

Country Economic Report 2001:7

The West Bank and Gaza Strip

A case of unfulfilled potential

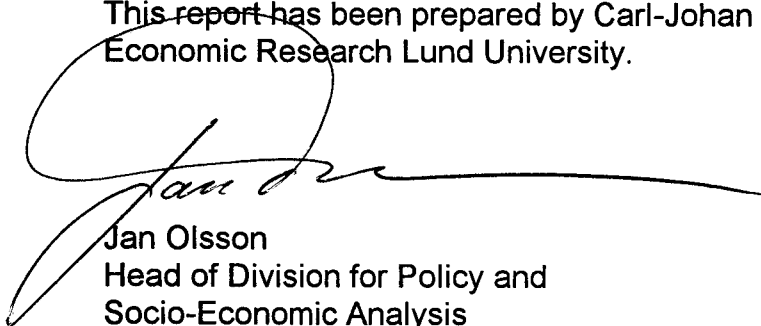
Carl-Johan Belfrage



SWEDISH INTERNATIONAL DEVELOPMENT
COOPERATION AGENCY

This country economic report on The West Bank and Gaza Strip is a part of a series of annual studies, which are undertaken by the departments of economics of three Swedish universities in collaboration with the regional departments of Sida, under an agreement with the Division for Policy and Socio-Economic Analysis. The purpose of these studies is to improve Sida's economic analysis and knowledge of the programme countries for Swedish development cooperation in order to enhance the effectiveness of programme as well as project support.

This report has been prepared by Carl-Johan Belfrage, Institute for Economic Research Lund University.



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Country Economic Report

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* I would like to express my gratitude to officials of the Palestinian Authority, as well as the staff of a number of organizations and consulates in the West Bank and Gaza Strip for providing valuable and useful information. Furthermore, I am grateful for the kind assistance and patience of the staff of the Swedish Consulate General in Jerusalem and the Asia Department of the Swedish International Development Cooperation Agency.

Timing of the report

This report is based on information about the situation prevailing in the West Bank and Gaza Strip (WBGS) before the recent violence which erupted after Israeli opposition leader Ariel Sharon's visit to the Temple Mount in Jerusalem on September 28, 2000. Since then, the socioeconomic conditions facing the inhabitants of the WBGS have deteriorated in a dramatic way. Extreme restrictions on the movement of people and goods have (as of November 26) tripled unemployment and raised poverty incidence by about 50 percent in just a couple of months.¹ The figures and some of the analysis provided in the following pages are thus in a sense outdated, but they can also be viewed as a point of reference for evaluations of the potential for economic stability and sustainability under alternative arrangements which may rise from the ashes of the present turmoil. The vulnerability of the Palestinian economy to adverse changes in the external environment, such as the ones currently in progress, is highlighted. Economic reasons for Palestinian frustration are also revealed in this report as it shows how a large development potential has been continually squandered through a combination of Israeli occupation policies and poor Palestinian governance. By pointing out those restrictions on economic activity, the report also suggests that a return to the situation prevailing before the recent violence is insufficient if one wants to see substantial and sustained improvements in the Palestinian standard of living.

Lund in December 2000

Carl-Johan Belfrage

¹ *The Impact on the Palestinian Economy of Confrontations, Mobility Restrictions and Border Closures, 28 September – 26 November 2000*. UNSCO, 2000.

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1 Introduction

The West Bank and Gaza Strip (WBGs) is a collection of land areas mainly inhabited by Palestinians, i.e. Arabs claiming citizenship of Palestine which in turn comprises a land area more than four times as large as the WBGs. The political contest with Israel for control over Palestine, highlighted by the recent outbreak of violence, is the context in which to view the socioeconomic status and development prospects under the present limited self-rule by the Palestinian Authority (PA) in the WBGs.

If one would somehow have managed to ignore the political conditions while observing the resources and opportunities existing in the nascent Palestinian state, one would probably be quite surprised to learn that its residents are suffering from worse economic conditions than their Arab neighbors and even the average developing country. Once the far-reaching restrictions on international trade, use of natural resources and labor mobility that Israel imposes on the WBGs economy are considered, however, Palestinian hardships become easier to understand. The picture becomes even clearer if one also considers how the Palestinian leadership's ways of handling the intricate domestic political situation has given rise to a system of governance in the WBGs which in itself acts as an important constraint on economic development and the safeguarding of human rights.

The WBGs is home to three million Palestinians, of which almost two thirds live in the West Bank. At least as many of those who consider themselves Palestinians live in Jordan, Lebanon and Syria in refugee camps created in connection with the wars of 1948 and 1967. The present report will, however, only be concerned with current residents of the WBGs (including around 450,000 people who presently live in refugee camps within this area), since our analysis is to be confined to issues of direct relevance to Swedish development cooperation with the WBGs, and since no large-scale repatriation of refugees into this area is currently expected. For similar reasons, the report will not be directly concerned with those Palestinians who permanently reside within the internationally recognized borders of the state of Israel.

This report begins by presenting reasons for believing in a large potential for prosperity and freedom from poverty, in section 2. Hints at what would have been possible are then contrasted with the current socioeconomic conditions in section 3. Since the rather widespread poverty is closely linked to labor market problems, which in turn can be traced to small and largely unproductive investment flows, section 4 is devoted to an overview over such macroeconomic conditions. Having pointed out some of the central macroeconomic problems facing the WBGs economy, we are ready to start uncovering clues as to why those problems are present despite the huge economic potential hinted at in section 2. The first step in the search for clues is a review of the economic history of the WBGs under Israeli occupation in section 5. During that review, some of the occupation-related restrictions on Palestinian economic activity are highlighted. Section 6 then analyzes some of those political, territorial and trade-related constraints. Unfortunately, there are plenty of other reasons for the residents of the WBGs to feel that their resources can not be put to the best uses. Section 7 covers a number of those restrictions that are internal to the

WBGS in the sense that they could be removed by, or are caused by, the Palestinian Authority. Section 8 concludes with some thoughts about the report's implications for what might follow the present turmoil.

2 Prosperity potential

There are plenty of good reasons for expecting an unoccupied and well-governed Palestinian entity comprising the West Bank and the Gaza Strip to be a prosperous country free of poverty.

Human resources

WBGS residents above the age of 15 are by international standards very well educated. In terms of average years of schooling, the educational level of the adult WBGS population (an average of 8.1 years in 1995) is equivalent to that of countries with per capita incomes above USD 10,000.² Although the world's highest population growth is putting the educational system under heavy pressure for the moment, and despite concerns about educational quality (see section 3.4 on education) most children are still receiving a basic education. On top of formal schooling, a strong entrepreneurial tradition and hence an unusually high ability to find and seize business opportunities is also commonly attributed to Palestinians.

Financial capital

The ability and willingness to invest in the WBGS, given the right conditions, is quite large. There is a large community of quite wealthy Palestinian expatriates ready and willing to give investments in the WBGS priority over investment opportunities elsewhere. Furthermore, Palestinian banks have since a few years back been receiving large amounts of deposits which they probably, all else equal, for reasons of credit information and social control would prefer to lend in the WBGS. In sum, for investments in the WBGS, financing could be obtained at a discount to international market rates.

Social capital

Social capital, commonly defined as "the norms and social relations embedded in the social structures of societies that enable people to coordinate action to achieve desired goals",³ is abundant in Palestinian society. The common denominator of suffering under occupation strengthened a sense of common purpose and induced the creation of a system of NGOs, educational institutions and hospitals. From an economic perspective, this abundance of social capital is likely to be conducive to the production of collective goods (by reducing the resistance to paying taxes) and contributes to information dissemination as well as the element of trust which is

² The 1995 figure for average years of schooling is that reported by Barro and Lee (1996) as quoted in Diwan, Ishaq; Shaban, Radwan A., 1999. *Development Under Adversity. The Palestinian Economy in Transition*. The World Bank.

³ www.worldbank.org/poverty/scapital/index.htm. The World Bank. 20 November 2000.

necessary for many economic transactions to take place.⁴ The use of “capital” to describe this phenomenon serves to illustrate that this may be as important to economic activity as other forms of capital.

The wide family networks and the character of most Palestinian NGOs also serve to promote equality of capabilities (see the reasoning about income and capabilities in section 3.3 on poverty). Social norms dictate transfers of income from richer to poorer within extended families and the activities of most NGOs are concerned with raising the capabilities of poorer segments of Palestinian society, e.g. by means of providing education and health services.

A well-connected and wealthy expatriate community

The Diaspora Palestinian community, created by the waves of refugees leaving what was once Palestine in connection with the establishment of the state of Israel in 1948 and the occupation of the WBGS in 1967, does not consist only of the millions of refugees living under dire circumstances in camps around the Middle East. There is also a large group of Palestinians with the common denominators of wealth (estimated at a total of between 40 and 80 billion USD), a network of worldwide business contacts, and a sense of attachment to their homeland (for example exhibited in a long history of substantial flows of financial contributions to educational and humanitarian organizations within the WBGS).⁵ By facilitating the movement of human and physical capital between the WBGS and the rest of the world, the Diaspora community will clearly be beneficial to the WBGS economy in times of improving prospects for the WBGS economy, but (aside from possible increases in charitable contributions) the opposite may be true for times of stagnation or depression.

A unique religious and cultural heritage

While it may be an important contributing reason for the conflicts in and occupation of Palestinian lands, the God-given plethora of sites of immense religious and historical importance could attract much larger crowds of visitors than have been seen over the past few years. The many places of religious and cultural interest in neighboring areas are likely to reinforce rather than reduce the attractiveness of visiting the WBGS (somewhat like neighboring stores in a shopping center).

Potential trading hub

Experience from trading with both Israel and Arab countries could make the WBGS an important east-west trading point. Mr. Arafat has even indicated that he would like to mould the WBGS on the Singaporean economy, the main economic characteristic of which is its role as such a trading point. The free trade agreements with the EU and the US are clearly useful, but not sufficient, for attracting export-oriented industries. In macroeconomic terms, the status as a trading hub would add to the set of options

⁴ It should be noted, however, that a subgroup of society which is rich on social capital may as a result be better able to act collectively in favor of its own members to the detriment of society as a whole.

⁵ Diwan, Ishaq; Shaban, Radwan A., eds. 1999. *Development Under Adversity. The Palestinian Economy in Transition*. The World Bank. p. 9.

for profitable employment of Palestinian factors of production, thus potentially raising the value of national income as well as attracting new investment for future benefit.

Very little debt, no inflation and substantial tax revenues

Unlike in many developing countries, current attempts to further economic development in the WBGS are not hampered by burdens of debt service or inflationary problems (see also section 4.4). On top of that, tax revenues have been substantial – above 20 percent of GDP.⁶ This is primarily due to the agreement on tax clearances with Israel, under which Israel is expected to pass on tariff revenues on goods headed for the WBGS and the value added tax collected on goods purchased by WBGS residents in Israel. It is, however, also due to successful early PA efforts at establishing a functioning domestic tax administration system through which about one fourth of public revenues currently are collected.

Sympathy from the international community

Highly influential powers within the international community possess a strong desire for regional stability for economic and security reasons, and arguably also some genuine sympathy for the plight of a people whose rights under international law have been violated for decades. The result has been a willingness to offer a per capita official development assistance (i.e. excluding military assistance) surpassed only by that for Israel (!) and Bosnia-Herzegovina, although the standards of living in the WBGS are not far below the median in international comparisons.⁷ Donor commitments for the 1994-98 period (two thirds of which was actually disbursed) amounted to close to USD 400 per WBGS resident per year.⁸

3 Current socioeconomic conditions

As already hinted above, the current socioeconomic conditions are not compatible with what might have been enjoyed by WBGS residents if the assets and beneficial circumstances outlined above would be fully utilized.

3.1 Average incomes

The level of incomes earned by the inhabitants of the WBGS, prior to the recent crisis were slightly higher than those in the average developing country or the closest Arab countries Egypt, Jordan and Syria, as indicated by the GNP per capita figures provided in table 1.

⁶ *The West Bank and Gaza Strip – Economic Developments in the Five Years since Oslo*. International Monetary Fund, 1999. pp. 22-24.

⁷ According to the *Human Development Report Palestine 1998/99* the WBGS ranks at position 104 out of the 175 countries included in terms of the human development index.

⁸ According to rough calculations based on information in the *Human Development Report 1999* and the *Human Development Report Palestine 1998/99*.

Gross domestic product, gross national product and the environment

The income measures used in this report are based on market values of new production of goods and services carried out in the WBGS (the gross domestic product, GDP) or market values of the services of factors of production (including labor) owned by people residing in the WBGS (the gross national product, GNP). The use of non-renewable natural resources is thus not taken into account, unless it is paid for, and if paid for it becomes treated not as a reduction in capital but as income. It should also be noted that the way GDP and GNP are measured, costs of environmental sanitation are added to (rather than deducted from) reported income. Since there is no mechanism for assigning a market price to good environmental conditions, neither the utility of living in a clean environment nor the disutility of living in a dirty one, will be reflected in GDP or GNP. Environmental damage that immediately causes output to fall, is however automatically measured at the market value of the lost output. The lack of taxation of environmentally hazardous production does at the same time give rise to higher levels and more harmful types of production than most people would find acceptable given its full cost.

Highly preliminary data from the UNDP and the World Bank do however suggest that if we consider only values of domestic production (i.e. if we use GDP) and adjust for purchasing power (i.e. price differentials), the comparison turns around to a disadvantage for the WBGS. The high Palestinian reliance on the Israeli labor market is of course an important explanation (since incomes earned abroad are excluded from the GDP), but purchasing powers may also differ to the disadvantage of the WBGS since the Palestinian population in effect (due to Israeli trade restrictions and the impossibility of trading some services) is forced to consume what has been produced according to the quality standards and costs of their ten times richer Israeli neighbors. Being divided into small enclaves cut off from trade (from other sources than Israel), Palestinians are also particularly likely to be charged higher-than-world-market prices by Palestinian or Israeli producers or trade agents incurring high trading costs while enjoying limited local competition.

Table 1. GNP per capita and PPP-adjusted GDP per capita in the WBGS and some neighboring countries

	GNP/capita in USD 1997	GDP/capita in USD 1997 PPP-adjusted
West Bank	1 763	2 286
Gaza Strip	1 970	2 485
WBGS Total	1 388	1 923
Lebanon	3 350	5 940
Jordan	1 520	3 450
Syria	1 120	3 250
Egypt	1 200	3 050
All developing countries	1 314	3 240
Israel	16 180	18 150

Sources: PCBS. *Human Development Report – Palestine 1998-1999*. *Human Development Indicators 1999*. *Palestine Poverty Report 1998*.

Average income, even when accurately reported, generally says little about the welfare of the poorer segments of the population. Nor does it provide an entirely satisfactory view of the average standard of living since that will also depend on the availability of public services such as healthcare and schooling. Let us therefore direct our attention to indicators of income distribution, poverty, public health and education.

3.2 Income distribution

Comparatively speaking, the distribution of income is rather even in the WBGS. Available estimates, however fairly old, point to a Gini coefficient (high values of which indicate large inequalities) of 0.378 for the WBGS (in 1995) which is about average for the neighborhood, in which Egypt has the lowest figure (0.320 in 1991), Israel is similar to the WBGS with 0.355 (in 1992), and Jordan has the highest recorded income disparities at 0.424 (in 1991).⁹ Within the WBGS, incomes seem to be more evenly distributed in the WB (0.355) than in the GS (0.395). One can think of two forces which are likely to have kept inequalities from becoming wider than they are. For one, the wide family networks as well as a number of civil society organizations of a charitable nature, have been redistributing incomes so that household expenditures (which are the figures underlying the WBGS Gini coefficient measure) have become more equal. The other possible reason why inequalities have not been more extreme is the scarcity of local opportunities to profitably employ (human or physical) capital, which makes wealthy Palestinians stay abroad.

⁹ Data for the WBGS from Diwan, Ishaq; Shaban, Radwan A., eds., 1999. *Development Under Adversity. The Palestinian Economy in Transition*. The World Bank. p. 27 and for the neighbors from the *World Development Report 1999*.

Given the low level of average purchasing power, the distribution of income is not narrow enough to keep a substantial part of the Palestinian population out of poverty. Let us therefore turn to the prevalence of poverty and how it is distributed among households.

3.3 Poverty

Definitions and measurement

The concept of poverty is notoriously difficult both to define, and if an agreeable definition has been given, to measure. A widely respected approach, developed by Amartya Sen and reflected in the construction of the human poverty indices reported in the UNDPs Human Development Report, begins with human capabilities. Such capabilities include basics such as the capability to be “adequately nourished, clothed and sheltered, and to avoid escapable morbidity and preventable mortality” and extends to other human functionings such as the “ability to participate in public life”. Poverty is then defined as the lack of one or several such capabilities and could be measured in a satisfactory way if reliable indicators of those capabilities (or rather the lack thereof) could be obtained.

Since this approach does not easily lend itself to one-dimensional quantitative results (although reasonable attempts, such as the construction of human poverty indices, have been made) and since the necessary data is usually missing, poverty measurement is usually confined to income or expenditure. Measures of poverty based on income or expenditures are, however, unable to account for differences in individual needs and differences in public provision of capability-generating inputs. A handicapped person who lives in a refugee camp earning (and spending) a thousand dollars may for example be considered deprived of basic capabilities and thus poor. The same person is, however, included among those above the poverty line since the greater amount of resources needed to generate basic capabilities for a handicapped person and the below-average provision of public services in the refugee camps are not taken into account in the poverty line measure.

The Palestine Poverty Report

The first, and to this date only, comprehensive effort at investigating and analyzing poverty in the WBGS is documented in the *Palestine Poverty Report 1998* (PPR 1998).¹⁰ While resorting to poverty measures based on (household) expenditures, the PPR sheds a little additional light on capabilities by reporting expenditures across family, rural/urban and other categories.

The PPR uses two poverty lines: one concerned with "deep poverty" below which not even the basic expenditures for food, clothing and housing are met by the household, and one concerned with "poverty" which takes into account that poverty can be said to involve also the deprivation of health care, education, transportation, personal care,

¹⁰ The study was conducted under the supervision of representatives of MOPIC, the PCBS, MAS, BirZeit University and the UNDP.

and housekeeping supplies. The amount of expenditure on the baskets of goods and services included in the "poverty" and "deep poverty" categories, respectively, are determined by the expenditure on those baskets by a reference household. A tricky issue, and one that is absolutely crucial to the extent of reported poverty, is the selection of the reference household. In the PPR it has 2 adults and 4 children (because this household configuration accounts for the largest proportion of the population) and is, in terms of expenditures on the relevant baskets, ranked at the 30th percentile. The latter implies spending at the level of 60 percent of the median household, which is claimed to be a common reference point for the construction of relative poverty lines. The poverty lines drawn in the PPR do thus have both an absolute element (a fixed basket of necessary goods and services) and a relative element (the amount that a household must spend on the the basket not to be considered poor varies with the spending of households at the 30th percentile). Efforts have been made to adjust for the demographic characteristics of households, i.e. to determine the possible poverty of a household which is not composed of exactly 2 adults and 4 children.

The report conveys that extreme deprivation, such as that caused by famine, is not characteristic of the present situation in the WBGS.¹¹ It is obvious, however, that a large part of the population is in a quite vulnerable position, which can become desperate following negative shocks to the economy like the prolonged closures currently imposed by Israel.

As shown in table 2, 14.5 percent of West Bank households were below the poverty line and half of those were in deep poverty in 1998.¹² Among households in the Gaza Strip, 33 percent were below the poverty line, two thirds of which suffered from deep poverty. The resulting 1998 average for the WBGS is a poverty rate of 20 percent and 12,5 percent of households in deep poverty. A rough calculation puts the poverty line used in the PPR at about 2 USD per person per day and the limit for deep poverty at about three fourths of that amount. International comparisons using a two-dollar poverty line adjusted for purchasing power parities, reveal that poverty is much more widespread in the WBGS than in Jordan. The WBGS average is lower than that of Egypt, but it should be noted that poverty in the Gaza Strip exceeds that of Egypt and is almost as widespread as in Yemen which has only half the per capita income.

¹¹ *Palestine Poverty Report 1998*. National Commission for Poverty Alleviation, Palestinian Authority. p. 25.

¹² The figures for 1998 are not from the PPR but calculated by the PCBS using the same principles as in the PPR.

Table 2. Poverty in the WBGS

	N WB	Jerusalem	C WB excl. Jer.	S WB	N GS	C GS	S GS	WB excl. Jer.	WB	GS	WBGS	Egypt	Jordan	Yemen
Poverty 1995-96	18,4	3,0	9,3	23,5	33,7	50,5	52,2	18,0	16,2	41,9	23,6			
Poverty 1997	18,1	2,7	8,4	24,4	30,8	39,5	50,8	17,8	15,6	38,2	22,5			
Poverty 1998									14,5	33,0	20,3	29	7	35
Poverty gap 1995-96	4,3	0,6	1,8	6,2	9,0	15,8	16,4	4,2	3,8	12,3	6,2			
Poverty gap 1997	4,4	0,2	1,6	7,1	8,2	12,7	14,4	4,5	3,9	10,8	6,0			
Poverty gap 1998									3,7	9,4	5,5			
Deep pov. 1995-96	9,2	1,9	3,9	14,4	21,4	37,5	37,8	9,2	8,4	28,9	14,3			
Deep pov. 1997	10,4	0,3	3,6	17,5	20,5	27,3	34,6	10,7	9,2	25,8	14,2			
Deep pov. 1998									8,4	21,6	12,5			
Pov. in cities 1997									11,5	34,2	20,1			
Pov. in villages 1997									18,2	40,7	20,5			
Pov. in camps 1997									13,8	41,7	33,2			

Sources: *Palestine Poverty Report 1998*. PCBS. World Bank.

Regional distribution of poverty

Aside from poverty being more widespread and more severe in the Gaza Strip than in the West Bank, there are other significant regional differences with regard to poverty (also revealed in table 2):

- The Palestinian parts of the Jerusalem area generally have lower poverty rates and suffer from less severe poverty than households in the rest of the WBGS. Less than 3 percent of Palestinian households in the Jerusalem area were considered poor in 1997, as compared to about 18 percent in the rest of the West Bank at that time. This can probably be explained by greater freedom of movement in areas controlled by the PA and by Israel, a relatively open access to the Israeli labor market, and partial access to the Israeli welfare system.
- In both the West Bank and the Gaza Strip, the southern regions are generally poorer than the northern ones. In the West Bank, the share of poor households vary between 11.5 percent in the northern regions and 24.4 percent in the area around Hebron in the south. In the northern parts of the Gaza Strip, about 30 percent of households are poor, while the corresponding figure for the southern parts exceeds 50 percent.

- The poor of the poorer regions are poorer, on average, than the poor of the affluent regions. This is indicated by the poverty gap measure which reveals the average distance to the poverty line among those who are poor.
- In the West Bank, the incidence of poverty in 1997 was highest in villages (18 percent) followed by refugee camps (14 percent) and cities (12 percent). In the Gaza Strip, on the other hand, refugee camps have the highest incidence of poverty (42 percent) closely followed by villages (41 percent).

Household characteristics and poverty

Another prism through which to view poverty incidence is the characteristics of individual households. The general pattern supports the rather self-evident propositions that poverty is less prevalent among households (i) with physical access to a good labor market, (ii) with characteristics which raise the value of household member labor on that market, and (iii) with few dependents per income provider. If, for example, the head of the household is of working age, has a good education, has a permission to work in Jerusalem and has one other adult and two children to provide for, it is not very likely that his household will be included among those below the poverty line.

Women are heavily exposed to poverty to the extent that they are heads of households, which in the data is limited to those cases where the household has no adult male member. In 1997, 30 percent of such households' expenditures warranted a position below the poverty line (compared to 22 percent of male-headed households), despite being the targets of a substantial part of private and public social assistance efforts. The household data used also hides how the burden of poverty is shared among household members. Separate statistics reveal that poor regions exhibit larger differences between girls' and boys' schooling beyond the primary levels. Another reason to fear that female household members on average are most adversely affected by poverty is their traditional lack of power over household assets and income flows.

Considering that large households are overrepresented among the poor, one suspects that children are particularly exposed to poverty. Indeed, a PCBS report on the socioeconomic conditions of children tells us that 24 percent of all children were below the poverty line in 1998, compared to 20 percent of all WBGS households.¹³ A similar relationship is present when deep poverty is considered. It affected 12.5 percent of all households in 1998 but 15.3 percent of all children.

Underlying reasons and remedies

It should be emphasized that, in the absence of more thorough studies or at the very least some statistical (multiple regression) analysis of the household survey material, the reported figures do not provide us with sufficient information to evaluate the relative importance of different factors affecting poverty (such as age, education or region-specific conditions). The data does, however, permit some qualified guesswork

¹³ *Palestinian Children. Five Years Under Palestinian National Authority*. Child Statistics Program, Palestinian Authority, 2000.

concerning the targeting of existing assistance programs and the importance of employment.

Public and private assistance programs

The poverty figures do however suggest that existing public assistance programs have some accuracy in their targeting of the poor but that they are of insufficient size for lifting the poor out of poverty. Households relying on public assistance as their main source of income do have a poverty rate that is three times higher than the overall figure and they suffer more from deep poverty.

Employment

Unsurprisingly, it is fairly easy to make a case for a close connection between unemployment and poverty based on the low incidence of poverty among those households where members are gainfully employed. The PPR data show that there is little poverty among households where the head has full-time employment, although there is a category of so-called working poor. Of those households where the head of household were employed during all months of the year, only 15,5 percent were poor in 1997, while 36,6 percent of the households with nobody employed were poor. This should be kept in mind as we eventually turn to the rather exceptional labor market problems faced by WBGS residents.

One often finds a strong correlation between poverty or vulnerability to poverty (measured in terms of income or expenditure) and low scores on human development indicators such as infant, child and maternal mortality, life expectancy, educational enrollment, access to sanitation and health services. Let us therefore consider some data on how the population of the WBGS fares in those respects.

3.4 Education

Considering the low average income level and the extent of poverty, a surprisingly large share of the WBGS population has received education at basic levels. Among adults, 92 percent of the men and 79 percent of the women are considered literate, as compared to the Middle East and North African regional average of 57 percent.¹⁴ There is also reason to believe in an amelioration of these figures during the next few years since close to 97 percent of all children today receive primary education.

¹⁴ The figures used in this section are taken from the *Human Development Report – Palestine 1998-1999* as well as the *Human Development Report 1999*.

Table 3. Education indicators

Education	WBGS	Men	Women	Lebanon	Jordan	Syria	Egypt	All dev.	Israel
Education index in HDR	0,82			0,82	0,80	0,68	0,59	0,67	0,90
Adult literacy rate	86	92	80	84	87	72	53	71	95
Combined first-, second- and third-level gross enrolment ratio	76	76	75	76	66	60	72	59	80
Primary enrolment ratio	95	95	95	76		95	95	86	
Secondary enrolment ratio	55	56	54			42	75	60	

Sources: PCBS. *Human Development Report Palestine 1998/99*. *Human Development Report 1999*. MAS Social Monitor, February 2000.

The problems faced by the WBGS education sector are instead questionable educational quality and appropriateness, as well as the need to keep up with a quickly growing number of school-age children. In international comparisons of basic skills, Palestinian students achieve about the same (low) results as those in other Arab countries. This is usually explained by a common exposure to outmoded educational form and content, as well as shortcomings regarding the scope and quality of teacher training. An additional problem, specific to the Palestinian situation, is that different school systems – concerning curricula, textbooks and systems of examination - are in use in the West Bank (the Jordanian system) and the Gaza Strip (the Egyptian system). The strong population growth makes it very (perhaps prohibitively) costly to maintain the current service level and quality within the school system. The number of pupils are increasing by 7 percent a year and the Palestinian Ministry of Education has estimated that the number of class rooms and teachers would have to increase by 30 percent over the next five years, if current standards are to be maintained.

3.5 Health

As in the case of education, the most common indicators show that the WBGS occupies a favorable position in international comparisons if the average income level is taken into account. Infant mortality, at 24 children per 1000 births, is at the low end of the Arab spectrum and cases of severe malnutrition are rare.¹⁵ Life expectancy, 70 years for men and 73 for women, is higher than in all Arab countries and places the WBGS in the 91st spot in the *Human Development Report* world ranking, while its position in a ranking based on PPP-adjusted GDP per capita is merely 115.

¹⁵ *Human Development Report – Palestine 1998-1999. Summary*. Development Studies Programme, Birzeit University, 1999.

Table 4. Health indicators

	WBGS	WB	GS	Men	Women	Lebanon	Jordan	Syria	Egypt	All DCs	Israel
Life expectancy index in HDR	0,74					0,75	0,75	0,73	0,69	0,66	0,88
Life expectancy at birth	71,5			69,9	73,1	69,9	70,1	68,9	66,3	64,4	77,8
Infant mortality per 1000 births	24	22	26	26	21	30	20	27	54	64	6
Child mortality below age of 5 per 1000 births	20	17	26			37	24	33	73	94	6
Maternal mortality per 100 000 births	70					300	150	180	170	491	7
% of children vaccinated against measles	94					89	90	93	92	79	94
AIDS cases per 100 000 people	1,3					3,1	0,9	0,3	0,2	28,9	8,1
Doctors per 100 000 people	83					191	158	109	202	76	459
Nurses per 100 000 people	141					122	224	212	222	85	671

Sources: PCBS. *Human Development Report Palestine 1998/99*. *Human Development Report 1999*. MAS Social Monitor, Feb. 2000.

A partial explanation for the relatively good Palestinian health indicators may be found in a relatively high level of health expenditure out of national income. One may also venture that there has probably been greater involvement by NGOs and government authorities in the provision of health services to vulnerable groups than in the neighboring states, since these services have been part of the mobilization against occupation and have played a role in internal Palestinian competition for political support.

4 Macroeconomic conditions

The poor current socioeconomic conditions outlined above, and fears that they may become even worse, can be traced to the preexisting and currently prevailing macroeconomic conditions. Below, selected indicators will show that employment and investment are at dangerously low levels while the PA budget reveals that the large public payroll makes it necessary to let all public investment be financed by

donors. A review of foreign exchange and inflation does, however, highlight the point made earlier about the relatively stable price level enjoyed in the WBGS.

4.1 The labor market

The few WBGS residents who enjoy the luxury of gainful employment do on average have many mouths to feed. Table 5 reveals that less than 1/5 of the population is employed. This is partially explained by a very large share of children under the age of 15 in the total population, but mainly by a combination of exceptionally low labor participation rates (particularly among women) and high unemployment rates which together limit employment to less than 40 percent of the working age population.

Table 5. The WBGS labor force and employment (in thousands, annual average)

	1992	1993	1994	1995	1996	1997	1998	1999
Population	2038	2120	2244	2388	2520	2667	2819	2977
Working age population (15-64)	932	1033	1096	1161	1248	1295	1370	1448
of which Men				587	631	654	692	732
of which Women				567	610	633	669	707
Labor force	389	431	464	498	528	542	577	619
of which Men				426	448	461	489	526
of which Women				72	80	81	88	94
Female labor force participation				13%	13%	13%	13%	13%
Male labor force participation				73%	71%	70%	71%	72%
Employed	372	402	394	407	402	431	486	533
of which Fully employed				298	339	380	446	498
of which Underemployed				109	64	52	41	35
Unemployed	17	29	70	91	126	111	90	86
Unemployed or discouraged					195	180	158	159
Not employed (all reasons)	561	631	702	754	846	863	883	914
Employed/working age population	40%	39%	36%	35%	32%	33%	36%	37%
Employed/total population	18%	19%	18%	17%	16%	16%	17%	18%

Notes: This combines data from different UNSCO quarterly reports with IMF data. Generally, the annual figures correspond to figures based on averages of the PCBS labor force surveys (conducted in most quarters) for quarters I and II of the year. For the years up to and including 1996, however, the figures are closer to annual averages. The author has made some minor adjustments for discrepancies in the UNSCO data and between data sources.

Sources: IMF, UNSCO.

Considering that employment seems to be a fairly good vaccine against poverty, the inability of the labor market in the WBGS to absorb new entrants into the labor force

is a particularly serious cause for concern. Table 6 shows that almost all new domestic jobs (82 percent of them) created since 1993 are government jobs (of which a large part, about one third of total PA employment, are estimated to be in the police and security forces).

Table 6. Where have Palestinians been working?

	1992	1993	1994	1995	1996	1997	1998	1999
<i>Palestinians working in the WBGS</i>								
Agriculture, Fishing	62	69	81	41	52	51	51	57
Manufacturing, Quarrying	37	45	55	60	59	61	66	66
Construction	27	44	55	49	40	38	43	49
Commerce, Hotels, Transport, Communication	52	65	62	90	85	90	97	95
of which Commerce, Hotels				70	66	71	76	74
of which Transport, Communication				20	19	19	21	21
Services, Other	59	73	70	102	110	116	126	143
of which Palestinian Authority			31	49	72	79	88	95
<i>Total Employed in the WBGS</i>	<i>237</i>	<i>295</i>	<i>324</i>	<i>342</i>	<i>347</i>	<i>356</i>	<i>382</i>	<i>411</i>
<i>Palestinians working in Israeli territories, settlements and industrial zones (ISI)</i>								
Agriculture, Fishing	12	11	8	9	6	8	12	12
Manufacturing, Quarrying	8	6	5	13	9	11	12	16
Construction	101	79	47	28	29	40	59	69
Commerce, Hotels, Transport, Communication, Services, Other	13	10	11	16	12	16	21	27
<i>Total Employed in ISI</i>	<i>135</i>	<i>107</i>	<i>71</i>	<i>66</i>	<i>55</i>	<i>76</i>	<i>104</i>	<i>123</i>

Notes: For 1997-99 figures are averages for observations from Q1 and Q2 whereas they are annual averages for earlier years. The data for 1992-95 are from the IMF and tend to slightly (by 1-2 percent) underestimate the no. of Palestinians working in the WBGS due to a different approach to annexed parts of East Jerusalem. All data tends to underestimate the share of Palestinian employment in Israeli territories, settlements and industrial zones (ISI's) because the labor force surveys only partly cover East Jerusalem whose residents are more likely to work in ISI's.

Sources: IMF. UNSCO. World Bank.

Table 6 also partly reveals the importance of the Israeli labor market. It not only provides close to 25 percent of all employment – it does on average pay almost twice the daily wage (according to Table 7). Assuming the same average intensity of employment for Palestinians working in Israel as for those working in the WBGS, the

figures for 1999 suggest that more than a third of all WBGS wage income comes from employment in Israel.

Table 7. Average daily wages

	NIS 1999
Israel and Israeli settlements	104.50
West Bank	64.90
Gaza Strip	51.90

Note: The figures are from the second quarter.

Source: *MAS Economic Monitor*, April 2000.

Israeli border closures at times of unrest cause large variations in the number of days that an Israel-employed WBGS resident can get to work, as detailed in table 8.

Table 8. Portion of work days lost due to Israeli border closures

1993	1994	1995	1996	1997	1998	1999
6,1%	23,1%	29,9%	31,9%	20,5%	5,2%	2,5%

Source: UNSCO.

The small variations in domestic employment and the heavy reliance on the Israeli labor market, together imply that Palestinian incomes vary very closely with the number of effective work days in Israel. Most of the recovery in the WBGS economy during 1998 and 1999 can for example be explained by the combination of an increase in employment in Israel and few days of closure.

4.2 Capital formation

Since the quantity of capital per worker is an important determinant of labor productivity, it is not very controversial to propose that – with some minimum wage level at which taking a job becomes meaningful – future employment (and wages) in the WBGS will depend crucially on current capital formation through public and private investment.

How much new investment would be needed to keep up with population growth and depreciation of the existing capital stock? A conservative guess concerning the ratio between the value of the capital stock and GDP (the capital-output ratio) used previously for the WBGS is that it takes on a value of 3.¹⁶ It implies that gross investment as a share of GDP would have to be three times the sum of the depreciation rate (assume 5 percent) and the population growth rate (4 percent), i.e. 27 percent of GDP just to avoid falling average incomes unless technological advances and efficiency gains can make up for the shortfall. As shown in table 9, the gross

¹⁶ Pedersen, Jon; Hooper, Rick, eds., 1998. *Developing Palestinian Society: Socio-economic trends and their implications for development strategies*. Fafo-report no. 242, Institute for applied Social Science, Oslo, Norway.

fixed capital formation over the last few years lies well below that figure. Furthermore, what is reported in the table is likely to be a substantial overstatement of productive capital formation since “construction activity is the main component of private investment in the Palestinian economy”, and since 85 percent of all construction is residential.¹⁷

Table 9. Investment in the WBGS (in percent of GDP)

	1994	1995	1996	1997	1998
Gross fixed capital formation	25,3	26,7	24,6	22,7	21,5
of which Private	20,2	17,1	15,1	13,6	14,0
of which Public	5,1	7,8	6,4	7,0	6,1
of which Change in inventories	0,0	1,7	3,2	2,1	1,3

Note: Public investment includes investment through UNRWA and NGOs to the extent that it is recorded by the MOPIC.

Source: IMF.

One indication of the limited extent of productive private investment flows is that new projects expected to receive tax incentives under the Investment Encouragement Law, i.e. Palestinian- or foreign-owned projects with a minimum of USD 100,000 in fixed assets and employing some minimum number of Palestinians, would (according to the applications) employ only 3,000 persons (if finally undertaken).

While only a small share of private investment affects the future productivity of labor and hence employment and incomes, most public investment efforts (if well selected and designed) can have directly productivity-enhancing effects, by means of providing physical infrastructure or education. During the period 1994-98, 35% of public investment has gone into physical infrastructure, 42% into health and education (mostly construction) and 22% into institutional capacity building.¹⁸

4.3 The government budget

The public budget (table 10) reveals a few important facts about how the PA is governed (to which we shall return in more detail in section 7.4). For one, over half of the recurrent expenditure is made up of salaries and wages, between a third and a half of which (reliable figures concerning this politically sensitive area are very hard to come by) are paid to police and security force personnel. A second notable feature is that almost all public investment expenditures are financed by donors. What is perhaps the most exceptional feature of the budget, however, is what it does not reveal - revenues from government-controlled business operations that, according to IMF estimates, may account for around 25 percent of the official revenues.

¹⁷ *Report on the Palestinian Economy*. UNSCO. Spring 2000. p. 6.

¹⁸ Based on donor disbursements (which have covered all public investment expenditures) as reported in *PASSIA Diary 2000*. Palestinian Academic Society for the Study of International Affairs, 1999.

Table 10. Estimated PA budget for the fiscal year 2000

	Million USD
Revenues	
Income tax	80
Customs and excises	326
Value added tax	440
Other taxes	1
Total tax revenue	847
Non-tax revenue	116
<i>Total domestic revenue</i>	<i>964</i>
Development grants	422
<i>Total revenue</i>	<i>1 386</i>
Expenditures	
Salaries and wages	562
Operating expenditure	183
Transfer expenditure	181
Current capital expenditure	15
1999 arrears	50
<i>Total recurrent expenditure</i>	<i>990</i>
Development projects financed by the PA	24
Development projects financed by donors	422
<i>Total development expenditure</i>	<i>446</i>
<i>Total public expenditure</i>	<i>1 436</i>
<i>Deficit</i>	<i>50</i>

Source: *MAS Economic Monitor*, April 2000.

In view of the large role played by donor funds, it should be noted that out of the USD 2 751 million that were disbursed between 1993 and 1999, USD 289 million (or 10.6 percent) were in the form of concessional loans.¹⁹ This share is expected to rise over time and there is thus a public debt build-up to watch in the future.

¹⁹ *Report on the Palestinian Economy*. UNSCO. Spring 2000. p. 13.

4.4 Currency concerns and inflation

Macroeconomic stability is not much of a problem in the WBGS. An important reason for this is that the PA, instead of launching an independent Palestinian currency, relies on the use of the New Israeli Shekkel (NIS), the Jordanian Dinar (JD) and the US Dollar (USD), which are all stable currencies backed by low-inflation countries. Table 11 reveals low inflation figures and the benefit of not relying on the NIS alone (the value of which has fallen substantially against the USD and the JD).

Table 11. Prices and exchange rates in the WBGS

	Monthly inflation rate	Exchange rate NIS/USD	Exchange rate NIS/JD
December 1996	1.81 %	3.30	4.66
December 1997	0.66 %	3.56	5.01
January 1998	1.77 %	3.58	5.04
February 1998	-0.36 %	3.60	5.06
March 1998	-0.75 %	3.60	5.06
April 1998	-0.28 %	3.76	5.28
May 1998	0.88 %	3.69	5.20
June 1998	-0.08 %	3.68	5.18
July 1998	0.50 %	3.67	5.16
August 1998	0.57 %	3.70	5.19
September 1998	1.98 %	3.84	5.38
October 1998	2.80 %	4.08	5.71
November 1998	1.45 %	4.25	5.95
December 1998	0.81 %	4.19	5.92
January 1999	0.99 %	4.09	5.77
February 1999	-1.45 %	4.07	5.72
March 1999	-0.17 %	4.03	5.69
April 1999	-1.22 %	4.05	5.72
May 1999	-0.05 %	4.12	5.80
June 1999	0.42 %	4.09	5.77

Source: *MAS Economic Monitor*, April 2000.

The drawbacks associated with not having a currency of one's own are (i) the inability to handle major changes in the economic environment affecting the WBGS but not the countries issuing the currencies it uses, (ii) the risk of importing inflation from those countries, and (iii) the inability to finance spending with the issuance of new

money (which amounts to a so-called “inflation tax” that Palestinians now in effect pay to Israel, Jordan and the United States). These drawbacks are, however, most probably outweighed by the avoidance of large exchange rate fluctuations and interest rate premiums on foreign borrowing associated with attempts at managing a new Palestinian currency.

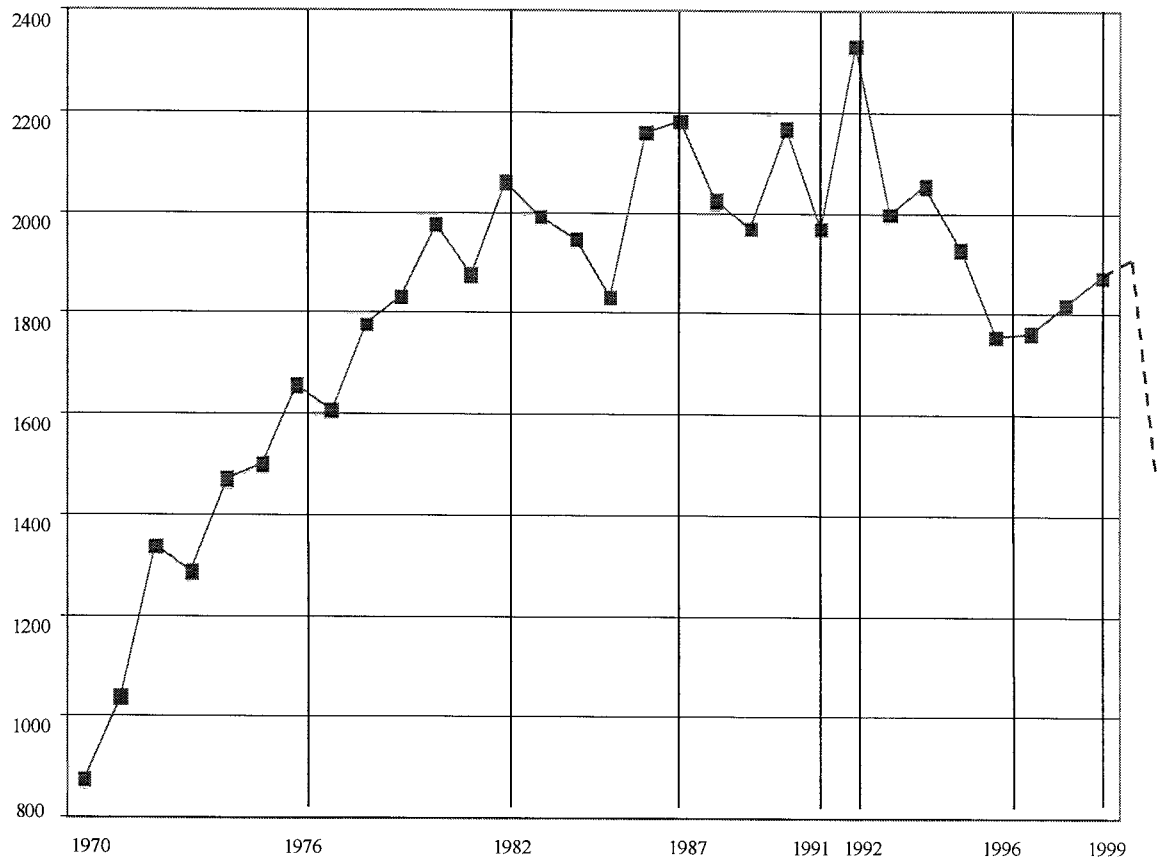
Let us now turn to the reasons why the standard of living in the WBGS is so far below the potential hinted at in section 2.

5 A brief economic history of the WBGS under Israeli occupation

In order to get a sense of what has brought about the current situation of frustration not only with the promises of a fair peace, but also with unfulfilled hopes of better material conditions, let us begin with a brief characterization of the development of Palestinian incomes since the Israeli occupation in 1967. This exercise is unfortunately severely circumscribed by the limited availability and reliability of data – an understandable yet frustrating obstacle to serious analyses of the WBGS economy. For the present purposes, we will have to rely on the estimates of the gross national product (GNP) per capita exhibited in figure 1, while noting that it leaves out inflows of foreign aid as well as remittances from Palestinian workers who are considered permanent residents of other countries.²⁰

²⁰ To be more exact, these are World Bank estimates of the gross national product (GNP) per capita based on Israeli (prior to 1994) and Palestinian (beginning 1994) data, complemented with some recent observations from the United Nations Office of the Special Coordinator for the Occupied Territories (UNSCO).

Figure 1. Gross National Product (GNP) per capita in the WBGS since 1970 (in constant 1997 USD)



Sources: World Bank. PCBS. IMF.

From 1967 to the mid-1970s

Integration with Israel, by means of occupation, and the beginning of the oil boom in the Gulf led to rapid growth in Palestinian incomes. A positive effect on average income following integration with a rich and technologically advanced neighbor is to be expected. The Israeli occupation did, however, also initiate a number of restrictions on Palestinian economic activity, the negative effects of which did not come into full force until years later. This occupational legacy includes severe controls on international trade flows, a repressive investment approvals regime, insufficient spending on public infrastructure and confiscation of important land and water resources. In section 6, we will return to some of those restrictions to the extent that they are impeding Palestinian economic development also today.

From the mid-1970s to the early 1980s

This period saw continued but slower per capita growth in the WBGS as strong Gulf remittances were somewhat tempered by a slowdown in the Israeli economy. In 1980, real per capita income in the WBGS reached the level it had at the turn of the century.

From the early 1980s until the beginning of the Intifada in 1987

The collapse of the oil boom reduced workers remittances from the Gulf but the effects on the Palestinians were softened due to continued growth in Israel.²¹

The early Intifada years (1987 through early 1991)

During this period, Israeli demand for Palestinian workers and products fell (except in the construction sector where large immigration flows into Israel created a minor boom) initially due to a recession and near hyperinflation in Israel and eventually also due to strikes and repression of economic activity.²² This coincided with the 1998 devaluation of the Jordanian Dinar which was damaging to those, including a substantial share of the population in the West Bank, whose incomes and savings were denominated in that currency. Palestinian support for Iraq during the Gulf war in 1990-91 also caused the introduction of restrictions on new employment in that area, as well as a significant fall in financial support from the Gulf states.

The early peace process years (late 1991 through 1992)

The Israeli introduction of a permit system marked the end of economic integration between the WBGS and Israel and complicated connections between different areas of the WBGS. While extremely damaging to the Palestinian economy when enforced later in the 1990s, the adverse consequences of the introduction of the permit system was during 1992 temporarily overshadowed by hopes for beneficial outcomes of the peace process and a drawdown in savings, resulting in a brief economic recovery.

The interim period of the peace process (1993-1997)

A severe decline in Palestinian economic activity primarily associated with the constraints on movements of Palestinian workers and goods due to the permit system, excessive security controls at borders and long periods of closures. The effects of Palestinian inability to maintain economic relations with the rest of the world, and even between different areas under Palestinian administrative control, were somewhat softened by a large donor-funded expansion of public employment and investment.

The recent period (1997-summer of 2000)

A period during which closures were rare, Israeli demand for Palestinian labor expanded and the declining trend in aggregate economic activity as a result seem to have been at least temporarily halted.

²¹ Diwan, Ishaq; Shaban, Radwan A., eds. 1999. *Development Under Adversity. The Palestinian Economy in Transition*. The World Bank. p. 3

²² Ibid.

The current crisis (fall of 2000)

Aside from military action against the large-scale Palestinian protests in the aftermath of Ariel Sharon's visit to the Temple mount on September 28, the Israeli authorities have put the Palestinian people under immense pressure by closing off most opportunities to move people and goods between the WBGS and Israel as well as between different areas under Palestinian control. According to UNSCO (2000x), the value of domestic production has halved during October and November and almost all opportunities to earn income through work in Israel have been lost.

6 External, occupation-related, constraints on the Palestinian economic potential

During the review of economic developments in the WBGS since 1967, there were hints at a number of serious restrictions on Palestinian economic activity, which persist today and can be attributed to the continued occupation. Those include the political uncertainty facing investors, restrictions on the control of land and water, as well as on movements of goods and labor to and from the divided Palestinian territories.

6.1 Political uncertainty

The uncertainty about the fate of what has been called the "peace process" is of crucial importance. As has recently become evident, armed conflict can quickly turn investments responding to new business opportunities into unused, or in some cases unusable, capital. Uncertainty about whether, and if so when, a peace treaty will be enacted is just part of the problem. Some possible versions of a final status agreement, particularly those which increase the degree of separation between Israeli and Palestinian territories, can be very harmful to activities which rely on access to factors of production and intermediate goods located or produced in different locations. In general, the political uncertainty will be more detrimental to investment the longer the investment horizon. This means a loss of benefits attributable to the fact that investors expecting a long-term involvement in an economy are likely to behave in a more responsible manner (e.g. with regard to the environment) towards the communities in which they operate.

6.2 Restrictions on control of land and water

The Israeli occupation implies that some land areas (those that currently contain settlements, military training areas and nature reserves) can not be used by Palestinians. Some of what may be regarded as their productive capital (the land) is thus blocked from generating Palestinian employment and consumption possibilities. An associated problem which limits the opportunities to borrow in order to finance new investment is the impossibility of using property as collateral for bank loans.

The current separation between Palestinian territories also adds to the problems of public governance (detailed in section 7.4), thereby restricting the ability to effectively use available production resources and making public investments of some kinds (in e.g. power plants, road networks and pipelines) impossible or very expensive to carry out.

The occupation also means limitations to Palestinian access to water resources. Although it may possibly be argued that further commercial use of Palestinian water would not be sustainable under any circumstances, the Israeli water policies makes it impossible to exploit opportunities in the agricultural sector for purposes of much-needed short-term employment and income generation.

6.3 Restrictions on international trade and movements of labor and goods between Palestinian territories

The agreement on economic relations between Israel and the PLO, the so-called Paris protocol, dictates a de facto customs union with a common external trade policy (largely based on the Israeli tariff regime) and unrestricted trade flows between the parties. In practice, however, only Israeli exports to the WBGS can be carried out under conditions resembling free trade. Claiming overriding security concerns, the Israeli military controls all trade flows to and from Palestinian areas. Extensive waiting periods at harbors and border crossings, arbitrary judgments passed on the quality of goods (the Paris protocol includes the provision that Israeli quality standards be applied to all imports, including those going to the WBGS) and other administrative barriers hamper Palestinian attempts to trade directly with the rest of the world. The value of potential Palestinian export revenues lost due to those arrangements is in part reflected in the high fees charged (or markups set) by Israeli middlemen who, due to their nationality, can bypass some of the trade barriers. It should be remembered that, due to the current territorial divisions, the problems just described also apply to trade in goods and services between different Palestinian enclaves. A permit system introduced in the early 1990s severely restricts movements in and out of Jerusalem which also hampers trade in an indirect way given Jerusalem's long-established role as a Palestinian trading hub.

There are a couple of clear indications of the severity of the restrictions imposed by Israel on Palestinian trade. A 1998 study by the Palestinian chambers of commerce found that firms on the West Bank on average faced 35 percent higher transaction costs when exporting or importing than Israeli firms in the same sectors.²³ One such indication, pointing particularly to the barriers to Palestinian trade with the rest of the world, is that 80 percent of all Palestinian merchandise trade in 1998 was with Israel.²⁴ In other countries, costs of transportation, preferential trading arrangements and better information on consumer preferences usually makes trade with neighboring

²³ The figure would likely be even higher if Gaza-based firms would have been included in the study. The study is cited in *Report on the Palestinian Economy*. UNSCO. Spring 2000. p. 45.

²⁴ *Report on the Palestinian Economy*. UNSCO. Spring 2000.

countries disproportionate to trade with the rest of the world, but it still rarely exceeds 20 percent of total trade. An indication of how difficult it is for Palestinians to export their goods even to their customs union partner Israel is a large trade deficit (in 1998 merchandise imports were six times as large as merchandise exports),²⁵ mainly paid for by means of labor migration to Israel, although working as migrant labor tends to be cumbersome and costly, and in the Palestinian case also requires degrading treatment at border-crossings.²⁶

All in all, the restrictions on Palestinian trade reduces the ability to effectively make use of existing Palestinian means of production according to comparative advantages. Of particular importance may be the detrimental effect on any activities requiring large-scale production (and thus are in need of access to a market in excess of nearby parts of the WBGS, and to some extent Israel) or access to a wide range of intermediate goods. Furthermore, the artificially high costs associated with exporting and importing goods to and from Palestinian areas means that Palestinian production can be converted into less consumption possibilities than would have been the case if trade were truly free. The Israeli border policies may not only constrain Palestinian opportunities to make effective use of currently available resources, but are also likely to discourage private investment and therefore keep employment and future incomes down.

The trading restrictions have also indirectly supported the Palestinian import monopolies which constitute an important element of the internal constraints on economic development (see the section on that subject below). Unless it cuts into their profit margins, the Israeli suppliers (being producers or importers) probably prefer to deal with the fewest possible number of Palestinian buyers. At the same time, on the Palestinian side, there is reason for the PA to be concerned with tariff and VAT revenues on goods from outside the WBGS purchased by WBGS residents. Those are first collected by Israeli authorities and, if the paperwork indicates that WBGS residents are the end buyers, passed on to the PA. There is, however, little incentive for individual Palestinian businesses to do the paperwork and undergo the administrative procedures required to ensure that the revenues are passed on to the PA. It may even entail automatic registration for Palestinian income taxes that might otherwise be avoided. This has encouraged PA ownership or control of important importers. The end result has been a few large such firms which provide the PA with tax revenues and (as of yet undisclosed) profits, partly at the expense of Palestinian businesses and final consumers who end up paying the high Israeli prices of items such as cement, iron and fuel.

²⁵ Ibid.

²⁶ Given these costs of labor migration, we would expect free trade to generate large exports of labor-intensive goods and imports of productive capital.

6.4 Arrangements designed to remove the external constraints

Building direct external trading channels

The main efforts at improving the infrastructure for direct trade with countries other than Israel are the construction of the Gaza international airport, which is already operational, as well as a harbor in Gaza, which is yet to be built. The airport is, however, of limited value for trading purposes because the Israeli military has taken upon itself to run extensive security checks and because air freight carries costs that are quite high in comparison to the value of potential Palestinian export goods.

Free trade agreements

Free trade agreements do not offer solutions to the border crossing problems associated with Palestinian exports and imports. To the extent that the Israeli handling of Palestinian exports raises transactions costs but do not effectively stop them, however, the free trade agreements may partially compensate those costs by putting Palestinian exports in a relatively advantageous competitive position in the partner country markets. Unfortunately, the agreement with the EU does contain clauses which severely limits its value from a Palestinian perspective. Agricultural products are largely exempted, although some can be traded with less restrictions than those originating from countries which do not have preferential trading arrangements with the EU. Furthermore, the Palestinian export opportunities are heavily circumscribed by the agreement's rules concerning what is known as cumulation of origin. These rules prescribe that the EU will only give preferential treatment to those goods which have been produced using almost exclusively Palestinian inputs, thus ruling out the lion share of potential exports – those containing a substantial share of Israeli inputs. This severe restriction is upheld although Israel also has a free trade agreement with the EU.

The free trade agreement with the United States does, however, allow Israeli (and U.S.) content of up to 65 percent of the value added in Palestinian goods for free import into the United States. Consequently, almost all Palestinian textile exports (the largest Palestinian manufacturing sector) are shipped to the U.S. and hardly anything to the EU, although one can expect similar demand conditions in both those markets.

Investment guarantees and export insurance schemes

At the initiative of the World Bank, Palestinian exporters have been given the opportunity to obtain insurance against the consequences of long waiting periods and disruptions of trading when Palestinian areas have been closed off by the Israeli authorities. This does, at least in theory, solve some of the problems mentioned above but partly due to the importance of reliable and speedy delivery in modern trading relationships, the programs have not been sufficiently effective. Another World Bank initiative is a special investment guarantee program for the WBGS, designed to insure investors against the exceptionally high political risks prevailing in the area.

7 Current internal constraints on the Palestinian economic potential

The severe occupation-related constraints on the Palestinian economy are unfortunately matched by a number of internal problems including the rapidly expanding population (see section 7.1), the poor condition of the physical infrastructure (section 7.2), cultural factors relating to the role of women and outdated business practices (section 7.3). All those constraints could probably be removed, however, were it not for some serious problems with public governance (discussed in section 7.4) which in themselves arguably constitute the most difficult obstacles to Palestinian economic development.

7.1 Demographics

There are two exceptional features of the Palestinian demography – its youth and its growth. Almost half the population is less than 15 years old. The dependency ratio, i.e. the ratio between people of non-working age (0-14 years and 65 or older) and those of working age was estimated at 1,01 in 1999. This can be compared to 0,72 in the average for Middle East and North Africa or 0,59 in the same income group (lower-middle income) worldwide. Some rough simulations (using PCBS data) suggest that the WBGS dependency ratio may rise even further in the short run but eventually fall to levels between 0,9 and 1.²⁷

It has been estimated that women in the WBGS on average give birth to 6.4 children (5.4 on the West Bank and 7.4 in the Gaza Strip).²⁸ Combined with a high life expectancy, this yielded a natural population growth of almost 4 percent in 1999. Population growth is in itself no problem for living standards if it takes place in an economy which is fully flexible and if it is possible for factors of production other than labor to grow at the same rate. However, none of those requirements are likely to be fulfilled in the present case. The large changes in the supply of labor which comes with the population growth requires greater flexibility than most well-developed economies can handle without bouts of unemployment and socially costly episodes of restructuring. Furthermore, the need for growth in the capital stock matching that of the working-age population does not seem to be fulfilled by current levels of private and public investment (see section 4.2) which signals a risk for increased unemployment and/or falling wages unless there are substantial increases in the efficiency at which available resources are used.

²⁷ This is based on a number of assumptions, *inter alia* that the number of births per woman and life expectancy remain at current levels.

²⁸ All population data used in this paragraph are taken from www.pcbs.org. Palestinian Central Bureau of Statistics. 16 August 2000.

7.2 The physical infrastructure

During the two and a half decades of Israeli occupation, investment in public infrastructure in the WBGS has been minimal. There has been almost no road construction, except for access roads to Israeli settlements, and the power supply capacity has been allowed to degenerate to a per capita level far below what is offered elsewhere in the region. Water supply and sewage systems have suffered similar neglect and are health hazards in a number of places.

Over the last few years, however, substantial efforts have been made to upgrade the physical infrastructure in the WBGS but much remains to be done. Considering the strong contribution of well-planned public infrastructure to the productivity of private capital and labor, public investment may have considerable influence on the extent of employment and private investment. Since the incomes from employment and private investment in turn will be important sources of tax revenue needed to fund future public investment, the current (largely donor-financed) efforts are likely to be critical.

7.3 Cultural factors

The position of women

The position of women in Palestinian society has, except for a temporary revision of social norms during the (1989-93) intifada, remained very weak. Most women are kept busy rearing a large number of children, and those who are not are confined (by tradition and cultural norms) to a limited part of the Palestinian labor market. Aside from the tragedy of oppression and discrimination, the just described pattern affects the region's total factor productivity negatively through underutilization of individual abilities.²⁹ Those tendencies are also likely to be self-reinforcing, and reinforce population growth, since they raise the relative attractiveness of child-rearing. Global experience also indicate that women's lack of influence (at household, local and national levels) makes for unnecessarily poor resource allocation and greater tendencies toward preventable damage to the natural environment.

Family enterprise

Another cultural constraint on Palestinian economic activity is the strong connection between family and business relationships. A strong expression of this, particularly common in the northern West Bank and the Hebron area, is the family enterprise system. Family firms are perpetuated through generations and form an integral part of social arrangements within the families concerned. There is generally overwhelming resistance to an opening of the firms to out-of-family ownership or management, creating small enterprises with very limited abilities to expand in response to new

²⁹ A region's total factor productivity can be defined as its ability to convert available resources (i.e. factors of production such as land, capital and labor) into production. Among two countries with identical amounts of productive resources, the country with the highest total factor productivity will be able to produce more goods and services.

business opportunities. Total factor productivity is thus unnecessarily low. The limited managerial ability (and lack of transparent business records) inherent in the family arrangements also make banks very hesitant to give loans to these firms. Together with the unnecessarily low level of productivity, this understandable lack of willingness to supply credit further constrains private investment in areas dominated by family enterprise.

7.4 Governance

There are a number of problems with governance in the WBGS which leads to inefficient use of the resources at the government's disposal and inhibit foreign as well as domestic attempts to establish business operations there. Awareness of these problems is widespread within the international community, following several reports, including that of an independent task force sponsored by the Council on Foreign Relations and headed by former French prime minister Michel Rocard. The political background to the reported problems is of course quite complex and impossible to represent in a few pages. Let us, however, start with a brief sketch of the Palestinian political situation before turning to a listing of identified shortcomings and their consequences.

A brief political background

The Palestinian struggle is to many people, Palestinians and non-Palestinians alike, personified by Yasser Arafat. His leadership has been criticized with increasing intensity since the beginning of the Oslo process, but opinion polls reveal that nobody can seriously compete with him as the highest representative of the Palestinian people. In efforts seemingly geared at consolidating this grip on power while using it to push Palestinian statehood, a few strategies used by the Palestinian leadership (with direct relevance for the current economically costly governance problems) can be identified. They include:

The concentration of control over the PLO's and the PA's central decision-making functions and financial flows to the chairman and president respectively (who is Mr. Arafat in both cases). This involves an absence of true separation of powers, leaving the judicial and legislative branches almost powerless when in conflict with the PA leadership.

Awards of influence and privileges to strong political opponents in return for cooperation, restrained criticism and acceptance of the current leadership.

The establishment of a huge security apparatus for purposes of (i) providing employment and income to those individuals who have built their lives around the armed struggle, and (ii) controlling those groups who can not be enticed into accepting the current leadership or its way of dealing with Israel.

Information suppression through forced self-censorship by journalists and a rhetoric of Palestinian unity framed so that criticism against the PA, its leadership or its policies appears as treason against the struggle for Palestinian rights.

Together with difficulties of transition from a situation with several parallel legal systems, and the problems associated with governing territories that are physically (and in some respects also culturally) separated, the pattern of leadership just outlined brings with it a number of significant governance shortcomings causing poor resource use in – and poor incentives to bring new resources (by means of investment) to – the WBGS.

Specific governance problems

Centralization of power

The concentration of power to the president's office implies that local governments, NGOs and academic institutions enjoy very limited influence on political decisions. The lack of autonomous and participatory decision-making at the local level is expressed in (i) PA appointments of local government leadership rather than through local elections, (ii) parallel administrative structures (governors appointed by the Ministry of Interior have areas of responsibility overlapping those of municipal government officials), (iii) an unclear division of responsibilities between central and local government, and (iv) centralized taxation (so that financial independence of municipalities hinges on the ability to directly attract donor funds).

This rather extreme centralization of power and the lack of input by NGOs and academic institutions implies a clear risk that valuable information and knowledge gets overlooked in the process of policy-making.

Incomplete division of labor between ministries and agencies

Either as a consequence of attempts at neutralizing potential competing power bases or due to the difficulties involved in quickly building a government apparatus, there are many and significant overlaps in areas of responsibility within and across ministries. These give rise to repetition of work and unnecessarily slow decision-making. On a more fundamental level, it hampers the formulation and implementation of a coherent *development vision*.³⁰

Patronage connections

A vast majority of Palestinians believe that the right political affiliations and/or personal connections (“wasta”) are necessary for obtaining positions in the PA.³¹ Such a patronage-based system may be in line with the broad strategies of the PA leadership outlined above as a convenient way of facilitating political consolidation and rewarding past service to the Palestinian national movement. It is, however, detrimental to a rule-based system of governance by signaling the primacy of

³⁰ The lack of a development vision and associated strategies has been pointed out in e.g. the *Human Development Report – Palestine 1998-1999* and in *Strengthening Palestinian Public Institutions*. Council on Foreign Relations, 1999.

³¹ According to opinion polls undertaken by the Center for Palestine Research and Studies (www.cprs-palestine.org. Center for Palestine Research and Studies. 16 August 2000).

connections and by giving rise to dependencies conflicting with the organization hierarchy of ministries and agencies.³²

In sum, the prevalence of patronage connections makes for poor matching of individual skills and abilities with positions in the PA hierarchies. They also makes knowledge of the informal structures within ministries and agencies an often costly prerequisite for effectively dealing with the government.

Government monopolies

As noted already in the section about externally imposed restrictions on Palestinian economic activity above, there are government-owned monopolies and quasi-monopolies controlling imports or setting the prices of key goods. Their accounts are undisclosed, the profits are left out of the official budget figures, and the end recipients are unknown (see also the discussion about the public budget in section 4.3). The profits gained and thus diverted from the government budget were, for 1997, estimated by the IMF to be somewhere in the neighborhood of 25 percent of total public revenue.³³

The monopolistic behavior involves pricing above cost, thus unnecessarily cutting into household budgets and raising the costs of production in other lines of business using the goods concerned as inputs. Losses experienced through the restricted supply (associated with monopoly pricing) will be incurred even if all monopoly profits were to be used by the government in useful ways. Such use of the profits may, at least hypothetically, be the case but the secrecy surrounding it rules out proper involvement in the official fiscal and development planning process while the possibility of diversion into private hands will continue to hurt the credibility of the PA leadership. The political costs of maintaining the current situation also include public blame being directed towards the PA when commodities are in short supply or of low quality, or when price increases occur.

Insufficient consolidation and transparency of government finances

Government finances in the WBGS are to a large extent hidden from the general public and their representatives. Aside from the undisclosed government monopoly profits, the president's office has been expending between 6 and 12 percent of the general budget in successive years for undisclosed purposes.³⁴ The PA has an external auditing body, the General Control Institute (GCI), which has a wide mandate (although the police force is beyond its reach) but no power to conduct audits on a regular basis or to make its findings known beyond the president's office. Furthermore, public servants willing to blow the whistle on mismanagement of ministries or agencies will find little encouragement or protection in laws, regulations or practices.³⁵

³² *Aid Effectiveness in the West Bank and Gaza*. The Secretariat of the Ad Hoc Liason Committee, 2000.

³³ *Strengthening Palestinian Public Institutions*. Council on Foreign Relations, 1999. p. 56.

³⁴ *Ibid.* p. 54.

³⁵ *Ibid.* p. 56.

Limited critical media coverage of government affairs

There is a law on press freedom for the WBGS but it has exceptions which can give rise to far-reaching interpretations by way of censorship. Furthermore, a combination of poor journalistic traditions, appeals to patriotism, subsidies, office closures, newspaper distribution blockades and harassment of journalists have resulted in a high degree of self-censorship among Palestinian media. Only highly selective information on the activities of PA ministries and agencies therefore reaches the general public.

Laws and their enforcement

As already noted above, the limited Palestinian self-rule in the WBGS has had to contend with multiple and outdated legal and regulatory frameworks tracing back to former rulers of Palestinian territories. The initial set of legal systems, composed differently in the WB than in the GS, include Ottoman, British, Egyptian and Jordanian laws as well as Israeli military orders. The courts in the WBGS do not only lack independence from the executive branch (hirings, promotions, dismissal and relocations of court personnel are handled by the ministry of justice). They also suffer from a severe shortage of resources which causes heavy case backlogs, and when rulings finally can be issued, they are frequently ignored if unfavorable to government bodies.

Aside from the consequences for the protection of human rights, the complexity of laws and their erratic enforcement make it difficult to handle contractual disputes and other problems involved in business transactions.

Inadequate human resources in policy-making functions

The high general level of education in the WBGS does not guarantee a supply of adequately prepared policy-makers and technocrats. As noted by the World Bank (2000), Palestinian universities are not known for a tradition of advanced training in areas such as policy analysis and strategic planning. Furthermore, remuneration within the PA is relatively low which makes it difficult to compete with private and/or foreign organizations for good analysts, particularly if their impression is that personal and political loyalties will be better rewarded than good analytical efforts.

A huge security apparatus

The PA has a very large public administration, particularly in terms of the number of people employed – about 100 000 people (as shown in table 5). A strongly contributing factor is the security apparatus comprising the civil police as well as an unclear number of security forces which has been estimated to employ about 35-40000 persons. Given the difficult unemployment situation, government-run employment projects may be necessary and worthwhile, particularly if they raise the level of public capital. However, with a low workload, low wages, and the particular powers possessed by police and security forces, this particular type of employment scheme clearly poses a threat to the rule of law, particularly given the current weakness of the court system and other checks on the behavior of government personnel (such as the news media).

Corruption

Several of the governance problems already mentioned – such as the heavy but non-transparent government involvement in monopolistic market transactions, poor public auditing mechanisms, the lack of critical media coverage and a dysfunctional court system – constitute an institutional environment that is highly conducive to corruption. Surveys have indeed shown that a vast majority of Palestinians believe that corruption exists in PA institutions.³⁶ Bribery is rumored to be a common feature of the distribution of licenses and permits and may also occur in connection with public procurement and awards of monopoly privileges. Furthermore, police and security forces have been accused of involvement in extortion and protection schemes. However, careful monitoring has not revealed any major corruption cases associated with transactions directly related to foreign aid.

A review of the economic implications of the governance problems

The governance problems outlined above constrains the potential living standards in the WBGS – today through inefficient resource use, and in the future by discouraging private investment, by establishing inefficient norms and by entrenching interests in the status quo.

The restrictions on information for policy-making and grass-roots participation, as well as the unchecked use of substantial shares of government funds caused by the governance problems reviewed above, imply that the current use of resources commanded by the PA will result in unnecessarily low outputs of much-needed government services today. It will also leave unnecessarily little room for public investment and, due to the lack of a development vision (noted under the discussion on overlapping areas of responsibility above), the optimal selection of projects for that investment may not be made.

In the longer term, low levels and inappropriate choices of public investment result in poor infrastructure which affects the return on private capital and the productivity of labor negatively, thus putting downward pressure on employment and the attractiveness of private investment.

Private investment is not only discouraged by poor government services and insufficient public investment, however. It is also rendered less effective (in terms of what it can produce) and thus less profitable, by the high costs of doing business in the WBGS. These high costs are incurred when dealing with government authorities where connections and informal lines of command substitute for a rule-based system enforced by courts, where there is no established system for settling business-related disputes and where input prices are kept high by monopoly control of key goods. An indication of the relevance of those (partly information-related) costs are that the limited large-scale investment that has taken place in the WBGS over the past years has been dominated by individuals and firms with close connections to the PA leadership. The presence of patronage and corruption may also redirect investment from accumulation of productive (human and physical) capital to the establishment of

³⁶ E.g. in polls conducted by the Center for Palestine Research and Studies.

skills necessary to navigate the complex political roadmaps or currying favors with key decision-makers (i.e. rent-seeking).

The governance problems which hence constitute a threat not only to the current delivery of government services, but also to current and future employment and incomes by discouraging the accumulation of new productive capital, may become self-perpetuating. Those who benefit from the current arrangements can over time increase their abilities to resist reforms, by strengthening their informal networks and using their informational advantages to slow down the making and implementation of political decisions. Furthermore, economic stagnation and deteriorating public support for the PA may threaten the ability to collect the revenues necessary for public investment and other development efforts.

7.5 PA plans and policies to remove the internal constraints

The official document in which the PA lays out its plans for addressing the constraints on Palestinian development is the *Palestinian Development Plan* (PDP), the latest version of which covers the period 1999-2003. It comprises macroeconomic forecasts for a few different scenarios, projections of resources available for development purposes, a discussion and description of sectoral priorities, as well as lists of projects which the PA would like to see undertaken.

The PDP indicates PA preferences on how public investment should be divided between some major areas of spending (infrastructure 49 %, social programs incl. education 25 %, projects with direct connections to the private sector of which some normally would be called infrastructure investments 17 %, and institution building 9 %) and includes a long wish-list of projects for each area. The document is ambitious but it does not convey ideas about the sequencing of projects and the interdependencies between efforts in different areas.³⁷ Another serious criticism often levied at the plan is that it does not provide the cost-benefit analyses needed to compare and prioritize among projects.³⁸ Recurrent costs associated with certain investments are often ignored, making project comparisons unreliable and threatening the long-term viability of projects for budgetary reasons. Furthermore, the emphasis on public investment clouds the issue of how the political organization and (the absence of) democratic functions constrains the efficacy of public investment efforts.

Let us now take a quick look at what the PDP reveals about PA plans for dealing with the internal constraints outlined above. As for demographics, the PDP offers no plans

³⁷ An attempt at addressing this problem is the World Bank's Comprehensive Development Framework (CDF) which is currently being tested at the Ministry of Planning and International Cooperation (MOPIC). A central part of the CDF is a matrix which, for a number of sectors, identifies the key constraints on development, how those constraints are to be addressed, how progress in removing the constraints is to be measured, what is currently being done or planned to be done in terms of specific projects, and who is doing what.

³⁸ *The West Bank and Gaza Strip – Economic Developments in the Five Years since Oslo*. International Monetary Fund, 1999. p. 45.

or policies in favor of a reduction in population growth, which is likely to be a culturally sensitive issue as well as possibly a strategic one (due to its effects on the composition of the population in disputed territories such as the greater Jerusalem area). The only idea for dealing with the population pressure presented in the PDP, is to bring about improvements in the rural infrastructure for purposes of attracting a larger share of the population to the countryside.

The physical infrastructure, on the other hand, receives the main thrust of attention in the PDP. If the MOPIC would have its way, about 60 percent of Palestinian public investment would be devoted to infrastructure development over the next few years. The main areas of concern in the proposed infrastructure budget are sewerage and wastewater treatment (about 40 percent) and transportation (about 20 percent) – investments which clearly could have the kind of productivity-enhancing effects on private investment (e.g. in the tourism sector) discussed above.

Among the cultural barriers to development identified above, the PDP makes no attempt to address the issue of traditional family enterprises. As for the position of women, labor force participation rates and the limited high-level representation of women are acknowledged as problems. Efforts at empowering women are mentioned, but this possible project area is not among those listed as priorities. The MOPIC has, however, committed itself to the creation of a gender planning and development directorate within the ministry.

Some governance issues are addressed under the heading of “institution building”. It is, however, noted in the PDP that this area has received a much higher priority among donors than at MOPIC. For the period 1994-98, earlier PDPs and other Palestinian planning documents have proposed that 8,5 percent of available funds be devoted to institution building but 22,4 percent of donor disbursements (donor disbursements constitute almost all of the funds available for public investment) went to projects in that area.³⁹

The problem of lacking popular participation in planning and policy-making, which is a direct consequence of the high degree of power centralization in the WBGS, is only superficially acknowledged in the PDP. The document has a separate section on participation (p. 130) where public participation is discussed. This has, however, been limited to a set of workshops where senior Governorate officials and junior planning officers have been able to discuss priorities with MOPIC representatives. Although these individuals are positioned closer to affected communities than are the MOPIC representatives, they have no popular mandate and there are no indications that they have consulted with local government officials or the man on the street.

Reference in the PDP is made to the need to dismantle monopolies (p. 123) but the need to consolidate all public revenues and expenses into one official government budget is not considered in the plan. In response to heavy criticism on this point from the donor community, especially following the Rocard report mentioned earlier, special councils (involving key individuals in the PA government) have been assigned

³⁹ *Palestinian Development Plan 1999-2003*. Palestinian Authority. p. 106.

the task of figuring out how to implement such a consolidation in practice. This does not guarantee a speedy handling of this sensitive matter, however, considering that the PA already (in the Tripartite Action Plan of April 1995) pledged to have all fiscal revenues, expenditures, and external receipts centralized in one account controlled by the Ministry of Finance by January 31, 1996.⁴⁰

As for the legal system, it is given second priority within the category institutional capacity building, but the focus is entirely on reforms of the legal and regulatory framework and no mention is made of the fundamental need for raising the capacity of courts or the respect for court rulings. This is not for a lack of available thinking of these issues within the PA. The Ministry of Justice has issued a *Rule of Law Strategic Development Plan* issued by the Palestinian Ministry of Justice and an integration of the two plans would be useful.

To summarize, the PDP arguably emphasizes the role of the external constraints on Palestinian development and downplays the internal constraints, with the exception of the physical infrastructure. Other plans or policies for attracting private investment appear to be confined to tax incentives (associated with the Investment Encouragement Law) and reforms of the regulatory framework. Given the political background sketched above, it is easily understood that reforms associated with the rule of law can meet with strong resistance from within the PA. In many cases such resistance is the only barrier to immediate reform, since a number of legal and organizational reforms are already planned in detail with the help of donor-financed consultants.

8 Concluding remarks

The review of constraints on Palestinian economic development carried out in this report points to some considerations to make in the event of an end to the violent conflict that is raging between Palestinians and Israelis at the time of writing.

Aside from views that one might have about the need for implementation of Palestinian rights according to a number of UN resolutions, an agreement that ends the conflict must ensure a free flow of persons and goods between all areas under Palestinian control and between those areas and international markets, including Israel. The present Israeli border practices, amounting to non-implementation of the Paris protocol on economic relations, combines with poor Palestinian public governance to render the WBGS little more than a pool of labor for the Israeli market.

The problems with public governance need to be immediately tended to, in order to avoid the self-reinforcing tendencies of rent-seeking and corruption. The respect for civil and political rights, inherent in good governance, is strongly connected to the moral legitimacy of the leadership both in the eyes of its constituents and in the eyes of the international community. The constituents' willingness to pay taxes, to provide each other and the government with useful information and to otherwise act in support

⁴⁰ *Aid Effectiveness in the West Bank and Gaza*. The Secretariat of the Ad Hoc Liason Committee, 2000. p. 97.

of social institutions are at stake. So is the support of the international community which has considerable power with regard to the external constraints on Palestinian economic development and the power to withdraw some of the substantial financial aid currently given to the WBGS.

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