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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
CBRs	Correspondent Banking Relationships
CMWU	Coastal Municipal Water Utility
GDP	Gross Domestic Product
GEDCO	Gaza Electricity Distribution Company
GNDI	Gross National Disposable Income
GoI	Government of Israel
GPP	Gaza Power Plant
GRM	Gaza Reconstruction Mechanism
IEC	Israeli Electricity Company
IMF	International Monetary Fund
LGU	Local Government Unit
MCM	Million Cubic Meters
MDLF	Municipal Development and Lending Fund
MENA	Middle East and North Africa
MENAFATF	Middle East and North Africa Financial Action Task Force
MoFP	Ministry of Finance and Planning
NORG	National Office for the Reconstruction of Gaza
NPL	Non-Performing Loans
PA	Palestinian Authority
PETL	Palestinian Electricity Transmission Ltd
PCBS	Palestinian Central Bureau of Statistics
PENRA	Palestinian Energy and Natural Resources Authority
PFM	Public Financial Management
PMA	Palestine Monetary Authority
PPA	Power Purchase Agreement
PWA	Palestinian Water Authority
SMEs	Small-Medium Enterprises
STLV	Short Term Low Volume
UNRWA	United Nations Relief and Works Agency
VAT	Value Added Tax
WDI	World Development Indicators

Executive Summary

1. **In the wake of a collapsing economy in Gaza, Palestinian living standards have continued to decline, with aid flows no longer providing the impetus for growth.** 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. With transfers to Gaza declining in the past year, the economy is in free fall registering -6 percent growth in the first quarter of 2018, and an unemployment rate of 53 percent (over 70 percent for youth). Initial indications are that Gaza has further deteriorated in the second quarter of 2018. Given that every second person in Gaza lived below the poverty line before these latest developments, the deterioration is alarming. While the situation in the West Bank is not as dire, the consumption driven growth story is faltering, and the economy is expected to slow considerably in the coming period. We forecast growth of only 1.7 percent in the Palestinian territories in 2018 – declining significantly in per capita terms. Moreover, there are significant downside risks to this forecast, especially with concerns surrounding the Israeli legislation to reduce clearance revenues, and the potential for increased tensions to spill over into unrest in Gaza.

2. **The improvement in the fiscal position has stalled in 2018 as a reduction in clearance revenues has negated the effect of the Palestinian Authority's (PA) significant expenditure cuts in Gaza.** Despite the PA's efforts to increase domestic revenue collections and reduce spending - mostly the wage bill for Gaza – a reduction in clearance revenues so far in 2018 is projected to lead to a full year deficit of USD1.24 billion (8.2 percent of GDP). This is similar to 2017 and is expected to result in a financing gap of around USD600 million. The size of the financing gap and the resultant arrears to the private sector and the pension fund remain a cause for concern as they could eventually choke the economy. Looking forward an additional major risk is the recent Israeli legislation that could result in a major reduction in clearance revenues. If implemented it is estimated that this would reduce clearance revenues by about USD 350 million – which would have a hugely detrimental impact on the fiscal position and the economy.

3. **The financial sector has maintained relatively stable growth in a challenging macroeconomic environment, however, several potentially destabilizing risk factors need to be monitored closely.** One concern is the potential spillover from the economic decline in Gaza. Although the data does not yet show a significant increase in non-performing loans and the Gaza banking sector is relatively small, this remains a worry. 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. With support from the IMF and the World Bank the authorities have taken steps towards aligning their AML/CFT controls and capabilities systems with international standards.

4. **The weakening economic activity in the past year emphasizes the need for 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 consumption financed through aid, remittances and credit in recent years, but, as most acutely demonstrated in Gaza, aid cannot continue to substitute for a poor business environment. 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. 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. A key element could be the potential offered by the digital economy

to create hope, jobs and the basis for a completely different growth model. A recent World Bank report assesses the challenges and makes recommendations to develop the "startup ecosystem."

5. **In view of the collapse in socio-economic conditions in the Gaza Strip, this report builds on the Bank's March AHLC assessment of the nature of the decline in Gaza, and identifies what is needed to unlock sustainable growth.** The productive base of the Gaza 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. The economy has been kept afloat by large amounts of transfers chiefly in the form of aid, remittances and PA and UNRWA expenditures. In this environment the USD30 million per month reduction in PA payments in 2018, the winding down of the USD50- 60 million per year operation of the US Government, and the cuts being made in the UNRWA program are having a significant effect on economic growth and unemployment. The deterioration in the past year also needs to be seen in the context of the significant deterioration in the socioeconomic conditions in Gaza since 2011.

6. **In the current context there needs to be a balanced approach to Gaza that combines an immediate crisis response with steps to create an environment for sustainable growth.** One immediate objective is to ensure a continuation of service delivery such as energy, water, education and health, as these are critical to both the livelihood of the people and as an input to production. Another is to increase household purchasing power to enable a return to basic economic activity. A further objective is to take initial policy steps to address the constraints on trade in line with a new growth model for Gaza. Extending the fishing zone beyond the highly restrictive 3 miles currently in place towards the 20-mile zone agreed in the 1990s would have an immediate effect, while allowing the graduation from the current 2G telecom network would also support job creation in the nascent digital economy industry for Gaza's innovative youth. An ultimate aim of the crisis response is to provide hope for the people of Gaza that there is a political and economic future worth pursuing.

7. **Beyond a crisis response, steps are needed to create a positive environment for economic growth over time that will create the jobs needed for youth.** A new dynamic is needed of economic opportunity leading to prosperity, legitimacy and stability. Allowing the economy to trade is key to allowing this to happen. Reforms are needed to streamline the movement of goods and people, and to support the trade in digital services, which could play a leading role – especially in the interim period. In terms of service delivery this will involve both working on the institutional issues that are vital to securing payment to run the utility operations, and investment in the projects needed to supply and distribute services.

8. **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, and efficient manner is essential for sustained development. Making progress on the stalled reconciliation talks is therefore vital. Governance reform is also needed to create a positive business environment. Therefore, the PA should enhance the quality of the tax system and 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.

9. **The GoI could play a catalytic role by easing restrictions that are the main impediment to trade**. While the restrictions on movement and access for goods and people is a challenging issue for GoI, unless it is addressed the economic situation in Gaza will never improve. An approach that restricts the import of any item that could be misused or imposes obstacles to the efficient export of goods and services will not allow the economy to develop as it should.

10. **Reversing the decline in donor support in the coming period is also key.** Gaza's economy will continue to depend critically on donor support 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. The PA and donors will also need to focus their assistance on revitalizing Gaza's public infrastructure both through direct investment and institutional reforms that facilitate provision by the private sector. 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 has established 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.

11. **The main body of the report is organized in two chapters with a supporting annex.** 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 assesses the status of the World Bank recommendations to the AHLC meeting over the years.

Chapter I: Recent Economic Developments

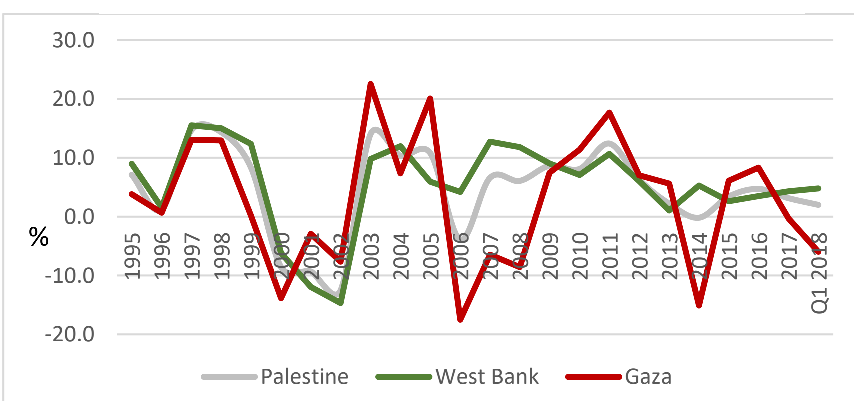
A. Economic Growth

12. **The economic conditions in the Palestinian territories have significantly weakened in 2018, due to a decline in activity in Gaza.** According to preliminary data by the Palestinian Central Bureau of Statistics (PCBS), real Gross Domestic Product (GDP) growth dropped to 2 percent in the first quarter of 2018 – half its average for the previous three years. The economy has been restrained for more than two decades by restrictions on movement, access, and trade that have kept investment levels extremely low and resulted in deindustrialization. Substantial transfers, mostly in the form of aid from the international community, have helped mitigate the impact of the restrictions through fueling consumption driven growth. Nevertheless, transfers have been declining and have witnessed a very large drop in 2017-18, particularly in Gaza, resulting in a lower growth trajectory for the overall economy and revealing the fragility of the aid-driven growth model.

13. **Gaza's economy has been facing severe challenges, pushing it towards a possible collapse.** In 2017, the Gaza economy did not witness any real growth due to severe cuts in aid for reconstruction and transfers from the PA's budget in addition to its continued economic isolation. The situation has become more difficult in 2018 as transfers from the PA have continued to drop - further worsening the liquidity squeeze and placing severe pressure on the depleting buffers of the economy. As a result, Gaza shrank by 6 percent in the first quarter of 2018 compared to the same period in 2017. The decline was seen in most economic sectors but mainly in construction, and public administration and defense- both of which were Gaza's main drivers of growth in recent years. The economic decline has also led to a rapid collapse in humanitarian conditions in Gaza.

14. **In contrast to Gaza's economy, the West Bank has continued to grow, but risks remain high.** According to the PCBS, real GDP growth in the West Bank was almost 5 percent in the first quarter of 2018, which is slightly higher than its level in 2017. Growth was concentrated in wholesale and retail trade and construction, as these activities remain less affected by the restriction system. On the expenditure side, growth was mainly driven by public consumption and to lesser degree by exports, while private consumption has slowed down as evidenced by a slowdown in private loans from the banking sector due to the rising political and security risks. Given the PA's fiscal situation and the decline in aid, the sustainability of a growth model driven by public spending in the West Bank is questionable.

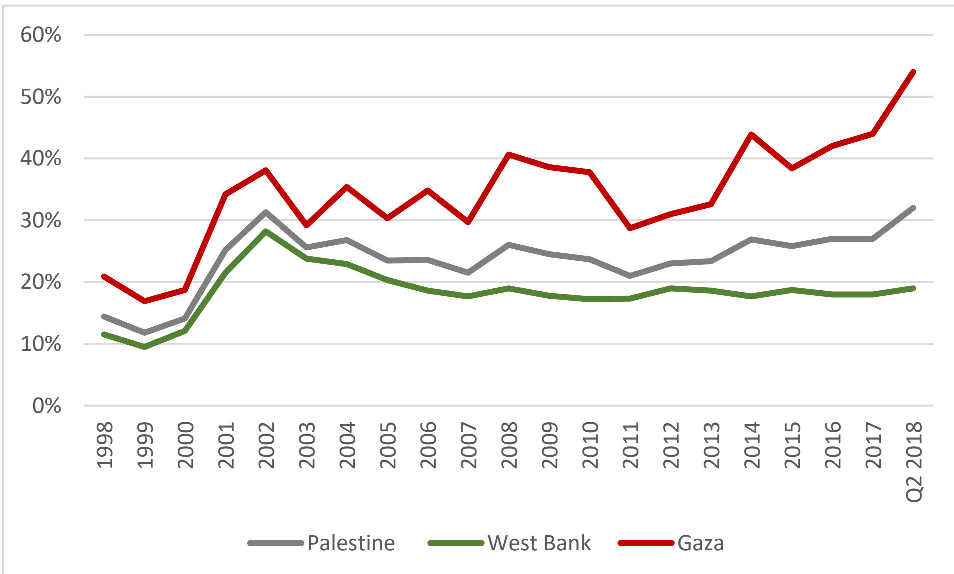
Figure 1: The Palestinian territories, real GDP growth: 1995-Q1 2018



Source: Palestinian Central Bureau of Statistics, National Accounts

15. **The unemployment rate in the Palestinian territories has reached a new high.** It peaked at 32.4 percent in the second quarter of 2018, which is about 5 percentage points higher than its average in 2017 and the highest rate in two decades. The increase is due to a large jump in Gaza, where 53.7 percent of those in the labor force were unemployed in the second quarter of 2018. Unemployment amongst Gaza's youth exceeded 70 percent while it was even higher for females, amounting to 78 percent in the second quarter of 2018 (see Box 1 for more information on female unemployment in the Palestinian territories). The situation in the West Bank has been very different with the unemployment rate remaining stable at around 18-19 percent over recent years.

Figure 2: The Palestinian territories, unemployment rate: 1998-Q2 2018



Source: Palestinian Central Bureau of Statistics, labor force survey

16. **Living conditions have deteriorated in recent years, driven by a significant decline in Gaza.** The latest poverty data is for 2017 and it shows that the poverty rate in the Palestinian territories has increased from 25.8 percent in 2011 to 29.2 percent. However, trends in the West Bank and Gaza diverged sharply over this period. The proportion of the population living below the poverty line in Gaza rose by 14.2 percentage points, from 38.8 to 53 percent (see chapter II section B for more details on living standards in Gaza). In the West Bank, poverty declined by 3.9 percentage points, from 17.8 to 13 percent. Despite the improvement in the West Bank, the situation remains very fragile particularly since household income and expenditure are highly sensitive to conflict and dependent on aid. According to analysis done by the World Bank, a reduction in expenditure as small as 5 percent in the West Bank could result in an increase in poverty by as much as 16-17 percent.[1]

[1] West Bank and Gaza Poverty and Shared Prosperity Diagnostic 2011-2017. The World Bank, 2018.

Box 1: Young, Educated and Unemployed: Understanding Reasons Why Skilled Palestinian Women Struggle to Find Work

In a recent (2018) study entitled *Enhancing Job Opportunities for Skilled Women*, jointly supported by the Norwegian government and World Bank, evidence shows that skilled Palestinian women face multifaceted constraints that limit their job options when compared to their male counterparts. While limited job opportunities affect everyone in the Palestinian territories (PT), a striking feature of its labor market is the significantly higher rate of unemployment among skilled women relative to skilled men. Unemployment rate for women with post-secondary education (47 percent) is more than double that of young men (18 percent). Furthermore, young and highly educated women represent the largest cohort of unemployed women seeking and willing to work: skilled females between the ages of 25 and 34 face an unemployment rate of 58 percent, which is much higher than their male cohorts (23 percent) and the overall unemployment share of skilled female.

Using a mixed methods approach that combines analysis of quantitative microdata from the labor market, focus group discussions, and a legal review of provisions related to women, the study reveals that a combination of labor and supply side factors **--** while not necessarily affecting skilled women exclusively – are at play. For example, legislation that limit women's choices in careers, sectors, and occupations exist and affect their ability to access certain jobs in the same way as men. Lack of affordable and high-quality child care stand in the way of skilled women's ability to work and compete in the job market. Employer-paid maternity benefits with no mandated paternal option may unintentionally raise the costs incurred by firms and thus discourage them from hiring females. Restrictive attitudes toward gender roles (i.e. viewing men as primary breadwinners, women as care providers) and concerns surrounding women's safety during work commutes are also constraints. Related to this, preferences for public sector jobs that offer shorter working hours and better security are still widespread among women who are willing to wait longer than men for a job that meets their expectations. Such preferences affect the types of higher degrees women pursue and, ultimately, their employability prospects in the private sector.

A set of policy recommendations targeting skilled women (and overall) is proposed by the study to be undertaken in the short and medium term, specifically:

- ***Short-term:*** (i) supporting entrepreneurship and microwork among skilled women, and (ii) strengthening labor market intermediation services and facilitation of job matching for skilled females, and (iii) Conducting a communications campaign with a focus on reducing biases and stereotypes in society, changing male behavior in the private sector and helping spread awareness of the benefits of female employment should also take place in parallel. Addressing safety concerns in public transportation and creating safe spaces for women to work away from harassment can also be implemented quickly.
- ***Long- term*****:** (i) reforming sex-based legislation that limits women's choices in careers, sectors, and occupations and (ii)improving labor regulations to maintain incentives to hire women and for women to accept private sector jobs such as through better parental leave policies and child care provision.

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. The World Bank has prepared a number of recent reports examining the nature of the constraints facing the economy. The findings are summarized in a discussion on growth prospects in Box 2.

Box 2: Growth prospects of the Palestinian economy [2]

The Palestinian economy has become stuck in a low-income low-growth trap because it has suffered for decades now under very difficult external constraints that have led to its isolation, particularly Gaza. Internal challenges, including the political divide between the West Bank and Gaza, have also played a role in the economic deterioration. However, an improvement in the external and internal environments that would allow the economies of the West Bank and Gaza to reintegrate and to rebuild links with external markets could significantly improve the growth potential and enhance living standards.

Easing the Israeli constraints on movement, access and trade would bring about the largest economic benefits. Analysis done by the Bank shows that ending Gaza's economic isolation and easing the blockade would open it up for critical trade needed to rebuild its infrastructure and economy, and could lead to additional cumulative growth in the range of 32 percent by 2025. Reducing the punitive and non-transparent non-tariff barriers imposed by the GoI would be critical to allow the West Bank and Gaza to import needed inputs for production and expand the market for its goods and services. Analysis done by the Bank shows that relaxing restrictions on the import of dual use goods (those that have both civilian and military uses) alone would bring about additional cumulative growth of 6 percent to the West Bank economy by 2025, with a bigger impact of about 11 percent in Gaza. In the West Bank, the removal of the Israeli restrictions on Area C (61 percent of the West Bank currently under Israel control) could bring about additional cumulative growth equal to 33 percent by 2025 as it would enable better access to critical scarce resources that would allow Palestinian businesses to take advantage of Area C's comparative advantages in agriculture, mining and quarrying, and tourism. Overall, alleviating external Israeli restrictions could raise real GDP by some 36 percent in the West Bank and 40 percent in Gaza by 2025.

There is also much to be gained from PA actions, particularly to end the internal divide, improve the business climate and accelerate fiscal reforms. On the business climate front, improving the doing business indicators, increased focus on vocational training to bridge the skill gap in the labor market and accelerating land registration to fully release this factor of production into the economy are key areas that the PA should focus on. On the fiscal side, rationalizing employment in the public sector, making tax collection more effective and efficient, removing price distortions (notably in energy and water), and providing adequate infrastructure are all areas that need to be improved. Our analysis shows that such reforms by the PA would significantly reinforce the positive impact of an alleviation of Israeli restrictions and could generate additional cumulative growth in the range of 24 percent in the West bank by 2025, and even higher at 30 percent in Gaza due to a lower base effect.

18. **The economic outlook for the Palestinian territories has become more fragile and highly uncertain given the recent political and security developments.** 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

[2] Findings in this box are based on a World Bank report entitled "Prospects for Growth and Jobs in The Palestinian Economy: A General Equilibrium Analysis" published in November 2017 and found on this link: http://documents.worldbank.org/curated/en/952571511351839375/Prospects-for-growth-and-jobs-in-the-Palestinian-economy-a-general-equilibrium-analysis.

economy is projected to reach 1.7 percent in 2018 (-5 percent in Gaza and 3.8 in the West Bank) and hover around 1.9 in the medium term. This growth level implies a decline in real per capita income and an increase in unemployment. Notably, downside risks to this projection remain significant. In the West Bank, if the Israeli legislation[3] to reduce clearance revenue transfers to the PA is implemented, this will result in larger than expected financing gaps and a drop in public consumption which will result in lower growth. In Gaza, if transfers through the PA's budget continue to decline and the United Nations Refugee and Works Agency's (UNRWA) funding gap is not offset, this will have a severe impact on economic activity, service provision, and social conditions in the Strip. Consequently, the Gaza economy is expected to slip into deep recession, significantly raising the potential for unrest.

19. **The technology sector is a current area of private sector activity and opportunity.** A key determinant of the success of the sector is the quality of internet infrastructure, and e-payments system. These issues are explored in a recent World Bank paper.[4] In the West Bank and Gaza context the antiquated 3G and 2G networks respectively, and the limitations in payment systems, are a significant constraint and a priority for reform. However, the firm level ecosystem for support is also important. In view of the potential for increased innovation and productivity from the sector, the World Bank recently conducted a review of the tech entrepreneurship space, including a comparison to other nascent and mature economies. A summary of the report titled "Tech startup ecosystem in West Bank and Gaza: findings and recommendations" is presented in Box 3.

[3] The "Palestinian Prisoners" Law promulgated by the GoI in July 2018 requires withholding an amount of clearance revenues equivalent to an estimate by Israel of payments made by the PA through its social spending on the families of "martyrs and prisoners".

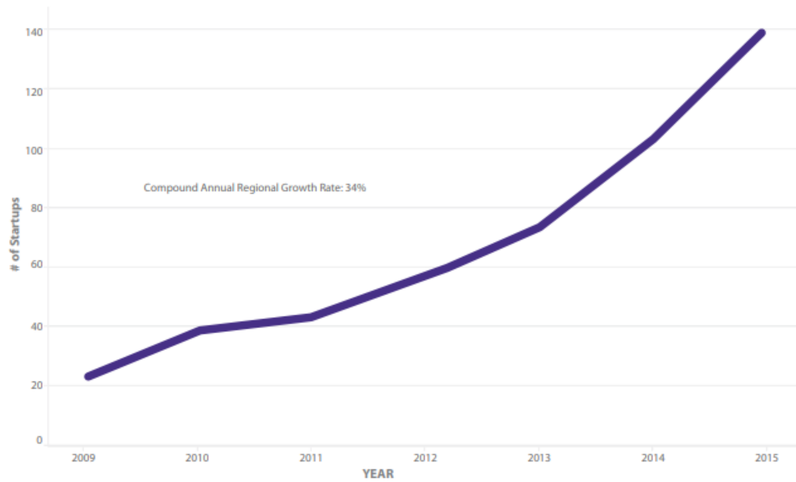
[4] See https://theforum.erf.org.eg/2018/06/26/moonshot-mena-laying-groundwork-modern-digital-economy/ for a discussion on the issues.

Box 3: Tech Startup Ecosystem

Technology is one of the main drivers of productivity and economic growth, and tech startups are an effective mechanism to both create local technology and absorb foreign technology. In recent years, there has been a surge of tech startups across the world. Fueled by technology-led cost reductions and increased access to resources, tech entrepreneurs are emerging in both developed and developing countries. These tech startups represent an attractive investment for early stage investors, as they can be used to test, launch, and validate a business much faster and cheaper than in traditional ventures.

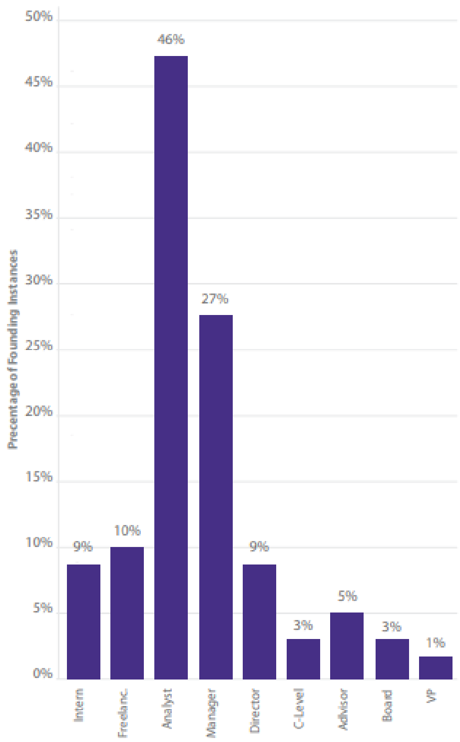
The World Bank recently published a report on the ecosystem of tech startups in the West Bank and Gaza. With over 400 entrepreneurs surveyed, general report findings indicated that the tech startup ecosystem in the West Bank and Gaza is at its early-stage and still maturing. It has highly educated founders and one of the highest rates of female entrepreneurs across analyzed ecosystems. However, the founders tend to be young with little managerial experience. On average, each year, 19 more startups are created than in the previous year, resulting in a 34% compounded annual growth rate in startup creation since 2009. Weaknesses include limited skills and experience of the entrepreneurs, and a lack of effective supporting infrastructure.

Figure 3: Startup Growth in the West Bank and Gaza



The West Bank and Gaza ecosystem stands out from other similar stage ecosystems in terms of age and gender of entrepreneurs. While founders are predominantly male, the West Bank and Gaza has one of the largest participations of female founders of all ecosystems surveyed, with 23% of founders being female. Founders were on average 27.7 years old at the time of founding, which is slightly younger than founders in other mid-stage and mature ecosystems. In the West Bank and Gaza, female entrepreneurs are also significantly younger at the time of founding than their male cohorts.

Figure 4: Previous Functions of Founders at Time of Founding



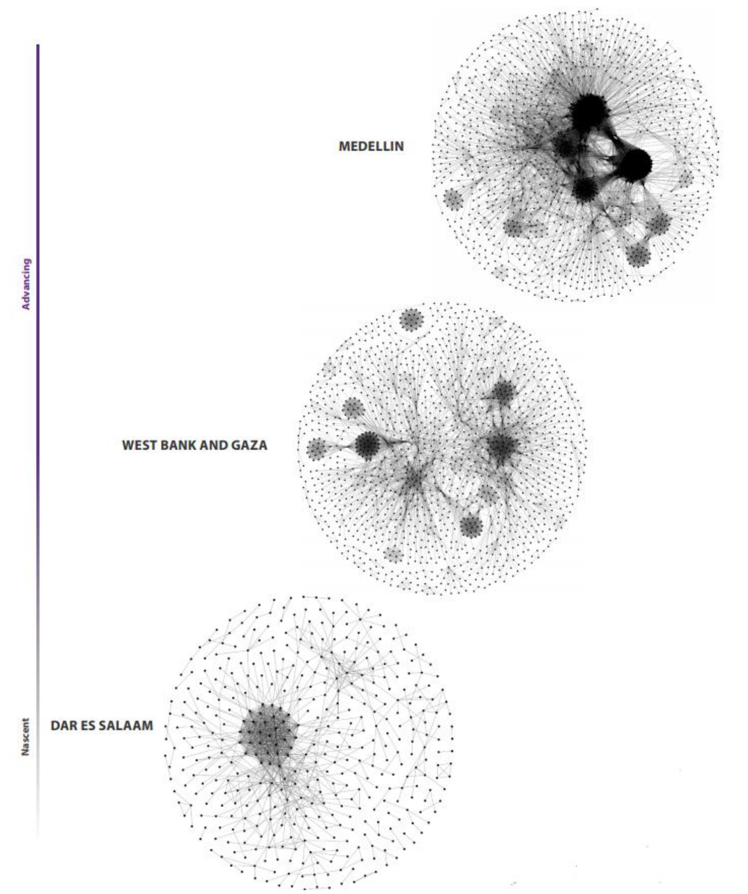
The quality of skills in the ecosystem is still nascent, as even with high levels of education, the experience and skillset of founders and teams of startups is still limited. The rate of education is especially high among founders in the West Bank and Gaza, with over 55% having a university degree, and over 19% with graduate degrees (masters, professional, or doctorate). However, the previous experience of founders is limited, with 46% having previous experience as analysts, and the remaining majority having junior-level experience. Higher professional experience matters for success, as startups with at least one founder with previous management experience were on average 1.45 times more likely to be funded. Based on interviews with existing financiers, the experience and balance of teams in the West Bank and Gaza is lacking, as is the ability to meet due diligence requirements to qualify for financing.

The supporting infrastructure for entrepreneurship in the West Bank and Gaza ecosystem is nascent, largely due to the mixed effectiveness of accelerators, incubators, and mentors. Data showed that 30% of accelerated startups were funded, while 35% of unaccelerated startups were funded. Of the startups that were funded, accelerated startups received an average of 1.37 investments, while unaccelerated startups received an average of 1.15 investments. Investment is interpreted as an improvement of startup quality, which suggests that accelerators in the West Bank and Gaza are having an impact in increasing quality, as they receive higher investments, but they are not effective in increasing the quantity of startups funded. Mentors do not seem to be very effective in supporting startups, not having a relevant impact on sustainability or access to funding from startups.

The community element of the West Bank and Gaza tech startup ecosystem is advancing, as there is large connectedness to international actors, and various clusters are evolving towards more connectivity. The key connectors of the West Bank and Gaza ecosystem are Gaza Sky Geeks, Birzeit University, and Startup Weekend, with each of them creating three main incipient clusters. A unique distinction of the West Bank and Gaza community is the clear separation of clusters between Gaza Sky Geeks and the West Bank clusters, which is consistent with the physical separation of these two territories. However, the ecosystem is highly connected to international actors, connecting to extensive networks of knowledge from clusters outside of the West Bank and Gaza. These international actors are both regional (MENA region) and international (primarily U.S. actors), including many university networks.

Investment in West Bank and Gaza startups is advancing. The data indicates that investors, including both individual and institutional investors, made a total of 62 investments in 47 startups, with nearly 60% of investments identified as equity financing. Younger startups were more prevalent and received relatively smaller investments, while older startups were less common but received larger investments. The heavy presence of donor-financed and university-led schemes is reported to have consequences for the investment-readiness of entrepreneurs, where some graduates of accelerator programs lacked the appropriate skills needed to endure the rigors of a market-driven entrepreneurial process. Similarly, there appears to be a large number of accelerators relative to the size of the ecosystem, partly due to donor investments in the sector, which do not always follow market rules of demand and supply. A transition to private-sector led, demand-driven entrepreneurial development would promote greater long-term sustainability.

Figure 5: Visualization of Ecosystem Connectivity



B. Public Finance

20. **A reduction in clearance revenues has exacted a toll on public income in 2018 despite a continued improvement in the performance of domestic revenues**. Between January and June 2018, the PA's domestic taxes grew by 6 percent (year-on-year) mainly driven by a pickup in VAT receipts due to higher collections from the local offices. Non-tax revenue also performed well, increasing by 16 percent (year-on-year) due to a large license payment by a telecoms operator and a lumpsum transfer by the GoI of fees collected from Palestinian workers in Israel during the period July 2017 until May 2018. Clearance revenues[5] witnessed a sharp drop between January and June 2018. declining by about 10 percent due to lower petroleum purchases from Israel and lower transfers by Israel to offset fiscal leakages compared to the same period in 2017.

21. **Public spending was reduced by about 7 percent in the first half of 2018 due to a drop in the PA's largest spending item, the wage bill, mainly following cuts in Gaza**. In fact, the wage bill dropped by 17 percent (year-on-year) following recent measures to cut the salaries of PA employees in Gaza and a decline in the number of public servants due to early retirements that the PA has been executing since early 2017. According to figures from the MoFP, the total number of PA employees dropped by more than 26 thousand since early 2017. The majority of the drop is in Gaza where more than 22 thousand employees have exited the public workforce compared to 4000 in the West Bank. Net lending[6] also declined by 12 percent in the first half of 2018 (year-on-year) due to the PA's reform efforts to control electricity related costs, while water and wastewater related costs continue to rise and need to be addressed. The decline in the wage bill and net lending offset a growth in transfers, which increased by 11 percent due to pension payments to those referred to early retirement.

22. **Despite these efforts, the PA's financing gap persisted in the first half of 2018 mainly due to insufficient budget support and was financed through additional arrears.** The PA's total deficit amounted to USD400 million in the first half of 2018. Aid received was USD240 million (USD183 million in budget support, and USD57 million for development financing), resulting in a financing gap of around USD160 million. Notably, aid received in the first half of 2018 was one third lower than in the same period in 2017. To fill the gap, the PA resorted to domestic resources, namely arrears to the pension fund and the private sector. Despite repaying some dues from previous years, net accumulation of arrears in the first half of 2018 reached USD177 million.

23. **The fiscal situation is expected to remain tight throughout the remainder of the year with significant downside risks in the medium term.** According to World Bank estimates, the PA's total deficit for 2018 is expected to reach USD1.24 billion or 8.2 percent of GDP, similar to its level in 2017. Aid inflows are projected at USD684 million. After accounting for external debt repayment, the size of the financing gap could thus reach around USD600 million (4 percent of GDP). Notably, this projection has high downside risks associated with it, particularly if donor aid ends up being lower than expected and if some of the Gaza measures are reversed. Also, if the Israeli legislation to reduce clearance revenue transfers by an estimated NIS1.2 billion (USD340 million) per year starting 2019 is implemented, the PA' fiscal stress is expected to significantly worsen. Under this scenario yearly financing gaps are projected to approach USD 1 billion, which would potentially have an adverse impact on PA salaries, service provision and arrears accumulation

[5] VAT and Import duties collected by the GoI on behalf of the PA and should be transferred monthly based on an arrangement instituted by the Paris protocol.

[6] Deductions made by the GoI from clearance revenues to clear utility bills owed by Palestinian Local Government Units (LGUs), utilities and distribution companies to Israeli suppliers.

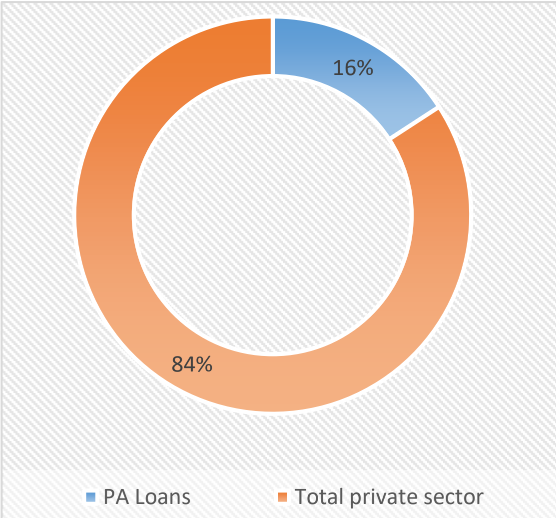
24. **While the PA needs to further accelerate reforms that align its spending and revenue capacity, in the short-term actions by the PA alone will not be enough to close the financing gap**. In addition to the efforts that the PA has so far implemented to increase revenues and rationalize public spending, more needs to be done to further control the wage bill in the West Bank and eliminate non-priority spending. The results, however, will not be enough to close the 2017 financing gap. Some financing may be available through borrowing from domestic banks as the PA still has some space before reaching the informal limit set by the Palestine Monetary Authority (PMA). However, this will also not be sufficient to meet the needs and will further increase the banks' credit exposure to the PA. As in previous years, the PA may resort to accumulating more arrears to the pension system and the pension fund. However, arrears to the pension fund are estimated at USD1.6 billion, and if current trends continue, the fund will become insolvent in a few years, according to World Bank analysis. Also, the stock of arrears to the private sector already exceeds USD600 million and is taking its toll on the economy. At some point, a large number of construction contractors were blacklisted with banks for not being able to repay loans due to PA arrears. Pharmaceutical companies have also dealt with cash flow issues as a result of delayed payments by the PA.

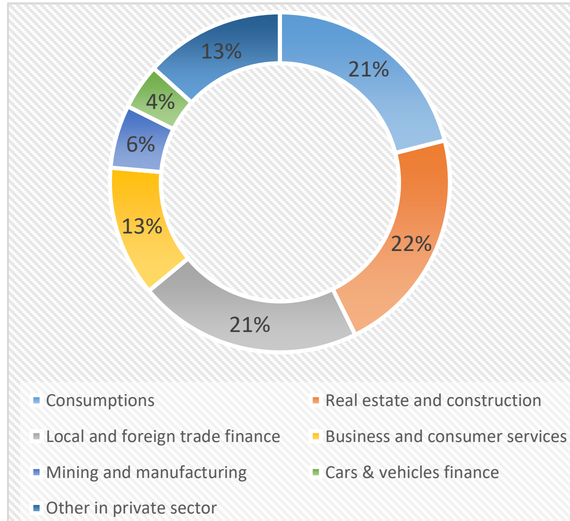
25. **Therefore, in the short term, there is no feasible alternative to budget support as a key source of financing**. A more drastic reduction in PA expenditures in the short term maybe harmful to the economy given the constraints on private sector activity and the role of public spending as a key stimulus to growth. It may also bring about negative social consequences. Donor support during these critical times is essential to sustain reforms and enable provision of services to the Palestinian population. 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, health referrals, and untargeted transfers. Consolidation efforts will also help create fiscal space for additional public investment in areas not viable for the private sector, and through which the PA can create a better environment for doing business.

C. Money and Banking

26. **During the first half of 2018, the Palestinian financial sector, composed primarily of traditional banking, largely maintained stable growth against the backdrop of a declining macroeconomic performance.** The Palestine Monetary Authority's (PMA) reporting through June 2018 indicates that the banking system's assets reached USD15.4 billion. Direct credit maintained a growth trajectory in line with recent years, reaching USD8.3 billion by June 2018, a growth of 10 percent over the past 12-month period. The overall credit-to-deposit ratio, which had a historical range of 50-60 percent in recent years, further increased to 69 percent as of June 2018, due to faster growth rate of credits (10 percent) over deposits (5 percent). Despite the recent and modest uptick in credit-to-deposits, the banking system is still regarded as liquid – confirmed by the latest PMA stress tests. A review of credit exposure to the private sector indicates persistent sectoral concentration, with 43 percent of all private lending going to construction or consumer loans. The impact of the deteriorating economic prospects in Gaza on nonperforming loans has been dampened through the rescheduling and restructuring of outstanding loans based on PMA guidance issued during 2017 and 2018. Nonetheless, PMA data registered an uptick in NPLs and classified loans during the first half of 2018, reaching USD234 million (equivalent to 2.8% of total loans compared to 2.3% at the closing of 2017) and USD492 million respectively. If the underlying causes persist, the delayed impact on NPLs will eventually materialize through a deterioration in the quality of SME and consumer loan portfolios, particularly for banks operating in Gaza.

Figure 6: Distribution of credit by sector (left) and by economic activity in the private sector (right)



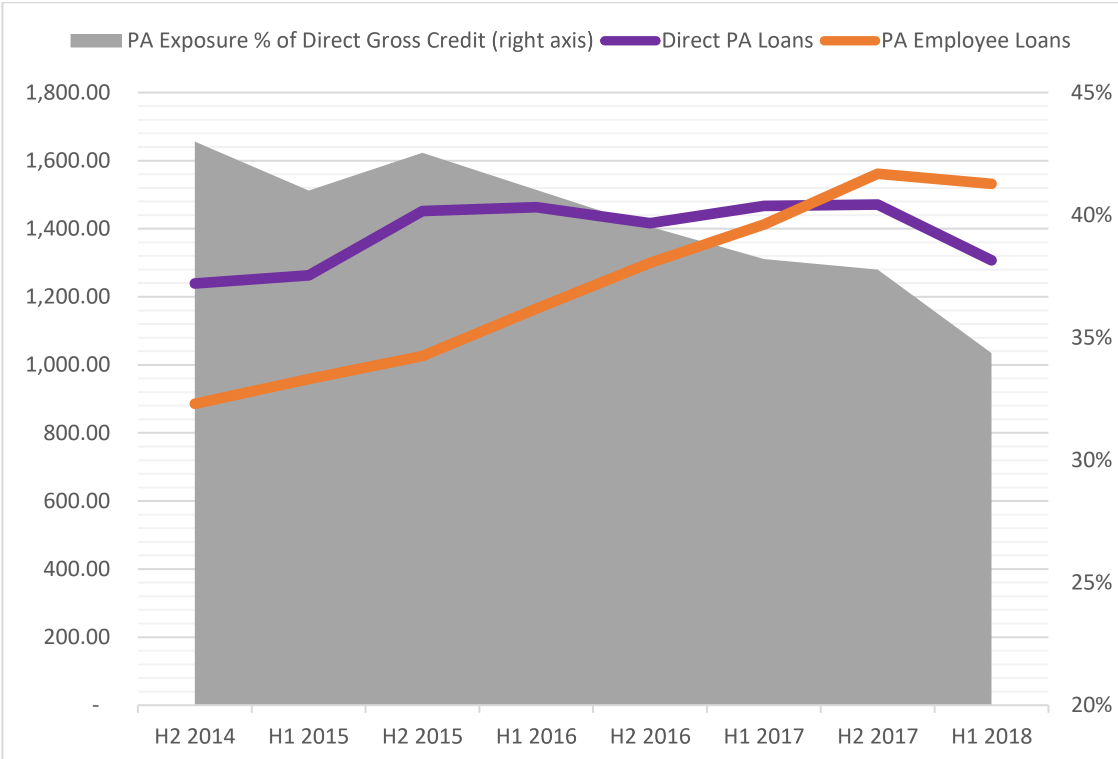


Source: Palestine Monetary Authority.

27. **Direct and indirect credit exposure to the public sector continue to present a significant risk to the stability of the banking system.** In light of the growing fiscal challenges faced by the PA, the banking sector's credit exposure to the public sector has caused unease. Reliance on bank financing grew steadily, raising concerns over credit concentration risk. In 2017, exposure to the PA stabilized at approximately USD 1.4 billion, equivalent to 20 percent of all lending by the banking system at the time. As of June 2018, PA loans contracted both in nominal terms (USD 1.3 billion) and in percentage of total bank lending (16 percent). PA loans currently account for 71 percent of the PMA imposed limit[7] for the Banking system's direct exposure to the PA, a significant decline compared to the peak of 96 percent in June 2016. It's important to note that the improvement vis-à-vis the PMA imposed limits also reflects an increase in bank capital, not just the decline a nominal decline in the stock of PA loans. While direct lending to the PA has moderated in 2018, the banking sector's exposure to the PA is not limited to direct credits. Borrowing by PA employees (using future PA salary as collateral) has been steadily growing since 2014, surpassing direct PA loans for the first time in 2017 at USD1.6 billion. When combined, the PA and public employees currently account for over USD2.8 billion, or 35 percent of total gross credit.

[7] The target limit for exposure is equivalent to the banking sector's total owners' equity at the time.

Figure 7: Direct and Indirect Exposure to the PA (USD million)



Source: Palestine Monetary Authority.

28. **The potential negative impact of de-risking by Israeli banks remains a cause for concern, with the potential to destabilize the Palestinian banking system.** Citing money-laundering and financing of terrorism concerns, key Israeli banks signaled plans to limit or terminate correspondent banking services to Palestinian Banks in 2016. 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 approved 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 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 at the final stages of concluding its first self-assessment of ML/FT risks. The 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. This exercise is being coordinated by the Financial Follow-up Unit (FFU). In line with the decree issued by Cabinet, the FFU leads a national team conducting the self-assessment, composed of 96 senior staff from relevant agencies including Ministries of Finance and Planning, Justice, Interior, and Foreign Affairs, the Public Prosecutor's Office, Customs Services, and other relevant stakeholders. In parallel to the self-assessment process, the PA requested, and has been granted approval for, an evaluation of its AML/CFT regime by the regional Financial Action Task Force (MENAFATF). The evaluation, currently scheduled to start during 2020, in combination with the self-assessment, represent key milestones towards aligning PA's AML/CFT systems with international standards.

29. **The PMA has implemented multiple new regulations and instructions in 2018.** During the first quarter of 2018, with IMF support, the PMA has issued instructions and guidelines to all banks and specialized lending institutions to facilitate the implementation of the international finance reporting standard (IFRS9). The PMA also developed and issued instructions related to the implementation of Basel III, including on corporate governance principles and on countercyclical capital buffers. In late 2016, the PMA adopted Risk-based Supervision (RBS), and in 2018 took actions to ensure the effective adoption of the approach such as through the preparation and adoption of the risk-based supervision manual, and internal training and capacity building. As of H1 2018, all licensed banks operating in Palestine have raised their paid-up capital above the minimum requirements of USD 75 million.

Chapter II: A vision for Gaza Development

30. **The World Bank report to the Brussels AHLC meeting in March 2018 presented an assessment of how the Gaza economy has evolved over the last two decades.** The assessment highlighted the nature of the deterioration and identified the increasing dependence on external transfers. It also set out some preliminary ideas on a way forward.

31. **This report continues to focus on Gaza by extending the analysis and developing a fuller vision for development considering the current situation.** In particular, the assessment takes account of further developments that negatively affect the Gaza population, and extends the analysis by looking at trends in poverty from a recent World Bank report.[8] It also elaborates further on both short and medium-term steps that are needed to address the situation, and elements of implementation.

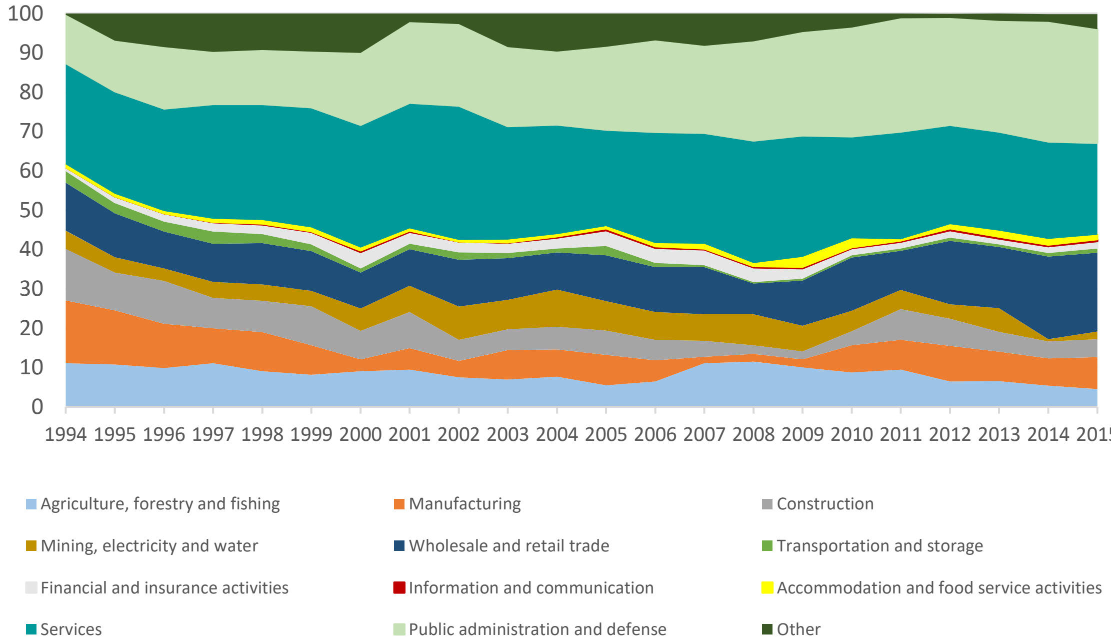
A. Performance of the Gaza Economy

32. **Gaza's economy has been hit by volatile shocks over the last two decades resulting in lower average growth than all comparators.** Even though the economy enjoyed good growth in the years following the signing of the Oslo accords, the positive trend was quickly interrupted after the outbreak of the second intifada in 2000. Despite some initial recovery afterwards, the economy was hit again with the Israeli decision to impose a full blockade on Gaza in 2007 after the takeover by Hamas, resulting in Gaza falling into a deep recession. Multiple episodes of war in 2008, 2012, and most recently in 2014 have all exacted a significant toll on Gaza's economy pushing it further into recession. Large amounts of aid for reconstruction after the last war allowed some recovery but most recent figures show that Gaza's economy has contracted again in the first quarter of 2018. As a result of these multiple shocks, Gaza's average growth over the last two decades has been lower than all comparators, including the West Bank.

33. **The blockade has caused Gaza's economy to deindustrialize, 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. In addition to the deterioration in the productive base, the isolation of the labor force due to restrictions on the movement of people is also expected to have led to an erosion in Gaza's human capital.

[8] World Bank: "West Bank and Gaza, Poverty and Shared Prosperity Diagnostic, 2011 – 2017", July 2018.

Figure 8: Gaza, Sectoral contribution to GDP



Source: Palestinian Central Bureau of Statistics

34. **Gaza's economy has been kept afloat by large amounts of transfers.** Aid and remittances are almost the only source of foreign exchange inflows that fuel consumption in Gaza, particularly since exports have been extremely small and investment activity very weak. 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 in 2014. Notably, this rate probably increased between 2014 and 2016 as large amounts of aid were received after the war to finance reconstruction.

35. **However, transfers have significantly declined starting in 2017, pushing Gaza's economy towards a possible collapse.** 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. However, data from a variety of other sources confirms the decline in the following category of transfers:

- **Wage payments to the employees of the *de facto* authority**. According to informal sources, the *de facto* authority has more than 40 thousand employees in Gaza with a total monthly wage bill of about USD20 million- the majority of which is no longer paid.

- **Transfers through the PA's budget to Gaza**. Starting in April 2017, the PA has implemented a number of measures in Gaza including cutting allowances to its employees in the Strip followed by wage cuts. This has reduced salary payments by an average of 30 percent in 2017, followed by a larger cut of 50 percent in 2018. This, amongst other measures, has resulted in a decline in the PA's monthly spending in Gaza from USD125 million in 2016 (prior to the measures) to USD96 million currently. A reduction in payments to the employees of the *de facto* authority and those hired by the PA combined has resulted in a severe liquidity squeeze for around 80 thousand families (almost one quarter of Gazans) negatively impacting spending and hence, economic activity.

- **UNRWA funding**. The agency is facing a funding gap of USD300 million which jeopardizes its activity in the Strip including food supplies to about one million Gazans and the operation of its 275 schools and 22 health facilities. A number of programs needed to be curtailed and in July 2018, 100 UNRWA staff in Gaza were laid off, exacerbating the liquidity squeeze in the Strip.

- **Aid for reconstruction**. In the Cairo Conference for Reconstructing Gaza that took place after the 2014 war, donors pledged about USD3.5 billion to rebuild Gaza. Between late 2014 and 2016, about USD1.8 billion of the pledged amount was disbursed playing a key role in reviving the Gaza economy. However, in 2017 and 2018, aid transfers for Gaza reconstruction have significantly declined. According to the National Office for the Reconstruction of Gaza (NORG), in recent months only USD33 million has been disbursed resulting in a significant decline in reconstruction activity.

- **Development aid from the USA Government.** Given the recent USA decision to reduce financial support to the PA, a large number of US-supported development and humanitarian projects have been affected. In the Gaza strip, US funding for such projects has been around USD50-60 million per year and this has mostly dried up in 2018.

36. **Recent decisions by the GoI are also expected to further exacerbate the economic and social conditions in Gaza.** In July, the GoI closed the Karm Abu Salem crossing, the only operational commercial crossing into Gaza. Since then, only food and medicine have been allowed into Gaza, but on a case by case basis, while all other goods including construction materials and fuel have been fully banned. The GoI also halved Gaza's fishing zone from 6 nautical miles to 3 nautical miles, against the twenty-nautical mile limit set by the Oslo Accords. These decisions have severely exacerbated the already difficult economic and social conditions in the Strip. In particular, the ban on fuel may soon result in a crisis in the health sector as reported by the Palestinian Ministry of Health, as fuel supplies required for running emergency generators have started to run out.

37. **The latest data indicates that further deterioration in Gaza can be expected**. The most recent available data on economic growth is for the first quarter of 2018 and it shows that Gaza's economy has contracted by 6 percent. Some of the measures discussed above had not yet taken effect in the first quarter of the year, hence their impact is not reflected in the growth statistics. However, new unemployment data covering the second quarter of 2018 were just released and they show that unemployment has reached a new high in Gaza of about 54 percent – 5 percentage points higher than in the first quarter. This is a strong indication that economic activity has further deteriorated in Gaza.

B. Living Standards of the People of Gaza

38. **The decline of transfers into Gaza, which is weighing on economic performance, is unsurprisingly also affecting the living standards of the Gaza population.** The World Bank has recently completed a "Poverty and Shared Prosperity Diagnostic," which used PCBS data to shed further light on the nature of the socio-economic decline in Gaza. The diagnostic uses the 2017 Palestinian Expenditure and Consumption Survey (PECS) to assess changes since the previous survey, conducted in 2011. It is notable that the Palestinian territories are unique amongst fragile countries in that they have continued to implement multiple surveys on a regular basis, despite protracted conditions of fragility and conflict.

39. **Poverty rates in Gaza have increased dramatically from 2011-17, rising from 38.8 to 53 percent.** The poverty line is set at the median expenditure level of a specific type of household for certain key items for the poorest 25 to 30 percent of households. The most recent poverty trend (2011-2017) uses 2010 the poverty line adjusted for inflation. In 2017, it was found that nearly a third of the population of both the West Bank and Gaza is living in poverty, with a growing divergence between the two. In Gaza, the poverty rate of 53 percent is a 14 percent point jump 2011. This leaves every second Gazan below the national official poverty line. In contrast the proportion of the population living below the poverty line in the West Bank declined by 3.9 percentage points from 17.8 to 13.9 percent

Figure 9: Since 2011, poverty has increased in the Palestinian territories, driven by divergent trends: a sharp increase in Gaza and a small decline in the West Bank

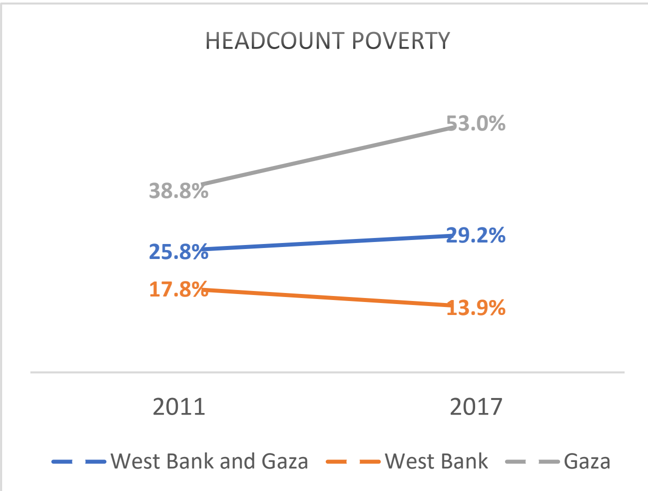
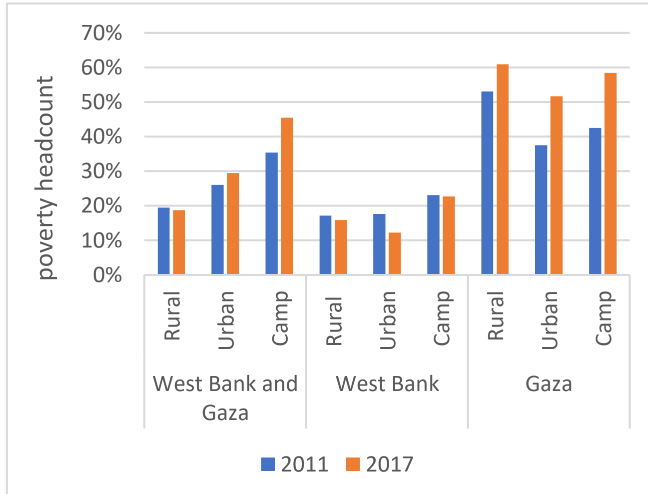


Figure 10: The decline in poverty in the West Bank was limited to urban households, while poverty increased across all groups in Gaza



Source: Staff calculations based on PECS 2011 and 2017

40. **Poverty in Gaza now accounts for more than two thirds of the poverty in the Palestinian territories.** The increase in poverty was relatively larger in urban areas and refugee camps than in rural areas. As a result, Gaza now accounts for 71 percent of poverty in the Palestinian territories, up from 57 percent in 2011. The reduction in poverty in the West Bank was limited to urban households. It should also be noted that these gains are fragile and a significant share of the population in the West Bank is vulnerable to falling into poverty if faced with small changes in household expenditures.

41. **The trends in monetary poverty are also consistent with subjective indicators of wellbeing that relate to self-assessment of income levels from Gallup Poll data.** This indicator asks households to assess whether their income is adequate to live comfortably, just enough to get by, or if it is difficult to make ends meet. Between 2011 and 2016, this indicator tracks the worsening situation in Gaza, as well as improvements in the West Bank. The share of respondents finding it difficult or very difficult to live on current income increased in Gaza from 63 percent in 2011 to 74 percent in 2016, while the same indicator declined in West Bank from 59 to 42 percent.

Figure 11: In Gaza an increasing share of households report difficulty in meeting basic needs since 2011 consistent with increasing poverty

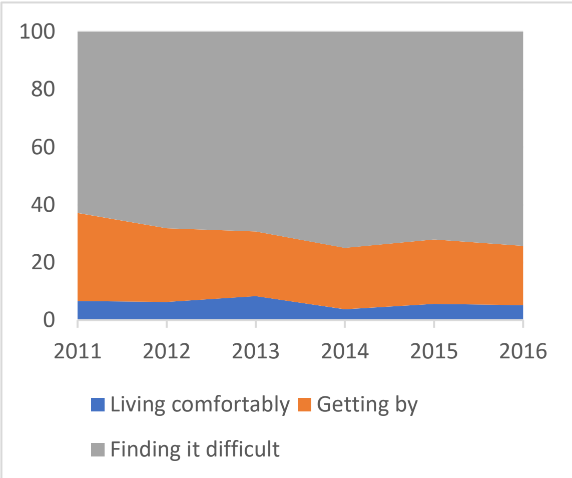
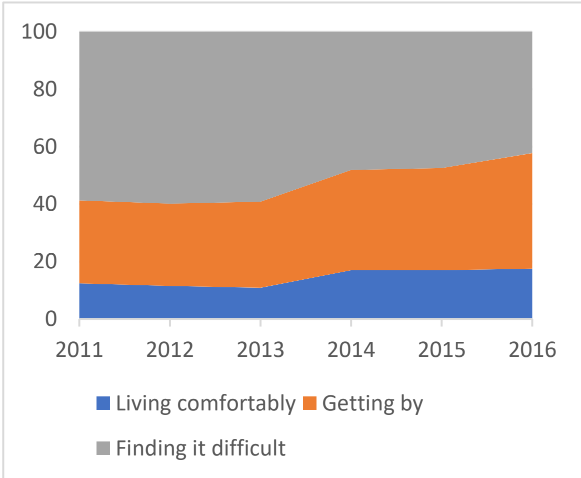


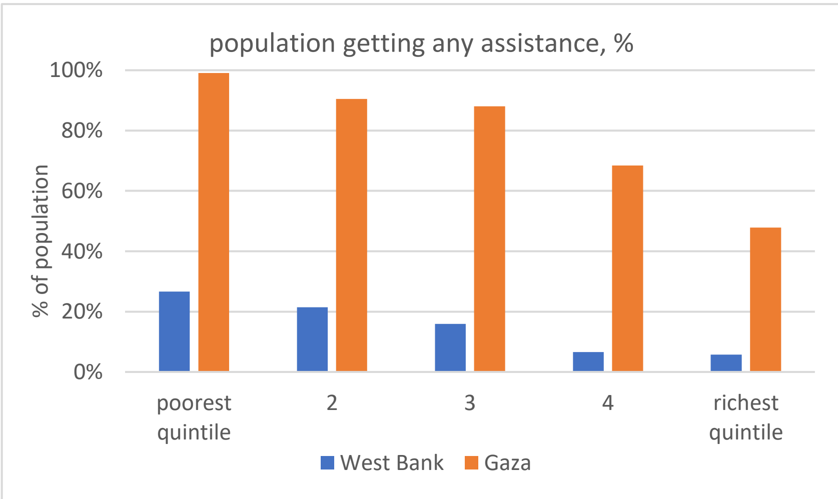
Figure 12: Subjective assessments about the adequacy of household income in the West Bank are consistent with measured welfare improvements



Source: Staff calculations based on Gallup poll data

42. **Gaza's heavy dependence on government and non-government assistance makes all Gazans vulnerable to sudden declines in aid.** 79 percent of the population of Gaza had access to some kind of aid from government or non-government sources in 2017 (compared to 15 percent in the West Bank). A majority of Gazans also had some access to aid in every consumption quintile including for the richest quintile, where 48 percent of the population accessed some form of aid. In total, aid accounted for close to 30 percent of expenditure of the poor in Gaza and it accounted for close to a quarter of average consumption expenditure across all quintiles. Measured as a percent of income, aid accounted for as much as 45 percent of total income of the poor in Gaza. This makes the population in Gaza extremely vulnerable to any change in the aid flows.

Figure 13: More than 90% of the bottom 40 in Gaza receive some form of aid; and even among the most well-off, half receive assistance



Source: Staff calculations, PECS 2017

43. **Despite low employment, changes in labor market earnings were the key driver of poverty reduction in the West Bank.** In contrast, declining transfers accounted for most of the increase in poverty in Gaza. Declining income poverty and inequality over the period 2011-17 in the West Bank was mostly driven by changing conditions in the labor market (earnings). In Gaza, declining transfers (pensions, retirement payments, and domestic remittances) were a key driver of the observed increases in poverty and inequality. While labor earnings contributed to some reduction in poverty, this effect was not strong enough to compensate for the magnitude of decline in income transfers.

Figure 14: The increase in income per adult equivalent poverty during 2011-17 in Gaza was driven by a decline in transfers, despite a decline in poverty due to labor earnings

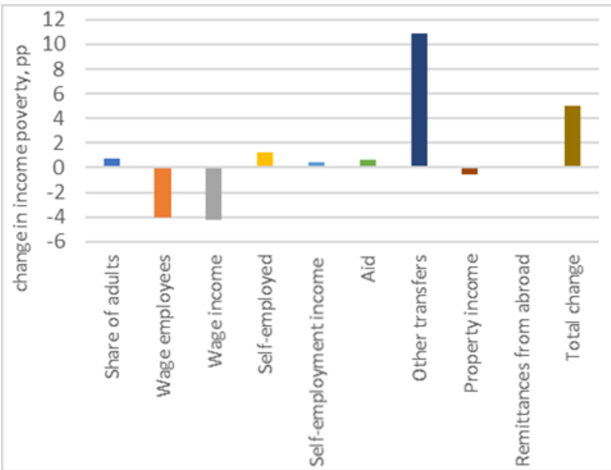
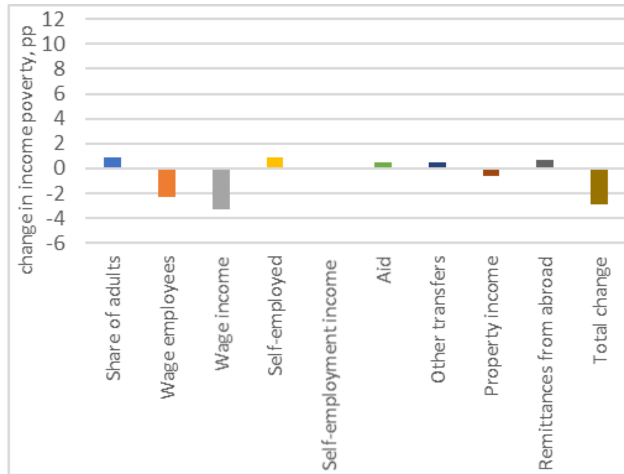


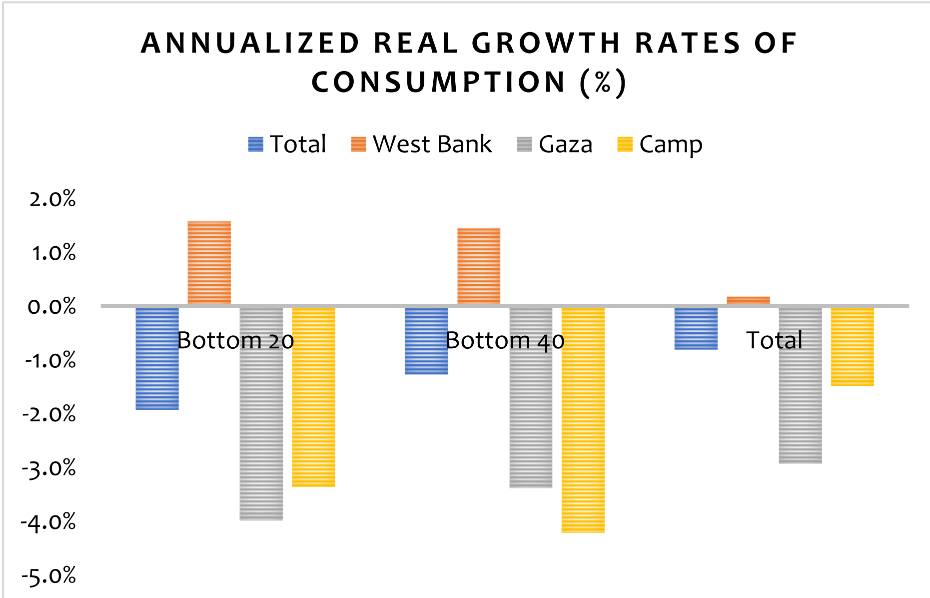
Figure 15: The decline in income per adult equivalent poverty during 2011-17 in the West Bank was driven by a shift towards wage employment and an increase in wage earnings



Source: Staff calculations based on PECS 2011 and 2017

44. **Consumption data further highlights that while all Gazans are suffering, the bottom deciles living in camps faced a precipitous situation.** The entire population of Gaza was worse off in 2017 compared to 2011, but the bottom -40 and -20 percent of the population were hit even harder with an additional decline of 1.1 and 0.5 percentage points, respectively, in consumption expenditures compared to the average. Moreover, consumption in refugee camps declined by 1.5 percent overall, with the poorest deciles suffering large declines in consumption. Specifically, the bottom -40 in camps witnessed a 3.4% decline in consumption expenditures, and this decline was even higher for the bottom -20.

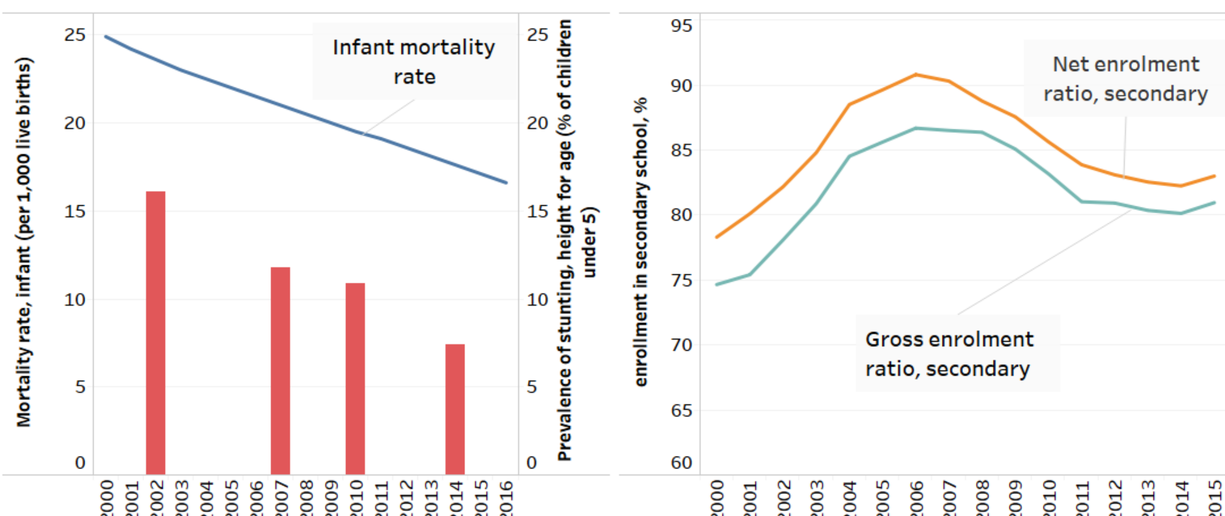
Figure 16: In the West Bank shared prosperity increased while in Gaza and in camps the less well-off bore the brunt of the decline



Source: Staff calculations, based on PECS 2011 and 2017

45. **While in general, the increase in poverty has not affected the delivery of social services, secondary school enrollments have been on a decade-long decline.** When compared to others in the region, the Palestinian territories have performed well in the provision of social services – such as health, education, and sanitation. However, while access to sanitation, and infant mortality rates continued to improve during this period, enrollment in secondary school started to decline. Both net and gross enrollment rates in secondary school gradually fell after 2007, settling at their lowest rate post 2011. A gender difference also emerged where in the West Bank in 2017, 7 percent fewer boys than girls completed grade 9, while in Gaza the difference was 13 percent.

Figure 17:While trends in infant mortality have maintained a secular decline since 2000, net and gross secondary enrollments have declined since 2007



Source: WDI accessed using wbopendata ado, 11 April 2018

46. **Access to social and essential infrastructure services in Gaza declined in 2017.** While coverage and equality in access to primary education are high in both the West Bank and Gaza, both these indicators worsen for higher levels of education and when quality is considered (having to repeat a grade), with Gaza performing worse on all indicators. For example, 81 percent of children complete ninth grade without repetitions in the West Bank versus only 76 percent in Gaza. In terms of essential infrastructure services, Gaza reports a 2 percent access to uninterrupted water supply and an overall lack of access to sustained electricity. Meanwhile, in the West Bank, about 45 percent of children aged 0-17 have access to piped water without interruptions, while 90 percent report access to electricity through the public grid.

47. **Inequality in access to selected services is also higher in Gaza.** While the coverage and access to secondary education (and high-quality education) were unequal in both regions measured by Human Opportunity Index,[9] inequalities were higher in Gaza, and the circumstances that drive these trends differ across the two regions (child and household characteristics). In Gaza, children from poorer households or with disabled household heads are more likely to face unequal opportunity, while poverty status is not the largest factor contributing to such inequality in the West Bank. In both regions - albeit to a larger extent in Gaza - boys are likely to face worse educational opportunity relative to girls. In addition, severe shortages of water and electricity in Gaza coincide with an unequal access to uninterrupted water and electricity services for children in refugee camps in the West Bank. Notably, Gaza had greater equity in access to health insurance relative to the West Bank, though this access relies on the provision of insurance by UNRWA.

Figure 18: Contributions of circumstances to inequality in access to different opportunities in Gaza in 2017

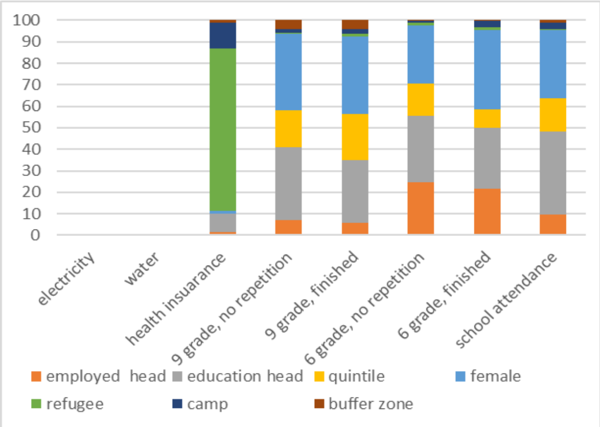
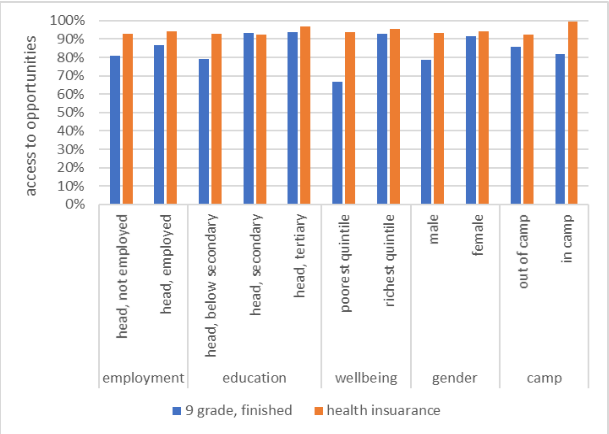


Figure 19: Access to finishing 9th grade (15-17 age) and health insurance (0-17 age) across selected circumstances in Gaza in 2017

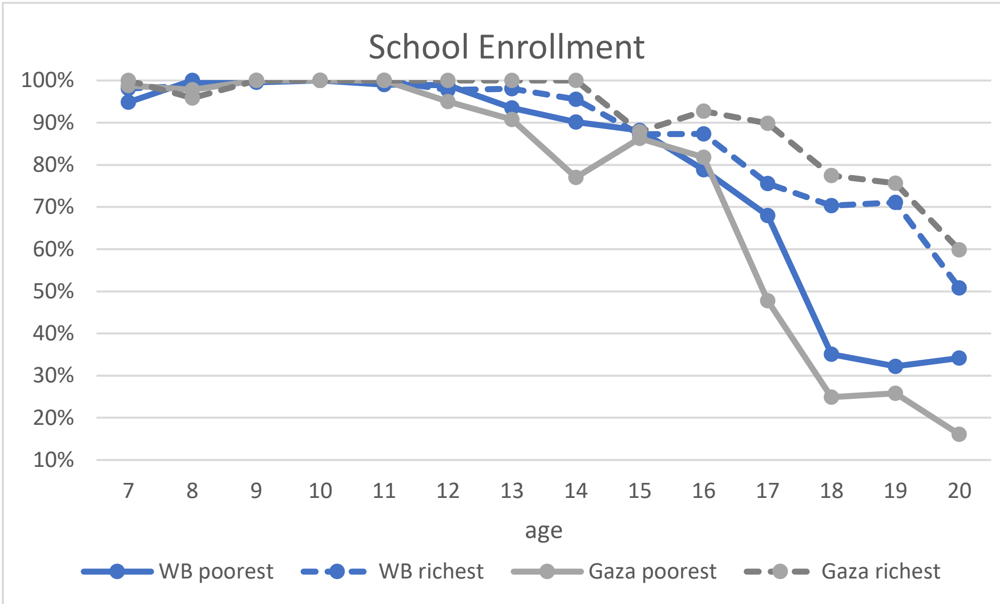


Source: Staff calculations, PECS 2017.

Note: Each opportunity is calculated for a specific age group. Access to electricity and water are close to zero, therefore contributions of circumstances are not calculated for these two opportunities.

[9] The HOI is defined as the difference between two components: (i) The overall coverage rate of the opportunity (C); and (ii) a "penalty" for the share of access to opportunities that are distributed in violation of the equality of opportunity principle (P). HOI can be constructed taking into account multiple circumstances and contribution of each circumstance to inequality can be calculated. More detailed explanation of HOI methodology can be found in Molinas Vega, J., R.P. de Barros, J. Chanduvi, and M. Giugale. 2011. Do Our Children Have a Chance? The 2010 Human Opportunity Report for Latin America and the Caribbean. Washington, DC: World Bank.

Figure 20: School enrollment among children 7-20 age across the poorest and richest quintiles in West Bank and Gaza regions



Source: Staff calculations, PECS 2017

Note: quintiles are calculated based on expenditure per capita separately for Gaza and West Bank regions.

C. Vision for Gaza Development

48. **The economic and social situation in Gaza that has been declining for over a decade, has deteriorated exponentially in recent months as transfers from outside the territory are squeezed.** The impact this is having on people can be seen in the significant increase in poverty and reduced opportunities since 2011 – which has worsened further in 2018. The situation has reached a critical point with increased frustration, feeding into downward cycle.

49. **A new dynamic is needed of economic opportunity leading to prosperity, legitimacy and stability.** Critical to this is an easing of the key constraints facing the Gaza economy - the movement and access restrictions, and internal governance weaknesses:

i. **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 capable of competing in regional and global markets and increasing its exports of goods and services. A key element will be efforts focused on easing the physical blockade, which has led to the isolation of Gaza's businesses for more than a decade. Over time the relaxation of these constraints should support increased regional integration which has been hampered by political challenges, but which offers benefits for all parties. However, there should also be a focus on removing obstacles to growth in the digital economy, which offers considerable potential to provide jobs for the innovative youth. In this area, moving beyond the current 2G network technology and resolving challenges in electronic payment would be key.

ii. **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, and effective manner, is an essential condition for the Strip's sustained development. Democratic systems that provide voice and accountability for the people would create the long-term stability needed for investment.

50. **A peace agreement could provide the conditions to deliver on this agenda, but steps can be taken in the interim.** Effecting the needed change would be easier in a positive political environment created by a peace agreement, but the situation of the people of Gaza cannot be held hostage to this development. With bold leadership much can be done in the short term in line with past agreements. Delivering on such a vision would involve prime roles for the GoI and the Palestinians – while the international community needs to provide complementary support.

D. Strategy for Gaza Development

51. **In the current context, there needs to be a balanced approach that combines an immediate crisis response, with steps to create an environment for sustainable development**. There are four collective outcomes that should be sought:

- **Ensure continuation of service delivery**
- **Increase purchasing power of households**
- **Initiate the policies and projects needed for sustainable economic development**
- **Provide hope for a political and economic future.**

To pursue these objectives, it is useful to consider a strategy that identifies: short term steps to mitigate the crisis; medium term measures to rebuild Gaza's economic potential, and implementation modalities that support efficient delivery.

Short-term steps to mitigate the crisis

52. **To prevent an immediate collapse, the recent corrosion in the livelihood of Gazans needs to be reversed.** The quick deterioration in conditions in Gaza in recent months has been driven by a severe weakening in purchasing power and economic activity, accompanied by a decline in service delivery. This situation needs to be addressed to avoid further blows to wellbeing, health, and stability. The quickest response mechanism would be to reverse the decline in transfers that have maintained services and economic activity in the past decade. These are among the short-term policy and project options to quickly inject cash, expand economic opportunity, and enhance service delivery. Box 3 sets out some short-term options.

53. **To help identify opportunities for additional project support, the World Bank and UNSCO collated information on current donor projects in Gaza.** Existing projects totaling over USD1 billion were identified in a range sectors. Many of these projects are potentially scalable. Moreover, information on the current projects can be used within the various sectors (water, energy etc.) to help identify gaps in activities that need to be addressed to enhance service delivery.

Box 3: Short term measures to address the Gaza crisis

Restore transfer flows

1. Restore aggregate PA payments to Gaza (these have declined by $30 million per month from 2017). Priority should be given to social assistance payments, medical supplies, and salaries for PA employees who are working.
2. Reverse the decline in donor funding to key service delivery agencies such as UNRWA.

Prioritize projects that both inject cash in the short term and support service delivery

3. Implement donor-financed cash for work schemes and labor-intensive projects;
    - Labor intensive projects would make use of the large pool of unemployed individuals and provide a ready cash flow to support the wider economy.
    - The World Bank is initiating two cash for work projects in 2018; one that targets the long term unemployed and will be implemented through NGOs, and the other which would scale up municipal investment with a focus on labor intensive projects.

4. Scale-up rooftop solar support to Gaza
    - Solar energy generation provides the only short-term option to provide additional electricity to households, business, and key public services. Potential of 0.5-0.7 MW installed solar capacity per $1 million.
    - Requires donors to scale-up financial support for rooftop-solar programs and GoI to facilitate importing solar panels and storage batteries into Gaza.

5. Upgrade Gaza Power Plant (GPP) to full current capacity;
    - Upgrade fuel storage and treatment facilities at GPP;
    - Subject to fuel availability and funding for recurrent expenditure could provide up to 60MW of electricity to Gaza, increasing electricity availability by around 2 hours per day

Remove Obstacles to Business

6. Selectively relax the list of imported items on the Dual Use list;
    - Constraints on importing key ingredients are hampering relief efforts and industrial production.

7. Remove the recent restrictions on the Karm Abu Salem crossing.

8. Expand Gaza's fishing zone from the recent 3 miles up to the 20 miles limit that was agreed in 1990s;
    - Fishing is an important industry within Gaza, which has the potential for scale up.

9. Further expand permits for business people;
    - Availability of business permits in Gaza was scaled back in 2017 and, while recently expanded, further provision would support potential business opportunities.

Provide Finance for Development

10. Pilot innovative financing mechanisms for the private sector;
    - Providing concessional finance and / or guarantees for otherwise marginal projects can make them bankable and deliver additional jobs.
    - World Bank has established a facility (the Private Sector Enhancement Facility) which could be utilized for this purpose.

Medium term measures to rebuild Gaza's economic potential

54. **Many of the short-term options necessarily focus on the provision of financial support from outside Gaza and will not be sustainable.** They provide immediate relief, but to a large extent they also represent a continuation of the activities that sustained the territory in the past decade to early 2017. The experience of the past year has demonstrated how vulnerable such a model is to a change in sentiment by the funders. Similarly, with service provision, while international partners are often prepared to make capital investments, it is critical to be able to cover the running costs of the service. Providing a supportive environment for private sector development (especially in the digital economy) is critical to generate the incomes needed to support these services.

55. **It is essential that short term efforts are accompanied by policy steps to address the underlying constraints on the Gaza economy: the movement and access restrictions, and internal governance weaknesses.** While the restrictions on movement and access for goods and people is a challenging issue for GoI, unless it is addressed, the economic situation in Gaza will never improve. An approach that restricts the import of any item that could be misused, or imposes obstacles to the efficient export of goods and services will never allow the economy to develop. Policy steps to gradually ease these restrictions are needed.

56. **More also needs to be done to address some of the internal constraints to the economy.** In the area of service delivery, a number of vital investments have been identified to address the infrastructure needs of the territory. These will take many years to complete, but they need to start now to avoid further suffering for the people. Table 1 sets out some of the most critical investments. Although, there is a natural focus on capital projects for infrastructure, these developments will never be sustainable if the requisite steps to secure on-going running costs are not made.

57. **Securing the revenue streams from the projects is also critical to unlock the potential for private sector financing of the investment.** Given the scarcity of development finance from partner countries it is important to maximize the potential for private sector investment alongside development partners. This has been recognized by the Bank and others in a strategy to "Maximize the Finance for Development (MFD)". The potential for private sector investment in Gaza is limited unless a revenue stream can be associated and captured by the investor. While a start should be made on some of the critical infrastructure projects needed for Gaza, this should be accompanied by steps to address the institutional and governance challenges that are inhibiting revenue recovery and hence payment. This is critical to both making the needed capital investments sustainable and to attracting private sector finance.

58. **Legal, regulatory and institutional changes are also vital to create the business environment necessary to support private sector development.** This is particularly important in the nascent area of the digital economy which has the potential to provide jobs for many of Gaza's innovative youth. Developing infrastructure beyond the traditional investment in energy and water is important to allow entrepreneurial activity to thrive. In this respect moving from the antiquated 2G network to provide a modern network infrastructure would increase opportunities. Similarly steps to encourage e-payment would facilitate commerce with the rest of the world – vital for a modern economy. Enhancing competition to create a dynamic environment for innovation would also be an important development. The proposed new competition law would be a positive step especially if accompanied by more competition in the telecom sector. The draft Companies Law that has been developed within the PA would, if applicable in Gaza, also introduce a range of modern provisions that would support all businesses but especially important for digital entrepreneurs.

Implementation Modalities that support efficient delivery

59. **While urgent action to address the dire service delivery crisis in Gaza is needed, interventions need to be well designed and coordinated with local operators.** Selected PA institutions (PENRA, PWA, MDLF) have existing institutional structures with a track-record of delivery and are the preferred method to manage projects that have their ongoing operational costs financed through cost recovery systems. Wherever possible, projects should be implemented through these institutions.

Table 1: Development Projects for Gaza

Project	Comment	Impact
Medium term (1-2 years)		
Expand energy import capacity – 161kv line from Israel and 66kv line from Egypt	Requires some investments in Israel; main issue: securing funds for recurrent expenditures estimated at around $132m p/a	Provide 120MW additional electricity Double the amount of electricity currently available to Gaza Meet about 50% of Gaza's total current electricity demand of 500MW within 1.5-3 years
Upgrade primary and secondary electricity distribution network capacity	$33m for internal transmission backbone, $22m for distribution network enforcements	
Construct Associated Works, including North-South Carrier Trunk water line	Total of six bulk supply packages and non-revenue water (loss) reduction to supply freshwater throughout the Gaza Strip	Reduce water losses by up to 40% Increase access to improved drinking water to 2 million people
Expand and upgrade primary and secondary water networks, including connection points and reservoirs	Includes storage and blending reservoirs to allow additional imports of water	
Develop gas import capacity for Gaza and convert domestic generation from fuel to natural gas	Build a transmission gas pipeline from Israel to connect Gaza Power Plant (GPP); includes cost for (re-) conversion of GPP from fuel to gas; issue: requires creditworthy off-taker in commercial gas purchase agreement	Expand GPP electricity generation capacity to 550MW in two phases to meet current supply gap and future demand
Long term (2-5 years)		
Expand water and wastewater treatment capacity	Includes $450m for the central desalination plant, of which $55m is an operating subsidy for 5 years	Provide 55 million cubic meter (MCM) of potable water to Gaza Meet about 50% of current water needs in Gaza Contribute to regenerating the coastal aquifer Reducing pollution in the Mediterranean

60. **The installation of rooftop solar systems for hospitals, primary health care clinics, key public services, businesses (SMEs), and households is one of the few short-term options to mitigate severe energy shortages.** More efforts and resources are needed to scale up existing initiatives. However, it is important to ensure careful and fit-for-purpose design of solar systems for individual facilities and ensure effective operation. Reports from Gaza indicate that almost a quarter of all rooftop solar systems are failing due to wrong-sizing, poor quality of material, particularly batteries, and weak operation and maintenance. Suitable rooftop space is limited, as buildings need to have the required strength to handle the weight of solar installations and be exposed to clear sunshine. Hospitals in particular require a careful assessment and system design to ensure the operation of critical medical services that require uninterrupted electricity supply and, hence, synchronization across different sources of supply. Assessments to right size the systems and integrate with the other elements, including supply from the grid and back-up generators, don't need to be particularly time consuming or excessive, but are a precondition to effective implementation on the ground.

61. **A rooftop solar program to serve households and businesses is currently being rolled out by PENRA and GEDCO with support from the Bank and other development partners.** A revolving fund is expected to be launched shortly along with the tender to procure rooftop solar PV systems. The revolving fund will offer 2-4-year repayment periods to make the systems affordable. It is important to avoid distributing free systems, as appropriate. Poorer households or micro enterprises should be offered deep discounts through the revolving fund. Global experience shows that cash buy-in of beneficiaries is crucial to ensure appropriate use of systems and to avoid creation of a black market. Given the state of the Gaza economy, there is a higher risk of misuse of components and environmental concern from battery waste. Expansion of the revolving fund would ensure a systematic roll-out of solar systems that maintains incentives to pay for electricity which is critical to address the underlying issues of the Gaza energy crisis, but also avoid distortions of free and pay-back systems being rolled out, including in the same neighborhood. From a long-term perspective, Gaza customers need to maintain the culture of payment to ensure GEDCO is able to generate revenue as/ when electricity supply conditions improve.

62. **Additional drinking water supplied from Israel and short-term/ low volume (STLV) desalination plants are the only available options to mitigate the water crisis in the short term.** However, the purchase of additional water quantities from Mekorot, agreed through the Red Sea/ Dead Sea MoU, needs to go hand in hand with investments in the Associated Works packages. This includes the main carrier, blending reservoirs, water connections to the Mekorot connection points, water wells, associated booster-pumping stations, and bulk water meters. Otherwise, water quality would not meet the minimum standards to be drinkable and hence not be used by households. Any additional capital investments to enhance treatment capacity, including through STLVs, need to be matched by solid arrangements to operate assets, including electricity supply and maintenance costs.

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

63. **The Palestinian economic outlook is worrying and bold actions are needed by all parties to get the Palestinian economy out of its deteriorating trajectory**. The most necessary 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. An additional set of recommendations concerning Gaza development have been included based on the World Bank report to the AHLC of March 2018. The following summarizes the main developments in these pillars.

A. Fiscal Sustainability

64. **While the PA managed to reduce its spending in the first part of 2018, more needs to be done on structural reforms that are key to achieving long term fiscal sustainability.** The Ministry of Health has finalized harmonizing standard procedures for medical referrals and published them online. There was also progress on controlling health referrals with Israeli hospitals - although a recent surge in referrals to these hospitals raises doubts on the effectiveness of the measures. 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 been made on steps to control electricity net lending – although the problem is increasing 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, although these have not been formalized. Moreover, 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.

65. **A number of administrative reforms have helped support the PA's revenues in the first part of 2018, but more needs to be done.** Domestic revenue collections have performed well in 2018 possibly due to the administrative measures introduced to widen the tax base in recent years. These include measures that increased the number of registered taxpayers by more than 20,000 to more than 200,000. Nevertheless, tax avoidance is still widespread, particularly amongst high earning professionals, and the PA needs to focus efforts on this group. While the MoFP submitted to the Cabinet revisions to the income tax law restoring the top income tax bracket of 20 percent, this has not yet been implemented. Progress has however been made on updating fees and charges with a notable recent decision to increase the license fee for petrol stations.

66. **The GoI continued to make one off payments to the PA to offset fiscal leakages in 2018, but a more systematic approach to fully eliminate these losses is yet to be adopted.** In recent months the PA received a one-off payment of the equalization levy relating to West Bankers working in Israel, which covers the period back to mid-2017. It is not clear why this cannot be paid on a monthly basis. Efforts should also 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. 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 but no progress has been made.

67. **The PA is now starting to take steps to improve the public financial management (PFM) system.** A highlight is the progress on addressing the major delays in the production and audit of financial statements. The audit of the 2012 financial statements was completed in 2017, and the 2013 statements have recently been completed. The 2014 audit is underway and is expected to be completed in October 2018 at which point the audit of the 2015 statements will commence. The good progress reflects well on both the MoFP and the State Audit Bureau. The PA has also prepared its first comprehensive PFM strategy and this will guide a more active reform agenda in the coming years.

68. **Budget support from donors has stabilized in nominal terms after a long period of decline, but remains insufficient to close the large financing gap.** The decision of Saudi Arabia to resume budget support at $20 million per month has been critical at a time when other donors have been reducing, or stopping, their assistance. However, the unpredictable timing of the payments from Saudi Arabia remain a concern. As a share of GDP, budget support has fallen from 32 percent in 2008 to a projected 5 percent in 2018.

B. Economic Development

69. **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. Further progress has been made on the piloting of door to door transport through the West Bank crossings, but the scope of this activity remains limited. Also, restrictions on the movement of goods and people in and out of Gaza have not been eased, while the recent closure / reduced capacity of Karm Abu Salem has created further hardship. With respect to the movement of people and the inflow of goods, this has been partially offset by the more frequent opening of crossings into Egypt.

70. **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.** After an extended period of development, the Ministry of National Economy has submitted a revised draft of the Companies Law to the Council of Ministers. The new draft would enable major improvements in the business environment once implemented. Similarly, a draft competition law has been prepared although it has yet to be introduced. A new Board is being established to oversee the operations of the Palestinian Land Authority, which should accelerate the registration of land in Areas A and B.

71. **Recent progress in the energy sector has stalled, and more needs to be done. The interim Power Purchase Agreement (PPA) signed between the GoI and the PA has allowed the Jenin substation to be energized.** Thanks to this agreement, the Palestinian Electricity Transmission Company (PETL) has started to operate as a wholesale transmission company servicing a small part of the Northern West Bank. Also within the West Bank, new management information systems are being rolled out to the distribution companies, and with associated revenue protection measures the collections by these companies are starting to increase. However, these developments stand in contrast to the limited progress in other areas. Negotiations on the main PPA for electricity purchases by PETL from the Israeli Electricity Company (IEC) have stalled over: the composition and final tariff charged to PETL; handing over of connection Points and access for PETL to maintain the grid; and handling of illegal consumption. 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 enable large-scale renewable IPPs but also 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.

C. Gaza Reconstruction and Recovery

72. **Most physical damages after the last Gaza war have been fixed, except for housing, but recovery needs remain large and donor funds pledged at the Cairo Conference have been drying up.** 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. 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 2: Summary of World Bank recommendations to prior AHLC meetings

Actions	Responsible Party	Progress Sept, 2016	As of Sept, 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		
Develop systems for monitoring and reporting expenditure arrears	PA		
Budget support			
Provide sizeable, predictable and timely support to the PA's budget	Donors		

Actions	Responsible Party	Progress Sept, 2016	As of Sept, 2018
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 long-term recovery needs	GoI and PA		
Strengthen NORG and institutional structure for cross-sector coordination of decentralized recovery planning	PA		
Gaza Development[10]			
Streamline trade procedures at commercial crossing and expand capacity	GoI		
Expand Gaza's fishing zone	GoI		
Implement donor-financed labor-intensive projects	PA, GoI, donors		

Legend

On track

Some progress achieved

No progress

[10] These are additional recommendations that were made in the World Bank's March 2018 report to the AHLC.