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West Bank and Gaza Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth

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CURRENCY EQUIVALENTS

(Exchange Rate Effective: April 13, 2012)

Currency Unit	=	New Israeli Shekel
1 NIS	=	US\$ 0.267
US\$1	=	3.75 NIS

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AML	Anti-monetary laundering	NDP	National Development Plan
	Automated System for Customs		
ASYCUDA	Data	NDTP	Non-discriminatory trade policy
CDs	Certificates of Deposit	NEDCO	Northern Electricity Distribution Company
CEM	Country Economic Memorandum	NIS	New Israeli Shekel
CMA	Capital Markets Authority	NLPF	National Land Policy Framework
CTA	Central Treasury Account	NTBs	Non-Tariff Trade Barriers
CU	Customs Union	OECD	Organization of Economic Cooperation and Development
ECD	Early Child Development	PA	Palestinian Authority
FTA	Free Trade Agreement	PACE	Palestinian Authority Customs and Excise
GACB	General Administration for Borders and Crossings	PCBS	Palestinian Bureau of Statistics
GDP	Growth Domestic Product	PHMC	Palestinian Housing and Mortgage Company
GFCF	Gross Fixed Capital Formation	PIF	Palestinian Investment Fund
GNDI	Gross National Disposal Income	PLA	Palestinian Land Authority
GoI	Government of Israel	PMA	Palestinian Monetary Authority
HEPCO	Hebron Electric Power Company	PMHC	Palestinian Mortgage and Housing Corporation
ICA	Investment Climate Assessment	PP	Paris Protocol
ICS	Investment Climate Survey	PRDP	Palestinian Reform Development Program
IDB	Islamic Development Bank	PSE	Palestine Stock Exchange
IFC	International Finance Corporation	PSI	Palestinian Standards Institute
IMF	International Monetary Fund	RoO	Rules of Origin
ISI	Israeli Standards Institute	TIMSS	Trends in International Mathematics and Science Study
JD	Jordanian Dinar	TVET	Technical and vocational education and training
LPTF	Land Policy Task Force	USD	United States Dollar
MFI	Microfinance Institutions	WB&G	West Bank and Gaza
MFN	Most Favored Nation	WHO	World Health Organization
MOF	Ministry of Finance	WTO	World Trade Organization

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WEST BANK AND GAZA

**Towards Economic Sustainability of a Future Palestinian State:
Promoting Private Sector-Led Growth**

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EXECUTIVE SUMMARY

i. Sustained economic growth, widely recognized as a key part of the Palestinian state building project will depend upon the establishment of a dynamic, private sector led economy. While the Palestinian Authority (PA) has had considerable success in building the institutions of a future state, it has made less progress in developing a sustainable economic base. Following a deep contraction in the first half of the decade there has now been five years of economic growth. However, the Government of Israel's (GOI's) security restrictions continue to stymie investment and the recent growth has largely been driven by donor aid. This situation is unsustainable and aid levels have already begun to fall. For a future Palestinian state to be viable, it is necessary that a private sector led economy is able to generate the jobs needed by a rapidly growing population and the resources required by the government to provide services. This paper reviews some of the most important issues facing the Palestinian economy and identifies steps that can be taken now to set the stage for private sector led growth.

ii. With the advent of the second Intifada, West Bank and Gaza (WB&G) suffered a severe economic contraction and by the end of 2006, real per-capita GDP was 23 percent below its peak in 1999. In 2007, the international community embraced the new PA cabinet and pledged more than US\$7.5 billion in aid. The improved security situation led the (GOI) to relax some of its restrictions, which also provided a boost to the economy. The return of growth has led to a fall in poverty in the West Bank, where poverty headcounts fell from 23 percent in 2004 to 16 percent in 2009. But the continuing closure in Gaza has meant that the poverty rate has actually increased from 30 to 33 percent during this same period.

iii. Despite the easing of some restrictions, most of the constraints on movement of people and access to resources have remained in place, constraining investment and productivity growth. Consequently, most of the recent economic growth can be attributed to the large inflow of aid, which has funded government expenditures. This has skewed the economy towards the public sector and non-tradables. Public administration, defense and other mostly public services such as health, education, electricity and water grew from less than 20 percent of GDP in 1994 to more than 27 percent in 2010. Meanwhile, the industrial and agriculture sectors declined from 13 to 10 percent and 9 to 6 percent respectively. The importance of aid cannot be overstated and by 2008 current transfers had risen to about US\$3.4 billion, double what they were in 2006.

iv. The PA has become increasingly dependent upon this donor assistance to fund its basic operations. This not only leaves it vulnerable to reductions in aid, but also means that the PA has few resources to devote to long-term development issues. In 1999, the PA recurrent budget had a small surplus and all aid was directed toward development projects. In 2002, at the height of the second Intifada, external budget support was still less than US\$500 million. But by 2009, the need for budget support to cover recurrent expenditures had increased to US\$1.6 billion, despite the improved security and resumption of growth. The high levels of budget support were seen by donors as temporary measures to help the new PA government deal with crisis and have begun to decline. However, they are still large and in 2010 budget support was nearly US\$1.15 billion. But even this large amount did not cover the full recurrent deficit, forcing the PA to borrow from the local banking sector and accumulate arrears at an unsustainable rate.¹

¹ These figures do not include any funds going to the government in Gaza. Thus, they understate the true aid dependency of WB&G.

v. ***The establishment of a Palestinian state and a comprehensive peace agreement can be expected to lead to rapid growth and more tax revenues for the PA.*** However, it is unlikely that even with significant growth the PA will be able to support an administration of the current size. Therefore, it is important that the PA take steps to reduce costs, raise revenues and move towards fiscal sustainability. Such efforts will help address the current fiscal crisis, free up resources for long term development and establish the ground work for fiscal sustainability.

vi. ***The PA is already taking actions to increase revenues through widening the tax base and improving tax administration, though progress has been slow.*** However, in 2010, the PA's gross domestic revenues were around 27 percent of GDP, which is not too different from neighboring countries. In 2009, total government revenues in Jordan and Egypt were 23.3 percent and 27 percent of GDP respectively.² Therefore, there will be a limit to how much additional revenue can be raised given the already substantial level of collections and low level of economic activity. More important will be efforts to slow the growth of the PA's spending. About three quarters of total expenditures goes for wages and transfer payments, which include large pension commitments. Electricity and water subsidies to municipalities were only about 8 percent of the budget in 2010 and have been dropping, leaving less than 20 percent of the budget for operational and minor capital expenditures. Clearly, the only way for the PA to make substantial savings is to address the growth of the wage bill and transfer payments.

vii. ***Substantial savings will only come from comprehensive civil service reform.*** It is unlikely that the PA will be able to shed workers until strong private sector growth resumes. But in light of the difficulty and time it takes to implement significant reform, the PA should begin the process of identifying what it truly needs to effectively provide services and establishing a coherent system to manage its workforce. The PA's pension system is one of its largest obligations; it is insolvent and effectively operating as a pay-as-you go system. It is imperative that the PA deals with this issue before the current employees retire and the system goes into crisis.

viii. ***No matter what steps the PA takes, it is unlikely to reach fiscal sustainability until there is a political settlement that allows the private sector to experience rapid and sustained growth.*** The major constraints to private sector activity are the tight Israeli restrictions, and growth will not be sustainable until Palestinians have access to resources and are allowed to move freely. However, there are a number of areas where the PA can focus its attention to not only improve current performance, but to lay the groundwork for a future state. The ongoing political and fiscal crises absorb the PA's attention, and there has been little recent progress on improving the conditions for private sector growth. But given the sector's importance for both the present situation and a future state, it is imperative that the PA focus more on the issue.

ix. ***WB&G is a small and open economy.*** Therefore its future development will depend upon increasing trade, particularly in exporting higher value added products. A future Palestinian state should seek to emulate Asian countries that have managed to sustain high levels of economic growth by adopting an outward orientation and integrating into world supply chains. In contrast, many of WB&G's Middle-Eastern neighbors have focused on the domestic markets and experienced slower growth. Given WB&G's lack of natural resources, but well educated and entrepreneurial population, it is likely that high value added services could play an important role in its growth, thus the service sector should not be neglected as the PA develops its policies.

² IMF Regional Economic Outlook, 2010

x. ***Increasing trade depends upon efficient trade facilitation beginning with the adoption of an appropriate trade policy.*** It is important that the PA decide what type of policy it expects a future state to adopt. This will help the guide the institution building agenda, allow the private sector to plan and also support the negotiators as they discuss the parameters of a future political solution. A well balanced customs union between a future Palestinian state and Israel could hold a lot of promise for both countries. However, the current quasi-customs union does not work well. There is no free movement of labor and Palestinian goods have difficulty accessing the Israeli economy. It is therefore unlikely that such a system would be acceptable option in. But moving to a non-discriminatory trade policy would limit free access to Israel, WB&G's leading trading partner. Thus, a system of free trade agreements between a future Palestinian state, Israel and neighboring countries might be the most promising option. It could be envisioned that in such a situation, Israeli manufacturers could tap skilled but inexpensive Palestinian labor to export, including to the Arab world. This would provide Israeli firms a competitive advantage and help build up Palestinian business through a transfer of knowledge.

xi. ***Whatever system is chosen, it is important that the PA begin to develop the necessary trade infrastructure, including the institutional infrastructure.*** The PA needs to establish a clear border management system that is designed primarily to facilitate trade and does not militarize the border. It should move rapidly to develop the capacity of its customs agency, both to prepare for a future state and to increase current revenues. At the same time it is necessary to begin developing the supporting legislative framework by enacting legislation that covers customs, health and safety standards, intellectual property rights, competition policy and other areas important to trade.

xii. ***Both firm level surveys and macro economic data indicate that there is relatively little private sector investment in WB&G.*** Though the Israeli restrictions remain the biggest constraint, there is also much that the PA can do to create a business environment that will attract the needed investment. To overcome the perceptions of risk resulting from years of conflict and attract the necessary high level of investment, the PA should strive to build a business environment that is among the best in the world and not merely on par with its neighbors. One of the most important steps the PA can take is to rapidly expand land registration in the West Bank.³ In the Palestinian controlled areas, vacant land suitable for development is scarce. What land is available is difficult to access because ownership is heavily fragmented and only a small portion is registered and titled. Consequently, one of the most important steps that the PA can take to spur investment is to increase the amount of land that is registered and legally titled. Likewise, it is important that the PA completes the registry of public lands in Areas A and B and plans for adding public land in Area C to the registry when the time comes. Increasing available land will also help develop the housing market, which could be a significant driver of growth, especially if political developments encourage a large number of Palestinians from outside return.

xiii. ***The legal and regulatory environment in WB&G is not adequate to attract the needed foreign and domestic investment.*** The current system of laws stems from different periods of Palestinian history, and consist of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws as well as Israeli Military Orders, which differ between Gaza and the West Bank. This disparate group of laws leaves significant gaps and contains many internal inconsistencies. Thus, reforming the current collection of legislation governing business is critical to improving

³ The Gaza Strip does not face the same types of challenges in terms of access to land. Since the evacuation of the Israeli settlements in 2005, the entire Gaza Strip is under Palestinian control. In addition, the land law in the Gaza Strip is the Egyptian law which makes all property sales binding only once registered in the Land Registry. As a result, less than 2 percent of land in Gaza has not been registered and titled.

the investment climate. The most pressing new laws are the secured transactions law, companies law, competition law, leasing law, tenants law and laws around land and housing.

xiv. A well functioning labor market that provides workers with appropriate skills is also critical to increasing the productivity and competitiveness of Palestinian businesses. There are no indications that PA labor regulations impede labor market flexibility and the high level of unemployment is mostly due to the low level of economic activity resulting from the restrictions. However, rising government wages and high wages earned by unskilled workers in Israel do distort the Palestinian labor market and affect competitiveness. A much more important issue is the skill level of Palestinian workers. Despite the large pool of unemployed workers, the Palestinian private sector consistently reports that it is unable to find workers with the skills that it needs. This is particularly a problem for exporters of high value added goods and services. If the Palestinian economy is going to integrate into world supply chains, it is critical that the education system prepares students for the modern workplace. Education must go beyond basic literacy and provide students with the high-level cognitive skills (such as analysis, problem solving, and communication) and behavioral skills (such as discipline and work effort) required by competitive industries. This will require the PA to accelerate education reforms in WB&G.

OVERVIEW

1. ***With the advent of the Oslo Peace Process and the establishment of the Palestinian Authority (PA) it was hoped that the Palestinian economy, free of Israeli security constraints, would grow quickly.*** Unfortunately, these hopes were quickly dashed. The peace process stalled, Israeli settlements expanded and violence along with the attendant security restrictions increased. Over that past decade, the Palestinian economy has become increasingly dependent upon foreign assistance to drive its growth as the productive sectors have declined in importance and government funded services have increased. For a future Palestinian state to be viable it is necessary that it have a private sector led economy that will generate the jobs needed by a rapidly growing population and the resources required by the government to provide services. This paper reviews some of the most important issues facing the Palestinian economy and identifies steps that can be taken now to set the stage for private sector led growth. It is designed as a synthesis of previous analysis that will help guide policy makers as they set medium term development agenda.

Structure of the Economy

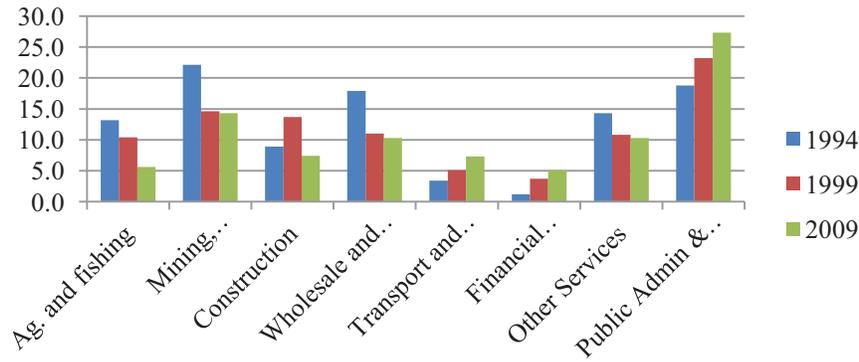
2. ***By the time that the PA was established in 1994, West Bank and Gaza (WB&G) had become almost completely dependent upon Israel.*** Nearly 60 percent of the West Bank's exports and more than 90 percent of imports were to and from Israel and the trade deficit was almost 45 percent of GDP. The figures for Gaza were similar, but the trade deficit was even higher.⁴ Nearly a third of the Palestinian work force was employed in Israel and the economy appears to have been largely driven by remittances from workers in Israel and the Arab Gulf. While neighboring countries had moved toward industrialization, the Palestinian territories were in a distorted state of development. The size of the average industrial establishment in WB&G was four workers, no larger than the average of such establishments in Palestine in 1927.⁵ The share of industry in GDP was low like a developing country. But the share of agriculture had also dropped while the share of services and construction in GDP were higher than would be expected for a country at that level of development.

3. ***In the mid 1990s, growth in WB&G accelerated, however the outbreak of the second Intifada was a severe blow and the economy shrank significantly.*** Since then, the well documented Israeli restrictions have constrained private investment and productivity growth and the economy has become increasingly driven by donor supported PA expenditures. As a result, the economy has skewed towards the public sector and non-tradables. Industry, agriculture, tourism and some other services have declined while donor funded sectors such as public administration, education, health and electricity have grown. Public administration and defense and other mostly public services such as health, education, electricity and water grew from less than 20 percent of GDP in 1994 to more than 27 percent in 2010. Meanwhile, the industrial and agriculture sectors declined from 13 to 10 percent and 9 to 6 percent respectively. The pattern was similar in both the West Bank and Gaza. Consumption and donor supported activities grew while the productive sectors declined and the economy hollowed out.

⁴ Arnon and Wienblatt 2001.

⁵ PCBS Economic Surveys and Roy 1999.

Figure 1. Share of GDP for Major Sectors, WB&G



Source: PCBS Annual National Accounts.

Recent Growth Trends

4. *During the second Intifada, widespread violence and the resulting harsh system of closures, curfews and other restrictions devastated the Palestinian private sector and led employment in Israel and its settlements to fall dramatically.* Between 1999 and 2002 real GDP fell by 27 percent. In 2003, the security situation improved and a low level of growth resumed, only to falter again in 2006. By the end of 2006, real per-capita GDP was 23 percent below its peak in 1999.

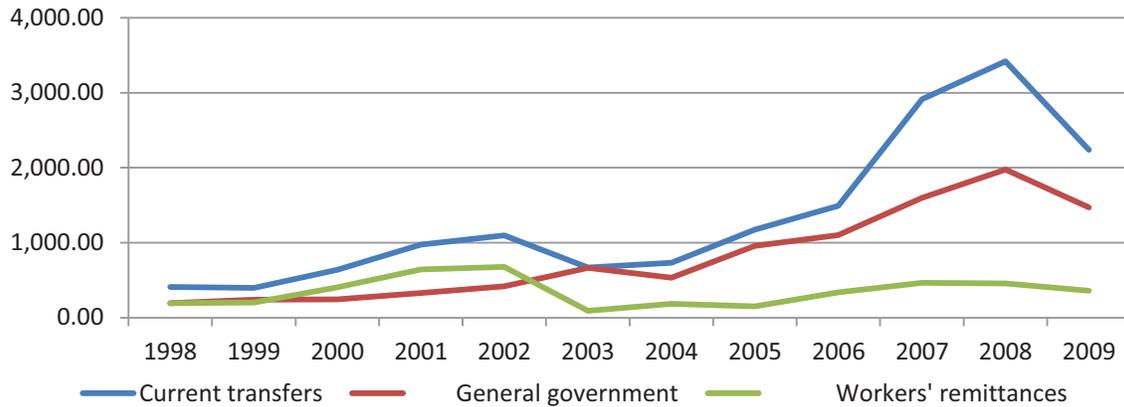
5. *In 2007, the international community embraced the Caretaker Government led by Prime Minister Fayyad and pledged more than US\$7.5 billion in aid.* The new government set about rebuilding institutions that had deteriorated and in response to improved security, the Government of Israel reduced some of its restrictions inside the West Bank. However, most restrictions on access to resources and movement outside of the West Bank have remained in place or even become tighter despite improvements in the security situation. Gaza meanwhile remained under tight seal.

6. *The large inflows of aid, combined with the PA's reform program and the improvement in security, led to a resumption of growth.* Real growth reached 5.4 percent in 2007 rising to 7.4 percent by 2009 and 9.8 percent in 2010. Most of the growth was in the West Bank; however Gaza experienced positive growth in 2009 as a result of increased aid and the expansion of trade through tunnels from Egypt. In mid 2010, the GOI relaxed its closure of Gaza and began to allow in consumer goods and some industrial inputs. This loosening combined with the tunnel activity spurred growth to an estimated 15 percent in 2010. While these figures are encouraging, growth is still relatively weak given the low starting base.

7. *Much of the growth appears to be driven by the large donor transfers. Balance of Payments estimates indicate that by 2008, current transfers had increased to about US\$3.4 billion.* This was about 56 percent of nominal GDP (Figure 2) and more than double the level in 2002, when the economy was at its nadir. Worker remittances remain important, however the majority of the growth has been in general government transfers, which began growing dramatically in 2005. They even exceeded US\$1 billion in 2006 when most donors cut off direct

aid to the PA.⁶ Such high levels of aid are not sustainable and since 2008 aid has decreased. However it remains substantial and in 2010, budget support to the PA alone topped US\$1.1 billion. These enormous aid inflows have been largely driving the recent economic upturn and supporting income levels.

Figure 2. Current Transfers, WB&G 1998-2009



Source: PCBS Balance of Payments Estimates.

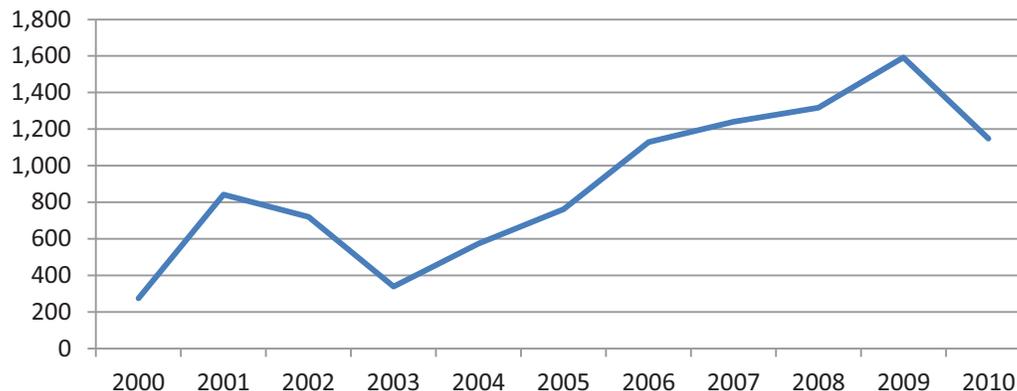
Fiscal Policy

8. *Since its establishment, the PA has become increasingly dependent on donor aid to fund its basic operating expenses. In 1999, the PA recurrent budget had a small surplus and all donor aid was directed toward development projects.* In 2002, at the height of the second Intifada, external budget support was still less than US\$500 million. However, since then, even as the security situation has improved and limited growth has resumed, the PA's need for budget support has steadily increased. By 2008, budget support had grown to nearly US\$1.8 billion or about 29 percent of GDP. While it has declined since then, in 2010 it was still nearly US\$1.15 billion. But even this large amount did not cover the full recurrent deficit, forcing the PA to borrow from the local banking sector and accumulate arrears.⁷ The largest share of government expenditures goes to wages and salaries, which were about US\$1.6 billion in 2010. This is more than the total projection of budget support and 21 percent of estimated GDP. However, this underestimates the true cost of the payroll. Transfer payments, which include a substantial amount of pension payments, were another nearly US\$700 million. Combined wages and salaries and transfers accounted for three quarters of the PA's recurrent budget in 2010. Subsidies for utilities were another 8 percent of the recurrent budget, leaving only about 17 percent for operational and minor capital expenditures.

⁶ In 2006 aid was provided through the President's office and other ways that bypassed the government such as the European Union's Temporary International Mechanism.

⁷ These figures do not include any funds going to the government in Gaza. Thus, they understate the true aid dependency of WB&G.

Figure 3. PA Recurrent Deficit in Nominal US\$ (millions) 2000-2010



Source: World Bank staff calculations.

9. ***Since the recurrent budget takes up almost all of the domestic revenues, the PA has very few resources for long term development and must depend on donor financing.*** The PA sets ambitious targets for development spending in hopes of attracting aid. For example, in 2010, the budget called for nearly \$700 million in development expenditures. However, donors only provided \$130 million and the PA itself funded another \$170 million, much of which was financed through arrears and local borrowing. As the PA's fiscal crisis worsens, it is unlikely that even this low level of development spending can be maintained.

10. ***Because the PA's recurrent budget deficit has outstripped the generous levels of budget support, the PA has been forced to substantially increase borrowing and incur large arrears.*** The PA does not have access to international financial markets and thus has to rely on local banks for short term credit. By the end of 2010, the PA was in debt to local banks for about US\$840 million most of which was in the form of short term loans and overdrafts. Given the constraints on the banking system, the PA will soon run out of room to finance its deficit from short term bank borrowing. In addition, the PA owes hundreds of millions of dollars in arrears most of which are owed to the pension system and do not have an immediate impact on economic growth. But an ever growing portion is owed to the private sector. PA arrears not only raise the cost to businesses – the private sector is essentially financing the PA – but damage the private sector's confidence in the government. Since government spending and spending by government employees have been the important drivers of growth, a lack of confidence in the government's ability to continue to spend could have serious consequences for investor confidence and economic growth.

11. ***Future growth will be affected by the PA's ability to reduce the recurrent deficit and redirect resources towards investment.*** To this end, the PA is making a concerted effort to mobilize domestic tax revenue including increasing the coverage of the property tax, establishing a large tax payer unit in the MOF and increasing efforts to collect VAT. In 2009, the PA's gross domestic revenues only covered about 50 percent of recurrent expenditures. But in 2010, the PA intensified its efforts to raise domestic revenues and to control spending so that by the end of the year domestic revenues amounted to more than 63 percent of expenditures. Gross domestic revenues were around 27 percent of GDP, which is not too different from neighboring countries. In 2009, total government revenues in Jordan and Egypt were 23.3 percent and 27 percent of

GDP respectively.⁸ Around 70 percent of PA revenues come from the taxes such as VAT and import duties collected by the GOI and remitted to the PA. The PA has no control over these funds and little way to increase them. However, domestic tax revenues, where the PA does have control, jumped by nearly 50 percent between 2009 and 2010. In the coming years, the PA will have to continue efforts to raise domestic revenue, but there is a limit to how much of an increase they can expect given the already substantial current level of collections (compared to other countries in the region) and low level of economic activity.

12. ***The establishment of a state and ending of many of the restrictions should provide a large boost to the economy and lead to increased tax revenues.*** However, even after the establishment of a state, it is unlikely that the Palestinian tax base will be able to support the current government structure. Reducing the deficit will require the PA to lower spending as well as increase domestic revenues. The largest share of spending goes to wages and salaries and this is where the PA can most profitably direct its efforts. The Caretaker Government recognized the importance of controlling the payroll and the PRDP called for hiring restrictions and a freeze on salary increases. The PA was not able to meet all of its commitments under the PRDP; for example, it has continued regular, though small, salary increases. However, the PA has been successful in reducing the rate of growth and the payroll fell from about 26 percent of GDP in 2006 to just under 22 percent in 2010. Going forward, the PA needs to initiate comprehensive civil service reform that will allow it to shift resources to investment projects. It is unlikely that the PA will be able to shed workers until economic growth recovers and the private sector is able to absorb them. But the PA can prepare for the future by implementing a number of steps such as establishing job descriptions for all PA positions, introducing position management, reforming the performance management system and introducing a civil service code of conduct.⁹

13. ***The public pensions system is one of the PA's largest obligations and the system is insolvent. It is effectively being operated as a pay-as-you-go system, where current contributions fund the cost of retirees instead of being built up to support future beneficiaries.*** Due to its unique history there are four different pension schemes operating in WB&G. The older three are being phased out and most employees in both the West Bank and Gaza fall under the new scheme. But even this scheme is not properly funded and preliminary estimates put the value of accumulated arrears at between US\$1.5 and US\$2 billion and growing by around US\$70 million a year.¹⁰ Analysis also shows that the fiscal burden of the PA's pension system will rise at an increasing rate as the population ages. The PA has recognized the need to reform its pension system and in July 2010, the PA formally adopted a plan that commits it to improving the pension administrative systems, implementing a number of parametric changes to reduce costs and to studying ways to improve the long term viability of the public pension system. However, reforms have moved slowly and it is essential that the PA begin to deal with this issue before current employees begin to retire and the system goes into crisis.

Next Steps

14. ***Recent growth has been largely driven by foreign assistance and is not sustainable.*** As assistance declines, it is necessary for the PA – to the extent that it can under the prevailing political situations – to take steps to increase private sector growth. As discussed in the following

⁸ IMF Regional Economic Outlook, 2010

⁹ The World Bank and other donors have provided the PA technical assistance on improving its civil service policies. See the World Bank Public Expenditure Review (2007) for a detailed discussion on civil service reform.

¹⁰ Estimates by World Bank staff based on information from MOF and Palestinian Pension Agency.

sections these include increasing trade, improving the investment climate and improving the quality of the work force. The large expenditures on wages and transfers are crowding out investment and development expenditures. In addition, aid is unlikely to remain at the recent high levels. Thus, the PA has already recognized the importance of reducing its dependence upon external budget assistance to fund the recurrent budget. There are a number of steps that the PA has already begun and should continue press or should initiate. These include:

- Implementing the pension reform plan adopted by the Council of Ministers including expanding efforts at public outreach to develop support for the reforms.
- Developing and implementing a medium term civil service reform plan as called for in the Palestinian National Development Plan that will rationalize the growth and deployment of the PA work force to reduce costs and improve service delivery.
- Improving revenue collections by widening the tax base and increasing the efficiency of tax collections by implementing the reforms set out in the IMF's assessments.
- Improving coordination with the Government of Israel to ensure all taxes due to the PA are transferred.
- Improving the public financial management systems by continuing to implement the PA's public financial management reform plan.

Trade and Trade Policy

15. *As a small open economy the development of a future Palestinian state depends upon increasing trade and especially the export of higher value added goods and services.* Increasing trade and integration into the international markets will provide consumers access to a wider range of products at lower prices, while producers will be exposed to competitive forces that increase their efficiency. In becoming more productive, Palestinian producers will be in a position to create job, raise wages, and reduce poverty.

16. *Since 1967, trade in WB&G has been controlled by GOI policies that have been overwhelming oriented towards Israel.* The majority of Palestinian exports are low value added goods that require a minimal level of processing. To achieve sustainable growth, the WB&G economy needs to further integrate into the world economy, expanding trade beyond the Israeli market and increasing the value added of its exports. Over the last 60 years, transportation costs worldwide have fallen significantly and this has been matched by an increase in international trade. Much of the growth has been in the trade of similar products between neighboring countries and increasingly through supply-chains. Indeed, the largest growth in trade has been in intermediate inputs and this has been a key factor in the emergence of "Factory Asia." Such trade provides an important opportunity for a future Palestinian state; located as it is close to both Israel and Europe. But to take full advantage of the opportunities provided by international trade, the PA will have to establish an appropriate trade policy regime and put in place the institutional, regulatory and physical infrastructure to facilitate trade.

17. *Trade policy in WB&G is supposed to be governed by the Protocol of Economic Relations (Paris Protocol or PP) signed in 1994.* This placed WB&G in a quasi customs union with Israel and effectively gave GOI control of WB&G's external economic relations. Other than a few exceptions, the PP extended Israeli tariffs, tax rates and in most cases technical standards to WB&G. In theory, the PP could have led to deep integration of the WB&G and Israeli economy along with the benefits that this would bring to both parties. However, the PP was never fully implemented as envisioned. There is no free movement of labor and Palestinian goods have difficulty entering the Israeli market. In addition, the Israeli security restrictions significantly

impact Palestinian's ability to trade. Thus, as the PA moves towards developing a future state, it must look to alternative ways to govern its trade relationship with Israel and the rest of the world.

18. ***The optimal trade regime for a future Palestinian depends upon what assumptions are made about the reaction of trade partners.*** However, it would be useful if the PA were to publicly establish goals and principles now so that investors in the private sector can begin to prepare. Determining the future trade regime will also help guide the PA as it develops the agencies, services and trade facilitation infrastructure required by a future state.

19. ***A future Palestinian state has three basic choices of trade regimes.*** The first is a customs union with Israel (CU). In many ways, this is a continuation of the current situation under the PP. However, it must be assumed that Israel agrees to fully implement the CU. The second is a non-discriminatory trade policy (NDTP) where the new state applies most favored nation tariffs to all trading partners without exception. The third option is to enter into a free trade agreement (FTA) with Israel and other countries. A fourth option is complete free trade, but this is essentially a variation of the NDTP option, where the external tariff is set to zero.

20. ***There are many benefits to a well functioning CU, which is why some analysts have argued that building on the PP and establishing a customs union that actually works is the best option for a future state.***¹¹ The main benefit of a CU is that it would allow a deep integration of the Palestinian economy with the much larger and richer Israeli economy and lock-in the PA trade policy. With a per-capita GDP more than 15 times that of the WB&G, Israel offers tremendous opportunities for the Palestinian economy. It could provide a large market for exports as well as be a source of technology and knowhow. WB&G has a well educated work force with wage rates far below those prevailing in Israel. Thus, Palestinian firms are the natural choice for Israeli firms to form partnerships with and to outsource labor intensive production.

21. ***Though there might be some exemptions during a transitional period, a CU would require the Palestinian state to adopt the same tariff structure and standards and, in some cases, taxes as Israel.*** But what is best for Israel may not be suitable for the much less developed Palestinian economy and the tariff issue needs more thorough study. However, the Israeli market is generally open and the government is committed to continuing liberalization, which should create fewer distortions for the Palestinian economy. In addition, the knowledge that Palestinian policy is constrained by the CU and Israel is an open economy with a high level of contestability may provide comfort to foreign investors.

22. ***A working CU would greatly benefit the economy of WB&G by deepening its integration with a much larger and richer neighbor.*** It would also save the PA resources since it would not have to collect taxes, implement rules of origin, manage duty drawback schemes or do many of the other tasks related to managing trade with its major trading partner. In addition, a well functioning customs union could dramatically increase Palestinian exports to Israel reducing concerns about the disproportionate benefits Israel receives from free trade. Unfortunately, the quasi-customs union established by the PP has never worked. Abstracting from security constraints, Palestinian goods and labor have never had free access to the Israeli market. Consequently, it is questionable if even under a comprehensive peace agreement, a CU can be fully implemented. Therefore, most PA officials and many other observers have started from the position that whatever trade regime a future state chooses, it will be one where the Palestinians retain control of their own trade policy.

¹¹ Bank CEM and Diwan and Panagryia 1997.

23. ***Most previous analysis has discounted the CU and recommended either an FTA or NDTP.***¹² An NDTP imposes the MFN tariff rates on all trading partners equally. Under such a system, a future state would retain control of its trade policy and set it in an optimal manner. A NDTP eliminates trade diversion and other distortions that create inefficiencies. However, an NDTP also means that Palestinian producers would lose preferential access to the Israeli market. Given that the PA has already entered into a series of FTAs with various partners, it is unlikely that a future state would abrogate these agreements and move to a complete NDTP. But not entering any additional agreements, including with Israel, is a viable policy option.

24. ***The NDTP option eliminates the need to manage complicated trade regimes, implement rules of origin (RoO) or expend resources negotiating trade agreements.*** The NDTP option would allow a future state to levy import duties on trade with Israel. In 2008, imports were about US\$3.2 billion, which even with a low fixed tariff rate would yield considerable income. It is imperative that tariffs be low and stable and not accompanied by quantitative restrictions and non-tariff barriers. Ideally, there would be a single, small, uniform tariff, which would ensure that the future state will benefit from the high levels of competition that drive productivity growth.

25. ***Stable and predictable trade policy will encourage investment in the highly uncertain environment of a new state.*** It will help create confidence and send an important signal to investors about the government's policy commitment. There are, of course, theoretical reasons to vary tariffs across commodities based on elasticities of demand. However, the institutions of a new Palestinian state will undoubtedly still be forming and it is unlikely that they could be expected to manage such a sophisticated tariff policy. A complicated tariff system could easily become an excuse for protecting politically connected producers; thus it is better to set a low and uniform tariff. If a uniform tariff is not possible, the future state should consider binding its tariffs to the prevailing rates on accession to WTO. In this way, it could use the discipline of the WTO system to resist efforts to distort trade.

26. ***A special case of NDTP is a free trade where tariffs are uniformly set to zero.*** Open economies have been shown to grow faster than closed ones and there have been a number of very small economies that have opted for this approach including Singapore, Hong Kong SAR, China and, most recently, Estonia. The free trade policies of Hong Kong SAR, China and Singapore are often credited with attracting the high levels of foreign direct investment that have driven their economies. A future Palestinian state would similarly be located in an area that would present many commercial opportunities and thus free trade is a possible future.¹³

27. ***Moving to a low tariff or free trade would require substantial adjustment.*** Producers in sectors that have been heavily protected, such as agriculture, will have to be supported as they transition to either becoming more efficient or leaving the sector. Also moving towards less protection would require a substantial real exchange rate depreciation to compensate import-competing and exporting firms. Such an adjustment will be difficult until the PA becomes less reliant on external aid and the wage rate becomes more flexible.

28. ***The most serious downside to a NDTP is giving up preferential access to the Israeli market.*** Currently, most Palestinian producers do not have easy access, despite the PP. However, under a peace agreement that leads to the establishment of a state, many of these issues should become less serious. Integration with Israel could be a major driver of growth in the new state but a customs border with Israel could greatly restrict trade and reduce cooperation. Even if the

¹² See de Melo et al, Astrup and Dessus (2002), and Schiff (2002).

¹³ This discussion taken from de Melo et al.

duties were relatively low, combined with the high transaction costs, they would make it difficult for Palestinian goods to compete against goods coming from the US, EU, Latin America and many other countries that Israel has FTAs with. In addition, trade in services might also face restrictions. For example Israel may not agree to recognize Palestinian professional standards and transit rights for people, such as tourists, are not guaranteed under WTO. Finally, it may be hard to implement given that the PA has already entered into a number of FTAs to which a future state would be expected to adhere.

29. ***Another option is for the future state to adopt a system of interlocking FTAs including with Israel, if the latter agrees.*** This would in theory allow the future state to reap the benefits of close integration with its much larger and richer neighbor without having to adopt trade policies that are optimized for a highly developed country. In addition, if it leads to Israel having similar arrangements with Arab countries, it could open the possibility of Israel using WB&G as a platform to export to the Arab world.¹⁴ A number of previous studies have recommended the FTA option.¹⁵

30. ***However, an FTA regime has its own drawbacks.*** Because of the difference in negotiating power, the system for determining RoO is often skewed for the benefit of the more powerful partner, which would certainly not be the new Palestinian state. Given the low level of industrial development, at least initially, Palestinian producers will have to depend upon importing inputs and assembling goods for export. But with the relatively low cost of labor, they may find it difficult to add enough value to meet RoO requirements, unless they use Israeli inputs when exporting to Israel. Thus, Palestinian producers would not be able to source their inputs in the cheapest place increasing trade diversion, which is an issue for any FTA.

31. ***Given the political economy issues, it is unlikely that Israel could be easily persuaded to include agriculture and the free movement of labor in any FTA.*** Israel already has relatively low MFN tariffs on many products, especially the labor intensive manufactured products in which Palestinian firms would likely initially specialize. Therefore an FTA may not be worth the lost customs revenue of granting Israeli firms free access to the Palestinian market. It is also necessary that any FTA include provisions for trade in services. Though there is currently little trade in services, it is a promising area for increasing Palestinian exports.

32. ***A system of FTAs would be expensive to negotiate and implement.*** An FTA system not only requires that the government be able to fully control its borders, but also to implement different systems for different trading partners since RoO systems are usually different for every agreement that a country enters into. This will require a tremendous amount of institutional development.

33. ***Any FTA must be accompanied by a transit agreement.*** The West Bank portion will be landlocked and dependent upon either Israeli or Jordanian transportation infrastructure. Even if a functioning port and airport are eventually allowed in Gaza, the West Bank will still be dependent upon transiting Israel to use them.¹⁶ For a future state to be able to significantly increase trade, it

¹⁴ It could also allow exports to the EU as the Euromed Palermo rules of origin allow for the cumulation of origin between partner states including Israel and the PA if they adopt compatible rules of origin.

¹⁵ Aix group.

¹⁶ In previous negotiations transit between West Bank and Gaza was not considered transit through Israel, but no agreement was ever reached, so it may be or may not be that transit between the two areas is considered transit through Israel.

must be able to ship goods through its neighbors efficiently. Without a well functioning transit agreement with all its neighbors, both trade and investment will be severely circumscribed.

34. ***A functioning CU with Israel offers many benefits including deep integration with the much larger and more sophisticated Israeli economy.*** However, since the PP has never been effectively implemented, it is unlikely that a future Palestinian state would be willing to turn its trade policy over to its more powerful neighbor. Interlocking FTAs with Israel and other neighbors hold significant promise if they are comprehensive and, at least with Israel, include agriculture, services, movement of labor and a transit agreement. While an FTA alone may be of little interest to Israel, if it is coupled with open markets in other regional countries Israel may be accepting. In this scenario, it could be imagined that Israeli firms establish plants in the Palestinian state to access cheaper labor and then export from there to the rest of the Arab world. This would bring employment and technology to the Palestinians, while providing Israeli goods free access to a large new market.¹⁷

35. ***No matter what regime is selected, developing the infrastructure required to manage an independent trade regime will take time and considerable effort, so it is important that the PA begin immediately.*** The PA has limited resources and must carefully choose where it will focus its state building efforts. But since the overall growth of the economy will depend upon increasing trade, establishing an efficient trade infrastructure should receive a level of attention similar that afforded to improving security. It is also important to begin developing the basic legal framework to manage trade effectively. If the PA opts for a very simple and transparent policy as advocated above, then the required legislation will also be relatively simple. The legislation for the most part should be a de facto implementation of WTO rules, which will make eventual accession easier and also provide the benefits of a stable rule based system. Needed legislation includes:

1. *Customs Act.* This legislation sets the legal basis for all levies on imports and exports, establishes valuation procedures, tariff exemptions etc. It must be accompanied by a tariff act that sets a general schedule of tariffs that is based on the Harmonized system.
2. *Indirect taxes.* The system of indirect taxes affects trade. The tax legislation must include provisions for trade including the levying of border adjustment taxes and refunds as they are collected on imports.
3. *Foreign Trade Act.* The foreign trade act provides the legal basis for non-tariff barriers, anti-dumping legislation, licensing procedures, safeguards, etc. These rules should be anchored in WTO rules and as argued above, they should be minimalist to prevent them from being used by special interest groups to restrict trade. If agriculture is not covered here, it will need a separate act.
4. *Health and Safety Standards.* If the procedures for establishing technical standards and phyto-sanitary standards are not covered in the foreign trade act, they must be established under separate legislation. Again they must be in accordance with WTO rules.
5. *Competition Policy.* Laws to establish competition are a part of domestic legislation. But they are also very important part of trade regulation. Before a future state can manage an independent trade policy, it must have in place legislation to regulate monopolies,

¹⁷ Israeli firms already export to the Arab world surreptitiously. This has been reported in many newspaper articles and is openly discussed by the Israeli business associations and government. Israeli goods are transshipped through other countries, particularly Turkey, which inflates official trade statistics. There is no measure of how large this business is but it is clear there is a large market for Israeli goods in the rest of the region.

prevent anti-competitive behavior, set government procurement rules, protect intellectual property, regulate subsidies, etc.

6. *Protection of Foreign Investment.* Protection of foreign investment is an important part of managing external economic relations. Foreign investment must be regulated according to WTO rules and there must also be adequate protection from expropriation and unfair taxation of investments.

36. *Trade in services promises to be an important area of growth in a future Palestinian state.* The most important factor for services is a supporting business environment, which ensures competition and modern international standards. Thus, it is important that there be the necessary legislation in place to regulate trade, foreign investment and operations in services. For the most part, this will be embodied in separate legislation for each sector. Currently, the banking sector is strong, well regulated and competitive. However, in other sectors, such as telecommunications, one of the most important markets in the economy, regulation is still weak.

37. *In addition to developing the legislative framework to support trade, the PA must build the institutional capacity to implement a trade policy.* Controlling borders is the most immediate issue as the roles and responsibilities of different organizations are unclear under the current organization. In any system ensuring security and sovereignty is important. However, facilitating trade should be paramount for any border control system. The border should not be militarized, instead there should be a civil integrated border agency to manage the flow of goods and people. A well-functioning border agency would promote certainty, predictability, and security of the international movement of goods and people by establishing clear, practical and precise standards. Such a system should aim to eliminate duplication and delays in international supply chains, such as multiple reporting requirements and inspections. Border authorities should gather information and pass cargo and people as quickly as possible with most checks done away from the borders. Most important, a well functioning system requires that authorities closely cooperate with their counterparts on the other side of the border.

38. *Developing customs administration is another key area for building the capacity to implement an independent trade policy.* Currently, the Customs and Excise Department in the Ministry of Finance (PACE) is small and relatively inefficient. Because it has no presence at the borders or crossings, and receives limited data from Israel Customs, its activities mostly comprise entering paper-based submissions from local traders into ASYCUDA and performing post-clearance revaluation of declarations. To manage an independent trade policy, it must be substantially upgraded. There have been a number of detailed studies on what is required, all of which emphasize the need to upgrade IT systems, develop risk management techniques, build capacity to conduct valuation and collect taxes and improve PACE's ability to conduct investigations and post clearance audits. Customs personnel require significant training and experience on modern techniques. Developing the capacity of PACE should be given a high priority not only because it is essential for a future state, but in the short term improving customs administration will help raise badly needed revenues for the PA.

Next Steps

39. *Given the importance of trade to the WB&G economy, it is imperative that the PA begin to take steps to improve trade facilitation and prepare for when it might obtain control over its borders.* In the short term there are a number of steps it could take including:

- Determining early what type of trade policy the future Palestinian will adopt, will help negotiators, the PA and the private sector prepare.

- Clarifying border management arrangements so when the PA is once again able to take control of some borders it is prepared to manage them efficiently.
- Continuing to improve the customs authority. Develop its ability to facilitate trade as well as collect duties.
- Continue to seek observer status at WTO and prepare for WTO accession.
- Begin work on developing the legislation required by a modern trade regime.
- Continue to develop the regulatory environment for service industries. It is particularly important that the PA implement the current law and establish an independent telecommunications regulator.

Private Sector Development

40. ***Sustained growth of the Palestinian economy depends on the establishment of a dynamic and productive private sector.*** The PA has made considerable progress in building the institutions of a future state; however, it has been less successful in developing a sustainable economic base. As discussed above, the economy has not grown or evolved like in neighboring countries and in the past 10 years the private sector, especially in Gaza, has been devastated by the economic restrictions imposed by the GOI. Thus, the most important economic challenge facing the PA is how to create an environment that will enable a dynamic and innovative private sector to flourish.

41. ***WB&G should look to the examples in Asia that have managed to sustain high levels of economic growth despite having few natural resources.*** In countries such as the Republic of Korea and Japan, the private sector had been devastated by war, yet within one generation they were able to dramatically increase incomes. Unlike WB&G's Middle Eastern neighbors, where growth has been low, most of the successful Asian countries adopted an outward orientation of increasing trade and integrating into world supply chains. In contrast to the Middle Eastern experience, firms in Taiwan (China), Korea, Singapore and other Asian countries actively sought to adopt new technologies and increase their productivity so that they could be successful in both the international and home markets.

42. ***Along with taking an outward orientation, WB&G should also recognize the potential of the service sector.*** WB&G has few natural resources, limited agricultural land and because of the prevailing costs, finds it difficult to compete in mass-produced low value added manufactured goods. However, it has a highly educated work force and an entrepreneurial people. There is almost universal literacy, a high level of English proficiency and significant internet penetration. In addition, the large Palestinian diaspora has strong connections to the country. There is already a well developed banking sector linked to Jordan and a nascent industry providing IT outsourcing to Israel. There are even a few firms in Gaza providing internet content and media services to the Arab world. All of this suggests that in addition to developing its manufacturing base, services could play an important role in the development of the Palestinian economy, much as in Jordan. In a similar way to India, WB&G might focus more on building its service sector instead to taking the more traditional route to development through manufacturing.¹⁸

43. ***The Palestinian private sector is overwhelmingly dominated by small family-owned enterprises.*** According to the most recent data, the average size of employment in the West Bank establishments was 3 and there were only 57 establishments with more than 100 workers in the

¹⁸ See Ghani Kharas for an in depth discussion of India's experience with the development of the service sector.

entire WB&G. Internal trade dominates, accounting for more than 40 percent of employment in the 2009 sample of the Palestinian Bureau of Statistics' (PCBS) Economic Survey. Service activities accounted for another 30 percent, while industrial activities were only about 22 percent of employment. The high cost of doing business in WB&G and the Israeli restrictions on movement all combine to lower the competitiveness of Palestinian businesses. Consequently, Palestinian businesses are mostly focused on the local market. Only 7 percent of manufacturing enterprises in the Economic Survey reported exporting and exports were only 11 percent of total sales.

44. ***Labor costs are also relatively high in WB&G compared to other countries specializing in labor intensive manufacturing, especially those in Asia.*** The average monthly manufacturing wage in 2009 reported in the Economic Survey was about US\$450 in the West Bank and US\$200 in Gaza. The higher wages in WB&G are well illustrated by looking at World Bank salary scales for offices around the world. These salaries are based on surveys of prices and salaries in the local market and based on the same qualifications for an employee in each country. An entry level worker, with no professional qualifications, in WB&G receives nearly 25 percent more in US Dollar terms than does the same employee in Turkey and more than 74 percent more than an employee in India. Entry level professionals in WB&G earn nearly 20 percent more than their counterpart in Turkey and 50 percent more than in India. To be competitive, the higher wages must be compensated by higher productivity. However, this does not seem to be the case in WB&G as discussed in previous Bank reports such as the 2007 Investment Climate Assessment. High wages, combined with higher transportation costs resulting from the Israeli closures, significantly reduce the competitiveness of Palestinian manufacturing. This analysis indicates that with the loss of trade protection, Palestinian enterprises are no longer able to rely on producing low value added, labor-intensive goods that once dominated the manufacturing sector. The significant decline in the apparel and leather and tanning industries reflect this fact.

45. ***To be competitive, the Palestinian private sector must raise productivity and shift towards high value added goods and services to support the relatively high wages.*** This in turn requires enterprises to increase investment and improve their internal capabilities. However, investment remains relatively low. In 2009, less than 14 percent of Palestinian enterprises in the Economic Survey reported an increase in gross fixed capital formation. The low level of investment is similar to the finding of the 2006 Investment Climate Survey (ICS)¹⁹, which revealed that only 50 percent of manufacturing firms in the West Bank and 25 percent in Gaza had made any investment expenditures in the previous year.

46. ***Firms in WB&G engage in relatively little innovation. About half of the ICS sample reported introducing a new product in the previous year.*** However, most of these “new products” were merely variations on existing products and did not reflect significant innovation. One reason innovation is low among Palestinian enterprises is that they have been cut off from mechanisms for enterprise learning. A firm’s performance depends upon its ability to acquire, adapt and implement new technologies. Both research and experience have shown that among the most important learning mechanisms are firms’ interactions with foreign customers, foreign direct investment, consultants, technology licenses and work experience with international companies; all of which are generally lacking in the Palestinian market. Experience from recent projects to support firm level innovation has also revealed that most Palestinian firms find it too risky to make significant investments in innovations. One project helped 226 individual

¹⁹ The World Bank’s Investment Climate Survey is distinct from the Investment Climate Assessment. The survey was only one component that fed into the ICA, while the ICA itself drew on information from many sources to complete and analysis of overall investment climate.

enterprises, including the most capable and sophisticated in WB&G. But only 15 obtained quality certificates, 20 conducted training and a mere 6 engaged in knowledge transfers such as buying licenses or adopting specialized technology. The majority of clients sought assistance to enter new domestic markets or introducing variations on existing products. For the private sector to replace the public sector as the driver of growth, Palestinian businesses must begin to invest, innovate and become internationally competitive.

47. ***The constraints on investment stem largely from the security and political situation and will only be solved by a successful peace process.*** However, there are many aspects of the investment climate that the PA can control and it is important that the PA establish a business environment that enables investment and encourages entrepreneurs to take risks. To overcome perceptions of risk resulting from years of occupation and attract the necessary high level of investment, the PA should strive to create a business environment that is among the best in the world and not merely on par with its neighbors. The PA has been taking steps to improve the business environment and has made notable progress, especially in establishing security and stability. However, there remains much to be done as evidenced by WB&G slipping from 133 in the 2010 overall Doing Business rankings to 135 in 2011.

48. ***Efficient use of limited resources including land, water, energy and electromagnetic spectrum will be critical to stimulating private sector investment.*** Currently, the PA has little authority in these areas as the GOI retains almost complete control. However, the government of a future state would be expected to manage its own resources. Thus, it is imperative that the PA develop its capacities in this area not only to improve economic performance under the current situation but to also be prepared for a future state.

49. ***The lack of land for development is a major impediment to the Palestinian private sector.*** About 60 percent of the West Bank is under Israeli control and effectively off limits to Palestinian development. In the Palestinian controlled areas, vacant land is scarce and what land is available, is difficult to access because only a small portion is registered and titled. This limits the extent to which Palestinians can develop, sell and collateralize their real property. One of the most important steps the PA can take to enable investment is to increase the amount of registered and legally titled land. Likewise, it is important that the PA complete the registry of public lands in Areas A and B, make the registry public and plan for adding public land in Area C to the registry when the time comes. The Gaza Strip does not face the same types of challenges in terms of access to land. Since the evacuation of the Israeli settlements in 2005, the entire Gaza Strip is under Palestinian control and less than 2 percent of land in Gaza is not registered and titled.

50. ***Housing is closely related to the land registration issue.*** To meet the growing need for houses, it is necessary to develop more affordable housing and in particular the rental market. Most scenarios envisioned for the establishment of a Palestinian state predict a high number of returnees. If even a small fraction of Palestinian refugees and expatriates return to a future state it would put enormous additional pressure on the housing market. But this could also represent a growth opportunity, as the large scale construction needed to meet the needs of the current and future population would provide a significant boost to the economy. However, attracting additional investment in housing projects will require addressing land laws, the land registration process, urban planning issues within municipalities and the legal environment. Particularly important is reforming the rental laws that provide disproportionate protection to renters and constrain the development of new rental properties.

51. ***Ensuring adequate water and power supplies are key factors in improving the investment climate.*** Water is a particularly difficult challenge. The Oslo Agreement and its subsequent interpretation severely limits Palestinian access to water in the West Bank. Though this was meant to be an interim arrangement lasting only 5 years; nearly 20 years later, these arrangements have left the West Bank and Gaza with a per-capita fresh water utilization at one quarter of neighboring Israel and the PA struggling to provide even the most basic level of service to the population. About one quarter of households in the West Bank receive less than 50 lpcd (liters per capita per day) supply, well below accepted World Health Organization standards minimum of 100 lpcd. In Gaza, supply is higher but suffers from high salinity, poor quality and uneven service.²⁰ Thus, developing an integrated water resource strategy and making significant investments in the water distribution networks and sewage collection and treatment facilities are priorities for the PA. The cost and reliability of power is another major constraint to expanding industry in WB&G. Firm surveys have found that managers in the West Bank are generally satisfied with electricity service. However, these surveys reflect the views of existing firms who have found ways to deal with the high cost and unreliable supply of electricity. New firms who would like to enter the market in industries that are energy intensive would probably find the cost of energy prohibitive. In Gaza, power is a much larger concern and most firms cite unreliable power as one of their biggest constraints. Any efforts to expand industry in the West Bank or to just maintain current businesses in Gaza will require substantial investment in the power sector.

52. ***It is important that the PA continue to reform the current collection of laws governing investment, commercial activity, trade, and other business activities.*** These laws stem from different periods of Palestinian history, and consist of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws, which differ between Gaza and the West Bank. The PA is in the process of drafting or discussing a number of new laws that govern business activities. It is difficult to pass new legislation in the absence of a functioning Palestinian Legislative Council (PLC) but improving the business environment requires new laws as well as the regulations needed to implement them. It is important also to ensure that Gaza and the West Bank share the same legal and regulatory environment. Among the more pressing laws are: Companies Law, Competition Law, Secured Transactions Law, Land Law and Tenants Law.

53. ***The WB&G financial system has been steadily developing and is generally able to meet the current needs of the private sector.*** However, it remains a bank-based system and though credit to the private sector is expanding, banks remain highly conservative. It is necessary to deepen credit markets and expand leasing, point of sales infrastructure, mortgage finance and other products required by a dynamic private sector. One of the most important issues is to increase the banking sector's willingness to lend to growing small and medium enterprises without requiring extremely high levels of collateral. There are a number of initiatives to help spur lending, including loan guarantee facilities and training programs for banks. Such efforts will need to be expanded as economic opportunities increase and small Palestinian enterprises demand more finance.

54. ***As in other sectors, passing and implementing new legislation is important for the development of the financial sector.*** Enacting the leasing law and secured lending laws would allow the growth of the leasing market, while establishing the movable assets registry called for in the secured lending law would help the leasing market and reduce the reliance on land for collateral. Growth in the mortgage market would be improved by passing the draft mortgage law and issuing the supporting regulations. Term transformation is an essential role for the banking system but is difficult to do in WB&G where almost all of the banking system's liabilities are

²⁰ World Bank 2009 Assessment of Restrictions on Palestinian Water Sector Development.

short-term demand deposits. It is important that the financial sector begin to develop markets for long-term debt including bank CD's and commercial bonds. The PMA is working on spurring development of these markets and its first steps include introducing its own CDs and securitizing government debt. These products will begin the development of the yield curve and initiate markets for directly placed debt, including commercial paper with the ultimate goal of establishing a market for long-term debt instruments.

Next Steps

55. ***The main constraints to private sector development are the restrictions imposed by the GOI.*** Barring a political solution to the conflict, there is little that can be done about these constraints. However, it is important that the PA continue to take what steps it can to improve the business environment. This will not only prepare the ground for a possible future state, but will lead to increased investment today.

- One of the single most important steps the PA can take is to accelerate the process of land registration. Increased registration will open up the housing market, provide collateral for loans, lower the cost of doing business and increase the tax base.
- Continuing to develop the water and power infrastructure as well as the ability to efficiently manage these services.
- Passing the key legislation discussed above, including the secured transaction law, competition law, etc.
- Continuing to develop secondary legislation to effectively implement laws.
- Continuing to develop the financial sector by encouraging the development of leasing, point of sales infrastructure, mortgage finance and other products required by a dynamic private sector led economy. Passing a new law for the PMA is also critical.
- Continuing to improve trade facilitation as discussed in a previous chapter.
- Establishing the independent telecommunications regulator and developing its ability to regulate the market.
- Continue to improve government services such as the business registration process and system for testing and establishing standards.

Labor and Employability

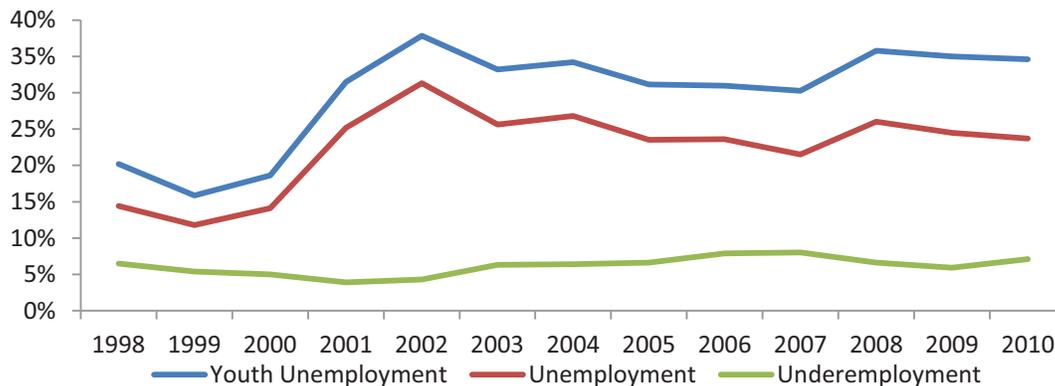
Labor Market

56. ***The WB&G labor market over the past decade has been characterized by high levels of unemployment and underemployment; a steady decline in youth employment and economic participation; and extremely low female labor participation rates.*** Mirroring output, the share of manufacturing in total employment has fallen, while the share of government and government funded services has risen. WB&G has witnessed some of the highest unemployment rates in the world. Peaking above 30 percent in 2002, the rate of unemployment was still well above 20 percent in 2010.²¹ Despite the recovery beginning in 2007, unemployment has remained stubbornly high, and in fact rose from 21.5 percent to 23.7 percent between 2007 and 2010. The high unemployment rates are accompanied by low levels of labor force participation, which have

²¹ The entire employment section draws extensively from World Bank. 2011. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*. This report analyzes principally the data from the quarterly Palestine Labor Force Surveys administered by the Palestinian Central Bureau of Statistics (PCBS) between 1999 and 2009.

remained steady at about 41 percent for most of the last five years. It is also important to note that the high unemployment rates actually understate the true degree to which Palestinians lack work because underemployment remains widespread and there are a significant number of discouraged workers.

Figure 4. Unemployment and Underemployment in West Bank and Gaza, 1998-2010



Source: PCBS Labor Force Survey.

57. **High unemployment has been accompanied by a steady decline in youth employment and economic participation.** In 2000, the youth unemployment (workers aged 15-29) rate was about 19 percent, about 5 percentage points higher than the mean unemployment rate. But by the end of 2010, this gap had risen more than 10 percentage points. Youth unemployment was nearly 35 percent even though by the end of 2010 youth labor force participation had declined to about 34 percent. Youth unemployment is particularly high in Gaza, where it was nearly 53 percent with less than 30 percent participation. Such high youth unemployment is a serious concern for the PA as it could lead to significant social unrest in the future.

58. **Women’s labor force participation rate has been below 16 percent throughout the last decade.** This is remarkably low, even when compared to the Middle East and North Africa (MENA) average of 26 percent, itself one of the lowest regional averages in the developing world. It is likely that Palestinian women face the same constraints on labor force participation as women in other MENA countries, such as social restrictions on work outside home, a societal preference for women confining themselves to the public sector, constrained mobility in looking for jobs and commuting to work, and a perception among employers that women are less productive.²² In addition, with few jobs to go around, there is evidence to suggest that men are favored over women in the hiring process – as one employer put it: “we prefer to hire men as they are family providers”.²³

59. **Over the past decade real wages in WB&G have fallen at all education levels, but much more so among the least educated.** For instance, among those with 5 years of schooling, real wages were about 30 percent lower in 2009 compared to 1999. Among those with 16-18 years of schooling (that is, those with post-secondary degrees), wages in 2009 were lower by about 10 percent. This is probably due to the loss of low-skilled jobs in Israel that carried a wage premium and the labor supply shock as Palestinians who held jobs in Israel returned home. Though the Israeli market offers Palestinians mainly unskilled employment, by 2003, workers in Israel earned

²² World Bank 2011d.

²³ Centre for Development Studies 2010, page 33.

around to 55-65 percent more than similarly educated workers in WB&G. Data from 2009 suggest that the Israeli wage premium remains high. In fact, it appears that as wages in Israel have continued to rise, the average wage for workers in Israel has even surpassed the average wage of well educated workers in WB&G.

60. *There has also been a steady decline in private sector wages relative to government wages. Government workers on average earned about 27 percent less than regular private sector workers in 1999.* However, large public sector wage increases in 2004 and 2005 combined with the falling private sector wages led to a narrowing of the gap between the private and public sectors. Previous World Bank analysis found that by the end of 2005, there was a 15 percent wage premium for working in the private sector once age, education and other factors were controlled for.²⁴ But more recent analysis indicates that though in 2006 and 2007, the government was paying about 8-11 percent more than the private sector, this premium did not persist into 2008. Moreover, it appears that the premium was driven by Gaza. In the West Bank, there is a clear trend of an increase in government wages relative to private sector wages however at no point was there a premium for government workers. In sharp contrast, the wage gap was positive through all years in Gaza, rising from 16 percent to above 50 percent.

Poverty

61. *The high unemployment and falling wages have led to high levels of poverty.* Between 2004 and 2009 the poverty head count fell from about 26 percent to 23 percent of the population. However, this masks large fluctuations and the fact that poverty rates are almost twice as high in Gaza as in the West Bank. Poverty has been steadily falling in the West Bank, but in Gaza it has yet to return to the 2004 level despite a sharp decline between 2007 and 2009. Though poverty rates have fallen, the Palestinian population remains highly vulnerable. In the West Bank 13 percent and in Gaza 16 percent of the population consumes no more than 1.2 times the poverty line. In other words, a shock that reduces consumption by 20 percent will dramatically increase poverty. Such a shock could easily come from deterioration in the security environment that leads to more closures or a significant fall in aid. Gaza is particularly vulnerable to a fall in aid that affects the PA's budget which pays more than 60,000 employees in the Gaza and provides social assistance to another 45,000 households.

Table 1. Poverty Head Count Rate 2004 – 2009

	2004	2005	2006	2007	2009	%Change (2004-09)
WB&G	25.9	24.2	24.0	31.0	22.6	-3.3
West Bank	23.4	21.5	20.1	20.2	16.2	-7.2
Gaza	30.2	28.5	30.0	49.5	33.7	3.5

Source: World Bank. Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza based on PCBS Palestinian Expenditure and Consumption Survey data.

Skills

62. *Developing skills is at the core of improving individuals' employment chances and increasing countries' productivity and growth.* While insufficient demand for workers remains a problem, particularly in WB&G, high unemployment rates are also a function of skill mismatches where workers are not equipped for the demands of employers. This may be due to a lack of education, but it may also be due to inadequate preparation by the education system. As

²⁴ See World Bank (PER).

economies move up the value-added chain, especially moving into high value added services, labor productivity will increasingly depend on high-level cognitive skills (such as analysis, problem solving, and communication) and behavioral skills (such as discipline and work effort). However, education systems may not be able to provide them, so the lack of skilled workers becomes an important constraint on business development. This is a complaint heard from many Palestinian firms, particularly exporters and other high productivity enterprise. Increasing the competitiveness of Palestinian businesses and improving job opportunities depends upon ensuring that Palestinian workers have the skills required by the modern economy.

63. *This section draws on a simple conceptual framework that can help policymakers think through the design of systems to impart skills that enhance productivity and growth in WB&G.*²⁵ The framework consists of five interlinked steps:

- **Step 1. Getting children off to the right start** – by developing the technical, cognitive, and behavioral skills through early child development (ECD), emphasizing nutrition, stimulation, and basic cognitive skills.
- **Step 2. Ensuring that all students learn** – by building stronger systems with clear learning standards, good teachers, adequate resources, and a proper regulatory environment.
- **Step 3. Building job-relevant skills** – by developing the right incentive framework for both pre-employment and on-the-job training programs and institutions.
- **Step 4. Encouraging entrepreneurship and innovation** – by creating an environment that encourages investments in knowledge and creativity.
- **Step 5. Facilitating labor mobility and job matching** – by moving toward more flexible, efficient, and secure labor markets.

Getting children off to the right start

64. *In terms of indicators of early childhood nutrition, WB&G is an outstanding performer.*²⁶ The incidence of stunting and wasting are very low and judged by anthropometric outcomes, WB&G performs better than most other countries in the world. For example, the average stunting rate for middle income countries is 30 percent, which is more than three times the figure for WB&G.²⁷ Performance in terms of wasting incidence is even more compelling: one in 10 children in a middle income country suffers from wasting, a rate that is 7 times lower in WB&G. The West Bank tends to have lower incidence rates than Gaza but even in Gaza, the rates are low.

65. *In addition to good nutrition, the skills developed in early childhood form the basis of future learning and labor market success.* Research indicates that ECD interventions are among the most cost-effective investments a country can make in its people and should be a top priority for efforts to promote employment and productivity later in life. But in WB&G, preschool enrollment rates dropped precipitously between 2000 and 2003, and while they have been increasing more recently, the 2009 enrollment rate remains lower than the rate in 2000.

²⁵ World Bank 2010a.

²⁶ World Bank. 2011. *Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza*, Social and Economic Development Group, Middle East and North Africa Region.

²⁷ In 2011, the World Bank classifies countries with a 2009 gross national income per capita in the range of US\$996-US\$12,195 as middle income.

Ensuring that all students learn

66. In WB&G, school enrollment has always been high, with an average of 90 percent enrollment for the school age population. Access to primary education is near universal – all children, girls and boys, in Gaza or West Bank, enroll in school between the ages of 6 to 12. The secondary gross enrollment rate in WB&G is on the order of 20 percentage points higher than the rate in the average middle income country, and 15 percentage points higher than the average rate in the MENA region.²⁸ But access to education does not provide the full story. Creating productive employees requires not only that all children attend school, but that all students learn. In this respect WB&G performs poorly on international student assessments, and worryingly, the performance exhibits a negative trend. WB&G participated in both the 2003 and 2007 international comparative student assessment Trends in International Mathematics and Science Study (TIMSS), which is designed to help countries all over the world improve student learning in mathematics and science. Around 50 countries participated in both years of the TIMSS and WB&G ranked low in terms of math performance – even when compared to other MENA countries such as Jordan, Syria, Egypt, Algeria, and Morocco. WB&G’s scores declined between 2003 and 2007 while scores neighboring Jordan, Lebanon, and Syria increased. Jordan managed to increase TIMSS science scores by a sizeable 30 points between 1999 and 2007, through a cluster of reforms that included international benchmarking, along with national testing, curricular reform, teacher training, and regular feedback between research and policy. Creating productive employees requires not only that all children attend school, but that all students learn. On this front the PA needs to follow the example of Jordan.

Building job-relevant skills that employers demand

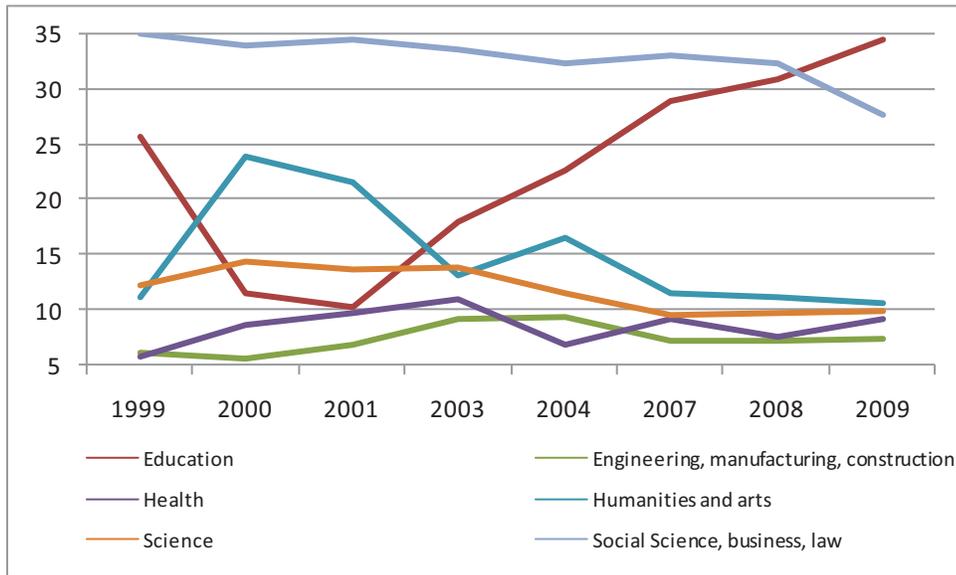
67. Despite the large number of unemployed youth, employers report that it is difficult to hire qualified job applicants. There is a clear mismatch between skills of the unemployed, many with university degrees, and those demanded by the labor market, which suggests that the education system needs substantial reforms. According to the private sector, the education system does not well prepare students for the demands of the modern workplace. Most topics are taught through traditional methods of lectures, memorization, and examinations, with less emphasis on critical thinking, problem-solving, and hands-on learning experiences.²⁹ Recent focus groups led by the World Bank clearly identified the lack of relevant skills as well as the low level of competencies and experience of graduates to be among the most important constraints to employment for youth in WB&G.³⁰

²⁸ Based on data from the World Bank’s EdStats database, available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTEDUCATION/EXTDATASTATISTICS/EXTEDSTATS/0,,menuPK:3232818~pagePK:64168427~piPK:64168435~theSitePK:3232764,00.html>

²⁹ USAID. 2010. *BizCLIR: For the Palestinian Economy, Commercial Legal and Institutional Reform Diagnostic of the West Bank*, Booz Allen Hamilton under the Business Climate Legal and Institutional Reform (BizCLIR) project.

³⁰ World Bank. March 2011e. *From Education-to-Work: Exploring Opportunities and Challenges for West Bank and Gaza*.

Figure 5. Distribution of Tertiary Education Graduates by Subject, 1999-2009



Source: Background analysis, Brodmann, S., E. Cuadra, M. I. Allouche, and S. A. Hillis. 2012. *From Education-to-Work: Opportunities and Challenges in the West Bank and Gaza*. World Bank Quick Notes Series No. 55.

68. ***One of the most important sources of skills development is technical and vocational education and training (TVET) institutions.*** However, the TVET system in WB&G is criticized for producing the same graduates year after year with little regard to labor market signals and the skills described above. Though the TVET institutions have in recent years embraced more rigorous and professionally oriented curricula, the system does not begin to reach its potential. First, as in other areas of WB&G education, teaching techniques in TVET remain relatively formal and traditional, not yet reflecting the learning that modern programs need. Second, vocational and technical schools are expensive to establish and maintain and because of this high cost, technology education is falling behind and students are not well prepared for the changes in employer demands. There is some cooperation between TVET institutions and private enterprise in the WB&G however, in general, this link is weak. In order to improve the relevance of the TVET system, it is necessary to strengthen the ties between the institutions and the industries they support.

69. ***As a result of a surge in enrollments in the last decade, WB&G enrollment rates in tertiary education are well above average rates in MENA and middle-income countries in general.*** Tertiary education can help countries become more globally competitive by developing a skilled and productive labor force and by creating and spreading new technologies. However, it appears that in WB&G young people are pursuing additional education because of a lack of job opportunities and the subjects they study may not be the ones needed by the private sector. The composition of university subjects amongst the tertiary education graduates is heavily skewed towards education, social sciences, business, and law instead of sciences, engineering or other technical fields. Less than 15 percent of graduates studied sciences or engineering, and the share is declining.

Encouraging entrepreneurship and innovation

70. ***The relationship between human development and private sector development is symbiotic.*** It is not enough to develop new products and processes; it is also necessary for individuals to be entrepreneurial in bringing them to good use. This calls for greater collaboration between educational institutions and the private sector. But education and business cooperation in WB&G is not yet institutionalized and remains based on individual endeavors.³¹ Business can play a crucial role in the identification of skill needs, in the implementation of apprenticeship schemes, and in the design and running of sector-specific training centers. Consequently, education institutions should become more proactive in involving business in the various phases of training programming, design, implementation, and evaluation, including participation in scientific councils.

Facilitating labor mobility and job matching

71. ***In addition to having a workforce with the proper skills, improving productivity and increasing employment depends on having a well functioning labor market.*** Employers need the flexibility to hire the correct number of workers with the right skills mix, while workers need to be able to move to jobs that put their skills to best use. Government can facilitate labor mobility through a combination of job and income protection policies, more proactive approaches to employment services and other interventions. However, governments should avoid the combination of rigid job protection regulation and weak income protection systems, which are detrimental to labor mobility. Labor markets in WB&G do not appear to be hampered by excessive labor regulations. The ICS interviews did not find labor regulations to be a significant constraint and of the relevant Doing Business indices, i.e. difficulty of hiring, rigidity of hours, difficulty of redundancy, rigidity of employment, and redundancy costs, only the latter stands out as relatively prohibitive at 91 weeks of the salary. The relatively large size of the redundancy package partially reflects the absence in WB&G of a strong social safety net.

72. ***Though PA regulations do not seem to be major constraints on labor market flexibility, youths in WB&G face a challenge in entering the labor market.*** The authority does not provide any significant help in finding jobs and there are few job matching services. Most new graduates find job using traditional methods such as newspaper ads or private connections through family and friends, with personal connections being particularly important in the private sector. Relying on contacts can be inefficient, since individuals see only a small part of the jobs offered and job seekers with weak social networks can be severely constrained in their choices. Thus, there may be scope to expand employment services in WB&G.

Next Steps

73. ***A future Palestinian state will be small and resource poor.*** Its main option for economic growth will be to build upon its most important resource; the skills and entrepreneurship of its people. The PA has been remarkably successful in providing basic services to its citizens and has ensured that there are high levels of school attendance and literacy. However, the education system is not providing its graduates with the types of skills required by a modern economy. Going forward, the Palestinian education system will need to improve quality and better link education to the needs of the private sector.

³¹ European Training Foundation 2010.

- Ensure that high public sector wages, especially for low-skilled employees, do not distort the private sector market.
- Continue to support the export of labor to Israel, while understanding that its importance will decline over time. In addition, the PA should seek agreements with neighboring and Gulf countries to accept more Palestinian labor, especially skilled labor.
- Reverse the decline in preschool enrollment rates, which would have important positive effects on future learning and labor market success, as well as on female labor force participation rates. However, before initiating reform in this sub-sector, it is necessary to conduct a thorough analysis to better understand the current availability of pre-schools as well as the current institutional and governance structures.
- Focus intensively on the quality of education provided and basic learning outcomes achieved, while maintaining high enrollment rates in basic and secondary education. In this regard the Ministry of Education and Higher Education's Strategic Plan 2008-12 identifies improving the quality of education as its primary focus and it lays out priority reform areas.
- Implement the Ministry of Education and Higher Education's Strategic Plan 2008-12, which calls for improving the relevance of education to the modern demands of the workforce by supporting innovative programs to reduce reliance on traditional methods of instruction and placing more emphasis on critical thinking, problem-solving, and hands-on learning experiences.
- Improve the transition from education to work by providing job matching services that are readily accessible to graduates.
- Initiate programs to better link educational institutions and the private sector. Such programs include apprenticeships and other ways to involve the private sector in the development of student skills. Seek private sector participation when designing the study programs for tertiary education institutions.

CHAPTER 1: MACROECONOMIC BACKGROUND

Introduction

1.1. *The establishment of the Palestinian Authority (PA) following the Oslo Accords brought with it high hopes for an economic renaissance in West Bank and Gaza (WB&G).* It was assumed that as the peace process progressed, the Palestinian economy would be freed of the many Israeli restrictions. Then fueled by investment from the Palestinians diaspora and donor aid, the economy would grow rapidly. However, the peace process stalled, settlements continued to expand and Israeli restrictions were not substantially eased. While the PA had authority in a limited area, the GOI retained control over most of the land and natural resources in the West Bank. In addition, it continued to control the population registry and all movement into and between the PA governed areas. Consequently, while growth accelerated in the mid 1990s, it never reached the high levels hoped for. In late 2000, with the advent of the second *Intifada*, the security situation, and along with it the economic situation, deteriorated dramatically. Since then growth has resumed but at a limited pace as the GOI maintains its tight economic and security restrictions. The PA has expressed its desire to achieve a Palestinian state in the near future and while it has developed the institutions that can manage an independent state, the economic foundations are much weaker. Much of the recent growth can be attributed to enormous inflows of donor aid and there appears to be relatively little private investment in sustainable economic activities. Thus, one of the key questions facing the PA is how to spur private sector led economic growth that will create the jobs needed by a rapidly growing work force and the tax based needed to provide essential service for the population.

1.2. *This chapter will briefly discuss the historical development of the WB&G economy followed by a short discussion of how the conflict has affected the performance and the actual structure of the economy.* Finally, it looks at the fiscal challenges facing the PA.

Historical Context

1.3. *To understand the economic situation in WB&G today, it is necessary to understand how it evolved during the almost 45 years of occupation.* What is most remarkable is how little the economic structure has actually changed. In 1967, WB&G had all of the hallmarks of an underdeveloped economy. Agriculture was the dominant sector and industry provided less than 10 percent of GDP. Most industrial establishments were family owned micro-enterprises using the lowest level of technology to produce for the local economy. Now, after 40 years of development — a time in which per capita incomes in WB&G have risen dramatically and the industrial sectors in neighboring countries have grown significantly — the structure remains much the same. The size of the average industrial establishment in WB&G was four workers, no larger than the average of such establishments in Palestine in 1927.³² The share of agriculture in GDP has fallen to about 6 percent but industry's share remains only about 12-13 percent.³³ While the Palestinian productive sectors have stagnated; government, services, trade and construction, have thrived leaving a heavily distorted economy in a state of arrested development.

³² PCBS Economic Surveys and Roy 1999.

³³ From PCBS flash National Accounts estimates for 2010.

1.4. ***Israel's initial policies were to encourage income growth for the Palestinian population while restricting activities that directly competed with Israeli businesses and to prevent development of sovereign institutions.***³⁴ There were two main aspects to implementation of the policy. The first was “open bridges”, where Israel maintained the bridge link with Jordan. It was hoped that Jordan would take Palestinian agriculture output that Israel did not want competing with its own agriculture sector. Israel also encouraged Palestinian industry to supply Arab markets via Jordan. Jordan did provide a market for significant amounts of Palestinian agriculture output, but exports of services and industrial products were extremely limited. Jordan enforced the Arab boycott of Israel against Palestinian products and also took measures to protect its own industry. Despite the open bridge idea, Palestinian imports were limited. Israel instituted its own barriers to protect domestic industry, which prevented Palestinian producers from accessing many inputs at world prices. In addition, Israeli security measures made it prohibitively expensive to import many goods.

1.5. ***The second aspect of Israeli policy was “integration”, whereby Israel sought to remove barriers between the Israeli and Palestinian economies.*** Palestinian income levels rose dramatically as tens of thousands of workers found employment in Israel. However, integration did little to help Palestinian enterprises. In a fully integrated economy, capital would be expected to flow into the Palestinian territories to take advantage of the lower labor costs. But, almost no Israeli or foreign capital was forthcoming. In addition, there was relatively little local investment despite the liquidity provided by remittances from Palestinians working in the Arab gulf or Israel. Most remittances went into real estate, housing and retail establishments instead of being invested into manufacturing or agriculture.³⁵

1.6. ***By the eve of the Oslo Accords, the occupied Palestinian territories had become completely dependent upon Israel and had little economic relations with other countries.*** Nearly 60 percent of the West Bank's exports and more than 90 percent of imports were to and from Israel and the trade deficit was almost 45 percent of GDP. The figures for Gaza were similar, but the trade deficit was even higher.³⁶ Nearly a third of the Palestinian work force was employed in Israel. While neighboring countries had moved toward industrialization, the Palestinian territories were in a distorted state of development. The share of industry in GDP was low like a developing country, but the share of agriculture had also dropped and the shares of services and construction were higher than would be expected for a country at that level of development. For the most part, the economy appears to have been driven by remittances from workers in Israel and the Arab Gulf.

1.7. ***The PA was established in 1994 and along with it came high hopes for economic growth. However, these hopes were quickly dashed as the GOI began to reverse its system of integration and looked to separation.*** In 1991, the GOI introduced a system of permits for Palestinians employed in Israel and also began to encourage the import of third country workers to replace Palestinians. By 1996, the number of Palestinians working in Israel had fallen to about 28,000 from more than 116,000 in 1992 with much of this decline being due to border closures imposed by the GOI in response to attacks inside of Israel.³⁷ The reduction in employment in Israel coincided with the reduction of employment opportunities in Gulf countries following the first Gulf War, which also was a significant blow to the economy.

³⁴ See Arnon and Weinblatt (2001) for a discussion of Israeli government economic policies in WB&G.

³⁵ Much of this section is drawn from the World Bank 2007 Investment Climate Assessment.

³⁶ Arnon and Wienblatt 2001.

³⁷ World Bank 1999 Development under Adversity.

1.8. ***In the later part of the 1990s, the security situation improved and a low level of growth resumed.*** Employment in Israel and its settlements rose to an estimated 128,000 in 2000.³⁸ In addition, the PA increased employment from about 40,000 in 1994 to around 115,000 by 2000. The improved security situation also brought about increased private sector investment. Consequently, average annual real GDP growth between 1994 and 1999 was about 8 percent.

Recent Growth Trends

1.9. ***The second Intifada broke out in September 2000 resulting in wide spread violence for the next two to three years.*** In response, the GOI imposed a harsh system of closure and curfews on both the West Bank and Gaza. The private sector was devastated and employment in Israel and its settlements fell to less than 50,000, almost all of which was from the West Bank. Between 1999 and 2002, real GDP fell by 27 percent; average real growth was -5.5 percent per annum. In 2003, the security situation improved and a low level of growth resumed, only to falter again in 2006 when Hamas won elections. Following the elections, the international community broke relations with the PA and the GOI tightened its economic and security restrictions. By the end of 2006, real per capita GDP was more than 23 percent below its peak in 1999.

1.10. ***In 2007, Hamas forces ejected all Fatah affiliated forces from Gaza and the Hamas government took over all security functions.*** The PA president responded by dismissing the elected government and appointing a caretaker government led by technocrats until elections could be held. However, this government only held sway in the West Bank while the Hamas government remained in control of Gaza. But the PA continued to pay the salaries of its employees, provide some services and deliver social assistance in Gaza.

³⁸ PCBS Labor Force Survey

Table 2. Selected Macroeconomic Indicators, 2008-11

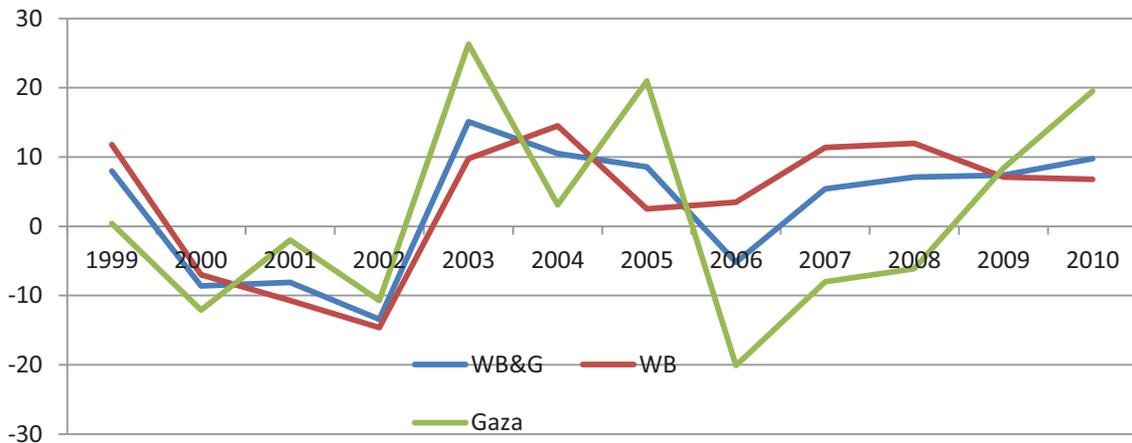
	2008	2009	2010	2011
Output and prices				
		(annual percentage change)		
Real GDP (2004 market prices)	7.1	7.4	9.8	10.5*
West Bank	12.0	7.1	6.8	5.7*
Gaza	-6.1	8.4	19.5	21.7*
CPI inflation rate (end-of-period)	7.0	4.3	2.8	2.7
CPI inflation rate (period average)	9.9	2.8	3.7	2.9
Investment and saving				
		(In percent of GDP)		
Gross capital formation, of which	19.3	18.3	18.5	16.3*
Public	4.1	6.3	4.4	3.3*
Private	15.2	12.0	14.1	13*
Gross national savings, of which	30.2	6.3	7.9	3.4*
Public	3.9	9.1	3.7	1.7*
Private	26.3	-2.7	4.2	1.7*
Saving-investment balance	10.9	-12.0	-10.6	-12.9*
Public Finances (commitment basis)				
		(In millions of US\$)		
Total net revenues	1765	1598	1909	2045
Gross domestic revenues	759	585	727	738
Tax revenues	273	302	456	482
Nontax revenues	486	284	271	256
Clearance revenues	1122	1103	1259	1423
Recurrent expenditures and net lending	2886	3190	3077	3323
Wage expenditures	1453	1467	1614	1782
Non wage expenditures	985	1349	1227	1401
Net lending	447	374	236	140
Recurrent balance (before external support)	-1120	-1592	-1167	-1278
Development expenditures	215	430	299	370
Overall balance (before external support)	-1335	-2022	-1466	-1648
Total financing	1752	1931	1361	1077
Net domestic bank financing	-227	176	84	93
External financing for recurrent expenditures	1763	1355	1147	814
External financing for development expenditures	215	400	131	169

Sources: Ministry of Finance, Palestine Central Bureau of Statistics and IMF estimates.

* Estimates based on first three quarters of 2011

1.11. *The international community embraced the Caretaker Government and in 2007 pledged more than US\$7.5 billion in aid over three years.* At the same time, the GOI of released tax clearance revenues it had withheld from the previous government. The new government set about rebuilding institutions that had deteriorated during the cutoff in international aid. It also made significant efforts to improve security, which led the GOI to reduce some of its restrictions inside the West Bank. However, most restrictions on access to resources and movement outside of the West Bank have remained in place or even become tighter. Gaza meanwhile was blockaded by the GOI; only humanitarian goods were allowed to enter and almost all exports were prevented. In addition, movement of people in and out of Gaza was severely restricted.

Figure 6. Real GDP Growth WB&G 1999-2010

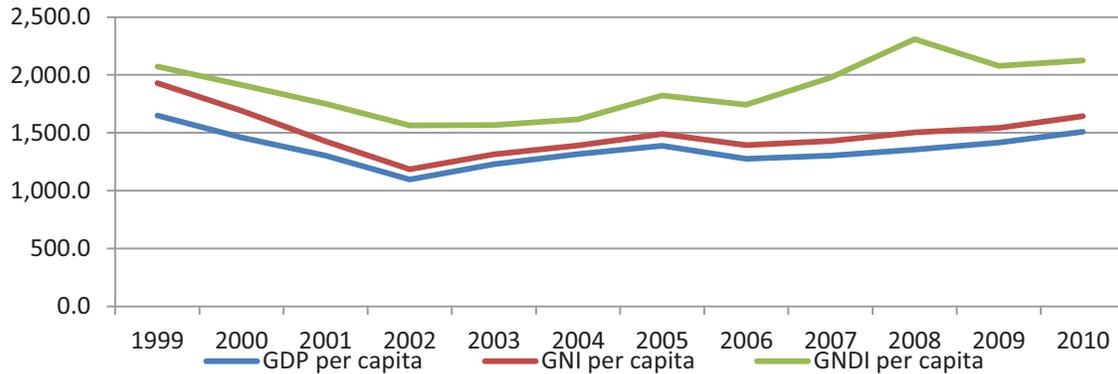


Source: PCBS Annual Estimates. 2010 are flash estimate.

1.12. *As a combined result of the massive inflows of aid, the PA reform program and the improvement in security, economic growth has resumed in the WB&G.* It is estimated to have reached 5.4 percent in 2007 rising to 7.4 percent by 2009 and 9.8 percent in 2010. Given the situation in Gaza, most of the growth has been in the West Bank. However, Gaza experienced positive growth in 2009 as a result of increased aid and the expansion of trade through tunnels from Egypt. In mid 2010, the GOI relaxed its closure of Gaza and began to allow in consumer goods and some industrial inputs. This loosening combined with the tunnel activity spurred growth to an estimated 19.5 percent in 2010. While these figures are encouraging, growth is still relatively weak given the low base it is starting from. In addition, it appears to be largely driven by donor aid and may not be sustainable.

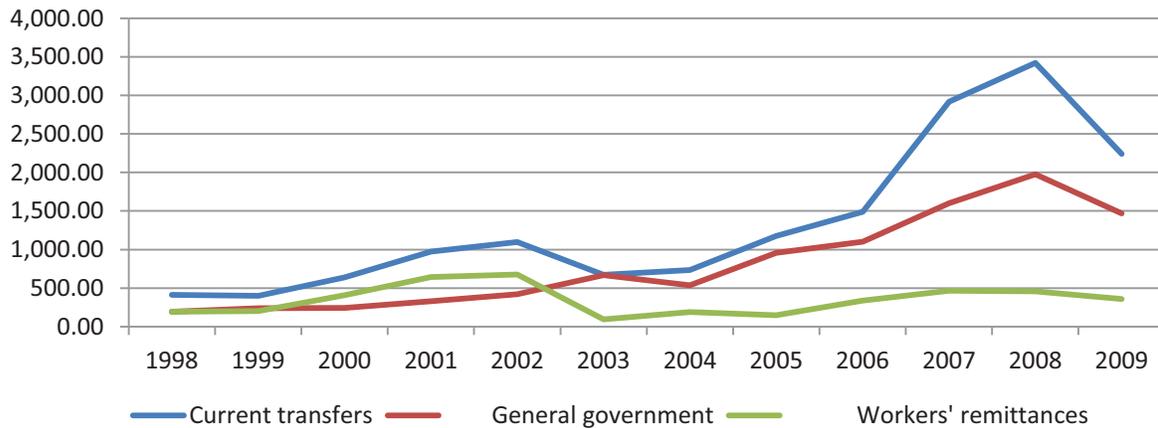
1.13. *The impact of the economic contraction during the first part of the decade was somewhat ameliorated by increasing donor aid.* While real per-capita GDP fell by nearly 34 percent between 1999 and 2002, Gross National Disposable Income (GNDI) declined by only 25 percent. The massive inflows of aid that accompanied the formation of the Caretaker Government led per capita GNDI to recover quickly and by 2008 it was 12 percent higher than in 1999 while per capita GDP remained about 18 percent below its 1999 level (Figure 7).

Figure 7. Real Per Capita GDP, GNI and GNDI (USD Millions), WB&G 1999-2010



Source: PCBS.

Figure 8. Current Transfers (USD Millions), WB&G 1998-2009



Source: PCBS Balance of Payments Estimates.

1.14. *The importance of donor transfers in recent economic performance cannot be overstated. Balance of Payments estimates indicate that in 2008, current transfers at about US\$3.4 billion were more than 56 percent of nominal GDP (Figure 8).* This is around 130 percent more than they were in 2006 and over 210 percent more than in 2002 at the height of the second *Intifada*. While worker remittances recovered somewhat, the majority of the growth was in general government transfers, which jumped dramatically beginning in 2005. They even exceeded US\$1 billion in 2006 when most donors cut off direct aid to the PA.³⁹ Since 2008, the level aid has decreased slightly but it still remains substantial. In 2010, budget support to the PA alone topped US\$1.1 billion. These enormous aid inflows have been largely driving the recent economic upturn and supporting income levels.

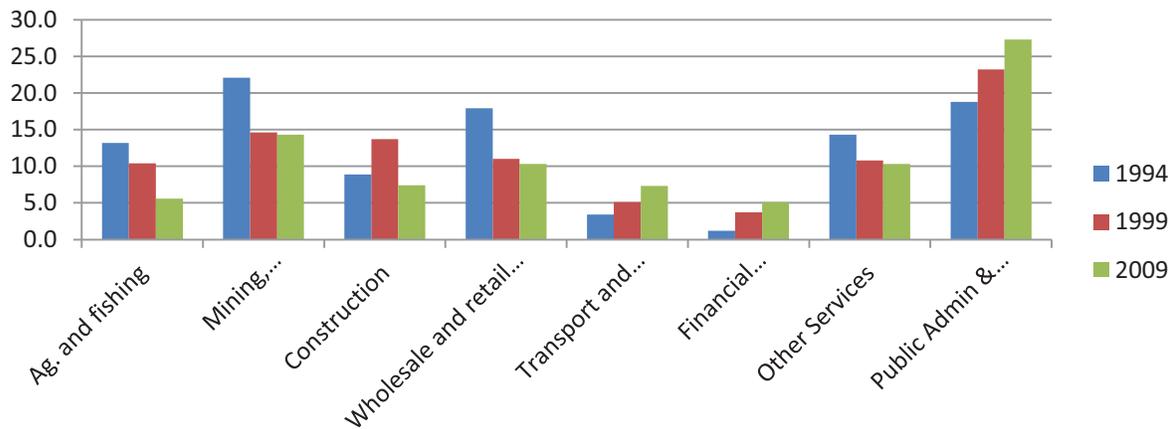
Structure of WB&G Economy

1.15. *Over the last 10 years the WB&G economy has not only shrunk in size, but its structure has altered.* The restrictions that limit private investment and productivity growth have skewed

³⁹ In 2006 aid was provided through the President's office and other ways that bypassed the government such as the European Union's Temporary International Mechanism.

the economy towards the public sector and non-tradables. Industry, agriculture, tourism and some other services have declined while donor funded sectors such as public administration, education, health and electricity have grown. The tradable sectors have shrunk while the non-tradable sectors have grown. In some ways this could be ascribed to an overvalued real exchange rate caused by the massive inflows of donor money and remittances from work in Israel and its settlements. Indeed many observers have noted that the higher wages paid in Israel and by the Palestinian public sector relative to the private sector have driven up the wages in WB&G and decreased the competitiveness of Palestinian products.⁴⁰ However, as discussed in following sections, real wages have shown flexibility downwards, yet there has been no reversal in the structural trends.

Figure 9. Share of GDP for Major Sectors, WB&G



Source: PCBS annual National Accounts.

* Public services include health and education

1.16. *Far more important have been the Israeli restrictions that have made it difficult for businesses to operate and have discouraged long term investment.* Restrictions on movement and access to land and other resources have severely constrained manufacturing, agriculture and the productive sectors.⁴¹ However, donor funded government activities have been able to grow unfettered and private consumption has jumped with the large aid inflows. Public administration, defense and other mostly public services such as health, education, electricity and water grew from less than 20 percent of GDP in 1994 to more than 27 percent in 2010. Meanwhile, the industrial and agriculture sectors declined from 13 to 10 percent and 9 to 6 percent respectively. Between 1999, the last full year before the first *Intifada*, and 2009 industry did not grow as a share of GDP while agriculture fell by nearly half. The pattern was similar in both the West Bank and Gaza. Consumption and donor supported activities grew while the productive sectors declined and the economy hollowed out.

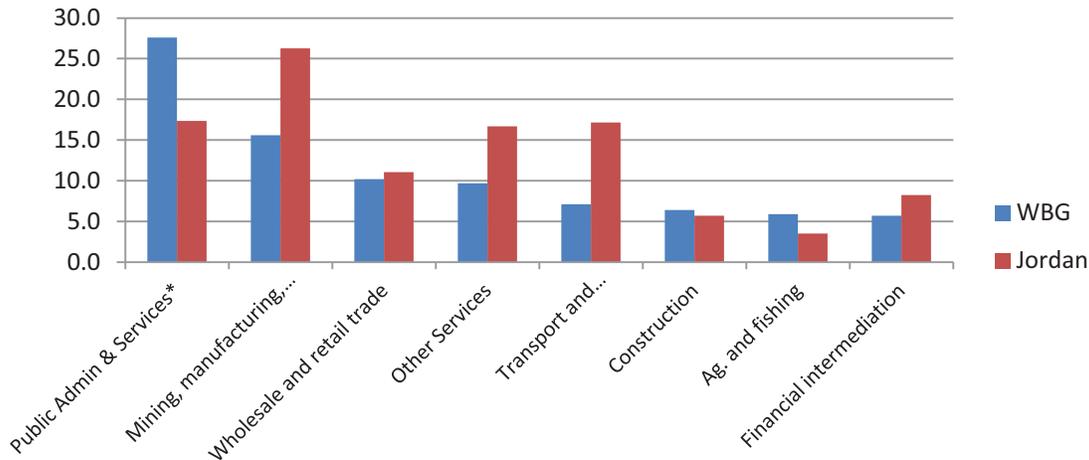
1.17. *A comparison to the Jordanian economy clearly illustrates the arrested development of the WB&G economy.* Jordan is in a very similar situation with limited resources and receiving a high level of donor support. In fact until 1967, the West Bank was one of the most developed parts of Jordan. However, since the West Bank was captured by Israel, the Jordanian economy has followed a much different course. By 2008, Industry had risen to more than 26 percent of

⁴⁰ Chapter 1 contains an in depth discussion of the labor market, While Chapter 2 discusses trade related issues.

⁴¹ See 2007 ICA for details on constraints to private sector activity.

GDP while agriculture had dropped to less than 4 percent.⁴² The respective shares of industry and agriculture in WB&G were 16 and 6 percent. Though Jordan has a relatively large public sector, it still accounts for only about 17 percent of GDP compared to more than 27 percent in WB&G (Figure 10).⁴³

Figure 10. Share of GDP for Major Sectors, WB&G and Jordan 2008



Source: PCBS annual National Accounts and Jordan Department of Statistics.
 * Public services include health and education

Growth Decomposition

1.18. *A simple growth decomposition analysis provides additional evidence that there has been relatively little investment and that most recent growth has come from better use of factors as the security situation has improved.* This suggests that the removal of restrictions in the future could result in large productivity gains for the Palestinian economy.

1.19. *Between 1970 and 2000 the Palestinian real GDP growth averaged nearly 6 percent per annum.* However, this impressive growth rate masks significant variability, which can mostly be traced to political factors and changes in the security situation. In the 1970s, real output grew at nearly 8 percent per annum as the Palestinian territories integrated with the larger and developed Israeli economy. During this period tens of thousands of Palestinians found work in Israel and there were important transfers of technology and expertise, especially to the agricultural sector that dominated the Palestinian economy. In the 1980's growth lagged for a variety of reasons including international shocks such as the rise in oil prices, hyperinflation in Israel and more Israeli restrictions on Palestinian agriculture. High growth resumed in the early 90s spurred by faster employment growth, particularly in the construction sector, only to falter in 1995-1996 with the deterioration of the security sector. There was a substantial recovery in 1998-1999 followed by a massive decrease in output during the second *Intifada*.

⁴² 2008 is the latest year for which Jordan publishes revised annual statistics.

⁴³ For this analysis we include education and health in the public sector since they are mostly funded by government.

1.20. *Surprisingly, real GDP growth actually accelerated during the first Intifada (1988-1993).* The higher output appears to have been driven by rapid growth in domestic employment as Palestinians lost their work in Israel. However, while GDP may have accelerated during this period, GNI fell due to the loss of income from Israel. This is in sharp contrast to the experience during the second *Intifada* when GDP and domestic employment significantly fell. The violence was more intense during the latter period and in addition, during the first *Intifada* the Palestinian territories were not subject to border closures that disrupted trade during the second *Intifada*.

Table 3. IMF Estimates of Contribution to Growth 1970 – 1999

Period	Growth of Output	Capital Stock	Contribution of Employment*	Total Factor Productivity
1970-1999	6.0	2.5	2.1	1.4
1970-1979	8.0	3.0	-0.2	5.2
1980-1989	3.1	2.3	1.5	0.7
1990-1999	6.8	2.3	5.0	0.4

Source: IMF 2001.

*Assumes depreciation rate of 4 percent and initial capital output ratio of 2.5. Elasticity of Capital to output is .35

1.21. *Capital accumulation appears to have been a key factor in the Palestinian economic growth prior to the Oslo accords.* Previous analysis by the IMF, based on a simple growth accounting model, suggested that capital accumulation contributed nearly 2.5 percentage points of the 6 percent real GDP growth rate during the 1970-1999 period (Table 2).⁴⁴ However, capital accumulation was uneven following the political and security ups and downs. It accelerated in the early 1970s and fell during the 1980s only to resume following the Oslo accords. IMF estimates suggest that investment rose to nearly 33 percent of GDP in the period 1994-1999. Prior to 1994, most of the investment was in construction reflecting the high demand for housing and the difficulty investing in any other areas. Following Oslo, investment also included substantial investment in infrastructure funded by donors. But there is no indication of significant private investment outside of construction.

1.22. *Employment was also an important driver of growth and the IMF analysis indicates that it contributed 35 percent of the annual growth during 1970-1999.* Employment during this period expanded at around the same rate as the populations – about 3 percent per annum – but below the rate of growth of the labor force. Political events influenced most short term fluctuations in employment and employment was substantially more volatile than output or investment.

1.23. *While factor accumulation was the most important driver of growth, Total Factor Productivity (TFP) was estimated to be 1.4 percent over the period 1970-1999.* But TFP was also highly variable. It grew by nearly 3 percent prior to 1994, but from 1994 through 1999 the IMF estimates indicate that it fell by 4.4 percent. In the first two decades of the Israeli occupation, there were significant technology transfers and investment in some areas such as agriculture. But following the Oslo accords and the increased closures during the mid 90s, much of capital stock would have been underutilized, which would have been reflected in the TFP figures.

⁴⁴ The IMF productivity analysis described here is found in IMF 2001.

Table 4. Growth Accounting Decomposition Analysis by Period, 1997-2010

Period	GDP Growth	Physical Capital	Labor Adjusted Skills	Total Factor Productivity	Per Capita GDP Growth	Pop Growth Rate
1997-1999	10.4%	2.1%	2.3%	6.0%	7.0%	3.2%
1999-2006	-0.6%	0.2%	0.6%	-1.4%	-3.4%	2.9%
2006-2010	7.3%	-0.1%	1.0%	6.4%	4.3%	2.9%

Source: World Bank staff calculations.

1.24. ***Real GDP reached its height in 1999 just prior to the second Intifada. From 1999-2006, average annual GDP was -0.6 percent and per capita GDP was -3.4 percent (Table 2).*** But there were large variations in growth. Output fell by 9 percent and 13 percent in 2001 and 2002 respectively during the height of the fighting. Output bounced back by nearly 15 percent and 12 percent in 2003 and 2004 as the security situation improved. A growth accounting analysis indicates that physical capital contributed 0.2 percent while skills adjusted labor a mere 0.6 percent during the 1999-2006 period. However, there was a decline in TFP of 1.4 percent, which reflects the fact that during the *Intifada* and the closures that followed much of the capital stock was idle. With the recovery, at least in the West Bank following the establishment of the Caretaker Government and the improvement in the security situation, growth resumed: average annual growth in 2006-2010 was 7.3 percent in WB&G. This large increase is captured in the Cobb-Douglas residual and it appears that almost all of the growth came from an increase in TFP, resulting from more efficient use of existing capital stock and a small increase in labor adjusted skills.

1.25. ***Capital accumulation does not appear to have played an important role in the recent growth.*** The growth accounting decomposition suggests that the contribution of capital was actually negative. This finding is supported by the information on investment, weak though it may be.⁴⁵ Unpublished PCBS estimates suggest that Gross Fixed Capital Formation (GFCF) may have fallen as much as 10 percent in real terms between 2006 and 2009 and in 2009 was less than 19 percent of GDP. In addition, nearly two thirds of the investment was in buildings as opposed to equipment. However, the share of equipment in GFCF has increased from 29 percent in 2006 to 34 percent in 2009. Given this low level of investment and even lower level of equipment investment, it is sensible that the productivity gains seen in the last 5 years are due to increases in capacity utilization and not productivity enhancing investments. The World Bank's Investment Climate Survey found that median capacity utilization for manufacturing firms was only 50 percent in 2006, and with about 50 percent of firms in the West Bank and 25 percent of firms in Gaza had invested anything in the last year. Thus, the micro level evidence supports the view that there were large gains to be made by increasing use of assets and that investment was low.

⁴⁵ PCBS is currently revising its GFCF series and has more confidence in estimates for later years.

Table 5. Contribution to Growth by Economic Activity and Period

Value Added, Main Economic Activities (US\$ Million of 2004)	Contrib. to Growth 1999-2010	Contrib. to Growth 2006-2010
Agriculture and fishing	-0.2	0.7
Mining and quarrying	0.0	-0.1
Manufacturing	-0.1	0.0
Electricity and water supply	0.3	0.3
Construction	-0.2	1.3
Wholesale and retail trade	0.3	1.1
Transport, Storage and Communications	0.5	0.3
Financial intermediation	0.3	0.7
Real estate, renting and business services	0.0	0.6
Community, social and personal services	0.2	0.2
Hotels and restaurants	0.0	0.1
Education	0.4	0.6
Health and social work	0.0	0.2
Public administration and defense	0.6	0.6
HOUSEHOLDS WITH EMPLOYED PERSONS	0.0	0.0
Less: FISIM (zero, as it was pro-rated across activities)		
Total Gross Value Added	6.9	6.3
Gross Domestic Product	2.2	7.3

Source: World Bank staff calculations based on PCBS National Accounts data.

1.26. *Growth decomposition analysis of GDP at factor costs supports the view that there has been little private investment in the productive sectors and that much of the recent growth has been driven by donor funding. Between 1999 and 2010, average annual growth was 2.2 percent.* Both agriculture's and manufacturing's contribution were negative while the largest contribution came from government and donor funded sectors such as public administration and defense, education and electricity and water. Other important sectors included transport, wholesale trade and financial intermediation reflecting higher consumption. In 2006 -2010, growth jumped to an average annual rate of 7.3 percent, with growth in the West Bank averaging more than 10 percent and Gaza 0. The patterns remained similar. Agriculture appears to have recovered and construction, driven by remittances and aid, becomes an important source of growth. But manufacturing remains flat and donor driven sectors and sectors reflecting higher consumption continue to drive growth.

Fiscal Policy

1.27. *Since its establishment, the PA has become more donor dependent at an increasing rate. In 1999, the PA recurrent budget had a small surplus and all donor aid was directed toward projects in the development budget.* In 2002, at the height of the second *Intifada* when economic activity was at its lowest point, external budget support was less than US\$500 million. Since then, even as the security situation has improved and limited growth has resumed, the need for donor budget support has steadily increased. By 2008, budget support had grown to nearly US\$1.8 billion or about 29 percent of GDP. While it has declined since then, in 2010 it was still nearly US\$1.15 billion and even this large amount did not cover the full recurrent deficit.⁴⁶ The PA's budget projections call for the need for budget support to decline rapidly. However, this is

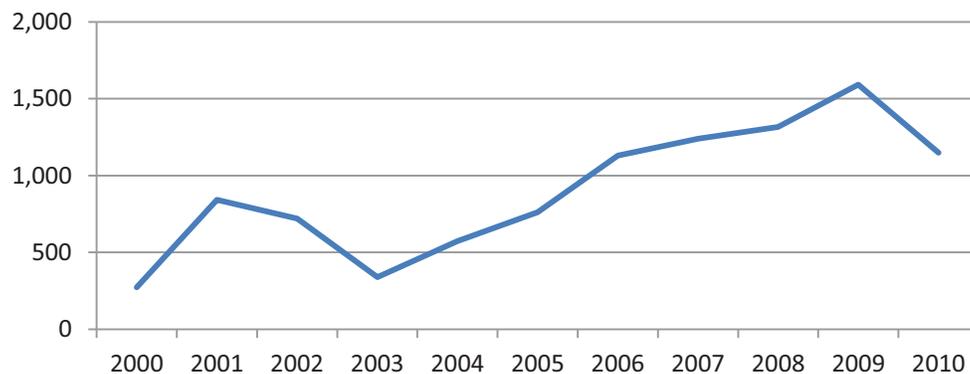
⁴⁶ These figures do not include any funds going to the government in Gaza. Thus, they understate the true aid dependency of WB&G.

based on optimistic assumptions about future GDP growth, which may be hard to attain if there is no substantial improvement in the political situation.

1.28. *The largest share of government expenditures goes to wages and salaries, which were about US\$1.6 billion in 2010.* This is more than the total projection of budget support and 21 percent of estimated GDP. However, this underestimates the true cost of the payroll. Transfer payments, which include a substantial amount of pension payments, were another nearly US\$700 million. Combined wages and salaries and transfers accounted for three quarters of the PA's recurrent budget in 2010. Subsidies for utilities were another 8 percent of the recurrent budget leaving only about 17 percent for operational and minor capital expenditures.

1.29. *The PA budget calls for all development expenditures to be fully financed by donors. According to the budget, the PA will not make any direct development expenditures from the Central Treasury Account (CTA) unless it expects immediate reimbursement.* The PA set ambitious targets for development expenditures but the donors have never fully funded them. The 2009 called for about \$500 million and the donors provided less than half of this amount to the PA. Faced with the low level of external support for priority development projects, the PA funded around \$170 million in development expenditures directly from the CTA. In 2010, donor provided about 130 million in development financing to the PA and the PA reports it again financed about \$170 million in development expenditures from its own resources. There is a large amount of development expenditure in WB&G financed directly by donors. However, the PA itself has very little resources to devote to development because of the enormous wage bill and large social transfers. In the near future, unless aid unexpectedly increases, it is unlikely that the PA will be able to spend as much as they have in the past on development expenditures as almost all available resources will have to be devoted to operating costs.

Figure 11. PA Recurrent Deficit in Nominal US\$ (000), 2000-2010



Source: World Bank staff calculations.

1.30. *Gross domestic revenues in 2010 (including import duties and VAT collected by Israel for the PA) were around 27 percent of GDP.* This compares well to other countries in the region such as Jordan and Egypt where total government revenues in 2009 were 23.3 percent and 27 percent of GDP respectively.⁴⁷ However, in 2009 PA revenues still only covered about 50 percent of its expenditures. Thus, in 2010 the PA intensified its efforts to increase domestic revenues and to control spending so that domestic revenues amounted to more than 63 percent of expenditures. Around 70 percent of revenues come from the taxes such as VAT and import duties collected by the GOI and remitted to the PA. The PA has no control over these funds and little way to increase

⁴⁷ IMF Regional Economic Outlook, 2010.

them. However, the PA has control of over domestic tax revenues and they jumped by nearly 50 percent between 2009 and 2010. They accounted for about 24 percent of total revenues but less than 15 percent of total recurrent expenditures. In the coming years, the PA will have to continue its efforts to raise domestic revenue but there will a limit to how much of an increase they can expect given the already substantial current level of collections and low level of economic activity.

1.31. ***While the donors have been extremely generous in the past several years, they have not met the full requirement to fund the PA's recurrent budget deficit and development projects.*** The PA does not have access to international financial markets. It currently has about US\$1 billion in external debt but almost all of this is to development agencies or bi-lateral lenders. Consequently, the PA has been forced to resort to short term borrowing from local banks and building up arrears to the private sector and pension system to finance its deficit. In 2009, net domestic bank was US\$176 million and net accumulation of arrears was nearly US\$300 million. In 2010, these debts continued to rise; 2010 net domestic bank financing reached US\$84 million and the net accumulation of arrears was US\$116 million.

1.32. ***At the end of 2010, the PA was in debt to local banks for about US\$840 million most of which was in the form of short term loans and overdrafts.*** In addition, it owed hundreds of millions of dollars in arrears. Much of the credit has been extended on the understanding that additional donor financing would be forthcoming. While most enterprises in WB&G do not have bank credit, it is unlikely that borrowing by the PA is crowding out domestic borrowing. Credit to the PA only accounts for about 9 percent of total banking assets and credit to the private sector has been increasing. Palestinian banks are highly liquid and the lack of credit to businesses is probably due to banks being reluctant to extend loans due to the risky environment. Likewise, most firms are unwilling to borrow at current interest rates.⁴⁸

1.33. ***A far more important issue for growth is the arrears. Most of the total arrears are owed to the pension system and do not have an immediate impact on economic growth.*** But an ever growing portion is owed to the private sector. PA arrears not only raise the cost to businesses – the private sector is essentially financing the PA – but damage the private's confidence in the government. Since government spending and spending by government employees have been the main drivers of growth in the past few years, a lack of confidence in the government's ability to continue to spend could have serious consequences for investor confidence and economic growth.

1.34. ***The high level of donor aid that the PA has received over the past few years is unlikely to be sustained.*** Thus, future growth will be affected by the PA's ability to reduce the recurrent deficit and redirect resources towards investment. To this end, the PA is making a concerted effort to mobilize domestic tax revenue. With the assistance of the IMF and donors, the PA continues to implement steps to increase revenues including increasing the coverage of the property tax, establishing a large tax payer unit in the MOF and increasing efforts to collect VAT. The bulk of tax collections come from the tax clearance revenues that the GOI collects for the PA. A future Palestinian state is expected to control its borders and take over responsibility for collecting duty and VAT on imports from the GOI. Consequently, it is essential that the PA begin to prepare for this now and build up the capacity of its customs and border management organizations.

⁴⁸ See discussion in the following section on finance and in the World Bank 2007 ICA.

1.35. *Improving tax administration is also a vital part of preparing for a future state. In 2010, IMF tax experts assessed that the PA's revenue administration is fragile and consequently the PA is directing more resources towards improving it.*⁴⁹ A medium term reform agenda that strengthens revenue administration and broadens the tax base offers the potential to make the revenue system fairer - by ensuring that those able to contribute are doing so - and more efficient to administer. There is little informality in the Palestinian economy in the sense that most businesses are registered. However, most of the registered tax payers do not actually file returns. Thus, the focus should be on reforms such as implementing self assessment, and integrating the administration of VAT and income tax. In a self assessment system, taxpayers calculate their own liabilities, file returns, and pay any tax they have assessed. If they fail to make accurate assessments, they run the risk of being detected, audited, and penalized. The system makes better use of audit tools, and can reduce the number of disputes lowering the costs for the government and the taxpayer. Integration of VAT and income tax administration can both reduce the costs of compliance for the taxpayer, and improve the efficiency of administration for the PA. International evidence is that both measures can be expected to increase tax collections.

1.36. *Rising GDP will lead to an increase in tax revenues and the establishment of a state and ending of many of the restrictions should provide a large boost to both the economy and tax revenues.* However, even after the establishment of a state and lifting of many restrictions, it is unlikely that the Palestinian tax base will be able to support the current government structure. Reducing the deficit will require the PA to reduce spending as well increase domestic revenues. The largest share of spending goes to wages and salaries and this is where the PA can most profitably direct its efforts. The Caretaker Government recognized the importance of controlling the payroll and the PRDP calls for hiring restrictions and a freeze on salary increases. The PA has not been able to meet all of its commitments under the PRDP; for example it has continued regular, though small, salary increases. However, the PA has successfully reduced the rate of growth and the payroll fell from about 26 percent of GDP in 2006 to just under 22 percent in 2010.

1.37. *Going forward, the PA needs to initiate a comprehensive civil service reform that will ultimately result in a reduction of the wage bill and more efficient provision of service.* This will allow the PA to shift resources to investment projects. However, it is unlikely that the PA will be able to shed workers until economic growth recovers and the private sector is able to absorb them. But in the Palestinian National Development Plan the PA commits to preparing a medium term plan for civil service reform, and identifies a number of priorities for administrative reform to improve its effectiveness and contain its cost. These involve both addressing the administrative structures of the PA and the way that staff are rewarded for performance. Although the number of ministries, departments and agencies is not particularly large compared with many other governments, there is duplication of mandates, organizational overlap, inconsistent reporting lines, and overstaffing. The employment arrangements within the PA do not reward performance; promotion is largely seniority based, the performance evaluation system is not well regarded by staff, and the pay structures are highly compressed. While civil service reform provides an opportunity to right-size the public sector, improve departmental efficiency and establish a stronger performance culture, it is a daunting challenges and will require a change to the way that the civil service is viewed by many PA employees and society in general. This in

⁴⁹ IMF: "West Bank and Gaza – Completing the Foundations of Modern Revenue Administration" 2010.

turn demands strong leadership, and dedicated management over a number of years if it is to succeed.⁵⁰

1.38. ***One of the PA's largest obligations is the public pensions system.*** This system is among the most generous in world for a society with WB&G's level of income and it is insolvent. It is effectively being operated as a "pay as you go" system, where current contributions fund the cost of retirees instead of being built up to support future retirees. Due to its unique history, there are four different pension schemes operating in WB&G, including those inherited from Jordan and Egypt. However, the older three are being phased out and all new employees in both the West Bank and Gaza fall under the same scheme. But even this scheme is not properly funded. Preliminary estimates put the value of accumulated arrears at between US\$1.5 and US\$2 billion and growing by around US\$70 million a year.⁵¹

1.39. ***Because the PA pension system is so generous, pension budgetary commitments were nearly 4 percent of GDP in 2008.***⁵² This is higher than the 3.6 percent average for countries in the Middle East and North Africa Region. It is also well above the share in countries with similar per-capita GDP, which ranges from 0.1 percent to 2 percent. The population of WB&G is young, with only around 3 percent of the population being over 65 years of age. Yet, various countries with similar percentages of elderly have higher coverage rates and expenditures are still below 4 percent of GDP. Analysis also shows that the fiscal burden of the PA's pension system will rise as the population ages. This will have a significant negative effect on the PA's fiscal position, further squeezing the PA's budget and its ability to fund development projects.

1.40. ***The PA has recognized the pressing need to reform its pension system and put it on a sustainable footing.*** In July 2010, the PA formally adopted a reform plan that commits it to improving the pension administrative systems, implementing a number of parametric changes to reduce costs and to studying ways to improve the long term viability of the public pension system. It is essential that the PA move to deal with the pension system before current employees begin to retire and the system goes into crisis. However, any reform that reduces costs and cuts benefits will be politically difficult to implement. Thus the PA has initiated a slow process of reform, beginning with efforts to educate stakeholders about the system's realities and build popular support for reform.

Next Steps

1.41. ***Recent growth has been largely driven by foreign assistance and is not sustainable. As assistance declines, it is necessary for the PA – to the extent that it can under the prevailing political situations – to take steps to increase private sector growth.*** As discussed in the following sections these include increasing trade, improving the investment climate and improving the quality of the work force. The large expenditures on wages and transfers are crowding out investment and development expenditures. In addition, aid is unlikely to remain at the recent high levels. Thus, the PA has already recognized the importance of reducing its dependence upon external budget assistance to fund the recurrent budget. There are a number of steps that the PA has already begun and should continue press or should initiate. These include:

⁵⁰ The World Bank and other donors have provided the PA technical assistance on improving its civil service policies. See the World Bank Public Expenditure Review (2007) for a detailed discussion on civil service reform. The Bank has also provided the PA with additional analytical work on this issue.

⁵¹ Estimates by World Bank staff based on information from MOF and Palestinian Pension Agency.

⁵² This section draws from recent analysis by World Bank staff to assist the PA in its reform process.

- Implementing the pension reform plan adopted by the Council of Ministers including expanding efforts at public outreach to develop support for the reforms.
- Developing and implementing a medium term civil service reform plan as called for in the Palestinian National Development Plan that will rationalize the growth and deployment of the PA work force to reduce costs and improve service delivery.
- Improving revenue collections by widening the tax base and increasing the efficiency of tax collections by implementing the reforms set out in the IMF's assessments.
- Improving coordination with the Government of Israel to ensure all taxes due to the PA are transferred.
- Improving the public financial management systems by continuing to implement the PA's public financial management reform plan.

CHAPTER 2: TRADE AND TRADE POLICY

Introduction

2.1. *As a small open economy, the development of a future Palestinian state will depend upon increasing trade and especially the export of higher value added goods and services that exploit its comparative advantage arising from relatively low wages for well educated workers.*

Increasing trade and integration into the international markets will provide consumers access to a wider range of products at lower prices, while producers will be exposed to competitive forces that would increase their efficiency. The Palestinian market is tiny and with greater market access, producers would also benefit from economies of scale. In becoming more productive, Palestinian producers will be in a position to create job, raise wages, and reduce poverty.

2.2. *Since 1967, trade in WB&G has been controlled by Israeli policies and been overwhelming oriented towards Israel.* But growth will require that trade be more diversified in the future. In 2008, the most recent year for which data is available, Israel accounted for nearly 89 percent of WB&G's exports and 81 percent of imports. The majority of exports were for low value added goods that required a minimal level of processing. To achieve sustainable growth, the WB&G economy needs to further integrate the world economy, expanding trade beyond the Israeli market and increasing the value added of its exports. This requires that the PA establish an appropriate trade policy regime and put in place the institutional, regulatory and physical infrastructure to facilitate trade.

2.3. *Over the last 60 years, transportation costs worldwide have fallen significantly and this has been matched by a similar increase in international trade.* But what is remarkable is that much of the growth has been in the trade of similar products between neighboring countries and increasingly through supply-chains. Indeed, the largest growth in trade has been in intermediate inputs. This has been a key factor in the emergence of "Factory Asia", for instance, as it has allowed Asian countries to develop their comparative advantage and specialize in tasks with increasing rates of return at all stages of transformation. This type of trade provides an important opportunity for a future Palestinian state: located as it is close to both Israel and Europe. (A 10 percent increase in transportation costs has been estimated to reduce trade volumes by as much as 20 percent. Intermediate goods are even more sensitive to transportation costs. For example, a 5 percent increase in transport costs can produce trade friction equivalent to an ad valorem tax of almost 50 percent when the share of the intermediate inputs in value added is 70 percent.)⁵³ While distance is important in determining trade costs, the impermeability of borders and differences in regulations and currencies have been shown to be more important. Thus, taking full advantage of the opportunities provided by international trade and integration will require the PA to focus on institutional arrangements that will lower trade costs.

Background

2.4. *Trade policy in WB&G is supposed to be governed by the Protocol of Economic Relations (Paris Protocol or PP) signed in 1994.* This placed WB&G in a quasi customs union with Israel and effectively gave GOI control of WB&G's external economic relations. With few exceptions, the PP extended Israeli tariffs, tax rates and in most cases technical standards to WB&G. In theory, the PP could have led to deep integration of the WB&G and Israeli economy along with the benefits that this would bring to both parties. Free trade in goods and services

⁵³ All information in this paragraph is drawn from the WDR 2009.

combined with the free movement of capital and labor should have led to rapid growth in WB&G and a gradual convergence of income levels. However, the PP was never fully implemented as envisioned.

2.5. ***Even before the violence of the second Intifada, the movement of people and goods was not free.*** The GOI announced a policy of reducing the amount of Palestinian labor in Israel and its settlements and began to limit the number of permits it issued. While goods from Israel entered WB&G freely, exports from the Palestinian territories were constrained in a variety of ways. Foremost among them were the security restrictions imposed on the movement of Palestinians goods. With the advent of the second *Intifada*, the restrictions on movement and access both within the WB&G and between WB&G and Israel were substantially increased.⁵⁴ The imposition of commercial crossing requiring back-to-back loading, the dramatic expansion of internal movement restrictions in the West Bank, the increase in restrictions on the importation of dual use goods and other measures have all had the effect of increasing the cost of trade and reducing the competitiveness of Palestinian exports both within Israel and in the rest of the world.⁵⁵

2.6. ***Beyond the security requirements, the access of Palestinian goods to the Israeli market is limited by the way in which quality, health and safety standards are implemented.*** Palestinian goods entering Israel or East Jerusalem must meet Israeli imposed standards, which in some cases were actually designed as non-tariff barriers.⁵⁶ There is not yet any reciprocal recognition of standards between the PA and GOI. This does not affect Israeli exports to the WB&G since the PA has no control over the crossings and no way to enforce their standards. But it means that Palestinian exports must receive Israeli certifications, which is difficult and in some cases impossible. GOI security requirements, except in exceptional circumstances, forbid the entry of Israeli citizens into PA controlled territories so its agencies cannot conduct inspections. At the same time, the GOI generally does not recognize third party certifications. Sending products for testing is expensive and difficult when it is even possible. Consequently, Palestinian enterprises report that standards and the way they are implemented is a major barrier to the entry of their products into the Israeli market.⁵⁷

2.7. ***In sum, the PP was never truly functional.*** There is no free movement of labor, Palestinian goods and services do not have easy access to the Israeli market and the envisioned dispute resolution systems are not functioning. As the PA moves towards developing a future state, it must look to alternative ways to govern its trade relationship with Israel and the rest of the world.

⁵⁴ These restrictions are extensively documented in any number of World Bank and other documents and will not be detailed here. See World Bank 2004, 2006, 2007a, 2007b.

⁵⁵ For example, in 2009 the USAID Trade Facilitation Project and a major Nablus importer/exporter calculated the compliance cost of delays for one truck of import cargo at one of the commercial crossings as follows: For the first two hours USD 20/hour for the drivers labor and on costs. After that US\$ 150/hour for the lost opportunity cost of the driver, use of an extra driver and truck plus the business owner's time away from revenue generating activity.

Total US\$ 1,090 based on labor costs of US\$ 15/hour and overhead costs of 50%.

⁵⁶ See Tovias 2008

⁵⁷ See World Bank ICA

Trade Patterns

2.8. ***Despite the difficulty entering its market, Israel is the main destination for WB&G's limited exports.*** Though there has been a small increase in the share of exports to the rest of the world, particularly the Arab countries, Israel dominates Palestinian trade and will continue to do so for the foreseeable future (Table 6). As a highly developed country, Israel can absorb much of the Palestinian exports but it cannot provide all of WB&G needs. Thus, according to PCBS figures, Israel has been consistently accounting for around 85-90 percent of Palestinian exports and 65-75 percent of imports. These figures undoubtedly overstate actual trade volumes. A recent study by the Bank of Israel found that almost 50 percent of non-water and electricity exports to WB&G were made by trading firms. While much of these sales were of Israeli goods, large amount of them would have also been re-exports indicating that even now Palestinians buy substantial amounts from the rest of the world despite the Israeli restrictions. Likewise, many Palestinian exports to Israel end up being re-exported as Israeli products.

2.9. ***Whatever the actual figures, it is clear that Israel is WB&G's main trading partner and it is highly unlikely that in the absence of its occupation policies that Israel would play such a dominant role.*** Some observers have argued that WB&G does not overtrade with Israel and that the Israeli trade dominance is a result of its comparative level of development and proximity.⁵⁸ However, others have indicated that if there was a different trade regime and if Israeli security measures were relaxed, trade with other countries would increase.⁵⁹ This latter result is more in line with the micro evidence.

2.10. ***Firm level interviews conducted for the Investment Climate Assessment (ICA) in 2006 revealed that many Palestinian enterprises deal with a only a small group of Israeli buyers.*** In many cases, these buyers re-export the Palestinian produced goods to other countries as Israeli products. The Palestinian firms do not attempt to develop their own international markets or expand their Israeli marketing connections because of the risk; they cannot be sure they will be able to ship their products because of Israeli security restrictions. Thus, they rely on their Israeli contacts. Likewise, most Palestinian businesses import through Israeli middlemen or buy imported goods from Israeli merchants. Palestinian managers report that Israeli restrictions make it too costly and difficult for all but the largest and best connected Palestinians to import directly.⁶⁰ The ability of Palestinian businessmen to import and export directly has not improved significantly since the ICA interviews. The Fund for New Market Development is a private sector support project established to help firms develop new markets. This project has worked with hundreds of the most capable enterprises in WB&G and its clients continue to report that they focus their activities on Israel and the domestic market because of the difficulties importing and exporting directly. Thus, if there is a political solution that leads to a Palestinian state and a relaxation of Israel's restrictions, it would be expected that Palestinian trade would begin to diversify.

⁵⁸ See World Bank CEM. The authors use a gravity model to argue that WB&G does not over trade with Israel.

⁵⁹ Astrup and Dessus (2002)

⁶⁰ See West Bank Trade Corridors paper for details.

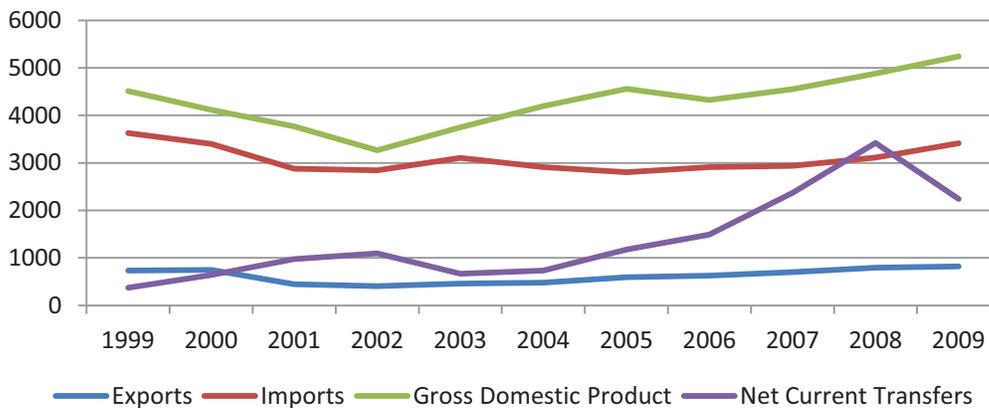
Table 6. Destinations of Palestinian Imports and Exports 2007

Main Destinations	Total (US\$,000)	Share in Total (%)
Export		
Israel	499,423	89.4
Arab Countries and Turkey	46,400	8.4
EU	8,068	1.4
North America	3,827	0.7
Asia	258	0.1
Non-EU Europe	283	0
Other	187	0
Total	558,446	
Imports		
Israel	2,794,829	80.6
EU	222,521	6.4
Asia	197,877	5.7
Arab Countries and Turkey	140,941	4.1
Non-EU Europe	38,399	1.1
North America	34,833	1.0
South America	22,360	0.6
	14,408	0
Total	3,466,168	

Source: PCBS, 2008.

2.11. *The export performance of WB&G has always been weak but it particularly suffered during the second Intifada.* Between 2000 and 2002, exports of goods and services declined by nearly 45 percent in real terms; falling from 18 to 12.5 percent of GDP. Since then they have recovered slightly and in 2008 they were equivalent to 16 percent of GDP. But despite the recent economic growth, the real value of exports in 2008 was only about 4 percent more in real terms than in 2000. The poor export performance, combined with the need to import almost all consumption goods have resulted in WB&G consistently running large trade deficits. Between, 2000 and 2008 the average deficit was US\$2.8 billion. The trade deficit fell by 16 percent in real terms between 2000 and 2002. But as the economy has recovered and aid flows have grown, the trade deficit has also grown and by 2008 was nearly as large as it was in 2000.

Figure 12. GDP, Current Transfers, Export and Imports 1999-2009



Source: PCBS and PMA.

2.12. *Not only are Palestinian exports limited, they are also low value added. As detailed in World Bank (2006 CEM), they are generally either natural resource intensive or labor intensive products that require low levels of processing and embody little technology.* The largest export in 2008 (see Table 7) was stone and marble, which accounted for nearly 19 percent of total exports and is mostly unprocessed stone. Another 16 percent was base metals and articles of base metals, much of which is scrap metal. Other major sectors included textiles, plastics, foodstuffs and vegetables. At the same time, there were relatively little exports of machinery, pharmaceuticals, software of other products that require substantial processing or embody significant technology. Though WB&G has a highly educated work force trade in services is small and between 2000 and 2008 exports of services averaged only about 23 percent of goods. Services appear to particularly suffer from the restrictions especially the inability of visitors to get visas and for Palestinians to travel to Israel to meet with clients or Israelis to visit the West Bank or Gaza.

2.13. *WB&G is able to maintain large trade deficit because of the transfers it receives from the rest of the world.* This includes substantial donor financing, remittances from workers in Israel and elsewhere and other current transfers. Current transfers as reported in the balance of payments jumped from US\$638.6 million in 2000 to US\$2.24 billion in 2009. The enormous increase can be attributed to massive inflows of donor support that began in 2005 and accelerated in 2007 with the establishment of the Caretaker Government. The majority of the recent donor aid has gone to pay PA salaries and arrears, which has pumped up consumption and imports of consumer goods.

Table 7. Largest Palestinian Exports by SITC in 2008

SITC-3 Code	Division	Value '000 USD	% of total Exports
66	Non-metallic mineral manufactures, n.e.s.	111851	21.8
82	Furniture and parts thereof, bedding mattresses, mattress supports cushions and similar stuffed furnishings.	31999	6.2
63	Cork and wood manufactures (excluding furniture).	28400	5.5
85	Footwear	28194	5.5
89	Miscellaneous manufactured articles, n.e.s	24336	4.7
67	Iron and steel.	21769	4.2
54	Medicinal and pharmaceutical products.	19836	3.9
42	Fixed vegetable fats, and oils crude, refined or fractionated.	18127	3.5
65	Textile yarn, fabrics, made-up articles, n.e.s and related products.	15574	3.0
58	Plastics in non primary forms.	13815	2.7
69	Manufactures of metals, n.e.s.	13219	2.6
2	Dairy products and birds eggs.	11315	2.2
5	Vegetables and fruit.	11173	2.2
55	Essential oils and resinoids and perfume materials, toilet, polishing and cleansing preparations.	10925	2.1
27	Crude fertilizers other than those of division chemical fertilizers, and crud mineral (excluding, petroleum and precious stones).	10710	2.1

Source: PCBS.

2.14. ***The main reason for WB&G's poor export performance is Israeli restrictions on movement and access to resources.*** As detailed in numerous previous reports, this comprehensive restriction regime discourages investment and drives up costs, reducing the competitiveness of Palestinian products on the international market.⁶¹ However, the growing flow of transfers also plays a part in lowering Palestinian competitiveness. They drive up the real exchange rate – the price of non-tradables compared to tradables – leading the non-tradable sectors to expand. This can be clearly seen in the recent growth patterns, where the government services, health, education, real estate and other non-tradable sectors have been expanding relative to manufacturing and agriculture.

2.15. ***As discussed in the section on labor, employment in Israel and in the PA drives up the real wage. Some estimates put the premium for working in Israel as high as 90 percent compared to similar jobs in the private sector in WB&G.***⁶² The number of workers in Israel and its settlements has declined in recent years because of closures and the reduction of permits. However, employment in the PA has increased to absorb many of these workers, and the wage difference between the public sector and private sector is shrinking. In fact there is a significant wage premium for working in the public sector in Gaza. The higher real wages may have reduced the competitiveness of Palestinian exports, especially in the labor intensive industries that continue to dominate Palestinian manufacturing.⁶³

Trade Regime

2.16. ***There has been a significant amount of analysis done on what would be the best trade regime for a future Palestinian state.*** While much of this work was done in the early 2000s, little has changed and it is still valid. What is the optimal trade regime is not clear as it depends upon what assumptions are made about the reaction of trade partners. However, what is clear is that the PA needs to publicly establish goals and principles now so that investors in the private sector can begin to prepare. Determining the future trade regime now will also help guide the PA as it develops the agencies, services and trade facilitation infrastructure required by a future state. The following section revisits the previous analysis and seeks to identify the issues and decisions the PA must begin to address.

2.17. ***A future Palestinian state has three basic choices of trade regimes.*** The first is a customs union with Israel (CU). In many ways, this is a continuation of the current situation under the PP. However, in this case it must be assumed that Israel agrees and that the CU is fully implemented. The second is a non-discriminatory trade policy (NDTP) where the new state applies most favored nation tariffs to all trading partners without exception. The third option is to enter into a free trade agreement (FTA) with Israel and other countries. A fourth option is complete free trade, which is essentially a variation of the NDTP option, where the external tariff is set to zero. To undertake any analysis, it is first necessary to make some basic assumptions about the nature of a future state. For purposes here we assume the following:

⁶¹ See *West Bank and Gaza Country Economic Memorandum Growth in West Bank and Gaza. Opportunities and Constraints*. World Bank 2007a. World Bank 2007b, *Movement and Access Restrictions in the West Bank: Uncertainty and Inefficiency in the Palestinian Economy and the WB&G Investment Climate Assessment among other documents*.

⁶² Ruppert-Bulmer 2001 cites 90 percent though more recent analysis suggests it is more like 65 percent. See Chapter 4.

⁶³ See discussion on productivity in following sections.

- A Palestinian state has been established that controls its borders.
- The state includes Gaza and at least parts of the West Bank.
- There is free movement between Gaza and the West Bank.

Customs Union

2.18. *Some analysts have argued that building on the PP and establishing a customs union that actually works is the best option for a future state.*⁶⁴ Many of the current restrictions are based on Israeli security concerns, which should be reduced with the implementation of any peace agreement that leads to the establishment of a Palestinian state. This view holds that there is scope to assume that a CU could be effectively implemented.

2.19. *The main benefit of a CU is that it would allow a deep integration of the Palestinian economy with the much larger and richer Israeli economy and lock-in the PA trade policy.* With a per-capita GDP more than 15 times that of the WB&G, Israel offers tremendous opportunities for the Palestinian economy. It could provide a large market for exports as well as be a source of technology and knowhow. WB&G has a well educated work force with wage rates far below those prevailing in Israel. Palestinian firms are the natural choice for Israeli firms to form partnerships with and to outsource labor intensive production. Therefore, integration from a well functioning CU could result in rapid growth of the Palestinian economy as it converges toward Israel.

2.20. *A CU would require the Palestinian state to adopt the same tariff structure, and standards as Israel.* Some taxes such as VAT, purchase and excise would also have to be harmonized. On one hand, what is best for Israel may not be suitable for the much less developed Palestinian economy. On the other hand the knowledge that Palestinian policy is constrained by the CU and that the two economies are closely linked may provide comfort to foreign investors. Israel is an open economy with a high level of contestability in most markets. Between 2000 and 2005, the average applied MFN tariff fell from 10.8 to 8.9 percent. About 48.5 percent of all tariff lines carry the zero rate, up from 45 in 2000. MFN rates on non-agriculture goods are particularly low, averaging only 5.1 percent. The low tariff range means that tariff escalation is not a problem in most markets. In practice, the tariff rates are not that significant because most trade takes place in the context of free trade agreements that Israel has with the United States, the European Union, Canada, Mexico, Jordan and others. In 2007, less than a quarter of Israel's imports took place under MFN agreements. Israel has been moving to convert many non-tariff barriers (NTB) but still retains a number of standards, quotas and other methods that are effectively non-tariff barriers to trade. In addition, many of these NTBs are administered in a non-transparent manner, often changing and creating uncertainty.⁶⁵ Despite this, the Israeli market is generally open and the government is committed to continuing liberalization, which should create fewer distortions for the Palestinian economy and result in less trade diversion.

2.21. *Israel's highest level of protection is reserved for the agriculture sector, where the average tariff rate being 32.9 percent.* The Israeli tariff structure also heavily protects the food industry where the simple average MFN tariff increased from 20.5 percent in 1999 to 25.5 percent in 2005. Tariffs are particularly high for dairy products (112.7 percent on average), manufacture of bakery products (60.9 percent) and meat products (50.3 percent).⁶⁶ These are all areas where Palestinian producers are active and the high levels of protection combined with

⁶⁴ Bank CEM and Diwan and Panagryia 1997.

⁶⁵ See Tovias 2008 for a discussion of the Israeli trade regime.

⁶⁶ All figures in this section on tariffs taken from Tovias 2008.

preferential access to the Israeli market might also benefit them. Generally Israel no longer heavily protects the labor intensive industries that used to be the back bone of Palestinian manufacturing. For example, MFN tariffs on textiles and wearing apparel have fallen from 12.5 percent and 31.2 percent respectively in 1999 to 7.7 and 11.3 percent. This along with relatively high real wages has devastated the garments sector, which used to be the leading industrial employer in WB&G.

2.22. *The current Israeli tariff system protects some of the markets that the WB&G private sector is particularly active in.* It is likely that this level of protection is necessary to allow them to survive in the face of the higher costs resulting from the Israeli restrictions. But it is not clear that this trade regime would be the optimal policy for a future Palestinian state. For example, food products account for about 20 percent of total imports, more than any other non-petroleum import. Reducing tariffs may hurt producers but might increase the living standards of Palestinian families who currently spend on average more than a third of their household income on food.⁶⁷ In addition, Israel imposes quality and phyto-sanitary standards of a high income country that may be less appropriate for a lower income country such as a future Palestinian state. Palestinian producers will have to meet international standards if they hope to increase exports. However for the domestic market, these standards especially in the case of Israel where they are often used as non-tariff trade barriers, raise the cost to consumers.

2.23. *A working CU would greatly benefit the economy of a future Palestinian state by deepening its integration with a much larger and richer neighbor.* It would also save the PA resources since it would not have to collect taxes, implement rules of origin, manage duty drawback schemes or do many of the other tasks related to managing trade with its major trading partner. In addition, a well functioning customs union should lead to dramatically increased Palestinian exports to Israel reducing concerns about the disproportionate benefits Israel receives from free trade because it exports so much more to WB&G than it imports. If necessary to avoid tax leakages, the future state could establish minimal border controls to ensure that it receives taxes and tariff revenues it is owed. Though with cooperation from the Israeli authorities, there are probably easier ways, such as more effective post clearance audits, to limit tax losses. Alternatively, there could be formula to distribute revenues such as found in South Africa and other customs unions.

2.24. *Unfortunately, the quasi-customs union established by the PP has never worked.* Abstracting from security constraints, Palestinian goods and labor have never had free access to the Israeli market. Thus, it is questionable if even under a comprehensive peace agreement, whether a CU can be fully implemented. Israel as the much more powerful partner will have the incentive and the power to implement only those parts it sees fit to. Thus, most PA officials and many other observers have started from the position that whatever the trade regime a future state chooses, it will not be CU but rather one where the Palestinians can retain control over its relations with the rest of the world.

Non-Discriminatory Trade Policy

2.25. *Most previous analysis discounted the CU and has recommended either an FTA or NDTP.*⁶⁸ An NDTP imposes the MFN tariff rates on all trading partners equally. Under such a system a future state would retain control of its trade policy and could set it in the optimal

⁶⁷ Information is from unpublished data on Palestinian Expenditure and Consumption Survey administered by PCBS.

⁶⁸ See de Melo et al, Astrup and Dessus (2002), and Schiff (2002)

manner. A NDTP eliminates trade diversion and other distortions that create inefficiencies. If the tariffs are low, the future state would reap all of the benefits of trade. Consumers would be free to buy from where prices are lowest and producers could sell to where prices are highest. However, an NDTP also means that Palestinian producers would lose preferential access to the Israeli market. Given that the PA has already entered into a series of FTAs with various partners, it is unlikely that a future state would abrogate these agreements and move to a complete NDTP, but a viable policy choice is to not enter any additional agreements, including with Israel, that distort trade.

2.26. ***The NDTP option eliminates the need to manage complicated trade regimes, implement rules of origin (RoO) or expend resources negotiating trade agreements.*** It is also important to note that experience has shown that when a small economy, such as a future Palestinian state, negotiates a trade agreement with a much larger and stronger partner, the weaker partner often receives negligible “extra” market access. This is mostly because of the way systems are established to determine RoO.⁶⁹ The NDTP option will allow a future state to levy import duties on trade with Israel. In 2008, imports from Israel were about US\$3.2 billion, which even with a low fixed tariff rate would yield considerable income. Much of these imports were actually goods imported into Israel and then re-exported to WB&G. However this does not matter, as under a NDTP, goods from all countries would face the same treatment, unless of course the future state maintains the currently negotiated FTAs.

2.27. ***It is imperative that tariffs be low and stable and not accompanied by quantitative restrictions and non-tariff barriers.*** This has been the successful example of Kosovo, another newly created country (See Box 1). Ideally, there would be a single, small, uniform tariff. A low tariff ensures that the future state will benefit from the high levels of competition that drive productivity growth. With low levels of protection, inefficient producers will not be able to survive and consumers will have access to goods at the lowest prices. Too often, trade policy is biased to protecting the interests of producers at the expense of consumers. In a country where so many people live on the edge of poverty, it is also important to keep in mind that costs to households of too much protection.

⁶⁹ See de Melo et al for an in depth discussion.

Box 1. Trade policy in post-conflict Kosovo

The armed conflict in Kosovo, a province in former socialist Yugoslavia that became part of Serbia following Yugoslavia's dissolution in the early 1990s, escalated in 1999 with the involvement of NATO and resulted in the establishment of an UN-administered territory. Under UN rule, Kosovo's legal and institutional framework was built from scratch and was largely influenced by European practices.

The regulation on trade policy, i.e. customs tariffs, was adopted within weeks of the start of the UN administration. A two-tariff model was introduced: 10 percent on most goods and a zero tariff on certain products (the list of tariff-exempted products was expanded over the years to include all capital goods). In addition, excises are applied to some products, such as tobacco, in line with international practices. This trade policy was maintained by the domestic authorities following Kosovo's independence in 2008 as it proved to be adequate for Kosovo's circumstances. Three factors support the existing tariff system. First, the country is assessed to have weak rule of law, so a simple tariff system is easy to implement both for customs authorities and importers. Second, revenue collection relies on border-collected taxes – largely VAT collected on imports – and a simple system with relatively low tariffs discourages smuggling. Finally, Kosovo's manufacturing base is low, hence protectionist tariff measures were never justified.

In terms of exports, Kosovo has free market access to the European Union (which was granted unilaterally by the European Commission to all Western Balkan countries in 2000) and is part of the regional free trade agreement which entered into force in 2007. As a result, Kosovo has free market access to its two main export markets. Kosovo has not yet begun WTO accession negotiations, but the tariff system may be affected by the WTO negotiations when Kosovo begins this process. The rest of Kosovo's trade policy, i.e. the customs code and other related legislation and institutions, transpose to large extent European standards and practices given Kosovo's objective to join the EU.

2.28. ***Stable and predictable trade policy will encourage investment.*** The situation in WB&G is highly volatile and the initial situation in a future state will also be uncertain. Any additional policy uncertainty caused by the government will discourage investment even more. Thus, a low and stable tariff will help create confidence and send an important signal to investors. There are of course theoretical reasons to vary tariffs across commodities based on elasticities of demand. But experience around the world clearly demonstrates that in many cases this becomes little more than an excuse to vary protection based on interventions by lobby groups. The institutions of a future Palestinian state will undoubtedly still be forming and it is unlikely that they could be expected to manage such a sophisticated tariff policy. Thus, it is better to set a low and uniform tariff. If a uniform tariff is not possible, the future state should consider binding its tariffs to the prevailing rates on accession to WTO. In this way, it could use the discipline of the WTO system to resist efforts to distort trade.

2.29. ***The government should resist any temptation to use trade policy to protect or encourage selected sectors.*** Efforts to “pick winners” through industrial policy have generally not been successful and doing so will be especially difficult in a future Palestinian state. Currently, the markets are heavily distorted by the GOI restrictions. Most exporters face high transportation costs that severely reduce their competitiveness. Producers for the domestic market may receive some protection because of the high transportation costs, but they also suffer from the cost and difficulty of importing raw material. In addition, the internal movement restrictions in the West Bank that make it difficult to ship between cities appear to affect domestic producers more than exporters. In a future state, many of these restrictions will be eliminated but it is not clear how many. The West Bank at least, will continue to be affected by high transportation costs. It will still be landlocked and despite any peace agreement, Israel is likely to continue to maintain a strict security regime. Even if Gaza has a functioning sea port, it is unclear how efficient it will be and what security restrictions it will face. Consequently, it is not possible to predict how the establishment of a future state will affect comparative advantage. Therefore, the government

should be wary of trying to use trade policy to introduce more distortions into an already highly distorted economy.

2.30. ***Raising government revenues should not be an excuse for setting high tariffs.*** The purpose of the trade regime should be to facilitate of trade and not fund the government. Import tariffs might be the only viable source of government revenue in some least developed countries. But WB&G is a lower middle-income economy with a fairly sophisticated government and a future state would be expected to be even more capable. Thus, it is possible and more economically efficient, to rely on VAT, income tax and other sources of government revenue. In 2010, customs receipts accounted for about 22 percent of total government revenue (Table 8) while VAT and Income tax accounted for 27 percent and 7 percent respectively. The PA is implementing a program to increase domestic revenues and the share of VAT, Income Tax and other taxes will be rising compared to Customs. Under an NDTP the future state will have to control its border with Israel, something that is not necessary under a CU arrangement. While this increases costs, it will also ensure that both more customs duties and other taxes are collected. Ending the tax leakage will also help obviate the need to have high tariff rates. Thus, there is no need for a future state to base trade policy on revenue needs.

2.31. ***A special case of NDTP is a free trade, where tariffs are uniformly set to zero.*** Open economies have been shown to grow faster than closed ones and free trade is the most open. There have been a number of very small economies that have opted for this approach including Singapore, Hong Kong SAR, China and most recently Estonia. For Hong Kong SAR, China and Singapore, it is generally believed that their free trade policies were instrumental in attracting the high levels of foreign direct investment that have driven their economies. A future Palestinian state would similarly be located in an area that would present many commercial opportunities and thus free trade is a possible option that the government of a future state should consider.⁷⁰

Table 8. Major Sources of PA Revenue in 2010 (Share of Total Revenue)

VAT (both on Imports and Domestic Sales)	27%
Customs	22%
Petroleum Excise Tax	22%
Non -Tax revenues	13%
Income Tax	7%
Other Taxes	8%

Source: Ministry of Finance.

2.32. ***A free trade regime would signal domestic and foreign investors that the new state is committed to good governance since it would preclude the state from providing preferential treatment to the politically connected.*** It would provide an incentive for outside investors to take the risk of investing in a newly established state. Free trade would eliminate trade diversion and ensure that the new state reaps all of the rewards of trade including the improved productivity that comes from competitive pressure. It would also reduce concerns about rent seeking behavior and the ability of the nascent government to manage trade. Without customs to collect or RoO to manage, customs officials could focus on enforcing health and safety standards, facilitating trade and helping exporters with RoO requirements in foreign markets. If free trade is not possible for all of a future state, some observers have suggested that it might be possible to establish a free port in Gaza.⁷¹

⁷⁰ This discussion taken from de Melo et al.

⁷¹ See Diwan and Panagryria 1997

2.33. ***Free trade, or for that matter moving to a low tariff, would require substantial adjustment.*** First producers in sectors, such as agriculture, which have been heavily protected will have to be supported as they transition to either becoming more efficient or leaving the sector. A move towards less protection will also require a substantial real exchange rate depreciation to compensate import-competing and exporting firms. Until the PA becomes less reliant on external aid and the wage rate becomes more flexible, this may be difficult. Free trade would also mean that the government will have to find other sources of revenue, though as discussed above, the PA does not depend heavily on customs duties and is working to increase other revenue sources.

2.34. ***The biggest loss from moving to a NDTP is giving up preferential access to the Israeli market.*** Currently, most Palestinian producers do not have free access, despite the PP. Israel enforces non-tariff barriers on Palestinian goods and its security restrictions are sometimes enforced in a way to restrict trade. However, under a peace agreement that leads to the establishment of a state many of these issues should become less serious. Integration with Israel could be a main driver of growth in the new state but a customs border with Israel might greatly restrict trade and reduce cooperation. For example, Palestinian producers would be expected to import inputs from Israel and using cheaper Palestinian labor, assemble products for sale in Israel. However, without a CU or FTA, these goods would be subject to duty, purchase tax, standards inspections and other transaction costs. Duty on imports of inputs could be refunded under a duty drawback scheme but the final product would still be subject to Israeli import duties. Even if the duties were relatively low, combined with the high transaction costs, they would make it difficult for Palestinian goods to compete against goods coming from the US, EU, Latin America and many other countries that Israel has FTAs with. In addition, trade in services would also face restrictions, for example, Israel may not agree to recognize Palestinian professional standards and transit rights for people, such as tourists are not guaranteed under WTO.

2.35. ***Overall the NDTP offers a credible option for a future states trade policy.*** A NDTP with low and uniform tariffs and no NTBs would provide the future state with all of the well known benefits of trade. However, it gives up free access for Palestinian producers to Israel, WB&G's biggest trading partner. In addition, its success will depend upon the government being able to administer a transparent system that is not captured by special interest groups. Finally, it may be hard to implement given that the PA has already entered into a number of FTAs that a future state would be expected to adhere to.

Free Trade Agreement

2.36. ***A third option is for the future state to adopt a system of interlocking FTAs including with Israel, if the latter agrees.*** This would retain preferential access to the large Israeli market without surrendering control over the trade policy with the rest of the world. It would in theory allow the future state to reap the benefits of close integration with its much larger and richer neighbor without having to adopt its trade policies that are optimized for a highly developed country. In addition, if it leads to Israel having similar arrangements with Arab countries, it could open the possibility of Israel using WB&G as a platform to export to the Arab world.⁷² A number of previous studies have recommended the FTA option.⁷³

⁷² It could also allow exports to the EU as the Euromed Palermo rules of origin allow for the cumulation of origin between partner states including Israel and the PA if they adopt compatible rules of origin.

⁷³ Aix group

2.37. ***However, an FTA regime has a certain drawbacks.*** First as noted above, experience has shown that when a weak country enters into an FTA with a much larger partner, it often does not obtain significant access to the larger countries markets. Because of the difference in negotiating power, the system for determining RoO is often skewed for the benefit of the more powerful partner. Because of the low level of industrial development, at least initially Palestinian producers will have to depend upon importing inputs and assembling goods for export. But given the relatively low cost of labor, they may find it difficult to add enough value to meet RoO requirements, unless they use Israeli inputs when exporting to Israel. Thus, Palestinian producers would not be able to source their inputs in the cheapest place increasing trade diversion, which is an issue for any FTA.

2.38. ***It is unlikely that an FTA with Israel could be easily negotiated to include agriculture and the free movement of labor.*** Given the current high level of protection and the political economy of the issue, it would be extremely difficult to persuade the GOI to remove trade restrictions and open up its market to cheaper Palestinian agriculture products. Since agriculture is one area where Palestinian producers are currently competitive, this could be a serious loss. Likewise, the Palestinian economy is highly dependent upon the export of labor to Israel to fund its trade deficit. But the GOI has indicated its desire to reduce the amount of foreign labor in Israel, so it is also unlikely that free movement of labor could be easily included in any agreement. Given that Israel already has relatively low MFN tariffs on many products, especially the labor intensive manufactured products in which Palestinian firms would likely initially specialize, an FTA may not provide much benefit. It may not be worth the lost customs revenue of granting Israeli firms free access to the Palestinian market. It is also necessary that any FTA include provisions for trade in services. Though there is currently little trade in services, it is a promising area for increasing Palestinian exports.

2.39. ***A system of FTAs would be expensive to negotiate and implement.*** The process of negotiating the arrangements in itself will require time and extensive expertise that the PA does not currently have. But implementation is even more expensive and difficult. An FTA system not only requires that the government be able to fully control its borders, but it must be able to implement different systems for different trading partners. RoO systems are usually different for every agreement that a country enters into. The PA already has agreements with the US, EU, Arab World and others, which it does not have the ability to implement. This is currently not a serious issue since under the PP, Israel manages the customs regime. But in a future state, the Palestinian government would have to be able to fully implement the systems for all its trading partners; something that will require a tremendous amount of institutional development. But this cost must be set against the benefit of having free access to a large part of the world.

2.40. ***Any FTA must be accompanied by a transit agreement.*** The West Bank portion of a future state will be landlocked and dependent upon either Israeli or Jordanian transportation infrastructure. Even if a functioning port and airport are eventually allowed in Gaza, the West Bank will still be dependent upon transiting Israel to use them.⁷⁴ Previous analysis has also shown that Egyptian ports offer a competitive option for Gaza trade.⁷⁵ Thus, for a future state to be able to significantly increase trade, it must be able to ship goods through its neighbors efficiently. Imports and exports must be able to transit smoothly without being subject to the same rules and checks as regular imports and exports. Shipments will of course have to be subject to security

⁷⁴ In previous negotiations transit between West Bank and Gaza was not considered transit through Israel, but no agreement was ever reached, so it may be or may not be that transit between the two areas is considered transit through Israel.

⁷⁵ Bank Gaza Trade Corridors paper

requirements. However, these security checks must not be allowed to interfere with commerce. Jordan has already signaled that it would consider replicating its Saudi transit agreement with a Palestinian state. However, at some point it may be necessary to bring in international observers to help establish and monitor a transit regime until trust is established. When a future state does accede to WTO, the WTO dispute resolution mechanisms will also be helpful. Without well functioning transit agreements with all its neighbors, both trade and investment will be severely circumscribed in a future Palestinian state.

The Way Forward

2.41. *Even now, before a political solution to the conflict has emerged, the PA could clearly establish what type of trade regime it envisions for a future Palestinian state.* This will give time to both the private sector and the PA to prepare for it. Also the steps required to implement a trade regime will improve the current business environment and help inspire investor confidence in all sectors.

2.42. *A functioning CU with Israel offers many benefits to a future Palestinian state.* Deep integration with the much larger and more sophisticated Israeli economy will spur growth in the Palestinian state. However, since the PP has never been effectively implemented, it is unlikely that a future Palestinian state would be willing to turn its trade policy over to its more powerful neighbor. Thus, a NDTP or FTA may be a more viable option.

2.43. *An FTA with Israel and other neighbors hold significant promise for a future Palestinian state.* But this is only true if it is comprehensive and includes agriculture, services, movement of labor and a transit agreement. Such an agreement may hold less attraction for Israel, especially opening up its protected agriculture market. Thus, the PA might plan to move in steps. Initially, the policy of a future state could be based upon a NDTP with the de facto implementation of WTO rules even before accession. This scenario envisions retaining the current FTA's the PA has signed, many of which overlap with Israel's. Once the NDTP system is established and the new government has developed its ability to control its borders, manage a customs regime and implement RoO, it could move to negotiations on an FTA with Israel. While an FTA with a future Palestinian state alone may be of little interest, if it is coupled with open markets in other regional countries, Israel may be more willing to accept it. In this scenario, it could be imagined that Israeli firms establish plants in the Palestinian state to access cheaper Palestinian labor and then export from there to the rest of the Arab world. This would bring employment and technology to the Palestinians, while providing Israeli goods free access to a large new market.⁷⁶ Whatever policy is adopted, it should be designed to facilitate trade not to raise government revenues, redistribute resources, or favor one sector over another. Tariffs should be low and there should not be quantitative restrictions or other NTBs.

Trade Infrastructure

2.44. *No matter what regime is selected, developing the infrastructure, both physical and institutional, required to manage a sophisticated trade regime will take time and considerable resources, so it is important that the PA begin immediately.* As in so many other areas, much

⁷⁶ Israeli firms already export to the Arab world surreptitiously. This has been reported in many newspaper articles and is openly discussed by the Israeli business associations and government. Israeli goods are transhipped through other countries, particularly Turkey, which inflates official trade statistics. There is no measure of how large this business is but it is clear there is a large market for Israeli goods in the rest of the region.

work took place previously until it was derailed by adverse political development. It is still constrained by political disagreements and Israeli restrictions. The PA's challenge is to reinvigorate its efforts to build a trade infrastructure and lower the cost of trade. The PA has limited resources and must carefully choose where it will focus its efforts. But since the overall growth of the economy will depend upon increasing trade, establishing an efficient trade infrastructure should receive a level of attention similar that given to the security sector.

Legislation

2.45. ***Before the government of a future state can implement an independent trade policy, it must have the basic legal framework in place to support it.*** If it opts for a very simple and transparent policy as advocated above, then the required legislation will also be relatively simple. The legislation for the most part should be a de facto implementation of WTO rules, which will make eventual accession easier and also provide the benefits of a stable rule based system. Needed legislation includes:

1. *Customs Act.* This legislation sets the legal basis for all levies on imports and exports, establishes valuation procedures, tariff exemptions etc. It must be accompanied by a tariff act that sets a general schedule of tariffs that should be based on the Harmonized System.
2. *Indirect taxes.* The system of indirect taxes affects trade. The tax legislation must include provisions for trade including the levying of border adjustment taxes and refunds as they are collected on imports.
3. *Foreign Trade Act.* The foreign trade act provides the legal basis for non-tariff barriers, anti-dumping legislation, licensing procedures, safeguards, etc. These rules should be anchored in WTO rules and as argued above they should be minimalist to prevent them from being used by special interest groups to restrict trade. If agriculture is not covered here, it will need a separate act.
4. *Health and Safety Standards.* If the procedures for establishing technical standards and phyto-sanitary standards are not covered in the foreign trade act, they must be established under separate legislation. Again they must be in accordance with WTO rules.
5. *Competition Policy.* Laws to establish competition are a part of domestic legislation. But they are also very important part of trade regulation. Before a future state can manage an independent trade policy, it must have in place legislation to regulate monopolies, prevent anti-competitive behavior, set government procurement rules, protect intellectual property, regulate subsidies, etc. Different laws cover different sectors but they must be harmonized under a consistent competition policy.
6. *Protection of Foreign Investment.* Protection of foreign investment is an important part of managing external economic relations. Foreign investment must be regulated according to WTO rules (for example, local content requirements are not allowed). It must also have adequate protection from expropriation and taxation of investments.

Services

2.46. ***Trade in services is often overlooked by developing economies, however it promises to be an important area of growth in a future Palestinian state.*** Consequently, services must be included in any trade agreements. The most important factor for services is a supporting business environment that ensures competition and modern international standards. Thus, it is important that there be the necessary legislation in place to regulate trade, foreign investment and operations in services. For the most part, this will be embodied in separate legislation for each sector. The

PA is making slow progress in this area. The banking sector is strong, well regulated and competitive. In other financial markets, such as leasing and insurance, the regulatory environment is still developing. However, in the telecommunications sector, one of the most important markets, regulation is still weak. Given its growth potential, it is important that PA continue to develop the regulatory environment for trade in services.

Institutional and Physical Arrangements

2.47. ***Once legislation is in place, the future government must have the institutional ability to implement it.*** Controlling borders is the most immediate issue. The General Administration for Borders and Crossings (GACB) is assigned overall authority to manage borders. The Customs and Excise Department in the Ministry of Finance (PACE) is assigned to collect taxes while the Border Police provide security. However since the closures of Karni and Rafah crossings in Gaza, the PA has had no opportunity to manage any borders or crossings. Customs was previously working at Allenby Bridge with Israeli counterparts but they were removed by the GOI in 2001. It is essential that the PA modernize its border management system and develop its capabilities if it wants to move to an independent trade policy.

2.48. ***The PA must first decide what type of presence it wants at the border.*** While ensuring security and sovereignty are important, the goal of facilitating trade should be paramount. The PA could aim to create a civil integrated border agency to manage the flow of goods and people at border crossings. A well-functioning border agency would promote certainty, predictability, and security for the international movement of goods and people by establishing clear practical and precise standards for movement across borders. In addition, it should aim to eliminate duplication and delays in international supply chains, such as multiple reporting requirements and inspections. Border authorities should gather information and pass cargo and people as quickly as possible. Most checks should be done away from the borders in order to facilitate movement. Above all, it is essential that the border authorities cooperate as closely as possible with their counterparts on the other side of the border. Depending on how the status of Jerusalem is resolved, it may be necessary to institute special arrangements there.⁷⁷

2.49. ***Developing customs administration is another key area for building the capacity to implement an independent trade policy.*** Currently, PACE is small, under resourced and consequently inefficient. Because it has no presence at the borders or crossings, and receives limited data from Israel Customs, its activities are restricted to entering paper-based submissions from local traders into ASYCUDA and performing post clearance revaluation of declarations. For it to manage an independent trade policy, it must be substantially upgraded. There have been a number of detailed studies on what is required, including by the World Custom Organization and most recently a technical mission from the IMF. All of the reports emphasis the need to upgrade IT systems, develop risk management techniques, build capacity to conduct valuation and collect taxes and improve PACE's ability to conduct investigations and post clearance audits. Customs personnel will require significant training and experience on modern techniques. Thus, the PA should continue to work with its Israeli counterparts to try and return Palestinian customs personnel to the Allenby Bridge where they can once again work alongside Israeli Customs and gain experience. Developing the capacity of PACE will take time and significant resources. The PA should give it a high priority not only because it is essential to managing the trade policy of a

⁷⁷ There is a large body of work on how to reform the Palestinian border management operations. Most of this analysis has been conducted by the United States Security Coordinator and USAID trade projects. While most of this is not in published documents, the analysis has been provided to the PA.

future state, but in the short term improving customs administration will help increase badly needed revenues for the PA.

Next Steps

2.50. Given the importance of trade to the WB&G economy, it is imperative that the PA begin to take steps to improve trade facilitation and prepare for when it might obtain control over its borders. In the short term there are a number of steps it could take including:

- Determining early what type of trade policy the future Palestinian will adopt, will help negotiators, the PA and the private sector prepare.
- Clarifying border management arrangements so when the PA is once again able to take control of some borders it is prepared to manage them efficiently.
- Continuing to improve the customs authority. Develop its ability to facilitate trade as well as collect duties.
- Continue to seek observer status at WTO and prepare for WTO accession.
- Begin work on developing the legislation required by a modern trade regime.
- Continue to develop the regulatory environment for service industries. It is particularly important that the PA implement the current law and establish an independent telecommunications regulator.

CHAPTER 3: PRIVATE SECTOR DEVELOPMENT

Introduction

3.1. *The ultimate success of the Palestinian state building project will depend upon the establishment of a dynamic private sector led economy.* While the PA has had considerable success in building the institutions of a future state, it has made less progress in developing a sustainable economic base. As discussed in the overview section, the economy has not grown or evolved like those of its neighbors and in the past 10 years the private sector, especially in Gaza, has been devastated by the economic restrictions imposed by the GOI. As a result, foreign aid has provided the base for recent growth. However, the current high levels of aid are unlikely to persist indefinitely and the GOI has made it clear that it wants to reduce the amount of Palestinian and other foreign labor in Israel. Thus, the most important economic challenge facing the PA is how to create an environment that will enable a dynamic and innovative private sector to flourish.

3.2. *To provide the growth needed by a future state, WB&G should look to the examples in Asia that have managed to generate sustained high levels of economic growth despite having few natural resources.* In countries such as the Republic of Korea and Japan, the private sector had been devastated by war, yet within one generation they were able to jump start growth and dramatically increase incomes. Unlike WB&G's Middle Eastern neighbors, most of the successful Asian countries adopted an outward orientation. They followed a strategy of increasing trade and exports and integrating into world supply chains. Firms in Taiwan (China), Korea, Singapore and other Asian countries actively sought to adopt new technologies and increase their productivity so that they could be successful on the international and home markets. One of the marked differences between the Asian and Middle Eastern experiences is the rate at which Asian firms invested and developed their internal capacities.

3.3. *WB&G also has few natural resources, limited agricultural land and may find it difficult to compete on mass produced low value added manufactured goods.* However, it has a highly educated work force and an entrepreneurial people. Though it is still necessary to improve the education and raise skills, there is almost universal literacy, a high level of English proficiency and significant internet penetration. In addition, there is a large Palestinian diaspora with strong connections to the country. This suggests that services could play an important role in the development of the Palestinian economy, much as in Jordan where many of the service sector firms have Palestinian roots. In a similar way to India, it might focus more on building its service sector instead to taking the more traditional route to development through manufacturing.⁷⁸ Indeed before the closures, the West Bank supplied many low level services such as car repair and retail services to Israeli residents. There is already a strong banking sector with extensive links to Jordan and a nascent industry providing IT outsourcing to Israel. There are even a few small firms in Gaza providing internet content and media services to the Arab world. Thus, there is evidence that services could play an important role in WB&G's outward looking approach. The PA's challenge is how to create an environment that will encourage the private sector to invest, upgrade their capabilities and adopt an outward looking strategy after years of occupation.

⁷⁸ See Ghani Kharas for an in depth discussion of India's experience with the development of the service sector.

Box 2. Growth Through Service Exports

Traditionally economic growth has been thought to arise as a country transitions from agricultural to industrial production, where manufacturing is the prime engine of growth. The remarkable success of the East Asian Tigers, whose growth and rising incomes have been driven by the exports of manufactured goods, has helped solidify this view. However, recent changes in technology and growth patterns suggest that the export of services may be another option for developing countries seeking sustainable development. A comparison of the growth patterns in China and India helps illustrate this. Both countries have experience rapid growth on the order of 7 per cent per annum. However, China has followed the traditional manufacturing led growth strategy, while India appears to have sidestepped the manufacturing phase and its growth has been driven largely by productivity increases in the service sector.⁷⁹

Services have been generally thought of as inputs into the production of goods and characterized by low productivity and non-tradability. However, technological improvements have changed this. Services have become increasingly transportable and tradable and there has been rapid growth in modern services such as banking, insurance, remote access services, call centers, etc that are final exports themselves.⁸⁰ Such services do not require face to face interaction and are becoming more like industrial products. They can be unbundled where a single task can be done separately in different locations allowing increased specialization. Their costs depend upon economies of scale, agglomeration, networks and division of labor. Most trade in goods is in intermediate goods and it appears that modern services are moving the same direction. The growth in services has been relatively recent following rapid improvements in telecommunications. Currently only about 10 percent of service value added is exported. However, since 2000, service value added in service exports are growing faster than goods exports in industry value added. In addition, modern services that are tradable are now growing more rapidly than traditional services such as tourism and education that require face-to-face interactions.

Exports of services may provide an attractive alternative to WB&G relying solely on the export of labor and manufactured goods. They depend on well educated labor that WB&G has in abundance as well as an efficient and well regulated telecommunication sector that WB&G is attempting to develop. Modern services are also relatively less affected by transportation costs, trade barriers and require lower capital intensities. However, it is critical that the level of sophistication in exports be high enough to support the cost structure in WB&G. Research has shown that it is not specialization alone that matters for growth, but also the sophistication of goods exports. If they are able, poor countries grow faster by exporting the same goods that rich countries do.⁸¹ Preliminary research into the exports of services appears to show similar results. High growth and the creation of well paying jobs, come not just from the export of services but from the export of relatively sophisticated services. In order to create an environment that is conducive for service exports, especially sophisticated service exports, WB&G must continue to invest in its human capital, its telecommunications infrastructure and to develop its regulatory framework.

Description of the Palestinian Private Sector

3.4. *The Palestinian private sector is overwhelmingly dominated by small family owned and managed enterprises.* According to the 2007 PCBS enterprise census, the average size of employment in the West Bank establishments was 3 for all enterprises and 4.5 for manufacturing. There were only 57 establishments with more than 100 workers in the entire WB&G and only 26 in the manufacturing sector. Internal trade dominates accounting for more than 40 percent of employment in the 2009 sample of PCBS' economic survey. Service activities accounted for another 30 percent, while industrial activities were only about 22 percent of employment (Table

⁷⁹ See Mishra, Lunstrom and Anand for detailed discussion on export led growth.

⁸⁰ Ghani and Kharas 2010.

⁸¹ Hausmann, Hwang and Rodrik (2006).

9). Labor force statistics show a similar pattern. Nearly 40 percent of all employment is in services, 20 percent is in commerce restaurants and hotels and less than 13 percent of the labor force survey statistics work in industry.

Table 9. Number of Establishments and Employment by Economic Activity 2009

	WB&G		West Bank		Gaza	
	No. of Establishments	Employ	No. of Establishments	Employ	No. of Establishments	Employ
Industrial Activities	15,322	67,052	11,791	54,064	3,531	12,988
Construction	508	5,200	301	4,558	207	642
Internal Trade	61,340	125,033	42,508	82,090	18,832	42,943
Service Activities	24,114	85,756	17,406	61,407	6,738	24,349
Transport, Storage & Communications Activities	1,169	9,568	718	8,107	451	1,461
Total	102,483	292,609	72,724	210,226	29,759	82,383

Source: PCBS Economic Survey 2009.

3.5. *The largest employment category was retail trade, which employed almost 97,000 people reflecting the predominance of small shops in the economy.* Other leading sectors by employment were sale and repair of motor vehicles and education. In manufacturing major employers were food and beverages, wearing apparel and manufacture of non-metallic products. This pattern has changed little over the past decade. Overall, industrial employment grew by only 5 percent between 2000 and 2009. The biggest drop came in the apparel sector where employment declined by 50 percent.

3.6. *The bulk of the decline occurred in Gaza, where the closures have shut off exports and where there is only a limited domestic market.* Industrial employment fell from about 19,000 in 2000 to only about 10,000 in 2009 despite the rapidly growing population. In 2009, nearly 52 percent of the Gaza employees in the activities covered by the economic survey were in internal trade compared to only 39 percent in the West Bank. Industrial employment accounted for about 16 percent of employment versus 26 percent in the West Bank. Services, mostly government funded, were similar at about 25 percent in both West Bank and Gaza.

3.7. *The Palestinian businesses are mostly focused on the local market.* The high cost of doing business in WB&G and the Israeli restrictions on movement all combine to lower the competitiveness of Palestinian businesses. Consequently, only 7 percent of manufacturing enterprises in the 2009 Economic Survey reported exporting and exports were only 11 percent of total sales.

Competitiveness of Palestinian Businesses

3.8. *The WB&G economy is closely tied to Israel's so much of the cost structure is similar to a highly developed economy.* In addition, the Israeli restrictions on movement and access to resources add substantially to costs. The price of serviced land is driven up by the lack of access to undeveloped land in Area C.⁸² The costs of utilities are also relatively high, especially for

⁸² The Oslo Accords divided the West Bank into areas A, B and C. A is under full PA control and consists mostly of Palestinian urban centers. Area B is under Palestinian civil control and Israeli security control and is comprised of Palestinian villages and areas surrounding the urban areas. Area C is the rest of the

water, due to limited supplies in both the West Bank and Gaza. The Israeli security requirements for shipping goods into and out of WB&G also add significantly to the costs.⁸³ Exporting is particularly expensive given the requirement for almost all goods to go through a back-to-back process where they are off loaded from Palestinian trucks, scanned, and then uploaded onto Israeli trucks to continue their journey.⁸⁴

3.9. ***Labor costs are also relatively high in WB&G compared to other countries specializing in labor intensive manufacturing, especially those in Asia.*** The average monthly manufacturing wage in 2009 reported in the Economic Survey was about US\$450 in the West Bank and US\$200 in Gaza. The higher wages in WB&G are well illustrated by looking at World Bank salary scales for offices around the world. These salaries are comparable across countries because they are based on surveys of prices and salaries in the local market and assume the same qualifications for an employee in each country. An entry level worker, with no professional qualifications in WB&G receives nearly 25 percent more in Dollar terms than does the same employee in Turkey and more than 74 percent more than an employee in India. The gap narrows for an entry level professional but is still high. Such an employee in WB&G earns nearly 20 percent more than his counterpart in Turkey and 50 Percent more than in India (Table 10).

Table 10. Difference Between Wages in World Bank Country Offices and WB&G Country Office

	Turkey	India	Jordan	Egypt
Non-Professional entry level	26%	74%	50%	58%
Professional entry level	20%	50%	44%	35%

Source: World Bank database.

3.10. ***To be competitive, the higher wages must be compensated by higher productivity.*** However, this does not seem to be the case in WB&G. One measure of wage competitiveness is value added to wages at the enterprise level. The higher this ratio, all else being equal, the more productive workers are for a given wage.⁸⁵ An inexact comparison between the data in the World Bank's Enterprise Survey database and the PCBS' Economic survey indicates that the average ratio of value added to wage bill in the WB&G is lower than many countries that produce labor intensive goods for the international market (Table 11). This lower wage productivity combined with higher transportation costs resulting from the Israeli closures significantly reduces the competitiveness of Palestinian manufacturing. This analysis indicates that the Palestinian private sector will not be able to rely on producing low value added, labor intensive goods that previously dominated the manufacturing sector. The significant decline in the apparel and leather and tanning industries reflect this fact.

West Bank and is under full Israeli control. This includes most agricultural and undeveloped land along with the Israeli settlements. Area C includes the economically vital Jordan Valley.

⁸³ These costs have been well documented in a number of studies and will not be repeated here. See the World Bank ICA, West Bank Alternative trade Corridors Paper, PalTrade border crossing monitoring reports, etc.

⁸⁴ On the Allenby bridge they are transferred to Jordanian trucks.

⁸⁵ It is necessary to assume that production technology is similar and that the firms do not have market power. Thus, we compare the same industries across countries and industries are in competitive international markets.

Table 11. Value Added to Wages for Selected Countries

	India 2006	Turkey 2008	Philippines 2009	Viet Nam 2009	West Bank 2009	Gaza 2009
Manufacturing	7.1	10.2	7.6	5.0	4.2	2.8
Garments	6.0	17.6	3.6	3.0	2.2	6.0
Furniture	8.4	NA	4.4	4.0	3.8	2.8

Sources: World Bank staff calculations. Palestinian Data from PCBS economic survey. All other data from World Bank Enterprise Survey database.

Investment, Innovation and Training

3.11. *Palestinian enterprises have been cut off from mechanisms for enterprise learning, which also helps explain their poor performance.* A firm’s performance depends upon its ability to acquire, adapt and implement new technologies. Often, new technologies are embodied in new equipment but in other cases it comes in the form of new production and management methods. Both research and experience have shown that among the most important learning mechanisms are firms’ interactions with foreign customers, foreign direct investment, consultants, technology licenses and work experience with international companies; all of which are generally lacking in the Palestinian market. There is little foreign direct investment, except in the form of local Palestinians with foreign passports. Most exporters sell through Israeli middlemen so they do not get the benefit of close interaction with international firms. Travel for Palestinians is difficult, restricting the opportunity to work abroad. In addition, international firms have been reluctant to allow their consultants to travel to the WB&G because of security concerns and insurance costs.

3.12. *To be competitive, the Palestinian private sector must raise productivity and shift towards high value added goods and services to support the relatively high wages.* This in turn requires enterprises to increase investment and improve their internal capabilities. However, investment remains relatively low. In 2009, less than 14 percent of all Palestinian enterprises in the PCBS Economic Survey reported an increase in gross fixed capital formation. In the manufacturing sector, 14 percent reported an increase. However Gross Fixed Capital Formation (GFCF) has begun to show some recovery. In the manufacturing sector in 2009, it was more than double its level in 2005 and had risen by nearly 30 percent since 2000. But, this is in nominal terms so there has not been a large real increase in GFCF reported by the industrial surveys. The low level of investment is similar to the finding of the 2006 Investment Climate Survey (ICS)⁸⁶, which revealed that only 50 percent of manufacturing firms in the West Bank and 25 percent in Gaza had made significant investment expenditures in the previous year.

3.13. *Firms in WB&G engage in relatively little innovation. About half the sample of the ICS reported introducing a new product in the previous year.* However, most of these “new products” were merely variations on existing products and did not reflect significant innovation. Palestinian firms also do relatively little to increase their internal capacity and learning mechanisms to improve technology are weak. The ICS found that only 35 percent of manufacturing companies in the WB and 15 percent in Gaza conducted formal training.

⁸⁶ The World Bank’s Investment Climate Survey is distinct from the Investment Climate Assessment. The survey was only one component that fed into the ICA, while the ICA itself drew on information from many sources to complete and analysis of overall investment climate.

3.14. *Many Palestinian entrepreneurs in the manufacturing sector obtained their initial experience working in Israeli companies inside Israel and many skilled workers developed their skills in the same way.* This is especially true in the furniture and garments industry. However, with the decline of Palestinians working in Israel, this last remaining source of enterprise learning is being cut off. Most of the Palestinians working in Israel in construction or agriculture, which provides little knowledge transfer to Palestinian business.

Table 12. Innovation Indicators for Manufacturing Enterprises

	WB	GZ	East Jerusalem
% introducing a new prod. in last year	63	49	68
% w/ foreign technology license	13	6	11
Age of Machinery (mean/median)	11/10	9.4/10	7.8/5

Source: 2006 World Bank/PCBS WB&G Enterprise Survey.

3.15. *The findings of the ICS are somewhat dated, however there is no indication of any major change in enterprises behavior.* In response to the low levels of innovation, the UK Department for International Development and the World Bank jointly established a matching grant scheme to assist enterprises in developing new products and entering new markets. To date, this fund called the Fund for New Market Development assisted 226 individual enterprises, among whom were the most capable and sophisticated in WB&G. But only 15 obtained quality certificates, 20 conducted training and a mere 6 engaged in knowledge transfers such as buying licenses or adopting specialized technology. The majority of clients sought assistance to enter new domestic markets or introducing variations on existing products. While, the business environment is improving, at least in the West Bank, Palestinian firms remain reluctant to invest or innovate. For the private sector to replace the public sector as the driver of growth this must be reversed and Palestinian businesses must begin to invest, innovate and become internationally competitive.

Business Environment

3.16. *To increase investment and raise employment, it is important that the PA establish a business environment that enables investment and encourages entrepreneurs to take risks.* It is not enough to have an investment climate that is on par with neighboring countries. To overcome the perceptions of risk resulting from years of occupation and attract the necessary high level of investment, the business environment of a future Palestinian state should strive to be among the best in the world. The PA recognizes this and is making a concerted effort to improve the business environment. It has made notable progress, especially in establishing security and stability, which is the basis for any development. However, there remains much to be done as evidenced by WB&G slipping from 133 in the 2010 overall Doing Business rankings to 135 in 2011.

Expanding Access to Resources

3.17. *Efficient use of its limited resources including land, water, energy and electromagnetic spectrum will be critical to stimulating private sector investment in a future state.* Currently, the PA has little authority in these areas as control remains with the GOI. However, the government of a future state would be expected to manage its own resources. Thus, it is imperative that the PA develop its capacities in this area not only to improve economic growth under the current situation but to also be prepared for a future state.

Land

3.18. *The lack of land for development is a major impediment to development of the Palestinian private sector. Nearly 60 percent of the West Bank, so called Area C, is under Israeli control and effectively off limits to Palestinian development.* In the Palestinian controlled areas, vacant land in the heavily urbanized Area A is scarce and only the most accessible parts of Area B are serviced and suitable for development. What land is available, is difficult to access because ownership is heavily fragmented and only a small portion is registered and titled. This limits the extent to which Palestinians can develop, sell and collateralize their real property. Consequently, the price of land in the West Bank is extremely high. Land in downtown Ramallah approaches the cost of land in major cities in Europe and the US.

3.19. *The Gaza Strip does not face the same types of challenges in terms of access to land.* Since the evacuation of the Israeli settlements in 2005, the entire Gaza Strip is under Palestinian control. In addition, the land law in the Gaza Strip is the Egyptian law which makes all property sales binding only once registered in the Land Registry. As a result, less than 2 percent of land in Gaza has not been registered and titled (settled), and the remaining 7,000 dunums are under a land registration program with Finnish funding.⁸⁷ Moreover, an estimated 70 percent of land parcels are of recent registrations.⁸⁸ However, undeveloped land in Gaza is extremely limited as are public land resources.

3.20. *In the West Bank, even where land has been registered and titled, the titles are often more than a generation old.* Inheritance rights follow Shari'a law whereby all children and some other surviving relatives receive a share.⁸⁹ Consequently, a single plot of land often has a large number of inheritors, each entitled to a small fraction. Intra-family disputes and even lawsuits related to the distribution of land among inheritors are all too common in the West Bank; registration claims, inheritance, and common property cases are the most common land cases brought to trial court.⁹⁰ This problem is likely to be exacerbated in the event of the establishment of a Palestinian state, with larger numbers of expatriates returning from abroad and demanding their share of a heretofore forgotten inheritance.

3.21. *The PA recognizes the importance of improving the land registration system and has launched a reform program.* But the program has been slow and the Palestinian Land Authority's (PLA) capacity is no match for the scale of the challenge of effectively managing public land resources and providing efficient land registration and administration services to the public. An inventory of public lands in Areas A and B, which are under PLA authority, is still incomplete and not yet public, creating opportunities for corruption and misuse. Only about 30 percent of land in the West Bank is registered. Systematic registration has only just begun and is expected to take decades to complete unless significantly more resources are provided. Meanwhile, the legislative framework has yet to be reformed to deal with the major problem of absentee owners, high land fragmentation, and lack of public land available for provision of municipal and public services.

⁸⁷ National Land Policy Framework, 2008.

⁸⁸ Interview with Sharhabeel Al-Zaeem, practicing attorney and legal expert in Gaza.

⁸⁹ Inheritance also follows Shari'a in Gaza, but since most land is registered and titles are not as old as in WB, fragmentation is less of a problem in Gaza.

⁹⁰ National Land Policy Framework, 2008.

3.22. *In preparation for a future state, the PA could prioritize a large scale campaign for land surveying, adjudication, and registration throughout Areas A and B in the West Bank.*⁹¹

Such a campaign could release significant assets into the economic space helping spur growth. This would require enhancing the PLA's capacity to manage simultaneous land registration programs throughout the West Bank and ensuring that supporting capacities, such as private land surveyors, settlement judges, and law enforcement were also prepared. Such a campaign may trigger an upswing in disputes among inheritors, an issue which ultimately will need to be solved by reforming the land laws in a manner that addresses the issue of fragmented ownership. While critical, this is highly sensitive and most likely will only be approached once the PLC is again functioning. In the meantime, support could be provided to facilitate the resolution of current and potential disputes through independent land valuation services, the mediation and adjudication of land swapping solutions, and the simplification of the re-titling process.

3.23. *Reforming the use of public land is equally crucial, and will become more so if a Palestinian state gains control over parts of Area C. Area C includes a large amount of public land and demand for undeveloped land for residential, commercial, industrial, and tourism investments are likely to increase dramatically.* The PA can begin to prepare for this by completing the registry of public lands in Areas A and B, making the registry public and planning for adding public land in Area C to the registry when the time comes. To enable investment, it is also important that the PA develop a system for allocating public land that is fully transparent and done with public consultation.

Housing

3.24. *Closely related to land is the issue of housing. Most scenarios envisioned for the establishment of a Palestinian state predict a high number of returnees, mainly from Palestinian refugee camps but also from the rest of the diaspora.* There are few predictions in terms of numbers, but there are an estimated 4.6 million Palestinians living in the diaspora (outside of the West Bank, Gaza Strip, and Israel), of which about 2.4 million are registered refugees living in the camps in Jordan, Lebanon, and Syria. So even a small fraction of refugees and expatriates returning to the Palestinian state would significantly increase the population and put enormous pressure on the already tight housing market. This could also represent a growth opportunity, as the large scale construction needed to meet the needs of the current and future population would provide a significant boost to the economy. However, attracting additional investment in housing projects will require addressing land laws, the land registration process, urban planning issues within municipalities and the legal environment.

3.25. *Most Palestinian households are homeowners; home ownership in 2009 was 91.6 percent in the Gaza Strip and 82.2 percent in the West Bank (excluding East Jerusalem).*⁹²

Particularly in rural areas, most Palestinian households live in their own homes built on family plots. Palestinians often act as their own general contractors or even build their own homes rather than purchase traded housing. This leaves a small market for traded housing and rentals. However, this situation cannot persist, especially if there is a large influx of returnees. Building plots, especially in urban areas, are scarce and becoming more so. The prices of new houses, even the least expensive, are already out of reach of most Palestinian households and are continuing to rise along with land prices. Based on income, it is estimated that only 21 percent of Palestinian

⁹¹ While the PA currently has no ability to affect such a campaign in the Gaza Strip, as has already been noted, Gaza has a high rate of land registration.

⁹² PCBS 2009 Statistical Yearbook No. 11

<http://www.pcbs.gov.ps/Portals/PCBS/Downloads/book1724.pdf>

families could afford a home for \$60,000 or higher, which represents the average cost of a finished housing unit in the West Bank outside of the Ramallah/ Bireh area.⁹³ In 2009, it was estimated that there was a demand for 50,000 additional housing units in the WB&G and this is growing as the population grows.⁹⁴

3.26. *To meet the growing need for houses, it is necessary to develop the more affordable housing and in particular the rental market as it is clear that most households cannot afford new houses.* Improving the housing market will first and foremost require dealing with the land registration issues discussed above. But there are other legal and regulatory issues to address as well. Particularly critical for the rental market is to reform the tenant protection enshrined in the current Owners and Tenants law of 1953 that is effective in the West Bank.⁹⁵ This law protects tenants of residential and commercial buildings from rent increases or eviction. Leases are open ended, and a property owner has very little recourse if a tenant chooses to stay in the property indefinitely. In residential buildings, this has led to a distorted market, where there is little financial incentive for investing in residential buildings for lease or rent. In commercial buildings, a “key money” system has evolved whereby, in addition to the agreed rent, the lessee pays a one-time payment (key money or “khlu”) shared by the previous tenant and the property owner (2/3 and 1/3 respectively).⁹⁶

3.27. *Meeting the growing demand for housing also necessitates reducing the cost of financing. There is already a nascent mortgage market but it is not yet large and does not provide a diverse range of products.* Growing the mortgage market will require addressing issues in the regulatory and institutional environment such as the role of the Capital Markets Authority (CMA) and Palestinian Monetary Authority (PMA) in regulation of mortgages by housing finance companies and banks respectively, the role of Palestinian Housing Mortgage Corporation (PMHC), Foreclosure and Mortgage Laws, and tax incentives. The laws and regulations governing housing finance as regulated by the CMA and PMA need review and consolidation (mortgage law, immovable property law, a new law for registering apartments, and eventually addressing the tenant protections in the Owners and Tenants Law).⁹⁷ Consideration should also be given to diversifying the PMHC’s insurance products to provide mortgage insurance on a portfolio coverage basis and stop-loss insurance to help lenders manage their risk, and the issuance of bonds. Mortgage enforcement is also a concern for lenders. Political and social sensitivities of eviction make foreclosure difficult and it is employed only as a last resort. Consequently, mortgages are primarily secured by personal guarantors. Improving mortgage enforcement could reduce dependence on personal guarantors, broadening the potential borrower base.

⁹³ Affordability determined as 4 times annual income. The source is a confidential housing market assessment prepared in 2010 for a local financial institution.

⁹⁴ Housing and Mortgage Loans in Palestine, MAS 2009.

⁹⁵ Jordan Law No. 62 in 1953, amended in 1958 in the West Bank, and British Mandate law of 1934 still in effect in Gaza. It should be noted that the Israeli military governor issued military orders amending the law in 1969 and again in 1989, allowing landlords to increase rents by set percentages, but these orders have been largely ignored by Palestinians as being issued by an illegal authority, even prior to Oslo.

⁹⁶ The law in Gaza (Residential Rent Law No. 44 of 1940) and subsequent British mandate and Egyptian Administration amendments is somewhat less protective of tenants and more elaborate in its procedures, including the establishment of a Rent Commission and Court and other procedures.

⁹⁷ Housing and Mortgage Loans in Palestine, MAS 2009

Water and Energy

3.28. ***Ensuring an adequate water supply for future Palestinian growth is a particularly difficult challenge.*** The Oslo Agreement limits the Palestinian allocation of the three West Bank water aquifers to about one quarter of the allocation to Israel and the settlements. This was meant to be an interim arrangement for only 5 years; nearly 20 years later, these arrangements have left the West Bank and Gaza with a per-capita fresh water utilization at one quarter of neighboring Israel and the PA struggling to provide even the most basic level of service to the population. In the West Bank, actual supply is estimated at 97 lpcd (liters per capita per day). About one quarter of households receive less than 50 lpcd supply, well below accepted WHO standards minimum of 100 lpcd. In Gaza, supply is higher, at 152 lpcd, but suffers from high salinity, poor quality and uneven service. Water expenditure makes up 8 percent of Palestinian household income, which is twice the globally accepted standard, with poor unconnected households paying the highest costs at nearly one sixth of their income. Given that the PA cannot provide adequate water for consumers, it is clear that the potential for industries that rely on large amounts of water, such as most agriculture, are currently limited. The results of the PCBS survey of perceptions of owners and managers of industrial enterprises in the first quarter of 2011 indicate that more than 22 percent of managers are not satisfied with the provision of water. However, it is an even more important constraint in Gaza where more than 40 percent of managers are not satisfied (Table 11). About 31 percent of Palestinians are connected to a sewage network and only four towns have sewage treatment plants, with the majority of sewage being dumped in the wadis without treatment and into the sea off Gaza.⁹⁸

3.29. ***A critical priority of a future Palestinian state will be to implement an integrated water resource strategy that will improve management and identify new sources of water including possibly imported water and desalinization.*** Significant investments in the water distribution networks and the installation of sewage collection and treatment facilities will be needed. This will require the focus of government vision and resources into a new investment strategy and rationalization of the fragmented “jungle” of small providers. Given the size of the needed investment, it will also have to include significant private sector investment in the sector.

3.30. ***The cost and reliability of power are other major constraints to expanding industry in WB&G.*** Most firms in the ICS did not rate power supply among their top three business constraints. But the ICS surveyed existing firms who have found ways to deal with the high cost and unreliable supply of electricity. New firms who would like to enter the market in industries that are energy intensive would probably find the cost of energy prohibitive. The PCBS managers’ survey found that less than a quarter of managers in the West Bank were not satisfied with power service. However, around 85 percent in Gaza were not satisfied to at least some extent. In Gaza, the power sector has suffered severely from the Israeli closures. The local power plant has been badly damaged and the distribution system for imported power has seriously deteriorated. Any efforts to expand industry in the West Bank or to just maintain current businesses in Gaza will require substantial investment in the power sector.

3.31. ***Managing and diversifying Palestinian energy resources and sources will be key to reducing Palestinian costs of production.*** The WB&G currently sources most of its energy from Israel through direct connections to Israeli power networks. Minimal amounts of electricity are also obtained from Jordan and Egypt (about 30 MW) and another 40MW produced by the Gaza power plant. The Gaza power plant, which supplies partial needs in Gaza, has not been operating at capacity due to uneven supply of fuel to the power plant. All electricity used in the West Bank

⁹⁸ World Bank 2009 Assessment of Restrictions on Palestinian Water Sector Development.

is imported, and has in the past been distributed primarily through isolated municipally managed networks. But this system is in the process of being restructured to put distribution under five commercially run companies.⁹⁹

3.32. *The Palestinian energy strategy needs to take into account strategic energy suppliers as well as infrastructure investments.* The Palestinian electricity network is currently integrated with the Israeli network, but not integrated internally, limiting the ability to transfer power supply through the network (say from NEDCO in the North to HEPCO in the South). Integrating the network internally would require building at least 8 additional substations. Connecting the Gaza Strip and West Bank networks, as well as reinforcing connections with Egypt and Jordan, would help resolve both supply and distribution problems. It is also crucial to build the infrastructure needed to diversify and reduce costs of fuel imports, namely pipelines, refineries, and reservoirs and storage facilities to permit the management of fuel and gas supplies. Developing the Gaza off-shore must also be part of an overall energy strategy that ensures security and controls the costs of the future Palestinian state's energy supply¹⁰⁰ as are considerations of renewable energy sources such as solar and wind.

Table 13. Percentage Distribution of Owners/Managers Opinions of Active Industrial Enterprises on Water and Electricity Services First Quarter 2011

		Total	Don't Know	Largely Not Satisfied	Not Satisfied to some Extent	Satisfied to some Extent	Largely Satisfied
Electric Supply	WB&G	100	1.0	25.4	12.2	39.0	22.4
	West Bank	100	1.1	10.2	14.0	46.2	28.5
	Gaza	100	0	79.4	6.2	13.4	1.0
Water Supply	WB&G	100	4.1	10.9	11.6	47.2	26.2
	West Bank	100	3.2	4.1	13.5	48.5	30.7
	Gaza	100	7.1	35.1	5.2	42.3	10.3

Source: PCBS Survey of Perceptions of Owners/Managers of Active Industrial Enterprises Regarding the Economic Situation First Quarter 2011.

3.33. *The magnitude of the investment necessary to develop the Palestinian energy sector demands private sector investment.* Public resources will not be adequate. Attracting such investment requires continuing to build the capacity of the regulatory agency and completing the legal and regulatory framework that governs public and private power suppliers and operators.¹⁰¹

⁹⁹ West Bank and Gaza Energy Sector Review, World Bank 2007 and interview with Enas Abu Laban, Negotiations Support Unit. The power companies include two long-standing companies, the Jerusalem District Electricity Company (JDEDCO) and the Gaza Electricity Distribution Company (GEDCO), and three more recently established companies, the Hebron Electric Power Company (HEPCO), the Southern Electric Company (SELCO), and the Northern Electricity Distribution Company (NEDCO).

¹⁰⁰ The Gaza Marine gas field holds an estimated 30 billion cubic meters of natural gas with an estimated value at current prices of \$6.5 billion. This project is however in limbo due to lack of clearances from the Israeli government to allow development and negotiations over sales to Israel. Source: PIF 2009 Annual Report.

¹⁰¹ See the West bank and Gaza Energy Sector Review (World Bank 2007) for detailed analysis and recommendations.

Legal and Regulatory Framework

3.34. ***Critical to improving the investment climate is reforming the current collection of laws governing investment, company registration, commercial activity, trade, land registration and other business activities.*** These laws stem from different periods of Palestinian history, and consist of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws as well as Israeli military orders, which differ between Gaza and the West Bank. It is difficult to reform these laws in the absence of the PLC and some observers have even argued that the muddle of laws is uniquely representative of the Palestinian reality and should be reformed sparingly and only as distinct needs arise.¹⁰² In this view, instead of proposing new laws, the focus should be on improving the business regulations and executing mechanisms that support the laws to a varying degree. However, the collection of antiquated laws drawing on disparate strands of civil, common, and Islamic legal traditions leaves significant gaps and creates conflicts. Furthermore, old Jordanian law, which represents the most dominant legal legacy in the West Bank and from which Palestinian law has borrowed heavily, represents the “conservative and interventionist” economic policy of Jordan at the time, not the open, free market economic policy espoused by the Palestinian Authority today.¹⁰³ Thus, the current legal and regulatory environment is not adequate to attract the foreign and domestic investment that is required by a modern, knowledge based economy.

3.35. ***The PA is in the process of drafting or discussing a number of new laws that govern business activities.*** It is important that these laws be enacted along with the regulations needed to implement them. It is important also to ensure that Gaza and the West Bank share the same legal and regulatory environment. In the view of World Bank and other observers among the more pressing laws are:

1. ***Companies Law.*** The Jordanian Companies Law of 1964, last amended by the PA in 2008, is in force in the West Bank, while Gaza is governed by the British mandate Companies Ordinance of 1929, last amended in 1939, and the Partnership Ordinance of 1930. There are differences between these laws in the definitions, registration procedures, and rules of operation of both corporations and limited liability companies between these laws.¹⁰⁴ The proposed draft Companies Law would abrogate both the Jordanian and British mandate laws and create a new law. Among other things, the draft law removes minimum capital requirements, permits sole proprietorship under certain limited conditions, and limits the role of the government. It would grant authority for approval of registration to the Company Controller rather than the Minister of National Economy.
2. ***Competition Law.*** Currently, the PA has no law that allows it to ensure a competitive market. It is important that there be an independent entity to regulate competition and the current draft law being worked on by the Ministry of National Economy calls for such a regulator. In the meantime, the Telecommunications Regulator Law was passed, which created a competition law and specialized regulatory agency for the telecommunications sector. However, establishment of the actual institution was stalled. Even if this agency were established, in the absence of a broader regulation of competition would remain a challenge.

¹⁰²While Israel has occupied the West Bank & Gaza since 1967, it is not obligated to pass laws. Instead it adopts the existing laws and issues new rules and regulations through military orders. These military orders are not recognized as having the force of law by the Palestinian Authority.

¹⁰³ Quoting MEPI, 2006, pg. 19.

¹⁰⁴ Roadmap for Palestinian Legislative Reform, Mustaqbal Foundation 2006.

3. *Secured Transactions Law*. This proposed law is in draft and would help unlock movable assets for collateral purposes. The law would create a registry within which lenders must register their interest in the property to be able to foreclose on the property in case of default. This law is expected to benefit small and larger businesses alike, but would particularly be expected to increase credit to small businesses with little or no real property to use as collateral.
4. *Land Laws*. The Land Policy Task Force (LPTF) prepared a National Land Policy Framework (NLPF) that included recommendations for the enactment of a legal framework of four new laws to replace the current land legislative framework (Palestinian Land Authority Law, Land Law, Registration Law, and Eminent Domain Law). The laws were to be based on a set of land policies drawn up and recommended by the LPTF. The Council of Ministers has adopted the NLPF, but the action plan has only partially been implemented. A Palestinian Land Authority Law was enacted in 2010 and included the establishment of a National Land Board, one of the policies recommended in the NLPF. The remaining laws have not been drafted, but some of the notable policies proposed in the NLPF include full registration of all land in the State of Palestine, a requirement that land inheritance rights be registered within 12 months of succession, protection of the rights of absentees, and limits on the use of Irrevocable Power of Attorney. It should also be noted that the current restriction of foreign ownership of land, except with the explicit permission of the Council of Ministers, has been maintained in the recommended policies of the NLPF.
5. *Tenants Law*. Reforming the tenant laws and establishing one law for both West Bank and Gaza are key elements in unlocking the full potential of the real estate market and ensuring sufficient housing is available for the growing population.

3.36. ***Incomplete, inadequate, or contradictory secondary legislation, including regulations and procedures issued at the ministerial level, also weaken the investment climate.***¹⁰⁵ For example, many regulations that have been cited in laws, have never been passed. These include:

- Regulation organizing commercial agents
- Insurance regulation against acts of theft
- Regulation for special procedures challenging the decisions of the Palestinian Capital Market Authority
- Regulation on the confidentiality of information inside the Palestinian capital market.
- Regulation on secrecy of bank accounts.
- Internal regulations and instructions for the law on Industrial Zones
- Internal regulation organizing work inside Industrial Zones
- Instructions on the process of collecting taxes – Income Tax Law
- Instructions on deduction from source - Income Tax Law
- Instructions on tax statements

3.37. ***In addition, other regulations have been drafted, approved, ratified and which are presently in effect within the related institutions, yet never published in the official gazette and thus properly disseminated among the business community.*** These include regulations related to licensing and procedures for insurance companies as well as regulations on mandatory technical instructions and conformity certificates to Palestinian standards.

¹⁰⁵ These regulations are identified in a paper produced by the 3rd National Economic Dialogue Program (NEDP) in 2008, the “Legal Framework for Regulating the Palestinian Economy”.

Improving the Quality of PA Institutions - with a Focus on Quality Infrastructure

3.38. *The strength of PA institutions that support the private sector is uneven.* While corruption is not viewed as a significant constraint and the PA institutions are not seen as predatory, many agencies are plagued by poorly trained staff, inadequate resources and a lack of clarity of purpose. In interviews, private sector representatives indicated that they believe security and judicial performance have improved, however the civil service capacity and performance in ministries remains weak. This perception is reinforced to a degree by the findings of the recent BizCLIR study. This study found that implementing institutions - those Palestinian institutions with the primary legal mandate to enforce the commercial legal framework – to be the weakest elements of the business environment while supporting institutions and social dynamics were the strongest.¹⁰⁶

3.39. *Judicial performance seems to be a highlight of institutional performance in the past few years, specifically for the West Bank.* While there is still much room for improvement, anecdotal evidence from Palestinian businessmen and lawyers indicate that efforts over the past few years to improve the performance of the judiciary seem to have been successful. This view is also supported by the findings of the BizCLIR study, which cited improvements in court administration, case management, and the cadre of judges.¹⁰⁷ Similarly, the ICA found that the private sector does not view the Palestinian court system as a major impediment to doing businesses.¹⁰⁸ The most recent PCBS perceptions survey found that the most business managers are satisfied with the effectiveness of the police and courts (Table 14).

Table 14. Percentage Distribution of Owners/Managers Opinions of Active Industrial Enterprises on Government Services First Quarter 2011

		Total	Don't Know	Largely Not Satisfied	Not Satisfied to some Extent	Satisfied to some Extent	Largely Not Satisfied
Integrity of Police	WB&G	100	12.7	3.9	7.1	44.0	32.3
	West Bank	100	8.2	2.6	8.8	45.6	34.8
	Gaza	100	28.9	8.2	1.1	38.1	23.7
Effectiveness of the Courts	WB&G	100	17.3	9.8	11.4	39.6	21.9
	West Bank	100	12.7	9.6	14.0	41.5	22.2
	Gaza	100	34.0	10.3	2.1	33.0	20.6
To Obtain Necessary Permits and Licenses	WB&G	100	20.8	7.3	15.9	44.0	12.0
	West Bank	100	15.2	4.9	16.6	48.5	14.8
	Gaza	100	41.2	15.5	13.4	27.8	2.1
Labor Law	WB&G	100	15.2	12.7	13.8	48.3	10.0
	West Bank	100	12.2	7.3	15.7	52.9	11.9
	Gaza	100	25.8	32.0	7.1	32.0	3.1

Source: PCBS Survey of Perceptions of Owners/Managers of Active Industrial Enterprises Regarding the Economic Situation First Quarter 2011

¹⁰⁶ BizCLIR, pg 3

¹⁰⁷ BizCLIR

¹⁰⁸ 2007 ICA

3.40. ***However, effectiveness of the judicial system will become a more pressing issue if foreign investment ever becomes significant and new businessmen without local contacts enter the market.*** On this forward looking note, an area in particular need of improvement is enforcement of judgments. While 8 out of 10 of the first–instance courts had departments for enforcing court judgments, the reported rate of enforcement is low.¹⁰⁹ The low enforcement rate was linked to several factors, some related to movement and access issues in the WB&G and limited resources, but others related to inadequate regulations and procedures. The Supreme Judicial Council has identified this as a priority reform area, which should have a positive impact on the business environment in terms of contractual enforcement.¹¹⁰

3.41. ***The cost and time of starting a business are an important constraint to developing the private sector in WB&G.*** In the 2011 Doing Business rankings, WB&G was rated 173 out of the 183 countries covered by the report. Initial registration of a business is centralized in Ramallah and attempts at decentralization by the Ministry of National Economy have been largely unsuccessful. In addition, smaller businesses can be overwhelmed by the complexity of annual registration, tax, and fee collection on the national and municipal level in particular with the tax office, Chamber of Commerce, Police, Emergency services, municipal waste collection, and others.¹¹¹ In fact, of the total 49 days on average needed to start a business in the WB&G as listed in the Doing Business report (compared to 6-7 days in Turkey and Egypt and 13 days in each of Jordan and Syria), 36 days are attributed to registration with the Chamber of Commerce and the local municipality alone.¹¹² Nearly a quarter of surveyed managers in the first quarter of 2011 were dissatisfied to some extent with the process to obtain necessary permits. It should be noted that labor law is not identified as a significant constraint in either the ICS nor the PCBS perceptions survey (Table 14).

3.42. ***The Palestinian Standards Institute (PSI), along with its associated regulations and supporting public and private institutions, must be a focus of any efforts to increase Palestinian exports or improve local production.*** The Palestinian quality infrastructure is currently highly dependent on Israeli institutions to regulate imports, including the safety testing of electronic equipment and food. The gaps in the Palestinian system that are currently covered by the Israeli Standards Institute (ISI), Israeli Ministry of Agriculture, and Israeli Ministry of Health in conjunction with the IDF Civil Administration must be filled. Under the Paris Protocol, almost all imports must meet Israeli standards and the ISI tests all goods destined for the WB&G according to its standards and using Israeli testing laboratories. The role of the Palestinian Standards Institute (PSI) on imports is limited. PSI and other responsible ministries conduct some market surveillance, but only at retail points as there is no Palestinian presence at entry points into the West Bank.

3.43. ***Transitioning from this current system to one where PSI and other PA institutions bear the full responsibility of inspection and testing and managing the process of holding and releasing goods will take some time.*** Imports from some countries could be handled through

¹⁰⁹ The First Instance Court of Ramallah reportedly only successfully enforced 20% of the 2000 cases brought to it for enforcement in 2008. This seemingly conflicts with the 2007 ICA in which a survey of 401 businesses reporting that judgments were enforced 64% of the time. This might be explained by geography, a sample bias, or perception bias.

¹¹⁰ Sally Fleshner, Assessment of Business and Regulatory Environment and Recommendations for Assistance, USAID/ Netham, October 2008.

¹¹¹ From interviews with the Palestinian Standards Institute, Federation of Chambers of Commerce, Industry, and Agriculture (FPCCIA), the Palestinian Federation of Industries (PFI), Paltrade and from the EC Quality Infrastructure report.

¹¹² Doing Business in the West Bank & Gaza 2011, The World Bank.

mutual recognition agreements, but these also would take some time to set up. One approach would be to begin taking responsibility slowly. For example, there is a proposal to begin piloting an arrangement where the PSI would be authorized to hold certain categories of goods, conduct testing and then provide evidence of testing to the ISI. This would serve as a way to build capacity and establish systems in both the PSI and other enforcing institutions such as the Ministries of Health, National Economy and Agriculture.

3.44. ***Testing capacity in the WB&G is limited. There are 23 testing laboratories specializing primarily in construction and building materials and food and water.*** There are also a few basic calibration laboratories, but other testing capabilities are lacking, particularly for electrical equipment. Most of these laboratories are private, but some capacity also exists within the Ministry of Health, the Consumer Protection Department in the Ministry of National Economy, and in PSI itself. There is a consensus among stakeholders that more testing capacity must be built up within the WB&G, but that PSI should only act as a reference laboratory and provide laboratory testing for tests required for technical regulations for which private laboratories do not offer service. In the future, it should also be possible to use well established Israeli laboratories for more specialized testing.

3.45. ***Upgrading the quality infrastructure will also require the PA to rationalize its legal and regulatory framework for standards and measurement.*** The Palestinian Specifications and Measures Law is deficient in particular on the means and authorities for enforcement of technical regulations. The law also overlaps and sometimes conflicts with other relevant laws, including the Consumer Protection Law, Public Health Law, Agriculture Law, Environment Law, Labeling, and Control of Precious Metals Law.¹¹³

Financial Sector

3.46. ***The WB&G financial system has been steadily developing and is generally able to meet current needs of the private sector.*** However, it remains a bank based system and it is necessary to continue to expand and deepen credit markets. It is particularly important to continue to develop leasing, point of sales infrastructure, mortgage finance and other products required by a dynamic private sector led economy. It is also important to create long-term debt instruments. To allow this growth, the PA must continue to develop the legal and regulatory environment for the financial sector.

Structure of the Financial Sector

Banking

3.47. ***The bulk of the financial services in WB&G are provided by 19 commercial banks, two of which are Islamic banks.*** There are 209 bank branches spread throughout WB&G ensuring that banking services are widely available. Half of the banks are foreign owned with eight of them being Jordanian. The sector is well capitalized but heavily concentrated and not highly effective. It did not suffer from the 2008 financial turmoil because of its conservative stance and because the Palestinian economy is relatively isolated from the world economy. The sector is closely regulated by the Palestinian Monetary Authority (PMA), which has ensured the banking sectors stability. The PMA has been particularly diligent in implementing anti-money laundering

¹¹³ Assessing the Legal Framework of the Palestinian Standards and Measures, and its Compliance with the WTO Requirements, MAS, 2010

procedures that have allowed the banking sector to continue to operate in Gaza despite the international sanctions on the government there.¹¹⁴

Securities Market

3.48. ***The Palestine Stock Exchange (PSE) was established in 1998 and there are only 44 listed companies.*** Given the small size and family-owned nature of most Palestinian enterprises, the potential for new applicants appears limited. The PSE is thinly traded, heavily concentrated – three companies account for nearly 60 percent of capitalization – and the index is volatile. The CMA is a nascent organization and is only just developing its capabilities. However, it is taking a number of measures to develop the market such as enabling the establishment of professionally managed investment funds for investment in securities and defining the CMA’s respective regulatory and supervisory roles vis-à-vis the PSE.

Insurance

3.49. ***Insurance companies are not major institutional investors like they are in other countries.*** They control less than 3 percent of the financial sector’s assets and the contribution of insurance premia to GDP was only about 2.2 in 2010. Spending on insurance per capita was about US\$30 compared to the average of 2.7 percent and US\$60 in developing countries. This situation mainly reflects depressed economic activity, transit restrictions and limited public awareness of insurance products. The insurance industry has not been well supervised in the past but the CMA is developing better supervision measures and is preparing to issue issued prudential and market conduct regulations.

Financial Leasing

3.50. ***Financial leasing is in its infancy.*** There are only a few active companies leasing mainly motor vehicles for commercial fleets. Some basic regulations have been issued by the CMA but a new leasing law is in draft and is awaiting passage. The passage of this law along with the draft secured transactions law will stimulate activity in this area and promote leasing for commercial and industrial equipment thereby improving access to finance in the private sector.

Housing Finance

3.51. ***There is a large need for affordable housing in WB&G however the supply is restricted by the limited amount of land available for Palestinians to develop due to Israeli restriction.*** In addition, the lack of mortgage finance constrains the growth of affordable housing. Currently, there is only a small amount of mortgages in the banking sector, about US\$60 million worth in 2010,¹¹⁵ despite ongoing efforts to develop the sector. The PMHC that provides refinance and mortgage guarantees has had a catalytic effect in the emergence of mortgage lending. It has recently initiated policy changes to maintain its attractiveness including providing mortgage insurance separate from re-financing. In addition, the Palestinian Investment Fund (PIF) along with other investors has launched the AMAL mortgage corporation to provide mortgages for affordable housing. As discussed in the previous section, the mortgage market is constrained by a weak legal and regulatory environment. The PA has no housing strategy, much of the land in WB&G remains unregistered and the condominium law is not appropriate. Most importantly,

¹¹⁴ The information in this section and much of the text describing the financial sector is drawn from the World Bank’s Financial Sector Review of 2008.

¹¹⁵ BiZClear 2010

there is no mortgage law in force. The PA has developed a draft law but it has not yet been passed.

Microfinance

3.52. ***The Microfinance sector is relatively well developed and there are 13 registered microfinance institutions (MFI) providing credit across WB&G.*** All but two of the MFIs are registered as NGOs and mostly they only provide credit. However, some of them are beginning to diversify their products including developing Sharia compliant instruments. Despite its size, there appears to still be significant room for additional growth. One technical assistance provider estimates that only 2 percent of the current demand¹¹⁶ is being met, however another study indicates it is as high as 39 percent. Funding for many organizations is by donors and reinvested profits and only a few larger MFIs are currently sustainable.

3.53. ***Operations infrastructure of the nine nonbank providers is being strengthened and a regulatory framework is being developed by PMA that requires MFIs to be organized as companies with effective corporate governance structures and procedures and contain rules for market conduct.*** If MFIs were permitted to take deposits from the public or convert to banks with moderate regulatory requirements, as acknowledged by the Basel Committee on Banking Supervision, it might enable some marginal MFIs to become sustainable. Moreover, profitable and expanding MFIs should result in those institutions providing access to finance for the middle market (households and small enterprises), thereby creating a financing continuum in the customer spectrum.

Pension Funds

3.54. ***There are no privately managed pension products in WB&G and the domestic financial sector currently lacks entities other than insurance companies which could offer or manage pension products.*** There are too few regulations in place for the provision of either pension products or the underlying products and services. The CMA needs significant technical assistance to train its personnel, develop the necessary regulatory framework, and establish bilateral supervisory agreements with regulators in other countries.

Equity Funds

3.55. ***Three private equity funds have recently begun operations in WB&G. These funds, while small, represent a significant development for the WB&G private sector.*** They will serve as a source of long-term capital for new and growing enterprises and will help bring international management practices to the Palestinian private sector. The existence of such funds will hopefully spur traditional, family-controlled companies to transition to more modern and competitive structures as they seek outside capital to grow their businesses.

Access to Finance

3.56. ***Like small and medium enterprises the world over, Palestinian enterprises face constraints in accessing affordable finance.*** However, access to finance is improving and it is not seen as the most pressing investment constraint by most enterprises. In the 2006 ICS only 37 percent of surveyed enterprises reported access to finance as a major constraint putting it well

¹¹⁶ PalNet as cited in BizClear page 80.

behind other constraints such as political uncertainty or electricity supply.¹¹⁷ While only 18 percent of the sample reported having bank loans, less than 15 percent of the surveyed enterprise could be considered financially constrained. Most managers reported that they did not have a loan because they did not want one at the current interest rates or they would not borrow for religious reasons. Few enterprise reported having been rejected for a loan or not having sufficient collateral. Since this survey was completed, there has been a significant revival of the private sector in the West Bank. But there has also been a significant increase in the provision of credit facilities to the private sector. The PMA reports that in the West Bank, it rose by more than 70 percent between the end of 2008 and 2010. The PMA has taken steps to increase bank lending in WB&G including increasing the percentage of bank assets that must be held in WB&G to 45 percent of deposits. This has pushed the banking sector to be more aggressive in seeking out profitable lending opportunities and in 2009 banks approved 79 percent of loan applications.¹¹⁸ While the majority of credit goes to the private sector, about 68 percent in 2009, the public sector is also major borrower of short term funds and in 2009 accounted for 32 percent of outstanding credit.

3.57. *Though the financial sector is growing and improving, there remains much to be done to ensure that growing enterprises will have access to the credit they need.* The financial system is still overwhelmingly bank based and there are few other well developed instruments. The banks are highly liquid, yet there is low intermediation between savers and borrowers. In 2010, the loan to deposit ratio was a mere 36 percent. This has been steadily increasing in the past few years but it is still well below the world average of 87 percent (Table 15). Banks remain wary of the risky environment and reluctant to lend to small borrowers. Banks continue to rely on high collateral values and have not developed cash flow lending sufficiently. Collateral is still mostly confined to land and buildings or offsetting cash balances. Large corporate firms are well served by the banking sector and small enterprises have access to the micro finance organizations. But the medium enterprises, which are among the most capable and offer some of the best opportunities for growth, are less well served.

Table 15. Palestinian Loan-to-Deposit Ratio (%) 2008-2010

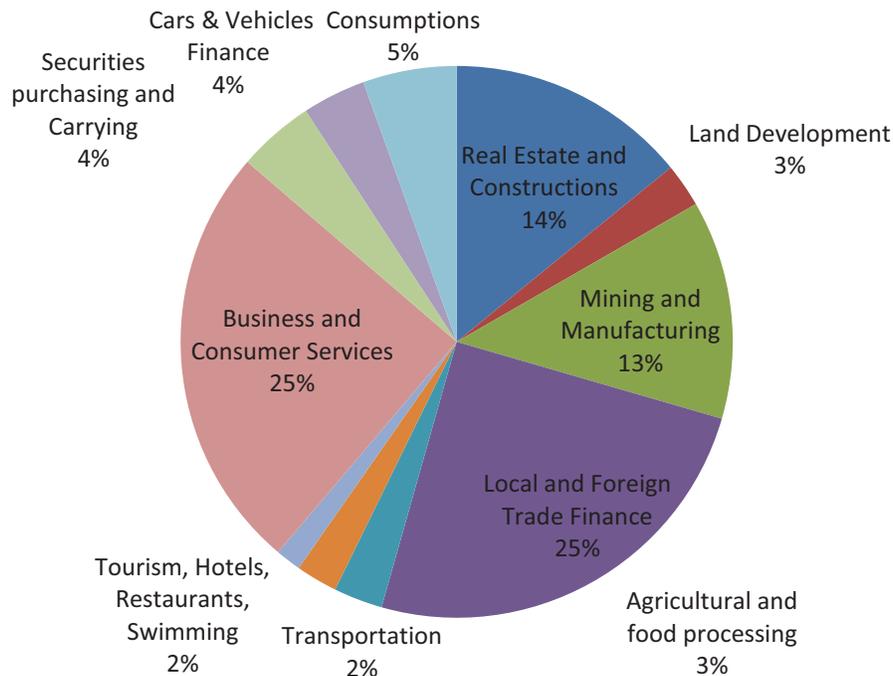
2008	2009	2010	World Average
31.3	35.5	33.6	87.0

Source: Ken Dorph USAID Consultant

¹¹⁷ The ICS surveyed formal firms. The majority were manufacturing however the sample also included a number of service sector firms.

¹¹⁸ PMA

Figure 13. Distribution of Outstanding Credit Portfolio among Economic Activities in 2009



Source: Palestinian Monetary Authority. Statistical Bulletin, various issues.

3.58. *The largest share of credit to the private sector credit is directed to financing trade and consumption.* In 2009, (see Figure 13) about 50 percent of credit went to these activities while real estate and construction and industry took only 14 percent and 13 percent respectively. It is particularly striking that agriculture took only 3 percent of total credit facilities.

3.59. *Going forward, it is important to maintain efforts to strengthen and deepen the Palestinian financial sector.* One of the most important issues is to increase the banking sector's willingness to lend to growing small and medium enterprises without requiring extremely high levels of collateral. Palestinian banks must become more adept at analyzing and assessing the risk of small firms. Likewise, small enterprises must become better at presenting business plans to banks. There are a number of initiatives to help spur lending to small and medium enterprises including two loan guarantee facilities. In addition, one large bank has recently announced that it will establish a number of small business lending units in the West Bank. Such efforts will need to be expanded as economic opportunities increase and small Palestinian enterprises demand more finance.

3.60. *Much of the drive to strengthen the financial sector depends upon passing new legislation.* Enacting the leasing law and secured lending laws would allow the growth of the leasing market making it substantially easier for small and medium enterprises to finance new equipment. Establishing the movable assets registry called for in the secured lending law would not only help the leasing market, but would open up new sources of collateral and reduce the reliance on land. Growth in the mortgage market would be improved by passing the draft mortgage law and issuing the supporting regulations. Reforming the condominium law and land ownership laws are also critical.

3.61. ***The PMA has a well established credit registry that is one of the best in the region. In 2010, it added a credit scoring system that provides each outstanding credit a score.*** Bankers and microfinance managers report that they rely on the credit registry to provide accurate and timely information. Thus, continuing to develop the bureau and add additional information such as allowing non-bank institutions to participate will be important to developing the financial system.

3.62. ***One of the most serious challenges facing the financial system is the lack of long-term funds.*** Term transformation is an essential role for the banking system but is difficult to do in WB&G where almost all of the banking system's liabilities are short term demand deposits. This makes it difficult for them to confidently lend long-term. It is important that the financial sector begin to develop markets for long-term debt including bank Certificates of Deposit and commercial bonds. The PMA is attempting to initiate this developing its own CDs and securitizing government debt. These products will begin the development of the yield curve and initiate markets for directly placed debt including commercial paper. Ultimately, as the markets develop long-term debt instruments will arise.

Next Steps

- The main constraints to private sector development are the restrictions imposed by the GOI. Barring a political solution to the conflict, there is little that can be done about these constraints. However, it is important that the PA continue to take what steps it can to improve the business environment. This will not only prepare the ground for a possible future state, but will lead to increased investment today.
- One of the single most important steps the PA can take is to accelerate the process of land registration. Increased registration will open up the housing market, provide collateral for loans, lower the cost of doing business and increase the tax base.
- Continuing to develop the water and power infrastructure as well as the ability to efficiently manage these services.
- Passing the key legislation discussed above, including the secured transaction law, competition law, etc.
- Continuing to develop secondary legislation to effectively implement laws.
- Continuing to develop the financial sector by encouraging the development of leasing, point of sales infrastructure, mortgage finance and other products required by a dynamic private sector led economy. Passing a new law for the PMA is also critical.
- Continuing to improve trade facilitation as discussed in a previous chapter.
- Establishing the independent telecommunications regulator and developing its ability to regulate the market.
- Continue to improve government services such as the business registration process and system for testing and establishing standards.
- Continue to improve government services such as the business registration process and system for testing and establishing standards.

CHAPTER 4: LABOR AND EMPLOYABILITY

Employment Trends

4.1. *Trends in the labor market in WB&G over the past decade can be characterized as follows:* high overall unemployment rates coupled with a steady decline in youth employment and economic participation; extremely low female labor force participation rate coupled with a change in the composition of the female labor force in favor of educated women; a drop in the share of manufacturing and construction in total employment coupled with a rise in the government share – driven largely by growth in health and social work, education, and public administration; and a drop in real wages at all education levels, but much more so among the least educated. There has also been a clear and robust trend of an increase in government wages relative to private sector wages in both the West Bank and Gaza. However, only in Gaza has it reached the point where government jobs actually pay significantly more than the private sector for the same education and experience.

4.2. *The impact on the labor market in terms of loss of employment and falling wages has translated into large increases in poverty rates, particularly for the unemployed and those out of the labor force.* This effect has been the strongest in Gaza, which was effectively cut off from access to markets in 2007 and where more than a third of the population lives below the poverty line. For individuals who managed to stay employed, poverty rates also increased, with the largest share of poor workers being private salaried workers or self-employed workers. In the West Bank, the self-employed seem to be the most vulnerable, while in Gaza; private sector employees are more vulnerable. Public sector workers were relatively more protected from falling into poverty, particularly in Gaza. The real imperative for poverty reduction lies in sustained and substantial job creation, driven by the private sector.

High Unemployment

4.3. *In the last decade, the WB&G economy has witnessed some of the highest unemployment rates in the world:* peaking above 30 percent in 2002, the rate of unemployment was still well above 20 percent in 2010.¹¹⁹ Despite the growth recovery beginning in 2007, unemployment has remained stubbornly high, and in fact rose from 21.5 percent to 23.7 percent between 2007 and 2010. The high unemployment rates are accompanied by low levels of labor force participation, which have remained steady at about 41 percent for most of the last five years. The high unemployment rates understate the true degree to which Palestinians lack work, since those who have jobs increasingly report being underemployed during the work week.¹²⁰ The incidence of underemployment among those holding jobs was about 7 percent in 2010.

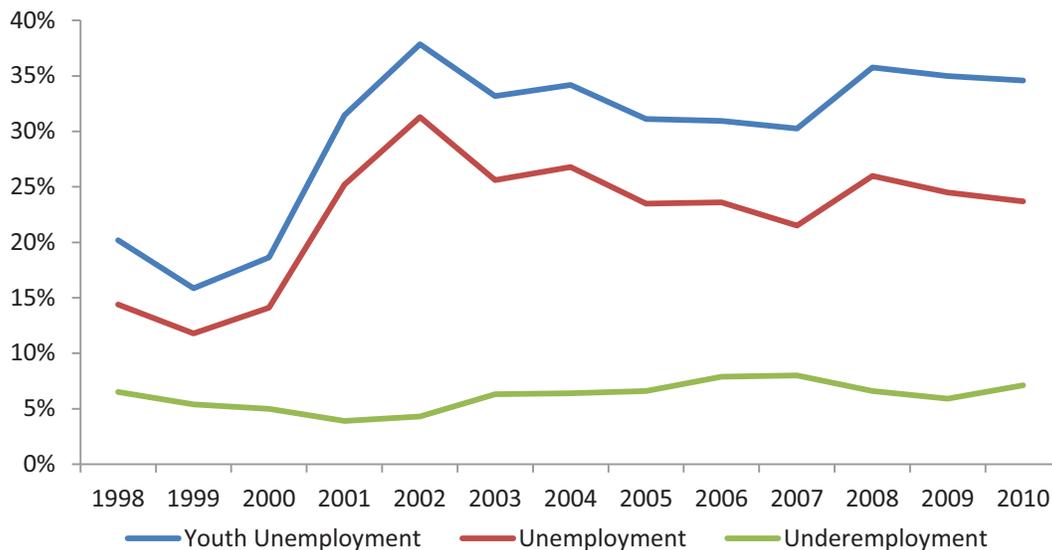
4.4. *The high unemployment rates have been accompanied by a disproportionate and steady decline in youth employment and economic participation.* In 2000, the youth unemployment (workers aged 15-29) rate was about 19 percent, about 5 percentage points higher than the mean unemployment rate. But by the end of 2010, this gap had risen to more than 10 percentage points with youth unemployment at nearly 35 percent. Youth unemployment remains high even though youth labor force participation has been declining and by the end of 2010 was

¹¹⁹ The entire employment section draws extensively from World Bank. 2011. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*. This report analyzes principally the data from the quarterly Palestine Labor Force Surveys administered by the Palestinian Central Bureau of Statistics (PCBS) between 1999 and 2009.

¹²⁰ An employed person is defined as under-employed if reported hours worked per week are less than 35.

only about 34 percent. Youth unemployment is particularly high in Gaza, where it was nearly 53 percent at the end of 2010 even though less than 30 percent of youth were even in the labor force. The high youth unemployment is a serious concern for the PA. WB&G has a young and rapidly growing population, so that the labor force is growing more rapidly than the overall population. For example, between the 1997 and 2007 census, PCBS estimates that the Palestinian population grew by about 27.6 percent while the labor force grew by 41 percent. Many young people have remained in school and delayed entering the labor force, hence the lower participation rate. But despite this, economic growth has not been able to keep pace with the growing work force and growing youth unemployment rates could lead to significant social unrest in the future as seen in other Middle Eastern Countries.

Figure 14. Unemployment and Underemployment in West Bank and Gaza, 1998-2010



Source : PCBS Labor Force Survey.

4.5. *A salient characteristic of the Palestinian labor force is its participation in two separate labor markets: the internal Palestinian market, which employs the majority of Palestinians, and the Israeli market, which includes both Israel and Israeli settlements in the West Bank.* A negligible number of Gazans have worked in Israel since Israel's disengagement from Gaza in 2005.¹²¹ For the West Bank, following the outbreak of the second *Intifada* in October 2000, the number of Palestinians employed in the Israeli market declined, falling from nearly 26 percent of the West Bank work force to less than 12 percent in 2004. It began to slowly pick up after 2005 with the subsiding of the *Intifada*, though Palestinian employment in Israel continues to fluctuate depending on the political situation. In 2010, on average about 14 percent of the West Bank work force, or nearly 79,000 Palestinians were employed in Israel and her settlements.¹²² Clearly a large number of them were working without Israeli permits since in 2010, an average of only 52,000 permits were available to Palestinians for work in Israel and the settlements: 30,000 in Israel and 22,000 in the settlements.¹²³ The vast majority of the workers in Israel are in low skilled construction and agriculture jobs.

¹²¹ Sayre and al-Botmeh 2009.

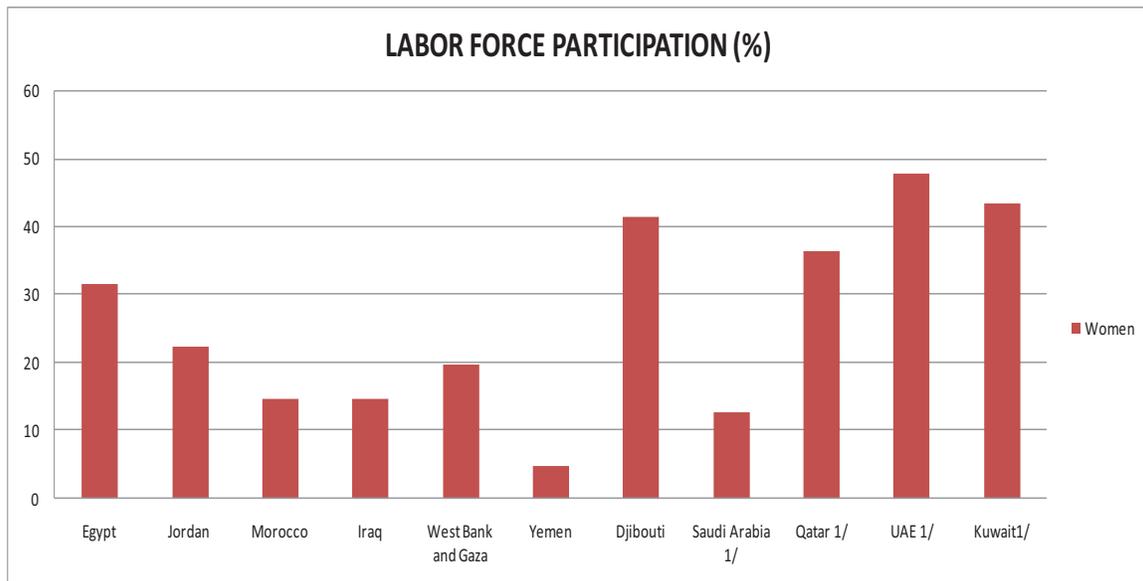
¹²² PCBS labor force statistics.

¹²³ (USAID 2011).

4.6. *Another key feature of the WB&G labor market is the marked gender differences. Women’s labor force participation rate has been below 16 percent throughout the last decade.* This is remarkably low even when compared to the Middle East and North Africa (MENA) average of 26 percent, itself one of the lowest regional average in the developing world (see Figure 15). It is likely that Palestinian women face the same constraints on labor force participation as women in other MENA countries, such as social restrictions on work outside home, a societal preference for women confining themselves to the public sector, constrained mobility in looking for jobs and commuting to work, and a perception among employers that women are less productive.¹²⁴

4.7. *The WB&G female labor force participation rate rose from 10 percent in 2002 to 15 percent in 2010 (see Figure 16), accompanied by a steady rise in the female unemployment rate implying that women are increasingly looking for jobs.* By 2010, the female unemployment rate had not only more than doubled to 27 percent relative to its low in 2000, but it also became higher than male unemployment. It may be that widespread male unemployment is pushing women into searching for work. At the same time, given the recent downward trend in male unemployment, it seems that with fewer jobs to go around, those that are available go first to men. There is evidence to suggest that men are favored over women in the hiring process – as one employer put it: “we prefer to hire men as they are family providers”.¹²⁵

Figure 15. Female Labor Force Participation Rates (ages 15-64 years), 2009



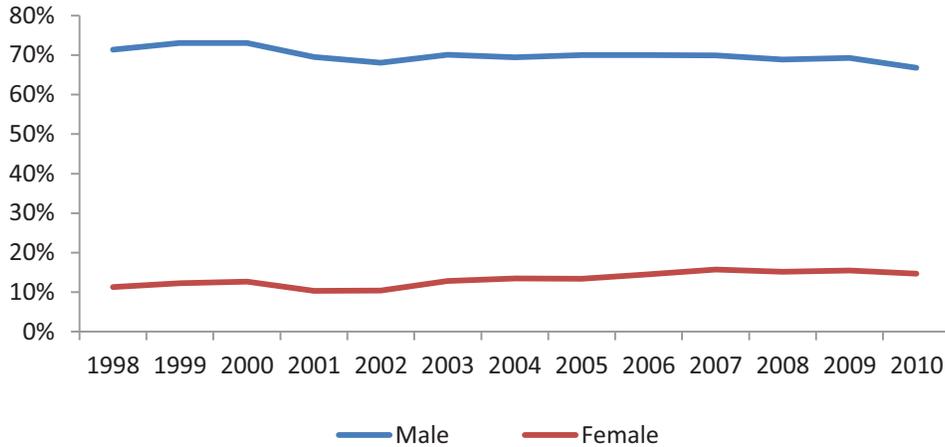
Notes: Estimates based on household Surveys except 1/: Official estimates for national non-immigrant population

Source: World Bank 2012 (forthcoming): Opening Doors: Gender Equality in the Middle East and North Africa, A companion to the World Development Report 2012

¹²⁴ *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza.*

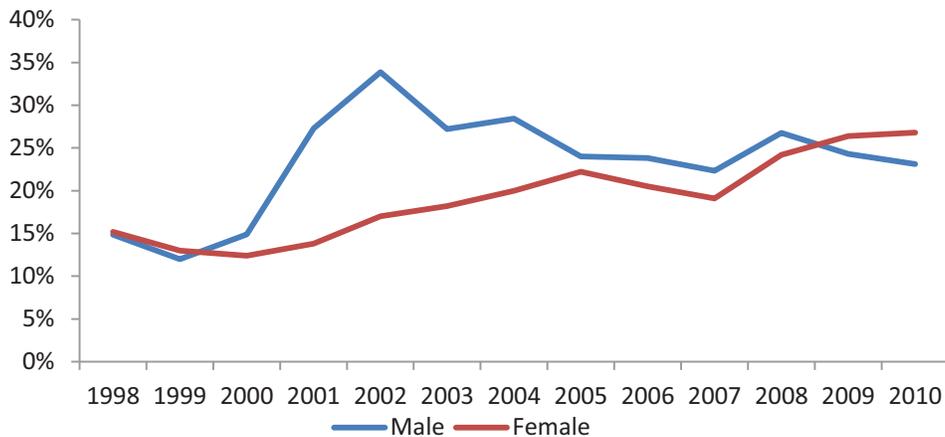
¹²⁵ Centre for Development Studies 2010, page 33

Figure 16. Labor Force Participation by Gender, 1998-2010



Source: PCBS Labor Force Survey.

Figure 17. Unemployment by Gender, 1998-2010



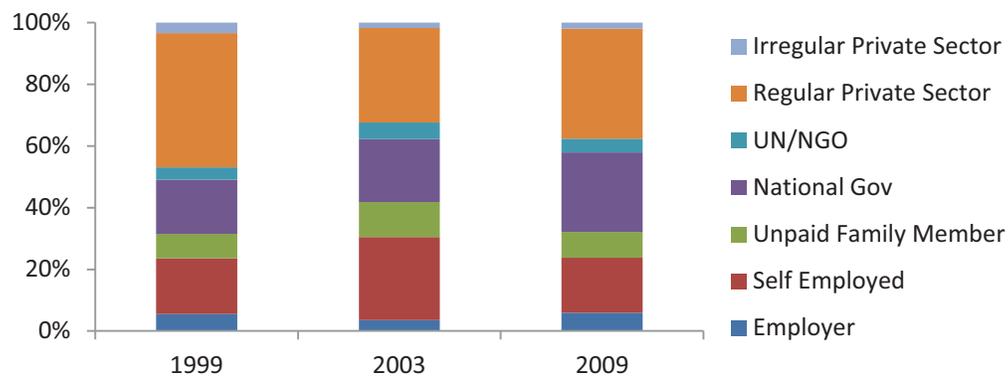
Source: PCBS Labor Force Survey.

High Share of Public Sector in Total Employment

4.8. *WB&G has experienced marked de-industrialization, with the share of manufacturing and construction in total employment falling from 37 percent in 1998 to 24 percent in 2009, and the government share rising from 17 to 26 percent over the same period.* The expansion of the public sector was largely driven by growth in health and social work, education, and public administration – while the share of private sector jobs fell from 47 to 38 percent between 1999 and 2009. A decline in manufacturing does not necessarily imply that the economy is not developing, especially if the tertiary sector is doing well. But in the case of WB&G, what is unusual is that most of the expansion in the tertiary sector is accounted for by health and social work, education, and public administration – all of which are essentially in the public sector. In other words, Palestinians are accumulating human capital, but this human capital is not finding a productive outlet in other service and manufacturing sectors and is therefore not fulfilling its potential to raise long-term growth.

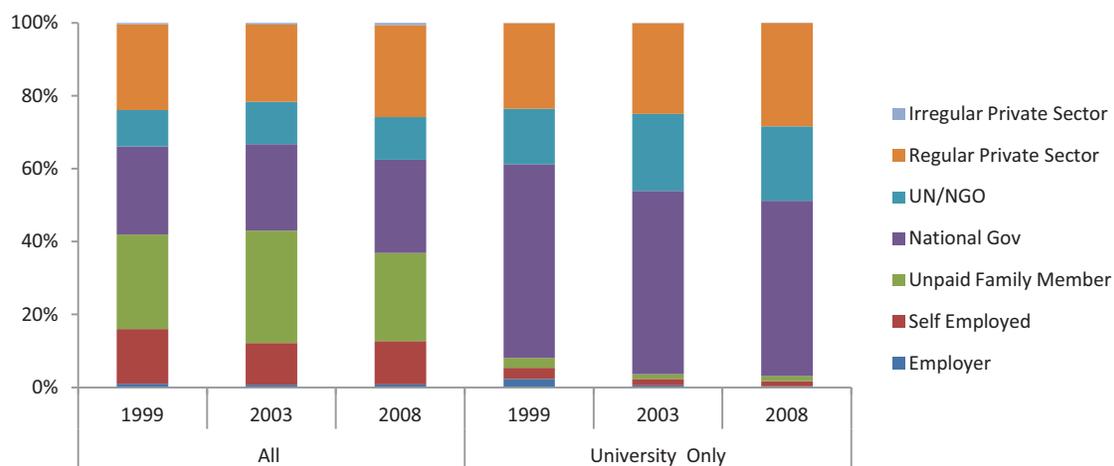
4.9. *College educated women work overwhelmingly in the government or for international agencies and NGOs (almost 70 percent in 2008 – see Figure 19).* Thus, less educated women lack access to government jobs to the same extent as college educated women – yet such jobs have increasingly become the most reliable source of employment in the WB&G. As many as a quarter of female labor force participants in WB&G work as unpaid family members¹²⁶, but this varies sharply by education levels. Thus, the share of self-employment and unpaid family work has fallen among college educated women. It also appears that self-employment, which could be an alternative to unpaid family work among less educated women, has not emerged as a viable alternative to the same extent that it has for men. The share of the self-employed is not only lower among women, but it has also declined markedly in the past decade.

Figure 18. Employment by Sector in West Bank and Gaza, all Working Age Individuals (15-64 years old)



Source: World Bank. 2011d. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*, page 4.

Figure 19. Female Employment in West Bank and Gaza by Sector and Education Level



Source: World Bank. 2011d. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*, page 32.

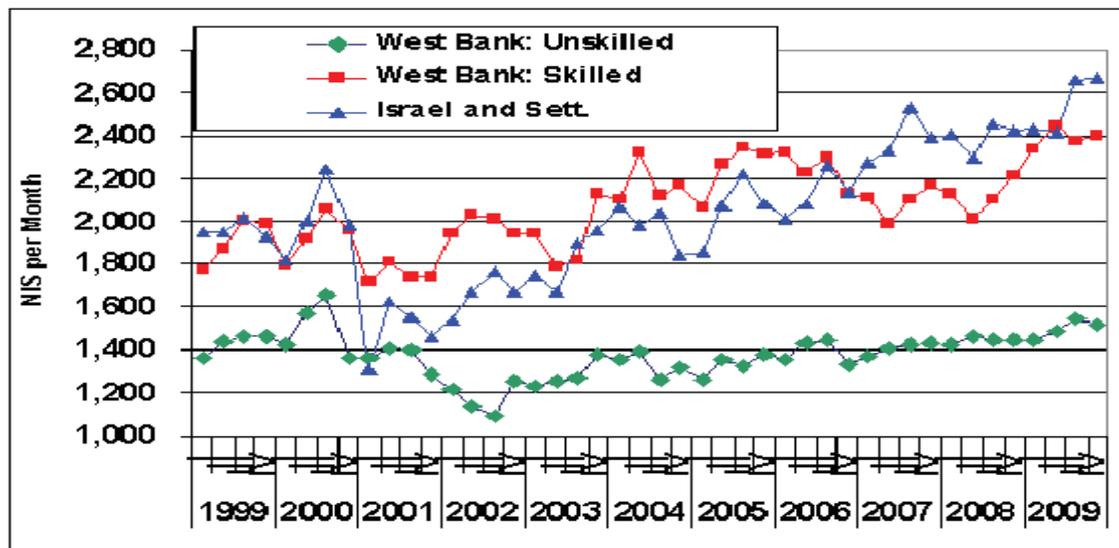
¹²⁶ Note that even this number is probably an underestimate of the incidence of unpaid work by women, since such work is likely to be underreported in labor force surveys.

Fall in Labor Earnings

4.10. *Though the Israeli market offers Palestinians mainly unskilled employment, those working in the Israeli market earned about 30-40 percent more than those who held domestic jobs in 1999, and by 2003, this premium had risen to 55-65 percent.*¹²⁷ Indeed, data from 2009 suggest that the Israeli wage premium still remains at such high levels, consistent with the continuance of strict controls on access to Israeli jobs. As wages in Israel have continued to rise, the average wage for workers in Israel has even surpassed the average wage of well educated workers in WB&G (see Figure 20). Palestinians working in Israel are on average less educated than those working within WB&G, consequently the 1999 gap in mean wages between workers with elementary education and those with college degrees was a mere 10 percent. This is consistent with a greater incidence of Israeli jobs with wage premiums among the less educated. By 2003, as unskilled Israeli jobs with wage premiums disappeared, the college educated group was earning 26 percent higher wages than those with elementary school education.

4.11. *Real wages have fallen at all education levels, but much more so among the least educated.* For instance, among those with 5 years of schooling, real wages were about 30 percent lower in 2009 compared to 1999 (see Figure 21). Among those with 16-18 years of schooling (that is, those with post-secondary degrees), wages in 2009 were lower by about 10 percent. In other words, the decline has been especially severe amongst the least educated, which is likely due to the loss of low-skilled jobs in Israel that carried a wage premium and the labor supply shock as Palestinians who held jobs in Israel returned home. The wages earned by those with high school or less education did not recover between 2003 and 2009.

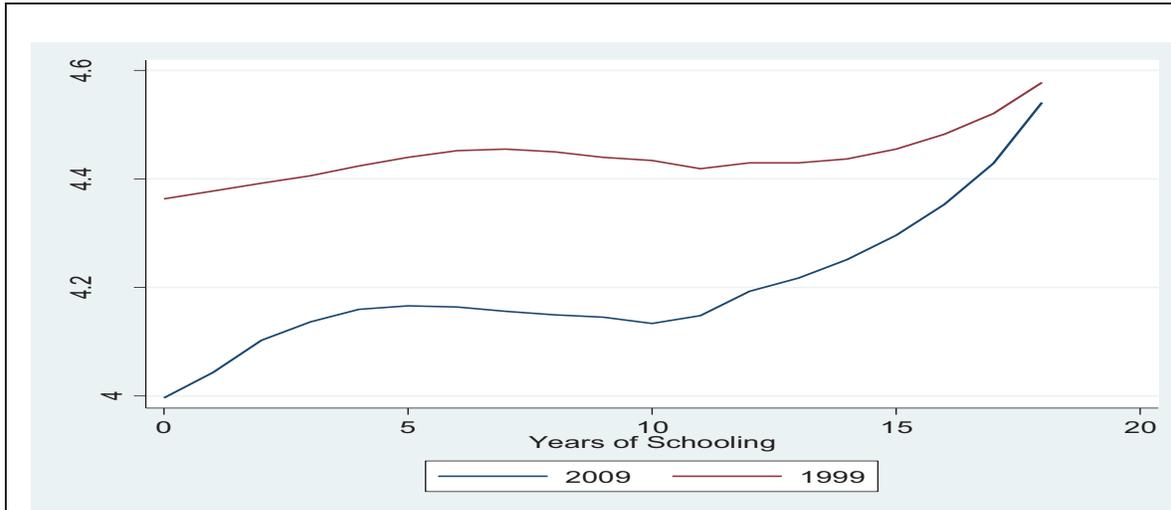
Figure 20. Mean Wage of Unskilled and Skilled Workers in West Bank versus Workers in Israel and her Settlements



Source: PCBS Labor Force Survey.

¹²⁷ Estimates of the premium for work in Israel are based on recent analysis of PCBS labor force statistics found in World Bank 2011a and may differ from estimates cited elsewhere from earlier analysis. However all analysis indicates that there is a large wage premium for working in Israel.

Figure 21. Mean Wage by Years of Schooling, 2009 vs. 1999



Non-linear regressions of real wages on years of schooling, males in 1999 and 2009. Wages are measured in logarithms.

Source: World Bank. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*, page 5.

4.12. ***A decline in private sector wages relative to government wages is another major post-Intifada development in WB&G.*** After controlling for education, location and age; government workers on average earned about 27 percent less than regular private sector workers in 1999. However, large public sector wage increases in 2004 and 2005 combined with the falling private sector wages led to a narrowing of the gap between private and public sector wages. Previous World Bank analysis found that by the end of 2005 there was a 15 percent wage premium for working in the private sector once age, education and other factors were controlled for.¹²⁸ However, more recent analysis indicates that this wage premium only exists in Gaza.¹²⁹ Estimates of the adjusted wage gap between government and regular private sector jobs indicate that the government paid about 14 percent less than the private sector (for the same education) in 2003 (see Figure 22). By 2005, given the relative improvement in government wages, wages were nearly equal in government and private sector. In 2006 and 2007, the government was paying about 8-11 percent more than the private sector, but this did not persist into 2008. Moreover, it appears that the premium was driven by Gaza. Looking at the West Bank, there is a clear trend of an increase in government wages relative to private sector wages, however at no point during this period was the government minus private wage gap positive. In sharp contrast, this wage gap was positive throughout this period in Gaza, rising from 16 percent to above 50 percent.

4.13. ***Previous analysis also found that less educated and lower paid workers in the civil service receive higher wages than similar workers in the private sector.***¹³⁰ However, this is reversed for high wage earners; well educated workers in the civil service receive less than their peers in the private sector. This analysis is consistent with anecdotal accounts where PA officials complain about the difficulty of recruiting and retaining skilled staff. Governments typically want to ensure that the public sector has access to staff with skills in high demand areas such as information technology or financial management, and to do so requires paying salaries that are

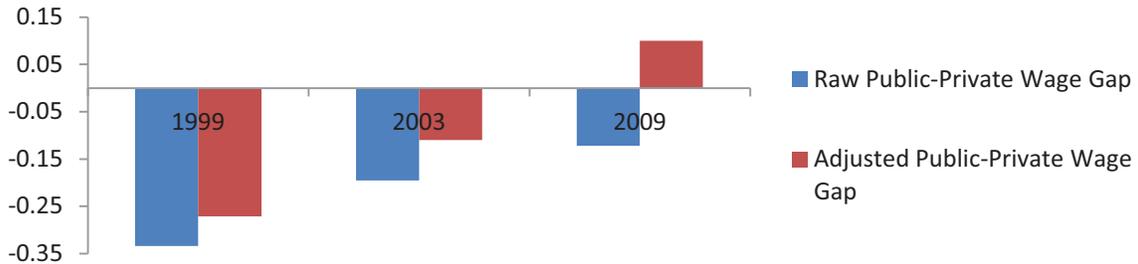
¹²⁸ See World Bank 2007c.

¹²⁹ World Bank 2011b.

¹³⁰ World Bank 2007c.

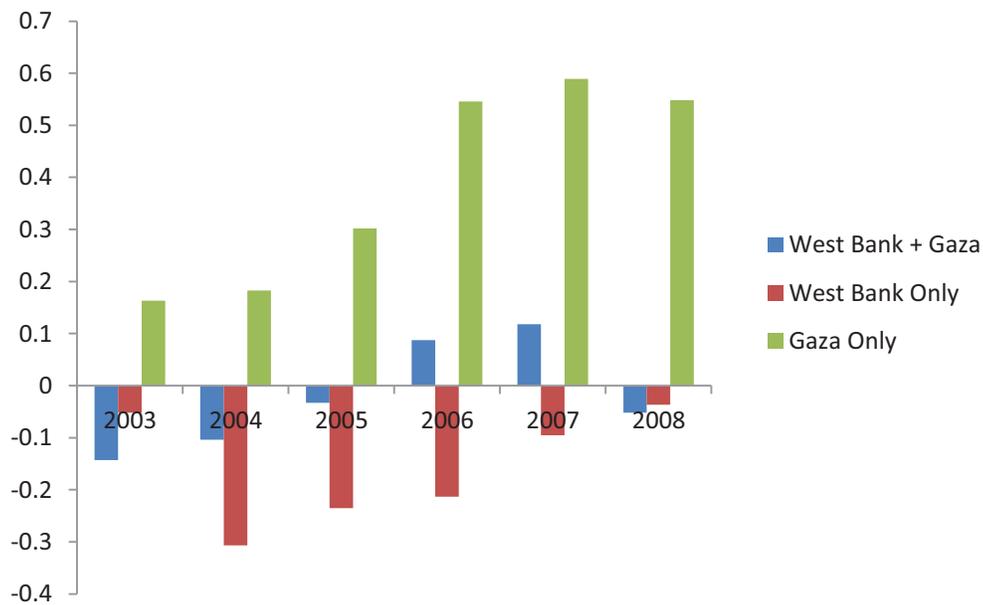
broadly competitive with the private sector. However, across-the-board pay increases that the PA has been granting are both unnecessary (given that attrition rates within the PA are very low) and inefficient because they do not target the types of skilled workers that the government needs to recruit.¹³¹

Figure 22. Wage Gaps between Government and Regular Private Sector Jobs



Source: World Bank. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*, page 19.

Figure 23. Adjusted Wage Gaps between Government and Regular Private Sector Jobs, Separately for the West Bank and Gaza



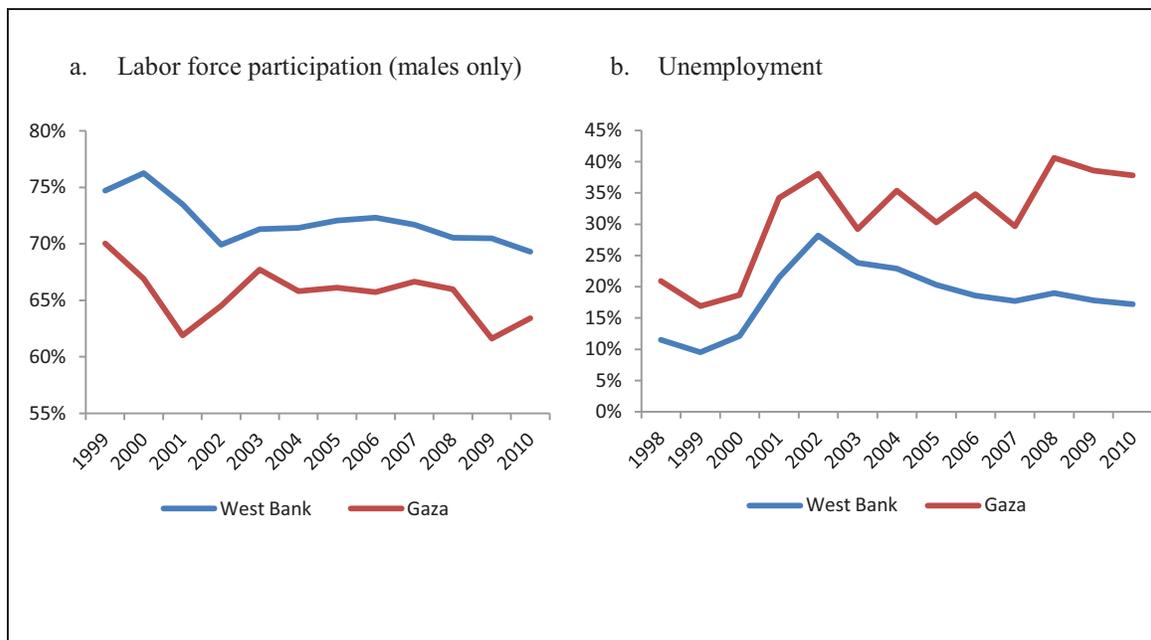
Source: World Bank. *Mobility Restrictions and Labor Market Dynamics in Conflict Affected West Bank and Gaza*.

¹³¹ World Bank 2007c.

Box 3. Gaza compared to the West Bank

In recent years, Gaza has done markedly worse than the West Bank along all measurable labor market dimensions. This is evident when looking at unemployment for the West Bank and Gaza separately (see Figure 24), and when comparing the two regions' labor force participation rates. In Gaza, wages are lower, regular private sector jobs are scarcer than in the West Bank, and those with jobs report high rates of absence from work (mostly due to "temporary stoppages") in recent years. In 2006, about 10 percent of the employed in Gaza reported having missed at least one full day of work in the past week. By 2009, this proportion was higher than 35 percent. Indicators of labor market 'discouragement' are also worsening. In 2006, 16 percent of jobless Gazans who responded to the PCBS labor force survey and said that they were available for work also reported that they had not actively sought work in the past week, largely because they were "discouraged to find a job" or were still awaiting the result of past job applications. By 2009, this rate was at nearly 20 percent.

Figure 24. Labor Force Participation and Unemployment: West Bank versus Gaza



Source: PCBS Labor Force Survey.

4.14. *While there does not appear to be a public sector wage premium in the West Bank, there is a large premium to working for international organizations.* In both the West Bank and Gaza, wages in the international organizations/NGO sector (which includes UN jobs) have been estimates to be at least 20 percent higher than private sector wages even after accounting for differences in characteristics such as education and age. This large premium for working in international organizations adds additional pressure on the PA and the private sector by attracting the most capable employees.

Poverty

4.15. *The high unemployment and falling wages have led to high levels of poverty.* In 2009, the latest year for which figures are available, about 23 percent of the population in WB&G lived below the poverty line. This was a four percentage point reduction from five years earlier. However, this encouraging trend masks large fluctuations and the fact that poverty rates are almost twice as high in Gaza as in the West Bank. While poverty has been steadily declining in

the West Bank, in Gaza it has yet to return to the 2004 level despite a sharp decline between 2007 and 2009. Following the closure of Gaza and the devastation of the private sector, the poverty headcount jumped from 30 percent in 2006 to nearly 50 percent in 2007. However, large increases in aid flows to Gaza led the poverty rate to fall sharply in 2009 to around 34 percent.

Table 16. Poverty Head Count Rate 2004-2009

	2004	2005	2006	2007	2009	%Change (2004-09)
WB&G	25.9	24.2	24.0	31.0	22.6	-3.3
West Bank	23.4	21.5	20.1	20.2	16.2	-7.2
Gaza	30.2	28.5	30.0	49.5	33.7	3.5

Source: World Bank. Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza based on PCBS Palestinian Expenditure and Consumption Survey data.

4.16. *Though poverty rates have fallen, the Palestinian population remains highly vulnerable to poverty.* In the West Bank 13 percent and in Gaza 16 percent of the population consumes no more than 1.2 times the poverty line. In other words, a shock that reduces consumption by 20 percent will dramatically increase poverty. Such a shock could easily come from deterioration in the security environment that leads to more closures or a significant fall in aid. Gaza is particularly vulnerable to a fall in aid. External assistance has directly supported consumption by funding the United Nations' and other relief efforts and more importantly funding the PA's payroll and social transfers. The PA pays more than 60,000 employees in the Gaza and provides social assistance to another 45,000 households. Anything that threatens these flows could have a profound impact on poverty in Gaza.

Employability

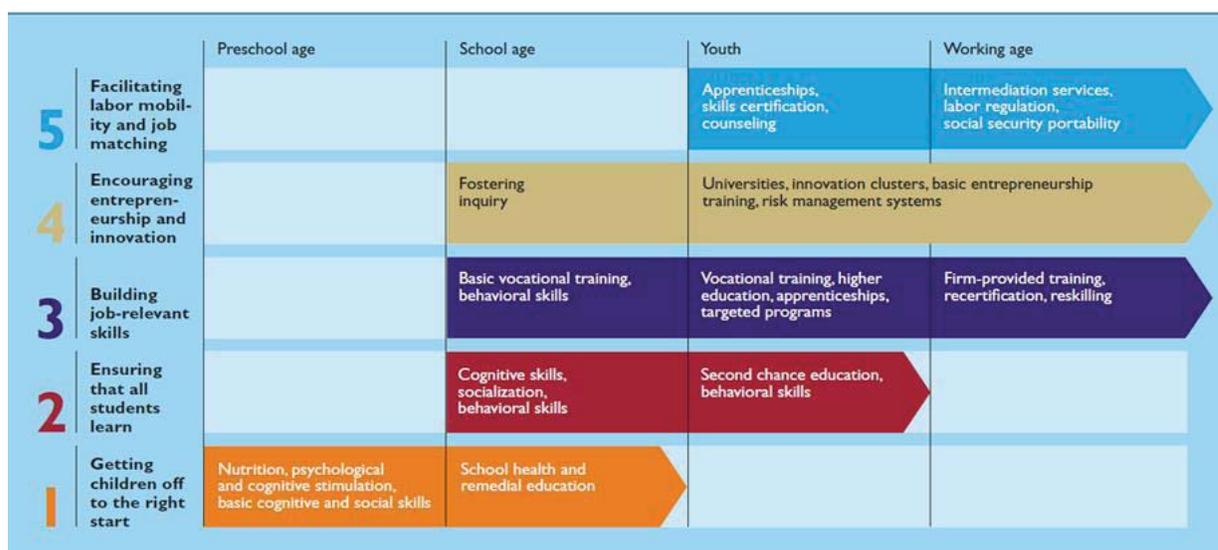
4.17. *World-wide, skills are at the core of improving individuals' employment outcomes and increasing countries' productivity and growth.* Making the most effective use of workers – using all of them, and using them to their greatest productivity – is vital to creating a sustainable economy in WB&G. While insufficient demand for workers remains a problem globally and particularly in WB&G, persistently high unemployment rates are also a function of skills mismatches where workers inadequately equipped for the demands of employers (World Bank 2010). This is sometimes because of insufficient education but also because education and training did not provide the skills that employers need. As countries become richer and move up the value-added chain, especially moving into high value added services, the skills demanded will change. Labor productivity will increasingly depend on high-level cognitive skills (such as analysis, problem solving, and communication) and behavioral skills (such as discipline and work effort). However education systems may not be in a position to provide them. There is also evidence that as middle-income countries become richer, more employers consider skills an important constraint on business development. A complaint that is echoed by many Palestinian firms, particularly exporters and other high productivity enterprise.

4.18. *This section draws on a simple conceptual framework that can help policymakers think through the design of systems to impart skills that enhance productivity and growth in WB&G.*¹³² The framework consists of five interlinked steps (see Figure 25):

¹³² World Bank 2010.

- **Step 1. Getting children off to the right start** – by developing the technical, cognitive, and behavioral skills conducive to high productivity and flexibility in the work environment through early child development (ECD), emphasizing nutrition, stimulation, and basic cognitive skills. Research shows that the handicaps built early in life are difficult if not impossible to remedy later in life and that effective ECD programs can have a very high payoff.
- **Step 2. Ensuring that all students learn** – by building stronger systems with clear learning standards, good teachers, adequate resources, and a proper regulatory environment. Lessons from research and ground experience indicate that key decisions about education systems involve how much autonomy to allow and to whom, accountability from whom and for what, and how to assess performance and results.
- **Step 3. Building job-relevant skills** – by developing the right incentive framework for both pre-employment and on-the-job training programs and institutions (including higher education). There is accumulating experience showing how public and private efforts can be combined to achieve more relevant and responsive training systems.
- **Step 4. Encouraging entrepreneurship and innovation** – by creating an environment that encourages investments in knowledge and creativity. Emerging evidence shows this demands innovation-specific skills (which can be built starting early in life) and investments to help connect people with ideas (say, through collaboration between universities and private companies) as well as risk management tools that facilitate innovation.
- **Step 5. Facilitating labor mobility and job matching** – by moving toward more flexible, efficient, and secure labor markets. Avoiding rigid job protection regulations, while strengthening income protection systems combined with information and intermediation services to workers and firms is the final complementary step in transforming skills into actual employment and productivity.

Figure 25. Implementing STEP as an Integrated Set of Programs Across Workers' Life Cycles



Source: World Bank. 2010a. *Stepping up skills for more jobs and higher productivity*, page 3.

Step 1. Getting children off to the right start

4.19. *In terms of indicators of early childhood nutrition, WB&G is an outstanding performer.*¹³³ Among children under the age of 5, only 11.5 percent suffer from stunting (low height for age) and a mere 1.4 percent from wasting (low weight for height). In the average middle income country¹³⁴, 30 percent of children are stunted, which is more than three times the figure for WB&G. Performance in terms of wasting incidence is even more compelling: one in 10 children in a middle income country suffers from wasting, a rate that is 7 times lower in WB&G. Thus, judged by anthropometric outcomes, WB&G performs better than most other countries in the world including the Middle East region, irrespective of income. In addition, overall incidence rates of stunting and wasting have been relatively stable over time. Looking across territories, the West Bank tends to have lower incidence rates than Gaza. Wasting rates are comparable and show a similar evolution over time. Stunting, however, has increased relatively more in Gaza, reaching 14 percent in 2006, which is a concern in light of the economic crisis that began in Gaza in 2007, a year for which comparable data are not available. Nevertheless, these rates remain very low by international standards. The outstanding nutrition results for WB&G are consistent with other indicators of child health and nutrition. For example, vaccination rates in WB&G exceed those of the average middle-income country and there is also near-universal coverage of prenatal care.

4.20. *Apart from nutrition and healthcare, the skills developed in early childhood – from birth to primary school entry – form the basis of future learning and labor market success.* ECD enhances a child's ability to learn, to work with others, to be patient, and to develop a wide range of other foundational skills for formal learning and interactions in the school years and beyond. A failure to develop these skills can lead to long-term and often irreversible effects on education, health, and productive earnings, imposing significant costs for both individuals and societies. Children who participate in quality ECD programs have higher cognitive development and overall school readiness on primary school entry, lower repetition and dropout rates in the early grades, greater learning in school, and higher school completion rates. ECD services can be delivered through various channels, but preschools are perhaps the best understood delivery mechanism.

¹³³ World Bank. 2011. *Coping with Conflict? Poverty and Inclusion in the West Bank and Gaza*, Social and Economic Development Group, Middle East and North Africa Region.

¹³⁴ In 2011, the World Bank classifies countries with a 2009 gross national income per capita in the range of US\$996-US\$12,195 as middle income.

Figure 26. Preschool Gross Enrollment Rates (%), 2000-2009



Source: World Development Indicators.

4.21. *ECD interventions are among the most cost-effective investments a country can make in its people and ECD investments should be a top priority for efforts to promote employment and productivity later in life in many countries.* Yet the rate of progress in increasing enrollment in preschool education in the Arab world in general has been uneven.¹³⁵ Some countries made initial advances in the first half of the 2000s while others began to progress more recently. Several countries, including Kuwait, Morocco and WB&G, registered declines in the preschool gross enrollment rates from 1999 to 2008. For WB&G in particular, preschool enrollment rates dropped precipitously between 2000 and 2003, and while they have been increasing more recently, the 2009 enrollment rate remains lower than the rate in 2000. In addition, the gap between the preschool enrollment rate in WB&G and middle income countries in general is widening.

Step 2. Ensuring that all students learn

4.22. *Schools are expected to teach basic competencies that enable students to acquire the skills that will help them make informed life choices and will later be valued by employers and useful for self-employment.* But information on learning outcomes indicates that schools in many developing countries are failing to teach foundational cognitive skills, much less the “expert thinking and complex communication” and occupational skills needed to function effectively in the modern labor market.¹³⁶ Thus, if students are not actually learning, high enrollment rates will not necessarily translate into productivity gains for workers or economic growth. The evidence indicates that, for individuals, one additional year of schooling raises earning 10-20 percent in low-income countries, and better quality schooling raises earnings even more. Improving the quality of education improves students’ performance on standardized tests in the short run and labor market access in the medium run – and contributes to sustained economic growth in the longer run.¹³⁷

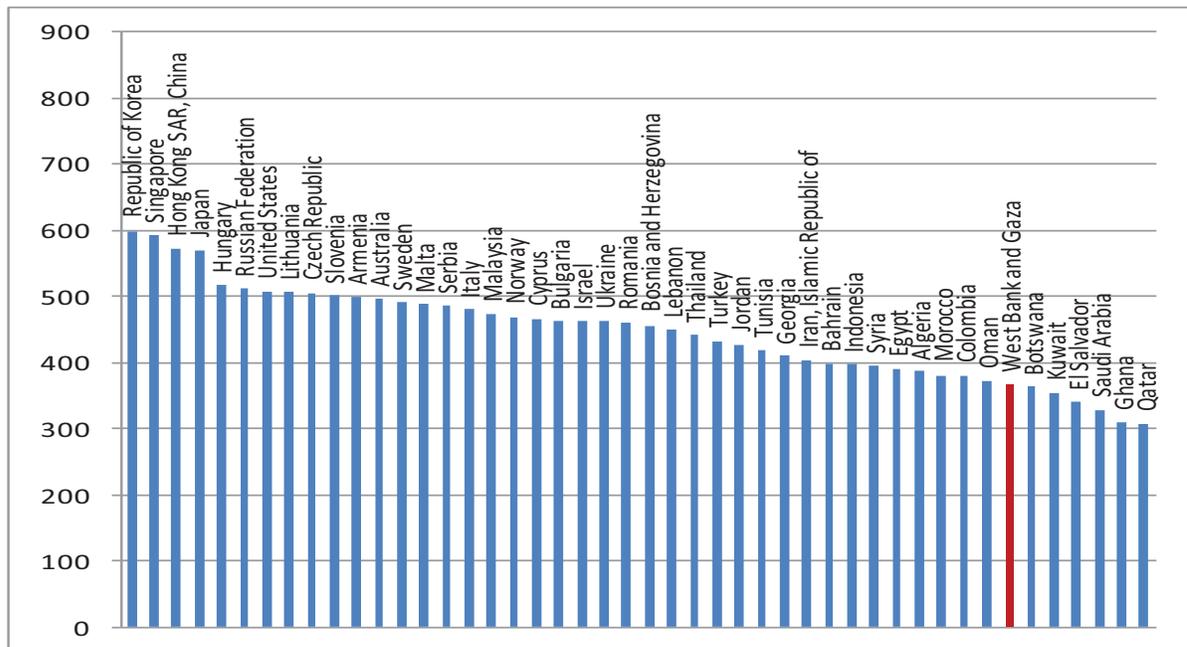
¹³⁵ UNESCO 2011.

¹³⁶ World Bank 2010a.

¹³⁷ World Bank. 2010a.

4.23. *In WB&G, school enrollment is consistently high over time with an average of 90 percent enrollment for the school age population. Access to primary education is near universal – all children, whether girls or boys, whether in Gaza or West Bank, enroll in school between the ages of 6 to 12.* However, differences between girls and boys begin to emerge in the teenage years, especially among late teens: at 17 years of age, rates of enrollment are more than 10 percent higher for girls than for boys. Student absenteeism rates – the proportion of children who miss school days among enrolled children – are consistently higher in Gaza than in West Bank for all ages and gender. Nonetheless, the secondary gross enrollment rate in WB&G is on the order of 20 percentage points higher than the rate in the average middle income country, and 15 percentage points higher than the average rate in the MENA region.¹³⁸

Figure 27. Comparative TIMSS Math Scores, 2007



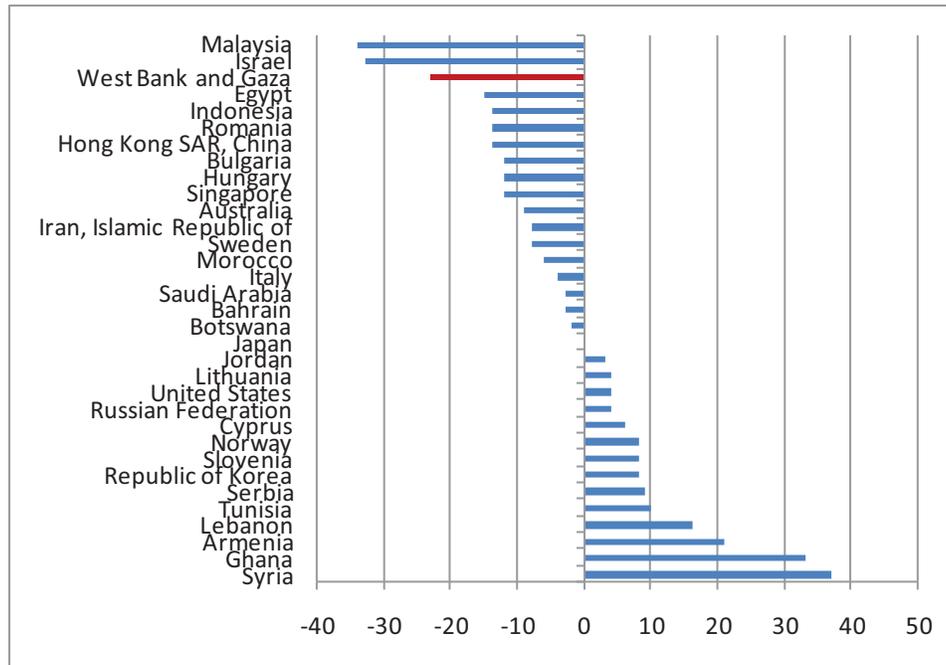
Source: Background analysis, Brodmann, S., E. Cuadra, M. I. Allouche, and S. A. Hillis. 2012. *From Education-to-Work: Opportunities and Challenges in the West Bank and Gaza*. World Bank Quick Notes Series No. 55.

4.24. *Yet access to education does not provide the full story, as WB&G performs poorly on international student assessments, and worryingly, the performance exhibits a negative trend.* WB&G participated in both 2003 and 2007 in the international comparative student assessment Trends in International Mathematics and Science Study (TIMSS), which is designed to help countries all over the world improve student learning in mathematics and science. Educational achievement data were collected from eighth graders to provide information about trends in performance over time together with extensive background information to address concerns about the quantity, quality, and content of instruction. Around 50 countries participated in both years (see Figure 27) and WB&G ranked low in terms of math performance – even when compared to other MENA countries such as Jordan, Syria, Egypt, Algeria, and Morocco. In addition, (Figure 28) WB&G had actually scored better in the 2003 than in the 2007 TIMSS. Instead of demonstrating an improvement in education quality over those 4 years (as was the case for

¹³⁸ Based on data from the World Bank’s EdStats database, available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTEDUCATION/EXTDATASTATISTICS/EXTEDSTATS/0,,menuPK:3232818~pagePK:64168427~piPK:64168435~theSitePK:3232764,00.html>

Jordan, Lebanon, and Syria), WB&G showed a deterioration. Indeed, Jordan increased science scores by a sizeable 30 points in the TIMSS between 1999 and 2007, through a cluster of reforms that included international benchmarking, along with national testing, curricular reform, teacher training, and regular feedback between research and policy.

Figure 28. Change to TIMSS Scores, 2007 Relative to 2003



Source: Background analysis, Brodmann, S., E. Cuadra, M. I. Allouche, and S. A. Hillis. 2012. *From Education-to-Work: Opportunities and Challenges in the West Bank and Gaza*. World Bank Quick Notes Series No. 55.

Step 3. Building job-relevant skills that employers demand

4.25. *Job-relevant skills refer to a set of competencies valued by employers and useful for self-employment, including skills relevant to the specific job of the worker as well as other skills that enhance his or her productivity.* These other skills include¹³⁹:

- a. *Problem-solving skills* or the capacity to think critically and analyze;
- b. *Learning skills* or the ability to acquire new knowledge (“learning to learn”), distill lessons from experience, and apply them in search of innovations;
- c. *Communication skills*, including reading and writing, collecting and using information to communicate with others, and using a foreign language and information and communication technologies (ICTs) as communications tools;
- d. *Personal skills* for self-management, making sound judgments, and managing risks;
- e. *Social skills* to collaborate with and motivate others in a team, manage client relations, exercise leadership, resolve conflicts, and develop social networks.

¹³⁹ World Bank. 2010. *Stepping up skills for more jobs and higher productivity*.

4.26. ***A central and paradoxical fact of the WB&G labor market is that employers find it difficult to hire qualified job applicants, despite the large number of unemployed youth.*** The mismatch between skills offered by a large pool of unemployed youth, including many with university degrees, and those demanded by the labor market, suggests that despite reforms to the educational system, much work remains to be done. According to the private sector in WB&G, education institutions teach most topics through traditional methods of lectures, memorization, and examinations, with less emphasis on critical thinking, problem-solving, and hands-on learning experiences. In other words, many in the private sector do not believe that the current system of education is relevant to the modern demands of the workforce.¹⁴⁰ Recent focus group discussions clearly identified the relevance of skills for the needs of the labor market as well as the level of competencies and experience of graduates to be among the most important constraints to employment for youth.¹⁴¹ The most often cited skills mismatches were: limited enrollment in technical specializations; limited attention to vocational education; large number of graduates in the same specializations; and lack of life skills.

4.27. ***There are basically two junctures where the training that builds job-relevant skills occurs: before employment and on-the-job.*** One of the most important sources of pre-employment skills development is public institutions that offer technical and vocational education and training (TVET). However, as in many countries, the TVET system in WB&G is criticized for producing the same graduates year after year with little regard to labor market signals and the skills described above. In addition, the tracking process used in the education system has negative repercussions for vocational education, which is viewed as the most inferior sort of education where the least capable students are enrolled. Once students complete the 10th grade, they may enroll in one of three tracks depending on their grades: science, literature and humanities, or TVET.¹⁴² The highest grades are required for the sciences track, followed by the literary track and then the vocational track. Students in higher tracks may switch to lower tracks but it is not possible to move up. Graduates of the science track are usually allowed to pursue any concentration at university or college. However, graduates of the literary track, even the highest performing ones, are restricted from a number of subjects at the post-secondary level, including natural sciences, mathematics, engineering, and medicine. Vocational education graduates normally end up in vocational colleges and are restricted from pursuing a large group of subjects. Because of this strict tracking system and a perception that TVET is only for the least capable students, after tenth grade only about 5 percent of students chooses the TVET track for the remainder of their secondary schooling.

4.28. ***Though TVET represents an important alternative to traditional secondary school or university education, and has in recent years embraced more rigorous and professionally oriented curricula, it does not begin to reach its potential.*** First, as in other areas of WB&G education, teaching techniques in TVET remain relatively formal and traditional, not yet reflecting the more hands-on, inquiry-based approach to learning that modern programs need. Second, vocational and technical schools are, relative to traditional institutions, expensive to establish and maintain. Because of this high cost, technology education is falling behind and students are not well prepared for the changes in employer demands that will accompany greater access to internet and technology-related services. There is some cooperation between TVET institutions and private enterprise in the WB&G. In certain areas, such as automobile

¹⁴⁰ USAID. 2010. *BizCLIR: For the Palestinian Economy, Commercial Legal and Institutional Reform Diagnostic of the West Bank*, Booz Allen Hamilton under the Business Climate Legal and Institutional Reform (BizCLIR) project.

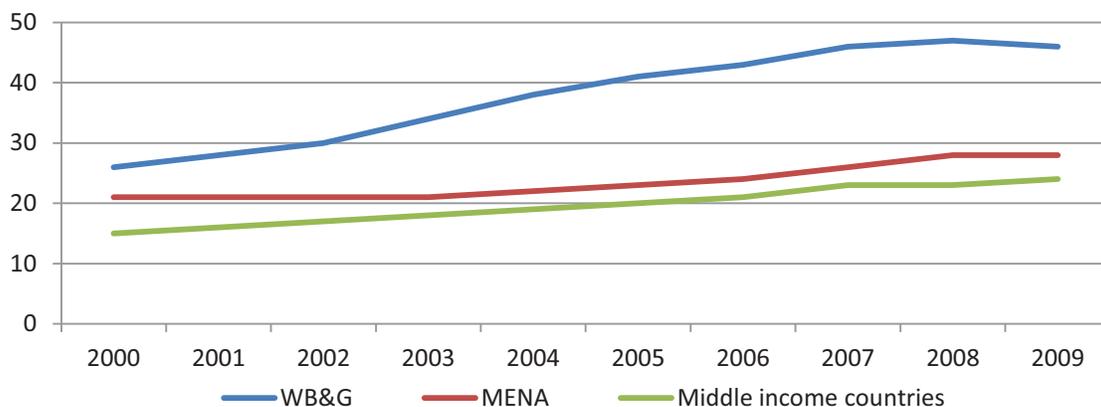
¹⁴¹ World Bank 2011f.

¹⁴² Sayre and al-Botmeh 2009.

maintenance and hotel management, apprenticeships are organized between schools and TVET students. However, in general this link is weak. Thus, as a part of the continued emergence of TVET, there should be considerable strengthening of internship and apprenticeship opportunities.

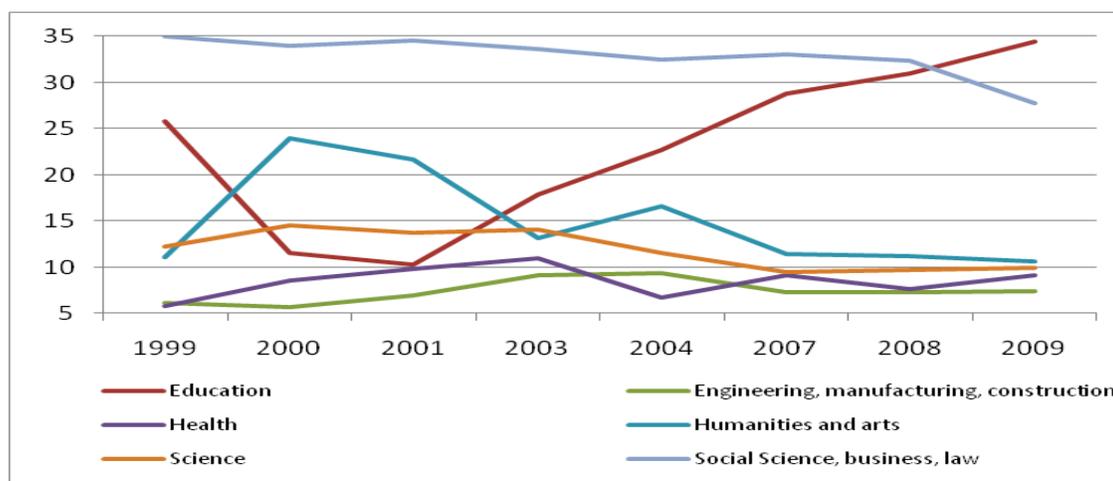
4.29. *WB&G exhibit, on the other hand, remarkably high enrollment rates in tertiary education as a result of a surge in enrollments in the last decade.* As Figure 29 shows, enrollment rates in WB&G have increased dramatically in recent years and are well above average rates in MENA and in middle income countries in general. Of course, tertiary education can help countries become more globally competitive by developing a skilled, productive, and flexible labor force and by creating, applying, and spreading new ideas and technologies. However, it appears that in many cases young people are pursuing additional education because of a lack of job opportunities and the subjects they study may not be the ones needed by the private sector. The composition of university subjects amongst the tertiary education graduates is heavily skewed towards education, social sciences, business, and law (see Figure 30). Indeed, the growth in recent years in the numbers of tertiary students studying education is phenomenal. By contrast, less than 15 percent of graduates studied sciences or engineering, and the share is declining.

Figure 29. Comparative Trends in Enrollment in Tertiary Education



Source: World Development Indicators and author's calculations.

Figure 30. Distribution of Tertiary Education Graduates, by Subject, 1999-2009



Source: Background analysis, Brodmann, S., E. Cuadra, M. I. Allouche, and S. A. Hillis. 2012. *From Education-to-Work: Opportunities and Challenges in the West Bank and Gaza*. World Bank Quick Notes Series No. 55.

4.30. *On-the-job training can contribute much to the stock of human capital, with estimates ranging from a quarter to half of all human capital formation in the United States.*¹⁴³

However, it tends to favor workers with higher levels of educational attainment and occurs more frequently in larger firms and in more dynamic, export-oriented sectors. Smaller firms in most countries are reluctant to provide training on the job for fear of losing trained workers to other firms and for lack of access to credit and information about training. For most large and well-established firms, on the other hand, on-the-job training is often so productive that they invest in it with little government intervention. The bias against small firms investing in training often puts countries in a paradox, with firms complaining about skill shortages while also being unwilling or unable to upgrade their own workers' skills through on-the-job training. This problem is particularly relevant in WB&G as discussed in the chapter on private sector development.

Step 4. Encouraging entrepreneurship and innovation

4.31. *Knowledge produces growth – as the world becomes more globalized, more reliant on technology, and more service oriented, a country's knowledge base will determine its growth path.*¹⁴⁴

Thus, it is important to simultaneously develop human capital, innovations systems, ICT infrastructure, and institutional regimes. This relationship between human development and private sector development is symbiotic, because a key aspect of innovation is not just developing new products and processes but also the ability of individuals to be entrepreneurial in bringing them to good use. Innovation is a process whereby people or groups of people with an entrepreneurial mindset (organizations, enterprises) develop new ideas or absorb and adapt existing ones. It is not only about scientists in laboratories, theoretical science, or new discoveries. It is also about building the capacity to find solutions to practical everyday development problems.

4.32. *Innovation cannot realize its full potential if innovators are isolated, so that greater collaboration between educational institutions and the private sector is key.* Yet, education and

¹⁴³ World Bank. 2010. *Stepping up skills for more jobs and higher productivity*.

¹⁴⁴ World Bank. 2010. *Stepping up skills for more jobs and higher productivity*.

business cooperation in WB&G is not yet institutionalized and remains based on individual endeavors.¹⁴⁵ Education and business cooperation faces several challenges such as: high fragmentation of representative organizations for the private and academic sectors; the structure of the private sector (mainly family-owned small and medium enterprises); overlapping training programs provided by education institutions; a dispersed education and training system in terms of types of institution, their objectives, and the bodies responsible for them; and a lack of tracer studies that follow graduates as they seek employment. Business can play a crucial role in the identification of skill needs, in the implementation of apprenticeship schemes, and in the design and running of sector-specific training centers. Consequently, education institutions should become more proactive in involving business in the various phases of training programming, design, implementation, and evaluation, including participation in the scientific councils.

4.33. *A recent report highlights three main areas for private sector involvement: vocational education and training, university education, and work readiness.*¹⁴⁶ For TVET programs, close involvement with the industry in areas such as curriculum content, training, and internship opportunities is needed, to ensure up-to-date curricula in line with industry requirements. For university education, there is substantial room to better tailor the educational curriculum to the needs of youth and private employers. The university leadership should actively seek industry involvement in shaping the practicum elements of degree programs; faculty needs to have an appropriate mix of academic theory and practitioner skills; students should experience full-time work placements and internships during their studies, facilitated by their universities; and the university should consider offering programs to part-time students through evenings/week-ends or on-line options, in order to expand its reach. The third area is with students who have completed secondary or post-secondary education but need to increase their ability to perform their jobs. Addressing this issue requires focusing on either building skills valued by employers (i.e. applied skills, soft skills, or language skills), or on equipping students with the entrepreneurial skills required for self employment.

Step 5. Facilitating labor mobility and job matching

4.34. *Even if individuals have the “right” skills to be productive and creative, employment and productivity can be hampered if labor markets do not function well.*¹⁴⁷ Employers need the flexibility to manage their human resources and find workers with the skills they need. Workers need to be able to move freely between jobs and find the ones that put their skills to best use. Youth entering the labor market for the first time find it particularly challenging to find suitable employment because their lack of work experience and professional references make it difficult to signal their skills to potential employers. Government can facilitate labor mobility and job searches through various interventions, including a better combination of job and income protection policies and more proactive approaches to employment services and skills certification. However, governments should avoid the combination of rigid job protection regulation and weak income protection systems, which are detrimental to labor mobility. Labor Markets in WB&G do not appear to be hampered by excessive labor regulations however the government does not provide any services to assist job seekers. Thus, they rely heavily on inefficient methods such as personal connections to find employment.¹⁴⁸

¹⁴⁵ European Training Foundation 2010.

¹⁴⁶ IFC and IDB 2011.

¹⁴⁷ World Bank. 2010. *Stepping up skills for more jobs and higher productivity.*

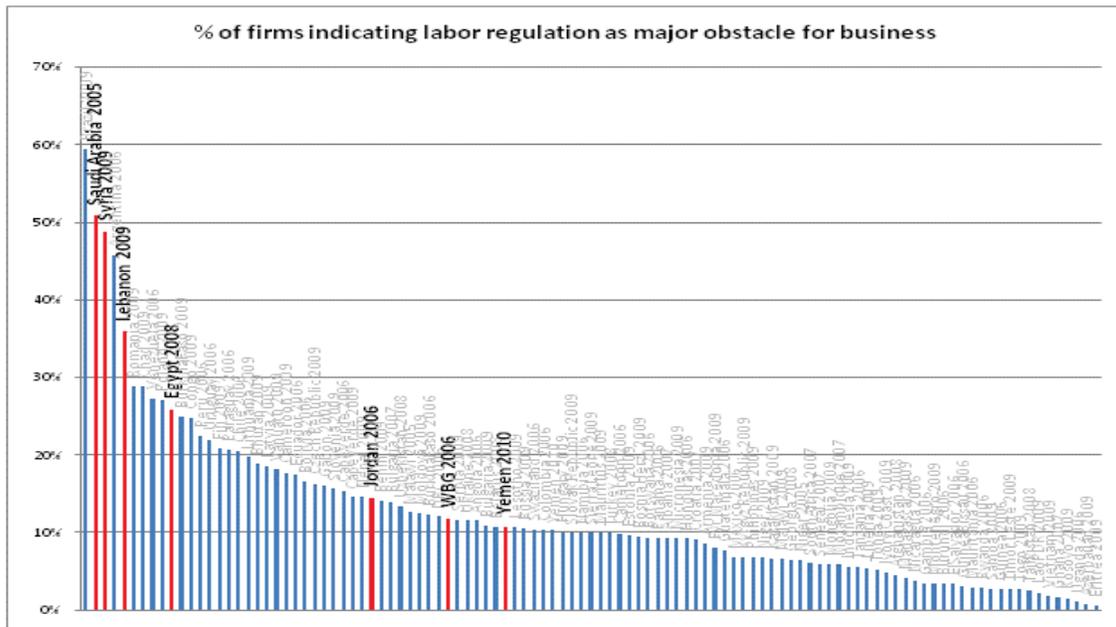
¹⁴⁸ USAID 2010.

4.35. ***Youth in WB&G face a significant challenge in entering the labor market as indicated by the duration of the education-to-work transition.*** An OECD indicator compares the age at which 50 percent of the population has completed education with the age at which 50 percent has found employment, with the difference in ages providing the average time it takes to transition from education to work. The labor market in WB&G is so constrained, however, that for several population groups employment never reaches 50 percent and a large proportion are simply not in the labor force, rendering this indicator less useful.¹⁴⁹ Utilizing instead a modified indicator that relies on the proportion actually entering employment as the upper ceiling, the transition rates are: (i) 3 years for male youth in the West Bank (median graduation age 18 and median age entering employment 21); (ii) 4 years for males in Gaza (graduation at age 20 and employment at age 24); (iii) 2 years for females in the West Bank (ages 21 and 23); and (iv) 1 year for females in Gaza (ages 22 and 23). Different patterns of employment are observed depending on the level of education and gender. Thus, the vast majority of university graduates who found work in the 6 months prior to data collection joined the public sector – fully 70 percent of university educated women were hired into the public sector (mainly education). Conversely, the majority of newly hired low-skilled Palestinians joined the manufacturing and construction sectors

4.36. ***Considering the relevant Doing Business indices, i.e. difficulty of hiring, rigidity of hours, difficulty of redundancy, rigidity of employment, and redundancy costs, only the latter stands out as relatively prohibitive at 91 weeks of the salary*** (see Figure 32). The relatively large size of the redundancy package partially reflects the absence in WB&G of a system of social security providing a safety net. Of course, certain reforms remain necessary with respect to employing workers in a manner that enhances private sector growth; in particular modification and clarification of the Palestinian Labor Law to both reflect the realities of a modern economy and better inform employers and workers about their respective rights and responsibilities.¹⁵⁰

¹⁴⁹ World Bank. March 2011e. *From Education-to-Work: Exploring Opportunities and Challenges for West Bank and Gaza.*

Figure 31. Percent of Firms Indicating Labor Regulation as Major Obstacle for Business



Source: Individual ICA surveys for MENA countries and standardized ICA data 2006-2010 for other countries.

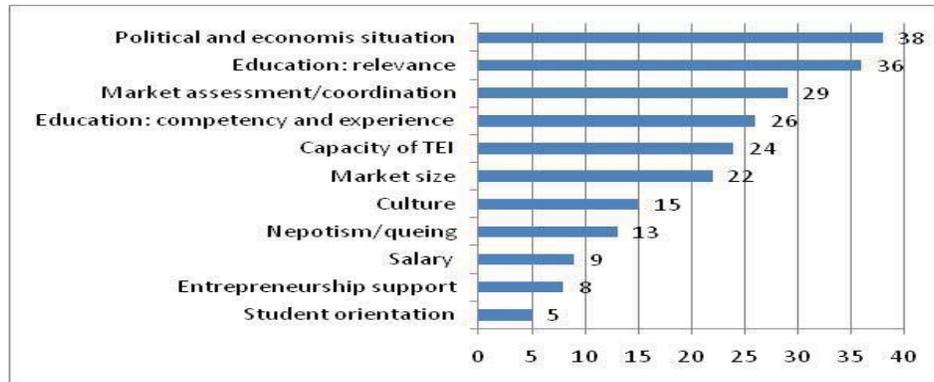
4.37. *There are few resources to assist job seekers in WB&G and many rely on an inefficient process of using personal connections.* In a survey conducted by the Centre for Development Studies in September 2009 that asked students how they would seek employment after graduation, only 10 percent of students stated that they would use a job matching service, while 50 percent planned to use more traditional methods, e.g. newspapers, and a further 30 percent stated that they would use private connections such as family or friends. Similarly, the PCBS 2006 Conditions of Graduates Survey found a lack of personal connections, cited by over half the respondents, as one of the top three reasons why they had difficulty finding a job. Recent graduates were also asked to rate the impact of several factors in finding a job on a scale from “very important” to “important” to “not important”. Similar to the responses concerning why they were delayed in finding a job, 58 percent of respondents said that personal connections were very important in getting a paid job after graduation. Indeed, the perception of the need for adequate connections is a common one, and nepotism was cited as a problem by the business community in particular.¹⁵¹ Relying on contacts is inefficient since individuals see only a small part of the jobs offered. While some might have the “right contacts”, those with weak social networks can be severely constrained in their choices.

4.38. *More recent data on the constraints to the education-to-work transition indicate a possible decline in the importance of nepotism to secure jobs.* Thus, focus group discussions held in 2011 probed into these constraints and, as Figure 33 shows, nepotism comes further down the list, with the main constraints cited being related to the political situation first and foremost and relevance of education next. In addition, a recent report on governance in WB&G cites the

¹⁵¹ The business community in particular cited nepotism as an issue in interviews with Paltrade. Specifically, the Palestinian Businessmen's Association complained in July 2009 that "the business sector may be hiring from families but instead they should have interview committees and procedures: all the candidates should go through the right processes to ensure that the best candidate gets the job. It is especially necessary for small businesses who are more likely to employ within the family but need to select most carefully to ensure that their performance is more effective" (CDS 2010, page 33).

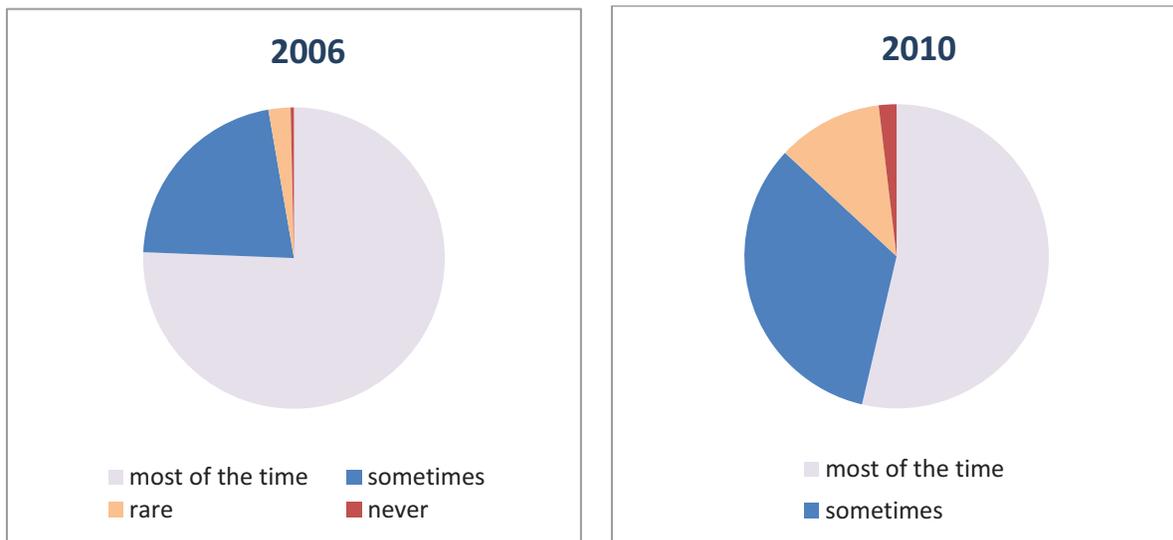
importance accorded to nepotism by survey respondents in terms of securing public sector employment in particular (see Figure 34).¹⁵² Yet here again, there is a decline in the perceived incidence of nepotism in this regard between 2006 and 2010. In other words, though nepotism continues to play a significant yet inefficient role in facilitating job searches, recent evidence points to a decline in its importance. The over reliance on personal connections could be further reduced by the establishment of employment services. They would help address the problems of poor information and make it easier for workers and firms to match jobs with workers who have the relevant skills.

Figure 32. Constraints to Education-to-Work Transition



Source: Background analysis, Brodmann, S., E. Cuadra, M. I. Allouche, and S. A. Hillis. 2012. *From Education-to-Work: Opportunities and Challenges in the West Bank and Gaza*. World Bank Quick Notes Series No. 55, page 3.

Figure 33. Perceived Incidence of Wasta/Nepotism in the Public Sector - 2006 and 2010



Source: World Bank. 2011c. *West Bank and Gaza: Improving Governance and Reducing Corruption*, page 11.

¹⁵² World Bank. 2011c. *West Bank and Gaza: Improving Governance and Reducing Corruption*.

Next Steps

4.39. A future Palestinian state will be small and resource poor. Its main option for economic growth will be to build upon its most important resource; the skills and entrepreneurship of its people. The PA has been remarkably successful in providing basic services to its citizens and has ensured that there are high levels of school attendance and literacy. However, the education system is not providing its graduates with the types of skills required by a modern economy. Going forward, the Palestinian education system will need to improve quality and better link education to the needs of the private sector.

- Ensure that high government wages, especially for low-skilled employees, do not distort the private sector market.
- Continue to support the export of labor to Israel, while understanding that its importance will decline over time. In addition, the PA should seek agreements with neighboring and Gulf countries to accept more Palestinian labor, especially skilled labor.
- Reverse the decline in preschool enrollment rates, which would have important positive effects future learning and labor market success, as well as on female labor force participation rates. However, before initiating reform in this sub-sector, it is necessary to conduct a thorough analysis to better understand the current availability of pre-schools as well as the current institutional and governance structures.
- Focus intensively on the quality of education provided and basic learning outcomes achieved, while maintaining high enrollment rates in basic and secondary education. In this regard the Ministry of Education and Higher Education has already identified improving the quality of education as its primary focus in its Strategic Plan 2008-12, including laying out key priority areas.
- Implement the Ministry of Education and Higher Education's Strategic Plan 2008-12, which calls for improving the relevance of education to the modern demands of the workforce by supporting innovative programs to reduce reliance on traditional methods of instruction and placing more emphasis on critical thinking, problem-solving, and hands-on learning experiences.
- Improve the transition from education to work by providing job matching services that are readily accessible to graduates.
- Initiate programs to better link educational institutions and the private sector. Such programs include apprenticeships and other ways to involve the private sector in the development of student skills. Seek private sector participation when designing the study programs for tertiary education institutions.

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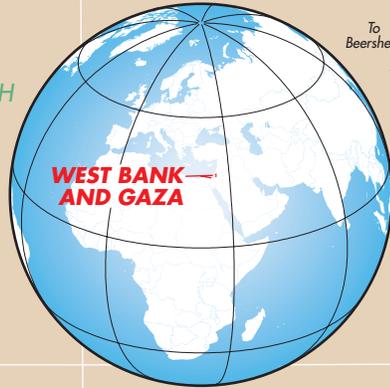
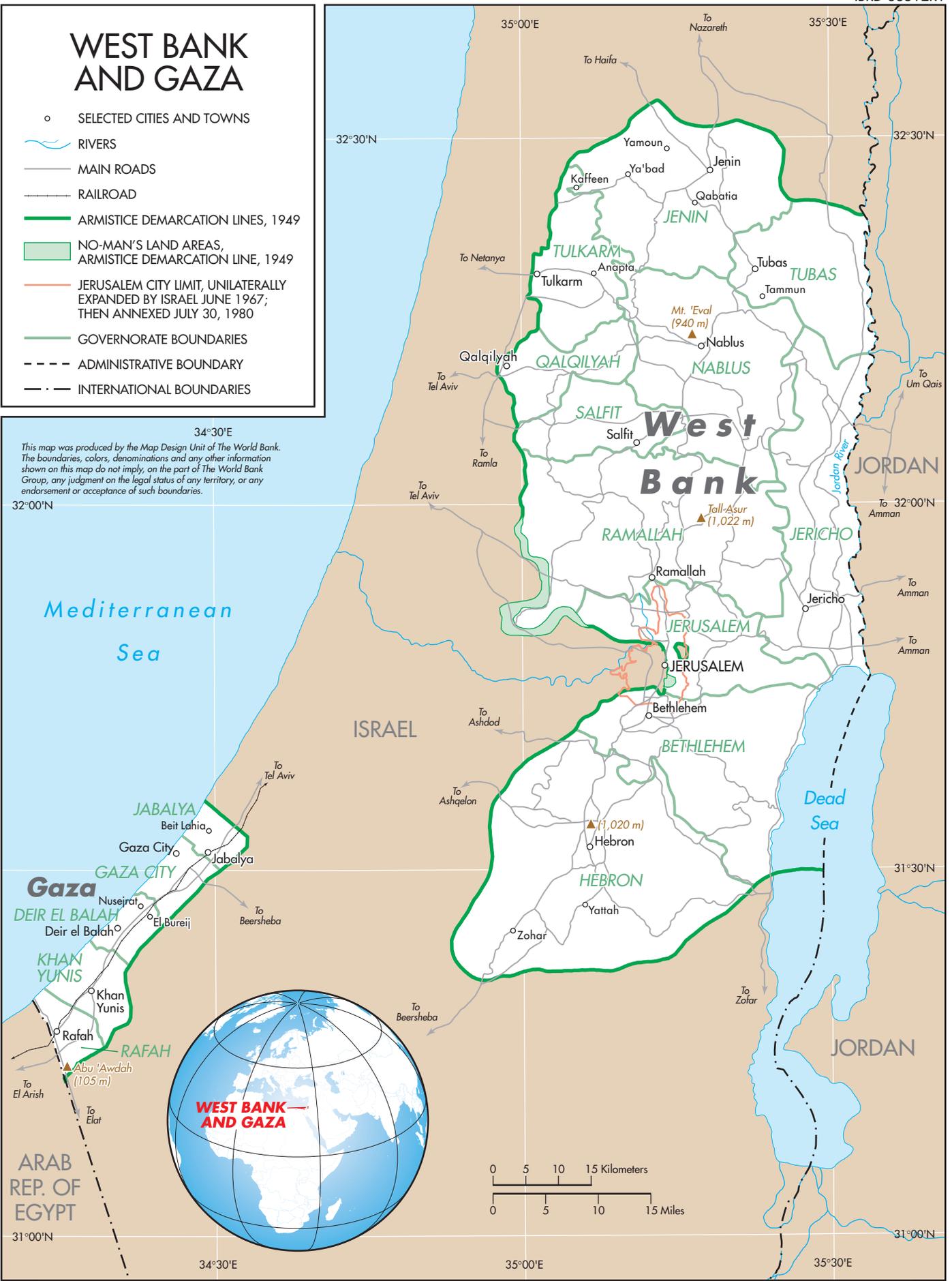
WEST BANK AND GAZA

- SELECTED CITIES AND TOWNS
- RIVERS
- MAIN ROADS
- RAILROAD
- ARMISTICE DEMARCATION LINES, 1949
- NO-MAN'S LAND AREAS, ARMISTICE DEMARCATION LINE, 1949
- JERUSALEM CITY LIMIT, UNILATERALLY EXPANDED BY ISRAEL JUNE 1967; THEN ANNEXED JULY 30, 1980
- GOVERNORATE BOUNDARIES
- - - ADMINISTRATIVE BOUNDARY
- · - INTERNATIONAL BOUNDARIES

34°30'E
32°30'N

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32°00'N



ARAB REP. OF EGYPT

31°00'N