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Report on UNCTAD assistance to the Palestinian people

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Report on UNCTAD assistance to the Palestinian people*

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Executive summary

The economy of the occupied Palestinian territory stagnated in 2007 and failed to recover from the 2006 contraction. As a result, gross domestic product (GDP) per capita continued its downward trend and poverty deepened. If it were not for the resumption of foreign aid in the second half of 2007, GDP would have contracted for the second year in a row. The construction of the separation barrier, the Israeli closure policy and the erosion of productive capacity continued to prevent recovery and entrenched "de-development". The economic gap between the West Bank and Gaza has widened as a result of recent political developments and the tight closure imposed on the Gaza Strip.

The Palestinian Authority announced significant reforms aimed at achieving fiscal sustainability. Reforms, rehabilitating the productive base and lifting the closure, while necessary, are not sufficient conditions for recovery and sustained growth. To put the economy on a path of sustainable development and self-sufficiency, they need to be complemented by empowering the Palestinian Authority with the appropriate policy instruments to carry out economic policies suited to the specific needs of the Palestinian war-torn economy. In addition to expanding the Palestinian Authority's policy space, there is an urgent need to strengthen its capacity to formulate and implement development policies and to provide sound economic management for their implementation.

UNCTAD continues to respond to the emerging needs of the Palestinian economy by intensifying assistance, in coordination with other United Nations and international organizations and in close consultation with Palestine. However, funding shortfalls threaten efforts to build on previous achievements and reach the hoped-for results. Improved extrabudgetary funding remains critical to achieving UNCTAD's mandate of responding to the evolving needs of the Palestinian economy.

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† This document was submitted on the above-mentioned date as a result of processing delays.
‡ The information in this document should not be quoted by the press before 8 September 2008.

Introduction

1. The economy of the occupied Palestinian territory has been faced with overwhelming challenges since September 2000. It has been dealing with tight closure policy, geographical fragmentation, a separation barrier that significantly reduces agricultural land, uncertain public revenue and donor aid, eroded productive capacity, an array of donor agendas and limited government and institutional capacity. Despite these challenges, the economy continues to function and the Palestinian people continues to show resilience in surviving the prolonged crisis.

2. Since its establishment, the Palestinian Authority has continued to formulate and implement development and reform plans, including, most recently, the Palestinian Reform and Development Plan for 2008–2010. The plan, which emphasizes reform and governance, was welcomed by the donor community at the Paris Donors Conference in December 2007 with $7 billion in pledges.

3. While lifting the closure imposed on the occupied Palestinian territory, institutional reforms, development plans and donor support are all essential for the recovery of the Palestinian economy, they are not sufficient on their own to place the economy on a path of sustained development. There is a need to empower the Palestinian Authority with a full range of economic policy space to realize the Palestinian development vision. This report demonstrates that the policy space presently available to the Palestinian Authority allows no more than the allocation of limited and uncertain public resources – much less than the policy instruments available to local governments in many countries. The report concludes that, if fiscal, monetary, exchange-rate, trade and labour policy instruments were made available, it would be possible to reverse economic regression and move towards full employment.

4. The international community should intensify its support for efforts to empower the Palestinian Authority with the economic policy tools necessary for the sustained development of the Palestinian economy. This will help pave the way for the establishment of an independent, democratic and viable State of Palestine, in line with the two-States vision expressed in Security Council resolution 1397 (2002).

I. A degraded economy under continued closure

5. The signing of the Oslo Accords between the Palestinian Liberation Organization (PLO) and Israel, and the establishment of the Palestinian Authority in 1994, raised high expectations. Over the next five years, the occupied Palestinian territory witnessed a period of unprecedented economic growth, with real GDP growing at an annual average rate of 8.5 per cent and a substantial increase in public and private investment. This was sufficient to reduce unemployment by 5 per cent and increase GDP per capita by an annual average of 4.3 per cent.

6. This growth came to an abrupt halt in 2000, and the gains made have now vanished. The year 2000 was a watershed in the occupied Palestinian territory: it witnessed the start of the second Palestinian intifada, and the subsequent intensification and expansion of the Israeli closure policy and other measures that restrict the movement of people and goods within the occupied Palestinian territory and between the latter and the rest of the world. Furthermore, against a background

of conflict, the last eight years have witnessed the destruction and erosion of Palestinian productive capacity and the transformation of the economy from one driven by private sector investment to one degraded by war-like conditions. The economy has grown dependent on public sector and foreign aid, which are presently geared towards satisfying essential consumption and providing relief rather than investment.

7. Closure, checkpoints and barriers impact the economy through multiple channels. They limit producers' access to the imported inputs required for production and maintenance of capital stock, while also blocking their access to export and local markets. Closure feeds a vicious circle whereby the resulting loss in income constrains output from the demand side, while uncertainty and the higher cost of imported inputs, transportation and storage constrain output from the supply side. Israel's closure policy is widely recognized as one of the most devastating factors limiting the Palestinian economy (PNA, 2008; World Bank, 2008a; International Labour Office, 2007).

8. Another factor that is detrimental to the long-term prospects for the Palestinian economy is the construction by Israel since 2002 of the separation barrier, which is now 60 per cent complete. All but 10 per cent of the planned barrier encroaches on the West Bank, with many West Bank cities completely surrounded by it. The barrier has a direct adverse impact on the economy. A stringent permit system limits access by producers, farmers and workers to their place of work. Under the permit system, individuals are allowed access to their work through designated gates that operate only at certain times. Some gates are open to Palestinians on a seasonal or weekly basis, while others are never open to them. The movement of equipment and material, such as tractors and livestock, is restricted at some gates. Transportation costs have increased considerably owing to the longer distances to designated gates, as the barrier severs traditional roads (OCHA, 2007). The barrier has especially eroded the agricultural sector's already limited natural resource base. Almost 15 per cent of West Bank agricultural land will be lost as the result of the construction of the barrier (UNCTAD, 2006b).

9. The closure policy, destruction and erosion of Palestinian physical capital and the construction of the separation barrier reinforce one another to form a mechanism that persistently holds back the Palestinian economy from recovery. The result is a cycle of "de-development" and divestment with serious implications for the future prospects of the Palestinian economy if urgent corrective action is not taken.

A. Economic stagnation with persistently high unemployment

10. Following a 5 per cent decline in 2006, the Palestinian economy stalled in 2007. Growth in 2007 would have been negative for the second year in a row had it not been for the gradual lifting of foreign aid restrictions in the second half of the year. Stagnation in GDP meant that GDP per capita continued its downward trend, falling to 60 per cent of its 1999 level in 2007. A combination of borrowing, foreign aid and expatriate workers' remittances have maintained consumption during the last two years and prevented a deeper regression. Eight years of closure have stunted the economy, battered the productive capacity and eroded the institutional structure of the occupied Palestinian territory. The Palestinian Authority (PNA, 2008) and the World Bank (2008a) reckon that if the economy had continued to grow at the 1995–2000 average rate, real GDP in 2007 would have been twice its size in 1995, whereas it is actually only 36 per cent higher.

11. The trend in employment broadly mirrors that in GDP. The unemployment rate in 2007 was 29 per cent, as compared with 21 per cent in 1999. Unemployment is much higher in the isolated Gaza Strip and is likely to deteriorate further (World Bank, 2008b). Palestinian Central Bureau of Statistics (PCBS) data show that the unemployment rate in the Gaza Strip in 2007 was 35.2 per cent, as compared with 24.5 per cent in the West Bank. Declining employment opportunities in the private sector put pressure on the Palestinian Authority to expand public employment and subsidies as safety valves to ensure social stability despite the high fiscal cost. Public employment expanded by 59 per cent between 1999 and 2006, although it declined slightly in 2007.

Table 1. The Palestinian economy (West Bank and Gaza Strip): key indicators [a]

	1995	1999	2002	2003	2004rev.	2005rev.	*2006prl.*	*2007est.*
Macroeconomic performance								
Real GDP growth (%)	6.1	8.6	-3.8	5.8	6.0	6.0	*-4.8*	*0.0*
Gross domestic product - GDP ($ million)	3 276	4 517	3 156	3 624	4 077	4 478	*4 533*	*5 045*
Gross national income - GNI ($ million)	3 779	5 454	3 546	4 105	4 534	5 017	*5 068*	*5 620*
Gross disposable income - GDI ($ million)	4 200	5 853	4 985	5 395	5 951	6 583	*7 108*	*8 001*
GDP per capita ($)	1 400	1 590	999	1 108	1 203	1 191	*1 165*	*1 261*
GNI per capita ($)	1 615	1 920	1 122	1 255	1 337	1 334	*1 303*	*1 405*
Real GNI per capita growth (%)	7.9	4.1	-8.9	6.2	1.5	-1.0	*-14.9*	*-0.7*
Population and labour								
Population (in millions)	2.34	2.84	3.16	3.27	3.39	3.76	*3.89*	*4.0*
Unemployment (% of labour force)[b]	26.6	21.2	41.3	33.4	32.5	29.0	*29.6*	*28.9*
Total employment (in thousands)	417	588	477	564	578	696	*621*	*665*
In public sector	51	103	115	119	131	145	*164*	*159*
In Israel and settlements	50	127	49	55	50	63	*64*	*63*
Fiscal balance (% of GDP)								
Government revenue	13.2	23.8	8.2	20.6	23.4	27.5	*25.4*	*23.6*
Current expenditure	15.3	22.5	27.6	29.4	32.8	35.9	*42.8*	*39.8*
Total expenditure	25.5	29.8	28.2	35.2	37.5	44.5	*50.2*	*50.3*
Recurrent balance	-2.1	1.3	-19.4	-8.8	-9.4	-8.4	*-17.4*	*-16.2*
Overall balance	-12.3	-6.0	-20.0	-14.6	-14.1	-17.0	*-24.8*	*-26.7*
External trade								
Net current transfers ($ million)	421	399	1 439	1 290	1 417	1 566	*2 040*	*2 381*
Exports of goods and services ($ million)	499	892	465	465	535	587	*535*	*595*
Imports of goods and services ($ million)	2 176	3 805	2 536	2 844	3 279	3 596	*3 558*	*3 960*
Trade balance (% of GDP)	-51.2	-64.5	-65.6	-65.6	-67.3	-67.2	*-66.7*	*-66.7*
Trade balance with Israel ($ million)	-1 388	-1 766	-1 149	-1 370	-1 618	-1 920	*-1 876*	*-2 119*
Trade balance with Israel (% of GDP)	-42.4	-39.1	-36.4	-37.8	-39.7	-42.9	*-41.2*	*-42.0*
PA trade with Israel/total Israeli trade (%)[c]	3.7	3.7	2.1	2.2	2.2	2.3	*2.1*	*2.2*
PA trade with Israel/total PA trade (%)[c]	78.8	58.4	58.6	59.2	59.6	65.7	*64.2*	*69.0*

Source: Data from PCBS, World Bank, IMF, ILO and the Israeli Central Bureau of Statistics.

[a] As PCBS has only limited access to East Jerusalem, data reported in this table exclude East Jerusalem.

[b] Unemployment rates include “discouraged workers”, according to the ILO “relaxed definition”.

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

B. Poverty deepens

12. As a result of rising unemployment, the hollowing of the productive base and the closure policy, poverty in the occupied Palestinian territory continued to deepen and spread (World Bank, 2008b), with a widening gap between the West Bank and the more isolated Gaza Strip. Since 2000, 62 per cent of households have lost more than 50 per cent of their income (PNA, 2008). Income-based poverty measures indicate that the percentage of the population of the occupied Palestinian territory living below the poverty line rose from 52 per cent in 2005 to 57 per cent in 2006, while the percentage of those living in absolute poverty rose from 40 per cent to 44 per cent (OCHA, 2008a).[1]

13. The deepening of poverty has forced Palestinian households to reduce expenditure on basic needs and to adopt erosive strategies such as selling possessions, delaying payments of utility bills and taking children out of school (Oxfam, 2007; OCHA, 2008b). The prolonged crisis also manifested itself in the deteriorating quality of education and health services. While the destruction of more than one third of Palestinian physical capital has been recognized, the loss in current and future human capital and its long term implications are yet to be assessed.

14. Under current conditions, poverty is expected to intensify in 2008 because the projected modest economic growth will not be enough to match population growth or make a dent in unemployment, especially in Gaza. Therefore the Palestinian Authority's fiscal reform efforts should be sensitively sequenced and preceded by a steady flow of foreign aid, efforts to lift the closure and public investment targeted to stimulate private investment in activities with high employment and spillover potential.

C. Stifled local economy in Gaza

15. While overall economic activity in 2007 remained at its 2006 level, the situation in the Gaza Strip, where 40 per cent of the population of the occupied Palestinian territory lives, continues to worsen. The almost complete closure imposed on Gaza effectively cuts off 1.5 million Palestinians from the West Bank and the rest of the world, with only the bare minimum of essential and humanitarian imports allowed in. The benefits of the resumption of foreign aid since 2007 have been restricted largely to the West Bank, while Gaza's local economy has continued to shrink. Poverty in Gaza is much deeper and more widespread than the already high level in the West Bank. In 2006, 79.3 per cent of Gazans lived in relative poverty, with 66.7 per cent living in absolute poverty. The relative and absolute poverty rates for the West Bank were 49.1 per cent and 36.4 per cent respectively.

16. The Gaza Strip suffers from severe capacity underutilization owing to the lack of access to inputs and markets. Some 95 per cent of Gazan industrial operations have been suspended, while the number of working establishments in the industrial sector fell from 3,500 at the beginning of 2005 to a mere 150 at the end of 2007 (PNA, 2008; World Bank, 2008a). By June 2007, businesses were operating at 46 per cent of production capacity, down from 76 per cent in early 2006. The situation worsened as a result of the tightened closure after June 2007, with production capacity utilization falling to 11 per cent. If the closure is not lifted, 53 per cent of

[1] In 2006, for an average household of six individuals in the occupied Palestinian territory, the relative and the absolute poverty lines were drawn at monthly incomes of $518 and $414, respectively.

Gaza-based enterprises say they would consider relocating outside Gaza. In the second half of 2007 alone, 36 per cent of Gazan businesses surveyed by the United Nations Development Programme (UNDP) reported cutting salaries by an average of 40 per cent, while 78 per cent of these businesses laid off considerable numbers of employees (UNDP, 2007). The emerging trend of divestment and the loss of physical and human capital pose additional risks to the long-term prospects of Gaza.

D. Fiscal challenges

17. Economic and political instability and prolonged Israeli closures have led to serious fiscal difficulties, as the decline and unpredictability of revenues, together with an expanding list of expenditures for essential and relief needs, have compounded fiscal difficulties. In addition to the economic regression of the last few years, the Palestinian Authority's revenue has been vulnerable to Israel's ability to withhold the tax and customs clearance revenue it collects on behalf of the Authority, as stipulated in the Paris Protocol signed by the PLO and Israel in 1994. This renders the Palestinian Authority's fiscal position inherently dependent on Israeli goodwill. For example, in 2002, when Israel withheld Palestinian Authority customs and value added tax (VAT) revenue clearance, Palestinian public revenues dropped by 66 per cent. With the resumption of transfers, total revenue jumped from $300 million in 2002 to $1.2 billion in 2005, but collapsed again to $358 million with the withholding of clearance revenue in 2006 (PNA, 2008).

18. Clearance revenue is the cornerstone of the Palestinian Authority's public finance, representing 60–70 per cent of revenues. The frequent withholding and unpredictability of such revenue not only makes budget planning extremely difficult, but also deprives the Palestinian Authority of the fiscal policy tools it needs to manage and stimulate the economy and makes medium-term planning impossible, leaving short-term liquidity management as the only option. Furthermore, the resulting irregularity of salary payments reverberates through the economy by choking aggregate demand and inhibiting banks from lending to public sector. Consequently, the Palestinian Authority's reliance on foreign budget support has become the norm. In 2007, international budget support reached $1 billion, accounting for 39 per cent of public expenditure.

19. Despite the Palestinian Authority's efforts, the fiscal deficit increased from 17 per cent of GDP in 2005 to 27 per cent in 2007. The widening deficit in 2006 was the result of a combination of Israel's withholding of clearance revenue and lower GDP. The gap was financed mainly by the accumulation of arrears on public wages, pension contributions and private suppliers. While the resumption of clearance revenue transfers eased the fiscal situation and allowed the Palestinian Authority to halt the accumulation of arrears in 2007, no major fiscal improvement is expected for 2008 because of the projected slow economic recovery.

20. Even though the Palestinian Authority's wage bill is the largest element of public expenditure, the prescription often recommended to developing countries to downsize public employment could be extremely harmful to the long-term fiscal position and the Palestinian economy as a whole, as it would depress private consumption and the tax base. It should be recalled that the 50 per cent increase in public employment between 1999 and 2007 was critical to softening the impact of the private sector's inability to generate employment under the closure policy and of the loss of 64,000 jobs in Israel. Thus, to maintain social stability and prevent GDP

from collapsing as a result of weak aggregate demand, the Palestinian Authority has acted as an income provider and employer of last resort.

21. Notwithstanding the Palestinian Authority's determination to implement politically challenging fiscal measures in deep crisis conditions, these reforms are unlikely to achieve the desired results unless Israel transfers clearance revenues on a timely basis and alleviates closure to enable a private sector revival. The phasing out of restrictions on the movement of goods and labour is the sine qua non for the successful implementation of the Palestinian Authority's fiscal reform agenda. Without this, the planned 12 per cent reduction in public employment could be too difficult and costly to achieve. It could be undercut by social unrest and resistance similar to the 2006 public servants' strikes that led to the near collapse of public services. Fiscal reforms will be hard to sustain if they worsen the already volatile political conditions, deepen fragmentation or undermine public confidence in and support for the Palestinian Authority. If the economy does not grow, the Palestinian Authority will face an unenviable choice between achieving fiscal sustainability or reverting to what it terms "pro–social stability spending", where public employment acts as a safety valve.

E. Weak external sector and continued dependence

22. The overall economic slide in the occupied Palestinian territory has impacted the external sector. As table 1 indicates, while exports in 2007 were one third lower than eight years earlier, imports increased by 4 per cent. The decline in exports reflects the erosion of productive capacity and the disabling environment facing the private sector. Sealing off the Gaza Strip was especially harmful, as its agricultural sector and many of its industries are export-oriented. Carnations and strawberries, Gaza's two main agricultural exports, are a case in point. As a result of the closure, carnation farmers exported only one-fifth of the 45 million flowers produced in 2007; the remainder were used as animal feed. As a result, they lost about $6.5 million. In the same season, strawberry exporters lost $7 million.

23. Trade dependence on Israel persists, judging by the overwhelming reliance on it as a source of imports and a destination for exports. The trade deficit with Israel has been persistently high, with over 40 per cent of GDP devoted to covering it. The deficit, in absolute terms, has been steadily increasing over time and peaked in 2007 at $2.1 billion. The hike in the trade deficit with Israel, by one fifth between 1999 and 2007, was largely driven by the loss of productive capacity and the resulting inability of domestic producers to meet local demand, which heightened dependence on imported consumer goods, mostly from Israel. The 2007 trade deficit with Israel is equivalent to almost 90 per cent of total net current transfers (mainly donor support). There is still a pressing need to reduce trade dependence on Israel and reorient Palestinian trade and integration into Arab and regional markets, where favourable trade deals can be negotiated and stable access guaranteed.

II. Policy space for economic recovery and sustained growth

24. The Palestinian Authority's ability to respond to the challenges of reviving a war-torn economy is constrained by the limited policy space available to its policymakers. The narrow set of policy tools presently available is not sufficient for the Palestinian Authority to lay the foundations for recovery and sustained growth.

While Palestinian Authority reform efforts, an end to the closure, sustained foreign aid and revitalized Palestinian productive capacity are necessary conditions for recovery, they are not sufficient to achieve long-term growth.

25. It is pointed out in the São Paulo Consensus (para. 8) that: “The increasing interdependence of national economies in a globalizing world and the emergence of rule-based regimes for international economic relations have meant that the space for national economic policy, i.e. the scope for domestic policies, especially in the areas of trade, investment and industrial development, is now often framed by international disciplines, commitments and global market considerations. It is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space.” However, the following discussion refers not only to the policy space discourse centred on global economic interdependence or international institutions and their impact on the policy options available to developing countries. It also refers to the limits imposed on Palestinian policymakers by the fact of limited sovereignty, which affects the design and implementation of policies relevant to the capacities, challenges and aspirations of the Palestinian people.

A. Limiting economic policy framework

26. The Palestinian Authority has no sovereignty over borders, natural resources, land, water or the movement of people and goods within its territories or through its national waters or airspace. Limited sovereignty, geographical fragmentation and restrictions on the movement of civil servants render the formulation and execution of coherent government policies a daunting task. Nor does the Palestinian Authority have a national currency to pursue appropriate monetary and exchange rate polices. In comparison with the typical policy toolkit available to sovereign States in a globalized world, the Palestinian Authority has only a limited and vulnerable fiscal policy space.

27. The Palestinian Authority can do little more than allocate public expenditure, which amounts to less policy space than that available to local governments in many countries. On the revenue side, the Palestinian Authority has to deal with highly unpredictable resources that depend on the international community and Israeli goodwill. Furthermore, the Paris Protocol requires the Palestinian Authority to align its VAT rate with that of Israel, with no regard to the differences in the structure and level of development of the two economies. Overall, the Protocol fails to alter the asymmetric nature of Palestinian-Israeli economic relations.

28. On the monetary side, the Paris Protocol does not allow the Palestinian Authority to issue a national currency.[2] As a result, there are three currencies in circulation: the Jordanian dinar, the United States dollar and the new Israeli shekel. Such an arrangement combines most of the negative aspects of the two polar-type exchange rate regimes. While the absence of a national currency renders monetary policy inaccessible (fixed exchange rate regime), the use of three currencies imposes excessive risk on banks and investors, who have to contend with fluctuations in three exchange rates. For instance, a depreciation of the Israeli shekel translates into rising costs for imported consumption and intermediate goods, and therefore rising

[2] This is probably why the issue has received little attention in the literature, though Naqib (1999), Cobham (2004) and Beidas and Kandil (2005) have done some pioneering work in this field.

production costs. Exports, on the other hand, benefit little if at all, considering the various barriers, high transaction costs and dependence on the Israeli market.

29. The introduction of a Palestinian national currency would allow the Palestinian Authority to implement an exchange rate policy that would adjust the currency to achieve external balance, deal with external shocks, react to differential productivity growth with competitors, improve export competitiveness and enhance growth by stimulating the production of tradable goods. A national currency would also allow the Palestinian Authority to raise seigniorage revenue to improve its fiscal position.[3] Cobham (2004) estimates that seigniorage revenues could range between 0.3 and 4.2 per cent of gross national income (GNI). Accordingly, the cumulative seigniorage loss between 1995 and 2007 could be anywhere between $178 million and $2.5 billion. It is worth noting that these estimates do not take into account transitional phase seigniorage, which is expected to be far more substantial.

30. It is becoming increasingly obvious that the present fiscal and monetary framework, enshrined in the Paris Protocol, does not equip the Palestinian Authority with the most basic tools it needs to pull the economy out of its externally precipitated decline, or even to adopt simple stabilization policies. As a result, the economy remains highly vulnerable to external economic and political shocks emanating from the asymmetric dependence on Israel and the global economy at large.

B. Expanding the Palestinian Authority's economic policy options

31. UNCTAD, in a forthcoming study,[4] assesses the potential impact of expanded policy space and demonstrates that substantial economic progress would be achievable if the Palestinian Authority was empowered with the relevant policy instruments. The study uses a macroeconometric model developed by UNCTAD, the "integrated simulation framework for Palestinian macroeconomic, trade and labour policy" (UNCTAD, 2006a), to simulate the future prospects of the Palestinian economy up to 2015, under various policy options. The analysis compares the long-term outcomes of the existing economic policy framework – the "baseline scenario" – with the outcomes of policy scenarios featuring the availability of the full range of policy instruments.

32. The baseline scenario incorporates the policy framework established by the Paris Protocol. This would entail a return to the pre-2000 economic (and political) climate, as outlined in the following assumptions:[5]

(a) Some movement towards political stability, with lower restrictions on the mobility of goods and labour. Over the forecast period, mobility restrictions will go back to the levels that prevailed during the period 1994–2000;[6]

(b) A quasi–customs union between the occupied Palestinian territory and Israel, which combines elements of free trade and a customs union arrangement;

[3] "Seigniorage" is the public revenue derived from issuing money. It has no inflationary consequences if the increase in money supply is in line with economic growth and the increase in demand for money. Sometimes Governments issue even more currency to raise revenue instead of collecting taxes; the resulting inflation is referred to as the "inflation tax".
[4] "Policy space for Palestinian sustained development and State formation".
[5] These assumptions are discussed in detail in UNCTAD, 2006a.
[6] However, this exercise cannot quantify the structural impact of the separation barrier, or of its possible dismantlement.

(c) Palestinian imports from the rest of the world are subject to a floor of Israeli tariff rates, except for a limited group of products imported from Egypt and Jordan within specific quantities;

(d) The application by the Palestinian Authority of the Israeli VAT rate, with the option of a 1–2 per cent divergence;

(e) Heavy reliance on indirect taxes with little attention to equity aspects;

(f) The collection by Israel, on behalf of the Palestinian Authority, of taxes on Palestinian imports;

(g) The allocation of public resources to recurrent budget items, with minor allocations to development expenditure;

(h) The absence of a national currency.

33. The analysis assesses the potential impact of the expansion of the Palestinian Authority's policy space by constructing alternative fiscal, exchange rate, trade and labour policy scenarios. All the scenarios assume a movement towards political settlement and less than perfect mobility of goods and labour, but with fewer restrictions. The analysis goes on to assess the impact of an integrated policy alternative where the features of all the individual expanded policies are grouped together in one package. The main elements of the proposed alternative policy scenarios are as follows:[7]

(a) The **fiscal policy scenario** assumes: (i) a 10 per cent and 5 per cent increase in, respectively, public investment and government transfers above the baseline scenario over the forecast period; and (ii) an investment distortion correction scheme to reduce the cost of non-construction investment by 15 per cent below the baseline level;

(b) The **exchange rate policy scenario** simulates the impact of introducing a national currency. The simulation assumes a 50 per cent devaluation relative to the level implied in the baseline scenario over the forecast period;

(c) The **trade policy scenario** assumes that the Palestinian Authority adopts: (i) a most-favoured-nation trade regime where its tariff on imports from Israel equals that imposed on imports from the rest of the world – the tariff on imports from Israel is increased from the baseline zero level to 17 per cent and the tariff on imports from other countries is increased by 3 per cent above the baseline level; and (ii) a distortion correction scheme to reduce the cost of Palestinian exports by 17 per cent below baseline-level prices, and therefore offset the impact of distortion arising from prolonged occupation and the various non-market obstacles Palestinian exporters face;

(d) The **labour policy scenario** attempts to generate more domestic employment and reduce dependence on the Israeli job market. It assumes a wage subsidy to generate domestic employment through a government–private sector wage-sharing scheme in the agricultural and industrial and services sectors;

(e) The **integrated policy package scenario** assumes that Palestinian policymakers have at their disposal all the instruments of the above policy

[7] The assumptions underlying the alternative policy scenarios are discussed in detail in the study mentioned in footnote 4.

options and are capable of integrating all of them in one package where the impacts of all policies are mutually reinforced.

34. Table 2 summarizes the impact of the policy scenarios on GDP and unemployment when each of them is applied individually and when they are combined as an integrated package. Figures 1, 2 and 3 depict the trajectory of GDP, GDP per capita and unemployment under the baseline scenario and the integrated package. For each policy area, the simulation results of the baseline scenario promise modest improvements in the medium and long term. However, the alternative policy scenarios offer better outcomes.

Table 2. Impact of policy space on GDP and unemployment

Policy scenario	GDP (in millions of 1997 $)		Unemployment Rate (%)		Improvement in 2015	
	2008	2015	2008	2015	Increase in GDP (%)	Reduction in unemploym't rate
Baseline forecast	6 019	8042	15.6	19.1	--	--
Labour	6 096	8208	10.3	12.3	2.1	6.8
Fiscal	6 114	8376	14.7	16.7	4.2	2.4
Trade: most favoured nation	6 189	8539	13.9	16.0	6.2	3.1
National currency	6 342	8861	12.8	14.1	10.2	5.0
Policy package	***6 610***	***9942***	***5.3***	***0.5***	***23.6***	***18.6***

Figure 1. Impact of policy space on GDP
(in millions of 1997 $)

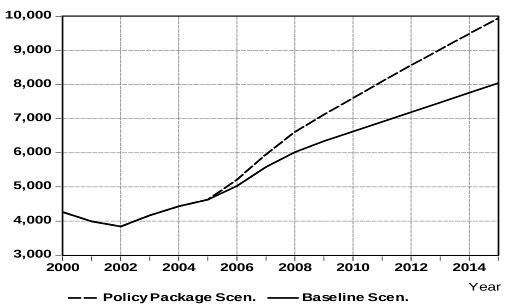


Figure 2. Impact of policy space on GDP/capita
(1997 $)

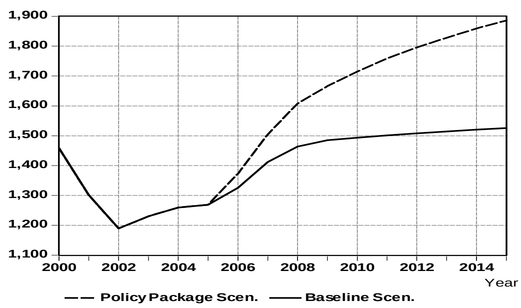
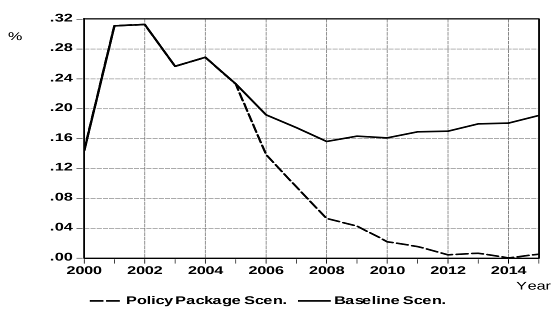


Figure 3. Impact of policy space on unemployment rate (%)



35. As far as the individual policies are concerned, the introduction of a national currency has the most dramatic impact on output growth, with GDP more than 10 percentage points above the baseline scenario in 2015. Nonetheless, the actual benefits of a national currency are likely to be higher because the simulation does not take into account the potential benefits of seigniorage revenues, interest rate policy and lower exchange rate risk. While each policy alternative implemented separately produces better economic results than the baseline policy framework, the analysis shows that bundling all policy alternatives into one package produces superior results.

36. The simulation suggests that implementing the integrated package would lead to full employment by 2012. While this may seem overly optimistic and difficult to envisage in the present circumstances, it confirms that a considerable reduction in unemployment would be possible if the necessary policy instruments became available. With no expanded policy space such as the one assumed here, the World Bank (2008a) concludes that a combination of reforms, aid flows and closure relaxation could lead to double-digit growth rates in the coming three years. Adding the proposed policy package to the mix would naturally lead to more robust growth than that projected by the World Bank. Such growth could bring the economy close to full employment.

37. The policy package projects a very different Palestinian economy from the one in the baseline scenario. What the policy scenarios affirm is that the present institutional arrangement for Palestinian economic policies, shaped by the Paris Protocol, is incapable of responding to the challenges of the economy and its eroded productive capacity. Its endurance entrenches a path of poverty, insufficient job creation, low economic growth, dependence on Israel and reliance on foreign aid.

38. Palestinian policymakers should thus keep in mind what their economy is capable of achieving, and should strive to acquire the policy space necessary to implement suitable policies. This will necessitate not only a different institutional framework, but also the active support of the international community in the form of sufficient aid and help for policymakers in their efforts to broaden their policy space.

39. Significant economic progress can be achieved prior to the establishment of a sovereign Palestinian State if policymakers have access to policy tools, if closure is relaxed and if aid continues at adequate and predictable levels. But it is important to bear in mind the peculiarity of the Palestinian war-torn economy when measuring and assessing the efficacy of foreign aid and economic policy.

40. The damage to the economic, social and institutional fabric of the occupied Palestinian territory in the last eight years cannot be overestimated. Indeed the Palestinian Authority warns that if the present restrictions on movement and access are maintained, any reduction in foreign aid would have grave consequences, including the erosion of the institutional capacities built since 1994 (PNA, 2008). To avoid this and to facilitate economic recovery will require urgent action along the following lines:

(a) Breaking the isolation of the Palestinian economy by lifting the mobility restrictions imposed on the West Bank and Gaza: without access to domestic and foreign markets, the private sector cannot invest and operate;

(b) Revisiting the policy framework of the Paris Protocol: serious efforts to expand the Palestinian Authority's policy space should be made. The international community can contribute to this by supporting the Palestinian Authority's efforts to obtain more policy instruments and by directing financial and technical aid in ways that ensure Palestinian ownership of reforms;

(c) Greater consistency and predictability in foreign aid to the Palestinian Authority to enable it to plan and execute effective fiscal policies;

(d) Large-scale public investment programmes to rebuild the infrastructure, expand and revitalize the eroded productive capacity and create an enabling environment for the private sector;

(e) The policy priority should be the promotion of pro-poor growth to reverse high unemployment and poverty, allowing for effective State institutions to evolve and for growth to be resumed;

(f) The widening gap between the West Bank and the Gaza Strip should be closed by including the latter in foreign aid and efforts to relax closure. Economic revival is impossible if it bypasses 40 per cent of the population;

(g) Genuine efforts to establish a viable, sovereign and contiguous Palestinian State, as called for in the relevant United Nations resolutions, in order to enable long-term Palestinian development.

C. Capacity development for expanded Palestinian policy space

41. The successful implementation of the proposed policy package requires developing institutional and human capacities to administer the policies. It is essential that the Palestinian Authority should start developing these capacities in tandem with efforts to expand policy space, since there is little point in seeking additional policy instruments if the capacity required to manage them does not exist. Above all, this capacity is a prerequisite for negotiating the attainment of the Palestinian-specific policy space required for the realization of the Palestinian development vision.

42. In a forthcoming study, UNCTAD surveys the Palestinian Authority's capacity development needs in key economic development areas. The preliminary findings suggest that in the area of public finance there is a need to enhance the capacity of the Palestinian Authority's Ministry of Finance in the areas of budget planning and implementation, the development of a medium-term expenditure framework, economic forecasting and policy evaluation, auditing and reporting systems, central and local government budgeting, and coordination with the relevant ministries.

43. In the domain of monetary and exchange rate policy, strengthening the research and supervision capacity of the Palestinian Monetary Authority is needed to assess the implications of alternative monetary arrangements under which a national currency could be introduced.

44. Enhancing trade performance requires greater government and private sector capacity to evaluate the costs and benefits of alternative trade regimes, formulate and administer trade policies and negotiate trade agreements. Equally important is the establishment of an export promotion fund and specialized institutions for international trade insurance and re-insurance. Trade facilitation is another area where capacity

development is needed, including further upgrading customs management capacity and building the capacity to construct and manage road networks to remove transportation bottlenecks and guarantee stable access to ports.

45. As for employment generation and labour policy, there is a need to strengthen the Ministry of Labour's capacity for policy evaluation and sectoral analysis. It is also important to consider establishing a credible legal framework with a coherent body of laws related to economic issues, strengthening the existing investment regime and introducing new financial services to facilitate enterprises' access to credit.

III. UNCTAD assistance to the Palestinian people

A. Framework and objectives

46. Since its establishment in 1984, UNCTAD's programme of assistance to the Palestinian people has been constantly evolving to respond to the Palestinian economy's emerging needs. Building on the experience of the UNCTAD secretariat as a whole, and in close cooperation with Palestine, the programme is designed to achieve specific national development objectives within four clusters: (a) trade policies and strategies; (b) trade facilitation and logistics; (c) finance and development; and (d) enterprise, investment and competition policy.

47. In line with the United Nations strategic framework for 2008–2009, the Accra Accord, the São Paulo Consensus and the Bangkok Plan of Action, UNCTAD's assistance to the Palestinian people in the past year has been intensified. This has involved venturing into new research areas and technical assistance activities to mitigate the adverse economic and social conditions and to contribute to building the capacities for the economic functioning of a sovereign and viable Palestinian State.

48. However, progress towards these objectives has continued to be affected by adverse field conditions, especially in view of the restrictions on the mobility of national project staff and difficult access for UNCTAD experts to the occupied Palestinian territory. Political instability compelled the secretariat to suspend planned activities in the Gaza Strip and several projects remain unfunded despite the secretariat's appeals to donors. Nonetheless, UNCTAD was able, through a selective and flexible mode of operation, to make significant progress.

B. Operational activities under way

1. Trade policy and strategy

49. The secretariat's activities under this cluster entered a new phase with the launching of a regional project, "Promoting subregional growth-oriented economic and trade policies towards achieving the Millennium Development Goals in Arab countries of West Asia and North Africa". With funds from the United Nations Development Account, the project will be managed by UNCTAD's programme of assistance to the Palestinian people. It targets six Arab countries, including the occupied Palestinian territory, to assist them in achieving growth-oriented regional integration

50. The project will be implemented in cooperation with the United Nations Economic and Social Commission for Western Asia and UNDP. It involves training,

advisory services, research and networking efforts to strengthen national capacities in the area of international trade. The objective is to provide national Governments with the required tools to ensure policy responsiveness. Building on UNCTAD's experience, the project focuses on formulating appropriate trade policy alternatives based on a development-driven approach to trade rather than a trade-driven approach to development.

51. In cooperation with the Economic and Social Commission for Western Asia, the secretariat has prepared a survey-based policy paper to guide Palestinian capacity development efforts in the areas of public finance and development strategies, trade policy and trade facilitation, and investment promotion and enterprise development. The paper sets out a development-driven approach to capacity development with proposals for the Palestinian Authority's consideration, and was presented to Palestinian public and private sector institutions at a workshop in Ramallah in March 2008.

2. Trade facilitation and logistics

52. Significant progress was made in the "Preparations for Asycuda" project, which seeks to modernize and strengthen the Palestinian Authority's customs capacities. With funds from the European Commission, the project has entered its third and last phase, which will see full system roll-out. Achievements to date include updating the system with 2007–2008 Palestinian customs declarations, thereby allowing the Palestinian Authority to accurately monitor revenues collected by Israeli customs on its behalf. A tailored "single administrative declaration" in Arabic has been launched to allow the Palestinian Authority to conduct critical financial operations such as post-auditing. Furthermore, the system is being upgraded from Asycuda++ to the web-based AsycudaWorld.

53. To foster national ownership, the project's national core team received advanced training in Geneva. The team has become well-versed in the system, and in turn has conducted hands-on functional training courses for Palestinian staff at the Ministry of Finance in Ramallah. As part of the Palestinian Authority's renewed development efforts, the system was launched in 2008 under the name "Tawasol" (trade accounting, web-based analysis solutions). The national team is enforcing new customs rules, and is actively responding to Palestinian Authority requests for assistance to ensure complete customs control at the main border points, including those with Jordan and Egypt.

54. One of UNCTAD's successes in the areas of institution-building and trade facilitation is the European Commission-funded project "Establishment of the Palestinian Shippers' Council (PSC)". The project was launched in January 2006 and is scheduled to end in October 2008. The present focus is on ensuring the PSC's long-term sustainability. UNCTAD fielded international experts to develop thematic training materials for the PSC future fee-based training and capacity-building activities. The experts have also assisted the PSC in conducting training workshops for PSC members and the Palestinian shipping community at large. Furthermore, the PSC's role as a focal point for addressing the Palestinian shipping community's needs was strengthened through study tours to Dubai, Egypt and Jordan.

55. The PSC is now a vibrant private sector institution with well trained staff, a committed board of directors, and a growing membership of 350 members. It is actively engaged in solving the daily problems of Palestinian shippers and in

strengthening their capacities, building on its network of national and regional partners. In January 2008, the PSC, in cooperation with the Palestine Trade Center (PalTrade), launched a project to help develop alternative routes for Palestinian trade through Jordan and Egypt.

3. Finance and development

56. Owing to a lack of funds, UNCTAD remains unable to capitalize on previous achievements under the "Strengthening capacities in debt monitoring and financial analysis (DMFAS)" project. The system has been installed at the Ministry of Finance with funds from the Government of Norway, but has yet to be utilized to its full potential. This comes despite the secretariat's readiness to resume planned activities, with the finalization of a study on debt strategies to guide the Palestinian Authority debt management policy.

4. Enterprise, investment and competition policy

57. The secretariat is presently finalizing the remaining components of the Norway-funded "Investment retention programme" project. The project, which is being implemented in close coordination with the Palestinian Investment Promotion Agency, aims to design a tailored programme to support Palestinian efforts to maintain existing investments. Informed by the results of a survey of existing investors and enterprises, the programme proposes a development-driven approach to investment retention with targeted interventions to address immediate and long-term growth bottlenecks at the macro, meso and micro levels, and to allow for their integration into the Agency's core functions, while creating synergy with ongoing reform and institution-building efforts.

58. However, the implementation of this programme under a "phase II" proposal is uncertain owing to lack of funds. Funding shortfalls in 2008 also obliged the secretariat to postpone the activities planned for phase II of the project on support for the development of small and medium-sized enterprises (Empretec Palestine). Phase II involves extending the programme to the Gaza Strip.

C. Coordination, harmonization and resource mobilization

59. In the design and implementation of its work programme, the secretariat has maintained close contact with the relevant international organizations, especially the United Nations Relief and Works Agency for Palestine Refugees (UNRWA), the Office of the United Nations Special Coordinator for the Occupied Territories (UNSCO), UNDP, the Economic and Social Commission for Western Asia, the International Labour Organization, the World Bank and the League of Arab States, as well as research centres and civil society institutions.

60. The secretariat has continued to benefit from UNDP field support, which provided indispensable logistical support for UNCTAD staff, experts and project personnel. The secretariat has also contributed to UNSCO inter-agency discussions, and provided substantive observations on the United Nations Humanitarian Plan of Action for the Occupied Palestinian Territory.

61. UNCTAD technical assistance to the Palestinian people has benefited from generous extrabudgetary support from the European Commission, the Government of Norway and the United Nations Development Account. However, the continued funding shortfalls in 2008 threaten to weaken the achievements to date and

undermine the selective and flexible mode of operation which allowed UNCTAD to circumvent deteriorating field conditions. This comes at a time when UNCTAD projects have a well established reputation for providing relevant and practical tools for supporting Palestinian development and institution-building. Unless more predictable extrabudgetary resources are made available to the secretariat, in accordance with the Accra Accord, the implementation of its mandate on assistance to the Palestinian people will be constrained.

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