$953 deficit called for by the PA's 2012 budget.** In addition, development expenditures for the full year are projected at US\$232 million, leading to total deficit of US\$1.5 billion. However, only around US\$1.14 billion in donor funding has so far been identified - US\$941 million in recurrent budget support and US\$202 million in external development financing. This leaves a sizeable gap of about US\$0.4 billion, if donor pledges are met. The PA's local debt is almost at the limit that the banking sector can sustain, and therefore it is unlikely that the banks will be providing additional financing. It is also doubtful that private suppliers will be providing further credit given the current high level of arrears. If no additional donor funding is identified, the PA may be forced to finance the gap through accumulating additional arrears to the pension system and cutting some of its basic spending such as wages, which could have severe social impacts.

### 3. The Banking Sector

16. **The Palestinian banking sector continues to perform well under the supervision of the Palestinian Monetary Authority (PMA).** The PMA continues to enhance its institutional capacity and is steadily building the capabilities of a central bank. It provides rigorous supervision and regulation of the banking sector, consistent with international practice. An Anti-Money Laundering law that was prepared in line with international standards with technical assistance from the IMF and USAID has been in force since October 2007.<sup>12</sup> The PMA is currently finalizing a draft law that solidifies its independence and provides the legislative framework for it to become a full fledged central bank. The PMA has continued to carry out improvements in the banking sector's infrastructure in 2012. A Deposit Insurance Law was recently prepared and approved by the PMA's Board of Directors. Work has also been initiated to establish a national switch that will interconnect domestic ATMs and points of sale, facilitating personal banking operations.
17. **The Palestinian banking sector continues to apply conservative practices in private sector lending due to high political risks.** Consequently, the sector's loan-to-deposit ratio continues to be relatively lower than in most countries at around 56 percent, as of June 2012. During the first six months of 2012, the percentage of nonperforming loans to total credit remained low at 3 percent. Notably, the Palestinian banking sector's return on average owners' equity amounted to 16 percent by June 2012 – almost 10 percentage points higher than the international average. This is mainly due to high interest rates charged by banks in WB&G.

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11 This figure refers to partial information as there are a number of schemes (i.e., scheme ii «Unified Pension Law», scheme ii «military sector», scheme iii and scheme iv) for which there are no exact data, funds or reconciliations so the actual arrears to the entire pension schemes are likely to be higher.

12 IMF 2012, Recent Experience and Prospects of the Economy of the West Bank and Gaza: Staff Report Prepared for the Meeting of the Ad Hoc Liaison Committee.

18. **The banking sector is heavily exposed to the PA and this is becoming a source of concern.** As of June 2012, the PMA reports that the Palestinian banking sector has provided more than US\$1.2 billion in credit facilities to the PA - about 13 percent of the sector's total assets and 99 percent of its equity. Credit to the public sector and PA employees, combined, represented around 48 percent of the sector's gross credit, as of June 2012. Consequently, the PMA has been carefully monitoring the risks associated with this high exposure. Since March 2011, it has been conducting quarterly stress tests on all banks operating in WB&G to assess the banking system's resilience to a variety of shocks, including delay of payments by the PA and loan delinquency by PA employees as well as by private businesses that supply goods and services to the PA. Latest results indicate that the banking system as a whole is resilient to these shocks. However, the overall results mask disparities among individual banks, whereby smaller ones performed better than some of the larger ones. As a result, some large banks were required by the PMA to raise their capital, adopt additional mitigation tools, and diversify their portfolios. Banks have also started providing short term credit facilities to the PA rather than the long term loans that were previously offered.
19. **The PMA continues to face difficulties in transferring cash to Gaza.** Moving money to Gaza requires coordination with the GoI, and the PMA reports that it has not been able to get permission to transfer cash as often as required. For instance, the last cash transfer to Gaza was made in May 2012 - almost one and a half years after the previous transfer. This is beginning to once again create a shortage of cash in the banks, which in turn leads the public to hoard cash making the shortage even worse. It is also slowly eroding the credibility of the formal banking sector in Gaza, and strengthening the role of the unregulated sector.

#### 4. Sustainable Economic Growth: Prospects and Constraints

20. **In the short term it is imperative that donors continue to provide support to the PA budget, and that the PA presses ahead with the reform agenda which has slowed in recent months.** Such actions will serve to sustain the important gains made in developing institutional capability, build confidence and ease the current crisis situation. However, it is equally imperative that 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. This must be through efforts to promote private sector led economic growth in the Palestinian territories. This will necessarily depend upon increasing private investment to enable the PA to expand the tax base, create jobs and significantly reduce its dependence on donor aid. Despite some easing of movement within the West Bank in previous years, and increased imports to Gaza, including for internationally funded projects, the current system put in place by the GoI<sup>13</sup> continues to stand in the way of potential private investment, and it remains the major impediment preventing the Palestinian economy from reaching its full potential.
21. **Movement into and out of the West Bank continues to be severely constrained by a multi-layered system of physical, institutional, and administrative restrictions that have fragmented the territory into small enclaves lacking most forms of economic cohesion.** Although physical restrictions are the most visible, there are other, often unpredictable, measures and practices that have a profound economic impact on private sector firms. For example, the high level of uncertainty linked to the political environment makes Palestinian firms reluctant to make further investments or upgrade their product lines. Obtaining visas for foreign investors to enter the Palestinian territories is controlled by the GoI, and investors report facing high levels of uncertainty in obtaining such permits which discourages them from exploring potential business opportunities. The list of "dual use" items that cannot be imported because the GoI views them as security threats, and the tight restrictions on access to resources such as water and the electromagnetic spectrum are other examples hindering the growth and development of the Palestinian private sector. Access to Gaza remains highly controlled, and only

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13 The GOI cites overriding security concerns that restrict its ability to continue to ease or lift restrictions on the West Bank and Gaza.

consumer goods and construction material for donor supervised projects are allowed in. Products from Gaza to the West Bank and Israeli markets, which traditionally were Gaza's main export markets<sup>14</sup>, are prohibited. Only small shipments of certain agricultural and manufactured products are exported to other markets through donor supported projects.<sup>15</sup> East Jerusalem, which is considered a highly lucrative market, is beyond reach.

22. **In particular, restrictions with respect to Area C are among the most detrimental to economic growth – given its endowment of natural resources and necessity in providing contiguity and economic cohesion across the territory.** Thus, movement on relieving constraints in Area C could have substantial positive effects on the Palestinian economy. However, the current arrangements make it almost impossible for the Palestinian private sector to realize gains offered by Area C, and hence, limit the overall growth potential of the economy. GoI has recently shown willingness to consider the relaxation of specific restrictions in Area C and according to the Israeli Ministry of Foreign Affairs, 119 infrastructure projects were approved in 2011. Further actions by the GoI to significantly ease the remaining obstacles would be the most effective and sustainable solution to encourage Palestinian private sector growth, which would in turn have concurrent positive effects on the economy and fiscal challenges.

## 5. Area C and its Role in Sustainable Economic Growth

23. The 1995 Interim Agreement between the Palestine Liberation Organization (PLO) and the GoI defined **Area C as “areas of the West Bank outside Areas A and B<sup>16</sup>, which, except for the issues that will be negotiated in the permanent status negotiations, will be gradually transferred to Palestinian jurisdiction in accordance with this Agreement.”<sup>17</sup>**(See Area C map in Annex 1<sup>18</sup>). Area C constitutes 61 percent of the West Bank and contains 5.8 percent of the population<sup>19</sup>. The PA does not have any municipal or planning authority in Area C.
24. **The lack of precision and timetable in how Area C was defined contribute to the situation faced today.** The indecisive nature of this definition made it difficult to clearly identify the exact boundaries of this territorial space, and, consequently, Area C became known as all West Bank territory that is not included in Areas A and B. Resolution of a number of issues addressed here is linked to political negotiations by the parties per the Oslo Accords and subsequent agreements. Nonetheless, an assessment of economic potential is valuable, particularly given the length of time that has passed since the signing of agreements (that led to the demarcation of Area C), and the subsequent developments on the ground that were not anticipated by those agreements. Less than 1 percent of Area C, which is already built-up, is designated by the Israeli authorities for Palestinian use while the remainder is heavily restricted or off-limits to Palestinians.<sup>20</sup> The limited part of Area C that is accessible for Palestinian use is subject to

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14 According to Gisha, an Israeli not-for-profit organization founded in 2005 to protect the freedom of movement of Palestinians, especially Gaza residents, 85 percent of Gaza products were exported to Israel and the West Bank prior to 2007 when the Israeli closure was tightened.

15 Gisha states that the GoI permits negligible amounts of agricultural exports from Gaza to Europe as part of a seasonal project financed by the government of Netherlands. It also mentions that in January 2012, the GoI allowed the first furniture shipment from Gaza since the Israeli closure was tightened in 2007. The shipment crossed through Israel and the West Bank to an exhibition in Jordan. In February and March 2012, six truckloads of tomatoes crossed from Gaza via Israel to Saudi Arabia.

16 World Bank AHLC Report, Palestinian Economic Prospects: Aid, Access, and Reform, September 2008. The 1995 interim agreement specified 18 percent of West Bank as Area A which is under full Palestinian security and civil control and 21 percent of West Bank as Area B which is under Palestinian civil control and joint Palestinian-Israeli security control. Areas A and B or a combination of both is surrounded by Area C.

17 The Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip, chapter 2, article XI, 3c; available on the Israeli Ministry of Foreign Affairs website: <http://www.mfa.gov.il/MFA/Peace+Process/Guide+to+the+Peace+Process/THE+ISRAELI-PALESTINIAN+INTERIM+AGREEMENT+-+Annex+VI.htm>

18 UN OCHA oPt map: [www.ochaopt.org](http://www.ochaopt.org)

19 Bimkom, The Prohibited Zone: Israeli Planning Policy in the Palestinian villages in Area C, June 2008, p. 159. The population figure is not precise mainly because data for distribution of population in Area C vs. Areas A and B is not available and since two-thirds of towns and villages fall partly in Area C and partly in Areas A and B.

20 OCHA 2009, Restricting Space: The Planning Regime Applied by Israel in Area C of the West Bank.

Israeli military regulations<sup>21</sup> for land administration, land development plans, as well as construction permits. In the majority of Palestinian villages in Area C, building permits are almost unattainable and the application process for building permits has been characterized by ambiguity, complexity and cost<sup>22</sup>.

25. **To build its economy the Palestinian private sector needs access to land in Area C – land whose availability for potential Palestinian use continues to shrink.** Built up areas of settlements in Area C have continued to expand over the years. For example, they grew by 35 percent between 2000 and 2011 and they now represent almost 3.25 percent of the West Bank or 5 percent of Area C.<sup>23</sup> This figure does not fully portray the actual territory that settlements control, which amounts to approximately 42 percent of the West Bank land. In addition to built up areas this includes settlement municipal boundaries, their master plans and road networks that are “settler only”. Reports by the Israeli Ministry of Defense state that an additional 10 percent of the West Bank has also recently been earmarked for settlement expansion. The continuous growth in the size of land that is allocated for settlement activity within the West Bank has fragmented the territory into smaller and more disconnected enclaves. The lack of contiguity between areas in the West Bank leaves limited prospects for a sustainable economic recovery, even if some land does eventually pass to the PA’s control. The growth of settlements and Israeli presence in the West Bank has also been connected with ongoing movement and access restrictions on Palestinians aimed at protecting settlement activity and the movement of settlers.<sup>24</sup>
26. **That parts of Area C can be beneficial economically is further illustrated by current Israeli economic activity in that area.** There are about 20 Israeli industrial settlements in the West Bank in addition to many others with cultivated agricultural areas (agricultural developments sometimes extend beyond the built up boundaries of the settlements). The GoI estimates that the value of goods produced in West Bank settlements and exported to Europe is US\$300 million per year. Other analysis also considers goods that were partially produced in settlements, resulting in an increased estimate of US\$5.4 billion in 2008.<sup>25</sup>
27. **Undoubtedly Area C is key for the development of a sustainable Palestinian economy.** Its significance lies primarily in its setting as the only contiguous land in the West Bank connecting 227 separate geographical areas classified as A and B. Hence, economic cohesion between these areas would continue to be greatly compromised as long as Israeli restrictions on access to Area C continue. Area C is also the most resource abundant space in the West Bank holding the majority of the territory’s water, agricultural lands, natural resources, and land reserves that provide an economic foundation for growth in key sectors of the economy. Ultimately, the entire Palestinian economy is affected by what happens in Area C.
28. Given the significance of Area C, the following section provides preliminary analysis on potentially economically lucrative areas for private sector growth. Further research will provide greater insights into these and other sectors, but the examples noted here clearly demonstrate potential areas for private investment when and if Area C restrictions are curtailed: Telecommunications, Tourism, Housing and Construction, Small and Medium Enterprise, and Agriculture<sup>26</sup>.

21 The Israeli Civil Administration (ICA), sub-ordinate to COGAT, administers the civilian affairs in the West Bank.

22 World Bank, The Economic Effects of Restricted Access to Land in the West Bank, October 2008. The complexity of the procedures is mainly attributed to GoI suspension of planning and land registration in 1968 which made it difficult and costly to prove ownership.

23 ARIJ database 2012.

24 World Bank, Movement and Access Restrictions in The West Bank: Uncertainty and Inefficiency in The Palestinian Economy, May 2007.

25 Spiegel Online, EU Court Allows Duties on Products from the Settlements, February 2010. <http://www.spiegel.de/international/europe/made-in-israel-eu-court-allows-duties-on-products-from-the-settlements-a-680380.html>

26 This section is based on preliminary research and analysis. Additional research needs to be conducted regarding the situation in the sectors noted.

## A. Telecommunications

29. **An efficient and competitive telecommunications system is essential for any modern economy.** It is particularly important for a country that hopes to develop exports of services. While the Palestinian telecommunications industry has been witnessing good levels of development and growth, it remains severely constrained by restrictions and particularly on access to Area C. As long as these restrictions, which effect both mobile and landline operators, remain in place, it will be difficult for this industry to provide competitive services, which will negatively affect growth in other sectors also.
30. **One of the main constraints faced by the Palestinian mobile operators is their inability to build infrastructure and towers in Area C.** The current number of facilities in Area C owned by Palestinian operators is considered insufficient to provide services. As a result, they lose the opportunity to serve many of the 100,000 Palestinians who live there. Palestinian carriers report that they are unable to provide coverage to large swaths of the West Bank that need to be connected through infrastructure in Area C. In the absence of this infrastructure, there is particularly weak coverage in the villages to the west of Ramallah, in the northern West Bank around Qalqilya and in the south around Yatta. Because of the lack of towers, important sections of roads connecting cities within the West Bank are also not covered by Palestinian carriers. There is little coverage between Ramallah and Jericho, Bethlehem and Hebron and on large sections between Nablus and Ramallah.<sup>27</sup> In addition, there is almost no coverage in most parts of the Jordan Valley. Palestinian carriers report that the lack of telecom infrastructure in Area C also increases the load on the already strained systems established in Areas A and B resulting in frequent dropped calls and lower quality of service.
31. **To further develop their operations, each of the two Palestinian carriers note they would need to build between 75 and 100 towers in Area C, but have so far been unable to obtain Israeli permission.**<sup>28</sup> One carrier reports that the GoI will provide permits to build towers but only to Israeli firms. This will require the Palestinian carrier to contract an Israeli firm to build and maintain towers instead of the company that already builds its infrastructure in the rest of the West Bank -- and thus incur substantial additional costs. Two other conditions were also reportedly attached. One was that the company would not be able to link the towers in Area C to its network in Areas A and B directly. Instead, the towers would have to be linked through an Israeli network passing through Israel, then through international switches to the carrier's network in the West Bank – adding substantial transmission costs. Secondly, Palestinian microwave frequencies could not be used to link to the Israeli network and the Palestinian firm would have to lease frequencies at US\$2,000 per year per tower from an Israeli firm. It is understood that the Palestinian operator has declined to pursue this agreement given the costs involved.
32. **Those using Palestinian cell phones in areas of the West Bank that are not covered by Palestinian carriers must pay large roaming fees to Israeli firms, who cover all of the West Bank to provide service to settlers.** Although customers are reportedly cautious about using their cell phones in these “uncovered” areas, some estimates place as high as 30 percent what many customers pay by way of roaming charges. According to PCBS, the share of Palestinian households owning Israeli mobiles was estimated at 30.3% in 2011. In addition, taxes from Israeli mobile operators do not accrue to the PA but rather to the GoI, thus meaning a loss of significant potential revenue to the PA Treasury.
33. **Unable to import switches into the West Bank, one Palestinian carrier must route local calls from the West Bank to Jordan and back again to the West Bank, as the main network center is located**

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27 Ramallah is in central West Bank, Jericho is in the Jordan Valley, Nablus is in the North of West Bank, and Hebron and Bethlehem are in South of West Bank.

28 According to the GoI, 57 telecommunications infrastructure facilities were approved in Area C in 2011. However, one of the Palestinian operators report that these were conditional approvals subject to prerequisites. These prerequisites include; a) the site should be installed in areas owned by Israeli Authorities; b) the site cannot be connected to Area A and B; and c) the transmission frequencies to connect sites in Area C should be allocated within the Israeli band. The Palestinian operator reports that only four out of 57 sites submitted have fulfilled the requirements to date.

**in Jordan.** The link between the Jordanian switches and Ramallah had to be made across Area C. Because the GoI would not give permission to the Palestinian operator to construct such lines, it was forced to contract an Israeli firm to establish and operate the link. According to local operators, having the link outside of Ramallah is estimated to add almost US\$20 million a year to costs, a large part of which goes to the Israeli operator to maintain the link with Jordan across Area C.

34. **Currently the GoI has not provided Palestinian carriers frequencies for 3G service, a major competitive disadvantage<sup>29</sup>.** The lack of 3G provides yet another reason for Palestinian consumers to use Israeli carriers who provide 3G throughout much of the West Bank. But its effects go beyond lost customers to the telecommunications companies. One of the fastest growing areas in the IT industry is developing applications for smart phones and wireless communications. With no 3G service to support it, this industry is stunted in the West Bank. One carrier estimates that 11 percent of its customers use smart phones, up from 2 percent only in 2010, despite being unable to either use full features of the phone or access the internet. Palestinian carriers believe that their survival may depend upon being able to offer 3G services as the number of smart phones increase and the world moves on to 4G services. Even if the GoI allows 3G frequencies in the future to Palestinian carriers, the latter would need to make major investments in infrastructure to provide it to customers. This would make it extremely difficult for the Palestinian carriers to compete against established Israeli firms that are currently making significant 3G infrastructure investment across the West Bank and do not bear the high costs imposed by the Israeli security constraints.
35. **Restrictions on access to Area C also create myriad challenges for the national landline operator in the Palestinian territories.** The company cannot expand its customer base in areas and localities in Area C due to the Israeli restrictions on building infrastructure there. The company estimates that this lost opportunity of serving around 8,000 potential customers could generate an additional US\$2 million per year in revenues. The company's main fiber optic network, laid between 1997 and 2001, covers Areas A and B and only limited parts of Area C. However since then, the GoI has been extremely sparing in issuing permits to expand the network in Area C. This has limited the company's ability to upgrade the quality of service and internet speed in large areas in the West Bank that are connected through fiber located in Area C -- including areas in Jenin, Tulkarem, and Qalqilya<sup>30</sup>. The company also finds it extremely difficult to get permission to carry out regular maintenance work or network faults repair in Area C, which leads to high churn rates among customers due to long periods of service disconnect. Its network segments in Area C are vulnerable to theft and vandalism because the PA cannot enforce law there. The company reports that in the first half of 2012, five major incidents of damage occurred in areas around Hebron causing a cut off of a few thousand customers for an average of 6 days each time. The company estimates that such incidents cost around US\$1.2 million in losses every year. The Palestinian landline operator estimates that due to all the above mentioned challenges, which also reduce competitiveness with respect to Israeli operators, restrictions on access to Area C cost it an average of US\$6 million per year.

## B. Tourism

36. **The West Bank is endowed with a variety of significant tourism sites that could be developed to provide a large number of jobs.** However, many of these sites are within Area C, largely preventing Palestinian development opportunities (though the GoI has developed a number of them). The Israeli-Palestinian Interim Agreement of 1995 recognizes the potential of tourism, as noted in Annex VI, Article V, paragraph 6, where it puts forward five areas for attention "In order to best utilize the unique advantages provided to the tourism industry in conditions of stability...". Recognizing the significance of the Dead Sea in particular, the same Annex notes "...the two sides shall examine ways to ...( 5)

29 Israel, as in other countries, has 60 MHz for 3G; 10MHz of which is under consideration for allocation by GoI to two Palestinian carriers (5MHz each).

30 Jenin, Tulkarem, and Qalqilya are in the northern part of the West Bank.

encourage joint ventures in the tourism field in all areas of mutual benefit including on the Dead Sea. In this regard Palestinian private projects as well as joint ventures in accordance with the DOP, will be located as agreed on the shore of the Dead Sea.”

37. A large portion of the northern end of the Dead Sea is in the West Bank. The northern end of the Jordanian side of the Dead Sea has seen large scale development of luxury hotels that draw tourists from around the world. By way of comparison, in 2010, the Jordanian Ministry of Tourism reported that more than 1,700 people were directly employed by these hotels. An even larger number are indirectly employed as contractors and providing off site support. Based on the number of package tourist nights spent at the Dead Sea hotels, the Palestinian Ministry of National Economy (MoNE) estimates that the Jordanian resorts generated about US\$360 million in revenues in 2010.<sup>31</sup>
38. **The West Bank side of the Dead Sea offers similar possibilities.** The Palestine Investment Fund (PIF) has developed preliminary plans to establish a tourism city on the north western side of the Dead Sea. As in Jordan, any large scale development would have to be funded by foreign direct investment and the PIF reports that it has received interest from a number of possible partners. The project plans to develop a number of hotels, residential areas and business facilities at a total cost of US\$1.4 billion. During the first three years, the project is expected to generate about US\$500 million in revenues and create around 50,000 new job opportunities. However, as long as Area C remains off limits to Palestinian investment, the potential of the Dead Sea cannot be realized. The unrealized economic gains go beyond just the potential Dead Sea resorts. Building such large scale infrastructure and improving tourism services would bring additional tourists to other sites, such as Jericho, as well as help spur the construction and service industries.
39. **Restrictions on Area C affect the development of other tourism sites in the West Bank.** The PA’s Ministry of Tourism and Antiquities has plans to excavate and develop ten archaeological sites located in Area C including Sebestia (near Nablus) and Tal Al Nasbeh (near Ramallah). The Ministry reports that it has not been able to obtain permission from the GoI to develop these sites. Meanwhile, Israel has developed several tourism sites in the West Bank such as the Ayn Fashkha Nature Reserves on the Dead Sea, the Qumran Caves in the Jordan Valley, the baptismal site on the Jordan River and the Herodian palace near Bethlehem. A small but thriving eco-tourism industry in its desert reserves has been developed by Jordan and similar conditions and opportunity exist in the West Bank. However, prohibitions on building in Area C prevent the establishment of eco-lodges by Palestinian operators, inhibiting potential development of another possible industry.

### C. Housing and Construction

40. **Construction has been one of the fastest growing sectors of the Palestinian economy in the last four years.** Most of this construction has been in small scale projects. The lack of available land in Areas A and B has prohibited investment in large scale housing and construction projects despite the growing shortage of housing needed for the expanding population. Large scale construction projects could be an important driver of growth and job creation and could provide opportunities for small Palestinian firms to develop capacity in architecture, engineering, and project management, for example. Such large scale projects are almost precluded by the lack of access to Area C, which offers large tracts of land for development if it were permitted. The PIF has plans to develop 8,000 *dunums*<sup>32</sup> of land that it owns in Area C, at the entrance of Jericho. It has developed preliminary plans to develop the land for housing and industry, and foreign investors have reportedly expressed interest in supporting the project. However, they have so far not been able to make progress in securing building permission from the GoI. The Israeli Ministry of Foreign Affairs reports that process is currently underway for the approval of 8 master plans in Area C.

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31 Palestinian Ministry of National Economy (MoNE) and the Applied Research Institute in Jerusalem (ARIJ). September 2011. “The Economic Costs of the Israeli Occupation for the Occupied Palestinian Territory” page 30.

32 A *dunum* is equivalent to approximately 0.25 acre.

41. **One major construction project that has been able to begin is the Rawabi housing project, north of Ramallah and it provides a valuable example of both potential and constraints.** This is the first planned town for Palestinians in the West Bank and the developers expect that it will eventually house nearly 40,000 residents in a modern city that provides housing and work places for its residents. The completion of the first phase (to house 6,000 residents) is expected by the summer of 2013. The project directly employs 2,300 persons full time and 1,000 part time, while thousands more are employed by the project's suppliers in Israel and the West Bank. Though Rawabi is being built entirely in Area B, its success hinges on access to Area C. Construction is proceeding apace, but the developers still do not have Israeli permission for a permanent access road to cross Area C. Without such a road, residents will have no effective way to travel from the new city to the rest of the West Bank, and Rawabi would end up being a city with no entrance. The GoI recently provided permission for a temporary road to cross 2.8 km of Area C to bring in construction material. However, the developer reports that there is no guarantee that this road will be allowed to remain. Delays in obtaining permission to use this road are estimated by the developer to have set construction back by a year or more, substantially increasing construction costs<sup>33</sup>.
42. **Rawabi is a unique experience and will be difficult to repeat unless restrictions on Area C are relaxed.** First it will be difficult to find such a large piece of land available in Area A or B. If land is available, it will be difficult to afford. Undeveloped, but registered land in villages around Ramallah have already reached more than US\$100,000 per *dunum*. Though land in other parts of the West Bank is less expensive, it is still costly. In addition, few other investors would be willing to undertake such a large project with uncertainty over the ability to establish a permanent access road.

## D. Agriculture

43. **In spite of its high potential, the agriculture sector's role in the Palestinian economy is diminishing steadily.** Since 1999, its contribution to GDP has fallen by more than half – from 9.3 percent in 1999 to 4 percent in the first quarter of 2012. This is mainly due to Israeli restrictions on access to land and water, the majority of which is in Area C. Notably, Area C holds approximately 63 percent of the West Bank's agricultural lands, including the highly fertile Jordan Valley.<sup>34</sup>
44. **The majority of the Jordan Valley, which comprises nearly half (46 percent) the land area of Area C<sup>35</sup> and holds one-third of the West Bank's underground water reserves<sup>36</sup>, cannot be developed by the PA.** The valley has unique climatic conditions and highly fertile soils that can be utilized to produce high value added agricultural products all year round for local and export markets. Yet, 94 percent of the Valley is off limits to Palestinian development due to the inability to obtain building permits and restrictions on access to Area C.<sup>37</sup> Also, only low intensity agricultural production is permitted on Palestinian land in Area C.<sup>38</sup> Flourishing Israeli agricultural production in the Jordan Valley settlements is testament to the area's potential, generating about NIS500 million annually in recent years<sup>39</sup>, yielding 60 percent of production of dates in Israel<sup>40</sup>. The Jordanian side of the Valley has also seen large scale agricultural development: 70 percent of Jordan's production of fruits and vegetables comes from this area. It is estimated that if the GoI allows Palestinians to cultivate an additional 50,000 *dunums* in Area C (which is 1.5 percent of Area C), an extra US\$1 billion per year (9 percent of GDP) could be generated

33 Another access road, to the north of the proposed city, cannot be constructed as it needs to cross a mere 300 meters of Area C.

34 A Review of the Palestinian Agriculture Sector 2007, Consulate General of Spain in Jerusalem.

35 World Bank staff calculations based on available data.

36 The number of Palestinian active wells in the Jordan valley dropped from 209 in 1967 to 89 in 2012. Palestinians are not allowed to drill wells deeper than 200 meters whereas Israeli settlers can drill down hundreds of meters.

37 OCHA, Humanitarian Fact Sheet on the Jordan Valley and the Dead Sea Area, February 2012.

38 The permit system constrains permanent investments and the intensification of agriculture.

39 MAS, Palestine Economic Research Institute, The Economic Base of Israel's Colonial Settlements in the West Bank, 2012, P. 34, cited from B'TSELEM 2011. Israeli settlements in the Jordan Valley produce crops for high-value added exports to the EU and International markets (OXFAM 2012).

40 OXFAM, On the Brink: Israeli settlements and their impact on Palestinians in the Jordan Valley. Statement by David Elhayani, Head of the Jordan Valley Israeli settlements Council.

by the Palestinian economy<sup>41</sup>. Furthermore, if GoI allows Palestinians to cultivate an additional 100,000 *dunums*, 150-200 thousand new job opportunities would be created by the agricultural sector<sup>42</sup>.

45. **Disparities in access to land and water have left Palestinian farmers at a competitive disadvantage vis-à-vis their Israeli competitors, and have prohibited the Palestinian agriculture sector from realizing its full potential.** In most areas, Palestinian farmers have to buy highly priced water transported in tanks to irrigate their land which significantly raises their costs<sup>43</sup>. In addition, the 10,000 settlers in the Jordan Valley and the northern Dead Sea area receive water allocation of around 44 million cubic meters per year, which is almost one third of the water amount accessible to the 2.5 million Palestinians living in the West Bank<sup>44</sup>. To deal with these difficulties, a recent interview revealed that a local Palestinian company has been exploring the viability of developing water and waste water facilities in the West Bank which could be used for agriculture but has been discouraged from doing so. Firstly, to be economically viable and environmentally safe the plant would have to be physically situated in Area C raising risk over permissions for such development. Secondly, most of the recycled water that would be produced for irrigation purposes would have to be sold to projects in Area C, given that the majority of agricultural land is located there. However the company reports that it believes it unlikely to receive GoI permission to build water pipes across Area C. Consequently, the company has so far not pursued any of these projects.
46. **The road network also poses constraints to agricultural development.** Four out of the five roads leading to the Jordan Valley are not accessible to most Palestinians<sup>45</sup>, and it is estimated that annually NIS7.2 million is incurred as additional transportation costs by Palestinian farmers due to such movement restrictions.<sup>46</sup> To transport agricultural products within the West Bank, to Israeli markets, and to world markets, Palestinian farmers and traders are required to make long detours and to spend considerable time at checkpoints and commercial crossings which reduce their products' quality and price. For instance, there is a well-maintained main road connecting Tubas, located in the north eastern part of the West Bank, and Bardala, northeast of Tubas in the northern Jordan Valley that Palestinian farmers could use to transport agricultural products. Yet, today Palestinians are not allowed to use the main road because it is controlled by the Tayasir checkpoint and are obliged to use an alternative route which passes through several villages thus adding considerably to their travel time.

### E. Small and Medium Enterprises (SMEs)

47. **The vast majority of Palestinian businesses are small enterprises with an average size of four workers, and, according to the last establishment census, there were only 57 enterprises with more than 100 workers in all of the Palestinian territories.** Small enterprises are affected by the limitations imposed by the Area C designation in a number of ways. There is an acute shortage of serviceable industrial land in Areas A and B. Most businesses operate on family-owned land often in the middle of residential neighborhoods. It is not uncommon to find small factories in the back yards of houses close to neighbors. This situation not only constrains the growth of the industrial enterprises, but it also poses a health risk.
48. **There is a large amount of land suitable for industrial development in Area C that could alleviate the congestion in Areas A and B.** The land is also much less expensive. A World Bank study in 2008 found that premiums for similar land in Areas A and B over Area C ranged from 30-150 percent

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41 Gal et al 2010, cited in the World Bank AHLC report in September 2010.

42 B'TSELEM, Dispossession and Exploitation: Israel's policy in the Jordan Valley and northern Dead Sea, May 2011, p. 58

43 There is a limited number of Palestinian farmers who receive lower tariffs as agreed by GoI as they owned wells prior to 1967. This is based on an application of a Jordanian law which stipulates the tariff should not exceed the extraction costs of water.

44 B'TSELEM, Jordan Valley: Taking control of water sources, May 2011, [http://www.btselem.org/jordan\\_valley/water](http://www.btselem.org/jordan_valley/water)

45 OCHA, Movement and Access in the West Bank, September 2011. Four of the roads are controlled by four permanently staffed checkpoints: Tayasir, Hamra, Ma'ale Ephraim, and Yitav. The majority of Palestinians are banned from crossing these checkpoints using their private vehicles with the exception of Jordan Valley residents (approximately 56,000) and those who can obtain special permit.

46 OCHA, Special Focus: West Bank Movement and Access Update, August 2011.

depending on the relative safety of the land in Areas A and B from confiscation and demolition.<sup>47</sup> Thus, being able to build in Area C would allow Palestinian enterprises to expand at a lower cost.

49. **Future research will shed more light on specific challenges, but it is useful to examine a few examples to begin to understand the constraints to SME development.** One such example is the experience of a real estate firm that planned to develop a residential project on family owned land in Area C. The project was not granted permission by the GoI, and therefore was moved to another piece of land in Area A. Consequently, the owner reports that the total cost per unit increased by an average of US\$30,000 due to higher costs in Area A. Another example comes from a small leather manufacturing enterprise in the Hebron area which obtained contracts for export to a European buyer and needed to expand to meet its new obligation. The current factory is located in a residential area, and given the chemicals used in leather manufacturing this was not considered a suitable site even if there was room to expand. The owner has land in Area C that would be suitable for development but permission from the GoI to build there was not obtained. The firm moved its operation to an industrial park in Greece, rather than building without a license and risking demolition. It subsequently created 15 jobs that would otherwise have been in the West Bank. These highlight some of the difficulties, though costs of utilities are also deemed to have been a constraint without the benefit of economies of scale. Thus, ideally, the PA would be allowed to develop industrial parks in Area C where land is cheaper and zoning for industrial operations more appropriate to distance them from residential areas. Under current circumstances Palestinian firms maintain operations in inappropriate locations and in some cases forego expansion due to the high cost of serviced land.<sup>48</sup>
50. **Palestinian enterprises that do manage to locate in Area C tend to avoid paying taxes to the PA.** Because the PA cannot exercise authority in Area C, it is unable to enforce laws or regulate businesses there. Consequently, Palestinian businesses located in Area C are able to conduct their operations without paying taxes, fees or meeting health and safety standards. The only recourse for the PA is to attempt to intercept products being brought into Areas A and B, where it can deploy its own enforcement. Consequently the PA loses tax revenues from small enterprises operating in Area C.

## 6. Conclusion

51. **As has been highlighted in this report, the PA's fiscal situation is increasingly difficult and could worsen by the end of 2012 with a financing gap about US\$0.4 billion projected by year end.** Continued and renewed efforts by the PA to accelerate ongoing reforms, raise revenues and closely manage expenditures are key. Moreover, support from donors to the PA's budget should continue. Fiscal reform and institution building, by nature, take time to produce results. Donor support has contributed to the commendable progress on institution building in the PA, and will be critical in the medium term to sustain such achievements and support the PA through its current crisis.
52. **However, while urgent attention to the short-term crisis is needed, it is essential to push forward on measures that will reverse the downward trend in economic growth.** This can be achieved through measures that promote private sector led development across the Palestinian territories. This report illustrates how the Area C demarcation of territory has created a web of constraints to private sector development and constrains investment. Efforts to tackle these problems and develop economic cohesion in the Palestinian territories will pay large economic dividends. This will result in an expanded tax base, and greater job opportunities, as well as reinforce institutional capacity – all of which are key aspects of a sustainable economy for the future Palestinian state.

<sup>47</sup> “The Economic Effects of Restricted Access to Land in the West Bank”, World Bank 2008.

<sup>48</sup> The 2008 World Bank study found that “land in the small Ramallah/ Beitunia industrial zone can cost anywhere from US\$100 to over US\$400 per square meter, if it can be found at all. In contrast, land at the site planned by the PA for the Tarqumiyah industrial estate (Area C, but for which permit is still pending) is estimated to be valued at about US\$4.5/m<sup>2</sup>. Even without utility connections, these prices are much more favorable than in nearby Hebron industrial zone (about US\$85 per sqm).”

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## 7. Annex 1 – Area C Map

