



C O U N T R Y B R I E F



Middle East &
North Africa Region - West Bank and Gaza

The Emergency Services Support Projects

The ongoing conflict has resulted in a near collapse of the Palestinian economy, soaring unemployment and a sharp increase in poverty. The median family income has dropped by 40 percent compared to pre-2000 levels, to which the Palestinian population has responded by resorting to coping mechanisms such as reducing their consumption levels, using personal savings, selling off assets, delaying payments and incurring debt. These strategies are nearly exhausted and unsustainable.

Donors have responded by doubling annual disbursements and shifting the bulk of their assistance into emergency support. The Bank is helping choreograph this transition and advising the Palestinian Authority (PA) and donors to maintain a balance between necessary emergency financing and a continued focus on the medium-term state building agenda—a strategy which the Bank has adopted for the West Bank and Gaza.

The First and Second Emergency Services Support Projects (ESSPI & II, US\$60 million from the Trust Fund for Gaza and the West Bank) are designed to address the ongoing fiscal emergency, and will supplement the PA's reduced revenues.

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Main development challenges

Closures continue to fragment Palestinian social and economic space. Palestinians' inability to trade and access markets has resulted in a severe recession in the years 2000-2. Despite positive growth rates during 2003-5, Palestinian incomes remain considerably lower than their pre-*intifada* levels, with real GDP per capita in 2005 about 31 percent lower than in 1999. At the pace of economic growth witnessed since 2003, pre-*intifada* per capita income levels would only be restored by 2010-12. The Palestinian Authority (PA), municipalities and NGOs, with extensive foreign assistance, have been able to maintain delivery of core services. Inevitably, however, standards of service have declined as a result both of access restrictions and strained public finances. Social protection instruments are insufficient to effectively alleviate poverty; some 44 percent of Palestinians and up to two-thirds of Gazans are living below the official poverty line of US\$2.3 per person per day. Perhaps 15 percent of the population is living in deep poverty—unable to afford basic subsistence. In spite of large and relatively effective humanitarian assistance, coping strategies for the poorest segments of the population are being stretched increasingly thin. School enrolment remains high at 88 percent for basic education, but crowding and a deteriorating learning environment are worrisome trends.

A radical easing of internal closures and facilitation of trade are indispensable to restore Palestinian economic prospects. As the Palestinian economy is highly sensitive to external stimuli, due to its degree of dependence on Israel and on foreign assistance, donors at the Ad Hoc Liaison Committee (AHLC) in December 2005 agreed that achieving desirable rates of Palestinian GDP growth would depend on the Government of Israel (GOI) continuing to transfer clearance revenues, rolling back the system of movement restrictions in force and maintaining or increasing labor access to Israel. Absent such measures, foreign assistance, albeit very high by international standards, will be insufficient to achieve sustainable Palestinian economic recovery. Adding to that are the worsening prospects for continued export of labor to Israel as a major source of income (the GOI intends to eliminate labor flows by 2008), which will require the Palestinian economy to significantly broaden its export base for goods and services through greater access to international markets.

Improved governance is high on the development agenda. The governance agenda is paramount, not least because its reinvigoration is essential to create stable institutions and an investor friendly climate. Progress remains insufficient on civil service reform: the increasing employment levels and wage costs are financially unsustainable, the machinery of government needs to be streamlined and the quality of administration improved. At the same time, significant steps have been taken since 2002 to improve public financial management, including an annual budget approved by the Palestinian Legislative Council (PLC); consolidated financial statements for the PA and their auditing; more transparent public procurement; direct deposits of public sector salaries to individual bank accounts; reforms in the oversight of the PA's public enterprises and investments through the establishment of the Palestine Investment Fund (PIF); and a Ministry of Finance website that posts estimated and actual annual expenditures for previous years, as well as monthly expenditure reports. However, the new external audit institution needs to commence work, expenditure management is still weak, and there is room for

The project is financing approximately 90% of the non salary budgets of the Ministries of Health and of Education. Thus it is supporting the continuation of health and education services in 398 laboratories, 2,613 primary health care centers and 18 hospitals, and 17 Directorate offices of the MOH, 1490 primary and secondary schools as well as the operations of the 17 Directorate offices of the MOE. It is also financing a portion of the salary budget of 9 universities whose budgets are partially financed by the Ministry of Finance. Several other ministries have been supported through financing part of their incremental operating costs (rent, utility charges, communication charges, maintenance, transportation, etc.)

improvement with respect to budget implementation, control, and accountability. In addition, legal and regulatory reform to ensure respect for the rule of law and the orderly conduct of commercial activity lags behind.

Following the legislative elections in January 2006, the outlook for the Palestinian economy has radically changed in nature. While most of the discussions of the recent years revolved around the possibility and means (Palestinian reforms, reduced closures and trade facilitation, foreign assistance) to accelerate the current recovery and raise the long term Palestinian growth potential, attention is now increasingly focused on (i) preventing the Palestinian economy from falling into deep recession and (ii) preserving the ability of the PA to operate. The recent announcements from the GOI and the donor community to, respectively, (i) suspend the transfer of tax revenues collected on the PA's behalf, restrict trade across borders and restrict or terminate Palestinian labor flows to Israel, and (ii) reduce aid flows, severely cloud Palestinian economic and social prospects. The Bank estimates that a combination of these measures would lead to real GDP per capita declining by 27 percent in 2006, and personal incomes (real GDI per capita) by 30 percent; at the same time, unemployment would reach 40 percent and poverty 67 percent by the end of this year.

Macro-economic issues

The Palestinian macro-economic environment remains highly contingent upon the political situation. As the Palestinian economy continued to recover from its very low 2002 level, real GDP grew by an estimated 6.3 percent in 2005, a rate similar to that observed in 2004. A confluence of factors explains this level of growth, including an expansionary (but unsustainable) fiscal policy by the PA, increased banking credit to the private sector, a relaxation of closures (permitting a higher number of Palestinian workers to find jobs in Israel), and increased Israeli demand for Palestinian exports. As noted, however, Palestinian incomes remain considerably lower than their pre-*intifada* levels, and the recent pace of economic growth is not sufficient to restore pre-*intifada* per capita income levels before 2010. This inability of the Palestinian economy to fully use its productive potential is first and foremost the result of restrictions on the movement of people and goods. This is illustrated notably by the continued high level of unemployment – 23.4 percent of the active population.

The PA's budget deficit widened substantially in 2005, to US\$777 million, as expenditure increases more than offset strong revenue performance. The average monthly deficit amounted to US\$65 million in 2005, up from US\$48 million in 2004. Only US\$349 million was received in external budget support, roughly half the US\$654 million that had been foreseen in the budget. The resulting gap was financed mainly by borrowing from domestic banks. While the PA's revenue increased by 28 percent in 2005, to reach US\$101 million per month, the higher government expenditures in 2005 stemmed mostly from large increases in public sector wages and the energy sector's inability to recover the higher costs of energy products. Total expenditures rose by almost 30 percent to about US\$166 million per month.

The fiscal outlook for 2006 is extremely worrisome. Owing to the full effect of last year's wage and pension increases, PA expenditures are expected to increase by 17 percent in the absence of offsetting mechanisms. Furthermore, a continued withholding of clearance revenue by the GOI would immediately cause a revenue shortfall of up to two-thirds (as agreed under the Paris Protocol of 1994, and consistent with the operation of the quasi-customs Union between Israel and the PA, the GOI remits to the PA through a regular 'clearance' mechanism taxes and VAT levied in Israel on merchandise destined for Gaza and the West Bank). Following the Palestinian elections in January 2006, the GOI announced it would suspend these transfers and deposit the proceeds due to the PA in an escrow account. Consequently, the PA's deficit would dramatically increase to reach approximately 80 percent – US\$1.7 billion a year or 42 percent of the GDP of 2005. In the event, the PA would face great difficulties to find alternative sources of financing: further donor assistance is uncertain and domestic sources have become increasingly unreliable.

Status of dialogue

The Bank has played a key role in West Bank and Gaza since the early 1990s. The PA, the GOI and the donor community have relied extensively on the Bank's analysis, project design and implementation capacity, and convening role. From the initial period of economic recovery and reconstruction through the state-building focus of the late 1990s, the emergency management efforts of the *intifada* and disengagement, the Bank has helped the parties shape their economic responses in an unpredictable socio-political environment.

Through its lending and analytical activities, the Bank has been supporting the Palestinian Authority in various development areas, such as community development, education, primary health care, municipal services, land administration, solid waste management, and water and sanitation. The Bank has also been involved in fiscal policy discussion together with the IMF, based on the principles of transparency, accountability and sustainability. The Bank is administering a multi-donor trust fund aimed at supporting the PA's public financial management reform agenda, which has disbursed US\$273 million since 2004. In this context, the Bank has been pursuing a dialogue with the PA on fiscal issues and reform, including notably the need to contain wage expenditures and to bring fiscal policy onto a sustainable path.

The Bank has been closely engaged in discussions with the PA and GOI on disengagement related issues, including trade facilitation, borders and passages. The guiding principles have been balancing Israel's legitimate security concerns against the viability of Palestinian trade in goods and services. These discussions culminated in the *Agreement on Movement and Access (AMA)* concluded between the parties on November 15, 2005. The AMA offers a meaningful way forward, and represents a major Israeli commitment to Palestinian economic growth in tackling the central issue of the movement of Palestinian people and goods across borders. However, neither the GOI nor the PA have fulfilled their respective obligations under the AMA and Palestinian trade remains severely stunted.

The Bank has also engaged in discussions with the PA and donors towards a new Palestinian Medium-Term Development Plan (MTDP) 2006-8, with the aim of refocusing both PA and donor attention on a development agenda - rebalancing emergency assistance with strategic activities that will drive economic recovery. To that effect, the MTDP emphasizes the paramount importance of the private sector and of good governance, and envisages actions in industry, agriculture, tourism, information and communications technology, trade infrastructure, infrastructure, housing, human capital, and the development of evacuated areas. Linked to the MTDP, donors and the PA have established an Economic Strategy Group as a new mechanism of donor coordination. The Bank would co-chair this group together with the Ministry of Finance.

World Bank financial assistance

Since the West Bank and Gaza is not a sovereign state, it cannot apply for membership of the IMF or the World Bank Group, and is therefore not eligible for the sources of financing normally available to Member states. To overcome these legal and practical obstacles, the *Trust Fund for Gaza and West Bank (TFGWB)* was established in 1993. The TFGWB has periodically been replenished through allocations from the Bank's surplus/net income. Since the establishment of the TFGWB in 1993, the Bank has committed over US\$500 million to 34 projects and disbursed US\$433 million. The current portfolio consists of 10 projects with a total commitment amount of US\$105.8 million. FY05 disbursement totaled US\$37.2 million, which represents a disbursement ratio of close to 50 percent. FY06 disbursement so far has reached US\$15.4 million, a ratio of 21.5%.

The Bank has been at the forefront of a number of donor investment initiatives over the past 12 years, putting in place the first multi-donor reconstruction, budget support and technical assistance projects in 1993-4, leading the emergency job creation work of the mid-1990s and shaping the policy-based sector programs that increasingly characterize donor investment efforts today. Despite the Bank's limited resources, almost 20 percent of

donor disbursements since 1994 are attributable to Bank projects, either directly or via joint and parallel financing—thereby enhancing the Bank's impact well beyond what was possible with Bank funds alone.

Since the outbreak of the intifada in September 2000, the Bank has focused on providing emergency assistance and maintaining Palestinian institutions. Over the past five years, the Bank has committed a total of US\$233 million from the TFGWB, of which US\$152 million were allocated toward emergency activities.

Recent projects

Four projects have been approved in FY05.

The **Gaza Emergency Water Project** (US\$20 million) aims to improve the provision of adequate water and wastewater services in Gaza, and functionally establish the Coastal Municipalities Water Utility (CMWU) as an autonomous well-run modern utility. In addition, the project strengthens the Palestinian Water Authority's (PWA) capacity to assume sector regulatory functions.

The **North Gaza Emergency Sewage Treatment Project** (US\$7.8 million) has the objective of mitigating the immediate and gathering health and environmental safety threats to the communities surrounding the effluent lake at Beit Lahia. In a second phase, the project aims to provide a satisfactory long-term solution to the treatment of wastewater for the Northern Governorate in Gaza.

The **Tertiary Education Project** (US\$10 million) has the following development objectives: 1) to improve the regulatory environment for tertiary education management, governance and quality assurance; 2) increase internal and external efficiency of the tertiary education system, as a first step towards achieving sustainability; and 3) to create incentives and provide the basis for improvements in efficiency, quality and relevance of tertiary education institutions in order to meet the socioeconomic needs of the Palestinian population.

The **Gaza Land Administration Project** (US\$3 million) aims to support the PA in reforming land administration by introducing policy, legal and institutional changes to achieve efficient procedures for the issuance of land titles and registration of property transactions, and transparent processes for the management and disposal of public land.

Upcoming projects

The planned **Avian Influenza Project** aims to address the effects of the recent avian influenza outbreak in the Gaza Strip.

The Bank's Economic and Policy Work

The Bank continues to undertake analytical work for the benefit of the PA and donors.

The *Quarterly Updates* highlight recent economic trends and new initiatives, including the most recent *West Bank and Gaza Economic Update and Potential Outlook*. The Bank has also produced three *Economic Assessments* of the impact of the *intifada*, the most recent of which was published in November 2004.

Papers on Movement and Access—Contributions to a Negotiated Solution (December 2005). In close collaboration with the Quartet Special Envoy, the United States and the EC, the Bank prepared twelve policy notes on a variety of critical issues, including alternatives to 'back-to-back' cargo movement, improved border logistics (infrastructure design, traffic flow, cargo inspection procedures and technology), options for developing a territorial link between Gaza and the West Bank, methods for initiating a convoy system of trucks and buses for the movement of goods and people between the two Palestinian territories as an interim measure, and on the creation of a Palestinian Border Service

Agency, among others. These notes have provided the technical underpinning for the negotiations between the two parties.

Economic Monitoring Report to the Ad Hoc Liaison Committee Number 1 (December 2005). This report entitled *The Palestinian Economy and the Prospects for its Recovery* was prepared as an input to the AHLC meeting of December 14, 2005. It indicated that the preconditions for sustained, rapid growth are not yet in place and presented the areas where policy measures by GOI and the PA need to be taken. The findings of the report were confirmed by the AHLC which deferred a decision about a pledging conference until, among others, the submission of the Bank's second *Economic Monitoring Report*.

All dollar figures are in US dollar equivalents.

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