Executive Summary

This report covers two distinct subjects. Chapter I of the report, as has been the norm with the World Bank AHLC reports, focuses on the assessment of recent macroeconomic and fiscal developments and government policies in West Bank and Gaza. Chapter II presents an analysis of Gaza's stark economic decline over the past 20 years and its human impact. It also presents a mix of policies that should ensure sustainable development of the Gaza strip and put an end to human suffering therein. The report also contains an annex which provides an overview of progress in meeting the pledges made for Gaza's reconstruction at the October 2014 Cairo Conference. Although the connection between the chapters of this report may not be obvious as they treat a diverse set of issues facing the Palestinian economy and public finances, together they provide insights into key policy and institutional development actions and reforms, which need to be taken by the Palestinian Authority, the Government of Israel, and the donor community to reverse the recent and worrisome slowdown in economic growth, to enable effective and efficient management of public finances in order to avoid a dangerous fiscal crisis and to support inclusive economic growth and poverty reduction.

1. Palestinian Economy and Public Finances

Despite surprisingly strong economic growth in the West Bank in 2014, the war in Gaza has had a devastating impact on the Palestinian economy, resulting in overall negative growth. Strong growth in private consumption, fueled by bank borrowing, and net exports were the drivers behind a remarkably strong growth of five percent in the West Bank. On the other hand, the closure of tunnels with Egypt and in particular the 2014 summer war shaved some USD460 million off Gaza's economy, leading to a 15 percent contraction of its GDP. Overall the Palestinian economy contracted three percent in 2014 on a per capita basis.

Unemployment and poverty increased markedly. In Gaza, unemployment increased by as much as 11 percentage points to reach 44 percent—probably the highest in the world--and that in the West Bank dropped by 1 percentage point. In Gaza, the poverty rate reached 39 percent and with poverty in the West Bank at 16 percent, the aggregate poverty rate amounted to 25 percent[1].

Remarkably, the fiscal deficit of the Palestinian Authority was reduced in 2014, but the increase in expenditures is of concern. Thanks to strong revenue performance, with clearance revenue growth of 20 percent, largely driven by the growth in fuel imports into Gaza from Israel and growth in registered imports from third countries, the PA managed to reduce its fiscal deficit by one percentage point of GDP. Nevertheless, the growth in government recurrent expenditures of 9 percent was large and unsustainable; growth in the government wage bill and net lending are of particular concern.

Against the backdrop of a sluggish reconstruction process in Gaza, the instability of clearance revenues, and high political uncertainty the economic outlook remains bleak. With the reopening of businesses following last year's war and the reconstruction process, Gaza's real GDP is expected to grow at 7 percent, while meager one percent growth is expected in the West Bank due to the reduction in consumption activity as well as the liquidity and confidence effects of Israel's withholding of the clearance revenue during the first four months of 2015.

2. The Destruction of Gaza's Economy, Human Consequences, and the Way Forward

[1] World Bank estimates.

Tremendously damaged by repeated armed conflicts, the blockade and internal divide, Gaza's economy has been reduced to a fraction of its estimated potential.[2] Gaza's economic performance over this period has been roughly 250 percent worse than that of any relevant comparators, including that of the West Bank, whose growth performance has been close to average despite the restrictions on movement and access imposed by the Government of Israel, which present binding constraints to growth.[3] Real per capita income is 31 percent lower in Gaza than it was 20 years ago and the difference in per capita income with West Bank increased from 14 percent to 141 percent over this period in favor of the West Bank. Its manufacturing sector—once significant—has shrunk by as much as 60 percent in real terms. Gaza's exports virtually disappeared since the imposition of the 2007 blockade. There are no other variables that could explain these developments other than war and the blockade. The impact of the blockade imposed in 2007 was particularly devastating, with GDP losses caused by the blockade estimated at above 50 percent and large welfare losses.

The human costs of Gaza's economic malaise are enormous. As mentioned above, if it were compared to that of other economies, unemployment in Gaza would be the highest in the world. Poverty in Gaza is also very high. This is despite the fact that nearly 80 percent of Gaza's residents receive some aid. These numbers, however, fail to portray the degree of suffering of Gaza's citizens due to poor electricity and water/sewerage availability, war-related psychological trauma, limited movement, and other adverse effects of wars and the blockade.

To reduce the human hardship and increase the prospects for peace, Gaza's economy has to be rebuilt. This, above all requires a unified Palestinian government in both West Bank and Gaza which can be a partner to multilateral and bilateral donors and substantial donor support to rebuild Gaza's infrastructure and homes, and it requires the lifting of the blockade on the movement of goods and people to allow Gaza's tradable sectors to recover.

Finally, it is noteworthy that good progress has been made so far to fulfill donor pledges for Gaza reconstruction, but it has to continue and—most importantly—solutions have to be found to enable faster inflow of construction materials into Gaza. By mid-April, almost USD1 billion of the USD3.5 billion pledged for Gaza reconstruction and recovery at the October 2014 Cairo conference have been allocated by donors. The reconstruction and recovery process will require that all donors fulfill their pledges. However, currently the binding constraint on Gaza's recovery is not financing, but the limitations on imports of construction materials into Gaza.[4] Therefore, taking into account legitimate security concerns of neighboring countries, ways have to be found to drastically improve access to construction materials in Gaza.

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[2] Following the electoral victory of Hamas in the Palestinian national elections in 2006 and Hamas' takeover of Gaza following violence, Israel has imposed a blockade on Gaza that severely limits the movement of goods and people in an out.

[3] As the World Bank's 2013 study, "Area C and the Future of the Palestinian Economy" shows only restrictions on access to Area C, which comprises 61 percent of the West Bank's territory reduce the Palestinian GDP by up to 35 percent.

[4] According to the Government of Israel, the restrictions are in place due to Israel's legitimate security concerns.