

Report No. 36320 WBG

West Bank and Gaza Country Economic Memorandum Growth in West Bank and Gaza: Opportunities and Constraints

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	I
CHAPTER I. MACROECONOMIC DEVELOPMENTS IN WEST BANK AND GAZA	1
A. Introduction	1
B. Disappointing Development Record Over the Last Decade.....	1
C. Israel and West Bank and Gaza: Economic Divergence?	5
D. Drivers of Growth: Crisis and Recovery.....	8
E. The Palestinian Authority in the Throes of Fiscal Crisis.....	9
CHAPTER II. ISRAEL’S SECURITY REGIME: IMPACT ON THE WBG ECONOMY	17
A. Introduction	17
B. Transmission Channels of Impact of Closures on the Economy: An Overview	18
C. Decline in Labor Flows to Israel.....	19
D. Frequency and Duration of External Closures and Their Cost	21
E. Fragmentation of the West Bank Economy: Impact of Checkpoints and Internal Closures	29
F. Other Costs of “Being a Palestinian Business”: Extra Trading Costs Related to the Security Regime.....	32
G. Conclusions and Recommendations	34
CHAPTER III. PROSPECTS FOR EXPORT-LED GROWTH.....	36
A. Introduction	36
B. Dynamics and Direction of Trade: Dominance of the Israeli Connection	37
C. Industrial Development as Revealed in WBG Export and Import Baskets.....	42
D. Enhancing Prospects for Export Led Growth: Trade Policy Options	46
E. Conclusions and Recommendations.....	54
CHAPTER IV. TOWARD A GROWTH-SUPPORTING BUSINESS ENVIRONMENT AND INSTITUTIONS.....	56
A. Introduction	56
B. A Snapshot of the Private Sector	57
C. Business Climate – Areas of Improvement.....	59
D. Crosscutting Issues for Business Development and Improved Competitiveness.....	70
REFERENCES	78

LIST OF BOXES

CHAPTER 1.

Box 1. Growth Accounting.....	3
Box 2. The Recent Evolution of the Wage Bill	11
Box 3. The Size and Composition of the PA’s Liabilities and Assets.....	13
Box 4. The Parameters of “Passive” Projection of Fiscal Trends in 2005-06 Beyond	14

CHAPTER 2.

Box 1. Unrealized Benefits of November 15 th Agreement on Israel’s Disengagement from Gaza	26
Box 2. Cost of Exporting Strawberries from Gaza Through Egypt.....	27
Box 3. Estimated Increase in Transport Costs along Major Trade Routes in the West Bank.....	31

CHAPTER 3.

Box 1. Other Border Measures Raising the Cost of Import.....	50
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LIST OF FIGURES

CHAPTER 1.

Figure 1. Growth Decomposition by Aggregate Demand Categories	3
Figure 2. Growth Decomposition by Sector for WBG	3
Figure.3. Cyclical Components of Wage Expenditure and GDP.....	5
Figure.4. Convergence between WBG and Israel.....	6
Figure.5. Dynamics of Convergence: WBG and Israel	6
Figure.6. Relative Income Gap – Israel, West Bank, and Gaza.....	7
Figure.7. Quarterly Closures and Remittances in 2000-2004.....	9
Figure 8. Monthly Budget Revenues in April 1996-April 2004 (in US\$ mill.).....	10
Figure 9. PA Staffing and Average Public Sector Salary in 1996-2005 (in Thousands and U.S. Dollars).....	11
Figure 10. Revenues, Expenditures and Overall Balance (in % of GDP in 1995-2005)	11
Figure 11. PA Debt to GDP Ratio	12
Figure 12. Fiscal Outlook – Passive Adjustment (Base) Scenario vs. Stabilization Scenario	15

CHAPTER 2.

Figure 1. Employment and Workers' Remittance from Israel in 2000-05.....	20
Figure 2. Monthly Trend of Closures (January 1996 through September 2004)	22
Figure 3. Closure Frequency 1997-2000 and 2000-04	23
Figure 4. Total and Extrapolated Exports in Current Prices in 1990-2005 (in Mln of Current US Dollars)	24
Figure 5. Change in CPI Index and in Transportation Cost Relative to CPI 2000-05 (in Percent)	30
Figure 6. Retail Prices Per Kilogram on February 15, 2006 in 11 Towns and Cities in West Bank (In Percent).....	32

CHAPTER 3.

Figure 1. Exports of Goods and Services (Including Remittances) to Israel in 2000-05 (in Millions of U.S. Dollars and Percent).....	38
Figure 2. WBG Exports to Israel in 1983-2005 (in Million of U.S. Dollars)	39
Figure 3. The Share of T&C Exports in Total (Non Oil) Exports in Selected MENA Economies in 2004 (WBG in 2002) in Percent	46

CHAPTER 4.

Figure 1. Employment in Selected Sectors.....	58
Figure 2. Trading across the Borders.....	61

LIST OF TABLES

CHAPTER 1.

Table 1. Key Macroeconomic and Social Indicators – Averages, 1990-2005	2
Table 2. Structure of Economic Activity by Major Sector, 1995-2005	4
Table 3. Key Determinants of WBG Economic Activity	8
Table 4. Deficit and Sources of its Financing in (in million of US Dollars and Percent)	12
Table 5. Decomposition of Change in PA Debt to GDP Ratio.....	13

CHAPTER 2.

Table 1. Estimated losses in Workers' remittances from Israel because of Cuts in Employment and Closures in 2001-05.....	21
Table 2. Exports Lost because of Closures in Relation to Actual and Hypothetical Exports in 1999-2003	25
Table 3. Estimates of Lost Export Revenues in Jan. 15-Feb.3, 2006 Border Closure	27
Table 4. The Impact of Uncertainty on Transport Costs: An Example from the Wood Industry in Gaza.....	28

CHAPTER 3.

Table 1. Directions of Trade of WBG in 1999-2003 (in Million of U.S. Dollars and Percent).....	41
Table 2. Developments in Trade by End Use in 1999-2002 (in Thousands of U.S. Dollars and Percent)	42

Table 3. Exports and Imports by the type of Technology Involved in their Production in 1999-2002 (in Million of U.S. Dollars and Percent).....	43
Table 4. Participation in Global Value Chains in 1999 and 2002 (in Thousands of U.S. Dollars and Percent).....	45
Table 5. Imports of Israel (in 2004) and WBG (in 2003) from Preferential Partners (in Million of U.S. Dollars and Percent).....	49
Table 6. Review of Benefits and Risks of Foreign Trade Regime Policy Options.....	53

CHAPTER 4.

Table 1. Overview of the Palestinian Private Sector 2001-2003.....	57
Table 2. Ownership Structure of Palestinian Firms.....	57
Table 3. Size of Palestinian Establishments – 2003.....	58
Table 4. Unpaid Family Labor and Self-Employed in the West Bank and Gaza.....	58
Table 5. Average Hourly Wage for Semiskilled Garment Workers (US\$).....	72
Table 6. Industrial Electricity Tariffs for Selected Countries, 2002.....	73

BOX TABLES:

CHAPTER 2.

Box Table 1. Total Transport Costs for an Export Container of Strawberries from Gaza to the EU (in US\$ per Container Weighing 3.4 tons).....	27
Box Table 2. Increase in Transport Costs Along Major Trade Routes because of Larger Distances in December 2005.....	31

CURRENCY EQUIVALENTS

(As of September 2006)

Currency Unit = NIS

US\$1.00 = NIS 4

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

CGAP	Consultative Group to Assist the Poor
CPI	Consumer Price Index
DAI	Development Alternatives, Inc.
DOP	Declaration of Principles
EU	European Union
FTA	Free Trade Agreement
GATS	General Agreement of Trade in Services Development
GDP	Gross Domestic Product
GNI	Gross National Income
GoI	Government of Israel
IMF	International Monetary Fund
IPA	Irrevocable Power of Attorney
ISO	International Standards Organization
MAI	Manufacturers Association of Israel
MAS	Palestine Economic Policy Research Institute
MFN	Most Favored Nation
MFis	Microfinance Institutions and Programs
MoNE	Ministry of National Economy
NAFTA	North American Free Trade Agreement
NIS	New Israeli Shekel
NTF	Non tariff Barriers
OECD	Organization for Economic Co-operation and Development
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PIEFZA	Palestinian Industrial Estate and Free Zone Authority
PIF	Palestine Investment Fund
PIPA	Palestine Investment Promotion Agency
PMA	Palestine Monetary Authority
PLO	Palestine Liberation Organization
PREM	Poverty Reduction and Economic Management Network
QAZ	Qualified Agricultural Zones
ROW	Rest of World
SME	Small and Medium Enterprise
T&C	Textile and Clothing
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization
US	United States
USAID	United States Agency for International Development

VAT	Value Added-Tax
WBG	West Bank and Gaza
WIU	Wood Industry Union
WTO	World Trade Organization

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EXECUTIVE SUMMARY

The last six years of escalated conflict in the West Bank and Gaza have left the Palestinian economy mired in economic crisis. Israeli military and security measures, increased during the Intifada, have imposed major costs on the WBG economy, heavily undercutting its current and future developmental prospects.¹ The closures regime—i.e. the multi-faceted system of restrictions on the movement of goods and people both within the WBG and through Israel to the rest of the world—along with construction of the separation barrier have fragmented the WBG economic space, and further reduced the WBG's productive potential. Recent decisions by the Government of Israel to suspend the transfer of clearance revenues collected on behalf of the PA and by western donors to cease budget support for PA have provoked an unprecedented fiscal crisis for the Hamas government installed in March 2006, threatening to undermine public institutions and authority. Increasing domestic political friction—which at several points has turned to violent confrontations between supporters of the former and current governments—could send the already fragile economic recovery of 2003-2005 into a tailspin.

The current situation presents the WBG with both short term challenges and challenges of more medium-to-long term in nature. In the *short run* the key problem is that WBG has few, if any, policy tools at its disposal to deal with the volatility and low level of economic activity; and the current fiscal crisis can easily bring down the machinery of government, undoing almost all of the post-Oslo institutional gains.

First, the number of Palestinian workers in Israel has declined precipitously in response to closures and reduction in work permits issued to Palestinians by the Israeli authorities, reducing the role this mechanism has played in dealing with excessive local unemployment. *Second*, while fiscal policy can be used to stabilize “periodic” fluctuations, this mechanism has already been exhausted. The Government of Israel's intermittent withholding of Palestinian customs and VAT has been a source of considerable instability for the Palestinian economy. Moreover, public sector expenditures have been increasingly allocated to support expanding public employment and wage bill, with the PA, increasingly becoming the “financier of last resort” to cover unmet obligations for other public entities. As a result, public expenditure, amounting now to around 50 percent of the GDP and entirely tied to statutory expenditures, are excessive. Fiscal re-balancing is required for sustainability of public finances. *Third*, while exchange rate adjustments for many countries provide an affective, if harsh, adjustment mechanism to deal with shocks in economic activity, this tool is also not available to the PA as the WBG is in a currency union with Israel and monetary policy together with exchange rate management is beyond the PA's control.

In the *medium term*, the WBG economy faces a series of challenges. *First of all*, as discussed in chapters I and II, the labor link with the Israeli economy has failed to generate a process of productivity convergence in the absence of movements of capital to the WBG, while pulling domestic wages above their market-clearing level. This is in striking contrast to, for example, the interaction between old and new EU members from Central Europe, where policy-induced, deeper economic integration has launched a convergence process. Today, the WBG economy faces high production cost—partly reflecting Israeli cost structure and partly costs of operation under Gol's security regime—and low productivity challenge, which severely undercuts its competitiveness.

¹ The Government of Israel maintains that such measures were and are appropriate measures in response to specific terrorist acts and the general increased level of violence during the Intifada. At the same time, Palestinians maintain that the right to resist Israeli occupation is fundamental, and that associated political frustration and economic insecurity are the cause of violence.

Second, as discussed in chapters III and IV, the political insecurity and uncertainty regarding a future negotiated settlement have prevented the WBG economy from tapping ample financial resources potentially available in neighbouring countries and from Palestinians living abroad to stimulate business investment in the WBG. The investment environment is perceived as being too uncertain, too lacking in infrastructure and not sufficiently hospitable to attract such flows.

Third, the recent flare up of internal strife does not augur well for the WBG economic future. In fact, the combination of internal instabilities and funding problems that have emerged from the current political stalemate appears to have effectively crippled the PA's capacity to govern. It also threatens to undo any progress on institutional reform that has been made so far.

As discussed in chapter IV, particularly damaging to WBG businesses is Israel's control over their access to Israeli and other external markets. International evidence overwhelmingly suggests that economic welfare of small countries in particular goes hand in hand with a country's expanding involvement into global economy. Both short term recovery and medium term productivity growth of the WBG economy critically depends on establishing stable and reliable foreign trading relations. The closures regime makes it extremely difficult, if not impossible, to achieve this.

One may identify three scenarios of economic developments in WBG:

- First, the PA might cease to govern—an undesirable outcome yet not beyond the realms of possibility under the current circumstances of political and financial turbulence. The consequences of a simultaneous collapse of administration, incomes and demand would undo most of the post-Oslo institutional gains. Equally undesirable, escalating closures regime may further suppress economic activity by turning the WBG economic space into a collection of island economies deprived of access to international trade and isolated from each other. Together, such *worst case* developments would probably also seriously compromise the prospects for peace in the region.
- The *second scenario* envisages continuation of the closures regime while the international community would find ways to assist the PA's fiscal adjustment efforts. This *continuation* scenario implies a reversion to earlier (pre-2006) trends in WBG economic development. While violence and extreme hardship might be avoided, the WBG economy would nevertheless remain stagnant and reliant on foreign aid to finance current consumption. The estimated direct cost to the WBG economy aggregated over 2000-05 has been enormous, amounting to almost US\$4 billion—the bulk of it related to the reduction in exports of labor (80 percent) and the fall in exports of goods (20 percent). These estimates, discussed in Chapters I and II, do not take into account indirect costs and the cost of lost developmental opportunities. Neither do they consider the costs associated with fragmentation of the WBG internal economic space that has distorted geographic patterns of trade and generated significant price gaps among local centers. This continuation scenario spells vicious cycle of economic backwardness.
- The *third scenario* assumes gradual relaxation of security measures to levels assuring restoration of normal economic activity together with other measures improving public finance management, investment climate and guaranteeing necessary investment in infrastructure. This is the only scenario reversing the vicious cycle of economic backwardness. Keys to it are stable direct trading relations with the rest of the world, removal of internal barriers to trade and a financially sound PA capable of providing internal security and business friendly environment based on protection and enforcement of private property rights.

This report assesses the economic costs of the *continuation scenario* as it has unfolded following the outbreak of the Intifada and attempts to provide some input to what is needed to re-start it, i.e., restoration of funds necessary for institutions of government to function properly. But its real focus is on what could be done to make the third scenario a reality:² what is needed to jump-start economic growth in the WBG?

MAIN FINDINGS AND RECOMMENDATIONS

Overall economic growth performance over the last fifteen years has been dismal, with high population growth outstripping the real GDP growth during most of this period. Looking forward, economic prospects remain grim and highly dependent on political outcomes. Israel's withdrawal from the Gaza Strip in September 2005,³ while leaving political and economic prospects uncertain, had generated optimism about the attainability of a final status agreement based on the peaceful coexistence of two neighbouring sovereign entities. The current political deadlock has significantly worsened the economic outlook.

In addition, there are signs indicating that the WBG's capacity to generate fast economic growth has been eroded, even if the closure regime becomes less oppressive: First, as the WBG economy has been becoming more inward oriented, its industrial capacities have been depleted. On the demand side of the economy, consumption rather than exports of goods and services has been the key lever of growth of the WBG economy. The role played by exports of labor, although—in the absence of investment inflows to WBG—a distorting one, has been vanishing with workers' remittances from Israel falling due to Israeli security measures. Goods export performance has never been impressive. Exports of labor appear to have crowded out those of goods and, together with aid inflows, erected barriers to industrialization through driving up the cost of labor and prices of nontradables that only investment inflows could help address. But these were not forthcoming because of lack of security even in the 1990s.

Second, the economic recovery in 2003-05 is not sustainable and reveals structural economic weaknesses. The construction and agriculture sectors together with public administration have emerged as key levers of growth on the supply side of the economy. Although manufacturing has also contributed to recovery, its share of GDP increased modestly and remained below its level in 1995, with competitiveness of the sector deteriorating throughout the decade, as discussed in chapters III and IV. Recent growth was pulled by expansionary fiscal policy, banking credit to the economy, a relaxation of the closures regime and recovery in private consumption. None of these recent trends is likely to continue over the period ahead.

Changes in WBG exports and imports baskets reveal progressive deindustrialization of the WBG economy, as both of them have moved to goods at lower levels of the technology ladder and imports of food products have largely crowded out investment goods. The level of processing embodied in exports, as captured by the aggregate share of food products together with industrial raw materials, was always low, but have recently significantly declined. A shift in import demand toward lower processed goods and the fall in investment goods imports have accompanied the contraction in total imports, suggesting a further erosion of the industrial base. Furthermore, many WBG businesses have lost external markets due to uncertainty of their deliveries and growing trading costs—consequences of the closure regime.

² This Report complements the analysis of the World Bank's December 2004 Study "Stagnation or Revival: Israeli Disengagement and Palestinian Economic Prospects," that dealt with similar issues by expanding the discussion on key conditioning factors that affects the environment in which Palestinian economy is evolving.

³ Israel's imposition of external closure on Gaza remains in full force.

Last but not least, as noted above, the PA is in the throes of a fiscal crisis, with large share of required adjustment falling on the expenditure side. The room for manoeuvre is rather limited. Expenditures are not pro-growth but pro-social stability, with the public expenditures going almost solely to wages. The falling governance capacity inevitably leads to deterioration in the business climate and discourages investments—placing further obstacles in the path to fiscal adjustment.

The challenge is to do away with impediments to economic recovery and growth, the most binding constraint of which is the uncertainty and extra cost of doing business because of the difficulty of access—not only to external markets but also to local markets—resulting from the Israeli security regime. The back-to-back system, mobile and fixed checkpoints and special security screenings of outbound and inbound shipments dramatically raise trading costs and fragment WBG’s economic space, both in its internal and external dimensions. The current security regime eats away at the capacity for growth. It not only undercuts the competitiveness of existing businesses but also dramatically curtails the range of feasible investment opportunities in WBG. In the absence of security measures, unfettered access to markets of such a highly developed economy as Israel would be a powerful magnet for domestic and foreign investments alike. The security measures suppress new investments and erode competitiveness of existing businesses in WBG, simply because they make the following extremely difficult, if not impossible, as the experience to date shows first hand:

- *The shift from a currently dominant type of interindustry trade to intraindustry trade, associated with a more sophisticated division of labor based on narrow industrial specialization within global value chains.* Global value chains usually require short, predictable delivery schedules unattainable under the closures regime. The WBG firms participated almost exclusively in chains present in Israel—the main destination for exports— and have faced contracting businesses along with the WBG exports. Considering the nature of global buyer supplier-chains organized around large retailers operating across the globe, establishing direct commercial contacts with global retailers would have resulted in larger contracts, offering economies of scale to WBG suppliers. Benefits from a direct relationship with a company operating at the top of a value can be significant, as global retailers often provide assistance in organizing production and setting up viable management systems which, taken together, could significantly contribute to improved productivity and competitiveness in WBG by addressing existing major weaknesses in these areas (see chapters II-III).
- *Attracting foreign and domestic investment in more sophisticated manufacturing.* This usually requires the use of imported inputs. Even if deliveries on tight schedules are not particularly relevant to a line of production, the necessity to maintain large inventories of imported inputs to ensure smooth production operations makes it non-competitive. For instance, firms operating in the wood furniture industry now export and import only few times a year, which leads to high inventories of both inputs and final products (see chapters II-IV).
- *Competing on a level playing field.* Whereas the location of a firm within the existing “customs envelope” arrangement might imply similar exposure of firms in WBG and those in Israel to competition, and similar conditions in accessing foreign markets, the security regime puts Israeli firms as well as other competitors in a far more advantageous position vis-à-vis their WBG counterparts. Moreover, local firms remain small and use outdated technologies, whereas firms (including those from Israel) operate in larger markets, have access to modern technology and expertise, and therefore tend to have significant cost and productivity advantages over WBG firms (see chapter III).
- *Expansion of existing firms through tapping economies of scale.* Without easy access to external markets, firms operating in small markets cannot grow, as is the case in WBG economy, where most firms are small, family-owned businesses (see chapter IV).

While prospects for economic revival are doomed to failure without considerable relaxation of the Israeli security regime, the steps that need to be taken do not belong to economics, although easing of tensions between the Palestinian Authority and Israel would yield substantial economic gains. For example, full implementation of the provisions of the Paris Protocol—which could have helped boost trade and growth—has been a victim of the politics of conflict. Unfortunately, as long as relations between Israel and PA do not improve, implementation of Protocol in ways to reduce the costly and inefficient border crossing procedures and differential treatment of Palestinian businesses (discussed in Chapter III) is likely to remain imperfect.

Implementation of the November Agreement on Movement and Access would be an important first step towards economic revival, especially in Gaza, combined with further rethinking of the balance between security and trade facilitation of border crossing facilities. The Gaza Strip is a landlocked economy politically, but not geographically. Leaving aside the contentious issue of opening its seaport and airport, one option would be to make the Rafah Agreement effective for making it possible to exports through Egypt. This would in turn require negotiations with the Egyptian government to agree on a transit regime from Rafah crossing to East Port-Said port or Al-Arish.

As noted above, the menu of economic policy tools available to the PA to boost WBG economic performance is limited. Its freedom of economic manoeuvre in the medium term is reduced to measures related to business climate and the control over public expenditure management. In both areas, however, there remains some room for improvement. While severity and unpredictability of closures, in terms of both timing and location, reduce the potential importance of reforms to improve business and investment climate, this should not justify a cavalier approach to reforming areas critical to the quality of governance and business climate. To the contrary, considering that WBG businesses already bear much higher trading costs vis-à-vis their Israeli counterparts and other competitors, every measure should be taken to lower the cost of doing business.

Although significant progress has been made in reducing locally generated hassle cost of doing business, the PA should take further steps to align legal and regulatory arrangement to the best international practice. Poor enforcement of court resolutions leads the list of issues of business concern in a recent survey by the Center for Private Sector Development. Improving commercial dispute resolution mechanisms and functioning of the judicial system, and enhancing the skills and independency of judiciary as well as implementation of commercial legal reforms are among the reform priorities. The key elements of regulatory framework that need further improvement are current registration procedures, particularly with regard to registration of foreign-owned companies and procedures administered at the municipal level; and labor regulations to achieve a better balance between the rights and obligations of employers and employees—particularly through streamlining of firing procedures and amount of severance payments; reintroduction of short-term contracts and other provisions for flexible forms of employment, and labor disputes resolution.

In a similar vein, the PA and donors should increase their emphasis on addressing the deficiencies in enterprise-learning mechanisms given constraints to foreign investment and other modes of foreign technology transfer. Among the important preconditions for rapid and sustained productivity improvement in WBG is strengthening mechanisms for enterprise-learning. Learning takes place by way of the transfer of technology—defined broadly to include new ideas, equipment, management practices, marketing strategies, and the like—from more advanced countries. A business friendly investment climate along with other factors that influence investment rates are important for productivity growth, but ultimately the efficiency of investment will depend on the technical ability of firms to acquire, adapt, and efficiently use new capital equipment and new ideas. The deficiencies in learning mechanisms, therefore need, more attention. Efforts should include PA and donor support to continue building up and improving management training and business advisory assistance. A key aspect of such programs should be to help

firms link up with advanced country sources of expertise. Assistance to develop technical and vocational training institutions (public and private) is also necessary. In addition, cost-sharing grant schemes are needed to assist firms in developing their own innovative, in-firm training programs, hiring expert consultants, and searching for new technologies and markets.

On the fiscal front, setting a better balance between salary and non-salary expenditures and putting the former in a sustainable track would improve provision of public services by freeing up scarce resources and by enhancing access to much needed external assistance in transition to a healthier fiscal position. Given the repressed economic activity and high unemployment, this transition process will, however, be made much easier if the economy is recovering rapidly, thereby creating more room to manoeuvre, because public expenditure can rise in nominal terms even when its share in GDP is to be reduced. This, in turn, requires concerted effort by donors, by the Israeli authorities and by the PA to effectively eliminate impediments to economic recovery and growth.

CHAPTER I

MACROECONOMIC DEVELOPMENTS IN WEST BANK AND GAZA

A. INTRODUCTION

1.1. More than five years into the outbreak of the latest round of the Israeli-Palestinian conflict (the second “Intifada”), the West Bank and Gaza (WBG) economy is in deep economic crisis. The closure regime—the multi-faceted system of restrictions on the movement of goods and people both within the WBG and through Israel to the rest of the world—tightened by the Government of Israel (GoI) during this round of conflict and further reinforced by Israel’s construction of the separation barrier, translated into a sharp reduction in economic activity, greater unemployment and increased poverty. Despite an economic recovery in 2004 and 2005, with growth rates of 6 percent per year, current real per-capita incomes still remains about 30 percent below their pre-Intifada level, with 46 percent of Palestinian population living in poverty, and unemployment rates above 23 percent.

1.2. Today, economic prospects for West Bank and Gaza remain grim and highly dependent on political outcomes. Recent growth was pulled by expansionary (but unsustainable) fiscal policy, banking credit to the economy, a relaxation of closures that permitted more Palestinian workers to find jobs in Israel in 2004 and 2005 (compared to the first years of the Intifada), and recovery in private consumption. None of these recent trends are likely to continue over the period ahead.

1.3. Notwithstanding Israel’s internal disengagement from the Gaza Strip in September 2005,⁴ economic prospects were uncertain before Hamas’ victory. Prospective increases in foreign assistance, envisaged in the aftermath of the disengagement, did not materialize because of the lack of political progress. The Hamas victory in the elections of January 2006 has significantly worsened the economic outlook. Further harming economic prospects is the decision on the part of the GoI to sever all bilateral contacts with the Palestinian Authority (PA), a decision supported by virtually all Western donors.

1.4. In particular, the decision of the GoI to suspend the transfer of taxes it collects on behalf of the PA, together with lower levels of donor assistance, will entail a strong contraction of the economy in 2006 (an estimated minus 26 percent in real GDP), unless offset by a substantial increase in financial transfers from other sources. In the event, the PA would be forced to sharply reduce its level of expenditures (consumption, transfers, investment) to an extent that could possibly rapidly threaten its viability.⁵

1.5. This chapter casts WBG’s macroeconomic outlook in a longer-term (pre- and post-Oslo) context, focusing first on overall growth performance in section A, then turning to issues related to the link with the Israeli economy and economic convergence vis-a-vis Israel in section B, followed by examination of the factors responsible for the current economic crisis and fragile recovery in section C. Section D looks at the fiscal position of the Palestinian Authority and gives some indication of the resources and measures needed to get the PA to function again.

B. DISAPPOINTING DEVELOPMENT RECORD OVER THE LAST DECADE

1.6. The post-Oslo period (1994–2005) witnessed three distinct phases in economic development: The growth phase in 1994–99, which extended into the outbreak of the Intifada in September 2000; the regression phase in 2000–02; and the relative recovery phase in 2003–05. The average annual rate of growth of GDP, which more than doubled following the Oslo Agreement, subsequently fell to a negative 8 percent over 2000–02 to record a similar rebound in 2003–05 (table 1 and box 1).

⁴ Israel’s imposition of external closure on Gaza remains in full force.

⁵ World Bank West Bank and Gaza economic update, March 2006.

Table 1. Key macroeconomic and social indicators—averages, 1990–2005

	1990–93	1994–99	2000–02	2003–05
Macroeconomic Indicators				
Real GDP (const. US\$)	2765	3642	3912	4233
Real GDP growth	1.3%	3.0%	-7.9%	8.0%
Inflation		8.6%	3.2%	4.4%
Exports/GDP		14.9%	13.8%	11.1%
Imports/GDP		71.8%	68.4%	69.6%
Labor/Social Indicators				
GDP per capita in constant prices (US\$)	1680	1536	1291	1247
Real per capita GDP growth	-3.0%	-1.6%	-12.0%	4.4%
Population growth rate	4.4%	7.7%	4.0%	3.6%
Unemployment rate		17.5%	23.6%	25.3%
Total Palestine workforce (1,000)		570.1	686.6	791.8
of which working in Israel (1,000)		93	78	56
of which working in Israel (%)		16.4%	11.4%	7.1%
Poverty rate		20.0%	45.3%	46.0%
Dependency ratio	5.6	6.0	6.3	6.2
Fiscal Indicators				
Primary surplus before donations & grants (in % of GDP)		-7.7%	-18.2%	-16.9%
Total primary deficit (in % of GDP)		1.5%	4.8%	5.9%
Government expenditure/GDP		33.0%	39.2%	39.9%
Vulnerability Indicators				
Nonperforming loans/total loans			9.0%	10.6%
Imports/months of reserves		0.5	1.1	1.5
Domestic credit growth		33.7%	1.0%	23.6%
Closure				
Total effective closure days (avg)	17	11	87	97
Effective work days/potential working days	93.9%	81.1%	68.5%	55.7%

Sources: World Bank staff estimates, Palestinian Central Bureau of Statistics (PCBS), and UNSCO⁶ closures database.

Note: Macro data is mostly exclusive of East Jerusalem.

1.7. Two other salient features of the WBG development record stand out. First, the overall economic growth performance has been dismal. Standards of living have deteriorated significantly since the pre-Oslo (1990–93) period. Except for the current recovery phase, high population growth has persistently outstripped the real GDP growth in other phases: the real GDP per capita in constant prices was lower in each successive phase, including the current one. So was the unemployment rate: it increased from 17.5 percent in 1994–99 to 23.6 percent in 2000–02 and 25.3 percent in 2003–05. In consequence, poverty has been on the increase, with the poverty rate more than doubling following the outbreak of the Intifada, to 46 percent.

1.8. Second, the growth of the WBG economy has been increasingly inward oriented. The modest growth in GDP has not been driven by exports of goods: GDP growth has consistently exceeded growth in exports. Furthermore, exports of labor to Israel, one of the most important income earners, have been falling, with the share of employed in Israel declining from an average of 16 percent in 1994–99, to 7 percent in 2003–05. Imports appear to have been less affected in terms of the GDP. They fell slightly more than the GDP in 2000–03, but increased slightly more than the GDP during the recovery phase. As discussed in chapter III, however, there has been a significant shift in import demand toward lower

⁶ “Effective closure days” are defined by the United Nations Special Coordinator’s Office (UNSCO) as the number of calendar days crossing points are closed (“comprehensive closure days”), minus weekends and religious and national holidays.

Box 1. Growth Accounting

Figures 1 and 2 decompose annual GDP growth into aggregate demand components (private consumption, public consumption, gross investment, exports, and imports) as well as by sector (agriculture, manufacturing, services, public sector)^{1/}. Overall, this analysis suggests that the 2000–02 recession was mainly caused by a contraction in trade and investment, while the recovery since 2003 has been driven by a sharp recovery in private consumption, possibly due to a combination of relaxation of labor flow restrictions to Israel and increased public expenditures that buffered household incomes. Foundations for sustainable economic recovery and growth have therefore yet to emerge.

Figure 1. Growth decomposition by aggregate demand categories

A decomposition by aggregate demand components shows:

- Exports and imports were particularly hard hit by the outbreak of the Intifada and the ensuing closures. Between 1999 and 2002, exports and imports of goods and services declined by 60 percent and 47 percent, respectively. Since then, trade has recovered somewhat, albeit more on the import side.
- Investments show a similar pattern after experiencing a dramatic decline through 2002.

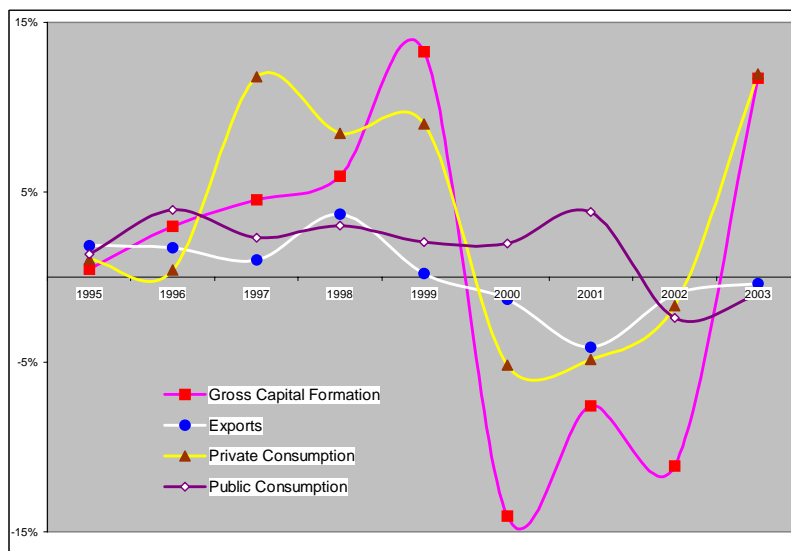
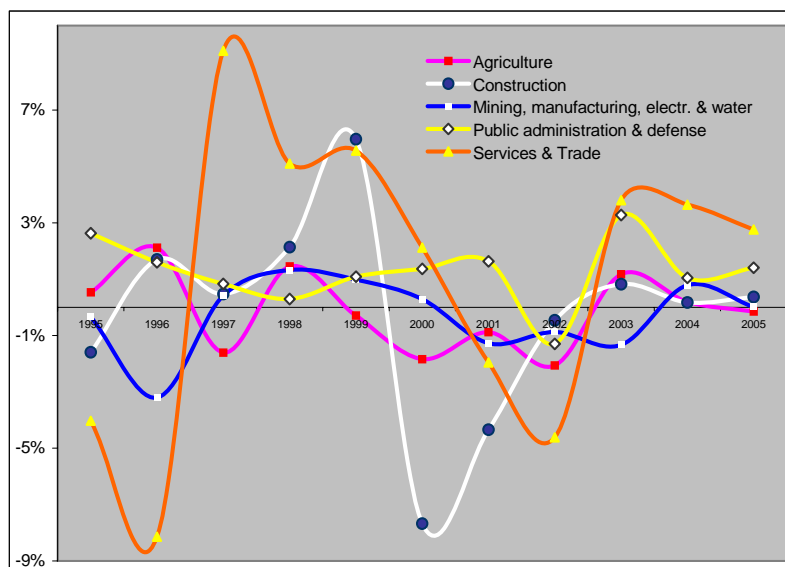


Figure 2. Growth decomposition by sector for WBG

A similar decomposition by economic activity shows:

- The service sector accounts for nearly half of GDP by 2005.
- Despite the lifting of tariffs of agricultural exports to Israel under the Paris Protocol, agriculture has contributed only modestly to economic growth over the last five years.
- Construction has suffered the most since the outbreak of the Intifada, but after recovering in 2003 has not contributed much to further growth recovery.
- The role of the public sector in driving growth has increased over time, largely accounted for by wage growth (albeit to some extent countercyclical).



^{1/} Based on the following simple identity for aggregated demand components, (see Lederman et al. 2000, *JIMF*).

$$\Delta Y_t / Y_{t-1} = (\Delta C_t / C_{t-1})(C_{t-1} / Y_{t-1}) + (\Delta I_t / I_{t-1})(I_{t-1} / Y_{t-1}) + (\Delta X_t / X_{t-1})(X_{t-1} / Y_{t-1}) + (\Delta M_t / M_{t-1})(M_{t-1} / Y_{t-1})$$

processed goods, which, although indispensable to meeting basic human needs and maintaining production operations, further erodes the industrial base.

1.9. Gloomy prospects for turning exports into an engine for growth raise serious concerns about sustainability of the current recovery phase. Although exports recovered somewhat in 2004 and 2005, prospects for continued expansion hinge critically on industrialization, based on foreign direct investment. As discussed in chapters II and III, as long as WBG businesses face an unpredictable closure regime driven by Israeli security concerns, high transportation costs, and the uncertainty of adhering to a delivery timetable, foreign and domestic investors alike will be discouraged. Furthermore, because of production and shipping interruptions, foreign purchasers will continue switching to more reliable sources of supply while Palestinian producers will continue shifting toward domestic markets.

1.10. The role assumed by construction and agriculture sector as key levers of growth and the high share of expenditures on public administration also sheds doubts on the sustainability of recovery (see box 1).⁷ The combined share of construction and agriculture in the GDP increased by 3.1 percentage points, from 15.5 percent in 2000 to 18.6 percent in 2005 (table 2). Although manufacturing has also contributed to recovery, its share of GDP increased modestly and remained below its level in 1995, with competitiveness of the sector deteriorating throughout the decade as discussed in chapter IV.

Table 2. Structure of economic activity by major sector, 1995–2005

Economic Activity (percent of GDP)	1995	2000	2005
Agriculture and fishing	13.0	9.2	10.2
Mining, manufacturing, electricity, and water	20.5	15.7	16.5
Mining and quarrying	0.9	0.8	0.7
<i>Manufacturing</i>	<i>18.5</i>	<i>13.4</i>	<i>14.4</i>
Electricity and water supply	1.2	1.6	1.4
Construction	6.9	6.3	8.4
Service sector	41.4	48.3	45.5
Wholesale and retail trade	15.2	12.2	12.8
Transport	3.2	6.9	6.3
Financial intermediation	2.0	4.5	3.0
Other services	21.0	24.7	23.4
Real estate, renting, and business services	10.5	13.2	10.6
Community, social, and personal services	0.6	0.8	0.8
Hotels and restaurants	1.3	2.3	1.9
Education	5.1	5.8	6.4
Health and social work	3.5	2.8	3.7
Public administration and defense	11.4	13.2	12.8

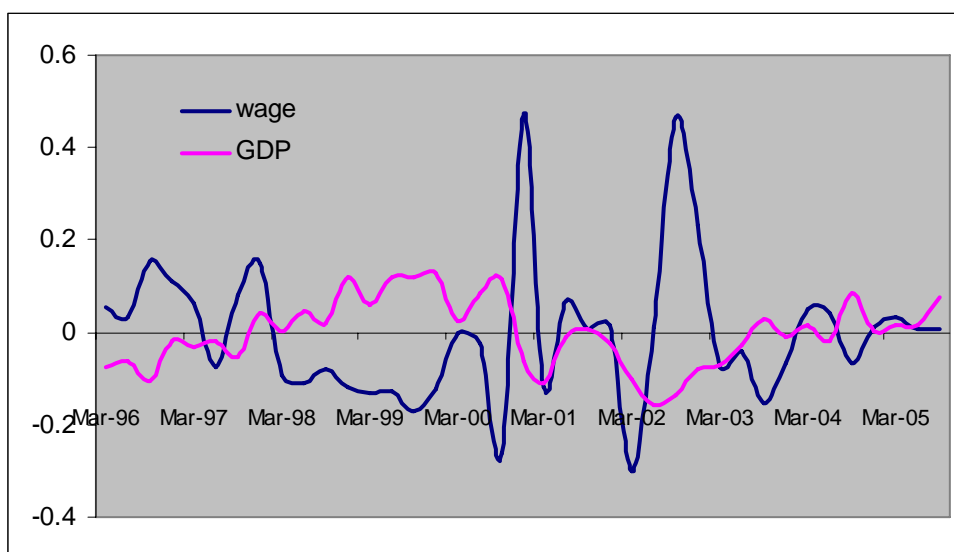
Sources: World Bank staff estimates and PCBS.

1.11. Simultaneously, the overall role of the public sector in the economy has remained unchanged, while public resources have been increasingly allocated to wages, currently accounting for 95 percent of total expenditure. To a large extent, the increase in the wage bill appears to have acted countercyclical and helped cushion household income in times of economic crisis. However, as can be seen in figure 3,⁸ at times (in particular during 2002–03), the wage expenditure was quite far above trend and in excess of what the cyclical downturn in economic activity would have suggested. Expenditures in this sector may contribute to social stability, but they do not contribute to growth. (see section D for further discussion)

⁷ For a detailed discussion on potential of agriculture sector in stimulating growth in WBG see the second volume, annex II of this report.

⁸ Figure 1 shows the Hodrick Prescott filtered cyclical components of quarterly GDP and quarterly wage expenditures. The cyclical components are negatively correlated (-0.48) at the 5 percent level of significance, fully confirming its countercyclical character.

Figure 3. Cyclical components of wage expenditure and GDP



Sources: World Bank staff estimates and PCBS.

1.12. In all, the period 1994–2005 stands as a lost decade in terms of economic development, with rather uncertain prospects for a strong recovery. The decade witnessed dramatic contraction in most of the critical macroeconomic and social indicators. It also witnessed a significant contraction in internationally competitive industrial capacities. In consequence, the foundation for economic expansion is fragile at best.

C. ISRAEL AND WEST BANK AND GAZA: ECONOMIC DIVERGENCE?

1.13. Whereas as a rule “policy-induced” economic integration between economies at different stages of development can be a significant channel for income convergence, there has been no perceptible convergence in income levels between WBG and Israel, albeit various periods yield different evidence. This is in sharp contrast to the regional integration record within Europe, which has helped poorer countries on the periphery such as Portugal, Spain, Greece, and Ireland to catch up.⁹ The World Bank’s 2002 economic report analyzes income convergence between Palestine and Israel during the period 1968–2002,¹⁰ pointing to the fact that despite deep integration of the factor and goods markets following the 1967 Israeli occupation, significant gains in terms of income convergence were absent.

1.14. These results are confirmed with the updated analyses presented below, using the revised official statistics. The WBG made significant progress in closing the income gap before 1977, when the income gap reached a historic low (figure 4).¹¹ Since then in terms of GDP, WBG and Israel have been diverging, undoing nearly all of the convergence gains of the 1970s. As can be seen from figure 5, divergence appeared to have slowed at the beginning of the 1990s, but has somewhat increased since 1999.¹²

⁹ Easterly, Fiess, and Lederman (2003) report a positive impact of income convergence between Mexico and the United States because of the North American Free Trade Agreement (NAFTA).

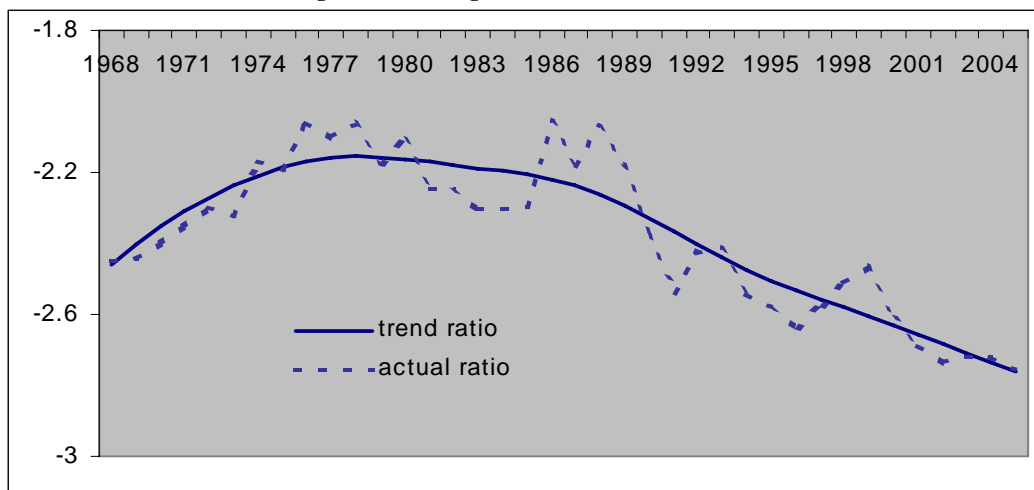
¹⁰ “Long Term Policy Options for the Palestine Economy” (World Bank, July 2002). See also Sébastien Dessus, “A Palestinian Growth History, 1968–2000” (*Journal of Economic Integration*, Vol. 19, No. 3, 2004).

¹¹ It appears that the 1977 turning point in convergence coincides with intensified settlement activity.

¹² Figure 5 plots the first differences of the logarithmic ratio of the Hodrick-Prescott filtered series of GDP and GDP per capita in Israel relative to WBG (shown in figure 4).

1.15. The pace of convergence or divergence in GDP per capita levels in relation to Israel is slightly different for West Bank and for Gaza in 1994–2003. Both West Bank and Gaza, albeit the latter to a much smaller extent, managed to begin closing the income gap in relation to Israel before the outbreak of the Intifada (figure 6). In 1996–99, GDP of the West Bank grew at 10 percent and that of Gaza at 5.7 percent, compared with 3.5 percent in Israel. But most of the gains were lost during the 2000–2002 crisis, when GDP declined across the West Bank and Gaza by 5.5 percent, while GDP in Israel grew by 1.8 percent. Despite that setback in convergence, the West Bank nevertheless managed to reduce the income gap relative to Israel. Gaza, on the other hand, gave back all its initial gains, with the income gap (vis-a-vis Israel) in 2003 right back where it started in 1994.

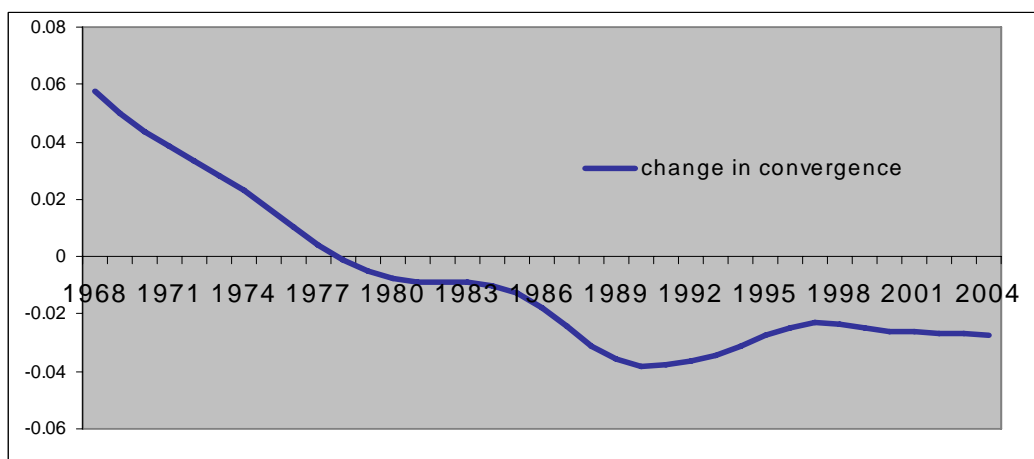
Figure 4. Convergence between WBG and Israel



Sources: World Bank staff estimates and PCBS.

Note: The dotted line shows the logarithmic ratio of per capita GDP in WBG to per capita GDP in Israel. The solid line shows the logarithmic ratio of trend per capita GDP in WBG to trend per capita GDP in Israel. A declining ratio indicates divergence in terms of WBG falling behind Israel. Trend per capita GDP is estimated via the Hodrick-Prescott filter.

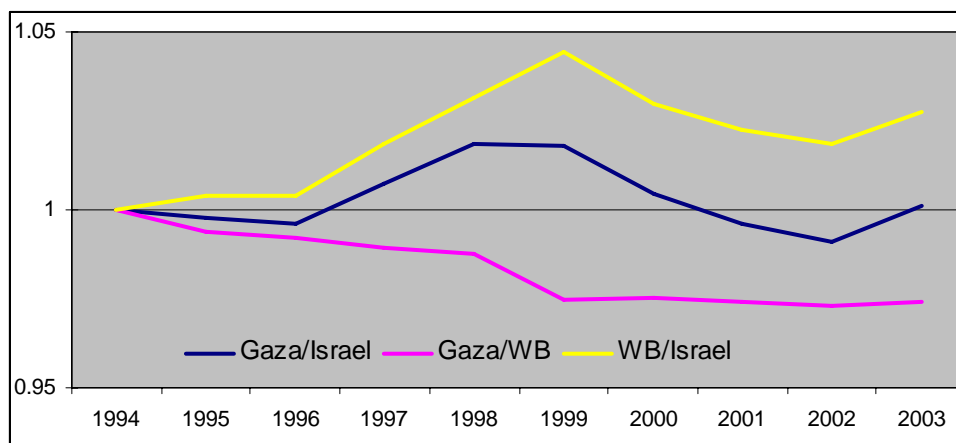
Figure 5. Dynamics of convergence: WBG and Israel



Sources: World Bank staff estimates and PCBS.

Note: The line shows the change in the logarithmic ratio of trend per capita GDP in WBG to trend per capita GDP in Israel. Negative values indicate divergence, positive, but declining values indicate that convergence is slowing.

Figure 6. Relative income gap—Israel, West Bank, and Gaza



Sources: World Bank staff estimates and PCBS.

1.16. Relative to the West Bank, GDP in Gaza diverged until 1999 and the income gap with respect to West Bank has remained constant since. Although these diverging growth dynamics need further investigation (which the unavailability of disaggregated quarterly data for West Bank and Gaza makes impossible), its major drivers have been external assistance and workers' remittances from Israel, rather than increased local productive capacities for tradable goods and productivity growth. Dessus (2004) shows that productivity in Israel and WBG has actually been diverging.¹³ In sum, the benefits of integration with a much more highly developed partner have not fully materialized. Foreign direct investments inflows, whose increase is one of the major benefits associated with "north-south" integration, have never taken off. In consequence, there has been no strong industrialization push. As discussed in chapters II and IV, among the reasons are the closure regime as well as slow progress in the establishment of a business-friendly environment by the PA, which assumed authority over WBG only in 1994.¹⁴

1.17. Conditions indispensable to releasing the process of deeper integration and attracting foreign direct investments were, however, not in place even before the Intifada. The Protocol on Economic Relations (commonly called the Paris Protocol¹⁵) signed in 1994 set the stage for a higher level of economic integration than that implicit in a standard customs union agreement.¹⁶ Although many of its provisions were not implemented before the Intifada, the level of "policy-related" integration remains high, including not only the common external tariff but also the absence of internal economic borders and the use of Israeli domestic currency in WBG. However, this integration has not generated economy-of-scale effects and although WBG has remained under a single customs "envelop," its economy has never been a single economic space.¹⁷

¹³ See Sébastien Dessus, "A Palestinian Growth History, 1968–2000" (*Journal of Economic Integration*, Vol. 19, No. 3, 2004).

¹⁴ "Self-government" was the result of the Israel-PLO Declaration of Principles on Interim Self-Government Arrangements (the DOP), signed in 1993, with a transfer of powers and responsibilities having been spread over 1994–98. WBG's powers remained curtailed, with WBG retaining no control over its borders or territories.

¹⁵ The Agreement was subsequently attached as an annex to the Interim Agreement between the Government of Israel and the Palestine Liberation Organization.

¹⁶ In contrast to many other customs union agreements, the common external tariff covers all products except for a very limited number of items under lists A1 and A2, consisting mainly of consumer goods traded with Jordan and Egypt, and list B, consisting mainly of machinery and unfinished goods.

¹⁷ Since border controls have been in place not only between Israel and WBG but also between the two territories, the WBG has been de facto a two-layered, if not multiple-layered economy, as trade has faced multifarious internal checkpoints (see chapter II and III for detailed discussion)

D. DRIVERS OF GROWTH: CRISIS AND RECOVERY

1.18. Econometric analysis of WBG growth dynamics corroborate earlier observations about the drivers of its growth and contraction: the level of economic activity in WBG is very much tied to developments in Israeli-WBG security relations, as reflected in the closure regime, and foreign aid, apart from developments in Israel¹⁸ (table 3). The impact of foreign aid on the GDP, as captured in our growth equation, is positive, albeit smaller than that of closures: a 10 percent increase in aid raises the real GDP of WBG around 0.9 percent.

Table 3. Key determinants of WBG economic activity

ARDL			Error correction representation		
Dependent Variable: $\ln Y_{PA,t}$			Dependent Variable: $\Delta \ln Y_{PA,t}$		
Regressor	Coefficient	T-Ratio[Prob]	Regressor	Coefficient	T-Ratio[Prob]
$\ln Y_{PA,t-1}$	0.53831	3.7100[.003]	$\Delta \ln Y_{IS,t}$	0.95832	3.8419[.002]
$\ln Y_{IS,t}$	0.95832	3.8419[.003]	$\Delta U_{PA,t}$	-0.91289	-2.8304[.015]
$\ln Y_{IS,t-1}$	-0.73068	-3.3034[.007]	$\Delta \text{eff}/\text{pot}_t$	0.05466	1.9169[.079]
$U_{PA,t}$	-0.91289	-2.8304[.016]	ΔAid_t	0.03914	1.8290[.092]
eff/pot_t	0.05466	1.9169[.082]	$\text{Ecm}(-1)$	-0.46169	-3.1820[.008]
Aid_t	0.03914	1.8290[.095]			
<i>Constant</i>	0.91322	.41379[.687]			

with error correction term, $\text{ecm}_t = \ln Y_{PA,t} -.493 * \ln Y_{IS,t} + 1.9773 * U_{PA,t} -.118 * \text{eff}/\text{pot}_t - 0.0848 * \text{Aid}_t - 1.97$

1.19. While foreign aid is crucial to political stability, supply of public services, and private sector operations, the closure regime affects the WBG through three distinct channels: workers' remittances, current movement of goods and services, and future capacity to export. As discussed in chapter II, the impact of closures within the first two channels can be assessed quantitatively, but the losses associated with forgone future capacity to export are impossible to assess—except that these are likely to be substantial, as the tight and unpredictable closure regime rules out the participation of WBG firms in the modern division of labor based on in-time production and inventory management. It also removes incentives to invest in these sectors, as well as in those critically dependent on economies of scale.

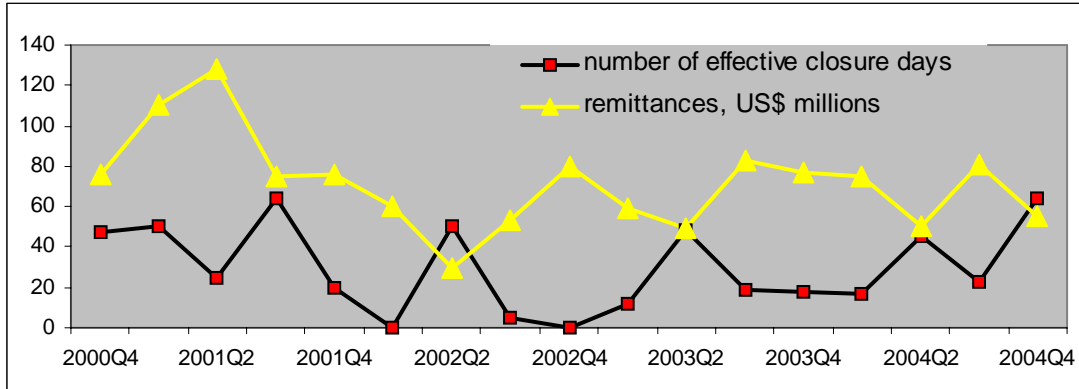
1.20. The closure regime therefore has a significant impact on GDP, which is reflected by the available data. We estimate that a 10 percentage-point increase in the ratio of effective to potential working days, equivalent to about 30 more days worked due to the removal of closure restrictions, increases the real GDP by 1.2 percent, or about 0.17 percent per day more worked. In other words, one day of closure is estimated to cost WBG about US\$7 million in terms of lost income.

1.21. Since the outbreak of the Intifada, the number of “closure” days has been high, and negatively correlated with workers' remittances¹⁹ (figure 7). Because of political interference, worker remittances have also become extremely volatile and tend to increase, rather than decrease, economic volatility. Furthermore, the uncertainty of closures erodes prospects for development of export-oriented industrial capacities that would provide employment to that reduced in Israel. Instead, as discussed in the next section, public employment has been on the rise, significantly exacerbating the fragility of the WBG's fiscal position.

¹⁸ We use an autoregressive distributed lag (ARDL) model (Pesaran 1996 and Pesaran et al., 2001) based on quarterly data from 1993Q1 to 2005Q4. See the second volume, annex I of this report for details.

¹⁹ The decline in workers' remittances, however, has been part of a longer trend and nothing suggests a turnaround: workers remittances increased significantly until the first Gulf war in 1991, reaching almost 28 percent in terms of GDP, but afterwards dropped sharply to an annual average of 15 percent in 1994–99 and 9.3 percent in 2000–05.

Figure 7. Quarterly closures and remittances in 2000–2004



Sources: World Bank staff estimates, PCBS, UNSCO.

E. THE PALESTINIAN AUTHORITY IN THE THROES OF FISCAL CRISIS²⁰

The Contracting Revenues and Expanding Expenditures in the Post-Intifada Environment

1.22. The outbreak of the Intifada marked the end of the post-Oslo period that had been characterized by a very rapid expansion in PA revenues. Revenues in U.S. dollars almost doubled between 1995—the first full year of the PA’s functioning—and 1999, from US\$510 million (15.8 percent of GDP) to US\$942 million (22.6 percent of GDP), mainly thanks to clearance revenue collected by the GoI.²¹ Clearance revenue reached and stabilized at more than 60 percent of total PA current revenues in 1999. However, domestic revenues also increased strongly, testifying to the impressive tax collection capacity established by the PA (figure 8).

1.23. Three months into the Intifada, however, revenues had fallen around 50 percent because of tightened restrictions on the movement of goods into and out of the WBG. These restrictions, together with cutbacks in Palestinian consumer spending, reduced imports and, consequently, trade taxes collected by GoI on behalf of the PA. Furthermore, beginning January 2001, the GoI suspended the regular transfer of clearance revenue until December 2002. Beginning in 2003 revenues began to gradually recover, reaching pre-Intifada levels in nominal terms in December 2003.

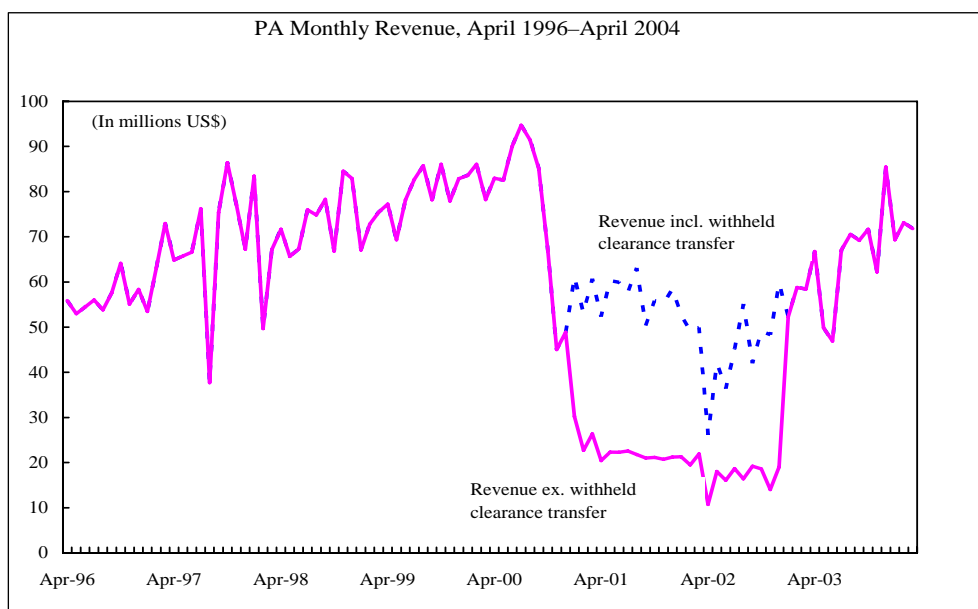
1.24. The second quarter of 2006, in the aftermath of the Hamas electoral victory, witnessed a repetition of fiscal woes experienced by the PA in 2001–02. This time, aggravated by the suspension of budget support provided by international donors, the GoI’s decision to suspend transfer of clearance income has created the current financial crunch. Moreover, all commercial banks have severed relations with the PA—in particular the Arab Bank, which houses the PA’s Single Treasury Account, ceased to serve the PA. This implies that the PA is unable to pay either suppliers or its employees—even if it had the funds to do so.²²

²⁰ For a fuller discussion, see the second volume, annex I of this report.

²¹ Clearance revenue is taxes collected by the Government of Israel on behalf of the PA. It is mainly trade taxes and value-added tax (VAT) on Palestinian imports, which the GoI collects as part of the arrangements under the quasi-customs union.

²² *The Impending Palestinian Fiscal Crisis, Potential Remedies* (World Bank, May 7, 2006), discusses the PA’s current fiscal travails in some detail.

Figure 8. Monthly budget revenues in April 1996–April 2004 (in US\$ mill.)



Source: Ministry of Finance.

1.25. On the expenditure side, although high growth in public expenditures and staffing was to be expected in the context of setting up new government functions basically from scratch, the increases have become increasingly associated with safety net consideration rather than provision of public services.²³ Public employment increased from 57,000 in 1995 to 104,000 in the end of 1999, outpacing (the otherwise rapid) population growth by a factor 2:1. Furthermore, the annual staffing growth of almost 13 percent was below the concurrent growth in the wage bill of approximately 14 percent per year, implying a relatively modest increase in average public salaries of 1–2 percent per year. By 1999, public expenditures amounted to 22.6 percent of GDP. Finally, despite the revenue crunch during the Intifada, the PA’s wage bill continued to increase unabated at a rate of 15 percent per annum between 1999 and 2005, further eroding its capacity to provide public services (see box 2).

1.26. In addition to salaries and staffing, the PA has increasingly become the “financier of last resort” to cover unmet obligations for other public entities. These obligations fall mainly in three categories: First, settlement of utility bills from Israeli suppliers that municipalities have not paid—municipalities, in particular in the West Bank—are the main retail providers of water and electricity. These payments are “netted out” from the monthly transfer of Palestinian customs revenue and amounted to a total of US\$132 million in 2005. The second significant category is the result of the PA’s contractual obligation to supply fuel for power generation by the Gaza Electricity Company, amounting to US\$119 million in 2005. Finally, the PA has covered losses of the Petroleum Authority, the public monopoly supplier of fuel products in the West Bank and Gaza.²⁴ These payments amounted to the US\$98 million in 2005. In total, these items resulted in a drain of the PA’s budget of US\$349 million in 2005.

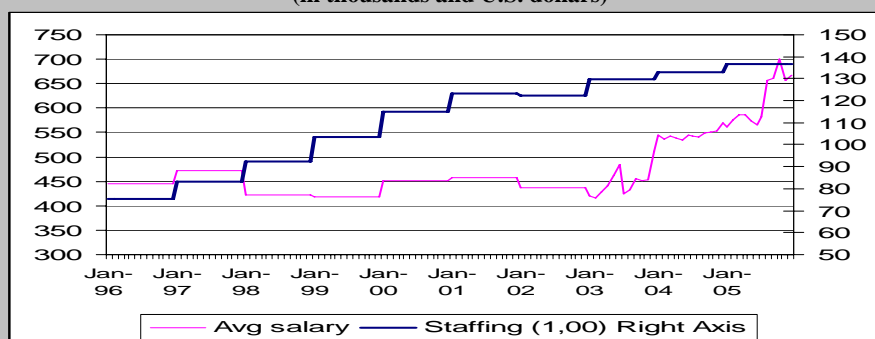
²³ It should be noted that the increase also reflected attempts to integrate returning PLO employees into public service and to absorb workers repatriated mainly from Gulf countries in the wake of the first Gulf war; as a result it clearly outpaced the increase in PA responsibilities for service provision. See *Strengthening Public Sector Management* (The World Bank, 1999).

²⁴ Occurring most likely because the Petroleum Authority sells its products (slightly) below market prices. It should be noted that in the case of the Petroleum Authority, the negative budgetary effect is to some extent counterbalanced by a rapid increase in petroleum excise revenue, as the Petroleum Authority has regained a large market share from smugglers in recent years.

Box 2. The recent evolution of the wage bill

The period 2003–05 witnessed two large salary hikes. The first occurred in late 2003 as part of the wage increase envisaged when the Civil Service Law, which had been pending since 1998, was implemented. As a result, average wages in the first quarter of 2004 jumped more than 20 percent compared to their levels a year before. Another 20 percent was added to average salaries during the second half of 2005; during the last quarter of 2005, the average salary for a PA employee reached US\$676 per month, up from US\$559 during the same period a year before—equivalent to an annual increase of 21 percent. The second round of salary increases benefited security service staff in particular relative to civil servants. Although at the beginning of 2003 civil servants on average earned 20 percent more than security service staff, the difference had narrowed to less than five percent by the end of 2005.

Figure 9: PA staffing and average public sector salary in 1996–2005
(in thousands and U.S. dollars)



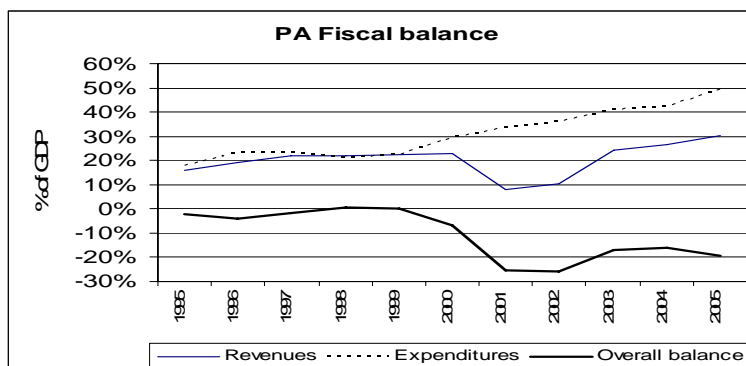
Source: Ministry of Finance, IMF, and World Bank staff calculations.

Note: The average salary is calculated by dividing the monthly wage bill by end-year staffing levels; thus, monthly variations in the average salary reflect wage bill variations and should be treated with caution, even though the trend is believed to be robust.

1.27. Overall, continued expansion in the expenditures during the Intifada resulted in a rapid expansion in the expenditure/GDP ratio, which was more than doubled during 1999–2005, reaching 49 percent—one of the highest ratios in the world.²⁵

1.28. The net result of stagnant, if not falling, revenues and continued expenditure expansion has been a dramatic increase in budget deficit: during 2000–05 the average budget deficit amounted to 17.7 percent of GDP.²⁶ Such large deficits are in sharp contrast to the pre-Intifada period, when the deficit amounted on average to a modest 1.3 percent of GDP (see figure 10).

Figure 10. Revenues, expenditures and overall balance (in % of GDP in 1995–2005)



Source: Ministry of Finance, IMF and World Bank staff calculations.

²⁵ Of the 122 countries for which world development indicators report central government expenditures, only Eritrea—at 53 percent in 2004—was higher. Namibia ranks third, at 35 percent; Israel was fourth, at 29 percent.

²⁶ The numbers concern only the recurrent budget. Since the PA's inception, capital expenditures have been almost exclusively financed by donors and have not been incorporated in the budget. Since 2000 the budget has included a small amount of PA-financed capital expenditures.

Financing, Debt, and Sustainability

1.29. Budget support from the international community has been the most important source of financing the PA deficits, equivalent to an average of almost 10 percent of GDP during 2000–05, after having practically ceased in the last few years before the Intifada.²⁷ The second most important source of financing for the PA has been borrowing from domestic commercial banks. By the end of 2005, the PA's debt to commercial banks reached US\$627 million—on average, equivalent to the annual borrowing of 3 percent of GDP. Exceptional transfers of profit from the Palestine Investment Fund (PIF) and accumulation of payment arrears added financing equivalent to a total of 2.1 percent of GDP (table 4).

Table 4. Deficit and sources of its financing in (in million of US dollars and percent)

	1995-1999		2000-2005	
	US\$ mln	US\$ mln	% Share in total	
Total Financing Requirement	223	3,709	100%	
External budget support	74	2,013	54%	
Of which grants	74	1,511	41%	
Of which soft loans	0	502	14%	
Exceptional transfers from Palestine Investment Fund	0	173	5%	
Gross withheld clearance revenue from GoI 1/	0	616	17%	
Net domestic bank financing	-56	627	17%	
Change in arrears/residual	205	279	8%	

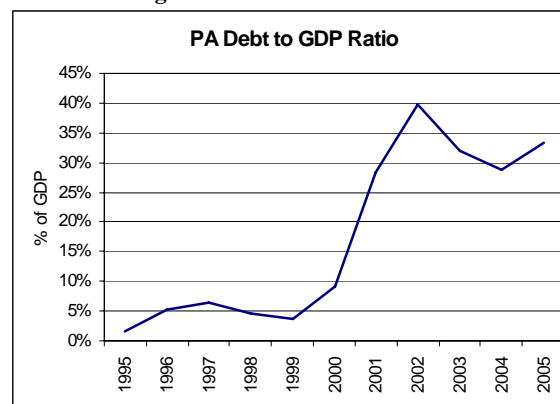
Source: Ministry of Finance, IMF and World Bank Staff estimates.

Note: Withheld clearance revenue line during 2000-05 represents only a temporal shift in the transfer of clearance revenue.

1.30. The PA's net debt amounted to an estimated 33 percent of GDP at the end of 2005 (box 3). World Bank estimates²⁸ suggest that debt-to-GDP ratio remained low during the pre-Intifada years, before accelerating rapidly in 2001–02, when the economic crisis bottomed out. At the same time the PA took on large amounts of (concessional) debt from Arab League countries to compensate for the withholding of revenues by Israel (table 4). Scheduled debt service payments on the PA's concessional debt amounts to about US\$50 million per annum in the next five years before gradually declining.

1.31. By international standards, the current level of indebtedness is relatively modest (figure 11). Given the PA's current large fiscal deficit, however, low debt-to-GDP ratio does not necessarily provide much comfort as continued borrowing will result in a very rapid buildup of public debt, if access to borrowing sources remains open. In effect, the PA is currently already in default on payments to several of its concessional lenders.²⁹

Figure 11. PA debt to GDP ratio



Source: Ministry of Finance & World Bank staff estimates.

²⁷ In general, a government can finance its spending in three ways: taxes, borrowing, and printing money. Considering the comparatively high revenue-to-GDP ratio in WBG, the scope for further tax increases appears modest at best. Printing money is likewise not an option, as WBG does not have its own currency. Note also that the PA's debt instruments are much more restricted than those of other countries as it cannot issue sovereign debt.

²⁸ For a detailed discussion, see the second volume, annex I of this report.

²⁹ Notably in payments to the Islamic Development Bank, which had grace periods as low as three years. Also, since July 2002, the World Bank has granted the PA a Moratorium on payments of service charges and commitment fees (but not principal payments) on its outstanding loans.

Box 3. The size and composition of the PA's liabilities and assets 1/

Total Palestinian Authority **liabilities** stood at 53 percent of GDP at the end of 2005. Approximately half of liabilities consists of *concessional debt*, of which 90 percent is debt to multinational creditors. The largest concessional creditor is the Islamic Development Bank, which provided a total of US\$497 million in budget support to the PA in the early years of the Intifada. The World Bank is the second largest creditor, with an outstanding loan amount equivalent to US\$326 million. The PA's debt to the World Bank has mostly been contracted to finance infrastructure investments and capacity building activities since the inception of the PA in 1994. The Government of Spain is the largest bilateral creditor to the PA in the amount of US\$67 million.

Borrowing from commercial banks makes up 30 percent of the PA's liabilities (the equivalent to 16 percent of GDP at the end of 2005). The terms of commercial bank borrowing are not publicly available. Informal discussions with Ministry of Finance officials suggest that the debt generally (i) is US\$-denominated; (ii) has a maturity of one year (and probably in some cases considerably shorter); (iii) carries a 5 percent rate of interest. The commercial bank debt exposes the PA not only to considerable exchange rate risks but also to refinancing risks, as the PA has to roll over the bank debt at short intervals. About one-third of the PA's debt to commercial banks (that is, around US\$215 million) is reportedly collateralized with assets from the Palestine Investment Fund.

Finally, the PA accumulated a sizable stock of **payment arrears** during the Intifada. At the end of 2005, the stock of arrears was estimated at approximately US\$440 million. A significant part of the arrears (perhaps more than US\$200 million) was incurred by the Gaza Pension and Insurance Company as the PA has defaulted on the employer contribution to the civil servants' pension scheme. Other arrears include payments to private Israeli companies. The PA has also accumulated payment arrears to suppliers of goods and services necessary for public sector operation and maintenance.

The PA holds sizable liquid **assets** in the Palestine Investment Fund (PIF). The most recent audited statements of the PIF concerns 2004. According to these, the assets in the PIF amounted to US\$1.01 billion as of December 31, 2004. However, during 2005 considerable cash payments were made from the PIF to the PA's budget, in the form of dividend payments and advances for a total estimated at US\$225 million, of which US\$173 million is so-called "exceptional profits." It should be noted that considerable PIF assets were used as collateral for some PA borrowing in commercial banks, notably the Arab Bank.

1/ See the second volume, annex I of this report for a more detailed discussion.

1.32. The debt decomposition analysis shown in table 5 corroborates this argument. The primary deficit has been an important driver of the increase in the debt-to-GDP ratio. In the absence of any mitigating factors, the primary deficit alone would have resulted in a debt-to-GDP ratio of more than 100 percent in 2005; most of the increase would have happened during 2001–2005, when the accumulated primary deficit amounted to 102 percent of GDP. Consistent with the sources of financing the PA's deficit, budget support has been the main mitigating factor, providing financing equivalent to a reduction in the debt-to-GDP ratio of about 60 percent.

Table 5. Decomposition of change in PA debt-to-GDP ratio

	1997–00	2001–05
Change in public sector debt-to-GDP ratio	3.8	24.2
Primary deficit	7.3	102.5
Contribution from real interest rate	-0.2	1.6
Contribution from real GDP growth	-1.4	-1.5
PIF transfers	0	-4.3
External budget support	-1.5	-59.1
Withheld clearance revenue	0	-18.5
Residual	-0.4	3.5

Source: World Bank Staff calculations.

Note: The table shows a decomposition of the actual change in public debt-to-GDP ratio into various components for different time periods, including the primary deficit, contributions from real interest rates, and real GDP growth, as well as other factors, such as PIF transfers, external budget support, and release of previously withheld clearance revenues. The residual measures the portion of debt accumulation that is unexplained; it could be due to measurement error or unaccounted expenditures or revenues. Positive coefficients indicate a contribution to debt accumulation; negative coefficients indicate a positive impact on debt reduction. As an example, debt increased by 3.8 percentage points during 1997 and 2000. Whereas the primary deficit alone would have accounted for a 7.3 percentage point increase in the public debt-to-GDP ratio, other factors such as GDP growth had a mitigating impact.

Declining real interest rates have slightly mitigated the the growth in the debt-to-GDP ratio, as has real GDP growth; together these factors reduced the debt burden by about 10 percentage point of the GDP.

1.33. Looking forward, a “passive” projection of fiscal trends suggest that the PA’s primary deficit could reach almost US\$1,100 million in 2006, equivalent to no less than 25 percent of GDP, up from 19 percent in 2005 (box 4). Beyond 2006, assuming for simplicity that the PA’s primary deficit remains constant as a share of GDP, the debt-to-GDP ratio (*or financing need*) could jump from 33 percent in 2005 to 47 percent in 2006. By 2010 the debt-to-GDP ratio will have more than tripled, to exceed 100 percent (figure 12).

1.34. A fiscal path that triples the debt-to-GDP ratio (*or financing need*) in five years is obviously unsustainable. Considering the PA’s restricted access to debt markets, it is also unrealistic: since the PA cannot tap domestic or international bond markets, the PA’s sole source of debt financing is domestic commercial banks. Indications in recent months are that this source of financing is rapidly drying up; for example, the Arab Bank—traditionally the PA’s largest creditor—has recently required the PA to pay back its US\$70 million credit line.

Box 4. The Parameters of “Passive” Projection of Fiscal Trends in 2005–06 and Beyond.

Assumptions—2005–06:

On the *revenue side*, the revenue-to-GDP ratio is expected to decline from 30.1 percent in 2005 to 27.9 percent in 2006 on account of lower nontax revenues, which were extraordinary high in 2005. On the other hand, it is assumed that GoI resumes the transfer of clearance revenue shortly, and that all clearance revenue due in 2006 will be transferred within the year.

On the *expenditure side*, PA expenditures are expected to reach highs of 53 percent of GDP, based on following key assumptions:

- The “overhang” from the public sector salary increases granted in the summer of 2005 will result in a 14 percent increase in the wage bill in 2006 compared to 2005. The wage bill is expected to reach US\$1,140 million in 2006, or 26.1 percent (up from 24.7 percent in 2005). A modest increase in staffing levels and the automatic wage drift are also factored in.
- The transfer component of the budget is expected to increase from US\$375 million in 2005 to US\$505 million in 2006; the outbreak of avian ‘flu is likely to add further to the PA’s expenditures, both through the need to compensate poultry farmers and financing the expense of culling. The main reason is the implementation of the Unified Pension Law, which expands coverage of the public sector’s pension scheme to include pensions for security service staff aged less than 45 years.

Assumptions—2007 and onwards

- Revenues and expenditures (except debt service payments) will increase in line with nominal GDP.
- GDP growth remains at around 6 percent annually—that is, on average, it is back to past growth performance.
- On the financing side, budget support remains at the levels seen in recent years (US\$350 million per annum), and any residual financing is to be met through borrowing for illustrative purposes.

Challenge of Fiscal Adjustment

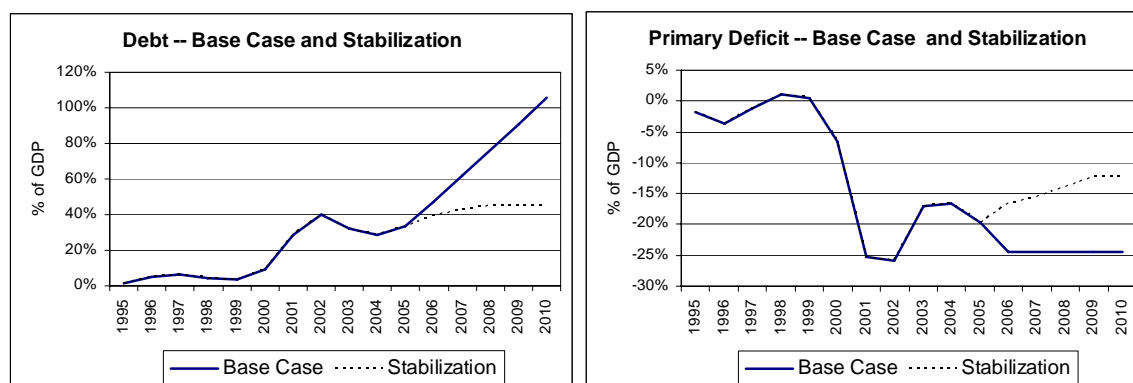
1.35. It will take a significant fiscal adjustment to gradually stabilize the debt-to-GDP ratio or, in other words, financing requirement after aid. To give a sense of the fiscal adjustment needed to keep the debt-to-GDP ratio from exploding, an illustrative “stabilization” scenario is created in which the debt ratio is allowed to gradually increase to 45 percent by 2008 (a three-year adjustment period) at which level it subsequently remains (figure 12).³⁰ As might be expected, the required fiscal adjustment is significant: in the stabilization scenario, the PA would have to reduce its primary deficit to 17 percent of GDP in 2006 (compared to an estimated primary deficit of 25 percent in the passive adjustment case), and further reduce it to about 12 percent in 2007–2010—equivalent to roughly half the level of the passive adjustment case.

1.36. The required fiscal adjustment may, however, be even larger than indicated above, which assumes that the PA will maintain a constant expenditure-to-GDP ratio (net of debt service) in the

³⁰ Specifically, it is assumed that the debt-to-GDP ratio reaches 39 percent in 2006, 43 percent in 2007, and 45 in 2008. See the second volume, annex I for a detailed discussion on the choice of 45 percent as a ceiling for WBG.

medium term. Compared to past trends, this entails an implicit tightening of fiscal policy. More importantly, the PA's fiscal outlook is subject to a number of additional risks, which might require further fiscal adjustment in the absence of additional resources to smooth the transition to a healthier fiscal position. Among the additional risks are the following:

Figure 12. Fiscal outlook—passive adjustment (base) scenario vs. stabilization scenario



Source: World Bank Staff estimates.

Note: For a description of the base case, see box 4, passive adjustment scenario.

- **Lower economic growth.** As discussed in this chapter, WBG's growth performance in the past decade has been rather dismal, and the assumption of 6 percent nominal GDP growth over the period ahead might prove to be too optimistic; if, alternatively, a more pessimistic assumption of 2 percent growth is assumed, even with our assumption of a constant tax revenue-to-GDP ratio, tax revenues would be approximately US\$100 million lower in 2008, requiring additional savings to be generated.
- **Lower levels of budget support.** The level of external budget support received by the PA during the Intifada years has been very large, continuation of which is uncertain. Lower budget support translates into additional required savings—amounting to as high as US\$120 per annum in our illustrative scenario, depending on the pace of decline in aid.
- **Demands to settle arrears.** At perhaps US\$500 million at the end of 2005, the PA's stock of arrears is considerable. An eventual elimination of this stock would require measurable additional savings—in excess of US\$100 million per annum if arrears were to be settled within, say, a three-year period.

1.37. This picture reflects the fiscal fragility with which the PA has to increasingly cope. Options for improving the fiscal position are relatively limited,³¹ with large share of adjustment falling on the expenditure side. On the domestic resources side, room for significantly improving revenue generation, even in the medium term, is limited as the PA tax-to-GDP ratio is already quite high both by regional standards and in comparison to other countries at similar income levels.³²

1.38. The picture, however, also highlights the key role that the economic recovery and growth plays in smoothing the adjustment path. *The adjustment process will be made easier if the economy is recovering rapidly, thereby creating more room to manoeuvre, because public expenditure can rise in*

³¹ Although their discussion goes beyond the scope of this Report, the Second Volume, Annex I of this Report offers a general assessment.

³² Although the PA tax system today has a number of features generally associated with a well-functioning tax system, the possibilities for significant increases with suppressed business activity and high level of taxation are limited. Thus, even if there may be gains especially on the income tax side to be expected, the impact on the fiscal balance is likely to be low.

nominal terms even when its share in GDP is to be reduced. This, in turn, requires elimination of impediments to economic recovery and growth. Building on discussion in this chapter, the rest of this report assesses such impediments and highlights key issues that need to be addressed toward their elimination over the short to medium term.

CHAPTER II

ISRAEL'S SECURITY REGIME: IMPACT ON THE WBG ECONOMY

A. INTRODUCTION

2.1 The most binding constraints on economic activity in the West Bank and Gaza (WBG) are the uncertainty and extra cost of doing business because of the difficulty of access—not only to external markets but also to local markets—resulting from the Israeli security regime. The latter includes special measures affecting imports into WBG: back-to-back system, the system of fixed and mobile checkpoints in the West Bank, and closures (including the separation wall). Closures impinge on all aspects of the movement of goods and people, and disrupt economic links between West Bank and Gaza, within the West Bank, and with Israel and the rest of the world in an unpredictable manner.³³ Back-to-back system and special security screenings of outbound and inbound shipments dramatically raise trading costs. Taken together, they make the WBG a nonviable economy as fragmentation of economic space, both in its internal and external dimensions, makes the development of more advanced forms of division of labor and integration into external markets impossible.

2.2. Although reforms in WBG business climate are work in progress,³⁴ the closure policies related to the security situation have been the main reason behind dismal economic performance since 2000. The causative links are illustrated in chapter 1, but the degree of coincidence is also illustrative. Suspension of closures in 1998–2000 coincided with an almost three-year-long economic recovery in WBG, with the real GDP growing 5 percent in 1998 and 6 percent in 1999 before coming to a grinding halt in the last quarter of 2000 after the outbreak of violence. In a similar vein, for the first time in more than a decade exports of goods showed some signs of growth in the second half of the 1990s, expanding in current prices at an average (least square) rate of 3.5 percent per year over 1996–2000.

2.3. Structural reforms, combined with macroeconomic stability, easy access to external markets, and unimpeded internal links to other sectors of the economy, are usually sufficient to spur economic growth led by exports of goods and services. Although it appears that exports of labor, which recovered by 29 percent in 2005, may remain an important source of income for some time in WBG (unless they are curbed by Israel for security reasons), development of the manufacturing sector is critical to addressing high unemployment levels and boosting economic growth in WBG. However, with limited access to external markets and an economy highly fragmented because of closures, WBG's ability to fully use its current productive potential in the manufacturing sector and the rest of the economy is limited.

2.4. Some direct channels of the impact of closures on economic activity—for example, the inability of Palestinian workers to show up for work in Israel—is relatively easy to assess quantitatively, but losses

³³ The term “closure” refers to the restriction that Israel imposed 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 forms: (i) internal closure within the West Bank and Gaza, reinforced periodically by curfews; (ii) external closure of the border between Israel and the West Bank and between Israel and Gaza—including the separation wall which will likely further tighten closure by restricting access from the West Bank to Israel and from the Seam Zone (i.e. the areas of West Bank caught between the separation barrier and the Green Line); and (iii) the external closing of international crossings between the West Bank and Jordan and between Gaza and Egypt (“Four Years—Intifada, Closures and the Palestinian Economic Crisis,” World Bank, 2004).

³⁴ Recent reforms, particularly the progress achieved in regulatory reforms in 2005, were significant. Nevertheless, there remains an unfinished agenda particularly in legal and judicial reforms (see chapter IV of this report for further discussion).

caused by obstacles to movement of persons to trade in goods or provide services in WBG are not amenable to straightforward quantification. Furthermore, the major economic impact of the security regime is realized not only through the cost of undertaking the existing activities, but through activities that are unlikely to occur as long as these policies are in place.

2.5. The remainder of this chapter is structured as follows. Section B provides an overview of the key transmission channels of the impact of closures on the economy. Section C examines developments in labor flows and workers' remittances from Israel. Section D assesses the impact of closures on flows of goods between WBG and the external world and within the West Bank, whereas Section E discusses other costs imposed by the security regime, including the resulting fragmentation of the West Bank economy. Section F looks at security measures imposed almost exclusively on WBG businesses. Section G concludes the chapter.

B. TRANSMISSION CHANNELS OF IMPACT OF CLOSURES ON THE ECONOMY: AN OVERVIEW

2.6. Israeli policies determine flows of goods to and from WBG, as well as the access of Palestinians to Israel's labor markets. Security tensions between Israel and WBG have led to the emergence of barriers to trade in goods, as well as in admission of WBG workers to labor markets in Israel and foreign providers of technical services to WBG. These barriers stem from external closures combined with fixed and mobile security checkpoints inside the West Bank, the tightening of Israeli permit policies, and the security risks of traveling to WBG to provide services on site. Together they inflict substantial economic costs, both current (through raising transaction costs) and future (through forgone investment opportunities of integrating into external markets).

2.7. The combined negative impact of barriers on trade in goods and movement of people is more than their simple sum, albeit difficult to quantify. For instance, the direct loss of income by Palestinian workers in Israel can be approximated through restrictions in permits issued to Palestinian workers, but other effects are more difficult to estimate. The loss of income by Palestinian workers indirectly affects the economy through reduced expenditure on total production. Security concerns often prevent specialists from Israel and other countries from providing indispensable services—for instance, maintaining sophisticated capital equipment.³⁵ Similarly, in the absence of barriers to trade in goods and services, downward pressures on both wages and prices of nontradables would have created new business opportunities for exports and enhanced international competitiveness of domestic production. In the presence of barriers, these opportunities cannot be made real.

2.8. The overall impact of the existing security regime on the current cost of conducting business is substantial. Current effects include increased trading costs because of higher transport fees, longer delivery times, and other costs of unpredictability. Depending on the cost structure, that is, the share of these costs in total cost, a firm may remain competitive in both domestic and external markets, as a low share of these costs leaves more room for their accommodation. However, low utilization of industrial capacities (rarely exceeding 60 percent across major sectors of the economy) and bankruptcies indicate clearly that these are rare cases.³⁶

2.9. The main problem with quantitative estimates of the security regime is that its major impact is on activities that are unlikely to occur as long as these policies are in place. In contrast to existing firms, investors have to incorporate extra costs of shipments and higher costs of inputs because of closures in

³⁵ Before the second Intifada, companies were able to bring in Israeli and other foreign experts to provide needed services to maintain and repair machines. Owing to the security situation in WBG, this is no longer possible. Machine parts have to be shipped abroad for repairs, which significantly raises cost of production.

³⁶ For more detailed discussion see Chapter IV, as well as the second volume of this report.

their predicted rates of return. Existing firms may survive by merely generating revenues sufficient to cover their variable costs; investors considering entry would, however, take a strong look at prospects of having revenues sufficient to cover the opportunity cost of capital. In brief, the existing security regime suppresses new investments and erodes competitiveness of existing businesses, simply because closures make the following extremely difficult:

- *The shift from a currently dominant type of interindustry trade to intraindustry or intraproduct trade, associated with a more sophisticated division of labor based on narrow industrial specialization within global value chains.* Global value chains usually require short, predictable delivery schedules unattainable under the closures regime. In a nutshell, the security regime makes it very difficult, if not impossible, for WBG firms to participate in any global supply chains that require meeting tight delivery schedules (see chapter III for further discussion).
- *Attracting foreign and domestic investment in more sophisticated manufacturing.* This usually requires the use of imported inputs. Even if deliveries on tight schedules are not particularly relevant to a line of production, a firm usually has to maintain significant inventories of imported inputs to ensure smooth production operations. For instance, firms operating in the wood furniture industry now export and import only few times a year, which leads to high inventories of both inputs and final products (see chapter IV for further discussion).
- *Competing on a level playing field.* Because of extra costs imposed on local businesses and differential treatment of firms in WBG in accessing foreign markets, the security regime puts Israeli firms as well as other competitors in a far more advantageous position vis-à-vis their WBG counterparts. Moreover, local firms are small and use outdated technologies, whereas firms (including those from Israel) operate in larger markets, have access to modern technology and expertise, and therefore tend to have significant cost and productivity advantages over WBG firms (see section F below and chapters III and IV for further discussion).
- *Expansion of existing firms through tapping economies of scale.* Without easy access to external markets, firms operating in small markets cannot grow, as is the case in WBG economy, where most firms are small, family-owned businesses (see chapter IV for further discussion).

C. DECLINE IN LABOR FLOWS TO ISRAEL

2.10. Since the outbreak of the latest *Intifada* in September 2000, Israel has significantly tightened its policy of issuing work permits to Palestinians in Israel, contributing to higher levels of already high unemployment and depriving a significant portion of the WBG population of income. Furthermore, external closures, including through separation barrier,³⁷ have reduced the number of days worked in Israel or prevented employment opportunities in Israel, further suppressing Palestinian workers' incomes.

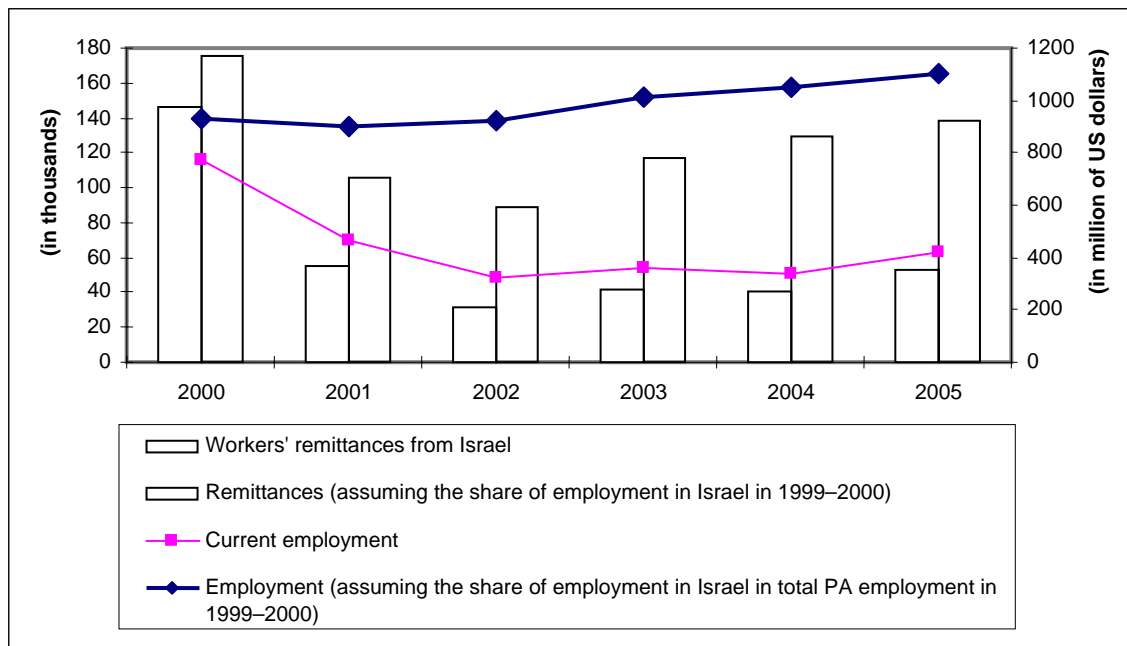
2.11. The employment of Palestinians in Israel fell from 146 thousand in the third quarter of 2000 to 43 thousand in the last quarter of 2000. So did the share in total Palestinian employment (both in Israel and WBG), from 22 percent to 9 percent. Although 2001 witnessed limited recovery (60 percent increase in employment over the last quarter of 2000), with the share of "Israeli" employment in total Palestinian employment rising to 15 percent during the first two quarters of 2001, the expansion did not continue. Since the last quarter of 2002, the share of employment in Israel in total WBG employment has stabilized around 10 percent. Yet the quarterly variation in Palestinian employment in Israel, as captured by the coefficient of variation, was significantly higher than in the WBG, indicating a stronger seasonal

³⁷ The World Bank's analysis of the PCBS labor force surveys suggest that employment in Israel and settlements among residents in governorates affected by the barrier declined faster than in other governorates (for detailed analysis see "Four Years - Intifada, Closures and Palestinian Economic Crisis", World Bank, October, 2004).

component of employment in Israel as well as the impact of external closures.³⁸

2.12. The loss of access to Israeli labor markets significantly reduced Palestinian workers' incomes, which—despite growing in 2004–05—stood at 36 percent of their 2000 level. Assuming that the share of “Israeli” employment in total WBG employment at the level registered in 1999–2000 (excluding the last quarter) remained unchanged in 2001–05, employment in Israel could have amounted to 165 thousand and earnings to US\$922 million in 2005, rather than 63 thousand and US\$351 million, respectively (figure 1). The difference in lost remittances from employment in Israel in 2005 amounted to US\$571 million. In total, because of permit restrictions, the total workers' earnings from work in Israel were US\$2.4 billion lower over 2001–05 than hypothetical remittances, assuming the level of employment determined by the share of this employment in total WBG in 1999–2000.

Figure 1. Employment and workers' remittances from Israel in 2000–05



Source: Remittances from Israeli Central Bureau of Statistics and employment as reported by PCBS.

2.13. External closures have exacerbated the negative impact of the decline in the number of work permits issued by the Israeli authorities. A stronger contraction in workers' earnings accompanying the falling employment in Israel reflects mainly the decline in the number of days worked because of external closures, as there are no indications of significant reduction in wages. For instance, had Palestinians worked the same number of days per year in 2005 and at the same average wage as they did in 2000, their earnings would have been US\$179 million higher, which can be roughly regarded as a lower estimate of the loss of income because of external closures in 2005 alone.³⁹ The overall income effect of the reduction in Palestinian employment in Israel would be much higher once the indirect impact of reduced

³⁸ The coefficient of variation of Palestinian quarterly employment (standard deviation to the average employment) over 2003–2005 in Israel was 13 percent, compared to 9 percent in the West Bank and 7 percent in Gaza.

³⁹ This is based on the following reasoning: Total annual workers' remittances per number of employed fell from US\$8.4 thousand in 2000 to US\$4.3 thousand in 2002, and rebounded to US\$5.4 and US\$5.6 thousand in 2004 and 2005. Since wages of Palestinians employed in Israel were not falling, the fall in remittances per employee can be attributable to the loss of days worked in Israel because of closures. The estimate is based on remittances per employee in 2000.

expenditure on total production and income is taken into account.

2.14. Hence, the total losses are substantial. As discussed above, these are due to the decline in employment of Palestinians in Israel by around half in 2002–05 in comparison to 2000, and the fall in remittances per employee attributable to a lower number of days worked because of closures. The estimated loss over 2001–05 because of lower employment amounted to US\$2.4 billion and because of closures to US\$928 million, with the total losses amounting to US\$3.3 billion (see table 1). In 2005 alone the total income lost because of lower employment and closures was US\$750 million—an equivalent of 58 percent of total aid of US\$1.3 billion provided to the Palestinian Authority in 2005.⁴⁰

Table 1. Estimated losses in workers’ remittances from Israel because of cuts in employment and closures in 2001–05 (in millions of U.S. dollars)

	2001	2002	2003	2004	2005	Total in 2001–05
Losses because of the fall in employment	342	385	500	588	571	2,386
Losses because of closures	222	200	178	149	179	928
Total losses	564	585	678	737	750	3,314

Source: World Bank staff calculations, based on data as in figure 1.

2.15. The loss of jobs in Israel that are higher paid than in WBG and very high dependency ratios in WBG have further exacerbated the negative impact of the Israeli security regime on economic welfare of the WBG economy. Whereas the wage differentials are likely to vary, the average wage earned by Palestinians in Israel is roughly two-thirds higher. Values of dependency ratios between 5.5 persons for West Bank and 8.2 persons for Gaza further amplify the cost of lost jobs in Israel: in relation to hypothetical employment estimates discussed in para.12, the loss amounting to around 100 thousand jobs in 2005 (as compared to the level assuming the 1999–2000 share of employment of Palestinians in Israel) directly affected the welfare of 600,000 to 800,000 people, or between 18 percent and 24 percent of the total population in WBG.

D. FREQUENCY AND DURATION OF EXTERNAL CLOSURES AND THEIR COST

2.16. The uncertainty inherent in security threats and their perception by Israeli authorities translates into highly unpredictable closure decisions, making their internalization by firms organizing their shipment schedules impossible. Unpredictability increases transportation costs. In the case of maritime transport, the standard deviation of 20 percent of transport time increases the transportation cost by nearly 45 percent.⁴¹ Since there is significant risk of a delay taking place, the transport operator takes it into account in fees charged for the longer delivery periods expected. For instance, in the case of prolonged closures, importers and exporters from Gaza experienced an almost tenfold increase in the cost of transport from the port of Ashdod to Gaza compared to that before the Intifada.⁴²

2.17. In circumstances of complete uncertainty concerning the length of time to deliver exports or obtain imports, producers relying on imported inputs bear the costs of increased inventories, as well as higher cost of transport, storage, and credit;⁴³ exporters face the risk of losing their orders because of delays in deliveries—importers and exporters of perishable agricultural products may lose their shipments completely. They both, however, incur additional costs for transport services and the cost of capital tied

⁴⁰ See West Bank and Gaza Update, Quarterly Publication of the West Bank and Gaza Office (World Bank, April 2006).

⁴¹ See E. Frankel, “The Economics of Total Trans-ocean Supply Chain Management,” *International Journal of Maritime Economics* (1999), Volume 1, Number 1, 61–69.

⁴² Before the Intifada this cost for transport of furniture was US\$250 per truck, whereas now it can cost as much US\$2,300 when security is tight (see the second volume, annex V of this report).

⁴³ Managers from food processing companies reported that movement into and within the West Bank and Gaza is so restricted that factories must keep up to six months of excess inventories on hand to ensure continuity of operations (see the second volume, annex III of this report).

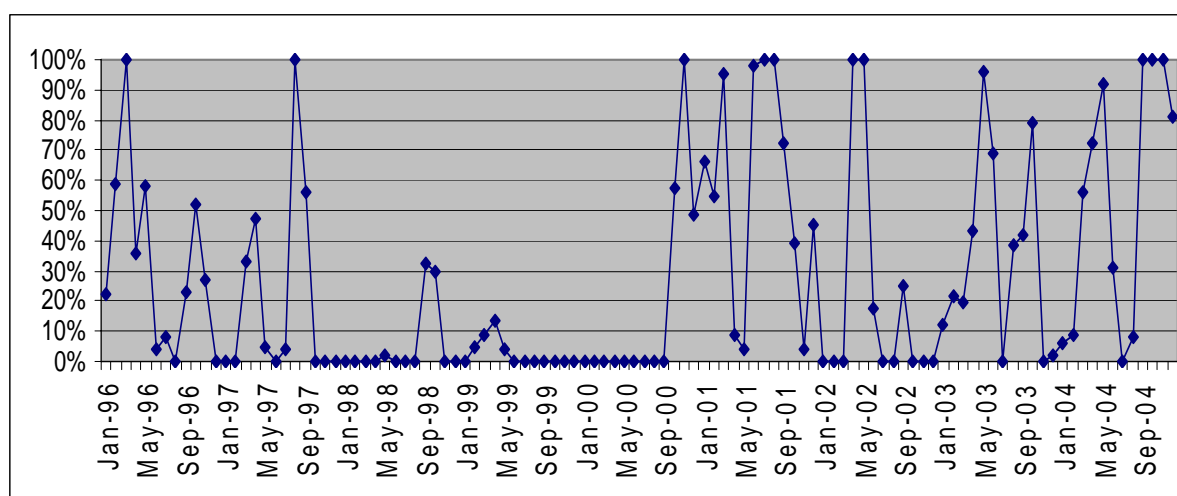
up in shipments. The largest costs are “development” costs to the economy, stemming from the fact that the high likelihood of experiencing such closure-related delays at a crossing point drastically reduces the range of feasible investment projects.

2.18. The remainder of this section seeks to shed light on the magnitude of losses associated with frequent and unpredictable closures incurred by businesses by estimating their overall impact on total WBG foreign trade, followed by a more detailed analysis of two empirical cases.

Increasing Frequency and Duration of Closures

2.19. Except for 1997–2000, closures were a constant feature faced by WBG traders since they were introduced back in 1993, with both their frequency and duration dramatically increasing following the outbreak of the Intifada in September 2000 (see figure 2). Between September 1997 and September 2000, closures were rare,⁴⁴ occurring on average only once every three months and of short duration. The probability of a closure taking place at least one day a month increased from 33 percent in 1997–2000 (first two quarters) to 78 percent after the outbreak of the Intifada.⁴⁵ Moreover, month-long closures occurred 12 times during this period, in contrast to only a single closure of this length in the pre-Intifada years 1997–2000.

Figure 2. Monthly trend of closures (January 1996 through September 2004)



Note: Left axis denotes the percentage of potential work days—defined as the number of calendar days excluding Saturdays, half-Fridays, and celebrated Muslim and Jewish holidays—lost because of closures.

Source: UNSCO database on closures.

2.20. Hence, the WBG exporter or importer is now very likely to wait for prolonged periods to get products through a crossing point to their final destination. The probability of a shipment “hitting a closure” once in a month increased from around one-third in 1997–2000 to 77 percent in 2000–04 (figure 3). Viewed daily, the probability of a trader facing a month with the number of closure days exceeding 18 days (excluding holidays) increased from a mere 4 percent in 1997–2000 to 25 percent in 2000–04.

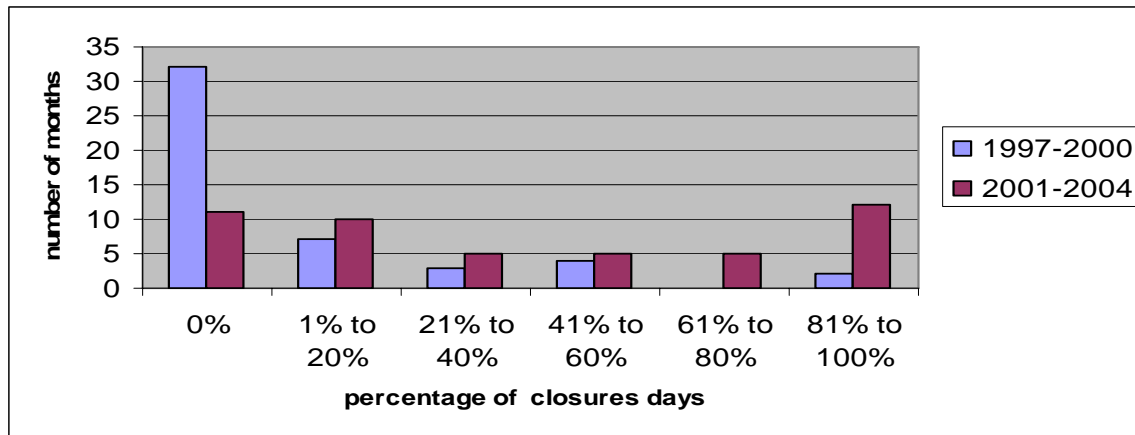
2.21. The high probability of outright closures makes shipments both within and outside the WBG very risky. The potential losses depend on product characteristics: these may range from losing the whole

⁴⁴ Closure days considerably increased from 1999 to 2003. In 1999, border facilities were closed for seven days, but in 2003 the figure reached 96 days after having peaked in 2001 to 159 days. Data for this period are available from the UNSCO database.

⁴⁵ During the 48 months between September 2000 and September 2004, there were only 10 months in which closures did not occur, whereas during the period 1997–2000, 32 months were unaffected by closures.

shipment (for example, perishable agricultural products) to the cost of capital tied up in a shipment (see section E). They also completely eliminate WBG producers from supply chains with short response times—for example, specialized garments or automobile parts.

Figure 3. Closure frequency 1997–2000 and 2000–04



Source: World Bank staff calculations, based on the UNSCO database on closures.

2.22. This “almost certainty” of experiencing closure-related delays at a crossing point drastically reduces the range of feasible investment projects relying on external links. As long as businesses face the prospect of their shipments being stopped at crossing points for unknown amounts of time, they are unlikely to undertake business activity—unless products are not sensitive to time and profit margins are substantial, to absorb cost of uncertainty. Very few sectors would ever be able to meet such demanding conditions. Even if one could predict closures with a very high degree of precision, frequent closures are unlikely to trigger a favorable investment climate or expansion of industrial output.

2.23. Although it is impossible to quantify activities that will never occur because of closures, some appreciation for the magnitude of losses inflicted on output for exports already produced and imports already consigned can be acquired in two ways: first, through estimates of the links between the duration of closures and the percentage of export and import flows that failed to go through; and second, by examining empirical cases of the actual direct impact of closures on magnitudes and costs of foreign trade. The following discussion presents such analyses.

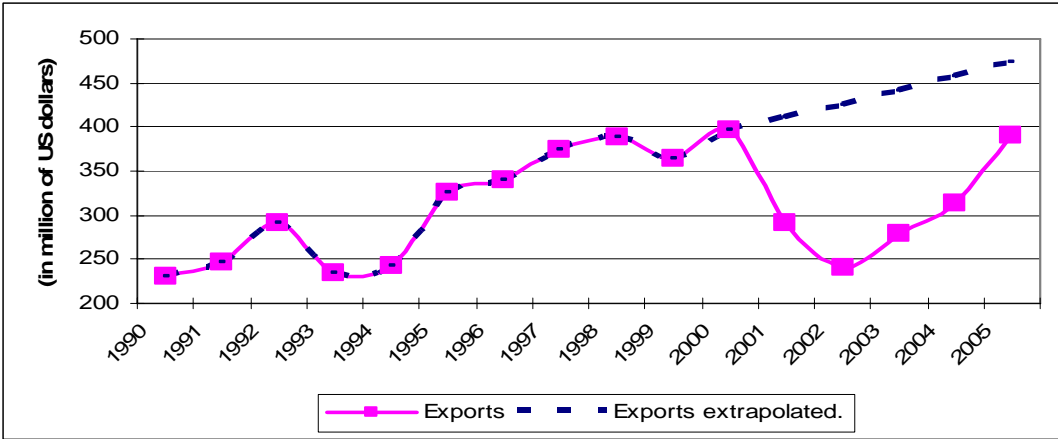
Aggregate Estimate of Lost Exports of Goods

2.24. Which portion of trade did not occur as a result of temporary breaks in access to external markets? Disentangling the impact of closures from those related to civil unrest, breakdowns in output, and the fall in import demand is not easy. On the import side, it is impossible to say which portion of the fall in imports was triggered by falling import demand and which was due to products that did not get to their destination because of closures. Except for perishables, one may assume that contracted imports were realized, although likely at higher prices. Furthermore, the WBG importer faces a set of circumstances different from those faced by an exporter: the latter has to compete with firms that do not operate in similarly restraining conditions and has to incur higher transaction costs because of existing security measures. Most important, the exporter will lose export orders if it is not competitive in terms of quality and prices. In contrast, an importer competes with other firms operating under the same set of conditions and similar trading costs. The importer will not lose its business to an outsider because of the extra costs with which each business has to cope.

2.25. For these reasons, our analysis focuses on goods exports lost because of closures. The challenge of estimating losses is, however, similarly daunting simply because foreign importers of WBG products can choose from a wide range of foreign suppliers. There are no data available on the number and value of contracts cancelled owing to the unpredictability of deliveries. More important, one may only speculate as to the value of contracts not awarded because of uncertainty concerning deliveries. The contraction in exports was not only due to closures but also to difficulties in sustaining production activity during the civil unrest. Furthermore, many industrial sites were either damaged or destroyed. Thus, the supply side was also negatively affected not only by closures but an overall unstable environment that is rarely, if ever, friendly to business activities.

2.26. The cost in terms of lost export sales because of the deterioration in Israeli-WBG security relations is estimated as follows: We assume that had there been no second Intifada, the exports would have grown at historical rates. The difference between exports assuming the continuation of earlier trends and their actual values provides an indication of an overall impact of developments during the Intifada including closures and other disruptions. For instance, hypothetical values of export derived from extrapolation from the trend observable during the period of very low occurrence of closures in 1997–2000 and actual values indicate that overall impact in terms of lost export sales was rather dramatic (figure 4). During 1997–2000, exports grew at an average (least square) rate of 3.5 percent per year. Had they continued growing in 2001–2005 at this rate, their value would have been US\$121 million, or 42 percent higher than the actual value in 2001, US\$185 million or 78 percent higher in 2002, US\$161 million or 58 percent in 2003, US\$144 million or 46 percent higher in 2004, and US\$83 million or 21 percent higher in 2005. The difference between extrapolated and actual values of exports cumulative over 2001–05 amounted to US\$693 million.

Figure 4. Total and extrapolated exports in current prices in 1990–2005 (in mln of current US dollars)



Source: World Bank staff estimates, based on data provided by the PCBS.

2.27. However, the difference between hypothetical and actual export performance covers all adverse factors following the outbreak of the Intifada. Closures were only one of many such factors. Hence, an interesting question is about a portion of these lost exports that can be attributable directly to closures, that is, temporary breaks in access to external markets. As discussed earlier (see paragraphs 24 and 25 above), any estimate of export losses because of closures will be merely a ballpark figure, underrating their overall impact. In what follows, we attempt to estimate the direct impact on exports that were either already shipped, or about to be shipped and never delivered because of closures. This analysis modifies

the assumptions of earlier World Bank estimates that dealt with the same issue.⁴⁶ Since 1999 had the lowest number of days of closures, and it was the year before the Intifada began, we use it as a benchmark for our estimates. We compare exports during the month during which no closures occurred in 1999 with that same month in 2003: their value was 30 percent lower in 2003. Furthermore, we assume that some portions of exports are lost (albeit not all of them), either because of delays or—over a longer period—cancellation of orders by a foreign importer because of continual delays. When terminals are open more frequently, as happened in 2003 and in 2004, some export activities resume. Nevertheless, overall we can estimate that at least 30 percent of export capacity disappeared between 1999 and 2003.

2.28. Even those highly conservative estimates show a significant cost in terms of lost exports. Without closures, exports would have been 5 percent higher than actual exports in 2000, 23 percent higher in 2001 and 15 percent in 2003 (table 2). Losses because of closures accounted for 55 percent of the difference between the values of extrapolated and actual exports in 2001; they fell to 13 percent in 2002 and again rose to 25 percent in 2003.

Table 2. Exports lost because of closures in relation to actual and hypothetical exports in 1999–2003 (in millions of U.S. dollars and percent)

	1999	2000	2001	2002	2003
Lost exports (in millions of U.S. dollars)	3	20	67	23	41
Lost and actual exports in percent of actual exports	100.8	105.0	123.1	109.7	114.5
Export loss in percent of actual exports	0.8	4.8	18.7	8.9	12.7
Export loss in percent of difference between extrapolated and actual exports	0	0	55.4	12.6	25.2

Source: World Bank staff estimates using data from the UNSCO database for closures and PCBS for exports.

2.29. Exports were not the only victims of closures. Imports were also affected, although losses in that case were directly related to perishables, and indirectly to the loss of access to imported inputs indispensable to exports that never occurred because of it. Developments associated with the closure of the only outlet for Gaza’s exports, the Karni terminal, summarized below, offer some insights illustrating the scope of the problem.

Gaza’s Lost Trade after Israel’s Disengagement

2.30. Because of security tensions between Gaza and Israel, the expected positive economic effects from Israel’s disengagement from Gaza in September 2005 have so far failed to bear out (box 1). On the contrary, the worst-case scenario has unfolded. The only “window to the world” available to Gaza traders, the Karni crossing at the border with Israel, has become more volatile in handling cargo and has been closed for prolonged periods, inflicting large costs on the Gaza economy. The number of trucks crossing the Karni terminal during September–November, 2005 peaked on the disengagement day (that is, September, 12th, 2005), reaching 46—a rather low figure compared to the estimated capacity of Karni terminal at 150 by the World Bank (without additional security equipment). Overall, the performance of Karni crossing remained at its lowest (with long periods of complete closures) during January–June, 2006 and well below what is envisaged in the November 15th, 2005 Agreement on the movement and access of goods (see box 1).⁴⁷

⁴⁶ Ishac Diwan and Radwan A. Shaban, “Development Under Adversity: The Palestinian Economy in Transition” (1999).

⁴⁷ For an assessment of capacity utilization, see *AlMontar Terminal Performance Brief Reports*, Paltrade, available at: www.paltrade.org/Publications/AlMontarPerformanceReport.pdf.

Box 1. Unrealized benefits of November 15th Agreement on Israel's disengagement from Gaza

Although the main consequence of Israel's disengagement was elimination of internal fragmentation in Gaza because of internal restrictions on movements of goods and persons, the benefits stemming from "internal consolidation" to the economy critically hinge on the opening of terminals to Gaza exports. The November 15th Agreement has addressed this issue by identifying two outlets for Gaza's foreign trade—Karni (the Israeli border) and Rafah (at the Egyptian border).

Concerning the Rafah crossing, the provisions of the Agreement envisaged operation of the Rafah crossing by the Palestinian Authority on its side under the supervision of a third party, the EU. They also envisaged allowing the use of the Rafah crossing for Gaza's exports of goods, but only to Egypt.

The provisions concerning Karni, the major channel for Gaza's exports to both Israel and other destinations, envisaged significant progress in facilitating trade flows through keeping the passage operating continuously and expanding "the number of exports trucks per day to be processed through Karni [...to] 150, and 400 by end-2006." Furthermore, the Agreement stipulated that "... Israel will permit export of agricultural produce from Gaza and will facilitate its speedy exit and onward movement so that quality and freshness can be maintained."

Last but not least, the Agreement also refers to the link between West Bank and Gaza, Gaza seaport, and the airport. The Agreement states that "construction of a seaport can commence."

The Agreement has not been implemented and Gaza is woefully lacking a good trade facilitation infrastructure. The Karni crossing has often been closed. On the other hand, the Rafah crossing is operational, although exports through Egypt remain hostage to the absence of transit arrangements with Egypt for goods originating in Gaza.

2.32. The frequent closure of Karni terminal imposed major costs on Gaza exporters. The timing of five weeks closure during January–February 2006 was particularly bad, as one-fourth of Gaza's annual agricultural production is harvested in January, with the bulk of it exported to the EU to take advantage of seasonal factors (that is, the lack of locally produced fruits at this time of year in the EU). The closure cost, on average, more than US\$246 thousand per day in terms of lost agricultural exports, or around US\$4 million over 16.5 days when the terminal was closed (table 3). For instance, producers of strawberries from Gaza were unable to deliver 500 tonnes of contracted exports with a farm gate market value of at least US\$2 million.⁴⁸ The loss might have been avoided had they been able to use the Rafah crossing-point to export strawberries through Egypt. Although strawberry suppliers faced with the total loss of their harvest would pay any price below the contracted price for delivery, rerouting through Egypt now appears—contrary to an earlier assessment⁴⁹—to be a viable option, at least for perishable products (see box.2).

⁴⁸ For a detailed discussion, see the second volume, annex II of this report.

⁴⁹ The losses owing to the rerouting of trade through the Aqaba and East Port-Said ports instead of Israeli ports, estimated at US\$60 million per year, were based on two assumptions that no longer hold: first, that Palestinian exporters would benefit from the same treatment as Israeli exporters and importers in Israeli ports and airports; and second, that Karni and other crossings would be open. See *Transit Trade and Maritime Transport Facilitation for the Rehabilitation and Development of the Palestinian Economy* (UNCTAD), Geneva 2004.

Box 2. Cost of exporting strawberries from Gaza through Egypt

Although both land transport costs and port charges are lower in Israel than in Egypt's East Port-Said, the latter now appears to be a better option when other factors are taken into account, e.g. for perishable products.¹ These factors include product damage, estimated *very conservatively* at US\$680 per container (5 percent of container load) in taking the value of a ton of strawberries as paid by Agroexco of US\$4,000 per ton, or US\$13,600 per container (or five percent of its value), as well as the difference between respective costs in relation to the value of a shipment in a container.

Box Table 1. Total transport costs for an export container of strawberries from Gaza to the EU (in US\$ per container weighing 3.4 tons)

	Land transport costs	Port charges	TOTAL	Product damage	TOTAL	Total in % of the value of shipment
Option 1: Israel	751	65	816	680	1,496	11.0
Option 2: East Port-Said	1,159	105	1,265		1,265	9.3

Source: Transit Trade and Maritime Transport Facilitation for the Rehabilitation and Development of the Palestinian Economy (UNCTAD, Geneva 2004) for option 1; and Egyptian freight forwarder for option 2 (land transport costs).

Notes: 20' container weight equals to 3.4 tons; its farm gate value is US\$13.6 thousand.

The Egyptian route is more competitive for perishable products than the Israeli route, provided that two conditions are met:

- Shipments through Egypt are subject to the transit regime in line with international rules.
- Exports leaving Gaza for Egypt are not subject to back-to-back system screening.

1/An ongoing World Bank study will soon be providing a comprehensive analysis on this issue.

2.33. As can be seen from table 3, the shipments from Gaza during this period of border closure were not limited to agricultural products, which accounted for 40 percent of the total value of shipments stranded in Karni. The rest were industrial products, which probably suffered relatively lower losses in export revenues as these are not perishable products. However, they, experienced significant opportunity cost of capital tied up in shipments stuck at Karni for periods up to 16.5 days, estimated—at a five percent interest rate—to amount to 0.2 percent of their value over this period. More important, however, as argued earlier, the bigger loss to producers of these products may come from cancelled orders.

Table 3. Estimates of lost export revenues in Jan. 15–Feb. 3, 2006 border closure

Sector	Average units exported/day	Unit	Value (in US\$/unit)	Daily lost exports (in US\$)
Strawberries	50	Tons	1,728	86,393
Cut flowers (carnations)	500	1000 stems	65	32,397
Gaza Agri. Project (various products)	22	Tons	845	18,590
Other agricultural products	194	Tons	550	106,700
Lost revenue from agriculture				4,027,320
Textile and garment	8	truckloads	20,000	160,000
Furniture	7	truckloads	15,000	105,000
Scrap metal	2	truckloads	10,000	20,000
Other industrial products	4	truckloads	22,000	88,000
Total daily lost export revenues				617,080
Total lost export revenues in Jan. 15–Feb. 3, 2006				10,181,828

Source: Information provided by Paltrade

The Case of a Furniture Producer in WBG

2.34. The case discussed below, illustrating the impact of uncertainty in deliveries and shipments on transport cost and profitability of furniture exports, has wider implications for at least three reasons. First, the furniture industry has developed significantly in Gaza, accounting for a relatively large sector of Gaza's economy today—in 2005, it included more than 600 establishments employing more than 5,500 people. Second, the sector is highly dependent on imports and, to lesser extent, on exports. Imported inputs account for almost 98 percent of raw materials coming from abroad, whereas exports make up an estimated 15.5 percent of production, most of which is destined for sale in the Israeli market. But overall, fewer than 50 furniture manufacturers are engaged in export activities, and very few of them have successfully exported directly to markets outside Israel.⁵⁰ Third, it shows the lack of prospects for future development. More and more, furniture production has been organized around large multinational retailers (for example, Ikea) establishing value chains across continents and countries. Participation in furniture global value chains hinges critically on the smooth functioning of services, including movements across borders, linking various production processes spread across the globe. Uncertainty in deliveries of parts and final products may effectively preclude manufacturers from becoming part of a chain.

Table 4. The impact of uncertainty on transport costs: An example from the wood industry in Gaza

Furniture parts	IMPORTS OPEN		IMPORTS CLOSED	
	Costs (in NIS)	In % of Load Value	Costs (in NIS)	In % of Load Value
Total Transport Costs	6,355	16.9	10,855	28.9
<i>of which:</i>				
Maritime transport	2,600	6.9	2,600	6.9
Port charges	1,875	5.0	1,875	5.0
Insurance	140	0.4	140	0.4
Ashdod-Gaza	1,500	4.0	6,000	16.0
Costs at Karni	240	0.6	240	0.6
Truckload value	37,500	100.0	37,500	100.0
Furniture	EXPORTS OPEN		EXPORTS CLOSED	
	Costs (in NIS)	In % of Load Value	Costs (in NIS)	In % of Load Value
Total Transport Costs	6,550	9.4	14,050	20.1
<i>of which:</i>				
Maritime transport	3,600	5.1	3,600	5.1
Port charges	0	0.0		0.0
Insurance	210	0.3	210	0.3
Gaza-Ashdod	2,500	3.6	10,000	14.3
Costs at Karni	240	0.3	240	0.3
Truckload value	70,000	100.0	70,000	100.0

Source: DAI (Development Alternatives, Inc.) Gaza.

2.35. The prolonged closures forestall participation in global value chains and increase the costs of doing business in this sector. Table 4 presents data assessing the impact of closure of the Karni crossing point on a producer of furniture in Gaza, which relies on imported inputs from Slovenia and exports to the EU. When Karni crossing is open, allowing for smooth movement of goods through the border crossing with Israel, total transport costs of imports from Slovenia into Gaza are 17 percent of import value; total transport costs of exports amount to 9 percent of the value of exports. On balance, total transport costs (NIS12,905) amount to 40 percent of the difference between the value of exports and the value of

⁵⁰ For a detailed discussion, see the second volume, annex V of this report.

imported inputs (NIS32,500), which approximates the value-added created in Gaza.

2.36. The profitability picture changes rather significantly when Karni crossing is closed. Traders estimate that in the case of closures lasting more than a week, land transport cost increases up to four times the “normal” cost, as importers and exporters have to pay extra charges for shipments stuck at the terminal. The computations presented in table 4, assuming a four-time increase in transport charges because of a one-week closure, demonstrate the degree to which prolonged closures cut into the value-added remaining in Gaza. These extra costs amount to 77 percent of the value added in the Gaza Strip. This drastically reduces profit margins, especially since higher land transportation costs are not the only costs incurred by a producer of furniture because of a closure. Part of the uncertainty is absorbed by raising inventories of imported inputs, but this comes at a price.

Conclusion

2.37. In summary, uncertainty associated with closures have three main intertwined effects for merchandise trade in a short- to medium-term perspective: First, closures decrease value-added remaining in the West Bank and Gaza because producers and consumers import at higher prices and companies export at lower prices. Closures therefore erode competitiveness because, when WBG exporters must include higher transportation costs and extra transaction costs in their selling price, their prices may become uncompetitive in external markets.⁵¹ Second, closures may compel producers of agricultural products to shift from higher value-added perishable exports to lower value-added products produced for domestic markets.⁵² Last but not least, prolonged closures erode further existing export capacity by leading to bankruptcies of WBG companies.

E. FRAGMENTATION OF THE WEST BANK ECONOMY: IMPACT OF CHECKPOINTS AND INTERNAL CLOSURES

2.38. Although WBG is effectively a landlocked economy today, in the case of Gaza this is solely because of political arrangements restricting external access to land crossing points after the Israeli disengagement last September. In addition, the economic space of the West Bank is chopped up into small pieces because of the system of internal fixed and mobile checkpoints. Checkpoints and internal closures as well as ongoing construction of the Separation Barrier⁵³ within the West Bank not only erect a huge barrier to future economic development but also significantly affect current economic activity especially (albeit not exclusively), in the agricultural sector. Rural communities in the West Bank have traditionally depended very strongly on urban localities for trading activity, employment, purchasing food and household supplies, and for access to services. Closures have affected these ties, with their negative impact particularly visible in transportation costs.⁵⁴

2.39. The increase in transportation costs was spread over five years of extensive closures, and increases have been “internalized” over time. Compared with 2001 and 2002, the difference between transport price inflation (a proxy for transaction costs) and overall consumer price inflation dropped in 2003 and 2004 and was negative in 2005, suggesting no further aggravation in movement restrictions last year (figure 5).⁵⁵

⁵¹ According to textiles and garments producers, the cost of using Israeli ship forwarders adds 10–25 percent to the cost of raw materials (see the second volume, annex IV of this report).

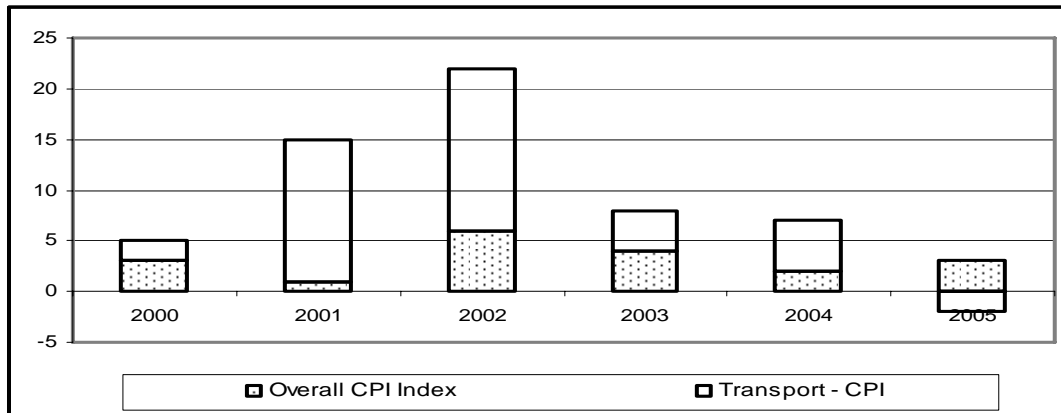
⁵² See the second volume, annex IV of this report.

⁵³ The construction of the barrier affects some of the most fertile agricultural lands in the West Bank, estimated to produce, on average, US\$16.4 million in gross agricultural output annually; its agricultural value added (contribution to GDP) amounted to USD 9.6 million annually (World Bank staff calculations; for more detailed discussion see second volume, annex II of this report)

⁵⁴ See the second volume, annex IV of this report.

⁵⁵ West Bank and Gaza Economic Monitoring Note (World Bank, April 2006).

Figure 5. Change in CPI index and in transportation Cost relative to CPI 2000–05 (in percent)



Source: World Bank staff estimate.

2.40. Nevertheless, the change in transportation cost relative to CPI does not take into account the closures-induced decline in the (total factor) productivity level of the transport sector by about 33 percent since the outbreak of the Intifada. In consequence, a truck that was able to make three rotations per day before the Intifada now makes only two.⁵⁶ This has significantly raised unit transportation costs.

2.41. Indeed, the picture that emerges from interviews of transport companies is bleaker than aggregate data would suggest. By restricting access to major agricultural trading centers such as Nablus, Jenin, and Jerusalem, closures have dramatically raised transportation costs in the West Bank. Based on interviews with drivers of two major Ramallah-based companies, transport costs alone have gone up more than 100 percent along major trading routes, compared to the pre-Intifada period (see box 3).

Fragmentation of Markets for Agricultural Products

2.42. Increased transportation costs clearly contribute to fragmentation of markets in the West Bank. Together with the prohibition on Israeli traders purchasing directly from Palestinians within the West Bank and other internal restrictions, higher transportation costs have altered the geographic pattern of internal trade. They have led, for instance, to the relocation of wholesale agricultural trade from Nablus to Beta, Farah, and Badan in the West Bank.

2.43. However, another major lever contributing to the divergence of prices of agricultural products among major trading centers in West Bank, which in itself is an indication of significant fragmentation of the local economic space, is the uncertainty of closures. Thanks to communication technology, traders are aware of the price differences. Yet, they do not act on this information because of the risk of a shipment being stopped at an internal crossing point for an unknown *a priori* time. In the case of perishables the stakes are high, as the whole shipment may be lost if traders are not sure they will be able to deliver their stock before it perishes.

⁵⁶ Ibid.

Box 3. Estimated increase in transport costs along major trade routes in the West Bank

Interviewers with two major Ramallah-based transport companies point to a substantial increase in transportation costs along major trading routes in West Bank since the outbreak of the Intifada. Box table 2 presents estimates that attempt to capture costs of increased travel distance during the Intifada years. To provide proxy costs generated by an increase in travel distance alone (as distinct from other factors increasing transportation costs, such as increases in fuel prices and labor costs), we assume the same 2005 fuel and labor costs for pre- and post-Intifada years. Concerning the fuel costs, it is assumed that NIS4.4 per liter, with the fuel consumption of a truck of 5 km per one liter, applied to estimates for both pre-September 2000 and December 2005 periods. As for labor costs, they include additional time spent by one driver, assuming a monthly salary of NIS2,200 and a work week of 48 hours (192 hrs a month) for the periods pre-September 2000 and December 2005. However, because of the back-to-back system screening, longer waiting times, and uncertainty, companies now send more than one driver. We do not factor in additional labor costs for additional drivers, since they are associated with increased uncertainty as distinct from increased travel distances alone. The estimates presented below do not take into account the resulting fall in the total factor productivity of the transport sector (para 36).

Box Table 2. Increase in transport costs along major trade routes because of larger distances in Dec. 2005

From Ramallah	Pre-September 2000			December 2005 Alternative Route # 1				December 2005 Alternative Route #2				
	Time	Distance	Cost	Time	Distance	Cost	% change in cost over pre- Sept. 2000	Time	Distance	Cost	% change in cost over pre- Sept. 2000	
To:												
Bethlehem	35	25	29.1	90	80	86.0	195%	210	105	130.4	348%	
Nablus	60	50	54.4	90	60	68.6	26%	180	90	111.8	105%	
Jenin	90	90	94.6	210	140	160.5	70%	420	200	252.2	167%	

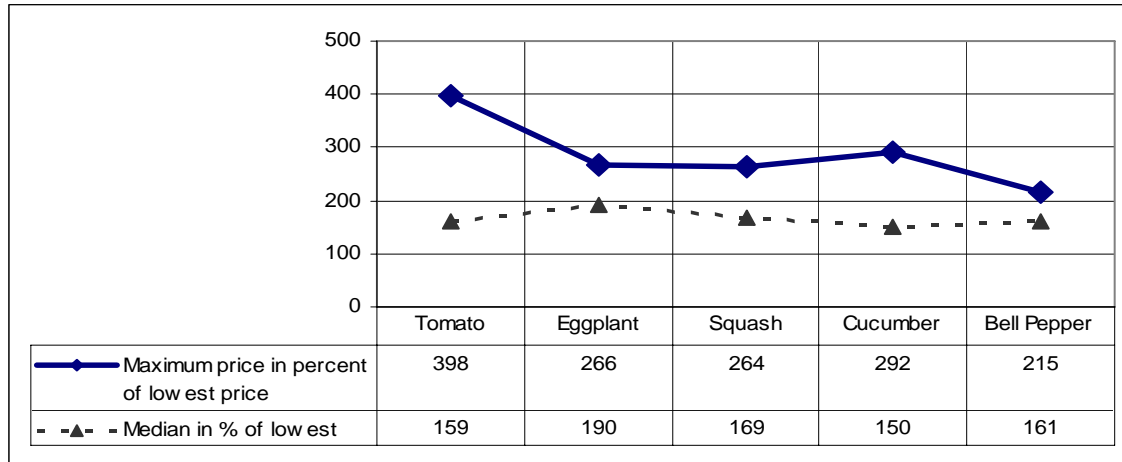
Source: World Bank staff calculations.

2.44. As a result, the price differentials may be very high as the review of prices of selected agricultural products in several localities across the West Bank, reported on February 15, 2006, clearly shows.⁵⁷ Differences between highest and lowest retail prices of tomatoes, eggplant, squash, cucumbers, and bell peppers ranged between 400 percent and 215 percent (figure 6). Prices in Ramallah were on average 79 percent higher than in Nablus, even though the two markets are only about 40 kilometers apart. Since on February 15 the closures were not particularly severe, this is a clear sign that markets for agricultural produce within the West Bank do not operate normally, mainly because of uncertainty regarding the timing and duration of closures.

2.45. Indeed, for the agricultural products presented in figure 6, uncertainty of closures rather than transportation costs is the main reason for price gaps between various markets in the West Bank. In February 2006, transport costs were roughly between 4 percent and 17 percent of the retail value of vegetable consignments. Even the cost of transporting a consignment from Bethlehem to Gaza amounted to 13 percent of its retail value. An extra 13 percent added by transportation costs pales in comparison to two- and fourfold differences in prices between local markets. Had the transport cost been the only factor taken into account by traders, they would have moved products from markets with the lowest price to those with the highest ones.

⁵⁷ The information for this analysis was obtained through a small survey conducted by the World Bank on February 15 across several markets in West Bank with assistance from Ministry of Agriculture.

Figure 6. Retail prices per kilogram on February 15, 2006 in 11 towns and cities in West Bank (in percent)



Source: World Bank and Ministry of Agriculture estimates.

F. OTHER COSTS OF “BEING A PALESTINIAN BUSINESS”: EXTRA TRADING COSTS RELATED TO THE SECURITY REGIME

2.46. How does a Palestinian business compare to an Israeli business in terms of imports and exports? Although both operate in the same trading zone or Israeli customs envelope, closures is not the only differentiating factor between them. For security reasons, their shipments face different border procedures and Israeli businesses do not confront “internal economic” borders. In consequence, WBG businesses face significantly larger transaction costs than their Israeli counterparts, although their impact on the cost of imported products varies depending on their unit values. Low value, bulky products are more affected.

Differential Treatment Within the “Customs Envelope”: Ports of Entry and Exit

2.47. Although Article III (13) of the Paris Protocol states that “the import and export of the Palestinians through the points of exit and entry in Israel will be given equal trade and economic treatment,” the reality is different. Whereas the location of a firm within the “customs envelope” might imply similar exposure of firms in WBG and those in Israel to competition from imports and similar conditions in accessing foreign markets, the security regime puts Israeli firms in an advantageous position vis-à-vis their WBG counterparts.

2.48. Differential treatment starts at the entry of imports. Although shipments destined for Israel and WBG are subject to the same procedures by the virtue of a customs envelope, they tend to be treated differently already at the port of entry into Israel. Higher costs do not depend on the mode of transportation—that is, by sea or air: clearance of shipments usually takes a longer time, justified in terms of security. Israeli imports face a “risk” of security checks amounting to 15–20 percent, whereas WBG importers face the “certainty” of security checks: all shipments destined for WBG are subject to security procedures. Cargo dwell time is one or two days for Israeli importers and at least one week for a WBG importer. According to a study by the Federation of Palestinian Chambers of Commerce, Palestinian companies exporting through the port of Haifa (as well as at Ashdod Port) faced higher costs (18 percent) and longer delays (20 percent) than comparable Israeli companies, whereas importers incurred higher costs (11 percent) and experienced much longer delays (52 percent) than Israeli companies in 2001 (FIAS 2002). Nothing indicates that the situation has changed for the better since the survey was conducted.

2.49. At Ben Gurion airport, WBG importers and exporters also face rather costly discrimination: In contrast to their Israeli counterparts, they must use dedicated cargo planes, as they are banned from using passenger planes (with some space dedicated to cargo). This is significantly more expensive, as wide-bodied passenger planes have large (often not fully used) cargo space available at attractive freight rates.

2.50. On top of the opportunity cost of capital tied up in a shipment, other expenses add up to extra costs. Containers and partial shipments weighing up to 10 tons landed in Israel may be stored free of charge at the port, or placed in public bonded warehouses or other places approved by customs for a period up to four days only. Subsequently, they are subject to a port storage fee with additional charges applied after 30 days. Containers weighing more than 10 tons are charged after six days. Other places approved by customs often include the premises of an importing firm, but only if the firm is in Israel.

2.51. Another form of asymmetrical treatment regarding WBG importers is that they are not allowed to run wholesale operations in either Israeli or WBG markets. In contrast to Israeli importers, WBG importers are required by Israeli authorities to sign a pledge that they will not sell their imported goods in Israel.

2.52. In sum, the security arrangements discriminate against WBG shipments in points of entry and exit in Israel, wiping away benefits that would be usually associated with deeper integration with a much more developed economy. They not only curb the capacity of WBG firms to compete in international markets but also subject them to competition from Israeli firms on an unequal footing. These conditions discourage entry of new firms and investments in WBG.

2.53. In addition, they also provide incentive to imports through Israeli intermediaries, although the scope of these indirect imports resulting in customs revenue losses to the WBG is difficult to estimate. To avoid paying extra costs because of border security measures, many firms directly purchase goods imported into Israel by Israeli firms. Palestinian importers of telecommunications and other high technology products resort to Israeli intermediaries. The cost of use of Israeli middlemen is some indication of extra costs incurred by importers because of security measures. Garment producers buying through these channels estimate that these costs amount to 10 to 25 percent of the value of imported materials. Since freight forwarding is highly competitive sector in Israel, this is probably a fairly accurate estimate of these costs.⁵⁸

Differential Treatment within the “Customs Envelope”: Back-to-back Transit Arrangements

2.54. Back-to-back transit arrangements further exacerbate developmental and welfare losses to the WBG economy. On top of less favorable treatment at the border, WBG inbound and outbound shipments face other costs. Both exporters and importers from WBG are confined to the use of Israeli transport companies when goods are destined for WBG or leaving WBG through Israel. Furthermore, shipments have to be reloaded at the crossing points with Israel and subjected to screening procedures.

2.55. Back-to-back transit arrangements further add to costs, not only because of extra unloading and loading operations but also because of extra time and possible losses in quality as a result of rough handling. In a nutshell, delays and rough handling caused by the back-to-back procedures affect timeliness and product quality. According to vegetable exporters from West Bank, the back-to-back transit arrangements imposed on the West Bank since October 2005 have added 24-hour delays.⁵⁹

2.56. The back-to-back system increases the cost of transportation for both finished products and raw

⁵⁸ For detailed discussion on selected industries, see the second volume, annex IV of this report.

⁵⁹ World Bank staff estimates.

materials. According to one estimate,⁶⁰ the added costs of transport are as follows:

- The transfer of products for raw materials from one trailer to another costs about NIS350 to 400 (US\$75–US\$86) because of additional handling and increased trailer costs.
- Waiting in line at the checkpoint and demurrage, as well as delays because of closure and security checks (as discussed in the preceding sections) increases costs.
- In the case of bulk materials, associated costs are even more important because of product damage during the loading and unloading process.

Conclusion

2.57. While it is impossible to come up with a single estimate of extra costs faced by businesses located in WBG, as many of these costs are constant (that is, not directly linked to the value of shipment), the discussion should leave no doubt that an Israeli firm operating in the same sector is much better situated than a WBG business to compete successfully in external markets, including those in WBG. It is less protected against competition from imports, as the cost of moving the same imports adds up to a higher level of protection for a similar WBG firm. But even assuming that their respective outputs do not require imported inputs, an Israeli firm has an important advantage over a WBG firm: even if it has higher costs, it can compete in WBG markets, whereas a WBG firm with a similar cost structure would be unable to compete in Israeli markets because of higher trading costs owing to discriminatory procedures at the crossing points and back-to-back operations.

2.58. The disadvantage of a WBG firm in terms of its capacity to compete in Israeli markets grows when its production requires imported inputs. It then has to absorb the higher cost of both imported inputs and shipments to external markets than does a similar firm in Israel.

G. CONCLUSIONS AND RECOMMENDATIONS

2.59. Israeli security measures, increased in response to the Intifada, have imposed a major cost on the WBG, heavily undercutting its current and future developmental capacity. The direct current cost relates to the reduction in the number of permits issued by the Israeli authorities to Palestinians to work in Israel; the lower number of days worked in Israel; the uncertainty of closures, and other measures affecting Palestinian imports (back-to-back arrangements and extra security measures). Cumulative losses over 2001–05 run in billions of dollars, with those due to lost income by the Palestinian workers in Israel estimated at more than US\$3 billion towering over the others. Cumulative loss in export earnings over this period estimated at not less than US\$693 million. Other current losses are more difficult to capture, although it can be safely assumed that the costs of imports increased considerably as a result of Israeli security measures.

2.60. More important, the current security regime eats away at the capacity for growth. It not only undercuts the competitiveness of existing businesses but also dramatically curtails the range of feasible investment opportunities in WBG. In the absence of security measures, unfettered access to markets of such a highly developed economy as Israel would be a powerful magnet for domestic and foreign investments alike.

2.61. Hence, although there is an unfinished agenda for improving the quality of governance and business climate, reforms will have limited impact on WBG economic development unless they simultaneously remove security measures affecting movements of goods and persons between Israel and WBG and within the West Bank.

⁶⁰ Saad Khatib, *Trade and Transport Facilitation Audit* (Paltrade, Ramallah 2005).

2.62. The steps that need to be taken do not belong to economics, although cooperation in security matters between the Palestinian Authority and Israel would yield huge economic gains. A systematic rethinking of the balance between security and trade facilitation of border crossing facilities might be an important first step.

2.63. Other smaller measures also belong to the realm of politics. The Gaza Strip, for instance, is a landlocked economy politically, but not geographically. Leaving aside the contentious issue of opening its seaport and airport, another option would be to make the Rafah Agreement effective to open it to exports through Egypt. This would in turn require undertaking high-level negotiations with the Egyptian government to discuss a transit regime from Rafah crossing to East Port-Said port or Al-Arish.

CHAPTER III

PROSPECTS FOR EXPORT-LED GROWTH

A. INTRODUCTION

3.1. The West Bank and Gaza (WBG) economy is not a typical economy facing standard developmental challenges. The government, an indispensable component of a modern market economy, has been in place only since 1994, with its powers drastically curtailed—it is a “self-government” that has control over neither its borders nor its territories.⁶¹ Furthermore, since there are internal borders not only between Israel and WBG but also between West Bank and Gaza, the WBG is de facto a two-layered, if not multiple-layered, economic space as traders face multifarious internal checkpoints (see chapter II). The Oslo Protocol “safe passage” linking Gaza with the West Bank is no longer in place. Border controls are for security, not economic reasons, as both territories fall under a single customs “envelop,” have comparable VAT rates, and Israeli customs authorities collect all border charges on external imports into WBG. Delays and uncertainty at the border crossings, rigid routings of goods, and the necessity to use Israeli trucks in transit through Israel all create a highly fragmented economy.

3.2. The “Protocol on Economic Relations” (commonly called the “Paris Protocol”⁶²) signed in 1994 did not give the Palestinian Authority (PA) control over its external economic policy. It, however, has laid the framework for deep integration (North-South type) of WBG into the Israeli economy, extending not only to tariffs but also to taxes and potentially to other areas, including technical standards. The Paris Protocol set up an Israeli “customs envelop” over WBG. Following the Uruguay Round Agreements in 1994, Israel has substantially liberalized its foreign trade regime.⁶³ It has also pursued a track of bilateral preferential liberalization, with the combined effect that now around half of total industrial imports and 40 percent of agricultural products enter Israel free of duties. In consequence, WBG has had a very liberal trade regime. This is especially true by the standards of economies at a similar level of economic development which, combined with other policies, usually has a positive impact on the competitiveness of domestic businesses and economic growth.

3.3. Against this background, the failure of the Paris Protocol to live up to the expectations of its signatories—that it would increase prosperity through transforming the WBG economy from primarily a labor-exporting economy to a goods-exporting economy through an environment more conducive to trade with Israel and third markets—does not entirely stem from weaknesses in its design. It rather results from the fact that—in the absence of a spirit of mutual trust and cooperation—several of its key provisions have not been implemented. Once cooperation prevails over confrontation, implementation of these provisions would boost an otherwise unimpressive WBG export performance.

3.4. Finally, WBG foreign trade performance has been held hostage not only to tensions in Israel-WBG security developments, but also to the unique structural and developmental characteristics setting WBG apart from Israel. Three characteristics of this performance stand out:

- *First, export performance has never been impressive.* Before the *Intifada* in 2000, exports of labor appear to have crowded out those of goods and, together with aid inflows, contributed to a very limited progress in industrialization through driving up the cost of labor and prices of nontradables.

⁶¹ “Self-government” is a reference of recent period; it was the result of the Israel-PLO Declaration of Principles on Interim Self-Government Arrangements (the DOP) signed in 1993, with a transfer of powers and responsibilities having been spread over 1994–98. The latest *Intifada* has derailed negotiations on the permanent status of WBG that began in September 1999.

⁶² The Agreement was subsequently attached as an annex to the Interim Agreement between the Government of Israel and the Palestinian Authority.

⁶³ See *Israel: Trade Policy Review* (World Trade Organization, Geneva 2006).

- *Second, the level of dependence on the goods trade with Israel has not been excessive.* To the contrary, WBG businesses—mostly for reasons related to tensions in Israel-WBG relations—have not been able to take full advantage of the proximity of Israel’s highly developed economy and Israeli links to global value chains. Participation of WBG businesses in global “buyer-driven” chains has been limited. On the other hand, however, WBG exports much more in processed goods to Israel than to other markets, indicating Israeli markets’ potentially positive impact on WBG industrial development.
- *Third, the recent period was characterized by progressive deindustrialization of the WBG economy, as revealed in WBG import composition and its export basket.* Both of them have moved to goods at lower levels of the technology ladder. Imports of foods and feeds contracted to a much lesser degree than those of investment goods.

3.5. The remainder of this chapter is organized as follows. Sections B and C examine developments in the WBG economy through the lenses of its foreign trade performance. Section D discusses the “customs envelop,” or more precisely, the Israeli foreign trade regime currently “enveloping” WBG, and briefly examines foreign trade policy options that may become feasible under the current circumstances. Section E concludes the chapter.

B. DYNAMICS AND DIRECTION OF TRADE: DOMINANCE OF THE ISRAELI CONNECTION

3.6. Three features shaping the dynamics of WBG export performance stand out. First, Israel has been the major market for WBG products and services. Second, the increases and decreases in security tensions resulted in volatility in WBG total exports. Third, workers’ remittances from Israel—or technically exports of services under GATS (General Agreement of Trade in Services Developments) mode 4 (presence of natural persons)—towered over other export earnings until the Intifada.

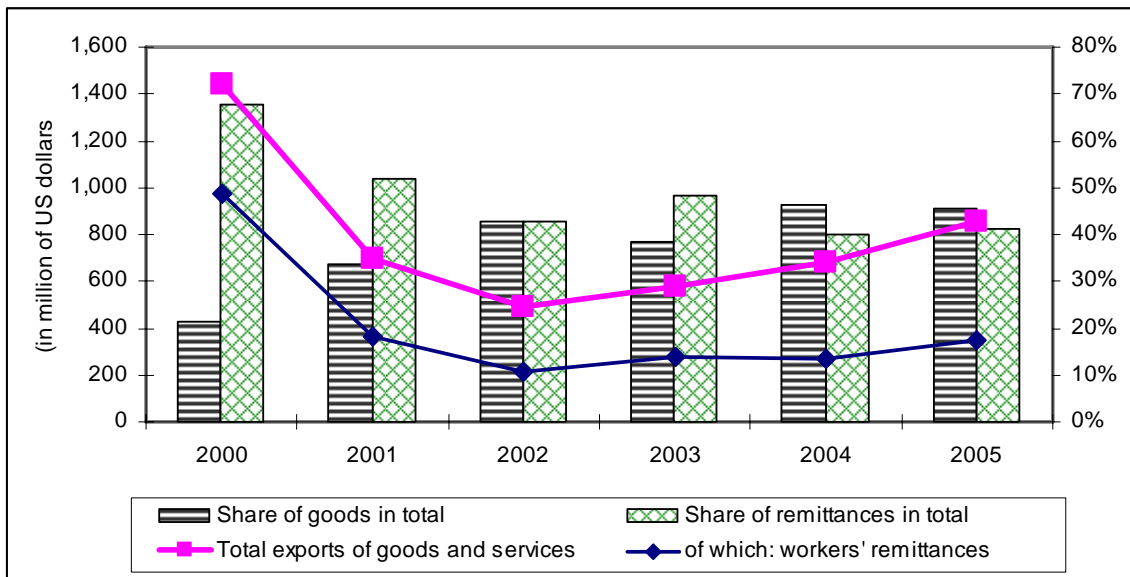
3.7. The analysis in this chapter is supported by trade data with varying periodicity, but this does not appear to have a major impact on the soundness of conclusions for the current period. For instance, the detailed trade data, broken down to five-digit SITC categories, are available only for 1999–2002, the period of a substantial contraction in WBG foreign trade. Nevertheless, as the recovery in 2003–05 consisted of exporting more of roughly the same products, observations derived from structural analysis hold for this period as well. The quality of the trade data in general is questionable, but detailed data appear to be satisfactory, as available sectoral studies broadly corroborate the composition of both exports and imports. Last but not least, the largest discrepancies between data reported by the Israel and Palestinian Central Bureaus of Statistics concern the magnitudes of flows but not their structure.⁶⁴

Dynamics of Exports to Israel: The Shift Away from Exports of Labor

3.8. The level of dependence of WBG on trade with Israel is much higher than Israel’s shares in WBG trade in goods might indicate. Historically, WBG’s major export item was services provided by Palestinians commuting daily to Israel or to settlements in West Bank. The inclusion of Palestinian workers’ remittances in exports almost doubles the “dependence” of WBG on Israeli markets for goods, services, and labor, as their share in total exports was 40 percent in 2005 (figure 1).

⁶⁴ The low quality of data is in large part inevitable as formal economic borders do not separate WBG and Israel. Despite the back-to-back system and other arrangements controlling flows of goods from and into WBG (see chapter II for a detailed discussion), there are no customs at the crossing points at either side of the border. In consequence, there are discrepancies in magnitudes of reported foreign trade flows in Israeli and WBG statistics.

**Figure 1. Exports of goods and services (including remittances) to Israel in 2000–05
(in millions of U.S. dollars and percent)**



Source: Export data from Israel’s Central Bureau of Statistics and workers’ remittances from Israel as reported by Palestinian Central Bureau of Statistics (PCBS)

3.9. The combination of cuts in permits issued to Palestinian workers and closures has resulted in the decline of both Palestinian employment in Israel and workers’ remittances, although both have slightly recovered from their lowest levels in 2002.⁶⁵ With the faster recovery of exports of goods in 2003–05, their value exceeded earnings from remittances in both 2004 and 2005. Total earnings from exports to Israel in 2005 were, however, stood 41 percent below their level in 2000.

3.10. The historical record of WBG exports of goods to Israel does not inspire optimism as to the prospects for any significant acceleration (figure 2). The least square average annual growth rate of value of exports at 2 percent in 1983–2005 indicates a significant decline in real terms.

How Exports of Labor have Hampered Exports of Goods

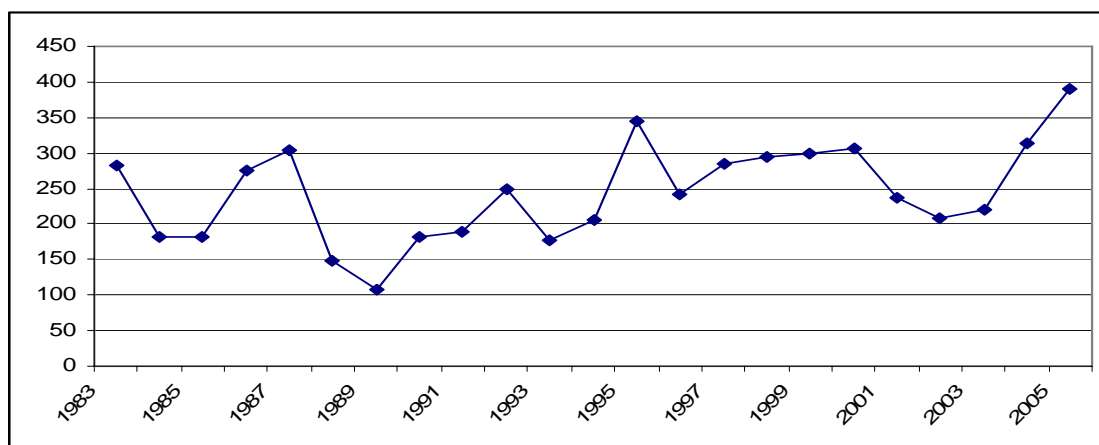
3.11. The combination of large exports of labor, together with limited investment in the industrial sector, has undermined the competitiveness of WBG industrial sectors. According to the international trade theory, movements of goods and of factors of production substitute for each other: the larger is the movement of the former, the lesser movement will be of the latter. The problem occurs when the movement of factors of production is limited to labor.

3.12. Considering the geographical closeness (allowing for daily commuting together with less restrictive regulations on the movement of people), as well as the differences in both size and economic development in favor of Israel, a much larger impact on labor movement from WBG to Israel than on trade in goods or capital movement would come as no surprise. Indeed, exports of labor to Israel have

⁶⁵ Since the early 1990s, Israel has reduced the number of work permits issued to Palestinian workers, replacing them with labor from Asia and Eastern Europe with a stated goal of eliminating permits to Palestinians by 2008. For a detailed discussion of the impact of Israeli security measures on workers’ remittances and employment, see chapter 2.

played an important role since 1967, with remittances reaching 69 percent of Gaza’s GDP and 38 percent of West Bank’s GDP in 1982.⁶⁶ During the 1970s and 1980s, around one-third of the Palestinian workforce worked in Israel.⁶⁷ Employment fell in the 1990s, but as the Aix-en-Provence Group report duly noted, “the Palestinian economic growth was not export-led but rather was driven by consumption deriving from higher incomes from workers’ remittances.”⁶⁸

Figure 2. WBG exports to Israel in 1983–2005 (in million of U.S. dollars)



Source: Israeli Central Statistical Bureau.

3.13. When the movement of factors of production is limited to labor and excludes capital,⁶⁹ as was the case in relations between Israel and WBG, the potential for growth in domestic labor productivity of an exporter of labor is limited at best. In WBG, the possibility of a daily commute to work in Israel increased wages beyond the underlying growth in productivity. The low level of investment led to the divergence in factor productivity compared to Israel.⁷⁰ The economic outcomes boiled down to the following:

- Overvaluation of the real exchange rate in WBG limited opportunities for growth.⁷¹
- Since prices of nontradable sectors (for example, construction) relative to tradable sectors have increased because of labor movements, competitiveness of tradable activities in world markets has eroded.
- Nontradable sectors expanded, whereas tradable sectors (for example, agriculture) contracted.

⁶⁶ See Michael Michaely, “Goods versus Factors: When Borders Open, Who Moves?” (*World Economy*, No. 3, 2003), 546.

⁶⁷ See *Economic Fragmentation and Adaptation in the Rural West Bank*, United Nations Office of the United Nations Special Coordinator (Jerusalem, October 2005).

⁶⁸ See *Economic Road Map—An Israeli-Palestinian Perspective on Permanent Status* (the Aix Group, January 2004).

⁶⁹ The uncertain and difficult operating business environment discouraged domestic investments and inflows of capital from abroad. According to the IMF, private investment fell from 24 percent of the GDP during 1988–1992, to under 15 percent during 1994–1998. Furthermore, the bulk of investment flowed (and continues to flow) to construction, targeting residential housing especially.

⁷⁰ See Sébastien Dessus, “A Palestinian Growth History, 1968–2000” (*Journal of Economic Integration*, Vol. 19, No. 3, 2004).

⁷¹ See Claus Astrup, Claus and Sébastien Dessus, “Exporting Goods or Exporting Labor?: Long-term Implications for the Palestinian Economy” (*Review of Middle East Economics and Finance* 3[1], 2005).

- Concentration of productive factors in nontradable sectors (that is, noncompeting sectors) has lessened pressure for innovation and productivity growth.
- Whereas the GDP of West Bank and Gaza increased between 1968–1987, the gap in relation to Israel remained roughly unchanged; that is, there was very little convergence in incomes.⁷²

3.14. The negative impact of remittances on export competitiveness, reminiscent of symptoms of the Dutch disease, could have been eased by higher investments and technology transfers. However, business investments in WBG remained very low, with the overvaluation of the real exchange rate further limiting investment opportunities.⁷³ As a result (as discussed in the next chapter), the competitiveness of industrial sectors was bound to decline, significantly effecting export performance.

3.15. With the decline in workers' remittances, the pressures on domestic wages and prices of nontradable goods and services will diminish and the potential competitiveness of WBG businesses will rise, opening new investment opportunities. However, as argued in chapter II, significant trading costs and the high level of perceived risks induced by the Israeli security regime, as well as concerns with security in WBG, will continue to prevent investors and firms from taking advantage of new opportunities unless these concerns are addressed effectively.

Geographic Patterns: Does WBG “Overtrade” with Israel?

3.16. Israel towers over WBG's external trade relations. West Bank and Gaza exports and imports display substantial geographical concentration, with Israel taking more than 90 percent of its exports and providing between three-thirds and three-fourths of its total imports. Between 1999 and 2003, there was a small increase in geographical diversification of trade due to a quite significant increase in exports to Pan-European markets (albeit from a very low base), and to Jordan (see table 1).

3.17. Not surprisingly, imports tend to be more diversified in terms of geography than exports. A much more developed and diversified economy than WBG, Israel can be an attractive market for a wide range of products that can be produced in the WBG; however, it cannot provide the WBG with all of its import needs. Among rest of world (ROW) economies, Jordan is the largest market for WBG exports, followed by countries from the Pan-European area (see table 1): its share in WBG exports increased from 0.4 percent in 1999–2000 to around 3 percent in 2002–03. A large number of countries, including neighboring Egypt, export to but do not import from the WBG, confirming both the WBG's limited export offer and the problems faced by their traders because of Israeli security measures.

3.18. Had political circumstances been assumed away—that is, had WBG been fully in charge of its international economic relations and subjected them entirely to WTO disciplines—would Israel have remained as WBG's dominant trading partner? Geographical proximity is only a part, albeit an important part, of the answer. Much more significant is the difference in size and level of economic development. WBG's gross national income (GNI) per capita is only a fraction, recently falling, of that of Israel: it stood at 7 percent in 2004, down from 10 percent in 2000.⁷⁴ Even more significant are differences in the size of the economy as captured by the gross domestic product (GDP). The GDP of WBG valued at about US\$4 billion in 2005 was a mere 3 percent of Israeli's GDP, down from 4 percent in 2000. The major asymmetries in respective economic weights are reflected in the relative importance of respective markets: WBG markets accounted for 6 percent of total Israeli exports in 2003, as compared with Israeli markets, accounting for 92 percent for WBG exports (table 1); and the share of exports originating in

⁷² See chapter I of this report. See also Michael Michaely, “Goods versus Factors: When Borders Open, Who Moves?” (*World Economy*, No. 3, 2003).

⁷³ See Sébastien Dessus, “A Palestinian Growth History, 1968–2000,” (*Journal of Economic Integration*, Vol. 19, No. 3, 2004).

⁷⁴ All preceding data, except for shares of Israel in WBG exports and imports, are from the World Bank database.

WBG in total Israeli imports of goods was 0.8 percent, while the corresponding rate in the case of WBG was 73 percent.⁷⁵

Table 1. Directions of trade of WBG in 1999–2003 (in million of U.S. dollars and percent)

EXPORTS	(in million of U.S. dollars)					(in percent of total)				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
Israel	359	371	273	215	256	96.8	92.3	94.3	91.7	91.7
ROW, of which	12	31	16	20	23	3.2	7.7	5.7	8.3	8.3
Jordan	8	8	11	12	15	2.3	2.1	3.8	5.0	5.2
Pan-Euro	2	2	2	7	7	0.4	0.4	0.7	3.0	2.5
Other	2	21	3	1	2	0.5	5.2	1.1	0.3	0.5
IMPORTS										
Israel	1,853	1,739	1,351	1,117	1,307	61.7	73.0	66.5	73.9	72.6
ROW, of which	1,148	643	682	394	493	38.3	27.0	33.5	26.1	27.4
Jordan	60	24	23	21	19	2.0	1.0	1.1	1.4	1.1
Pan-Euro	650	347	441	244	234	21.7	14.6	21.7	16.1	13.0
ROW	438	272	218	129	240	14.6	11.4	10.7	8.5	13.3
TOTAL TURNOVER										
Israel	2,212	2,110	1,624	1,332	1,563	65.6	75.8	69.9	76.3	75.2
ROW, of which	1,160	674	698	414	517	34.4	24.2	30.1	23.7	24.8
Jordan	68	33	34	33	34	2.0	1.2	1.5	1.9	1.6
Pan-Euro	652	349	443	251	241	19.3	12.5	19.1	14.4	11.6
Other	439	293	222	130	242	13.0	10.5	9.5	7.4	11.6

Sources: Based on data provided by the Palestinian Central Bureau of Statistics (PCBS).

Note: (1) For 2003, estimates for trade with Israel, Jordan, and the Pan-European area derived from data for 2002 and aggregate direction of trade for 2003; (2) Pan-European area includes EU-25, EFTA (Iceland, Norway, and Switzerland), Bulgaria, Romania, and Turkey.

3.19. Hence, considering geographical proximity and the large gap in the level of economic development, with or without the Israeli security regime limiting WBG’s access to external markets, Israel would remain—as long as its commercial interaction is subject to at least World Trade Organization (WTO) multilateral disciplines—a major trading partner of WBG. Gravity estimates fully corroborate this observation. When bilateral trade between WBG and Israel is examined in the context of the bilateral trade of several other countries, no support can be found for the case that WBG overtrades with Israel given their proximity, GDP, population, and other variables.⁷⁶

3.20. Therefore, the answer to the question of this section is a qualified “no.” WBG does not seem to overtrade with Israel. In a different set of political circumstances, the corresponding shares of Israel in exports and imports would be probably lower. So would they be with the progress in industrialization. For instance, once the WBG trade basket moves away from agricultural foods, feeds, and construction materials (marble and building stone), which are highly distance-sensitive products that reward geographical proximity (and which now accounts for almost half of WBG exports and imports), the share of Israel would inevitably decline, although with a caveat. As shown below, WBG’s Israeli-oriented

⁷⁵ However, the picture is more complex at the level of firms, pointing to mutual dependence in many sectors. As Moshe Nahum, an official from the Manufacturers Association of Israel (MAI), argues in an article published in the January 2005 issue of the MAI periodical, *The Industrialists*, some Israeli industries sell more than 30 percent of their output to the PA and there are also sectors totally dependent on Palestinian production subcontracting. He also notes that excluding diamonds and services, Israel’s exports of goods to the PA represent in fact some 5 percent of Israel’s total exports.

⁷⁶ See Geoffrey Bannister, and Ulric Erickson von Allmen, “Palestinian Trade: Performance, Prospects, and Policy” in Valdivieso, Rosa, Erickson von Allmen, Ulric, Bannister, Geoffrey, Davoodi, Hamid, Fischer, Felix, Jenkner, Eva and Said, Mona (*West Bank and Gaza*, International Monetary Fund, Washington, DC, 2001).

export basket contains products characterized by a much higher level of processing than in ROW exports. On the other hand, WBG trade in goods and services, now amounting to only around 60 percent of its GDP, would be much higher and industrial links between WBG and Israeli firms much more developed, with mutually positive impact on competitiveness in global markets.

C. INDUSTRIAL DEVELOPMENT AS REVEALED IN WBG EXPORT AND IMPORT BASKETS

3.21. Except for a few sectors, exports considerably declined between 1999 and 2002. The composition of WBG exports and imports points not only to low levels of technology and processing embodied in exported products, but also suggests the virtual absence of participation of WBG firms in intraindustry or intraproduct trade. The latter indicates a very low and unsophisticated manufacturing base in WBG. Furthermore, a relatively low and falling share of capital equipment imports in 1999–2002 is also a strong indication of the virtual absence of industrial investments during that period.

Fall in the Degree of Processing

3.22. The level of processing embodied in exports, as captured by the aggregate share of foods and feeds together with industrial raw materials, was low and significantly declined between 1999 and 2002. These are regarded as traditional production inputs, simply because they are not processed in their present form. Their share in WBG exports was 31 percent in 2002 (table 2). It is noteworthy that the shift toward less processed goods was much more pronounced in exports to markets other than Israel. The combined share of foods and industrial raw materials in exports not destined for Israel rose from 34 percent in 1999 to 64 percent in 2002.

Table 2. Developments in trade by end use in 1999–2002
(in thousands of U.S. dollars and percent)

	Exports (in US\$'000)		Index, 2002 1999=100	Composition in percent		Share of Israel		Exports as % of imports	
	1999	2002		1999	2002	1999	2002	1999	2002
Agricultural Food & Feeds (SITC 0+1+2+4-27-28)	83,336	55,319	66.4	22.5	23.1	95.2	77.3	11.9	12.7
Industrial Raw Materials (SITC 27+28+68), Machinery, excluding auto (SITC 7-78),	12,710	7,991	62.9	3.4	3.3	99.8	64.2	20.9	22.1
Autom.& parts (SITC 78)	16,716	8,078	48.3	4.5	3.4	89.8	91.0	3.9	5.8
Text.& Clot.(SITC 65+84)	4,569	3,806	83.3	1.2	1.6	96.7	99.9	2.5	9.6
<i>of which garments (84)</i>	17,086	9,942	58.2	4.6	4.2	98.3	99.8	9.9	19.4
Other Consumer Goods (SITC 5+6+8+9-65-68-84)	7,951	5,353	67.3	2.1	2.2	98.0	99.8	10.6	27.2
<i>Of which: Non-metallic mineral manufac. (66).</i>	231,060	151,900	65.7	62.4	63.4	97.6	95.2	21.7	33.8
<i>of which footwear (85)</i>	87,195	60,362	69.2	23.5	25.2	96.3	96.2	34.9	60.6
Fuels (SITC 3)	22,243	11,485	51.6	6.0	4.8	97.7	99.6	95.9	119.3
Total (SITC. 0 through 9)	4,952	2,481	50.1	1.3	1.0	99.0	72.4	1.3	0.7
	370,428	239,517	64.7	100.0	100.0	96.8	89.9	12.3	15.8

Sources: World Bank staff calculations based on data provided by the PCBS and the Palestinian Authority (PA).

3.23. A closer examination of the composition of exports suggests that the bias in favor of low processed goods was even larger than the share of traditional input might suggest. Low processed goods dominate among final consumption goods with three products—cut marble, alabaster, and cut or sawn building stone—accounting for almost a quarter of total WBG exports in 2002.

3.24. A shift in import demand toward lower processed goods has accompanied the contraction in total

imports, further eroding the industrial base. Imports of fuels, foods, feeds, and industrial products—essential for meeting basic human needs and maintaining production operations—recorded relatively smaller contraction (around 80 percent of these imports comes from Israel), while imports of capital and transport equipment experienced the largest contraction.

Technology Intensity of Exports and Imports

3.25. The results presented in Table 3 corroborate earlier observations drawn from the analysis of WBG trade in terms of degree of processing. They clearly point to a significant de-industrialization or, more precisely, an absence of activities designed to modernize the industrial structures. Products whose production processes characterize medium to high technology intensive activities have demonstrated the largest resilience to the fall in exports, although they account for a relatively small share of total exports (Table 3),⁷⁷ whereas imports of these products were the most affected.

Table 3. Exports and imports by the type of technology involved in their production in 1999–2002 (in million of U.S. dollars and percent)

	(in US\$ million)		Index, 2002	Composition in percent		Index, 2002
	1999	2002	1999=100	1999	2002	1999=100
A. EXPORTS						
Natural resource intensive products	178	118	67	48	49	103
<i>Of which: Monumental or building stones (66135)</i>	36	28	76	10	11	117
<i>Marble travertine and alabaster (SITC. 66136)</i>	29	20	70	8	9	109
Low-technology, labor intensive	131	77	59	35	32	91
<i>Of which: Tomatoes fresh or chilled (05441)</i>	6.2	0.9	15	1.7	0.4	23
<i>Cucumber fresh or chilled (05456)</i>	11	2.9	27	2.9	1.2	42
Medium to high technology-intensive products	62	45	72	17	19	111
<i>Medicaments in measured doses (SITC. 54293)</i>	9.4	7.2	77	2.5	3.0	119
<i>Mattresses of cellular rubber or plastics</i>	4.1	5.4	133	1.1	2.3	206
TOTAL	370	240	65	100	100	100
B. IMPORTS						
Natural resource-intensive products	1,265	770	61	42	51	121
Low-technology, labor intensive	903	502	56	30	33	110
Medium to high technology-intensive products	833	239	29	28	16	57
TOTAL	3,001	1,511	50	100	100	100

Sources: World Bank staff calculations based on data provided by the PCBS.

3.26. On the export side, the product composition of exports did not significantly change in degree of processing and technological level. Low processed products continue to account for around one-fourth of

⁷⁷ We use a simple taxonomy developed by M. Landesman and R. Stehrer, “Structural Patterns of East-West European Integration: Strong and Weak Gershenkron Effects,” (in *WIIW Structural Report 2003 on Central and Eastern Europe*, Vol. 1, The Vienna Institute for International Economic Studies, Vienna, 2003), linking SITC product-categories to three types identified in terms of factor inputs and labor skills needed to produce them: those characterized by resource-intensive activities, low technology and labor-intensive activities, and medium to high technology-intensive activities. Resource-intensive products include wood and wood products, coke, refined petroleum products, chemicals, manmade fibers, and nonmetallic mineral products. Low-tech and labor-intensive products include food products, beverages, tobacco, textiles and clothing, and leather and leather products. Medium-to high-tech industries include machinery and equipment, transport equipment, and electrical and optical equipment, and pharmaceuticals.

total exports and natural resource-intensive and low tech, labor-intensive sectors for more than 80 percent of total exports. Yet, a further breakdown of exports suggests some degree of reshuffling within the sectors (characterized, however, by similar factor inputs and labor skill requirements of industrial activities).

3.27. In contrast, the fall in domestic use of more technology intensive products was significant. The share of medium to high tech-intensive sectors fell from 28 percent of total imports in 1999 to 16 percent in 2002, with their value at 29 percent of that in 1999. The import basket switched considerably to consumption of natural resource-intensive and low tech, labor-intensive products, with their combined share moving from 72 percent to 84 percent in 1999–2002. As noted above, not surprisingly, the import basket moved to “essentials:” foods, feeds, and fuel.

Participation in Global Value Chains: Textiles and Clothing, Footwear, and Furniture

3.28. Participation in global value chains has created a unique opportunity for producers in less developed economies to move from servicing small local markets to supplying large multinational firms and indirectly, their customers all over the world. The term “global value chain” refers to the whole range of activities involved in the design, production, and marketing of a product. The distinction is usually made between “buyer-driven” and “producer-driven” chains. West Bank and Gaza producers are not present in producer-driven chains usually involving foreign direct investments by MNCs. “Buyer-driven” value chains refer to global buyers creating a supply base on which production and distribution systems are built without direct ownership. They usually encompass the following sectors: clothing, footwear, and to a lesser extent, furniture. These sectors have been the quintessential engines of export growth for many developing countries, with significant implications for poverty reduction.

3.29. An important question is the extent to which WBG firms have become part of these chains. Although without firms’ surveys it is impossible to provide a fully reliable and precise answer, an examination of trade flows usually allows one to make an assessment. Five features stand out (table 4). First, exports of chains parts and products continue accounting for a significant portion of total exports—16 percent in 2002. They were not, however, immune to the general contraction in WBG exports. Their combined value fell almost fully in line with total exports, with their share in total exports and in manufactured exports retracting one percentage point. Exports of parts fell less than exports of final products largely because of a relatively small contraction in exports of furniture parts than of other exports. In other chains, exports of parts contracted stronger than exports of final products.

3.30. Second, the size of a downfall varied considerably across value chains; none of them, however, avoided a decline in their trade. The largest decline was experienced by exports of footwear; the smallest, by the furniture sector. The share of the furniture sector in combined total exports of three chains rose from 38 percent in 1999 to 45 percent in 2002. However, its export orientation is relatively small, with 84 percent of production sold in WBG.⁷⁸

3.31. Third, in contrast to most other Middle East economies, the textile and clothing (T&C) sector in WBG remains underdeveloped—it contributed to only 4 percent of WBG earnings from exports of goods, considerably below the corresponding rate in Jordan, Morocco, and Tunisia (figure 3). Much higher labor costs in WBG than in potential or actual competitors (China, Egypt, Jordan), as well as higher power and utility costs put WBG producers at a significant disadvantage.⁷⁹

⁷⁸ For a detailed discussion, see the second volume, annex V of this report.

⁷⁹ For a detailed discussion, see the second volume, annex IV of this report.

Table 4. Participation in global value chains in 1999 and 2002
(in thousands of U.S. dollars and percent)

<i>Global value chains</i>	Exports (in US\$'000)		Index, 2002
	1999	2002	1999=100
T&C			
Textiles	9,130	4,589	50
Garments	7,951	5,353	67
Total	17,081	9,942	58
<i>Memorandum:</i>			
Share in total exports	5	4	90
Share of imported textiles in T&C exports	450	220	49
FOOTWEAR			
Parts	616	65	11
Final products	21,627	11,420	53
Total exports of parts and final products	22,243	11,485	52
<i>Memorandum:</i>			
Share of footwear parts and final products in total exports	6	5	80
Share of imported parts in total footwear exports	7	49	650
FURNITURE			
Parts	13,090	10,859	83
Final products	10,766	6,480	60
Total exports of parts and final products	23,856	17,338	73
<i>Memorandum:</i>			
Share of furniture parts and final products in total exports	6	7	112
Share of imported parts in total exports	42	10	23
TOTAL CHAINS			
Exports of parts	22,836	15,513	68
Exports of final products	40,344	23,253	58
Total chains exports	63,180	38,765	61
Share of T&C in total chains' exports	27	26	95
Share of footwear in total chains' exports	35	30	84
Share of furniture in total chains' exports	38	45	118
<i>Memorandum:</i>			
Share in total exports	17	16	95
Share in exports of manufactures	23	22	95

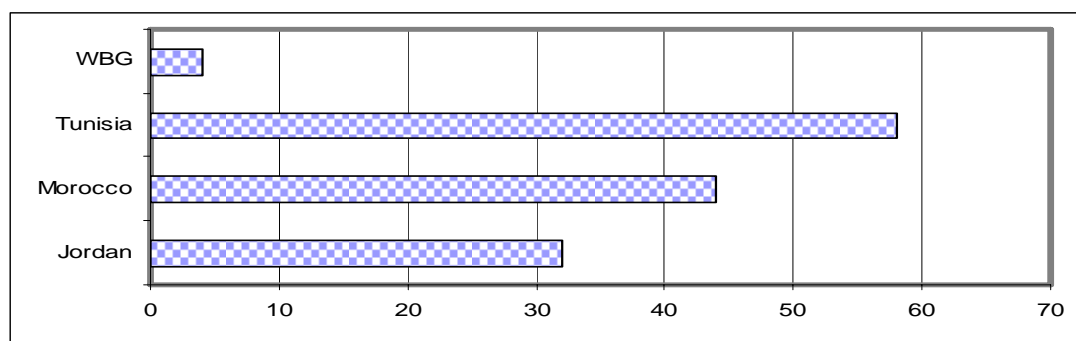
Sources: World Bank staff calculations based on data provided by the PCBS and PA.

3.32. Fourth, it is very difficult to assess the extent to which supplies in value chains rely on imported inputs. Usually, the share of imported parts in total exports of parts and final products, also referred to as import intensity of chain exports, provides a good indication of the scope of backward linkages. The value of this share below 100 percent, together with its declining trend, suggests the increase in export-orientation and increased involvement of upstream local suppliers. Only the furniture chain meets these conditions, albeit with a caveat. Since the value of exports of both parts and final products significantly declined, the fall in import intensity may also suggest (in addition to the development of local industrial capacities) a switch to furniture relying less on imported inputs. Developments in T&C lead to a similar observation. On the other hand, the footwear sector experienced both the increase in import intensity and the rather significant contraction in exports of parts: both suggest a large retrenchment in local production of parts and significantly higher reliance on imported inputs.

3.33. Last but not least, WBG firms participated almost exclusively in chains present in Israel, which has been the main destination for exports—the share of Israel in furniture exports was 99.9 percent in 2002; 99.8 percent in clothing, and 99.9 percent in footwear. On the import side, however, the presence of other than Israeli suppliers is much more pronounced—in 2002, they accounted for 6.5 percent of imports of parts by the footwear sector, almost 60 percent of furniture parts imports, and 60 percent of textiles and

fabrics in the T&C chain. The dependence on contracts from Israeli firms located higher in value chains does not come as a surprise, given security-economic arrangements, geographical proximity, and well-established Israeli commercial links with companies operating at the top of chains in major world markets.

Figure 3. The share of T&C exports in total (nonoil) exports in selected MENA economies in 2004 (WBG in 2002) in percent



Source: UN COMTRADE database and Palestine Central Bureau of Statistics for WBG.

3.34. Yet, considering the nature of global buyer supplier-chains organized around large retailers operating across the globe, establishing direct commercial contacts with global retailers would result in larger contracts, offering economies of scale to WBG suppliers. Benefits from a direct relationship with a company operating at the top of a value can be significant, as global retailers often provide assistance in organizing production and setting up viable management systems which, taken together, contribute to improved productivity and competitiveness.⁸⁰ They do not come by default, however. A good business climate and an infrastructure facilitating movement of goods have to be in place.

D. ENHANCING PROSPECTS FOR EXPORT-LED GROWTH: TRADE POLICY OPTIONS

3.35. The framework governing foreign commercial relations of WBG, enshrined in the Paris Protocol signed in 1994, is a “quasi-customs union” with Israel. Two features set the arrangements apart from a standard customs union: First, Israel has full control of WBG borders including airspace, despite the fact that WBG borders other states—Jordan and Egypt. By the same token, customs clearance and collection of border charges can be conducted exclusively by the Israeli Customs Administration, although some provisions have been established for cooperation between respective customs. Second, it limits access and purchases by WBG firms in foreign markets, although since July 2003 Israel has gradually lifted its import licensing requirement from WTO members that have no diplomatic relations with it or that prohibit imports from Israel into their markets.⁸¹

3.36. The current arrangements represent a higher level of economic integration than does a standard customs union, as there are no internal economic borders and Israeli domestic currency can be used in

⁸⁰ For instance, many furniture suppliers of IKEA are connected to IKEA’s computer system, through which invoices as well as payment and delivery information are processed. For an extensive discussion of the case of a Lithuanian firm operating in IKEA’s global value chain, see box 2, chapter 6 in *From Disintegration to Integration: Eastern Europe and the former Soviet Union in International Trade* (The World Bank, Washington, DC 2005). As a result of close cooperation that began in 1998, sales grew from around US\$5.5 million to around US\$30 million in 2002; its employment almost doubled; and the value of its exports increased more than tenfold.

⁸¹ That is, Bahrain, Bangladesh, Kuwait, Pakistan, Tunisia, Indonesia, Malaysia, Morocco, Oman, Cuba, Brunei, Chad, and the United Arab Emirates (WTO 2006). Trade with such non-WTO members as Iran, Lebanon, and Syria is banned.

WBG, which does not have its own currency. The absence of economic borders demands similar levels of taxation of commercial transactions and observance of the same technical standards. Last but not least, in contrast to many other customs union agreements, common external tariff covers almost all products except for a very limited number of items under lists A1 and A2, consisting mainly of consumer goods traded with Jordan and Egypt, and list B, consisting mainly of machinery and unfinished goods.⁸²

3.37. Yet, these points should not suggest that WBG and Israeli firms operate in a similar institutional and policy environment. Although they are all exposed to similar pressures from competition from imports, there are other significant differences. Leaving aside the higher quality of business environment in Israel than in WBG and ingredients of the Israeli security regime applied exclusively against WBG businesses (see chapter II), WBG firms face much higher administrative barriers for both export and import activities and are handicapped in relation to their Israeli equivalents in terms of dealing with technical standards (see chapter IV). West Bank and Gaza firms have to comply with a larger number of national mandatory technical standards mandated by the Palestine Standards Institute. Furthermore, in many cases Israel does not accept Palestinian testing. For instance, as discussed in chapter IV, food products are not covered by the mutual recognition agreement. Neither are pharmaceuticals—an important export from WBG to markets other than Israel. Last but not least, a Memorandum of Understanding in the area of testing and certification of products between the Standards Institutions of Israel and the Palestinian Standards Institution, signed in 2000, allows the party who is supposed to recognize the certificate of the other party to carry out additional conformity tests and thus renders it meaningless (article 3.6). Clearly, without trust these arrangements rarely work.

3.38. In general, the Paris Protocol has set the framework fostering “North-South”-type regional integration, which in other contexts has proved to be a powerful vehicle for establishing a modern, business-friendly environment, attracting foreign investments and setting into motion the process of economic catching up.⁸³ However, conditions indispensable for releasing the process of deeper integration were not in place even before the *Intifada*. As was argued earlier in this chapter, political tensions and uncertainties, combined with slow progress in establishing competent governance in WBG, discouraged foreign and domestic investment, thus exacerbating distortions triggered by exports of labor.

3.39. However, Israeli security measures in response to the *Intifada* have changed the context of the Paris Protocol arrangements.⁸⁴ These measures have not only led to fragmentation of the West Bank economy and its detachment from Gaza but have also resulted in establishing borders between Israel and WBG. These still are not economic borders, although the movement of people and goods is subject to strict controls. Yet, they impose similar (in fact, much larger as shown in chapter II) costs as economic borders always do. By adding customs to security checkpoints, these could be easily transformed into full-fledged economic borders.

3.40. On the other hand, Israeli disengagement from the Gaza Strip has ended its fragmentation and made a potential dent in a “customs envelop.” Although the agreement on movement and access through

⁸² Most goods listed are set as quantitative quotas. Except for live meat and live animals, the use of quotas in 2004–05 was well below 50 percent and many items were not imported at all (data from Israeli Customs Administration). Since the Palestinian Authority did not set tax rates different from those accepted in Israel regarding goods listed in List B, List B has not been activated.

⁸³ See Maurice Schiff and L. Alan Winters, *Regional Integration and Development* (World Bank and Oxford University Press, Washington DC, 2003).

⁸⁴ It is noteworthy that many of measures introduced to limit trade can hardly be justified in terms of security concerns. Examples abound. For instance, the ordinance compelling Palestinian importers to sign a pledge that imported goods will not be sold in Israel has no justification, as taxes and border payments do not differentiate between exports to Israel and WBG. Another example is the need for Palestinian exporters to obtain Israeli export licenses. Both measures encourage WBG firms to use Israeli intermediaries, which, in the case of imports, results in revenue loss for the PA.

the Rafah crossing point in principle allows exports of goods through Egypt, effective implementation of this would call for an agreement on transit between the Palestinian Authority and Egypt.

3.41. In a nutshell, Israeli disengagement from the Gaza Strip, combined with the separation barrier, may set into motion an overall economic disengagement from WBG with important economic policy implications. It is impossible to estimate how soon this may happen, but the point is that the situation on the ground has altered the benefit-cost parameters of the Paris Protocol arrangements.

Customs Envelop: Israel's Foreign Trade Regime

3.42. Under the Paris Protocol, Israel's external commercial and tariff policy determines conditions of access to PA markets. Israel is clearly an open economy with a high level of contestability in most domestic markets, which should bring benefits to the PA economy. Most favored nation (MFN) tariff rates apply to only a quarter of Israel's total import, as most of its trade takes place under preferential trade arrangements and is subject to zero tariff rates. In contrast to high-tech sectors of the economy, traditional industrial sectors and agriculture enjoy very high levels of tariff protection.

3.43. **MFN tariff rates:** Israel has relatively moderate applied MFN tariff rates in comparison to recent EU members—that is, before they joined the EU in 2004, as well as EU candidate states (except Turkey) that have a customs union arrangement with the EU. The simple average in 2004 would place Israel somewhere in the middle of this group, although well above the EU-15 and its customs union partner, Turkey, but below other EU candidates, Bulgaria and Romania. Since Israel has a large number of agricultural products subject to specific tariff rates, actual levels of tariff protection may be slightly higher especially for agricultural products in relation to comparator countries.⁸⁵ Nevertheless, even leaving aside high specific rates on agricultural products, the level of MFN tariff protection of agricultural products is several times that of industrial products and so is its tariff dispersion.⁸⁶ Around 49 percent of all tariff lines are zeroed.⁸⁷

3.44. Israeli MFN tariff rates tend to be higher for sectors, which, incidentally, are dominant in the WBG. As for agricultural products, tariffs are particularly high on dairy products (with an average rate of 124 percent), edible fruits (87 percent), edible vegetables (63 percent), live animals and products thereof (50.4 percent), and preparations of cereals, flour, starch, or milk products (42.3 percent). As far as industrial products are concerned, they tend to be particularly high on traditional industries such as beverages, clothing, footwear, and plastics industries. Tariffs are relatively low on chemicals and photographic supplies (with an average rate of 2.2 percent), mineral products (3.6 percent), and transport equipment (3.6 percent). Except for mineral products, these are not sectors well developed in WBG.

3.45. **Preferential agreements:** The bulk of Israeli trade, however, is conducted under preferential trade agreements that significantly lower the overall level of tariff protection. Around three-fourths of goods entering Israel were subject to preferential tariff treatment in 2004 (see table 5). Israel has had a

⁸⁵ According to *Trade Policy Review—Israel* (WTO, Geneva 2006), the average applied MFN tariff was 8.9 percent in 2005 down from 10.8 percent in 2000. MFN tariffs on agricultural products (WTO definition) remain high, with an average tariff of 32.9 percent, and rates varying considerably among product groups, with a maximum tariff rate of 560 percent.

⁸⁶ The weighted average MFN tariff rate applied to agricultural products was more than five times higher than to industrial products. Including the *ad valorem* equivalents of specific, compound, and alternate duties levied almost exclusively on foods and feeds, the average MFN applied tariff on agricultural products was 41 percent in 2005. The coefficient of variation of 2.0 for agricultural products suggests high tariff dispersion—its value for industrial products of 1.3 indicates relatively low levels of dispersion.

⁸⁷ See *Trade Policy Review* (WTO, Geneva 2006).

free trade agreement with the EU since 1975 (which was “deepened” in 1995), as well as with the United States (1985), the EFTA States (1993), Canada (1996), Turkey (1997), Mexico (2000), Romania (2001), and Bulgaria (2001). Furthermore, under the framework of the Israel-United States free trade area agreement, Israel concluded the Qualified Industrial Zone (QIZ) Agreements with Jordan (1997) and Egypt (2004).

**Table 5. Imports of Israel (in 2004) and WBG (in 2003) from preferential partners
(in millions of U.S. dollars and percent)**

	US\$ mln	in percent	US\$ mln	in percent
	Israel		WBG	
Pan-European Area	17,301	56.8	234	13.0
NAFTA	5,535	18.2	32	1.8
Jordan	27	0.1	19	1.1
WBG	256	0.8	N/A	N/A
Israel	N/A	N/A	1,307	72.6
TOTAL ABOVE	23,119	75.8	1,591	88.4
WORLD	30,482	100.0	1,800	100.0

Source: UNCTAD TRAINS database and the PCBS.

3.46. As a result of free trade agreements, around half of total industrial imports enter Israel duty-free as compared to about 40 percent for agricultural goods⁸⁸—almost all industrial imports from preferential partners enter Israel duty-free.⁸⁹ In addition, there has been selective liberalization in conditions in access to agricultural markets. The share of preferential imports as well as the share of duty-free imports is considerably larger in WBG imports than in Israeli imports, mainly because of a much larger share of imports from Israel (table 5). These imports, including agricultural products, enter WBG markets free of any border charges, including tariffs.

3.47. **Other border measures:** Other border measures, however, significantly raise the cost of imports. As described in Box 1, these include fees, levies, some features of customs valuation system and tax system, including and the use of so called “TAMA” system to assign a value to an imported item for taxation.

3.48. **Nontariff barriers (NTB):** According to WTO’s 2006 Trade Policy Review for Israel, significant progress has been made in removing NTBs. Technical barriers to trade, usually constituting the most important area of nontariff protection, have been considerably reduced, with the share of items at the HS eight-digit level subject to technical regulation, having fallen from 39.4 percent in 1999 to 7.8 percent of total tariff lines in 2005—however, U.S. businesses complain that enforcement of mandatory standards on domestic producers can be spotty, and in some cases (for example, refrigerators, auto headlights, plywood, carpets, and packaging and labeling for food items) standards are written so that domestic goods meet requirements more easily than imports.⁹⁰ Furthermore, packaging and labeling standards are regarded as a significant barrier to a broad range of U.S. food imports.

3.49. Despite the increase in the proportion of Israel’s mandatory standards that are equivalent to international standards (from one-fourth in 1999 to one-third in 2005), the current number of specific Israeli mandatory technical standards of 411 is quite large by the standards of highly developed countries.

⁸⁸ Ibid.

⁸⁹ Duties on industrial imports from the EU were zeroed already in 1989, from EFTA in 1993, from the United States in 1995, and from other partners in 1999–2004.

⁹⁰ 2004 National Trade Estimate Report on Foreign Trade Barriers (United States Trade Representative, Washington, DC 2004), 239.

Box 1. Other Border Measures Raising the Cost of Imports

In addition to tariffs, imported goods are subject to a wharfage and ports fee of 1.02 percent on the cost-insurance-freight (c.i.f.) costs of imports into Israel;¹ some items, mainly edible oils, are subject to “safeguard” levies,² a tariff surcharge. Domestic taxes are levied on the duty-inclusive c.i.f. value of imports, and on the wholesale price of locally produced goods. Domestic indirect taxes include a 16.5 percent value-added tax (VAT), a purchase tax ranging between 5 percent and 120 percent on a number of “luxury goods,” and various excise taxes (fuels and tobacco) and stamp duties on several types of contracts and financial transactions.³ Purchase taxes are levied mostly on products not manufactured locally. These include, among others, motor vehicles, consumer electrical goods, alcoholic beverages, and a limited number of intermediate goods.

The basis for customs valuation is the transaction value, as declared by an importer, defined as the price paid or payable for the goods when they are sold for export to Israel. Ad valorem duties are applied on the transaction value, adjusted to reflect some costs and services not already included in the price incurred by the buyer (that is, fees and commissions other than buyers’ commissions): containers, packaging, royalties and license fees, transportation to the ports, loading, unloading and handling, and insurance.

Another practice contributing to higher protection than implied by tariffs is the use of the so-called “TAMA” system (the Hebrew acronym for additional rate of increase) to assign a value to an imported item for taxation by adding “estimated profits,” insurance, and inland freight to the declared value of an import for calculating purchase taxes, although its impact is limited to around 1 percent of all imports subject to ad valorem duties in 2004.⁴ It seeks to approximate the value of a product to the local wholesale value. Since coefficients used to calculate TAMA vary from industry to industry and product to product, they often result in assigning a higher valuation, and hence higher taxes, on imported goods than on those that are domestically produced. Registered importers, however, have the option of declaring the actual wholesale value of their products.

1/The wharfage fee is higher on imports, 1.02 percent of the c.i.f. cost of imports, than on exports, 0.2 percent on the free-on-board (f.o.b.) value. Total annual income from the wharfage fee is about NIS800 million. The authorities intend to change the fee to 0.3% for both imports and exports.

2/In August 2005, five items, mainly types of oil and oilcake, were subject to the surcharge (see table III.6 in *Trade Policy Review* (WTO, Geneva 2006).

3/See table III.7 in *Trade Policy Review* (WTO, Geneva 2006).

4/See *Trade Policy Review* (WTO, Geneva 2006).

3.50. All food and health products must be registered with the Ministry of Health before they can be sold in Israel. Procedures applicable to phytosanitary standards often raise the cost of imports. For instance kosher certification is not always transparent. Importers have to bear the costs of paying for rabbinical inspection to determine that the ingredients and manufacturing process of the product satisfy religious standards.

3.51. **Conclusion:** Although Israel’s foreign trade regime departs in many respects from what is considered “best practice” (transparency, uniformity, and multilateral rather than bilateral liberalization), it is not far from it in terms of assuring high levels of contestability of domestic markets for industrial goods. Furthermore, conditions in market access for external suppliers have significantly improved over the last decade.

The Paris Protocol: Its Pros and Cons

3.52. The central tenet of the Paris Protocol is the Israeli “customs envelop” extended over WBG. In more general terms, the question about the Paris Protocol boils down to a question on whether a “quasi-customs union” is in the economic interest of WBG. As a number of studies have addressed this question, including analysis of issues possible under the final status solution, this section focuses on more immediate questions that take current Israeli security arrangements into account. These arrangements allow for relatively easy outfitting of the fixed crossing points with customs on both sides: Is the common external tariff itself detrimental to the economic interests of WBG? Do the Israeli external tariff and customs procedures erect barriers to economic growth in WBG?

3.53. The “customs envelop”—with or without internal customs borders and with larger or smaller positive lists of exception—possibly has some advantages over a free trade area (FTA) with Israel for several reasons. First, given the political economy of agricultural protection, the FTA could soon be limited to industrial products. Pressures on both sides could result in percolation of multilateral barriers into bilateral barriers, with a likely push upward on agricultural prices in WBG. Israel’s MFN and preferential applied tariffs protect sectors that could exert pressure (probably successful, given the experience of other countries in the region) to obtain protection, had the PA possessed full autonomy in foreign trade policy. Hence, there are reasons to argue that trade practices not enforced by WTO disciplines could deteriorate, and autonomy in foreign trade policy result in the emergence of a relatively protectionist foreign trade regime with a bias against foreign trade.

3.54. Second, the advantage of customs union is the lack of need to resort to rules of origin. The rules of origin limit the development of local manufacturing, based on inputs imported from the most competitive sources of supply. They create red tape and leave considerable bureaucratic discretion to the authorities in determining whether the product meets the criteria—that is, wholly obtained or substantially transformed. They are the equivalent of a tariff on imports and tax on exports.

3.55. Third, Israel’s trade practices—its external commercial policy, including regional liberalization, as well as Israel’s MFN tariff structure—are not sources of significant economic distortion for WBG. Trade practices are WTO-compatible and Israel’s trade regime has been significantly liberalized since the completion of the Uruguay Round of Multilateral Trade Negotiations in 1994.

3.56. Fourth, customs procedures are both transparent and computerized. Customs administration is at levels compatible with those in highly developed economies. The caveat, however, is that these observations do not apply to WBG exporters and importers (see chapter II for security-related differences in treatment, and chapter IV for the much larger bureaucratic “load” related to trade in WBG).

3.57. Last but not least, the Paris Protocol opens possibilities for deeper integration into Israel’s economy. In a generic sense, considering the large gap in income levels and institutional arrangements in favor of Israel, potential benefits from this type of integration for a less developed partner are substantial, as the experience of many countries has demonstrated. Thus, it seems that the Paris Protocol is potentially a vehicle for the economic development of WBG. Its major weaknesses have little to do with the design itself, except for its procedure underlying the distribution of customs revenue.

3.58. Otherwise, as argued in paragraphs 3.36-3.43, the main problems stem from security measures that allow the agreement to be circumvented, non-implementation of some of its provisions, and the absence of a spirit of cooperation in updating and amending the framework established by the Paris Protocol. As discussed previously, security measures have been largely responsible for violations of the Article III (13) of the Paris Protocol stipulating equal treatment of Israeli and WBG shipments at Israel’s ports of entry and exit. Solutions should, therefore, be sought mainly by assuaging Israeli security concerns.

3.59. Two groups of issues present in the Paris Protocol, either in letter or in spirit, have not been implemented. The first group concerns customs cooperation, Article III (14). This Article states that “In the entry points of the Jordan River and the Gaza Strip: [...], the Palestinian Authority will have full responsibility and powers in the Palestinian customs point (freight area) for the implementation of the agreed customs and importation policy as specified in this protocol.” More important, however, the spirit of the Paris Protocol and effective management of a customs union require close cooperation among the customs authorities of the parties. This is particularly important in areas such as customs valuation, classification, and rules of origin, whereby the parties should act on the basis of harmonized rules and

where there should be close administrative cooperation. Such customs cooperation has been limited.⁹¹

3.60. The second group concerns cooperation on improvement in the Paris Protocol framework, as envisaged in setting up the institution of the Joint Economic Committee (also responsible for dispute settlement). The Joint Economic Committee, however, has not been convened since the outbreak of the Intifada in September 2000. For instance, from the outset it was recognized that some of the provisions of the Protocol would need to be amended. In particular, those referring to quotas set in positive lists of exceptions (lists A1, A2, and B) were intended to be updated according to evolving market needs in WBG. These have been neither updated nor examined since 2000, despite their apparent weaknesses.⁹²

3.61. Another area that calls for cooperation is strengthening the collection of WBG customs revenues. Because of transport and security issues, several Palestinian importers have recourse to Israeli importers, of whom signing the pledge is not required. This has been the source of discontent among Palestinian authorities over the loss of customs revenues. As discussed earlier, favorable treatment of Israeli importers provides a strong incentive to indirect imports into WBG. This has erected the barrier to integration, although other barriers—stemming from adversarial relationship—clearly have been much more binding.

3.62. Another area calling for cooperation relates to the pursuit of a track of regional liberalization by both the government of Israel and the PA. For instance, the Oslo II provisions recognizing each party's "economic ties with other markets" and allowing the PA to "sign economic agreements with third parties—states or international organizations—as far as they were in compliance with the Paris Protocol" have not been respected by Israel. Moreover, despite the existence of free trade agreements signed by the EU with each party, Israel and the PA cumulated products are currently excluded from the Pan-Euro-Med cumulation scheme.

3.63. In sum, to generate the expected benefits from the Paris Protocol framework, actions should focus on reviving the Joint Economic Committee, ending discrimination against WBG traders by Israel's customs, and setting the institutional framework for amending provisions and improving regulatory underpinnings. Other actions should focus on overall implementation of the Protocol to foster mutual trade and establish cooperation concerning security and customs.

Other Foreign Trade Regime Options in a Comparative Perspective

3.64. Yet, the Israeli disengagement from Gaza inevitably raises the question of other trade options. For instance, if goods are allowed to enter the Gaza through the Rafah crossing point, the prospects that cannot be dismissed offhand; the Paris Protocol "customs envelop" would then have a crack at prompting Israeli authorities to establish customs control at the Karni crossing between Gaza and Israel. Once customs controls are at one crossing—that is, there is precedent—similar arrangements would likely mushroom at other crossing points as well, expanding the range of options to include an "economic policy-induced disintegration" between Israel and WBG.

3.65. The range of other trade options boils down to the following: Paris Protocol fully implemented (Option A); customs union with customs borders (Option B); full disengagement from Israel leading to two other options: full autonomy under multilateralism (Option C1) and full autonomy with a web of free

⁹¹ With the process of Gaza disengagement, the Palestinian custom authorities will assume enhanced responsibilities in the administration of customs. This will make it all the more necessary to reinforce cooperation among the parties.

⁹² Products in lists A1 and A2 heavily overlap; 31 products out of 41 products in list A2 are also included in the same quantities in list A1.

trade agreements, including with Israel (Option C2).⁹³ Options A and B are a variation of the current customs union arrangements. Option A, discussed previously, depicts a status quo with one important modification—full implementation of the Paris Protocol, combined with efforts at deeper integration (for example, technical standards). Table 6 summarizes pros and cons of these four options.

Table 6. Review of benefits and risks of foreign trade regime policy options

Trade policy options	Benefits	Risks	Requisites
<i>Option A:</i> Paris Protocol extended and implemented	Unlimited access to Israeli market and greater integration into a much more developed economy		Full implementation of Paris Protocol and cooperative relations
<i>Option B:</i> Option A but with customs borders	As above, plus customs revenues collected directly by PA	Israeli security measures on transit; weak PA customs administration	1. Israel’s transit regime for WBG shipments in line with international practice (not special security measures); 2. Competent and disciplined customs administration
<i>Option C1:</i> Autonomy in trade policy combined with multilateral liberalization	Standard benefits from multilateral liberalization, thanks to removal of antitrade biases and allocation of resources to potentially most competitive sectors	Protectionism owing to capture of foreign trade policy by narrow interest groups; weak customs; loss of preferential access to Israel’s markets and prospects for deeper integration	1. Customs as above in Option B item #2. 2. Credible commitment to liberal foreign trade policy, including free trade
<i>Option C2:</i> Option C1 plus bilateral liberalization, including FTA with Israel	As above, plus better access to Israel’s markets	Agricultural products may be taken out from Israel-PA FTA; rules of origin emerging as a barrier	As in Option C1

3.66. Option B implies adherence to Israel’s MFN-applied tariff rates and preferential arrangements as well as other border measures, including limits on trade with some non-WTO members maintained by Israel with a caveat; the current crossing points would become an economic border with customs and other trade-related border controls on both sides. Palestinian Authority customs officers would collect all border charges. Yet, this does not necessarily imply that goods shipped to and from WBG would be subject to international rules while transiting Israel. As long as current Israeli security measures remain in place, the cost burden on WBG traders will not change. The only difference will be that they will not pay duties and other taxes at the port of entry into Israel, whereas subsequently their shipments would be subject to the international transit regime. In a nutshell, this would end the indirect trade possible under Option A and the associated leakage of customs revenue. To compare the costs and benefits of Options A and B, one would have to have a good estimate of customs revenues lost by the PA because of shipments entering as Israel-destined and sold in WBG, and of costs of establishing and running customs controls, as well as a good estimate of revenues lost because of the unavoidable capacity and effectiveness gaps of PA customs administration, at least at the outset of its establishment, compared with that of Israel. Higher effectiveness and lower levels of corruption tend to be positively correlated with the level of GDP.

3.67. In contrast, option C with its two variants—C1 and C2—would represent a dramatic departure from the current arrangements, with the PA assuming full control over its foreign trade policy. Both C1

⁹³ The option not discussed here concerns transforming the Gaza Strip into a free trade zone. The reason is that it could be done under any of the scenarios discussed here, although dramatic liberalization of access to WBG markets under foreign trade autonomy would render it irrelevant.

and C2 differ from Option B in one important respect: goods imported into WBG are no longer subject to Israel's tariffs and other commercial measures. Option C1 and Option C2 also assume a very liberal foreign trade policy. In the context of an economy with the GDP below US\$5,000, this is a laudable assumption, as the level of protection tends to fall with the increase in the GDP. In other words, the real risk is that WBG's foreign trade regime could become much more protectionist than the one under the "customs envelop."

3.68. Option C1 is always a winner under partial or general equilibrium simulation runs, as uniform and low tariff rates minimize distortions in consumption and investment patterns. Another important advantage is the "irrelevance" of determining the origin of a product for a fiscal reason, unless it is subject to antidumping or other safeguard measures. Rules of origin are the main cost imposed by bilateral liberalization under Option C2.

3.69. The preceding analysis points to Option A, that is, the current arrangements improved in line with the letter and spirit of the Paris Protocol, as the better option. Other studies identify either C1 or C2 as options generating higher welfare gains, mainly on the basis of much lower tariffs on agricultural products.⁹⁴ Indeed, with WBG importing almost all foods (around 30 percent of its total imports) from Israel, deep reductions in tariffs on these products would significantly lower prices of foods.⁹⁵ While on purely economic grounds multilateral trade liberalization always produces the highest welfare returns, there are some arguments in favor of Option A combined with deeper, policy-induced integration. These appear to be threefold:

- First, there are significant dynamic gains from closer economic integration with Israel—a highly developed country with good institutions supporting competitive markets. Static analysis of the effects of reducing tariff rates does not take into account dynamic gains. Furthermore, since Israel has been significantly easing up conditions of access to its markets, welfare gains from liberalization under MFN tariffs applied in 2006 would be much lower than five years ago.
- Second, one cannot take for granted that low and relatively uniform tariff rates will survive unavoidable attempts of various private interest groups to obtain higher levels of tariff protection. Moreover, as duties are easily collected, the temptation to turn to them as a source of extra government revenue may be difficult to resist. In consequence, low and uniform tariff rates may not stay in place for long.
- Last but not least, the rules of origin always impose significant extra trading costs—they amount to an extra tariff on both exports and imports.

E. CONCLUSIONS AND RECOMMENDATIONS

3.70. Neither past WBG export performance nor the current policy and institutional arrangements faced by WBG businesses augur well for turning exports of goods into an engine of economic growth in the short term. Export performance was dismal on all counts. First, although no detailed data are available for years before 1999, there appears to be little change in terms of technologies and factors embodied in exports. Traditional production inputs, together with low processed construction materials, account for

⁹⁴ *Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospect* (The World Bank, Washington, DC 2004), and Maurice Schiff, "FTA, Customs Union or Unilateral Trade Policy? Final Status Options for the West Bank and Gaza" (*Journal of Economic Integration* 18[1], 2003).

⁹⁵ However, these highly protected agricultural products account for around one-fifth of WBG exports to Israel. Under autonomous multilateral liberalization, they would have to compete with imports from other countries subject to the same high tariffs. Although considering geographical proximity, many of these products might retain their competitiveness, this cannot be taken for granted.

more than half of total exports. Moreover, exports of more processed goods were more affected by the collapse in exports in 2000–02.

3.71 Second, WBG firms have yet to tap benefits offered by the division of labor formed around value chains. Not surprisingly, given the cost and uncertainty of closures, participation of WBG-located firms in global value chains has been limited in comparison with economies at a similar level of economic development. This has been so mainly because of very low exports of textiles and clothing. Furthermore, if WBG firms are part of chains, they appear to participate in them mainly as subcontractors of firms based in Israel.

3.72 Last but not least, the dynamics of exports was unimpressive at best. West Bank and Gaza exports have barely bulged in real terms over the last two decades. Yet, export-led growth is the only option for economic recovery of WBG. Leaving aside restraints imposed by the Israeli security measures—in particular closures discussed in chapter II, which rule out any prospect for export expansion if they continue to be applied randomly and if they last for unpredictable amounts of time—anything short of significant increase in investment outlays, domestic and foreign alike, would fail to boost the export capacity of WBG over a longer period.

3.73 However, considering the low levels of capacity utilization in manufacturing sectors in WBG, improvements in policy environment might provide some boost to exports. These include:

- First, taking effective steps to fully implement the letter and spirit of the Paris Protocol as soon as political conditions are conducive to it. For a variety of reasons, this seems to be a good policy option from the point of view of economic welfare of the WBG, at least during the period of final agreement negotiations, despite some weaknesses in the Israeli structure of tariff protection (high level of protection of agriculture driving up their prices). Among the key actions are reviving the Joint Economic Committee, ending discrimination against WBG traders by Israel's customs (as overviewed in chapters II-IV), and setting the institutional framework for amending provisions and improving regulatory underpinnings.
- Second, an effort should be made to implement measures to adopt features of the Israeli economic regime as they pertain to administrative procedures governing exports and imports and standards, with the latter on its way to be aligned with international standards. Concerning the standards regime, developing WBG national technical standards imposes an unnecessary and hard-to-justify extra cost burden on businesses.
- Third, the PA should take steps to align legal/judicial and remaining regulatory barriers to improved business competitiveness with good practices, which is the subject of the next chapter.

CHAPTER IV

TOWARD A GROWTH-SUPPORTING BUSINESS ENVIRONMENT AND INSTITUTIONS

A. INTRODUCTION

4.1 The private sector remains an important source of economic growth and employment generation in West Bank and Gaza (WBG), despite the increasing role of the Palestinian Authority (PA) in creating jobs in the economy over the last six years. As highlighted in previous chapters, the private sector's development performance in WBG has been constrained both by the distortional effects of labor and trade regimes on the economy and by the Israeli security regime. The latter, by causing transaction costs to multiply, negatively affecting the timeliness of delivery of supplies and finished products, and increasing perceived risk and uncertainty, creates major obstacles to economic activity and productive investments. This has compounded the negative effects of the former⁹⁶: some traditional export markets have been lost, internal markets have shrunk and become highly fragmented, and the competitiveness of the private sector has further deteriorated.

4.2 Beyond these major constraints, however, success in stimulating and sustaining private sector development and growth also depends on two critical factors: a supportive climate for investors and business managers, and the ability of entrepreneurs to learn and become fast, flexible, and responsive to changing market conditions. These are particularly important factors for small country success in international trade. Other key factors for competitive success in WBG include improving property rights, promoting working capital instruments, and supporting higher-value production in manufacturing and agriculture. These key elements of private sector development and growth strategy are the subject of this chapter, complemented with the background analysis presented in the second volume of this report.

4.3 The chapter consists of two sections. The first section provides a "snapshot" overview of the private sector. The second section looks at investment climate conditions in WBG, focusing on recent policy and institutional reforms, as well as assessing what has been accomplished and still needs to be done. The chapter then turns to the findings from a series of industry studies conducted to assess the market and government failure constraints facing firms. These studies included interviews with companies up and down the chain of production, from upstream agricultural activities to downstream processing and final goods. They assess how enterprise capabilities, industry structures, and various aspects of the business environment influence enterprise costs and competitive positions in domestic and international markets. Five such studies are undertaken as part of the background analysis under this report, focusing on the agriculture sector as a whole; food processing, wood furniture, textile and garments; and the information and communication technology sectors.⁹⁷ The discussion also draws from recent, in-depth analysis of the data published by the Palestinian Central Bureau of Statistics (PCBS), Paltrade sectoral studies, and other sector and firm-level studies conducted by WBG research institutes and donors.⁹⁸ Finally, findings from the World Bank's recent Doing Business indicators on WBG business environment⁹⁹ are included where applicable.

⁹⁶ The restricted customs union directs trade to be conducted predominantly through Israel and Israeli-controlled areas; access to high-paying Israeli jobs raises domestic wages, depressing labor demand and rendering export products less competitive.

⁹⁷ See volume II of this report for details.

⁹⁸ Center for Private Sector Development (2005) "Private Sector Perceptions Relative to Economic Policies and Institutions," available on line at www.cpsd.ps; IMF (2005) "Macroeconomic Developments and Outlook in West Bank and Gaza"; Makhool and Atyani (2004), "Cost Structure, Economies of Scale and Their Effect on the Competitiveness of Palestinian Industries," Jerusalem and Ramallah: Palestine Economic Policy Research Institute; Paltrade (2005) "Economic Growth through Exports"; Paltrade (2005), "The Palestinian Processed Food Sector"; Paltrade (2005), "The Palestinian Furniture Sector"; Paltrade and Palestinian Federation of Industries (2002), "Private Sector Needs Assessment: Industrial Sector Survey"; Palestine Economic Policy Research Institute—MAS (2005), "Financing Palestinian SMEs"; CGAP (2006), "Meeting the Demand for Micro-finance

B. A SNAPSHOT OF THE PRIVATE SECTOR

4.4 Most WBG firms are small family-owned businesses. In 2003, there were 65,559 enterprises employing 186,836 people, 33 percent of total employment in the West Bank and Gaza (table 1).¹⁰⁰ The private sector has been badly hurt by the outbreak of the second *Intifada* in September 2000 and the subsequent, more restrictive closure regime imposed by Israel. A 2002 firm level survey¹⁰¹ showed that between 2000–2002 firms reduced employment by 45 percent. About 76 percent of surveyed firms operated at lower capacity and 17 percent closed operations. Uncertainty and restrictions in the movement of goods and people have restrained private investment. Firms have developed coping strategies such as reorienting their activities and employing unpaid family members. The situation has somewhat improved in the last two years, as firms have adapted and closures have become more predictable. Yet, employment creation by the private sector has been limited, with the sector lagging far behind the pre-Intifada levels of activity. A changing policy environment, slow progress in reform of the regulatory and legal framework, and weak property rights further increased the perceived risk of investments in WBG economy. Today, the private sector faces important challenges to support improved performance of the economy.

Table 1. Overview of the Palestinian private sector 2001–2003

	2001	2003
Number of enterprises	66,193	65,599
Number of persons engaged	203,007	186,836
Output (thousands US\$)	2,336,179	2,316,063
Gross value added (thousands US\$)	1,181,861	1,343,958
Gross fixed capital formation (thousands US\$)	38,214	41,195

Source: PCBS, Economic Survey Series.

4.5 Palestinian firms have relied increasingly on family labor and self-employment to cope with the dire economic conditions that prevailed after 2000. According to a 2002 survey, sole proprietorship and family businesses represent 74 percent of Palestinian firms (table 2). Ninety-six percent of Palestinian firms have fewer than 10 employees (table 3).

Table 2. Ownership structure of Palestinian firms

Type of Ownership	West Bank and Gaza	West Bank	Gaza
Public Ownership	2.97%	4.65%	1.85%
Sole Ownership	39.70%	30.70%	45.68%
Family Business	34.14%	40.93%	29.63%
Partnership	23.19%	23.72%	22.84%

Source: PFI and Paltrade 2002. "Private Sector Needs: Industrial Survey," prepared by the Palestinian Federation of Industries and Paltrade in cooperation with Market Access Program, funded by USAID

4.6 More than half of small and medium enterprise (SME) employees are business owners or unpaid family members; thus, less than half receive salaries. Between 1999 and 2003, the number of people employed as unpaid family labor increased by 35 percent, although it leveled off in 2004. The number of self-employed increased to 156,841 people in 2003 (up 39 percent from 1999), then dropped slightly in 2004. The share of self-employed in total employment increased from 19 to 26 percent during those years

in West Bank and Gaza"; Portland Trust (2004), "Beyond Conflict: The Economic Impact of Peace on Palestinians and Israelis"; World Bank (2005) "The Palestinian Economy and the Prospects for its Recovery"; European Commission and The World Bank (2004) "Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospects."

⁹⁹ *Doing Business in 2006: Creating Jobs*, World Bank Report. Doing Business data are available at www.doingbusiness.org

¹⁰⁰ All data cited in this section are from the Palestinian Bureau of Statistics unless otherwise noted.

¹⁰¹ Palestinian Federation of Industries and Paltrade (2002), "Private Sector Needs: Industrial Survey," prepared by the Palestinian Federation of Industries and Paltrade in cooperation with Market Access Program, funded by USAID.

Table 3. Size of Palestinian establishments–2003

	Fewer than 10 workers	Between 10–49	More than 50
Agriculture	99.8	0.2	0.0
Mining and quarrying	87.1	11.7	1.2
Manufacturing	91.7	7.0	0.4
Electricity and water supply	97.6	1.6	0.8
Construction	66.5	31.9	1.6
Wholesale and retail and repairs	99.5	0.5	0.0
Hotels and restaurants	97.5	2.3	0.2
Transport, storage, and communications	84.9	12.5	2.7
Financial intermediation	83.4	14.9	1.7
Real estate, renting, and business activities	97.2	2.6	0.1
Education	84.6	13.9	1.5
Health and social work	93.2	5.6	1.2
Other services	96.4	3.5	0.1
Overall	96.7	3.0	0.2

Source: Paltrade, based on PCBS, Establishment Survey.

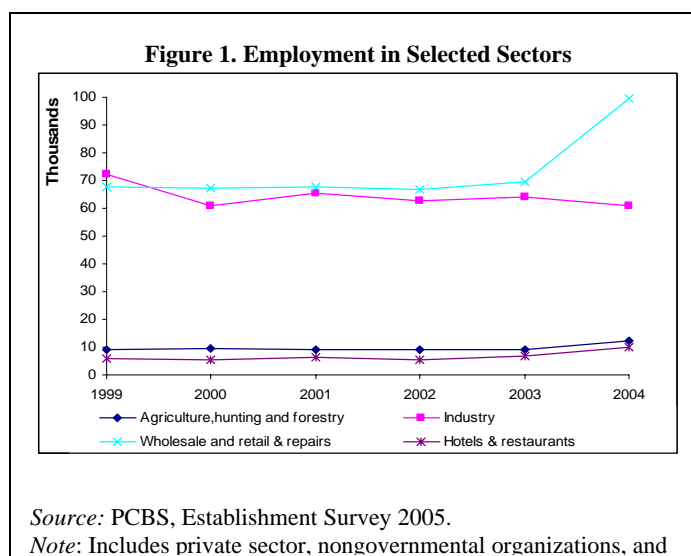
(table 4). There are reports of increased informality between 2000 and 2003. An estimate from 2003 put the number of informal business at approximately 110,000, more than three times (168 percent) the number of enterprises reported by PCBS and up from 50,000 at the beginning of the Intifada.¹⁰²

Table 4. Unpaid family labor and self-employed in the West Bank and Gaza

Number of people	1999	2000	2001	2002	2003	2004
Unpaid family member	47,610	58,030	46,222	48,706	64,457	64,302
Self-employed	112,939	117,244	121,313	126,804	156,841	153,256
Total employment	405,506	393,067	313,306	280,496	322,960	336,792

Source: PCBS.

4.7 Most Palestinian firms engage in labor-intensive, low-productivity activities. Internal trade, which involves wholesale, retail, and small repair shops, is the largest sector, accounting for 13 percent of total WBG employment (77,500 employees) in 2003. Preliminary data from the 2004 establishment survey¹⁰³ show an increase in employment in this subsector by more than 40 percent in 2004, reaching 38 percent of the total employment (99,333 employees) (figure 1). Most establishments in this subsector are small shops and repair outlets with fewer than 5 employees.



¹⁰² CGAP (2006). *Meeting the Demand for Microfinance in West Bank and Gaza*. Washington, DC: Consultative Group to Assist the Poor.

¹⁰³ PCBS, Establishment Survey 2005.

4.8 Stone and marble and light manufacturing dominate the industrial sector—food processing and stone and marble sectors alone represent more than 40 percent of industrial output. In 2003, there were 301 enterprises (0.5 percent of total enterprises) in the stone and marble sector and 13,392 enterprises in the manufacturing sector (21 percent of total enterprises), accounting for about 10 percent of total employment (60,200 employees). Total industrial value added (at about US\$477 million) represented 35 percent of the total. In terms of employment, major subsectors include textile and apparel, which accounts for 22 percent of manufacturing employment; food processing (19 percent); nonmetallic products (19 percent); and metal products (12 percent). Employment in the industrial sector has declined by 19 percent since 1999. No rebound has been reported in the establishment survey of 2004. The largest reductions in employment since 1999 took place in manufacturing of transport equipment, leather products, and apparel. Two subsectors report increases in employment by 20 percent or more in 2004: food processing and furniture.

4.9 The tourism industry has suffered big losses since the beginning of the Intifada and the imposition of the closure regime. The sector collapsed as violence broke out in popular destinations such as Bethlehem. The number of guests in Palestinian hotels dropped from 330,000 in 2000 to a mere 51,000 in 2002. A mild recovery started in 2003, reaching 100,000 guests in 2004 (still only one-third of the pre-2000 level). Palestinian firms have lost market share in favor of the Israeli tourism sector. Tourists use primarily Israeli hotels and tour operator services, with limited expenditure in WBG.

4.10 The fastest-growing sectors in 2005 were construction (5 percent) and transport (7 percent). This reflects an overall economic recovery and an expansion of internal and international trade. Informal construction, however, represents more than half of value added in construction.

4.11 During 2005 firms' expectations for the near future have deteriorated. The percentage of firms that expected higher employment in the following six months dropped from 60 percent in February 2005 to 22 percent in November. Similarly, the percentage of firms expecting higher sales volume went down from 77 percent to 48 percent.¹⁰⁴

4.12 Against this background, the discussion in the following sections assesses investment climate conditions in WBG, an area in which issues and reforms are currently under the PA's control; and how the industry structures, enterprise capabilities, and various aspects of the business environment influence enterprise costs and competitive positions in domestic and international markets.

C. BUSINESS CLIMATE—AREAS OF IMPROVEMENT

Administrative Barriers

4.13 The progress achieved in regulatory reforms in WBG is encouraging, especially when measured by investment climate indicators and benchmarked against neighbouring countries and other developing economies. This reflects the progress of recent reforms in the policy and institutional systems that are in the PA's disposition today for easing the constraints facing businesses.

4.14 Although *business registration* used to be a long and quite expensive process, the past year brought substantial changes and improved the situation significantly. The time required for registration decreased and procedures were simplified. A recently established electronic unified business registry operates under the auspices of the Ministry of National Economy (MoNE), and business entities receive a

¹⁰⁴ PCBS, Survey on the Perceptions of the Owners/Managers of the Industrial Establishments Toward the Economic Conditions (November 2005).

single identification number that is also used for tax payment purposes. Local businesses do not perceive registration as an obstacle to their activities, which, however, face somewhat simplified requirements compared to those for foreign-owned firms. There is, however, a need for further improvement in registration system by streamlining existing procedures. At present, procedures require tax registration in a separate office as well as acquisition of a municipal permit and operating license, which, in turn, involve approvals and inspection from fire and health departments. The registration of foreign-owned companies would benefit most from further simplification. The current requirement for notarized certification of all company documents, along with the inefficiency of civil servants involved at different stages of the registration process, may require two or three months of a local lawyer's time in completing the registration of a foreign company. To address this problem, the Palestinian Investment Promotion Agency (PIPA) initiated establishment of a one-stop shop for foreign investors to facilitate the processes of business registration, location site search and acquisition, access to utilities, and so forth.

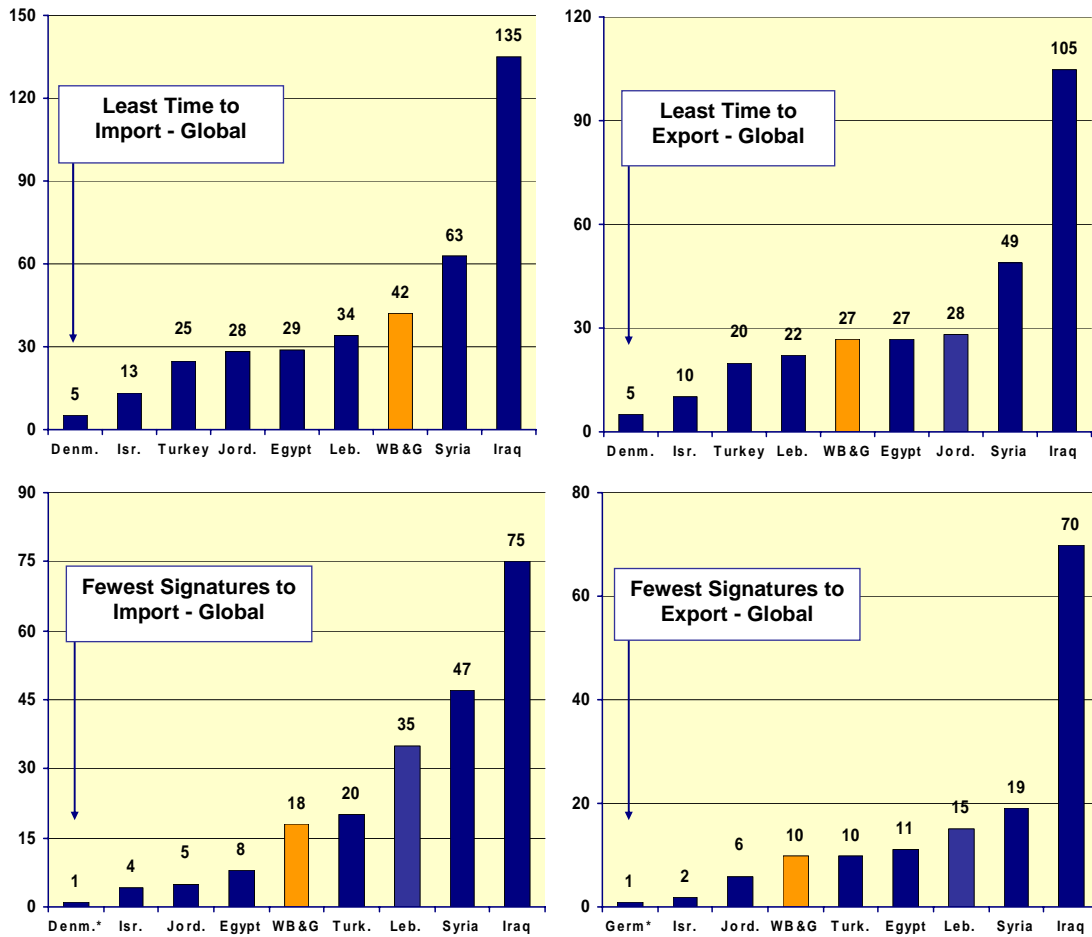
4.15 The interviews with business associations and enterprises confirmed that WBG is not burdened by overregulation and administrative barriers. *Licensing* of business activity, *permits and inspections*, which typically lead the list of business concerns in many countries, were not mentioned as obstacles to doing business in WBG. Although there is some room for streamlining the process for issuance of construction and operational permits at the municipal level, it requires improvement of municipal staff efficiency in service delivery rather than regulatory changes.

4.16 Another typical area of business complaints, *taxation*, is also not an obstacle to doing business in WBG. The tax regime is aimed to encourage investment in WBG and is not considered to be burdensome by entrepreneurs. In 2005, a number of changes were introduced in the tax regime: the VAT was lowered from 17 to 16 percent, the company income tax rate went down from 20 to 16 percent effective January 1, 2005, and personal income tax rates were lowered simultaneously. These changes took place in the context of the adoption of the new Tax Law (2004), which, among other things, aims to harmonize tax legislation across WBG.

4.17 Future sustainable development of the Palestinian private sector depends on its success in exporting goods and services. *Trading across the borders* depends, among other things, on procedural and documentary requirements for trading, efficient customs, trade/transport infrastructure, some key elements of which are not under the PA's control. Measured by standard Doing Business indicators, WBG fares reasonably well when compared to other peer countries in the region.¹⁰⁵ However, as demonstrated in figure 2, the time required for import (42 days) and export (27 days) exceeds similar indicators for Israel by three times. Palestinian businesses are required to obtain 18 signatures for import and 10 signatures for export compared to four and two signatures respectively in Israel. As discussed earlier, these indicators reflect the way the current quasi-customs union with Israel is implemented, affecting the Palestinian trade regime in many controversial ways. On one hand, Palestinian enterprises benefit from access to efficient Israeli customs and trade infrastructure. On the other hand, they have to comply with Israeli customs and clearance procedures; documentation requirements, including Israeli standards requirements; import and export licensing; permits, authorizations, and certificates of origin; and commercial and shipping documentation (apart from the imposed system of restrictions on movements and access), as well as a unique back-to-back system of cargo transportation.

¹⁰⁵ WBG was included for the first time in the most recent Report on *Doing Business in 2006: Creating Jobs*, where the data set characterizes the situation as of January 2005 and does not reflect the outcomes of the reform progress and changes introduced in the last year, especially in the regulatory reform area. Besides, the existing data sets cover 8 out of 10 Doing Business indicators; Protecting Investors and Closing Business data are not available. Therefore, the assessment in this chapter is based on recent reform progress on the ground. The trade indicators presented in this section might change in the next issue (as the data is refined), however, improvements in this area are not solely under the PA's control as discussed in several chapters of this report.

Figure 2. Trading across the borders



Source: Doing Business (2006).

4.18 Hence, the area of trade regulations, as applied to Palestinian enterprises, requires substantial streamlining and symmetrical application of customs union provisions, which, in turn, requires attention of Israeli authorities, as many of these administrative constraints are beyond Palestinian control. For example, all Palestinian companies trading across the borders have to obtain Foreign Trade Dealing registration, administered by the Ministry of National Economy. Although the ministry also takes care of Israeli clearances, the process can be time-consuming as it requires dual authorization. A similar approach is applied to export licenses, which according to Paris Protocol can be issued by the Palestinian Authority. In practice, an enterprise has to apply to the Palestinian Ministry of Agriculture, which forwards the application for the approval of Israeli authorities. The export license is issued for a certain volume of product and the established thresholds are quite low. This means the enterprise might be required to renew the export license regularly.

4.19 Palestinian *employment regulations* are generally on par with prevailing employment regulations in the region, and are more flexible than the labor legislation applied in Turkey and Egypt.¹⁰⁶ However, they still are somewhat rigid and compliance with them is quite costly for employers, particularly with regard to the cost of firing workers. Because of persistent high unemployment and poverty levels in the

¹⁰⁶ Doing Business Database, World Bank.

WBG, the PA in its latest labor law (2000) provided extensive benefits to the employees. The law contains several vague areas; for example, severance payments calculations. From a business standpoint, the law is more restrictive than the previous one with regard to hiring and firing employees. For example, it does not allow for short-term contracts: after one year of employment a person automatically becomes permanent staff. In the case of labor disputes, courts always give the benefit of doubt to employees. These features of labor regulations should be carefully reviewed to achieve a better balance between the rights and obligations of employers and employees in the context of upcoming EU support for strengthening the Palestinian economic legislative framework (see discussion in the next section).

4.20 In sum, administrative regulations that are within Palestinian control—measured both by business perceptions and comparisons with international benchmarks—do not generally impose serious impediments on doing business. The progress of reforms in most of the previously mentioned areas is obvious, although some of them can benefit from further streamlining and simplification along the lines recommended. However, many administrative barriers effective in WBG are imposed by unpredictable features of Israeli security regime. As discussed in previous chapters, these barriers add enormous uncertainty and major compliance costs that further undermine the already limited competitiveness of the Palestinian enterprises and deter foreign investors. Sustainable development of the Palestinian private sector and its job generation capacity is not feasible without removal of these barriers.

Recommendations:

- Further streamline current registration procedures, particularly with regard to registration of foreign-owned companies and procedures administered at the municipal level;
- Simplify the issuance of construction and operational permits at the municipal level through improvement of municipal staff efficiency and service delivery to business clients;
- Substantially streamline trade regulations, including procedural, documentary, and authorization requirements for export and import, and ensure symmetrical application of customs union provisions to Palestinian enterprises; this requires systemic identification of inefficiencies in each step and providing clear delineation of responsibilities of Israeli and Palestinian authorities in this area to avoid duplication and reduce the compliance costs of enterprises;
- Carefully review labor regulations to provide adequate flexibility and achieve a better balance between the rights and obligations of employers and employees, with particular focus on (i) firing procedures and amount of severance payments, (ii) reintroduction of short-term contracts and other provisions for flexible forms of employment, and (iii) labor disputes resolution.

Legal and Judicial Systems

Legal System

4.21 Unlike the case of regulatory reforms, progress in the legal and judicial reform in WBG remains slow and requires effective action. An appropriate legal framework for commercial activities and an effective judicial system to implement laws and protect property rights are critical to establishment of an investment environment in WBG that would be conducive to sustainable business development and growth. The renewed focus on legal and judicial reform became apparent in the policies and actions of the PA in 2005.

4.22 The fully integrated Palestinian legal system has yet to emerge; it remains one of the most complex systems in the world as a result of past occupations, each bringing a new set of rules and institutions. Aside from the laws passed since the establishment of the PA in 1994—which govern both

the West Bank and Gaza—the two areas have different laws, each reflecting various periods in history of changing rules.¹⁰⁷ Previous laws and regulations continue to have force and effect until amended or explicitly repealed by Palestinian law. The quality of the new Palestinian legislation also varies considerably: some of the laws are still based on antiquated principles, whereas some newer drafts are of very high quality. The result is a complex and sometimes contradictory set of substantive and procedural laws that the judiciary cannot interpret and apply in a coherent and effective way due to weaknesses in the capacity. These weaknesses are reflected in the findings of an industrial enterprise survey (2002), whereby 50 percent of respondents identified business codes and practices as their leading policy concern.¹⁰⁸

4.23 Hence, there is an urgent need to accelerate commercial legal reform to rationalize, streamline, and complete the legal framework for private sector development in Palestine, as well as to build adequate institutional capacity for implementation. A significant backlog of unpassed, good-quality draft laws and amendments, important for the orderly conduct of commercial activity, remains. They have been pending for a considerable time because of a power struggle between old and new thinking; they should be finalized and enacted urgently. These include, among others, company law; secured transactions law, which is in turn required for beginning operation of the Pledge Registry created with the USAID's support; law on quality infrastructure; and leasing law and additional leasing regulations related to taxation of leasing activities.

4.24 In parallel to filling the gaps in the priority areas of commercial legislation, a systematic and comprehensive review of existing secondary regulations is highly warranted. This should be aimed at identifying existing gaps in implementing regulations that many of the experts interviewed referred to as one of the main obstacles to efficient law enforcement, harmonization of the existing regulations, and amending and eliminating outdated and contradictory provisions. To conduct the regulatory review process in an expedient manner, several modern regulatory review and simplification techniques can be recommended, including a so-called “regulatory guillotine.”¹⁰⁹

4.25 To support legal reforms, the EU has funded extensive diagnostic review of Palestinian commercial and financial legislation and is planning to proceed with the program of strengthening the Palestinian economic and financial legislative and private sector institutional frameworks.¹¹⁰ Reforms in this area may benefit from additional donors' assistance, as the task and scope of activities are daunting.

Recommendations:

Accelerate implementation of commercial legal reform by the following means:

¹⁰⁷ Legal layers established over the years include Ottoman laws; British Mandate laws and emergency regulations; Sharia; Jordanian laws in the West Bank and Egyptian administrative orders and court decision influence in Gaza; Israeli civil law; and the new legislation introduced by the Palestinian Authority.

¹⁰⁸ Private Sector Needs Assessment: Industrial Sector Survey (Palestinian Federation of Industries and Paltrade, September 2002).

¹⁰⁹ Regulatory guillotine is an innovative reform instrument used to launch bold, top-down reforms of the existing stock of regulations. The regulatory guillotine is intended for situations in which governments are moving rapidly through the reform process. It is based on the view that the regulatory problem is vast and systemic, and that isolated and marginal reforms must be replaced by comprehensive reforms that extend across the public sector. The regulatory guillotine has been successfully applied in a number of OECD countries, as well as in developing and transitional countries.

¹¹⁰ The analysis presented in this section draws substantially on the findings of the EU-funded diagnostics review of the Palestinian commercial and financial legislation.

- Finalizing and enacting urgently the unpassed, good-quality draft laws and amendments, including company law, secured transactions law, law on quality infrastructure, leasing law and regulations related to taxation of leasing activities;
- Filling the gaps in the priority areas of commercial legislation, including *inter alia* commercial code, insolvency law, civil and commercial procedural law, comprehensive financial legislation, competition law, and consumer protection legislation;
- Conducting a systematic, comprehensive review of existing secondary regulations with the objective of eliminating outdated and contradictory provisions and developing the new ones required for efficient law enforcement.

Judiciary System and Enforcement

4.26 The performance of the judiciary system in settling commercial disputes and fostering the rule of law is one of the most important prerequisites of a healthy business and investment climate. Given the turbulent political and economic circumstances in the WBG, the role of the judiciary system becomes even more critical.

4.27 A recent survey¹¹¹ by the Center for Private Sector Development points to a high ratio of perceived problems with weak performance of judiciary system. Poor enforcement of court resolutions leads the list of issues of business concern in judicial area, with 50 percent of respondents defining enforcement as “bad.” Businesses rarely use the judicial system for commercial dispute resolution or contract enforcement, as the procedures are very long and expensive. Filing the case usually takes about 75 days, but may drag from six months to a year. There is a huge volume of pending litigation cases that are delayed, resolution of which can take two to three years.¹¹² Finally, enforcement is extremely problematic—connections with rival groups and militants often intimidate the police to the point of inaction. According to Doing Business indicators, the time for contract enforcement in WBG compares unfavorably with similar indicators for most countries in the region and is on a par with those of Syria and Lebanon. Inefficiency of contract enforcement has a negative impact on bank lending to private business. Piloting of a donor-sponsored alternative dispute resolution program has not brought positive results yet because of lack of attention to the problem of incentives.¹¹³

4.28 The shortcomings of the Palestinian court system are widely acknowledged and have been dealt with in part—for example, the reforms of 2002 laid the foundation for the separation of executive and judicial powers, and for an increase in the powers and capacity of the civil courts to adjudicate commercial disputes, areas of major importance to the private sector. In 2005, a steering committee for the development of judiciary was established, and a new judicial authority law, which provides clarity on a number of critical issues, was adopted. However, the constitutionality of its certain provisions was questioned by the Supreme Court, which might result in further amendments. Considering the lack of public and business confidence in the judicial system, there is an urgent need to clarify next steps for implementation of the Law and making the training of judges and lawyers a priority. This would help ensure the implementation of court decisions.

¹¹¹ The survey was conducted in March 2005 and covered a sample of 750 firms (450 operate in West Bank and 300 in Gaza).

¹¹² The latest estimates of Doing Business Database, suggests judgment takes about 600 days and execution another 150 days.

¹¹³ As of September 2005, the program has been in effect for 12 months, with 13 cases submitted and only 3 resolved. “Alternative Disputes Resolution—When It Works, When It Doesn’t,” PREM Notes, September 2005, No. 99.

Recommendations:

- Improve commercial disputes resolution through summary proceedings, improvement of the alternative disputes resolution mechanism, and strengthened enforcement of judicial decisions;
- Finalize reform of the judicial system;
- Support training of judges, court clerks, and lawyers.

Governance, Transparency and Anticorruption

4.29 The perception of corruption has not changed materially in the last few years. According to the recent enterprise survey of the Center for Private Sector Development, Palestinian entrepreneurs still perceive a degree of corruption in the PA and insufficient transparency of its activities.¹¹⁴ The issues of major business concerns encompass the PA's direct involvement in commercial activities (for example, fuel, cement, cigarettes) and the lack of progress with promised gradual withdrawal; the size of the public sector workforce and the recruitment practices that have not improved in the last 10 years; favors and privileges obtained by business from public authorities on the basis of personal, family, or political connections; quality of governance in economic public sector institutions and their insufficient level of coordination. At the same time, findings from an earlier Enterprise Survey by the World Bank (2000) confirmed by the recent enterprise interviews indicate that business concerns do not relate to petty corruption (informal payments to officials) or corruption in procurement. The types of corruption that are most frequently encountered are elsewhere—for example, relating to transparency of public sector operations and public sector capture.

4.30 President Abbas came to power underlining his commitment to governance reform and on March 1, 2005, the PA presented the London Meeting on Supporting the Palestinian Authority with a *Declaration on Institutional Renewal*. In 2005 the PA implemented a number of its commitments, including strengthening internal auditing and public procurement reforms. Palestinian authorities also undertook a range of anticorruption measures. These included adoption of the Law on Illicit Gains, applicable to high and medium-level PA officials, and developing a comprehensive anticorruption strategy. The law established a commissioner's office to investigate complaints and inspect financial and property statements submitted by officials. The former Speaker of the Palestinian Legislative Council was appointed as a commissioner. The PA has also been willing to confront officials suspected of wrongdoing—for example, launching investigations of several corruption cases and reversing some illegal activities, such as confiscation of land.¹¹⁵ However, the action in this area has been insufficient so far. More active steps are needed to combat corruption and counter damaging public perceptions.

Recommendations:

- Exercise gradual withdrawal of the PA from direct involvement in commercial activities;
- Increase transparency of PA functioning, including further strengthening of internal auditing and enhancing transparency of public procurement, publishing the terms of exclusive licenses to firms;
- Maintain the ongoing public-private dialogue regarding major economic policy decisions and other issues of business concern;

¹¹⁴ *Private Sector Perceptions relative to Economic Policies and Institutions* (Center for Private Sector Development, Palestinian Businessmen Association, March 2005).

¹¹⁵ *West Bank and Gaza Update*, A Quarterly Publication of West Bank and Gaza Office (The World Bank, November 2005), 7.

- Finalize and initiate implementation of a comprehensive anticorruption strategy that is currently under preparation.¹¹⁶

Access to Finance

4.31 Limited access to finance is not a major constraint for private enterprise operations while they are in survival mode. However, adequate business finance will be needed to fuel any recovery. Once the political situation improves, transformation of economic recovery into sustainable economic growth would inevitably require an increase in investment for technological and managerial modernization that is crucial for productivity growth, and for improving competitiveness of Palestinian enterprises. In 2002, the investment to output ratio in WBG enterprises was a mere one percent,¹¹⁷ which is very low by international standards and indicates that firms were spending less than required to even replace depreciated capital. Normalization of private sector investment practices¹¹⁸ will demand improved access to financial resources and services.

4.32 The *financing patterns* of Palestinian firms are well documented and primarily based on retained earnings and family sources. The industrial sector enterprise survey data (2002)¹¹⁹ confirms that at the peak of Intifada only 16.3 percent of industrial firms reported using bank finance and 4.7 percent tapping on money lenders for financing fixed assets, while the use of external financing for working capital was slightly higher. Firms located in the West Bank tend to use bank financing more than the ones located in Gaza. At the same time, more than 73 percent of businesses referred to using self-financing and 34 percent had family financing.¹²⁰ Although the share of enterprises that have used bank financing in the last five years is small, the recent study of the small and medium enterprise (SME) financing conducted by Palestine Economic Policy Research Institute (MAS) shows that 63 percent of respondents have plans for expansion of their business, and 66 percent state that they currently need external financing.

4.33 The *financial sector* in WBG survived the difficult economic situation of recent years and remains fundamentally healthy. The Palestinian banking sector consists of 22 banks with 138 branches; 12 of the banks are foreign. Although banks remain very liquid, with private sector deposits at 74 percent of GDP, they are extremely conservative in their lending practices.

4.34 *Commercial bank lending* activity declined considerably during the first two years of the Intifada. This reflected both lower demand on the part of borrowers and greater risk aversion on the part of bankers during the period of economic downturn and political uncertainty. From its low point in March 2003, when the stock of credit outstanding was US\$737 million, lending started to climb again in spring 2004 and increased to US\$1.04 billion by the end of June 2005. Nevertheless, despite a 30 percent growth during 2005, credit to the private sector continues to be low by international standards and amounts to approximately 28 percent of GDP, significantly lower than the regional average, and less than half the level of Jordan.¹²¹ When measured as percent of total assets, lending to the private sector at 19.2 percent

¹¹⁶ For detailed discussion on selected reform measures see the World Bank's forthcoming Public Expenditure Review (June 2006).

¹¹⁷ Palestinian Central Bureau of Statistics Industry Census, 2002.

¹¹⁸ Investment to output ratio of 6 percent, which is in line with international comparisons, was observed in 1994, the earliest year for which the data are available, "Beyond Conflict: The Economic Impact of peace on Palestinians and Israelis" (The Portland Trust, December 2004).

¹¹⁹ Private Sector Needs Assessment: Industrial Sector Survey, Palestinian Federation of Industries and Paltrade, September 2002.

¹²⁰ Firms may use more than one source, so the numbers may not add up to 100 percent.

¹²¹ *The Palestinian Economy and the Prospects for its Recovery*, Economic Monitoring Report to the Ad Hoc Liaison Committee (The World Bank, No. 1, December 2005), 8.

by the end of June 2005 was still below its pre-Intifada level of 22.1 percent in September 2000.¹²² At the same time, the quality of loan portfolios improved with the continuing decline in the share of nonperforming loans—it reached 8.3 percent by mid-2005, down from 10.4 percent at the beginning of the year,¹²³ and down from 29 percent at the end of 2002.¹²⁴

4.35 Highly unstable political and macroeconomic environment of interim political and economic agreements is not the only reason for the lenders' risk aversion. Institutional factors, such as a confusing legal framework, inefficiency of contracts enforcement and creditor rights protection through the court system, and unclear land titles in most areas outside Ramallah and Nablus, negatively affect the credit environment. Growing informalization of the private sector and lack of reliable business financial statements complicate the situation further.

4.36 Banks respond to these challenges by relying heavily on relationship- and collateral-based lending, in which the range of assets eligible for use as collateral is very narrow. Lack of collateral is considered a major constraint on lending.¹²⁵ Traditional assets required as security for loans comprise personal guarantees, land and buildings with clear title, and securities. Movable assets—equipment, vehicles, inventories, and receivables—are rarely used as collateral as the Pledge Registry is not yet operational.¹²⁶ Cash flow-based lending is not part of bank lending practices in WBG. This affects small firms particularly, limiting their access to the formal credit market.

4.37 A reliable full service *credit information system* typically helps bring down the costs of lending by providing a lender with an additional way to assess the creditworthiness of many potential new borrowers. At present no private credit information market exists in WBG. The Palestinian Monetary Authority (PMA) collects data from banks on loans exceeding US\$10,000 and can inform them about outstanding balances of loan applicants. It also maintains a blacklist of bank customers that issue checks on insufficient funds. Nevertheless, PMA does not accumulate positive information on borrowers and cannot furnish their credit history to lenders.

4.38 Two *loan guarantee facilities* have been recently established by donors to share the risk of SME lending with the banks. Although these mechanisms can be useful in facilitating bank lending to private sector, particularly if they are part of a broader reform package, their scope is quite limited and they cannot compensate for all systemic problems that deter banks from lending to SMEs.

4.39 There are few *financing opportunities beyond the banking sector*. Other potential sources of finance, for example, *leasing and factoring* are virtually nonexistent in WBG. The development of leasing requires changes in tax legislation, which can be introduced by the Ministry of Finance based on provisions in tax law. However, such amendments have yet to be developed. *Equity financing* is in the nascent stage, with Palestinian Economic Development Company¹²⁷ considering a few first equity investments, and several private companies establishing a private equity fund. In addition, there is a

¹²² *West Bank and Gaza Update*, A Quarterly Publication of West Bank and Gaza Office (The World Bank Group, November 2005), 7.

¹²³ *The Palestinian Economy and the Prospects for its Recovery*, Economic Monitoring Report to the Ad Hoc Liaison Committee (The World Bank, No. 1, December 2005), 8.

¹²⁴ *Economic Performance and Reform under Conflict Conditions* (IMF Report, September 2003), 45.

¹²⁵ According to the MAS and PCBS survey of 450 SMEs conducted in August 2005, 70 percent of respondents indicated insufficient collateral as the main reason for credit application rejection, whereas credit officers noted that one-third of loan applications were rejected for this reason.

¹²⁶ The work on establishment of Pledge Registry is led by the MoNE with USAID support.

¹²⁷ The Palestinian Economic Development Company was recently established with funding from the Palestinian Investment Fund to invest in projects within Palestine.

Palestinian Securities Exchange based in Nablus, where 27 companies are listed, but in which shares of only seven companies are actively traded.

4.40 There are 10 active *microfinance institutions and programs* (MFIs) in WBG that strive to extend financing opportunities to the lower end of microbusinesses and individual entrepreneurs.¹²⁸ With an average number of active borrowers at 2,690, which is a fraction of the global average of 47,688, they cannot meet the existing demand for microloans and financial services. All the MFIs continue to rely on grants to finance both loan capital and operational costs; for this reason, they are not operating on a sustainable basis. This situation is in part due to the consequences of Intifada, and in part due to a combination of MFIs' lack of exposure to international best practice, inadequate management information systems, and lack of strategy and business plans.

4.41 The absence of easily accessible property registries and full-scope credit information service, together with conservative approaches to lending is leading banks to reorient their operations toward consumer lending. This is the fastest growing segment of banks' portfolios,¹²⁹ which rely on using salaries of public employees paid through the bank account as collateral. Consumer loans vary in size, amounting to 20 to 40 monthly salaries. High repayment performance and interest rates make this activity much more attractive to banks than does risky lending for business purposes. With the oversized public employment and recent substantial increase in the salaries of public servants, rapid growth of consumer lending not only further represses credit to the private sector for business purposes, but also creates additional potential risk to macroeconomic stability.

Recommendations:

- Improve the legal framework to increase efficiency of creditor rights protection and court judgment enforcement for facilitating enterprise access to investment finance;
- Complement these steps with the following measures to improve bank lending practices with immediate attention to capacity building needs:
 - ✓ Broaden the range of assets that can be used as collateral by (i) improving registration of land and buildings in Area A (see section below); (ii) adopting a secured transactions law; and (iii) starting operation of the Pledge Registry;
 - ✓ Expand and strengthen the credit information system and services through engaging a private sector provider, accumulating both positive and negative payment history data, eliminating the minimum reporting amount requirement, and expanding credit bureau service provision beyond the banking sector to all potential lenders;¹³⁰
 - ✓ Support development of leasing through introduction of required amendments to the tax legislation;
 - ✓ Facilitate commercial banks involvement in SME-lending and microfinance by providing capacity building assistance that can cover (i) transfer of alternative credit risk assessment techniques to bank staff, which would support introduction of cash flow-based lending into banking practices; (ii) development of products and services tailored to specific needs of

¹²⁸ The review of the microfinance sector situation is based on the analyses provided in the recent CGAP Report *Meeting the Demand for Microfinance in West Bank and Gaza (draft)* by Mohammed Khaled, Kate Lauer, and Xavier Reille (January 2006).

¹²⁹ In some banks interviewed, the volume of consumer loans doubled during 2005.

¹³⁰ The PMA expressed interest in helping establish a full-service credit information bureau and was put in contact with IFC credit information experts.

- different groups of SMEs and microenterprises; (iii) support for establishing partnerships between banks and MFIs;
- ✓ Provide technical assistance to MFIs, with emphasis on introducing modern management information systems, enhancing skills in management and business planning, and sharing best international practices.

Access to Land

4.42 Enterprise access to land in WBG is constrained by its scarcity because of the consequences of Israeli occupation and high costs. For example, the cost of serviced land in WBG is three times the cost of land in Egypt and five times the cost in Jordan.¹³¹

4.43 *Security of land tenure and property rights and inefficient functioning of land markets* pose even bigger challenges in WBG. Land and property, as in many developing countries, are a common means of storing wealth in WBG. It is estimated that 25 percent of the court disputes in the West Bank are land related. Ownership and title issues are complicated by continued Israeli occupation in areas B and C.¹³² Land with clear title, highly valued as collateral by banks, is limited to area A and very scarce. It constitutes only 18 percent in the West Bank, while land in area C, fully controlled by Israel, amounts to 61 percent. The final status of land in areas B and C is uncertain; in addition, title for land in these areas is generally unavailable. After the recent Israeli disengagement, all land in Gaza is controlled by the PA, which is expected to provide additional business opportunities.

4.44 *Land titling, registration, and efficient administration* are critical to private sector development in WBG. The PA acknowledges the need to address them more diligently and they have been included in the Palestine Development Plan. This requires developing an efficient system of land titling and administration based on coherent policies and laws, and supporting the system with appropriate institutional structures. A discussion of several important reform areas follows.

4.45 Development of a consistent land policy and harmonized regulatory framework, including a set of new land codes, is the top priority. At present, land titling and registration are governed by 26 different laws and regulations, which are often contradictory and vary considerably in the West Bank and Gaza. Special attention must be paid to the regulation of transparent management and disposal of state land and other immovable property.

4.46 The establishment in 2003 of the Palestine Land Authority (PLA) that united the functions of land surveying and registration demonstrates PA commitment to institutional reforms in this area. PLA institutional capacity building needs are extensive and would benefit from substantial donor support.

4.47 There is an urgent need to computerize land and property registries to facilitate access to information and decrease transaction costs. At present, all records are created and maintained manually. The PLA has to manage three sets of records in the West Bank and four sets of books in Gaza. Retrieval of such records is burdensome and time-consuming.

4.48 Moreover, very few land transactions are currently recorded in the land registry. Most people and businesses prefer to use the alternative registration system at the public notary, based on the irrevocable

¹³¹ FIAS 2001.

¹³² Land in WBG is divided into areas A, B, and C. The Palestinian Authority executes full civil and security control only over area A; in area B, the PA controls civil affairs, but security control is shared with Israel. Area C is fully controlled by Israel, with PA sharing some civil responsibilities. This being said, many parts of area A has also been effectively under the Israeli control since the onset of the second Intifada.

power of attorney (IPA). The IPA was expanded to ensure the flexibility of real estate transfer under closures and movement restrictions, but eventually became a substitute for recording transactions in the registry. Although current registration procedures need to be simplified to encourage registration with the land registry, the duration of registration validity based on IPA must be limited. The recent reduction of transaction fees to one percent of the real estate value is the right step in this direction.

4.49 Last but not least, although 90 percent of land is registered in Gaza, only 28 percent of land is registered in the West Bank. The growing volume of sporadic land registration and business readiness to pay for it confirms the existing demand for conducting systematic land registration. The World Bank, in cooperation with USAID and the Government of Finland, is addressing some of these issues under the Gaza Land Administration Project. Piloting of systematic land registration and establishing two modern land registration offices with project support can, if successful, be rolled out to the whole territory controlled by the PA.

Recommendations:

- Introduce regulation ensuring transparent management and disposal of state land and other immovable property;
- Provide technical assistance for PLA institutional capacity building;
- Initiate systematic land registration in the West Bank;
- Further simplify existing registration procedures with the land registry, while limiting the duration of registration validity based on the IPA, to encourage broader use of the land registry and increase the share of properly registered transactions;
- Computerize land and property registries to facilitate access to a unified information database and reduce transaction costs;
- Develop consistent land policy and harmonized regulatory framework, including a set of new land codes.

D. CROSSCUTTING ISSUES FOR BUSINESS DEVELOPMENT AND IMPROVED COMPETITIVENESS

4.50 For nearly 40 years the WBG economy has been intertwined with that of the Israeli market. Palestinian workers have served as a source of cheap labor for Israel producers and Palestinian firms have provided low-cost, labor-intensive products for Israeli distributors. However, with the outbreak of the Intifada, political and economic developments have increasingly brought pressure to bear on many of these traditional markets. Israel is steadily reducing the number of Palestinian workers allowed to work in Israel and replacing them with inexpensive labor from Asia and Eastern Europe with a stated goal of eliminating permits by 2008. At the same time, traditional industries are facing reduced protection, increased competition from imports, shrinking markets, and rising costs. Israeli companies have responded to these changes by moving up market and out of labor-intensive manufacturing toward higher value-added goods and services. However, as described in previous chapters, Palestinian companies have found it much harder to reorient their production. The Palestinian industrial sector remains focused on traditional labor-intensive industries such as garment production, furniture, and low value-food processing.

4.51 Over the medium-term, expanding access to the Israeli market remains the Palestinian private sector's best chance for growth. However, if Israel moves forward with stated policy of separation, Palestinian producers will find it increasingly difficult to access their traditional Israeli markets and will have to develop new links to markets in the rest of the world. This, in turn, requires elimination of the closure regime and restoration of free movement. But beyond obtaining access, Palestinian industry will

also have to overcome challenges of high costs, low productivity, and lack of market links. The following section highlights the most important challenges facing Palestinian producers as revealed in interviews with Palestinian businessmen in key sectors of the WBG economy (for details see the second volume of this report).

Closures, Movement, and Market access

4.52 The success of the Palestinian private sector ultimately depends on having access to both markets and private technology transfer mechanisms, as well as freedom of movement. The current closure regime is therefore the biggest constraint on growth and, unless it is relaxed, Palestinian output will continue to stagnate. The closures affect all facets of business. It keeps firms from entering the world market, prevents producers from attaining minimum efficient scale, increases transportation and other costs, and limits access to strategic planning, marketing, and technology transfer mechanisms, all of which critically depend on the strength of the investment climate.

4.53 The ability to guarantee delivery of consistent quality on a specified schedule is required to enter the international market. Quick turnaround and just-in-time delivery characterize high-value markets—the markets that Palestinian producers have to target to compensate for their high costs. As discussed in previous chapters, the current security regime prevents Palestinian firms from adhering to delivery schedules and effectively prevents most firms from entering the world market or moving into production of high-value added products. Some companies in the West Bank have been able to find ways around the closures, albeit at high cost. They can ship their goods to Israel using Israeli cars, or hire Israeli trucks. For instance, a few garment and textile firms have been able to prosper because they are flexible and can quickly fill small orders for Israeli firms. However, there is no way around the closures in Gaza, and with completion of the wall and stricter enforcement of travel regulations, West Bank companies may also find it impossible to meet delivery schedules.¹³³ More recently, Palestinian dual-citizen businessmen have also raised concerns about tightening in Israeli visa procedures, which risks further reduction in private sector investments and loss of skills for the economy.

4.54 The closures reduce the size of potential markets and raise transportation costs. The Gaza market is effectively isolated and few firms are able to sell into the West Bank or Israel. The West Bank is becoming increasingly segmented and closures make it difficult and expensive to ship goods between cities. One food firm in Nablus reports that the cost of sending a truck from Nablus to Ramallah has increased nearly fourfold since 2002. Firms report that in some cases it is cheaper to bring goods from Israel into certain areas of the West Bank than from other parts of the territory. The effect of the closure regime on transportation costs is well illustrated by the case of the wood furniture industry in Gaza. According to estimates by the Wood Industry Union, the cost of a truck from the port of Ashdod to Gaza before the Intifada was about \$250, whereas today it can cost as much as \$2,300 when the security regime is tightened. The security regime also increases the cost of final products sold in Israel. Today it costs around \$1,100 to ship a truckload of furniture from Gaza to Tel Aviv, compared to about \$160 before the Intifada.¹³⁴

4.55 Security closures are not the only barriers to Palestinian goods entering Israel. Most goods sold in Israel need to be kosher or have the Israeli quality mark. However, it is becoming nearly impossible for Palestinian producers to receive these certifications because Israelis cannot travel to the WBG. Israel and the PA have negotiated a reciprocal arrangement for recognizing each other's standards for certain products. However, in many cases Israel does not accept Palestinian testing. Food products, one of the markets in which Palestinian goods can be competitive in Israel, are not covered by the mutual

¹³³ See chapter II and the second volume for a more detailed discussion.

¹³⁴ WIU sector profile, 2005. See chapter II and the second volume for more detailed discussion.

recognition agreement. Consequently, most Palestinian food items are not certified for sale in Israel or East Jerusalem. Previously, some dairies were able to market their goods in East Jerusalem but are no longer allowed to do so. Palestinian pharmaceuticals, another important Palestinian product, are also not certified for sale in East Jerusalem, though they are of high enough quality to be sold internationally.

4.56 Palestinian products also face difficulties accessing non-Israeli markets. The PA has signed trade agreements with several countries and has agreements with some of them for mutual recognition of standards. However, not all countries adhere to the agreements and the PA has little power to enforce them. The Arab League decided unanimously to grant Palestinian goods duty-free access, but a number of countries, including Egypt, have not implemented the agreement. Palestinian exporters also have difficulty exporting through Egypt because of inefficiencies at the border. Under the customs union, Israel does not recognize any agreement that the PA signs directly with other countries.

4.57 In sum, the WBG economy is isolated, segmented, and burdened with unpredictability and high perceived risks that increase the cost of doing business and constrain competitiveness. While, as discussed in this chapter, the private sector faces a number of other challenges to become competitive, addressing concerns such as high production costs and low productivity will have little effect as long as market access is denied.

High Costs, Low Productivity, and Enterprise Capability

4.58 Because the Palestinian economy is essentially part of the Israeli economy, it faces a similar cost structure. Whereas average labor costs are only about 60 percent of the cost in Israel, they are much higher than in neighboring countries, and countries that produce the goods with which most Palestinian industry competes. This places a particular burden on labor-intensive industries such as garments, which make up the bulk of Palestinian industrial employment. Despite unemployment rates that currently run at a high of 24 percent, Palestinian wages remain more than double those of Jordan and around three times those in Egypt for similar workers. High wages persist for a number of reasons, including opportunities to work in Israel or settlements and high public sector wages.

Table 5: Average hourly wage for semiskilled garment workers (US\$)

West Bank	Gaza	Israel	Egypt	Turkey	China
1.75	1.20	9.81	0.82	2.88	.48

Source: World Bank Estimates and Werner International.

4.59 In addition to wages, the costs of raw material are also higher than in competitor countries. Most Palestinian producers either use Israeli-produced inputs or imported raw materials bought from Israeli middlemen. Palestinian producers favor Israeli inputs because they are usually less expensive and of higher quality than local Palestinian production. They purchase imported goods through Israeli dealers because of the difficulty Palestinians face in importing directly. If there are complications at the port of entry, Palestinians from the West Bank and Gaza are not able to travel to the port or to the offices of Israeli government officials to sort out the problem. Direct imports by Palestinians will also be scrutinized more closely and delayed by security checks longer than goods imported by Israelis. Thus, Palestinians usually buy through Israeli middlemen, which, according to firms, adds anywhere from 10 to 25 percent to the international price of imported goods.

4.60 **High Utility Costs.** The cost of utilities in Palestine is among the most expensive in the world. Power is particularly expensive and significantly reduces the competitiveness of the industries (such as food processing or stone and marble production) of which it is an important element in the cost structure. Electricity in Ramallah is reportedly 60 percent more expensive than in Israel and more than double the cost of electricity in Jordan. Water is also significantly more expensive than in neighboring countries.

4.61 **Low Productivity.** Not only do Palestinian producers face higher costs than producers in other countries, they also have relatively low productivity. There are few industry studies, but evidence from representative industries suggests that Palestinian labor productivity does not come anywhere close to compensating for its higher costs. For instance, one recent study found that the ratio of value added to wages, a good measure of labor productivity, in the garments sector is more than three times higher in Egypt, and two and a half times higher in Turkey than in WBG.¹³⁵ Similarly, a survey conducted in 1999 by the Fashion Technology Institute in Beit Sahour, revealed that the average efficiency of Palestinian garments producers was only about 59 percent of international benchmarks as measured by Standard Allowed Minutes.

4.62 Probably the most important factor explaining the low productivity is weak mechanisms for enterprise-learning, a key driver of productivity improvement. Learning takes place by way of the transfer of technology—defined broadly to include new ideas, equipment, management practices, marketing strategies, and the like—from more advanced countries. Depth of financial markets, supportiveness of the investment climate, and other factors that influence investment rates are important for productivity growth too, but the efficiency of investment will depend on the technical ability of firms to acquire, adapt, and efficiently use new capital equipment and new ideas. The leading source of technical learning in firms is private learning mechanisms. These operate through the internal efforts of private firms to learn through interactions with foreign buyers and suppliers, interactions with other foreign and domestic firms in the same industry, hiring expert consultants and expert foreign employees, and internal and external training programs for managers and workers.

4.63 Productivity improvement will also require better strategy and marketing. Palestinian firms must do what they are doing more efficiently, while also developing new strategic approaches that make improved efficiency profitable. The latter will involve the capability to assess the strategic positioning of the firm. Producers in every sector, however, consistently report that it is difficult to find experienced managers in WBG. Although there are many highly educated Palestinians, there are few experienced managers familiar with the latest production, marketing, and management techniques. This problem is exacerbated by the fact that Palestinian enterprises are predominantly family owned and often loath to hire managers from outside the family. There are few institutions that train business managers, almost no foreign-owned firms where Palestinians can observe international best practice, and limited opportunities for Palestinians to gain practical work experience. Without skilled and experienced managers, however, Palestinian enterprises will never achieve the level of productivity necessary to make them internationally competitive.

**Table 6. Industrial electricity tariffs
For selected countries, 2002**

Country	U.S. cents /kwh
Czech Republic	4.9
Denmark	7.0
Greece	4.6
Israel	6.2
Hungary	6.0
Ireland	7.5
Jordan ¹	4.2
WBG	10.2
Turkey	9.4
US	4.8

Source: U.S. Energy Information
Adm., Jordan Electric Power
Company, Israel Electric Corporation.

¹³⁵ Makhool and Atyani, *Cost Structure, Economies of Scale and Their Effect on the Competitiveness of Palestinian Industries* (Jerusalem and Ramallah: Palestine Economic Policy Research Institute, 2004).

4.64 Small-scale and old equipment also reduces productivity levels. Most Palestinian enterprises are small or micro-sized firms—too small to attain an efficient scale of production. Closures and lack of access have reduced potential markets for most enterprises to their immediate area. Consequently, despite their already small size, most enterprises are operating well below full capacity. The wood and food industry associations estimate the average capacity utilization in their industries to be around 65 and 60 percent, respectively. Because of their small size and lack of capacity utilization, few firms have the incentive or ability to invest in new machinery or production technologies. For example, a survey conducted by the Wood Industry Union suggests that 50 percent of the wood furniture producers in Gaza rely on manual machinery, and only 16 percent uses fully automated machinery. With old equipment and small-scale and low utilization rates, it is not possible for Palestinian producers to attain productivity levels that allow them to be internationally competitive.

4.65 **Learning and Marketing.** When asked about the biggest constraints to expanding their markets beyond WBG, Palestinian producers invariably mention lack of knowledge about other markets. Decades of occupation molded Palestinian industry into an adjunct of Israeli industry. Palestinian producers served the low end of the small local market and provided labor-intensive goods for Israeli distributors. Palestinian sewing shops assembled garments from designs and material provided by Israeli firms who then distributed them in Israel or exported them to the United States and Europe. Stone and marble producers sent unfinished stone to Israel for polishing and export. Food products were largely kept out of the heavily protected Israeli market, except for traditional foods (such as tahina, zatar, and so forth), for which there are few Israeli producers. Whereas the reliance on Israeli distributors facilitated Palestinian goods to enter the international market, it also left Palestinian producers completely dependent on Israeli channels with no ability to do their own marketing.

4.66 As a consequence of this structure, Palestinian managers concentrated on managing production and did not develop independent market contacts or the knowledge needed to enter new markets. Most of the recent successes in direct exports have been one-off exercises and few Palestinian enterprises are exporting consistently. Most Palestinian producers do not know how to design packaging or products for export markets. They are unfamiliar with what is required by consumers and regulators abroad, and there are few business service providers who can supply this information. Closures and the security situation play a major role in this situation. Few international buyers will visit the WBG because of security concerns. At the same time, Israeli restrictions make difficult and expensive for Palestinians to travel abroad to build contacts or learn about potential markets. For the Palestinian private sector to grow and enter new markets, firms must develop a marketing capability independent of their links with Israel.

4.67 **Quality.** An additional factor undercutting Palestinian producers' ability to access new markets is low product quality. Since most producers traditionally served the low end of the local market, they have not developed adequate knowledge or sources of supply necessary to produce high-quality products. In many cases, especially in food products, local inputs can achieve the required quality. However, without market access few producers will invest in the equipment, training, and sources of supply needed to produce high-quality goods. For instance, if properly handled, Palestinian olives can produce some of the highest quality oil in the world. However, without opportunities to market high-quality oil, few farmers or presses will invest in the necessary equipment, such as stainless steel containers, or proper handling to produce high-quality oil. Many Palestinian firms have obtained ISO and other quality certifications, and the industry associations and Palestinian Standards Institute have moved to introduce quality marks. However, most Palestinian products remain of low quality and not suitable for the export or the high-value end of the market.

Entrepreneurs' Perception of Business Environment

4.68 Faced with major constraints beyond its control, the PA has worked diligently to improve the business and investment environment in WBG. Many issues regarding petty corruption, inspections, and other rent seeking by government officials commonly found in developing countries are not cited as significant issues by managers in WBG. The Ministry of Economy has led the way in trying to reduce red tape and improve government services, and few managers cite the regulatory burden as a serious constraint on doing business. However, managers report that there are still significant areas where the government falls short in providing a supportive business climate. These are discussed in detail in Section B of this chapter and highlighted below, based on feedback from industry case studies undertaken for this Report.

4.69 **Courts and Judiciary.** Few businessmen go to court to settle business disputes. The courts function but they are slow and expensive. Managers said that they do not use courts because once a judgment is rendered, enforcement is problematic. Consequently, most business disputes are solved informally. This is not a major impediment to business in a small community where business relations are long-standing. However, this situation will not support a higher level of investment and is not conducive to foreign direct investment by parties that do not have deep ties in the community.

4.70 **Financial Markets.** As described in earlier sections, the banking system is highly liquid and can provide most types of loans. But few Palestinian firms use external finance because they operate on a small scale and are able to finance their current needs from retained earnings and informal sources. Because of the uncertain business environment, banks demand high levels of collateral, which also makes firms less willing to borrow. Finance is available and few firms cite it as a binding constraint on their growth. However, if the Palestinian private sector were to take off and firms began to invest beyond what they can self-finance, its access to finance almost certainly would become an important constraint. The high levels of collateral, lack of legal framework and other issues described in Section B will become more pressing.

4.71 **Industrial Land.** Several private sector companies, particularly those in garments and textiles, cited the lack of well-serviced industrial land as an important constraint. Most Palestinian businesses, often attached to the owner's home, are located in residential areas. In many cases these residential neighborhoods do not have the infrastructure needed by industry, which raises the cost of production, leads to issues of congestion and pollution, and in some cases prevents firms from expanding.

4.72 Local authorities have set up several municipal industrial zones to meet the needs of local producers. However, they are all underused and in many cases residential buildings have been erected in zones set aside for industry. The lack of use may be due to the high cost of land. Israeli settlements and unresolved ownership issues have driven land prices to artificially high levels, so most Palestinian firms operate on land already held by the business owner. The PA has also launched an industrial estate program aimed at providing the necessary infrastructure and business environment to attract investment. The Palestinian Industrial Estate and Free Zone Authority (PIEFZA) has carried out preliminary studies for 15 local industrial zones, and funding for establishing some of these estates has been promised by various donors. However, only the Gaza Industrial Estate (GIE) has been built so far. The planned industrial estates are mostly located along the border with Israel, and aimed at attracting Israeli and Palestinian investments. However, the closure regime has meant that the GIE has attracted limited investment, and only from local Palestinians. Thus, it is unclear how pressing the issue of industrial land may be for most enterprises.

Recommendations and Policy Options

4.73 **Movement.** Free movement is the *sine qua non* for economic growth. Without the ability to access markets sustainably, the Palestinian private sector will not prosper. Unfortunately, the situation has been getting worse rather than better. Agreements to ease access from Gaza have not been implemented and internal closures in the West Bank have increased. More recently, Palestinian dual-citizen businessmen have also raised concerns about tightening in Israeli visa procedures, which risks further reduction in private sector investments and loss of skills for the economy. It is essential to direct efforts to implementing previous agreements and removing the closures.

4.74 **Industry Support.** Marketing Palestine itself is a first step to creating new opportunities for individual products. Few outside buyers think of Palestinian firms as capable suppliers and most Palestinian firms do not believe that they have strong opportunities outside their traditional markets. Yet, there are several promising opportunities. Olive oil producers have already demonstrated their ability to sell high-quality oil on the export market. Garments producers have been told by European distributors that with regard to some products, if they were able to directly access the market, their prices would be competitive with those of North African and Bangladeshi producers. European buyers have already made small purchases directly from Palestinian garment producers in the West Bank. Among other sectors, hardwood furniture produced in Gaza appears to be internationally competitive and opportunities exist in traditional foods.

4.75 Supporting two or three promising industries and creating export success will have a powerful demonstration effect on other industries. Showing that it is possible for Palestinian goods to compete internationally will help encourage other industries to seek new opportunities. Efforts are already underway to support the olive oil industry by strengthening the supply chain and developing marketing collateral. Work on clusters for the wood furniture, stone and marble, and pharmaceuticals industries has also been initiated. These efforts should be strengthened and other industries supported.

4.76 **Learning and Market Contacts.** Palestinian producers do not have the contacts or knowledge to enter new markets. Efforts to provide information about potential markets and develop contacts with Palestinian companies are essential. Initiatives by Paltrade, PIPA, and other organizations should be reviewed and strengthened. The appointment of commercial attaches by the Ministry of Economy and Ministry of Foreign Affairs is a positive step. If they can be linked to the organizations in WBG, they will be an important source of information on potential markets.

4.77 The deficiencies in learning mechanisms also need more attention if firms are going to upgrade their technical capabilities and productivity to compete internationally. These efforts should include PA and donor support to continue building up and improving institutions. They should be managed by private sector entities and focused on management training and business advisory assistance. A key aspect of such programs should be to help firms link up with advanced country sources of expertise and improve their skills. Assistance to develop technical and vocational training institutions (public and private) is also necessary. These training institutions must cooperate closely with the private sector in developing and providing innovative programs for worker training. In addition, cost-sharing grant schemes are needed to assist firms in developing their own innovative, in-firm training programs, hiring expert consultants, and searching for new technologies and markets.

4.78 **Improving Access to the Israeli Market.** In the foreseeable future, Israel will remain the most important trading partner. Palestinian producers sell a variety of products to Israel but there is potential to significantly increase sales, especially among the Arab population. East Jerusalem is another important market from which most Palestinian producers are excluded. Besides security closures, the main

constraints seem to be standards and other nontariff trade barriers. Continuation of efforts to effectively address these issues is a priority.

4.79 **Improving Access to the Arab World.** The Arab world is the largest potential export market for Palestinian products. The PA has signed a number of trade agreements; however, they are often not implemented. The PA should continue to press for implementation of trade agreements and harmonization of standards. Transit agreements with neighboring countries are essential. Passage through Egypt is critical to firms in Gaza; it is currently difficult, not only because of the security issues but the bureaucratic burden on the Egyptian side of the border. Negotiating a transit agreement through Egypt and Jordan should be a short-term priority for the PA.

4.80 **Industrial Areas.** The PA views reviving the Industrial Estates Program as a priority. Most of the sites are located on the borders and aimed at attracting Israeli and foreign investment. Foreign investment is needed and Israeli investment might encourage the Government of Israel to ease access controls. However, the negotiations required to establish these industrial estates are complicated. At this point the Government of Israel has not accepted their free zone status, nor have they relaxed prohibitions on Israelis' traveling to areas not under Israeli Defense Force security control. Thus, actually establishing the operating industrial estates will be a long and difficult process.

4.81 Foreign intervention may ease the process. Recently Turkish investors have been negotiating to take over the Erez Industrial Estate and manage it with the goal of servicing local Palestinian investors and Israeli investors previously located in Erez, as well as attracting new foreign tenants. Foreign management may help solve some of the security issues and encourage the Government of Israel to assure access. However, there has been no agreement and the issue of free zone status is still a major sticking point. Yet, this initiative should be given priority as foreign investment is desperately needed in WBG. The broader effects of reopening the Erez industrial park may be much more than the immediate employment it generates.

4.82 The PA should move to assess the demand for well-serviced industrial areas throughout the WBG to serve the needs of all local producers. It has been suggested by the private sector and the PA that placing the municipal estates under PIEFZA authority and giving them free trade status would help attract investment. However, this may not be necessary, especially given that free zone status is not yet recognized.

Recommendations:

- Accelerate reform and capacity building efforts in the judicial system;
- Negotiate transit agreements with Egypt and Jordan;
- Negotiate and enforce new mutual standards recognition agreements between Palestinian and Israeli authorities;
- Finalize institutional reform of the national quality system; improve the capacity of the Palestinian Standards Institute; develop and adopt internationally compatible standards and specifications for areas such as electrical equipment and solar heaters and for industrial calibration; and create, build capacity for, and equip testing laboratories;
- Identify and address deficiencies in learning mechanisms and develop technical and vocational training institutions (public and private): these efforts need to be managed by private sector entities and supported by both the PA and donors;
- Expand initiatives to develop market contacts in the region and beyond for Palestinian producers;
- Evaluate the need for additional industrial estates.

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