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Editors: Paul Rivlin and Yitzhak Gal Assistant Editors: Brandon Friedman and Moran Levanoni

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The Palestinian Economy, Gaza Reconstruction, and Israel: Crises and Possibilities

Yitzhak Gal

The prolonged freeze of Palestinian tax revenues, which are collected by Israel for the Palestinian Authority (PA), at the beginning of the current year, underscore the severity of the budget crisis of the PA and put the stability of the PA in one of the most dangerous situations it has been in since the Second Intifada (2000-2004). The agreement to transfer the tax revenues to the PA after the March 2015 elections in Israel alleviated the immediate crisis. However, uncertainty about the regular transfer of tax revenue remains unresolved, as do the risks. The unusual severity of the budget crisis stems from the fact that it has evolved along with a deep economic crisis, reflecting the fundamental weaknesses of the Palestinian economy. These weaknesses are related, to a large extent, to the complex economic regime which was established by the provisions of the Paris Protocol of 1994, alongside an entangled network of barriers and restrictions on Palestinian economic life that has developed over the last two decades. The much sharper economic decline in the Gaza Strip, and the slow pace of its reconstruction, enhance frustration and tensions in this region too, and increase the risk of a new round of violence between Hamas and Israel. As in the past, when violence erupts in one part of the Palestinian territories, it can affect the other part of the territories as well.

However, despite this pessimistic assessment, there are signs of positive change in the Palestinian economy. This change reflects a growing recognition in the Palestinian territories that the political and security costs of the current economic trends may be too high. Despite the political impasse between the PA and Israel, progress on the economic track may be possible. Such was a result, in part, of Israeli actions to facilitate the rebuilding of Gaza which is creating an opportunity to revitalize the Palestinian economy. As a result, the PA’s revenues have grown, according to updated figures for the fourth quarter of 2014 and the first quarter of 2015. This improvement was related to Israel’s decision to permit reconstruction in Gaza.

There have been several studies that included plans for improving the Palestinian economy. These plans have not been politically contested, which means if they are used in combination with the emerging political will to address the Palestinian economic crisis, new possibilities for changing the course of the Palestinian economy may emerge.

The Palestinian budget crisis started between the years 2010 to 2012. The immediate and direct cause of the crisis was the reduction of foreign economic assistance to the PA. Foreign aid to fund the PA's budget and development projects had increased significantly following the Second Intifada, and reached a peak of about $2 billion in 2008. In 2009 foreign aid started to decline, and in 2011 – 2012 it bottomed out at less than a billion dollars per year, which was less than half of what it received in 2008. As a result, the total amount of PA earnings (tax, foreign aid, and other revenues) fell from close to $4 billion in 2008, to an annual average of slightly more than $3 billion a year between 2009 and 2012.

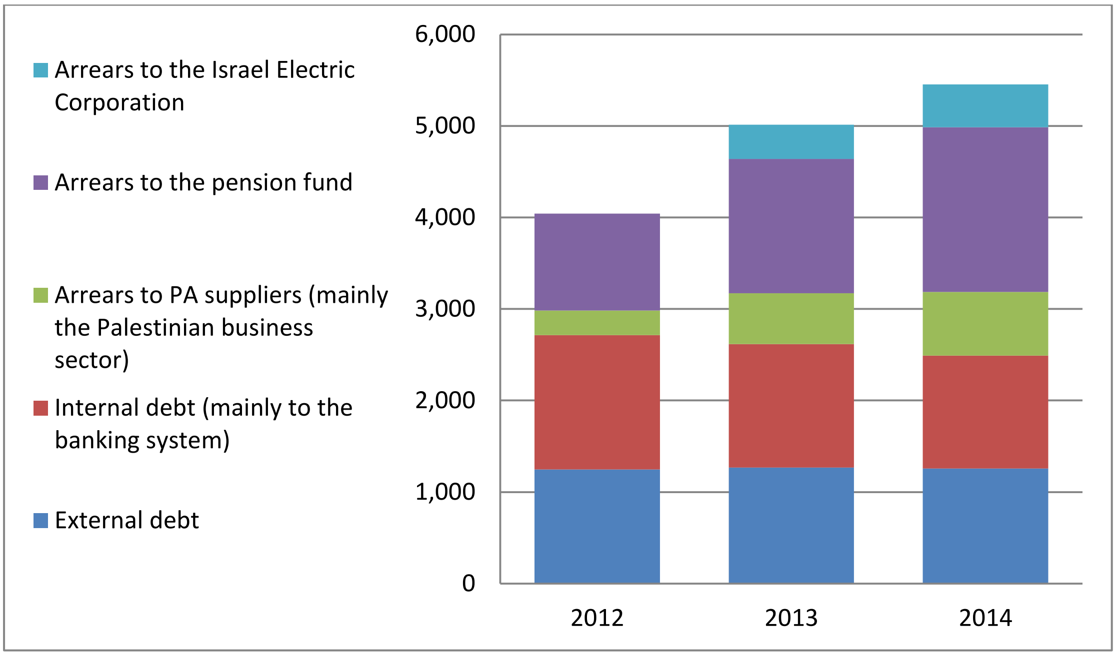
This decrease in revenue forced the PA to borrow funds, time and again, from the local banking system to finance its deficit. At the end of 2012, the PA's debt to local banks was close to $1.4 billion, compared to $500 million in 2008 (in addition to foreign debt of more than $1 billion). The size of its debt made more borrowing extremely difficult for the PA. Thus, in 2012, the PA became almost entirely dependent on the timely flow of foreign aid and tax funds from Israel to pay salaries on time and finance its operations. The inflow of foreign aid is unreliable, which means the PA has been unable, again and again, to pay the salaries of public sector workers on time and in full. Given this situation, if Israel delays transferring tax revenue to the PA, it becomes, almost immediately, a budget shock for the PA.

The economic and social implications of this situation are far-reaching. Civil servants and security forces comprise more than a quarter of the purchasing power in the West Bank, and their wages are a main pillar of economic and social stability. When salaries are not paid on time and in full, the economic security of public sector workers is damaged for an extended period of time, which radiates through the West Bank society and economy as a whole. Moreover, Palestinian banks were aggressively marketing loans to public sector workers in recent years. Many government employees took large mortgage loans to buy apartments, cars, and other significant assets. Their ability to repay these loans depends on being paid regularly by the PA.

In addition to the PA's struggle to pay government salaries on time, it has failed to pay its suppliers and contribute to the pension fund of its employees, which further undermines the financial stability of the business sector and the economic security of individual households. The large arrears in payments to its suppliers has increased almost threefold in the past two years, from $269 million at the end of 2012 to $695 million at the end of 2014, damaging the financial stability of thousands of businesses and service providers. The government's debt to the pension fund grew from a little more than a billion dollars, at the end of 2012, to $1.8 billion at the end of 2014. Total public sector debt (of the PA and related entities) increased from about $4 billion at the end of 2012 to around $5.5 billion at the end of 2014. Most of this additional debt is owed to the pension fund and to the Israel Electric Corporation.

Another consequence of the decline in foreign aid was that tax revenues, which are collected by Israel, became a much larger share of the PA's total earnings, making the PA much more dependent on the timely transfer of these revenues. In 2014, tax revenues accounted for more than 50 percent of the PA's total earnings, compared to 30 – 40 percent between 2007 and 2010. In 2014, the remaining 50 percent of the PA's earnings came from local collection of taxes by the PA (20 percent) and foreign aid (nearly 30 percent).

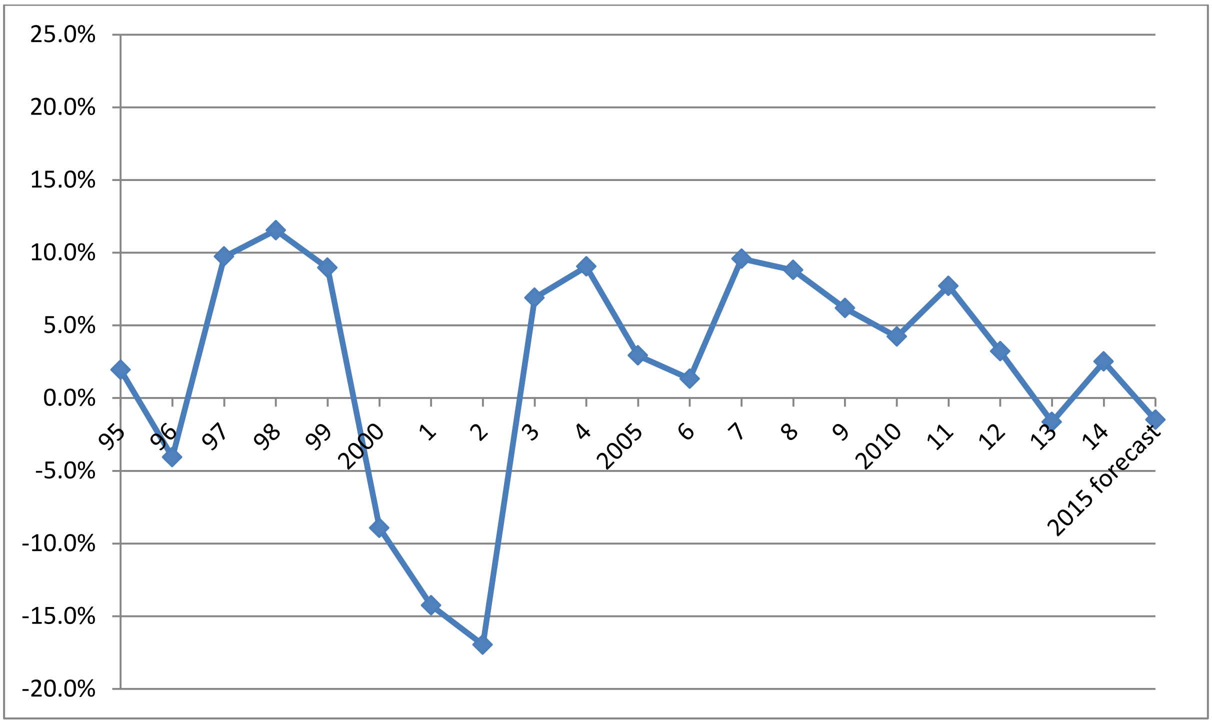
Chart 1: PA public debt by main components 2012 – 2014
(in millions of dollars, end of period)



Source: IMF

The severity of the PA's budget crisis stems from the fact that it has developed in parallel to and as a part of a wider and deeper economic crisis. The unprecedented amount of foreign aid, combined with more relaxed security and other restrictions in the West Bank in the years following the Second Intifada, fed rapid economic growth in the West Bank between 2005 and 2009, as well as into the early years of the following decade. In recent years, however, the PA's growth rate has been slowing as a result of the decline in foreign aid, and the fading effect of relaxed security restrictions. Between 2007 and 2011, per capita GDP (gross domestic product) grew by nearly 7.5 percent per year, in real terms. Since then, growth per capita has slowed, and in recent years it is stagnant and even negative – as shown in Chart 2. The economic crisis reflects the fundamental weaknesses of the Palestinian economy. These weaknesses are related to the complex economic regime which was established by the provisions of the Paris Protocol of 1994; the network of barriers and restrictions on Palestinian economic life that has developed over the last two decades; an under-developed economic infrastructure; and, population growth and unemployment. The unstable pattern of economic growth in the Palestinian economy, as illustrated in Chart 2 below, is also a sign of the weak fundamentals of the Palestinian economy.

Chart 2: West Bank GDP Per Capita – Real Growth 1994 – 2015 (percents)



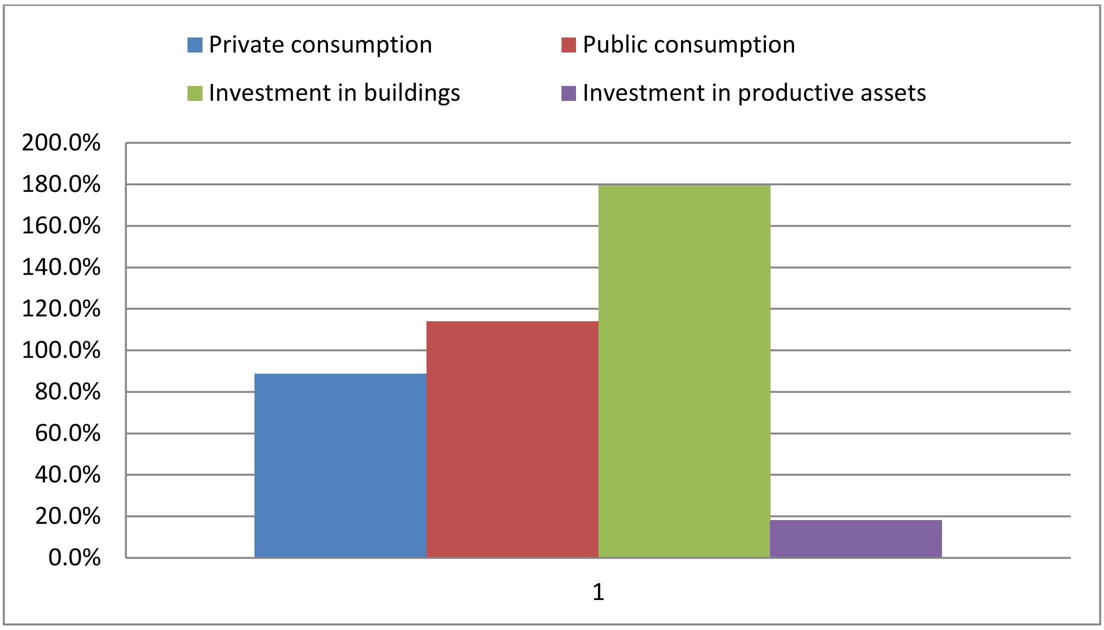
Sources: PCBS, IMF forecast

Chart 3 shows that the West Bank's relatively strong growth figures following the Second Intifada was an "economic bubble," a result of foreign aid, rather than sustainable economic growth. Private consumption almost doubled between 2002 and 2013, public consumption (expenses of the Palestinian Government) more than doubled, while investment in building (almost entirely for residential purposes) almost tripled. Investment in machines and other non-building assets, on the other hand, barely grew compared to the low point of the Second Intifada in 2002.

This "bubble" growth pattern was mirrored in dramatic changes in the structure of the economy. The share of agriculture and industry, the most productive branches of the economy, decreased by one half, from 30 percent in 1994 to slightly more than 15 percent today; while other productive (and exporting) branches, such as tourism or information technology, remained insignificant. Economic growth was concentrated in those branches, such as trade and personal services, that were fueled by foreign aid.

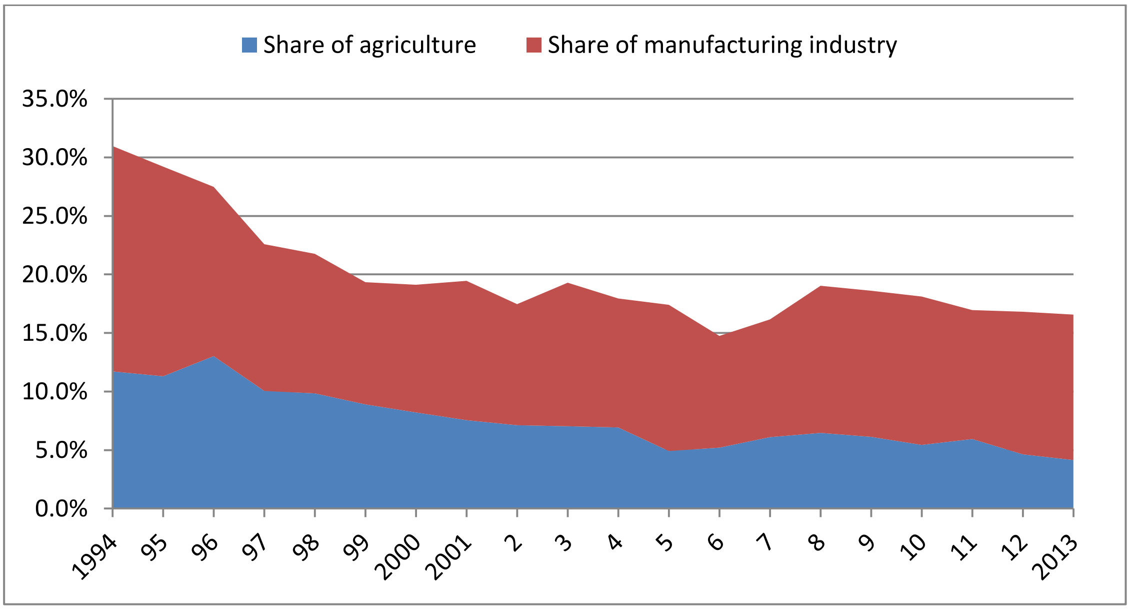
Chart 3: The development of the Palestinian economy by Main Uses 2002 – 2013

(percents, cumulative growth in 2004 constant prices)



Source: PCBS

Chart 4: Sharp decrease in The Share of Agriculture and Industry 1994 - 2013
(percents, share in the GDP in 2004 constant prices)



Source: PCBS

The rapid growth in consumption and the slow growth in production are evident in the huge increase in imports, while exports remained modest. The gap between exports and imports increased fourfold between 2002 and 2014. This gap in Palestinian foreign trade is yet another manifestation of the economy's dependence on foreign aid.

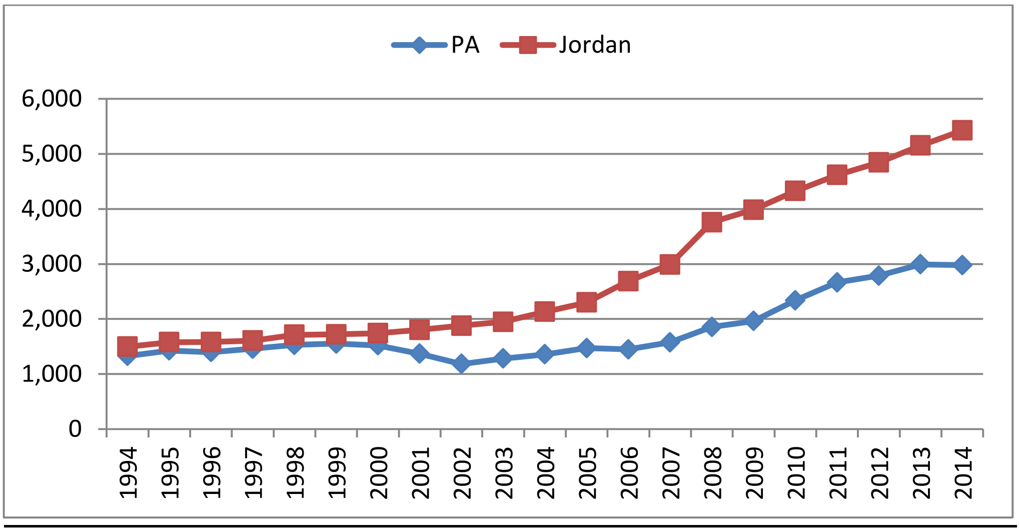
Chart 5: Palestinian Foreign Trade – Export and Import of Goods 1995 – 2014 (USD millions, current prices)

Source: PCBS, Foreign Trade Statistics

The structural weakness of the Palestinian economy also has an important effect on the purchasing power and the standard of living for Palestinians. The Palestinian economy's partial economic integration with Israel, under the Paris Protocol economic regime, means that prices in the Palestinian territories are similar or close the level of prices in Israel, while Palestinian wages and household income are much lower. As a result, the real purchasing power of Palestinian households is considerably lower than in neighboring Arab economies, where many basic products are considerably cheaper.

International comparisons show that Palestinian per capita GDP is much lower than that of neighboring Arab countries, such as Egypt or Jordan. Chart 6 illustrates how the gap between the Palestinian and the Jordanian per capita GDP has developed, as a result of the low long-term growth rates of the PA. From 1994 to 1999, the Jordanian per capita GDP was only 10 percent higher than that of the PA. Today, the Jordanian per capita GDP is nearly double that of the PA.

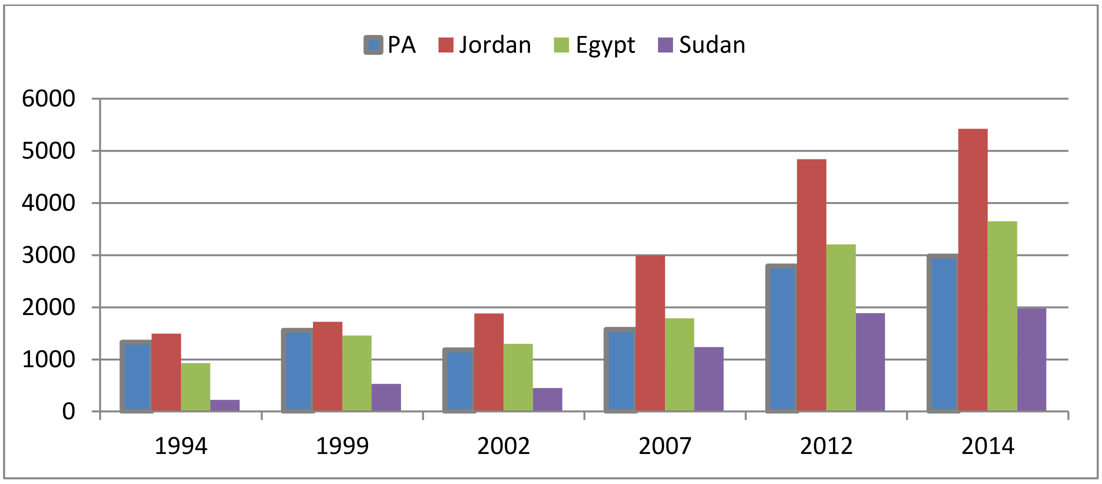
<u>Chart 6: GDP Per Capita – the PA in comparison to Jordan 1994 – 2014</u>
(USD, current prices)



Sources: PCBS, Central bank of Jordan, IMF

Chart 7 compares the Palestinian per capita GDP to poorer Arab countries. In 1994, the per capita GDP was more than 40 percent higher than that of Egypt. Today, Egypt's per capita GDP is about 20 percent higher than that of the PA. In fact, the Palestinian per capita GDP is approaching the level of the poorest Arab States. While in 1994 per capita GDP was 500 percent higher than that of Sudan, today the gap has narroweed and the PA’s per capita GDP is only 50 percent higher than Sudan’s per capita GDP.

<u>Chart 7: GDP Per Capita – Comparison to Selected Arab Countries 1994 – 2014</u>
(USD, current prices)



Sources: PCBS, Central bank of Jordan, IMF

Despite this negative overview of the Palestinian budget and economy, there are positive recent developments that are worth noting. If these developments continue, and are complemented by additional measures, it may be possible for the fiscal and economic situation to improve.

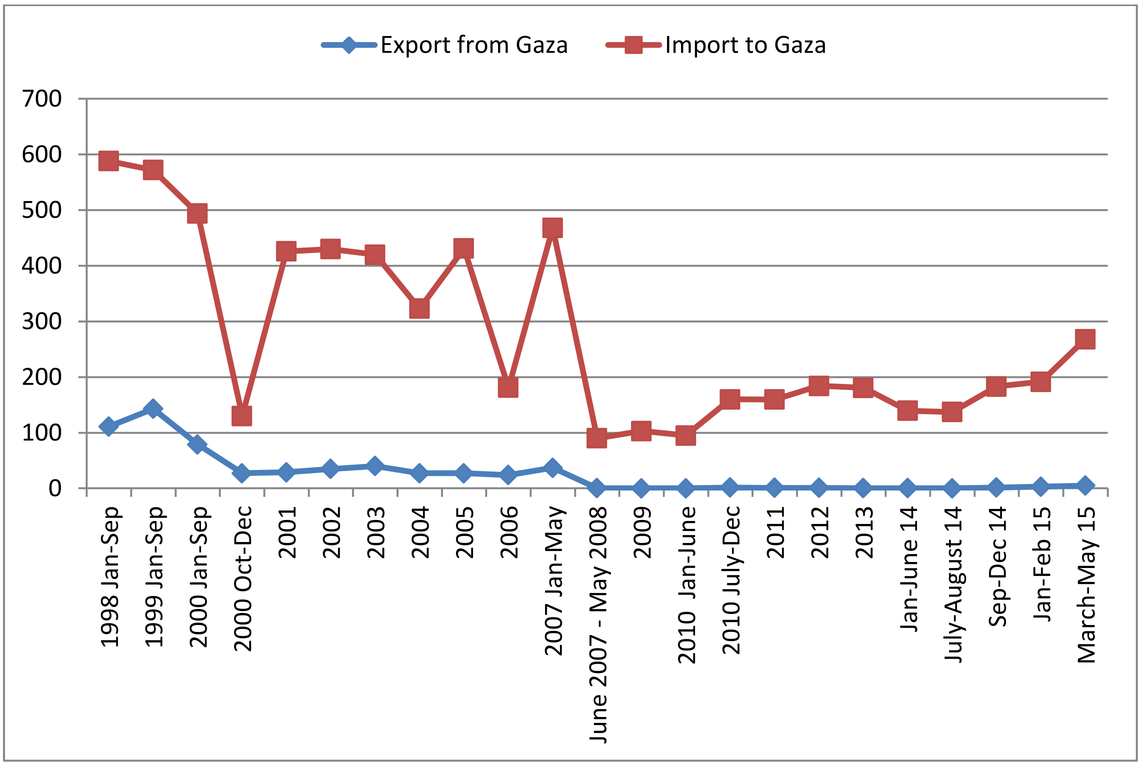
There have been three noteworthy developments: First, there has been a significant increase in the entry of imports from Israel into Gaza, allowing Gaza to begin reconstruction; second, there has been a steady increase in the number of Palestinian workers employed in Israel; and, third, there has been significant increase in the amount of tax revenues collected by Israel for the PA, which is associated with the two developments mentioned above, as well as certain technical and administrative improvements in the collection and clearance processes of these taxes.

In the year that has passed since the last war in Gaza, the number of truckloads entering Gaza from Israel doubled - from an average of 140 trucks per day in the first half of 2014 to nearly 270 trucks per day in March through May 2015 (calculated from monthly data, in consideration of 26 working days per month). On certain days in April and May, the number of trucks entering Gaza reached 500-600, a number comparable to the average during the period before the Second Intifada (Chart 8). Moreover, a large part of the goods entering the Gaza Strip are construction materials, which are loaded on large trucks (full trailers) carrying over 30 tons of goods. Thus, the total weight of cargo entering Gaza from Israel in recent months is estimated to be of similar magnitude to that of the period before the Second Intifada.

The volume of exports from Gaza, however, is still insignificant, though some improvement has been registered in this respect too. Before the last war in Gaza only agricultural products were allowed to be exported to overseas markets. These exports totaled 200 to 300 trucks per year (an average of between 0.5 – 1 trucks per working day), and were concentrated almost entirely in the winter months. Exports to Israel and the West Bank were banned. In recent months the ban on exports to the West Bank and Israel has been relaxed, and the average volume of export shipments from Gaza, from March to May 2015, climbed to an average of 5 trucks per workday.

Despite this considerable growth in the volume of trade, the present volume of imports into Gaza is only a quarter of what would be expected given normal economic conditions (including import to re-export and for sustaining the reconstruction of Gaza). As for exports from Gaza, the present figures represent no more than 2-3 percent of anticipated export volumes under normal economic conditions.

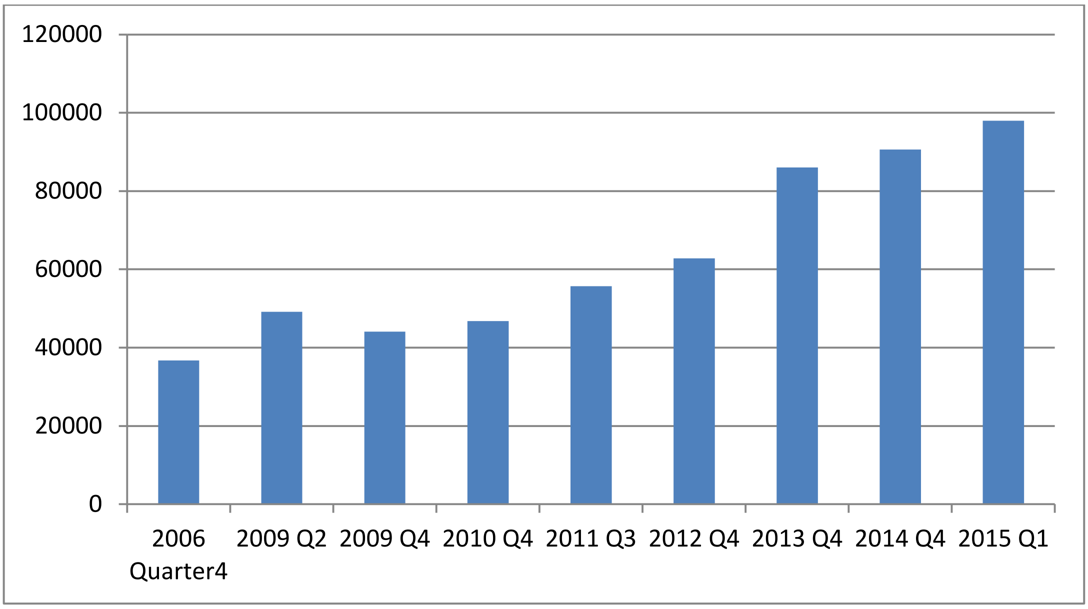
Chart 8: Truck Movement Between Gaza and Israel 1998 – 2015
(number of trucks per working day, indicative figures, all goods except for petroleum products)



Sources: COGAT, Gisha (based on PalTrade, OCHA-OPT, UNSCO)

The second positive development for the Palestinian economy has been an increase in the number of Palestinian workers from the West Bank employed in Israel. Between 2010 and early 2015, their number (including those employed in Israeli settlements) more than doubled – from less than 50,000 to about 100,000 (not including workers from East Jerusalem). Approximately 60 percent of them have work permits, and 40 percent are employed illegally. This increase followed a much slower increase during the previous decade, from a very small number in 2001-2002, the peak of the Second Intifada, to 35,000 – 45,000 workers at the end of the decade.

Chart 9: Number of Palestinian Workers in Israel 2006 - 2015
(with and without permits, excluding workers from East Jerusalem)

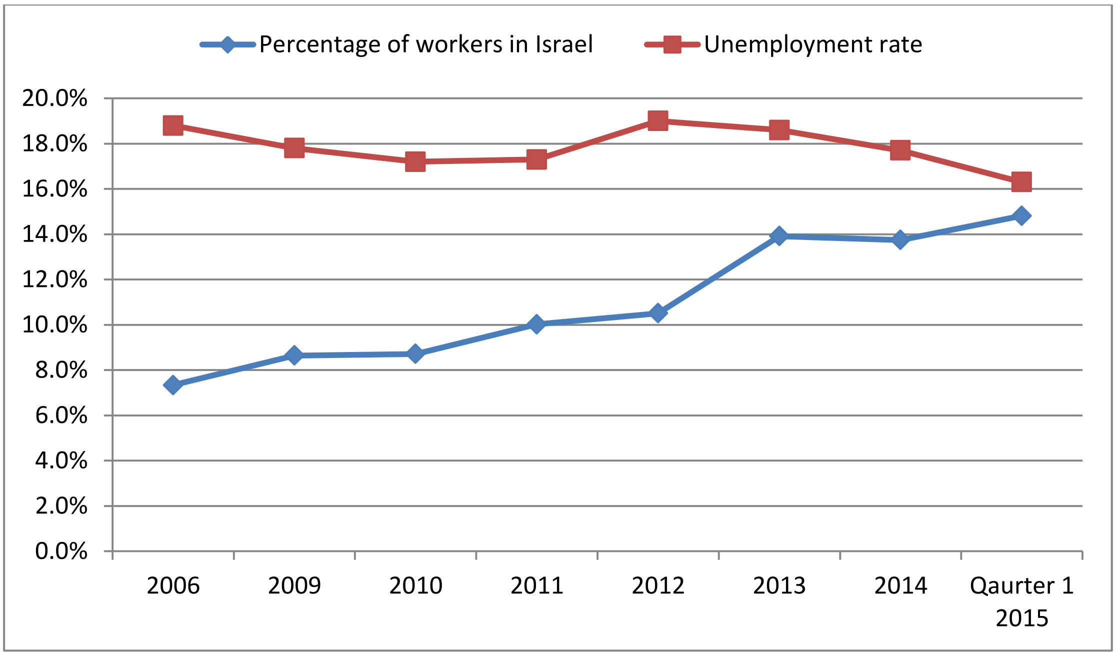


Source: PCBS, Labor Force Surveys

The addition of more than 50,000 new jobs in Israel was nearly one-third of all new jobs created between late 2010 and early 2015 for the West Bank workforce. The number of Palestinian workers in Israel (including settlements) as a share of total employment in the West Bank grew from 8-9 percent in 2009-2010 to 13.5-14 percent in 2013-2014, and 15 percent in the first quarter of 2015.

This increase in Palestinian employment in Israel kept unemployment in the West Bank at 18-19 percent. If not for these new jobs in Israel, the unemployment rate in the West Bank would have risen to 23-24 percent, similar to the employment rate during the end of the Second Intifada (2003-2004).

Chart 10: West Bank - Share of Employment in Israel in Comparison to the Unemployment Rate 2006 - 2015
(employment in Israel and settlement, excluding workers from east Jerusalem)



Source: PCBS, Labor Force Surveys

The contribution of Palestinian labor in Israel to the West Bank's economy has been much greater than that reflected in charts 9 and 10. The average monthly income of Palestinian workers in Israel is two-thirds higher than that of Palestinians in the West Bank. The average daily net wage of Palestinian workers in Israel (Israeli settlements) was NIS 196.4, compared to an average daily wage of only NIS 94.2 for those working in the West Bank (2015, first quarter). However, given that the average number of working days per month of workers inside the West Bank is higher than Palestinian workers in the Israel, the average monthly net wages of Palestinian workers in Israel was approximately NIS 3,690, while the monthly average wage of those who work inside the West Bank was NIS 2,060. Considering this gap in wages, the contribution of Palestinian workers in Israel to households incomes in the West Bank, is much larger than the contribution to employment. The addition of more than 50,000 jobs in Israel added 10 percent to the total household income in the West Bank. The overall contribution of employment in Israel to household income in the West Bank is about 20 percent (first quarter 2015), which is a substantial contribution to social and political stability.

These two processes – the start of Gaza reconstruction (although at a slow pace) and the increase in the number of Palestinian workers in Israel, have had an immediate macroeconomic effect on the Palestinian economy. Their combined contribution is estimated at about 2 percentage points of GDP growth in the second half of 2014 (annualized calculation). As a result, in 2014 Palestinian GDP, which was expected to decline by 2 – 3 percent, fell by only a 0.5 percent according to the International Monetary Fund (IMF). The projection for 2015 shows real economic growth of 2.5 percent (1 percent in the West Bank and 7 percent in Gaza). The estimated contribution of these two processes – Gaza reconstruction and the increase of Palestinian labor in Israel – to GDP growth in 2015 is as large as 4 percentage points. Hence, these two processes are the only engines of economic growth in the Palestinian economy today. Without these new developments, the Palestinian economy would be on a path to contract, at an annual rate of 2-3 percent.

These two developments have also had an important effect on the PA’s tax revenues. The sharp increase in imports from Israel into Gaza has resulted in a significant increase in tax and customs revenues generated for the PA on these imports. At the same time, the increase in the volume of work in Israel has been reflected in larger tax income, fees, and other revenues related to the wages of those workers. As a result of these developments (along with some other developments), the PA registered an increase of more than $300 million in tax revenue in 2014 – all of which was collected by Israel for the PA. The 2014 increase followed an increase of over $200 million in 2013 (which resulted from the higher tax income on petroleum products that were a result of rising oil prices at the time). This increase in the PA’s tax revenues allowed the PA to endure an acute budget crisis, despite the decline in foreign aid. The vital contribution of Palestinian labor in Israel is also reflected in the PA’s balance of payments. In 2014, the volume of private transfers from abroad to the PA, mainly consisting of the wages Palestinian workers in Israel, grew to nearly $1.8 billion – more than the value of the foreign aid, and almost double the total value of Palestinian exports.

Several studies indicate high growth potential for the Palestinian economy. This huge potential can be tapped, if political stability is achieved, and given a change in the economic eco-system that removes barriers and encourages sustainable economic growth.

Such a new political and economic eco-system would release the growth potential of the large and highly-educated Palestinian labor force, and the unused industrial and agricultural production capacities in the Palestinian territories. It would also benefit tourism and other productive branches of the economy. Beyond this, export-oriented growth is expected to be greatly improved by investment in the presently under-developed economic infrastructure (transport, energy, water, and other infrastructures). In an environment that supports economic growth, the Palestinian economy will be able to benefit both from its access to the Israeli market and from its access to the large Arab markets, particularly the wealthy Arab Gulf States.

In conclusion, the structural weaknesses of the Palestinian economy described earlier in this article are largely the result of the political impasse between Israel and the PA, and affect all aspects of economic and social life of the PA. As the economic and budget crises continue and deepen, economic damage and social problems also accumulate, potentially leading to dangerous political and security consequences. The generous foreign aid the PA received, which enabled it to operate for the last decade and a half, was designed to support the Israeli-Palestinian peace process. Therefore, it is not surprising that the prolonged deadlock in the peace process has gradually weakened the donor countries' commitment, reflected in the steady decline in foreign aid to the PA since 2010. The political context of economic aid to PA was stated in the donor conference which convened in Brussels in May 2015, as follows: "The financial assistance aims to underpin the political process by supporting the building of sustainable institutions for a Palestinian state. The donors emphasized that it is urgent to take steps to rebuild trust and help create the conditions necessary for resuming future negotiations."

On the other hand, the positive developments described in the second half of this article, and Israel's willingness to deal with the Palestinian economic crisis and the challenge of rebuilding Gaza, create new opportunities. Some of the research includes detailed plans that, if implemented, could help move the Palestinian economy onto a new path to growth.

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