Economic Monitoring Report

to the Ad Hoc Liaison Committee

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List of Acronyms

AML/CFT	Anti-Money Laundering and Combating Financing of Terrorism
AW	Associated Work
CCGT	Combined-Cycle Gas Turbine
CBRs	Correspondent Banking Relationships
GCDP	Gaza Central Desalination Plant
GDP	Gross Domestic Product
GEDCO	Gaza Electricity Distribution Company
GNDI	Gross National Disposable Income
GNI	Gross National Income
GoI	Government of Israel
GPP	Gaza Power Plant
GRM	Gaza Reconstruction Mechanism
ICRS	International Committee of the Red Cross
IMF	International Monetary Fund
LGU	Local Government Unit
LTU	Large Taxpayer Unit
LPCD	Liters per Capita per Day
MCM	Million Cubic Meters
MENA	Middle East and North Africa
MoFP	Ministry of Finance and Planning
MoH	Ministry of Health
NCTP	National Cash Transfer Program
NGEST	North Gaza Emergency Sewage Treatment
NIS	New Israeli Shekel
NORG	National Office for the Reconstruction of Gaza
NPL	Non-Performing Loans
NRW	Non-Revenue Water
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PENRA	Palestinian Energy and Natural Resources Authority
PMA	Palestine Monetary Authority
PPA	Power Purchase Agreement
PTSD	Post-Traumatic Stress Disorder
SMEs	Small-Medium Enterprises
STLV	Short Term Low Volume
UNDP	United Nations Development Program
UNFPA	United Nations Fund for Population Activities
UNOCHA	United Nations Office for the Coordination of Humanitarian Activities
UNOPS	United Nations Office for Project Services
UNRWA	United Nations Refugee and Works Agency
VAT	Value Added Tax
WA	Wassenaar Arrangement
WDI	World Development Indicators
WHO	World Health Organization

Executive Summary

1. **Palestinian living standards continue to decline, with aid flows no longer providing the impetus for growth, amidst increasing uncertainty.** The on-going restrictions in the West Bank along with the decade long blockade in Gaza have continued to hollow out the productive sector and prevented the economy from achieving its potential. After two years of stronger growth driven by post war reconstruction, the most recent data revealed growth of 2.4 percent in 2017 led by the West Bank - while in Gaza it was a mere 0.5 percent. Unemployment rates continued to be high - reaching 44 percent in Gaza - even with low labor force participation. A range of additional challenges emerged in 2017 and the economic outlook is highly uncertain. We forecast growth of only 2.5 percent in 2018 – declining in per capita terms. There are significant downside risks to this forecast with doubts surrounding donor flows and the potential for increased tensions to spill over into unrest.

2. **The fiscal performance was better than expected in 2017, but the Palestinian Authority's (PA) financing gap persisted resulting in additional arrears accumulation.** On the back of a strong pickup in major tax categories due to the PA's efforts and expenditure reductions focused on Gaza, the total deficit stood at 7.7 percent of GDP in 2017 – down from 8 percent in 2016. To a large extent, the deficit is a Gaza story as the position in the West Bank has been broadly in balance in recent years. Despite the improved fiscal performance, a further decline in donor support led to a financing gap of around USD420 million, which was mostly filled by bank credit and additional payment arrears. The financing gap for 2018 is expected to be around USD440 million. However, the potential reconciliation with Gaza, a positive for the territories overall, could increase the financing gap to USD1 billion in the short term. The PA is proposing a range of policy measures to increase revenues and rationalize spending, but those will not be enough to close the gap. Unless donor aid is significantly stepped up, the PA will be forced to exhaust domestic sources of financing including debt from local banks and arrears to the private sector and the pension fund. This could eventually choke the economies of both the West Bank and Gaza and impose large negative consequences on suppliers, banks and ultimately growth and tax generation.

3. **The financial sector remains stable, but warrants close monitoring.** The financial sector managed relatively stable growth in 2017. However, several potentially destabilizing risk factors need to be monitored closely including a recent increase in delinquent loans and bounced checks, particularly in Gaza. Possible cuts to the United Nations Relief and Works Agency's (UNRWA) funding could pose another risk with approximately 18,000 of the agency's staff using their salaries as loan collateral. Another constant cause of concern for the banking system and the Palestinian economy is a possible disruption in Correspondent Banking Relationships (CBRs) between Palestinian banks and their Israeli counterparts due to de-risking by Israeli banks. Given these risks, the sector warrants close monitoring going forward.

4. **The recent economic decline emphasizes the need to move towards a more sustainable growth path driven by the private sector, and this requires a relaxation of the external and internal constraints.** Growth in the Palestinian territories has mainly been driven by aid-financed consumption in recent years, but aid cannot continue to substitute for a poor business environment. The private sector is the only sustainable engine for growth, and the focus should be on removing the constraints and creating the right conditions for it to flourish and create jobs for the youth. In view of global economic developments in the past decades, creating the right environment to enable the development of modern services, particularly in Gaza, can open a path to prosperity through offering jobs to Gaza's innovative youth and allowing its economy to integrate with external

markets. Even though the Palestinian economy will not be able to reach its full potential without a final political resolution, actions by the Government of Israel (GoI) to ease the restrictions and efforts by the PA to accelerate fiscal and economic reforms could significantly improve the economic outlook and fuel private sector activity. In the short term and until private investment picks up, the role of public spending as a key stimulus to growth will continue to be needed.

5. **In view of the recent liquidity squeeze in Gaza that has led to a rapid collapse in socio-economic conditions in the Strip, this report focuses specifically on exploring the nature of the decline and identifying what is needed to unlock sustainable growth.** In recent months, around a quarter of Gazans have seen their incomes significantly drop, resulting in a severe liquidity squeeze that has impacted all aspects of the economy. This, compounded with a gradual deterioration in the structure of the economy over the last two decades, has placed Gaza at a critical juncture. Over the past 20 years Gaza has undergone deindustrialization and the economy has become dependent on transfers from outside. The productive base of the economy has been eroded with the combined size of the manufacturing and agriculture sectors falling from 27 percent of GDP in 1994 to 13 percent today. Real per capita incomes have fallen by a third since 1994. While the blockade has been the key factor in this decline, the internal divide since 2007 has also exacted a toll; making potential reconciliation a positive prospect. Going forward, a growth strategy for Gaza that requires cooperation by all parties and that builds on the Strip's rich human capital would be critical to unlock its economic potential.

6. **Addressing the dire humanitarian situation in Gaza is a priority, but this should not delay reform efforts to help the economy unlock its potential and escape the current deteriorating trajectory.** Because some reforms will take time to materialize, it is important to act now to reverse the recent corrosion in the livelihood of Gazans and avoid potential unrest through providing increased liquidity to the economy. This will be critical for reinstating payments to public servants in Gaza, pending a resolution of the civil service integration. This will also ensure that risks surrounding funding to UNRWA - one of the main providers of jobs and services in Gaza - are addressed.

7. **For a sustainable recovery, Gaza needs to be able to trade effectively with the outside world, and this requires actions by all parties.** Proposed projects to increase the supply of water and electricity are extremely welcome, but unless there is an opportunity to boost incomes through expanding trade the sustainability of these investments will be in doubt. Efforts must focus on easing constraints that currently stifle private activity and setting the enabling conditions for private investment. An improved growth performance would also ease the PA's fiscal situation and ease risks faced by the financial sector. Minor changes to the restrictive system currently in place will not be sufficient, and bold efforts are needed by all the parties to set Gaza on a sustainable private sector-driven growth path.

8. **Effective governance systems and institutional strengthening under the PA's leadership are a necessary precondition for the sustained economic recovery of Gaza**. Addressing the issue of civil service integration and building legitimate institutions in Gaza that enjoy the support of the international community and that will govern Gaza in a transparent, accountable, and efficient manner is essential for sustained development. Efforts to increase revenues will also be key as Gaza currently generates less than 10 percent of the PA's total revenues. In Gaza, alongside revenue reforms, efforts to support economic growth can lead to a drastic increase in the tax base and revenue generation. Therefore, the PA should extend reforms it is currently implementing in the West Bank to improve the business climate, facilitate access to finance for SMEs and bridge the skill mismatch in the labor market to Gaza. Increasing energy supply is also critical for the Gaza

economy and this needs to be done in close cooperation with the GoI and in a sustainable way that addresses institutional constraints and the low financial performance of the sector.

9. **The GoI could play a catalytic role by easing restrictions that are the main impediment to trade**. This recommendation has been made before, but technological developments and the opportunity to reverse many of the restrictions imposed, particularly if reconciliation progresses, make the case for change even stronger. Key actions include relaxing the dual use restrictions and facilitating additional exports from Gaza to the West Bank and Israel – Gaza's most lucrative markets prior to the blockade. Streamlining trade procedures at Gaza's commercial crossing and expanding its capacity in addition to reversing the recent decline in the number of business permits granted to Gaza traders is key for facilitating trade and building relationships with external markets.

10. **Continued donor support is also key.** Gaza's economy will continue to depend critically on donor support for several years to come until its tradable sectors gradually replace the role of donor aid as the key source of foreign exchange to fuel the economy. Budget support to the PA is important to enable it to cover the deficit emanating from its operations in Gaza, particularly if civil service integration advances. In the medium term, the PA and donors will need to focus their assistance on revitalizing Gaza's public infrastructure not only through water and electricity projects, but also other infrastructure that will enable the growth of Gaza's tradable sector such as the transportation network, product safety and quality infrastructure, etc. Donors can also help by offering innovative financing instruments that can mitigate risks holding back transformative investments by the private sector in Gaza. In line with this approach, the World Bank Group is establishing a Private Sector Enhancement Facility (PSEF) that aims to mitigate financing risks for the private sector, leverage the resources of development partners and catalyze both short-term and long-term financing.

Table 1: Development recommendations for Gaza

Actions	Responsible Party
Implement civil service integration and build stronger institutions and governance arrangements in Gaza	PA
Conduct fiscal reforms and better tax effectiveness in Gaza	PA
Unify business regulation between the West Bank and Gaza	PA
Improve access to finance for SMEs in Gaza	PA
Align Gaza's dual use list with the West Bank's	GoI
Alleviate blockade allowing higher exports to Israel and the West Bank	GoI
Streamline trade procedures at Gaza's commercial crossing and expand its capacity	GoI
Issue higher business permits for Gaza traders	GoI
Expand Gaza's fishing zone	GoI
Set up the right environment for the service sector to develop	PA and GoI
Increase electricity supply to Gaza	PA and GoI
Build new industrial zones and rehabilitate existing ones	PA and GoI
Provide additional financial support	International community
Set up innovative financing mechanisms for the private sector	International community
Implement donor-financed labor-intensive projects	PA, GoI, International community

Explore additional trade routes linking Gaza to external markets	PA, GoI, international community

11. **The main body of the report is organized in two chapters with two supporting annexes.** Chapter I focuses on recent economic developments in the real, fiscal and banking sectors, while providing a near term outlook that highlights critical challenges facing the Palestinian economy. Chapter II explores the nature of the decline of the Gazan economy and identifies the needs going forward. Annex 1 examines in more detail issues surrounding the integration of the civil service in Gaza under the PA's control, while Annex 2 assesses the status of the World Bank recommendations to the AHLC meeting over the years.

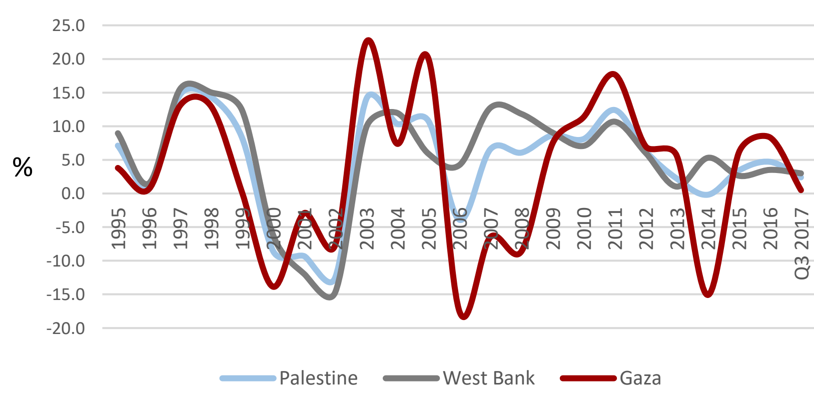
Chapter I: Recent Developments

A. Economic Growth

12. **The economic conditions in the Palestinian territories deteriorated in 2017 as growth, mainly driven by consumption, has run out of steam.** The economy has long suffered from restrictions on movement, access and trade that have kept investment levels extremely low and resulted in an erosion of the productive base. Substantial amounts of financial assistance from the international community have helped mitigate the impact of the restrictions on growth through fueling public and private consumption. However, this growth model is not sustainable and aid cannot continue to substitute for a poor business environment. Latest data by the Palestine Central Bureau of Statistics (PCBS) indicates that real Gross Domestic Product (GDP) growth in the Palestinian territories dropped to a mere 2.4 percent in 2017.[1]

13. **Gaza's economy is at a critical juncture due to a severe liquidity squeeze arising from sharply reduced reconstruction aid flows and disrupted fiscal relations with the West Bank, in addition to continued economic isolation.** The Gaza economy is estimated to have grown by a mere 0.5 percent in 2017 compared to around 8 percent in 2016. This is partly due to a severe drop in aid for reconstruction as inflows in 2017 amounted to around USD55 million compared to USD400 million in 2016.[2] As a result, the construction sector, which had been the main driver of Gaza's economy in recent years, did not make any contribution to Growth in 2017. Also, consumption witnessed a strong drop in 2017 as wage payments to the employees of the *de fact*o authority have almost ceased while some allowances to PA employees in the Strip have been suspended since mid-2017. This has resulted in a severe liquidity squeeze for around 80 thousand families (almost one quarter of Gazans) negatively impacting spending and hence, economic activity.

Figure 1: Real GDP growth rate (2015 base year), 1995-Q3 2017



Source: Palestine Central Bureau of Statistics

14. **Meanwhile, growth in the West Bank economy slightly declined in 2017.** Real GDP growth in the West Bank is estimated at 3 percent in 2017, which is slightly below its rate in the previous

[1] Based on data for the first three quarters of 2017.

[2] These figures are based on disbursements of pledges made at the 2014 Cairo Conference for Gaza Reconstruction.

year. Growth was mainly concentrated in construction, wholesale and retail trade, services and manufacturing. On the other hand, the agriculture sector continues to suffer from constraints on trade, movement and access and contracted by 11 percent in 2017.

15. **Unemployment in the Palestinian territories continued to be high, and labor force participation low, with structural problems of inclusion particularly for young people and women.** According to data from the PCBS labor force survey for 2017, unemployment reached 27.4 percent, which is 0.5 percentage point higher than in 2016. The rise was driven by an increase in Gaza where the rate stood at 43.6 percent in 2017, up from 41.7 percent in 2016. In the West Bank, unemployment remained almost constant at 18 percent. The Palestinian labor market suffers from structural problems of inclusion particularly for young people and women. In 2017, only 41 percent of those aged between 15 and 29 were active in the labor market, reflecting high pessimism regarding employment prospects. Despite a low participation rate, unemployment amongst this category reached 40 percent. There are also dramatic differences in labor force participation by gender. Male participation rates reached 71 percent in 2017 while women have long been underrepresented in the Palestinian labor market with recent participation rates of 19 percent.

16. **Prices witnessed a slight increase in 2017 following deflation in the previous year.** In 2016, the Palestinian territories witnessed deflationary trends with prices declining by 0.22 percent (year-on-year), reflecting low food and housing prices as well as deflation in Israel. Prices started to increase again in 2017 with average inflation in the Palestinian territories reaching 0.2 percent. The increase was mainly driven by a rise in housing prices in addition to an increase in prices in Israel whose currency (the New Israeli Shekel) is the main currency in circulation in the Palestinian territories.

17. **To achieve sustainable economic growth in the Palestinian territories, growth and job creation going forward will need to be private sector driven.** For a small economy, achieving a sustainable growth path depends to a large extent on having a private sector that is able to compete in regional and global markets and increase its exports of goods and services. The private sector is the only sustainable engine for growth, and the focus should be on removing the constraints and creating the right conditions for it to flourish.

18. **The economic outlook for the Palestinian territories is particularly fragile at this juncture with significant downside risks, and associated consequences on broader stability.** Under a baseline scenario that assumes a continuation of the Israeli restrictive regime and the persistence of the internal divide between the West Bank and Gaza, private sector activity is not expected to pick up and real GDP growth of the Palestinian economy is projected to reach 2.5 percent in 2018. This growth level implies a near stagnation in real per capita income in the West Bank and a continued decline in the income levels of Gazans. Notably, downside risks to this projection remain significant. In Gaza, if the United Nations Refugee and Works Agency's (UNRWA) funding gap is not offset, this will have a severe impact on its ability to provide education, health services and food parcels to more than one million Gazans and will result in cuts to the income of around 13 thousand employees directly employed by UNRWA.[3] Consequently, economic and social conditions in the Strip will further deteriorate, significantly raising the potential for unrest. There are also significant downside risks on the West Bank, including if donor support declines faster than expected. Elevated security risks could negatively impact economic activity in both Gaza and the West Bank.

[3] If employees indirectly hired by UNRWA through its cash-for-work and construction projects are also considered, the number of affected individuals could reach 30 thousand.

B. Public Finance

The PA's Fiscal Performance in 2017

19. **The PA's efforts succeeded in growing domestic revenues in 2017**. Between January and December 2017, domestic taxes grew by 15 percent (year-on-year) following a strong pick up in all major tax categories. Income tax receipts grew by 22 percent due to higher collections from local tax offices as well as the Large Taxpayers Unit (LTU) following enhanced tax administration efforts by the PA. Collections from domestic customs on cars also grew by an impressive 19 percent due to a rate hike implemented in mid-2016. Revenues from excise on tobacco increased by 12 percent due to additional collections following the establishment of a new local tobacco company in 2017.[4] Nontax revenues also performed well despite a strong decline in investment profits from the PA's sovereign wealth fund, the PIF, due to a pickup in collections from domestic fees and charges.

20. **Clearance revenues[5] also performed well with a year-on-year growth of 3 percent[6] in 2017.** They were driven by an increase in customs and VAT– in line with an increase in Palestinian imports, as reported by the PCBS. Notably, the GoI transferred to the PA in March a lump sum payment of NIS131 million covering income tax collected from Palestinians working in Israel over a period of several months, in addition to NIS107 million in health fees and equalization levies transferred in June. Another NIS225 million was transferred by the GoI towards the end of the year to offset some VAT leakage. These transfers also helped boost the PA's revenues.

21. **The PA managed to reduce public expenditure in 2017, predominantly but not only due to cuts affecting Gaza**. Data from the Ministry of Finance and Planning (MoFP) show that public expenditure in 2017 was 2.5 percent lower than in 2016, due to a decline in all major spending categories. The largest spending item, the wage bill, declined by 2.6 percent following recent measures to cut the salaries of PA employees in Gaza and the decline in the number of public servants as some employees were referred to early retirement in 2017. According to figures from the MoFP, the total number of PA employees dropped from 156,718 in 2016 to 137,114 by the end of 2017: 18,941 employees exited the public service in Gaza while in the West Bank the decline was limited to 667 employees.[7] Transfers, another major spending item, declined by 2 percent in 2017 (year-on-year) as the first quarter payment of the National Cash Transfer Program (NCTP) was not fully disbursed to poor households. Net lending[8] declined by 7 percent following a reduction in electricity-related costs which comprise the largest share of this spending item. The decline in electricity net lending offset the increase in water and sewerage related costs which continue to grow.

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[4] A new local tobacco company was licensed by the PA and established in 2017. The company is in charge of buying all local rolling tobacco produced in the West Bank and selling it to the local market. Prior to the establishment of the company, rolling tobacco was produced in the West Bank and sold in the black market, hence the PA was not collecting any taxes on it.

[5] Clearance revenues are VAT and import duties collected by the GoI on Palestinian imports and then transferred to the PA on a monthly basis.

[6] This year-on-year growth figure is calculated after adjusting for transfers by the GoI to offset fiscal leakages under the revenue sharing arrangements between the two parties in 2016 and 2017 in order to get a better idea of the underlying growth without these one-off transfers.

[7] Employment in the national fund increased by four employees.

[8] Net lending represents deductions by the GoI from clearance revenues to offset utility bills owed by Palestinian Local Government units (LGU) to Israeli suppliers.

22. **Despite an increase in revenues and a decrease in expenditures, the PA's financing gap persisted mainly due to less than needed budget support, and was filled by bank credit and arrears**. The PA's total deficit amounted to USD1.14 billion in 2017 (7.7 percent of GDP). Aid received amounted to USD719 million (USD544 in budget support and USD175 million for development financing), resulting in a financing gap of around USD420 million. Notably, aid received was 11 percent lower than in 2016 mainly due to a decline in budget support, while development financing increased in 2017. To fill the gap, the PA resorted to domestic sources of financing. It increased its net domestic bank financing by USD85 million resulting in its total domestic debt reaching USD1.5 billion, as of December 2017. The PA also resorted to arrears accumulation and despite repaying some dues from previous years, net accumulation in 2017 reached USD338 million.

Box 1: Impressive fiscal consolidation by the PA over the last decade

The most noteworthy fiscal development over the period between 2006 and 2017 has been the reduction in the relative size of the PA's total fiscal deficit from 30 percent of GDP in 2006 to below 8 percent in 2017 – a highly impressive achievement. This is owed to a reduction in the relative size of the wage bill and net lending to GDP. The wage bill peaked at 23 percent of GDP in 2006 and has since been reduced to 14 percent thanks to hiring control and wage growth restraints, coupled with solid GDP growth – especially in the early period. Net lending has been a significant source of the fiscal burden and the PA has taken a number of actions that have reduced it from nearly 10 percent of GDP in 2006 to below 2 percent in 2017. Despite the internal divide and the inability of the PA to collect taxes in Gaza over the last decade, the PA has managed to grow its revenues from 22 percent of GDP in 2006 to about 24 percent in 2017. This can mainly be attributed to the MoFP's efforts in widening the tax base and rolling out reforms to address tax evasion. Cooperation by the GoI to offset some of the fiscal leakages under the current revenue sharing arrangements between the two parties has also contributed to revenue growth in recent years.

The 2018 Budget

23. **According to the PA's 2018 budget, the financing gap will remain large at around USD500 million.** The budget projects a 5 percent increase in revenues compared to 2017, mainly due to economic growth and a license payment of USD63 million from a telecom operator. As for PA expenditure, it is budgeted to increase by 2.9 percent as a result of a rise in wage and non-wage spending. In fact, the wage bill is projected to grow by 3.2 percent, on the back of a 1.25 step wage increase mandatory by law, and additional hiring and promotions. Non-wage expenditure is expected to grow by 3.5 percent driven by pension salaries to employees that were referred to early retirement in 2017. The budget projects net lending to decline by around 6 percent in 2018, relative to its 2017 level. The recurrent deficit is projected to reach USD743 million, while development expenditures are expected to total USD530 million, leading to a total deficit of USD1.27 billion (8.3 percent of GDP). The budget assumes that aid will amount to USD775 million (USD600 million in budget support and USD175 million in development financing), resulting in a financing gap of around USD500 million.

24. **The 2018 financing gap could be lower as additional budget support was recently pledged, but the options for closing the gap continue to pose some risks.** Growth projections underlying the revenue target in the 2018 budget may be too optimistic and the budgeted decline in net lending could be high. Based on previous years' trends, development spending may be lower than assumed by the budget. Aid inflows are projected to reach USD745 million -- slightly lower than expected by the PA. Put together, this will result in a financing gap of about USD440 million (2.9 percent of

GDP), according to Bank estimates. If no additional donor funding is identified, the PA will resort to domestic sources to fill the gap. With limited potential for additional bank borrowing, one option would be to accumulate further arrears to the pension fund and private suppliers. Debt to the pension fund already stands at 12 percent of GDP and additional arrears could cause the PA to falter on its dues to pensioners, as the Bank projects that the fund will become insolvent in a few years. The stock of arrears to the private sector currently constitutes about 6 percent of GDP and is highly damaging to the economy. Additional private sector arrears could further worsen the PA's fiscal situation as private companies run out of cash to pay their taxes to the government. An alternative option, would be for the PA to not meet its wage commitments and its social transfers to the poorest of the population. Both options would risk social unrest. These options could also spill to the banking sector if the PA and its employees are unable to repay their loan installments in due time.

Box 2: Potential fiscal implications of the reconciliation in 2018

Internal reconciliation could result in significantly increasing the PA's financing gap in 2018. The reconciliation agreement signed in October 2017 between Hamas and the PA prioritizes the need to address the issue of civil service integration (for further details on this issue, see Annex 1). This is key for sustaining service delivery in Gaza particularly as employees of the *de facto* authority have been providing key services to the Gaza population over the last decade. Additional wage spending by the PA to pay the salaries of around 20 thousand civil employees hired by the *de facto* authority post 2007, is estimated at USD234 million (This figure is based on salary amounts that the *de facto* authority has been paying to its employees and not on average remuneration paid by the PA). Moreover, the cost of operationalizing line ministries in Gaza is estimated at USD247 million - in addition to USD300 million to finance development projects in the Strip. In total, the PA's spending in Gaza is expected to increase by USD781 million in 2018 as a result of the reconciliation. Even though the internal reconciliation will increase the tax effectiveness of the PA in Gaza allowing it to collect more domestic tax, nontax and clearance revenues, widening the tax base and improving tax administration in the Strip will take some time to bear fruit. Hence, the PA is expected to only collect an additional USD250 million in revenues from Gaza in 2018. Consequently, the PA's financing gap in 2018 is projected to be around USD1 billion, if reconciliation progresses.

25. **While the PA needs to further accelerate reforms that align its spending and revenue capacity, in the short-term actions by the PA alone will not be enough to close the financing gap.** The PA has proposed a number of measures to help generate more revenues and reduce spending. The MoFP has submitted to the Cabinet revisions to the income tax law to increase the rate for high-income earners from 15 to 20 percent. It is also in the process of revising some public fees upwards including those paid by gas stations, in addition to land registration and court fees. The MoFP also proposes to operationalize the dividend tax law that was passed several years ago but not implemented. Efforts will also focus on rationalizing expenditures through reducing net lending and health referrals. If implemented, these measures are expected to generate an additional USD325 million in savings, according to the MoFP, which will not be enough to offset the financing gap. Limited additional financing may be available through borrowing from domestic banks, but this will also not be sufficient to close the financing gap and will further increase risks linked to the banks' credit exposure to the PA.

26. **Therefore, in the short term, budget support remains a key source of financing in an environment where fiscal stimulus is still needed to support growth.** A more drastic reduction in PA expenditures in the short term maybe harmful to the economy given the constraints on private sector activity and the role of public spending as a key stimulus to growth, and may also bring about negative social consequences. Donor support during these critical times is essential to support the reconciliation agenda, sustain reforms and enable provision of services to the Palestinian population. Also, additional actions by the GoI to systematically eliminate the PA's fiscal losses under the revenue sharing arrangement instituted by the Paris Protocol will also have significant fiscal benefits. Long term fiscal sustainability, however, cannot be achieved without a prudent and stringent fiscal consolidation program by the PA. This program needs to address reform areas such as the pension system, civil service reform, and untargeted transfers.

27. **Gaza's fiscal deficit can be eliminated in the medium term**. If the blockade is eased allowing exports and investment to gradually reach their pre-blockade levels, this is expected to result in a higher growth trajectory for Gaza. The increase in economic activity alongside efforts by the PA to improve the business environment and strengthen tax effectiveness is expected to generate enough revenues to eliminate the Strip's fiscal deficit in the medium term.

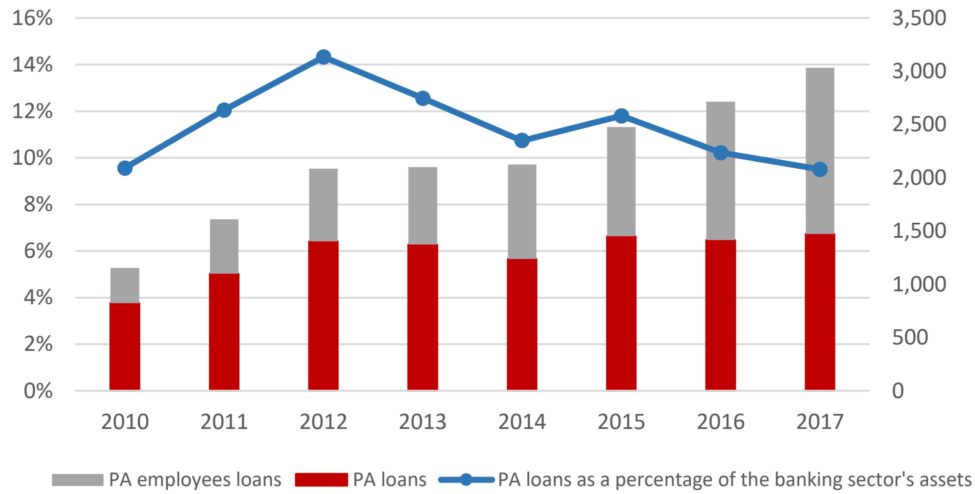
C. Money and Banking

28. **The Palestinian financial sector, composed primarily of traditional banking, maintained a stable growth in 2017.** According to the Palestine Monetary Authority (PMA) data, total net assets of the banking sector exceeded USD15 billion by the end of 2017 -- a 12 percent growth over 2016. In line with historical trends, direct credit grew by just above USD1 billion in 2017, reaching USD8 billion by the end of 2017. The bulk of new lending was driven by private sector and consumer loans while direct lending to the PA stabilized at around USD1.45 billion for the second year in a row. With the sustained growth in direct credit, the overall credit-to-deposit ratio (historically at 50-60 percent) further increased from 63 percent in 2016 to 67 percent by December 2017. Despite the recent uptick in the credit-to-deposit ratio, it remains within the regional average and the banking sector system is still regarded as liquid – confirmed by the latest PMA stress tests.

29. **Financial sector risks need to be very closely monitored in the context of potentially destabilizing risk factors.** In line with the sector's historical data, the banking sector maintained its overall risk averse lending position as reflected by a low nonperforming loans (NPL) ratio of 2.3 percent.[9] However, several potentially destabilizing risk factors need to be monitored closely. The NPL coverage ratio has declined in recent years, reaching 58 percent by the end of 2017. The volume and value of returned checks doubled over the past 3 years, from USD513.5 million in 2015 to over USD1 billion in 2017 -- equivalent to 7 percent of total presented checks. Returned checks can carry particularly detrimental consequences on cashflow management of affected small and medium enterprises (SMEs), especially with the prevalence of retail financing. Another source of risk in the banking sector is the impact of potential UNRWA budget cuts, mentioned earlier in the report. With approximately 18,000 UNRWA staff using their salaries as loan collateral, large scale disruption is likely to have an impact on some of the banks' balance sheets.

[9] NPLs are slightly higher in Gaza at 2.9 percent compared to 2.2 in the West Bank.

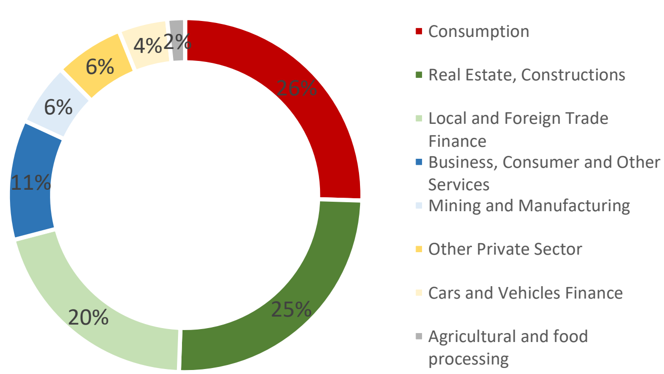
Figure 2: Bank lending to the PA and its employees (USD millions)



Source: Palestine Monetary Authority

30. **The banking system's credit exposure to the public sector moderated in 2017, but indirect exposure through households increased.** Over recent years, the PA's reliance on financing from the banking sector have raised concerns over credit concentration risk. During 2016 and 2017, exposure to the PA stabilized at a range of USD1.4-1.5 billion. Total credit grew by over USD1 billion from USD6.9 to USD8 billion resulting in a decline in the proportion of government loans from 21 percent in 2016 to 18 percent in 2017. The PMA sets an informal PA exposure limit equivalent to the banking sector's total owners' equity. In December 2017, PA debt was equivalent to 78 percent of the banking sector's total owners' equity. While direct exposure to the PA through direct lending has stabilized, indirect exposure is on the rise. Borrowing by PA employees (using future PA salary as collateral) exceeded PA borrowing for the first time in recent years, reaching USD1.6 billion. When combined, PA and public employees account for over USD3 billion, or 40 percent of total banking sector credits.

Figure 3: Distribution of private sector credit by economic activity

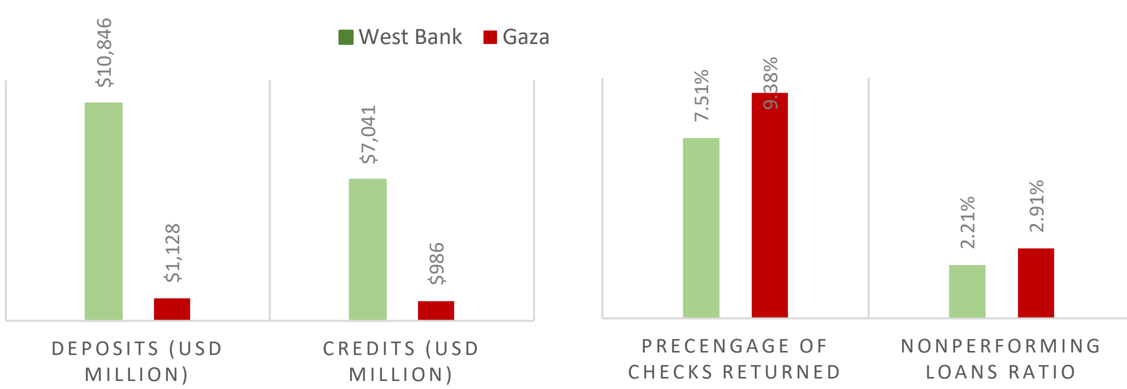


Source: Palestine Monetary Authority

31. **A constant cause for concern for the banking system and the Palestinian economy is the potential negative impact of de-risking by Israeli banks.** Citing money-laundering and financing of terrorism concerns, key Israeli banks signaled plans to limit or terminate correspondent banking services to Palestinian Banks. Such termination of correspondent banking relationships (CBRs) by Israeli banks could have significant economic impact due to the highly interlinked structure of the two banking systems, and the use of Israeli Shekel as the primary currency in the Palestinian economy. In January 2017, the GoI assumed part of the risks by approving an indemnity and immunity package for Israeli banks working with Palestinian banks to alleviate the potential for disruptions to CBRs between the two banking systems. The letters are currently being negotiated with the Israeli banks. The PMA has also been taking steps, with support from the International Monetary Fund (IMF) and the World Bank, towards upgrading the Palestinian anti-money laundering and combating financing of terrorism (AML/CFT) system to be more in line with international practices. The IMF assistance focuses on issues related to the legal and regulatory framework. With World Bank support, the PMA is conducting its first self-assessment of ML/FT risks. This technical assistance aims to enhance the ability of relevant AML/CFT stakeholders in the Palestinian territories in identifying, assessing and understanding the money laundering and terrorism financing risks they face.

32. **The structure of the banking sector balance sheets in Gaza mirrors the deterioration in the Gazan economy.** Financial sector indicators confirm a growing divergence in the health and stability of the financial sector in Gaza compared to the West Bank. Credits and deposits, the bulk of the banking services offered in Gaza, represent a fraction in volume and value compared to the West Bank, which is a sign of both a stagnant economy and a risk-averse banking sector. Returned checks as a percentage of total checks presented for clearing, which has been on the rise in both West Bank and Gaza, is more prevalent in Gaza reaching approximately 10 percent in value and 13.5 percent in volume. The NPL ratio is slightly higher in Gaza compared to the West Bank, however, the effect of salary disruptions on NPLs is likely to be muted in the short-term due to loan deferments.

Figure 4: Selected financial sector indicators



Source: Palestine Monetary Authority

33. **Results of banking system stress testing by the PMA are in line with previous findings and confirm the system's tolerance against tested shocks.** The PMA regularly conducts stress testing, in line with the Basel II principles, to ensure the resilience of the Palestinian banking system against specific events and scenarios. According to the latest available data (June 2017), the PMA reports that the banking system is well capitalized and is able to withstand a range of economic and

liquidity shocks. However, considering the range of potentially destabilizing risk factors, the stability of the financial sector needs to be closely monitored.

Chapter II: Gaza's Evolution Over the Last Two Decades

34. **This chapter aims to provide a comprehensive look at Gaza's economy over the last two decades, the human consequences of its evolution and the path forward towards a sustainable recovery for Gaza**. It will start with an overview of the main economic indicators in Gaza to show that the structure of the economy has been tremendously altered. The second section will look at the human consequences of the economic decline by describing the current humanitarian crises in Gaza. In light of the significant potential of the Gazan economy, the second half of the chapter will quantify some of this potential. It will then present recommendations on how to address infrastructure and development needs in Gaza and unlock private sector potential, to reverse Gaza's deteriorating trajectory – and to place it on a sustainable path for recovery.

The Gaza Economy: From One Crisis to The Next

35. **Gaza's growth experience over the last twenty years has been volatile, mirroring political events**. Gaza was the first territory to be transferred to the authority of the Palestinians in 1994, after the signing of the Gaza-Jericho agreement - a follow up treaty to the Oslo accords. Between 1994 and 1999, Gaza enjoyed good levels of growth averaging around 6 percent per annum due to higher inflows of capital, increased investments, and a significant improvement in the security situation. This positive trend was interrupted after the outbreak of the second intifada in 2000 when the Gaza economy fell into recession with growth rates slipping to an annual average of minus 8 percent until 2002. Several years after the second intifada, the economy started to recover but was hit again with the turmoil surrounding the internal divide following the parliamentary elections of 2006. The economic decline got deeper with the Israeli decision to impose a full blockade on Gaza in 2007 after the takeover by Hamas, resulting in growth dropping to minus 7 percent that year. Multiple episodes of war in 2008, 2012 and most recently in 2014 have all exacted a significant toll on Gaza's economy pushing it into recession. In fact, economic growth after the 2014 war dropped to minus 15 percent. The crackdown on illegal tunnel activity with Egypt in 2013-14 also had a negative impact on economic activity. Inflows of aid for reconstruction after the 2014 war allowed the economy to rebound with average growth rates reaching 8 percent in 2015-2016. However, the lack of additional aid for reconstruction and a significant decline in consumption in 2017 caused GDP growth to drop to a mere 0.5 percent.

36. **As a result of these multiple shocks, Gaza's average growth over the last two decades has been lower than all comparators**. Average annual growth in Gaza over the last two decades was limited to around 2 percent. Looking at the economic performance of all suitable comparators makes it clear that this growth level is very low. In fact, all comparators were able to achieve at least twice as high average annual growth levels over the last two decades. For example, average annual growth was 4 percent in the Arab world, 5 percent in both low income and low-middle income countries and 5 percent in MENA (excluding high income countries).[10] With a relatively educated population, access to the sea and proximity to a developed country, one would expect Gaza's GDP growth to be at least in line with the West Bank's which grew by an average of 5 percent per year over the last two decades. Interestingly, growth trends in Gaza exceeded those in the West Bank prior to 2006/7. Afterwards, the impact of the blockade, multiple conflicts and the internal divide resulted in a much lower growth trajectory for Gaza.

[10] Based on WDI data, the World Bank.

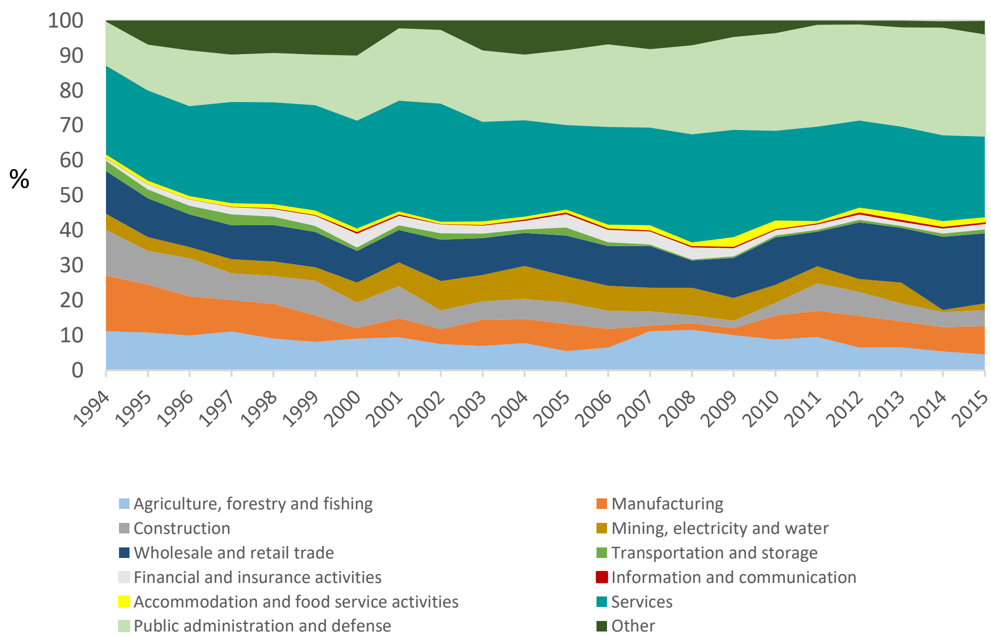
Box 3: Timeline of political events in Gaza, 1994-2015

1994 ---------------------------------	Gaza Jericho Agreement
1995 ---------------------------------	Israel installs parameter fence surrounding Gaza
2000 ---------------------------------	Second Intifada starts
2001 ---------------------------------	Israel closes safe passage between Gaza and West Bank
	Israel bombs Gaza airport
2002 ---------------------------------	UN-Israeli Bertini Commitment easing access restrictions
2005 ---------------------------------	Israel unilaterally disengages from Gaza
2006 ---------------------------------	Hamas wins Palestinian elections
	Israel stops the entry of Palestinian workers into Israel
	Israeli soldier captured by Hamas, operation “Summer rains” launched
2007 ---------------------------------	Hamas takes over Gaza and Israel imposes a blockade
	Israel closes Karni crossing except for a conveyer belt
	Israel passes the 2007 Defense Expert Control Law on dual use items
2008 ---------------------------------	Escalation in hostilities: Operation “Cast Lead”
	Fishing activities beyond 3 Nautical Miles prohibited
	Israel passes a Security Order for controlling dual use goods transferred to the WBG
2009 ---------------------------------	Access to areas closer than 300m from the fence is prohibited
2010 ---------------------------------	Israel closes Nahal Oz Crossing
	Israel intercepts flotilla headed to Gaza from Turkey
	Israel eases import restrictions
	Egypt reopens Rafah Crossing
2011 ---------------------------------	Israel closes Karni conveyor belt
	Israel closes Sufa Crossing
2012 ---------------------------------	Escalation in hostilities: Operation “Pillar of Defense”
	Fishing areas extended to 6 Nautical Miles
2013 ---------------------------------	Egypt launches military campaign to destroy tunnels
	Egypt closes Rafah Crossing to entry of commercial goods
2014 ---------------------------------	Fateh and Hamas signed a reconciliation agreement and a unity government was established
	Escalation in hostilities: Operation “Protective Edge”
	Sale of some goods from Gaza to West Bank resumes
	Egypt closes Rafah to movement of people, with exceptions
2015 ---------------------------------	Entry of building materials for reconstruction begins through the GRM
2017 ---------------------------------	Most recent reconciliation agreement between Fateh and Hamas signed in Cairo

Source: UNOCHA and World Bank

37. **Gaza's economy has been deindustrialized over the last twenty years, with an erosion of its productive base.** The structure of the Gaza economy has substantially deteriorated since the nineties. The size of the manufacturing sector, which is one of the key drivers of export-led growth globally, dropped from 16 percent of GDP in 1994 to 8 percent currently. The size of the agriculture sector also shrank from 11 percent of GDP to below 5 percent. The rapid decline in these productive sectors was not replaced by growth in high value-added services that could lay the basis for the economy to integrate into regional and global markets. In relative terms, most growth occurred in the public sector whose share in total output increased from 12 to 29 percent from 1994 to the present. Growth in public sector output was not accompanied by an expansion of sectors with potential to generate sustainable growth and revenues to continue the provision of public services over the medium and long term, raising serious questions over the sustainability of Gaza's growth model. In addition to the deterioration in the productive base, the isolation of the labor force due to restrictions on the movement of people is expected to have led to an erosion in Gaza's human capital.

Figure 5: Sectoral contribution to GDP, 1994-2015



Source: Palestine Central Bureau of Statistics

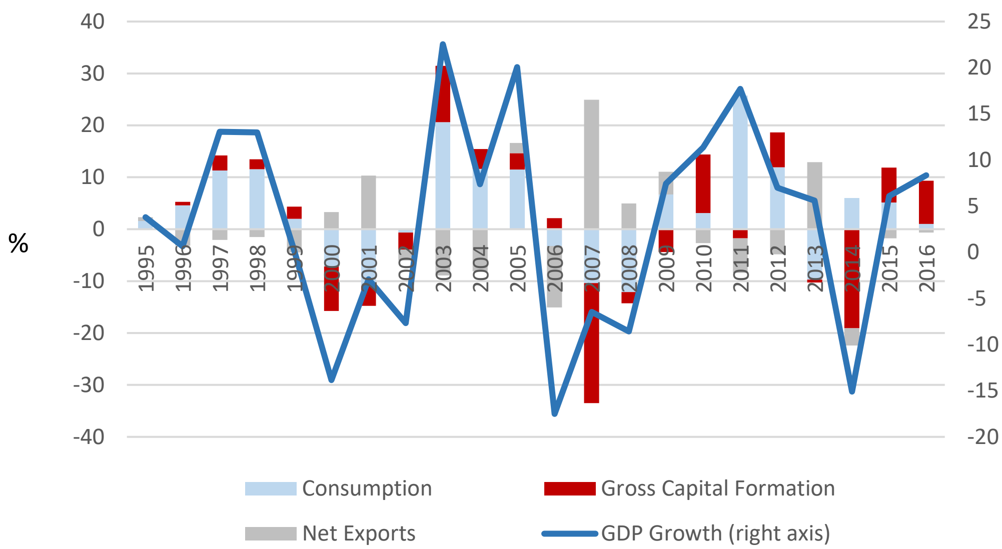
38. **On the expenditure side, consumption was the main driver of growth in Gaza over the last two decades while investment did not play a role**. PCBS data suggests that private and public consumption financed by aid inflows were the dominant contributors to Gaza's economy over the last two decades, adding 80 percent to GDP growth between 1994 and 2016. The role of net exports was negligible contributing a mere 2 percent to growth over the period. Investment has had a negative contribution to Gaza's growth over the last twenty years, at minus 6 percent.[11]

39. **Anemic rates of investment have prevented Gaza from rebuilding the capital stock lost through depreciation and conflict-related destruction, resulting in the de-development of the territory**. According to the IMF, the 2008 war in Gaza is estimated to have eroded over 60 percent

[11] The remainder is accounted for through errors and omissions.

of Gaza's total capital stock. Damage assessments of the 2014 conflict show that it led to economic losses estimated at USD1.7 billion and resulted in an 85 percent decline in Gaza's capital stock. As a result, most investment that took place over recent years was to make up for the physical destruction that resulted from the wars, and was not able to put a dent in the low capital stock levels. This has left Gaza's capital stock depleted and the capital/output ratio a fraction of what it was two decades ago, resulting in the de-development of the territory. Without a sufficient level of capital stock, output per capita cannot be expected to meaningfully grow as workers are not properly furnished with the tools to increase productivity.[12]

Figure 6: Contribution to real GDP growth in Gaza, 1995-2016

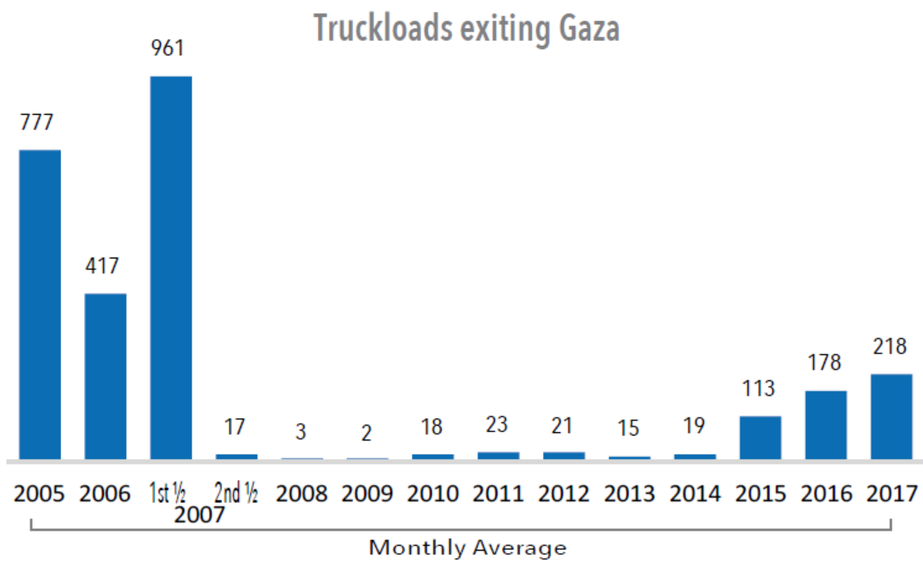


Source: Palestine Central Bureau of Statistics and World Bank staff calculations

40. **Gaza's exports virtually disappeared after the blockade, and they continue to be a fraction of their pre-blockade level.** In 2007 when the blockade was imposed, the GoI banned almost all exports out of Gaza. In fact, figures by the United Nations Office for the Coordination of Humanitarian Activities (UNOCHA) show that the number of yearly truckloads exiting Gaza dropped from more than 5000 prior to the blockade to 30-40 truckloads in the following years. In 2010, the ban on exports was slightly eased to allow the exit of negligible quantities of goods, primarily flowers and strawberries, to overseas markets only. After the 2014 war, the GoI took some measures to enable economic activity to rebound in Gaza by allowing some sales from Gaza to the West Bank. Initially, goods were limited to agricultural produce but were later expanded to cover textiles and furniture. Since early 2015, a small amount of exports has also been permitted from Gaza to Israel. Nevertheless, truckloads out of Gaza continue to be much lower than their level pre-blockade, with the majority destined for the West Bank.

[12] See Annex III entitled "The Cost of Conflict and Political Uncertainty for the Economy's Capacity to Grow" in the IMF's report to the Ad Hoc Liaison Committee, August 2017.

Figure 7: Exports from Gaza, 2006-2016

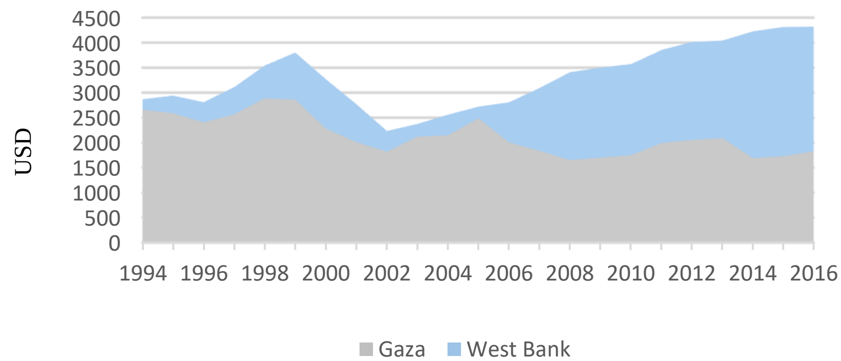


Source: The United Nations Office for the Coordination of Humanitarian Activities

41. **The internal Palestinian divide, which fragmented institutions and systems across the Palestinian territories, exacted a toll on Gaza's economy.** After 2007, the *de facto* authority in Gaza passed numerous laws and regulations that differ from the ones applied in the West Bank. This created two parallel regulatory frameworks which complicated doing business particularly for companies that operate in both the West Bank and Gaza. In fact, many firms that originally had their headquarters in Gaza moved to the West Bank after the internal divide to avoid procedural complications and double taxation. The financial sector in Gaza, a key pillar for any economy, was also severely hit after the internal divide. For example, a large number of customers, including the PA, withdrew their deposits from bank branches in Gaza leading to a sharp decline in liquidity and banking activities in the Strip. Israeli banks also severed ties with banks in Gaza in 2007 ending correspondent banking relationships. Banks in the Strip operate under a very restrictive environment as their ability to do business elsewhere would be damaged if they were seen to be cooperating with the *de facto* authority, leading to a deterioration in financial inclusion. Overall, the internal divide led to a significant deterioration in governance which has negatively impacted economic prospects.

42. **Gaza's economic decline over the last two decades has had a severe impact on the living standards in the Strip where real per capita incomes have significantly declined over the last two decades.** Since 1994, Gaza's population increased by roughly 90 percent. Economic growth was much lower over the period resulting in real per capita income (GNI) dropping by a third, from USD2659 in 1994 to USD1826 currently. Consequently, while GNI per capita in the West Bank was only 8 percent higher than in Gaza in 1994, that difference increased to 137 percent, currently. Even if one takes into account remittances and official transfers, which buffer the impact of the drop in GNI, a 29 percent reduction of disposable real income per capita in Gaza (GNDI) over the period is still observed. These numbers clearly indicate a substantial reduction in the standard of living of the Gazan population over the past two decades.

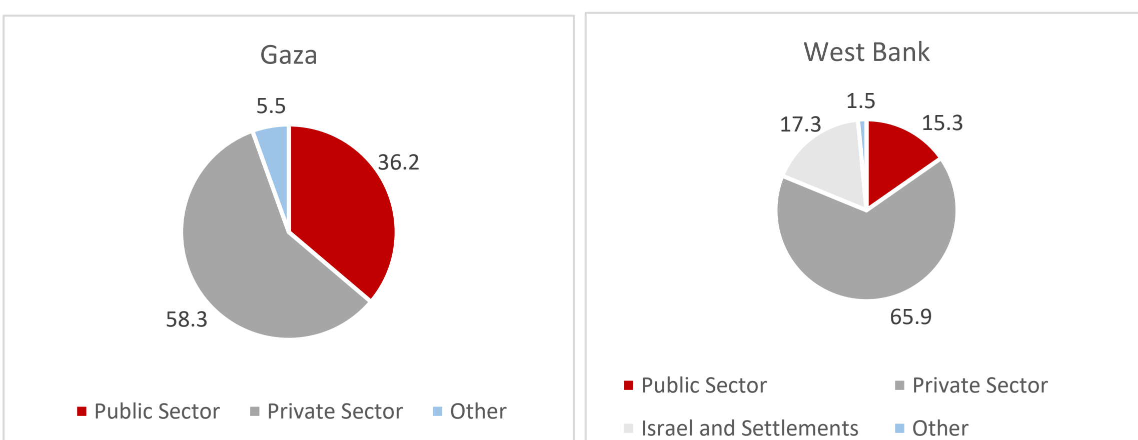
Figure 8: Real per capita Gross National Income (GNI), 1994-2015



Source: Palestine Central Bureau of Statistics

43. **Unemployment amongst Gazans has been on the rise and is currently amongst the highest in the world: averages disguise a particularly high youth unemployment rate.** In the early years after the signing of the Oslo accords, unemployment dropped considerably mostly due to growth in employment opportunities in Israel. Unemployment quickly bounced back, however, after the second intifada reaching 38 percent. The 2007 blockade led to a sharp increase in unemployment to 41 percent. By the end of 2013, the crackdown of the illegal tunnel trade between Gaza and Egypt led to a significant loss of employment opportunities. Since then, the combination of the ongoing Israeli blockade and the lasting impact of the 2014 war have continued to push the unemployment rate as it currently stands at around 44 percent. In fact, Gaza currently has the highest unemployment rate in the World Bank's World Development Indicators (WDI) database. Unemployment amongst those aged between 15-29 is particularly striking as it currently stands at 61 percent. Due to the lack of employment opportunities, the public sector in Gaza has been the largest single employer, employing 36 percent of those in employment. This rate is considered extremely high even when compared to the West Bank's which currently stands at 15 percent.

Figure 9: Distribution of employment (%), Q4 2017



Source: Palestine Central Bureau of Statistics Labor Force Survey

44. **Given that poverty is highly correlated with labor market outcomes, it is not surprising that a large share of the Gazan population lives below the national poverty line.** According to the latest available data for 2011, poverty in Gaza stood at 39 percent – more than twice as high as that

in the West Bank. In fact, the poverty gap between the West Bank and Gaza has always been high. In 2004, the poverty headcount in Gaza was 29 percent higher than in the West Bank. By 2007, this gap had expanded exponentially to reach 145 percent after the blockade was imposed. While the gap declined after 2009, it continued to be over a 100 percent and never returned to its pre-crisis level.

45. **Social assistance, mainly through UNRWA, has played a key role in maintaining the livelihood of Gazans.** Close to 70 percent of the Gaza population has a refugee status, and according to the PCBS, individuals living in refugee camps are more likely to be poor. Notably, social assistance has played a key role in maintaining the livelihood of Gazans, and according to UNRWA, 80 percent of the Strip's population receive some sort of social assistance. These payments have helped reduce poverty levels in Gaza as without them an additional 11 percent of the Gazan population would immediately fall below the poverty line. UNRWA funding also provides food supplies to about one million Gazans and operate 275 schools and 22 health facilities that mostly provide services to the poor across the Gaza Strip.

46. **In addition to sustaining the livelihood of a large share of Gaza's population, transfers and cash remittances have played a key role in driving Gaza's economy, particularly since the 2007 blockade.** Aid and remittances are almost the only source of foreign exchange inflows that fuels consumption in Gaza, particularly since exports, as mentioned above, are extremely small and investment activity is weak. Gaza remains largely a cash economy so figures from formal bank flows are not very helpful in trying to estimate either trade or non-trade flows of foreign exchange, and data on private remittances is equally hard to get. However, it can be safely assumed that the PA and UNRWA's expenditures in Gaza represent the largest sources of non-trade related financial inflows. In 2014 (latest available data), these two sources amounted to more than USD2.3 billion. Informal flows to the *de facto* authority amounted to another USD500 million in that year. Thus, altogether it is estimated that transfers (excluding remittances) amounted to close to 100 percent of Gaza's GDP. Notably, this rate is expected to have significantly increased in the following years as large amounts of aid were received after the 2014 war to enable reconstruction.

Table 2: Transfers to Gaza, 2013 and 2014

Transfers to Gaza (USD million)	2013	2014
PA expenditure[13]	1,391	1,471
UN system – humanitarian	250	845
Aid to *de facto* authority[14]	464	500
Total	**2,105**	**2,816**
Gaza GDP (current prices)	3,092	2,912
Aid inflows as a share of GDP (%)	68	97

Source: PA MoF, ICRC and World Bank

47. **Spending on Gaza accounts for one-third of total PA spending, but Gaza revenues are just one-tenth of total PA revenues.** According to data provided by the PA MoF, PA spending in

[13] This includes donor projects financed through the PA's budget. Since donors provide budget support to the PA, these expenditures are also indirectly enabled by donor aid.
[14] Based on data provided by the International Committee of the Red Cross (ICRC).

Gaza in 2016 was close to USD1.5 billion and represented 33 percent of total spending by the PA. More than half of this amount was spent on wages to PA employees – a large portion of which is staying at home. The second largest expenditure category by the PA in Gaza is social transfers, while spending on development projects was very small, around USD72 million. In the same year, revenues generated by the PA from Gaza were about USD325 million – less than 10 percent of the PA's total revenues. The absolute majority of Gaza revenues comprise clearance revenues on fuel imports from Israel in addition to some income tax collected from the PA's employees in the Strip. As a result, Gaza's fiscal deficit before financing approached USD1.2 billion in 2016. In contrast, PA spending in the West Bank in 2016 was slightly higher than public revenues collected there resulting in a small surplus.

Table 3: Palestinian Authority finances disaggregated by West Bank and Gaza, 2016

USD million	Gaza	West Bank	Palestine
Expenditure	**1,496**	**3,065**	**4,561**
Wages	817	1,235	2,052
Goods and Services	110	557	667
Social Transfers	235	714	949
Net Lending	190	79	269
Social contributions[15]	73	123	196
Development Spending	72	265	337
Other	—	91	91
Revenue	**325**	**3,146**	**3,471**
Clearance Revenues	285	2,053	2,338
Tax and Nontax	40	1,186	1,226
Tax refund (minus)	—	93	93
Fiscal Balance	**-1,171**	**81**	**-1,090**

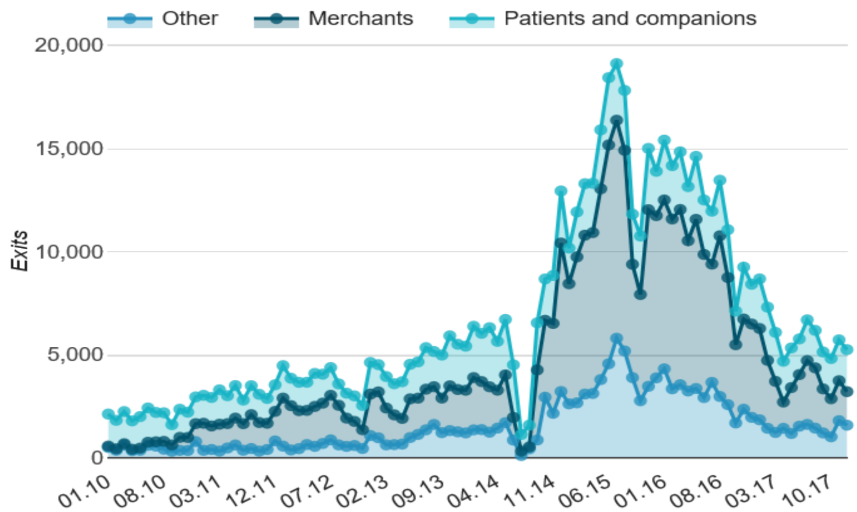
Source: PA MoF, Norway and World Bank

The Humanitarian Crises in Gaza

48. **The protracted difficult living conditions have exacted a large human toll on Gazans over the years, while the recent liquidity squeeze has led to a rapid collapse in humanitarian conditions**. As mentioned earlier in the report, almost a quarter of Gazans have seen their incomes significantly drop in recent months, resulting in a corrosion of livelihoods. This, compounded with protracted difficult living conditions and the isolation of Gazans, has brought Gaza to the verge of collapse. Movement of people in and out of Gaza has been severely restricted and limited to those who hold special permits. This has left the absolute majority of Gaza's two million residents confined in an area of 365 square kilometers for more than ten years. Gaza has one of the highest population densities in the world with 5,556 persons for every square kilometer -- 10 times more than in the West Bank. In 2017, the GoI cancelled a large number of business permits granted to Gaza traders resulting in a 51 percent drop in the number of outstanding permits compared to the previous year, adding to the isolation of Gazans.

[15] The breakdown for this expenditure item was calculated by disaggregating the full figure provided by the MoFP per the share of employees in Gaza and the West Bank.

Figure 10: Monthly number of Gazans exiting the Strip through the Erez crossing, 2010-2017



Source: GISHA – Legal Center for Freedom of Movement

49. **The deteriorating state of the health sector also has severe effects on the wellbeing of Gazans.** Importing key medical machinery and equipment, including dialysis machines, heart monitors and scanners, is highly restricted due to the blockade. The state of medical equipment currently available in Gaza continues to deteriorate with the import of spare parts restricted. Gaza's health system also suffers from an ongoing shortage in drugs that has significantly worsened in recent months. In fact, almost half of the items on the essential drugs list is currently unavailable. This, in addition to a severe shortage in medical disposables, such as disinfectants, syringes, and anesthetics, has resulted in catastrophic consequences for patients. The medical crisis in Gaza has recently escalated due to a major shortage in fuel (diesel) used for electricity generators, and according to the Palestinian Ministry of Health (MoH), three hospitals and ten medical centers have already suspended services due to this issue. Previously, a large share of Gazan patients used to be referred for treatment outside Gaza. However, the number of those referred for medical treatment outside Gaza has recently declined, limiting this option. Moreover, only 54 percent of medical permits to exit Gaza were approved by the GoI in 2017, the lowest rate since 2008.[16] As a consequence of confinement and repeated cycles of wars, a sizeable share of Gaza's population suffers from psychological trauma, including post-traumatic stress disorder (PTSD).[17]

50. **Electricity supply is as little as a third of needs, with far reaching consequences for households, businesses, and public service delivery.** Gaza's average demand for electricity is estimated at 500MW, while total electricity supplies currently reach 170MW only. Current supplies include the recently restored 50MW from Israel and an additional 25MW from Egypt. Operation of the Gaza Power Plant (GPP) depends on the availability of fuel. On average, the GPP generates

[16] According to Amnesty International: https://www.hrw.org/news/2018/02/13/israel-record-low-gaza-medical-permits
[17] Data suggest that close to 60 percent of Gaza's children suffer from PTSD. Also, almost half of the adults that seek support from UNRWA clinics in Gaza report a case of poor wellbeing.

around 45MW, but output varies widely between 0-60MW due to the irregular fuel supply.[18] This leads to severe power shortages for households, the economy, key public infrastructure, hospitals and schools. Currently, Gazans receive 3-6 hours of electricity per day, followed by 12-18 hours off. Public services are acutely underserved by the power sector with the health sector highly dependent on diesel, as mentioned above, and water and waste water services operating at minimal service levels. Overall, electricity has become the top binding constraint reported by Palestinian firms in Gaza.

51. **Although almost all houses in Gaza have a piped water connection, the poor quality of piped water results in reliance on expensive alternatives.** Long-term water and sanitation trends in Gaza show an alarming situation. Years of overexploitation and sewage infiltration into the aquifer have resulted in the pollution of 95 percent of groundwater resources in Gaza with high proportions of nitrates and chlorides -- well above international guidelines for potable water resources. From a position of close to universal access in 1995, access to improved drinking water sources in Gaza declined to one of the worst in the world today -- even below the average of 66 percent for low-income countries. Although most households in Gaza are connected to the piped water network, the connection does not guarantee timely access to drinking water, let alone adequate quality. In 2016, access to improved drinking water in Gaza was almost zero percent – compared to 93 percent in the West Bank. More than 97 percent of the households in Gaza rely on potable water delivered by private tanker trucks. Gazans are paying a high tariff for this service, around NIS30−35 per m^3 -- much higher than the NIS1.5−3 per m^3 charged for piped water. Poorer customers who cannot afford truck delivery tend to buy drinking water from supermarkets in 20-liter jerry cans.

52. **Despite high levels of sewage collection, wastewater is only treated partially and subsequently discharged to the environment creating a major public health threat.** 99 percent of Gazans have access to improved unshared sanitation, with 78 percent of households connected to public sewage networks. About 48 million cubic meters (MCM) of wastewater is collected each year -- over 90 percent of which is at least partially treated. However, treatment plants are overloaded and function poorly mainly due to underfunding, lack of electricity, and limited availability of spare parts and consumables required for operations. As a result, around 25MCM of partially treated wastewater and 7MCM of raw sewage is discharged annually to open ponds and the Mediterranean Sea -- equivalent to around 90 million liters per day.

53. **Poor housing conditions and internal displacement also negatively impact the quality of life in Gaza**. Gaza's citizens are crammed in a small living space. This is mainly due to high population growth, lack of adequate access to building materials, restrictions on building on land close to the border with Israel (ranging in size from 300 to 1,000 meters from the border fence), and destruction inflicted by previous wars. To address demographic growth alone, there is a backlog of 70 thousand housing units in Gaza. The housing shortage significantly increased after the 2014 war which resulted in the destruction or severe damage of about 17,800 housing units, leaving approximately 100,000 people displaced. Good progress has been achieved in rebuilding partially destroyed housing units through the Gaza Reconstruction Mechanism (GRM) that was set up after the war. Nevertheless, more than three years after the war, UNOCHA estimates that 29 thousand individuals (or over 5,500 families) are still displaced. Most of these families have not been allocated funding for reconstruction.[19]

[18] Considering both the capacity charges and the fuel costs, operating the Gaza Power Plant comes at a high cost of approximately NIS1.05-1.65 (USD0.30-0.45) per kilowatt-hour, more than three times the Israeli Electric Company power import tariff.

[19] https://www.ochaopt.org/content/three-years-2014-conflict-29000-people-remain-displaced

The Economic Decline Will Continue Under a Status Quo Scenario

54. **The status quo involves declining inflows, hence the economic decline in Gaza will continue.** Transfers, which have been the main driver of Gaza's growth over the last decade, are expected to continue to significantly decline in the coming period, particularly as additional aid for reconstruction does not seem forthcoming and cuts in UNRWA funding have been announced. Also, aid to the *de facto* authority, which has also played a role in boosting growth in recent years, is projected to continue falling. In the absence of change, it is expected that growth in Gaza will hover around 1-2 percent in the medium term. This will have a severe impact on service delivery and on public and private consumption in Gaza.

55. **Expected growth rates will not be enough to improve living standards nor reduce unemployment.** Gaza has a very high fertility rate of 4.5 children per woman. Based on this, in addition to other social factors, it is expected that Gaza's annual population growth will exceed 3.6 percent over the coming decade, and the size of the population will increase from about 2 million currently to 2.6 million by 2025. The projected annual economic growth rate is much lower than the expected population growth, hence will not be enough to increase per capita incomes resulting in a continuous deterioration in the living standards in Gaza. Given that population growth plays a key role in the supply of labor, it is not surprising that the size of the labor force in Gaza will significantly increase over the coming period (see table 4). Only to absorb the new entrants to the labor market while maintaining the current number of the unemployed, 27 thousand additional jobs need to be created in Gaza every year over the coming decade. [20] The projected growth levels, however, will not be able to keep up with the growing labor force resulting in an increase in the unemployment rate to more than 50 percent in the coming period.

Table 4: Actual and projected number of participants in the labor force, Gaza[21]

Year	2017	2020	2025	2030	2035	2040	2045	2050
Gaza's Labor Force (thousands)	499	593	725	875	1055	1266	1516	1792

Source: PCBS and UNFPA

56. **Future education needs in Gaza will also be difficult to address if the status quo persists, significantly impacting Gaza's economic prospects and increasing the risk of renewed conflict**. Gaza's educational infrastructure has significantly deteriorated in recent years due to destruction by multiple episodes of war as well as lack of investment. There is a severe shortage in classrooms and 85 percent of schools operate double shifts to accommodate the current number of students. School-age population is expected to increase in the coming period due to demographic changes and an increase in enrollment rates, according to the United Nations Fund for Population Activities (UNFPA). In fact, it is projected that the number of students in Gaza will increase from 630 thousand in 2015 to 1.2 million in 2030. To meet this student demand, there will be a need for 900 additional schools in addition, of course, to a significant increase in teachers.[22] However, if current trends persist, neither external aid nor spending by the PA in Gaza will be enough to cover these large investment needs, resulting in a significant increase in the number of uneducated youth

[20] UNFPA. (2017). Palestine 2030: Demographic Change, Opportunities for Development: http://palestine.unfpa.org/sites/default/files/pub-pdf/Palestine%202030%20Summary%20-%20English%20revised%20edition.pdf

[21] According to UNFPA, projections assume that the male participation rate (currently 75 percent) will remain constant while the female participation rate (currently 18 percent) will increase throughout the projection period.

[22] UNFPA. (2017). Palestine 2030: Demographic Change, Opportunities for Development.

in Gaza over the coming ten years. This, in addition to its severe impact on Gaza's future development and economic prospects, is a major risk to peace and stability.

Gaza's Potential Can Be Unlocked by Easing Internal and External Restrictions

57. **The following section lays out the main external and internal constraints facing the Gaza economy, and quantifies the impact of their removal on growth in the medium term**. A general equilibrium model was used as the basic tool to capture the broader and dynamic economic impact of removing the external and internal constraints.[23]

Internal Challenges

58. **The internal divide has exacted a toll on Gaza and recent progress in reconciliation rekindles hope for the Gaza economy and its people**. The main aim of the reconciliation agreement recently signed between the PA and Hamas is ending the ten-year internal divide that has exacted a toll on Gaza's economy through leading to further fragmentation of the Palestinian territories. Also, the blockade imposed after 2007 has been the largest contributor to Gaza's economic decline. Progress on reconciliation could raise projected real GDP growth rates in Gaza in 2018 from 1-2 percent (under a status quo scenario) to 5-6 percent on the back of an increase in public and private spending. This boost to growth emanating from the reconciliation will only be sustained in the medium term if additional reforms are carried out.

59. **Continued domestic reforms are key for a sustainable recovery of the Gaza economy**. The political division (and strife) between the West Bank and Gaza since 2007 has resulted in two parallel regulatory frameworks, thus further fragmenting the already limited economic space. Therefore, unifying business regulation between the West Bank and Gaza is key as it is expected to significantly ease doing business, particularly for firms that operate in both territories. Internal reforms should also address the skill mismatch in Gaza's labor market through education reforms in order to improve employment outcomes in the Strip. More efforts are also needed to improve access to finance to encourage new investments in Gaza. Gaps in access to finance for dynamic start-ups further limit the space for Gaza's well-educated and entrepreneurial population, including in promising services such as IT and telecommunications. Greater access to finance for these firms should begin with supporting financial inclusion, further developing non-bank financial institutions and addressing their collateral constraints. Finally, it is key that internal reforms focus on generating additional revenues from Gaza while increasing the efficiency and efficacy of public spending in the Strip in order to eventually reach a more sustainable fiscal position. **Our analysis suggests that internal reforms covering the areas mentioned above could generate additional cumulative growth in the range of 30 percent in Gaza by 2025.**

External Restrictions

60. **Removal of the decade-old blockade on Gaza is projected to result in the largest gain.** The land, air and water blockade that that has prohibited the movement of goods and people since 2007 into and out of the Strip has had severe consequences on all aspects of the economy. Even though

[23] For more details on the model, see the 2017 World Bank report entitled "Prospects for Growth and Jobs in The Palestinian Economy: A general equilibrium analysis": http://documents.worldbank.org/curated/en/952571511351839375/Prospects-for-growth-and-jobs-in-the-Palestinian-economy-a-general-equilibrium-analysis

the GoI took some steps to ease the blockade in 2010 and then later in 2014, Gaza's exports and imports continue to be much lower compared to their pre-2007 level, and the movement of people is severely restricted. Also, sales to East Jerusalem and the West Bank, which were former lucrative markets for Gaza's businesses, remain highly restricted. The GoI allows imports of consumer products and some construction material for donor supervised projects, but the inflow of materials remains much below the needs. Years of blockade have undermined the living conditions in Gaza and fragmented the economic and social fabric of the Palestinian territories. The isolation of Gaza has been exacerbated by additional constraints imposed by Egypt on the Rafah crossing. Lifting the blockade would enable exports out of the Strip to gradually reach their pre-blockade level through higher capacity utilization, and would open Gaza up for critical trade needed to rebuild its infrastructure and economy. **Our analysis suggests that lifting the blockade alone could lead to additional cumulative growth in the range of 32 percent by 2025 for the Strip's economy.**

61. **The GoI applies a longer list of dual use items restricting exports/re-exports from Israel to Gaza than to the West Bank.** Similar to other advanced countries, Israel controls its exports of goods that have both civilian and military uses, or the so called dual use items. The most common regulatory basis governing the movement of such goods is the 1996 Wassenaar Arrangement (WA).[24] Though not a signatory to the WA, Israel uses the arrangement's lists to license the export of all dual use goods manufactured or assembled in Israel. When it comes to exports/re-exports to the Palestinian territories, the GoI enforces further controls on additional items that it has deemed as "dual use" through the Defense Export Control Law of 2007 and a Military Order passed in 2008 stipulating that all dual use items destined to the Palestinian territories require a special permit and reporting duties.[25] Currently, the dual use list for Gaza and the West Bank includes 6 fertilizers, 2 pesticides, 23 chemicals in their pure form and 26 types of materials, machinery, and equipment. There are an additional 61 items that only apply to Gaza. The additional items include inter alia reinforcing steel, cement, aggregates, insulating panels, timber for furniture manufacture.[26]

62. **Gaza's dual use has an impact on almost all economic sectors and its relaxation could result in significant economic gains.** Some organizations such as the UNOCHA and the Israeli NGO GISHA have indicated that the dual use list for Gaza is too extensive making it more like a sanction rather than a defensive measure.[27] Traders report that nearly any item can be deemed as "dual use" at the entry to Gaza, even if it has been imported previously by the same importer with no special controls. In addition, the procedure to import such goods is described as vague, unpredictable and nontransparent by traders which discourages them from initiating the process in the first place. Some of the items on the list are very broad in nature such as "telecommunications equipment' which makes it difficult for traders to fully understand what is covered by the list, adding to the complications. Almost all economic activities in Gaza are somehow impacted by the dual use list, but the most affected sectors are—agriculture, manufacturing, and ICT—and, in particular, the subsectors of food processing, beverages, metal fabrication, furniture, textiles, leather, paints, detergents, and cosmetics. Further, aid organizations report that dual use restrictions negatively impact their operations in the Strip making it difficult to address the humanitarian needs of Gazans.

[24] The Wassenaar Arrangement is an international agreement aimed at increasing global stability through transparency and supervision of dual-use exports. States following the arrangement maintain national export controls on listed items. The lists, including those under the various categories of "Dual-Use Goods & Technology," very narrowly describe items of concern and are updated annually by the WA secretariat. For more info, see http://www.wassenaar.org.

[25] According to the GoI, the law was created as a way of protecting Israelis from attacks using material initially intended for commercial or civilian use.

[26] The GoI reports that timber was recently taken off the list.

[27] GISHA – Legal Center For freedom of Movement. (2016). Dark Gray Lists: http://gisha.org/UserFiles/File/publications/Dark_Gray_Lists/Dark_Gray_Lists-en.pdf

Our analysis suggests that relaxing the dual use list alone would bring about additional cumulative growth of 11 percent to the Gaza economy by 2025.

63. **Labor movement and trade restrictions are also tight for Gaza and are a severe deterrent to investment.** For instance, while the Paris Protocol of 1994 stipulated free movement of labor between Israel and the PA, no Gazans have been granted permits to work in Israel since 2000.[28] Imports and exports of goods are required by the GoI to go through a highly cumbersome "back-to-back" process as well as lengthy security and clearance procedures at Karem Abu Salem (the only currently operational commercial crossing in Gaza), more complicated than those applied at West Bank crossings. This further pushes the transportation cost for Gaza's traders.[29] The Israeli authorities also completely prohibit the use of containerized shipments at Karem Abu Salem. Highly limited numbers of permits granted to Gaza's business people to leave the Strip stands in the way of building trade links with the West Bank, East Jerusalem, Israel and the outside world. Also, obtaining permits to enter Gaza, even for foreign investors, is controlled by the GoI. The high level of uncertainty linked to the political environment, in addition to the lack of access to markets and inputs, has limited any new potential investments in Gaza. It has also made Gazan firms highly reluctant to scale up their businesses or upgrade their product lines. Overall, these external measures and practices have all had a significant and longstanding effect on Gaza's trade and economy over the years.

64. **Alleviating external and internal constraints provides a medium-term path to rapid growth and job creation for the Gaza economy.** Real per capita income growth is expected to exceed 5 percent in Gaza by 2025. This growth level would result in an increase in job creation estimated at 60 thousand additional jobs in Gaza by 2025 relative to a baseline scenario. This will result in a significant reduction in unemployment, while absorbing additional participants in the labor market - not least women. At the same time, such growth levels would dramatically reduce the dependence on foreign aid.

Infrastructure Needs in Gaza: Water and Electricity

65. **Substantial infrastructure investments and sectoral policy reforms will also be needed to give a boost to the economy and improve the quality of life for Gaza's population**.

66. **Meeting electricity demand in the Gaza Strip will require a mix of investment and policy actions.** Overall, Gaza's alternatives to improve the energy sector are more constrained compared to the West Bank, and the premium associated with full energy independence would be particularly high.[30] Medium-term energy demand is projected to grow at a rate of 6-7 percent per annum, including suppressed demand from currently unserved customers. Estimated investment needs to meet this demand range from USD340 million (with a medium-term emphasis on optimizing Israeli

[28] The Paris Protocol (the agreement governing economic relations between the PA and the GoI) states that labor should be allowed to move freely under "normal circumstances".

[29] In Gaza, the back-to-back aspect of the trade procedure involves three trucks, one of which operates as a "sterile" vehicle, which always remains within the complex where it operates. Israeli trucks transporting goods destined for Gaza are scanned by x-ray, and then transfer their load onto the ground in a walled area or "room" for security and customs checks. Goods are then loaded onto the "sterile" truck inside the terminal, which then proceeds to the other side and unloads into a second fenced-in "room." When that area is full, the gates to the Israeli side are closed and locked, and a third Palestinian truck will enter for each load, and the goods are loaded and delivered to Gaza.

[30] Findings in this section are based predominantly on a 2017 World Bank report entitled "Securing Energy for Development in West Bank and Gaza": http://documents.worldbank.org/curated/en/351061505722970487/Main-report

and Egyptian imports) to approximately USD1.4 billion (with a longer-term focus on maximizing domestic energy production predominantly from gas-fired power generation). Regardless of the scenario eventually implemented, any significant investment in domestic power generation in Gaza would require the Gaza Electricity Distribution Company (GEDCO) to substantially improve network quality and commercial performance, including collection rates to ensure operational and financial sustainability.

67. **The GPP could meet almost half of the total electricity demand in Gaza if operated on gas, but instead depends on expensive diesel with limited availability.** A projection of levelized electricity cost from different sources (see figure 11) highlights the urgency of addressing today's dependence of the GPP on diesel. The GPP was originally designed to operate on natural gas. Re-converting the GPP to combined-cycle gas turbine (CCGT) gas-fired technology would save between USD45-62 million annually in fuel bills. Operated at its originally intended capacity of approximately 265MW, the GPP could meet almost half of the total electricity demand in Gaza and provide the Strip with a cost-effective domestic source of power generation. However, this requires first to (i) complete the necessary infrastructure, including a gas pipeline to Gaza; and (ii) close commercial agreements with a creditworthy off-taker to supply gas to Gaza. In the meantime, the Gaza Action Plan prepared by the Palestinian Energy and Natural Resources Authority (PENRA) anticipates a significant increase in Egyptian electricity imports to balance Israeli imports, while the future of the GPP is being decided. However, any scenario will require promoting energy efficiency, intensively developing solar rooftop PV, and expanding Egyptian imports in parallel.

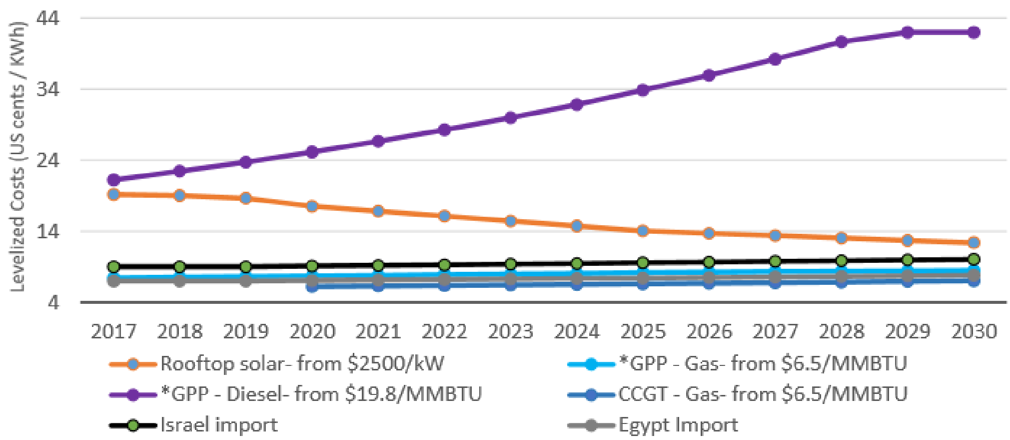
68. **Underlying institutional constraints and low financial performance will need to be addressed first to reach more sustainable electricity supply options in the medium term.** The Palestinian electricity sector has yet to establish a track record as a creditworthy off-taker for wholesale power. Despite important efforts by the regulator, PERC, electricity is not priced at cost recovery levels throughout the Palestinian territories. The gap between tariffs and costs is particularly large in the case of Gaza, where tariffs have not been adjusted over the last decade. In addition, the revenue collection rate remains low. Although some distribution utilities in the West Bank have been improving their operational performance, the situation in Gaza is troubling - with revenues covering not more than 50 percent of electricity purchases. Finally, even when revenues are collected, they are sometimes diverted by the local authorities to cover other expenditures rather than being channeled to the purchase of power. Those implicit subsidies to the electricity sector have been estimated at around 4-5 percent of GDP in Gaza.

69. **Gas imports will have to constitute a critical part of any scenario improving energy security, until supplies from the Gaza Marine gas field become available and commercially viable.** Across all options for energy security development in the West Bank and Gaza, power-generation capacity is expected to rely on gas imports to meet between 46 and 83 percent of electricity needs. Hence, coordinated efforts to enhance the sector's financial sustainability will be critical to secure gas supply agreements at acceptable fiscal risk and, eventually, enable the commercial development of a domestic Palestinian off-shore gas field with Gaza Marine.

70. **Gaza's renewable energy potential is largely limited to rooftop solar and is unlikely to meet more than 6 percent of energy needs.** While the overall contribution to meeting energy demand would be limited, Gaza's renewable potential needs to be maximized to provide a basic safety net where possible. Based on a preliminary assessment, 30 percent of all households in Gaza have the technical potential for rooftop PV installations. Approximately 2,800 non-residential buildings, i.e. public facilities, schools and commercial establishments, have appropriate roof space. Taken together, these could account for over 150MW of rooftop PV in Gaza. for example, a feasibility

study conducted for the North Gaza Emergency Sewage Treatment (NGEST) plant estimates the potential for over 5MW of solar PV and almost 1MW of biogas.

Figure 11: Levelized cost of electricity by source



Source: World Bank 2017, Securing Energy for Development in West Bank and Gaza

71. **Because Gaza's power cost structure is relatively high and its population impoverished, power sector investments will initially have high reliance on public funding.** In addition, public funding would also be crucial to address affordability concerns, which are more serious in Gaza than in the West Bank, given the higher current costs of electricity and a more impoverished population. Based on the distribution of income in Gaza, as much as 40 percent of the population would struggle to buy 160 kilowatt-hours per month at the required financial equilibrium tariff of NIS1.20 (USD0.33) per kilowatt-hour. Assuming that these needy households could be identified using existing social registries, the cost of a targeted subsidy to safeguard their basic consumption and payment to GEDCO would amount to a maximum of NIS80 million (USD22 million) per year in 2021. This further underscores the urgent need to improve efficiencies, even as new sources of electricity are being added. Eventually, this would contribute to stimulating the local economy, creating jobs, and limiting the need for social protection to the poorest segment of the population.

72. **Investment needs in Gaza's water and sanitation infrastructure are enormous.** PWA's 2016 Strategic Development Plan, accompanied by the Water Sector Investment Plan 2017–2022, provides the framework for developing Gaza's water and sanitation sector. In total, around USD1.25 billion (or around 8 percent of GDP) would be required to upgrade critical infrastructure in the short- to medium term, most of it in the Gaza Strip. The plan includes investments in both infrastructure development and institutional strengthening to address the Gaza water and sanitation crisis. Core elements include building a Gaza Central Desalination Plant (GCDP) along with the required associated works network infrastructure; increasing water imports from Israel; constructing a minimum of three Short Term Low Volume (STLV) seawater desalination plants; reducing Non-Revenue Water (NRW); developing waste water treatment and reuse schemes; establishing a National Water Company; and Strengthening the Gaza Coastal Municipalities Water Utility (CMWU) as the sole utility for water and sanitation service delivery in Gaza.

73. **Gaza only has two available sources of additional freshwater supply: desalinated sea water from domestic desalination capacity and purchases from Israel.** Gaza consumes an average of around 80 liters per capita per day (lpcd), well below the minimum of 100 lpcd potable water

recommended by the World Health Organization (WHO). Currently, all water supplied for domestic uses in Gaza—a total of 95 MCM per year in 2015—is originating from Gaza's coastal aquifer, domestic desalination plants, and imports from Israel. Some 90 percent of this water is supplied at high saline levels from the almost-depleted coastal aquifer. With domestic demand projected to reach around 145 MCM by 2030, new freshwater will need to be imported or developed in Gaza. PWA has the objective to meet the future water demand by increasing supply from sea water desalination and decreasing reliance on the coastal aquifer. Hence, PWA is advancing plans to build the GCDP that would produce 55 MCM in its first phase, doubling to 110MCM in its second phase. Capital investment costs for the GCDP alone are estimated at around USD500 million.[31] Another 30-40 MCM of freshwater would need to come from Israel and local STLVs. However, until those major investments have been completed, water supplied by tanker trucks will remain the major source of potable water in the short term and there is an immediate need to regulate commercial supply in terms of minimum standards, price and quality. In the medium term, there is a need to build network infrastructure to absorb 20 MCM agreed to be provided by Israel; and complete the planned STLVs that would produce up to another 15 MCM by 2020. In addition, it will be critical to enhance the distribution system's efficiency and reduce technical as well as commercial losses. This is important since both water from Israel and the STLVs has to be mixed with water from the aquifer to reach potable quality and maximize the benefit to the Gaza consumer.

74. **Expanding water supply through efficient use of desalinated water would reduce the price for Gaza consumers and provide the basis for more sustainable service provision.** This will require implementing a series of investments to upgrade the primary and secondary distribution network, the so-called Associated Works (AW). The AW have been designed to receive desalinated water as the principal source of supply from multiple locations and blend it with saline groundwater to improve it to the quality of tap water and reduce cost. The AW include construction of a main North-South carrier line of 42.5 km, with additional North, Middle and Southern pipelines loops; twelve main pumping stations; five main booster stations; blending tanks with a total capacity of 200,000 m^3; connection points with Israel; and secondary distribution networks with a Non-Revenue Water (NRW) reduction program. Total costs are estimated at up to USD200 million.

75. **Parallel investments in waste water treatment capacity will be key to preventing further deterioration of the aquifer and curbing public health risks from environmental pollution.** Commissioning of the North Gaza Emergency Sewage Treatment (NGEST) plant is going to be launched in March 2018 and the plant would become fully operational by April 2018. Construction of the Gaza Central Waste Water Treatment plant is well advanced and expected to start operation by the end of 2019. These two plants will support the other five wastewater treatment plants in Gaza, increasing total design capacity of all plants to around 66 MCM, equivalent to the sewage treatment capacity currently needed for the Gaza strip. Treatment capacity would need to increase to around 115MCM by 2030. However, these plants will not operate without reliable energy sources. NGEST alone requires 6MW to operate the current phase. The total estimated energy required to operate all water and wastewater facilities in Gaza would reach around 100MW by 2025, equivalent to around 15 percent of the total projected energy demand for Gaza in the same year. The PWA will have to consider options for transboundary waste water treatment agreements and increased power supply from Israel.

76. **However, institutional capacity and financial performance need to improve along with capital development for Gaza to secure sustainable water services.** Investing in new fresh water resources and wastewater treatment capacity alone would not suffice to achieve water security in Gaza. The capacity of the water and sanitation sector institutions will have to be strengthened in

[31] This figure excludes the necessary Associated Works referenced in the following paragraph.

parallel, and a key priority will be to reengineer CMWU as the sole service provider for Gaza. A better financial performance can only be achieved through increasing levels of cost recovery along with enhancing citizens' willingness to pay. However, citizens will demand growing and more effective involvement in the decision-making process, in addition to better water quality, if they are to pay for services. PWA is launching a Water Security Development Program that aims at improving access to improved water and sanitation services, enhancing the water sector institutions, and providing infrastructure investment financing applying a performance-based incentive approach. However, PWA is highly dependent on aid and multiple donors operate in Gaza's complex political environment. This will require strong coordination among donors and alignment in harmonization with the national water sector development plans.

The Way Forward

77. **The status quo in Gaza is unsustainable and has incalculable socioeconomic and human consequences**. **Hence, it is of utmost importance that efforts are conducted by all parties to help Gaza escape its deteriorating trajectory.** As shown by the above analysis, the combination of multiple episodes of war, the blockade and internal challenges have had a huge toll on Gaza's economy. Unemployment and poverty have reached staggering rates and the quality of life for the large majority of Gaza's citizens is hardly bearable. The feeling of hopelessness has been pervasive. The access and quality of basic services have continued to deteriorate adding to the hardship of Gazans. The recent decline in incomes for a large share of Gazans has significantly worsened the situation, causing Gaza to be "on the verge of collapse".[32] The relationship between Palestinian economic revival and stability and Israeli security remain unarguable and of fundamental importance to both societies' well-being. Therefore, it is of utmost importance that all parties act now to reverse the decline. This section provides recommendations on short term actions that are required to reverse the recent economic deterioration, and it also provides medium to long term recommendations that can put Gaza on a more sustainable development path. Actions are also needed to address the growing humanitarian needs in Gaza, but those are not the focus of this report.

Short-term Actions

78. **To prevent an immediate collapse, the recent corrosion in the livelihood of Gazans needs be addressed through higher transfers.** The quick deterioration in economic conditions in Gaza in recent months has mainly been driven by a severe drop in transfers affecting almost a quarter of the Gaza population and resulting in a severe weakening in purchasing power and economic activity. To reverse the recent decline, additional inflows are urgently needed. This will be critical for introducing stipend payments to employees of the *de facto* authority that have been providing services in Gaza, taking steps to resume full salary payments to PA employees and increase social payments to the poor, which will inject much needed liquidity in the market, while pending final reconciliation. Additional aid inflows will also be key to maintain the operations of UNRWA – one of the main providers of jobs and service delivery in Gaza. Introducing additional job creation programs in Gaza may also help.

79. **Implementing donor-financed labor-intensive projects can provide quick relief**. Public works schemes for municipal services including solid waste recycling and sorting are options that can be easily set up. Implementing donor-financed projects for road rehabilitation, particularly inner-city roads, would have an immediate positive impact on unemployment and the state of infrastructure

[32] https://www.haaretz.com/israel-news/.premium-israeli-security-officials-gazan-economy-infrastructure-on-verge-of-collapse-1.5730680

in Gaza. Donor-financed projects to address housing needs for families that are still displaced after the 2014 war and have not been allocated funding for reconstruction, can provide a boost to the construction sector and create considerable job opportunities. Existing mechanisms (through UNRWA, UNDP, UNOPS) can be utilized to channel donor funds to the affected families.

80. **Expanding Gaza's fishing zone would quickly improve the livelihoods of 35 thousand Gazans.** According to the Oslo Accords, Palestinians should be able to access 20 nautical miles of fishing area. However, access for Palestinian fishermen has mostly been restricted to 3-6 nautical miles since 2006. Expanding the fishing area to 20 nautical miles, as stipulated by the Oslo Accords, would significantly expand production and improve the quality of this industry's output. It will also better the lives of 35 thousand Gazans who depend on this industry for their livelihoods.

Medium to Long-term Actions

81. **For a sustainable recovery, Gaza needs to be able to trade with the outside world.** For a small economy, achieving a sustainable growth path depends to a large extent on having a private sector that is able to compete in regional and global markets and increase its exports of goods and services. Therefore, efforts must focus on easing constraints that currently stifle private activity and setting the enabling conditions for private investment.

82. **Effective governance systems and institutional strengthening under the PA's leadership are a necessary precondition for the sustained economic recovery of Gaza.** Building legitimate institutions in Gaza that enjoy the support of the international community and that will govern Gaza in a transparent, accountable, effective, and efficient manner and addressing the issue of civil service integration to ensure sustainable service delivery in Gaza is a *sine qua non* for the Strip's sustained development. It is therefore highly encouraging that recent reconciliation efforts between the PA and Hamas have shown some good progress with the PA taking control of the crossings and the counting exercise for pre-2007 employees already done. These efforts will hopefully pave the way for building effective governance systems and strong institutions under the PA's leadership in Gaza. **It is also imperative that the international community strongly supports this objective through additional aid.**

83. **Once the PA is fully in charge of Gaza's public sector, it will have to take prompt actions to ensure sustainability of its governance arrangements in Gaza, in particular through fiscal reforms.** As shown in the analysis, Gaza currently exacts a significant toll on the PA's finances as less than 10 percent of the PA's total revenues are collected there. The potential is much larger even now when Gaza's economy is severely depressed. However, the eventual integration of the civil service in Gaza would further increase spending, and the PA's deficit would continue to be unsustainably large. The deficit will have to be reduced by conducting civil service reform to reduce the size of the central government wage bill. Further, efforts to increase the tax base in both the West Bank and Gaza will also be essential. In Gaza, alongside revenue reforms, efforts to support economic growth can lead to a drastic increase in the tax base and revenue generation. Therefore, the PA should extend efforts it is currently implementing in the West Bank to improve the business climate, facilitate access to finance for SMEs and bridge the skill mismatch in the labor market to Gaza as well.

84. **Relaxing the dual use restrictions is critical for reviving the export sector in Gaza.** Restrictions on inputs to production that the GoI deems as dual use have hindered the development and export capacity of almost all economic sectors in Gaza. With Gaza's crossings now being managed by PA officials, this is an opportune time to consider aligning Gaza's dual use list more closely with the

West Bank's. It is also key that the application procedure for dual use goods become clearer and the approval process more transparent. Eventually, dual use restrictions applied by the GoI in the Palestinian territories will need to be significantly revised as a precondition for sustainable economic growth in both the West Bank and Gaza.

85. **Lifting restrictions on exports to Israel and the West Bank will enable Gaza to rebuild trade relations with these two important markets**. As mentioned earlier, traditionally, Israel and the West Bank were Gaza's most lucrative markets until the 2007 blockade. Since then, exports out of Gaza to these two destinations have been restricted. Since trade into Gaza through illegal tunnels has almost disappeared, and most raw materials enter Gaza from/through Israel, this is an opportune time for the GoI to review its policy and allow exports from Gaza to enter the Israeli and West Bank markets more freely, as stipulated by the Paris Protocol.

86. **Efforts are also needed by the GoI to streamline trade procedures at Gaza's commercial crossing and expand its capacity**. As mentioned earlier, the existing back-to-back process significantly increases traders' costs and reduces the competitiveness of Gaza's exports. A more technologically advanced system that can provide the same level of security at a much shorter processing time needs to be introduced. Also, putting in place scanning technologies at the commercial crossing, allowing containerization and using trusted trader arrangements will significantly facilitate trade. To address Gaza's growing needs, the current commercial crossing (Karem Abu Salem) needs to be expanded. In addition, the GoI could consider reopening facilities at the Karni crossing and building new accommodations at Erez. Karni's geographical location in the northern part of Gaza makes it more efficient and cost effective for moving goods to the West Bank and to Israeli ports.

87. **In view of global economic developments in the past decades, adopting policies to support the development of the service sector in Gaza is also critical.** Looking to the future, the aim should not be to recreate the Gazan economy of the 1990s. Gaza has a highly educated and innovative youth. This is an advantage that could help the Strip develop modern services in the ICT sector, for example, that can be exported to external markets. For this to happen, Gaza needs to enjoy higher connectivity and a stable supply of electricity. The recent Israeli decision to release electromagnetic spectrum allowing the provision of 3G services in the West Bank is a good start. It is hoped that this would be extended to Gaza soon and followed by actions to launch 4G services in both territories. Easing restrictions on the import of telecommunications hardware and equipment to Gaza would also be needed to allow this sector to develop. On the domestic side, there is a need for strategic investments in human capital to improve the competitiveness of the labor force and efforts to create linkages with regional value chains.

88. **Reversing the recent decline in the number of business permits granted to Gaza traders is key for rebuilding trade relationships with external markets**. There has been a significant drop recently (by 51 percent) in the number of business permits granted to Gaza's traders. This adds to the isolation of Gazans and makes it very difficult for traders to build and maintain their relationships with the external markets. In late February 2018 an increase in permits for business people was announced but there needs to be a consistent policy rather than ad hoc adjustments if Gazans are to facilitate trade opportunities. It is also important that foreign investors are granted permits to visit Gaza and explore business opportunities in the Strip. Allowing specialists and technicians to visit Gaza to rehabilitate factories and build lost capacity will also be key.

89. **Increasing electricity supply to Gaza will also be crucial for boosting business activity and improving living conditions in the Strip**. Failure to invest in Gaza's power sector would make an already dire situation even worse. Gaza is already unable to meet more than 50 percent of its

demand today. If no further power options are developed, the extent of unserved energy would further escalate to 63 percent of demand by 2030. To avert this outcome, Gaza needs to develop additional power supply options. Generating electricity locally through the diesel-fired Gaza Power Plant becomes increasingly financially unattractive over time relative to alternative options, according to recent work by the World Bank. Hence, additional supply either has to come from Israel, which can be imported at a fraction of the cost of current domestic generation, or from Egyptian imports that are even cheaper though heavily restricted in supply and rather unreliable. If additional supplies are to be imported from Israel, reforms need to be put in place to improve collection rates in Gaza and ensure that bills owed to the Israeli Electric Company are regularly paid. In the long term, other options could be considered. For example, conversion of the Gaza Power Plant to fire on gas would make it competitive with Israeli and Egyptian imports. While rooftop solar looks relatively expensive today (though still undercutting the Gaza Power Plant), the cost is expected to fall significantly in the future converging towards imports from Israel. [33]

90. **Establishing new industrial zones or rehabilitating existing ones can also support economic activity in Gaza**. The implementation of a large number of the measures mentioned above including trade facilitation procedures, easing dual use restrictions, implementing known trader programs, amongst others, is much easier to introduce in a confined geographical area, such as an industrial zone, due to better and easier controls. Also, given the high population density in Gaza, it is better for industrial activities to be moved away from city centers. Therefore, rehabilitating the existing industrial zone at Karni or establishing others would be of benefit for the Gaza economy.

91. **Improving access to finance is also needed to support additional private sector activity in Gaza**. Gazan enterprises find it extremely challenging to access finance due to a high risk aversion amongst financial institutions in the Strip. The risk profile of the Gaza market makes it difficult for banks to provide credit during these critical times as their ability to do business elsewhere would be damaged if they were seen to be cooperating with the *de facto* authority. Until banking relationships between the West Bank and Gaza are normalized, policies should focus on alternative financing options including microfinance and non-bank financing. Domestic efforts should also foster financial inclusion amongst the unserved, namely women and youth, through risk mitigation schemes.

92. **Continued donor support for a number of years transitioning to a stronger emphasis on the development of Gaza's infrastructure is also necessary**. Gaza's economy will continue to depend critically on donor support for several years to come, and gradually Gaza's tradable sectors will be replacing the role of donor aid as the key source of foreign exchange to fuel Gaza's economy. Donors that have yet to honor pledges made at the Cairo Conference should aim to do so as additional aid is still needed to reconstruct damages caused by the 2014 war. Budget support to the PA will also be key to enable it to cover the deficit emanating from its operations in Gaza, particularly if employees of the *de facto* authority are merged with the PA's civil servants as part of the ongoing reconciliation process. In the medium term, the PA and donors will need to focus their assistance on revitalizing Gaza's public infrastructure, primarily electricity, water and sewerage services. In addition, efforts should focus on revitalizing and developing other infrastructure that will enable the growth of Gaza's tradable sector, such as the transportation network (including looking at the feasibility of building a commercial port in Gaza), product safety and quality infrastructure, etc.

[33] The World Bank. (2017). Securing Energy for Development in The West Bank and Gaza. http://documents.worldbank.org/curated/en/351061505722970487/pdf/119769-WP-P157348-v1-Securing-Energy-PUBLIC-ACS.pdf

93. **Higher coordination for development efforts in Gaza will also help.** The current governance arrangements in Gaza have contributed to a situation where efforts by the international community have not been sufficiently coordinated. Given the large needs going forward, coordinating donor efforts become key for achieving development objectives.

94. **Donors can also help by offering innovative financing instruments that can mitigate risks holding back transformative investments by the private sector in Gaza**. For example, as part of its new strategy in the West Bank and Gaza, the World Bank plans on establishing a risk mitigating financing facility for the private sector in both the West Bank and Gaza, leveraging the resources of development partners and catalyzing both short-term and long-term financing. The facility will provide partial risk guarantees and first loss components as mechanisms to mitigate payment risks, thus providing comfort to private investors and lenders to infrastructure projects. An example is currently piloted through the World Bank's "Finance for Jobs" project, which uses investment co-financing to facilitate a private sector investment in rooftop solar power generation at an industrial park in Gaza. Similar initiatives by other donors may help by providing assurances for the private sector and encourage investments in Gaza.

95. **Additional trade routes linking Gaza to external markets can also be considered**. In a report published in 2007, the World Bank explored the option of the Rafah trade corridor through Egypt.[34] The report suggests that using Rafah to ship goods through the efficient and privately managed container terminal at the entrance to the Suez Canal and to Cairo International 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 2005 Agreement on Movement and Access and the Arab League Agreement on Transit which allows for duty-free transit of Palestinian goods through Egypt.

Table 5: Development recommendations for Gaza

Actions	Responsible Party
Implement civil service integration and build stronger institutions and governance arrangements in Gaza	PA
Conduct fiscal reforms and better tax effectiveness in Gaza	PA
Unify business regulation between the West Bank and Gaza	PA
Improve access to finance for SMEs in Gaza	PA
Align Gaza's dual use list with the West Bank's	GoI
Alleviate blockade allowing higher exports to Israel and the West Bank	GoI
Streamline trade procedures at Gaza's commercial crossing and expand its capacity	GoI
Issue higher business permits for Gaza traders	GoI
Expand Gaza's fishing zone	GoI
Set up the right environment for the service sector to develop	PA and GoI
Increase electricity supply to Gaza	PA and GoI
Build new industrial zones and rehabilitate existing ones	PA and GoI
Provide additional financial support	International community
Set up innovative financing mechanisms for the private sector	International community

[34] The World Bank. (2007). Potential Alternatives for Palestinian Trade: Developing the Rafah Trade Corridor. http://documents.worldbank.org/curated/en/698721468320951419/Potential-alternatives-for-Palestinian-trade-developing-the-Rafah-trade-corridor

Implement donor-financed labor-intensive projects	PA, GoI, International community
Explore additional trade routes linking Gaza to external markets	PA, GoI, international community

Annex 1: Civil Service Integration

1. The PA and the *de facto* authority in Gaza have recently signed a reconciliation agreement, in October 2017, mediated by Egypt. The main aim of the agreement is ending the ten-year internal divide and addressing the issue of civil service integration. This is key for maintaining service delivery in Gaza as the employees of the *de facto* authority have been providing key services for the Gaza population over the last decade. This annex provides insight into the approach currently being considered by the authorities to merge the employees hired by the *de facto* authority in Gaza post 2007 with those currently on the PA's payroll. It also provides a number of recommendations to allow for the integration to happen in a successful and sustainable way.

2. **According to the PA, integration of the civil service in Gaza will build up from incumbent PA employees in Gaza as of 2007.** A legal and administrative committee was established following the reconciliation agreement and was tasked with "finding a solution" for dealing with the employees hired by the *de facto* authority after 2007.[35] Data obtained by the Bank shows that the *de facto* authority currently employs 20,466[36] civil servants (excluding civil police) whose situation is being looked into, while there are no plans to integrate the security personnel. The committee agreed that the starting point for the integration exercise will be to allow all PA employees in Gaza who were asked by the PA to stay at home in 2007 to return to their positions. Therefore, a counting exercise was carried out in November 2017 to register the final number of PA employees currently residing in Gaza and that would like to report back to duty. Figures from that exercise have not been made available yet. It has been reported, however, that about 1,200 of the pre-2007 PA employees (mainly in health and education) have already returned to their jobs.

3. **The approach proposed by the legal and administrative committee to integrate the civil service in Gaza takes into consideration the increase in population needs since 2007.** Following the counting exercise mentioned above, figures on the number of PA employees in Gaza willing to report back to duty has become available by ministry. The 2007 employment figure will be used as a base representing the needs by each ministry at that point. This figure will be revised to take into consideration yearly population growth in Gaza and the turnover rate of employees over the last ten years. The gap between the 2007 base and the new employment figure is to be filled with the *de facto* authority employees and fresh graduates in Gaza. Even though the overall approach seems reasonable, it has some major shortcomings. First, the 2007 figures may not be a good starting base that accurately represent the employment needs as a lot of hiring took place that year prior to the elections. Second, even though this approach may be feasible for certain ministries where needs are impacted by population growth, such as health and education, it may not apply to other entities such as the MoFP where only a single function is needed and reforms should be carried out to eliminate duplicate responsibilities.

4. **Other issues also have to be considered to allow for a successful and sustainable integration**. Since it may be some months before reintegration is completed, some form of a temporary social payment mechanism has to be put in place to enable employees hired by the *de facto* authority to keep working so that service delivery in Gaza is not interrupted. Also, a screening for these employees should be carried out as soon as possible to determine the integrity of their hiring.

[35] Based on the actual text of the agreement found here: https://www.timesofisrael.com/translation-of-leaked-hamas-fatah-agreement/

[36] Hamas' civil employees are divided into three categories: a) 17267 employees that were hired by Hamas after 2007, b) 2463 employees that were part of the PA's public service in Gaza before 2007 and that have joined Hamas' civil service after the internal divide, c) 736 PA employees that reported back to duty after 2007 and have been receiving salaries from the PA but to whom Hamas has also been paying complementary salaries.

Improperly hired staff should be terminated without the normal civil service separation and pension rights.

5. **The absorption of staff appointed by the *de facto* authority into the PA public service should not be automatic**. It should be done against current staffing needs in each sector that are justified based on the existing staffing levels and whether these are above or below accepted norms. In the education sector, any absorption of employees hired by the *de facto* authority should be within the context of rebalancing teacher student ratios nationally. In the health sector, there is an imbalance of PA staff between West Bank and Gaza, which needs to be considered. At the same time, however, the Palestinian territories overall have more health professionals per capita than equivalent low middle-income countries, as well as a high proportion of administrators in the sector, leading to an already unaffordable public health care system. Thus, any absorption of staff hired by the *de facto* authority must be determined in the context of changes to sector wide staffing policies.

6. **Integration of the two administrations should be costed and included in the PA's medium term fiscal framework and presented to the donor community**. A properly conducted reintegration based on justifiable needs (which implies some separation payments) and that is financially sustainable in the medium term will require special short-term financing beyond the capacity of the PA to afford. For this to be credible, the PA must be able to show how the integration process will be part of broader public service reforms that will ensure more sustainable wage bill to GDP and domestic revenues ratios in the medium term.

7. **A security vetting process should be carried out for employees hired by the *de facto* authority and that will join the PA's civil service**. Employees that are to be integrated should undergo a vetting and security clearance process based on international standards. This is key for encouraging donor funding and also to ensure that those that will be integrated receive their salaries from the PA's payroll. A similar vetting exercise took place in 2014 to allow for the provision of humanitarian payments to the *de facto* authority employees by the international community. The same approach can be used for the integration.

8. **Civil service reforms and training programs currently implemented in the West Bank should be extended to Gaza**. The current civil service reform program that is being implemented by the General Personnel Council (GPC) in the West Bank should be extended to Gaza. In turn, any decisions on pay, grading, the development of job descriptions etc. in Gaza should be made consistent with the direction of the broader civil service reform program. Since staff recruited by the *de facto* authority have generally not been integrated into the training programs provided by the PA, it will be desirable to review training needs in the main service delivery sectors, and consider mounting special programs for Gaza.

9. **Given that it will be necessary to retrench staff in excess of needs, the PA will need to develop a separation policy, which could be partly through termination and partly through voluntary retirement**. Either way will require special funding, which should be estimated and allowed for. If some *de facto* authority staff are to be terminated, it will be desirable to separate them with an equitable compensation package on a basis different to regular civil service termination, which will shift them to pension rolls. This compensation package could be consistent with any social protection arrangement put in place in Gaza in the aftermath of the 2014 war.

Annex 2: Stock Take of World Bank Recommendations to the AHLC Meetings Over the Years

1. **The Palestinian economic outlook is worrying and bold actions are needed by all parties to get the Palestinian economy out of its deteriorating trajectory.** Most needed actions have been identified in previous reports by the World Bank to the AHLC meeting but implementation has been limited. In our September 2016 report to the AHLC, a stock take of all previous World Bank recommendations to the meeting was conducted. This exercise was intended to provide a baseline for evaluating progress in achieving the Palestinian territories' development priorities. In addition, it was hoped that it would galvanize the reform efforts of all parties to address the immediate need while setting in place reforms that will deliver over time. In this report, the stock take is updated to show progress since March 2018 using the same three pillars 1) fiscal sustainability, 2) economic development and 3) Gaza reconstruction and recovery. The following summarizes main developments in these pillars.

Fiscal Sustainability

2. **While the PA managed to reduce its spending in 2017, more needs to be done on structural reforms that are key to achieving long term fiscal sustainability.** There has been some progress on controlling health referrals with the arrangements earlier developed for Israeli hospitals now extended to seven local facilities. The MoH has also finalized harmonized standard procedures for medical referrals and published them online. Notably, however, it will not be possible to significantly reduce outside referrals until the main source of hemorrhage, which is a very generous health insurance system, is reformed. Progress has also been made on steps to control electricity net lending – although the problem is now emerging with other utility payments, mainly water and sewerage. As mentioned earlier in the report, recent measures have been adopted to reduce spending on the wage bill in Gaza, but there have been no structural changes to control the wage bill in the West Bank nor implement parametric reforms to support the pension system's sustainability.

3. **The PA's revenues performed well in 2017 due to better administration, but more needs to be done.** A geographic decentralization of tax administration offices has helped boost revenue collections in 2017 through facilitating efforts to widen the tax base. In fact, the number of registered taxpayers exceeds 200,000 - up by more than 20,000 from a year ago. Nevertheless, tax avoidance is still widespread, particularly amongst high earning professionals and the PA needs to focus efforts on this group. Encouragingly, the MoFP reports that it has submitted to the Cabinet revisions to the income tax law restoring the top income tax bracket of 20 percent. It is also in the process of revising some public fees and charges upwards, as most have not been updated in two decades. The MoFP is also considering operationalizing the dividend tax law that was passed several years ago but not implemented. Additional efforts are also warranted on the policy front. For example, the IMF recommends eliminating some of the generous tax exemptions, such as those offered by the investment promotion law. Also, laws should be amended to enable the PA to apply penalties for non-compliance with the tax system.

4. **The GoI continued to make one off payments to the PA to offset fiscal leakages in 2017, but a more systematic approach to fully eliminate these losses is yet to be adopted.** Efforts should focus on implementing the Paris Protocol's provisions regarding full information sharing on trade that takes place between both parties, including Israeli sales to Gaza. As stipulated by the Protocol, this could be done through setting up an "interconnected computer system" between the Israeli and Palestinian VAT authorities. Immediate focus should also be on revising the high Israeli handling fee, and a systematic

transfer of the health and equalization levies. To date, there have been positive discussions between the PA and the GoI on these issues on the technical level, but these have failed to translate into positive proposals and the situation on the ground remains unchanged. Talks have also been underway for some time between the GoI and the PA to initiate the introduction of bonded warehouses for Palestinian imports and the transfer of some customs authority to the PA over the coming years. This is a potentially positive development, although care will be needed in the implementation to ensure that revenues are protected and no additional costs are imposed on the Palestinian private sector. Recent proposals by the GoI on this issue appear to retain existing Israeli customs processes while adding additional steps with the Palestinian customs – and are unlikely to be acceptable for traders.

5. **The PA is now starting to take steps to improve the public financial management (PFM) system.** The audit of the 2012 financial statements was completed in 2017. The 2013 statements have already been audited by the Audit Bureau and the final opinion is currently being prepared. The 2014 and 2015 statements will both be sent by the MoFP to the Audit Bureau in May 2018. The PA has also prepared its first comprehensive PFM strategy and it is intended that this will guide a more active reform agenda in the coming years.

6. **Budget support from donors has continued to decline and this has been a key factor behind the large financing gap.** As a share of GDP, budget support has fallen from 32 percent in 2008 to 5 percent in 2017.

Economic Development

7. **The Israeli constraints on movement, access and trade continue to be the main impediment to economic growth in the Palestinian territories.** In particular, restrictions related to Area C and the blockade on Gaza represent the biggest challenges to growth, and their removal can generate momentous economic benefits. Nonetheless, progress in easing these constraints has not yet materialized. Area C continues to be mostly off limits for Palestinians and the number of master plans approved for this Area has not increased since our last reporting. Also, restrictions on the movement of goods and people in and out of Gaza have not been eased. In fact, the number of people leaving Gaza through the Erez crossing in 2017 was the lowest since 2014. Also, the GoI cancelled a large number of business permits granted to Gaza traders resulting in a 51 percent drop in the number of outstanding permits in 2017, compared to the previous year.

8. **At a domestic level, the PA has initiated steps to reduce the cost of doing business and improve the business climate but these have yet to be fully implemented.** The Ministry of National Economy has submitted to the Council of Ministers a new Companies Law that includes simplified business registration procedures, new types of companies and shares, and good practices for protecting minority investors and resolving insolvency. The law is currently undergoing revisions and is expected to be approved by the President in 2018. Similarly, a draft competition law has been prepared although the timing of its implementation is less clear. The abolition of land titling fees has led to an increase in land registration while consideration is also being given to new institutional arrangements to accelerate land registration.

9. **Some progress in the energy sector is highly encouraging, but more needs to be done.** The interim Power Purchase Agreement (PPA) signed between the GoI and the PA to energize the Jenin substation, which will increase the electricity supply in northern West Bank, is highly encouraging. Thanks to this agreement, the Palestinian Electricity Transmission Company has moved closer to operational sustainability. However, negotiations on the main PPA for electricity purchases by PETL from the Israeli Electricity Company (IEC) have stalled over IEC insistence that GoI continue to have the option to deduct from clearance revenues despite substantial commercial guarantees being offered. In addition,

diversification of electricity supply from other neighboring countries needs to be pursued but it is hindered by problems of land access, security and payment risk. For instance, restrictions of access and construction in Area C are major obstacles to build and upgrade interconnectors with Jordan, and security issues in Sinai reduce the viability of additional electricity from Egypt. Most urgent, though, is the need to increase energy supply to Gaza. The additional 161kV power line from IEC to Gaza would bring much needed relief; however, the question of payment has not been resolved yet.

Gaza Reconstruction and Recovery

10. **Most physical damages after the last Gaza war have been fixed, except for housing, but recovery needs remain large.** Good progress has been made in most sectors, with physical damages repaired. However, the lion share of fully damaged houses is yet to be replaced and recovery needs that go beyond physical destruction remain enormous. Progress remains slow as a result of limited funding, slow material entry, and political divisions between the PA and the *de-facto* authority. Disbursements after the Cairo conference in October 2014 have reached a plateau at around 53 percent which is causing a funding shortage that curtails progress particularly in those sectors with the highest financing needs identified in the DNA, e.g., in the housing sector. Good progress has been made in developing a results-tracking mechanism to complement the pledge tracking under the leadership of the National Office for the Reconstruction of Gaza (NORG). However, with financial support for NORG ceasing, achievements establishing an institutional structure to support and monitor progress with the Gaza recovery is at risk. Despite some progress in accelerating materials entry through the Gaza Reconstruction Mechanism (GRM), materials remain in short supply and long delays in approval and delivery prevail, particularly for more complex infrastructure projects.

Table 6: Summary of World Bank recommendations to prior AHLC meetings

Actions	Responsible Party	Progress Sept, 2016	As of March, 2018
FISCAL SUSTAINABILITY			
Expenditures			
Control the oversized wage bill	PA		
Control medical referrals to Israel	PA		
Control medical referrals to local facilities	PA		
Implement administrative reforms for the pension system	PA		
Implement parametric reforms to restore the pension system's sustainability	PA		
Reduce the size of net lending	PA		
Revenues			
Enhance the PA's tax effectiveness in Gaza	PA		
Increase the number of registered large taxpayers	PA		
Strengthen legislation to penalize non-compliant taxpayers	PA		
Revise government fees and charges upwards	PA		
Transfer to the PA fiscal losses accumulated over the years	GoI		
Implement institutional measures to reduce fiscal losses on clearance revenues	PA and GoI		
Public Financial Management			
Improve budget preparation procedures	PA		
Align budget execution with available resources	PA		
Clear the backlog of outstanding financial statements 2012-2015	PA		

Actions	Responsible Party	Progress Sept, 2016	As of March, 2018
Develop systems for monitoring and reporting expenditure arrears	PA		
Budget support			
Provide sizeable, predictable and timely support to the PA's budget	Donors		
ECONOMIC DEVELOPMENT			
Area C			
Expand spatial plans for Palestinian villages in Area C	GoI		
Increase number of building permits approved in Area C	GoI		
Grant approval to Palestinian business projects in Area C	GoI		
The Gaza economy			
Allow exports out of Gaza to reach pre-2007 level	GoI		
Significantly reduce items on restricted dual use list for Gaza	GoI		
Create a unified PA in both the West Bank and in Gaza	PA		
The business climate			
Adopt the Secured Transactions Law & establish a movable asset registry	PA		
Adopt the new Companies Law & the Competition Law	PA		
Accelerate land registration in Areas A and B	PA		
Improve access to finance for SMEs	PA		
Reform the education system to bridge gap between graduates' skills and labor market needs	PA		
Securing energy for development			
Sign an interim PPA to energize the Jenin substation	GoI and PA		
PETL operating on commercial basis	PA		
Diversify electricity supply	GoI and PA		
Increase power supply to Gaza	GoI and PA		
GAZA RECONSTRUCTION AND RECOVERY			
Complete a DNA to guide reconstruction and recovery	PA		
Accelerate disbursements of Cairo Conference pledges	Donors		
Establish and monitor time line indicators for review and approval of dual use items	GoI		
Include delivery monitoring in GRM system	GoI and PA		
Set-up results-based tracking program to monitor recovery	PA		
Establish Gaza import mechanism able to handle Gaza's long-term recovery needs	GoI and PA		
Strengthen NORG and institutional structure for cross-sector coordination of decentralized recovery planning	PA		

Legend

On track
Some progress achieved
No progress