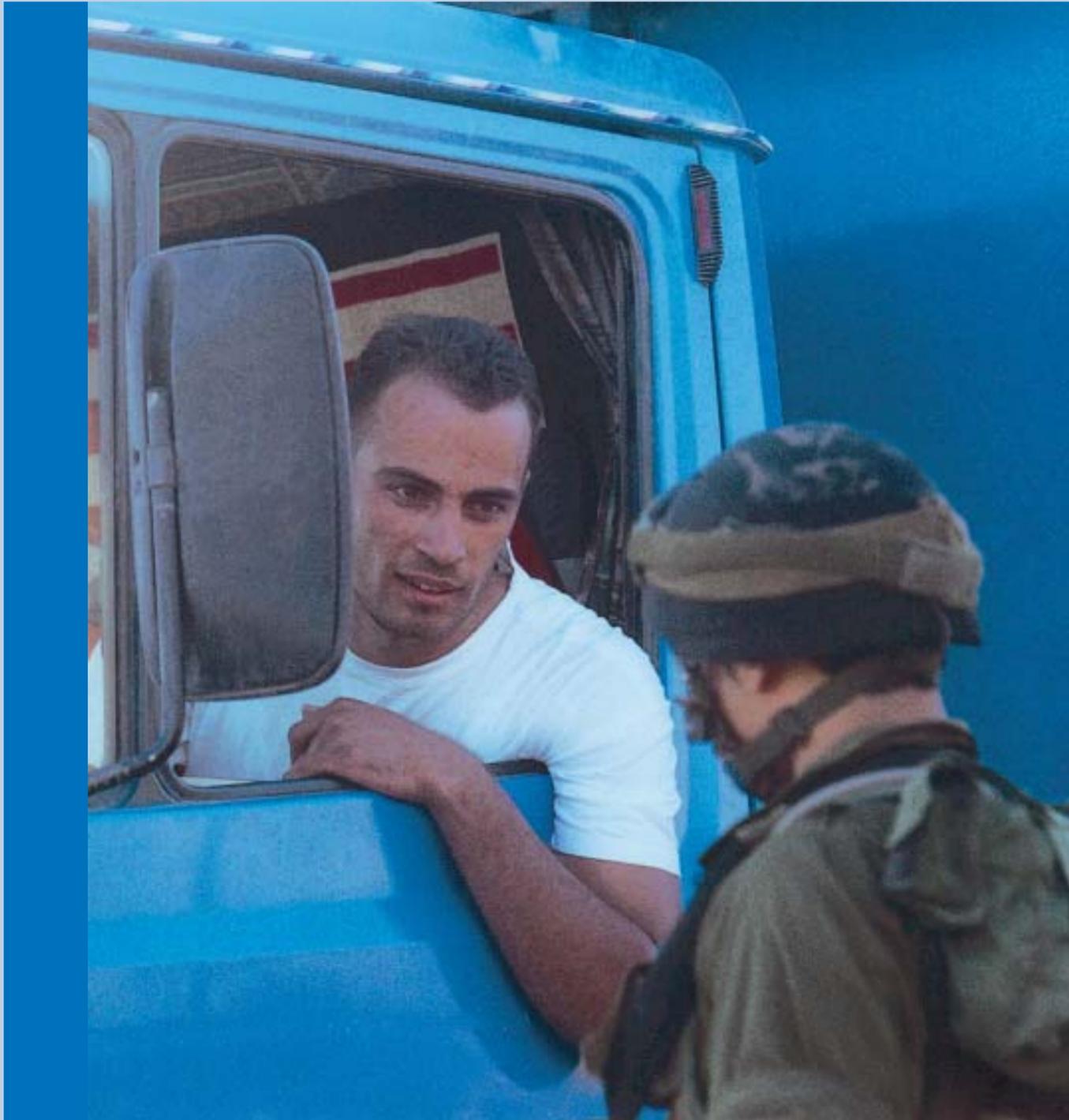




# Twenty-Seven Months - Intifada, Closures and **Palestinian Economic Crisis** An Assessment



**Twenty-Seven Months - *Intifada*, Closures  
and Palestinian Economic Crisis**

*An Assessment*

**The World Bank  
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## PREFACE

“Twenty-Seven Months -- *Intifada*, Closures and Palestinian Economic Crisis: An Assessment” has been prepared as a follow-up to a report published in March 2002 (“Fifteen Months -- *Intifada*, Closures and Palestinian Economic Crisis”). The main objectives of this second Assessment are once again to help donors and the Palestinian Authority (PA) cope with the deep economic crisis in the West Bank and Gaza, as well as to encourage and inform discussion on Palestinian economic issues among the donors, the PA and the Government of Israel. Despite an inevitable preoccupation with short-term emergency issues, the report seeks to preserve a focus on the types of medium-term economic and institutional policies that will return to prominence once the current conflict ceases to dominate the daily lives of Palestinians and Israelis.

The report has been written by the World Bank, but has benefited from significant inputs from the PA and the donor community, as well as from an internal World Bank review committee in Washington, D.C. An initial draft of the report dated February 14, 2003 was presented to a meeting of the Ad Hoc Liaison Committee (AHLC) in London on February 18-19, 2003, and a summary of this draft’s findings was shared with local and international media on March 5, 2003.

Since then, the report has been modified on the basis of corrected employment data for the Third Quarter plus new employment data for the Fourth Quarter of 2002 from the Palestinian Central Bureau of Statistics (PCBS). These data show that unemployment did not decline dramatically in the Third Quarter of 2002 as previously feared, and indeed recovered quite substantially in the Fourth Quarter.

Detailed written comments on the February 14 draft were received from a PA committee chaired by the Ministry of Planning and International Cooperation (MOPIC), as well as from DFID, USAID, UNRWA, WFP, SDC and CARE International. Five local review meetings were held in the West Bank -- one under MOPIC’s chairmanship in Ramallah, one to discuss data on malnutrition, featuring PCBS, the Johns Hopkins/Al Quds Universities Nutritional Assessment team and FAFO; one on donor assistance priorities, featuring the major donors to WBG, and two on welfare instruments, featuring UNRWA, the EC, USAID, WFP, UNSCO, ICRC, FAO and CARE International. The discussion on instruments, in particular, has led to significant changes in this final version. The report was also shared with the Government of Israel (The Ministry of Foreign Affairs and the Coordinator’s Office).

The team leader for the Assessment was Kazuki Itaya, and the team members were Sébastien Dessus and John Wetter. Staff contributions were made by Claus Astrup, Ibrahim Dajani, Sima Kanaan, Stefano Mocci and Ma’moon Sbeih. Written peer review comments were provided by Aline Coudouel, Robert Ebel and Stephen Karam. Contributions on social impact and coping strategies were provided by Francine Pickup. The photographs were taken by Susan Brannon. Final copy editing and formatting was done by Brigitte Petit. Nigel Roberts oversaw the exercise.



## ABBREVIATIONS AND ACRONYMS

BBC	British Broadcasting Corporation
COGAT	Coordinator of Government Activities in the Territories
CPI	Consumer Price Index
CU	Customs Union
DFID	Department for International Development (UK)
EC	European Commission
ECHO	European Community Humanitarian Office
ECTAO	European Commission Technical Assistance Office
ESSP	Emergency Services Support Program
EU	European Union
FAFO	Institute for Applied Social Science (Norwegian acronym)
FAO	Food and Agricultural Organization
FTA	Free Trade Area
GDP	Gross Domestic Product
DNP	Gross National Product
GHI	Government Health Insurance
GNI	Gross National Income
HEPG	Humanitarian and Emergency Policy Group
ICBS	Israeli Central Bureau of Statistics
ICRC	International Committee of Red Cross
IDB	Islamic Development Bank
IDF	Israeli Defense Forces
IFC	International Finance Corporation
IIS	Israel and Israeli Settlements
ILO	International Labour Organization
IMF	International Monetary Fund
JLC	Joint Liaison Committee
JMCC	Jerusalem Media and Communication Center
LACC	Local Aid Coordination Committee
LGU	Local Government Unit
MOA	Ministry of Agriculture
MOEHE	Ministry of Education and Higher Education
MOF	Ministry of Finance
MOFA	Ministry of Foreign Affairs
MOH	Ministry of Health
MOPIC	Ministry of Planning and International Cooperation
MOSA	Ministry of Social Affairs
NDT	Non-Discriminatory Trade
NGO	Non-Governmental Organization
NIS	New Israeli Shekel
OCHA	United Nations Office for the Coordination of Humanitarian Affairs
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PECDAR	Palestinian Economic Council for Development and Reconstruction
PFI	Palestinian Federation of Industries

PIF	Palestinian Investment Fund
PLC	Palestinian Legislative Council
PLO	Palestine Liberation Organization
PHG	Palestinian Hydrology Group
PRCS	Palestine Red Crescent Society
PWA	Palestinian Water Authority
RSG	Reform Support Group
SDC	Swiss Agency for Development and Cooperation
SHC	Special Hardship Case
STA	Single Treasury Account
TFPI	Task Force on Project Implementation
UN	United Nations
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
UNIFEM	United Nations Development Fund for Women
UNSCO	Office of the UN Special Coordinator for the Middle East Peace Process
UNRWA	UN Relief and Works Agency for Palestinian Refugees in the Near East
USAID	United States Agency for International Development
VAT	Value Added Tax
WAC	Welfare Association Consortium
WBG	West Bank and Gaza
WCLAC	Women's Center for Legal Aid and Counseling
WFP	World Food Program
WHO	World Health Organization

## SUMMARY

### THE PALESTINIAN ECONOMY IN 2002

#### Dramatic Decline, Signs of Stabilization

1. After twenty-seven months of the second Palestinian *intifada*, 1,972 Palestinians and 694 Israelis had died, and over 20,000 Palestinians and some 5,000 Israelis had been injured.<sup>1</sup> This report is written against a backdrop of death, injury, trauma and the loss of livelihoods and hope. It attempts to paint a factual picture of the state of the Palestinian economy and of the international donor effort to preserve that economy from ruin, and makes recommendations to all parties involved in the conflict.

2. The second year of the *intifada* witnessed a further steep decline in all Palestinian economic indicators. By the end of 2002, Real Gross National Income (GNI) had shrunk by 38 percent from its 1999 level. Unemployment stood at the end of 2002 at 37 percent of the workforce, after peaking at 45 percent in the Third Quarter.<sup>2</sup> With a 13 percent growth in the population of the West Bank and Gaza over the past three years, real per capita incomes are now 46 percent lower than in 1999, and poverty -- defined as those living for less than US\$2.1 dollar per day -- afflicts approximately 60 percent of the population.

3. Between September 2000 and December 2002, Palestinian exports and imports both contracted by about a third. Total investment has fallen from about US\$1.45 billion in 1999 to some US\$150 million in 2002, a decline of about 90 percent.<sup>3</sup> Raw physical damage resulting from the conflict jumped from US\$305 million at the end of 2001 to some US\$930 million by the end of 2002. If account is taken of the additional wear and tear on equipment and infrastructure, total damage climbs to about US\$1.7 billion. As a result of both damage and the fall in investment, the productive capital stock declined by US\$1 billion between 1999 and 2002 (or by 19 percent in real per capita terms).

4. Overall GNI losses reached US\$5.2 billion after 27 months of the *intifada*. Given that GNI amounted to US\$5.4 billion in 1999, the opportunity cost of the crisis was equal to almost one full year of Palestinian wealth creation.

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<sup>1</sup> Sources: Palestinian Red Crescent Society (PRCS) and B'Tselem. These numbers are updated on the following web pages: <http://www.palestinercs.org/intifadasummary.htm> and [http://www.idf.il/daily\\_statistics/english/6.gif](http://www.idf.il/daily_statistics/english/6.gif).

<sup>2</sup> Using a definition of unemployment in which those no longer seeking work are included. Under the more restrictive ILO definition of unemployment, the unemployment rate stood at 27 percent by the end of 2002, after peaking at 36 percent during the third quarter.

<sup>3</sup> In opportunity cost terms this represents a loss of US\$3.2 billion (had investment grown at the same pace as GNI was projected to in the absence of the *intifada*).

5. The Palestinian Authority (PA)'s fiscal position remains precarious. As a result of rising unemployment, reduced demand, and the withholding by the Government of Israel (GOI) of taxes collected on the PA's behalf, monthly revenues fell from some US\$91 million in late 2000 to just US\$18 million by end-2002. A collapse of the PA has been averted by emergency budget support from donor countries, which averaged US\$39 million per month through 2002 -- about half of total PA budget outlays over the period.<sup>4</sup> In this context, the recent decision by GOI to resume the monthly transfer of the PA revenues is a very important step.

6. The private sector has absorbed much of the shock to the economy. Over a quarter of the pre-*intifada* private workforce has been laid off<sup>5</sup> and real private GDP (measured at factor costs) declined by some 35 percent between 1999 and the end of 2002. Private agricultural and commercial assets have suffered over a half of all physical damage. Commercial bank credit to the private sector is drying up, and by the end of 2002 the PA owed private suppliers almost US\$200 million in unpaid bills. Although direct donor assistance to private firms has been negligible, donor disbursements have played a major role in sustaining the private sector by stimulating the demand for Palestinian goods and services.

7. The proximate cause of the Palestinian economic crisis is closure, i.e. restrictions imposed by GOI on the movement of Palestinian goods and people across borders and within the West Bank and Gaza -- restrictions which GOI view as essential to protect their citizens from violence. Closures take two major forms: internal restrictions reinforced by curfews, and external closure of the border between Israel and the Palestinian territories, including limitations on access by Palestinian workers to work in Israel and the Israeli settlements. The further sharp contraction of the Palestinian economy in 2002 resulted from the destruction, curfews and tight internal closures associated with Operation Defensive Shield and its aftermath.

8. In March/April 2002, following an escalation of violence, Israeli Defence Force (IDF) operations transformed many West Bank cities, towns and villages into restricted military zones, with residents under sustained curfew for days at a time. The movement of goods inside the West Bank has been seriously interrupted by a new "back-to-back" system, which requires all non-humanitarian goods to be off-loaded from incoming trucks and re-loaded onto local trucks at eight checkpoints near major West Bank cities. In practice, these restrictions have been applied more rigorously to manufacturers and traders attempting to move goods out of Palestinian cities than to those bringing goods in from Israel.

9. In September 2000, an estimated 128,000 Palestinians worked in Israel and the Israeli settlements.<sup>6</sup> With the outbreak of the *intifada*, GOI at first cut back heavily on the issuance of reduced work permits, but in recent months has begun to provide significant numbers once again. Some 32,000 were being issued by the end of 2002, though only about a half of these were being used. For one thing, internal closures make it hard for workers to move through the West Bank

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<sup>4</sup> A total of approximately US\$1.1 billion by the end of 2002, of which US\$738 million came from Arab League countries and US\$214 million from the EU (Source: IMF).

<sup>5</sup> Includes those working in Israel. In Q3 of 2002, the private sector provided about 42 percent less jobs than in September 2000.

<sup>6</sup> Including and estimated 22,000 Palestinians living in the East Jerusalem who are working in Israel and Israeli settlements.

and Gaza to the designated workplace. In addition, many employers have now hired foreign workers.<sup>7</sup>

10. The Fourth Quarter of 2002 witnessed a strong recovery in employment. The number of employed climbed to its highest level since the *intifada* began, giving rise to hope that the economy had adjusted to the shock of Operation Defensive Shield. An examination of the 19 percent increase in employment, however, suggests a need for caution. About half of the new jobs were in agriculture, and reflect strong seasonal demand (particularly for the olive harvest). Another one fourth were in construction and seem to be associated with a time-bound effort to repair physical damage. When assessed from the perspective of employment status, moreover, one fourth of the “new jobs” take the form of unpaid family labor.

11. It would thus be premature to think that an economic recovery is underway. Until there are signs of a real political *rapprochement*, the economy, and with it Palestinian longer-term competitive prospects, will continue to languish.

### **Averting Economic Collapse**

12. A year ago, many observers feared that the Palestinian economy was on the brink of collapse. Although battered, the economy still functions.

13. One key reason is that the PA still operates and is still able to deliver basic services. Thanks in large measure to donor budget support, 125,000 people receive a regular monthly salary and provide essential services to the population. Today the PA employs 26 percent of those still working inside the West Bank and Gaza, and pays 40 percent of all domestic wages. These wages were instrumental in supporting the livelihoods of many private employees, and made the difference between the halting survival of the domestic private sector and a far more dramatic eclipse.

14. Budget support accounted for 60 percent of an extraordinary, sustained donor effort which disbursed US\$1,026 million in 2002, after doubling from pre-*intifada* levels to US\$929 million in 2001. Donor support of all forms played an essential part in cushioning the impact of the economic shocks of 2002.

15. Another key is that Palestinian society has displayed great cohesion and resilience. Despite violence, economic hardship and the daily frustrations of living under curfew and closure, lending and sharing are widespread and families for the most part remain functional. Even with a dearth of formal safety nets, outright destitution is still limited -- those who have income generally share it with those who do not. The West Bank and Gaza has absorbed levels of unemployment that would have torn the social fabric in many other societies.

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<sup>7</sup> An informal survey of Gazans with work permits conducted by the Ministry of Economy and Trade in early 2003 suggests that approximately a half of those questioned have returned to working for their previous employer; one quarter were told by their previous employers that they had been replaced, generally with foreign workers, under contracts that have several months remaining (offering the possibility that once these contracts expire, Palestinian workers might be reemployed); and the remaining one quarter, also replaced with foreign workers, were told that they would not be rehired in the future.

## IMPACT ON ORDINARY PALESTINIANS

16. The economic crisis has seriously compromised household welfare. Many families have endured long periods without work or incomes, and despite the various employment generation efforts of the PA, donors and NGOs, many now depend on food aid for their daily survival. Coping with the situation has meant selling assets, borrowing from families, neighbors and shopkeepers and cutting consumption, including food.

17. Using a poverty line of US\$2.1 per day, the World Bank estimated that 21 percent of the Palestinian population were poor on the eve of the *intifada*, a number that increased to about 60 percent by December 2002. Accounting for population growth, the numbers of the poor have tripled, from 650,000 to 1.9 million. The poor are also getting poorer. In 1998, the average daily consumption of a poor person was equivalent to US\$1.47 per day. This has now slipped to US\$1.32. More than 75 percent of the population of the Gaza Strip are now poor. The high rate of Palestinian population growth (4.3 percent per annum) is fuelling the growth in poverty.

18. The health status of the Palestinian population has deteriorated measurably. Real per capita food consumption has dropped by up to a quarter when compared to 1998 levels. A recent survey<sup>8</sup> found that global acute malnutrition (GAM) protein-calorie malnutrition in 9.3 percent of the children across the West Bank and Gaza (13.3 percent in Gaza and 4.3 percent in the West Bank).

19. The crisis has affected different social groups differently. Adolescents are particularly vulnerable. Of an age to understand the economic hardships that their families face, but generally too young and inexperienced to be able to help much, they are particularly susceptible to trauma and to feelings of powerlessness and rage. Teachers are reporting an increase in violent behavior at school; many adolescents see no sense in continuing their education, and drop-out rates in this age group have risen markedly during the *intifada* -- although teenagers have a very limited chance of finding employment in the formal labor market. Many of these adolescents may find themselves locked into a life-long poverty trap, with poor prospects of escaping it when the economy recovers. International research shows how devastating protracted unemployment can be in patriarchal societies, and how this can translate into domestic violence. A range of social and human rights organizations working at the household level in the West Bank and Gaza have noted an increase in violence against women and children as the crisis has lengthened.

## WHAT CAN BE DONE?

20. World Bank analysis shows the limited power of donor assistance under the conditions pertaining in 2002. Since the beginning of the *intifada*, donors have provided about US\$315 per person per year, an unprecedented level of international financial commitment.<sup>9</sup> Despite the

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<sup>8</sup> *Nutritional Assessment of the West Bank and Gaza Strip*, conducted by Johns Hopkins University/Al Quds University and financed by USAID through CARE International, September 2002.

<sup>9</sup> Disbursements to WBG in 2001 and 2002 can be compared to other high-profile "post-conflict" cases such as Bosnia (US\$5.4 billion over 5 years for a population of about 5 million, or roughly US\$215 per person per year) and, more recently, East Timor (US\$350 million over 2 years for a population of about 0.5 million, or roughly US\$235 per person per year).

importance of these contributions in staving off fiscal disintegration and the disappearance of the PA as a viable service provider, the economy has contracted by almost a half. A doubling of donor disbursements to US\$2 billion in 2003 and 2004 -- something which there is no reason to believe can happen -- would only reduce the poverty rate by seven percentage points by the end of 2004.<sup>10</sup> On the other hand, if internal closures were removed and exports facilitated, GDP could surge by about 21 percent in 2003 and poverty could fall by fifteen percentage points by the end of 2004.<sup>11</sup> The point is clear: it is politics that determine the health of the Palestinian economy, and in an adverse political climate all donors have been able to do is slow the rate of economic decline.

21. Israel is also paying a heavy economic price. The Israeli economy has experienced a 9 percent decline in real GDP per capita between September 2000 and December 2002, and the Bank of Israel recently estimated that the costs to the Israeli economy of the *intifada* in 2002 amounted to between US\$3 and US\$3.6 billion, a figure well in excess of total Palestinian economic losses in the period, but still comparatively modest when viewed in relation to the overall size of the Israeli economy of about US\$100 billion.

22. A return to a political process is indispensable for the resumption of economic and social development in both Israel and the Palestinian territories.

### **Recommendation to the Palestinian Authority**

23. The main service providers -- the Ministries of Health and Education and the municipalities -- have maintained a basic network of sound public services in an environment beset by curfews, closures, periodic violence and severe fiscal compression. These institutions have continued to do their job thanks to the commitment of thousands of Palestinians who work in schools, clinics and municipal service departments, supported in the field by the UN system (in particular UNRWA) and by Palestinian and international NGOs.

24. At a strategic level, however, the PA has not managed to communicate to the public how it is coping with the crisis. Partly as a result of this, the PA's emergency efforts are undervalued by Palestinians. The PA needs to formulate a clear economic plan, and to use the process of plan preparation to energize a collective social effort to cope with the crisis.

25. A key difference from a year ago is the PA's adoption of a serious program of reform. The PA Reform program aims to weed out corruption by enforcing full fiscal accountability, to create a predictable and transparent legal environment, and to build a modern, merit-based civil service. The PA's Ministerial Committee on Reform has committed itself wholeheartedly to the cause. Considerable progress has been made in some areas, in particular the management of the PA's finances -- in spite of strong resistance from entrenched interests. Much has been done to repair the credibility of the PA in the eyes of the international community. That said, there is now no way back -- having acknowledged the need to combat corruption and to transform itself into a democratic, modern and accountable instrument of statehood, the PA must deliver a successful reform program or lose both domestic and international legitimacy.

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<sup>10</sup> This is in part because closures dampen the ability of foreign assistance to raise real incomes, with most of the funding translating into imports and inflation rather than domestic production.

<sup>11</sup> Assuming unchanged donor disbursements.

## Recommendations to the Donors

26. The World Bank estimates that donors so far have committed US\$1,274 million and will likely disburse about US\$919 million in 2003. These sums fall some way short of the US\$1,527 million committed and US\$1,026 million disbursed in 2002.

27. Significant shortfalls against needs can be identified in a number of areas. Particular mention should be made of

- Budget Support for the PA (excluding local governments) -- in 2002 a total of US\$464 million was disbursed against the PA budget. A realistic appraisal of donor intentions suggests that disbursements of about US\$400 million are likely this year, evidencing some donor fatigue in this area.<sup>12</sup> The PA has estimated its external budget support requirements for 2003 at US\$535 million, even with regular monthly revenue transfers by GOI. Donors are urged to do what they can to support the PA budget in 2003, and thereby to ensure that adequate basic public services can be provided. Donors currently concerned about the fungibility of general budget support, moreover, should be reassured by GOI's willingness to resume revenue transfers.
- Support for UNRWA's programs -- UNRWA is responsible for basic service provision to 1.5 million registered refugees in WBG, or almost half of the population, and is entirely dependent on donor contributions. In 2002, UNRWA disbursed US\$220 million in WBG (regular budget plus emergency appeals). At the time of writing, UNRWA is projecting a financing gap of US\$61 million shortfall to its US\$94 million Fifth Emergency Appeal. The need for additional support is urgent.

28. At the request of donors, an annex to this report discusses the relative merits, from the macro-economic and welfare perspectives, of four donor assistance instruments -- budget support, food aid, cash assistance and job creation programs. The report argues that budget support has been the most important instrument of financial support provided during the *intifada*, and that it has high economic and welfare benefits. It is also clear that each of the other three instruments has played a useful and complementary role. Despite lingering questions about its negative impact on agricultural GDP, food aid has supported depressed incomes, as well as having particular value for communities and social groups vulnerable to nutritional stress. The cash schemes operated by the Ministry of Social Affairs and UNRWA are well-targeted but under-funded, and can be expanded. The voucher (quasi-cash) scheme introduced by ICRC shows promise, and should be evaluated with a view to further expansion. Job creation programs are a relatively inefficient way of transferring funds to beneficiaries, but confer greater dignity than food aid, cash or voucher schemes. They need to be designed to better maximize labor content and the use of local materials, and to broaden their employment base beyond male construction workers.

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<sup>12</sup> The report details the difficulties associated with the burden-sharing formula adopted by the Arab League Summit in Beirut in March 2002, as well as the concerns expressed by European parliamentarians that EU budget contributions may have been diverted to fund attacks on Israelis. The report also points to the fact that GOI has resumed revenue clearances as an important sign to donors of growing Israeli confidence in the way that the PA's finances are now managed.

29. It is clear that donors have not abandoned their medium-term development programs, and aid indications in these areas for 2003 are higher than at any previous point in the *intifada*.<sup>13</sup> This suggests that donors perceive that there is a real possibility of a political break-through in 2003, and that they are gearing themselves up accordingly. If these plans can be realized, they will arrest the worrying decline in donor developmental expenditures.

### **Recommendations to the Government of Israel**

30. The actions of the Government of Israel will have greater direct bearing on the Palestinian economy in 2003 than the economic policies of the PA or the activities of donors. The *sine qua non* of economic stability and recovery is the lifting of closure in its various forms, and in particular *internal* closure. As long as Palestinian internal economic space remains as fragmented as it is today, and as long as the economy remains subject to extreme unpredictability and burdensome transaction costs, the revival of domestic economic activity will remain a distant prospect, and Palestinian welfare will continue to decay.

31. Israel's legitimate right to defend its citizens from attack is not at issue, but nor should the specific applications of closure be seen as beyond well-intentioned discussion. There is room for a more open debate on those aspects of closure that do, or do not, protect Israeli security. The challenge is to find ways of maintaining Israeli security without stifling the Palestinian economy and impairing the livelihoods of ordinary Palestinians.

32. GOI's decision in December 2002 to resume the transfer of the PA's monthly clearance revenues is an important and commendable initiative. If these flows (averaging US\$35 million per month over the first quarter 2003, according to the IMF) continue on a regular basis and are segregated from day-to-day political pressures, they will play a vital part in stabilizing the Palestinian economy. GOI's continued repayment of the stock of withheld arrears<sup>14</sup> will in addition permit the PA to clear its debts to the domestic private sector and the Palestinian pension system, both of which steps are very important to its internal credibility.

33. The recent increase in the number of permits issued to Palestinians for work in Israel and the settlements is also very positive.

34. Donors need GOI to do more to facilitate the work of humanitarian agencies, be they donor, UN or NGO. The report describes the intensified relationship between donors and GOI in the context of the Task Force on Project Implementation (TFPI), and remarks on the collegial working relationships developed between TFPI donors and the Office of the Coordinator for the Occupied Territories (COGAT). But the report also points to significant disconnects between commitments provided to donors by COGAT and the actions of IDF soldiers on the ground.

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<sup>13</sup> Commitments to infrastructure and capacity-building work with a medium-term focus fell from US\$482 million in 1999 to US\$279 million in 2001 and to US\$197 million in 2002. In 2000, the ratio between development and emergency assistance was approximately 7:1 in favor of development assistance. By 2002, the ratio had shifted to almost 5:1 in favor of emergency assistance. Although overall commitments increased by 57 percent in the period, development assistance declined by 70 percent, while emergency assistance increased by a factor of 10. For 2003, however, infrastructure and capacity-building commitments are currently estimated at US\$548 million, and potential disbursements at US\$245 million.

<sup>14</sup> Since January 2003, the GOI is repaying every month NIS100 million (approximately \$21 million) from the withheld stock, of which an estimated NIS2.2 billion remained owing to the PA in December 2002 (Source: IMF).

This not only undermines the efficiency of the humanitarian effort, but also exposes aid staff to appreciable physical danger. Donors have also pointed out in strong terms the need for the IDF to avoid further destruction of donor-financed infrastructure and project facilities.<sup>15</sup>

35. Donors have also asked GOI to permit freedom of movement for the Palestinian officials and parliamentarians critical to the implementation of Palestinian reform, consistent with Israel's own call for the reform of the PA. In addition, it is important that GOI facilitate regular meetings of the Palestinian Legislative Council to enable the passage of critical reform legislation and to permit oversight of the reform process.

## LOOKING AHEAD

36. While any short-term recovery will depend on the lifting of closures, this will not suffice to put the Palestinian economy onto a sustainable growth path. The *de facto* customs union with Israel formalized under the Paris Protocol makes the Palestinian economy particularly vulnerable to closure. In a structural sense, though, the long-term growth potential of the Palestinian economy has been stunted by the upward pressure on domestic Palestinian labor prices created by the wages paid to Palestinian workers in Israel. Domestic wage increases have exceeded underlying growth in productivity, and have undermined Palestinians' ability to export competitively-priced goods to the rest of the world. Bank analysis shows that a proactive policy of export development, in which a more open and less discriminatory trade regime is adopted, should result in higher incomes by 2010 than a return to previous levels of employment in Israel.

37. Between 1968 and 2000, Palestinians in the West Bank and Gaza pursued a development strategy which featured the export of labor rather than goods. In June 2000, three months before the current Palestinian *intifada* began, 21 percent of all employed Palestinians worked in Israel, mainly in low-skilled construction and agricultural jobs. Net incomes from abroad provided more than 21 percent of Palestinian GNI, making it one of the most remittance-dependent economies in the world. This is why the loss of jobs in Israel in the past two years has had such a strong impact. Put another way, the *intifada* has demonstrated the vulnerability of a development strategy, which relied so heavily on labor exports to Israel.

38. The shift to a goods-based export policy would take time, would be subject to many uncertainties and would require the active cooperation of Israel to succeed; it is thus part and parcel of a political *rapprochement*. It is also true that restoring access to the Israeli labor market would be the quickest way to boost incomes for a large number of ordinary Palestinians. Realistically, though, a return to pre-September 2000 employment levels for Palestinians in Israel seems unlikely -- and would anyway risk perpetuating a high level of Palestinian economic dependence on Israel, hindering the emergence of a diversified development strategy with much greater long-term growth potential.

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<sup>15</sup> The World Bank estimates that some US\$150 million in damage to donor-financed infrastructure and project facilities has taken place since September 2000.





## 1. CLOSURE AND CURFEW

1.1 The term “closure” refers to the restrictions placed by Israel for security reasons on the free movement of Palestinian goods and labor across borders and within the West Bank and Gaza. These restrictions take three basic forms: (i) internal closure within the West Bank and the Gaza Strip, reinforced by curfews; (ii) external closure of the border between Israel and the West Bank and between Israel and the Gaza Strip; and (iii) the external closing of international crossings between the West Bank and Jordan, and between Gaza and Egypt. The withholding of Palestinian tax revenues collected on behalf of the PA by the Government of Israel can also be considered a form of closure.

### INTERNAL CLOSURE

1.2 The development of a dense network of fixed and moving (“flying”) military checkpoints has been characteristic of the entire *intifada* period. In addition to this extensive system, numbering some 140 checkpoints in the West Bank and 25-30 in Gaza, there are another 200 or so unmanned roadblocks. Under “severe closure”, pedestrian and vehicle mobility on main roads is reserved for Israeli military personnel, settlers, and non-Palestinians; during periods of “partial” internal closure, Palestinians still face considerable delays and frequent harassment, and must often resort to using roundabout routes over fields or unpaved roads. The latter half of 2002 also witnessed the introduction of permit requirements for internal West Bank movement. As previously documented, such interruptions in routine business, commerce, and social intercourse have had profound effect on economic and social life, including in the more remote areas where links between villages and urban areas were often cut.

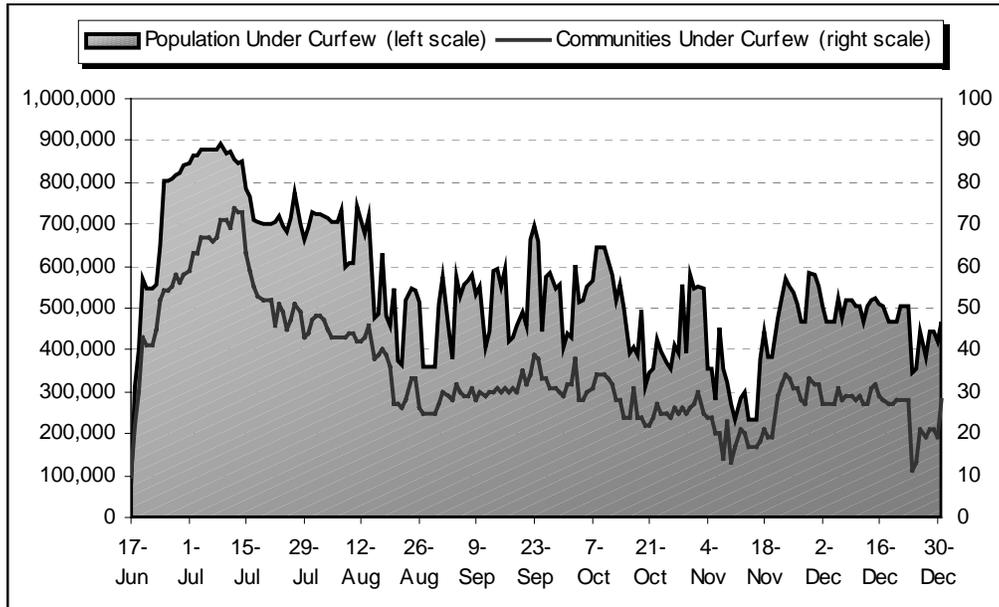
1.3 **Curfew.** In spring 2002, following an escalation of violence, the Israeli Defense Forces (IDF) launched Operations “Defensive Shield” (March 29, 2002) and “Determined Path” (June 18, 2002). IDF operations transformed many West Bank cities, towns and villages into restricted military zones, with residents under sustained (often 24-hour) curfew for days at a time. At times, nearly 900,000 West Bank residents in 74 communities were under curfew, and on average during the six-and-a-half month period between June 17 and December 31, 2002, 37 localities and 547,000 persons were directly affected. Nablus was the most severely impacted, with curfews in force for all or part of every day in the period (197 days from June 21, during which curfew was lifted for 1,069 out of 4,656 hours, see Figure 1).<sup>16</sup> Other towns significantly affected were Tulkarem (189 day of curfews), Jenin (141 days) and Qalqilya (112 days) in the northwest, Ramallah (138 days) in the central West Bank, and Hebron (140 days) and Bethlehem (97 days) in the south. Jericho alone among major West Bank urban areas avoided curfew, but like all parts of the West Bank suffered from the intensification of movement restrictions.

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<sup>16</sup> Curfew hours are taken from Palestinian Red Crescent Society sources. PRCS reports number of hours that curfews have been in effect or have been lifted for seven major West Bank cities. The PRCS database begins on June 18, 2002.

Within the Gaza Strip, closures have often effectively divided the territory into three areas (Gaza City, the environs of Jabalia, and Khan Yunis/Rafah), severely disrupting north-south travel. Although ambulances are generally permitted to operate during curfews and a limited number of permits have been granted to municipal workers for conducting emergency repairs, commercial activities virtually halt during curfews.

**Figure 1: The West Bank under Curfew, June 17 – December 31, 2002**



Source: OCHA Humanitarian Information Center, Curfew Monitoring Database.

1.4 ***Movement of Goods within WBG.*** The internal movement of goods in the West Bank was seriously interrupted in the West Bank during Operation Defensive Shield. In May 2002, the extension of the "back-to-back" system was announced -- according to which all non-humanitarian goods must be off-loaded from incoming trucks and then re-loaded onto local trucks at eight checkpoint locations near major West Bank cities under the supervision of the IDF. In practice, UNSCO and Bank staff observations suggest an erratic implementation of this policy. The difficulties and delays associated with moving goods between West Bank cities seem to bear more on manufacturers and traders attempting to move goods *out* of Palestinian cities than on those bringing goods *in* from Israeli suppliers.

## EXTERNAL CLOSURE

1.5 From the beginning of the *intifada*, the permit system applicable to Palestinians wishing to enter or transit through Israel was considerably tightened. Permits were frequently cancelled and border crossings sealed, greatly reducing employment in Israel as well as commercial transactions with or through Israel. These restrictions were further tightened in the context of Operations Defensive Shield and Determined Path.

1.6 ***Work Permits and Employment.*** Even with the introduction of travel permits during the first *intifada*, Palestinian employment in Israel remained significant prior to the institution of closure policies in 1993. Until 1992, more than one-third of the Palestinian workforce -- approximately 160,000 workers, of whom roughly 120,000 were permit holders -- found

employment inside the Israeli labor market.<sup>17</sup> On the eve of the *intifada*, an estimated 128,000 Palestinians worked in Israel and the Israeli settlements (IIS), representing 21 percent of Palestinian employment and accounting for about 21 percent of Palestinian incomes. According to PCBS, after an initial contraction to about 25,000 in the first three months of the *intifada*, the number of workers in IIS held relatively steady throughout 2001 at about 51,000 (with and without permits).

1.7 All Palestinian work permits were suspended at the end of March for a period of several weeks, particularly affecting Gaza (given the lack of border porosity/unofficial labor flows). In recent months, however, GOI has taken steps to issue considerable numbers of permits once again, reportedly issuing a daily total of up to 32,400 by year's end.<sup>18</sup> By no means are all of these taken up, however, as internal closures can make it prohibitively difficult for workers to reach the Green Line. In addition, the demand for Palestinian workers in Israel remains significantly depressed in light of the conflict and due to their gradual replacement by other foreign workers. The total number of Palestinians working in IIS, with *and* without permits, declined to 39,000 in the first quarter (Q1) of 2002 and to 21,000 by mid-2002. Since then, numbers have picked up somewhat and averaged 35,000 in the July-December 2002 period.

1.8 ***Movement of Goods between Israel and WBG.*** Restrictions on the movement of goods to and from WBG and Israel remained considerable throughout the period under review, with delays at Karni passage in Gaza and Allenby bridge often experienced. Inconsistencies in the limited data available prevent quantitative comparison with pre-*intifada* levels, although it appears that the number of trucks transiting Karni, stable at around 400 daily during the period August-November 2002, climbed in December to approximately 500. Commercial truck movements to and from the West Bank and Israel have fallen by as much as 50 percent when compared to the pre-Defensive Shield period. Generally, trucks bearing humanitarian cargo or raw materials for donor projects and driven by international drivers or residents of East Jerusalem are allowed easier passage. A limited number of permits have been granted for Israeli trucks bearing goods such as milk and medicine without being subject to back-to-back controls, as well as for Israeli trucks carrying stone products from Bethlehem into Israel. At times of heightened security concerns, restrictions are placed on these trucks as well.

1.9 ***External Closure: Between the West Bank and Gaza; with the Rest of the World.*** The "Safe Passage" route, designed to allow Palestinians to move relatively freely between the West Bank and Gaza, was closed by the Israeli authorities on October 6, 2000 after nearly a year of operation, and has not reopened. Border closures with neighboring countries meant that both passenger and commercial traffic through international crossings remained heavily restricted. According to data collected by the Israeli Airports Authority, the number of Palestinians crossing Israel's land borders fell by 28 percent in the period between January and October 2002.

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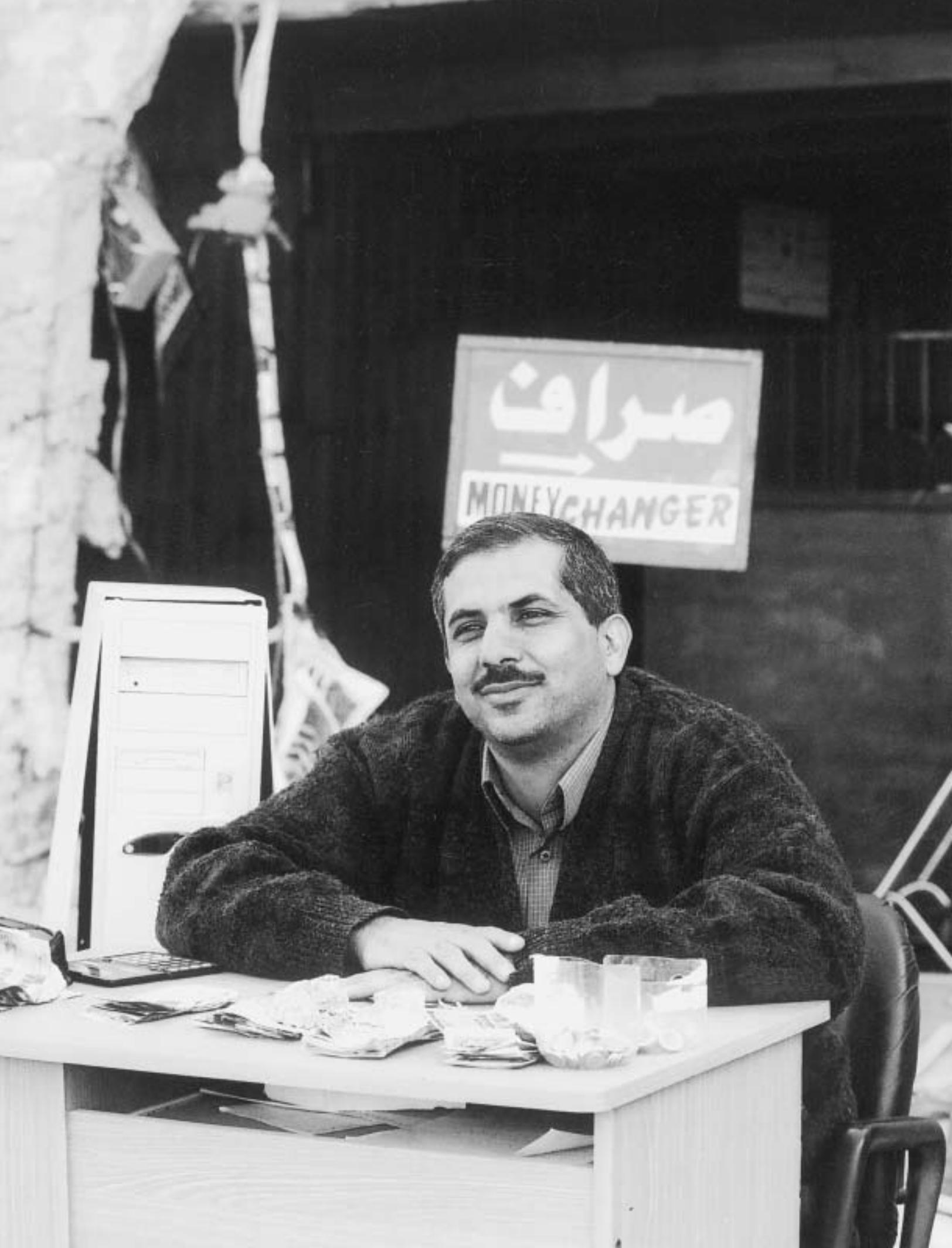
<sup>17</sup> Jerusalem Media and Communications Center, *Israeli Obstacles to Economic Development in the Occupied Territories*, 2<sup>nd</sup> Edition, April 1994, cited in *Palestinian Workers Exploited and Israeli Economic Oppression: The Case of Settlement Workers -- Palestinian Workers in Israeli Settlements in the West Bank and Gaza Strip*, Palestinian Society for the Protection of Human Rights and the Environment (LAW), August 2000.

<sup>18</sup> Gaza work permit information for the period March-September 2002 is taken from the OCHA Humanitarian Update -- Gaza Strip, and from OCHA *Weekly Humanitarian Update*, various issues. Work permit information for Gaza and the West Bank for the period August-December 2002 is taken mainly from relevant weekly reports of the Office of the Coordinator of Government Activities in the Territories (COGAT).

**Table 1: Closure Systems Compared**

Previous system	New system (Post Operation Defensive Shield)
<i>For Palestinians (including Palestinian staff of donor organizations)</i>	
Permits required for travel between West Bank and Jerusalem/Israel	No travel between West Bank and Jerusalem/Israel Exceptions: <ul style="list-style-type: none"> <li>• WB to Israel: limited number of vital staff members after security clearance</li> <li>• Israel to WB: total of 20 donors' drivers with Israeli ID to be given permit for travel to WB.</li> </ul>
No permits required for travel within the West Bank (movement was restricted but possible)	Permits required for travel within the West Bank between major cities
Free movement for Palestinians within the Gaza strip (although at times restricted at major checkpoints)	Movement for Palestinians across major checkpoints at times of heightened security only if accompanied by international staff (maximum of three in car with one international staff member)
<i>For project materials and aid commodities</i>	
Back-to-back system in place, in limited form and few locations and only for transport of goods across the Green Line	Full implementation of back-to-back system for transport of goods across the Green Line as well as between cities in the West Bank
Humanitarian and project goods transported to Gaza through Karni without prior coordination	Only humanitarian goods allowed through Karni, project related goods allowed on a case-by-case basis and after prior consultation
Transport of goods to West Bank allowed but at times restricted at checkpoints	Transport of goods to West Bank allowed only in trucks with white plates and driven by international drivers.





## 2. ECONOMIC AND SOCIAL IMPACT

### ECONOMIC IMPACT

2.1 In “Fifteen Months -- *Intifada*, Closures and Palestinian Economic Crisis” the World Bank described a Palestinian economy under tremendous external pressure, with closure the main force in its decline. The report painted a picture of a society increasingly deprived of work, and suffering rapid impoverishment. Already by December 2001, real Gross Domestic Product (GDP) per capita had declined by 19.5 percent compared with a year before, and real Gross National Income (GNI) per capita by over 23 percent.<sup>19</sup> Unemployment had risen from 10 percent of the workforce in September 2000 to 26 percent, and the level of poverty from 21 percent to about 46 percent of the population within the same period. Overall damage to the economy during the first fifteen months of the *intifada* was estimated at US\$2.4 billion in real GNI terms, raw physical damage at US\$300 million and lost investment opportunities at US\$1.2 billion.

2.2 In projecting the possible course of events in 2002, the Bank used a range of economic scenarios. The most pessimistic of these (short of an outright collapse of the PA) assumed a significant further tightening of the closure regime. The resultant outcome was not considered sustainable “in any conventional sense, and would lead in all probability to a gradual fragmentation and dissolution of normal civil governance, capital flight and a reversion from modern business activity into barter trade and subsistence farming. Donor fiduciary standards would become harder to maintain. Dependence on food aid would grow, as under such conditions a monetized economy has decreasing relevance for many (thus dampening the impact of many conventional donor contributions). Unemployment could climb to over 40 percent by the end of 2002, poverty rates could reach 60 percent of the population, and GNI per capita could fall another 30 percent, to only half the pre-intifada level. Considerable physical damage and a dramatic drop in investment would significantly reduce the stock of productive assets, and in turn the ability of the Palestinian economy to recover when the crisis eventually ends”.

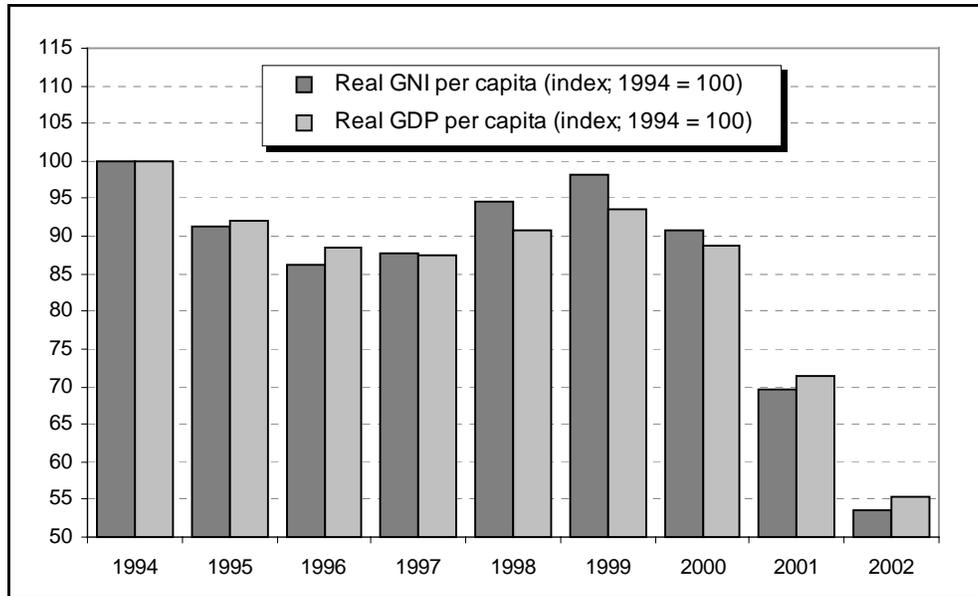
2.3 This scenario, sadly, has proven close to the mark. Real GDP per capita fell an estimated 19 percent in 2002, and real GNI per capita fell by 23 percent. Real GNI per capita was in 2002 some 46 percent lower than in 1999, while unemployment stood at 27 percent in December 2002 after peaking at 36 percent in Q3/2002. If those not seeking work (“discouraged workers”) are included, unemployment at the end of 2002 stood at 37 percent of the workforce. Poverty now afflicts some 60 percent of the population. Overall GNI losses have reached some US\$5.2 billion in 27 months -- when one considers that GNI was estimated at US\$5.4 billion in 1999, the opportunity cost of the crisis represents almost one entire year of Palestinian wealth

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<sup>19</sup> Gross National Income (total income earned by a country’s residents) is Gross Domestic Product (total income earned within the country) plus net factor income (positive or negative) coming from abroad. In WBG net factor income is positive and consists mostly of Palestinian workers’ remittances from Israel.

creation. Cumulated raw physical damage has jumped in the last year to some US\$930 million, and lost investment to US\$3.2 billion.<sup>20</sup>

**Figure 2: Real GNI and GDP per Capita, 1994-2002**



Source: World Bank staff calculations. Data excludes East Jerusalem.

2.4 The health status of the Palestinian population has also deteriorated measurably. Real per capita food consumption has dropped by up to 25 percent since 1998, and the prevalence of acute malnutrition recently observed in Gaza, 13.3 percent,<sup>21</sup> constitutes an emergency with serious long-term implications for Palestinian health and development. Unsanitary conditions in urban areas are the norm, with broken sewerage lines common and garbage scattered through the streets. As the incidence of diarrhea and parasitic disease rises, health services are poorly positioned to respond, compromised as they are by a fearsome operating environment and declining resources. Likewise, education has been frequently interrupted and high levels of distraction and shortages of funds for equipment and textbooks have affected the quality of instruction at all levels. More than the loss of income and capital stock *per se*, the damage to the psychosocial environment in which Palestinian children are growing up will take years to reverse.

2.5 It is again worth stressing that the bulk of Palestinian economic losses stem from closure and curfew. In a crude sense, GNI losses outweigh those from physical damage by a factor of over 5:1, even if raw physical damage is adjusted upwards to take account of the more rapid depreciation of the capital stock under today's harsh operating environment (see para. 2.32). With the utilization rate of productive capacity now so diminished, the destruction of physical capital has had relatively little effect on output. Even assuming *no* physical damage, GNI losses

<sup>20</sup> Lost investment is here defined as the gap between what investments might have been in the absence of conflict (assuming investments grew at the same pace as projected GNI), and actual investment.

<sup>21</sup> *Nutritional Assessment of the West Bank and Gaza Strip*, conducted by Johns Hopkins University/Al Quds University and financed by UNAID through CARE International (September 2002).

from closure and curfew would still amount to some US\$5.0 billion of an estimated total of US\$5.2 billion.

2.6 In “Fifteen Months”, the initial sharp shock of the first three months of the *intifada* was followed by a slower rate of decline in 2001 -- as a result of the clandestine restoration of significant numbers of jobs in Israel, effective household coping strategies and the combined efforts of the PA, donors and NGOs. In particular, donor budgetary support maintained public employment and thereby a minimum level of economic demand. Operation Defensive Shield and its aftermath of restrictions amounted to a second major shock to the weakened Palestinian economy, resulting in the loss of another 45,000 jobs in the following two quarters (almost 10 percent of the jobs available in March). Though further compromised, the economy, the PA and Palestinian social structures have not disintegrated, and in this sense the dire predictions of many observers have not been fulfilled. In the last quarter, moreover, employment rebounded and 83,000 jobs were restored (see para. 2.16).

2.7 Even deeper crisis was averted by a combination of social resilience and a sustained effort of donor support. Particularly critical has been donor support for PA salaries. In 2002 it is estimated that donors contributed some 50 percent of all PA salary payments.<sup>22</sup> At the end of December 2002, PA employment accounted for 26 percent of total Palestinian employment (against 17 percent on the eve of the *intifada*), and 20 percent of all Palestinian income (40 percent of total wage income in the West Bank and Gaza). Without budget support the PA might have ceased to function, and public welfare would have sunk to much lower levels.

2.8 The deteriorating social indicators, though, demonstrate that there is no room for complacency. There is also worrying evidence in recent months that the regular flow of budget support which characterized much of 2001 and the early months of 2002 may be hard to sustain. Even with a political breakthrough and a rapid roll-back of closure, World Bank projections indicate that a return to pre-*intifada* income and poverty levels will not occur in the foreseeable future. Nonetheless, a drastic relaxation of closure remains the key to any significant short-term economic recovery.

2.9 The *intifada* continues to damage the Israeli economy as well. The Israeli Central Bureau of Statistics (ICBS) estimates that the Israeli economy has been in recession for the last two years. This is the first time the Israeli economy has experienced two consecutive years of negative growth. Real GDP dropped by 0.9 percent in 2001 and by 1.0 percent in 2002. As the Israeli population has grown by 4.5 percent during the *intifada*, the country has experienced a decline of 9 percent in real GDP per capita between September 2000 and December 2002.

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<sup>22</sup> PA budget support from donors has not been allocated formally to any particular public expenditure line; however, it provided 57 percent of the PA’s *cash* expenditures (commitments minus net accumulation of arrears) in the 2002 Budget, and ensured that the PA’s top fiscal priority -- the payment of salaries -- could be met (salaries accounted for 78 percent of the Budget’s cash expenditures).

### Box 1: How Long Can This Go On?

At various times during the past two years, observers have expressed their fear that the Palestinian economy is on the brink of collapse. The Bank itself, for example, in "Fifteen Months" wrote of the prospect of the economy "unraveling" if closures were further tightened (as they have been), as well as pointing out that household savings would likely be exhausted by the spring of 2002, even under a *status quo* scenario less detrimental to economic activity than what occurred. FAFO in early 2001, in its study of coping strategies in the villages of Rantis and Beit Furik, suggested that the systems of informal credit from family, friends and shopkeepers were "in danger of breaking down" unless conditions improved. And yet, while all key economic indicators have continued to deteriorate dramatically, the economy clearly did not collapse.

There are several points worth making here. The first is the tendency to use loose terminology when appraising economic stress. To speak of 'collapse' conjures up images of falling buildings. This metaphor is usually too absolute to describe what happens to economies, which consist of networks of transactions rather than physical structures. It is true that certain *components* of economies do at times collapse -- most notoriously, banking and financial systems (though one of the interesting phenomena in WBG is the relative strength of the financial system). In the WBG case, several components do now appear close to breakdown (e.g., the informal networks of shopkeeper credit), or to have already disintegrated (e.g. Palestinian agro-industrial exports). The sub-system that would most certainly have 'collapsed' without external intervention is the central government fiscal system, where the payment of PA salaries has only been possible for the last two years because of donor budget support. Had this failed to materialize, the PA would probably have ceased to function, leading to a widespread breakdown of basic social services as well as to unemployment of stunning proportions. A cessation of salary payments to the PA remains the most critical threat to sustaining a modicum of economic order in the West Bank and Gaza.

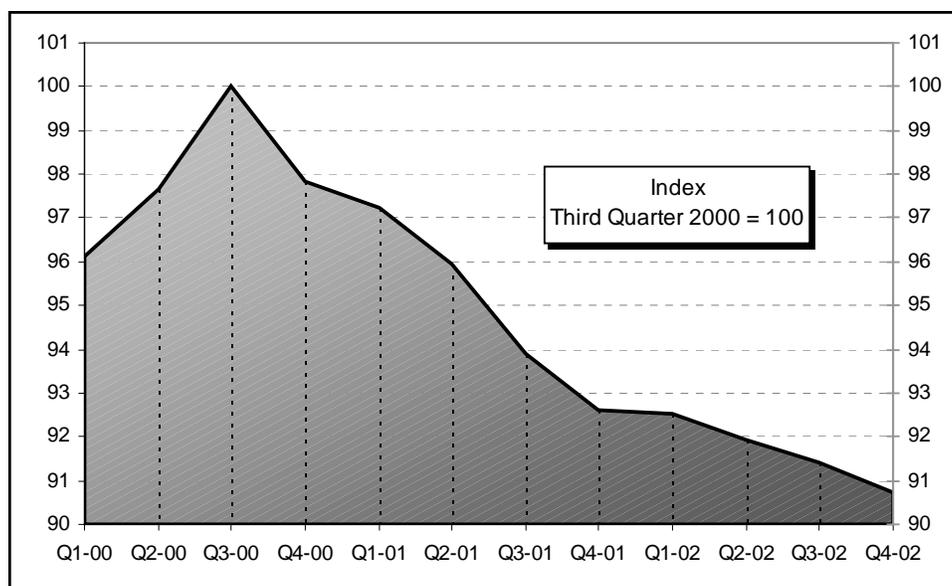
It is also relevant to ask whether the nature of the damage inflicted on an economy can be said to have pushed it to a point at which the damage is irreversible. In the Palestinian case, there are two particular forms of damage that warrant such a question. The first is the damage to investor confidence, particularly with the initial windfall of repatriated Palestinian savings a thing of the past. The second is the damage to human capital. Economic history (e.g. Barro, R. and X. Sala-I-Martin (1995), *Economic Growth*, McGraw-Hill, New-York) tells us that the effects from damage to human capital are more lasting than from simple material destruction. The logic is simple: a road can always be rebuilt, and often better and more cheaply, provided that the know-how associated with its construction is not lost. Death, injury, psychological impairment, malnutrition, school dropout and the emigration of skilled labor can have irreversible consequences at the level of individual families, while the sale by households of their assets (particularly at discounted prices) can propel them into poverty traps that in turn lead to risky or unsustainable behavior. In WBG, though, such impacts are still modest when compared to the traumas experienced in this century in, say, Russia and China, or in modern times by Vietnam or Rwanda. The overall impression created on those working in support of the Palestinians is still one of social resilience, characterized by a high willingness to share and an ability to adapt -- though the disruption of social relations and institutions associated with this *intifada* period could yet turn out to impair Palestinian efforts to develop a competitive industrial culture once the current phase of conflict has passed.

2.10 The Bank of Israel has recently estimated that losses to the Israeli economy as a result of the *intifada* in 2002 amounted to US\$3.1-3.9 billion<sup>23</sup> due to the climate of uncertainty and insecurity. Compared to 2001, overall real fixed investment declined by 8.5 percent (non-

<sup>23</sup> Bank of Israel Annual Report, 2002 (preliminary version), Chapter 1 *The Economy: Developments and Policies*, Central Bank of Israel Research Department, available on Bank of Israel website. "In its first year, the *Intifada* hit mainly tourism, construction, agriculture, and exports to the Territories. Its effects expanded to other areas in 2002, among them private consumption, in the wake of the entrenchment of individuals' assessments that the *Intifada* was not a passing phase, but an ongoing situation with far-reaching repercussions on income and taxes, adding up to a fall in permanent disposable income...The *Intifada* caused the loss of between 3.0 and 3.8 percent of GDP in 2002 measured against a benchmark scenario in which it would end in 2001...This loss exceeds that incurred due to the slowdown in world trade, and the slump in the high-tech industry in particular" (page 3). The Bank of Israel estimates 2002 GDP at US\$102.5 billion.

residential real fixed investment fell by 9.3 percent); exports (excluding diamonds) fell 8.0 percent; tourism receipts 2.1 percent; and private consumption 0.5 percent (2.5 percent on a per capita basis). Direct investment in Israel by nonresidents declined by 53.1 percent (from US\$3.2 billion to US\$1.5 billion), and portfolio investment in Israel by nonresidents by 42.9 percent (from US\$0.7 billion to US\$0.4 billion). Inflation during 2002 reached 6.5 percent, and unemployment increased to 10.3 percent of the workforce. The overall public sector deficit climbed from 2.0 percent of GDP in 2000 to 4.0 percent in 2001 and 4.4 percent in 2002.<sup>24</sup>

**Figure 3: Per Capita Real GDP Index, Israel (Index 100 = Q3 2000)**



Source: World Bank's staff calculations based on ICBS. Data seasonally adjusted.

## Employment

2.11 To understand the employment dynamic in the West Bank and Gaza, it is important to see how the availability of work in Israel and Israeli settlements (IIS) interacts with the domestic Palestinian private labor market. The labor markets for Palestinians in IIS is highly volatile. Most jobs are low-skilled and cyclical in nature (mainly in agriculture and construction), many are clandestine (and thus not protected by Israeli labor regulations) and all are affected by closure. The health of the Israeli job market has a pronounced impact on private sector employment in the West Bank and Gaza: workers' remittances from Israel represented some 21 percent of disposable Palestinian income in 2000, increasing the demand for goods and services within the West Bank and Gaza, and thereby creating jobs. Reliance on labor export to/remittances from Israel under conditions of extreme uncertainty continues to characterize the Palestinian economy, and is the key Palestinian economic policy dilemma. The issue is explored in paras. 4.10-4.16.

2.12 In net terms around 220,000 jobs were created between the third quarter (Q3) of 1995 -- the first time Palestinian labor markets were surveyed by the Palestinian Central Bureau of

<sup>24</sup> Source: World Bank staff calculations based on Bank of Israel data.

Statistics (PCBS) and Q3 of 2000 -- and the eve of the *intifada*.<sup>25</sup> This represents a 9 percent per annum increase in the number of jobs, exceeding the annual growth in the size of the labor force (around 7 percent). As a result, unemployment decreased dramatically over the period, from 19 percent in late 1995 to 10 percent by September 2000. The composition of this new employment is significant, however. Of the 220,000 new jobs, 70,000 were created in Israel and 50,000 in the PA -- markets with limited if any further capacity for expansion. The 100,000 jobs created in the Palestinian private sector represented a rate of job increase (4 percent) which was failing, even then, to keep pace with the rate of labor force expansion.

2.13 At the beginning of the *intifada*, the labor force in WBG was some 688,000 strong. Despite rapid natural growth, the number of those actively engaged in the economy (working or seeking work) has hardly increased (by a mere 4,000), due to the discouraging environment (saturated demand in the public sector, internal and external closures, depressed labor demand and falling wages in the private sector). Formal employment statistics indicate that unemployment has increased from 10 percent in Q3 of 2000 to 27 percent in Q4 of 2002, after peaking at 36 percent in the third quarter 2002. If those who are not seeking work are included -- the “discouraged” workers -- unemployment increased from 20 percent in Q3 of 2000 to 37 percent in Q4 of 2002. Moreover, from employing 74 percent of the labor force in September 2000, the private sector (in Israel and WBG) now only employs 54 percent.<sup>26</sup> With public sector employment having increased by 17 percent during the period, it is apparent that the private sector has absorbed the full force of the employment crisis.

2.14 As Table 2 below reveals, Q4 of 2002 witnessed a sharp increase in employment, with the number of the employed recorded at its highest level since the *intifada* began. While very encouraging and offering significant income relief, it is not clear that this recovery will be sustained. An examination of the 19 percent increase in the numbers employed between Q3 and Q4 2002 suggests a fortuitous coincidence of seasonality with reconstruction activities. Of the 83,000 jobs created in this period, as much as three-quarters may have been in the form of daily wage-labor or self-employment -- 44,000 (53 percent) of the “new jobs” were in agriculture, and seem to reflect the seasonal demand, in particular olive harvest-related,<sup>27</sup> while another 19,000 (23 percent) are recorded as construction jobs, and are probably in large measure associated with private, PA and donor efforts to repair the damage from Defensive Shield, and may also be quite temporary in nature. What is more, when assessed from the perspective of employment *status* as well as *income*, over 21,000 of the “new jobs” took the form of “unpaid family labor”.

2.15 ***Loss of Jobs in Israel.*** As a result of external closures, by the end 2002 some 92,000 of the 128,000 Palestinians employed in IIS had lost their jobs. This includes almost all of the 30,000 workers employed from Gaza in Q3 of 2000, of whom only some 7,000 remained employed in the Erez industrial estate, in settlements in Gaza and in Israel.<sup>28</sup> As for the West Bank, as many as 69,000 of the 98,000 employed in IIS in September 2000 have lost their jobs.

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<sup>25</sup> For the sake of statistical consistency, East Jerusalem data is not included in the discussion since some indicators are only available for the rest of the West Bank and Gaza.

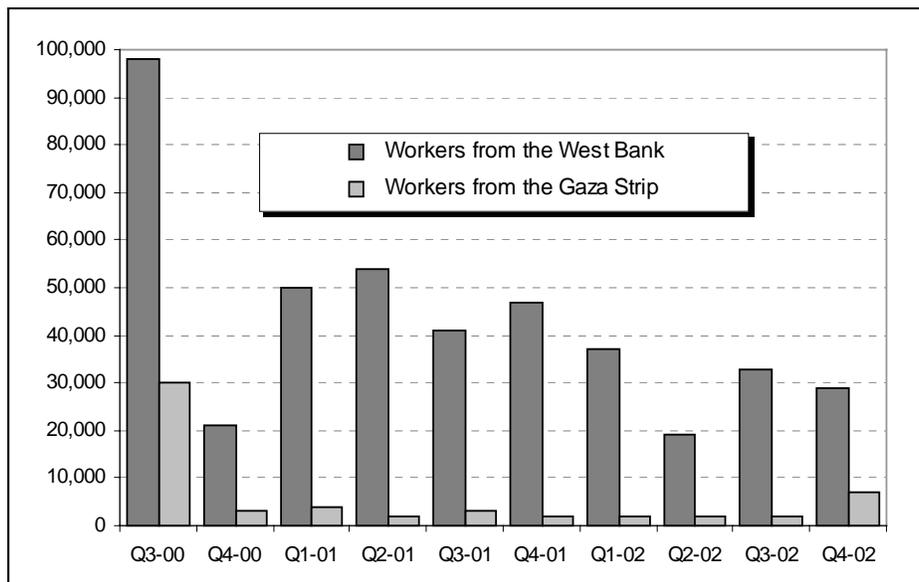
<sup>26</sup> Only 47 percent if discouraged workers are included, down from 66 percent on the eve of the *intifada*.

<sup>27</sup> The biannual “olive cycle” meant that 2002 was a peak harvest year (see also para. 2.55).

<sup>28</sup> In the last quarter of 2002 Gaza employment in Israel revived. From the beginning of the *intifada*, no more than 4,000 had been employed each day in IIS (this in Q1/2001), and numbers by Q3/2002 had fallen to only 2,000. In Q4/2002 this number increased to 7,000.

Most of the approximately 29,000 remaining workers are believed to be clandestine, working close to the Green Line in Israel, and in settlements. While employment in IIS increased by 15,000 from Q2 to Q4, much of this may have been seasonal. The ongoing construction of Israel's separation barrier in the West Bank is also likely to impact on the number of clandestine workers able to continue accessing jobs in Israel in 2003.

**Figure 4: Palestinian Employment in Israel, 2000-02**



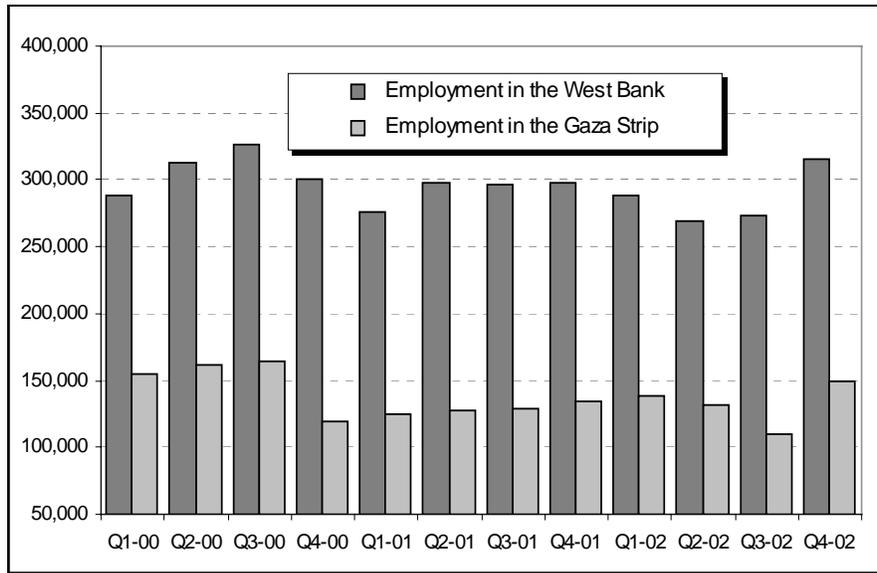
Source: World Bank's staff calculations based on PCBS. Data excludes East Jerusalem.

**2.16 Loss of Jobs in WBG.** The negative impact on domestic employment of job losses in Israel was aggravated by the difficulties in conducting business within the West Bank and Gaza: internal closures and curfews<sup>29</sup> are attended by significant transaction costs, disruption in production cycles, losses of perishable output, and lower economies of scale. Regional variations in unemployment and labor participation between the West Bank and Gaza are significant. By Q3/2002, 51,000 of the 327,000 eve-of-*intifada* private sector jobs had been lost in the West Bank (16 percent), and 54,000 of 164,000 in Gaza (33 percent). The fourth quarter witnessed something of a recovery, however, with the restoration of 42,000 jobs in the West Bank and 40,000 in Gaza.

**2.17** At this stage of the *intifada*, a net total of some 11,000 sector jobs have been lost in the West Bank (3 percent), and 14,000 jobs (8 percent) in Gaza. Dependency ratios -- that is, the number of persons dependent on each breadwinner -- stood by end-2002 at 5.8 in the West Bank and at 8.2 in Gaza, up from respectively 4.3 and 5.9 on the eve of the *intifada*.

<sup>29</sup> Figures reported in Table 2 do not capture the impact of curfews on the number of hours actually worked. Using UNSCO data, the World Bank estimates that the number of hours worked in West Bank over the second quarter of 2002 declined by 15 percent as a direct result of curfews. This is factored in the Bank's national accounts estimates.

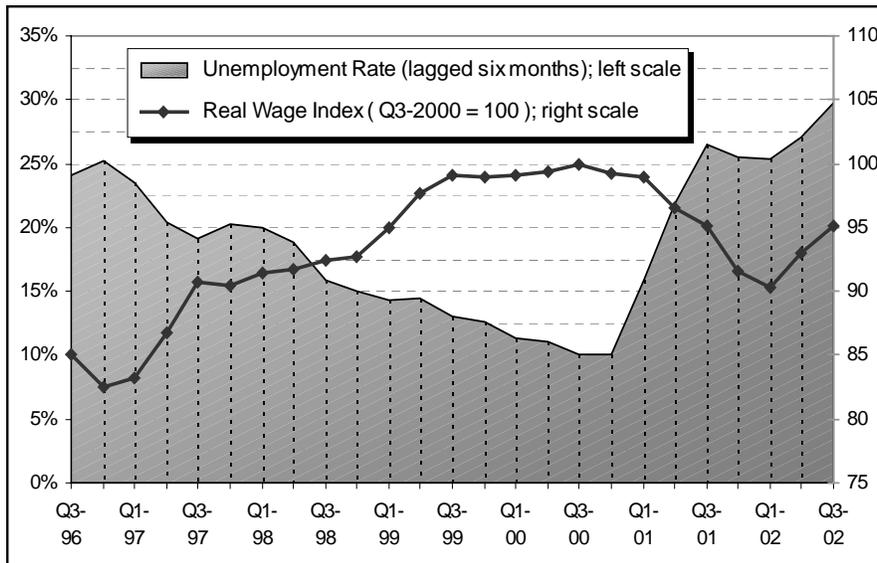
**Figure 5: Employment in the West Bank and in Gaza, 2000-02**



Source: World Bank staff calculations based on PCBS. Data excludes East Jerusalem.

2.18 While unemployment remains difficult to measure accurately,<sup>30</sup> there is no doubt about the broad trends. Furthermore, the conjunction of low labor demand and high labor supply is clearly exerting a downward pressure on wages, and thus incomes. Figure 6 demonstrates an inverse relationship between unemployment (lagged six months to capture its impact on wages) and real wages (wages divided by the consumer price index). Since the outbreak of the *intifada*, real wages have fallen 5 percent.

**Figure 6: Real Wage Adjustment, 1996-2002**



Source: World Bank staff calculations based on PCBS. Data excludes East Jerusalem. Wage and Unemployment figures are 3-quarter moving averages.

<sup>30</sup> Partly because there are no incentives to register as unemployed in WBG due to the lack of an unemployment benefits system.

2.19 This 5 percent drop in domestic real wages has taken place at a time when domestic employment has decreased by 19 percent. It also appears to mark a change with respect to the pre-*intifada* period, when real wages were responding more strongly to changes in employment. Put another way, the labor market has absorbed the shocks of the *intifada* primarily through a reduction in employment, rather than wages. On the face of it this would appear unfortunate. For one thing, it would serve the interest of social equity better if the economic burden was more evenly spread among the population. Second, one of the few potential benefits of the current crisis could arguably be the emergence of a wage structure which is more internationally competitive. There are two points worth making. The first is that there is a composition effect at work. Since unemployment has struck hardest at the less-skilled low-wage earners (especially in Gaza), the average wage of those still employed is automatically pushed up, thereby dampening the effect of declining wages. Second, though, the segmentation of the labor market as a result of internal closures has reduced its capacity to match labor demand and supply and often leads to local unemployment rather than to a more general downward pressure on wages. Workers may be unable to reach their workplaces and remain unemployed, while firms face a shortage of labor and are disinclined to reduce workers' compensation.

**Table 2: Employment and Unemployment (thousands)**

	Q3-00	Q4-00	Q1-01	Q2-01	Q3-01	Q4-01	Q1-02	Q2-02	Q3-02	Q4-02
Total Employment	619	445	455	481	470	481	466	421	420	503
Unemployment (ILO)	69	177	169	152	161	173	191	216	236	189
Discouraged workers	86	102	107	110	109	91	102	126	108	104
Domestic Employment	491	420	401	425	426	432	426	400	384	466
Workers in West Bank	327	300	276	298	297	298	289	269	274	316
Workers in Gaza	164	120	125	127	129	134	138	132	110	150
Palestinian Authority	107	115	117	119	119	122	125	124	124	125
Private Sector	384	305	284	306	307	310	301	276	260	341
Employment in Israel	128	25	54	56	44	49	39	21	35	36
Workers from West Bank	98	21	50	54	41	47	37	19	33	29
Workers from Gaza	30	3	4	2	3	2	2	2	2	7

Source: World Bank staff calculations based on PCBS and IMF. Data excludes East Jerusalem. Employment includes underemployment. PA employment is central government only; private sector employment includes local government and public enterprises. "Israel" includes Israeli settlements.

## Trade

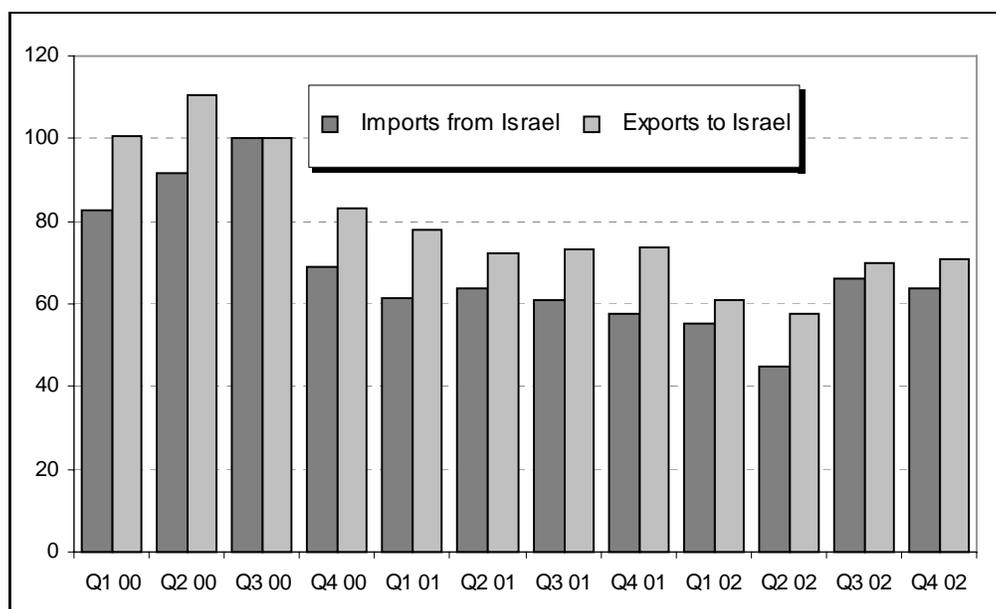
2.20 Trade has always played an important role in the small and open Palestinian economy. In 1999, imports of final goods, services, equipment, and intermediate inputs represented approximately 70 percent of GDP, with exports of goods and services representing about

20 percent of GDP. The lion's share of this trade takes place with Israel -- data from ICBS suggests that Israel accounts for some 80 percent of total trade with the West Bank and Gaza.<sup>31</sup>

2.21 Between September 2000 and December 2002, Palestinian exports declined by some 29 percent in value (measured in NIS), most notably after March 2002, while imports have contracted by some 36 percent. This last figure implies a more rapid decline in import volume, given that the domestic price of imported goods increased during the period as a result of significantly higher transaction costs and a depreciated shekel. Although depressed wages and a depreciated shekel would under more normal conditions have stimulated exports, these competitive advantages were more than offset by increased transaction costs and by the difficulty of fulfilling orders on time.

2.22 The curfews and tightened closure regime following Operation Defensive Shield initially caused a steep fall in Palestinian exports. Both imports and exports recovered somewhat in Q3/2002 as the initial restrictions were gradually relaxed and traders became more used to working within a tighter closure regime. As noted earlier (para. 1.4), the back-to-back regime does not seem to have been consistently enforced, and this is substantiated by the fact that there was hardly any net increase in transport prices from March to December 2002.<sup>32</sup>

**Figure 7: Trade with Israel (Index 100 = Q3 2000, current NIS)**



Source: World Bank staff calculations based on the Israeli Bureau of Statistics.

<sup>31</sup> In 1999 total Palestinian trade (imports plus exports) was estimated at \$3.9 billion, of which 79 percent was with Israel. The corresponding figures for 2001 were US\$2.7 billion and 79 percent (World Bank staff estimates). Trade flows are not properly registered since there are no customs stations between the West Bank and Israel, though in effect there are between Israel and Gaza. ICBS nevertheless estimates such flows.

<sup>32</sup> Between March and December 2002 (that is, in the period just following the implementation of the back-to-back regime), transport prices in West Bank increased by 3.3 percent -- less rapidly than the overall price index during the same period (4.0 percent). It should be noted, though, that the CPI mostly measures the price of transport of people, rather than goods. Source: PCBS.

## Investment and Productive Capacity

2.23 Reduced investment, the destruction of physical infrastructure and the accelerated depreciation of certain assets have significantly affected the supply capacity of the Palestinian economy and its ability to recover rapidly from recession.

2.24 **Private Investment.** In *Fifteen Months*, the World Bank reported that high risks and low returns had led to decreased private investment and a withdrawal of capital from the market; that perceived risks included damage from fighting, inability to meet export orders on time, the erratic availability of imports and the reduced capacity of the Palestinian Authority to enforce property rights; and that, in addition, returns to capital had been depressed by low domestic demand and increased transaction costs. Potential private investment has continued to be diverted to maintaining firms' solvency and for household consumption, and in today's depressed economic environment the Bank estimates that the average return to capital is now only half of what it was in 1999.<sup>33</sup> As a result of recession and the reluctance of the banking sector to provide new loans, the pool of savings available for investment has shrunk dramatically. Investment in sectors which offered opportunities before the crisis, such as tourism, housing, or export-oriented activities (notably within the framework of the new industrial estates) has all but evaporated. Private investment is hard to assess in WBG, but a rough Bank estimate suggests that total private investment (including residential housing and the rehabilitation of damaged building), which totaled approximately US\$1.25 billion in 1999, is unlikely to have exceeded US\$50 million in 2002.

2.25 **Public Investment.** Prior to the crisis, approximately 93 percent of public investments were financed by donors through grants and soft loans. The increasing difficulty of implementing development projects in an uncertain environment has meant that the pace of donor investment disbursements has declined, despite donors' efforts to repair damaged infrastructure and their continued commitment to medium-term development. The need to sustain the PA budget and to provide an increasing amount of emergency assistance has also diverted investment funds into short-term consumption. Donor investment expenditure reached an estimated US\$220 million in 1999, falling to US\$150 million in 2001 and to as little as US\$100 million in 2002. PA contributions to public investment fell from US\$22 million in 2001 to only US\$4 million in 2002 (Source: IMF).

2.26 With suitable caveats, the World Bank estimates that total investment flows fell from about US\$1.45 billion in 1999 to about US\$150 million in 2002, a decline of about 90 percent. In opportunity cost terms this represents a loss of US\$3.2 billion.

2.27 **Physical Damage.** The intensification of IDF operations from March 2002 onwards more than doubled the raw physical damage of the initial fifteen months of the *intifada*, as well as shifting the locus of destruction from Gaza to the West Bank and the predominant type of damage from private agricultural assets to public infrastructure in urban areas.

2.28 The first 23 months of conflict (October 2000 – August 2002) have resulted in an estimated US\$728 million of raw physical damage in the Palestinian territories. At the end of

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<sup>33</sup> Pre-tax rate of return to capital is estimated to have dropped from 12.2 percent in 1999 to 6 percent in 2002 (World Bank staff estimates).

2001, after fifteen months of the *intifada*, the total damage was estimated by the Bank at US\$305 million. In the first eight months of 2002, a further US\$423 million was added to this total. From a geographical perspective, the West Bank has by now suffered most, with total damage almost twice as high as in Gaza (US\$468 million against US\$250 million); this compares to an end-December 2001 situation in which two-thirds of the damage caused to that point had occurred in Gaza. Within the West Bank, Nablus, Ramallah, Jenin and Bethlehem have been hardest hit; these three municipalities and those of North Gaza and Gaza City have collectively absorbed almost 70 percent of the damage.

**Table 3: Physical Damage by Governorate and Sector from September 28, 2000 and August 30, 2002**

Governorate	Infra-structure	Public Buildings	Private Sector	PA Institutions	Agri-culture	Cultural Heritage	NGOs	Vehicles	Total
Bethlehem	18	3	21	1	8	4	1	3	57
Hebron	28	2	14	0	1		0	0	46
Jenin	35	1	18	0	5	1	1	1	62
Jericho	3	0	0	0	4				7
Jerusalem	3	0	0	0	0				4
Nablus	46	2	40	1	11	47	0	0	148
Qalqiliya	7	0	2	0	12			0	21
Ramallah	37	2	30	12	6		2	4	94
Salfit	7	1	1	0	5				13
Tulkarem	16	2	3	1	4		1	0	26
Gaza North	7	1	3	0	50				61
Gaza	9	1	6	7	45				68
Middle Area	2	0	5	0	35				42
Khan Yunis	13	1	4	0	16				34
Rafah	20	0	5	6	15				45
<b>Total</b>	251	16	152	28	217	52	5	8	728
<b>Percent</b>	34	2	21	4	30	7	0.5	1	100

Sources: Ministry of Public Works and Housing, Office of the President, Ministry of Agriculture, Donor Support Group, European Union / IMG. NA: Not Assessed. Figures reported do not include damage to security buildings and installations.

2.29 From a sectoral perspective, the damage inflicted on public infrastructure is the greatest, at US\$251 million (34 percent of the total), with agriculture following at US\$217 million (30 percent -- in contrast to the end-2001 situation, in which US\$177 million in agricultural damage constituted some 58 percent of total damage). Public infrastructure damage includes road sub-structures, surfaces, medians and sidewalks; water and wastewater networks; electricity stations, transformers and street lighting; telecommunication equipment; and solid waste collection trucks and bins. Most of this infrastructure had been financed by donors in the period since 1994. Up until Operation Defensive Shield, damage resulted mainly from IDF operations to clear areas near major junctions, borders and settlements of trees and buildings, as well as attacks on PA security facilities -- and was concentrated in Gaza. Since the end of March 2002,

most of the damage has resulted from the extensive use of armored vehicles and from fighting in the cities of the West Bank. Although not adequately captured in the Bank's figures, the pattern of damage to PA facilities has also changed. Prior to Defensive Shield, the IDF had generally refrained from targeting civilian PA entities. In April 2002, in addition to targeting remaining security installations (in particular the *Muqata* complex in Ramallah), IDF actions also featured the widespread ransacking of PA ministry buildings and municipal offices, particularly in Ramallah.

2.30 On balance, private sector assets have suffered the most (some 52 percent of the total). In Gaza, almost two-thirds of the total damage is in agriculture, which is virtually all under private ownership. In the West Bank, private property (housing, commercial buildings and agriculture) was almost as badly affected in aggregate as public infrastructure.

**Table 4: Physical Damage between September 28, 2000 - August 30, 2002**

Sectors	Gaza	West Bank	Total	Gaza	West Bank	Total
	------(US\$ million)-----			------(Percent)-----		
Infrastructure	51.5	199.5	251	21	42	35
Agriculture	161	55	216	64	12	30
Public Buildings	2.9	12.4	15.2	1	3	2
Private Buildings	22.8	129	151.7	9	27	21
PA Institutions	12.2	15.7	27.9	5	3	4
Private Social Services	NA	1	1	NA	0	0
Cultural Heritage	NA	52	52	NA	11	7
NGOs	NA	4	4	NA	1	1
Vehicles	NA	8.5	8.5	NA	2	1
Total	250.3	476.7	727.9	100	100	100

Sources: Ministry of Public Works and Housing, Office of the President, Ministry of Agriculture, Donor Support Group, International Management Group/EC. NA = Not Assessed. Figures reported do not include damage to security buildings and installations.

2.31 An indicative updating of the total raw physical damage brings the total to US\$930 million as of the end of December 2002.

2.32 It should be noted however that the *cumulative* impact of the crisis on the existing stock of infrastructure is by far greater than the sum of the raw damage, because equipment has had to be operated in a much more adverse environment, and because the remaining infrastructure assets -- in particular roads -- are subject to over-use and additional stress once they have already been damaged. It is estimated that, as of the end of 2002, the total impact of damage and additional stress on the infrastructure stock in the West Bank and Gaza as a result of conflict amounts to approximately US\$1.7 billion on a replacement cost basis.<sup>34</sup> On account of the quantum of damage and the declining flow of new investments during the period, the productive capital stock -- which embodies the potential productive capacity of the Palestinian economy if all factors of production are fully employed -- has declined by over US\$1 billion between 1999

<sup>34</sup> The calculation assumes that on top of the US\$930 million in raw physical damage as of end 2002, the annual depreciation rate of the entire capital stock (estimated at US\$11.207 billion in 1998 -- or twice GDP [Bank staff estimate]) increased from a standard rate of 5 percent in 1999 to 8 percent in 2002, as a result of inappropriate/over use and lower levels of maintenance.

and 2002. In real per capita terms, this amounts to a decline of some 19 percent. Based on the average pace of capital accumulation observed between 1970 and 2000, it would take approximately 5 years to reconstitute a per capita stock of productive capacities similar to the one observed on the eve of the *intifada*.

**Table 5: Investment, Depreciation, Destruction and the Capital Stock, 1998-2002**  
(US\$ 1998 million)

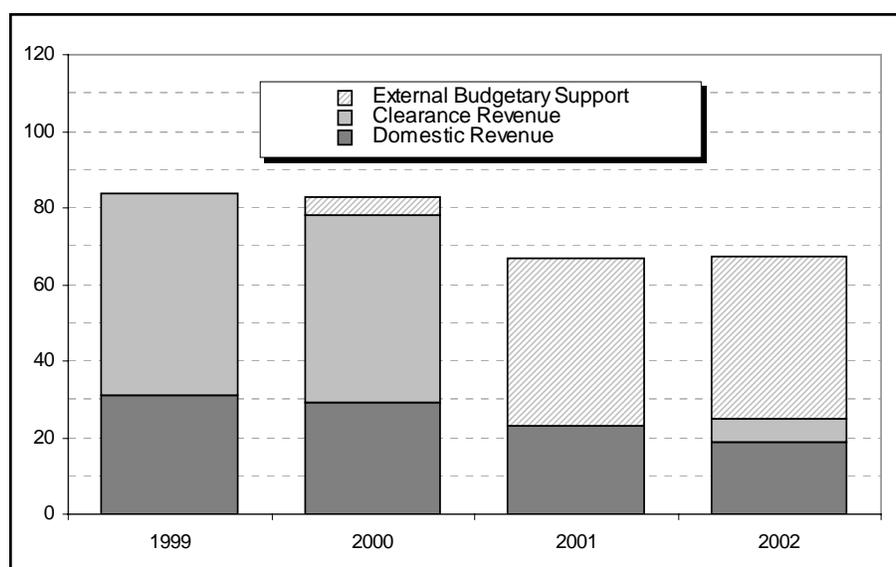
	1998	1999	2000	2001	2002
Capital Stock	11,207	12,148	12,674	12,393	11,134
Gross fixed Investment		1,501	1,376	987	228
Depreciation		-560	-795	-1017	-862
Destruction		0	-55	-250	-625

Source: World Bank Staff calculations. The capital stock in any given year is equal to the previous years' capital stock plus previous years' investment minus previous years' depreciation, and minus destruction in the current year.

## Fiscal Accounts

2.33 **PA Current Revenue.** PA current revenues prior to the *intifada* were intimately linked to the level of demand, with over 80 percent of revenues derived from indirect taxes on consumption (particularly VAT, import taxes and excise taxes). PA revenues during the *intifada* have fallen dramatically as a result of rising unemployment and reduced demand, and from the withholding by the Government of Israel of revenues collected on the PA's behalf. In addition, closures and curfew have interrupted tax collection activity in the West Bank and Gaza.

**Figure 8: Revenues of the Palestinian Authority, 1999-2002**  
(Monthly Average - US\$ million)



Source: IMF, budgetary prospects as of February 17, 2003.

2.34 PA revenue fell from a monthly average of US\$82 million in Q3 of 2000 (of which US\$52 million were clearance revenues and US\$30 million were domestic revenues) to just

US\$33 million by Q4 of 2002,<sup>35</sup> leaving the PA highly dependent on budget support from donor countries. This totaled about US\$1.1 billion by the end of 2002 (US\$54 million in November and December 2000, US\$539 million in 2001 and US\$464 million in 2002), and averaged US\$39 million per month during the past 27 months -- almost half of total PA budget outlays over the period. Of this total, the major share, US\$738 million, has been provided by the Arab League States, with the European Union providing US\$214 million. Budget support has declined in recent months, however; between November 2000 and June 2002, monthly donor disbursements in support of the PA budget averaged US\$46 million; between July and December 2002 they averaged US\$35 million, and in the first three months of 2003 they averaged only US\$23 million (including ESSP). This reflects both a decline in Arab League disbursements and a suspension of EC budget support during this period (see para. 2.44).

2.35 Despite a combination of donor contributions and severe cutbacks in non-wage expenditures (see below), with domestic revenues so reduced the PA has faced a serious unfunded budget gap, averaging some US\$18 million per month since the beginning of the *intifada*. This has been managed through a combination of accumulating arrears to suppliers, borrowing from domestic banks, and delaying the payment of salaries and pensions.

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<sup>35</sup> In 2001, domestic revenues averaged US\$23 million per month, a figure that fell to US\$16 million per month in Q2 of 2002 (a quarter marked by Operations Defensive Shield and Determined Path), and recovered slightly thereafter.

**Table 6: Palestinian Authority Fiscal Accounts - Monthly Average (US\$ million)**

	1999	2000	2001	2002	Budget 2003
Revenue	83	77	23	25	44
Domestic	31	29	23	19	17
Clearance	53	49	0	3	27
Withheld revenue released by the GOI				4	40
Current expenditure (commitment basis)	79	99	91	83	87
Wages	44	52	57	56	..
Non-wages	35	48	35	27	..
Recurrent balance	4	-23	-70	-58	-2
PA-financed capital expenditure	0	1	2	0	2
Overall balance (commitment basis)	4	-23	-72	-59	-4
Expenditure arrears (net accumulation)	1	5	23	14	-35
Overall balance (cash basis)	5	-18	-49	-45	-39
Financing	-5	18	49	45	39
External budgetary financing	0	5	44	39	45
Domestic bank financing and residual	-5	13	5	6	-6
Memorandum items:					
Stock of expenditure arrears (end of period)	..	..	253	415	0
PA employment (thousand employees, end of period)	104	115	122	125	..

Source: IMF, budgetary prospects as of February 17, 2003, and Ministry of Finance. Data exclude local governments.

2.36 At the end of December 2002, accumulated PA arrears amounted to US\$415 million. The rate of arrears accumulation slowed from US\$23 million per month in 2001 to US\$14 million per month in 2002 as a result of tighter expenditure control, but the stock of arrears still represented about 12 percent of GDP by end 2002 and have had a damaging impact on the private sector -- contributing to liquidity shortage, non-performing loans in the banking system, and increasing cases of insolvency.

2.37 In the latter part of 2002 the United States conducted an intensive dialogue with the Government of Israel, while the donor community adopted the position that a resumption of regular monthly clearances was vital to the stability of the PA and thus to the program of Palestinian institutional reform which President Bush alluded to in his speech of June 24, 2002 (and Prime Minister Ariel Sharon in his speech of December 4, 2002). Following an agreement reached with the PA Minister of Finance, GOI had rebated the equivalent of US\$45 million of withheld clearance revenue by end-2002 plus US\$30 million corresponding to clearance revenue flows in December 2002. This was followed in 2003 with the resumption of regular transfers of clearance revenue (averaging US\$35 million per month over the First Quarter), plus an additional US\$21 million per month from the stock of clearance revenues withheld by the GOI.

2.38 **PA Current Expenditure.** Average monthly expenditures were reduced from US\$107 million in the quarter prior to the *intifada* to an initial average of US\$91 million in 2001, and were reduced further to US\$79 million per month in the first half of 2002, before rising to an

average of US\$88 million in the second half of the year. The PA persisted throughout 2002 with a strategy of paying PA salaries as its first priority, on the grounds that this was essential to the maintenance of political stability as well as aggregate demand. As a result, and at a time when the PA has been obliged to devote a high proportion of available non-salary recurrent expenditure to emergency work, non-wage expenditures for regular public services fell from US\$52 million per month in mid-2000 to US\$23 million by mid-2002. This squeeze on operating costs was relieved somewhat in late 2002 with the implementation of the Emergency Services Support Program, which between September and December 2002 contributed an average of US\$4 million per month for non-salary outlays.

2.39 ***The PA's 2003 Budget.*** The Palestinian Budget for 2003 was approved by the Palestinian Legislative Council (PLC) on February 1, 2003. This is the first time that a PA budget has been disclosed publicly, and in detail. At a policy level, the budget includes provisions to extend the fiscal accountability reform process, and provides for the elimination of the use of cash in government transactions, extending the direct deposit scheme currently used to pay civilian wages to cover the police and other security officials. This provision will close an important loophole in the PA's system of financial management.<sup>36</sup>

2.40 The Budget proposes a prudent level of expenditures. Compared to the preliminary results for 2002, expenditures are planned to increase slightly, from US\$83 million per month in 2002 to US\$89 million (including US\$2 million for capital expenditures), allowing some headroom to increase provisions for non-salary operating expenditures.

2.41 On the revenue side, domestic revenue is expected to decline by 7 to 8 percent in 2003 compared to 2002, as a result of a similar decline in GDP. The Budget embodies the assumption that GOI will continue the regular monthly transfer of revenues throughout the year (net clearance revenues are expected to amount to US\$324 million in 2003<sup>37</sup>), and that it will also fully repay clearance arrears (another US\$480 million). This cash injection of US\$804 million (compared to only US\$75 million in clearance revenues in 2002) would have a significant impact on domestic demand, and, in turn, on tax revenues -- which would likely be higher than estimated in the Budget. This suggests that the projected recurrent financing gap could turn out to be less than the US\$535 million projected.

2.42 The clearance revenue arrears would be used principally to repay debts to the commercial banking system, settle bills from commercial suppliers, and clear delayed internal payments, including to the PA pension schemes (these PA arrears are estimated by the PA and the IMF at US\$415 million as of the end of December 2002, see para. 2.36).

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<sup>36</sup> In his speech to the PLC on December 31, 2002, the Minister of Finance stated his intention to ensure "full compliance by all the PNA ministries and agencies with the provisions of the General Procurement Law that pertains to bidding in the acquisition of goods and services. Toward this end, I will not hesitate to use the powers vested in me by the law, including the withholding of budgetary appropriations of violating agencies. And, lest there be doubt in anyone's mind, let me state unequivocally that when I say all ministries and agencies, I mean all ministries and agencies, including the Security Financial Administration. In particular, I wish to point to the exclusive transactional relationship between this administration and the Security Cooperative. This relationship represents a clear violation of the law, and it, therefore, should not, and will not, be allowed to continue."

<sup>37</sup> Representing 61 percent of total tax revenue, a ratio close to the pre-*intifada* period (63 percent in 1999).

2.43 The Budget aims to eliminate any financing gap in 2003, and to clear all the PA's arrears -- thereby restoring its credibility with the private sector and providing a significant stimulus to the recovery of commercial activity. Whether this budget can be fully financed depends on the situation on the ground, particularly the severity of closure; on whether GOI transfers PA revenues every month; and on the level of donor budget support.

2.44 Significant issues surround future budget transfers from the Arab League and the EC. Due to the burden-sharing formula adopted by the Arab League at the Beirut Summit in March 2002, the relative share of the Gulf countries in the Palestinian pledge declined in favor of contributions from some other Arab League member states -- some which have not paid in part or in full. Monthly disbursements from Arab League states have declined from an average of US\$45 million in Q2 of 2002 to US\$36 million in Q3 to only US\$12.5 million in Q1/2003 -- a drop of over 70 percent. The EC, for its part, is facing questions from European parliamentarians about alleged misuse of EU budget funds. The EU Anti-Fraud Office has launched an investigation, and it is not likely that EC budget support will continue in the form it took in 2001-2002.<sup>38</sup> In addition, donors' reluctance to provide budget support other than as a last resort may mean they will be inclined to reduce such contributions in response to Israel's resumed transfer of clearance revenues.

2.45 At the end of Q1/2003, domestic revenues were slightly lower than projected (US\$ 16 million per month against US\$17 million budgeted), while clearance revenues are proving more buoyant than anticipated (US\$35 million per month against US\$27 million budgeted). With external budget support averaging only US\$23 million per month, however, total monthly PA current revenue amounted to only US\$74 million per month compared with US\$89 million projected. In response to this the Ministry of Finance released only a half of the authorized non-salary Budget to PA agencies in the First Quarter. As the Minister of Finance recently stated to the donor community,<sup>39</sup> an overall revenue shortfall leaves the PA the option of either cutting back on non-salary recurrent expenditures, or using part of the stock of withheld revenues for recurrent obligations, or both.<sup>40</sup> Another option, which the PA strongly wishes to avoid, is to once again incur debt to commercial suppliers.

## Output

2.46 **GDP and GNI.** Real GDP declined by 17 percent from 1999 to 2001, and is estimated to have declined a further 19 percent in 2002. This brings the total decline to 33 percent between

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<sup>38</sup> On April 30, 2003, the EU announced its intention to provide new form of budgetary assistance to the PA, at a similar level as in 2002, by earmarking €80 million for the payment of PA arrears, €22 million through the ESSP, and €18 million under the 2002 budget support scheme for a total of €120 million.

<sup>39</sup> At the April 1, 2003 meeting of the LACC in Ramallah. At this meeting the Minister also reported that the PA had repaid US\$80 million of outstanding PA debt since February 2003 (of which some US\$50 million went to private suppliers out of a total of up to US\$187 million owed them, IMF estimates), as well as settling some US\$88 million in municipal debts to PA and Israeli water and electricity companies.

<sup>40</sup> The Budget assumes that a monthly average of US\$40 million of withheld clearance revenues will be returned to the PA by GOI in 2003. For Q1/2003, the monthly average was US\$21 million. Unless the rate of arrears repayment by GOI increases, it may not be possible to eliminate the PA's stock of arrears in 2003. One serious issue facing the PA is that a number of Israeli parties have succeeded in having the Israeli courts attach NIS 900 million of the withheld arrears (approximately US\$191 million) against debts allegedly owed them by Palestinian suppliers, and against claims for *intifada*-related damages.

1999 and 2002. The corresponding decline in real GNI is greater -- 38 percent -- as a result of the precipitate drop in workers' remittances. In per capita terms, the outcome is even starker. With population increasing at 4.3 percent per annum, GDP and GNI per capita fell respectively by 41 and 46 percent between 1999 and 2002.<sup>41</sup>

2.47 A combination of demand and supply side effects underlies this recession. External closures have reduced workers' remittances, creating a negative multiplier effect on the demand for domestic goods. The combination of internal and external closures have led to a sharp increase in transaction costs, which has reduced the productivity and competitiveness of Palestinian firms. The partitioning of the economy into different blocks ("cantonization") has reduced its capacity to adapt to the decline in activity and demand. The impacts of closure are compounded by a high structural dependency on imported inputs, with little possibility for producers to substitute domestic inputs in the short-term. The World Bank estimates that such substitution has remained very modest throughout the crisis, with a the ratio of imports as a proportion of GDP (in nominal terms) rising from about 70 to 75 percent between 1999 and 2002.

**Table 7: Summary of West Bank and Gaza Estimated Macro Economic Trends and Projections**

	1999	2000	2001	2002
Gross National Income (GNI), current US\$ mill.	5,056	5,455	4,526	3,768
Gross Domestic Product (GDP), current US\$ mill.	4,198	4,637	4,034	3,396
Real annual change (NIS, 1998 prices):				
GNI per capita	4%	-8%	-23%	-23%
GDP per capita	3%	-5%	-20%	-23%
Private Consumption	8%	-6%	-16%	-15%
Public Consumption	20%	31%	-2%	-1%
Total Fixed Investment	-8%	-28%	-77%	-44%
Export	2%	-9%	-13%	-24%
Import	5%	-16%	-29%	-13%
Other items:				
Poverty, share of population below poverty line	20%	31%	46%	59%
NIS/US\$ , annual average	4.14	4.08	4.21	4.74
CPI, annual change	5.5%	2.7%	2.1%	5.7%
Population, mid-year (1,000)	2,842	2,966	3,096	3,231

Note: All data excludes East Jerusalem. Sources: World Bank Staff estimates, PCBS.

2.48 **Prices.** Price trends attest to the different macroeconomic conditions in the West Bank and in Gaza throughout the crisis. In the West Bank, consumer prices increased steadily (up by 11 percent between September 2000 and December 2002) -- mostly as a result of transport cost

<sup>41</sup> The last year for which national accounts were published was 1998. In order to project macro-economic developments in WBG, the Bank uses a quantitative economic model which describes the economic relations between households, producers, government and the rest of the world through a set of accounting and behavioral equations. See Astrup, C. and S. Dessus (2001), *Trade Options for the Palestinian Economy: Some Orders of Magnitude*, MENA Working Papers Series #21, The World Bank, and Astrup, C. and S. Dessus (2002), *Exporting Labor or Goods: Long Term Implications for the Palestinian Economy*, MENA Working Papers Series #29, The World Bank, for a presentation of the model.

increases (41 percent), which contributed more than half of overall CPI increase (Box 2). On the other hand, the price of tradable goods (food, textiles, manufactured goods, etc.) did not significantly increase over the period. In Gaza, though, price levels remained more stable overall (up by only 2 percent since September 2000), with the exception of transport (up 11 percent, contributing one-third of the overall CPI increase). Food prices are somewhat cyclical, but have not increased significantly over the period (only 5 percent in the West Bank and -1 percent in Gaza). Importantly for donor humanitarian aid strategy, this suggests that neither the West Bank nor Gaza experienced any generalized or sustained food supply problems.

## **The Private Sector<sup>42</sup>**

2.49 The domestic private sector has absorbed much of the economic shock of the *intifada*. While 17,000 jobs were created in the PA between September 2000 and December 2002, 43,000 jobs (11 percent) were lost in the Palestinian private sector during the same period,<sup>43</sup> with a peak of 124,000 jobs (32 percent) lost during the Third Quarter of 2002. In addition to job losses, over half the raw physical damage has been inflicted on private sector assets. Sources of credit to the private sector have dried up (para 2.57), while the PA financed its current deficit in 2001 and 2002 largely by accumulating arrears to commercial suppliers. The Bank estimates that real private GDP (measured at factor costs) had declined by 35 percent by the end of 2002 when compared to its 1999 level. During the same period, real public GDP, conventionally measured with reference to the government payroll, remained roughly unchanged. As a result, the private sector's contribution to GDP has now fallen from 87 percent in 2000 to 80 percent of a much smaller economy today.

### **Box 2: Transport Costs**

To illustrate the large increase in transport costs that has resulted from the movements restrictions, Massar Associates, a consultant firm, followed a shipment of imported consumer goods headed for Gaza: From April 1 to May 20, 2002 the shipment was delayed at Israeli ports for 40 days, with storage costs of US\$50/day. After being released from the port, goods had to be unloaded and arranged for transport on multiple pallets. The cost of this activity was US\$300-400 with goods having to be loaded onto several trailers. Regulations stipulating the use of pallets resulted in a 20-foot container needing 2 trailers (instead of half a trailer) to move the products to the checkpoint at Karni, with a total crossing time at Karni for trucks carrying pallets estimated at 2-3 nights. Shipments of goods, which previously totaled US\$151 per container, effectively increased to US\$1,814. For consumer goods shipments, a significant increase has been reported on lost goods (stolen at Karni), and in some cases the lost material totaled 60% of the shipment. One US\$4,000 kitchenware container incurred US\$443 in storage cost to the Israeli ports authorities and US\$2,000 for transportation. When the goods arrived at the warehouse it was discovered that US\$1,500 worth of them had been stolen during that process.

From May 20 to June 1, restrictions on the movement of goods into Gaza were relaxed and containers were allowed to enter Gaza. Procedures for moving containers include similar charges for clearance and storage costs at Israeli ports, with containers loaded on Israeli trucks. The Israeli truck cost is approximately US\$300-400. At Karni, trucks wait for clearance, and the container itself is loaded on a Gazan truck. Once the container is unloaded in the storage facilities in Gaza, it is not allowed to return to Israel. The shipping company thus would send the businessman two bills: one for delays, at US\$30/day, and the second for the price of the container, US\$2,000.

Source: Massar Associates, from *A Strategy for Private Sector Development in the West Bank and Gaza: From Crisis to Sustainable Growth*, World Bank, draft, March 2003).

<sup>42</sup> See World Bank, *The Impact of Recent Israeli Incursions, Closures and Curfews on the Economy of the West Bank and Gaza Strip*, draft, September 2002, for a more complete description and analysis of private sector developments.

<sup>43</sup> On the eve of the *intifada*, there were approximately 56,000 business units in WBG, employing 384,000 people, or 78 percent of those employed within West Bank and Gaza.

2.50 **Business Environment.** The crisis has made it difficult to implement reforms aimed at improving the business environment. Such reforms have been urged by entrepreneurs long before the *intifada*, and relate principally to simplifying regulatory and administrative procedures (such as VAT refunds, tax assessments, licensing, registration, land titling and accounting standards) -- and to better enforcement of existing laws.<sup>44</sup> At present, firms express frustration at new legislation, which lacks implementing regulations, and existing legislation, which is too complex and does not cover all eventualities. Entrepreneurs have also identified inadequate physical and financial infrastructure as a major problem.

2.51 All of these issues pale into insignificance when set against the impact of closure and curfew, however, and the focus of most Palestinian firms is on survival, in particular on raising the working capital needed to ensure this. The vignettes in Box 3 illustrate typical enterprise-level difficulties in a range of firms interviewed in mid-2002.

2.52 **Services.** Private services (including construction) accounted for 64 percent of GDP in 1999, and have contracted by about 35 percent in real terms since. The impact has varied between different sub-sectors. Before the *intifada*, construction services accounted for three quarters of total private investment, and construction GDP has probably declined by no less than 75 percent since then in spite of the efforts of communities and the PA to rebuild damaged houses and infrastructure. Transport services have also experienced a major loss of demand and profitability, and the Bank estimates a 50 percent decline in transport GDP since September 2000.<sup>45</sup> Local private services (private education and health, retailers, petty commerce, repair and financial services) have been less impacted by movement restrictions and the general investment climate; nonetheless, GDP in these services has probably declined by some 25 percent since 1999.

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<sup>44</sup> Source: *A Strategy for Private Sector Development in the West Bank and Gaza: From Crisis to Sustainable Growth*, April 2002, The World Bank, Washington DC.

<sup>45</sup> The Ministry of Transport recently indicated that of the nearly 9,000 taxis in the West Bank, only 40 percent were still running in September 2002 -- and that buses, which used to make an average of \$250 daily, now earn less than \$40 a day.

### Box 3: Enterprise-Level Difficulties

A food processing company: From March 28 to April 25, 2002 the company shut down completely, and in mid-2002 was operating at 50% of capacity due to an inability to move products within cities in the West Bank and Gaza. Shipments of perishable products from Ramallah to Nablus, which had formerly taken 2 hours, now took 3-4 days with a high percentage of lost merchandise. The company had laid off 50% of its roughly 30-member workforce.

A soap and detergent company: This company produces detergents and cosmetics and was experiencing delays of 3 months in shipments of raw materials from Israeli ports, leading to costs estimated at more than half the value of the final product manufactured. By mid-2002, sales were 20-25% of normal and workers were being encouraged to work part time in order to keep payroll costs down. The company has lost key customers to Turkish competitors.

A feed factory: was operating at 50% production capacity, and had reduced its workforce by 30%. This company was suffering from inconsistent deliveries of raw materials, affecting both the quality and reliability of production. The factory received supplier credit for 45 days, but was obliged to offer clients credit for 60 days. In mid-2002, the company was owed more than US\$150,000 by clients.

A restaurateur: had experienced a sales decline from US\$6,000 to US\$300 per day, and had cash debts of nearly \$230,000 plus \$26,000 in overdrafts. The company needed to reschedule its existing debt. A highly trained labor force had been reduced from 42 to 6.

Source: World Bank staff interviews, May 2002, cited in *A Strategy for Private Sector Development in the West Bank and Gaza: From Crisis to Sustainable Growth*, draft, March 2003.

2.53 **Manufacturing.** Manufacturing accounted for approximately 15 percent of GDP in 1999, and the Bank estimates that the sector has contracted by about 35 percent in real terms in the past three years. Along with cutting staff and wages, manufacturing firms have reduced their operations. According to the September 2002 *Industrial Sector Survey*,<sup>46</sup> only 7 percent of firms operated at their September 2000 level of capacity. Of the rest, 76 percent were operating at lower capacity and 17 percent have shut down entirely. Traditional sectors of activity (food processing, textile, metal, plastic, etc.) have suffered the greatest decline, while more modern sectors (pharmaceuticals, information technology) have managed to adjust better.

2.54 Current trade and movement restrictions have raised the prices of raw materials and made their delivery highly uncertain, yet Palestinian manufacturers have little alternative but to stick with their Israeli suppliers since the investment climate is not conducive to the development of domestic alternatives. These difficulties in inputs supply, combined with higher transport costs, have raised production costs. When erratic delivery is added, it is easy to see why Palestinian competitiveness is eroding. Manufacturers have perforce become dependent on selling their products in small-radius local markets as internal closures and curfews have become more invasive. Demand is very slack, forcing manufacturers into smaller production runs -- which further increase unit costs. The Industrial Sector Survey indicates that the vast majority of Palestinian firms have relied on themselves to weather the crisis, with 73 percent of assets and working capital self-financed. As a result, only 15 percent of surveyed firms were in default on loan payments as of mid-2002, although more than half of them reported being under financial stress. This relative lack of integration with the banking system may well have helped reduce economic damage to the banks. However, the survey indicates that only a small proportion of firms would use formal credit in the future, preferring to rely on profits and loans from relatives.

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<sup>46</sup> *Private Sector Needs Assessment: Industrial Sector Survey*, Palestinian Federation of Industries and Palestinian Trade Center, September 2002. The survey covered 526 firms (202 in West Bank and 324 in Gaza).

What has helped cushion adverse impacts on the financial system, in other words, will hamper the speed of any recovery of the private sector.

**Table 8: Share of Firms in Financial Stress and in Need for Funds by Sector, July 2002**

	Financial Stress Status			Needs for Funds		
	Slightly Behind in Payments	Currently in Default	Financial Stress	To Cover Operational Costs	To Repay Existing Debt	Borrowing Stress
Chemicals	25%	5%	30%	30%	15%	45%
Construction Materials	23%	7%	30%	28%	12%	40%
Food	21%	11%	32%	22%	11%	33%
Handicrafts	25%	18%	43%	17%	21%	39%
Information Technology	30%	15%	45%	37%	11%	47%
Metal	31%	13%	44%	24%	26%	50%
Pharmaceutical	40%	0%	40%	20%	20%	40%
Plastic	7%	0%	7%	33%	15%	48%
Sewing	42%	27%	69%	63%	14%	76%
Stone and Marble	47%	17%	64%	33%	33%	67%
Textiles	22%	25%	47%	28%	19%	47%
Wood	29%	10%	39%	6%	50%	56%

Source: PFI / Paltrade.

**2.55 Agriculture.** Agriculture accounted for 8 percent of GDP in 2000. Production during the *intifada* has been compromised by the destruction of fields and trees, restricted access to fields, and the unpredictability and higher costs associated with exporting goods into Israel (in particular perishables). In addition, the increasing quantities of imported food aid have exerted a depressive effect on the sector, and Bank estimates suggest consequential losses equivalent to 2 to 5 percent of agricultural GDP. While providing an important safety net, the observed trend in favor of low value-added subsistence produce intended for private consumption and local market is also compromising the long-term growth potential of the agricultural sector. In spite of the excellent 2002 olive harvest, which accounts for 15-20 percent of all agricultural output,<sup>47</sup> the Bank estimates that the value of agricultural production in 2002 fell by approximately 25 percent compared to 2000.<sup>48</sup>

**2.56 Banking and Finance.** After an initial drop in the first month of *intifada*, residents' deposits remained relatively stable at about US\$3.2 billion until the IDF incursions into Palestinian cities in 2002, after which they rose slightly. This demonstrates the confidence that Palestinian households maintain in their banking system, which is perceived as a safe haven for personal savings.<sup>49</sup> On the other hand, the profitability of local banks has been severely affected as the demand for their more lucrative lending and retail banking services has decreased. This is

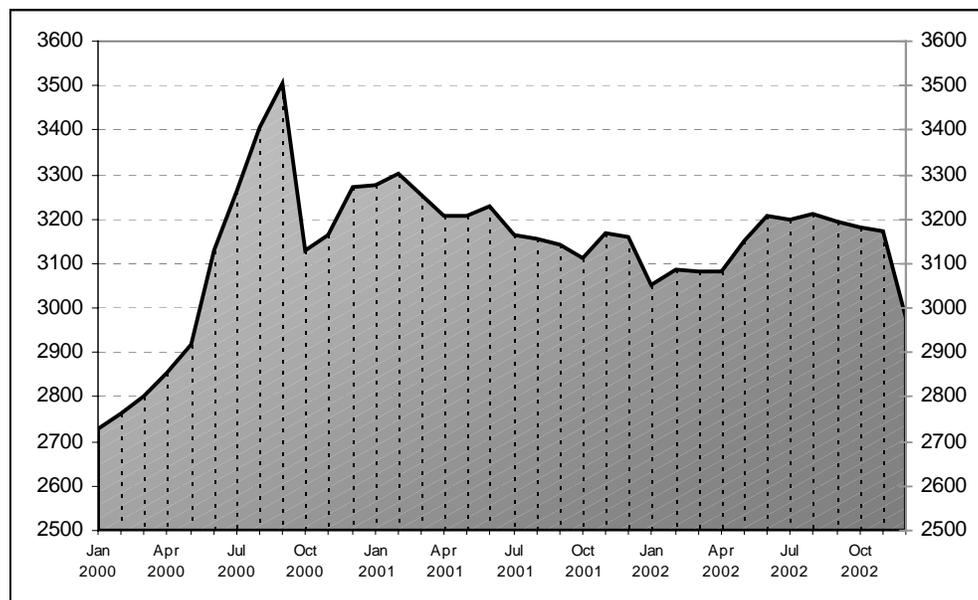
<sup>47</sup> 31.7 thousand metric tonnes, compared with 27 thousand metric tonnes in 2000, the previous record year since data collection began by PCBS and MOA.

<sup>48</sup> Agricultural GDP is highly cyclical, making comparison difficult. Two-year comparisons show a marked decline in agricultural GDP in 2002 when compared to 2000 and 1998, however.

<sup>49</sup> It also appears to reflect the fact that the withdrawals needed by households to cover living expenses were offset in this period by inflows of cash holdings, which were banked out of fear that Israeli soldiers might steal them in the course of house-to-house searches.

illustrated by a 53 percent decline in the value of cleared checks in the September 2000–December 2002 period. This decline outstripped the fall in GDP, and attests to a degree of demonetisation of the Palestinian economy.

**Figure 9: Resident Private Sector Deposits (end of period, US Dollars, millions)**



Source: World Bank staff calculations.

2.57 As a coping strategy, banks have chosen to reduce lending, giving priority to solvency rather than profitability. Throughout the *intifada*, the volume of credit extended to the private sector has continued to fall as bankers have adopted an increasingly conservative posture. Just as deposits took a downturn in the first month of the *intifada*, credit to the resident private sector fell by US\$91 million, or 7 percent, in October 2000. In the case of credit, though, the trend continued. By September 2002, private sector credit had fallen by US\$242 million, or 24 percent from its level two years before. Expressed as a share of total bank assets, private sector credit has fallen from 21 percent to 17 percent during the period. Thus, while the quality of the banks' loan portfolios has suffered, the low percentage of loans to total assets has dampened the impact of insolvencies on the financial health of the banks.

## SOCIAL IMPACT

### Impact at the Household Level

2.58 **Overview.** The economic crisis has seriously compromised household welfare. Many families have endured long periods without work or incomes, and despite the various employment generation efforts of the PA, donors and NGOs, many are now dependent on food aid for their daily survival. Coping with the situation has meant selling assets, borrowing from families, neighbors and shopkeepers and cutting consumption, including food. In an increasing number of families, shortages are now manifesting as malnutrition. The incidence of psychosocial trauma continues to climb, and family dynamics are under great pressure. The erratic provision of basic health, education and water services is further compromising the environment in which young Palestinians are growing up.

2.59 **Poverty.** Beginning in January 2001, PCBS began to survey the *Impact of the Israeli Measures on the Economic Conditions of the Palestinian Households*. The fourth round of the survey was conducted in January and February 2002, and establishes an important benchmark for the period immediately prior to Operation Defensive Shield. Even by then, the deterioration in household income was remarkable. Survey results indicate that 56.5 percent of Palestinian households had, by early 2002, lost over half their pre-*intifada* nominal income. Using a poverty line of US\$2.1 per day,<sup>50</sup> the World Bank estimated that 21 percent of the Palestinian population were poor on the eve of the *intifada*, a number that increased to 33 percent by December 2000, 46 percent by December 2001 and to about 60 percent by December 2002. Accounting for population growth, the numbers of the poor have tripled, from some 650,000 to about 1.9 million today. This dramatic increase in poverty is driven by the fact that a large share of the population was clustered just above the poverty line before the crisis. The poor are also getting poorer. In 1998, the average daily consumption of a poor person was equivalent to only US\$1.47 per day. This has now slipped to US\$1.32.

2.60 The impact of the crisis has differed from one area to another, depending on previous employment patterns and the local impact of closures and curfew. Regionally, the poor now exceed 75 percent of the population in the Gaza Strip, as compared with 50 percent in the West Bank. As observed in "Fifteen Months", the "new poor" of the *intifada* have tended to be those in traditionally poor areas -- either those dependent on labor in Israel, such as the southern West Bank, or those dependent on low-wage agricultural labor, such as the southern Gaza Strip. With private sector wage labor of all kinds the first casualty of the closure regime, the crisis naturally deepened poverty in these places. The pattern observed in 2001 persists. Areas such as Ya'bad, Al Jiftlik, Yatta, Adh Dhahiriya in the West Bank and Jabalya, Khan Yunis and Rafah in Gaza had higher concentration of the poor before the crisis, and are by definition more vulnerable to economic crisis. In addition, poverty has increased in some communities in the northwest of the West Bank, which are being isolated or cut off from the rest of the West Bank by the ongoing construction of Israel's security barrier. Once the first part of the barrier is completed in mid-2003, some 13,500 Palestinians will be confined to a narrow strip between the 1967 Armistice Line and the barrier. With the whole of the western face of the barrier complete, at least 95,000 Palestinians could find themselves disconnected from the West Bank. The economic and social viability of these affected communities is of serious concern to the donor community.<sup>51</sup>

2.61 The very high rate of Palestinian population growth -- some 4.3 percent per annum (4.1 percent for the West Bank and 5.2 percent for Gaza) -- is fuelling the growth in the numbers of the poor. The population of the West Bank and Gaza has increased by approximately 280,000

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<sup>50</sup> The National Commission for Poverty Alleviation developed the poverty line of US\$2.1 a day (*Palestine Poverty Report*, 1998, Palestinian Authority). The poverty line was calculated to reflect what is considered to be a minimum budget for food, clothing, housing, health care, education, transportation, personal care and housekeeping supplies.

<sup>51</sup> "Projections of the remaining course of the Wall are complex and subject to a great deal of speculation, as no official map of the entire route has been released by the GOI. The following estimates must, therefore, be treated as illustrative. Based on reports of land requisitions and housing demolitions and Israeli press articles on IDF plans for the Wall's future alignment, it appears that at least 95,000 Palestinians could find themselves located between the Wall and the Green Line -- i.e. approximately 4.5 percent of the population of the West Bank, excluding East Jerusalem.....Some representatives of settlers' organizations have proposed amendments to the Wall's already (partially) approved alignment to ensure that certain settlements are on the western side of the Wall -- in the process affecting an additional 20,000 Palestinians." *The Impact of Israel's Separation Barrier on Affected West Bank Communities*, Humanitarian and Emergency Policy Group of the LACC, April 2003.

to some 3.2 million<sup>52</sup> during the *intifada*. Given economic growth prospects even under the most optimistic scenarios of political *rapprochement*, Palestinian families will face severe problems in accessing water, schooling, housing and social services if the rate of population growth continues as today.

2.62 Poverty in the West Bank and Gaza presents a very different aspect to poverty in Bangladesh or Ethiopia. In a town such as Yatta in the southern West Bank, a visitor will be struck by the dissonance between the poverty statistics cited above -- in Yatta's case, some 70 percent of households in the district are now estimated to fall below the poverty line, as compared with 45 percent two years ago -- and the physical appearance of the town. Yatta features many substantial stone houses and apartments, built largely with the earnings of laborers and contractors who worked for many years in Israel. Public infrastructure is adequate, if slightly dilapidated. People are reasonably well dressed. The town's stores -- those that are open -- still display an adequate range of consumer goods, including many items associated with modern urban dietary habits. Hidden from view, though, is the impact of two years of gradual asset stripping. Many of those same houses are now empty of their furniture; their kitchens bare of anything much except food aid provisions rations; the family's car idle for lack of cash to buy petrol. Although a façade may remain, many family economies have been hollowed out.

2.63 **Social Relations.** The crisis has affected different social groups differently. Adolescents are particularly vulnerable. Of an age to understand the economic hardships that their families face but generally too young and inexperienced to be able to help much, they are particularly susceptible to trauma and to feelings of powerlessness and rage. Teachers are reporting an increase in violent behavior at school; many adolescents see no sense in continuing their education, and dropout rates in this age cadre appear to have risen markedly during the *intifada*.<sup>53</sup> However, this age group has a very limited chance of finding employment in the formal labor market, given the strong negative relationship between the level of education and unemployment observed in the West Bank and Gaza. If the trend continues, many of these adolescents may find themselves locked into a life-long poverty trap that even an economic recovery may not lift them out of.

2.64 There is a great deal of international research that shows how devastating protracted unemployment can be in patriarchal societies, and how this can often translate into domestic violence against women and children.<sup>54</sup> A range of social and human rights organizations working at the household level in the West Bank and Gaza are concerned with the potential for an increase in domestic violence as the economic crisis has lengthened, and because less protection available to women from the authorities as Palestinian law enforcement capacity has been reduced by the incapacitation of the police, particularly in the West Bank. This aggravates

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<sup>52</sup> This figure does not include the population in East Jerusalem.

<sup>53</sup> Mission Report: *Special Hardship Cases Program: Assessment and Proposal to Expand and Improve the Program*, The World Bank, October 2002, pp.2-3.

<sup>54</sup> See, for example, *World Report on Violence and Health*, WHO, 2002; *With an End in Sight: Strategies from UNIFEM Trust Fund to Eliminate Violence Against Women*, UNIFEM, 2000; *Human Development Report 2000: Human Rights and Human Development*, UNDP, 2000; *The World Bank Brief: Gender-Based Violence*, October, 2000.

a pre-existing lack of adequate legal protection for women against abuse and violence under Palestinian law, particularly from their spouse.<sup>55</sup>

2.65 At a general societal level, moreover, the environment of struggle, violence and radicalization has led, as in other occupied societies, to internal political violence. At a more subtle level, tolerance and the willingness to compromise and participate are placed at risk in the pressure-cooker social environment of the West Bank and Gaza, and some commentators have argued that an atmosphere of continual crisis works against the development of democratic norms. Donors were criticized in the pre-*intifada* era for excessive tolerance of PA authoritarianism.<sup>56</sup> Now, with many Palestinians seeing themselves as further than ever from statehood and identifying this regressive process with the Oslo period and the PA, greater numbers are professing support for non-democratic political structures. An analysis of the well-respected opinion polls conducted by the Jerusalem Media and Communication Center (JMCC) over the past ten years suggests an inverse relationship between perceptions of progress towards statehood and support for radical alternatives to the PA.

2.66 Increased hardship and the dissolution of the security services after Operation Defensive Shield have helped permit a rise in crime, including semi-organized crime.<sup>57</sup> With resources scarce, territory fragmented and official sanctions weak, social distortions of this kind are not unexpected, and are symptomatic of the growing informalization of the economy. Such phenomena may prove hard to reverse once the formal economy does revive and central control can be re-established.<sup>58</sup>

2.67 Nonetheless, what is quite remarkable is the continued cohesion of Palestinian society. Despite violence, economic hardship and the daily frustrations of living under curfew and closure, lending and sharing are widespread and families for the most part remain functional. Even with dependency ratios at the end of 2002 of over 8 in Gaza and a dearth of effective formal safety nets, outright destitution is still limited -- those who have income generally share it widely with those who do not. Donors were saying even prior to Operation Defensive Shield

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<sup>55</sup> For example, pre-occupation Jordanian penal law currently used in the West Bank absolves a rapist if he marries his victim. Palestinian women's organizations are currently working closely with the PLC to ensure that two new laws, the Family Law and the Child Law, are framed in accordance with the 1993 *Vienna Declaration and Program of Action* adopted by the World Conference on Human Rights. For further reference, see Asma Khader, *Law and the Future of Palestinian Women*, 1998.

<sup>56</sup> The International Crisis Group (ICG)'s report argues that "While the donor community sponsored numerous projects in support of Palestinian public institutions and as a rule meticulously accounted for its own funds, the PA was generally not held accountable on the basis of objective performance criteria, and was ultimately judged on the basis of its willingness to continue implementation of the Oslo agreement." *Middle East Briefing: The Meanings of Palestinian Reform*, ICG, November 12, 2002. In an interview with ICG on October 14, 2002 in Ramallah, Nabil Amr, PLC member and former PA Minister of Parliamentary Affairs, reportedly said: "We [the PA] would score 20 percent on a test, and they [donors] would give us a grade of 90 percent." *Middle East Briefing*, op. cit., p. 6.

<sup>57</sup> Middle East Newline's *Palestinians Struggle Amid Rise in Crime*, Vol. 4, No. 472, December 12, 2002, reported that a network of gangs had emerged in Jerusalem and Ramallah and was engaged in violent extortion and theft, and that these gangs faced little danger of action by either Israeli or Palestinian authorities. The same article reported that Palestinian dailies, including Al Quds, had published announcements warning the public against these gangs, which were said to be engaged in drug trafficking, forgery and theft.

<sup>58</sup> Albania and Kosovo serve as recent examples of how local criminal networks become entrenched as a result of periods of breakdown in central authority.

that Palestinian society was absorbing levels of unemployment that could well have fractured the social contract in industrial societies.<sup>59</sup>

## **Adaptive Strategies**

2.68 How are Palestinians managing to cope with severe, sustained income compression? As can be expected, a variety of strategies are being employed. On balance these have worked well, but they are not sustainable *ad infinitum*, and signs of exhaustion are apparent.

2.69 A study of the local level impact of closure in the first nine months of the *intifada* by the Norwegian institute FAFO pointed out at that time that “the effects on the household are perhaps somewhat *less* than suggested by the tremendous macro-economic impact.” This was put down to a number of factors that are not adequately captured by macroeconomic aggregates -- including the persistence of various kinds of employment (in the public sector, clandestine work over the Green Line and in settlements for West Bankers, some residual work in the domestic private sector); and recourse thereafter to savings, traditional mutual help practices and external social assistance to the poorest. The mix of strategies employed today is similar,<sup>60</sup> though the proportions have changed: there is, in essence, less work, less capital to dispose of, a greater reliance on external relief, and the same use of reduced consumption as the “balancing item”. Now, however, signs of long-term damage are more evident, as exemplified by the emergence of severe malnutrition.

2.70 ***Working Whenever Possible.*** The current recession is best understood as a closure-induced employment crisis, in which families are losing their ability to purchase goods and services.<sup>61</sup> Those who are still employed are by and large able to manage, since the supply of day-to-day goods and services remains relatively intact, and price increases for consumer have remained modest. PA employment has become an essential part of the Palestinian safety net. It now accounts for 26 percent of all Palestinian employment, compared with 17 percent on the eve of the *intifada*, and is also fully-paid employment -- unlike much of the work available in the private sector, a good deal of which is associated with discontinuous daily labor (including in Israel and the Israeli settlements, on farms and construction sites and in small family-based businesses that depend on market demand and must adjust pay according to business earnings).<sup>62</sup>

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<sup>59</sup> For example, see an article in Ha'aretz, May 19, 2002 reflecting on “Fifteen Months”.

<sup>60</sup> As evidenced in FAFO's latest report, *Coping with Conflict -- Palestinian Communities Two Years into the Intifada*, Pal Sletten and Jon Pedersen, FAFO Report No. 408, Oslo, 2003. The report cites four particular mechanisms that have helped sustain food security -- wages to public and private sector employees, which have a “very important trickle-down redistributive effect”; food and cash handouts; the delayed payment of bills, in particular to utility companies, and the PA health insurance scheme introduced during the *intifada*, which permits free medical treatment.

<sup>61</sup> In commenting on this paragraph, the PA's review committee (see Preface) remarked that “We believe that this is a systematic destruction of the Palestinian economy and not a mere recession, and that it is a function of the occupation and not merely an employment crisis.”

<sup>62</sup> PCBS labor data shows that about 21,000 of the 83,000 jobs created in Q4 of 2002 took the form of “unpaid family employment”, meaning that the work -- on farms, in shops, etc. -- required additional labor which could not be directly remunerated.

2.71 For earners who do not have regular employment,<sup>63</sup> the options for work are limited. An estimated 15 percent of those unemployed in 2001 managed to secure occasional paid work under various job-creation schemes, and this provided an average of 15-20 days of employment per beneficiary per month. The numbers of the self-employed has increased by some 26,000 since the beginning of the *intifada*, and there is anecdotal evidence of growth in contract sewing and peddling, but there is no reliable data on the extent of these precarious forms of work. In rural areas, households relied increasingly on agriculture in 2002, as employment outside the village became less accessible -- but the cost of inputs (water, seeds, pesticides and fertilizers) in an environment in which supplier credit is tight meant that many farming households were unable to produce at near their capacity. In addition, farmers face barriers to transport, and in some places have lost land, crops and water supplies to IDF land clearance activities and settler vandalism.<sup>64</sup> As a result, there appears to have been a marked shift in 2002 away from integrated commercial agriculture to production for local consumption and family subsistence.

2.72 ***Drawing Down Savings, Selling Assets, Borrowing and Sharing.*** In “Fifteen Months”, the World Bank estimated that household savings would permit reasonable levels of aggregate consumption only through the spring of 2002. While households traditionally sell personal belongings such as jewelry in order to get much-needed cash during hard times, Oxfam has noted that some households are now also selling productive assets such as land, livestock and tractors.<sup>65</sup> The sale of core assets (at knock-down prices in today’s depressed market) indicates that many households’ more liquid savings are depleted, and could pose significant problems for a recovery of the rural economy.

2.73 Local co-operation has provided an informal safety net for struggling households. SDC data indicates that relatives, friends and personal business acquaintances have provided much more assistance to households than the PA, donors, NGOs and charitable organizations taken together.<sup>66</sup> A particularly vital component in this system of sharing social misfortune is the informal credit provided by local retailers to their regular customers. There is anecdotal evidence, though, that this important form of assistance is drying up. Traders, shopkeepers and water suppliers, themselves under pressure from suppliers to pay in cash, are in many cases restricting credit lines to households that have cleared outstanding debts and have stable salaries.<sup>67</sup> As time wears on and the proportion of those in difficulty rises, it has become more difficult to rely on neighbors for assistance. ICRC<sup>68</sup> argues that one cause of hardship is that “richer” relatives are no longer able to support poorer households, while other research shows that many who previously gave loans to friends and relatives have been forced to call them back in.<sup>69</sup> According to the December 2002 report by the Swiss Agency for Development and

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<sup>63</sup> PCBS Q4/2002 data shows 146,000 of the 478,000 who are employed *and* paid (see footnote above) as “self-employed”. This represents 30 percent of all earners, as compared with 20 percent in September 2000.

<sup>64</sup> The start of the olive harvest in October 2002 witnessed a number of attacks by settlers on harvesters -- see Ha’aretz, 7 October and 20 October 2002 editions.

<sup>65</sup> *Forgotten Villages*, Oxfam, 2002.

<sup>66</sup> *Report No.5 on International and Local Assistance during the second Intifada*, Swiss Agency for Development and Cooperation, December 2002, p. 26.

<sup>67</sup> *Forgotten Villages*, op. cit., pp. 14-15.

<sup>68</sup> ICRC and British Red Cross, *Urban Food Economy/Market Study in the West Bank*, 17 June 2002, p. 8.

<sup>69</sup> R. Giacaman and A. Husseini, *Life and Health During the Israeli Invasion of the West Bank: The Town of Tulkarm*, 25 May 2002.

Cooperation (SDC)<sup>70</sup>, 20 percent of an interviewed sample population said they could not longer cope with the situation, 38 percent said they were barely coping, and 9 percent said they would only be able to cope for a few more months. Increasingly, therefore, households are coming to depend on relief measures from outside.

**2.74 Accessing Humanitarian Assistance.** Already in January-February 2002, the fourth round of PCBS' *Impact of the Israeli Measures on the Economic Conditions of the Palestinian Households* indicated that 58 percent of Palestinian households were receiving humanitarian assistance (45 percent in the West Bank, and 86 percent in Gaza), with the bulk of this in the form of food supplies (72.5 percent), and with UNRWA the main source of food aid (providing 55 percent of the total). A comparison of SDC's December 2002 data with previous survey rounds shows that for the first time families are now reporting food as their first priority -- 39 percent of the sample, as compared to the 30 percent who identified employment (and hence cash) as their first need. This result reflects deepening poverty and, arguably, the relatively insignificant impact that the employment programs of the PA, donors and NGOs have managed to have so far (only 16 percent of SDC respondents reported having received any job assistance in the past six months). FAFO's recent study, however, suggests that while some households have less food, most deny that food shortage *per se* is a problem, as food remains available for those who have the means to buy it.<sup>71</sup>

**2.75 Reducing Food Consumption.** For all of the abovementioned efforts to distribute food, however, nutritional indicators suggest that relief efforts are not keeping pace with the decline in the ability of the very poor to purchase food. The Bank estimates that per capita real food consumption declined by as much as 25 percent between 1998 and the end of 2002. Given the inelastic response of food consumption to changes in income and the stability of food prices, it is likely that consumption of less essential goods declined by at least as much as the decline in food consumption.

**2.76** Three-quarters of Palestinian households have reported reduced food intake behavior during the *intifada*. The impact of this on child health is now significant, as was revealed in the July 2002 PCBS Nutrition Survey and the August 2002 Johns Hopkins University/Al-Quds (JHQ) University *Nutritional Assessment*.<sup>72</sup> According to the JHQ study, the primary reasons cited for reduced food consumption were lack of money (65 percent) and curfews (33 percent), with 53 percent of surveyed households indicating that they had been obliged to borrow money to buy food. Both studies reported high levels of malnutrition and anemia among children between 6 and 59 months.<sup>73</sup> An update of the Nutritional Assessment in January 2003 found global acute protein-calorie malnutrition (GAM) in 9.3 percent of the children across the West Bank and Gaza (13.3 percent in Gaza and 4.3 percent in the West Bank). The figure for Gaza is

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<sup>70</sup> *Report No.5 on International and Local Assistance during the second Intifada*, op. cit.

<sup>71</sup> FAFO, op cit. FAFO's work is based on case studies in four communities -- Gaza City, and Beit Furik, Rantis and Jericho in the West Bank.

<sup>72</sup> *Nutritional Assessment of the West Bank and Gaza Strip*, conducted by Johns Hopkins University/Al Quds University and financed by USAID through CARE International, September 2002.

<sup>73</sup> The *PCBS Nutrition Survey* found 33.9 percent of children below five years as suffering from mild anemia (37.3 percent in Gaza; 30.3 percent, West Bank) and an additional 15.6 percent suffering from moderate-to-severe anemia (17.4 percent in Gaza, 13.6 percent, West Bank).

particularly worrying.<sup>74</sup> As the table below indicates, however, JHQ’s findings are disputed by PCBS. At the request of both parties, therefore, the Bank will provide a neutral expert to assess the survey methodologies and findings of JHQ and PCBS’ 2002 surveys, and to offer an opinion on the relative validity of their divergent findings.

**Table 9: Malnutrition in the West Bank and Gaza**

	Survey	Acute malnutrition*	Chronic malnutrition*
West Bank	PCBS 1996	2.2	6.7
	PCBS 2000	1.5	7.0
	PCBS 2002	2.3	7.7
	JHQ 2002	4.3	7.9
Gaza	PCBS 1996	3.7	8.2
	PCBS 2000	1.4	8.3
	PCBS 2002	2.0	10.6
	JHQ 2002	13.3	17.5

\* Percent of children aged 6-59 months.  
Source: FAFO, 2003 (op. cit.).

2.77 There has been a significant increase in the aggregate quantity of food aid distributed since the beginning of the crisis. UNRWA estimates that a total of 1.7 million people, or over half the population of the West Bank and Gaza, are in receipt of food aid.<sup>75</sup> It is estimated that the donor community spent some US\$76 million on food aid in 2002 (7 percent of total donor disbursements), as compared with US\$40 million in 2001.

2.78 It is widely recognized that there is no general problem of food shortage in the West Bank and Gaza, although certain isolated communities have experienced periods of curfew or tight closure that have made access to food stocks difficult for varying periods of time. Though demand factors underlie the reductions in food consumption noted earlier, the emergence of consumption and nutrition deficits argues for the use of food aid for supplemental feeding programs while the crisis persists (in Annex 1 the use of food aid as a form of general income support is also discussed). The JHQ *Nutritional Assessment’s* January 2003 edition’s recommendations section argues for a “limited targeted supplemental feeding program [for] children at high risk -- large lower income families with poor access, children with mothers of lower education, weaning infants of lower income level households, and focused initially in the Gaza Strip.”

<sup>74</sup> GAM in Gaza consisted of a prevalence rate of moderate acute malnutrition of 9.5%, and of severe acute malnutrition of 3.8%. Acute malnutrition is associated with wasting and is a consequence of short-term nutritional deficiencies. In LDCs as a whole, GAM prevalence is about 10% (moderate acute of 8% plus severe acute of 2%). A 13.3 GAM prevalence is comparable to Eritrea in 1995 (13.3% plus 3.1% = 16.4%) and Nigeria in 1999 (7.5% + 4.9% = 12.4%) -- but also to Yemen in 1997 (10.3% + 2.6% = 12.9%) and UAE in 1995 (11.4% + 3.8% = 15.2%). Source: *UNICEF Global Database on Child Malnutrition* ([www.childinfo.org/eddb/malnutrition/database1.htm](http://www.childinfo.org/eddb/malnutrition/database1.htm)).

<sup>75</sup> Of which some 1.1 million (96% of whom are refugees) are now receiving food regularly from UNRWA. Other key providers of food are the World Food Program, ICRC, the Ministry of Social Affairs and various NGOs including Islamic Relief and NGOs financed by ECHO and USAID). Those in receipt of food generally receive it as a supplement to other forms of subsistence -- in UNRWA’s case, the food package is calibrated to the size of the family and aims to provide 60% of the caloric and 65% of the protein requirements of the household.

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### **3. THE INSTITUTIONAL RESPONSE**

3.1 “Fifteen Months” described how the PA, municipalities, NGOs and the international community sought to counter the severe economic impact of closures and fiscal compression, and how they succeeded in helping avert institutional and socioeconomic dissolution.

3.2 Operation Defensive Shield embodied a second major shock to Palestinian social and economic structures. While aspects of the collective response remained relatively constant, a number of important new developments emerged. First, the PA for the first time began to implement far-reaching structural reform. Second, donors intensified their cooperative efforts, as witnessed in the West Bank damage assessment, the formation of international and national task forces to support Palestinian reform, and efforts to craft a common position on humanitarian assistance. Third, important shifts in the fiscal picture emerged in the last quarter of 2002/first quarter of 2002. While the flow of donor budget support funds sharply declined, the Government of Israel resumed regular transfers of monthly clearance revenues, one of the key stabilizing steps advocated by donors throughout the *intifada*.

#### **THE RESPONSE OF THE PALESTINIAN AUTHORITY**

##### **Crisis Management and Overall Coordination**

3.3 “Fifteen Months” noted the lack of a “shared governmental vision of how to manage the crisis”, the absence of an apex-level crisis management forum and a loss of momentum in PA/donor coordination mechanisms (including the demise of any effective system for tracking donor commitments and disbursements) -- a situation that persisted through 2002 (but see paras. 4.52-4.54). But as the following account of selected ministry responses shows, performance at the decentralized level continued to be impressive, under even more constrained conditions of physical access than in 2001. Though shaken, the basic structure of social and economic services for which the PA is responsible still functions.

##### **The Reform of the Palestinian Authority**

3.4 The case for thorough reform of the PA’s security and civilian structures was made forcefully by a number of external parties in mid-2002, most prominently by U.S. President Bush.<sup>76</sup> What is also important to stress that *internal* pressure was a decisive element in the inception of reform in 2002, and is the key to the Palestinian Reform Program’s resonance and vitality today. The Palestinian public has for a long time voiced its criticism of the PA’s

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<sup>76</sup> “A Palestinian state will never be created by terror -- it will be built through reform. And reform must be more than cosmetic change, or veiled attempt to preserve the status quo. True reform will require entirely new political and economic institutions, based on democracy, market economics and action against terrorism.” U.S. President George W. Bush, Address of June 24, 2002.

performance. Concerns have focused in particular on financial corruption in the PA,<sup>77</sup> but have also encompassed nepotistic practices, a restrictive environment for the private sector and inefficiency in the provision of certain basic services.<sup>78</sup> In “Fifteen Months” the key recommendations to the PA related to structural reform, on the premise that the emergency made it more, not less urgent to implement the reform agenda that had been the subject of so much discussion in the 1999-2000 period.<sup>79</sup> “Some have argued that it makes little sense to focus at this stage on anything [other than coping with the day-to-day emergency], the PA believes the opposite -- that extreme cash shortages, a decaying investment climate and serious impediments to implementation require greater budgetary efficiency, enhanced internal coordination and a better operating environment for the private sector, all of which are key issues on the structural agenda.”<sup>80</sup>

3.5 Following Operation Defensive Shield, the siege of the *Muqata’a*, a contentious meeting of Fatah’s Central Committee and statements about the need for reform by prominent Palestinians,<sup>81</sup> a PA Ministerial Committee for Reform (MCR) was established. The MCR set about framing an action agenda which was published as the PA’s *100 Days Reform Plan* on June 23, 2002 (<http://www.jmcc.org>). The 100 Day Plan contained many of the same measures as previous documents and declarations, and bears a strong resemblance to the agenda summarized in “Fifteen Months” -- while also encompassing reforms in the security and political domains.

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<sup>77</sup> According to public opinion polls conducted over the years by JMCC. For example, in Poll No. 20 of May 1997, in response to the question “Some think that the level of corruption in the Palestinian Authority is high, others think that there is corruption but it is not widespread while others think there isn’t any corruption. What do you think?”, 38.8% of respondents said there is a great deal of corruption in the PA while 43.8% said there is a fair amount of corruption in the PA (82.6% total). In Poll No. 47 of December 2002, when asked whether there is corruption in the PA, 82.7% of respondents responded “yes”. These polls are considered methodologically sound by the donor community and are widely used to track evolving Palestinian attitudes.

<sup>78</sup> In an interview with ICG on June 22, 2002 in Ramallah, Mamduh Nofal, member of the Palestinian National Security Council and Presidential Advisor for Internal Affairs, said that “ the general opinion of the Palestinian street has been that there is a basic problem with the PA’s civil and security institutions, their development and performance. The view is that they are still dominated by the old mentality of the PLO days, a mentality of Fatah domination, of tribalism, paternalism, and clientelism rather than a scientific and institutional mentality appropriate to an emerging state.” *Middle East Briefing*, op. cit., p. 5.

<sup>79</sup> See, for example, the June 1999 “Rocard” report (*Strengthening Palestinian Public Institutions*, Council on Foreign Relations), the World Bank’s 1999 Public Expenditure Review, the World Bank Governance and Business Survey in 2001, the October 1999 version of the *Tripartite Action Plan* and the *Economic Policy Framework* developed with the IMF and presented to the AHLC in June 2000. It should be noted that donors’ concerns also reflected widespread dissatisfaction within the Palestinian governance structure as well. In July 29, 1997, PA Comptroller Jarar al-Qudwa issued a report stating that at least US\$326 million (nearly 40%) of the PA’s US\$800 million Budget for 1996 had been squandered through corruption and mismanagement, named various PA ministers as culpable and urged President Arafat to dismiss his Cabinet and file charges against them. None of those named were investigated or censured. In 1997 the PLC issued *The PLC Special Committee Report* on corruption, which can be found at <http://www.jmcc.org/politics/pna/plc/plccorup>. In December 1999 a group of 20 Palestinian academics and PLC members, including some from the Fatah faction of the PLO, published a letter criticizing the PA for “opening the door for widespread corruption and exploitation of the Palestinian public” (reported by the BBC on November 30, 2001).

<sup>80</sup> *Fifteen Months*, op. cit., p. 95.

<sup>81</sup> See *An Open Letter to President Arafat* by former Minister of Parliamentary Affairs Nabil Amr, published in Al-Hayat on September 2, 2002.

#### **Box 4: The “100 Days Plan” of the Palestinian Authority**

Released on June 23, 2002, the PA's Reform Agenda expressed the commitment of the Palestinian Authority to a broad program of reforms. Because a number of specific measures were identified to be implemented within 100 days (while implementation of all other measures would be initiated so as to have a "tangible and visible" effect within three months of the plan's adoption), the entire agenda has come to be known as the “100 Days Plan.” The agenda items are summarized below:

##### ***In the general domain:***

- Reinforce separation of powers of the legislative, executive and judiciary branches of government
- Restructure and modernize ministries and government institutions
- Prepare for municipal, legislative and presidential elections
- Put into force all laws that have been passed
- Improve the standard of living, particularly of the unemployed and other segments of society that live in dire conditions
- Rebuild the infrastructure that has been destroyed by the occupation
- Tend to the needs of the wounded, families of those killed during the occupation, prisoners and detainees

##### ***In the domain of public security:***

- Restructure and modernize the Ministry of Interior
- The Ministry of Interior is to be in charge of all matters relating to internal security
- Activate the role of the Ministry of Interior in the enforcement of court rulings
- Respond to the expectations of the people for safety, order and respect of law
- Improve discipline in the security services and strengthen social control
- Reinforce the loyalty of the security services to the job, the Authority and the country
- Raise awareness of the population of the measures above and secure their understanding, cooperation and support

##### ***In the financial domain:***

- Reform operations in the Ministry of Finance
- Deposit all incomes of the PA in a single account of the treasury
- Manage all commercial and investment operations through a Palestinian Investment Fund, which is subject to stringent standards of disclosure and audit
- Limit expansion of employment in the public sector and unify payroll administration under the Ministry of Finance
- Modernize the pension scheme
- Strengthen internal and external auditing
- Develop the process of preparing the general budget to include recurrent and developmental expenditure
- Develop a monthly expenditure plan for the remainder of 2002
- Begin preparation of the 2003 budget
- Reorganize the financial relations between MOF and the municipalities/local authorities

##### ***In the judicial domain:***

- Strengthen the judiciary, through appointment of judges and development of infrastructure
- Implement measures required by the Judiciary Law
- Prepare draft laws, decrees and decisions to accompany the Basic Law
- Establish the Government Legal Cases Administration to handle cases to which the government is party

##### ***In other domains:***

- Reinforce the Palestinian values, including the spirit of democracy, enlightenment and openness
- Activate the role of the Ministry of Awqaf to serve national and religious objectives
- Resolve the financial crisis of the universities, schools and hospitals
- Review government institutions that operate outside the jurisdiction of the ministries with a view to attach or incorporate them with the ministries
- End the role of the security services in civilian affairs
- Improve employment policy, to prevent an inflated civil service
- Unify and develop institutions -- and promulgate laws -- that encourage investment
- Improve the training and conditions of employment of human resources
- Increase the effectiveness of the Palestinian diplomatic corps
- Rebuild the management boards of government institutions according to the law
- Pay special attention to the pollution of the environment

3.6 With the stated goal of making the Palestinian Authority “more efficient and effective in the service of the national good,” the agenda consisted of 39 items spread across five “domains” (Box 4). Eleven months after the 100 Days Plan was issued, important achievements have been realized. In some areas (particularly in the financial accountability domain) progress has been considerable; in others, less so. There has been resistance to reform in specific instances (notably in the legal and judicial reform domain, though recent movement has taken place), while the inhibiting effect of the general environment for governance has interfered with the consultative processes needed as part of any broad-based and committed change process. Importantly, though, donors have observed a significant attitudinal shift. The MCR, the PLC and many of the technical staff involved in various ways in the implementation of reform clearly welcome the process and believe it is vital to the prestige and survival of the PA.

3.7 The degree of corruption and inefficiency in the PA is open to debate, and dispassionate analysis of the issue is in short supply. When it comes to delivering basic social services, as “Fifteen Months” and this report both argue, the PA has managed well under arduous circumstances. Be this as it may, the pertinent issue is that many Palestinians perceive the PA as corrupt and inefficient. By launching the 100-Day Plan the PA in effect acknowledged this perception and committed itself to changing the way it does business. It is vital that the new government of P.M. Abu Mazen continues the reform process and ensures its success.

### **Health Service Delivery**

3.8 Access to health service facilities has become progressively harder as a result of IDF measures,<sup>82</sup> particularly in the West Bank, where Operation Defensive Shield and its aftermath multiplied the difficulties faced by West Bank villagers in accessing secondary and tertiary health care (over 70 percent of the population in the West Bank live in rural areas<sup>83</sup>). Oxfam has described how villagers have managed to maintain partial access to city hospitals by using back-to-back ambulances, traveling to hospital by donkey and/or moving in with urban relatives<sup>84</sup> -- but many others are not now able to obtain the care they need.

3.9 “Fifteen Months” described how a severe shortage of operating budgets, combined with increasing demand for emergency services in an environment where closure works against economies of scale in service provision, had precipitated a crisis in health service delivery. The report called for an immediate infusion of non-salary operating cost support to MOH. Towards the end of 2001 and in 2002 MOH’s financial situation improved somewhat due to increased donor disbursements/in-kind supplies, but financing remains inadequate and uncertain. Shortages of drugs, in particular, have combined with disruption and access problems to cause a significant reduction in service provision, and towards the end of 2002 MOH reported that its facilities were operating at about 30 percent of their capacity.

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<sup>82</sup> The health situation of Palestinians is “deteriorating as a result of the escalation of the conflict, compounded by further border closure and curfews throughout the West Bank and Gaza Strip since March 2002. There have been explicit restrictions on population movements, which hinder the delivery of health care services” -- statement issued by the Director-General of WHO on the health situation of Palestinian people living in the occupied Palestinian territory, Statement WHO/04, September 27, 2002.

<sup>83</sup> HealthForum *Newsletter*, No. 12, September 15, 2002.

<sup>84</sup> *Forgotten Villages*, op. cit.

3.10 On a day-to-day basis, MOH continues to cope as well as can be expected. The measures taken earlier in the *intifada* to decentralize management and to establish PA-UNRWA-NGO mobile teams<sup>85</sup> remain in place. The health sector offers the best sectoral example of PA-donor-NGO cooperation in managing the crisis. Health Inforum, a donor-financed information and operational coordination service housed in the Italian Consulate and attached to the Health Sector Working Group have facilitated this cooperation.<sup>86</sup> Health Inforum publishes bi-weekly electronic bulletins describing the activities of various actors in the sector, and pinpointing urgent needs (e.g. for medicines and supplies in specific areas disrupted by curfews and closure).

3.11 Like all PA institutions, MOH is facing financial difficulties. While employees' salaries have continued to be paid, non-salary recurrent budgets have been underfunded and slow to arrive. The situation reported in "Fifteen Months" (only 19 percent of budgeted non-salary funds for 2001 received by mid-year) has improved in the aggregate, but unpredictability of funding/supplies flows remains a serious issue in a system subject to demands that are hard to forecast, and which need immediate responses. In 2001 as a whole, MOH was able to cover 63 percent of its non-salary operating costs. Despite the deterioration in the PA's overall fiscal situation in 2002, a doubling of donor contributions in 2002 (when compared to 2001) meant that 87 percent of non-salary requirements for 2002 were met. Most of the US\$31 million in operating cost support received from donors in the period came from the Emergency Services Support Program (ESSP), designed in response to the PA's operating cost crisis. The problems experienced by the health system in 2001 and early 2002 from operating cost starvation and from the lags of the procurement cycle should now abate, making it easier to meet the "real time" needs in the sector in 2003.

**Table 10: Ministry of Health: Non-Salary Operating Costs, 2000-2002 (US\$ thousand)**

	2000	2001	2002
Budget Allocation	49,800	51,177	47,811
Funds Received from MOF	4,527	16,064	10,266
Funds Received From Other Sources	4,956	16,095	31,217
Financing Gap	40,317	19,018	6,328

Source: MOH.

### Education Service Delivery

3.12 **Schools.** Palestinian society is very young, with 46 percent of the population under 15.<sup>87</sup> As a result of this age structure, the school system has had to cope with over 65,000 new entrants during the two years of the *intifada*. Even under normal circumstances, then, it is a considerable challenge to provide quality education to a rapidly expanding system. As in the health sector, financing and access problems have dominated the coping agenda of the Ministry of Education and Higher Education (MOEHE), albeit with important differences of emphasis.

<sup>85</sup> *Fifteen Months*, p. 46.

<sup>86</sup> Health Inforum was established by the World Health Organization, Italian Cooperation, USAID/Maram, UNSCO and UNDP.

<sup>87</sup> 'Palestinians at the End of Year 2002,' PCBS, December 2002, p. 19.

3.13 The problem of accessing schools and ensuring the continuity of the education process has been particularly difficult in 2002, above all in the West Bank as a result of closures and curfews.<sup>88</sup> A press release by UNICEF in November 2002 confirmed that more than 226,000 children and over 9,300 teachers are unable to reach their regular classrooms, and at least 580 schools have been closed at one time or another due to curfew and closure. According to PCBS, during the previous school year (2001/2002), 60 percent of school children (542,000) were absent from school for at least one day, with a median absence of ten days. Problems of access were particularly severe in early summer 2002, when high school students were expected to attend their high-school *tawjeehi* exams. Despite the difficulties, MOEHE was able to hold the examinations.

3.14 MOEHE has responded to the difficulties commendably, continuing its policy of decentralized management (whereby District Education Offices and schools are empowered to take decisions based on daily developments).<sup>89</sup> In addition, some 12,000 teachers have been redistributed as a response to the cantonization of the West Bank, and many students have been transferred from schools in dangerous areas with provision for them to “second-shift” elsewhere. The use of distance learning techniques also expanded notably in 2002, with schools making available to parents a comprehensive set of worksheets that permit self-study at times when school attendance is impossible.

3.15 Nonetheless, the impact of these disruptions and the enormous distraction factor for students is inevitably taking its toll on the quality of education. Data obtained from UNRWA and UNICEF indicates that for the 2000-2001 school year, final exam marks dropped appreciably. Passing grades in Arabic declined from 71 percent in 1999-2000 to 38 percent in 2000-2001, and in mathematics from 54 percent to 26 percent. MOEHE has responded to the loss of school-time by adding catch-up days, and has encouraged the establishment of makeshift classrooms in mosques, basements and private homes. While such alternatives have made it possible to sustain school education, quality is certain to have suffered. Capital funding constraints have also meant that MOEHE was only able to build 438 new classrooms, less than half the 1,000 needed to accommodate new school entrants.<sup>90</sup> Thus many schools have become over-crowded, forcing the re-introduction of two and even three shifts as a regular feature.

3.16 In 2002 MOEHE’s ability to cover non-salary operating costs improved compared with 2001, as donors almost doubled their financial assistance. Typically, however, schools in the West Bank and Gaza are relied upon to cover some 50 percent of their recurrent budgetary needs from student fees, and this has left them vulnerable to the family income compression that characterizes the current crisis. Families often struggle to buy uniforms and pay for

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<sup>88</sup> *A Report on the implementation of 2002 Plan and Emergency Needs for 2003*, presented to the Education Sector Working Group by MOEHE, November 2002. Since the beginning of the Intifada, nine schools were closed by IDF orders and 41 schools in Alkhader, Bethlehem, Huwara, Sawiya, Nablus and Yanoun were turned into military bases, and students and teachers in 50 schools that were located in areas of frequent confrontation were transferred to safer areas.

<sup>89</sup> School administrative committees are now supposed to be formed of those living in the immediate vicinity of a school, to minimize curfew and closure-related disruptions to school management.

<sup>90</sup> In 2002 MOEHE prepared a US\$73 million *Emergency Plan* for donor financing. This Plan focused on the necessary capital expansion of the system, curriculum upgrading and some specific capacity building activities. Only US\$31 million could be mobilized for the Plan, however, which restricted MOEHE’s ability to manage the required expansion of the system

transportation, contributing to increasing drop-out rates. To address the decline in the school enrollment, MOEHE has decided not to deny any children schooling if their parents cannot pay their fees.

**Table 11: Ministry of Education and Higher Education:  
Non-Salary Operating Costs, 2001 & 2002 (US\$ thousands)**

	2001	2002
Budget Allocation	14,609	17,222
Funds Received from MOF	2,993	3,465
Funds Received from Other sources	6,413	11,083
Financing Gap	5,203	2,674

Source: MOEHE.

3.17 **Higher Education.** MOEHE's recent *Higher Education Financing Strategy*<sup>91</sup> highlights a growing financial crisis in the university system. The financing of the system has been precarious for many years, relying on unpredictable outside support for approximately 30 percent of annual recurrent costs (student fees typically financed about 70 percent of the universities' recurrent budgets before the intifada, US\$36 million out of a total US\$53 million in 1999-2000). As a result of the income compression of the past two years, some 20 percent of the student body are now unable to pay fees, and in 2002 fee income shrank to US\$31 million from US\$38 million in 2001,<sup>92</sup> raising the system's annual deficit to US\$24 million and the accumulated system deficit to US\$80 million. During the same time, the numbers of students enrolled grew in 2001-2002 to 82,000, up from 62,000 in 1999-2000.

3.18 A cornerstone of MOEHE's *Financing Strategy* has been the establishment of a Student Revolving Loan Fund (SRLF), and in the second semester of 2001-2002 the SRLF was expected to extend loans to 18.5 percent of the student population. This is a promising start, but total funds disbursed through the SRLF so far are equal to only 9 percent of fees. A 50 percent increase in the numbers of students needing loans is also expected this academic year, raising the cost of an effective SRLF to US\$10 million per annum.<sup>93</sup>

3.19 The higher education system is now facing a cash crisis. Without emergency support, some institutions may be forced to close, and many students obliged to discontinue their studies -- bringing immediate social problems as well as long-term damage to the Palestinian human capital stock. For 2003 the recurrent budget requirements of the nine institutions amount to US\$75 million (for 87,000 students). Of this, US\$44 million is expected to be financed by self-generated fees (US\$26 million) and donors' loans to students (US\$18 million). The PA has made a provision for another S\$20 million to the universities under the 2003 Budget, but is

<sup>91</sup> *Palestinian Higher Education Financing Strategy*, MOEHE/World Bank, August 2002.

<sup>92</sup> This is consistent with SDC survey results, which suggest that at least 15% of university students have dropped out during the *intifada* because they are unable to pay their fees. See *Report No.5 on International and Local Assistance during the second Intifada*, Swiss Agency for Development and Cooperation, December 2002.

<sup>93</sup> Other components of the *Financing Strategy* involve providing direct support to institutions for certain "priority fields" for which the full costs of courses exceed the fees paid by students (which are not differentiated between subjects), and the provision of subsidies to students enrolled in these fields, in the form of vouchers that can be cashed in by universities. According to MOEHE, the funds required to finance this system of vouchers/direct support would amount to US\$13 million per annum.

counting on external financing for most of this (the PA has indicated that it can finance approximately US\$5 million in 2003 from revenues). The remaining US\$11 million would need to be found by the universities themselves through a combination of spending cuts and additional revenue efforts.

### **Social Assistance Delivery**

3.20 With a tripling in the numbers of the poor over the past two years, applications for assistance under the Special Hardship Cases (SHC) program of the Ministry of Social Affairs (MOSA) are increasing substantially each month. A recent World Bank report on the program concluded that it is effectively managed and that there is virtually no leakage of benefits to the non-poor<sup>94</sup> (one key feature of the SHC program is that it cross-checks information with UNRWA to determine if MOSA clients are also receiving aid from UNRWA).

3.21 Due in part to its niche targeting (the program is intended for groups in Palestinian society who are not able to make a living<sup>95</sup>), and due also to shortages in funding, the scheme plays a modest role in the patchwork social safety net that has grown up over the last two years. The scheme served some 36,000 beneficiary families as of June 2002 (estimated at about 150,000 people). Participants receive only limited assistance (the equivalent of US\$16.5 per individual per month, or US\$0.55 per day -- short of the poverty "gap" of US\$0.78 cents per day).<sup>96</sup> Nor are benefits always paid on time (MOSA was unable to pay beneficiaries once in 2000, from July through October in 2001, and again in March 2002).

## **THE RESPONSE OF THE MUNICIPALITIES**

3.22 Most of the large West Bank municipalities have been re-occupied for varying lengths of time since the end of March 2002, and have absorbed the bulk of the physical damage that occurred as a result of Operations Defensive Shield and Determined Path. The fiscal coping strategies described in "Fifteen Months" (reducing services, delaying non-emergency maintenance, laying off temporary staff, reducing salaries) have continued to be used, but against a much harsher backdrop: the sheer physical difficulty and frequent danger of delivering municipal services/maintaining basic utilities has added an unwelcome new dimension to a severe fiscal management problem.

3.23 The most notable change in the status of municipal and village services in recent months is the deterioration in water services. Urban systems have suffered from inadequate maintenance and appreciable physical damage,<sup>97</sup> but in rural areas the situation is now worse. At particular risk now are the 280 communities not served by piped water networks, which rely on water

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<sup>94</sup> A forthcoming World Bank study, *The Ministry of Social Affairs and its Poverty Alleviation Programs*, provides the basis for this section.

<sup>95</sup> Hardship cases are defined as individuals or households who meet one of the following criteria: 1) female-headed households (widows, separated or divorced women) without any income; 2) female-headed households due to the imprisonment of the father and lack of any income; 3) Families whose breadwinner is deemed permanently disabled or unfit for work because of a chronic illness; 4) Single, unmarried, older females; and 5) Orphans.

<sup>96</sup> The average daily consumption of a poor person is equivalent to US\$1.32 per day, US\$0.78 cents short of the poverty line of US\$2.1 per day.

<sup>97</sup> According to the International Management Group database, estimated physical damage to the water and wastewater sector is around US\$140 million (around US\$60 million in water and US\$80 million in wastewater).

transported in by tanker. The quality of tankered water no longer meets WHO drinking water standards, while the price of this water has risen by up to 80 per cent since September 2000 as a result of increased transport costs. Based on their survey of 25 villages in the West Bank, Oxfam estimates that some households now spend as much as a third of their total family income on water. Unable to meet the rising prices of trucked water, households go into debt to water providers and are also forced to seek alternative and often dirty water, as well as to cut water consumption. Oxfam points out the serious impact this has on livelihoods, with farm animals dying and villagers being forced to sell their livestock at depreciated prices.

3.24 The World Bank followed up the work done in “Fifteen Months” by assessing the finances of the municipalities for the period June 2001 - June 2002, expanding the previous sample of municipalities in the West Bank from 10 to 36, and in Gaza from 4 to 16. As expected, the municipalities’ fiscal situation has deteriorated further during this period. Total quarterly municipal revenue collection in the Bank’s sample declined by 44 percent between September 2000 and June 2002, while expenditures declined by 41 percent. This can be compared with the survey work in “Fifteen Months”, which showed a decline in quarterly revenues of 30 percent and in quarterly expenditures of 20 percent between September 2000 and June 2001. On the face of it, it seems as if the municipalities, albeit at great cost in service delivery, have managed to adjust to the situation, and have made the necessary hard choices (such as continuing to pay their Israeli suppliers, both to avoid disconnection and to minimize the high interest penalties imposed on non-paying clients). However, if one looks at non-weighted averages (thereby giving less importance to the largest municipalities), the picture that emerges is different. Now the gap between expenditures and revenues increases from 4 percent to 19.7 percent -- in other words, many municipalities have been running significant deficits so they can carry on delivering essential services. There is also a wide range of fiscal management responses between different municipalities, and some have virtually ceased to deliver services. This situation argues for much more careful targeting of PA and donor assistance to municipalities in 2003.

**Table 12: Municipal Finance Situation, September 2000 - June 2002**

	Revenue	Expenditure	Expenditure Over Revenue Ratio
% Change, Total	-43.7%	-41.5%	4.0%
% Change, Non-weighted Averages	-44.3%	-35.0%	19.7%

Source: World Bank Staff calculations. Calculations based on accounts expressed in NIS.

3.25 One positive development is that the donors provided budget support to the municipalities in 2002-- US\$19 million in total,<sup>98</sup> through tax collection, most municipalities have had no choice but to continue cutting back on maintenance and reducing the wages and salaries of public employees, and the scope for further adjustment without incurring costly long-term system damage is now quite limited. The Emergency Municipal Services Rehabilitation Project (EMSRP) has been developed to provide financial assistance to local government units to mitigate further deterioration in the coverage of municipal ESSP, of which US\$10 came from the EC specifically for salaries. Current budgets continue to be fragile, though, and in need of PA and donor support. In spite of serious efforts to increase services and their quality, particularly in

<sup>98</sup> Equivalent to about 15% of the municipalities’ pre-*intifada* real budget expenditures.

the areas of solid waste collection and electricity, water and sanitation services. EMRSP is a dual instrument, addressing the emergency as well as the development of the sector, and will also support the creation of a Municipal Fund to link central and local government budgetary planning processes -- and, in time, to serve as a channel for municipal investment funding from the PA and donors.

## THE RESPONSE OF UNRWA

3.26 UNRWA is the second largest provider of social services in the West Bank and Gaza after the PA, and is responsible for delivering health, schooling and humanitarian assistance to registered refugees in WBG, who amount to almost half of the population of the Territories (and over 70 percent of Gazans). UNRWA offers basic health, education and relief services to some 1.5 million people in the West Bank and Gaza, of whom 42 percent live in refugee camps.<sup>99</sup> The agency runs 168 schools and 17 clinics in Gaza and 95 schools, 34 clinics and a hospital in the West Bank, and currently employs over 12,000 staff in WBG. UNRWA's emergency programs were described in "Fifteen Months",<sup>100</sup> and continue to be held in high regard by the population.<sup>101</sup> The January 2003 SDC survey found that 64 percent of those supported by the agency were satisfied with the services provided to them.

3.27 As the crisis deepens, UNRWA has become more important than ever in helping the Palestinian population cope. With the current intensification of the closure regime, however, UNRWA is facing serious operational difficulties (all but some 86 of its WBG-based staff are Palestinian), despite adapting flexibly to curfew and closure by redeploying staff so they work closer to their homes and can minimize the need to cross checkpoints. UNRWA lost 72,000 teacher-work days because of movement restrictions during the 2001-2002 academic year, and 340 treatment days in its West Bank medical facilities between January and August 2002. According to the SDC survey, approximately 43 percent of the respondents said that their households received assistance from UNRWA.<sup>102</sup>

3.28 **UNRWA's Regular Budget.** The regular budget covers needs in WBG and elsewhere in the region (about 46 percent of UNRWA's regular budget apply to WBG, the remaining part to UNRWA's operations in other countries in the region). The United States is the agency's single largest donor, and provides an average of about 30 percent of UNRWA's funding. UNRWA's financial situation is often difficult, and for 2002 the agency is reporting a deficit of \$20 million against its regular budget of US\$313 million. The agency's proposed total budget for 2003 is US\$344 million. The increase in the 2003 budget compared with the 2002 budget comes largely from increases in local staff and supplies costs.

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<sup>99</sup> There are currently 27 refugee camps in the West Bank and Gaza (19 in the West Bank and 8 in Gaza), hosting 636,578 refugees.

<sup>100</sup> *Fifteen Months*, op. cit., pp. 58-59.

<sup>101</sup> *Palestinian Public Perceptions on Their Living Conditions*, op. cit., pp. 107-109.

<sup>102</sup> The same survey revealed that 96 percent of Gaza refugee camp respondents said that they have received some assistance from the agency, compared with 68 percent in West Bank refugee camps. Fifty percent of those who live outside refugee camps in Gaza received assistance, compared with 25 percent in the West Bank; 68 percent of villages in Gaza have been supported by UNRWA, compared with 33 percent of the West Bank villages.

**Table 13: UNRWA Estimated Cash Flow, 2002 (US\$ million)**

	<b>Recurrent Budget</b>	<b>Projects Budget</b>
Expected Receipts	279.3	12.9
Expected Disbursement	296.0	17.0
Deficit	16.7	4.1

Source: UNRWA.

3.29 **UNRWA's Emergency Budget.** Between the beginning of the *intifada* and December 2002, UNRWA received pledges of cash and in-kind donations totaling US\$225.5 million for its *emergency* programs, with about 50 percent of these pledges coming from EU countries and European Commission. Disappointingly, only US\$91 million (53 percent) of UNRWA's \$172.7 million emergency appeals for 2002 (for food, medicines and job creation schemes) were funded -- and only US\$65 million of this, or 38 percent of the appeal, had been paid to UNRWA as of March 31, 2003. UNRWA has also incurred other unforeseen costs: US\$0.5 million in physical damages from the IDF operations and US\$2.5 million in port and storage charges resulting from tighter security, the cost which the UNRWA's Commissioner-General has called "a tax on humanitarian aid".<sup>103</sup> The financing gap from the 2002 emergency appeals have not been rolled over into the 2003 appeal, and remains unfunded.

3.30 UNRWA launched a Fifth Emergency Appeal on December 10, 2002, this time asking for US\$94 million to provide for additional emergency-driven programs through the first six months of 2003 (the agency felt that planning a one-year program under current circumstances was "not realistic").<sup>104</sup>

3.31 Under the Fifth Appeal, the agency plans to deliver the largest food aid program in the West Bank and Gaza, and to raise its current coverage from 217,000 families to approximately 222,000 families (132,000 families in Gaza and 90,000 families in the West Bank) -- or some 1.1 million people, at a cost of US\$32.5 million. UNRWA also aims to create more than one million job-days for refugees under its proposed Employment Generation Program, of which some 867,000 job-days will be financed under its direct hire program.<sup>105</sup> As of March 31, 2003, however, only US\$35 million had been pledged by donors towards the Fifth Appeal, and only US\$10 million disbursed.

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<sup>103</sup> A statement made by the Commissioner-General of UNRWA on *Hunger in Palestine*, December 10, 2002.

<sup>104</sup> UNRWA Emergency Appeal 2003, January-June 2003, p. 3.

<sup>105</sup> The program hires medical personnel, administrative staff, laborers and guards to serve of maximum period of three months. Professionals hired under the program such as engineers, social workers, teachers or health specialists can serve for the length of a specific project. Under the Fifth Appeal, the direct hire program will be expanded to permit the posting of qualified professionals in institutions outside UNRWA, including municipalities, community rehabilitation centers supported by the agency and other local institutions providing relief and social aid to the community

**Table 14: UNRWA's Proposed Fifth Emergency Program,  
January-June 2003 (US\$ million)**

	West Bank	Gaza	Total
Food Aid	13.7	18.8	32.5
Job Creation	9.4	19.9	29.3
Shelter Reconstruction	4.2	8.7	12.9
Health	1.9	1.2	3.1
Education	2.2	2.0	4.3
Social Services*	3.7	6.5	10.1
Operations Support	0.8	0.7	1.6
<b>Total</b>	<b>35.9</b>	<b>57.8</b>	<b>93.7</b>

Source: UNRWA, \* including direct cash transfers of US\$3 million for the West Bank and US\$3.4 million for Gaza.

3.32 Given the importance of UNRWA in combating the crisis, the cumulative under funding of an effort that caters to the needs of half of the population of WBG poses serious risks to Palestinian welfare and should be seen by donors for the emergency that it is. A minimum of US\$11.2 million<sup>106</sup> in addition to what has already been pledged will be required to sustain UNRWA's regular services in WBG in 2003, in addition to the shortfall on the Fifth Appeal of US\$59 million -- let alone funds for any Sixth Appeal for the second part of 2003.

### THE RESPONSE OF THE NGOS

3.33 In "Fifteen Months" the Bank reported on the findings of a survey of the impact of the *intifada* on NGO operational capacity in the period ending December 2001. Qualitative and anecdotal information gathered for this report suggests that the earlier findings remain relevant; namely that many NGOs had to shift their focus towards emergency work, and that many (particularly the smaller ones) suffer from reduced financing, forcing them to suspend regular services. As in all other sectors, closures and difficulties of movement have had the greatest impact on the ability of NGOs to sustain their service delivery programs. Information gathered from managers of NGO grant-awarding programs (*Tamkeen* and the Welfare Association Consortium, WAC) shows an average lag of 3-4 months in project implementation due to these problems.

3.34 Although no systematic effort has been made to collect information on total funding provided to the NGO sector in 2002, a rough estimate of total *donor* funds disbursed by or through NGOs suggests a total of about \$120 million, most of it through international or large Palestinian NGOs, and perhaps a third of it in the form of food aid or medicine. Palestinian NGOs that typically rely on *local* resources to cover the cost of their services, however, are suffering. A recent study commissioned by WAC<sup>107</sup> confirms that up to 78 percent of resources available to NGOs now originate from external sources, and that more than 80 percent of these funds go to less than 15 percent of the NGOs in the West Bank and Gaza. The study also shows a widening gap between the financial and operational capacity of urban-based NGOs and those working in isolated rural areas -- a phenomenon reinforced by closure. In a number of assessments of communities' views of their situation during the *intifada*, the deficiencies in

<sup>106</sup> UNRWA's 2003 regular budget for WBG is US\$154.2 million (US\$99.5 million for Gaza and US\$54.7 million for the West Bank).

<sup>107</sup> *The Longer Term Financial Sustainability of the Palestinian NGO Sector*, WAC, September 2002.

services provided to rural communities are repeatedly highlighted, pointing to a need for donors to target more resources to rural-based NGOs.

3.35 Despite the controversies over the role of Islamic organizations and the widespread speculation in early 2002 that their activities would be curtailed, studies confirm that they continue to provide, directly or indirectly, emergency cash/food assistance and medical care to at least one out of six Palestinians.<sup>108</sup> According to a recent UN Study, four of the largest Islamic social welfare organizations alone were providing food assistance to 145,450 households. The same study maintains that there has been a 15-fold increase in the number of families receiving cash assistance from *zaqat* committees.<sup>109</sup>

3.36 There is as yet little evidence that the *intifada* has altered the basic dynamic between the NGO sector and the PA during the Oslo period -- marked as it was at the political level by mutual suspicion and political differences, but at the sector level (particularly in health) by excellent practical cooperation. The continuity in PA political attitudes to the NGO sector was symbolized by the dissolution of the Ministry of NGO Affairs and its immediate replacement by a Commission with a similar mandate to observe, mould and, to a limited extent, facilitate the work of Palestinian NGOs. This *status quo* is now likely to change, however. One of the Palestinian reform program's key medium-term objectives is the greater empowerment of civil society, as part of a process of deepening the democratization process in Palestinian society.

## THE RESPONSE OF THE DONORS

### The Quantity and Composition of Donor Assistance

3.37 One of the many frustrations of the current crisis has been the erosion of the development effort financed by the international community, and the loss of time, effort and capital associated with this. With the significant exception of the PA reform program, the overwhelming emphasis in donor work is now directed towards mitigating the impact of the economic and social crisis. Despite a significant increase in donor commitments in 2002 compared with 2001, commitments to infrastructure and capacity-building work with a medium-term focus continued to decline. In 2000, the ratio between the two types of aid, in commitment terms, was approximately 7:1 in favor of development assistance. By 2002, the ratio had shifted to almost 5:1 in favor of emergency assistance. Although overall commitments increased by 57 percent in the period, development assistance declined by 70 percent (while emergency assistance increased by a factor of 10).

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<sup>108</sup> *Islamic Social Welfare Activism in the Occupied Palestinian Territories: A Legitimate Target*, 2 April 2003, International Crisis Group Middle East Report No. 13, Amman/Brussels.

<sup>109</sup> *Food and Cash Assistance, October 2000-August 2001: A Brief Overview*. UNSCO/OCHA. Unpublished manuscript quoted in International Crisis Group op. cit.

**Table 15: Donor Commitments and Disbursements, 1998-2002 (US\$ million)**

	1998	1999	2000	2001	2002
Commitments:					
Regular (Development) Support	667	692	852	473	261
Emergency and Budgetary Support	0	0	121	755	1266
<b>Total Commitments</b>	<b>667</b>	<b>692</b>	<b>973</b>	<b>1228</b>	<b>1527</b>
<b>Total Disbursements</b>	<b>419</b>	<b>482</b>	<b>549</b>	<b>929</b>	<b>1026 million</b>

Source: World Bank staff calculations.

3.38 *Commitments and Disbursements.* *Commitments* have continued to climb appreciably, driven by the donors' response to the emergency, and rose by 24 percent in 2002; of the total of US\$1,527 million, 56 percent (US\$860 million) were in the form of budget support to the PA and the municipalities, with 83 percent (US\$1,266 million) provided for all kinds of emergency assistance. *Disbursements* rose by 10 percent in 2002. Of a total of US\$1,026 disbursed, 50 percent (US\$519 million, including municipalities) went to budget support, and 81 percent (US\$829 million) to all forms of emergency assistance (compared with 70 percent of 2001 disbursements).

3.39 *Composition.* Several points need to be made about the continuing sea-change in the composition of donor assistance.

3.40 The first is that the shift into emergency assistance was appropriate -- donors had no choice if they wanted to keep alive the hope of reconciliation, since a collapse of the PA service structure and the further radical impoverishment of the population would have vitiated this.

3.41 The second point is that the growing emphasis on humanitarian assistance needs to be programmed and managed as part of an integrated response strategy that addresses *all* the necessary components of emergency assistance, and balanced to the extent possible with medium-term development priorities. This was clearly recognized by the UN in its Humanitarian Plan of Action of December 2002: "The cause of the current humanitarian crisis in the occupied Palestinian territory is fundamentally political. The problem cannot be solved with humanitarian aid alone...The Humanitarian Action Plan is not intended to supplant development activities, but to provide critical support to populations in need." Humanitarian assistance also has undesirable consequences if it leads to habitual dependencies -- and donors should seek wherever possible to accompany emergency interventions with strategies that help Palestinians enhance self-reliance and prepare for post-crisis challenges.<sup>110</sup>

3.42 Third, and as mentioned in paras. 2.44 and 3.32 above, the decline in emergency budget support and the shortfalls in UNRWA financing will pose significant problems for Palestinian welfare if the emergency continues throughout 2003.

3.43 *Key Donors.* As in 2001, the three major donor contributors were the Arab League States, the European Commission and the USA, together accounting for over 70 percent of commitments and disbursements. If the EU member states are added to the EC's contributions,

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<sup>110</sup> One such example is the proposed creation, with donor support, of the Municipal Fund (para 3.25).

Europe overtook the Arab League to become the largest donor to the West Bank and Gaza in 2002 in disbursement terms.

**Table 16: Commitments and Disbursement by Donors, 2002 (US\$ millions)**

Country	Commitments	Percentage	Disbursements	Percentage
League of Arab States	630	41.3%	316	30.8%
European Commission	269	17.6%	217	21.1%
United States (USAID)	201	13.2%	194	18.9%
World Bank	75	4.9%	37	3.7%
Italy	60	3.9%	32	3.1%
Norway	49	3.2%	44	4.3%
Germany	45	2.9%	21	2.1%
Sweden	31	2.0%	16	1.5%
Switzerland	17	1.1%	12	1.1%
Denmark	16	1.0%	18	1.8%
Canada	14	0.9%	14	1.3%
France	13	0.8%	11	1.0%
United Kingdom	13	0.8%	12	1.1%
Japan	13	0.8%	12	1.1%
Others	82	5.6%	71	7.0%
<b>Total</b>	<b>1,527</b>	<b>100.0%</b>	<b>1,026</b>	<b>100.0%</b>

Figures do not include donor support to UNRWA's regular budget.

Source: World Bank staff calculations, EC database, and donors.

### Emergency Assistance in 2002

3.44 “Fifteen Months” reflected a consensus on emergency donor support needs for 2002, and defined seven priority areas for assistance. Needs were projected on the basis of three possible scenarios -- “*Status Quo*”, a lifting of closures (“optimistic”) and tightened closure (“pessimistic”, or what actually occurred). “Fifteen Months” estimated that the tightened closure scenario would need some US\$1.7 billion in donor assistance if the PA was to be kept functional, and Palestinian society provided with a minimal safety net. Following the publication of “Fifteen Months” in March 2002, and in the wake of Operation Defensive Shield, the AHLC met in Oslo in April 2002, and a new set of projections were made under which a total of US\$2 billion was requested from donors.<sup>111</sup> The table below shows these needs, and the funds that donors disbursed against them in 2002.

<sup>111</sup> To say “emergency needs” totaled either US\$1.7 billion or US\$2 billion deserves some explanation. To prevent further economic deterioration under this scenario would have required a great deal more than either sum, but the figures were projected with an awareness of how much money was likely to be available. Certain categories -- budget support and service delivery, for example -- were based on the actual basic requirements of the PA and municipalities. In other categories -- private sector support, employment and welfare -- sustaining needs were far higher than the figures used, but were so clearly in excess of anything available that it made no sense to use such figures.

**Table 17: Emergency Donor Disbursement Needs in 2002  
under the Tightened Closure Scenario (US\$ million)**

<b>Program</b>	<b>Needs ("Fifteen Months")</b>	<b>Needs (AHLC)</b>	<b>Committed</b>	<b>Disbursed</b>	<b>Gap (AHLC Needs minus Disbursed)</b>
Budget Support	876	876	741	425	-451
Basic Service Delivery	96	219	119	94	-125
Private Sector Support	75	75	37	19	-56
Employment and Welfare	250	327	176	151	-176
Physical Reconstruction	125	300	90	65	-235
Student Scholarships	30	30	12	10	-20
UNRWA	200	173	91	65	-108
<b>Total</b>	<b>1,722</b>	<b>2,000</b>	<b>1,266</b>	<b>829</b>	<b>-1,171</b>

Source: World Bank staff calculations.

3.45 The shortfall of almost US\$1.2 billion on required disbursements is sobering,<sup>112</sup> and illustrates that donor support for the West Bank and Gaza is not infinite. Donors' responses to the emergency, while influenced by collective strategic judgment, are also driven by their own institutional priorities and comparative advantages, and some unevenness can be expected between an agreed financing plan and its execution. While there are significant shortfalls in all areas, a number are worth comment. *Budget support* materialized at only 60 percent of commitments, due in large measure to the difficulties associated with the Arab League burden-sharing formula. Estimates of needs for *service delivery support* exceeded what was available; although the experience with ESSP has been positive, the donors funding the program (the World Bank, the EC, and individual EU member countries on a bilateral basis) have been constrained by the need to balance this priority against others. The same was apparent with the financing of *employment and welfare schemes, including UNRWA's emergency program*, where needs of US\$500 million translated into disbursements of US\$216 million. *Support to the private sector* has been disappointing, with extensive discussions between several donors, the private sector and the PA only delivering a small flow of funds at the end of the year. *Physical reconstruction* featured very prominently at the AHLC, following the donors' West Bank damage assessment, but the US\$300 million proposed in Oslo only yielded commitments of US\$90 million and disbursements of US\$65 million. In part this reflects the longer preparation and disbursement cycles associated with physical works -- but with the continuation of incursions and damages through the rest of the year, the PA and donors alike have been at times reluctant to repair infrastructure that could well be damaged again in short order (this applies particularly to road resurfacing). The movement of construction equipment, personnel and materials has also proven extremely difficult. A psychological factor also came into play in this area -- communities adapted to the shock of destruction, and the immediate impulse for full restoration gave way to an acceptance of a dilapidated environment and the allocation of higher priority to measures that provided food and employment.<sup>113</sup>

<sup>112</sup> Disbursements also fell short of commitments by US\$412 million mainly due to the shortfall on budget commitments (US\$291 million).

<sup>113</sup> Because of this perception of continued risk, donor-financed physical reconstruction has been driven largely by a need to repair critical utility systems, or in situations where the employment benefits are also deemed substantial. The same is not true of PA municipality or privately-financed repairs (see para. 2.14 for a putative relationship between reconstruction efforts and the recovery in Q4 employment in WBG).

3.46 To protect employment and services or to address the needs of families that have lost their means of support, donors have elected to use four main instruments -- budget support for the PA and the municipalities, food aid, job creation programs, and cash assistance.

3.47 Donors in 2002 disbursed a total of US\$683 million against these four instruments. Indications for 2003 suggest that donors are so far likely disburse about US\$565 million against the four instruments, with the bulk of the shortfall accounted for by the likely decline in budget support (see also paras. 4.17-18, 4.32-37 and Table 21).

**Table 18: Welfare Instruments -- Disbursements (US\$ millions)**

Instrument	Disbursed in 2002	Likely Disbursements in 2003
Budget support	483	420
Food	75	42
Jobs	95	81
Cash	30	22
<b>Total</b>	<b>683</b>	<b>565</b>

Source: World Bank staff calculations.

3.48 A discussion of the relative merits of these different welfare instruments (from a macroeconomic, targeting, and welfare point of view) can be found in **Annex 1**.

### **Donor Coordination**

3.49 Donor assistance in 2002 was delivered in a context of deepening emergency, and in the absence of any clarity about the future course of political events. At the same time, donor coordination is itself a political activity and continues, at the capitals level, to be used to demonstrate sustained commitment to the Palestinian people and to the resumption of the peace process. In pursuit of this message, six international meetings took place in 2002 and early 2003 -- Ad Hoc Liaison Committee (AHLC) meetings in April 2002 and February 2003, and four meetings of the newly formed International Task Force on Palestinian Reform. These meetings all served useful purposes. Both PA and GOI representatives attended five of the six.

3.50 Local donor coordination moved in 2002 from the state of shock characterizing the early response to the *intifada* into a period of intense effort. Five overlapping stages in local donor coordination can be discerned: i) discussions of "Fifteen Months" helped donors agree with the PA on a unified response strategy, and to underline the importance of resuming the process of institutional and policy reform that had been left in limbo for many months; ii) Operation Defensive Shield evoked a strong coordinated donor effort in April–June 2002. The Local Aid Coordination Committee (LACC) established an *ad interim* Donor Support Group to assess the physical and institutional damage caused by the incursions, and to mobilize funds for repairs. In the course of this exercise, special Sector Operations Rooms (composed of technical staff from the PA and donor agencies) were formed to carry out regional damage assessments and to discuss reconstruction priorities with local communities; iii) with the emergence of the PA's 100 Day Plan, this effort was superseded by a strong donor commitment of time and staff to a new coordination structure -- the local Reform Working Groups, which interact regularly with the PA's Ministerial Reform Committee and have overseen a considerable body of technical work; iv) donors from May 2002 onwards stepped up their contacts with the IDF Coordinator's Office

in order to develop more systematic facilitation arrangements for the movement of donor staff and supplies in the West Bank. The main mechanism used for this was the Task Force for Project Implementation (TFPI); the expansion in the TFPI's mandate is described below; and v) by mid-2002, rising concern at a prospective humanitarian crisis led to the development of the *UN Humanitarian Plan of Action*, and in December the LACC donors formed the Humanitarian and Emergency Policy Group (HEPG), a body featuring key donors and intended to monitor the emergency and develop unified responses in real time.<sup>114</sup>

3.51 Much of this expenditure of energy has been productive and has helped donors achieve and maintain a common understanding of the challenges and how they might best address them. A degree of hyperactivity was also apparent in mid-2002, however -- and to an extent this reflected a sense of powerlessness in the technical donor community when faced with a deteriorating situation over which actors on the ground had no control. Not all the initiatives justified the efforts invested in them. The West Bank Damage Assessment was supposed to be replicated in Gaza, but the donor assessment teams never finished their work there, and the top priority given to damage repair in mid-year faded (a total of US\$65 million was disbursed for damage repair in 2002, compared with original pledges of about US\$150 million in June 2002). One clear need that emerged in the course of 2002 was for an upgraded secretariat function to help the LACC co-chairs direct traffic and help donors prioritize; and in September an LACC Office was created.

### **IMPEDIMENTS TO DONOR ACTIVITY, ISRAELI FACILITATION**

3.52 IDF operations in the West Bank and Gaza since the end of March 2002 have significantly interfered with donors' ability to carry out their work. Apart from sheer conflict, many routine privileges granted the staff of international organizations and agencies in relation to free movement within the West Bank and Gaza Strip have been suspended from time to time by the IDF. For several weeks in the April-June 2002 period, areas of the West Bank were declared "closed military zones" and placed off limits to international staff. The permit system applicable to the Palestinian population in the West Bank introduced in May 2002 meant that national donor staff movement within the West Bank was initially limited to permit-holders. From October permits for movement within the West Bank were no longer needed by national donor staffs as they have since then been allowed to move within the West Bank and the Gaza Strip on the basis of their organizational ID. In practice, though, this policy is not always observed by the IDF.

3.53 The transport of project-related goods has been severely affected: only trucks with diplomatic license plates carrying humanitarian and/or project cargoes, driven by international and Jerusalemite drivers, are permitted to move across checkpoints in the West Bank -- and only after prior coordination with the IDF. Other project goods are subject to long delays, resulting in a chronic shortage of construction materials and sharply increased project costs.<sup>115</sup> As a result,

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<sup>114</sup> The HEPG is chaired by the EU/EC, with UNSCO as Vice-Chair. Members are the US, Norway and the World Bank. Secretarial services are provided by UN-OCHA and the LACC Office.

<sup>115</sup> No systematic estimate of additional costs attributable to intifada-related closures has been attempted, but indicative Bank estimates suggest that infrastructure projects with a high import content (water, roads) may now cost as much as 15-20% more than before, and more again if international contractors are involved. The EC has been asked by the Humanitarian and Emergency Policy Group to make a more formal estimate the these costs.

contractor compensation claims have multiplied and many donors have canceled or put on hold their more substantial infrastructure projects. In addition, damage to donor-financed projects as a result of IDF incursions increased greatly in 2002. While no comprehensive assessment of damage to donor-financed projects has taken place, it is likely to amount to at least 50 percent of the value of damage to public infrastructure, public buildings and PA institutions, most of which were put in place with donor assistance; this would give a figure of about US\$150 million.

3.54 The problems faced by international NGOs in this conflict bear mention. The importance of international NGOs (INGOs) to donors is significant, since much humanitarian assistance is not delivered through the PA; rough calculations suggest that approximately US\$100 million, or 10 percent of disbursed donor assistance in 2002, was delivered through INGOs. These organizations are not afforded the same protection as donor organizations and there is concern about the safety of their staff and vehicles in the field. The visa status of the several hundred international INGO staff has also been in doubt. As of January 1, 2003, the Israeli Ministry of the Interior stopped issuing the B1 visa (a one-year, multi-entry work permit) which many INGO staff previously enjoyed, and indicated that they might only be entitled to receive B4 visas (a 3-6 month single-entry volunteers' visa that does not allow the holder to work in Israel). With the increased need for NGO personnel and the Government of Israel's expressions of appreciation for the humanitarian work being done by the international community, this anomaly needs correction.

3.55 The Task Force on Project Implementation (TFPI) is the main donor interface with GOI, in the persons of the Coordinator of Government Activities in the Territories (COGAT) and his staff. With the growing involvement of COGAT in ensuring the delivery of humanitarian assistance, the importance of the TFPI to both donors and GOI has increased, and its work has become more strategic and policy-oriented. For example, in December 2002 the TFPI agreed on the need to i) develop protocols to protect donor agency staff working under curfew conditions; ii) compensate WFP for the destruction of a food warehouse in Gaza; iii) follow up on the agreements forged between the UN Secretary General's Humanitarian Envoy, Catherine Bertini, and the Prime Minister of Israel in August 2002, and iv) establish a TFPI working group to look at contingency planning issues (specifically to exchange views and information on the possible impact of the Iraq War and the construction of the Separation Barrier on the Palestinian population). Despite the difficult situation on the ground, work with COGAT has been conducted in a collegial spirit and with a mutual commitment to maintaining professional working relations.

3.56 A report by the TFPI Chair to the AHLC Meeting in London on 18-19 February lists these positive developments, and organizations like UNRWA and ICRC report a distinct improvement in field access and facilitation. But the TFPI Chair's report also makes the following observations: "Despite the progress and recent changes, significant obstacles remain to the effective and efficient implementation of donor assistance programs. First, the methods established by COGAT frequently require personal intervention by COGAT, TFPI or donor staff to resolve problems, placing tremendous strain on all the organizations involved. Second, important issues are often not addressed for lengthy periods without explanation or notice. Third, agreements for alleviating problems are often informal and *ad hoc*. Fourth, the authority of COGAT is circumscribed and the interactions between COGAT and the IDF are not always well coordinated; this has particular impact on issues pertaining to the safety of international

personnel and consistent access of personnel to the Palestinian population.” In other words, there remains a disconnect between cordial relations in the TFPI, and practical results.

3.57 In the view of some, one of the key issues at play is that the decisions taken by the senior level of the Civil Administration have little bearing on IDF field commanders and their units. A study commissioned by the IDF Chief of Staff recommends the establishment of Civil-Military Liaison Units (CIMIT) together with various other measures intended to improve IDF facilitation of donor work. This report was prepared in mid 2002, however, and many of its recommendations have not yet been implemented. The findings of the Personal Humanitarian Envoy of the UN Secretary-General in August 2002 also highlighted the existence of wide gaps between official Israeli policy and its implementation on the ground.<sup>116</sup>

3.58 Contrary to donor expectations, the IDF did not enforce any blanket precautionary curfew in WBG during the Iraq War, and the situation remained relatively quiet. An Access Operations Room (AOR) was established by the TFPI in anticipation of a potential curfew-induced humanitarian crisis in WBG, but this did not emerge and the AOR was quickly disbanded. These were positive developments at a time when an additional period of tight closure would have caused considerable economic and social damage.

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<sup>116</sup> Report of the Catherine Bertini mission, August 2002, p.20. The UN *Humanitarian Plan of Action Plan* also identified a series of measures that need be implemented by the Government of Israel to ensure that the humanitarian effort can go forward without undue difficulty. Among its various recommendations, particular emphasis was put on the need to i) allow international organizations direct access to representatives of the operational command structures within the IDF to discuss closure measures at the policy and operational level, ii) ensure that agreements reached through liaison structures are not terminated or altered unilaterally when political or security realities on the ground change, and iii) improve internal communication within the IDF to ensure that agreements reached are implemented quickly on the ground.





## 4. GOING FORWARD

### THE ECONOMIC OUTLOOK FOR 2003-4

4.1 As closure in its various manifestations is the proximate cause of Palestinian economic decline, it follows that easing closure is the best way to trigger some immediate economic recovery. If the ultimate objective of donor interventions is to resolve the humanitarian crisis, however, then the economic vulnerabilities that contributed to the crisis will also need to be addressed. Replicating an economic relationship with Israel, which depends for its viability on a closure-free environment no longer seems a sensible policy choice.

4.2 To illustrate a range of possible outcomes in 2003 and 2004, the Bank has developed three illustrative economic scenarios. They can be summarized as follows:

- A *Status Quo Scenario*, which assumes comparable levels of violence and a persistence of levels of internal and external closure similar to those of today.
- A *Lifting of Internal Closure Scenario*, which assumes that the early implementation of the Quartet Roadmap leads from mid-2003 onwards to a progressive lifting of internal closure. External closure is relaxed somewhat, but pre-*intifada* flows of goods and labor between WBG and Israel/the rest of the world are not achieved. Since economic recovery is based largely on the reanimation of the small internal Palestinian market, it will be limited in vigor and will taper off in 2004.
- A *Lifting of Internal Closure plus Trade Facilitation Scenario*, which assumes that donors, the PA, and Israel to facilitate Palestinian trade with the rest of the world pursue greater efforts.<sup>117</sup> In other respects it assumes the same conditions as the *Lifting of Internal Closure Scenario*.

4.3 It is perhaps worth stressing the obvious -- that the choice of scenarios and the variables within each inevitably embody predictions which are either political in nature, or which bear upon economic policy-making. The Bank's purpose in this narrow context is *not* to try and predict political events or recommend specific policies, but rather to explore what would happen if certain events manifest themselves, and thereby to help the parties understand the economic and welfare implications of certain decisions.

4.4 Important *assumptions about Israeli Government policy* are factored into the scenarios, and these are of course open to debate.

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<sup>117</sup> In this last scenario, it is assumed that external trading costs in 2004 are similar to those prevailing in 1999.

4.5 The most important relate to closure and trade. Under the *Lifting of Internal Closure* and *Lifting of Internal Closure plus Trade Facilitation Scenarios*, both of which embody the notion of a political *rapprochement*, Israel would significantly and progressively ease internal closures and curfews from the middle of 2003 onwards. Under the *Lifting of Internal Closure plus Trade Facilitation Scenario*, it is assumed that Israel would facilitate the development of Palestinian exports to third countries.

4.6 Assumptions are also made about *labor flows to Israel*. We project that current flows (on average 33,000 workers per day in 2002) will be maintained in the *Status Quo Scenario*, and that they will further increase to about a half of the pre-*intifada* level (ultimately 60,000) under the other two scenarios -- but that they will not recover further. This recognizes that Israeli public opinion is significantly less well-disposed to the presence of large numbers of Palestinian workers in Israel than it was before the *intifada*, and that many of the jobs once open to Palestinians have now been taken by other immigrants. It also acknowledges the likely impact of the Separation Barrier's construction on the flow of "clandestine" labor into Israel from the West Bank.

4.7 As far as *revenue clearances* are concerned, in all the scenarios, even the *Status Quo Scenario*, it is assumed that there will be no interruption by GOI in the monthly clearance process. Under the *Status Quo Scenario*, monthly payments would average US\$35 million through 2003, as they have done in Q1. In the two other scenarios, monthly payments are larger as a result of greater economic activity. As for the stock of withheld revenues, we assume that under *all three scenarios* GOI will continue monthly rebates at the same rate as in Q1, i.e. at US\$21 million per month, until the stock of withheld revenue is eventually exhausted (by October 2004 at the current pace).

4.8 ***Assumptions are also made in the model about donor behavior*** in 2003 and 2004. Based on Q1/2003 results and indications provided by donors, we assume that total budget assistance will approach US\$1 billion in 2003 under all three scenarios. Assumptions, however, differ for 2004: under the *Status Quo Scenario* the need for budget support would persist at significant levels through 2004. Overall aid disbursements are projected to fall to US\$800 million under this scenario, as some degree of donor fatigue is expected to set in. In the other two scenarios, the need for budget support will taper off quite rapidly from the second half of 2003. Since these scenarios are associated with a resumption of a political process, we assume that increased development financing in 2004 will to some extent offset the reduction in budget support, and that disbursements will total some US\$700 million.

4.9 ***Finally, an assumption is made about PA budget management*** in 2003 and 2004. To this point MOF has dealt with the 2003 First Quarter's financing gap by withholding non-salary budget appropriations (para. 2.45). We assume, though, that this is a short-term cash management tactic, and that for 2003 the PA *will* spend an average of US\$86.7 million per month as envisaged in the Budget (see para. 2.40), and will maintain the same level of expenditures in 2004 (in all three scenarios). As for the repayment in 2003 of PA arrears to the private sector, we assume the PA will reimburse as much as it can without destabilizing the budget -- in other words, any income over and above the US\$86.7 million needed for monthly current expenditures will be used to eliminate arrears. Furthermore, we assume that donor budget support will cover the PA's financing gap in 2004, and that arrears to the private sector will be eliminated by the end of 2004.

**Table 19: Three Economic Scenarios, 2003-2004**

Scenario	Status Quo		Lifting of Internal Closure		Lifting of Internal Closure plus Trade Facilitation		
	2002	2003	2004	2003	2004	2003	2004
Real annual change							
GDP	-19.1%	2.0%	-3.1%	15.3%	9.4%	21.2%	11.9%
GNI per capita	-23.2%	-2.5%	-7.0%	11.5%	6.4%	16.6%	8.5%
GDP per capita	-22.4%	-2.3%	-7.3%	10.5%	4.7%	16.2%	7.1%
Exports	-24.3%	-8.4%	0.3%	5.4%	12.0%	27.2%	42.0%
Imports	-12.9%	15.1%	-7.2%	19.7%	2.7%	33.0%	17.7%
Poverty rate	58.6%	57.0%	59.7%	53.2%	51.4%	49.6%	44.5%
Unemployment rate*	31.5%	32.9%	33.7%	28.9%	27.2%	28.9%	25.3%
Monthly PA budget, US\$ million							
Current expenditures	81.5	86.7	86.7	86.7	86.7	86.7	86.7
Clearance revenue	2.5	34.7	33.7	39.0	43.4	40.8	46.2
Domestic revenue	18.7	18.4	17.9	21.7	24.2	22.7	25.8
Withheld revenue released by GOI	3.8	21.1	17.5	21.1	17.5	21.1	17.5
External budgetary financing	38.7	33.4	31.2	33.4	7.8	33.4	0.5
Net accumulation of arrears	9.2	-20.9	-13.7	-28.5	-6.1	-31.3	-3.3
Closure policy							
Workers in Israel and the settlements	33,000	33,000	33,000	45,000	60,000	45,000	60,000
Internal closures	idem	idem	idem	eased**	eased	eased**	eased
Trade facilitation	idem	idem	idem	idem	idem	activated**	activated

Source: World Bank staff calculations. (\*): ILO definition of unemployment. (\*\*): during the second half of 2003.

- ***The Status Quo Scenario.*** Under this scenario, real GDP would increase slightly in 2003 compared to 2002 (mainly as a result of larger clearance revenue flows), but would contract again in 2004. Unemployment would also rise slightly, while poverty would remain at levels similar to those of today (with the absolute number of the poor up from 1.9 million now to 2.1 million by the end of 2004). In spite of persistent high levels of financial support, donors would not be able to foster an economic recovery and could, at best, hope to sustain current levels of welfare. Development expenditures would remain depressed, partly as a result of donors' continued unwillingness to invest in large capital assets at a time of continued insecurity, and partly due to the higher priority they would continue to give to emergency and humanitarian activities. The quantity of donor financing required to balance the budget would remain substantial in 2004, at US\$ 31.2 million per month.
- ***The Lifting of Internal Closure Scenario.*** A progressive lifting of internal closure would have an immediate, significant economic impact from the middle of 2003 onwards. GDP would grow at an estimated 15 percent in 2003, fuelled by greater internal trade and production. The increased domestic revenue generated by the recovery

in GNI would greatly ease the budgetary situation, and would enable the PA to eliminate its arrears to the private sector more rapidly than under *Status Quo*. Real per capita incomes would still be 35 percent lower at the end of 2004 than in 1999, however, with approximately 27 percent of the Palestinian population unemployed and more than half of the population still living below the poverty line. The difficulties of accessing external markets would continue, and in 2004 GDP growth would fall to 9.4 percent.

- ***The Lifting of Internal Closure plus Trade Facilitation Scenario.*** If all parties maximize efforts to facilitate the trade of goods between the West Bank and Gaza, Israel and the rest of the world, the gains from trade could, in time, place the Palestinian economy on a sustained path of recovery and development. Even by the end of 2004, it is estimated that GDP could be 8 percent higher under this scenario than under *Lifting of Closure* alone. Unemployment would decline to 25 percent and poverty to approximately 45 percent by the end of 2004. Under this scenario, the level of donor support required to balance the budget would be marginal by 2004.
- ***A “Fourth Scenario” -- The Demise of the PA.*** Should the civilian apparatus of the PA cease to function, the donors would lose their main channel for providing support to the Palestinian people. The immediate consequences of a collapse of the administration and the disappearance of PA incomes and the demand generated by them would be severe, resulting in widespread personal hardship and the evaporation of the institutional gains of the last decade. Donors would continue to provide emergency and humanitarian relief through a mix of UNRWA, NGOs and local governments, but it would take time for donors to adjust, and the sums transferred would be much smaller than at present. Likewise, any developmental and institution-building projects transacted through the PA would cease. It is not unreasonable to imagine that flows of donor funds could shrink to as little as US\$20 million per month at first, with most of this in the form of food, cash and employment programs. The loss of budget support and other forms of public expenditure would induce a far stronger economic contraction than under the *Status Quo Scenario*. Real GDP per capita could fall by another 18 percent in 2003 (and real GNI per capita by 15 percent). Unemployment could exceed 50 percent and poverty could reach 65 –70 percent by the end of 2003.

### **SOME ASSUMPTIONS UNDERLYING RECOVERY AND GROWTH<sup>118</sup>**

4.10 Between 1968 and 2000, Palestinians in the West Bank and Gaza pursued a development strategy which featured the export of labor rather than goods. In June 2000, three months before the current Palestinian *intifada* began, 21 percent of all employed Palestinians worked in Israel, mainly in low-skilled construction and agricultural jobs. Net incomes from abroad provided more than 22 percent of Palestinian GDP, making it one of the most remittance-dependent economies in the world. This is why the loss of jobs in Israel in the past two years has had such a strong impact. Put another way, the *intifada* has exposed the vulnerability of a development strategy which is so dependent on labor export to Israel. The ongoing crisis naturally raises the

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<sup>118</sup> This section is based on analysis of World Bank staff. For further information, see Claus Astrup and Sébastien Dessus, *Exporting Labor or Goods? Long-term Implications for the Palestinian Economy*, March 2002; and *Long-Term Policy Options for the Palestinian Economy*, The World Bank, July 2002.

question of whether a strategy less reliant on labor export is feasible, and could offer sustainable growth opportunities.

4.11 The Paris Protocol formalized a *de facto* customs union with Israel that has existed since 1967 and which has proven extremely costly -- not only because of the closures that have interfered with its implementation. In a structural sense the long-term growth potential of the Palestinian economy has been stunted by the upward pressure on domestic Palestinian wages created by wages paid to Palestinian workers in Israel. Domestic wage increases have exceeded any underlying growth in productivity, and have thereby undermined Palestinians' ability to export competitively-priced goods to the rest of the world. As noted in para 2.19, there are early signs of such an adjustment. As internal closure is lifted, the impact of lower employment in Israel and lower levels of remittances should in time pull down domestic wages, improving export and labor competitiveness and encouraging the reallocation of resources towards exports.

4.12 World Bank prospective analysis compares three different policy cases, as illustrated in the table below.

**Table 20: Macroeconomic Aggregates, 2000-2010, Under Three Different Cases**

	Year	Per Capita Income	Productive Investment	Export Receipts
Initial situation	2000	100	100	100
Case 1: progressive re-opening of the Israeli labor market.	2010	105	129	168
Case 2: permanent closure of the Israeli labor market.	2010	95	134	223
Case 3: permanent closure of the Israeli labor market, trade liberalization & VAT reform.	2010	110	184	334

Source: *Exporting Labor or Goods? Long-term Implications for the Palestinian Economy*, March 2002. Income and investment figures are in real terms.

4.13 This table suggests that continued reliance on the export of labor to Israel (Case 1) would result in higher incomes than if the Israeli labor market were closed and Palestinians were obliged to export goods instead (Case 2) -- confirming the potentially high welfare cost to Palestinian society of a loss of access to Israeli labor markets. However, the table also shows that a proactive policy of export development -- in which a more open and less discriminatory trade regime is adopted (Case 3) -- would result in higher incomes by 2010 than a return to previous levels of employment in Israel.

4.14 The West Bank and Gaza will need to take better advantage of its strategic geographical position, relatively open economy and preferential access to US and European markets for industrial exports if such a strategy is to succeed. No-one should under-estimate the difficulties and sustained effort involved in achieving such a transition. Over the past few years, export performance has been very poor, accounting for only 17 percent of GDP in 2000, as compared with over 40 percent of GDP in Jordan. At present, WBG exports are not competitive, as a result of high transaction costs and limited access to the cheaper inputs available on world markets -- a function of movement restrictions, and a fiscal/trade regime featuring high import taxes on non-Israeli products and a higher effective rate of VAT on imports than on domestic production. A non-discriminatory trade regime would, in theory, lower the price of third country imports,

which could in turn encourage a substitution of the export of labor to Israel by employment in the goods and services export sectors in the West Bank and Gaza.

4.15 Such gains from trade would take time to materialize, and restoring access to Israeli labor market would certainly be the quickest way to boost incomes for a large number of ordinary Palestinians. But a return to pre-September 2000 employment levels for Palestinians in Israel seems unlikely, and would anyway continue to expose the Palestinian economy to possible future work permit closure. Some have said that this is not the right time to discuss export strategy options, and that the focus of the PA and the donors should be on emergency and humanitarian assistance. If one accepts that the current crisis is in part a product of pre-September 2000 economic arrangements, though, then this *is* the right time to consider change -- albeit by studying carefully the experiences and the policy choices of economies in transition, particularly to ensure that the vulnerable are protected during the transition.

4.16 Others will claim that the challenge of transforming a shattered economy into one that is internationally competitive is not a realistic one. Some of the pertinent issues are briefly elaborated in the box below. Two fundamentals, it is clear, are a well-managed administration, and orderly economic cooperation between Israel and the PA. As a significant comparative advantage, the West Bank and Gaza has one of the best-educated populations in the region -- an asset that is, however, eroding under current conditions.

#### **Box 5: Facilitating Palestinian Trade**

The Palestinian economy is small and poor, and cannot rely on local demand if it is to grow. Under the premise that the export of labor to Israel will be severely restricted for the foreseeable future, the West Bank and Gaza in fact has no choice but to boost the export of goods and services. In the medium to long run, boosting exports will mean increased trade with other countries as well as Israel, which has a limited capacity to absorb Palestinian goods. The Palestinian economy will thus need to adopt a more neutral and open trade regime, which can in turn be facilitated by accession to the World Trade Organization (WTO) upon statehood, and by the full implementation of the Euro-Med Association Agreements. Diversifying trade routes will also require trade infrastructure such as a seaport and an airport.

For such a strategy to succeed, the West Bank and Gaza will have to become more competitive. Competition in external markets has both quality and price dimensions. Quality can be enhanced by training, investment, research and development, increased internal competition, and a better knowledge of what the foreign consumer actually wants. The price of exports can be contained by decreasing the various component costs of production (inputs, labor, equipment, transport, taxes, etc).

Essential to competitiveness is addressing the very high transaction costs on exports of Palestinian goods, and on the import of intermediate goods required for manufacturing exports. In addition to removing internal closures, proposals have been made to reduce the transaction costs relating to external border security, in particular by improving the efficiency and effectiveness of inspection methods without compromising Israel's security\*. One such proposal is the generalized adoption of advanced technology (scanners, x-rays) to inspect containers. Another could be to move to a one-time inspection for Palestinian goods, which would include sealing containers as they leave the Israeli customs house. This would speed trade flows and reduce the costs and the damage caused by the current back-to-back system.

Donors could help finance the required investments by Israel and the Palestinians, as they have offered to do in the past. The PA could support the efforts of exporters by removing disincentives such as exit fees for exports, and minimizing delays in VAT reimbursement.

\* See for instance IMF, *West Bank and Gaza: Economic Performance, Prospects and Policies*, 2001.

### **DONOR FINANCING IN 2003**

4.17 In 2002, donors committed US\$1,527 million and disbursed US\$1,026 million to the West Bank and Gaza. At the time of writing, donors have firmly committed US\$1,274 million to

WBG for 2003, a sum the Bank estimates will translate into US\$919 million in disbursements this year. At this stage, when compared with 2002, commitments are down 16 percent and projected disbursements by 10 percent. This is mainly due to the decline in donor budget support to the PA. In 2002, donors disbursed US\$464 million in PA budget support, and the Palestinian Budget for 2003 budget shows a need for US\$535 million this year. So far US\$401 million is likely to be disbursed in this form in 2003.

4.18 Table 21 shows the financing thus far available for a set of emergency instruments similar to those advocated in “Fifteen Months”, as well as for programs with a medium-term developmental focus. The various instruments and programs are described in “Recommended Donor Actions” below.

**Table 21: Donor Disbursements in 2002 and 2003**

<b>Instruments and Programs</b>	<b>Disbursed in 2002</b>	<b>Likely Disbursements in 2003</b>
PA Budget Support		
Budget Support (#1)	425	348
Emergency Services Support Program (#2)	39	53
<b>Total PA Budget Support</b>	<b>464</b>	<b>401</b>
Other Emergency and Humanitarian Instruments		
Budget Support/Emergency Financing for Municipalities (#3)	55	42
Private Sector Relief (#4)	19	35
Welfare Instruments (excluding UNRWA’s emergency appeals)	151	120
-- <i>Employment Generation</i> (#5)	72	70
-- <i>Food Aid</i> (#6)	53	30
-- <i>Cash Schemes</i> (#7)	26	20
Infrastructure Repairs (#8)	65	30
Support to the Universities (#9)	10	10
Support to UNRWA’s emergency appeals (#10)	65	35
<b>Total Other Emergency/Humanitarian</b>	<b>365</b>	<b>272</b>
Investments and Institution Building		
PA Reform	5	25
Other Institutional Development	92	125
Capital Infrastructure	100	95
<b>Total Medium-Term Development</b>	<b>197</b>	<b>245</b>
<b>Grand Totals</b>	<b>1026</b>	<b>919</b>

Source: World Bank staff calculations.

## RECOMMENDED DONOR ACTIONS

### Emergency Support

4.19 The priority areas for emergency assistance elaborated for 2002 in “Fifteen Months” remain a useful framework for planning emergency assistance. It is recommended that donors focus their emergency support on a similar list of **ten** priority programs in 2003.

## ***1. Budget Support for the PA***

4.20 The PA's Budget for 2003 indicates a budget support requirement of US\$535 million, and presumes that all arrears are eliminated by end-2003. The Bank's *Status Quo Scenario* suggests that tax revenue will exceed the estimates in the Budget (US\$637 million forecast, against US\$531 million budgeted). On the other hand, transfers of withheld clearance revenue by GOI might be lower than budgeted (US\$253 million forecast, against US\$480 million budgeted). Under these conditions, some US\$656 million in donor budget support would be needed to eliminate all PA arrears in 2003 (while keeping current expenditures at their budgeted level). Under the assumption that donors will disburse US\$401 million in 2003 for budget support, the PA would be able to repay some US\$251 million to the private sector. Under the Bank's *Lifting of Internal Closure* and *LOIC with Trade Facilitation Scenarios*, the PA would be able to repay US\$342 million and US\$375 million respectively in 2003.

4.21 Quite apart from its political and service delivery benefits, budget support in WBG has significant macro-economic and welfare benefits. Donors should therefore set aside their traditional reservations about using grant or quasi-grant funds for what are often considered consumption expenditures. While donors will in time wish to reduce budget support to free up resources for development work, they are urged a) to ensure that this year's budget gap is fully financed, and b) to retain the flexibility to increase budget support payments should Israel once again suspend payments of regular or withheld clearance revenues.

4.22 Over the past several months, EU budget support has encountered scrutiny from European parliamentarians (para. 2.44). It is important that concerns about the possible misuse of generalized budget support not be allowed to linger unanswered, thereby imposing a silent veto on this form of support. The fact that GOI has chosen to resume transfers of clearance revenues is perhaps the best reason for improved confidence in the Ministry of Finance's control procedures -- since it was GOI that first suspended this form of budget support in December 2000, amid allegations that these funds were being siphoned off to finance terrorism. In addition, the Minister of Finance has invited the World Bank and DFID to undertake a Country Financial Accountability Assessment in mid-2003. The CFAA is a widely used tool, which assesses fiduciary management capacity in both public and private sectors. This CFAA will take a fresh look at MOF's financial control systems, and will thereby assist donors to make an analytical determination of the risks -- or lack thereof -- in providing generalized budget support to the PA.

4.23 The Arab League, for its part, is urged to re-examine the burden-sharing arrangements currently in force, with a view to improving the relationship between pledges and actual disbursements. In Q1 2003 only about one fifth of the pledged amounts were disbursed.

## ***2. Support for PA Basic Service Delivery***

4.24 The donors' objective in 2003 should be to finance US\$80 million of the PA's non-salary operating costs in 2003. ESSP funds are targeted principally to operating costs in the health and education sectors, since these are the most essential of the PA's basic services.<sup>119</sup> Total

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<sup>119</sup> Contributors to ESSP in 2003, in estimated disbursement terms, are the Bank (US\$23 million), Denmark (US\$2.8 million), the EC (US\$18.1 million), Finland (US\$1.2 million), Italy (US\$5 million), the Netherlands

disbursements in 2003 to the PA budget under ESSP of US\$53.4 million are currently expected. In Q1 2003, ESSP managed to disburse US\$14.2 million, at an average of US\$4.7 million per month. Probable disbursements in the remainder of 2003 amount to about US\$39.2 million, an average of US\$4.4 million per month. If ESSP can disburse at this rate through 2003 it will play a valuable part in shoring up the formal social safety net, but ESSP could easily absorb an additional US\$25 million as operating cost support to the PA.

4.25 One of the reasons that ESSP is an attractive instrument is that funds are disbursed against *contracts* rather than as cash.

4.26 ESSP has also been providing support for municipal salary and non-salary operating costs (Program #3), and there is also a case for using it to provide salary support for the university system in 2003 (see Program #10 below).

### ***3. Budget and Emergency Support for the Municipalities***

4.27 Chapter 3 described a situation in which the municipalities' efforts to assure essential water and sewerage, electricity and waste disposal services have been undermined by a reduction in revenues of almost a half. In the second half of 2002, donors provided almost US\$20 million in salary and operating costs support to local governments, a sum equivalent to about 30 percent of their pre-*intifada* expenditures for a six-month period. Donors should aim to match this level of support in 2003, and thereby provide about US\$40 million in budget support. In addition, the Bank estimates that municipalities can easily absorb another approximately US\$30 million in funds for equipment maintenance/replacement, or damage repair under locally managed job creation programs.

4.28 Thus far donors have indicated likely disbursements to the municipalities of about US\$42 million in 2003 for budget support, job creation schemes, developmental projects and the rehabilitation of services -- of which US\$11 million would come through ESSP as operating cost support, over US\$20 million through the distribution mechanism established under the Emergency Municipal Rehabilitation Program, EMRP, and the rest as direct disbursements to various municipalities under bilateral programs of repair and rehabilitation. While the economic case for providing salary and operating cost support to municipalities is strong, the Bank has recently detected some reluctance among donors to finance such expenditures, out of concern that financial accountability is hard to ensure in a decentralized system with greatly variable quality of management from one LGU to another. EMRP offers a mechanism that should answer such concerns. A Municipal Fund, managed initially by an internationally-recruited Agent will oversee the preparation of emergency financing proposals by municipalities, in which salary and operating cost requirements will be "projectized" into repair and rehabilitation packages. After careful appraisal, implementation will be monitored and expenditures rigorously audited. Serious LGU financial mismanagement will be penalized by a loss of subsequent access to the Municipal Fund.

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(US\$4 million), Sweden (US\$3 million) and the UK (US\$7.4 million), for a total of US\$64.5 million. This includes disbursements to the PA (US\$53.4 million) and to the municipalities (US\$11 million).

#### **4. Relief for the Private Sector**

4.29 “Fifteen Months” argued that “the private sector has been hard hit, has received relatively little donor assistance and is vital to any Palestinian recovery”. While it is true that the bulk of funding in 2002 was directed to public sector employees and institutions, the assertion is, on reflection, simplistic on two counts. The first, of course, is that wages paid to public employees are used predominantly for the consumption of items sold by private sector retailers and service providers (virtually nothing is being saved or invested at present). Second, the assertion fails to recognize the quantum of donor support provided to the domestic private sector in the form of the financing of PA purchases from private suppliers, civil works contracts managed by the PA and local governments, service and handling charges paid by the PA and by donor/NGO implementing agencies, and TA contracts.

4.30 When it came to the provision of *direct* support to private firms, the donor record in 2002 was certainly poor, and only US\$19 million was disbursed for this against a target of US\$75 million. In the last months of 2002 both USAID and the EC established modest lines of credit for businesses under stress. USAID and the EC have emerged as the main donors prepared to provide direct financial support to troubled businesses in 2003 as well, and are likely between them to disburse perhaps US\$35 million through the facilities described in Box 6 below.

4.31 This report suggests two particular sub-sectors of private sector activity that would benefit from access to working capital loans -- the *commercial wholesale sector*, and the *agriculture sector*. Credit offered by local retail stores to their customers has proven an important safeguard for those who have lost their incomes, but anecdotal evidence suggests that this source of support has been drying up as wholesalers’ ability to provide credit has diminished. The decapitalization of the agriculture sector alluded to in para. 2.55 represents a potentially serious impediment to the revival of agro-exports, and loans that assist farmers to avoid forced asset depletion could pay dividends once an improved export climate emerges.

### **Box 6: Reviving the Private Sector**

The EC and USAID have emerged as the main sources of direct emergency support to the private sector. The EC has set up a 15 million Euro SME support fund managed by the Palestinian Development Fund and the Palestinian Banking Corporation, which is providing financial relief and working capital assistance to SMEs in Gaza and the West Bank/East Jerusalem to eliminate threatening liabilities accrued in the last two years, and to maintain current operations. USAID will also support a US\$2 million line of credit to private sector operators through commercial banks, and injecting additional emergency funds into the private sector through damage repair/reconstruction grants for small enterprises.

The World Bank also debated establishing a Private Sector Crisis Fund to provide risk capital to commercial banks willing to increase lending to the private sector, but staff concluded that the banks would likely lack the incentive to lend to productive businesses, and would prefer to use donor capital to help erase a portion of their bad loan portfolios. Rather than opt instead to finance agency lines of credit, as USAID and the EC have done, the Bank was requested by the PA to focus instead on providing indirect support to the private sector through financing contracts (which has been done through ESSP 2 and the Emergency Municipal Reconstruction Project, both of which were approved in December 2002).

In addition to offering emergency programs, donors feel it is imperative to continue improving the legal and regulatory framework for PSD, and particular mention should be made of USAID's efforts to strengthen export capacity (via the Market Access Program), restructure and revitalize private businesses (the *Inaash* Program) and support the integration of the former Ministry of Trade and Industry into the former Ministry of Economy. Many private firms perceive themselves disadvantaged not only by Israeli security measures, but also by the ad hoc and bureaucratic practices of the PA (see Table 7). In particular the PA must begin to address obstacles to investment created by distortionary regulations and procedures and by bureaucratic delay and inefficiency. The new Ministry of Economy, Trade and Industry (MOETI) and the newly created Joint Economic Council (which brings together private sector representatives and the key regulatory agencies of the PA) have done a good job of pressing ahead with the preparation of key laws and procedures. This process needs to be accelerated under the aegis of the PSD domain of the Palestinian reform program.

".....the current crisis offers an opportunity for the PA to tackle fundamental weakness in the legal and regulatory framework for firms and investors. While the PA launched a number of important reform measures in the mid 1990s, inconsistencies and lack of transparency in a number of aspects in the public-private interface inhibit the entry, productive growth and exit of firms. The key constraints are cumbersome licensing such as acquiring access to land, outdated laws and legal vacuums in some cases, and lack of published forms and procedures. Recommended actions include (i) simplifying existing regulations and licensing procedures, particularly in the area of industrial licensing and land titling; (ii) eliminating legal and regulatory vacuums, particularly with respect collection of bad debts; (iii) modernizing, harmonizing existing laws and regulations and providing national coverage with respect to company, commercial agency and intellectual property rights registration; (iv) creating and publishing standard forms and procedures particularly in the area of income tax administration; (v) introducing effective mechanisms for the enforcement of laws and regulations; and (vi) improving public-public and public-private coordination; particularly with respect to the roles of the Directorate of Industrial Licensing, PIPA, PIFZA and the chambers of commerce. Other priorities for action in the short term include simplifying export and import licensing procedures and expediting VAT refunds." -- from *A Strategy for Private Sector Development in the West Bank and Gaza: From Crisis to Sustainable Growth* (World Bank, March 2003, draft).

## **5. Food Aid**

4.32 In 2002, an estimated US\$75 million (including UNRWA's emergency appeals) was spent on food aid in WBG. As a working assumption, around US\$100 million will be needed to sustain through 2003 the same level of food aid as was being delivered by year's end. Thus far

the equivalent of about US\$40 million in food is likely to be disbursed to UNRWA, WFP and other food providers in 2003, leaving a gap of about US\$60 million.

## **6. Employment Generation Programs**

4.33 MOPIC's National Strategy argues the merits of job creation programs, while recognizing that they cannot be seen as a panacea for unemployment: available funds are nowhere near sufficient to replace the jobs lost as a consequence of the crisis (the report shows that creating jobs for 160,000 unemployed would cost US\$150 million per month, or US\$1.8 billion per annum, whereas between September 2000 and January 2002 donors disbursed US\$105 million in total for job creation programs). MOPIC's subsequent Emergency and Public Investment Program (EPIP, see para. 4.53) proposes that US\$176 million be allocated to job creation programs in 2003. Based on the arguments elaborated in **Annex 1**, this figure would be hard to justify, and indications from donors are that this is not an achievable financing target. Currently, some US\$70 million seems likely to be disbursed by donors to job programs this year.

4.34 The National Strategy contains many useful lessons of experience that should be factored into the design of future job creation programs. These include i) the use of standardized contracting procedures and specifications, ii) the choice of projects, and of designs and technologies within those projects, that maximize the use of labor and local materials. The intent of these measures is to increase the multiplier effects of job creation programs. In addition, iii) projects should be selected and prepared in much better consultation with local communities, and iv) transparent criteria should be applied when hiring labor, and emphasis given to the local unemployed as well as to needy women and other vulnerable groups. In order to help ensure these recommendations are followed, a Technical Resource and Monitoring Unit should be formed. This unit would serve as a resource center for PA agencies, municipalities, local communities, NGOs and UN/donor agencies involved in job creation, and would make available to them information on key factors such as labor-based designs and technologies, import substitutes, the geographical distribution of poverty and unemployment, etc. The unit would also become the secretariat for the Sector Working Group on Job Creation and thereby help bind all stakeholders into a common set of principles and practices.

## **7. Cash Programs**

4.35 One immediate need is for additional financial support for the Special Hardship Cases (SHC) program of the Ministry of Social Affairs. The current annual cost of the program is roughly US\$30 million. The scheme currently reaches some 150,000 of the chronically poor, and is well managed and could be scaled up without appreciable risk. Assuming a continuation of payments at current (inadequate) rates and an expansion of beneficiaries by one third in the second half of this year, required SHC financing for 2003 would amount to some US\$39 million. If the "poverty gap" were covered, the costs of the scheme would rise to US\$42 million with the current numbers of beneficiaries (and US\$56 million if the numbers were expanded by one-third). For 2003 the PA has budgeted US\$49 million against MOSA's SHC scheme. Likely donor disbursements against the SHC scheme currently amount to only US\$8 million, and without additional earmarks it may be difficult for MOF to assure full budget financing.

4.36 Looking ahead, the World Bank's report on MOSA<sup>120</sup> report recommends a number of improvements to the SHC program: eligibility criteria and the assessment process can be simplified, an up-to-date operational manual needs developing,<sup>121</sup> and a formal auditing and evaluation process should be introduced (some donors have tended to hold back from financing the program due to unanswered concerns about targeting, etc). Ways should be explored to expand the SHC program to supplement the incomes of a wider range of the poor, including through the introduction of health and education-specific payments under a "conditional cash transfer" (CCT) approach.<sup>122</sup>

4.37 The possible expansion of the type of voucher scheme currently financed by ICRC should also be considered. In Chapter 3 it is argued that voucher programs have some economic advantages over food distribution in an environment in which there is no generalized food shortage. The ICRC program is still quite restricted in scope, serving 20,000 West Bank families in nine towns and costing about US\$20 million a year. International experience has shown that there can be significant design and implementation issues associated with such schemes. While ICRC's program appears to be well-designed and appropriately targeted (in cooperation with MOSA), it would be useful for the PA and donors if a dialogue were initiated around the ICRC experience with a view to exploring the case for expanding the use of vouchers in WBG. It is recommended that the LACC organize such a dialogue with the assistance of ICRC.

## **8. Reconstruction and Emergency Infrastructure Development**

4.38 Disbursements for infrastructure repair in 2002 fell well short of the US\$150 million pledged by donors at an LACC forum in June 2002. Of the US\$90 million committed in 2002, some US\$65 million was actually disbursed. For 2003 new commitments total only about US\$20 million, but this is to some extent definitional, as a good portion of what are classified as job creation commitments are for damage repair. At this stage it appears likely that some US\$30 million may be disbursed under the reconstruction and emergency infrastructure program category (# 8) in 2003. The World Bank estimates that donors by the end of 2003 will have disbursed some US\$130 million for the repair of various types of physical damage caused during the *intifada* (by the end of December 2002 these damages totaled some US\$930 million in net terms, para 2.31). Clearly donors are still inhibited by continuing confrontation, although this has abated considerably since mid-2002, and have chosen not to undertake certain kinds of repairs such as road resurfacing. Appropriately, priority has instead been given to the rehabilitation of the PA's administrative and social infrastructure (PA offices and their equipment, schools and clinics) and to maintaining and selectively expanding local utility networks. Electricity and water services in the West Bank and Gaza have been under particular stress, and donors are advised to help ensure they are kept in good operating order in the coming months.

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<sup>120</sup> "The Ministry of Social Affairs and its Poverty Alleviation Programs", op. cit.

<sup>121</sup> The current manual is based on an old manual prepared by the Israeli Civil Administration when they initiated the program in the mid-1970s.

<sup>122</sup> CCT programs are intended in part to ensure that cash is well targeted within families; this is done by targeting malnutrition in infants and school drop-out problems in children and adolescents, and by requiring families to show proof of appropriate clinic and school attendance.

## **9. Supporting the University System**

4.39 According to the PA's Higher Education Financing Strategy,<sup>123</sup> some US\$10 million is required in 2003 to support the Student Revolving Loan Fund (SRLF) scheme, along with US\$13 million in direct support and student vouchers to finance the expansion of "priority fields" of study. The PA has begun a higher education reform process by establishing the SRLF, the cost of which is likely to be met by the Arab Fund in 2003. The other two programs, however, still need detailing out before donors can be expected to finance them, and this process is unlikely to be finished this year.

4.40 Donors are understandably reluctant to finance the operating costs of a university system which MOEHE itself describes as characterized by "uncontrolled growth and unplanned expansion, questionable social relevance and academic quality, unreliable financing, and ineffective governance as the size and scope of the sector outgrew traditional operational modes and established organizational structures".<sup>124</sup> Nevertheless, the higher education system forms the third of the "trio" of essential Palestinian public institutions (along with the PA and its ministries, and the municipalities), and will need to play its part in modernizing the Palestinian economy.

4.41 Further contributions to university running costs are both necessary and justifiable in 2003. It is recommended that MOF and MOEHE reconfirm a minimum package of priority emergency support needs and convene the donor community to solicit their financial support for this. It will be necessary to convince donors that a high standard of financial accountability can be applied to this emergency support program. In the 2003 PA Budget, US\$20 million is allocated for the university system; of this, about US\$10 million is currently expected to be covered through the Emergency Services Support Project, and another US\$5 million by the PA.

## **10. UNRWA**

4.42 For 2003, UNRWA has appealed for US\$93.7 million for emergency funding for the first six months of the year, and only about one third of this (US\$35 million) has so far been committed. Under a *Status Quo Scenario*, one would assume that UNRWA's Fifth Appeal would need augmenting in 2003. At a minimum, and in view of the fact that UNRWA is responsible for delivering basic services to almost a half of the population of WBG, donors should aim to fully finance the Fifth Appeal.

### **Medium-Term Development Assistance in 2003**

4.43 Donors should continue to finance the development of the institutions and infrastructure required by a future Palestinian state, to the extent that circumstances permit. Donor commitments for medium-term development declined from US\$852 million in 2000 to US\$473 million in 2001 and US\$261 million in 2002. For 2003, donors have indicated commitments of US\$548 million for medium-term development activities, higher than at any previous point in the *intifada* -- indicating a consensus among donors that there is a realistic prospect of resumption of political dialogue in 2003.

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<sup>123</sup> *Palestinian Higher Education Financing Strategy*, MOEHE/World Bank, August 2002.

<sup>124</sup> *Ibid.*, p.15.

4.44 One critical and immediate support area for donors is the *PA's Reform Program* with TA/institutional development costs estimated at US\$35 million in 2003 (against which donors have committed approximately US\$25 million to date). If pension reform is to commence this year, some \$20 million of a transitional bill of perhaps US\$150 million is recommended in support of this (see Box 7 below).

4.45 When prior commitments are included, donors intend to activate about US\$305 million in new infrastructure projects in 2003, if conditions permit. Of this, the bulk of the financing planned is for the water sector, with USAID (in particular), the EC and the World Bank together intending to initiate non-emergency water projects valued at US\$243 million.

### **Priorities in Aid Management and Coordination**

4.46 The donor response to the *intifada* has been timely and appropriate -- disbursements doubled in 2001 and held steady in 2002, while the progressive shift into budget financing and other kinds of emergency support was unavoidable and necessary. Nor have donors lost sight of the state-building agenda, despite the lack of any stable political outlook during the past two years.

4.47 Continued adaptability and forethought has been further demonstrated in the way donors seized upon PA Reform as a metaphor for re-engagement in the state-building agenda, and by the indications they are now providing of their willingness to switch quickly back into medium-term institutional and developmental work. Should the implementation of the Roadmap take hold in 2003, donors will need to formalize this shift by moving to a *New Economic Strategy* which shadows the political stages of the Roadmap with a compatible program of economic revival and policy development. A key aspect of this new economic strategy will be a shared understanding of what constitutes a viable economic relationship between a future Palestinian state and Israel.

4.48 "Fifteen Months" spoke to the need for donors to pursue greater operational harmonization. In the past two years donors have done a good job of informing one another of their plans and agreeing on coordinated strategies. Program harmonization remains a challenge for the future, however, as do other issues of aid management such as achieving strategic focus and taking account of donor comparative advantage. A listing of all donor-financed projects in the West Bank and Gaza reveals a breathtaking number of initiatives -- a testament to enthusiasm rather than to any shared sense of priorities. Similarly, a review of activity by donor reveals little evidence of specialization. To an extent this reflects a lack of strategic leadership by the PA, which has not managed to provide clear direction to donors on investment or capacity building priorities, or to plan on the basis of available donor resources.

## **Box 7: Pension Reform**

The pension sector is dominated by two civil service pension schemes -- the West Bank Scheme (the Two Percent Scheme) and the Gaza Scheme (the Ten Percent Scheme), and by a draft Security Force Pension Law, for which worker contributions are being withheld, but to which the PA has not yet contributed. Both the existing civil schemes are bankrupt and in need of reform.

In May 2000, the West Bank Scheme was closed to new members, and the Gaza Scheme began enrolling new civil service employees. This change was intended to create a unified pension regime that would redress the unequal treatment of civil service members and serve as the basis for expanding coverage to the private sector -- for which there are no coherent social security arrangements.

The West Bank and Gaza Schemes are among the more generous civil service pension schemes in the world. The burden of financing them in both the short and the long run is beyond the means of either the PA or donors, and the financial drain from trying to do so would seriously affect the ability of the PA to engage in long-term infrastructure development and to extend social insurance programs to vulnerable groups. On a cash-flow basis, a sizeable and rapidly growing deficit will emerge from the two schemes in the very near future, perhaps in as little as three to five years. Enacting the Security Force Pension Law is essentially impossible without substantial prior reform of the whole system. In addition, there are potential liabilities whose costs have not yet been determined. An unknown number of those currently covered under the West Bank and Gaza Schemes have prior service as members of the PLO and PLA; these individuals have not been identified yet, and the extent of their previous service is unknown.

Government arrears to the pension schemes are estimated to stand at more than US\$170 million. For the Gaza and Security Forces Funds, the government deducts 10 percent from employee wages and contributes 12.5 percent as employer. The PA has been in arrears in transferring its contributions to the funds, using them to partially offset the financing gap in its budget. Consequently, the Gaza Scheme has been paying benefits from locally held reserves that will be completely liquidated by 2006-7 if these arrears continue unchecked.

Despite recent progress in improving administrative and investment controls, substantial administrative and governance issues still need to be addressed. Over the past eight years the nominal rate of return on offshore and local pension funds assets managed by the Gaza Pension and Insurance Corporation (GPIC) has been slightly greater than zero, while inflation over the period has averaged about 5 percent; in other words, the funds are depreciating rapidly in real terms. Nor are pension members given any information regarding the performance of their fund. Both these factors indicate an urgent need to review the governance and administrative structure of GPIC, including investment procedures and oversight as well as internal and external controls and record keeping. Efforts are underway to address these concerns.

The PA needs to look at staffing levels from the viewpoint of the sustainability of the public pension system. Overstaffing will substantially increase the long-run cost of pensions, and will further undermine financial sustainability. The greater the overstaffing, the more radical the reforms needed to bring deficits within a manageable range. Thus civil service pension reform is most effective if combined with other civil service reforms, most notably rationalization of overall compensation and optimization of staffing.

Private sector workers in formal labor markets in the West Bank and Gaza are not covered under any national social security scheme, and private pension coverage is very limited, with uncertain and often inadequate benefits. The situation is different for Palestinian workers with jobs in Israel. Many Palestinians have contributed to Israeli pension schemes. The Israeli Government has agreed to transfer these contributions to the PA once a national system is in place, arguing that transferring the money any earlier might permit these funds to be used for unintended purposes. Consequently, many workers and former workers in Israel are not receiving their benefits. In response, the PA has begun work on a Social Insurance Draft Law which, on account of structural labor market barriers and sluggish wage growth, would only add to the PA's financial burdens without decreasing the risks faced by elderly retiring workers.

The World Bank, *Pensions in the West Bank and Gaza: Reform in a Context of Unrest*, February 2003.

4.49 Looking ahead to 2003 on the basis of what has been learned from the local aid coordination process during the *intifada*, the following recommendations can be made.

- Donors have tended to slip too far into a “donors only” mode. While understandable in light of the arduous working conditions often facing the PA, the habit should be avoided whenever possible, as it weakens the PA’s ownership of its programs. One appropriate way to re-engage with the PA is to revive and reform a number of the Sector Working Groups. These have in most cases withered away during the *intifada* -- proving to be too cumbersome to appeal to donors as fora in which useful emergency coordination can be carried out. The Operations Rooms, a number of which are still functioning (in particular Health and Water) suggest a more flexible, results-oriented approach to sector coordination. The LACC Office and MOPIC are currently discussing how a small number of key SWGs can be revived in a way that will help the PA and donors manage the emergency better. They are likely to feature “core groups” of PA staff and the most engaged donors, and a dedicated secretariat that will in effect manage the coordination process.
- One key to enhancing PA leadership of the development process, as well as accelerating progress towards ultimate program harmonization, is for donors to channel their development funds through the Single Treasury Account in MOF (under suitably identified project sub-accounts). This will permit the requisite degree of financial control over donor contributions as well as facilitating orderly financial and development programming.
- The data gaps identified in “Fifteen Months” have not been remedied. At a very basic level, regular information is needed on donor commitments and disbursements. As for “Fifteen Months”, the donor information presented in this report had to be collected for the purpose by the report’s authors. MOPIC, which provided quarterly donor data reports before the *intifada*, was not able to provide accurate or timely data since. It is hoped that the creation of a new Ministry of Planning will lead to a close collaborative relationship between MOP and MOF and to the definition of a functioning donor data tracking system. At a broader level, it is important that donors and the PA coordinate the collection of economic data more carefully than at present, and that they agree as far as possible on the methodologies and findings pertaining to key economic indicators used by all parties in reporting on the economy -- such as national accounts, employment and labor force data, poverty measures, physical damage, etc. In the course of its review of this paper, MOPIC and PCBS asked the Bank to assist in convening a “data forum” to explore how an agreed set of basic economic indicators can best be collected and used by all relevant parties, and how donor efforts can be better synchronized in support of the PA in this area. A meeting will shortly be convened to explore this idea further.
- Donor coordination should ultimately translate into additional funding and more effective programs on the ground. The LACC co-chairs recently commissioned a quick review of the *effectiveness* of aid coordination from this perspective during the *intifada*. This review is being carried out by experts who have followed the development of West Bank and Gaza’s aid structures from the outset, and will provide the co-chairs with advice on how to focus the system, prioritize and avoid excessive allocations of staff time to process, as opposed to practice.

- Finally, donors should continue to give their full attention to the Palestinian reform program. From evidence to date, the program is real and can succeed, provided the international community and the Government of Israel offer genuine support and avoid inappropriate interference. All parties owe it to the PA's reformers and the Palestinian public to help them change the current governance system into one bound by accountabilities and the rule of law. In practical terms, donors need to overcome their bureaucratic procedures when it comes to providing financial support in a timely manner -- thus far, donor support for key reforms has been materializing much too slowly.

## RECOMMENDED PA ACTIONS

### Managing the Crisis

4.50 *Maintaining Expenditure Discipline.* While the continued timely payment of PA salaries remains an overriding prerogative at the moment, maintaining fiscal discipline with minimal erosion of the non-salary budget means avoiding the recruitment of additional PA staff - apart from those required to cater to the natural expansion of the school and health systems. The Finance Ministry has made it clear that it intends to adhere to this policy. The Ministerial Reform Committee has indicated that the question of the "right size" of the public sector needs to be addressed in the context of the Palestinian reform program.<sup>125</sup>

4.51 *Strengthening the Local Government System.* Over the last year, donors have begun to provide emergency salary and operating cost support to the municipalities. While positive and necessary, this process needs more active management by the PA. First, it is important that a transparent system of allocation of available donor funds to local governments be established -- up to now allocations have been somewhat *ad hoc* and have lacked clear criteria. Second, local governments are characterized by great variety in their management capacity, from strong to outright shambolic. As a matter of urgency, the PA needs to establish minimum criteria to ensure that donor budget support funds are properly used and can be adequately accounted for. If this is not done soon, it is unlikely that donors will be able to sustain the argument for continued emergency budget support to local governments, and will be obliged to redirect such funds either to repairs/equipment replacement or to job creation at the local level.

4.52 *Developing a National Vision and a National Emergency Plan.* "Fifteen Months" reflected an agreement between the PA and donors to develop by April 2002 a National Emergency Plan, and to involve municipalities and civil society fully in elaborating it and

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<sup>125</sup> Estimates of the number of PA employees vary between 118,000 and 125,000. Excluding the security services, the civil service *per se* consists of some 65,000 staff. As a proportion of the total population of WBG, civil servants amount to some 2.1 percent, which is not excessive in international comparative terms. If, however, the refugee population -- to whom UNRWA provides many basic services -- is excluded, the proportion rises to about 4 percent, which is excessive, compared to countries with per capita income equivalent to pre-*intifada* level. More to the point, however, is the fiscal sustainability of the WBG civil service, which will become an important issue once there is a return to economic stability. At that point it will be necessary to review the size of PA employment as a whole against the emergent medium-term fiscal outlook, and to ensure that public sector wages do not crowd out non-salary operating costs and the PA's contributions to the development budget. This review should be conducted in parallel with the development of a service delivery strategy that makes best use of Palestinian NGOs and the private sector as mainstream service providers.

monitoring its delivery. This was not done, but the process of preparing the current report has helped revive this understanding.

4.53 Prior to the AHLC Meeting in London on February 18-19, 2003, MOPIC established a senior inter-ministerial committee, and developed an *Emergency and Public Investment Plan* (EPIP) for 2003.<sup>126</sup> This committee conducted meetings and workshops with other PA agencies and ministries as well as with local governments, the private sector and NGOs, and built a plan on the basis of a sectoral analysis of needs and suitable projects. Potential interventions were screened on the basis of geographical need, institutional capacity, accessibility under emergency conditions and ability to create employment (full account was taken of the National Job Creation Strategy described in Annex 1, para. 29).

4.54 On a commitment basis, EPIP would require US\$1.747 billion from donors in 2003, of which US\$520 million would be needed for budget support and US\$250 million for medium-term institutional and infrastructure programs. In 2002 donors committed US\$1.527 billion, and have so far committed some US\$1.274 billion this year. On a disbursement basis, EPIP requires some US\$1.256 billion in 2003, as against indicated disbursements of US\$919 million so far -- so the targets are ambitious. The heart of EPIP is US\$634 million required in disbursements for emergency, humanitarian and capacity building programs, against which the Bank estimates that some US\$429 million is thus far likely to be available -- with the main shortfalls currently against job creation schemes and infrastructure repair/emergency programs. Programmatically EPIP bears a very close resemblance to the priorities advocated in this report, as can be seen in Table 22. Moving on from the EPIP, it is proposed that donors support the efforts of the Ministry of Finance, the new Ministry of Planning and the new Ministry of National Economy to prepare an *Economic Recovery Program* for 2004 once the Roadmap process is underway. This program could be used as the basis for a dialogue between the PA and the public on economic priorities and management, as well as for donor fund-raising purposes.

**Table 22: Core Emergency and Public Investment Plan Sub-programs (US\$ million)**

Sub-Program	EPIP – Required Disbursements	Likely Disbursements in 2003
Budget Support/ Financing for Municipalities ( <i>Program #3 above</i> )	41	42
Private Sector Relief ( <i>Program #4</i> )	26	35
Employment Generation ( <i>Program #5</i> )	176	70
Food Aid ( <i>Program #6</i> )	99	30
Cash Schemes ( <i>Program #7</i> )		20
Infrastructure Repairs ( <i>Program #8</i> )	111	30
Support to Universities ( <i>Program #9</i> )	10	10
Support to UNRWA's emergency appeals ( <i>Program #10</i> )	95	35
Capacity Building and PA Reform	76	150
<b>Total</b>	<b>634</b>	<b>429</b>

Sources: MOPIC and Bank Staff Estimates.

<sup>126</sup> The inter-ministerial committee consisted of representatives from the Ministries of Finance; Economy, Trade and Industry; Agriculture, Local Government, Housing and Public Works; and PECNDAR.

## Deepening the Reform Process

4.55 The Palestinian reform process continued to advance throughout the second half of 2002 and early 2003, largely due to the determination shown by the Ministerial Reform Committee. The recent creation of a Reform Coordination Support Unit with permanent links to line ministries has helped maintain momentum.

4.56 Although substantive work has been done in all the reform domains, concrete results have not always been achieved at the pace expected or desired. In a number of cases, this was due largely due to restrictions on movement, including on the movement of key PA officials actively involved in the reform process. Other issues, however, could not be resolved because of resistance to reform within the PA.

4.57 The interest of the international community in the reform process is considerable, and will grow with the publication of the Roadmap. Nonetheless, the Palestinian Authority -- both executive and legislative branches -- must remain the driving force behind Palestinian reform. Continuous decisive action is needed if the PA is to maintain the credibility of the process in the face of its detractors and a skeptical public.

- ***In the Area of Financial Accountability.*** Significant progress has been made in this area -- notably the submission to/approval by the PLC of a balanced budget for 2003, the consolidation of all PA revenues into a Single Treasury Account (STA) under the sole control of the Minister of Finance, the consolidation of all PA commercial activities into a Palestinian Investment Fund (PIF), and the strengthening of internal auditing procedures and controls. Further important measures include completing the audit and valuation of PIF assets<sup>127</sup> and the transfer of PIF profits to the STA; the integration of public investments into future PA budgets; enhancing external audit procedures and legislating the independence of the Office of the Auditor General; and ensuring that all government financial transactions, including the payment of wages to security service employees, are managed through the banking system.
- ***In the Area of Market Economy.*** Although private investment will not resume to any appreciable extent until the political/security situation improves, much can be done now to create a better business environment. Some immediate relief has been provided recently. Following the resumption of revenue transfers/the return of tax arrears by GOI, MOF has begun to ensure the prompt refund of VAT to businesses, as well as to clear its debts to the private sector. A Joint Economic Council has been created under the auspices of the Ministry of Economy, Trade and Industry, and has developed a broad consensus on measures that must be taken to remove obstacles to recovery. Top priority should be given to progressing the extensive legislative/regulatory agenda through the PLC and the Executive. Key laws include the Capital Markets Authority Law (already passed by the PLC), the Income Tax Law amendments, the Chambers of Commerce Law, the Insurance and Securities Law, the Competition Law (under discussion in PLC committees), the Foreign Trade Act, the Intellectual Property Law and revisions to the Customs Law and tariffs. The restructuring of the Ministry (now the Ministry of

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<sup>127</sup> The audit and valuation of PIF assets is close to completion, and publication is expected shortly.

National Economy) should also be completed, and the Office of the Land Authority strengthened so it can carry out its responsibilities quickly and effectively.<sup>128</sup>

- ***In the Area of Public Administration and Civil Service Reform.*** Recent internal debate indicates that a consensus has been reached on the need to move forward with a major restructuring and rationalization of PA public administration. A Ministerial Reform Committee paper outlining a civil service reform program has received initial Cabinet approval,<sup>129</sup> and should be implemented as soon as possible. A solvent and fiscally sustainable pension system must also be developed without delay (Box 7). The process of organizational reform and of developing a civil service recruited and rewarded on performance grounds will need sustained commitment, particularly as a degree of downsizing may in time be required.
- ***In the Area of Local Government.*** Municipalities and local government remain the front-line providers of services to citizens, but their capacity to perform these functions is now very limited. Although the conflict is the main reason for this, the PA also needs to support the municipalities by developing a central/local revenue sharing scheme and by permitting the development of broad-based own-source revenue generation on the part of municipalities (the Property Tax Law should be amended to give more responsibility for collection and enforcement to the municipalities). Other steps that would promote local government reform include activating the role of the Internal Monitoring and Inspection Department at the governorate and municipal levels, continuing the preparations for local elections and cooperating with the appropriate PA institutions to improve judicial and law enforcement systems at the local level. The Ministry of Local Government should develop a comprehensive work plan to guide the municipal reform process.
- ***In the Area of the Judiciary and the Rule of Law.*** Just as the financial reforms are critical to the PA's credibility, reforms ensuring that Palestinian governing institutions are accountable under law are critical to the PA's legitimacy. Until March 2003, progress on a number of important legal and judicial reform issues had been negligible, leading to concern over the sincerity of the PA's commitment to reform in this domain. In particular the delineation of responsibilities between the Ministry of Justice and the Supreme Judicial Council was unclear, the Supreme High Judicial Council appeared to have been reappointed in a manner inconsistent with the Judiciary Law, and State Security Courts had not been abolished. In March 2003, the PA moved to address these concerns. Pending amendment by the PLC of the Judiciary Law to remove certain ambiguities, a committee of judges, general prosecutors, court and Ministry of Justice officials is now working on identifying judicial responsibilities. It has been clarified that the current Council is temporary (as allowable by law), and that the permanent Council will be appointed this June, in accordance with the Basic Law and the Judiciary Law. In addition, the State Security Prosecution has been implicitly abolished by the appointment

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<sup>128</sup> A working system of land registration, the provision of clean titles to land, and the settlement of disputes related to land ownership are of fundamental importance to the development of the private sector.

<sup>129</sup> These concern, *inter alia*, government or public institutions that operate outside the jurisdiction of ministries, the establishment of a model organizational structure and personnel registers for ministries, and the rationalization of Cabinet procedures.

of the Attorney General for State Security Courts as Attorney General (with responsibilities subject to the Penal Procedures Law of 2001) -- and by suspending the operation of the State Security Courts. Moving forward, the independence of the judiciary and its capacity and competence will be greatly enhanced by the appointment and training of new judges, prosecutors and other court officials, as well as by the construction/refurbishment of a basic network of courthouses.

- ***In the Area of Elections.*** Fair elections conducted in an atmosphere free from violence and intimidation are crucial if Palestinian society is to determine who should govern on its behalf. Recognizing the impossibility of holding national elections under current conditions, the previously-announced January 20 date has been postponed. The task facing the Central Election Commission (CEC) is substantial, and preparations require the active contribution of the PLC and of the Central Elections Commission, as well as sizeable further assistance from the donor community. There is as yet no endorsed legal framework for either national or municipal elections, and the PLC must address this issue soon so mechanical matters (such as the establishment of voter registries) can move forward. Delays in this area have hindered the work of the CEC, and limited donor assistance to start-up support -- much of the remaining assistance pledged by donors is contingent on the adoption of the legal framework.
  
- ***In the Area of Civil Society.*** Despite mobility problems, the PA has held a number of public-private dialogues on various aspects of reform. These interactions should be strengthened and broadened, so that ordinary citizens are given the opportunity to become more actively engaged in defining and realizing the reform process. For its part, civil society needs to work on organizing itself so it can present its concerns and positions on reform more systematically to the PA.

## **RECOMMENDED GOVERNMENT OF ISRAEL ACTIONS**

4.58 The actions of the Government of Israel are the key to the Palestinian economy in 2003. Of far greater influence than the economic policies of the PA or the activities of donors is closure in its various forms. Economic recovery cannot *begin* without Israeli significantly reducing the economic pressures that are being applied.

4.59 The *sine qua non* of economic stabilization is a significant easing of the current regime of *internal* closures and curfews, and the granting of easy access to external markets. As long as Palestinian internal economic space remains as fragmented as it is today, and as long as the economy remains subject to extreme unpredictability and excessive transaction costs, the revival of domestic economic activity will remain a distant prospect, and Palestinian welfare will continue to decay.

4.60 The Government of Israel's recent decision to resume the transfer of the PA's monthly clearance revenues is very welcome. If these flows are transferred on a regular basis without interruption and segregated from day-to-day political pressures, donors providing budget support will in time be able to switch their assistance back to more conventional, growth-oriented investments. GOI should also clear the stock of withheld arrears, and should seek to resolve any legal issues associated with this in as rapid and constructive a manner as possible (consistent

with Israel's separation of powers). The return of these withheld arrears is permitting the PA to clear its own arrears, in particular to the domestic private sector. This injection of cash is already exerting a beneficial effect on the faltering Palestinian private sector.

4.61 The recent increase in the number of permits issued to Palestinians for work in Israel and the settlements is also a positive step. If further expanded, it will have an important impact on unemployment, and will contribute significantly to the regeneration of internal Palestinian demand.

4.62 GOI should permit freedom of movement for the Palestinian officials and parliamentarians critical to the implementation of the Palestinian reform program. It is inconsistent with Israel's own call for the reform of the PA that those essential to its implementation who pose no security threat should be unable to travel and to conduct meetings as the process requires, and this point has been made on several occasions by the donor community -- including at the London meeting of the International Task Force on Palestinian Reform on February 20, 2003.<sup>130</sup>

4.63 The expressions of support for the international humanitarian efforts emanating from the Coordinator of the Civil Administration should now be translated into practical steps. As one aspect of this, GOI should ensure the implementation of the Prime Minister's commitments to Ms. Catherine Bertini on facilitating the work of humanitarian actors. Israel also needs to ensure the full protection donor and international NGO staff working in the field, including during curfews, and to take steps to avoid the destruction of donor-financed infrastructure assets or project facilities.

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<sup>130</sup> The Final Statement from the meeting mentions the following: "While acknowledging Israel's legitimate security concerns, there was consensus in the Task Force that mobility restrictions constitute a major impediment to reform, slowing progress and undermining the credibility of the reform process in many areas. In particular the inability of the PLC to meet on a regular basis hampers the passage of critical reform legislation and the PLC's ability to play an effective oversight role. The Task Force urged the Government of Israel to do all it can to facilitate the reform process and minimize the impact of its security measures on the civilian population."



## ANNEX 1: A COMPARISON OF WELFARE INSTRUMENTS

1. Donors have asked the Bank to compare the relative merits of the four welfare instruments currently used in WBG, namely **budget support, food aid, cash assistance and employment generation programs**. An early comparison was released as part of the draft of “Twenty-Seven Months” presented to the AHLC in February. It has subsequently undergone intensive discussion with the PA and donors -- in particular the EC, FAO, ICRC, UNRWA, USAID and WFP. As a result of this, the Bank’s analysis has been significantly modified.

2. Donors in 2002 disbursed a total of US\$683 million against these four instruments. Indications for 2003 suggest that donors are so far likely disburse about US\$565 million against them, with the bulk of the shortfall accounted for by the likely decline in budget support .

**Welfare Instruments -- Disbursements (US\$ millions)**

<b>Instrument</b>	<b>Disbursed in 2002</b>	<b>Likely Disbursements in 2003</b>
Budget support	483	420
Food	75	42
Jobs	95	81
Cash	30	22
<b>Total</b>	<b>683</b>	<b>565</b>

Source: World Bank staff calculations.

3. A first definitional point is that budget support includes support for both salaries and non-salary operating costs -- though 84 percent of the US\$519 million provided in 2002 was used for salaries.<sup>131</sup> It also includes support for the municipalities as well as for the PA.

4. Second, some initial distinctions need to be drawn between budget support and the other three instruments.

5. *Budget support* is significantly different in both intent and scale from the other programs analyzed here. In the WBG context, budget support had two original objectives, political and service-related. As PA revenues collapsed in early 2001 under the twin pressures of closure and the withholding of PA revenues by GOI, donors responded to the threat to the PA’s continued viability (to day-to-day governance as well as to the PA as a repository of ultimate statehood). The scale of this response and the identity of those providing budget support at the outset -- the Arab League states, the EU and Norway -- reflected a strong political commitment to preserving the PA, a commitment that over-rode normal donor reluctance to finance recurrent costs. A second explicit objective at the time was to sustain public services to the non-refugee population -- in particular the PA’s health and education systems. In time, the macroeconomic and welfare implications of providing salary support became clearer, but they do not feature prominently in the early discourse on budget support. Another basic feature of this instrument is that it only directly benefits those employed by the PA or the municipalities.

<sup>131</sup> US\$435 million out of US\$519 million was used for salaries (US\$425 million for PA salaries, US\$10 million for municipal salaries) and US\$84 million for PA and municipal operating costs.

6. In contrast, *food aid, cash payment schemes and job creation programs* have essentially humanitarian objectives, and aim to alleviate suffering at the micro-economic (family) level. To achieve this, they are targeted specifically to those experiencing hardship, and require carefully-designed and well-administered delivery mechanisms -- which budget support does not. This need for careful management means that donor capitals often require UN or international NGO involvement, which inevitably adds to program overheads; this also the case in the West Bank and Gaza. In WBG these three instruments have been dimensioned to supplement or substitute for incomes rather than provide full family subsistence, partly out of concern not to encourage dependency in what is seen as a temporary emergency, and in part because of limited resources and the need to spread them among the needy. In this sense they also differ from budget support, which has maintained public servants' incomes at their normal levels. The relatively modest scale of these three instruments means they have a much smaller macroeconomic impact than budget support<sup>132</sup>. Finally, the three instruments are to some extent complementary, in that they all aim to address the consequences of unemployment,<sup>133</sup> fill different niches, and are (at least at an agency level) designed and dimensioned in relation to one another.<sup>134</sup> Budget support, in contrast, has acted to preserve employment.

### **Budget Support**

7. The most striking aspect of donor support for public sector recurrent costs is its scale. Over the first 27 months of the *intifada*, donors provided US\$1.1 billion in budget support, or an average of US\$39 million per month. This is quite without precedent in the annals of post-World War II donor activity.

8. By providing 57 percent of the PA's cash expenditures in 2002, donors enabled the PA to pay full salaries and to avoid any layoffs, thereby maintaining the structure and the essential functions of central government.<sup>135</sup> Indeed, in an environment of sharply contracting private sector employment, the PA was able to increase public sector employment in 2002 by the 2 percent needed to cater to the natural growth in school enrollments. Thus the donors met one key objective.

9. Donors' second main objective was to assure continuity in service provision. In this they also achieved their goal, and the PA's basic structure of services remains intact and functional. This is in large measure because salaries were paid (salaries represented 94 percent of the PA education sector budget and 56 percent of the health budget for 2002).

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<sup>132</sup> Of the three, job creation received the most donor support in 2002. This amounted to less than one-fifth of what donors spent on budget support.

<sup>133</sup> Food aid has been used incrementally during the *intifada* as the numbers of the unemployed have grown, and the numbers of those slipping below the poverty line have increased in consequence. Job creation schemes were put in place early in the *intifada* as a "first line of defense" against unemployment, favoring laborers thrown out of work in Israel (and now also laborers who have lost their jobs within WBG). Cash schemes pre-date the *intifada* and are targeted to the chronically poor who have little prospect of employment.

<sup>134</sup> "UNRWA's food assistance is not delivered in isolation, but is part of a more comprehensive poverty alleviation strategy" (UNRWA comments on the Bank's draft report, March 19, 2003). UNRWA funds food aid, jobs and cash programs under its Emergency Appeals program in WBG. The same point was made by USAID and the EC in review meetings.

<sup>135</sup> Apart from security in the West Bank. The security services ceased to function after March 2002 for reasons unrelated to PA financing.

10. One can argue that donors and the PA were less than fully successful in meeting the service provision objective, since basic public services of all kinds came under great stress in 2001 and much of 2002. Leaving aside the extreme operating environment, central government services were constantly short of *non-salary* operating costs, since the PA elected to pay all salaries in full rather than reduce salaries or lay off any staff to protect operating cost budgets.<sup>136</sup> In a “second generation” response to this, donors in late 2002 launched ESSP (para. 3.11), a facility *restricted* to operating cost support. ESSP has helped ease the situation: MOH and MOEHE received 63 percent and 64 percent respectively of their operating cost budgets in 2001, and over 80 percent in 2002.

11. The PA also gave very little budget support to the *municipalities* until the advent of ESSP. As a result, municipal employment rolls were cut by perhaps 25 percent (about 3,000 staff) between September 2000 and June 2002, and budget expenditures by roughly 40 percent (para. 3.24). Basic service provision has deteriorated seriously -- particularly the provision of clean water and the collection of garbage -- and routine maintenance of the basic infrastructure stock has been ignored. ESSP injected US\$19 million in the second half of 2002, equivalent to about 30 percent of pre-*intifada* municipal budgets for a six-month period, and this has helped stabilize municipal finances somewhat. In early 2003, the PA made a major contribution to clearing the municipalities’ arrears to Israeli utility companies by repaying some US\$89 million of their debts,<sup>137</sup> thereby averting the possibility of a suspension of these water and electricity services.

12. It is clear, though, that the PA believed the political price it would pay by reducing central government salaries or laying off staff would outweigh any repercussions from under-financing operating costs or limiting support for municipal budgets. Some will argue that the PA should, at the margin, have reduced the level of protection afforded central government workers in favor of better service provision to the public at large. From a macro-economic perspective the PA’s decision was preferable: the multiplier effects<sup>138</sup> of salaries exceed those associated with operating costs. Assuming that PA salaries do not give rise to any savings<sup>139</sup> in today’s environment, a dollar disbursed against salaries will be allocated to a basket of goods and

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<sup>136</sup> Average monthly PA *non-salary* recurrent expenditures declined by 43 percent in 2002 compared with 2000, while average monthly PA *salary* payments increased by 9 percent during the same period.

<sup>137</sup> NIS 370 million in electricity dues and NIS 54 million in water dues (information provided to donors by the Minister of Finance at the April 1, 2003 LACC meeting).

<sup>138</sup> The “multiplier effect ” is a measure of the extent to which a particular expenditure stimulates domestic economic activity by being spent on goods and services with high Palestinian value-added. Since the West Bank and Gaza today is highly dependent on imports, internal demand is depressed and productive capacity has been considerably reduced -- so one would not expect large multiplier effects from any of the four instruments examined here. Bank estimates suggest that a doubling of donor disbursements in 2003 and 2004 in an unchanged structural environment would result mainly in additional imports and high inflation, with only a modest positive impact on domestic activity. Simulations suggest that increasing donor disbursements to US\$2 billion in 2003 would result in an increase in imports of 51 percent. Nominal GDP would increase by 36 percent, but with inflation of 25 percent, real GDP growth would be restricted to 9 percent.

<sup>139</sup> The assumption is that rising dependency ratios have resulted in a wide distribution of PA salaries to sustain unemployed relatives and friends -- an assumption borne out by FAFO’s ongoing case study findings (*Coping with Conflict -- Palestinian Communities Two Years into the Intifada*, Pal Sletten and Jon Pedersen, FAFO Report No. 408, Oslo, 2003.)

services with a higher domestic content than a dollar disbursed against operating costs, the bulk of which pay for items with a high import content (such as fuel, medicines and spare parts).

13. The macro-economic benefits of budget support are clear, particularly if one considers that much of this donor money would not have been available otherwise.<sup>140</sup> The US\$519 million of budget support injected by donors into the Palestinian economy in 2002 represented about 15 percent of GDP. Donor contributions to PA salaries accounted for about 28 percent of all wages paid in WBG in 2002,<sup>141</sup> directly employing 15-18 percent of those with work in 2002, and perhaps the same number again indirectly (in the domestic private sector).

14. The welfare benefits from salary payments to the PA are also significant.<sup>142</sup> We can assume that the 75,000 PA salaries effectively funded by donors supported a minimum of 480,000 people, using an average household size of 6.4. We can also estimate the poverty impact had there been no budget support in 2002. Counterfactual analysis suggests that canceling budget support could push another 100,000 people into poverty.<sup>143</sup> This relatively low figure most probably results from the fact that most households relying on public wages are already slightly below the poverty line.<sup>144</sup>

15. Budget support is simple to design and administer, with minimal overhead costs. Arguably, though, donors should have spent more on oversight mechanisms in 2001 and early 2002,<sup>145</sup> thereby putting themselves in a better position to answer questions about the diversion of these funds finance terrorism.

16. As a final point, the remarkable fact that public sector employment increased by 17 percent during the *intifada* should be understood as an emergency measure, and not one that would be advisable under more normal circumstances. Once the immediate crisis is in hand, careful thought will need to be given to sizing the civil service in a way that is fiscally sustainable.

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<sup>140</sup> Exemplifying this, the decline in budget support from Arab League states in 2003 has not been offset by any non-budgetary contributions. Norwegian budget support during the *intifada* has been provided on top of normal bilateral contributions. This is also true for the EU, though efforts are being made to ensure that the additional Euro 120 million per annum provided as budget support in 2001 and 2002 is retained in 2003, by earmarking funds for payment of PA arrears.

<sup>141</sup> If we assume that all non-ESSP donor budget support contributions were used to pay salaries, donors effectively financed 2/3 of the PA establishment, or some 75,000 staff. PA salaries accounted in 2002 for 40% of all wages paid in WBG in 2002.

<sup>142</sup> Strictly speaking, arguing the merits of budget support on the basis of its scale is methodologically suspect -- the various instruments should be compared on a dollar-for-dollar basis. However, budget support has evoked a scale of response unavailable to the other instruments discussed here, and for this reason the scale argument has merit.

<sup>143</sup> This analysis uses the econometric model developed by the World Bank (see *Poverty in West Bank and Gaza*, The World Bank, 2001) to assess the marginal impact of job creation/destruction in the PA on the poverty rate. The model was recalibrated to account for the current situation.

<sup>144</sup> According to the IMF, the average net PA wage per worker per month was US\$392.8 in December 2002. Dividing this amount per 6.4 (the average household size), and by 30.4 (the average number of days in a month) gives a figure of US\$2.0 per day per capita. The average PA wage is thus not sufficient to cover the basic consumption needs, estimated at US\$ 2.1 per day per capita (the poverty line) in 2002.

<sup>145</sup> That is, prior to the launch of the PA's *100 Days Reform Plan*.

## Food Aid

17. Prior to the *intifada* some 21 percent of the population of WBG was poor, and donors used food aid selectively as one of their welfare instruments. About US\$11.9 million was spent on food aid in 1999, mainly by UNRWA and mostly on chronically poor households that lacked a breadwinner (prior to the *intifada*, UNRWA provided food to 11,000 refugee families, and is now targeting 260,000 families<sup>146</sup>). As the numbers of the poor have risen during the *intifada*, so has the scale of food aid. In 2002 food aid valued at US\$76 million was provided, and UNRWA and WFP alone have requested US\$110 million for 2003 in submissions under the *UN Humanitarian Plan of Action*.

18. While there is no generalized food shortage in WBG, as a quick appraisal of food prices will testify,<sup>147</sup> it is clear that the population as a whole is getting hungrier: Bank estimates show a 25 percent decline in per capita food consumption, by real value, between 1998 and the end of 2002. In addition, a serious problem of child malnutrition has emerged (para. 2.76). From a macro-economic perspective the benefits of providing salary support to the PA are convincing, but budget support does little to address the subsistence requirements of those who are not public servants. Some economists would argue that it is, in principle, better to provide cash to the poor as an income supplement, thereby giving them broader consumption choices. In WBG, however, the micro-economic instruments used to distribute cash -- job programs, the Special Hardship Cases programs and ICRC's new Urban Voucher Program -- cannot be expanded sufficiently in 2003 to obviate the need for food aid, and will only receive limited donor funding anyway (para. 4.33). Food aid, for many donors, is the preferred instrument for supplementing the incomes of the poor, in part because it disposes of food that accrues as a result of domestic agricultural price support policies.

19. As an instrument designed to assist the poor, it follows that a major challenge in administering food aid is to target it properly: this will ensure it is directed to those who really need it, and will also avoid waste, and thereby excessive imports (which, as is argued below, depresses agricultural GDP). The agencies involved in food aid distribution, in particular UNRWA and WFP, place great emphasis on targeting. UNRWA avoids using third parties and instead issues its own ration cards on the basis of eligibility lists maintained by its network of social workers, and gives priority to the unemployed and to those with no regular income. The targeting of food aid in WBG has been criticized in the past,<sup>148</sup> but recent survey evidence suggests that a good degree of general accuracy is now being achieved -- i.e. that most food distributed is reaching the poor<sup>149</sup> (in part because most people are now poor, it could be argued). The emergence of malnutrition, however, suggests that more needs to be done to refine targeting

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<sup>146</sup> Of which 96% are registered refugees.

<sup>147</sup> Food prices have increased at a lower pace than the general consumer price index (CPI) throughout the crisis in both Gaza and the West Bank -- food prices rose by 5 percent from September 2000 - December 2002 in the West Bank, while the CPI rose by 11 percent. Food prices declined by 1 percent from September 2000 - December 2002 in Gaza, while the CPI there rose by 2 percent. Source: PCBS

<sup>148</sup> See Willy Egset, "Employment and Poverty among Palestinian Refugees", paper presented at the World Congress of Middle Eastern Studies, Mainz, Germany, September 2002.

<sup>149</sup> Of the 13 percent of households saying they rely primarily on assistance to obtain food, 59 percent had a monthly income of less than 1,600 NIS, just below the poverty line applicable to a family of six (*Report No.5 on International and Local Assistance during the second Intifada*, Swiss Agency for Development and Cooperation, January 2003).

techniques to make sure food is serving a *second* important objective -- preventing or alleviating malnutrition. The Johns Hopkins/Al Quds (JHQ) *Nutritional Assessment* argues for a “limited targeted supplemental feeding program [for] children at high risk -- large lower income families with poor access, children with mothers of lower education, weaning infants of lower income level households, and focused initially in the Gaza Strip.”<sup>150</sup> Identifying the vulnerable needs more work, and it is hoped that FAO’s ongoing study on food security will in time assist in refining current approaches.<sup>151</sup>

20. Questions arise over the appropriate quantity of food aid for today’s conditions. Agencies distributing food argue that current provision is insufficient, and have asked for additional funding for food in 2003. The case appears reasonable, both in light of food consumption and nutritional data,<sup>152</sup> and also because of the practical constraints to expanding other types of welfare schemes. An estimated 1.7 million people are currently receiving food aid, which is less than the total number of the poor (about 1.9 million). Nor do recipients appear to receive the optimal ration package.<sup>153</sup> According to the January 2003 SDC *Living Conditions Survey*, for example, only 11 percent of food recipients had received food once each month, with 14 percent receiving it once every two months, 33 percent once every 3-4 months and 42 percent only once every 6 months<sup>154</sup> -- more as a function of funding and physical availability, it would seem, than because a particular frequency of distribution met their individual needs. The Bank estimates that food aid accounted for only about 10 percent of the food consumed in WBG in 2002 by (imputed) value.

21. The major residual concern associated with food aid in WBG is the economic impact of *imported* food aid.<sup>155</sup> The Bank has argued that imported food aid exerts a depressive effect on agriculture and commerce, and that each additional US\$50 million spent on food aid could result in income losses of US\$10-15 million in the agriculture and commerce sectors<sup>156</sup> due to a) lower demand for domestically-produced food, and b) trading losses. The counter-argument -- that most of the foods imported and distributed (e.g. rice, flour, corn oil) are not produced locally, and would therefore need to be imported anyway, is not wholly valid, as it does not take account of how people switch their consumption patterns when free food is available. However, the Bank’s case is based on PCBS’ 1998 Supply and Use tables (which show that 70 percent of food

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<sup>150</sup> P. 52, September 2002.

<sup>151</sup> FAO is carrying out a *Food Security Assessment*, funded by the EU and USAID, and in cooperation with WFP, UNRWA and CARE International. This exercise is intended to help improve food and nutrition security and to assist in deriving “more detailed and timely information for better targeting and better design of programmes and interventions, including but not restricted to food aid”. The exercise envisages the eventual establishment of a National Food Security Commission and a National Food Security and Vulnerability and Mapping System.

<sup>152</sup> A 25% drop in consumption per capita translates into US\$332 million per annum in food deficits, as against the value of food provided by donors in 2002 -- US\$76 million gross/US\$52 million net of overheads. Even though imported food aid is priced wholesale and is thus worth more in local retail terms, the gap is clear.

<sup>153</sup> The UNRWA food package is intended to meet 60 percent of a family’s calorific needs and 65% of its protein requirements, and typically includes flour, rice, sugar, cooking oil, powdered milk, chickpeas and olive oil (West Bank)

<sup>154</sup> Ibid.

<sup>155</sup> For example, The JHQ *Nutritional Assessment* (op. cit.) observes that “markets are generally functioning and food is plentiful. Therefore, additional large bulk food distribution programs (beyond that which UNRWA already supplies) will likely do more harm than good, undermining the functioning markets and further deflating prices.”

<sup>156</sup> Albeit leaving *overall* GDP unchanged.

consumed in WBG is locally-produced -- with local production accounted for in particular by meat, vegetables, fruits and olive oil). These tables are the latest available, and are outdated. Since 1998, as poverty has grown, food consumption patterns have shifted away from the locally-produced high-value items that made up much of the value of the pre-*intifada* food basket towards cheaper foods. It may be that this shift has altered the composition of the food basket in favor of imported cereals, thereby lessening the depressive effect of imported food aid on agricultural GDP, but this is not certain.<sup>157</sup>

22. The Bank has also argued that food aid's adverse economic impact can be nullified if it is purchased in local markets, as this results in another form of cash injection (and in this sense there is much to be said for voucher programs -- see para. 26-27 below). UNRWA's decision to substitute imported cooking oil with locally produced olive oil is a welcome development.<sup>158</sup> The adverse impact of food aid on agricultural GDP argues for a disciplined use of the instrument -- through careful targeting and by shifting to other forms of assistance once the crisis shows signs of abating.

23. There are a number of other arguments that are commonly made for and against food aid,<sup>159</sup> but none of them would appear to alter a basic judgment that food aid has its place in WBG at this time both as an income supplement and as a nutritional intervention tool, and that it is somewhat under-funded. As long as the crisis persists, donors should attempt to respond to responsible appeals from the agencies on the ground with a track record in food distribution. As compared with last year's disbursements of US\$76 million, donors have indicated they would provide the equivalent of US\$42 million for food aid this year. The total of all appeals is estimated at US\$150 million. Maintaining the levels achieved in the last quarter of 2002 would translate into a food aid budget of about US\$100 million for 2003.

### Cash Schemes

24. Unlike food aid, the cash payments made under the Special Hardship Case (SHC) programs administered by MOSA and UNRWA are targeted mainly to households that cannot fend for themselves; the schemes are thus not strictly part of any emergency response, but represent a social expenditure that needs to be financed under any circumstances. It can be argued that they should provide a payment sufficient for subsistence, rather than just an income supplement -- as is the case with food aid (or vouchers, see below). At present, though, the stipend is equivalent to US\$0.55 per day, only 26 percent of poverty line consumption. The level of payment cannot realistically be adjusted, however, while SHC program funding is

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<sup>157</sup> See the *Nutritional Assessment*, p. 51: "reproductive age women are eating 13% less protein than before the *intifada*....market disruptions from curfews.....affected key high protein foods, especially meat and poultry and dairy products....." op. cit. However, the extent to which this shift has been towards imported cereals, as opposed to domestically-produced pulses and vegetables, has not been clearly established.

<sup>158</sup> *Emergency Appeal 2003*, op. cit., p. 7.

<sup>159</sup> These include a) the appropriateness of the food basket (this does not appear to be an issue in WBG), b) the relatively high overhead associated with importing food aid (the Bank estimates that US\$0.32 cents of every US\$1 spent on food aid are consumed in overheads -- but this should be set against the knowledge that for WBG most food aid provided is in essence additional assistance, as it is generally contributed by donors from special non-fungible "emergency" budget lines, c) the perceived humiliation of relying on food handouts (see, for example, *Fifteen Months*, p. 70), and d) problems with timeliness of supply, exacerbated by cases of GOI holding food deliveries up in port for lengthy periods (ibid.).

inadequate to cater to all of those who should be eligible -- estimated to be 30-40 percent more than the current number of beneficiaries.

25. Cash schemes are often criticized for poor targeting. As pointed out in para. 3.20, however, the eligibility criteria used under the SHC schemes are solid, MOSA's and UNRWA's SHC programs are cross-checked to insure against double-dipping, and both use effective networks of case-workers to select beneficiaries and administer the schemes. Thus there is little leakage<sup>160</sup> -- the targeting of this instrument in WBG is good.

26. The instrument as designed today is not strictly comparable with food aid, since it is not used as a income supplement for anyone who is poor.<sup>161</sup> The argument has been made that the SHC scheme *should* be extended to cover the basic needs of poor families,<sup>162</sup> since those living in households headed by unemployed, able-bodied men currently have no recourse to cash assistance from official organizations -- but no major developments in this direction should be anticipated until late in the year. Meanwhile, current donor indications are insufficient to cover the basic budgets of existing schemes.

27. An instrument more directly comparable to food aid is the recently developed (quasi-cash) voucher scheme introduced by the International Committee for the Red Cross. ICRC, in partnership with MOSA, initiated the Urban Voucher Program (UVP) in August 2002 in 9 West Bank towns. The scheme now caters to 20,000 very poor families (approximately 120,000 beneficiaries). It provides 6-weekly vouchers worth US\$135 each, which can be redeemed at a network of 73 shops under contract to UVP.<sup>163</sup> The voucher is intended to meet approximately 40 percent of a household's minimum needs, though in the case of the very poorest, ICRC has observed that it covers up to 65 percent of household expenditures and 100 percent of what is spent on food. The dimensions of the program are thus comparable to MOSA's SHC scheme.<sup>164</sup>

28. One advantage of a voucher scheme of this kind over *imported food aid* is that vouchers can be used to orient a significant share of household consumption towards locally produced items and local stores, and in the process stimulate the domestic economy and help keep a brake on imports. An advantage over *cash schemes* is that vouchers direct consumption towards essential goods, in particular nutrient-rich foods, thereby addressing one key criticism of cash

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<sup>160</sup> See World Bank, *The Ministry of Social Affairs and its Poverty Alleviation Programs*, forthcoming.

<sup>161</sup> The scale of a cash program needed to "eradicate" poverty would be approximately US\$550 million per year (assuming perfect targeting), as opposed to the US\$25-30 million currently disbursed through such schemes each year.

<sup>162</sup> Including modifying it for this purpose by introducing "conditional cash transfers", i.e. additions to the basic cash benefit to counter child malnutrition and adolescent school dropout (via "health cash premia" for families with children under six, and "educational cash premia" for the out of pocket school expenses for children between the ages of 12 and 18 -- see para. 4.40).

<sup>163</sup> Of the US\$135, US\$37 is earmarked for locally produced or packed goods such as soap, tea leaves, sugar, olive oil and vegetables. The other US\$98 can be redeemed against any items within 5 groups -- staple foods (rice, cooking oil, pasta, coffee etc); fresh foods (milk, meat, eggs, etc); hygiene and cleaning items; household essentials (blankets, cutlery, etc); and books and stationary.

<sup>164</sup> MOSA's scheme served about 150,000 beneficiaries in 2002, providing each beneficiary with US\$16.5 per month, or about 25% of needs; total net program cost was US\$29.7 million. The UVP serves some 128,000 families, providing about \$22.5 per person per month, reckoned to cater to about 40 percent of needs; projected total net program costs for the whole of 2003 would amount to US\$23.4 million.

schemes used as income supplements for poor families -- that male-headed households often do not make optimal consumption choices for their families.<sup>165</sup>

29. However, international experience has also shown there can be significant design and implementation issues associated with voucher schemes, such as the imposition of inappropriate choices on households, the distortion of local markets by favoring the shops at which vouchers can be redeemed, the danger of inflated prices in the voucher stores, and high administrative overheads. Before expanding the promising UVP, a review of experience so far in WBG should be carried out. This suggests that the scope for rapid expansion (or replication) of the scheme in 2003 is limited.

### **Job Creation Programs**

30. Based on a World Bank/ILO study of job creation programs implemented during the *intifada*, MOPIC, supported by UNDP and Sweden, developed a National Strategy for Job Creation which was discussed with donors and adopted in January 2003. The National Strategy provides a basis for analyzing this particular instrument.

31. During the periodic closures of the Oslo period, job creation programs were the favored emergency instrument, and were designed to mop up the short-term unemployment caused by external closure. In the 1990s, donors disbursed about US\$97 million for job creation programs, and in the process created some 2.5 million work-days. At the beginning of the *intifada*, the PA and donors turned once again to emergency job creation programs as a first line of defense against growing unemployment.

32. Put simply, this strategy did not work. Unemployment increased from 10 percent on the eve of the *intifada* to 27 percent in December 2002, or a loss of 116,000 jobs. The National Strategy shows that between September 2000 and January 2002 donors disbursed US\$105 million in total for job creation programs, creating at best some 8,000 jobs (i.e. 6 percent of those lost). Replacing the 116,000 jobs would have cost about US\$128 million per month, or US\$1.5 billion per annum -- half as much again as donors have disbursed on all programs in WBG for each year of the crisis. Job creation programs need instead to be looked at as microeconomic interventions, taking their place alongside food and cash schemes as one among several emergency instruments.

33. There are several arguments advanced in favor of job creation programs. The first is that they confer more dignity on the unemployed than food and cash schemes. This is undoubtedly correct, and the Bank's extensive experience of administering job creation schemes over the past eight years<sup>166</sup> attests to beneficiary satisfaction with the instrument and a deep preference in being able to work as opposed to being forced to accept "charity".

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<sup>165</sup> "At the intra-household level, food aid creates a concept of entitlement for women, who are traditionally in charge of administering food...the fact that the aid comes in the form of food endows the household members who give a higher priority to food and nutrition with a greater control over the household budget. Several studies show that food aid is less likely to be wasted on leisure items and activities than cash assistance, generally controlled and administered by men." UNRWA, comments of the draft of *Twenty-Seven Months*, March 19, 2003.

<sup>166</sup> Since 1996 the Bank has administered or financed US\$91 million in job creation schemes, through the Holst Fund, the Emergency Response Project, and the PEACE Facility.

34. A second common argument is that most job schemes leave behind tangible infrastructure assets, unlike the financing of food and cash schemes, which are consumption expenditures. This argument is flawed from an economic perspective: food and cash support result in the preservation of *human* capital, which deserves higher priority than insentient structures. In reality the tangibility argument is a political one, since the visibility of the activity and its infrastructure product demonstrate purposefulness by the PA, local authorities and donors. Nor can one convincingly maintain that the new infrastructure will stimulate economic activity, since the utilization rate of productive capacity is very low in today's environment.<sup>167</sup>

35. If -- adhering to the welfare perspective -- one does not accept that creating infrastructure is a compelling argument in favor of job creation, then the low proportion of donor funds that make their way to the beneficiaries becomes a signal disadvantage of such schemes. Bank calculations suggest that cash payment/voucher schemes deliver about 80-90 cents of each dollar to the beneficiary, and food aid about 68 cents; for the job creation schemes reviewed in the National Strategy, only some 30 cents on the dollar went to beneficiaries.<sup>168</sup> While the National Strategy argues that this proportion can be enhanced through better project design (to about 50 cents per dollar<sup>169</sup>), the difference is significant. Looked at from a multiplier perspective, moreover, job creation schemes are less appealing than food or cash/voucher schemes due to the high import content of the materials used in construction -- though this can to some extent be redressed by obliging contractors to make maximum use of local materials.

36. From an implementation perspective, these schemes have advantages and disadvantages. Because a job creation program usually consists of many individually-tailored schemes, they take time to prepare and raise capacity issues in the way that food and cash schemes do not. Targeting, however, has been satisfactory up to now: job programs generally incorporate self-targeting by offering wages at below-market rates (in 2002, a typical scheme would pay a laborer 75 to 80 percent of the open market wage, and would thereby attract only the unemployed or underemployed). Leakages to the non-poor are thus minimized. The National Strategy points out that one shortcoming of the current generation of job schemes is that they benefit mainly unskilled adult males,<sup>170</sup> but this can be modified through a greater mix of construction with non-construction schemes and the design of projects that cater specifically to the young, the skilled and women.

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<sup>167</sup> The World Bank estimates that the utilization rate capacity could have declined 25 percent since December 2000 (i.e. if 80 percent of productive capacities were used in 2000, only 58 percent of a lower stock of productive capacities is being used today).

<sup>168</sup> Put another way, it has cost about US\$13,125 to create one job-year equivalent. This can be compared to US\$6,000 per PA job preserved by donor budget support.

<sup>169</sup> The proportion could be increased significantly if job creation schemes were based on activities like trash collection and wall-painting, as in the Job Creation Program in Gaza in the mid-90s. Although creating more jobs per dollar than infrastructure projects, these early job schemes were widely regarded as unproductive and were largely phased out (though the Cooperative Housing Foundation is implementing such a scheme today, using USAID financing). One can argue that the PA and the donors elected for political reasons to pursue a secondary objective (infrastructure creation) which was unrelated to job creation, and thereby compromised the instrument's effectiveness.

<sup>170</sup> This mostly stems from the fact that no clear operational distinctions are made between development programs and employment generation programs. The former employ unskilled workers for infrastructure projects because the objective is to create infrastructure -- while the latter should employ the unemployed poor because the purpose in this case is to provide income to poor.

## **In Conclusion**

37. The enormous expenditure on *budget support* has been justifiable on political/institutional grounds, as well as from a macro-economic and a welfare perspective. However, it is not strictly comparable with the other three instruments. A comparison of *food aid, cash schemes and job creation programs* shows that food aid is necessary and somewhat under-funded -- in spite of its negative impact on agricultural GDP, and in part because competitive alternatives (in particular, vouchers and new poverty alleviation cash schemes) are only in their infancy/design phase. Job creation schemes are the least attractive of the three instruments on macro-economic and welfare grounds: but they continue to have their place in the welfare mix because of their strong psychological and political appeal.

