

# A Palestinian State in Two Years: Institutions for Economic Revival

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*Economic Monitoring Report to the Ad Hoc Liaison Committee*

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## Acronyms

COGAT	Coordinator of Government Activities in the Territories
CPA	Crossing Points Authority
EUPOL COPPS	EU Police Co-ordinating Office for Palestinian Police Support
GDP	Gross Domestic Product
GoI	Government of Israel
HJC	High Judicial Council
ICBS	Israeli Central Bureau of Statistics
ICT	Information and communication technologies
IDF	Israel Defense Forces
IMF	International Monetary Fund
IPA	Irrevocable Power of Attorney
MDLF	Municipal Development Lending Fund
MENA	Middle East and North Africa
MoF	Ministry of Finance
MoFA	Ministry of Foreign Affairs
MoI	Ministry of Interior
MoJ	Ministry of Justice
MoNE	Ministry of National Economy
MoPAD	Ministry of Planning and Administrative Development
MoSA	Ministry of Social Affairs
NGO	Non-governmental organization
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PFM	Public financial management
PIF	Palestinian Investment Fund
PLA	Palestinian Land Authority
PLC	Palestinian Legislative Council
PMA	Palestinian Monetary Authority
PRDP	Palestinian Reform and Development Plan
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
WB&G	West Bank and Gaza

## Executive Summary

- a. On August 25, 2009, the Palestinian Authority (PA) presented a program entitled “Palestine: Ending the Occupation, Establishing the State” (hereafter referred to as Program), which envisions the establishment of an independent state within two years. The following report analyzes some of the economic and development conditions necessary for achievement of this goal.
- b. The Program accords high priority to institution-building. Substantial efforts are still required to remedy institutional weaknesses in two crucial sectors – the judiciary, where the institutional setup lacks a clear legal structure and mutually accepted competencies, and land management, where there are significant strategic and operational bottlenecks to expanded and expedited land registration. In addition, reform of the public finance management system is not yet complete. However, PA institution-building performance is generally satisfactory and it has demonstrated competence in the provision of basic services. Therefore, provided Gaza and the West Bank are reintegrated, the PA is well positioned to establish the institutional basis for Palestinian statehood in the near future.
- c. Achievement of another central goal of the Program -- “economic independence and national prosperity” -- requires more than well-functioning institutions, however. The Israeli closure regime, significantly tightened since the outbreak of the Second Intifada in 2000, has stymied Palestinian private sector growth. This growth is a key condition for the sustainable economic development required for fiscal independence.
- d. Since the beginning of 2009, the Government of Israel (GoI) has taken significant steps to ease movement restrictions in the West Bank and to allow greater access to West Bank markets for Arab citizens of Israel. At the same time, the security environment in the West Bank has improved dramatically. Together these developments have led to increased investor confidence and more economic activity.
- e. Access to markets outside the West Bank -- in Gaza, in Israel, and elsewhere in the world -- is still severely limited, however. In addition, much of the administrative system that undermines investor confidence and restricts access to natural resources, such as Area C land (which constitutes some 60 percent of the West Bank), water, and telecommunications frequencies, remains in place.
- f. Therefore, even if the continued economic stagnation of Gaza is not included in the analysis, it is too early to conclude that the signs of new growth in the West Bank – though they may lead for the first time in years to positive Palestinian per capita GDP growth in 2009 -- represent a trend towards sustainable economic growth<sup>1</sup>. Much of the growth appears to have

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<sup>1</sup> The IMF projection that real GDP growth in the West Bank and Gaza will increase to 5.5 percent in 2009, from about 2.3 percent in 2008, has been frequently cited. The IMF emphasizes, however, that its macroeconomic framework assumes that all parties (PA, the GoI, and donors) would proactively push the peace process forward and support growth-enhancing reforms. In addition, while the projected recovery would be a major achievement, it would still leave living standards below pre-closures in 2000.

been generated by donor spending, which rose significantly in response to Israel's recent military operation in Gaza, and may not be sustainable.

g. Indeed, the PA's fiscal position remains precarious and it is currently facing a \$400 million financing gap for 2009. While PA performance in wage bill control has improved dramatically, overall expenditure control requires improvement -- total expenditures in the first half of the year were 12 percent higher than the budget target. No amount of restraint will, however, be sufficient to address the unsustainable deficits generated by revenue shortfalls. For the PA to approach its deficit target, revenues must substantially increase in the second half of 2009.

h. Net revenues, however, were more than 15 percent below budget target in the first half of 2009 and around 13 percent lower than the same period of the previous year. Therefore, unless further major steps are taken to enable sustainable private sector growth -- particularly by improving access to Israeli markets and to international ones, via either Israel, Jordan, or Egypt - the PA will continue to require large amounts of donor aid for the foreseeable future.

## Introduction

1. **On August 25, 2009, the 13<sup>th</sup> Government of the Palestinian Authority (PA) presented a program entitled “Palestine: Ending the Occupation, Establishing the State” (hereafter referred to as the Program<sup>2</sup>) outlining several national goals, including the achievement of “economic independence<sup>3</sup> and national prosperity”<sup>4</sup>.** Positing that a “capable state is built on the foundations of a strong, sustainable, active, and efficient economy”<sup>5</sup>, the Program outlines the Government’s commitment to building a free and competitive economic system through close cooperation between a competent, capable, and visionary public sector and a pioneering private sector committed to achieving prosperity for the Palestinian people. The Government further commits to economic policies and development plans that focus on developing domestic capacities and resources, creating an environment that attracts investment, and laying the foundations of sustainable growth and development which will ultimately reduce dependence on external aid. While in the near term the Program describes the Government’s aim as providing essential economic stimulus in order to alleviate poverty, the longer term objective is to build a vibrant, knowledge-based economy capable of producing competitive goods and delivering high quality services.

2. **The Program accords high priority to the development of the public institutions of the PA in order to achieve the stated national goals.** It acknowledges that maintaining an efficient and effective public sector that provides citizens with high quality services and value for money is a constant challenge. As such, the Government commits to consolidating and building on the achievements of previous governments in building a responsive, transparent, accountable, efficient, and effective Palestinian public sector. The Program seeks to involve all sectors and segments of Palestinian society in the drive to develop and advance institutions. Furthermore, the Government identifies its main institution-building priorities in five core areas, including unification and modernization of the legal framework; rationalization of government organizational structures and processes; and management of financial resources<sup>6</sup>.

3. **Assuming the PA maintains its performance in institution-building and delivery of public services that began with the Oslo Accords in 1993, it is well-positioned for the establishment of a Palestinian state at any point in the near future.** Indeed, relative to other

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<sup>2</sup> This Program can be characterized more as a vision statement as opposed to a detailed plan for the coming years. In terms of planning, the current Palestinian Reform and Development Plan remains in effect until 2010, and the process has begun for devising the next National Plan for 2011-13.

<sup>3</sup> The terminology “economic independence” refers to the desire to reverse the Palestinian economy’s “dependence on the Israeli economy” (Program page 11) as opposed to a quest for autarky, for example.

<sup>4</sup> Palestinian Authority. 2009. *Palestine: Ending the Occupation, Establishing the State – Program of the Thirteenth Government*, page 11. This goal was the seventh in a list of eleven goals, i.e. end the occupation of the Palestinian territory since 1967; promote national unity; protect Jerusalem as the eternal capital of the Palestinian state; protect refugees and follow up on attainment of their rights; secure the release of prisoners; ensure human development; bring equality and social justice to all citizens; consolidate good governance; bring safety and security across the homeland; and build positive regional and international relations.

<sup>5</sup> *ibid*

<sup>6</sup> The two remaining core areas for institution-building are expansion of the use of information and communication technology (ICT) in the public sector and management of human resources.

countries in the region, the public sector in West Bank and Gaza (WB&G) is arguably already more effective and efficient. As will be explained in more detail in this report, in some areas, such as management of public finance and establishment of security and the rule of law, important reforms have taken place and progress continues to be made. Other areas, such as the judiciary, land management, and border<sup>7</sup> management, are proceeding at a slower pace of reform, in some cases as a result of a need for capacity-building of existing institutions.

4. **No amount of well-functioning institutions, will, however, lead to economic growth in the absence of access to markets, whether within the West Bank and Gaza, in Israel, or in the rest of the world.** In this regard, the recent developments in easing of movement and access restrictions by the Government of Israel (GoI) represent a welcome first step. As will be explained further below, additional steps are required to secure access of Palestinian products to the Israeli as well as other markets. Only then will investors return to the WB&G in sufficient numbers to provide the necessary fuel for the engine of growth. The next section begins by reviewing the recent easing of movement and access restrictions, followed by an analysis of economic and fiscal developments, before delving deeper into the set of issues around access to markets and long-term growth. The section after looks in more depth at the performance of PA institutions to date.

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<sup>7</sup> The term “border” is used in this report with the understanding that several commercial crossings between the West Bank and Israel to which this term would apply are located within the internationally recognized boundaries of the West Bank. The term is therefore used for ease of reference and without prejudging any final agreement between Israel and the Palestinians on the boundaries of the future Palestinian state.

## Potential for Economic Revival

### Easing of Movement and Access Restrictions

5. **The GoI has taken steps to ease movement restrictions in the West Bank and to allow greater access to West Bank markets for Arab citizens of Israel.** Perhaps the most salient impact of these measures is the easing of the flow of Palestinian traffic to and from major West Bank cities, and the reduction of time required for Palestinians to access these cities. The GoI further reports that, since April 2008, it has, amongst other measures<sup>8</sup>: a) removed 147 roadblocks and checkpoints; b) approved agricultural vehicle movement in the Jordan Valley; c) allowed access to 7 West Bank cities by Arab citizens of Israel; d) approved 5,000 overnight permits for Palestinians working in Israel; and e) extended the operating hours of Allenby Bridge so that it remains open until midnight instead of 5pm. The latter measure is an outcome of the Cabinet Ministerial Committee established and chaired by Prime Minister Netanyahu, with a membership of six Deputy Prime Ministers and the Minister of Finance. The Committee's mandate is to advance the GoI's policy of "economic peace"<sup>9</sup> in the West Bank by, inter alia, discussing ways of improving the state of the Palestinian population, encouraging economic activity, and promoting personal welfare by testing options to remove bureaucratic and other obstacles<sup>10</sup>.

6. **Alongside the above-mentioned measures, a process of entrenchment of some of the other mechanisms used to control and restrict Palestinian movement has taken place (UN OCHA 2009).** In particular, this includes the expansion of the alternative "fabric of life" roads network, which exacts a price from Palestinians in terms of land loss and deepening fragmentation of West Bank territory. Thus, these roads reconnect Palestinian communities that were disconnected due to the restricted access of Palestinians to a main road, or due to the obstruction of a road by the Separation Barrier, at the expense of reinforcing the exclusion of Palestinians from the primary road network and of undermining the territorial contiguity between different areas. The pavement of these "fabric of life" roads entails the expropriation of private and publicly-owned land, thus further shrinking the space available for Palestinian development. Finally, it remains true that, to date, there remain a total of 613 closure obstacles within the West Bank territory, which obstruct the internal movement of Palestinians, including access to East Jerusalem<sup>11</sup>.

7. **Though the easing of movement restrictions within the West Bank, excluding East Jerusalem, has helped Palestinian producers regain their markets, the measures remain palliative, in particular in the face of continued settlement growth and Israeli control of**

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<sup>8</sup> August 5<sup>th</sup> presentation by the Coordinator for Government Activities in the Territories (COGAT)

<sup>9</sup> Speech delivered by Prime Minister Netanyahu on June 16, 2009 at the Begin-Sadat Center at Bar-Ilan University. The complete speech is available through the Prime Minister's Office at <http://www.pmo.gov.il/PMOEng/Communication/PMSpeaks/speechbarilan140609.htm>

<sup>10</sup> Communication from the Israeli Ministry of Foreign Affairs.

<sup>11</sup> Despite some definitional differences, this figure has been confirmed by the Israeli army's Central Command and the United Nations Office for the Coordination of Humanitarian Affairs, occupied Palestinian territory (UN OCHA oPt), following detailed crosschecking and a series of joint field trips.

**nearly 60 percent of the West Bank land.** While it is now easier to transport goods from the northern West Bank to cities in the southern West Bank, Israel remains in control of the majority of the land in the West Bank, most of which, including the economically valuable Jordan Valley, is off-limits to Palestinian development. Most importantly, settlement growth continues unabated: a recent decision by Israeli Prime Minister Netanyahu to approve the construction of hundreds of housing units in settlements before the settlement freeze goes into effect means that the number of new housing units will not actually decline compared to previous years<sup>12</sup>. Instead, while construction permits are normally given gradually throughout the year, the GoI will issue hundreds of permits within a few days and before the official announcement of the settlement freeze is made. Based on Israeli Central Bureau of Statistics (ICBS) data, the average annual rate of housing starts in the settlements was 1,711 over 2005-2008, so that the current plans for 2009 of completion of 2,500 housing units and an immediate start to 455 new units continues the growth trend of recent years<sup>13</sup>.

## Recent Economic Developments

8. **In the first half of 2009, the political stalemate in Gaza continued and the economy stagnated.** Hamas controls Gaza and holds captive Israeli soldier Gilad Shalit (captured in June 2006). The GoI maintains its blockade, begun in June 2007, and allows only a limited range of humanitarian goods to enter. During the two years following the imposition of the blockade, the daily average of truckloads of goods entering Gaza (112) was less than one fifth the comparable figure for truckloads entering in the first five months of 2007 (583)<sup>14</sup>. Food products comprised approximately 70 percent of imports during this period, while imports of most industrial, agricultural, and construction materials were either prohibited or severely restricted. Prior to the blockade, 95 percent of the inputs used by Gaza manufacturers were imported through the crossings with Israel. The GoI has completely banned exports in the past two years with the exception of 147 truckloads of cut flowers and strawberries allowed out of Gaza, compared to a monthly average of 1,090 truckloads exported during the first five months of 2007 to the West Bank, Israel, and Europe. Consequently, the private sector in Gaza has collapsed: what little activity remains depends upon inputs coming in through tunnels along the Egyptian border or the limited selection and volume of goods allowed in by the GoI. At this point, the Gazan economy is almost completely driven by PA salaries and humanitarian assistance and work programs provided by the UN and other donor agencies.

9. **In 2008, restrictions on the entry of New Israeli Shekels (NIS) into Gaza destabilized Gaza's economy and caused social hardship, but in the past few months, the GoI has allowed regular shipments of NIS 50 million along with replacement bills for worn notes.** On any given day, the Palestinian Monetary Authority (PMA) estimates that the 43 banks in Gaza require around NIS 300 million to meet regular needs for transaction cash. Almost all commercial imports from Israel to Gaza have to be paid for in cash. Consequently, to maintain the necessary level of Shekels, the banking system requires monthly injections of Shekels. Thus, the recent development of regular shipments has been a major boost for commercial bank

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<sup>12</sup> *Haaretz*. September 7, 2009. "2009 West Bank construction mirrors yearly trend."

<sup>13</sup> *Ibid.*

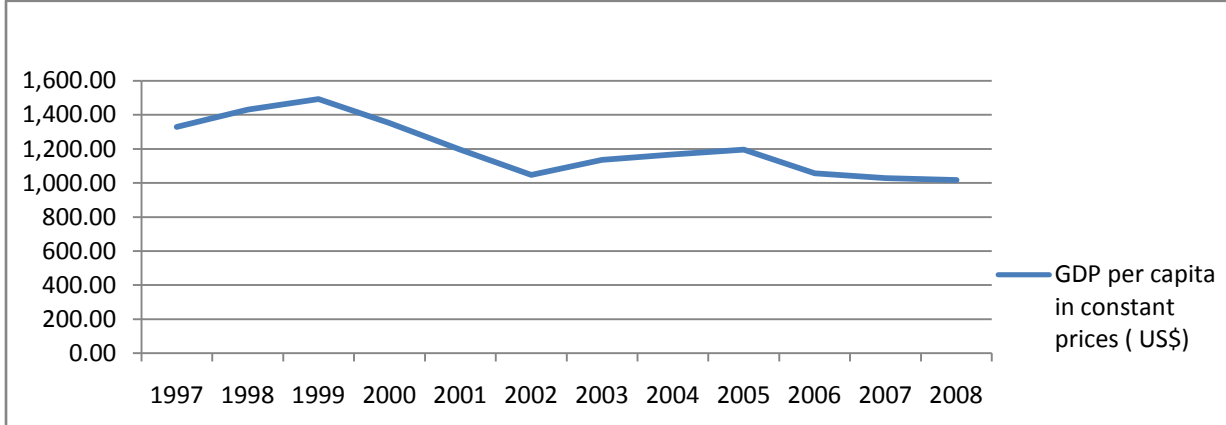
<sup>14</sup> The source for the figures in this paragraph is UN OCHA, August 2009.

operations in Gaza. However, there are still no regular shipments of US dollars or Jordanian Dinars, both of which are used for various transactions, with the exception of regular shipments of \$13.5 million per month for the salaries of the staff of the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA). The PMA and the Office of the Quartet Representative believe that the banking system needs regular shipments of up to US\$15 million and JD 10 million a month and this issue is still being negotiated.

**10. The West Bank economy is showing signs of new growth, so that it is possible that for the first time in years, WB&G may have positive per capita GDP growth in 2009.**

However, given the current conditions in Gaza, most of the growth will probably be restricted to the West Bank. In the first quarter of 2009, real GDP in WB&G together grew by nearly 4 percent compared to the fourth quarter of 2008, though much of this growth could be a rebound from the last quarter in 2008 when GDP had dropped by 3 percent. Nonetheless, growth was nearly 6 percent compared to the first quarter in 2008. Furthermore, despite the absence of GDP estimates for the second quarter of 2009, there are indications that growth has continued. For example, the industrial production index in the West Bank increased by 0.74 percent in the second quarter. In addition, the Ministry of National Economy (MoNE) reports that building licenses and business registrations both increased. If these trends continue, the 7 percent real growth rate for 2009 in the West Bank, projected by the International Monetary Fund (IMF) and the PA, may take place. However even if this is achieved, it is still quite low for an economy recovering from conflict and where per capita GDP has fallen by nearly a third since 1999 (see Figure 1).

**Figure 1: Economic Growth, 1997-2008**



Source: Palestinian Central Bureau of Statistics (PCBS) and World Bank staff calculations

**11. The growth pattern in 2009 suggests, however, that much of the first quarter growth was driven by spending associated with responding to Israel’s recent military operation in Gaza<sup>15</sup> and other donor-supported public spending.** According to estimates by the Palestinian Central Bureau of Statistics (PCBS), in the first quarter of 2009 most of the growth took place in two sectors: 1) real estate, renting, and business services; and 2) community, social, and personal services, both of which grew by more than 24 percent. Public administration grew

<sup>15</sup> Operation Cast Lead, December 27, 2008 – January 18, 2009.

by nearly 9 percent and construction by over 10 percent. Meanwhile, mining and manufacturing grew by only 2 percent and agriculture fell by more than 17 percent. This growth pattern does not indicate higher output based on private investment in productive sectors. Instead, the pattern is commensurate with a previously reported longer-term trend that shows manufacturing, agriculture, and tourism declining relative to donor-funded sectors such as health, education, and public administration.

**12. Since the small resurgence of growth appears to be driven more by the enormous inflows of donor assistance than by improvements in investor confidence, there is a danger that it will not be sustained.** In 2008, budget support to the PA alone increased by nearly 80 percent from the 2007 level and at close to \$1.8 billion, was equivalent to about 30 percent of GDP. In the first eight months of 2009, donor funding for the recurrent expenses of the PA was over \$950 million and is currently expected to reach more than \$1.1 billion for the year. The PA has used these funds to pay salaries, cover operating costs, and help provide compensation to families that have suffered in the recent Israeli military operation in Gaza. This large amount of aid has increased consumption and appears to be driving much of the recent economic growth. It is not possible to know the precise level of public investment since most of it is project finance from external sources, which are often not reported to the PA Ministry of Finance. The 2009 budget calls for about \$535 million in development and minor capital expenditures but they are reported at only around \$120 million for the first six months of the year. There are no published estimates of private investment.

**13. Though WB&G have experienced a drop in unemployment between the first and second quarter of 2009, it can be mostly attributed to the seasonal increase in agricultural employment that occurs in the second quarter of almost every year<sup>16</sup>.** Thus, unemployment in the West Bank fell from 20 percent in the first quarter of 2009 to 16 percent in the second quarter while in Gaza it fell from 37 to 36 percent over the same period. The labor force participation rate in the West Bank rose by 1, and in Gaza declined by 1, percentage point. Unpaid family labor increased in the second quarter, rising from 8.6 to 10.8 percent of the work force in the West Bank, again probably reflecting seasonal agricultural employment. The share of underemployed workers continued to fall in the West Bank while it rose in Gaza. Notwithstanding these improvements, high unemployment, particularly amongst the younger segments of the population, remains possibly the biggest challenge for the PA<sup>17</sup>. Finally, adding discouraged workers to those officially listed as unemployed<sup>18</sup> increases the unemployment rate to 21 percent in the West Bank and 42 percent in Gaza<sup>19</sup>.

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<sup>16</sup> Recent reliable poverty figures are not available, but based on data from a 2007 PCBS household survey, poverty levels are estimated to be much higher in Gaza than in the West Bank, with a poverty rate of 30 percent in Gaza compared to 19 percent in the West Bank. This gap is likely to have increased in 2008 and 2009 given the ongoing blockade of Gaza.

<sup>17</sup> PCBS estimates that unemployment rates among 20-24 year-old males in the West Bank and Gaza were 29 and 57 percent, respectively. Considering that the labor force participation rate for males aged 20-24 in Gaza was just 37 percent, almost 85 percent of males aged 20-24 in Gaza have not worked in the second quarter of 2009.

<sup>18</sup> Unemployment figures also do not include the large number of “workers absent from their usual work”. In the PCBS calculations, these workers are assumed to be temporarily away from jobs due to illness, work stoppage, natural disaster or for other reasons but still receiving normal pay. UNRWA estimates that nearly 45,000 Gazans have become “absentee” workers since the first half of 2007.

<sup>19</sup> Source: PCBS Labor Force Survey Quarter 2, 2009.

## The PA Fiscal Position

14. **Despite the possible resurgence of growth in the West Bank, the PA's fiscal position remains precarious: for the PA to reach its targeted deficit, it must substantially increase revenue and lower expenditures in the second half of 2009.** In the first half of the year net revenues, excluding one-off items such as license fees and dividend payments, were about 5 percent below the budget target while total recurrent expenditures were about 3 percent higher than the budget target (not taking into account the additional Gaza emergency spending)<sup>20</sup>. In addition, in the first half of 2009 the PA received only a small part of the one-off payments expected for the year. To cover this gap the PA has had to resort to large-scale, short-term borrowing from local banks to tide it over until foreign assistance materializes. In addition, the PA is once again accumulating arrears. Some of the failure to meet the budget targets can be attributed to the situation in Gaza. In August 2009 the PA introduced a budget amendment indicating that it will require an additional \$300 million to meet emergency needs in Gaza<sup>21</sup>. However, even abstracting from the funds required for Gaza, the recurrent operating deficit is on track to be larger than called for in the original budget. Given current expectations of revenues, if spending in the second half of the year is at the same as in the first half, and not including Gaza relief, the recurrent deficit on a commitment basis could be as much as 20 percent of GDP, i.e. above the budget target of 18 percent. With the Gaza aid included, the deficit could rise to 25 percent of GDP.

15. **Net revenues in the first half of 2009 were more than 15 percent below budget target and around 13 percent lower than the similar period of 2008.** Some of this decline can be ascribed to Israel's Operation Cast Lead in Gaza. During much of the first quarter, shipments of fuel and other goods to Gaza were even more restricted than they had been earlier. Consequently, clearance revenues in NIS terms in the first quarter of 2009 were nearly 23 percent below budget and more than 11 percent less than the first quarter of 2008. While there was some recovery in the second quarter it did not fully make up for the lost revenue. But the fall in clearance revenues was only a part of the overall shortfall in domestic revenues. While domestic tax revenues hit their budget target and were about 4 percent higher than the first half of 2008, non-tax revenues fell well short. In 2008, the PA received a large amount of funds through one-time payments including \$55 million in cash dividends from the Palestine Investment Fund and nearly \$80 million as a license fee from Wataniya Telecommunications Company<sup>22</sup>. The 2009 budget anticipated additional large payments from various sources and non-tax revenues were projected

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<sup>20</sup> Throughout this discussion, budget targets are determined by allocating the full year target equally across months. Since the PA does not provide a detailed annual cash plan, this is the best approach and the one generally followed by the PA in its own reporting.

<sup>21</sup> The PA budget is executed in New Israeli Shekels (NIS). However, the Ministry of Finance publishes its accounts on the web in terms of US\$ and donor assistance is pledged in US\$. Consequently, this report uses US\$ when discussing the overall deficit and need for external support and NIS elsewhere. The exchange rate was US\$1=NIS 3.81 on August 31, 2009.

<sup>22</sup> An AFP report on September 3, 2009 indicates that Israel may not be fulfilling a contractual obligation to free up 4.8 megahertz of frequencies by mid-September, at which point Wataniya may seek financial remedies from the PA (amounting to hundreds of millions of dollars) to recover its investments since the contract was signed in July 2008. See also: Office of the Quartet Representative. September 10 2009. *WATANIYA: Technical note on the need for 4.8 MHz of bandwidth.*

at NIS 1.4 billion. Unfortunately, only NIS 255 million materialized in the first half of the year, leaving a large hole in the budget. However, in July 2009 the PA received \$100 million from the telecommunications company Zain after it acquired Jawwal (another telecommunications company) and another \$100 million is expected. These payments would largely fill the gap in non-tax revenues.

**16. Total expenditures in the first half of the year were about NIS 675 million or 12 percent higher than the budget target.** They were more than 30 percent higher than in the first six months of 2008. Much, but not all, of the higher spending can be attributed to the needs in Gaza and the PA reports sending \$78 million in emergency aid in the first half of the year. The excess spending was driven by non-wage expenditures as the wage bill met the budget target. Transfers exceeded the pro-rated budget target by more than NIS 300 million and operational expenditures by more than NIS 160 million. Recently released estimates for the month of July show another spike in non-wage expenditures and operational expenditures for July alone account for nearly a quarter of the entire year’s budget. Some of the growth in transfers reflects about NIS 125 million in emergency aid to Gaza reported in the first quarter and another NIS 48 million in the second quarter. However, pension payments account for the bulk of transfers and their growth highlights the pressing need for the PA to undertake pension reform. Not only are the various pension schemes underfunded, but they are unsustainable even if the PA was making all required contributions (see more in the next section). While there have been some large expenditures on pharmaceuticals and textbooks in the first half of the year, these do not fully explain why operational expenditures have been rising.

**17. The PA continues to control the wage bill and it met its budget target for the first half of the year.** The budget included the legally required general wage increase of 1.25 percent as well as an additional 4 percent to help offset the unexpectedly high inflation in 2008. As of the end of June, total PA employment was reported at 145,727, a net increase of 2,790 in the first half of the year. There was a net increase of 1,325 in the security forces while the Ministry of Health lost 94 workers (see Table 1). The increase in security personnel reflects the need to staff the new security units that are being trained in Jordan (see more in the next section). Net employment in the West Bank increased by 3,077 and in Gaza declined by 296.

**Table 1: Net Change in Employment in Most Significant Sectors  
End-December 2008 - End-June 2009**

Security Forces	1,325
Education	639
Health	-94
Ministry of Social Affairs	133
Land Administration	108

Source: PA Ministry of Finance Monthly Reports

**18. The PA continues to require large amounts of donor funding and is currently facing a roughly \$400 million financing gap for 2009.** The 2009 budget calls for \$1.15 billion in budget support for the recurrent budget and another \$500 million in development aid. In the first six months of the year, the PA reported receiving an estimated \$406 million in budget support and \$32 million in development financing. This left a substantial financing gap that the PA was forced to fill through domestic borrowing. Net domestic bank borrowing was \$287 million,

which raised the PA's total debt to domestic banks to about \$733 million at the end of June 2009. In addition, the PA ran up nearly \$180 million in arrears. In the past two months, the PA has received substantial amounts of budget support, including almost \$200 million from the United States, \$200 million from Saudi Arabia, and \$68 million from the World Bank and the multi-donor Palestinian Reform and Development Plan (PRDP) Trust Fund it administers<sup>23</sup>. Despite this support, based on an estimated recurrent budget deficit of nearly \$1.5 billion and known donor commitments, there could still be a \$400 million financing gap that needs to be filled by either domestic borrowing or increased aid<sup>24</sup>.

## Beyond Easing of Movement and Access Restrictions: Prerequisites for Sustained Growth

19. **The macroeconomic framework assumes that all parties (PA, the GoI, and donors) will proactively push the peace process forward and support growth-enhancing reforms and institution-building (IMF 2009).** In particular, it assumes, first, that the trade environment would continue to improve, i.e. not only within the Palestinian territories as it has to date but also with the rest of the world, which will require a continuation of the process of easing restrictions on movement and access in the West Bank and ending of the Gaza blockade. Second, the PA would continue with a prudent fiscal policy based on expenditure restraint, institution- and capacity-building, and structural reforms (Box 1). Third, donors would provide adequate and timely financial assistance to cover both the recurrent budget deficit and expanded public investment and reconstruction needs.

20. **With the above policy expectations, the IMF projects that real GDP growth in the WB&G will increase to 5.5 percent in 2009, from about 2.3 percent in 2008.** Real GDP growth in the West Bank is projected to rise from about 5 percent to 7 percent, while in Gaza there would be an upturn in growth from -5 to about 1 percent. While trade with Israel could be affected by the global slowdown, the WB&G's prospects would be much more strongly influenced by the lifting of restrictions. The above growth rates would imply that Gaza's real GDP per capita would continue to decline, in contrast to the West Bank where real GDP per capita would grow by about 4 percent, representing the first significant improvement in living standards since 2005. Over the medium term, under the IMF's baseline scenario, real GDP growth in the WB&G is projected to be in the range of 7 to 8 percent per year.

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<sup>23</sup> The donors were UK, Australia, and France.

<sup>24</sup> The latest IMF estimates are for the budget deficit to be \$1.592 billion, including \$300 million in emergency support for Gaza. The \$465 million projection assumes no borrowing and that the PA repays its current 2009 borrowing of almost US\$ 300 million.

### Box 1: Current PA Reform Agenda

In its most recent Letter of Development Policy issued in April 2009, the PA laid out a number of important reforms over the next year. The agenda covered by the letter focused on strengthening the PA's fiscal position and improving public financial management. Among other things the PA committed to:

- 1) *Control Public Sector Wage Bill*: Maintain the 2009 public sector wage bill in line with the 2009 annual budget and reduce the wage bill to less than 22 percent of GDP.
- 2) *Reduce net lending*
  - *Institute measures to increase collection of electricity bills from users*: Continue to distribute at least 20,000 pre-paid electricity meters and reduce net lending to 6 percent of GDP.
  - *Transfer all electricity supply and distribution to distribution companies established in accordance with the Companies Law*.
  - *Improve targeting of social safety net to increase efficiency and ensure the most vulnerable populations are protected*: The Ministry of Social Affairs (MoSA) increases its targeting data base from 40,000 to nearly 50,000 households. In addition, MoSA merges the two largest cash assistance programs into a single PA-administered cash assistance program guided by the MoSA targeting database.
- 3) *Improve efficiency and transparency of the budget preparation process*: Develop a new economic and administrative budget classification and use it in the preparation of the 2010 budget.
- 4) *Establish upgraded institutional and regulatory procedures to support public financial management (PFM) reforms*: Ensure that at least 10 line ministries are using the new computerized accounting system.
- 5) *Strengthen PFM infrastructure and improve auditing functions*: The Ministry of Finance (MoF) will strengthen the Central Treasury Account by closing non-zero balance line ministry and agency bank accounts for recurrent expenditures for line ministries connected to the computerized accounting system. The PA will pilot commitment control procedures in the MoF and the 10 line ministries connected to the computerized accounting system. In addition, the PA will have its 2008 financial statements audited and build capacity for its own audit staff.
- 6) *Increase financial accountability through improved and more transparent municipal accounts*: The Ministry of Local government will work with the Municipal Development Lending Fund (MDLF) and local governments to improve financial management in municipalities and that will result in 35 percent of WB&G municipalities moving up one rank on the MDLF scale measuring municipal financial management effectiveness. The MDLF will also work to ensure that 32 West Bank municipalities use the new financial management information system.
- 7) *Establish a comprehensive public procurement system that is suitable for a market economy and introduces transparency, economy, and efficiency into the system*: The PA will enact a new public procurement law and take steps to implement it by developing supporting regulations and establishing an independent procurement unit.
- 8) *Pension reform*: The PA will adopt an action plan to reduce PA short term pension liabilities and begin to implement the plan by including measures in the 2010 budget that will reduce PA pension liabilities and put the PA pension schemes gradually back on a path to ensure their financial sustainability.

Source: World Bank 2009b

21. **While the projected recovery would be a major achievement, it would still leave living standards below pre-closures in 2000 (IMF 2009).** Real GDP is estimated to have declined by a cumulative 13 percent since the imposition of movement and access restrictions in 2000 up to 2008 (or a cumulative 30 percent in per capita terms), suggesting that income in the Palestinian economy today is well below potential. Yet even in this scenario, real income per capita in 2012 would still be about 20 percent below its level in 2000. Finally, while the rate of unemployment would decline substantially to 13 percent by 2012, it would still be higher than the 12 percent recorded in 1999.

22. **The year 1999 also saw a balanced PA recurrent budget, while under current IMF projections, and despite a forecast of 7 – 8 percent real GDP growth per year, the PA is still likely to require budget support of roughly 11 percent of GDP in 2012.** Put differently, if PA tax revenues are to replace budget support by 2012, then based on current IMF projections, the economy would need to grow at more than 20 percent per year for the next three years. While this is a high growth rate by any standard, post-conflict countries can, indeed must, achieve double-digit growth on the path to recovery<sup>25</sup>. If, on the other hand, the peace process is stalled and lifting of movement and access restrictions is not completed, further expansion in trade and private investment would be inhibited, as would the implementation of the donor-financed public investment program and reconstruction. This would mean that the recurrent budget deficit would decline very slowly and would be as high as 20 percent of GDP even by 2012 and real GDP per capita would remain stagnant.

23. **The WB&G's potential for sustained growth has always been heavily reliant on trade with Israel, given the long common border, Israel's much larger economy in both absolute and per capita terms<sup>26</sup>, as well as the fact that Israel is the WB&G's key outlet to external markets in the absence of a functioning domestic seaport or airport (IMF 2009).** Yet, trade with Israel reflects the increased inflows of donor assistance and limited economic growth. Although PCBS has not yet produced recent balance of payments and trade data for WB&G, the vast majority of trade is with Israel for which the ICBS provides some information. Between 2007 and 2008, official merchandise imports from Israel increased by nearly 25 percent in nominal terms. Given the extraordinary large inflow of budget support that allowed the PA to not only resume paying salaries but repay arrears, this large jump likely reflects pent-up demand from when salaries were not being paid<sup>27</sup>. On the other hand, exports to Israel increased only about 6.5 percent in nominal terms in 2008. The first quarter of 2009 saw a 9.5 percent decrease in merchandise imports from Israel, compared to the first quarter of 2008, which can be attributed to the more strict closure of Gaza and cut-off of fuel shipments in the first months of the year. Exports to Israel grew by 8 percent compared to the first quarter of 2008. Overall, the substantial increase in imports and little change in the real value of exports to Israel seem to indicate rising donor-funded consumption rather than sustainable economic growth in WB&G.

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<sup>25</sup> For example, over the decade 1994-2004, the average annual GDP growth rate in Bosnia & Herzegovina was 16.6 percent; the average annual GDP per capita growth rate was 12.5 percent; and the average annual growth rate of exports of goods and services was 20.5 percent (Source: World Bank World Development Indicators).

<sup>26</sup> Israel's GDP in 2008 is estimated to be about thirty times as large as that of the WBG, while its GDP per capita is about fifteen times higher. Since the onset of the occupation in 1967, over three-fourths of the WBG's exports and imports of goods and services have gone to, or come from, Israel.

<sup>27</sup> The jump in nominal imports reflects the global increase in food and fuel prices that led to an almost 10 percent annual inflation for 2008.

24. **Israel has completed construction of six commercial crossings between Israel and the West Bank, so that the reported increase in trade probably also reflects the fact that the GoI is able to capture more of the trade in its official statistics as trade is increasingly routed through those crossings.** Almost all Palestinian commercial goods are required to be shipped through these crossings using a back-to-back system. Though the Israeli Crossing Points Authority (CPA) is making efforts to improve the efficiency of the crossings and to ensure they function smoothly, average crossing times for both imports and exports remains at 1 to 2 hours<sup>28</sup>. Thus, there are reports of Palestinian shippers who bribe Israeli West Bank settlers to transport their goods (settlers are not required to use the crossing points) in an effort to avoid the delays and damage to their goods during the cross loading at the commercial crossings<sup>29</sup>.

25. **Historically, East Jerusalem has been the heart of the West Bank economy, but the GoI has taken additional steps to restrict trade between it and the rest of the West Bank.** It has been reported that the GoI is now forbidding West Bank licensed distributors of imported products from selling into East Jerusalem. The GoI has also recently announced possible new restrictions on the sale of West Bank produced meat and dairy products in East Jerusalem. Since 2000, Palestinian companies have received special permits to sell their products in East Jerusalem, their products have been subject to monthly testing on behalf of the Israeli Ministry of Health, and the Ministry itself periodically undertakes testing of samples it collects from retailers in East Jerusalem. To date, no violations have been found. Yet, in March 2009, the GoI notified Palestinian companies that as of April 1, 2009, their permits would no longer be valid and they would not be permitted to market their products in East Jerusalem, which would be in contradiction of the Paris Protocol on Economic Relations<sup>30</sup>. The Palestinian Food Industries Association has appealed this decision. To date, the permits of Palestinian companies have been extended until the end of 2009, and one option under consideration is the hiring of Palestinian inspectional staff under the umbrella of the Israeli army to conduct inspections on behalf of the Israeli Ministry of Health. The case of the meat and dairy products illustrates the uncertain environment that discourages private sector investment in WB&G.

26. **For the Palestinian economy to grow, Palestinian enterprises will have to move toward higher value added goods and also expand their potential markets (World Bank 2007c).** While Israel will remain the largest trading partner for the time being, Palestinian producers cannot rely on Israel indefinitely and must seek out new markets. In the past Palestinian industry developed to provide low cost, labor intensive products such as garments, furniture, and shoes for the heavily protected domestic and Israeli markets. However, the Israeli economy has undergone a profound structural change. As incomes have risen, production costs have increased and Israel is moving toward higher value products and services. At the same

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<sup>28</sup> Based on a sample study of 100 trucks per month at four crossings (Taybeh, Tarqumiya, Betunia, Al-Jalameh) conducted during March – July 2009 by the Palestine Trade Center (Paltrade).

<sup>29</sup> For example, *Haaretz* reports that “Palestinian stoneworkers and Israeli traders are joining hands against swindlers, many of them settlers, who sell fictitious permits to expedite the passage of stone products from Palestinian workshops in the West Bank into Israel. Trucks with waybills bearing the names of Israeli factories can pass through crossing points more cheaply and easily, at all hours of the day or night, without having to unload and reload the goods at the crossing” (“Con men, security forces throw West Bank stone trade into shambles”, July 23, 2009).

<sup>30</sup> The “Paris Protocol” was signed on April 9, 1994 by Israel and the Palestine Liberation Organization and attached as Annex V to the Palestinian-Israeli Interim Agreement on the West Bank and Gaza Strip.

time, it has reduced protection and opened its markets to low cost imports. The Palestinian enterprises, squeezed between rising costs and falling protection, can no longer compete in their traditional low value, labor intensive products such as garments and footwear. To survive, they must successfully enter new markets, for which they will have to increase their productivity, lower costs, and improve quality.

27. **Therefore, for the West Bank, in addition to improved access to Israeli and East Jerusalem markets, the trade route over Allenby Bridge and through Jordan's ports and airport is key (World Bank 2008).** This is particularly attractive as Jordan improves the facilities at Queen Alia Airport and the Port of Aqaba. The latter in particular is competitive for shipments to Asia. Similarly, Queen Alia Airport offers an attractive alternative to Israel's Ben Gurion Airport since Israeli security measures restrict most Palestinian shipments to cargo aircraft and prohibit them from flying on passenger aircraft. For shipments to the Arab Gulf, the most cost effective way is by land across Jordan.

28. **However, all routes through Jordan, whether through the Airport, Port, or overland, are constrained by operations at Allenby Bridge.** Exports through Allenby require back-to-back transfer of pallets – containers may not be used. The loading and unloading not only raises costs, but, as at the commercial crossings, can lead to significant damage to goods. There are no cold storage facilities at Allenby Bridge. Given that the crossing takes 4 – 8 hours, this significantly limits the shipment of perishable goods. The Bridge is not open during Israeli holidays or the Israeli week-end<sup>31</sup>. While Israel does not generally scan exported goods, all imports across the Allenby Bridge must be transferred through the back-to-back system and scanned by Israeli security. Cargo that cannot be scanned in the small scanners at the Bridge must be trucked to the Israeli port of Ashdod at the shipper's expense for scanning.

29. **For Gaza, re-establishment of the social and economic ties with the West Bank is of primary importance, as is using Rafah as a trade corridor to ship goods from Gaza to Egypt's efficient and privately managed container terminal at the Suez Canal and to Cairo International Airport (World Bank 2007b).** Both the Canal and Airport can provide competitive trade logistics in terms of performance and at a cost generally equivalent to or less than Israel's ports and airports. The legal underpinnings for using Rafah for transit trade are in place, including the *Agreement on Movement and Access* approved by the GoI and PA which specifically allows for Rafah to be used for exports, as well as the *Arab League Agreement on Transit*<sup>32</sup> which allows for duty-free transit of Palestinian goods through Egypt. To make the corridor operational requires, in addition to the political decision, relatively straightforward procedures for a secure supply chain at the Rafah terminal and transit protocols to be agreed between the Palestinian and Egyptian Governments. Critically, this trade corridor would offer the Palestinians direct access to the Gulf and Europe which are potentially the most lucrative markets for Palestinian exports. For the Gulf, the Rafah corridor has the advantage of providing direct services by air to the Gulf and other Middle East locations, and the possibility of trucking goods directly by land (4-5 days of travel). For Europe, the Rafah corridor offers comparable services in time and cost by sea freight.

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<sup>31</sup> As mentioned in paragraph 5 above, the GoI has recently extended the operating hours of Allenby Bridge so that it remains open until midnight instead of 5pm.

<sup>32</sup> Signed in 1977 by most Arab countries, including Egypt, Jordan, and the Palestinians.

**30. In summary, this analysis reaffirms that for the recent upturn in the West Bank economy to translate into a sustained economic recovery, the relaxation of movement and access restrictions within the West Bank must be supplemented by further opening that allows a vigorous revival of Palestinian trade with Israel and the rest of the world.** Thus, without efficient and predictable movement of people and goods, there is very little prospect for a sustainable Palestinian economic recovery (World Bank 2007a). While the GoI has relaxed some internal West Bank restrictions, as described earlier, such incremental steps are not likely, by themselves, to lead to any sustainable improvement. This is because these incremental steps lack permanence and certainty and can be easily withdrawn or replaced by other restrictions. Moreover, sustainable economic recovery will remain elusive if large areas of the West Bank – currently almost 60 percent of the land -- remain inaccessible for economic purposes and restricted movement remains the norm for the vast majority of Palestinians and expatriate Palestinian investors. Only through a fundamental reassessment of closure, and a restoration of the presumption of movement, will the Palestinian private sector be able to reach out to the world, recover, and fuel sustainable growth.

## Progress to Date in Institution-building

31. **As mentioned in the introduction, the Government's Program highlights the role of public institutions in achieving the stated national goals, in general, and economic growth, in particular.** This section reviews the progress made in several institutions of the PA, focusing on some salient ones. For example, one of the factors that have bolstered investor confidence and growth so far in 2009 is the improvement in the security conditions reflecting the redeployment of PA forces in major West Bank cities, which has helped reduce crime and inspired greater public confidence in the PA and its ability to create an investment climate conducive to private investment. Another factor is the PA's public finance reforms – identified by the PA itself in its Program as an institution-building priority. The PA also highlights the importance of institution-building in the area of the legal framework, so this will be discussed further in this section. Finally, land and border management are particularly important for the economic development of WB&G and the PA's fiscal sustainability, so the institutional progress in these two areas will be taken up in this section as well.

32. **Regardless of the strengths and weaknesses of existing PA institutions to date, it must be kept in mind that the PA provides basic social services, education and health, in particular, with impressive results compared to other countries in the region.** The PA's commitment to the education and health sectors is apparent when considering the 2008 budget, where the Ministry of Education and Higher Education spent roughly 20 percent and the Ministry of Health roughly 10 percent of total PA expenditures<sup>33</sup>. The education and health indicators in WB&G compare favorably to those in the rest of the Middle East and North Africa (MENA) region: for example, the secondary gross enrolment rate in WB&G is above 90 percent compared to above 70 percent in MENA as a whole, and the infant mortality rate is 24 per 1,000 live births compared to 32 in MENA<sup>34</sup>. The challenge for the PA is to prevent any decline in these achievements as it faces fiscal and other pressures and as living standards in Gaza continue to deteriorate.

33. **Local governments have historically played an important role in service provision and the Municipal Development Lending Fund (MDLF) assists municipalities in providing services (through grants) as well as itself offering technical assistance to develop their capacity.** The 132 municipalities in the WB&G, accounting for 70 percent of the population, are assigned 28 functions by law but most often provide the following services: (i) solid waste collection; (ii) town planning (including building and maintenance of streets, roads, and sidewalks); (iii) water supply; (iv) school maintenance; (v) public parks; and (vi) electricity provision. Most municipalities are currently running budget deficits that cannot be sustained over the long term, impairing their ability to provide effective public services. The deficits are due to the low revenue base but also to mismanagement and lack of fiscal accountability. The PRDP has singled out the MDLF as its preferred institution to support the implementation of municipal reforms to improve fiscal autonomy and enhance municipalities' financial, managerial, operational, administrative, and technical capacity.

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<sup>33</sup> Only the Ministry of Interior and National Security spent more at 31 percent of total public expenditures.

<sup>34</sup> World Bank World Development Indicators, 2006 data for education and 2007 data for health.

## Security

34. **The PA’s Program stresses that guaranteeing security, safety, peace, and tranquility within Palestinian society is a fundamental duty of the state and requires an effective and efficient state security apparatus that adheres to the rule of law, and respects the independence of the judiciary and equality of all before the law.** Undoubtedly, one of the most important recent developments in the West Bank has been the continued improvement in the security situation. There have been few acts of large-scale violence in the past year and the PA is pushing forward with its efforts to professionalize its security forces and expand their operations throughout the West Bank. With the help of the office of the U.S. Security Coordinator under the leadership of Lt. Gen. Keith Dayton, the PA has trained and equipped three new battalions of security forces and is currently training a fourth. These new forces have been deployed in cities like Jenin, Nablus, Bethlehem, Ramallah, and parts of Hebron. The Ministry of Interior (MoI) has achieved considerable results in the demobilization of militias across the West Bank (Governance Strategy Group 2009). Coordination among the Palestinian security forces has also increased significantly: operations are conducted jointly, and the security forces have been holding weekly meetings with the Prime Minister and Minister of Interior. Ongoing structural reform efforts of the MoI and the unified financial planning and budgeting process aim at further strengthening the MoI and its command and control structure over the individual forces.

35. **Israeli incursions into major Palestinian cities in the West Bank and movement and access restrictions continue to undermine and impede the operations of the Palestinian security forces (Governance Strategy Group 2009).** Thus, the Palestinian Monitoring Group reports that during the month of July 2009, the Israeli army carried out a total of 773 raids into Palestinian residential locales, including 753 in the West Bank and 20 in the Gaza Strip. The Israeli army opened fire during 66 of the 773 raids, and imposed curfews 3 times over residential compounds in the West Bank during raids. In an article in the *National Journal*, unnamed U.S. military officials comment that “Palestinian security forces will never supply the level of security Israel demands unless the Israel Defense Forces (IDF) lifts the numerous restrictions it puts on the Palestinians’ counter-terrorism capabilities and authorities” (Kitfield 2009, page 35). An unnamed senior US officer states that until the Israelis change their thinking, “Israel will continue to undermine the credibility of the more professional Palestinian security forces we’re trying to create, by making it seem that they are only doing the bidding of Israel and the settlers” (Kitfield 2009, page 36).

## Public Finance Management

36. **Since 2002, the PA has taken a number of steps to strengthen its public financial management (PFM) system, as ensuring that government resources are managed in a transparent and accountable manner is an important objective of any state.** Among the initial reforms were the consolidation of banking arrangements in a central treasury account,

establishment of the Palestinian Investment Fund (PIF) under which all commercial enterprises were consolidated and placed under the oversight of the MoF, the posting of MoF financial controllers in line ministries, and the publication of monthly fiscal reports. During the period of the Hamas Government, the PFM system became fragmented as donors were unwilling to use the PA systems, and as strikes by PA staff not receiving their wages meant some of the procedures were not maintained.

**37. With the formation of the Caretaker Government in mid-2007 another series of PFM reforms was initiated to re-establish the earlier systems and replace controls that were earlier managed from Gaza.** This has been used as an opportunity to further improve the quality of the PFM systems. The main reforms have included:

- i. Initial steps towards a program-based budget that improves the link between planning and budgeting and provides more transparency on the activities that the budget is intended to support;
- ii. Development of a computerised accounting system, which is being rolled out to all line ministries. The system will provide better control and reporting on budget execution and has allowed the PA to prepare 2008 financial statements that will be subject to audit; and
- iii. Development of an internal audit function to provide management assurance on the implementation of expenditure controls.

These reforms quickly established control over cash balances, which was an important concern following the problems in Gaza in 2007.

**38. The focus is now shifting towards improving the effectiveness and efficiency of government expenditures.** In the coming period, the PA aims to complete the move to a simple program-based budget, introduce a comprehensive chart of accounts and international accounting standards, reform the procurement system, and devolve more authority and accountability for expenditures to line ministries. Once these initiatives are implemented, the PA would have in place the main elements of a modern PFM system.

**39. During 2009, the pace of PFM reform has slowed as the crisis period was seen to pass, and the nature of the reforms has become more complex.** With a number of challenging reforms still on the agenda there is therefore a risk that objectives will not be met and the realization of an improved PFM system will be delayed. To ensure that momentum is maintained the PA needs to manage the reform process with a clear identification of priorities and a focus on results.

## Legal and Judicial Systems

**40. An appropriate legal framework for commercial activities and an effective judicial system to implement laws and protect property rights is critical to establishment of an investment environment in WB&G that is conducive to sustainable business development and growth (World Bank 2006).** The fully integrated Palestinian legal system has yet to emerge. Aside from the laws passed since the establishment of the PA in 1994 – which govern both the West Bank and Gaza – the two areas have different laws, each reflecting various periods

in history of changing rules. Thus, legal layers established over the years include Ottoman laws; British Mandate laws and emergency regulations; Sharia; Jordanian laws in the West Bank and Egyptian administrative orders and court decision influence in Gaza; and Israeli civil law. Previous laws and regulations continue to have force and effect until amended or explicitly repealed by the PA.

**41. The institutional setup for the judicial authorities lacks a clear legal structure and mutually accepted competencies, and efforts to fundamentally amend the Judicial Authority Law have failed so far in the absence of a functioning legislature<sup>35</sup> (EUPOL COPPS 2009).** Thus, while it is widely recognized that the PA is committed to building effective institutions and consolidating the rule of law while championing judicial independence, several challenges remain. Chief amongst these is the conflict over mandates and authorities in the following areas: supervision and management of courthouses; supervision of the Judiciary Training Institute; accountability boundaries of the Attorney General to the Ministry of Justice; the relationship between the Attorney General and the Supreme Judiciary Council; and the relationship between the Supreme Judiciary Council and the President’s Advisor for Legal Affairs. The negative implications of the lack of coordination and conflict over authorities include: absence of a strategic plan for the justice sector; the questioning of transparency and objectivity of appointments and promotions of judges; and competition between different judiciary institutions to secure the support and funding of different donors.

## Land Management

**42. Land titling, registration, and efficient administration are critical to enhancing economic development in general and private sector development in particular in WB&G (World Bank 2006).** Although 90 percent of land is registered in Gaza, only 20 percent of land is registered in the West Bank, and the completion of registration of about 1.5 million parcels of land is a formidable challenge for the PA. Increasing the number of formal land transactions and the use of land as collateral for loans requires the establishment of an efficient and trusted system of land registration and cadastre. To establish such a system, several important steps have been taken:

- i. In 2002, the PA created the Palestinian Land Authority (PLA), consolidating all land administration functions under one government entity;
- ii. In 2007, the PA established the Higher National Group for Legislative Planning in the Council of Ministers with responsibility for controlling Government’s legislative agenda;
- iii. The Chief Justice issued an Instruction in June 2009 that made an Irrevocable Power of Attorney (IPA) valid for one-time use only, if it relates to land already registered with the

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<sup>35</sup> Thirty-four Palestinian parliamentarians, elected on the “Change and Reform” list in the January 2006 Palestinian Legislative Council (PLC) elections, were arrested by Israel on or after June 29, 2006 and subsequently charged with standing in the election on the “Change and Reform” list, which in the view of the Israeli prosecution authorities is the same as Hamas. The Speaker of Parliament was released in June 2009, and a further 9 PLC members were released in August 2009, having spent more than 3 years in prison.

PLA, and for which a title exists - this latter step constitutes a significant achievement, as the IPA threatens the sustainability of a land registration system.

43. **While many of the policy elements are falling into place, there are significant strategic and operational bottlenecks to expanded and expedited registration that are essential to overcome in the PLA.** *First*, being a young organization, the PLA has limited capacity, both with respect to manpower and essential equipment, as well as with respect to knowledge that could enable it to adapt international experience to develop home grown innovations that could enhance the efficiency of its operations. *Second*, the accuracy requirements that the PLA has established for its operations are extremely high and uniformly applied over rural and urban land regardless of its value, exceeding the requirements in many developed countries, including the United States, Canada, and Australia. Thus, despite the fact that surveying constitutes only about 20 to 30 percent of the effort needed to register a parcel, it represents a disproportionate cost of the PLA's land administration work. *Third*, the operational focus of the PLA remains on surveying rather than on the biggest bottleneck to registration in the West Bank, i.e. adjudication. The latter constitutes about 70 to 80 percent of the effort in the registration of property rights as defined in the PLA's settlement manual. There is therefore a need to both review the methodology for adjudication and simultaneously develop a program to establish an adequately sized pool of qualified, well trained, and full-time land settlement judges so that disputes can be resolved in a timely manner. In the absence of addressing the adjudication bottlenecks, there is a significant risk that the expansion of systematic surveying will not result in a commensurate increase in the number of properties that are brought into the PLA's land registry.

44. **The PLA is eager to gain experience and establish a track record that both the public and business sectors require to embrace investment in the formal land market.** It has demonstrated initiative in revising its procedures to improve the efficiency of its operations, and is applying the lessons learned from donor-funded projects to its operations in Bethlehem. Donor support will remain essential in the years to come to provide the PLA the opportunity to undertake systematic surveying on an expanded scale which will help establish a critical mass of properties in its land registry. This critical mass is essential for financial sustainability, not just of the land registry, but also of the PLA's operations, as over the medium term, the PLA's dependency on budgetary transfers from the PA should decline.

## Border<sup>36</sup> Management

**45. Cooperation between the GoI<sup>37</sup> and PA is critical in order for the PA to establish a presence at the borders of WB&G to ensure that it captures a high proportion of what is owed in value added tax and import duties.** The resulting increase in the collection of domestic tax revenues will be an important factor in ensuring the fiscal sustainability of the future Palestinian state. The PA's presence at the borders is also important to facilitate trade, gather trade statistics, and ensure the safety of the consumer. Currently, the PA has no presence on any of the crossings with Israel or other countries, resulting in loss of substantial amounts of revenue and inability to regulate the WB&G markets.

**46. The PA is currently moving to establish a competent border management system that can be put in place at the commercial crossings and the borders of the future state.** The PA presence should be sufficient to facilitate trade and collect information. It must not become a heavy security presence that burdens trade or becomes a rent seeking operation as observed in so many countries around the world. The MoNE is leading the effort to design such a system and has formed a border management committee with the intention of establishing a border management authority. The expectation is that this authority will be in place in the near future as the PA recognizes the urgency of the matter.

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<sup>36</sup> The term "border" is used in this report with the understanding that several commercial crossings between the West Bank and Israel to which this term would apply are located within the internationally recognized boundaries of the West Bank. The term is therefore used for ease of reference and without prejudging any final agreement between Israel and the Palestinians on the boundaries of the future Palestinian state.

<sup>37</sup> The GoI wishes to reiterate at this juncture that "the Palestinian presence at the borders is a matter for the final status agreement" (GoI remarks on the draft for the World Bank's monitoring report to the AHLC, September 22 2009).

## Concluding Remarks

47. **An OECD review of state-building in fragile situations finds that successful state-building will almost always be the product of domestic action, though it can be significantly enabled by well-targeted, responsive international assistance (OECD 2009).** In addition, where the state leadership has a credible strategy, a state-building approach would strongly emphasize forging a joint, multi-donor strategy with the government and then providing direct support to the state budget. Arguably, the international community active in WB&G, which according to the Ministry of Planning and Administrative Development (MoPAD) numbers 42 donor countries and 30 UN and other multilateral agencies, has behaved remarkably similarly to the recommendations of this OECD review. Within the framework and stated priorities of the PA's PRDP, donor coordination mechanisms are in place for donor investments and technical assistance, while at the same time a sizeable share of donor assistance flows directly as budget support.

48. **While the international community active in the WB&G has emphasized institution-building throughout its interventions in support of the PA, the need to provide humanitarian assistance detracts from the long-term institution-building agenda.** Thus, MoPAD reports that every donor-funded project contains a capacity-building component, and that institution-building is so integral to donor interventions that it is virtually impossible to separate funding for it from investment funding. At the same time, different donors espouse different approaches to and models for institutional development, and once a donor is working with a specific Palestinian institution, other donors tend to shy away from this institution, resulting in lack of overall coherence. While all donor interventions identify the long-term institutional development priorities in their initial designs, in the interim, given humanitarian needs and other constraints, actual implementation does not live up to the previously set high standards of institution-building. A joint rethinking and refocus by the international community and the PA of the institution-building agenda is therefore warranted at this time in light of the PA's recently proclaimed Program for the future Palestinian state.

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