

Stagnation or Revival? Palestinian Economic Prospects

Economic Monitoring Report to the Ad Hoc Liaison Committee

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Acronyms

AHLC	Ad Hoc Liaison Committee
CMWU	Coastal Municipalities Water Utility
GDP	Gross Domestic Product
GoI	Government of Israel
GPP	Gaza Power Plant
IEC	Israel Electric Corporation
IMF	International Monetary Fund
IT	Information technology
JSC	Joint Service Council
MCM	million cubic meters
MENA	Middle East and North Africa
MoF	Ministry of Finance
NCTPS	National Cash Transfer Payment System
NDP	National Development Plan 2011-13
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PFM	Public financial management
PMA	Palestine Monetary Authority
PNERRP	Palestinian National Early Recovery and Reconstruction Plan for Gaza
PWA	Palestine Water Authority
UNOCHA, oPt	United Nations Office for the Coordination of Humanitarian Affairs, occupied Palestinian territory
VAT	Value-added tax
WB&G	West Bank and Gaza
WHO	World Health Organization

A. Executive Summary

- a. The Palestinian Authority continues to experience a severe fiscal crisis, which threatens to become protracted given recent and projected declines in donor assistance. The Palestinian Authority is making a concerted effort to strengthen its fiscal position, including taking steps to raise domestic revenues and control expenditures. However, these efforts will not be successful unless they are supported by concrete and known actions of the Government of Israel, such as the sharing of relevant tax information on Palestinian revenues. In addition, in the short-term it is imperative that additional donor funding be identified as the Palestinian Authority simply cannot take enough steps to reduce the projected recurrent deficit to the currently expected level of aid. A continuation of the current trend of reduction in donor aid would likely aggravate the Palestinian fiscal crisis, potentially jeopardizing gains made in recent years in institution-building.
- b. The West Bank economy grew in 2011 at a slower rate than it did in 2010. The slowdown in growth in the West Bank can be attributed to falling donor support combined with the uncertainty caused by the Palestinian Authority's fiscal crisis, as well as lack of significant new easing of Israeli restrictions.
- c. Ultimately, sustainable economic growth and an end to the fiscal crisis will require unleashing of the Palestinian private sector's potential. This in turn necessitates a lifting of Israeli restrictions on access to land, water, a range of raw materials, and export markets. But it also requires that the Palestinian Authority improves the business environment and attracts needed investment through such measures as expanding land registration in the West Bank; reforming the current collection of laws governing business; and building its own capacity to regulate the economy and ensure competition.
- d. Gaza experienced double-digit growth, demonstrating continued recovery. The high growth in Gaza reflects, in part, the low base from which it is starting – the average Gazan today remains worse off than s/he was in the late nineties. But it can also be attributed to a combination of aid inflows and easing of restrictions by Israel, in particular on entry of building materials for infrastructure projects implemented by international organizations. In addition to increased movement of materials through the tunnels from Egypt, this has led to a construction boom in Gaza. However, the state of Gaza infrastructure is such that massive investments in key sectors such as water and wastewater, electricity, and solid waste remain desperately needed. Such investments would generate short-term employment but also promote longer term growth and job creation. These investments would not fulfill their potential, however, in the absence of a lifting of the Israeli blockade on Gaza.

B. Introduction

1. **This report begins by documenting the Palestinian Authority's (PA's) ongoing fiscal crisis that threatens its ability to provide basic services to the population.** In 2011, the PA required about US\$1.5 billion dollars in budget support, of which US\$200 million to cover development expenses not funded directly by donors¹. However, it only received about US\$814 million in budget support and US\$169 million in development financing, for a total of US\$983 million. The PA financed this gap by borrowing from the local banking sector and accumulating around \$260 million in arrears to the private sector. It is unlikely that the banks and the private sector will allow the PA to continue to borrow so heavily. Yet the 2012 budget – though not yet published -- is expected to have a recurrent budget deficit of around US\$1.1 billion. Currently, the PA is only able to identify about US\$610 in external support, leaving a gap of some US\$540 million. The PA is making a concerted effort to strengthen its fiscal position, including taking steps to raise domestic revenues and control expenditures. However, these efforts will not be successful unless they are supported by actions of the Government of Israel (Gol). In the meantime, it is imperative that donors increase support to the PA to keep basic services functioning.

2. **Ultimately, the PA can only hope to achieve fiscal sustainability through a combination of sustained private sector growth and continued internal reforms.** Robust private sector growth is necessary for the PA to generate the revenues needed to sustain service delivery. Yet the private sector remains stifled as a result of Israeli restrictions on access to natural resources and markets². In particular, Area C, nearly 60 percent of the West Bank, remains off limits to Palestinian development while Israeli settlements continue to grow. Almost all exports from Gaza remain prohibited and imports are still heavily restricted. Without exports and access to the traditional markets in Israel and the West Bank, the Gazan private sector will not be able to recover. In addition, PA legal and regulatory reforms, which had helped investor confidence in the past, have slowed. Yet, even under the current circumstances, there remains much to be done by the PA to create an enabling business environment that attracts needed investment. Such actions include rapidly expanding land registration in the West Bank; reforming the current collection of laws governing business; and building the PA's capacity to regulate the economy and ensure competition.

3. **The West Bank has experienced a slowdown in economic growth in 2011, combined with double-digit growth in Gaza.** The recovery in Gaza can be attributed to a combination of aid inflows and easing of restrictions on entry of goods from Israel – though it is important to keep in mind that the average Gazan today is worse off than s/he was back in the late nineties. The recent growth in Gaza is also driven largely by a boom in the construction sector, and Gazan infrastructure exhibits such gaps and disrepair that major investments are necessary and would generate important employment as well as future growth. For those investments to materialize and operate successfully requires not only the necessary funding but a substantial

¹ All fiscal figures in this report are provided on a commitment basis.

² The Gol cites overriding security concerns that restrict its ability to continue to ease or lift restrictions on WB&G.

easing by the Gol of the current blockade on Gaza. The slowdown in growth in the West Bank, on the other hand, is the result of falling donor support, uncertainty caused by the PA's fiscal crisis, and lack of significant new easing of restrictions by the Gol.

C. The Palestinian Authority's Fiscal Crisis

4. **Despite keeping expenditures in line with the budget, the PA's fiscal crisis deepened in 2011 due to lower than projected revenues and donor assistance.** Thus, the PA continued to maintain tight control over its expenditures in 2011. Total expenditures and net lending³ for 2011 amounted to NIS⁴11.9 billion (see Table 1): around 0.5 percent below budget and 4 percent more than in 2010. The PA was able to keep spending below budget by squeezing operational and minor capital expenditures, which were 96 percent and 64 percent of their budget targets, respectively. The PA has adopted a number of measures to keep its operational expenditures under control, including withdrawing car privileges, reducing travel, use of cell phones, and other allowances. Transfer expenditures, which include pensions and payments to local governments, ended the year 2 percent higher than budgeted and 21 percent higher than 2010. Since transfer expenditures constitute the bulk of nonwage expenditures, these were 1 percent below budget in 2011, but still 10 percent more than last year.

5. **The PA's wage bill continued to grow in 2011 and ended the year 1 percent over budget and 6 percent higher than 2010.** Given that the average Consumer Price Index change was 3 percent in 2011, this indicates a significant real increase in the wage bill. Though growth in the wage bill and transfers was offset by the restraint in operating expenditures in 2011, these were arguably one-off savings while the commitments reflected by the higher wages and transfers will continue to grow over time. In 2011, net growth of the public labor force was 2,010, significantly below the 3,000 cap set in the 2011 budget. Overall, PA employment rose by 2,995 hires in the West Bank and decreased by 356 in Gaza⁵. Notably, the PA continued to increase employment in the security sector where 1,325 new employees were added to the payroll system during 2011: 1,122 in the West Bank and 203 in Gaza. In the education sector, 546 new workers were added while the number of workers in the health sector decreased by 49.

³ Net lending refers to subsidies provided to municipalities by the central government mostly for electricity bills that were not paid to the Israel Electric Corporation.

⁴ The 2011 average New Israeli Shekel (NIS) exchange rate to the US\$ was 1 US\$ = NIS 3.58, available at <http://www.bankisrael.gov.il/deptdata/mth/average/averg11e.htm>.

⁵ In addition, employment in the Palestine National Fund and the embassies was reduced by a total of 629 employees in 2011.

Table 1: Palestinian Authority expenditures by category, 2011

Expenditure Item	Amount (NIS million)	Percent of total expenditure
Wage expenditure	6,381	53.6
Nonwage expenditure	5,015	42.2
-- Operational expenditure	1,792	15.1
-- Transfers	3,165	26.6
-- Minor capital expenditure	58	0.5
Net lending	501	4.2
Total	11,897	100

Source: Palestinian Authority Ministry of Finance

6. **The PA continued to make steady progress in reducing net lending, and in 2011 it was 15 percent below budget and 43 percent lower than 2010.** However, it was 76 percent higher in the fourth quarter when compared to the third. In fact, the last quarter's net lending figures were the highest in the year. The Israeli Ministry of Finance (MoF) withheld a large amount from the fourth quarter clearance revenues to cover some electricity and net lending arrears, which was reported as net lending and explains some of the fourth quarter jump. The MoF has reported that certain municipalities have recently not been paying their bills to the Israel Electric Corporation (IEC) because the PA has been having trouble making all required transfers to local governments. If this situation persists, it could jeopardize the PA's progress in reducing net lending.

7. **In 2011, gross domestic revenues were nearly 12 percent lower than called for by the budget, amounting to NIS2.6 billion.** The 2011 budget called for domestic revenues to grow by almost 11 percent, yet they actually fell by 3 percent. Domestic tax collections were projected to grow by 11 percent in 2011 even though they had jumped by nearly 50 percent between 2009 and 2010⁶. This was an ambitious target and in the end, domestic tax collections were only 2 percent above the 2010 figure. In 2011, income tax collections were lower by almost 9 percent, value-added tax (VAT) collections increased by 6 percent, and property tax receipts fell by almost 12 percent. This may indicate that the PA's success in collecting more tax revenues in 2010 was due to one-off collections and not systemic changes to tax administration. The biggest shortfall in domestic revenues was in non-tax revenues which were 18 percent lower than budget projections and 9 percent less than 2010.

8. **In comparison to domestic tax revenues, clearance revenues performed well throughout 2011 despite the fact that they ended the year below their optimistic budget target.** Clearance revenues totaled NIS5.1 billion, i.e. 4 percent below their 2011 budget target, but 9 percent higher than 2010. When compared to 2010, customs and VAT receipts grew by 11 and 14 percent, respectively, while petroleum excise receipts rose by a mere 0.3 percent in 2011. This is partly attributable to the GoI's decision to decrease the petroleum excise tax. In addition, the Gaza Power Plant stopped importing fuel from Israel and replaced it with cheaper

⁶ The PA MoF has recently revised the 2010 tax figures that underlie this growth calculation and will be posting the revised figures on the MoF website shortly.

fuel from Egypt. In May and November 2011, the GoI temporarily suspended the transfer of clearance revenues. Since clearance revenues account for over two thirds of total PA revenues and finance around 43 percent of spending, the suspension greatly exacerbated the PA's fiscal crisis at the end of the year.

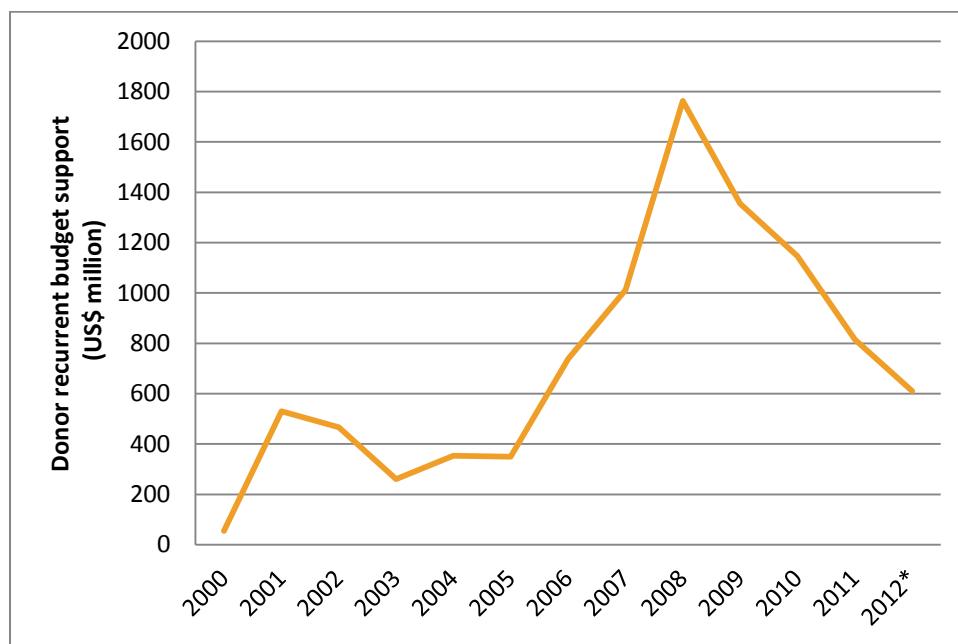
9. **The combination of expenditures almost on budget but lower than projected revenues translated to a recurrent budget deficit of NIS4.58 billion -- 14 percent higher than the budget target and 5 percent above the 2010 deficit.** In addition, development expenditures for 2011 were NIS1.3 billion, but the PA received only NIS605 million in development financing. Thus, the total need for external financing, including recurrent and development financing, amounted to NIS5.9 billion, compared to total donor support of NIS3.5 billion. Budget support was nearly NIS1.7 billion less than required by the budget, and much of this was not received until later in the year⁷. As a result, the PA had to accrue large stocks of arrears and increase domestic bank borrowing. By the end of 2011, total arrears accumulation amounted to NIS1.94 billion. The PA also had to turn to the local banking sector, and in 2011 bank borrowing increased by NIS984 million, raising total domestic debt to NIS4.15 billion or about US\$1.1 billion. The PA's local borrowing has almost reached the limit that the domestic banking sector can sustain, and it is unlikely that local banks will provide much more additional credit in the coming year. Given the large arrears, the private sector is likewise reluctant to provide further credit.

10. **The PA's fiscal situation appears likely to worsen in 2012.** The 2012 budget has not yet been published, but it appears that the projected recurrent deficit is expected to be about US\$1.1 billion. This represents a nearly 14 percent decline from the 2011 budget – an ambitious target given the current economic situation. It reflects the PA's determination to control spending and increase revenues. However, only around US\$610 million in donor financing has been currently identified, leaving a sizable gap. As Figure 1 shows, donor funding for recurrent spending is showing a steady decline since its peak in 2008. Consequently, the PA is making a concerted effort to find additional savings and reduce the deficit to a more manageable size.

11. **It is imperative to identify additional donor funding as the PA cannot take enough short-term steps to reduce the projected recurrent deficit to the level of expected aid.** Failing to support the PA at this juncture could jeopardize the significant progress that the PA has made in building the institutions of a future state and would undercut its ability to provide basic services to the Palestinian population. It is important that additional resources be identified as soon as possible. PA expenditures and reforms have been important drivers in West Bank and Gaza's (WB&G's) economic recovery. Uncertainty around the PA's ability to meet its obligations and maintain its reform program could significantly damage business confidence and reduce economic growth. This would make the fiscal crisis even worse and likely increase poverty amongst the population.

⁷ Some of the lower than expected aid was due to the depreciation of the US Dollar, which is how most external support is received. The budget planned on an exchange rate of NIS3.7 to US\$1 but it averaged only NIS3.58 to US\$1 during 2011.

Figure 1: Donor recurrent budget support (US\$ million)



* 2012 figure is based on International Monetary Fund (IMF) projections

Source: PA MoF, IMF, and World Bank

C.I. Increasing Palestinian Authority Revenues

12. **The PA is discussing a number of measures to increase revenues.** Foremost among them is a tax package that includes raising the tax rate on the upper income tax brackets and new taxes on capital gains and savings in financial institutions. There are also proposals to raise some fees including increasing the land registration fee from 1 to 2 percent of the land value. The tax increases are not expected to produce enough revenue to have a significant effect on the deficit. The higher rates on the upper brackets are accompanied by a widening of the exempted bracket. Additionally, in 2011, domestic income tax revenues, at NIS474 million, were only 6 percent of net revenues. Even if they were to increase by nearly 50 percent, as they did in 2010, this would cover only about 10 percent of the projected gap in financing.

13. **The Palestinian and Israeli Ministries of Finance have been cooperating to develop systems for exchanging information that will allow the PA to reduce tax leakages and substantially increase clearance revenues.** This is particularly important as tax clearance revenues collected by the Gol and transferred on a monthly basis to the PA constitute the largest source of PA revenues. In 2011 they amounted to NIS5.10 billion, i.e. 70 percent of total PA revenues and 40 percent of spending. The ministerial technical teams have come to agreement on how to implement the above-mentioned systems. However, the Gol put implementation of the agreement on hold following the signing of the Palestinian reconciliation

agreement in April 2011. The PA is requesting two types of information that, if available, could substantially reduce tax leakage, though it is not possible to estimate today by how much. But if clearance revenues could be increased by as little as 5 percent above projected 2012 levels, this would still amount to around NIS280 million, and help reduce the projected gap in external aid by more than 15 percent. In other words, this sharing of information could improve the PA's fiscal position and reduce the financing burden on donor countries. Thus, it is hoped that the Gol will quickly agree to implement the arrangements that the technical teams have worked out.

14. The first type of information is real time data to be shared by Israeli Customs on imports they clear whose final destination is the Palestinian territories. The customs duties, VAT, and excise tax on these direct imports accrue to the PA. However, the PA believes that there is widespread undervaluation and that Israeli Customs rarely questions declarations of WB&G bound goods. Moreover, even if the Israeli authorities penalize Palestinian importers for under-invoicing their declarations, the accrued enforcement fees are not transferred to the PA because the Israeli authorities do not view them as part of the revenue arrangement. The PA is also not informed when Israeli Customs issues amendments to the declarations. Thus, the PA is requesting that Israeli Customs provides information from its MALAM system to the PA's recently activated ASYCUDA⁸ system. The data will allow PA Customs to develop a risk management system to improve tax collection on imports. Since customs rates are relatively low in Israel, there may not be a lot of room to increase customs receipts. However, under-invoicing also affects VAT collections, which could be substantial.

15. Secondly, the PA requires information on the VAT receipts issued by Israeli traders to Palestinian importers. This VAT accrues to the PA, but to obtain these funds from the Gol, the PA must present its own copies of the receipts. Since the PA does not exercise control over borders, it is difficult to collect the receipts from Palestinian merchants seeking to avoid paying VAT. This is a particular problem in Gaza, where PA tax authorities cannot operate and lose most of the VAT they are due. The Israeli MoF has the information on how many tax invoices have been issued by Israelis to Palestinian traders and could send the information to the Palestinian MoF and remit the funds. This information would allow PA tax authorities to follow up and ensure that they collect VAT for such indirect imports when they are sold in the PA-controlled areas. Since all PA-bound cargo moves through Israeli-controlled commercial crossings, the Gol knows not only how many VAT invoices have been issued to Palestinian merchants, but also what goods have actually left Israel. This is particularly true for Gaza where the border with Israel is sealed and there is only one crossing. The PA also believes it loses revenue from goods that are diverted from the Israeli settlements to PA-controlled areas – a more complex issue for the PA to tackle in the absence of any control over borders.

16. In the absence of information on VAT receipts from the Israeli MoF, estimating the potential magnitude of gains to the PA must remain speculative. However, based on actual VAT receipts collected, the Palestinian Central Bureau of Statistics (PCBS) estimates that imports from Israel in 2011 were US\$2.85 billion. Even increasing this by 5 percent could raise

⁸ Automated SYstem for CUstoms DAta

around US\$20 million in clearance revenues, in addition to the extra VAT from ensuring collections on the goods when they are sold in PA-controlled areas. In 2006, when PA tax officials could still operate in Gaza, VAT receipts from Gaza were about 17 percent of VAT receipts in the West Bank. In 2010, they were only 6 percent. Admittedly, the Gaza economy has declined since then and more goods are coming from Egypt. Nonetheless, if 2010 VAT collections from Gaza had still been 17 percent of VAT from the West Bank, the PA would have had an additional US\$42 million.

17. Another area where better cooperation between the PA and Gol would raise PA revenue relates to Allenby Bridge fees. A standard exit fee has long been paid by passengers crossing the Allenby Bridge. The original agreement was made by the Israeli border authority and its Palestinian counterpart, and it states the exit fee is initially collected by PA officials on Allenby Bridge, and then transferred to the Israeli authorities. The Israeli authorities then take their share and transfer back the remainder to the PA. This original agreement set the exit fee at US\$26 per traveler, to be shared on a 46/54 basis, whereby US\$12 are transferred to the PA and US\$14 accrue to the Israeli authorities. Over the years, the Israeli authorities have gradually increased the exit fee and by early 2011, it was around US\$40 per traveler. However, the additional fees have not been shared with the PA because the Israeli authorities consider them user fees that should not be included in the revenue-sharing arrangement. Therefore, the Israeli authorities have continued to transfer only US\$12 per traveler to the PA. The PA, on the other hand, believes that the additional fees should be equally shared, and it reports that the Israeli authorities now owe it around NIS60 million.

18. While two-thirds of PA revenues (15 percent of Gross Domestic Product (GDP)) are from clearance revenues, the collection of domestic VAT and income tax for which the PA is responsible constituted only 5 percent of GDP in 2011. Over the past decade, the main focus of public finance reform has been on expenditure management, and efforts to improve the functioning of the revenue system have made little progress. As a consequence, the IMF assessed that the PA's revenue administration is fragile (IMF 2010). 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. It would also increase collections.

19. In the area of tax administration, the focus should be on reforms such as implementing self assessment, and integrating the administration of VAT and income tax (as advised by the IMF). 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 and pay incorrect amounts, 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, thus 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 indicates that both measures can be expected to increase tax collections.

20. **For tax policy, a particular focus would be on examining the merit of the myriad of tax exemptions that are at present provided.** Many of these exemptions were established through the *Law on the Encouragement of Investment in Palestine* (Law No. 1 of 1998). While the exemptions result in considerable foregone revenue, and create inequities in the tax system, it is not clear whether the objectives remain relevant or whether the mechanism is cost effective.

C.II. Reducing Palestinian Authority Expenditures

21. **One of the fastest growing parts of the PA's budget has been transfer expenditures and any attempt to deal with the PA's fiscal crisis must address this growth.** Indeed, the PA has not made concrete proposals on lowering future spending other than reducing transfer expenditures by nearly 9 percent. In 2007, transfers were about 13 percent of total expenditures but by 2011 they had risen to nearly 27 percent. In real terms, transfers grew by 88 percent in 4 years, while total expenditures only increased by 14 percent. A complete breakdown of transfer expenditures is not currently available. But initial calculations indicate that much of transfers are pension payments and miscellaneous transfers such as payments to local governments and education grants. Significantly, about 52 percent of transfers go to social payments, i.e. about NIS1.65 billion in 2011. The PA has been developing a unified national cash transfer payments system (NCTPS) to channel all social payments using a proxy means test that ensures that recipients are among the extreme poor. However, to date it appears that only about 40 percent of total social payments to households go through the NCTPS, with a large share of social payments targeting segments of society who may not be poor. In addition, the NCTPS is currently making payments to roughly 100,000 households, of whom 75 percent are extremely poor, while nearly a quarter are considered vulnerable but not extremely poor. As a result, based upon recent poverty estimates, it is possible that the NCTPS is only covering about 60-70 percent of the extremely poor households in WB&G. Thus, to ensure that its limited resources only go to support the poorest households, the PA should attempt to consolidate all of the programs for social payments into the NCTPS and ensure that the NCTPS only covers the extreme poor.

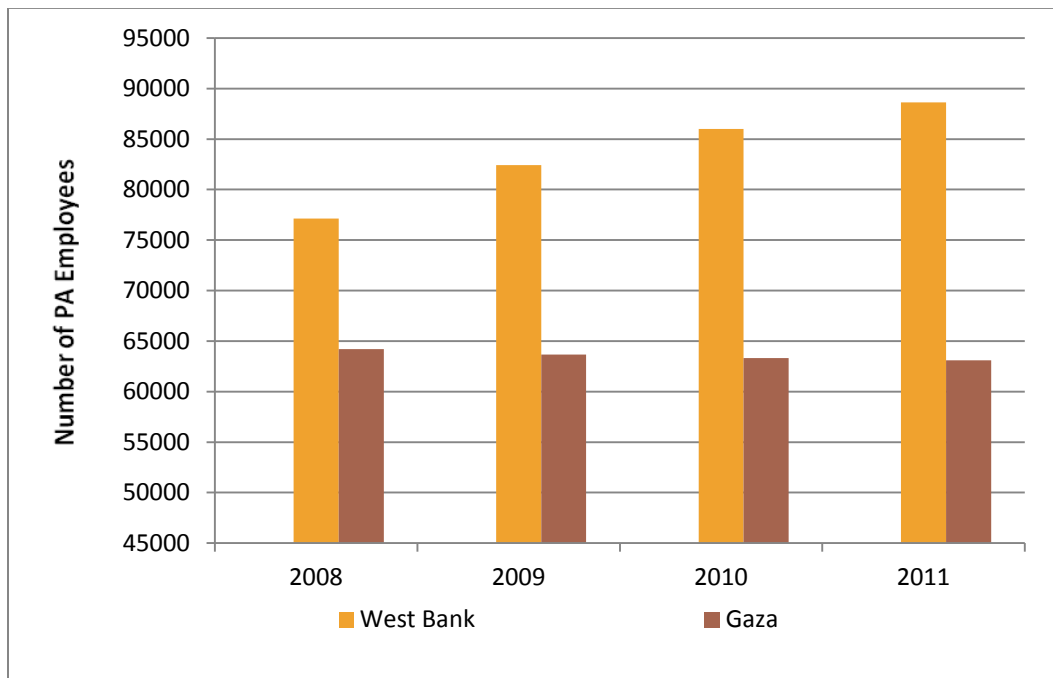
22. **The current public pension system threatens the PA's drive towards fiscal sustainability, as it represents one of the PA's largest obligations and is currently insolvent.** It is effectively being operated as a pay-as-you-go system, where current contributions fund the cost of retirees instead of being built up to support future retirees. The PA is only making enough payments to the system to cover current retirees and is accumulating significant arrears. Preliminary estimates suggest that the value of accumulated arrears is US\$1.5-2 billion and growing. In 2011, arrears to the pension system were well over US\$100 million. 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 studying ways to improve the long term viability of the public pension system. However, reforms have been moving slowly and the PA took no significant steps in 2011 or 2012 to date.

It is essential that the PA tackles the pension system before current employees begin to retire and the system falls into crisis.

23. Arguably, major expenditure savings can only be found by addressing the wage bill.

As Table 1 showed, the employment of civil servants constitutes the largest single component of the PA budget with over 50 percent of recurrent expenditures. Over the life of the PA, growth in the numbers employed and the wages paid have often been driven by social considerations and the civil service has at times been considered an employer of last resort (see Figure 2). As a result, the payroll grew to over 25 percent of GDP in 2006, and though economic growth in recent years has seen this reduced to less than 20 percent this is still exceptionally high. By way of comparison, the PA wage bill as a share of GDP is at least twice the average share for the Middle East and North Africa (MENA) region, a region that has a high share already compared to the rest of the world. Therefore, short-term measures that the PA might consider with respect to the wage bill are to freeze hiring, reduce the annual cost of living increase, limit promotions, and cut some allowances for Gaza staff who are not working. These measures will not be able to close the funding gap and would probably only result in savings of less than US\$75 million. However, they would be a significant step in dealing with the larger fiscal challenges facing the PA and would send a clear message about the PA's commitment to dealing with its fiscal crisis.

Figure 2: Number of Palestinian Authority employees, 2008-2011



Source: PA MoF

24. **In the Palestinian National Development Plan 2011-13 (NDP), the PA sets out an intention to prepare a medium term plan for civil service reform, including a number of priorities for administrative reform to improve effectiveness and contain costs.** 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 prospect of political reconciliation between the West Bank and Gaza raises an additional challenge as there is overlap of staff functions between the PA and the *de facto* authorities in Gaza. Furthermore, 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, the challenges of implementing such a reform should not be underestimated. It will require a change to the way that the civil service is viewed by many PA employees and society in general, and making this change will demand strong leadership, and dedicated management over a number of years if it is to succeed.

C.III. Further Improving Public Finance Management

25. **There has been considerable improvement in the quality of the PA's public financial management (PFM) in recent years.** The reforms have spanned the range of financial management functions; however, the area where the most progress has been made is in the financial management system. One of the virtues of the system's development is that it provides a platform for developments in many elements of PFM. As a result, there have been improvements in the control over expenditures, and the reliability of reports, while a separate module has also been developed to support budget preparation. In the period since the last Ad Hoc Liaison Committee (AHLC) meeting in September 2011, progress in these areas has continued with the completion of the audit of the 2009 financial statements, and the submission of the 2010 statements for audit. There has also been a major effort to improve the analysis of budget execution in the MoF's quarterly reports by the recently established Macroeconomic and Fiscal Unit.

26. **While the systems development has been a success, the improvements in management practices to exploit the opportunities created by the new systems invariably take more time.** The current fiscal crisis and the recent debate on the PA's proposed package of reforms have highlighted areas where progress with PFM has been more measured, and which should feature in the reform agenda in the coming period. In particular:

- a) **Strengthening the budget as a tool for prioritization.** While the systems used for budget preparation have been reformed, to a large extent the process continues to focus on incremental adjustments to the budget of the prior year. There is not a rigorous review of

expenditures and therefore there is limited scope for policy makers to identify possible areas for reprioritization. The development of a program-based approach to the budget will provide a good basis for expenditure analysis but this reform will take time to be effective. In the short term, there are opportunities to enhance expenditure analysis by deepening the monitoring of budget execution through the new financial management system, and establishing a stronger link between this monitoring and the preparation of future budgets.

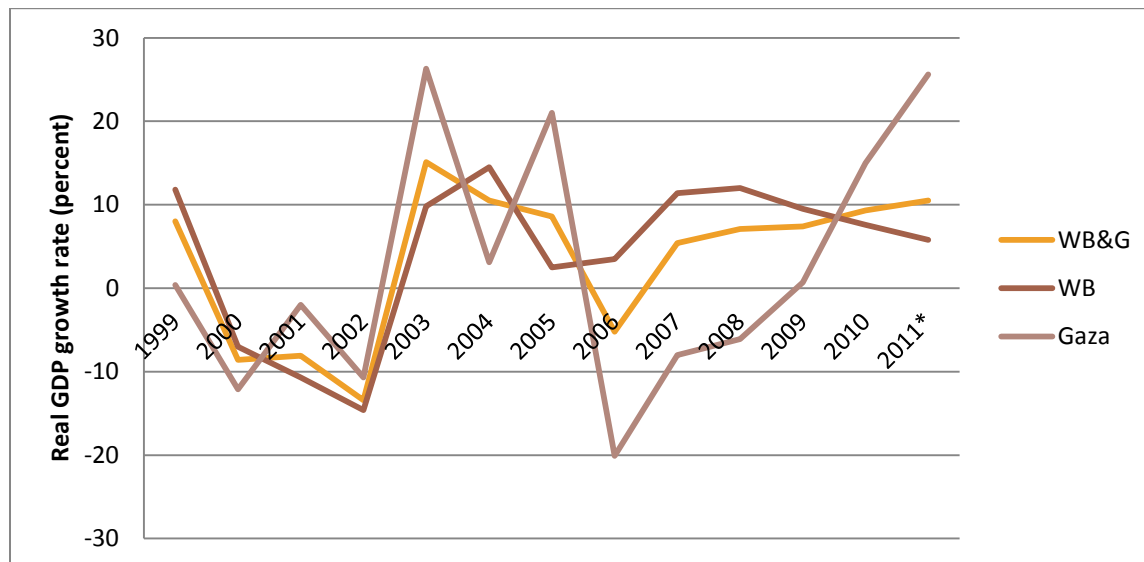
b) Giving more focus to explaining to the Palestinian people how resources are being used. The PA has made a major investment in the preparation of timely monthly and quarterly reports on budget execution. These reports concentrate on explaining how activity compares against the budget for broad expenditure aggregates, which are of interest to macroeconomic specialists. However, the reports provide relatively limited information of interest to the average Palestinian wishing to know where resources are being spent. The new financial management system has extensive information on expenditures, which provides an opportunity to improve the communication of how resources are used. A positive development during 2011 was the introduction of specific reports on the main projects financed by the development budget and this example should be extended, in particular by giving consideration to:

- explaining in detail the various transfers that are made and how they compare against the approved budget;
- providing an explanation of the main expenditures in important sectors such as health, education, and security; and
- preparing a guide to the 2012 budget that explains the main elements of expenditure and revenue.

D. Recent Economic Developments

27. **Driven by a continuing recovery in Gaza and despite a slow-down in the West Bank, economic growth in WB&G remained robust in 2011.** Thus, the real growth rate in the first three quarters of 2011 is estimated to have reached 10.5 percent⁹, i.e. higher than the corresponding 2010 growth figure and more than the 9 percent growth forecast in the PA's budget. This strong growth has been driven by continuing recovery in Gaza, where real GDP is estimated to have expanded by 25.8 percent in the first three quarters of 2011 (see Figure 3). By contrast, growth in the West Bank was only 5.8 percent, down from 7.5 percent for the corresponding period in 2010. In terms of growth for the full year of 2011, and pending availability of the official growth estimates by PCBS for the fourth quarter of 2011, the WB&G economy is expected to have slowed so that overall growth is projected to be about 9.5 percent¹⁰. This slowdown in growth is expected to continue into 2012, so that real growth in WB&G for 2012 is projected at 7 percent – 5 percent in the West Bank and 12 percent in Gaza. Despite the growth in the WB&G economy in recent years, however, the GDP on a per capita basis in WB&G today remains below that in 1999 (see Figure 4). In particular, while it is true that in 2010, GDP per capita in the West Bank surpassed its level in 1999, in Gaza individual income today remains lower than it was in the late nineties.

Figure 3: West Bank and Gaza real GDP growth rate, 1999 - 2011



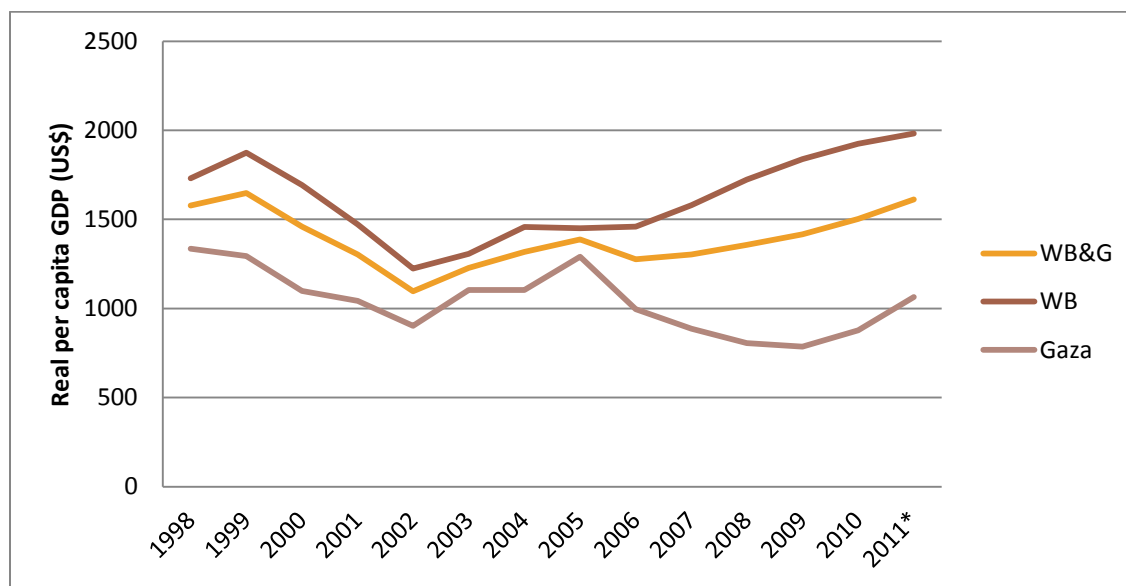
* Based on data for the first 3 quarters of 2011.

Source: PCBS

⁹ This 2011 growth rate is calculated relative to the same period in 2010.

¹⁰ This is a projection prepared by the IMF in consultation with PCBS, the World Bank, and the PA.

Figure 4: West Bank and Gaza real GDP per capita, 1998-2011



* Based on data for the first 3 quarters of 2011.

Source: PCBS

28. **The high growth rate in Gaza reflects the low base from which it is starting and can be attributed to a combination of aid inflows, easing of restrictions on entry of goods from Israel, and increased imports through tunnels from Egypt.** In particular, construction was the driver of growth, with construction output estimated to have increased by more than 141 percent in the first three quarters of the year, contributing close to 12 percentage points of the 26 percent growth (see Table 2). Though a general ban on the import of basic construction materials has been in place since the imposition of the Gaza blockade in 2007, the easing of restrictions by the GoI in June 2010 meant that some international organizations implementing infrastructure projects are eligible for Israeli permits to bring in limited amounts of the restricted building materials (UNOCHA oPt 2011). Since then, approximately 160 such projects have been approved by the GoI, and dozens of additional projects are awaiting approval. In addition, for the first time since October 2008, the Israeli authorities allowed in November 2011 entry of building materials for Gazan private sector companies. In terms of other sectors contributing to growth in Gaza, government and government-funded services continued to grow, contributing more than 4.5 percentage points of overall growth. Thus, the pattern of growth in Gaza reflects the high external aid which continues to fund public services, and construction that has been enabled by the loosening of import restrictions on construction materials primarily for donor projects.

29. **The slowdown in growth in the West Bank can be attributed to falling donor support combined with the uncertainty caused by the PA's fiscal crisis, as well as lack of new easing of restrictions by the GoI.** As in previous years, growth in the West Bank resulted from an expansion of government-funded activities. Public administration and defense contributed

nearly 1.8 percentage points of the 5.8 percent of total growth in the first three quarters. Encouragingly, the manufacturing sector grew by more than 9 percent compared to the same period in 2010 and contributed about 1 percentage point to overall growth. This is a substantial improvement over 2010, when it fell by 6 percent. However, the agriculture sector in the West Bank declined and output fell by nearly 4.5 percent in the first three quarters. Significantly, construction, which has been a major driver of growth in the West Bank, has slowed: in the first three quarters of 2011 it grew by less than 2 percent compared to 14 percent in the first three quarters of 2010.

Table 2: Contribution to GDP growth by economic activity, 2011*

Economic Activity	West Bank	Gaza	West Bank and Gaza
Agriculture and fishing	-0.1	2.0	0.4
Mining, manufacturing, electricity, and water	1.8	1.9	1.5
Construction	0.2	11.9	3.1
Wholesale and retail trade	0.7	2.0	1.0
Transport, storage, and communications	0.5	0.4	0.5
Financial intermediation	0.5	0.1	0.4
Services	0.5	4.5	1.5
Public administration and defense	1.8	3.0	2.1
Total real GDP growth rate	5.8	25.8	10.5

* Based on data for the first 3 quarters of 2011.

Source: PCBS and World Bank staff calculations.

30. **Despite improvements, labor force participation rates continue to be low and unemployment rates high.** Unemployment in WB&G declined from 23.4 percent in the fourth quarter of 2010 to 21 percent in the same period of 2011 (see Table 3). In the West Bank, unemployment remained constant together with an increase in the labor force participation rate from 44.5 to 47.3 percent. Unemployment in Gaza remains high at 30.3 percent, but that is about 7 percentage points lower than in the fourth quarter of 2010. Much of this decline is due to the increased hiring by donor supervised projects that picked up following the ease of Israeli restrictions in mid 2010. Though unemployment has fallen, labor force participation remains very low in Gaza: only 39.5 percent in the fourth quarter of 2011. Additionally, high youth unemployment and low youth labor force participation continue to represent a major concern. In Gaza, only 33 percent of young Palestinians aged 15-29 years were active participants in the labor force in the fourth quarter of 2011, and 46.5 percent of those were unemployed. In the West Bank, youth unemployment amounted to 25.8 percent with a participation rate of 40.8 percent. Relative to 2010, youth labor force participation increased in both West Bank and Gaza, and youth unemployment dropped in Gaza while it remained constant in the West Bank.

Table 3: Labor force statistics, fourth quarter 2011

(percent)	West Bank	Gaza	West Bank and Gaza
Unemployment rate			
-- Overall	16.6	30.3	21.0
-- Youth	25.8	46.5	32.7
Labor force participation rate			
-- Overall	47.3	39.5	44.4
-- Youth	40.8	33.0	37.8

Source: PCBS Labor Force Survey

D.I. Continued Israeli Restrictions

31. Israeli restrictions remain the biggest constraint facing Palestinian private sector growth. Thus, Israel retains security control and jurisdiction over planning and construction in close to 60 percent of the area of the West Bank – Area C¹¹ -- while the PA is responsible for the provision of services there. The PA’s ability to do so is severely impeded by Israel’s control over planning and construction: for example, the PA can provide a teacher, but not build a school for the teacher to teach in. In addition, as land is a common means of storing wealth and a powerful economic asset, providing a foundation for economic activity in sectors as varied as agriculture, industry, housing, and tourism, the lack of control over Area C has profound detrimental effects on the Palestinian economy (World Bank 2010). The present situation also severely handicaps Palestinian economic activity in the Jordan Valley, as most of the Jordan Valley is Area C, thereby denying Palestinians a potential powerhouse of export-oriented high value-added agriculture. Most Palestinians are also denied access to East Jerusalem, and since East Jerusalem has historically been the center of the West Bank economy and society, its separation also has debilitating economic and social effects (World Bank 2010). Nor is the situation improving: in 2011, there was a 20 percent increase in construction starts in Israeli settlements in the West Bank, and the highest number in a decade of plans in East Jerusalem (Peace Now 2012).

32. Previously, the GoI significantly eased movement restrictions in the West Bank, which contributed to economic growth, but there have been few recent measures. Movement into and out of the West Bank remains severely constrained. All cargo must use a back-to-back loading system, where shipments are downloaded from Palestinian to Israeli trucks or vice versa: a procedure that adds significant cost and delays to the shipping process. Businesses in

¹¹ The West Bank is divided into 3 areas: Area A corresponds to all major population centers and is under PA security and civilian control; Area B includes most rural communities and the PA exercises only civilian control there; and Area C is under Israeli control for both security and civilian affairs related to territory, including land administration and planning.

the West Bank are hurt by the growing list of “dual use” items that cannot be imported because the GoI views them as security threats, and it remains difficult for investors to get visas to enter and remain in the West Bank¹². In addition, the GoI maintains tight restrictions on Palestinian access to resources such as water and the electromagnetic spectrum. For example, Palestinian telecommunications companies are not allowed to cover 3G wireless services, which constrains the market for developing applications for mobile phones, one of the fastest growing fields in the IT industry.

33. Israel maintains the ban on almost all exports from Gaza and significant restrictions on imports. The sole remaining crossing point into Gaza¹³ has been recently expanded and can now handle up to 450 truckloads of imports and exports a day (UNOCHA oPt 2012). Because of the ongoing Israeli restrictions on exports and imports, together with the limited number of international projects that are approved, this capacity is currently underutilized, with just over 220 daily truckloads in January 2012. However, if the restrictions on exports and imports were to be lifted and pending projects approved, the crossing would not be sufficient to meet demand. In addition, if it were to be closed unexpectedly – a likely scenario given the unstable security situation – its closure could further jeopardize the already vulnerable humanitarian situation in Gaza. November 2011 witnessed the export of strawberries from Gaza to Europe – the first truckloads to leave Gaza in 6 months. In January 2012, one truckload with 15 pallets of furniture exited Gaza for Jordan¹⁴ – constituting the first non-agricultural exports since the start of the blockade in June 2007. Trade with Gaza’s traditional markets in the West Bank and Israel remains banned. Without access to these large markets, Gaza’s industry will not manage any significant recovery. The Gaza private sector continues to be constrained by the difficulty in importing needed inputs. While many products have recently been allowed in, the closing of the Al Montar/Karni crossing and shifting of all imports to Karm Abu Salem/Karem Shalom has increased costs. The longer Gaza remains closed, the harder it will be to restart businesses once the borders open again. Managers report that their former customers have found new suppliers, their skilled labor is drifting away or losing their skills, and machinery is deteriorating. Thus, it is critical to reopen trade with Gaza as soon as possible and let Gazan manufacturers once again ship to Israel, the West Bank, and the rest of the world. Other significant restrictions on growth in Gaza include the inability to develop the Gaza Marine gas field (see more below) as well as continued impediments for the second mobile operator, Wataniya, to enter the Gaza market.

¹² See for example Hamdan, Sara. February 22, 2012. “Palestine Securities Exchange a Bright Spot in Equities,” *The New York Times*, available at http://www.nytimes.com/2012/02/23/world/middleeast/palestine-securities-exchange-a-bright-spot-in-equities.html?_r=3&ref=middleeast&pagewanted=all. In this article, Khaled Sabawi, general manager of Union Construction & Investment, the largest construction company listed on the Palestinian Securities Exchange, is cited as saying that business is complicated by curfews and checkpoints, and that he was denied entry to Palestinian territory three times in 2009 although his businesses were based in Ramallah and he held Canadian citizenship.

¹³ Al Montar/Karni crossing was completely dismantled in January 2012.

¹⁴ These goods, coming from 6 Gazan businesses, did not represent actual sales but were showcased in a furniture exhibition in Amman.

D.II. Improving the Business Climate

34. **While Israeli restrictions are the biggest constraint on the growth of the Palestinian private sector, there remains much to be done by the PA to create an enabling business environment that attracts 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 create a business environment that is among the best in the world and not merely on a par with its neighbors. Unfortunately, faced with the immediate concerns of a deep fiscal crisis and an unstable political situation, the PA has made little recent progress in improving the business environment. Yet fiscal sustainability will only be achieved through sustained and rapid private sector growth. Therefore, it is imperative that the PA devote significant resources and political capital on steps to improve the business environment.

35. **One of the most important steps that the PA can take is to rapidly expand land registration in the West Bank¹⁵.** 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 since 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 estate 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 USA. Thus, one of the most important steps that the PA can take to increase 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, make the registry public, and plan for adding public land in Area C to the registry when the time comes.

36. **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 consists of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws, which differ between Gaza and the West Bank. This disparate group of laws leaves significant gaps and contains many internal inconsistencies. In addition to the outdated primary legislation, much of the secondary legislation -- including regulations and procedures issued at the ministerial level -- is also incomplete or contradictory. Thus, critical to improving the investment climate is reforming the current collection of laws governing business. Passing new legislation is of course difficult in the absence of a functioning Palestinian Legislative Council. However, the PA needs to build consensus and move to enact a number of laws that have been drafted and are under consideration. Among the most pressing are the secured transactions law, companies law, competition law, leasing law, tenants law, and laws around land and housing.

¹⁵ Gaza does not face the same types of challenges in terms of access to land. Since the evacuation of the Israeli settlements in 2005, all of Gaza is under Palestinian control. In addition, the Egyptian land law applies in Gaza, 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.

37. **It is also important that the PA continues to build its capacity to regulate the economy and ensure competition.** Sound regulation is particularly important for service industries, which present a significant opportunity for growth in WB&G. The PA has still not established an independent regulator for the telecommunications sector as called for in the current law. Telecommunications is the single largest sub-sector in the private sector and efficient telecommunications services are essential for many other businesses. Ensuring the telecommunications sector is regulated in a way that promotes competition and spurs productivity growth is essential for the Palestinian economy. The fact that the PA is unable to adequately regulate the largest monopoly in WB&G also sends a strong, but negative, signal to potential investors in all sectors¹⁶.

D.III. The Banking Sector

38. **The Palestinian banking sector continues to perform well and is strongly regulated by the Palestine Monetary Authority (PMA).** The PMA continues its institutional development and is steadily building the capabilities of a central bank. It applies a strong supervisory and regulatory framework and one of the most effective anti-money laundering laws in the world. The PMA is finalizing a draft law that solidifies its independence and provides the legislative framework for it to become a full-fledged central bank. It is also continuing its efforts to develop a deposit insurance scheme as well as to improve its research group and its capabilities to regulate banks according to Basel II. The growing strength and sophistication of the local banking sector can be seen by the steady increase in credit to the private sector, which grew by almost 20 percent in 2011. During 2011, the percentage of nonperforming loans to total credit remained low at less than 3 percent.

39. **Even though the local banking sector has built up significant credit exposure to the PA and its employees, the PA's fiscal crisis is not perceived as a threat to its stability.** The PA's domestic borrowing amounted to US\$1.1 billion as of December 2011, representing about 12 percent of the banking sector's net assets. Credit to the public sector and PA employees, combined, increased from 40 percent of gross outstanding credit at the end of 2010 to 45 percent in December 2011. Consequently, the PMA has been carefully monitoring the risks imposed by the rising political and economic uncertainties, combined with the sector's high exposure to the PA. It has ordered banks to implement necessary measures, including decreasing credit exposure to certain borrowers and raising capital and reserve requirements. In March 2011, the PMA began implementing quarterly stress tests on all banks according to Basel II principles. These tests account for both economic and political shocks and are applied to various scenarios. The latest results indicate that all banks passed the minimum requirements specified by Basel II principles. Smaller banks, however, performed better than some larger ones due to a higher credit exposure to the PA amongst the latter. As a result, some large banks were required by the PMA to raise their capital, adopt additional mitigation

¹⁶ The mobile market has been opened to competition but PalTel retains its monopoly on landlines.

tools, and diversify their portfolios. Most of these banks have already applied the measures while the rest are in process of doing so. The PMA also asked banks to start performing their own semiannual stress tests using customized scenarios according to the specific characteristics of each bank.

40. **The PMA continues to face difficulties in transferring cash to Gaza.** Moving money to Gaza requires coordination with the GoI, and the PMA reports that it has not been able to transfer Israeli shekels into Gaza since October 2010. This is beginning to once again create a shortage of cash in the banks, which in turn leads the public to hoard cash making the shortage even worse. It is also slowly eroding the credibility of the formal banking sector in Gaza, and strengthening the money changers and unregulated banking sector.

E. Gaza Infrastructure

41. **As described earlier in this report, Gaza has experienced a high rate of growth in 2011, driven primarily by the construction sector, and leading to a reduction in unemployment rates.** A forthcoming World Bank report assesses the potential for job creation through infrastructure investments in the MENA region and finds that infrastructure investment can not only serve as a potential source of immediate jobs, but also boost long-term growth and employment (World Bank forthcoming 2012). In addition, spending on construction of roads and bridges is found to generate more than twice as many direct jobs as the same amount of spending in any of the other infrastructure sectors, with construction of water and sewage infrastructure as the second most job-intensive activity relative to spending.

42. **The PA continues to stress the need for important investments in infrastructure in Gaza.** In the NDP, the PA reiterates the need for the majority of the recovery and reconstruction requirements, identified in the Palestinian National Early Recovery and Reconstruction Plan for Gaza 2009-2010 (PNERRP), to be realized. While the PNERRP includes interventions in a wide range of sectors, the infrastructure sector captures the largest share of required funding (see Table 4) and though the expected timeframe for implementation was 2009-2010, the NDP now anticipates the timeframe to extend to 2013.

43. **This section of the report lays out infrastructure needs in Gaza in the three key sectors of water and wastewater, electricity, and solid waste.** As mentioned above, infrastructure investment does not only lead to immediate jobs – in and of itself most desirable to combat Gaza’s high unemployment rates – but can promote a virtuous cycle of growth and job creation. Indeed, it is difficult to imagine a real recovery in Gaza in the absence of sufficient water and electricity supplies, as well as a functioning solid waste management system. As the discussion below will show, Gaza faces monumental challenges in the three above-mentioned sectors, but technical solutions are available. It is therefore a matter of bringing about the necessary

coordination and cooperation between the PA, Gol, and the donors in order to ensure that funding is not only available but also able to be put to good use.

Table 4: Gaza financing requirements, by sector

Sector	Financing (US\$ million)	Share of total financing (percent)
Infrastructure	531	40
Economy	412	31
Social	315	24
Governance	68	5
Total	1,326	100

Source: Palestinian Authority. April 2011. *National Development Plan 2011-13 – Establishing the State, Building our Future*, page 71.

E.I. Water and Wastewater

44. **The water sector in Gaza suffers a severe deficit in quantity, a rapid deterioration in quality, and inefficiency and fragmentation in service delivery.** The coastal aquifer, Gaza’s main water resource, is over-drafted by around 100 million cubic meters (MCM) annually. The groundwater aquifer underneath Gaza provides more than 95 percent of Gazan water demand. Its estimated abstraction volume in 2010 was around 160 MCM, divided roughly equally between abstraction from agricultural and domestic municipal wells. Around 5 MCM are supplied annually by the Israel National Water Company (Mekorot). The aquifer replenishment from rainwater is estimated at 50-60 MCM annually and the annual deficit in the water resource budget is around 100 MCM. The over-drafting of the aquifer is causing a rapid decline of the groundwater table, seawater intrusion, and deterioration of the aquifer water quality (Palestine Water Authority 2011).

45. **The Gazan water supply quality is rapidly deteriorating.** Seawater intrusion in the aquifer, percolation of untreated or partially treated wastewater, leachate from unqualified landfills and random dumpsites (see more below), and residues from agricultural chemicals are causing contamination by chloride and nitrates. In 2009, the Palestine Water Authority (PWA) and Coastal Municipalities Water Utility (CMWU)¹⁷ reported more than 90 percent of all municipal wells having salt and nitrate levels above World Health Organization (WHO) standards (World Bank 2009). In 2012, the PWA and CMWU reported that this share had risen to 95 percent.

46. **The available water supply is restricting demand and causing low consumption rates by regional standards.** The CMWU estimates withdrawals at around 100 liters per capita per day at source, with actual consumption dropping to roughly 70-80 liters per capita per day

¹⁷ The regional distribution utility.

depending on the governorate when taking losses in the networks into account. With the exception of the West Bank, the lowest in the region, consumption rates in Gaza are less than one quarter of rates in Israel and other neighboring countries (World Bank 2009). The current available water resources for Gaza constitute a limiting constraint on meeting the growing domestic demand and the prospects for growth in the agricultural sector.

47. **Though 98 percent of Gazan households are connected to the water supply networks, the water supply is intermittent and the service is of low quality.** Water supply networks are fragmented with no connections between the various governorates and no equitable distribution in terms of quality and quantity can be achieved without reconfiguring the networks and the construction of a north-south carrier line. The average access of households to piped water is less than eight hours daily and the population relies mainly on roof-top water tanks. Water supply is interrupted by electricity outages (see more below), fuel shortages, and breakdowns of old and under-maintained water wells and facilities.

48. **Service provision is fragmented and the efforts to consolidate CMWU remain ongoing.** Almost all 25 Gazan municipalities receive water and wastewater services from the CMWU to varying degrees. The CMWU issues the water bill in 14 municipalities but only Rafah municipality has joined CMWU both administratively and financially. Collection rates are below and losses are above business standards – estimated by CMWU at roughly 50 and 40 percent, respectively. Cost recovery is constrained by high poverty and unemployment rates and CMWU is highly dependent on donor aid for capital investments, operation, and maintenance. Major efforts are needed to improve the quality and efficiency of service provision including reducing losses (especially illegal connections) and improving cost recovery by increasing collection and adjusting tariffs.

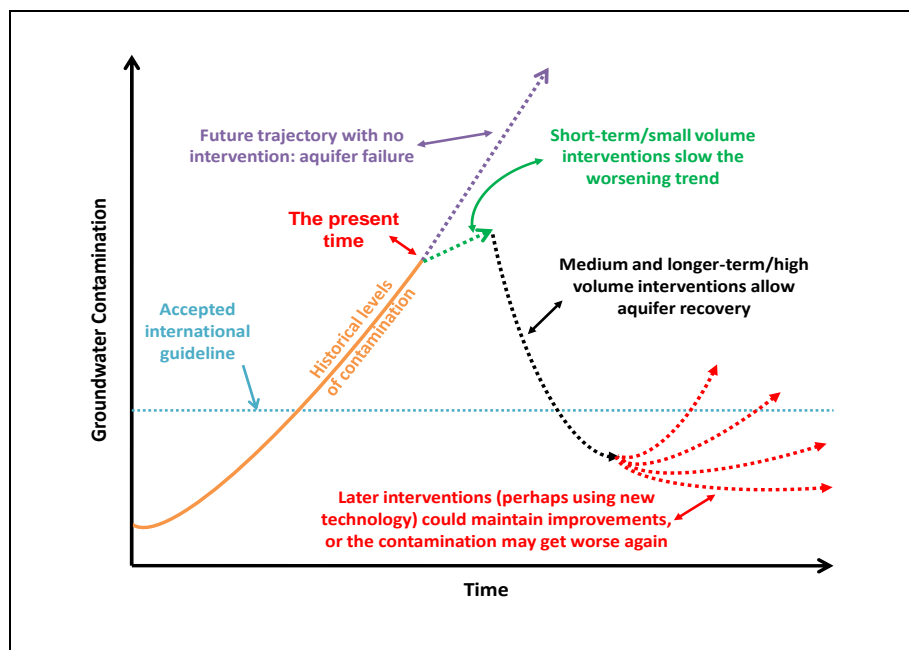
49. **Wastewater collection networks and wastewater treatment facilities are underdeveloped.** Some communities still rely on septic tanks and remain unconnected to the wastewater networks. Wastewater treatment plants serving different governorates in Gaza are at different stages of development. Gaza City is served by a treatment plant that has been rehabilitated and expanded recently; the construction of a wastewater treatment plant and reuse system for northern Gaza with donor funding is ongoing; and Khan Younis and Rafah cities are served by plants with partial treatment capacity. A number of inland wastewater streams and sea outfalls can be observed in different governorates.

50. **The PWA has attracted significant donor attention to the serious needs of the sector, but development of the water sector still requires massive financial support and institutional strengthening.** Thus, investments have been directed toward enhancement of water supply through the drilling and rehabilitation of wells; construction of main distribution pipelines to increase access to water; repair, replacement, and rehabilitation of service connections; development of wastewater facilities; and strengthening of managerial capacity and promotion of appropriate institutional reforms. The CMWU has implemented a large portfolio of projects worth more than US\$150 million, making tangible progress towards improving access of households to water supply; disinfection of water supply; reduction of network losses; and

maintenance of water and wastewater facilities to cope with increasing demand by the population.

51. **Recently, the PWA developed a strategy to address shortages and quality of water supply in Gaza (PWA 2011).** The strategy proposes short, medium, and long-term interventions. In the short term, the strategy’s objective is to slow down the deterioration of the aquifer and improve water supply quality using a number of interventions, including short-term low-volume desalination, increased water imports, improved service provision and efficiency, reconfiguration and rehabilitation of the distribution networks, and piloting wastewater reuse. In the medium and long term, the strategy stresses primarily major desalination plants and imports to meet the forecasted demand and reduce the stresses on the groundwater aquifer, as well as major wastewater reuse schemes in agriculture. Figure 5 below provides a schematic presentation of the PWA strategy.

Figure 5: Schematic of PWA water supply strategy



Source: Palestine Water Authority. August 2011. *Comparative Study of Options of Water Supply in Gaza.*

E.II. Electricity

52. **Electricity consumption in Gaza grew at an average rate of 10 percent annually from 1999 to 2005, but in recent years growth has been constrained by the shortage of supply, damage to electricity networks, and the Israeli blockade.** By comparison, West Bank electricity consumption grew at 6 percent annually during 1999-2005, 8 percent during 2006-2010, and is projected to grow at roughly 7 percent during 2011-2013. In Gaza, electricity is

supplied from three different sources: (i) imports from IEC; (ii) imports from Egypt; and (iii) the Gaza Power Plant (GPP). The existing supply capacity from IEC to Gaza is approximately 120 megawatt and energy is fed from Israel through ten points along the border. Gaza also received up to 17 megawatt from Egypt since 2006 as an emergency measure – and this was increased in February 2012 to 22 megawatt. The generating capacity of the diesel-operated GPP is 140 megawatt, but since the Israeli Operation Cast Lead on Gaza (December 2008 – January 2009), the GPP's transmission capacity has been curtailed and hence its dispatchable capacity ranges from 30-60 megawatt. In addition, the plant's utilization rate can decrease further due to limited diesel availability – even reaching a complete shut-down as occurred in February 2012.

53. Thus, available electricity capacity in Gaza ranges from roughly 170 to 200 megawatt, as compared to estimated 2010 peak demand of 280 megawatt. To cope with the deficit, 8-hour electricity outages have been scheduled daily. Electricity shortages and cuts impact negatively all social and economic aspects of daily life in Gaza, ranging from hospitals and schools to water, sanitation, agriculture, and commercial enterprises. Private back-up generators are used extensively during periods of electricity cuts, but these generators are in many cases unsafe, environmentally polluting, in addition to not being affordable to the poorer segments of the population.

54. The electricity shortage is further exacerbated by the deteriorated conditions of the electricity networks in Gaza. Despite some progress in the last two years in repairing damage to the electricity distribution networks, several problems remain, including: (i) overloading and limited capacity of the medium voltage feeders from the main supply points (IEC, GPP, and Egypt) to the main load centers; (ii) inadequate capacity of the low voltage networks to meet existing loads, including unsafe installations and very low reliability and voltage profiles; and (iii) high network losses reaching up to more than 30 percent of the electricity supply, which in turn exacerbates the electricity supply deficit.

55. Addressing the shortages of electricity supply and meeting growing demand remain formidable challenges for Gaza, but technically feasible investment options are available. One option is to convert GPP to burn natural gas instead of diesel – saving millions of dollars annually in view of the prevailing high fuel prices, and allowing the plant to operate at full capacity as well as making future expansion feasible. The investments required to convert the plant to operate on gas include constructing a gas pipeline to the plant along with reinforcement of transmission connections to the network. The source of the gas supply, whether Egypt, Israel, Gaza Marine¹⁸, or elsewhere, would need to be agreed upon by all relevant parties. Another option entails increasing the supply of electricity from Egypt to Gaza, which would require construction of a 220 kilovolt interconnection between Gaza and Egypt. Four to seven kilometers of the 220 kilovolt high voltage transmission lines, connecting substation and medium voltage feeders, would be constructed inside Gaza to connect with the

¹⁸ In 2000, the British Gas Group announced the successful discovery of two natural gas wells with roughly 35 billion cubic meters proven gas reserves. This Gaza Marine field is located about 36km offshore and has not yet been developed and could be a source of natural gas to the GPP.

50 kilometer segment of the line in Egypt. Yet another option would be to increase the supply of electricity from Israel to Gaza, which would require the expansion of the northern Gaza substation and the reconfiguration of the distribution system in the north. Hand-in-hand with increasing supply, and given the deteriorated condition of the electricity networks, there is a need to increase the capacity of the networks as well as improve their performance efficiency, safety, and utilization. This in turn requires major rehabilitation and expansion of the networks in Gaza including investments in the low- and medium-voltage distribution systems and metering.

E.III. Solid Waste

56. **Though improvement in the management of solid waste¹⁹ is one of the PA's priorities, and despite the gravity of the current situation, little attention has been paid to this sector in Gaza.** Collection and disposal²⁰ services are poor, resulting in a threat to public health from the breeding of disease-carrying vectors. The burning of garbage poses serious environmental threats, and the seepage of leachate (toxic liquid runoff) from badly managed dumpsites threatens Gaza's already polluted underground water aquifer. In the West Bank, the PA's strategy (PA 2010) calls for construction of three regional sanitary landfills²¹: one for the north, a second for the middle area, and a third for the south. A northern West Bank sanitary landfill was constructed in Jenin and has been in operation since 2007. A southern area sanitary landfill that will serve the Bethlehem and Hebron governorates is currently under construction and should be operational in 2013, and the third landfill to serve the middle area of the West Bank is under development. For Gaza, the PA's strategy calls for at least one if not two such landfills.

57. **A recent study (DHV 2012) indicates that though most of the garbage generated is collected, important problems related to methods, management, costs, and cost recovery**

¹⁹ The solid waste sector includes domestic, industrial, and agricultural waste, as well as hazardous and non-hazardous waste from hospitals. Unless properly managed and disposed of, these wastes can be a threat to the environment and public health due to their hosting of infectious disease vectors and contribution to atmospheric and groundwater pollution.

²⁰ Solid waste management includes: (i) primary collection, i.e. collection from households and establishments and transport from collection points (large containers, etc.) to transfer stations; (ii) secondary collection, i.e. transport from the transfer stations to disposal sites or landfill; and (iii) disposal, i.e. the deposit and management of the wastes at landfill sites, including more advanced composting and recycling. This section focuses on secondary collection and disposal. Primary waste collection is largely the responsibility of the 33 municipalities in Gaza, and collection practices vary from area to area. In many densely built-up residential areas collection is done house to house daily; in some busy commercial areas, collection is done more than twice daily from large containers; and in less densely built-up areas, it is done at street containers within 100 meters walking distance from the dwellings, two or three times a week.

²¹ A sanitary landfill, as distinct from a dumpsite or an ordinary landfill, is designed, constructed, and managed on an environmentally sound basis. This includes the adoption of environmentally sound methods for depositing and covering the waste to prevent access by disease vectors and reduce atmospheric pollution, and preventing the seepage of toxic effluent from the waste into the sub-soil. Ordinary landfills and dumpsites do not normally make such provisions and are thus environmental threats.

remain. Thus, garbage collected is disposed of either at one of the three main dumpsites or at one of ten illegal disposal sites. A highly conspicuous aspect of the collection system in Gaza is the deployment of some 475 donkey carts – 260 alone in Gaza Municipality. The proliferation of donkey carts is the result of Israeli restrictions on the import of equipment and spare parts. They are seen by many as a visible indicator of Gaza’s impoverishment, as well as a relic of bygone times, not to mention being environmentally dubious and inefficient. Gaza does have more conventional solid waste management equipment, including tipper cranes, tractor trailers, tipper and compactor trucks, etc. However, much of this equipment is old and/or in a poor state of repair, and a considerable amount needs to be replaced. In this context, it is worth noting that 22 new trucks destined for Gaza Municipality have been waiting for the last 3 years in Ramallah for the necessary permits from the Israeli authorities in order to enter Gaza. In the meantime, the continued use of old vehicles is causing significant disruption of the service due to regular breakdown. In addition, service costs have increased due to continuous purchase of spare parts – often not original, resulting in yet more problems. All of which results in poor service, low public satisfaction, and low cost recovery.

58. There are currently some 10 disposal sites in Gaza, of which three are official landfill sites, and only one a sanitary landfill. The Deir al-Balah sanitary landfill was constructed in 1995 and is today close to capacity, as well as being close to the Israeli military exclusion zone on the border between Gaza and Israel. The Johr el-Deek landfill is also close to capacity as well as being close to the Israeli military exclusion zone, so that its expansion entails risks. The third landfill at Sufa is the least problematic in terms of capacity and room for expansion. However, responsibility for disposal lies with 4 main service providers: North Gaza Joint Service Council (JSC); Gaza Municipality; Deir el-Balah JSC; and Rafah JSC. All are urgently in need of capacity strengthening. An even more fundamental problem, however, is the absence of any clear institutional responsibility for overall sector management and development—in Gaza as well as the West Bank.

59. In Gaza, there is a need for construction of two sanitary landfills, one serving the northern, and another serving the middle and southern municipalities. These new landfills are expected to serve the population in Gaza until 2032 and 2043, respectively. To help further improve solid waste management, there is a need to close and rehabilitate all remaining dumpsites, establish transfer stations to reduce hauling costs, and replace the old collection fleet with a new one. To ensure system sustainability, there is further a need for public awareness and education campaigns and significant improvement in fee collection.

60. In summary, infrastructure investments in Gaza in the water and wastewater, electricity, and solid waste sectors would improve the quality of people’s lives, lead to immediate jobs, and promote further growth and job creation. Though the needs are sizeable, they are well understood and the necessary technical solutions are available. What remains is to bring about the necessary coordination and cooperation between all parties concerned – the PA, GoI, and the donors – in order to secure not only the necessary funding but also efficient implementation and sustainable operation of resulting investments.

F. Conclusion

61. **A 2004 World Bank report stated that “an unfettered flow of people and goods between Gaza and the West Bank is needed to link the two territorial elements of the Palestinian economy, and to lay the basis for viable statehood” (World Bank 2004 p. 14).** It further elaborated that a functioning link between Gaza and the West Bank would create a larger effective internal market, help trigger price and income convergence by directing factors of production more efficiently, and provide a pathway from the economy of the West Bank to a future seaport in Gaza. These findings remain true today – indeed, the mention of the Gaza seaport is a stark reminder that the discussion today is in some ways behind what it was back in 2004. This reminder might serve to prompt all relevant actors – the PA, Israel, and the international community – to redouble efforts today to ensure sustainable economic growth for Palestinians in WB&G.

62. **Sustainable economic growth for WB&G results from private sector growth, which in turn requires easing of Israeli restrictions.** The slowdown in West Bank growth in 2011 demonstrates its dependence on donor aid, which is on a negative trend, and the lack of new Israeli easing of restrictions. The resulting fiscal crisis faced by the PA threatens to undermine provision of services as well as the gains made over the past years in institution-building. Though the PA is making a concerted effort to strengthen its fiscal position, including steps to raise domestic revenues and control expenditures, it cannot accomplish this task without the cooperation of the Gol. At the same time, the PA cannot take enough steps in the short term to reduce the projected recurrent deficit to match expected donor aid, so that an increase in this aid is absolutely necessary. The recent upswing in growth in Gaza demonstrates the importance of easing of Israeli restrictions on the entry of raw materials in combination with the availability of donor financing for investments. Gaza’s infrastructure needs are such, in addition, that a virtuous cycle of growth and jobs could result from further investments in the water and wastewater, electricity, and solid waste sectors, to name a few.

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