126323

PALESTINE: FROM DEPENDENT TO AUTONOMOUS GROWTH

Ishac Diwan and Michael Walton

Working Paper 9409

WORKING PAPER SERIES

ECONOMIC RESEARCH FORUM
FOR THE ARAB COUNTRIES, IRAN & TURKEY

PALESTINE: FROM DEPENDENT TO AUTONOMOUS GROWTH

Ishac Diwan and Michael Walton

Working Paper 9409

Please address correspondence to: Ishac Diwan, Senior Economist, MENA Region,
The World Bank, 1818 H Street NW, Washington D.C. 20433, U.S.A., Fax: (202) 477 7978.

Palestine: From Dependent to Autonomous Growth

Ishac Diwan and Michael Walton

The World Bank

March, 1994

We would like to thank -- without implicating -- Samir Abdallah, George Abed, Abdelfattah Abu-Shokr, Arie Arnon, Samir El-Khoury, Ephraim Kleinman, and Radwan Shaban for their comments, and Marc Stephens for research assistance. The paper draws in parts on *Developing the Occupied Territories, An Investment in Peace* World Bank, 1993, Volume 2. The views expressed here reflects solely those of the authors and not those of the World Bank or its Board of Directors.

Abstract

The paper explores the issues and choices thrown up by the current state of development in the occupied Palestinian territories and the economic agreements that could emerge from the on-going peace negotiations. The present economic crisis is related to the uneven pace and distorted nature of growth in the past and the sequence of adverse economic shocks of the 1980s. In the future, policies will be central to a reorientation in the pattern of development. The paper discusses the desirable components of a post-peace economic strategy that would lead to a more autonomous growth path.

ملخص

تحاول الورقة تحليل القضايا والإختيارات التى تطرحها التطورات الحالية فى الأراضى المحتلة والأتفاقيات الاقتصادية التى يمكن أن تتمخض عن مفاوضات السلام الجارية. وتستعرض الورقة أولاً التاريخ الأقتصادى للأراضى المحتلة وترجع الازمة الحالية إلى طبيعة النمو غير المتماثل وغير المتوازن وإلى تتابع الصدمات الأقتصادية غير المواتية فى خلال الثمانينات. وفى المستقبل ستكون السياسات هى محور أعادة توجيه نموذج التنمية. وتناقش الورقة مكونات الأستراتيجية الأقتصادية المطلوبة فى مرحلة ما بعد السلام.

The economies of the West Bank and Gaza are in a state of crisis. Economic difficulties started in the early 1980s and stagnation set in after 1987. Expectations of peace fueled a recovery in 1992, but this was followed by a severe crash in 1993. Open unemployment has increased sharply, underemployment is rampant, and poverty has risen dramatically. One fifth of the population of the West Bank, and one third of that of Gaza now live in poverty.[1] Many public services are in disarray: municipalities are starved of cash; power outages are frequent; public water supply is below WHO quality standards; and garbage rots on the streets in refugee camps in Gaza.[2]

In September 1993, the PLO and Israel signed the Declaration of Principles for the limited transfer of authority from the Israelis to the Palestinians in the Occupied Palestinian Territories (OPT) until a final settlement is reached between the two parties. At the time of writing, the mechanisms to make the Declaration operational, both on the security and economic fronts, were being negotiated. Economic agreements with Jordan and Egypt have already been signed, and talks are continuing with a view to reach specific agreements on trade and finance. But some key economic issues are clear. Future growth in incomes will have to be generated at home. Expansion of domestic production is needed to create jobs for the unemployed, make room for the Palestinians working or residing abroad, and increase the diversification and autonomy of the economy.

The major past sources of growth of the West Bank and Gaza--employment in Israel and in the Gulf -- have gone, in whole or part. But there are potentially major new opportunities. Compared to Eastern Europe, where reform started with an implosion of traditional markets, the West Bank and Gaza could enjoy a large expansion in trading opportunities. And unlike Russia, where donors finance amounts to a drop in the ocean, assistance to the Palestinians is likely to be large. In October 1993, donors pledged $2.4 billion for the reconstruction of the infrastructure in the West Bank and Gaza during the next 5 years, equivalent to some 15 percent of GDP per year of external transfers.

These potential opportunities could easily be squandered. Medium and long-run success will depend on structural policy choices and the building of new institutions. This paper attempts to analyze the issues and choices faced now, in the context of the structures that evolved during the Israeli occupation. Throughout, the focus is on economics rather than politics. Political events are, of course, crucial for the future, but, political progress can be undermined by economic failure.

---

[1] Agricultural Relief Committees Data-Base, 1993.

[2] See FAFO, 1993.

A. The Past: Asymmetric Integration and Stalled Growth

Past economic performance and current economic structures have been profoundly influenced by the 25 years of development under the Israeli occupation. The effects of a forced integration with a much larger neighbor with a vastly different economic structures had initially led to large gains from trade due to the large initial wage and price differentials. But as the adjustment process run its course, the economy was left unable to find new sources of growth.[3]

Some key features of economic performance are reported in Table 1. The table contrasts GDP growth over the two periods 1970-79 and 1980-87. In both the West Bank and Gaza, growth was remarkably high in the first period, but it fell sharply in the second period (to less than the rate of growth of the population). Gaza achieved a 1979 peak in income per person which, with the exception of 1987, it has never recaptured, and incomes in the West Bank stagnated in the 1980s (see also Figure 1).

The factors underlying the sharp fall in performance are clearly apparent when past growth is decomposed in three parts: one related to changes in the labor force, one to changes in capital stocks, and the remainder, which we attribute to changes in the productivity of labor and capital.[4] The results reveal three striking facets of the pattern of past growth.

o The labor force shrunk during the whole period; as a result labor contribution to the growth of domestic production was negative.

o In contrast, there has been terrific growth in capital. In fact savings and investment rates have traditionally rivalled those of East Asia at 30 percent of GDP in the West Bank and 40 percent in Gaza. As a result, the contribution of investment to the growth of GDP has been substantial; by the second period, it was the only source of growth left.

o Total productivity gains (TFP) explain two thirds of the growth performance in the first period; but in the second period, their contribution is negligible in the West Bank, and negative in Gaza.

---

[3] Writing in the mid-1970s, Van Arkadie (1977) notes the fall in momentum. He argues that the initial spur in growth was part of an adjustment process that has run its course, and predicts that strong growth would not be sustained for much longer. See also Abdallah's (1993) decomposition of the stages of growth.

[4] The growth arithmetic requires the knowledge of the aggregate production functions over each of the two periods. These functions where estimated econometrically using investment, labor force, and production data from CBS.

Table 1: Growth in GDP, Factors and Total Factor Productivity (in percent per annum)				
	West Bank		Gaza	
	1970-79	1980-87	1970-79	1980-87
Annual growth:				
GDP	8.54	3.56	6.27	1.57
Capital a/	8.87	7.95	6.07	6.09
Labor	-0.63	-0.95	-0.74	-0.45
Contribution to GDP growth of:				
Capital	3.55	3.18	2.43	2.44
Labor	-0.38	-0.57	-0.44	0.27
TFP b/	5.37	0.95	4.29	-0.60
TFP as a percent of growth in GDP	63	27	69	-38

a/ Based on a series constructed from national accounts statistics on investment.
b/ Total factor productivity (TFP) is the residual of the growth accounting equation, assuming a 40 percent capital share.

Sources: Central Bureau of Statistics, and Authors computations.

This pattern of growth was the result of the environment in which the Palestinian economy evolved. There were heavy constraints on domestic growth: production and export were both repressed. This led to a drive to export labor, which was met initially with rising opportunities. Four aspects of this process are of direct relevance to the future: unbalanced international economic relations; regulatory repression of economic activity; fiscal compression and the absence of useful regulation; and a declining natural resource base.

Distorted integration and economic repression. The West Bank and Gaza have been highly economically integrated within the Region, but in a highly distorted fashion. Palestinians have (often) been able to sell manual labor abroad, but not commodities. As a result, past economic development was mainly characterized by the specialization of Palestinian labor in two external activities: manual work in Israel; and skilled work in the Gulf. For roughly the first half of the period of occupation, incomes and wages grew very fast[5]. The number of Palestinians working in Israel rose from zero to about 75,000 in 1979 and 110,000 by 1987, accounting for 35 percent of the employed population in the West Bank, 45 percent in Gaza, (and all of the growth in Palestinian employment), and 7 percent of total employment in Israel (a share that has been fairly stable after the mid-1970s).[6] A roughly equal number also emigrated to work abroad. The oil price rises of the 1970s caused this source of demand to falter, but fueled a surge in demand for skilled labor in the Gulf. Palestinians working in the Gulf earned considerably higher wages. But from the 1980s the picture changes. By the early 1980s both Israeli and Gulf demand for Palestinian labor stabilized and ceased to be a source of buoyancy. The *Intifada* was an additional factor after 1987, through the effects of strikes, a reduction in non-construction sector Israeli demand and some tightening of economic controls. But this only sharpened a problem that had already set in from the early 1980s.

At the same time, domestic production has become increasingly restricted on both the supply and demand sides. Opportunities to invest in domestic production of goods have been restricted by an extensive framework of regulations that limited investment in activities competing with Israeli producers. In the 1970s growth was driven by expansion of capital and productivity growth--the latter representing a mixture of technological catchup and the gains from reallocation of labor from lower to higher productivity activities (primarily moving from agriculture to services[7]). In the 1980s overall productivity fell. Throughout, the bulk of capital investment went into housing, and very little into machines, a consequence of the regulatory repression, especially after Likud came to power in 1977, lack of financial intermediation, and political uncertainty.[8] In 1992, 21 percent of West Bank income and 29 percent of Gaza's income came from work in Israel; only 5-7 percent came from domestic manufacturing.[9]

There are two particularly striking aspects of the pattern of Palestinian commodity trade: its orientation toward Israel (90 percent of imports and 70 plus percent of exports) and its unusual concentration in industrial products, especially subcontracting, given the OPT's income level. The

---

[5] Income growth, being mostly labor intensive, was also broad based and inequality decreased during this period. See Abu-Shokr, 1990.

[6] For good reviews of labor relations, see Abu-Shokr, 1987, Shaban, 1992, and Kleinman 1992.

[7] For a comparison with the sources of growth in the 1940s, see Metzer, 1992.

[8] Arnon and Gottlieb, 1992.

[9] A good review of industrial performance is in Abu-Shokr, Abdallah, and Alawneh, 1992.

dependence of trade with Israel was a function of both trade diversion and trade creation. Trade diversion occurred from Jordan and Egypt through the imposition of a customs union in 1967: imports of manufactured goods from all countries except Israel became subject to a more than fourfold increase in duties in that year. With workers remittances boosting incomes, imports from Israel boomed but exports remained compressed by a web of military regulations, including a ban on exports of competing agricultural goods to the Israeli market. There is also asymmetry with the Arab World. Many Palestinian households receive remittances from the Gulf, have benefited from transfers from Arab bodies, have bank accounts in Amman and (in the West Bank) hold their savings in Jordanian Dinar. But, because of the Arab boycott on Israel, Palestinian firms and farmers found it even harder to export to Arab markets, and Israel came to dominate other countries as a market for (small) West Bank and Gaza exports.

As a consequence of this pattern, the external trade deficit has been immense, at 26 percent of GNP in the 1985-87 period, and the bulk of it with Israel. This trade deficit has, however, been almost entirely financed by labor remittances and the current account has been generally in a small surplus until the early 1990s. And there is, of course, no official debt.[10]

Fiscal compression and public services. Parallel to the pattern of asymmetric integration in the region and regulatory repression at home was a pattern of under-provision of public goods. The level of provision of government services is substantially below that in economies of a comparable income level. Provision of water, sanitation, roads and electric power are all below par in quality and/or quantity.[11]

Public provision of services has been broadly limited to available revenues: to taxes and fees collected by, or assigned to, the Civil Administration and municipalities for government activities; and, at most, to retained earnings for the public utilities that are owned by the municipalities. Deficits have been negligible in recent years (though they appear to have been higher in the 1970s). Low revenues and the inability to borrow have been the primary reason for the low levels of service provision. Both revenues and spending by the Civil Administration and the municipalities are unusually low by international standards, at about 16 percent of GDP or a mere 12 percent of GNP in the 1987-91 period, despite high statutory income tax rates (significantly higher than in Israel).[12] These levels are of the order of half those of comparable economies, and a quarter those prevailing in Israel. There are, however, two

---

[10] For a detailed presentation of the external accounts, see Zakai.

[11] Abed (1988), FAFO, 1993.

[12] Alawneh, 1992.

major adjustments that have be made to revenue and spending levels by the Civil Administration and the municipalities: spending by non-governmental agencies; and fiscal relations with Israel.

Other agencies, both official and private, have responded to fill the gaps left by the weak governmental effort. Foremost amongst these is the United Nations Relief and Works Agency (UNRWA), which provides basic services to the approximately 40 percent of West Bank and 60 percent of Gaza residents that have refugee status. UNRWA has spent US$100 million annually in the recent past, equivalent to 4.5 percent of GDP, of which 85 percent went on education and health. Jordanian aid amounted to an estimated $50 million per annum until 1988, dropping to $15 million thereafter. PLO expenditures must have been at least as large until they collapsed in 1990, but their magnitude is not well known.[13] Aid by other Arab governments and non-government agencies, UNDP, EC and a large number of non-Arab NGOs, also provided resources or services.

More controversial are the fiscal transfers between the Occupied Territories and Israel. Palestinians pay some taxes that accrue to the Israeli treasury, and Israel provides services. Until 1993, there was no available statistics on these transfers. Taxes passed to Israel include the Value Added Tax (VAT), customs revenues, fuel taxes and purchase taxes. On reasonably conservative estimates of the base and of rates, these amounted to some $150 in 1991, equivalent to 8 percent of GDP.[14] Palestinian consumption of Israeli services is difficult to assess. Outlays on subsidized goods and the use of public hospitals, in which there is a direct fiscal outlay that would not have otherwise occurred amount to some $25 million, or 1.2 percent of GDP. In addition, some direct capital spending comes from the Israeli budget estimated at 0.8 percent of GDP. Thus, the Israeli non-security contribution is estimated at 2 percent of GDP. The net effect of this relationship is therefore a leakage of Palestinian taxes accruing to the Israeli Treasury estimated at about 6 percent of the occupied territories' GDP in 1991.

The overall picture is of significantly higher revenues paid by Palestinians, at 22 percent of GDP, and higher spending at about 24 percent of GDP. Adjusted revenues are comparable with other Arab and other middle income countries (though lower than Israel's 39 percent, see Table 2). Spending is lower

---

[13] See Abed, 1992 for estimates.

[14] See World Bank, 1993. This can be considered an under-estimate since as it does not include income tax paid by Palestinians working in Israel or any indirect costs, such as the price-raising effects of tariff protection on Israeli production. By contrast, income tax paid by workers that commute to work abroad is often shared between the countries of residence and of work. And in the Southern African Customs the sharing formula for customs revenues between the Republic of South Africa and the other countries of the union (including Lesotho and Swaziland) *does* include adjustments for indirect costs.

than international norms (and especially if the appropriate base is GNP rather than GDP), because of the absence of normal deficit finance. The radical shortfall, by international standards, is in development (i.e., investment-related) spending. The 3.5 percent of GDP allocated to this item in the OPT is a small fraction of the spending levels in the other economies at this level of development.[15]

Table 2: Revenue and Expenditure Comparisons: Egypt, Israel, Jordan, the Occupied Territories and Developing Countries

Average: 1987-91

	Egypt [a/]	Israel [a/]	Jordan [a/]	OPT [a/]	Developing Countries[b/]
(In percent of GDP)					
Revenue	23.1	38.6	27.2	21.7	22.1
Tax revenue	15.2	33.9	14.3	16.1	17.5
Direct taxes	5.7	17.5	3.4	4.2	5.4
Indirect taxes	9.5	16.4	10.9	11.9	12.1
Nontax revenue	7.9	4.7	12.9	5.6	4.6
Expenditure	42.2	50.2	46.4		28.0
Current expenditure	28.9	45.7	37.2		21.0
Development expenditure	13.3	4.5	9.2		7.0
Expenditure excluding defense	37.2	36.8	30.5	23.6	25.6
Current expenditure excluding defense	23.9	32.3	21.3	20.1	18.6
Development expenditure	13.3	4.5	9.2	3.5	7.0

a/ Refers to integrated public sector including the Civil Administration, UNRWA and the major NGOs providing social services.
b/ For the larger sample the information is limited to the central government
Sources. World Development Reports, various issues; Statistical Abstract of Israel, various issues; World Bank,1993.

Availability of natural resources. A further constraint which has influenced the pattern of

[15] Recently however, and to counteract the effects of the borders closure, the Civil Administration increased its investment program by about 50 percent during 1993.

development is the stagnation or shrinking of the land and water resource base in the face of a large population increase over the past 25 years. Much has been written on the subject.[16] Annually renewable groundwater resources in the West Bank and Gaza amount to about 750 million cubic meters, while annual use by the Palestinians has remained capped at about 200 million cubic meters--the pre-1973 level. Current restrictions on access to water, including administrative limitations on surface water harvesting, and the high costs of water caused by difficulties to renew inefficient and worn-out wells have meant a modest expansion of the irrigated area under Palestinian cultivation. In selected areas, notably in some areas in Gaza, increasing salinity levels in wells caused by excessive extraction have virtually halted agricultural production. Loss of land to settlements and military use and land-use that restricts the development of towns have increased during 1980s and early 1990s.[17] Access of Palestinian sheep and goat farmers to military land and land declared nature reserve has been restricted. While the area cultivated by Israeli settlers in the West Bank is unknown, in Gaza settlers occupy about 10 percent of the cultivated area. Security-related restrictions affecting the fishing areas in which Gaza fishermen can operate (recently increased from 12 to 20 miles) have been limiting fish production to a fraction of the pre-1967 levels.

Effects of recent shocks. The unbalanced nature of past economic development left the Palestinian economy highly vulnerable to the external economic shocks that have buffeted the economies of the West Bank and Gaza over the past several years. Israeli hyper-inflation was completely imported in the mid-1980s. West bank residents could, and did, shift into Jordanian Dinar, but were then hit by the unexpected Jordanian devaluation. Also in 1988 the Jordanian government stopped supplementing the salaries of civil servants (something it had continued to do since 1967). The Gulf war had a drastic impact: temporarily leading to border closure with Israel, and permanently leading to a loss of Palestinian employment in the Gulf, and especially in Kuwait. It also hastened the financial squeeze on the PLO, that in turn led to reduced grant flows into the West Bank and Gaza.[18]

The economies would have crashed much more severely if it weren't for two special factors. First, the arrival of about 400,000 immigrants (mostly from Russia) into Israel during 1990-92 caused a construction boom, and increased demand for Palestinian workers in this sector. Second, many

---

[16] See for example Benvenisti and Khayat, 1988.

[17] For a recent case study of the politics of land in the Jerusalem area, see for example Cohen, 1993.

[18] For a detailed account, see UNCTAD, various issues.

Palestinian households had built sizeable cushions of savings, especially from Gulf income. After the Gulf war much of this was brought back. Indeed, in the wake of expectations of peace in 1992 there was a construction boom, especially in Gaza, that was central to the economic recovery that year (the West Bank was also helped by a bumper year in the biannual olive cycle).

By 1993 these factors had largely gone. Following three years with intermittent disruptions caused by curfews and borders closure,[19] the number of permits issued for work is Israel was sharply reduced in March 1993. There were short-run security and political reasons for this, but it also marked a turning point in the demand for Palestinian labor in Israel as the Israeli construction boom faded and the new immigrants replaced Palestinian workers in industry and services. The number of workers with jobs in Israel collapsed by mid-1993 before partially recovering to 75,000.[20] This had a large impact on domestic labor markets. Wages have fallen sharply in both the West Bank and Gaza since 1991 (Figure 1), and unemployment has risen, especially in Gaza.[21] Households are now more economically insecure than in some 15 years, especially in Gaza which was hit hardest.[22] The West Bank and Gaza are beginning the next phase of the peace process in a highly fragile economic state.

B. Post-Peace Economic Strategy

The shocks of recent past--from the Gulf to Israel--add up to a large and permanent adverse change in the old, external sources of income growth. Future income growth will have to depend on an expansion of production based in domestic centers of economic activity. There is also an urgent short-run

---

[19] After the curfews of end-1990 related to the Gulf war and the border closure in the first quarter of 1991 (which lasted about 5 weeks), the number of Palestinians working in Israel started to increase again in the second quarter, and remained high during all of 1992. A series of closures and curfews in 1992 affected mostly Gaza (in May and December 1993). The border was closed completely for 46 working days in March and April 1993.

[20] In late 1993, the numbers of permits issued was about 55,000, but CBS estimates that a larger number of workers commuted for work in Israel, with most undocumented workers coming from he West Bank.

[21] Palestinian economists and Israeli statistics differ markedly on the measurement of unemployment. The former place the figure at around 30 percent (Abu-Shokr, 1993), while the latter's estimate is around 15 percent for 1993.

[22] There seem to be three main reasons: Gaza is poorer to start with, more of its work-force commutes to work in Israel, and it proportionally lost more jobs because the permit system is easier to enforce in Gaza than in the West Bank.

need to offset the fall in labor demand, to prevent the economy falling into a vicious cycle of falling income and rising social unrest, that would only heighten the large risk of continued violence. In addition, the creation of jobs at home is a goal in itself in the current historical circumstances, since this would allow to attract back Palestinian labor from Israel, make room for Palestinians now abroad, and increase the diversification and autonomy of the Palestinian economy.

Expansion of domestic production requires the reorientation of economic activity and investment, especially private investment. Both politics and economics will determine the outcome. Significant private investment will only occur if both the strategic uncertainty is resolved by a believable political settlement,[23] and if economic conditions are good. The peace process could bring three areas of economic gains: the potential for expanded international trading opportunities; increased autonomy of domestic economic policy; and (for a few years, at least) inflows of official money. However, these opportunities could easily be squandered; in particular there is plenty of experience showing that money alone cannot bring about economic takeoff, and can even subvert sound long-term development.

Palestinian economic policymakers face significant tensions in policy choices. Should markets in Israel be preserved or trade be reoriented to the Arab world? How far should government play a leading role in promoting industry and kickstarting the economy? How can they get through the first years of depressed labor demand? And what is the best use of the foreign capital windfall? These tensions become more marked when the interests of Israel and Jordan are brought into play.

International economic relations. Central to the overall stance of the Palestinians will be international economic relations--on goods, labor and capital. Past development has been characterized by asymmetric integration within the region. If Palestinian wages and employment are to grow, trade in goods will have to substitute for exports of labor. Increasing economic autonomy and self-sustaining development in the West Bank and Gaza means diversifying trading patterns and relations, shifting from dependence on a few external sources of growth, that are now in decline, to a broader interdependence with other parts of the region and the world. The West Bank and Gaza have potentially large advantages in their geographic location and intermediary position in the Middle East. Turning inward behind trade barriers is a non-starter for a small, open economy.[24] The choices range from remaining predominantly linked to Israel in trading terms to severing links to Israel and turning elsewhere. An assessment of the

---

[23] That development cannot takes place in the absence of a political settlement is an old argument which has important current implications. See Sayigh, 1988.

[24] On this subjec, see Abed, 1990.

options suggests that all have costs and benefits, and that some may not be politically feasible in the short term. However, it is likely that extreme options have high costs and that some form of intermediate position will be both preferable and feasible. Even if the loss of substantial labor access to Israel is permanent, it makes sense to maintain trade access to largest market and if possible to expand this to agricultural goods. At the same time diversification requires opening the West Bank and Gaza both to the region, and especially Jordan, and to the rest of the world, especially Europe.

For the Palestinians, the best economic outcome would probably be a free trade area with Israel linked with a significant opening of trade to Jordan and the rest of the Arab world. A free trade area with Israel would differ from the present (partial) customs union in allowing the West Bank and Gaza to have different tariffs from Israel with third countries. It would preferably also involve a level playing field with Israeli producers e.g. with respect to subsidies, especially in agriculture. Such an approach would maintain access to the Israeli market (where 70 percent of Palestinians exports go now) but could avoid protectionist aspects of Israel's trade regime that are ill-suited to the economic structure of the economy of the West Bank and Gaza. Opening to the rest of the world could either be through participation in Israel's free trade agreements, or through separate arrangements[25] and the maintenance of a high degree of openness overall. This would be consistent with an opening up of trade with Jordan, including the possibility of a free trade area with Jordan.

While a three-way free trade area is attractive in principle, there are likely to be problems in practice. First, there is the border issue. There is no agreement on the location of a border between the West Bank and Israel--especially in the early part of the transition. Any custom border will be leaky, and while an "invisible" border based on company accounts is feasible in principle, it may be costly to implement. Leakiness is likely to be of concern to Israel on grounds of lost revenue and lost protection, if the West Bank and Gaza were to have lower tax rates. Second, the three economies are likely to be concerned about competition for their industries: Jordan fears Israeli competition for some of its more inefficient capital intensive industries; Israel is wary of Palestinian and Jordanian competition in labor-intensive areas such as garments and agriculture; and the OPT may not be competitive in agriculture and labor intensive industries compared to Jordan where wages are much lower. These create tensions for a three way trading structure.

Some of these difficulties apply primarily to an interim period. In the longer term, a border will presumably be agreed. Israel is in the middle of a multi-year program of liberalization of its economy--so

---

[25] As already exists with the European Union.

it will face competition for its labor-intensive sectors in any case. More important will be concerns over revenue losses should the West Bank and Gaza have a significantly lower VAT, in view of the importance of this tax instrument, and Israel is likely to want closer harmonization of VAT rates than customs tariffs over the medium term. Jordan too faces the need to effect a major restructuring of the economy, and is also in process of unilateral liberalization to the rest of the world. And the fiscal systems in the three economies are converging now that Jordan is instituting a consumption tax. However, in the interim, conflicts in economic objectives will remain. These will require transitional solutions and hybrid arrangements, some of which are now on the table. This may include Israel tolerating the possibility of moderately different Palestinians tariffs and taxes, and of asymmetry in trading relations with Jordan.

The role of government (i): spending and taxing. In the past the Palestinian economy has had both too much and too little government. Too little is clearly the case in the field of provision of infrastructure. Expansion in publicly goods is require both to support growth and social welfare: in power, in water supply and sewerage, in industrial land and in education. This will require the rehabilitation and expansion of investments and the establishment of the sectoral institutions (most sectors now have some combination of weak public institutions and a multiplicity of non-government bodies). In the short run, action on economic infrastructure will play a vital role in removing constraints or costs to business expansion, e.g., in developing industrial land and in expanding the provision of electric power, roads and water. This will require policy changes in some areas (e.g., on land allocation decisions) and also a crash investment program.

There are also costs related to new expenditures, in particular, police and security which can amount to at least 5 percent of GDP. Security and the rule of law is of course a necessary condition for any economic activity, and in the early part of the transition, this is likely to be the main concern of the leadership.

In the medium to longer term, *both* economic infrastructure and social development are central in maintaining the historical comparative advantages of Palestinians (in skills and entrepreneurship) and in supporting the steady reorientation of comparative advantage in favor of greater interdependence. There is a parallel between infrastructure and trade. The West Bank and Gaza economies can potentially exploit their geographic and, to some extent, political position in between Israel and the major Arab states. For some infrastructure sectors (notably regional transport and electric power) the rational economic strategy would be to exploit this intermediary location, for example linking into power networks in Jordan and Egypt, in addition to Israel, as well as taking advantage of some peaking capacity within the West Bank. This would also tend to increase the degree of mutual interdependence amongst economies, which would increase the security of the West Bank and Gaza.

For social services, Palestinians are probably still ahead in skills within the Arab world, though this advantage has been eroded by large brain-drain.[26] A sensible education strategy is likely to require improving quality and a swift modernization of curricula at all levels. The tertiary education system has been heavily oriented toward the academic subjects and the professions. A substantial reorientation is likely to be needed to support growth in skilled employment.[27]

More public spending implies more finance. Does it mean more taxes? Some of the taxes paid by the Palestinians currently accrue to the Israeli treasury. These need to be explicitly recognized as part of the domestic tax effort and an agreement would have to be reached with Israel on how the Palestinian budget would capture these taxes. If a customs border is established between the West Bank and Gaza and Israel, then the "destination principle" could be applied to trade between the two, and the revenues would automatically accrue to the budgets of the taxpayers. If a customs border cannot be maintained, then agreement would need be reached between the two parties on how to compensate for any tax leakage either based on company accounts or estimation of trade flows.[28]

As seen above, even if all taxes paid by Palestinians are included, the West Bank and Gaza do not appear to be overly taxed. The substantially lower indirect tax/GDP ratio compared with Israel, despite the general closeness of the tax structures, is partly due to the non-application of taxes to agricultural production (that is less important in Israel), but also suggests that tax evasion might be a problem facing the OPT at the present time. There appears to be a large underground economy that goes untaxed, and a major need for the emerging self-governing entity will be to widen the tax base--hardly the most popular enterprise for the new regime. This is a big challenge given the limited experience in tax administration and collection (now undertaken by the Israeli-led Civil Administration). Another avenue for strengthening the revenue effort is through boosting non-tax revenues (fees, charges, etc.) by instituting cost recovery mechanisms for covering the operations and maintenance costs and debt servicing associated with the new public sector investments.

---

[26] In the wake of the crash in Gulf demand, relatively more skilled workers have returned to the OPT. As a result, wage differentials between skilled and unskilled jobs have collapsed in the past few years. See Abed, 1992, and Angrist, 1992.

[27] See Abed, 1990, and more recently, Zahlan, 1993 for specific proposals.

[28] It should be noted, however, that the availability of such revenues to the new self-governing entity is contingent on the entity having a trade deficit with Israel. If this is not the case, then alternative revenue sources would need to be mobilized.

The role of government (ii): regulating for private sector growth. Private entrepreneurship -- an important Palestinian asset -- has a crucial role to play in moving the economy into a more autonomous growth path. A combination of too much and too little public action is clearly also true from the perspective of the private sector: government activity has been active in controlling and restricting private production, but has been weak in providing the legal, financial and institutional infrastructure for private activities. All the international experience suggests government direction of economic activity would be costly and counterproductive. But there is an important role for a stronger, not weaker government, in support of private investment.

The kinds of policies that can be changed to improve the business environment can be usefully divided into two: lifting regulatory burdens and building institutions. Lifting regulatory burdens can often be undertaken swiftly. The Civil Administration has taken some action through a streamlined approval of investment permits, dropping the *de facto* difficulties in getting approval for industrial activities that compete with Israeli firms and providing tax incentives for investment.[29] Considerable uncertainty remains, and a new self-governing authority would need to take further steps to solidify these initial moves.

Building institutions, by contrast, takes time. In particular, the legal and regulatory systems that are so important protecting private activity and enforcing contracts need to be carefully fostered. Absence of financial services will also be a short-run constraint on activity. Some checking services are already being provided with apparent efficiency by money lenders,[30] and almost everywhere in the world, equity is the primary source of finance for expansion. However, a sound banking system is of great importance to future development, to support the mobilization of household deposits and provide working capital and other financial services to an expanding business community. This will require decisions over entry, banking regulations and supervision. In the absence of an established monetary Palestinian authority, both the Israeli and Jordanian central banks have a role to play in the initial period of self-governance.

A development bank is already on the agenda. There is a case for some support for long-term credit, and some donors have pledged large amounts of loans to support private sector growth (about $500 million). But it is essential that this supply remains at the wholesale end -- as a resource that private banks can draw on. Retail development banks have characteristically become disasters--and over the long run have worsened, not improved the availability of long-term finance for sound investors.

---

[29] The supply response has been moderate, see Alawneh, 1992, for an analysis.

[30] A recent review of this sector is in Hazboun, 1993.

Should economic policy go further and promote (i.e. subsidize or protect) specific industries? A quick glance at East Asian success might seem to support such an option. This is likely to be a mistake. Industrial policy appears not to have been necessary for East Asian success, while high investment, good macro policy, export push and nurturing of financial systems were. Moreover attempts to replicate industrial policies in less propitious political economic conditions have tended to promote inefficiency and not growth. Devoting scarce fiscal resources to expanding public goods is a strategy with a much higher probability of payoff in growth of private production.

Macroeconomic policy and money. Should the Palestinians be developing an independent macroeconomic policy? This is tied up with the question of a Palestinian currency. Some macroeconomic policy action requires an independent currency and monetary policy, e.g., facilitating real wage declines and perhaps, exceptionally, defaulting. There are, however, advantages and disadvantages associated with a separate currency. It provides additional discretion in some areas of policy, but is only likely to be effective once both the currency and overall macroeconomic policy acquire credibility. In some areas independent policy is desirable and is commonly associated with a separate currency, but such a link is by no means necessary, e.g., managing "excessive" capital inflows, borrowing at home and abroad, and supervising/providing liquidity to banks. All of these can be managed by other instruments or without an independent currency. As a source of revenue, seignorage (i.e, the ability of a government to print money) is traditionally large in the region, but is unlikely to be so for the West Bank and Gaza (especially initially), because of the likely initial low level of credibility of a new currency, and high capital mobility.

The potential for high capital inflows by Palestinian investors is in fact the main reason why macroeconomic stability is so important. In the early period, stability will in fact be strengthened by the absence of an independent monetary policy. The most precious commodity of macroeconomic management is credibility, something that is hard to earn and that requires a track record of prudent macroeconomic management. The West Bank and Gaza do not have such a history, and new institutions of macroeconomic management are likely to be both fragile and under pressure. Public spending is likely to be under great pressure to expand (notably for public employment), to avoid tough tax administration issues and, at least for a while, may face a soft budget constraint due to external capital inflows. If a system with an independent currency is chosen, it would be desirable to start with a relatively restricted version, as in a Currency Board.[31] This could gradually evolve to a fully fledged currency that brought

---

[31] This would allow for some limited seignorage revenues but would not allow for an independent monetary policy.

greater discretion once discipline, and the associated demand for the currency, was well established.[32]

Labor demand and poverty in the transition. Employment and wages will be the primary determinant of the extent and depth of poverty. There are well-developed mechanisms for protecting vulnerable groups via extended family and community networks and the activities of UNRWA. However, these are least well-equipped with widespread declines in labor demand, because the effects of declining labor incomes are so pervasive. The management of labor demand will be central to the reduction in poverty in the short to long run, and to providing jobs for Palestinians now working in Israel or living abroad.

A labor-demanding strategy is likely to require three parts. First, there is a happy coincidence between the urgent needs for rehabilitation and expansion of social and economic infrastructure, the availability of external finance and short-term jobs in the public sector.

Second, in the medium to long-term, permanent jobs must flow from the reorientation of production, that should, amongst other things, substitute expanded trade in goods for export of labor. The strategy of reorienting international relations, regulating for private growth, and expansion of public goods outlined above are the necessary ingredients for this.

Third, it is probable that the first two components will still leave a significant gap in high unemployment and underemployment. This matters most for unskilled labor, since unskilled workers are disproportionately in poor households with the weakest alternative coping mechanisms. The best way of reaching this group is via low-wage public works, preferably, but not necessarily, in productive activities. Low wages are important to reach the largest number of poorest households, and to avoid pushing up wages for permanent productive activities. The Civil Administration started such a scheme after the border closure of 1993 --that is still in high demand in Gaza (the scheme employs between 10,000 and 19,000 workers), but stopped apparently for lack of demand in the West Bank. The stigma of association with the Civil Administration should not lead to stopping a program that is an effective way of getting cash to the poor.

But such a transitory policy is to be sharply distinguished from permanent public employment. There will be a need to build up the Palestinian administration, but this needs to be carefully controlled to avoid future fiscal and public pay problems--this could be a tough area in view of both the slack market for skilled Palestinians and the pool of PLO quasi-public official now living abroad.

---

[32] The introduction of a currency would be an issue of concern for Israel and especially Jordan, given the substantial holdings of Shekels and Jordanian Dinars by Palestinians. The phasing and terms of any such large-scale conversion would have to be worked in the context of any currency reform.

Managing external transfers. Transfers from abroad have been important in the past, but tended to dry up when needed most--since the late 1980s. There is now some potential for a surge in official transfers at a genuine time of need. The signing of the Declaration was followed by a donors meeting where $2.4 billion was pledged by various bilateral and multilateral groups for the purpose of emergency relief and economic development in the OPT. And Palestinian wealth and talent abroad are substantial, and could contribute in important ways to domestic activity if the security, policy, and regulatory frameworks are supportive.

The financing available now represent however both a one-time-option that should not be misused, and a potential danger if the economy does not remain flexible enough to adjust to its future reduction. The danger is that of a failure, on the part of the new self-government, the international community or Israel, to put in place the policy and structural conditions that would sustain rapid growth and attract private capital over the medium term. There are many ways in which this could occur. There could be inadequate resolution of the supply-side constraints on growth, whether in the form of the legal framework for private sector activity or tackling the infrastructural bottlenecks. Trading opportunities might remain restricted, whether due to failures to improve access in the Arab world, the OECD or Israel, or to an attempt to spur industrialization through high protection by a Palestinian governmental entity. Public savings could stall, owing to failures in revenue mobilization or excessive current spending rises, and there could be public investment in inefficient and unproductive activities.

Foreign assistance-led-growth also creates its own source of vulnerability. Other countries in the world, and many in the Middle East, have experienced booms that ended up in busts. When booms are generated by foreign inflows, a reduction of such flows can play havoc with the domestic financial system, as well as with the social and economic well-being when the system in place is not flexible enough to adjust to a fall in foreign resources. Flexibility has many facets, such as the issues of the public wage structure, the role of the NGOs during the transition, the tax collection effort during the transition, extent of the welfare function of the state (the issue of entitlement) and of its industrial policy (the sustainability of new industries), the effect of the inevitable rise in the prices on non-tradable (on competitiveness, and also on the implications for the needed safeguards in the banking system). On all these front, it would be crucial for the new government to attempt to put in place early on some mechanisms to avoid the dangers of excessive aid dependency.[33] A key principle is that foreign official inflows should complement, not substitute for, the domestic tax effort. Unless there is progress on the domestic front to mobilize resources

---

[33] On this, see Dakkak, 1992.

for development, the provision of external finance in the interim could set the West Bank and Gaza in a path of external dependency (and vulnerability to debt crises) and not of sustainable development.

The issue of the returnees. Large numbers of Palestinians from the West Bank and Gaza now live abroad. Some have maintained residence rights and are, in principle, free to return (some 13 thousand returned in 1990 and 1991, net of outflows), while the return of others will be subject to the bilateral negotiations between Israel and the PLO. It is nevertheless of interest to ask what the impact would be on growth and the labor market if there were to be a substantial return migration in the future. Whether this leads to unemployment and labor market problems or a spur to growth depends crucially on whether increased labor is accompanied by productive capital, sound domestic policies and market opening abroad. Unlike workers who lose jobs in Israel, returnees have demands for social services and other public goods.[34] Success here depends on complementary action with respect to public capital investment (and adequate progress on public institutional capabilities). To avoid labor market adjustment problems, there is a case for attracting back relatively unskilled Palestinians only as the economy recovers and takes off.

Conclusions

Past economic growth in the West Bank and Gaza was driven by demand for Palestinian labor in outside centers of activity, in Israel and the Gulf. These sources of growth are gone, or are going. As a consequence, most Palestinian households are entering the interim period in a more economically insecure state than for very many years. Peace can open opportunities: of trade, of more independent public action, and of more foreign money. These opportunities could be used to reorient the economy toward new, domestic sources of growth or could be squandered. Choices over economic strategy are likely to make the difference. Five areas matter: maximizing trade linkages; providing the environment for private investment; building institutions--from the health ministry to a private banking system; providing a safety net during what could be a tough transition, especially via temporary public financed employment; and managing aid to foster autonomy rather than create dependency, not least by expanding the domestic tax base. Some of these will require facing internal conflicts, while others involve negotiations with Israel and Jordan. It is likely that action in all of these areas will be necessary to shift the economy onto a path of autonomous development.

---

[34] For example, Sayigh (1993) estimates that about $3.6 billion would be needed to house 500,000 returnees. This represents about twice GDP and 1.5 times the external assistance available for the next five years.

References

Abed, Georges, editor. The Palestinian Economy: Studies in development Under Prolonged Occupation. Routledge, 1988.

------------, The Economic Viability of a Palestinian State, IPS Papers, Institute for Palestine Studies, 1990, Washington D.C.

------------, The Effect of the Gulf Crisis, 1992, Journal of Palestine Studies [get exact reference]

Abdallah, Samir. Economic Growth in the Occupied Territories, 1993, ESCWA (in Arabic).

Abu Shokor, Abdelfattah, "Income Distribution and Its Social Impact in the Occupied Territories" in Abu Jaber, K., Buhbe, M., and Smadi, M. (eds.), *Income Distribution in Jordan*, Westview Special Studies on the Middle East (1990).

--------------, The problem of unemployment in the Occupied Territories, October 1993, ESCWA (in Arabic).

--------------, The Labor Market in the West Bank and Gaza, 1987, University of Al-Najah (in Arabic).

--------------, The social and economic conditions of the Palestinian workers in Israel. 1987. Al-Najah University (in Arabic).

Abu-Shokr, A., S. Abdallah, and A. Alawneh. Industry in the West Bank, Al-Najah University, 1992 (in Arabic).

Alawneh, A. Between the encouragement of investment and security requirements: an analysis of military order 1342. Al-Ufoq institute for studies, 1992 (in Arabic).

----------, The structure of taxation in the Occupied Palestinian Territories. Open University of Jerusalem, 1992 (in Arabic).

Arnon, A. and D. Gottlieb , 1992. An Economic Analysis of the Palestinian Economy. The West Bank and Gaza, 1968-1990. Central Bank of Israel.

Agricultural Relief Committees, Agricultural Data Base, December 1993.

Angrist, Joshua D., *Wages and Employment in the West Bank and the Gaza Strip: 1981-1990*, The Maurice Falk Institute for Economic Research in Israel, Discussion Paper No. 92.02, Jerusalem, 1992

Benvenisti, M. and S. Khayat, The West Bank and Gaza Atlas, West Bank Data base Project, 1988, Jerusalem.

Central Bureau of Statistics, *Judea, Samaria and Gaza Area Statistics*, various issues, Jerusalem.

-------, *Statistical Abstract of Israel*, various issues, Jerusalem

Cohen, Saul, E. The Politics of Planting. Israeli-Palestinian Competition for Control of Land in the Jerusalem Periphery. The University of Chicago. Geography Research paper No. 236.

Dakkak, Ibrahim. Towards a Protected Palestinian Development Space. In Palestine, Development for Peace, ECCP-NENGOOT Conference volume, 1992.

FAFO. Palestinian Society: A Survey of Living Conditions, 1993.

Hazboun, Samir. Services in the Occupied Territories. UNCTAD, 1992.

Kleinman, Ephraim, The Flow of Labor Services from the West Bank & Gaza, WP 260, Hebrew University, 1992

-----------, Economic interdependence of the West Bank and Gaza Strip and Israel, WP 220, Hebrew University.

Metzer, Jacob, What Kind of Growth? A Comparative Look at the Arab Economies in Mandatory Palestine and in the Administered Territories, Journal of Economic Development and Cultural Change, Vol. 40, July 1992: 843-865.

Sayigh, Yusif. Development Strategies for the Palestine Development Programme. Mimeo, Department of Economic Affairs and Planning, PLO, September 1992.

------------. Dispossession and Pauperization: The Palestinian Economy Under Occupation. I Abed, editor: The Palestinian Economy, Routledge, 1988.

Shaban, Radwan. Labor Mobility and the Palestinians of the West Bank and Gaza strip. February 1992, mimeo.

United Nations Conference for Trade and Development, *Report on the Economy of the Occupied Palestinian Territory (West Bank and Gaza Strip)*, various issues.

Van Arkadie, B. Benefits and Burdens: A Report on the West Bank and Gaza Strip Economies Since 1967. 1977, Carnegie Endowment for International Peace, Washington, D.C.

World Bank, *World Development Reports* (various issues), Washington

World Bank, Developing the Occupied Territories. An Investment in Peace, 1993 (six volumes), Washington

Zahlan, A.B. Towards a Programme for Palestinian Human Resources Development. Mimeo, 1993

Zakai, D., *Economic Development in Judea, Samaria and Gaza*,(various issues), Bank of Israel, 1986

ECONOMIC
RESEARCH
FORUM
FOR THE ARAB COUNTRIES, IRAN & TURKEY

7 Boulos Hanna St., Dokki, Cairo, Egypt
Tel: (202) 700810, Fax: (202) 3616042, E Mail: ERF @ vrit 01 eg.