



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.5.2004
SEC(2004) 565

COMMISSION STAFF WORKING PAPER

European Neighbourhood Policy

Country Report

Palestinian Authority of the West Bank and Gaza Strip

{COM(2004)373 final}

TABLE OF CONTENTS

1.	Introduction	3
1.1.	The European Neighbourhood Policy	3
1.2.	Relations between the European Union and the Palestinian Authority	3
2.	Political Issues.....	5
2.1.	Political Situation	5
2.2.	Democracy and the rule of law	6
2.3.	Human rights and fundamental freedoms	10
3.	Economic and Social Situation	11
3.1.	Macroeconomic and social developments.....	11
3.1.1.	Recent sector developments	11
3.1.2.	Fiscal management, monetary and exchange rate policy	12
3.1.3.	Social situation and Human Development Policies	13
3.2.	Structural and fiscal reforms	13
3.3.	Trade, market and regulatory reform	14
3.4.	Energy, environment and research and innovation	17

1. INTRODUCTION

1.1. The European Neighbourhood Policy

On 1 May 2004, the enlargement of the European Union took place with the accession of ten new Member States. It has brought changes to the EU's political geography offering new opportunities to deepen existing relations between the Union and its neighbours to the East and to the South. The Union is determined to further develop partnerships with its neighbours to mutual benefit, promoting security as well as stability and prosperity. The EU's external borders will not become new dividing lines but the focus of enhanced co-operation.

The European Neighbourhood Policy sets ambitious objectives for partnership with neighbouring countries based on strong commitments to shared values and political, economic and institutional reforms. Partner countries are invited to enter into closer political, economic and cultural relations with the EU, to enhance cross border co-operation and to share responsibility in conflict prevention and resolution. The Union offers the prospect of a stake in its Internal Market and of further economic integration. The speed and intensity of this process will depend on the will and capability of each partner country to engage in this broad agenda. The policy builds upon and reinforces the existing framework of co-operation.

In the present report, the Commission provides an assessment of bilateral relations between the Union and the Palestinian Authority. The report reflects progress in relations under the Interim Association Agreement, and describes the current situation in selected areas of particular interest for this partnership: the development of political institutions based on the values – democracy, the rule of law, human rights - underlined in the Agreement, structural and fiscal reforms that will create new opportunities for development and modernisation, for further liberalisation of trade and for gradual participation in the Internal Market. The report provides guidance for the preparation of a joint action plan, and may also serve as a basis for assessing future progress in the Union's relations with the Palestinian Authority.

The report reflects the particular circumstances created by the Middle East conflict. This has a major impact on political and economic conditions in the West Bank and Gaza Strip.

1.2. Relations between the European Union and the Palestinian Authority

The European Institutions and the Member States have been working closely with the Palestinian Authority to build up the institutions of a future democratic, independent and viable Palestinian State in peace and security with Israel and its neighbours.

The **Interim Association Agreement** on Trade and Co-operation between the European Community and the PLO (for the benefit of the Palestinian Authority) was signed on 24 February 1997 and entered into force on 1 July 1997. The primary objective of this Agreement is to establish the conditions for increased liberalisation of trade and to provide an appropriate framework for a comprehensive dialogue between the EU and the PA. These measures are aimed at integrating the Palestinians into the Euro-Mediterranean Process.

Since the outbreak of the second Intifada in September 2000, implementation of the Interim Association Agreement has proven extremely difficult. A Joint Committee meeting of the Interim Association Agreement was held in Ramallah on 26 June 2003. This meeting was the second of its kind and the first in over three years. The meeting discussed ways in which to facilitate trade between the EU and the West Bank and Gaza Strip and means to fully

implement the Interim Association Agreement, including provisions related to the Palestinian reform programme.

European Community assistance to the Palestinians began in 1971, when the first contribution was made to the regular budget of the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA).

Community assistance 2000-2003				
Budget Heading	Commitment appropriations (million €)			
	2000	2001	2002	2003
<i>MEDA</i>	119.60	0.00	104.50	92.75
<i>Community operations in connection with the Peace Agreement</i>	20.40	43.05	87.75	47.00
<i>Contribution to the UNRWA</i>	40.24	57.25	55.00	57.75
<i>Humanitarian aid (ECHO)</i>	18.20	26.26	35.00	38.00
<i>Food aid/Food security</i>	16.06	17.10	35.00	20.28
Total	214.5	143.66	317.25	255.78

The EU is the most important financial donor to the Palestinians, providing humanitarian assistance, support to refugees, development assistance and support to the Palestinian Authority. EU and other international donor assistance to the Palestinian Authority have been essential for the PA to carry out basic public services in times of crisis. Total assistance from the European Community budget in support of the reform process and in response to the worsening economic and humanitarian crisis stands at €570 million for 2002-2003. This covers assistance to the PA, an emergency fund for the Palestinian private sector, rehabilitation of municipalities, preparations for elections, assistance to refugees, food aid, support for the health sector, institution building and judicial reform.

The EU attaches a number of conditions to its financial support with the aim of advancing Palestinian reform efforts including **administrative and judicial reform**, and **financial accountability**. Particular importance has been put on improving the management of public finances by the PA and strengthening the system of financial control.

The Palestinian Authority participates in a range of Euro-Med programmes promoting people-to-people contacts, cultural cooperation and co-operation between actors of civil society, youth associations and NGOs. The PA is eligible for participation in the Community programmes in the field of higher education, namely Tempus and Erasmus Mundus.

West Bank/Gaza has been one of about 30 “focus countries” for the European Initiative for Democracy and Human Rights for the year 2002-4 and has benefited of support amounting to 2,5 ME. The EIDHR supports civil society initiatives that aim to promote democracy and human rights.

The EU continues to support initiatives to further the peace process, in particular through civil society, to promote a culture of tolerance and mutual understanding, and to strengthen democratic principles and respect for human rights.

2. POLITICAL ISSUES

2.1. Political Situation

In September 1993, the Palestinian Liberation Organisation (PLO) and Israel signed the Palestinian Declaration of Principles establishing the framework for an interim period of Palestinian self rule in the Gaza Strip and Jericho. This was the first in a series of steps known as the "**Oslo Peace process**".

A transfer of powers and responsibilities from Israeli to Palestinian control took place following the Israel–PLO Cairo Agreement of 4 May 1994 on the Gaza Strip and the Jericho Area. As an immediate result of this agreement, the head of the PLO, Yasser Arafat returned from exile in Tunisia to take over as Chairman of the newly established Palestinian Authority.

The transfer of civil government and partial security responsibilities from Israel to the Palestinian Authority took place in other areas of the West Bank pursuant to the Israel-PLO September 28, 1995 Interim Agreement, the January 17, 1997 Protocol Concerning Redeployment in Hebron and the September 4, 1999 Sharm el Sheikh Agreement. Pursuant to the Interim Agreement, the Palestinian Territory was divided into Areas A, B, and C indicating differing levels of Palestinian and Israeli control, although the effective exercise of responsibilities in these areas has been blurred since the onset of the Intifada.

In January 1996, Palestinians held their first and only presidential and legislative elections for an interim 88-member Palestinian Legislative Council and President (Ra'is) of the Palestinian Authority.

The Declaration of Principles under the Oslo accords had established a two-phased timetable. After the interim period, the second phase was expected to address "permanent status" or "final status" issues, and resolve "remaining issues", including: Jerusalem, refugees, settlements, security arrangements, borders, relations and cooperation with other neighbours, and other issues of common interest. A final status agreement would mark the official peace agreement between Israel and the Palestinian Authority, including the possible establishment of a sovereign Palestinian state. These negotiations were postponed on a number of occasions and the Camp David summit in July 2000 failed to reach an accord.

Developments since September 2000: with the onset of the second Intifada in late September 2000, the region has experienced unprecedented levels of violence and bloodshed. Official negotiations between Israel and the Palestinian Authority for a peaceful resolution to the conflict collapsed soon after the Taba talks in January 2001 and violence and terrorist attacks increased dramatically. In particular, a campaign of suicide bombings was launched primarily by groups rejecting the Oslo peace accords and the right of existence of the state of Israel. As a result, there have been regular Israeli incursions into and reoccupation of a large part of Palestinian controlled towns and villages, curfew and severe restrictions imposed on the movement of persons, in both the West Bank and the Gaza Strip. The Intifada and violence associated with the conflict had, by the beginning of 2004, claimed the lives of over 3300 people and over 24,000 persons had sustained injuries.

Closures and curfew, restricting movement of both goods and people, have led to a worsening humanitarian situation and the Palestinian economy has experienced an unprecedented decline since September 2000.

Israel has begun to construct a “separation barrier” in the West Bank on the grounds that this will provide greater security against attacks and suicide bombings inside Israel. The Israeli Government has argued that this is a temporary measure and that the barrier can be taken down once the security outlook has improved. However, Palestinians have argued that the barrier, by deviating from the “Green line” and cutting deep into the West Bank, undermines the possibility of a negotiated settlement and a lasting peace based on a viable Palestinian state. The United Nations and the World Bank have also reported to the international community on the negative social and economic consequences of the barrier for the Palestinian population.

The **Quartet** (UN, US, EU and Russia) **Roadmap**, published in April 2003, sets out the steps which need to be taken towards a comprehensive settlement to the Israel-Palestinian conflict by 2005, by which time an independent, democratic and viable Palestinian state should emerge, living side by side in peace and security with Israel and its neighbours. The political horizon set in the Roadmap was confirmed at the Aqaba Summit in June 2003. The European Union, along with the international community, has supported this process.

Reform of the Palestinian Authority: the need to **strengthen and reform Palestinian public institutions** was first addressed in a comprehensive and systematic manner in 1999 by the EU-supported Independent Task Force led by former Prime Minister Michel Rocard under the auspices of the Council on Foreign Relations.

In June 2002, the Palestinian Authority, in response to increasing domestic and international pressure, adopted a wide-ranging programme on reform. A number of important measures were taken, such as the adoption and entry into force of the Basic Law, and legislation on the independence of the judiciary. In February 2003 the Palestinian Legislative Council (PLC) adopted the 2003 budget which was, for the first time, made public, and more generally, important efforts were made to strengthen financial control.

In March 2003 the PLC revised the Basic Law establishing a post of Prime Minister of the PA. In his inaugural address to the PLC on 29 April 2003, the first PA Prime Minister, Mahmoud Abbas stated that further progress on reform would be a high priority for the new government. He made a number of commitments to establish rule of law, to halt incitement, to respect human rights and to prepare for free and democratic elections. He also announced a detailed PA reform programme for 2003 and a new administrative reform strategy. Following the resumption of violence after a period of cease-fire, Mahmoud Abbas resigned in September 2003, and a new cabinet under a new Prime Minister, Ahmed Qurei, was endorsed by the PLC in November 2003.

2.2. Democracy and the rule of law

The **general constitutional order** of the Palestinian Authority arises from the interim agreements, on the basis of which the Basic Law was approved by the Palestinian Legislative Council in 1997, and belatedly enacted by President Arafat in 2002.

The Basic Law provides for the establishment of three separate branches: the executive, the legislature (embodied in the 88-member Palestinian Legislative Council), and the judiciary.

The post of Prime Minister was instituted following an amendment to the Basic Law in 2003. The cabinet was placed, thereafter, under the authority of the Prime Minister.

International representation is still the responsibility of the Palestine Liberation Organisation, and the Palestinian National Council is the forum comprising representatives from both the Diaspora and the West Bank and Gaza Strip.

The Basic Law provides for a **parliamentary democracy**, political and party pluralism and fundamental freedoms. The system of government could be further defined as semi-presidential. Whilst the PLC is accorded with a number of important powers to control the executive (e.g. approving laws, adoption of the budget), one of the main characteristics of the Palestinian Basic Law is the important role it gives to the President who is responsible for appointing a Prime Minister, signing laws after their approval by the PLC, issuing decrees that have the power of law, as well as overall control of security forces.

The PLC's legal term expired in 1999 and no new elections have been held since then. This has, according to opinion surveys and civil rights groups, weakened the legitimacy of PLC members in the eyes of the Palestinian population. Movement restrictions have prevented members of PLC in Gaza and within the West Bank from travelling to plenary sessions in Ramallah and Gaza respectively.

In January 1996 presidential **elections** were held. Mr Yasser Arafat was elected "Ra'is" (Arabic for chairman or president) of the Palestinian Authority, with 88.1 percent of the vote. His main opponent, Samiha Yusuf Khalil gained 9.3% of the vote.

For the PLC elections, the majority of the 88 seats were won by Fatah or independents affiliated with Fatah. The elections were officially boycotted by groups rejecting the Oslo peace accords such as Hamas and the Popular Front for the Liberation of Palestine.

In October 2002, following a commitment by the PA to carry out wide-ranging reform, an independent Central Elections Commission was established. Prime Minister Ahmed Qurei's Government Programme includes a commitment to hold elections in the course of 2004.

There are a number of difficulties in organising elections to the Palestinian Authority. There are the practical questions of updating the voter register and freedom of movement to allow for canvassing, work of election officials, and eventually, voting; and there are sensitive issues such as the framework for elections, participation in East Jerusalem in accordance with the interim agreement and the participation of Palestinian refugees in local council elections.

There is currently no legislation regulating **political parties**. Draft legislation from 1998 has never been adopted by the Palestinian Authority.

The main political groups and factions within the West Bank and Gaza Strip and in the Diaspora fall under umbrella of the Palestinian Liberation Organisation (PLO). These include the majority faction Fatah which is led by the chairman of the PLO, Yasser Arafat, the Palestinian People's Party, the Palestinian Democratic Union (FIDA), the Popular Front for the Liberation of Palestine; and the Democratic Front for the Liberation of Palestine. Other major Palestinian groups outside the PLO which are active both in the Palestinian Territory and the region include the Islamic Resistance Movement (Hamas) and the Palestinian Islamic Jihad. Both the Palestinian Islamic Jihad and Hamas are classified as terrorist organisations by the EU.

At the centre of **government** are the institutions of the President's Office, the Council of Ministers, and the ministries. The President assumes the presidency of the Palestinian Authority and the Executive Committee of the Palestine Liberation Organisation. Until the Basic Law was amended in early 2003, the President also headed the Cabinet of Ministers. Each PLC member or the Cabinet can introduce draft bills. The President can issue decrees with the power of law in exceptional cases, and while the PLC is not in session. The validity of such decrees is however subject to subsequent PLC approval.

According to the amended version of the Basic Law of March 2003, there may not be more than 24 ministers in the cabinet in addition to the prime minister, while the previous version of the law envisaged only 19. The Cabinet was formed twice in 2002 (in June and October) and three times in 2003 (in March, October and November) including the formation of an emergency restricted Cabinet.

The **central administration** within the West Bank and Gaza Strip is divided into sixteen governorates: ten in the West Bank, five in Gaza and Jerusalem. Governors are appointed by the President.

There is a single tier of local government in the Palestinian territories, the units being either "municipalities" or "village councils". The Local Government Law, which was amended in 1997, sets out the formation, financing and responsibilities of elected local authorities. In the absence of local elections since 1976 the Ministry of Local Government has appointed mayors and council members.

Since its establishment, there has been a proliferation of public institutions and agencies within or attached to the Palestinian Authority. The civil service payroll has grown and now exceeds 70,000, not including the various PA security services. Without clear division of responsibilities, job profiles and unclear lines of reporting, the Palestinian public administration lacks efficiency and effectiveness. This problem is compounded by the absence of any coherent human resource development programme and training for civil servants.

Public institutions have, furthermore, been severely affected since the outbreak of the Intifada and the resulting violence by Israeli incursions into the West Bank and Gaza Strip, curfews and damage to physical infrastructure which have weakened the capacity of the Palestinian Authority to carry out basic functions.

Comprehensive public administration and civil service reform has become a priority in the overall reform programme of the Palestinian Authority. There has, however, been limited progress in implementing this programme. The Civil Service Law from 1998 has not been fully implemented.

Of the measures which have been taken, a Cabinet paper was drawn up in February 2003 and a pilot project was launched in June 2003 involving five ministries – Labour, Local Government, Social Affairs, Culture and Planning. A number of institutions have been brought under the control of ministries. The petroleum and tobacco monopolies have, for instance, been brought under the direct responsibility of the Ministry of Finance and all monopolies and investments have been incorporated into the Palestinian Investment Fund.

The Palestinian Authority, upon its establishment, set about putting in place a new **judicial system**. In addition to new and unified PA laws which apply to the whole Palestinian

Territory, the West Bank relies on civil or French-influenced Jordanian law, while the Gaza Strip relies on Egyptian and British laws. Some Ottoman and Israeli laws and decrees continue to be applied in both areas, as well as laws used by the PLO prior to the establishment of the PA.

The key legal bases for the PA judicial system are the Basic Law and the Judicial Authority Law which provide for separation of powers and regulate the formation of courts, delineation of jurisdictions and enforcement of judicial rulings. Most of the legislation applying to the functioning of courts in the West Bank and Gaza Strip has now been unified.

Much of the legislation has not been implemented and the judicial system is far from being fully operational. The division of responsibilities between the Ministry of Justice and the Higher Judicial Council remains unclear. There are also major challenges in implementing the newly unified legal framework under current Israeli movement restrictions and closures. The court infrastructure is extremely poor. Courts are unable to hold sessions most days of the year, resulting in an increased backlog of court cases. There are insufficient resources for proper training within the judiciary. Judges and court personnel also suffer from lack of communication between courts, ineffective procedures and poor management of records. This is once again compounded by movement restrictions between the West Bank and Gaza Strip.

The independence of the judiciary has, according to human rights organisations, been undermined by interference from the executive.

Whilst in principle the State Security Courts were formally abolished in 2003, the military courts, established in 1995, remain active, including some competence in civilian cases. Military Courts jurisdiction applies to police and security force personnel as well as crimes by civilians against security forces.

The Oslo Accords provided for the establishment of a PA police force. At least ten largely autonomous police and security forces now operate in the PA, including civil police, criminal investigation, preventive security, general intelligence, and military intelligence. Efforts to unify the various security services have been unsuccessful.

Prisons, known as reform and rehabilitation centres, come under the police directorate. The various security forces operate their own detention and interrogation centres, access to which has often been denied to outside bodies or international human rights organisations.

Towards the end of 2003, there were increasing signs of a deterioration of law and order in the West Bank and Gaza Strip. Central commands have been de-connected from local units, and forces are unable to move, due to closures. Police and Preventive Security commanders have often been unable or unwilling to carry out arrests of criminals and armed militants, since this often results in armed confrontations with radical groups or large family clans.

The Transparency International **Corruption** Perceptions index included the Palestinian Authority for the first time in 2003 with a ranking of 78 out of 133. Recent polls have indicated a general perception of lack of public confidence in Palestinian public institutions.

Since its announcement of a comprehensive reform programme in June 2002, the Palestinian Authority has set about addressing shortcomings and improving its overall system of public finances. Progress has since been achieved in the area of financial transparency and important achievements have been recognised by the International Monetary Fund.

2.3. Human rights and fundamental freedoms

Palestinian legislation includes a number of provisions for the **protection of human rights and basic civil liberties**, without explicit reference to international texts and conventions. The Palestinian Authority has made the political commitment to respect International Human Rights standards. Human rights organisations have, however, reported numerous violations.

The Palestinian Basic Law prohibits **torture, force against detainees and illegal arrests**. However, there have been numerous reports of cases of torture and ill-treatment in PA detention centres, namely those operated by the security services. According to human rights organisations, security services arbitrarily detain persons and use excessive force. Despite PA declarations condemning such practices, the security services do not appear to have clear procedures for investigating complaints effectively and impartially and there is limited control over their interrogation methods.

The Basic Law guarantees **freedom of expression**. In practice, however, freedom of expression remains highly restricted. **Freedom of association** is also provided for in the Basic Law relating to the establishment of trade unions, guilds, associations, societies, clubs and public institutions. The general right of association is stated in the Non-Governmental and Benevolent Organisations Law.

The printing and publication Law provides for **freedom of the press and media**. Despite legal guarantees, freedom of the press is, in practice, restricted and there is government censorship on the Palestinian mass media. Several journalists and human rights activists have been arrested or interrogated. There are also several cases where newspapers, magazines or TV/radio stations have been closed. Court orders to reopen media centres closed by the security branches are often ignored. According to human rights organisations, harassment has led to self-censorship of the press and media.

The main religious groups within the Palestinian Territory are Muslims (92%), Christians (7.5%) and Samaritans (0.3%). According to the Basic Law, Islam is the official religion of the West Bank and Gaza Strip. **Freedom of other religions** is guaranteed insofar as they do not violate public order or public morals. Freedom of religion is generally respected within Palestinian society.

Women account for only 13% of the formal labour force, mostly concentrated in the services sector such as health and education. Whilst **equality of rights** has not been given highest priority in the past, there has recently been some change in public attitudes. Discussions on issues such as violence against women, rape (including marital rape and so-called “honour crimes”) and woman’s shelters have been held and in November 2003, a Ministry for Women Affairs was established.

Civil society organisations play an important role in the Palestinian society. As the worsening situation on the ground impairs the Palestinian authorities to provide basic services, NGO’s often are the only organisations capable of delivering these services to the population in a wide range of areas, such as health, education, vocational training, culture, children and youth, women, agriculture, water and small businesses.

In addition, in the current context of the PA reform process, the involvement of Palestinian civil society has increased. The National Reform Committee, which was established in May 2003 to oversee the reform agenda, includes representative of civil society organisations.

A Law on NGOs entered into force in 2000. Relations however, between the PA and civil society are generally poor, with the PA closely monitoring the activities of several civil society organisations, in particular those promoting greater reform and protection of human rights. Organisations are also faced with excessive delays in registering as NGOs with the Ministry of Interior.

A number of NGOs promotes intercultural dialogue based on equality and reciprocity between Arabs and Israelis, including the Arab Palestinian minority in Israel with the aim of working together for mutual benefit and tangible results. These initiatives are designed to help re-create the conditions among civil society for relaunching the peace process.

The Basic Law and the law on NGOs regulate the establishment of **unions and rights of association**. The Palestinian General Federation for Trade Unions (PGFTU) represents the workers movement in Palestinian Territory. Its board and chairman are appointed by the President of the Palestinian Authority. There are reports of acts of intimidation and arbitrary arrests of strike leaders by security services.

Equality of all Palestinians under the Law and Judiciary is affirmed in the Basic Law which does not permit **discrimination** on the basis of race, sex, colour, religion, political views, or disability. The Palestinian Electoral law sets a quota of representatives of religious minorities at the PLC.

3. ECONOMIC AND SOCIAL SITUATION

3.1. Macroeconomic and social developments

3.1.1. Recent sector developments

Since the beginning of the Intifada at the end of 2000, the Palestinian economy has gone into severe decline. The conflict and Israeli closure policy have hit the Palestinian economy through several channels, including collapse of tourism, the inability of Palestinian workers to work in Israel, and the inability of Palestinians within the territories to undertake basic economic activities. Transaction costs have significantly increased and lower incomes have forced the population to use savings to finance daily expenditures, thereby negatively impacting upon the level of investment. All these factors have had a negative impact on domestic demand, with estimates of the decline in real income ranging from 30%-50% over three years to the end of 2003.

In 2002, real GDP was estimated to have dropped by around 15%, with consumption down by around 8% in real terms, investment down by over 30%, and exports dropped by over 20%. In 2003, the economy stabilised somewhat and a modest pick-up in economic activity could be recorded due to several positive factors. The launching of the Roadmap improved the political situation, and violence diminished in the first part of 2003. In addition, Israel began to repay arrears on tax revenues (clearance) collected on behalf of the PA, providing a stimulus for domestic demand. There was also some easing in the closure policy, allowing a recovery of the number of Palestinian workers in Israel. Despite some deterioration in the second half of 2003, these factors have led to a positive real growth of around 4.5% in 2003, albeit from a low base.

The standard of living of a large proportion of the population has fallen dramatically. GNI per capita (which includes workers remittances from abroad) fell by around 26% in 2002, and poverty levels increased dramatically, with those living on less than US\$ 2 per day tripling to

60% of the population since the beginning of the Intifada. This per capita level has improved only slightly during 2003. Health and food consumption indicators have also declined.

The close monetary and economic ties, particularly trade links, between West Bank and Gaza Strip and Israel mean that overall price movements are highly correlated, and tend to be linked to shekel/US dollar rate movements. However, recent price developments in Gaza and in the West Bank have shown different trends due to the different impact of the Intifada and closure policy. For example, in Gaza, the recession has been much more pronounced than in the West Bank, and domestic demand has been more subdued. The tighter closure policy in the West Bank has had a much greater impact upon transportation costs, which has to a large extent offset the dampening effect of the recession. As a result, price increases in the West Bank in 2002 reached around 6%, compared to 2.7% in the Gaza strip, broadly 5.7% overall. In 2003, prices are expected to have risen by around 1.1% in the West Bank and Gaza Strip.

3.1.2. Fiscal management, monetary and exchange rate policy

Palestinian revenues collapsed as Israeli transfer payments, accounting for broadly two-thirds of the PA's pre-Intifada revenues (derived mainly from indirect taxes, VAT, import taxes, and excise taxes), were stopped at the beginning of the Intifada and only resumed on a regular basis in 2003. Against this background, the PA has implemented a series of austerity expenditure plans to limit spending and allocating resources to areas that are crucial to maintain the viability of the Palestinian Authority.

In 2002, domestically collected revenues reached US\$ 225 million, with some clearance payments made by Israel totalling US\$ 29 million. With expenditures limited to US\$ 90 million per month, there was a financing gap of US\$ 773 million for the whole year. This was filled through external donor support and some domestic bank financing and through arrears accumulation. By the end of 2002, total gross revenues withheld by Israel amounted to over US\$ 700 million or US\$ 450 million, netting out PA payments due to Israel for electricity, water and other services.

The 2003 budget maintained a tight expenditure stance of broadly US\$ 90 million per month, assuming continued donor support around the same level as in 2002. Although domestic revenues increased in 2003, as a result of transfer revenues received from Israel, external donor support and Israeli transfers from the stock of arrears was less than expected. The PA cleared much of its arrears to the private sector, but it was unable to reduce its bank debt. As a result, in 2003, the deficit totalled US\$ 527.4 million (an average of US\$ 44.0 million per month).

The Palestine Monetary Authority (PMA), established in 1994, has only limited functions, as set out in the Paris Economic Protocol. It is responsible for licensing, supervising and inspecting banks; determining the liquidity requirements on all deposits held by banks operating in the self-rule areas; and managing foreign exchange reserves and foreign currency transactions. The PMA also has the power to regulate and supervise capital activities in the self-rule areas, including the licensing of capital market institutions, finance companies and investment funds.

Despite the stresses caused by the Intifada, the financial system continues to function, and provides basic services to the population. This is to a large extent due to rapid growth in bank deposits between the mid-1990s and the second Intifada, which have been mostly re-invested overseas. Furthermore, the banks have adopted a cautious lending policy due to the risky

political and security environment, as well as the difficulty in enforcing contracts. Nevertheless, during the period of the Intifada, non-performing loans have increased from around 8% to around 30% in 2002 (given the nature of banks' balance sheets, this represents less than 10% of assets).

3.1.3. Social situation and Human Development Policies

Using a **poverty** line of US\$2 per day, the World Bank estimated that 21% of the Palestinian population were poor in 1999; this figure increased to 60% by 2003. Average daily consumption of a poor person has also dropped from US\$1.47 per day in 1998 to US\$1.32 in 2002.

As a result of external closures nearly 100 000 Palestinian workers (or two thirds of the Palestinian workers formerly employed in Israel) have lost their jobs in Israel since September 2000. This decrease had direct consequences on the income of Palestinian households as workers' remittances from Israel represented some 18% of their total disposable incomes.

The unemployment rate in the West Bank has fallen to 20.7% (115,000 persons) in the fourth quarter of 2003 (down from 31.4% in the first quarter of 2003). In Gaza, fourth quarter 2003 unemployment stood at 31.9% (83,000 persons).

In 1994, authority in the **education** sector was transferred from the Israeli civil authorities to the Palestinian Authority. The Palestinian Ministry of Higher Education was officially established in June 1996 in response to the need to create a centralised public body to develop and co-ordinate Palestinian higher education. The Ministry of Higher Education has now been merged with the Ministry of Education. There are several Palestinian universities and technical colleges in the West Bank and Gaza Strip. All were established after 1967, and two of them as late as the 1990s.

3.2. Structural and fiscal reforms

In June 2002, the PA released a new reform agenda, in which it expressed its commitment to a broad programme of reforms, including the promotion of transparency and accountability in the public sector, and the creation of a supportive environment for private sector development. Towards the end of 2003, the PA formulated a Medium Term Plan setting out the financing needs for the Palestinian economy in 2004 and 2005.

The regulatory framework for the Palestinian economy is in the process of being developed and key laws still need to be adopted, including the Capital Markets Authority Law, the Income Tax Law amendments, the Competition Law, the Foreign Trade Act, the Intellectual Property Law, Insurance and Securities Laws and revisions to the Customs Law and tariffs.

Since the beginning of the Intifada, several reforms have been implemented to improve effectiveness, efficiency and transparency in the context of EU and other donor budget support operations. On the revenue side, all revenues are now transferred to the Single Treasury Account (STA) at the Ministry of Finance, including the transfer of income from PA commercial activities. After an independent evaluation, PA assets have been transferred into the newly created Palestinian Investment Fund (PIF), with consideration now being given to privatisation of those assets.

On the expenditure side, control has been improved through various measures. PA employment is more tightly controlled after the transfer of the payroll in August 2002 to the

Ministry of Finance. While this has had a positive effect, PA employment levels continued to increase. The move towards bank account payments for security service personnel has been a step towards further tightening in this area by allowing for greater control through a full data base. Other measures have included the development of modern and effective internal and external audit services.

In order to improve transparency, extensive budget data is now published on a regular basis, and the 2003 and 2004 budgets are more comprehensive than in previous years, including the macroeconomic framework, comparisons with previous years outturns, information on employment, PIF activities and bank borrowing. Progress has been made on establishing modern internal and external audit capabilities within the administration.

In the last few years, but particularly in 2003, reform of the pension system was examined with assistance from international financial organisations, including steps to unify pensions schemes and including security staff within the scheme, while putting it on a more sustainable footing.

3.3. Trade, market and regulatory reform

Despite trade and co-operation agreements with Jordan, Egypt, Saudi Arabia, the European Union, the United States and others, which all provide preferential access for Palestinian exports, there has been almost no geographical diversification of trade. West Bank and Gaza trade remains dominated by Israel, according to World Bank data, which amounts for more than 70% of Palestinian imports, and some 90% of Palestinian exports, in the context of an overall compression of Palestinian trade since 2000.

Imports account for around 85% of GDP, while exports account for around 15% of GDP. The Palestinian Authority's chronic trade deficit (60-75% of GDP) reflects trade orientation towards Israel, a narrow export base and the substantial import dependence of the economy. Furthermore, the disadvantage of narrow industrial and agricultural production bases has been exacerbated by Israeli restrictions on the use of natural resources, as well as occasional border closures. Although earnings by Palestinian workers in Israel and remittances from abroad partly offset the large trade deficits, resulting in current account deficits of around 30% of GDP, international donor support has been needed to meet the remaining financing requirement. In 2002-03, these financial assistance flows have allowed to compress the current account deficit below 20% despite an increase of the trade deficit to close to 80% of GDP.

According to World Bank data, exports dropped by around 35% in value terms between the beginning of the Intifada and the end of 2003, while imports fell by around 31% over the same period.

The Paris Protocol on Economic Relations of April 1994 governs the trade relations between the PA and Israel. It also defines responsibilities for the PA in a number of economic spheres, including the movement of goods. In the area of **technical regulations and standards for industrial products**, according to the Paris Protocol, standards for Palestinian imports should be in conformity with Israeli standards, with the exception of certain goods under the PA's authority. Palestinian standards are set through the Palestinian Standard Institute.

The movement of Palestinian goods has been severely affected in recent years by restrictions imposed by the Israeli authorities on security grounds, which apply to the movement of both goods and persons within the West Bank and Gaza Strip.

The need to restructure the Palestinian economy has been addressed within a wider Economic Recovery Strategy for the PA. Several issues, resulting mostly from the crisis, need to be addressed to set solid foundations for economic stabilization and recovery, including private sector institutional reform, access to financing, enhanced competitiveness and private-public dialogue.

Customs legislation in the West Bank and Gaza Strip derives from Jordanian or Israeli law/Israeli military orders. In addition to this, the Paris Economic Protocol of 1994 governs economic and trade relations between the PA and Israel. Most customs procedures and tariff measures are based on Israeli norms, and to a large extent, Israeli controlled. However, on the basis of the Paris Economic Protocol, certain products fall under the authority of the PA, which can determine increases or decreases in tariff rates. Other products fall under the PA's authority but are still subject to quantitative restrictions or Israeli standards.

The PA has established directorates for VAT, and Customs and Excise, unified under the Customs and Excise General Directorate of the Ministry of Finance. In terms of administrative capacity, it is necessary to ensure the existence of a strong customs law and codes and that the Customs Directorate the necessary powers to effectively fulfill its functions.

The Palestinian Authority, as a partner to the Barcelona Process, endorsed the new Protocol on rules of origin in July 2003 allowing for the extension of the Pan-European system of cumulation of origin to the Barcelona Partners. The next stage aims at amending the origin protocol in the relevant Euro-Mediterranean Agreement in order to insert the changes necessary for the application of diagonal cumulation. This could help fostering economic integration and allow for a better use of the complementarities and the economics of scale in the Euro-mediterranean area.

In the area of **taxation**, the Palestinian Authority has put in place a system of VAT, income tax, purchase tax, property tax and excise taxes. VAT was introduced in 1976 and is covered by two separate but identical military orders issued by the Israeli Occupation authorities in the West Bank and Gaza Strip. In March 1999, the PA passed new legislation on income tax brackets for individuals and companies. Property tax is covered by the Property Tax Laws of 1967.

The Ministry of Finance currently has three major departments, which are responsible for the administration of tax laws: the Customs and VAT Department, the Income Tax Departments and the Property Tax Department. Due to the absence of any formal fiscal or customs borders with Israel, Israel continues to be the major collector of Palestinian revenue, receiving two thirds of the tax for later transfer to the PA.

Work is underway to introduce a modern tax system and to establish a regulatory framework on the basis of international best practices. The fragmentation of the tax administration has been exacerbated by the absence of coordination between West Bank and Gaza treasuries and tax administrations. Effective enforcement of legislation is still lagging behind.

In the area of **competition policy**, regulatory structures are in transition. Many of them have been inherited from Jordan or the British Mandate. Applicable legislation may differ between West Bank and Gaza Strip, however unification is in progress. A new basic regulatory framework, including a new Competition Law, has not yet been adopted.

The Civil Claim Law of 1993 in Gaza and the Commercial Law of 1953 and Patent Law of 1953 in the West Bank currently govern **intellectual property**. Registration is done at the Ministry of Economy and Trade. In the area of **public procurement**, the General Procurement Law was adopted in 1998 and has since been modified by the PLC in May 2003.

Regarding **provision of services and right of establishment**, the Law on Encouragement of Investments promotes capital investment in all sectors of the Palestinian economy by both local and foreign corporations registered to do business in the West Bank and Gaza Strip. Two other laws govern investment in the Industrial Estates and Free Zones: the 'Industrial Estates and Free Zones Law' and the 'Encouragement of Investment in Palestine Law'. A foreign investor can fully own a company without any local partnership requirements. Investors may invest in any sector of the Palestinian economy under the free admission principle. Transfers of foreign currency are free and there is freedom of repatriation of income generated from investment in Palestine. The Palestinian Investment Promotion Agency (PIPA) is the implementing agency.

The Jordanian Companies Law of 1964 governs the registration of companies in the West Bank, with the exception of companies doing business in non-autonomous areas of the West Bank which is governed by the Israeli Military Order of 1970. The prevailing legal framework for registering a company in Gaza is the British Mandatory Companies Law of 1929. In the West Bank, registration of companies falls within the purview of the Ministry of Economy and Trade and in Gaza, under the Ministry of Justice, which is also responsible for administering the company law.

As regards financial services, despite the decline in economy, the Palestinian financial system remains upright, functioning and liquid.

The **Banking Law** of 1997, revised in 2002, and was approved by the PLC and entered into force in 2003; however it is not fully implemented. The Law was revised to bring it more in line with Basle core principles. It stipulates that locally incorporated banks and foreign branches must set aside 10% of net annual profits to a local reserve, up until a maximum of its capital base. The revised law also details guidelines for both internal and external auditing of banks, data obligations to the Monetary Authority and sets out the guidelines for on- and off-site inspection, penalties, liquidations and mergers. The regulatory framework for the banking sector is in general further advanced than those for the securities and insurance sector. The **insurance law**, at the moment under the supervision of an inter-ministerial committee (National Economy, Finance and Justice) has been drafted and is awaiting approval by the Palestinian Legislative Council. The Security law is expected to pass a first reading in 2004. At present the Ministry of Finance acts also on a temporary basis as supervisor of security exchanges. Eventually, both laws should fall under the permanent supervision of the Capital Market Authority; the CMA Law is awaiting the signature of the President, who asked the Cabinet for an opinion and, in addition, regulations and forms still need to be prepared.

Financial control over the PA's public finances has been developed over the past years, both on the revenue and the expenditure side. Revenue management was developed following the Oslo agreements and the subsequent transfer of clearance revenue from the Israeli authorities

to the PA with the establishment of a Single Treasury Account (STA). Revenues, including those stemming from PA commercial activities, excise duties, and revenues from PA monopolies, have been gradually consolidated under the direct control of the Ministry of Finance. In a further step, all commercial activities were consolidated in a newly created Palestinian Investment Fund (PIF). The PIF assets have been audited by an international auditing firm. In 2003, the Petroleum Authority was brought fully under the responsibility of the Ministry of Finance, leading to an increase in revenues.

On the expenditure side, two main issues were pursued following the appointment of Finance Minister Salaam Fayyad: the consolidation of expenditure management in the West Bank and Gaza, and the limitation of recruitment in the civil service. All expenditure requests are checked for corresponding budgetary appropriations, accounting systems in the West Bank and Gaza are unified, and advances from commercial banks are no longer possible. Reporting on revenues and expenditure is made public. The integration of the whole payroll under the Ministry of Finance was achieved in August 2002.

In the field of internal audit, reform has started with the establishment of an Internal Audit Department (IAD) in the Ministry of Finance. A General Control Institute (GCI) which operates under the direct supervision of the President has been established in 1994 as the external audit institution of the PA. However, the GCI has not submitted any annual reports to the PLC, as stipulated by the Basic Law and both its effectiveness and independence have been called into question. A new law is required to bring the legal framework for external audit in line with international standards.

Despite the positive developments of the last few years, there remain shortcomings in the Palestinian financial control system, which require further reform and capacity building to bring it up to international best practices.

3.4. Transport, energy, environment and research and innovation

The Palestinian **transport sector** is under the responsibility of the PA Ministry of Transport. In practice, transport operations within the West Bank and Gaza Strip are dictated by the closure policy which is enforced by Israel as a result of the worsening conflict. The Gaza seaport and airport are not functioning, due to Israeli security concerns and much of their infrastructure has been destroyed by the Israeli army. Road transport has been highly restricted as a result of permanent and flying Israeli checkpoints throughout the West Bank and Gaza Strip. Road freight and passenger transport operations are highly restricted and freight transport within the West Bank is subject to a cumbersome back-to-back transportation system.

The Palestinian **energy sector** relies to a large extent on imported energy, either directly from Israel or under the supervision of the Israeli authorities for oil products. The domestic resources are restricted to limited production of biomass, small private electricity generation and solar energy. About 95% of the Palestinian electricity is generated by the Israel Electricity Corporation (IEC). The rest is produced privately, mainly in the remote regions. The energy institutions established are the Palestinian Energy Authority (PEA) charged with the overseeing of the energy sector policy and development and the General Petroleum Authority (GPA). The PEA in 1997 formed the Palestinian Electricity Company (PEC). The efficiency of the distribution utilities is poor and the transformation and distribution losses range from 25% to as high as 30-35%.

The restructuring process of the regulatory environment for the Palestinian energy sector is still ongoing. A Palestinian Energy Authority has been established, and draft regulations are under discussion in the PLC.

In an initiative sponsored by the EU, the Palestinian Energy Authority has signed three agreements with the Israeli Ministry of Infrastructure and the Israel Electricity Corporation to outline the principles of cooperation and to organise the sector. In this context, a number of proposals have been discussed, including the possibility of constructing a Combined Heat Power Plant and interconnections of the gas network with Israel and neighbouring countries.

The Palestinian Authority disposes of offshore gas resources and is developing a pipeline network to supply its territory.

As regards the **environment**, the Environmental Law of 1999 sets out the general legal framework. The Palestinian Authority has developed a ten-year Environmental Strategy and a National Environment Action Plan, which have adversely been affected by the ongoing conflict. In 2002, an Environmental Quality Authority was established as successor to the Ministry of Environmental Affairs and it reports to the Cabinet of the Palestinian Authority.

Most activities on environment issues have been suspended since the onset of the Intifada. The Palestinian Authority has been beneficiary of Community support under the programmes SMAP and LIFE-Third Countries', although such support has been limited due to the conflict.

The Higher Council for **Research**, established within the Palestinian Ministry of Education, plays a central role in setting strategies and priorities for academic research. In spite of the difficulties in implementation caused by the ongoing conflict, Palestinian institutes and universities have participated in a number of projects under the EU 5th Framework Programme and have been selected for further projects under the 6th Framework Programme.