IMF urges the Palestinian Authority and Donors to reassess priorities

Two years ago, the staff of the International Monetary Fund (IMF) concluded that the Palestinian Authority is able to conduct the sound economic policies expected of a well functioning state. The assessment was based on impressive progress in building institutions for public finances, the financial sector, and economic policy. This assessment still stands. However, the Palestinian Authority—and its donors —now need to reassess priorities.

These priorities include lowering the wage bill to make room for investment in education and public infrastructure and to ensure future financial and economic viability. Such a major shift in the allocation of public resources is not easy and will require cooperation and backing from the international community.

It is clear the Palestinian economy is facing daunting challenges. Almost one in four Palestinians who want a job can't find it. Youth unemployment has reached a staggering 37 percent. Growth has slowed, and is far too low to generate more jobs. The private sector is suffering from restrictions on imports, exports, and the movement of people and goods, as well as from constrained access to land, water, and other resources.

Public spending is heavily tilted towards wages, pensions, and transfers, rather than much-needed public investment. Donor aid targeted for building productive capacity is instead used to finance a budget deficit that last year reached $1.7 billion (17 percent of GDP) while bills remained unpaid—again hurting the private sector. Bank debt has grown to $1.3 billion. Such a financing model is harmful for the economy, unsatisfactory for donors, and not a viable way to manage public resources.

There is no denying that many economic problems in the West Bank and in Gaza are rooted in a longstanding conflict with Israel and that resolving that conflict, more than anything, would lift the economy. Crucial efforts are being made in that direction under the leadership of U.S. Secretary of State John Kerry, complemented by plans from the Office of the Quartet Representative to boost the private sector and the call for action on the peace process from Israeli and Palestinian businessmen who have joined forces under the banner 'Breaking the Impasse'.

The IMF welcomes these efforts and believes they should be supported. Yet, time is of the essence and we can't stand by and wait for a breakthrough while the Palestinian Authority's finances deteriorate and the economy stumbles. Both the donors and the Palestinian Authority must find a way to ensure viable public finances under any scenario.

The Palestinian Authority spends 17 percent of GDP on wages for its employees, compared to 8 percent of GDP that is spent in Egypt, and 5 percent of GDP in Jordan. An inflated wage and pension bill comes at the expense of other, more productive, spending and with the price of high deficits. Revenue collection is improving, but low tax compliance and generous tax exemptions are adding to lost revenue. The private sector is suffering, for sure, but it is doubtful that the tax incentives are generating new investment and jobs because they often come in the form of poorly targeted, long tax holidays. It should be feasible to reduce wage spending and limit tax incentives, and use some of the savings and extra revenues to lower the deficit and invest in education and infrastructure.

Donors also have a crucial role to play. Aid should be more predictable and, ideally, all donors should commit for multiple years. This would raise confidence, support investment and growth, and allow the Palestinian Authority to make the required adjustments to the budget. Over time, as the deficit shrinks, donors could redirect aid from budget support to assistance for investment in education, infrastructure, and private-sector development. Ideally, the situation would go back to where it was in 1998–99, when virtually all donor support was used for economic development instead of budget financing. Donors could also help by committing additional support as the Palestinian Authority moves ahead with budgetary reforms.

There is no substitute for the far-reaching relaxation of Israeli restrictions that is needed to unshackle the private sector. This effort needs to encompass all sectors of the economy, without tying it to specific projects. At the same time, donors and the Palestinian Authority can make progress regardless of the existing constraints. By redirecting budget priorities and donor aid in a way that links commitments of donor support and budget reforms under a multiyear framework, they can work together to build a dynamic Palestinian economy with viable public finances.

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