West Bank and Gaza: Facing the Present, Building a Future

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The Palestinian economy has faced difficult times recently. For the past three years, economic growth has been insufficient to keep pace with population growth. This had led to very high unemployment rates, with one in four Palestinians unemployed and Gaza recording one of the highest levels of unemployment in the world, with 2 out of every 5 Gazans out of work. This situation has caused a significant drop in living standards. And growth is fuelled by consumption rather than investment, posing a threat to future economic prospects.

The story in the West Bank is one of an economy slowing down under the weight of Israeli restrictions and restricted access to two-thirds of its territory and resources. Gaza, meanwhile, is slowly recovering from war and grappling with a dire humanitarian situation. With little sign of a breakthrough in the peace process between the Government of Israel (GoI) and the Palestinian Authority (PA), or of a lasting national reconciliation between rival domestic political factions, Palestinians face a highly uncertain future, and the youth is particularly affected.

Mastering crisis management

In this harsh environment, the PA deserves credit for persevering in its efforts to preserve economic stability and cement the institutions of statehood.

The clearest and most recent example of its ability to manage crises was when Israel withheld clearance revenue—indirect taxes on imported goods, which account for two-thirds of the PA's total revenues— during the first four months of 2015. Through skillful fiscal management, the PA succeeded in keeping social tensions from escalating as it made emergency spending cuts. And during last year's Gaza war, implementation of a robust business continuity plan by the Palestine Monetary Authority (PMA) helped maintain financial stability in Gaza. The PA also faces a continued decline in donor support, which covers close to one-third of its budget and has shrunk by more than 20 percent over the past two years.

Despite these shocks, the PA remains committed to further lowering the fiscal deficit, building on the good progress made in recent years, and safeguarding its banking system.

Staying the fiscal course

In the near term, with limited room to borrow domestically and a large financing gap to fill, the risk is that new payment arrears may accumulate, further depressing private sector activity. Strong fiscal discipline will therefore be needed, with a combination of revenue-enhancing measures and restraints on current expenditures.

On the revenue front, the focus should be on registering new taxpayers, broadening the tax base, and strengthening tax collection. On the expenditure front, priorities include containing the high wage bill and limiting its increase to the rate of inflation, until ambitious civil service and pension reforms are launched to strengthen fiscal sustainability. In addition, a further reduction in fuel and electricity subsidies should be combined with an increase in directed and timely transfers to the most vulnerable households.

The latest debt sustainability analysis shows that donor support remains the PA's lifeblood over the medium term. However, mobilizing additional aid flows these days is no easy task, given budgetary constraints in advanced economies and competing needs arising from other conflicts in the region.

Strong policies by the PA, including the fiscal measures we describe combined with structural reforms, will thus be crucial to convince development partners to maintain or increase their aid. Structural reforms could focus on increasing fiscal transparency, strengthening accountability, and enhancing the business environment by simplifying procedures, facilitating land registration, and promoting competition through regulatory reform.

Nurturing hope through economic cooperation

Looking forward, it is clear that without a political breakthrough, growth will remain below what is needed to durably reduce unemployment and improve living standards. Progress on the peace front and an easing of Israeli restrictions could dramatically improve economic outcomes, not least by allaying some of the concerns of private sector investors. It would also facilitate the shift to a fiscal paradigm in which the government invests in human and physical capital, rather than act as an employer of last resort.

At the same time, even in the absence of a breakthrough on the peace front, improvements in Palestinian-Israeli economic cooperation at the technical level could prove highly beneficial.

In the spirit of the Oslo Accords, and in line with the international community's objective of achieving a two-state solution, the GoI and the PA should resume regular meetings of the Joint Economic Committee that brings together the Palestinian and Israeli finance ministers. Moreover, efforts should be made to reconvene the Joint Liaison Committee (with a third party presence) in order to resolve outstanding issues linked to the implementation of the Paris Protocol, including the full transfer of taxes, fees, and health payments to the PA.

As a first step, a mutually acceptable solution should be found concerning both parties' claims on outstanding electricity debts, based on a transparent audit conducted by a reputable international accounting firm. Such an audit could lead to agreement on a repayment plan and allow for scheduled transfers of clearance revenue, free of deductions, contributing to forward-looking fiscal policy formulation and implementation.

At this critical juncture, the main stakeholders must work together to get on a sounder fiscal footing, safeguard institutions, and ensure a steady inflow of donor aid. The costs of inaction are potentially severe: sustained recession, rising unemployment, and, ultimately, social unrest. A constructive dialogue is needed now more than ever. For its part, the IMF will continue to help in its areas of expertise.

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