United Nations TD/B/58/4

United Nations Conference on Trade and Development

Distr.: General
15 July 2011

Original: English

Trade and Development Board
Fifty-eighth session
Geneva, 12–23 September 2011
Item 11(b) of the provisional agenda

Report on UNCTAD assistance to the Palestinian people: Developments in the economy of the occupied Palestinian territory[1]

Note by the UNCTAD secretariat[2]

Executive summary

While the economy of the occupied Palestinian territory (OPT) grew by 7.4 per cent in 2009 and 9.3 per cent in 2010, unemployment remained high, at 30 per cent in both years. The growth was driven by donor support, and reflects an economy recovering from a low base. Economic growth has not altered the reality of worsening long-term development prospects, caused by the ongoing loss of Palestinian land and natural resources, isolation from global markets, and fragmentation. Unemployment, poverty and food insecurity, especially in Gaza, continue to be alarming. The Palestinian Authority's fiscal position remains precarious, despite recent improvements. A large trade deficit and dependence on the Israeli economy persist. New evidence suggests that the trade deficit with Israel is overstated by official data, which mask "indirect imports". The tax revenue on such indirect imports, currently lost, could increase Palestinian public revenue by 25 per cent. Meanwhile, the economic ramifications of the severance of East Jerusalem from the rest of the OPT call for serious attention too. In spite of limited resources, UNCTAD continues to respond to the needs of the Palestinian economy in coordination with other United Nations organizations and donors, and has recently commenced a new project to "strengthen Palestinian trade-facilitation capacity".

[1] The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries. In accordance with the relevant resolutions and decisions of the United Nations General Assembly and Security Council, references in this report to the occupied Palestinian territory (or territories) pertain to the Gaza Strip and the West Bank, including East Jerusalem. Use of the term "Palestine" refers to the Palestine Liberation Organization (PLO), which established the Palestinian Authority following its 1993/94 accords with Israel. References to the "State of Palestine" are consistent with the vision expressed in Security Council resolution 1397 (2002).

[2] The information in this document should not be quoted by the press before 23 August 2011.

I. Aid-driven, jobless economic growth, with an eroded productive base

1. Compared to the previous few years, the performance of the economy of the occupied Palestinian territory (OPT) showed some improvement in 2010. It is estimated that economic growth in 2010 stood at 9.3 per cent, compared to 7.4 per cent in 2009. Growth was more pronounced in Gaza, where gross domestic product (GDP) grew by 15 per cent, compared to 7.6 per cent in the West Bank.

2. However, this is not a sign of sustainable recovery, but rather a sign of an economy operating from a low base, given the economic regression of the last decade and an ongoing de-industrialization process. Against the background of the sharp economic decline experienced since 2000, the continuing Israeli closure policy and confiscation of Palestinian land and natural resources raise concerns about the sustainability of the growth experienced in 2010, and the development prospects of the Palestinian economy. Concerns about the sustainability of the 2010 growth path also stem from the reliance on a large injection of foreign aid and on public-sector expenditure, as has been the case in most of the recent episodes of growth. Moreover, the Palestinian private sector continues to be constrained by years of restrictions on movement and access, blockade, extremely limited access to external markets to export goods and import production inputs, and shrinking capital and natural resource bases.

3. Furthermore, about two thirds of Palestinian public revenue is dependent on Israeli controls. In accordance with the 1994 Paris Protocol on Economic Relations between Israel and the Palestine Liberation Organization, Israel collects customs and value added taxes on goods imported through Israel and then clears them to the Palestinian Authority (PA). This is a tenuous arrangement in a situation characterized by frequent political and security tensions. In the last ten years, Israel has delayed clearing these revenues to the PA more than twice, sometimes for prolonged periods, and most recently in May 2011 when the clearance process was delayed for several weeks. International support and positive growth can be translated into sustainable economic gains via measures to prevent instability in Palestinian tax revenue and to reduce the restrictions placed on access by Palestinian producers to external markets, both for exports and for importing inputs.

A. Erosion of manufacturing capacity

4. According to the International Monetary Fund (IMF) (2011), the Palestinian economic contraction observed in the post–Oslo Accords period was combined with technological regression at an average annual rate of decline of total factor productivity of half a percentage point per year from 1994 to 2010. Had the pre-Oslo trend of productivity growth continued between 1994 and 2010, real GDP per capita in the OPT would have been 88 per cent higher than its 2010 level.

5. While manufacturing output declined by 6 per cent in 2010, hotels and restaurants, construction, public administration and agriculture grew, at rates of 46, 36, 6 and 22 per cent respectively. However, the growth rate for agriculture came after continuous decline for a decade, whereby the level of value added in the sector in 2009 was 47 per cent of the level a decade earlier.

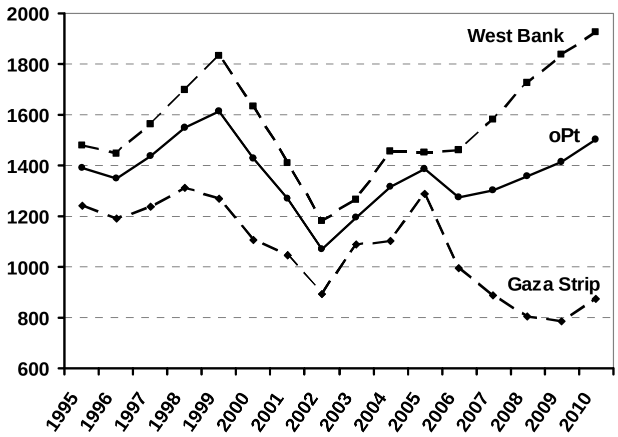
6. The steady decline of Palestinian manufacturing is a major concern, not only because of the immediate loss of potential output, but also because of its long-term implications, which are related to and reinforced by the effects of the observed technological regression. This is because firms in the manufacturing sector tend to be more innovative and efficient than firms producing non-tradable goods which are not exposed to

the rigours of global competition. According to the Office of the United Nations Special Coordinator for the Middle East Peace Process (UNSCO) (2011b), real GDP growth between 2009 and 2010 was caused mainly by an increased number of workers and labour force participation, amidst a decline in productivity.

B. Broad economic divergence between Gaza and the West Bank

7. In Gaza, a modest relaxation of the Israeli blockade over the last 18 months (Government of Israel, 2011) has enabled an improvement in economic activity. This has been concentrated in the non-tradable goods sector, mainly construction, whose output doubled in 2010. Despite the urgent need to rebuild the private and public property destroyed by the 24-day Israeli military operation in Gaza that took place in December 2008 and January 2009, the importing of construction materials is still banned, with the exception of imports by international organizations. However, construction inputs continued to be imported at inflated costs via clandestine tunnels from Egypt. The 15 per cent GDP growth registered in Gaza in 2010 is partly the result of recovery from a low economic base whereby real GDP fell by 30 per cent cumulatively between 2006 and 2009, and partly a reflection of relaxation of some Israeli constraints on imports in mid-2010.

Figure 1: Real GDP per capita in 2004 US$



8. Humanitarian conditions in Gaza remain dire, and the Israeli blockade imposed since 2007 is still largely in place. Restrictions on imported raw materials still constrain private-sector recovery and thwart the public investment in infrastructure envisioned in the Palestinian National Early Recovery and Reconstruction Plan. The World Bank maintains that Gaza's manufacturing output declined by 4 per cent in 2010. On the other hand, agricultural output rose significantly, albeit from the nadir it had reached in previous years. However, about 35 per cent of Gaza's agricultural land and 85 per cent of its maritime space remain inaccessible to farmers and fishermen (UNSCO, 2011a).

9. Socio-economic indicators in Gaza remain much worse compared to before 2006 or to current conditions in the West Bank. For example, the abject educational situation in Gaza and massive school overcrowding have forced the United Nations Relief and Works Agency (UNRWA) to operate the schools it runs on a double-shift basis, to rotate classes, and to operate schools from ship containers. The tight closure imposed on Gaza has not only deteriorated socio-economic conditions; it has also elevated regional disparities by precipitating broad economic divergence between Gaza and the West Bank (fig. 1). Real GDP per capita in Gaza deteriorated from 89 per cent of that of the West Bank to about 43 per cent during 2009; by 2010 it was still less than half the West Bank level.

Table 1
Economy of the occupied Palestinian territory: key indicators [a]

	1995	**1999**	**2002**	**2004**	**2006**	***2008*** ***rev.***	***2009*** ***prl.***	***2010*** ***est.***
Macroeconomic performance								
Real GDP growth (%)	6.0	8.8	-13.3	12.0	-5.2	*7.1*	*7.4*	*9.3*
GDP ($ mil.)	3,220	4,179	3,433	4,198	4,619	*6,247*	*6,764*	*7,575*
Gross national income ($ mil.)	3,699	4,932	3,656	4,430	5,047	*6,884*	*7,311*	*8,166*
Gross national disposable income ($ mil.)	4,099	5,306	4,708	5,151	6,323	*10,057*	*9,437*	*10,227*
GDP per capita ($)	1,400	1,493	1,125	1,317	1,363	*1,737*	*1,827*	*1,987*
GNI per capita ($)	1,608	1,763	1,199	1,390	1,489	*1,914*	*1,975*	*2,142*
Real GNI per capita growth (%)	0.7	4.1	-16.7	9.1	-6.5	*5.2*	*2.7*	*4.9*
Population and labour								
Population (mil.) [a]	2.34	2.96	3.23	3.41	3.61	*3.83*	*3.94*	*4.05*
Unemployment (%) [b]	32.6	21.7	41.2	32.5	29.8	*32.4*	*30.1*	*30.0*
Total employment (thousands)	417	588	452	551	636	*667*	*718*	*744*
In public sector	51	103	125	131	148	*161*	*181*	*179*
In Israel and settlements	68	135	42	45	55	*67*	*73*	*78*
Fiscal balance (% of GDP)								
Revenue net of arrears/clearance withheld	13.2	23.9	8.5	25.0	25.0	*25.7*	*25.9*	*26.1*
Current expenditure	15.3	22.6	29.0	36.4	49.3	*47.2*	*51.9*	*41.6*
Total expenditure	25.6	29.9	35.4	37.1	55.0	*50.7*	*58.4*	*45.3*
Overall balance – cash basis	-12.3	-6.1	-27.0	-12.1	-30.0	*-25.0*	*-32.5*	*-19.2*
External trade								
Net current transfers ($ mil.)	400	399	1,096	734	1,491	*3,230*	*3,219*	*2,697*
Exports of goods and services ($ mil.)	499	684	380	484	678	*960*	*919*	*992*
Imports of goods and services ($ mil.)	2,176	3,353	2,519	2,909	3,202	*4,086*	*4,363*	*4,954*
Trade balance (% of GDP)	-52.1	-63.9	-62.3	-57.8	-54.6	*-50.0*	*-50.9*	*-52.3*
Trade balance with Israel ($ mil.)	-922	-1,598	-886	-1,500	-1,887	*-2,888*	*-2,558*	*-2,840*
Trade balance with Israel (% of GDP)	-28.6	-38.2	-25.8	-35.7	-40.9	*-46.2*	*-37.8*	*-37.5*
PA trade with Israel/total PA trade (%) [c]	92.3	69.7	56.3	72.1	74.1	*89.7*	*74.4*	*73.6*
PA trade with Israel/total Israeli trade (%) [c]	4.3	3.9	2.1	2.4	2.4	*2.8*	*3.0*	*2.8*

Sources: Palestinian Central Bureau of Statistics (PCBS), World Bank, IMF, International Labour Organization (ILO), and Israel Central Bureau of Statistics.

[a] Due to PCBS inability to access East Jerusalem, the data exclude East Jerusalem, with the exception of population figures.

[b] ILO's "relaxed definition" of unemployment includes discouraged workers.

[c] Palestinian and Israeli trade data refer to goods, and non-factor and factor services.

C. High levels of poverty and food insecurity

10. Despite GDP growth in 2010, poverty and food insecurity decreased only slightly – remaining high throughout the OPT, not just in the Gaza Strip. The latest PCBS data indicate that poverty remains a serious problem. Using the consumption-based definition of poverty, 26 per cent of the Palestinians in the OPT lived in poverty in 2009 and 2010. The poverty rate was 18 per cent in the West Bank, but was much higher in Gaza at 38 per cent. Were it not for the significant social assistance extended to Palestinian households, the poverty rate in the OPT in 2010 would have been 31 per cent (PCBS, 2011).

11. According to the World Food Programme (WFP) (2011), 50 per cent of Palestinian households in the OPT were impacted by food insecurity – 33 per cent were classified as food-insecure, and nearly 17 per cent were classified as vulnerable to food insecurity. In Gaza, 65 per cent were impacted by food insecurity, with 52 per cent classified as food-insecure and a further 13 per cent vulnerable to food insecurity. The fact that 33 per cent of agricultural land in Gaza is inaccessible to farmers and some 85 per cent of Palestinian maritime space is off-limits to fishermen has contributed to food insecurity.

12. According to a survey conducted by WFP, the Food and Agriculture Organization of the United Nations (FAO) and PCBS (2010), Palestinian people have used various strategies to cope with poverty and food insecurity under prolonged Israeli occupation. These strategies have included – in addition to borrowing – receiving food support from family and friends, restricting food to adults in order to feed children, reducing health and education spending, running down savings, and selling off jewellery, furniture, and productive assets. The top three coping strategies used are deferring payment of utility bills, lowering the quality and quantity of food intake, and borrowing. The recent installation of prepaid meters and the privatization of electricity distribution to ensure payment imply that the coping strategy of deferring utility bills is no longer available to poor and vulnerable households. Coping by resorting to credit has a limited viability, leaving lowering the quantity and quality of food intake, already used by 29 per cent of households, as the only remaining alternative. This poses a threat to Palestinian health and human capital formation in the long run.

D. High and persistent unemployment undermines the quality of human capital

13. The GDP growth in 2010 was to a large extent "jobless" because it failed to make a dent in the high unemployment rate that has persisted for a decade. The growth was achieved largely by better utilization of existing resources but does not reflect an increase in investment. Weakness of the private sector and the high risk it faces, combined with the PA fiscal austerity which features – inter alia – containment of public employment and salaries, explain the lack of progress on job creation.

14. Unemployment has remained at around 30 per cent since 2009,[3] with 47 per cent in Gaza in 2010, compared to 20 per cent in the West Bank. Even though the unemployment rate in the OPT is among the highest in the world, the reported rate does not capture the full severity of the problem, given the prevalence of underemployment, disguised unemployment, discouraged potential labour-market participants, and low labour-market participation. Palestinian youth under 30 are particularly vulnerable to the labour-market conditions, with unemployment for this age group at 43 per cent.

[3] Relaxed definition of unemployment.

15. Beyond the immediate socio-economic consequences, the persistence of high unemployment of Palestinian labour for such a long period poses lasting threats to the livelihoods of the Palestinian people in the OPT, without mentioning the strains on the social fabric and on solidarity. Prolonged interruption of production activities entails a risk of “de-skilling” Palestinian workers and entrepreneurs, and inflicts long-term damage on human capital as it will be costly to re-cultivate lost skills.

E. Separation barrier deepens isolation from global markets

16. The consequences of severing the Palestinian economy from the global economy have been worsened since 2002 by the construction of the “Separation Barrier”. On 9 July 2004, the International Court of Justice (2004) rendered an advisory opinion on the “Legal Consequences of the Construction of a Wall in the Occupied Palestinian Territory”, which states that the sections of the Barrier which ran inside the West Bank, including East Jerusalem, together with the associated gate and permit regime, violated Israel’s obligations under international law. According to UNSCO (2011a), by 2011, 440 kilometres (62 per cent) of the planned 709-kilometre-long barrier was completed. About 85 per cent of the barrier is built inside Palestinian land, thus redefining the 1967 borders and dispossessing Palestinian land and natural resources (Office for the Coordination of Humanitarian Affairs (OCHA), 2009).

17. Due to the construction of the Barrier and related access restrictions, Palestinian exports to Israel, which account for about 90 per cent of total exports, fell by 30 per cent during 2008–2009. Restrictions on Palestinian exports, and on imports of production inputs, were further tightened during 2010 (IMF, 2011). Repeated and lengthy Israeli security checks force Palestinian traders into long queues at the crossing points, which have inadequate facilities and limited working hours. The conditions of access into Jerusalem for UNRWA staff provide an example of the prohibitive cost imposed on the Palestinian economy. With 350 UNRWA staff entering Jerusalem daily from the rest of the OPT, waiting and crossing at barriers results in the loss of 1,350 work-days per month – the equivalent of $730,000 per year (UNSCO, 2010).

18. The restrictions imposed on the movement of goods to/from/within the West Bank and Gaza have stifled the emergence of an export sector capable of contributing to economic development. Steady access to global markets at normal cost is not only of critical importance to Palestinian economic development, it is actually a precondition for such development to take place. The small size of the OPT market implies that improvements in living standards cannot be achieved without building a dynamic, high-value-added export sector.

19. The realization of scale economies, cost efficiency and technological progress require the removal of barriers to Palestinian trade with the rest of the world, as these have denied the Palestinian private sector essential imported inputs and export markets, and have exacerbated transaction costs. In the West Bank alone, there are fixed 500 obstacles to the movement of Palestinian people and goods (UNSCO, 2011b). West Bank producers and traders are undermined by prohibitive transaction costs at crossing points arising from long waiting times, and by damaged goods – especially fresh produce.

F. Heavy dependence on trade with Israel, and a worsening trade deficit

20. Table 1 shows that Palestinian exports fell to $919 million in 2009, from $960 million in 2008, and then mildly improved to $992 million in 2010. However, export share of GDP declined from 15.4 per cent in 2008 to 13.1 per cent in 2010. By contrast, imports

increased to $5 billion in 2010, or 65 per cent of GDP, up from $4.4 billion in 2009. The constrained Palestinian exports were therefore incapable of narrowing the persistent trade deficit, which has expanded, in absolute terms, from $3.4 billion (51 per cent of GDP) in 2009 to $4 billion (52 per cent of GDP) in 2010.

21. A salient distortion of the Palestinian trade structure is its heavy dependence on Israel since 1967 as the source or channel for exports and imports. Israel absorbs about 90 per cent of Palestinian exports, most of them low value-added, and is the source or channel for about 80 per cent of imports. In 2010, Palestinian trade with/through Israel accounted for 74 per cent of total Palestinian trade, and the trade deficit with/through Israel accounted for more than 70 per cent of the total deficit. The trade deficit with/through Israel rose from $2.6 billion in 2009 to $2.8 billion in 2010. This deficit was greater than the $2.7 billion of net current transfers, which included the total donor support to the PA during 2010.

22. Recent evidence published by the Bank of Israel suggests that of the total Palestinian imports from Israel reported by official statistics, only 42 per cent are actually goods produced in Israel. The remaining 58 per cent are produced in a third country, and transit to the OPT via Israel. Factoring out these “indirect” imports negates the overstated importance of the Israeli economy to that of the OPT. The officially reported share of imports from Israel would be closer to 35 per cent, rather than 75 per cent, of all Palestinian imports. Under normal trade and transit conditions, therefore, Israel would no longer enjoy overwhelming dominance as the leading OPT trading partner. This underscores the failure of Palestinian–Israeli convergence and economic integration under prolonged occupation. And, as shown below, this arrangement deprives the PA of significant customs revenue that it needs in order to meet essential obligations, lower its structural budget deficit, and reduce aid-dependence.

G. Fiscal vulnerability remains high, despite austerity measures

23. In the last few years, the PA has carried out strict fiscal reforms to control the budget deficit, improve fiscal discipline and sustainability, and lessen dependence on donor aid. As a result, the recurrent budget deficit, on cash basis, fell to 15 per cent in 2010, from 24 per cent in 2009. This was achieved by a combination of spending controls, especially with regard to containment of public employment and wages, and enhanced revenue collection. Tax revenue grew by 57 per cent in 2010, and total public revenue grew by 22 per cent, to $1.9 billion, while expenditure was reduced by 4 per cent. On a commitment basis, the recurrent budget deficit was $1.2 billion in 2010, down from $1.6 billion in 2009, and the total budget deficit stood at $ 1.5 billion.

24. At first glance, the 2010 budget indicators imply significant progress towards fiscal sustainability, but a closer examination reveals highly uncertain prospects. Despite the impressive growth in 2010, tax revenue covered only 15 per cent of total spending, while spending on public investment remained very low. Of the $3.1 billion in total spending, public investment accounted for only $298 million – less than 10 per cent of the total spending and about 4 per cent of GDP.

25. Another indicator of persistent fiscal weakness is the fact that $1.3 billion of the PA’s budget shortfall or 42 per cent of total spending was financed by donors. Such a high level of foreign aid is neither stable nor sustainable, especially given the current state of the world economy. In fact, in the first quarter of 2011, aid disbursements were below expectations (IMF, 2011). In 2010, shortfalls in expected aid disbursements forced the PA to resort to borrowing from domestic banks to bridge the spending gap, thus increasing domestic debt to more than 11 per cent of GDP (World Bank, 2011).

26. The worthy PA goal of steadily reducing the recurrent budget deficit to 4 per cent of GDP, envisaged in the 2011–2013 Palestinian National Plan, is unlikely to be achieved by the stated date. Achieving a sustainable budget deficit will remain elusive unless all Israeli restrictions on movement and access are lifted, and the Palestinian people in the OPT gain access to their natural resources, paving the way for private-sector revival.

27. While fiscal reforms are important, it is no less critical that the poor should not be made to pay the cost. A salient feature of the PA fiscal reform has been the reduction of net lending (utility subsidies).[4] In 2010, the PA cut net lending by 37 per cent, thus reducing it to 3.4 per cent of GDP from 11 per cent in 2007, and there are plans to eliminate it by 2011 with the full privatization of electricity distribution (IMF, 2011). It is expected that 43 per cent of Palestinian households that use utility bill payment deferral to cope with the crisis will be impacted by the moves towards eliminating net lending (WFP, 2010). Such fiscal measures without concomitant provision for adverse social impacts are incongruous with the realities of a debilitated economy under occupation.

II. Public revenues: instability and leakages

A. Withholding PA customs clearance revenue aggravates fiscal instability

28. The PA has continuously had to contend with the unpredictability both of aid disbursements, and of the revenue it collects. PA revenue instability is caused by a number of factors, such as the volatility of the tax base, and the vulnerability of the level of economic activity to the Israeli closure policy and recurrent military confrontations. However, another major source of fiscal instability is rooted in Israeli control over the tax and customs clearance revenue that it collects on behalf of the PA. Israel has often resorted to withholding tax and customs clearance revenue on account of unilateral considerations, such as in 2002 and 2006 (UNCTAD, 2008).[5] This is especially destabilizing to the Palestinian economy, since revenue from customs clearance represents 60–70 per cent of total PA revenue. Such unpredictability makes fiscal planning difficult, undermines the PA’s ability to pay the private-sector agents who supply it with goods and services, and threatens its ability to pay the salaries of more than 150,000 public employees.

29. In early May 2011, Israel once again considered withholding some $100 million of customs clearance revenues owed to the PA following Palestinian national reconciliation efforts (BBC, 2011). Israel eventually released the delayed revenue, but the episode highlighted such risks to the Palestinian economy. The negative impact of fiscal instability on economic growth is widely recognized.[6]

30. The unpredictability of Israel’s clearance of Palestinian customs-related revenues has a major impact on Palestinian economic development, and can easily destabilize public consumption and investment. Public expenditure has a critical role in stimulating Palestinian GDP and in compensating for the constraints upon the potential of the

[4] The money for net lending comes from the government budget, to cover the inability of poor households to pay utility bills or to pay them on time.

[5] Israel released the withheld revenue in each case, after periods of varying length, but the point is that withholding causes fiscal unpredictability and instability.

[6] Ebeke and Ehrhart (2011) analyse data from 39 sub-Saharan African countries and conclude that tax revenue instability is highly detrimental, since it increases public spending volatility, which impacts negatively on the level and stability of public investment.

Palestinian private sector to achieve its potential role in promoting growth, job creation and poverty reduction. Unpredictability in customs clearance revenue further elevates the PA's already high degree of fiscal uncertainty.

B. Indirect imports from Israel; lost Palestinian revenue

31. Withholding of clearance revenue, and the uncertainty it breeds, is not the only factor that constrains the PA fiscal space and limits its ability to optimize the use of limited resources for economic recovery. As early as 2004, UNCTAD (2004) pointed out that not all Palestinian imports from Israel are goods actually produced in Israel. A significant portion of these imports are produced in a third country and then re-exported to the OPT as if they had been produced in Israel. The World Bank (2002) has estimated that these "indirect imports" account for about one third of what is officially reported as Palestinian imports from Israel. A recent study by the Bank of Israel (2010) indicates that "indirect imports", exported to the OPT through the Israeli trade sector, accounted for at least 58 per cent of the trade that was reported as PA imports from Israel in 2008.

32. Customs revenue from these "indirect imports" is collected by the Israeli authorities but not transferred to the PA, as they are not labelled as being destined for the PA and are imported in bulk by Israeli importers and resold to Palestinian consumers. In 2008, clearance revenue, transferred to the PA, on imports from countries other than Israel amounted to $1.1 billion. Had the PA also collected taxes on "indirect imports" from Israel, clearance revenue could have increased by about $0.5 billion to reach $1.6 billion.[7] This figure represents more than 8 per cent of GDP and 25 per cent of public revenue, and would have covered one third of the budget deficit in 2008. The fiscal loss to the PA mirrors a fiscal gain to Israel arising from its control over Palestinian trade routes. Figure 2 shows the Palestinian clearance revenue collected and transferred, as well as the level that would have been achieved had it been augmented by the additional revenue from "indirect imports".

33. In addition to the fiscal cost of "indirect imports", the Palestinian economy pays a greater cost in terms of the additional GDP and employment that could have been generated had these fiscal resources been available to stimulate the economy. To assess the magnitude of the economic and employment cost of lost revenue, UNCTAD's macroeconometric model of the Palestinian economy has been simulated under alternative scenarios.

34. A baseline scenario simulates the economy under the present conditions based on the actual historical data for all the policy and exogenous variables including clearance revenue. The alternative scenarios maintain the actual data for all policy and exogenous variables with only two exceptions. The first exception is an increase – above the baseline level – in clearance revenue equivalent to the amount that could have been raised from the tax on "indirect imports" (fig. 2). The second exception is an equivalent increase in government spending so that all raised revenue is used to finance an expansionary fiscal policy. Furthermore, the expansionary fiscal policy is assessed under alternative options. The first is the transfer scenario, where the entire additional revenue is allocated to increasing government transfer payments to the poor. The second is the export support scenario, where the additional revenue is allocated to expanding the economy's productive base by supporting export industries.

[7] Assuming that "indirect imports" represent 58 per cent of total imports from Israel and would be taxed at the average 14 per cent VAT plus 10 per cent tariff.

Figure 2: Palestinian clearance revenue - million $

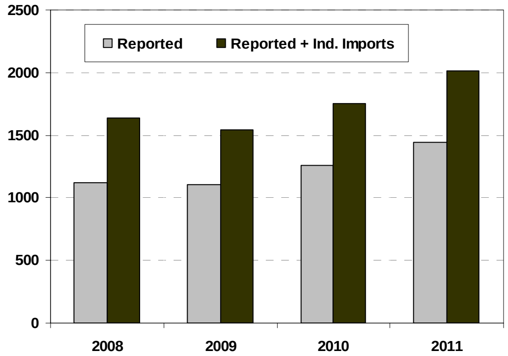


Figure 3: Real GDP - million 2004 $

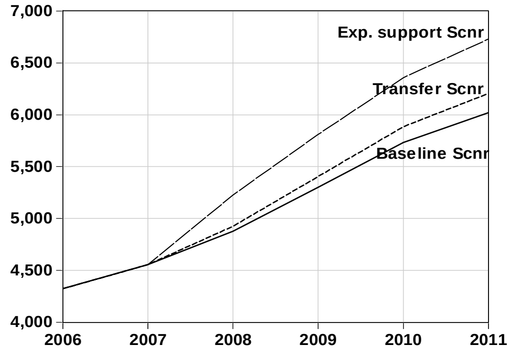


Figure 4: Real GDP per capita - 2004 $

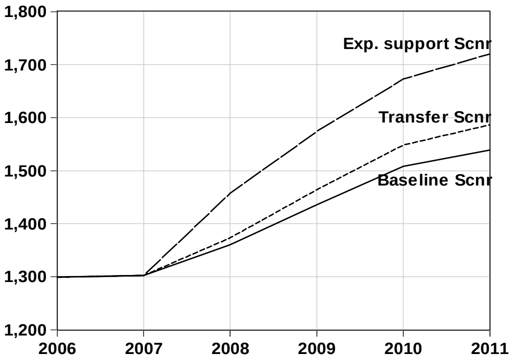
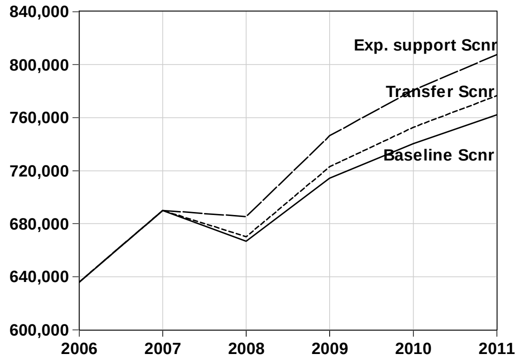


Figure 5: Total employment



35. Figures 3 to 5 indicate that the potential impact of additional clearance revenue would be substantial, and would provide policymakers with wider policy space to consider. In terms of GDP, while the transfer scenario would increase real GDP (in 2004 dollars) by about $0.15 billion (8 per cent) above the baseline in 2010, the export support scenario would increase it by $0.63 billion (11 per cent). Real GDP per capita would increase in the two scenarios, by $40 and $165 respectively. In terms of employment, in 2010 the transfer and export support scenarios would generate 14,000 and 45,000 additional jobs respectively, above the baseline scenario. This appears to be a strong argument for fiscal stimulus and policy space.

36. Based on the previous analysis and the present size of the economy, the estimated costs to the Palestinian treasury of not receiving the tax revenue on “indirect imports” from Israel may be in the range of $480 million per year, equivalent to more than 25 per cent of public revenue;[8] 10 per cent in lost GDP; and 30,000 jobs per year (4 per cent of average annual employment). Therefore, it is urgent that an operational mechanism be explored to accurately distinguish bona fide imports from Israel from “indirect imports”. This necessitates reconsideration of the revenue clearance arrangement in place, and the implementation of measures to remedy the negative fallout from the serious information asymmetry between the two sides, including expanded operations by PA customs, and interface with Israeli customs.

[8] This does not account for the increase in revenue associated with expansion of the tax base. The export support scenario would produce a larger tax base and more revenue than the transfer scenario.

37. The above data confirm that Palestine’s trade openness is actually with the rest of the world, and less so with Israel. This also implies that the economy of a future viable Palestinian State should look eastwards, or at least beyond Israel, when designing a trade, fiscal and related macroeconomic policy framework suited to its needs and to existing global relations.

III. The Palestinian economy in East Jerusalem

38. A significant constraint on the potential for development of the Palestinian national economy is the growing separation of East Jerusalem from the rest of the OPT, a process that has been inadequately documented. While this has been framed by the lack of PA jurisdiction over East Jerusalem as per the Oslo Accords of 1993, separation has intensified especially since 2000. A recent OCHA study (2011) highlighted the changing geography and borders of East Jerusalem, and the deterioration of its education, health and social services. The physical and demographic separation of East Jerusalem has been accelerating. Palestinians from the rest of the OPT are not permitted to reside in East Jerusalem and are denied free access for worship, study, work or healthcare, while Palestinian Jerusalemites are granted Israeli “resident” status.

39. The viability of a future independent Palestinian State depends, inter alia, on reintegrating the economy of East Jerusalem within the broader national economy and allowing it to reassume its historic pivotal economic role. As far back as a decade ago, UNCTAD (2001) emphasized that the PA had demonstrated competence in management of public finances and delivering services in an unfavourable environment of occupation and recurrent crises, and was ready to assume national governance functions. Its continuing positive track record in this regard was confirmed most recently at the Ad Hoc Liaison Committee (AHLC) meeting of April 2011 in reports by the IMF, World Bank and United Nations. The cohesion and dynamism of the economy of a future Palestinian State requires action to end the separation and occupation of East Jerusalem. The UNCTAD secretariat is in the process of producing an analytical study focusing on key challenges facing the economic development of East Jerusalem, as outlined below.

A. Salient economic and social indicators

40. According to Israel’s Central Bureau of Statistics, the Palestinian population within the eastern part of Jerusalem Municipality in 2009 was around 275,000, making up approximately 34 per cent of the city’s population. Palestinians in East Jerusalem represent 9.5 per cent of the total population in the OPT and broadly share the key demographic characteristics of their compatriots: the average household size in East Jerusalem was 5.2 in 2007, compared to 5.8 in the OPT in the same year, and the fertility rate in East Jerusalem was 5.2 in 1997, compared to 6.0 in the OPT. Whereas Jerusalem used to be an employment pole for Palestinian labour before occupation, it has increasingly exported its labour force to the OPT market (in services, civil society organizations and the public sector) as well as to the Israeli market (in manufacturing and services).

41. The Palestinian labour force in Jerusalem in 2009 comprised 89,000 workers. Prior to 2000, unemployment rates in the West Bank and East Jerusalem were similar. PCBS data show that unemployment in 2000 was 12.1 per cent in the West Bank and 11.5 per cent in East Jerusalem. Unemployment rates are higher among youth, and there is a high percentage of unemployment among the skilled and educated in both the West Bank and East Jerusalem. Despite those similarities, the labour force in East Jerusalem has two unique characteristics, namely the higher rate of full-time employment (84 per cent compared to 70 per cent in the OPT in 2009), and the relatively low unemployment rate

among Palestinian women in Jerusalem compared to the West Bank, which stands at 13.5 and 18.8 per cent respectively.

42. While per capita GDP and average monthly household consumption levels in East Jerusalem are generally higher than in the remaining West Bank, East Jerusalem Palestinians must cope with the higher consumer price index (in Israel). Furthermore, Palestinians in East Jerusalem face a tax burden equal to that of Jewish Israeli citizens, which lowers their purchasing power relative to West Bank Palestinians. The private and public services sectors comprise the largest part of the value added of East Jerusalem, estimated at around 40 per cent, followed by transportation (23 per cent), manufacturing (16 per cent) and commerce (13 per cent), while construction, agriculture, fishing and financial intermediation together account for under 10 per cent. According to the latest PCBS data, in 2009 there were 6,860 economic enterprises in the greater Jerusalem region (2,659 in the Jerusalem Municipality area and 4,201 in the surrounding Jerusalem area) – a 30 per cent increase compared to 1999. Most of that increase (1,044 enterprises) took place in the greater Jerusalem area under PA jurisdiction. During the same period, only 346 new Palestinian enterprises were established within the Jerusalem Municipality area.

B. Future challenges: reversing economic disintegration and separation

43. Rehabilitating and restructuring the fragmented East Jerusalem economy will call for a significant national effort in the coming years to reconnect it to the Palestinian territory through better integration of trade, labour and financial markets. Since 1967, the Israeli authorities have taken a series of measures which have altered the physical character of Jerusalem and hence the functioning of its economy (OCHA, 2011).[9] These include the construction of settlements within East Jerusalem amidst Palestinian neighbourhoods, and the construction of the Separation Barrier which redefines the borders around the greater Jerusalem area, as more zones outside the municipal boundary are brought onto the Jerusalem side of the Barrier.

44. Another indispensable condition for reintegration of the East Jerusalem economy into the West Bank hinterland is efficient access and freedom of movement of goods and labour. Together with sovereignty at borders, this is essential for a vibrant internal and external trade sector – a sector which is deeply rooted in the economy of Jerusalem and is a major contributor to its output and employment. The construction of the Barrier has forced West Bank residents to seek alternative markets, while the Israeli permit system has significantly reduced the number of Palestinians attending Friday prayers at Al-Aqsa mosque; more than 280 shops in East Jerusalem catering to Palestinian religious tourism have closed since 1992 (OCHA, 2007). The East Jerusalem economy has not only lost a wide array of Palestinian customers for its goods and services, but also cannot easily access relatively inexpensive consumer goods from the West Bank due to restrictions on movement. Obtaining the required Israeli permits that allow trade from the West Bank to East Jerusalem is complex and expensive. Since June 2010, Israel has prohibited any pharmaceutical, dairy or meat products from the West Bank from entering East Jerusalem, which is estimated to entail up to $48 million in losses annually for the Palestinian economy. Even when goods are allowed into East Jerusalem, they pass through commercial crossing points where they undergo offloading and reloading, in a process called “back to back” which adds to the high transaction costs of Palestinian trade.

[9] OCHA’s study states that these measures are neither recognized by the international community nor by the United Nations Security Council.

45. Given the relatively weak natural resource base of the Palestinian economy, human capital has been a main asset of its development potential. Moreover, economic hardship, coupled with the absence of effective economic policies to alleviate adverse conditions, has forced the Palestinian people to stress educational attainment. Repairing and mobilizing human capital will be a major challenge in the coming years, including in East Jerusalem. The relatively limited access to education and health services for Palestinian Jerusalemites (as compared to Israelis living in the city) are indicative of the wider adverse policy environment that Palestinians must contend with. For example, the Equality Index of Jewish and Arab Citizens in Israel (Sikkuy, 2007), indicates significant inequality between Palestinians and Israelis in Jerusalem in the education index (at 0.34).[10] In addition, restrictions on access to health services in East Jerusalem affect Palestinians on both sides of the Separation Barrier (OCHA, 2011).

46. Economic divergence from the rest of the occupied territory has entailed a high incidence of poverty among Palestinians in Jerusalem, as compared to Israelis living in the city. All indicators suggest that poverty among Palestinians in East Jerusalem is much worse than among Israelis in the city and in Israel in general. In 2007 in Jerusalem Municipality, 67 per cent of non-Jewish families were living below the poverty line, compared to 23 per cent of Jewish families (Jerusalem Institute for Israel Studies, 2010). The picture is bleaker for children: in 2008, 74 per cent of non-Jewish children in Jerusalem were poor, compared to 45 per cent of Jewish children. Furthermore, the average per capita income among the Jewish population of Israel ($23,300) was 8 times that of the Palestinian population in East Jerusalem. The average daily wage of a Palestinian from East Jerusalem working in Israel was about $30, or 68 per cent below the average within the Jerusalem Municipality area. Combating poverty in East Jerusalem is not only an immediate welfare priority, but has significant longer-term implications for the economic and social cohesion of the city.

47. Long-term investment prospects are clouded by the impediments in access to finance and credit faced by Palestinians and businesses in East Jerusalem, whether for consumption or for trade and investment purposes. This is particularly significant in Jerusalem, since prices are higher than in the rest of the West Bank. There are no branches of Palestinian banks operating within the Jerusalem Municipality area; there are few Israeli bank branches in East Jerusalem, and they do not cover the basic needs of Palestinians. The difficulties faced by Palestinians in accessing credit in East Jerusalem were recognized in the Quartet report to the AHLC in Brussels in April 2011 (Office of the Quartet Representative, 2011), which stresses "(a) expanding access to mortgage loans to provide improved housing opportunities to Palestinian East Jerusalemites"; and "(b) raising funds for investment in East Jerusalem to be channelled towards small to medium enterprises as a means to revitalize the local economy…"

48. Exclusion of East Jerusalem from the rest of the OPT has critical consequences for both the local and national economies. PCBS data for the six years following the establishment of the PA in 1994 indicate that the size of the East Jerusalem economy, relative to the rest of the OPT, declined during that period, from 9.3 per cent in 1995 to 8.2 per cent in 1999. Accordingly, the output of the East Jerusalem economy today is estimated at close to $680 million. If the East Jerusalem economy were under the jurisdiction of the PA, the 2010 GDP of the Palestinian economy could have increased from $7.6 billion to $8.3 billion. This implies considerable fiscal (public) revenue and national economic multiplier effects for a future Palestinian State, which could further expand the national

[10] The index ranges between 1 indicating total inequality of the Palestinian population, -1 indicating total inequality of the Jewish population, and 0 indicating full equality.

economy. The imperative of greater attention to the economic development needs of East Jerusalem cannot be overemphasized in setting the scene for a viable economy for an independent Palestinian state.

IV. UNCTAD assistance to the Palestinian people

A. Framework and objectives

49. In 2010, UNCTAD continued to extend its support to the Palestinian people and their efforts to cope with the adverse socio-economic conditions and build the capacities and institutional base of the envisioned sovereign Palestinian State, as called for by United Nations resolutions, and in line with the mandates of UNCTAD X, XI and XII.

50. Drawing on its intimate knowledge of the Palestinian economy garnered from 26 years of sustained support to Palestinian development efforts, UNCTAD's work seeks to strengthen the institutional and managerial capacities of the PA, and to support the Palestinian private sector to respond to the evolving needs of the Palestinian people. UNCTAD's multifaceted programme of technical assistance to the Palestinian people builds on the experience of UNCTAD as a whole, and is carried out in close cooperation with Palestine, the Palestinian private sector, civil society organizations, United Nations agencies and other international agencies. The programme emphasizes the interrelated treatment of trade, finance, and enterprise development, with technical assistance activities in four areas: (a) trade policies and strategies; (b) trade facilitation and logistics; (c) finance and development; and (d) enterprise, investment, and competition policy.

B. Operational activities under way

51. UNCTAD activities in support of Palestinian Customs continued in 2010. Substantial achievements were made under the "Programme to Modernize and Strengthen Institutional and Managerial Capacities of the Palestinian Authority Customs Administration, Phase III" technical cooperation project, including the training of 48 Customs employees in 10 functional areas, including clearance procedures, IT, functional administration, customs management, customs procedures, operations, Automated System for Customs Data (ASYCUDA) reports, and direct trader input. Training on the ASYCUDA system was also extended to staff from other government ministries and agencies and from the Palestinian private sector. Some Palestinian ministries are now connected, and can exchange data directly with ASYCUDA. Private-sector agents can also directly input data, and process and complete customs clearance procedures more efficiently, resulting in substantial time and cost savings.

52. As a result of progress achieved under this project, Palestinian Customs has been able to implement new customs procedures and to interface with the Israeli customs system more effectively. This has led to more efficient customs control, and has enhanced customs revenues. At the conclusion of the project on 31 December 2010, the PA and the donor (European Commission) recognized the significant achievements that had been made, and started considering a new technical cooperation project to consolidate achievements, ensure a proper and complete handover and Palestinian ownership, and strengthen the PA's overall customs and fiscal capacity. This is expected to commence in late 2011.

53. In early 2011, UNCTAD completed the implementation of the Development Account project entitled "Promoting Subregional Growth-Oriented Economic and Trade Policies towards Achieving the MDGs in Arab Countries of West Asia and North Africa",

which benefits the OPT and four other Arab countries. The final expert meeting was held in Geneva in October 2010. It was attended by consultants, and by representatives and staff from trade ministries and statistical agencies of the participating governments, including the PA. The workshop and meeting provided a platform for the exchange of ideas and experiences among national policymakers, UNCTAD staff and experts. The studies and discussions generated by the project, which was conducted with Millennium Development Goals 1 and 8 in mind, will result in publication of a book on pro-poor economic and trade strategies, harmonization of trade statistics, and infrastructure and institutions to facilitate deeper regional integration. Palestinian policymakers benefited from project's activities, and contributed to its successful implementation; this included a detailed study on Palestinian external trade, along with a wide range of trade indices and quantitative indicators that are essential for sound Palestinian trade policymaking.

54. UNCTAD has pursued its initiative to introduce the United Nations Chief Executives Board Inter-Agency Cluster on Trade and Productive Capacity in the OPT. This aims at developing the Palestinian trade and productive sectors within a flexible framework of coordinated interventions capable of fostering dynamic synergies between humanitarian interventions and of building a sound Palestinian productive base. The secretariat has designed a joint proposal for a programme within the context of the United Nations' "Delivering as One" and in collaboration with the United Nations agencies operating in the OPT. This initiative aims at achieving inter-agency coordination and integration, and at maximizing the coherence of activities which will be carried out within a strategic framework that emphasizes the linkages between trade, poverty reduction, human development and the Millennium Development Goals. The proposal was endorsed by the United Nations country team in the OPT in December 2010; subsequently, an inter-agency mission took place to discuss the proposal with relevant PA officials, Palestinian private-sector institutions and the donors. The Cluster will be launched formally when funding is secured.

55. UNCTAD's research in the recent past has highlighted the fact that Palestinian traders are hampered by weak infrastructure and logistical services, as well as by restrictions imposed on the movement of goods and people. These factors combine and give rise to prohibitive transaction costs, which erode the competitive position of Palestinian enterprises and pose trade barriers of greater significance than import tariffs. The effectively landlocked status of the OPT and the barriers imposed by occupation ensure complete dependence on the port facilities of Israel for participation in international trade.

56. In response to the needs identified in the findings from this research, UNCTAD extended support to Palestinian institution-building and trade facilitation by successfully completing the Establishment of the Palestinian Shippers' Council (PSC) project in 2008. To capitalize on what has been achieved, enhance the capacity of the PSC to serve the needs of the shipping community, and ensure its long-term sustainability, UNCTAD, in cooperation with the PSC, has developed a new technical cooperation project to "strengthen the Palestinian trade facilitation capacity" and has discussed the proposed intervention with the PA and potential donors. The Canadian International Development Agency funded this project as part of its strategy of intervention in the OPT, and implementation began in May 2011.

57. The project seeks to build the knowledge base of Palestinian exporters and importers by proceeding along two parallel lines: consolidating the institutional capacity of the PSC, as the main representative of the Palestinian community of exporters and importers, and increasing the Palestinian shippers community's awareness of the different aspects of internationally recognized best practices of trade facilitation. The project will strengthen Palestinian national institutional capacities and structures for providing continuous expert

training and advisory services to Palestinian shippers and policymakers in the area of trade facilitation.

C. Resource mobilization, coordination and harmonization

58. In the course of 2010, UNCTAD discussed with the PA's Ministry of Finance a project for strengthening capacities in debt monitoring and financial analysis. An assessment mission by UNCTAD staff from the Assistance to the Palestinian People Unit and the Debt Management and Financial Analysis System (DMFAS) visited the OPT and met with relevant PA staff, and a project document was developed. The PA has formally declared to donors its decision to adopt DMFAS and to commence implementation in the near future when funding shortfalls are overcome.

59. Despite significant achievements and progress made in resource mobilization and project implementation, the secretariat's goal of intensifying its support of Palestinian economic development, as called for in the Accra Accord, remains constrained by the inadequacy of resources, extrabudgetary funding shortfalls, and the lack of a field presence. In addition, further facilitation of the entry and access by UNCTAD international and national staff to the field in the OPT will prevent delays in the implementation of planned activities and mission, and will help in overcoming the difficult conditions in the field.

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