

# Economic Monitoring Report to the Fiscal Working Group

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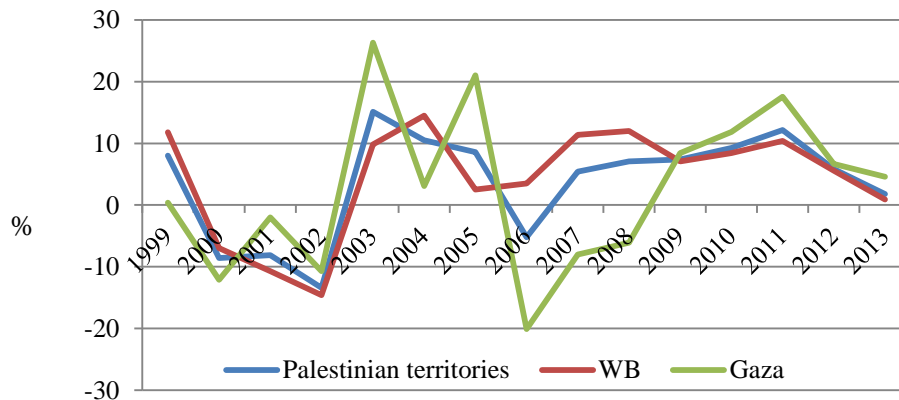
GDP	Gross Domestic Product
GoI	Government of Israel
IMF	International Monetary Fund
MENA	Middle East and North Africa Region
MoF	Ministry of Finance
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PIPA	Palestinian Investment Promotion Agency
PMA	Palestine Monetary Authority
UNRWA	United Nations Relief and Works Agency
US\$	United States Dollar
VAT	Value Added Tax
WB&G	West Bank and Gaza

## A. Recent Economic Developments

1. **In 2013, GDP growth hit its lowest point in six years, resulting in declining per capita income.** The Palestinian territories enjoyed a sustained period of growth between 2007-11, supported by large inflows of donor assistance accompanied by PA-led reforms and slight easing of movement restrictions by the Government of Israel (GoI)<sup>1</sup>. This fuelled a significant expansion in public and private consumption which pushed growth rates to an average of 8 percent during this period. In 2012, however, aid inflows decreased by more than half in comparison to their peak in 2008. This development, against the backdrop of the Israeli restrictions on economic activity, led growth rates to decline to 5.9 percent by the end of 2012. The economic situation further deteriorated in 2013 and latest estimates indicate that GDP growth sharply dropped to around 2 percent<sup>2</sup>. Given that population growth is estimated at around 3 percent, this indicates that real per capita GDP declined in 2013.

2. **Economic activity weakened significantly in both the West Bank and Gaza.** The economy of the West Bank contracted by 0.6 percent in early 2013 due to a significant increase in the level of uncertainty created by the PA's fiscal difficulties, which negatively affected consumption patterns. Even though consumption picked up slightly later in the year as the PA's fiscal stress eased, it continued to be restrained by the uncertainty on the political front. Hence, GDP growth in the West Bank for the whole year is estimated at around 0.9 percent. Growth in Gaza started out strongly in the beginning of 2013 at 12.2 percent due to large inflows of donor aid directed towards construction projects implemented to offset damages caused by the conflict in late 2012. However, this source of growth was interrupted following crackdown on the tunnel economy, which has also had a negative effect on consumption. Consequently, growth in Gaza dropped substantially to an estimated average of 4.6 percent for the year.

Figure 1: Real GDP Growth Rates, 1999-2013



Source: PCBS national accounts data

<sup>1</sup> The GoI has applied measures over the past few years to ease some restrictions. In terms of movement within the West Bank, a number of checkpoints were removed and some blocked routes were opened. The GoI also states that it has improved facilities at the Allenby Bridge and the Jalameh crossing through installing container scanners. The GoI cites security concerns that restrict its ability to further ease or lift various restrictions on economic activity in the West Bank and Gaza.

<sup>2</sup> GDP data for 2013 is based on preliminary estimates produced by PCBS. PCBS is expected to revise national accounts data for 2011-2013 in June 2014. Current information indicates that the growth rate estimate for 2013 is likely to be even lower.

3. **As a result of this sharp deceleration in growth, real income per capita is falling and unemployment is on the rise and is disturbingly high in Gaza, as well as among youth and women.** Unemployment in the Palestinian territories reached 26 percent in Q1 2014 up from 24 percent in Q1 2013. The overall figure masks wide regional divergence. Unemployment in Gaza, at a staggering 41 percent, is more than twice as high as that in the West Bank at 18 percent. Q1 2014 labor force data by PCBS indicates that youth unemployment has recently surged, particularly in Gaza where close to 60 percent of young people in the workforce are unemployed. In addition to low labor demand, females continue to face social and political challenges when joining the labor force and therefore, female participation rate in the labor market is very low at around 20 percent in Q1 2014, with a high unemployment rate of almost 37 percent.

**Table 1: Labor Force Statistics, Q1 2014**

<b>Indicator</b>	<b>Palestinian territories</b>	<b>WB</b>	<b>Gaza</b>
Unemployment Rate	26.2	18.2	40.8
Underemployment Rate	7.6	6.7	9.1
Labor Force Participation Rate	46.3	47.2	44.8
Youth Unemployment (Ages 15-29) Rate	39.4	28.5	58.2
Female Unemployment Rate	36.5	27.1	52.4

*Source: PCBS Labor Force Survey Q1 2014*

4. **Moreover, no improvement in economic performance is expected in 2014 and the potential downward risk is significant due to a highly uncertain political outlook.** Israeli restrictions on trade, movement and access continue to be the binding constraint to production and investment. These restrictions substantially increase the cost of trade and make it impossible to import many production inputs into the Palestinian territories. For Gaza, the restrictions on import and export are particularly severe. In addition to the restrictions on labor movement between the Palestinian territories, the restrictions on movement within the West Bank also have a strong negative impact on economic growth. Against this backdrop, growth is highly dependent on the outcome of the peace talks. In a baseline scenario which assumes that the Israeli restrictions system remains unchanged, the peace negotiations remain on hold and that donors maintain current aid levels, GDP growth is projected to be close to its 2013 level. However, if no progress is made on the political front and the GoI withholds the transfer of clearance revenues or donors scale back aid levels, the economy would likely contract. On the other hand, positive developments on the political front and easing of Israeli restrictions could lead to a surge in GDP driven by private investment (such as investments envisaged in the Initiative for the Palestinian Economy) and an increase in consumption.

## **B. Fiscal Developments**

### **C.I. Palestinian Authority Fiscal Performance 2013**

5. **The PA managed to reduce its recurrent deficit as a percentage of GDP in 2013, despite a significant and unexpected drop in growth.** The PA reduced the recurrent deficit from 26 percent of GDP in 2007 to 14 percent in 2012. This trend was driven by solid PA reforms supported by strong growth. Even though growth significantly slowed in 2013, with the PA's tight control over spending and efforts to improve revenue performance, the recurrent deficit was reduced by an additional two percentage points to 12 percent of GDP.

**6. The PA's revenue performance was strong in 2013.** Domestic tax revenues grew by 16 percent (in nominal NIS terms) when compared to 2012. This growth was mainly driven by a significant increase in VAT collections as the PA focused efforts to collect VAT arrears and liabilities owed by delinquent tax payers. The PA also raised the VAT rate by one percentage point to 16 percent in June 2013. Clearance revenues, which are the PA's main source of income, grew by 9 percent (in nominal NIS terms) in 2013. This is partly due to the rise in the VAT rate, but also due to higher collections from petroleum VAT and excise as a result of additional tax receipts from Gaza, which started importing fuel from Israel. The PA also signed an agreement with the GoI in late 2013 to share data on direct imports. These are goods that are directly imported to the Palestinian territories from outside of Israel and which are cleared by Israeli Customs<sup>3</sup>. Following the agreement, Israeli Customs have been sending data on daily basis to the PA's Customs regarding these imports<sup>4</sup>. This data has enabled the PA to go after merchants that undervalue their declarations, which has also contributed to increasing tax collections. The PA's gross revenues as a percentage of GDP grew by 1.2 percentage points, but net revenues only grew by 0.2 percentage points in 2013, reaching 21 percent due to a significant increase in fuel tax refunds, i.e. subsidies.<sup>5</sup>

**7. Despite increased spending on fuel subsidies, the PA managed to reduce the share of government expenditure in the economy in 2013.** Fuel subsidies paid by the PA grew by more than 50 percent in 2013 in an effort to reduce the cost of transportation for the general public following an increase in the rate of VAT by one percentage point and amid the recent decline in real per capita GDP. Nonetheless, the PA managed to reduce its recurrent public expenditure by about two percentage points of GDP to an estimated 33 percent in 2013. This is due to a reduction in the share of net lending, nonwage spending, and public wage expenditures in the economy. Net lending declined by 0.8 percentage points of GDP in 2013, but this improvement needs to be viewed with caution as it resulted from lower deductions by the GoI from clearance revenues and not from a substantial decline in the incidence of nonpayment to the Israeli Electricity Company<sup>6</sup>. Furthermore, the share of nonwage expenditures in the economy decreased by 0.6 percentage points in 2013 due to the PA's efforts to rationalize spending, particularly on the use of goods and services and transfers. In addition, the PA adopted various measures to limit the growth of the wage bill in 2013, which is the largest spending item representing more than 50 percent of recurrent expenditures. Specifically, the PA implemented a zero net hiring policy and reduced the Cost of Living Allowance to 0.75 percent from 3.5 percent in previous years. These measures successfully limited the growth of the wage bill (in nominal NIS terms) to 1.7 percent in 2013 compared to around 7 percent in previous years. Nevertheless, the wage bill as a percentage of GDP remained very close to its 2012 level at around 17 percent as the nominal GDP in NIS terms increased by a mere 3 percent.

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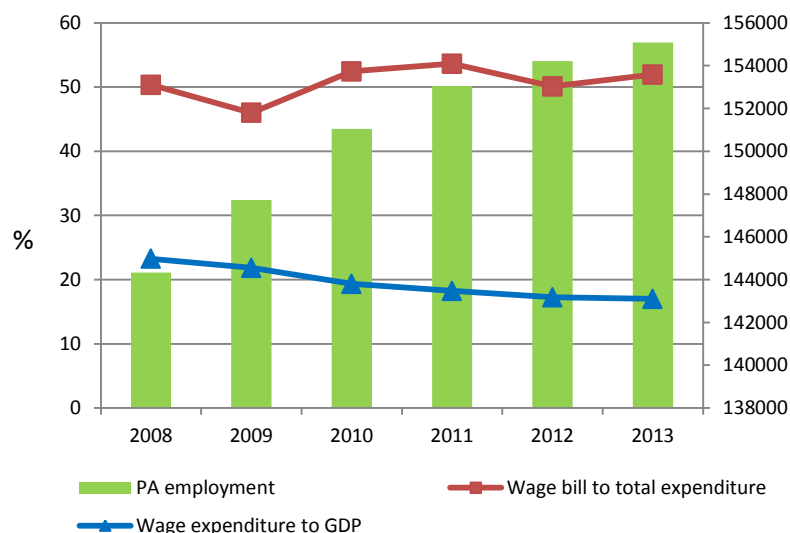
<sup>3</sup> The PA believes that these imports are widely undervalued as Israeli Customs rarely question declarations of West Bank and Gaza bound goods, which leads to fiscal leakages.

<sup>4</sup> Information on direct imports is currently sent by the Israeli Customs to their Palestinian counterparts by the end of each day. Palestinians hope that a more comprehensive agreement is reached which entails sharing this information on real time basis through linking the Palestinian ASYCUDA (Automated System for Customs Data) system to the Israeli information system.

<sup>5</sup> Tax refunds, mostly given to the Petroleum authority as a means of subsidizing fuel expenditures increased from US\$113 million in 2012 to US\$231 million in 2013.

<sup>6</sup> It is estimated that the total amount of debt that is owed to the Israeli Electricity Company amounted to NIS1.5 billion as of May 2014.

Figure 2: The share of wage bill to GDP has been declining in recent years



Source: PA Ministry of Finance and WB staff calculations

**8. In spite of these reform efforts, the PA’s fiscal situation remained difficult in 2013 for several reasons.** Even though budget support increased in 2013<sup>7</sup>, it has been on a declining trend since its peak in 2008 and although there has been a very substantial fiscal adjustment in response, it has, understandably, not been commensurate with the reduction in aid flows. Second, revenue performance, despite some improvement in 2013, remains weak. Particularly problematic is the low amount of revenues raised in Gaza compared to PA’s expenditures there<sup>8</sup>, but the tax base in the West Bank also remains small due to inefficiencies in both enforcement and policy. These problems are aggravated by the sharp slowdown in growth. With reconciliation, there should be an opportunity to improve revenue performance for Gaza.

**9. Thus, in 2013 the PA continued to depend on arrears as a significant source of deficit financing.** The PA accumulated about US\$462 million in domestic arrears in 2013, more than what was needed to offset the shortage in aid. About US\$155 million or 34 percent of these arrears is owed to the private sector, while the majority of the rest is owed to the pension system. Part of the excess financing that resulted from arrear accumulation - in excess of what was needed to cover the shortage after accounting for external aid - enabled the PA to reduce its net domestic bank financing by almost US\$248 million in 2013<sup>9</sup>.

<sup>7</sup> Budget support reached US\$1.26 billion in 2013 up from US\$776 million in 2012. Notably, the amount received in 2013 includes US\$200 million from the USA that was supposed to be disbursed in 2012 but was delayed until 2013.

<sup>8</sup> The PA reports that only 3 percent of its revenues were generated from Gaza while 43 percent of its expenditures are concentrated there.

<sup>9</sup> The objective of this policy was to reduce interest expenditures. Other efforts have also been made with the same objective, such as the planned bond issuance.

## C.II. Assessment of the 2014 Budget

**10. According to the 2014 budget, the PA's financing need would remain large.** The budget projects the total deficit at US\$1.63 billion or about 13.7 percent of GDP – only around 0.2 percentage points less than in 2013. As for expenditures, the wage bill is budgeted to increase by 5 percent compared to less than 2 percent in 2013, despite a decision to continue implementing a zero net hiring policy and to reduce transportation and supervisory allowances in 2014. The increase is driven by a 1.25 percent increase that is mandatory by law, 2.5 percent Cost of Living Allowance, and across the board wage increases to public security staff, teachers, doctors and engineers. These wage increases are based on the agreements that the public sector trade unions made with the PA in 2013, and which will be implemented in 2014 and 2015. The budget assumes a substantial increase in transfers and spending on goods and services that is above the projected inflation rate for 2014. Fuel subsidies and net lending are projected to decrease by 31 percent and 23 percent respectively when compared to 2013. As for revenues, the budget envisages an increase of 8 percent in domestic tax revenues, based on improvements in revenue administration and on tax policy reform. Nontax revenues are also projected to increase by 8 percent due higher dividends from the Palestine Investment Fund. As for clearance revenues, they are budgeted to grow by 7 percent due to better cooperation and information sharing by the GoI. Finally, the budget assumes that sufficient external financing will be received to cover the PA's recurrent and development needs in 2014.

**11. Bank staff assessment of the budget identifies a few significant risks.** Projected growth in domestic and clearance revenues is perhaps achievable, but the reduction in fuel subsidies that is envisaged by the budget is considered large especially given the recent increase in fuel supplies to Gaza. In addition, the decrease in net lending is considered optimistic because the implementation of reforms to address the underlying causes of this problem is only beginning. Development spending is expected to be lower than the budgeted amount based on underspending in recent years. Latest pledges by donors indicate that budget support will be about US\$1.2 billion in 2014 and previous years' experience demonstrates that external support for capital projects could be less than the assumed US\$300 million. Put together, it is expected that the PA will need sizeable additional financing of about US\$0.3 billion in 2014. Unless aid is found, this financing requirement will be covered through domestic sources including arrear accumulation and borrowing from local banks.

## C.III. Fiscal performance during 2014

**12. Despite successful efforts to enhance revenue generation, the PA's fiscal outlook for 2014 remains uncertain.** Domestic tax revenues performed well during Q1 2014 growing by 24 percent when compared to the same period last year. The PA introduced an 8 percent discount on early VAT payments in 2014 on top of the property and income tax incentives that apply to tax receipts in the first 90 days of the year. Growth in domestic revenues in Q1 can therefore be mainly attributed to advance payments rather than a significant widening or deepening of the tax base. In fact, figures for April indicate that domestic revenue growth has already started to slow down. Clearance revenue performance has so far been impressive in 2014 mainly due higher receipts from fuel imports to Gaza. It is highly important that the transfer of these revenues by the GoI continues to be consistent and on time in order to avoid placing fiscal stress on an already tight budget. Tax refunds were 44 percent above expectations mainly due to higher than anticipated spending on fuel subsidies. As for expenditures, the PA managed to keep its largest spending items including wages and transfers below expectations, however, spending on the use of goods and services and net lending both exceeded their prorated budget targets by 44 and 59 percent, respectively, in the first four months of 2014. consistent



**13. External financing so far received in 2014 was less than needed to cover the PA's needs.** Between January-April 2014, the PA's total deficit amounted to US\$511 million while aid received was US\$243 million, and was less than half the amount assumed by the budget. As a result, the PA resorted to domestic arrears to cover its needs and it accumulated around US\$274 million in domestic arrears between January-April 2014, almost half of which is owed to the private sector while the majority of the rest is to the pension fund<sup>10</sup>.

**14. Risks could also arise due to the fiscal implications of the reconciliation.** The short run impact of the reconciliation is not yet clear due to the lack of data on the spending by the former de facto Government in Gaza. It is expected that the PA's deficit and financing requirement for 2014 will significantly increase if all the staff on the payroll of the Gaza de facto government—currently estimated roughly at 35,000--were to be added to the PA's payroll to ensure continuity of public services in Gaza. For example, if the average salary for the additional staff were to be equal to that currently received by PA employees, the PA's wage bill would increase by as much as US\$430 million or 4 percent of GDP, pushing the aggregate wage bill to 21 percent of GDP. The reconciliation is also expected to result in the growth of revenues from Gaza. However, those revenues are expected to be slow to materialize as they will primarily depend on the trade regime that yet has to be put in place with Israel and Egypt. Thus, it is unclear to what extent those revenues will offset any possible increase in the wage bill and other expenditures. Although the vast majority of international actors have welcomed the reconciliation, it is not certain that aid pledges made prior to the reconciliation would fully materialize. In addition, if the transfer of clearance revenues by the GoI is disrupted, the financing requirement will increase.

## C. The Banking Sector

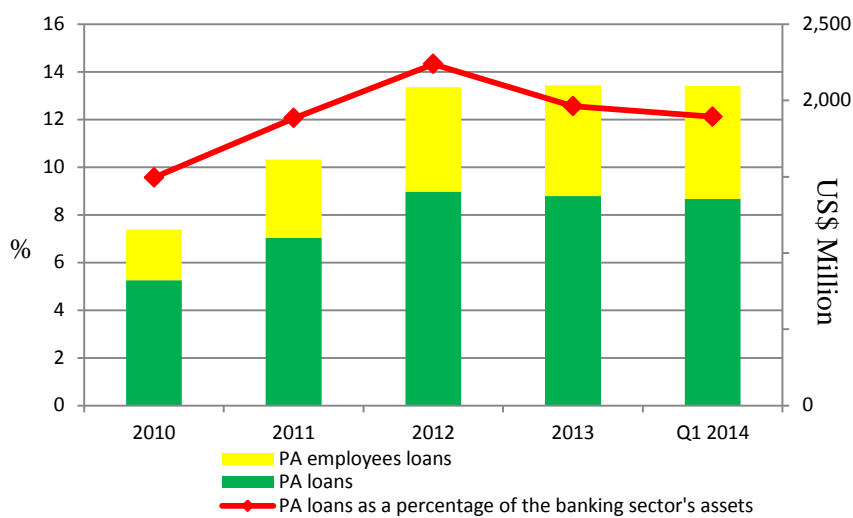
**15. The Palestinian banking sector remains healthy.** It is well regulated by the Palestine Monetary Authority (PMA) which is steadily building the capabilities of a central bank. Banks in general are risk averse and profitable mainly due to high interest rate margins. The ratio of non-performing loans to gross loans continues to be low at 3 percent. Credit to the private sector grew by about 11 percent in 2013, higher than nominal GDP growth but lower than in previous years.<sup>11</sup> Recent figures indicate, however, that growth of private sector credit has picked up again in 2014. A Deposit Insurance scheme was introduced in mid-2013 and it aims at compensating depositors against the loss of insured deposits up to US\$10,000 placed with member institutions in the event of a member institution's failure. This system will strengthen public confidence in banks, and hence, mobilize more savings and deposits which will in turn contribute to enhancing the soundness of the overall sector. The PMA and the Ministry of Finance (MoF) have recently developed a program to securitize the PA's local debt through issuing government bonds. The program aims to extend the maturity of PA debt to three years and also reduce interest payments. The first bond issuance will take place in 2014 and it will amount to US\$200 million. Even though securitization of government debt could improve banks' liquidity management, its overall effect on the PA's budget is still unclear because banks are offered tax exemptions as incentives to join the program.

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<sup>10</sup> Arrears accumulated in Q1 2014 exceeded what was needed to offset the shortage in external aid. Part of the excess financing enabled the PA to reduce its net domestic bank financing by US\$105 million.

<sup>11</sup> The decline is mainly attributable to the fact that since the restart of the peace negotiations in mid-2013, most individuals and companies have been keeping on hold investment and consumption plans until the end of the negotiations - hoping that economic and political prospects would have been clearer then. Uncertainties over PA's finances and the accumulation of arrears to the private sector, may have also contributed to the slowdown in credit growth.

**Figure 3: The PA's debt to domestic banks has recently been on the decline while loans to PA employees have been growing**



*Source: Palestine Monetary Authority*

**16. Despite a decline in the PA's bank borrowing since 2012, the banking sector's credit exposure to the public sector remains a concern particularly in light of an increase in credit facilities to PA employees and challenges in financing the PA's budget.** As of March 2014, the PMA reports that the Palestinian banking sector has provided US\$1.35 billion in credit facilities to the PA, down from US\$1.4 billion by the end of 2012. This represented about 12 percent of the sector's total assets and 96 percent of its equity. However, credit to public sector employees increased by 6 percent in 2013 and it continued to grow in 2014 to reach US\$742 million by the end of the first quarter. Credit to the public sector and PA employees, combined, represented around 45 percent of the sector's gross credit, as of March 2014. This high credit concentration represents a threat to the overall viability of the banking sector, especially if the PA's fiscal stress increases and causes a delay in loan installments by the PA and/or interruption in salary payment of public servants which will affect their ability to repay their bank loans.

**17. The PMA has been carefully monitoring related risks.** It has been carrying out stress tests designed according to Basel II principles that are used to evaluate the banking system's resilience to shocks. The PMA reports that the results of the March 2014 tests indicate that the banking sector is well capitalized with the Tier 1 capital as a ratio of risk weighted assets at 21 percent. This ratio far exceeded the minimum requirements specified by Basel II principles under all but two extreme scenarios. The first scenario relates to an economic shock that could lead to a significant decline in the fair value of Palestinian investments inside and outside WB&G, a 30 percent default rate for private sector loans and withdrawal of about 20 percent of deposits from the banking system. The second scenario relates to a political shock which assumes that 40 percent of PA loan installments are delayed while 50 percent of loans to public servants default, among other things.

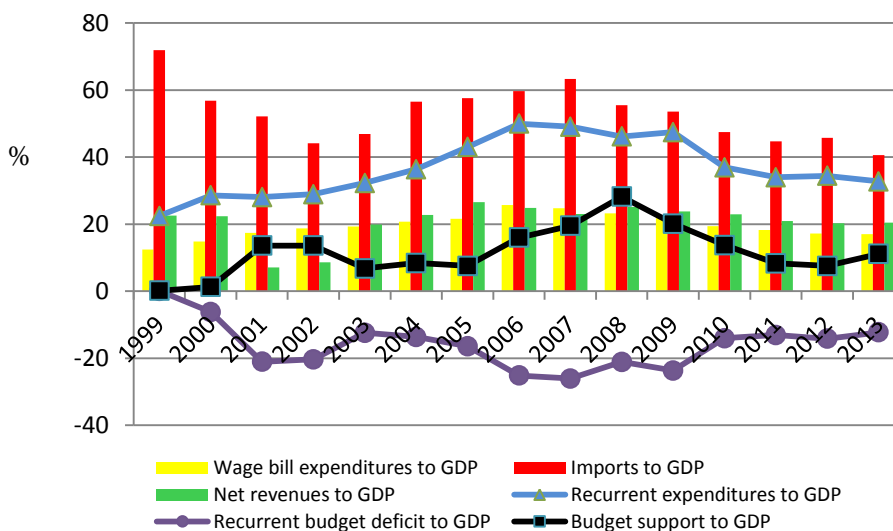
**18. The banking sector suffers from a high level of excess NIS liquidity due to restrictions on cash deposits admitted by Israeli banks from their Palestinian counterparts.** The PMA reports that in 2010, a maximum limit of NIS120 million was imposed by the GoI on the monthly cash amount that Palestinian banks were allowed to collectively deposit in Israeli banks. Even though the maximum limit was raised to NIS300 million in late 2013, it has not been enough to absorb the NIS liquidity in the West Bank where large amounts of cash have been mounting. The PMA states that in April, following the

suspension of the peace negotiations, the GoI decided to completely suspend all cash shipments from Palestinian banks<sup>12</sup>. Only one extraordinary shipment of NIS200 million was allowed on 20 May 2014. This is expected to hurt the sector's profitability due to losses resulting from the lost opportunity of placing these idle funds in Israeli banks. Notably, the cash shipment restrictions are only applied to Palestinian banks and not to foreign banks operating in Palestine which has created an uneven playing field that is not conducive to competition.

## D. Budget Support: The Unsustainable Fuel for Economic Growth

19. Given the ongoing restrictions on movement and access and the absence of political progress, budget support to the PA has been the crucial driver of recent economic growth, essential service delivery and reform efforts. With budget support amounting to roughly a third of the PA's total recurrent expenditures and half of its revenues, its indispensability to the PA's capacity to finance key programs is clear. This section discusses how budget support has contributed to growth and other aspects of the Palestinian economy and society.

Figure 4: In response to the reduction in budget support and weak revenue performance, the PA's expenditures as a percentage of GDP were reduced



Sources: PCBS and PA MoF

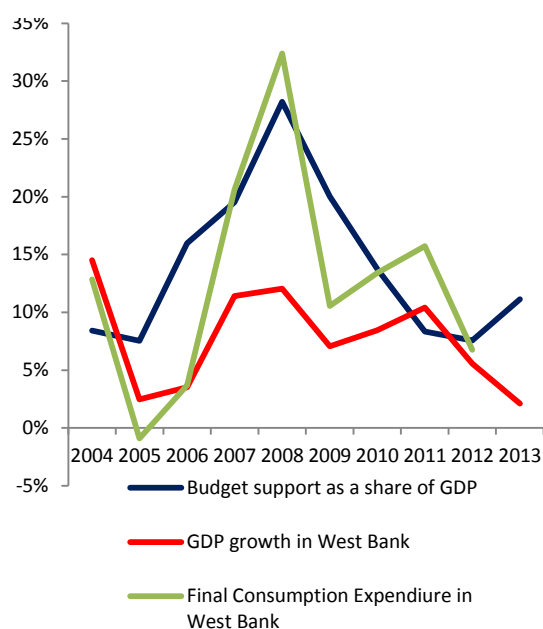
20. The second Intifada, with its severe impact on growth and PA's revenues, made it very difficult for the PA to continue balancing its budget. By 1999, the recurrent budget had a small surplus and all foreign assistance was dedicated to development expenditures. With the advent of the second Intifada in 2000, the restrictions on movement and access both within the WB&G and between WB&G and Israel were substantially increased. These restrictions also included reducing the number of work permits for Palestinians in Israel and its settlements. As a result of the tightening of restrictions and the outbreak of violence, the Palestinian economy suffered a severe economic contraction. This led to a

<sup>12</sup> See "Israeli Punitive Action Target Palestinian Banks". Haaretz, May 16<sup>th</sup> 2014. <http://www.haaretz.com/business/premium-1.591019>.

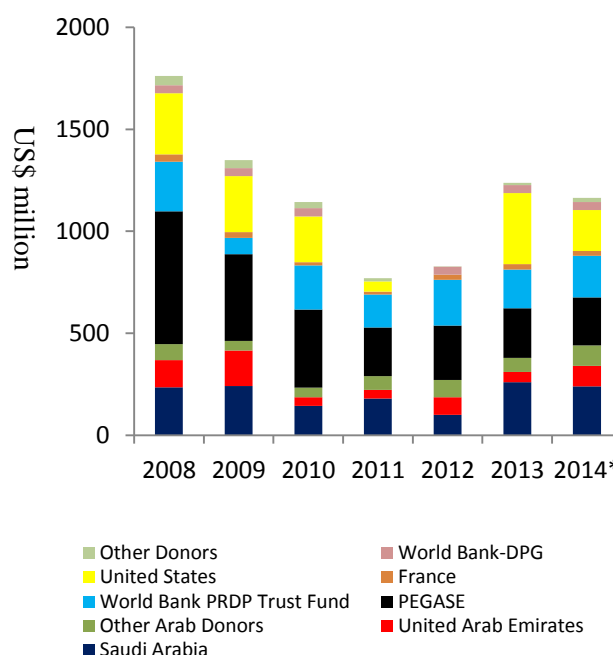
significant decline in the PA’s tax revenues – by 2001 the PA’s tax revenues dropped by as much as 70 percent. During the same period, the PA’s wage bill grew by 13 percent as the PA started absorbing many of the Palestinian workers who previously worked in Israel and Israeli settlements. Consequently, the PA’s recurrent deficit burgeoned to US\$820 million by the end of 2001.<sup>13</sup>

**21. To bolster PA’s efforts in dealing with the aftermath of the Intifada donors substantially stepped up their budget support.** As a result, PA’s expenditures grew again in 2005 and reached a peak in 2006 at 50 percent of GDP. Increases in the wage bill, social and other transfer payments were the main driver in expenditure growth. Although budget support continued to increase substantially until 2008, expenditures as a share of GDP were stabilized after 2006. On the other hand, tax revenues as a share of GDP were on the downward path since 2005 and were particularly hit in 2007 as a result of the internal split between Hamas and Fatah and the loss of revenues for the PA from Gaza.

**Figure 8: In the West Bank, growth has largely tracked inflows of donor aid**



**Figure 9: External financing to the PA’s recurrent budget has been volatile**



Source: PCBS, MoF and IMF

\* Figures for 2014 are based on projections

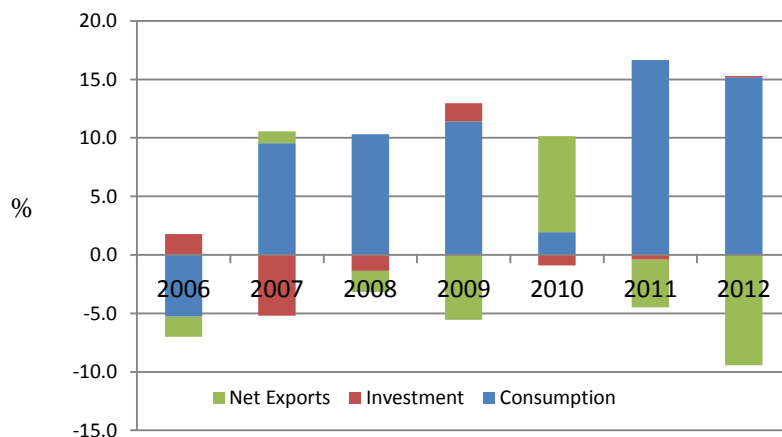
**22. In recent years budget support has been the main driver of growth, in particular in the West Bank.** Budget support directly increased gross disposable income in the Palestinian economy through salary and other current spending. According to estimates, Palestinians spend 94 percent of their

<sup>13</sup> Even in 2003 when slow growth resumed the deficit and need for external finance continued to rise due to pay increases and some new hiring.

disposable income and consequently budget support has been a significant driver of consumption.<sup>14</sup> It is therefore not surprising that most growth in recent years has been consumption driven as shown in Figure 10 below. Specifically, when budget support reached its peak in 2008, private consumption growth in the West Bank also peaked at 30 percent and has since dropped to single digits as budget support started to decline. Consequently, growth in the West Bank reached a high level of 12 percent in 2008 and by 2013 it fell to 0.9 percent. On the other hand, during this period investment has remained quite low and exports stagnant and declining as a share of GDP.

**23. In addition to fueling consumption, budget support catalyzed some expansion of import-competing domestic production to meet the growing demand.** Total imports of goods as a share of final consumption dropped from 42 percent in 2004 to 34 percent in 2012. Some of this drop can be driven by weak accounting of Gaza’s imports following the government split in 2007, but a significant drop was also recorded in years following the split. More detailed import statistics confirm the import substitution argument and show that Palestinians are relying on domestic production for an increasing share of food, textiles, furnishings as well as some construction materials. Furthermore, a part of the drop in imports also appears to be related to low levels of investment, as the imports of various machinery and equipment dropped while there is no evidence that shows a significant domestic production of these goods.

**Figure 10: In recent years, consumption has been the main contributor to economic growth in WB&G**



*Source: PCBS National Accounts Data*

**24. In addition, budget support has enabled the PA to continue expanding its poverty reducing programs and services despite persistent fiscal challenges.** Budget support assistance has contributed to the PA’s fiscal capacity to substantially expand the number of beneficiaries under its well-targeted cash transfer program from 45,000 poor households in 2007 to 109,000 in 2013. The budget for extremely poor and vulnerable families has also increased from 150 million NIS in 2007 to 462 million NIS in 2013. The expansion in cash transfers to the most disadvantaged segments of the Palestinian population has had a substantial impact on poverty reduction. Estimates from 2011 conducted by the PCBS show that social assistance alone reduces the poverty rate by as much as 18 percent.<sup>15</sup>

<sup>14</sup> 0.94 is the estimate for GNDI/private consumption elasticity used in the UNCTAD-developed econometric model used by PCBS to forecast national accounts variables.

<sup>15</sup> Palestinian Central Bureau of Statistics, Living Standards Statistics, 2011.

**25. The PA has also been able to significantly increase its education programs, resulting in notable improvements in student enrollment and literacy rates.** During the last decade, the PA's education budget increased from US\$290 million to US\$760 million. As a result, the number of government schools increased from 1,580 to 2,038 during the past decade. During the same period, the number of students attending government schools increased from 706,000 to 760,000 and the literacy rate increased from 92 percent to 96 percent of the population.

**26. But the reduction in budget support by nearly US\$800 million between 2008 and 2011 has put a strain on PA's finances and caused a dent in economic growth.** The PA responded to the loss of financing with relatively impressive fiscal consolidation efforts, but those were not sufficient to compensate the large loss in grant financing. Expenditures as a share of GDP went down from 48 percent of GDP in 2009 to 33 percent in 2013<sup>16</sup>. The reduction in budget support did not only reduce deficit financing, it also negatively affected consumption, which, given the impediments to investment and exports, has been the main driver of growth. The slump in consumption has adversely affected imports and PA's tax revenues. Thus, between 2008 and 2013, imports dropped from 55 percent of GDP to 41 percent of GDP and clearance revenues dropped from 18 percent of GDP in 2008 to 14 percent of GDP in 2012 and recovered only slightly to 15 percent in 2013, but largely thanks to fuel tax increases and additional tax collections on direct imports<sup>17</sup>. Consequently, the combination of substantially lower budget support and lower clearance revenues has forced the PA to start relying on payment arrears to the pension fund and private suppliers as a last resort to close a financing gap that ensued. The arrears are detrimental to the private sector, have a negative impact on growth and employment, which in turn negatively affects tax collection.

**27. In conclusion, budget support has been the main driver of growth in recent years; however this growth model is not sustainable.** As shown by the above analysis, budget support has played a key role in fueling public and private consumption, pushing PA reforms, and improving the quality of public services provided to the Palestinian population. However, it has become increasingly clear that the current model of economic growth is no longer effective in sustaining growth and creating jobs as per capita growth contracted in 2013, for the first time since 2007, and growth projection for 2014 is far lower than what is needed to keep the unemployment stable. Therefore, there is an urgent need to move towards a more sustainable growth model that depends on the private sector as the main engine of shared growth.

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<sup>16</sup> During this period, the PA reduced the wage bill from 22 percent of GDP to 17 percent of GDP. In addition, net lending contracted from 5 percent of GDP to 2 percent of GDP. While expenditure containment has had a negative impact on consumption and growth, it was certainly necessary.

<sup>17</sup> The PA signed an agreement with the GoI in late 2013 to share data on direct imports. Direct imports are goods that are directly imported to the Palestinian territories from outside of Israel and which are cleared by Israeli Customs. The PA believes that these imports are widely undervalued as Israeli Customs rarely question declarations of WB&G-bound goods. Following the recent agreement, Israeli Customs have been sending data on daily basis to the PA's Customs regarding these imports. This data has enabled the PA to build a risk management system that allows it to go after Palestinian merchants that undervalue their import declarations.