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aid, development and state formation

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The Palestinian war-torn economy:

aid, development and state formation[*]

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EXECUTIVE SUMMARY

After almost four decades of occupation, restrictive measures, violent confrontations and war-like conditions continue to dominate economic prospects of the Palestinian territory of the West Bank and Gaza. Setting the Palestinian economy on a path of sustained growth requires understanding the conditions that influenced its long-term development prospects, particularly the structures established after the occupation of the West Bank and Gaza and the institutional set-up affecting its growth dynamics. Economists and economic historians have long recognized that once structures have been formed, they tend to lock-in a certain evolutionary path. It is therefore important to recognize the adverse "path dependence" of the Palestinian economy formed during the occupation era. Needless to say, conditions of conflict, political instability, an elusive sovereignty and much-promised statehood have taken a growing toll on the ability of the PA to ensure any governance, much less of the corruption-free, best-practice model against which the PA is often measured.

Despite the challenge of establishing pre-state apparatuses in the uncertain environment of 1994-2000, the PA with the support of the international community achieved significant progress in creating basic institutional and regulatory frameworks for operating the economy in the areas under its jurisdiction. This interim period has shown that the institutionalization of restrictive measures, in the context of what may be termed a *policy of asymmetric containment*, has inflicted a heavy toll on the economy. While the current institutional set-up does feature some aspects of integration with Israel, these are mainly shaped by the asymmetric containment policy. And though the constraints imposed on the Palestinian economy since 2000 could still subside, their persistence should nevertheless be incorporated into any analysis of development options for its recovery.

The economic crisis since 2000 created a widening consensus among Palestinian public and private sector actors on the need for a new development vision to reduce economic dependence on Israel, address the new economic realities generated by the protracted conflict and build public institutions featuring transparency, efficiency and accountability. These concerns along with renewed, though reserved, hopes in the renewal of a peace process stimulated a number of development plans by the PA, especially since 2004. These reflect an evolving debate that is yet to produce clear outlines, much less a consensus, on the optimal strategy for setting the economy on the path of recovery and sustained development.

In the context of the limited economic policy options available to the PA during the interim period and a shrinking horizon for political settlement since, it resorted to rent-creation strategies, which included participation in commercial ventures, promotion of expatriate investment and non-fiscal mechanisms to increase public revenues, and hence room for political manoeuvre. In the light of the persistence and intensification of constraints and the overwhelming challenge of building modern, transparent public institutions in such an environment, the quality of PA governance since the interim self-government period could only deteriorate. It is perhaps not surprising that it came to be viewed so harshly by observers, donors and evidently by the Palestinian people themselves as witnessed by the Palestinian legislative elections of 2006.

Until 2000, when the benefits of economic cooperation and integration, however limited, could still be discerned, both donor and public tolerance levels towards mismanagement and public sector corruption remained high as the promises of the peace process were still plausible. However, as income levels plunged, poverty became commonplace and the meagre political gains of the previous decade became evident, the quality of PA governance weakened under the constant pressure of confrontation, crisis management and the threat of bankruptcy.

A multiple challenge thus faces Palestinian development efforts, whereby recovery and reconstruction must proceed under: (i) adverse conditions of conflict; (ii) intensified, systematic mobility restrictions; (iii) lack of national sovereignty; (iv) an ambitious, if not unrealistically large scale, reform agenda; and (v) limited policy space available to the PA to manage the economy, and (vi) its now systemic dependence on foreign aid.

This means that any future phase of economic rehabilitation and "peace-building" in the region cannot simply take as its goal a return to the pre-crisis situation. At the same time, humanitarian and relief assistance should no longer be addressed in isolation from long-term development needs, especially in light of the debilitated supply capacity. The PA and the international community should work together within a framework of a Palestinian socio-economic development vision capable of *relieving the poorest* from the dire impact of the economic siege, while at the same time reducing dependence on imports from Israel and expanding markets for Palestinian exports.

While the PA did initiate sustained reform efforts in public finance and other areas, its current policy is based on the premise that it must reform and renew public institutions and policies and achieve good governance before the envisioned State of Palestine can enter the community of nations. The PA continues to reform public institutions intended for a transitional, self-government phase, instead of responding to the imperative of forming the appropriate national institutions of governance. This runs the risk that the State that emerges will respond more to the considerations of interim solutions, rather than the strategic imperatives of Palestinian sovereignty as envisioned by the international community, not to mention the Palestinian people themselves.

Reforming, and more pertinently *forming*, the institutions required for the efficient operation of the PA is without doubt an essential step towards the establishment of a future Palestinian State. However, what is no less essential is the national development vision that guides the priorities of reform and institutional building. The PA needs to set out the goals, policies and institutions for an independent, democratic and modern State, including an economic road map to statehood to ensure cohesion between immediate and strategic goals, where efforts are focused on addressing the economy's structural weaknesses and poverty reduction. Trade expansion should serve this focus and be addressed through a longer-term sequenced approach. But to facilitate a powerful role for trade in reducing poverty, Palestinian efforts should be rooted in a development-driven approach to trade rather than a trade-driven approach to development.

Under conflict conditions, if it is unlikely that external political influence can do much to change the internal or external constraints to development, "non-distorting" aid and relief can at best hope to identify a number of ways in which the general population can be assisted with coping strategies. In such a situation, the critical question is whether there are feasible aid strategies that could weaken these external constraints. Given the significant role of external constraints in driving both the conditions of this particular conflict and affecting economic development, analysis of distorting aid and development has to look at the interplay of all these factors.

Analysis of international aid to Palestine suggests the possibility of a distorting aid and development pattern prior to 2000, which has intensified after the escalation of conflict and the switch from development to relief assistance. It is now apparent, if it was not a decade ago, that the greatest developmental constraints facing the Palestinian people are predominantly related to the fact that they do not have their State within which a meaningful reform process can be managed. The economy's development potential has been dependent on fiscal, trade and monetary policies and labour mobility criteria, which Israel regulates in the light of its own sovereign interests. While a number of governance failures within the PA were certainly avoidable, other cases were directly induced by the external constraints under which the PA laboured. These aspects of internal governance have been the subject of a number of reforms to improve the transparency and accountability of the PA's executive branch following the developments since 2000 that led to the PA's near collapse. But the external factors that have been by far the most important constraints on development, and which arguably drove the PA to adopt some unconventional economic policy measures, remain in place. Indeed, despite progress in reform of the PA, economic decline has been persistent since 2000.

The specific characteristic of the Palestinian situation is that asymmetric economic control facilitates compliance with security and political goals. This means that attempts to foster economic development for the envisioned State of Palestine have to deal with an externally imposed institutional architecture that maintains the vulnerability of the Palestinian economy. As a result, successful developmental policies in the Palestinian context *can be expected* to be unorthodox owing to the unique set of externally imposed constraints. The capacity of the state to create rents for investors can be useful if there are specific external constraints that need to be overcome. These capacities can be adversely affected if they are subjected to sustained attrition or even neglect.

This is not an argument against traditional relief in a context of extreme human hardship. There is no question that in the immediate future, humanitarian relief and budget support must continue to account for a major part of aid delivery. But vital as they may be, such instruments have to be recognized as inadequate for making a lasting dent in Palestinian poverty and economic vulnerability in a context of asymmetric containment. Rather, a long-term relief strategy for the Palestinian economy is needed, and it is this that may be viewed as non-distorting aid.

There is little that suggests that occupation or the strategy of asymmetric containment are likely to be phased out any time very soon, even though they may take different forms and intensity. *Relief has to be repositioned within a long-term development strategy and the attendant steps on this developmental path have to be taken even if they take time to implement*. It is now evident that sustained economic recovery requires *either* dismantling the policy of asymmetric containment, *or else* pursuing a strategy to deal with it as an external constraint in the short term, while at the same time working towards its eventual elimination. Although the latter option may not lead to a high-growth recovery, it could perhaps halt or reverse the adverse path dependence, by placing the war-torn economy on a platform from which it can cope realistically with these constraints.

This in turn requires going beyond the conventional economic policy wisdom and tailoring the development process to the economy's present distinctive features and institutional set-up. Such an approach should be based on a participatory mechanism and needs to be concrete in detailing policies for poverty reduction, with specific programmes that clearly link all types of aid, including relief, to long-term development objectives and a state-formation agenda. Above all this approach has to be clearly identified as a means to achieve a widely-accepted national Palestinian socio-economic vision to drive both domestic and international support measures, as well as the reform agenda, towards the establishment of a democratic, contiguous and economically viable State of Palestine.

CONTENTS

Tables

Figure

Abbreviations

AFTA	Arab Free Trade Area
ASYCUDA	Automated System for Customs Data Analysis
CTA	Central Treasury Account
CU	Customs Union
DoP	Declaration of Principles
EFTA	European Free Trade Association
EPF	Economic Policy Framework
EPP	Economic Policy Programme
EU	European Union
FAO	Food and Agricultural Organization
GDP	gross domestic product
GNI	gross national income
ICT	information and communications technology
ILO	International Labour Office
IMF	International Monetary Fund
IT	International Technology
LDCs	least developed countries
MENA	Middle East and North Africa
MNE	Ministry of National Economy
MoF	Ministry of Finance
MoP	Ministry of Planning
MRC	Ministerial Reform Committee
MTDP	Medium-Term Development Plan
NDTP	Non-Discriminatory Trade Policy
NGOs	non-governmental organizations
NRC	National Reform Committee
NTDP	National Trade Dialogue Project
OCHA	Office for the Coordination for Humanitarian Affairs
MNE	Ministry of National Economy
ODA	official development assistance
oPt	Occupied Palestinian Territory
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PCHR	Palestinian Centre for Human Rights
PICCR	Palestinian Independent Commission for Citizens' Rights
PIF	Palestinian Investment Fund
PLC	Palestinian Legislative Council
PLO	Palestinian Liberation Organization
PPSCC	Public and Private Sectors
PNA	Palestinian National Authority
RCSU	Relief Coordination Support Unit
SC	Security Council
TFP	total factor productivity
TFPR	Task Force on Palestinian Reform
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
WB	World Bank
WBG	West Bank and Gaza
WTO	World Trade Organization

I. THE PALESTINIAN WAR-TORN ECONOMY

A. A conflict economy

After almost four decades of occupation, the economy of the occupied Palestinian territory (oPt) in the West Bank and Gaza (WBG) continues to be subject to restrictive Israeli measures and five years of violent confrontations and war-like conditions.[1] These factors have had serious ramifications on the growth, structure and functioning of the economy. Between 1999 and 2004, the economy contracted with a 15 per cent loss in gross domestic product (GDP). The welfare impact is more serious: real per capita gross national income (GNI) dropped by more than 33 per cent, in 1997 US dollars, from $1,860 in 1999 to $1,237 in 2004 (UNCTAD, 2005). As a result, poverty has risen substantially, leaving 63 per cent of the population below the (income) poverty line of $2.3 per person per day, including 16 per cent of the population living in extreme poverty below $1.6 per person per day in 2003, unable to meet their basic needs (World Bank, 2004a). In terms of deterioration of households' income, it is estimated that 61 per cent of households were living beyond the poverty line of $350 per household (of four persons) per month by the end of 2004 (PCBS, 2005a). Households' median monthly income fell by 45 per cent from $610 in 2000 to $330.[2]

These sharp contractions of household and national income have been hard to reverse under the Israeli policy of internal and external closures and the complex system of mobility restrictions that has been incrementally tightened since October 2000. The system has effectively turned the West Bank into isolated islands, involving at the height of the closure regime up to 600 physical barriers in the form of permanent checkpoints, metal gates, earth mounds and walls, roadblocks and trenches. By 2005, 300 of these were still in place as the Israeli separation barrier has created new physical and economic constraints. Moreover, Palestinians are either restricted or entirely prohibited from using 41 roads that cover over 700 km of roadway, including several main roads (B' TSELEM, 2005 and OCHA-oPt, 2005a).

The situation in Gaza was no better, with the system of fixed checkpoints (until the 2005 disengagement) dividing Gaza into four isolated enclaves (OCHA-Opt, 2005b). The flow of goods through the Karni Cargo crossing with Israel has become highly problematic, because of the tightened security measures and back-to-back transport arrangements that have become systematic. Until the end of 2005, the Rafah crossing with Egypt was open during limited hours and was subject to strict security measures (OCHA-oPt, 2005c). Following the November 2005 agreements on reopening the Rafah crossing, passenger crossing conditions have improved remarkably.

In addition to the impact of the above measures, the destruction of physical infrastructure and private and public property is estimated to have cost the economy around $3.5 billion, equivalent to 30 per cent of pre-2000 capital stock (UNCTAD, 2005). UNCTAD's analysis of the impact of prolonged occupation and violence on Palestine's economic development prospects, coupled with significant income and capital losses, suggests a situation common to war-torn economies and situations of complex humanitarian emergencies, where vulnerability is exaggerated by the depletion of the economy's supply capacity that have set in motion a cycle of de-development. The direct effect of these measures has been the disruption of internal economic activities and external trade, resulting in the loss of income and job opportunities within the oPt and in Israel.

In addition to capital stock losses, UNCTAD estimates that the cumulative economic opportunity cost of potential income (GDP) over the period 2000-2004 alone was about $6.4 billion, in 1997 US dollars (UNCTAD, 2005). This is equivalent to 140 per cent of Palestinian pre-crisis GDP. During the same period, unemployment soared from less than 12 per cent in 1999 to almost 32 per cent by the end of March 2005,[3] leaving 272,000 Palestinians jobless.

Table 1.1 - Palestinian economy (West Bank and Gaza Strip): key indicators [a]

	1995	1999	2000	2001	2002[Rev.]	*2003[Est.]*	*2004[Est.]*
Macroeconomic performance							
Real GDP growth (%)	6.1	8.6	-5.6	-6.6	-3.8	*4.5*	*-1.0*
GDP (million US$)	3225	4201	4108	3816	3484	*3921*	*4011*
GNI (million US$)	3699	4932	4793	4143	3700	*4204*	*4373*
GDP per capita (US$)	1380	1478	1386	1229	1073	*1158*	*1146*
GNI per capita (US$)	1583	1736	1617	1335	1140	*1242*	*1249*
Real GNI per capita growth (%)	7.9	4.1	-10.7	-16.1	-9.8	*2.8*	*-4.2*
Domestic expenditure (% of GDP)	151.8	163.6	155.4	143.3	161.0	*153.0*	*164.4*
CPI inflation (%)	10.8	5.5	2.8	1.2	5.7	*4.4*	*3.0*
Population and labour							
Population (million)	2.34	2.84	2.96	3.10	3.25	*3.39*	*3.50*
Unemployment (% of labour force)[b]	26.6	21.7	24.6	36.2	41.2	*33.4*	*32.6*
Total employment (thousand)	417	588	597	508	486	*591*	*607*
In public sector	51	103	115	122	125	*128*	*131*
In Israel and settlements	50	127	110	66	47	*53*	*48*
Fiscal balance (% of GDP)							
Government revenue	13.2	23.8	23.1	7.1	8.3	*19.5*	*23.3*
Current expenditure	15.3	22.5	29.1	28.7	28.5	*27.2*	*31.1*
Total expenditure	25.5	29.8	34.9	34.3	34.9	*34.7*	*31.9*
Recurrent balance	-2.1	1.3	-5.9	-21.5	-20.2	*-7.8*	*-7.9*
Overall balance	-12.3	-6.0	-11.8	-27.1	-26.6	*-15.2*	*-8.6*
External balance							
Exports of goods and services (million US$)	499	684	657	534	529	*378*	*467*
Imports of goods and services (million US$)	2176	3353	2926	2336	2654	*2456*	*3049*
Trade balance (% of GDP)	-51.8	-63.6	-55.4	-43.3	-61.0	*-53.0*	*-64.4*
Current account balance (% of GNI)	-21.7	-31.7	-20.9	-13.0	-13.6	*-8.9*	*-16.5*
Trade balance with Israel (million US$)	-1388	-1644	-1506	-1541	-1123	*-1524*	*-1621*
Trade balance with Israel (% of GDP)	-43.0	-39.1	-36.7	-40.4	-32.2	*-38.9*	*-40.4*
Current account balance with Israel (% of GNI)	-24.7	-18.5	-17.1	-29.3	-24.5	*-29.5*	*-28.8*
Imports from Israel /PA private consumption (%)	56.5	52.4	50.7	53.8	36.8	*45.7*	*46.3*
Total PA trade with Israel/total Israeli trade (%)[c]	3.7	3.6	2.8	2.7	2.0	*2.4*	*2.3*
PA trade with Israel/total PA trade (%)[c]	78.8	67.1	71.2	78.6	53.4	*75.1*	*66.8*

Sources: Historical data from the Palestinian Central Bureau of Statistics; data for 2003–2004 are estimated by the UNCTAD secretariat on the basis of recently released PCBS data,[4] and IMF fiscal estimates (2004). Israeli trade data are obtained from the Monthly Bulletin of Statistics of the Israeli Central Bureau of Statistics.

[a] All data exclude East Jerusalem.

[b] Unemployment rates include discouraged workers following the ILO relaxed definition.

[c] Total Palestinian and Israeli trade data refer to goods, and non-factor and factor services.

Furthermore, the recent crisis has aggravated deep-seated structural weaknesses and vulnerability to external shocks arising from prolonged occupation, as manifested by volatile economic growth, persistent, high unemployment rates and chronic internal and external imbalances. As shown in previous reports by the secretariat (UNCTAD, 2005), the Palestinian Authority (PA) budget deficit as a percentage of GDP increased from 6 per cent in 1999 to 8.6 per cent in 2004. In dollar terms, the deficit rose from $250 million to reach $345 million in 2004. During this period, the trade deficit was maintained around 64 per cent of GDP, declining marginally from $2.7 billion to reach $2.6 billion in 2004. With depleted production capacity, both the internal and external deficits can hardly be expected to improve as Palestinians are forced to produce less and rely more on imports. The ramification of the double deficit is further expenditure switch from investment to consumption. The share of total investment in GDP dropped from 43 per cent in 1999 to 27 per cent in 2004. This will also constrain the future growth of Palestinian production capacity. By the end of 2005, the PA deficit had risen to over $700 million, with only donor aid as a possible shield against further deterioration.

The deepening of structural weaknesses has imposed additional challenges to the private sector, which will take years of intensified efforts to overcome. By 2004, 16 per cent of pre-2000 services and industrial sector enterprises had permanently closed. In the construction and internal trade sectors this figure was 14 per cent (PCBS, 2004a). Manufacturing and construction employment declined between 1999 and 2004, and therefore lost their importance as major sources of employment and income. Their contribution to employment declined from 16 and 22 per cent to below 13 and 12 per cent, respectively, of the labour force.

Meanwhile, the agriculture and services sector (including PA institutions) became major sources of employment. The former employed around 16 per cent of the Palestinian labour force in 2004 as compared to 13 per cent in 1999, while the latter absorbed nearly 35 per cent of the labour force up from 28 per cent (PCBS, 2005b) in 1999. These sectors have also increased their contribution to GDP, from 41.6 to 42.2 per cent in the case of services, and from 11 to 12.4 per cent in the case of agriculture. The remaining sectors have witnessed the decline of their shares in GDP over the same period, with the construction sector's share falling from 11.8 to 3 per cent, and that of the industrial sector from 16.1 to 15.7 per cent (PCBS, 2004b).

These changes are underscored by a shift in the industrial base towards low-productivity, low-pay activities. In addition to depletion of the economy's capital base and the drop in private investment, the period since 2000 witnessed an overall contraction in the average size of enterprises and an expansion of micro-enterprises, with less than five workers. Nonetheless, small (employing 5-19 persons) and medium (employing 20-50 persons) enterprises acted as a shock absorber for the troubled economy. This was mainly attributed to the marked expansion in manufacturing enterprises' activities, i.e. those engaged in the production of food and beverages, mining and quarrying activities and furniture, which registered substantially increased the size of their paid labour force, total value added and compensation levels (UNCTAD, 2004a).

Structural changes experienced in the last five years were also exacerbated by the coping strategies adopted by Palestinian households to withstand income losses. In addition to reducing expenditures and switching demand to basic needs, these strategies have involved selling personal assets, postponing the payment of bills and borrowing. By the end of 2004, these strategies appear to have been exhausted; only 17 per cent of the West Bank households were reported as having adequate sources of income to withstand the adverse conditions for more than one year, compared with around 33 per cent in Gaza. While around 44 per cent of households found it increasingly difficult to afford medical treatment, 49 per cent were in dire need of emergency assistance in the form of food supplies (PCBS, 2005a). Moreover, at the height of the crisis (in July 2003), 40 per cent of Palestinians had become food insecure, with an additional 30 per cent facing a similar fate in the near future (FAO, 2004).

At the same time, the continuous confiscation of Palestinian lands by Israel has undermined the agricultural sector's absorptive capacity (PCBS, 2005b). By July 2004, 86 per cent of the land confiscated for the construction of the Israeli separation barrier in the West Bank (Section D) was agricultural land, leading to the loss of some of the region's most fertile areas (PCHR, 2004). Largely as a result, the percentage of Palestinian labour force employed in the agricultural sector in the West Bank dropped from almost 23 per cent in 2004 to slightly above 14 per cent by the end of March 2005 (PCBS, 2005b). In the Gaza Strip, the levelling of land by the Israeli forces effectively decommissioned, until 2005, 15 per cent of the agricultural land in the Strip. Add to this the destruction of 357 irrigation networks, 102 wells, 65 greenhouses and 46 water pumps over the period between April 2003 – April 2004 alone (PCHR, 2004). Consequently, the agricultural sector absorbed only 13.2 per cent of Gaza's labour force by the end of March 2005, as compared to 14.1 per cent in the first quarter of 2004 (PCBS, 2005b).

Against all odds, the Palestinian economy continues to function and defies the devastating conditions of the past five years. Three main factors explain why the economy and society as a whole was able to withstand such conditions, namely:

(i) the resilience and cohesiveness of Palestinian society and the informal safety nets and innovative responses developed by enterprises;

(ii) the ability of the PA to continue functioning and employing at least 30 per cent of those who are currently working; and

(iii) the increase in disbursements of donor support for budgetary solvency, relief and development efforts.

Indeed, recent employment figures reveal the resilience of the economy and the social cohesiveness of the Palestinian people that prevented a complete collapse. During 1999–2004, total employment increased by almost 20,000 to reach 607,000, while Palestinian employment in Israel retracted by almost 80,000 (62 per cent) to reach 48,000. This means that the domestic economy was able to absorb this shock and generate almost 100,000 additional jobs through employing the 80,000 who no longer worked in Israel in addition to 20,000 new jobs (UNCTAD, 2005). This is a positive adjustment to redistribute reduced national income. The price to pay for this, however, has been a major reduction in labour productivity — yet another casualty of the stunted development path of the Palestinian economy.

B. Prolonged occupation and the economic policy framework

Setting the Palestinian economy on a path of sustained growth requires a clear understanding of the conditions surrounding its past development trajectory, particularly the institutional structures influencing its growth dynamics. Particularly important in this regard are those structures established after the occupation of the West Bank and Gaza and which continue to shape the economy's long-term development prospects.

Following its occupation of the Palestinian territories in 1967, Israel established mechanisms that effectively tied the Palestinian economy to its own. Most notably were the procedures that collectively amounted to what has been referred to as a "quasi customs union" (CU). For the first 25 years of occupation, these allowed for the movement of goods and labour between the two economies within the context of non-reciprocal restrictions, where Palestinian exports and imports where subject to complicated certification measures, through military orders, with limits on the type and quantities of raw materials allowed access to the West Bank and Gaza Strip (Abu Kishk, 1988). Investment projects also required the approval of military authorities. Palestinian industries were subject to discriminatory tax policies, non-tariff trade barriers[5] and were annexed to Israeli channels of production through subcontracting arrangements that assigned labour-intensive activities to Palestinian industries to reap the benefits of lower labour costs. These measures, combined with the confiscation of Palestinian natural resources effectively set the limits for the economy's development prospects. These policies and practices created asymmetric trading relations, regulatory constraints, fiscal compression and declining access to natural resources.

With the establishment of the Palestinian Authority (PA) in 1994, widespread optimism surfaced with the expectation that the peace accords would create an environment that maximized the mutual benefit of both the Israeli and oPt economies, and therefore would be conducive for the socio-economic development of the Palestinian people (World Bank, 1993). However, the key promises of the so-called "peace dividend" did not materialize. Israeli settlement activities and confiscation of Palestinian natural resources continued to shape the salient features of Palestinians' daily lives during the interim period (1994-2000) and beyond. During this period, the PA had limited formal authority over security, economic management and service delivery. Restrictions on Palestinian labour mobility to Israel became more stringent than before and were extended to control labour movement between villages and towns even within the occupied territories.

The quasi-CU was formalized under the terms of the 1994 Protocol on Economic Relations between Israel and the Palestinian Liberation Organization (known as the Paris Protocol). Although the trade regime stipulated by this Protocol is presented as a CU, it is more of a mixture of a free trade and a CU arrangement. It entails liberalizing trade between Israel and Palestine within a common external tariff, while maintaining subsidies, indirect taxes and non-tariff barriers applied by Israel, on a range of imports.[6] Furthermore, Palestinian imports from the rest of the world are subject to a floor of Israeli tariff rates, except for a limited group of products and within specific quantities, imported from Egypt and Jordan.

The Palestinian-Israeli economic relation is very far indeed from the full economic union arrangement between two equal partners envisaged by the United Nations in its 1947 Partition Plan, even though it includes features of both the customs union and monetary union that underpinned General Assembly Resolution 194 (II). Nor did the design or operation of the Protocol match the content, mechanisms and revenue-sharing formulas of successful customs unions (e.g. Southern African Customs Union - SACU). Alongside the formal trade arrangements, Israel's predominant position pushed the Palestinian economy towards greater dependence on Israel as a destination of excess labour and export and as a source of imports. Between 1999-2004, Palestinian trade with Israel represented about 64 per cent of total Palestinian trade, with a trade deficit with Israel representing about 40 per cent of Palestinian GDP. Furthermore, during that period real GNI fell by more than 11 per cent, mainly as result of the collapse of workers remittances from Israel as reflected by the 55 per cent drop in the net factor income from abroad. These figures highlight the vulnerability of the Palestinian economy to external shocks, especially those emanating from its CU-partner, Israel.

C. Path dependence: a distorted growth trajectory

Understanding the *fundamentals* of the Palestinian development story requires focusing on the lessons drawn from the experience of the period of limited self-rule (1994-2000). In general, the policy package endorsed by the donor community for that period, and adopted by the PA, was not overly-concerned with the specificity of the Palestinian economy at the time.[7] The policy recommendations of this period stressed:

- the leading role of the private sector;
- the need to reduce the role of the government to a minimum;
- integration of the Palestinian economy into the world market through a liberalized trade regime based on strengthening the existing CU-relation with Israel; and
- an environment within which micro-efficiency and macro-stability could be enhanced.

To all intents and purposes, the package was identical to what was becoming known at the time as the “Washington Consensus”, and was also advocated as the correct strategy for the transitional economies of Eastern Europe. But the situation in the Palestinian economy at the time was strikingly different from that of East European countries. The latter countries were trying to dismantle the structure of government imposed by a centrally planned system dominated by public sectors and to tear down the walls of tariffs erected to protect non-competitive national industries. The Palestinian territory, on the other hand, had neither a government nor a public sector; however, some institutions provided sub-optimal level public services such as health and education. Industry was, meanwhile, marginalized by a trade regime geared to protecting heavily subsidized Israeli industries.[8] Obviously, these differences stem from the fact that the problem of East European countries was how to rid the *domestic* economic structure of government failure inefficiencies, while the Palestinian problem was how to get rid of *foreign* economic structures that disenfranchised the domestic economy, and relegated it to subordination and dependency.

Relevant economic research could provide some insights into the Palestinian case, particularly in the assessment of economic dependence on Israel. The analysis of "*path dependence*" suggests that after years of independence, some countries continue to suffer from growth inhabiting structures that were formed during the colonial era and not dismantled after independence (Cypher and Dietz, 1997). The argument further maintains that once structures have been formed, they tend to lock-in a certain evolutionary path for the country. Guided by these considerations, it is important to understand the adverse path dependence formed during the occupation era.

In 1967, when Israel occupied the West Bank and Gaza Strip, and integrated their markets into its own, the Israeli economy was more than fifteen times the size of the Palestinian economy. Its product diversification was much greater, and the manufacturing sector's share of GDP was more than four times larger. The difference in size and structure was that between a sovereign, large, advanced and rich economy, and a small, underdeveloped, landlocked, poor, and non-sovereign economy. The dynamic of the integration of two such structurally different economies generates two opposing forces that disproportionately affect the smaller economy and shape its development.

A favourable repercussion is an increased demand for the products of the small economy, a diffusion of technology and knowledge, as well as other *spread effects* resulting from the geographical proximity to a large market, such as subcontracting, joint ventures and coordination in services. Unfavourable repercussions, known as *backwash* or *polarization effects*,[9] arise from the disappearance of many industries in the small country's economy, confinement to producing low-skill goods, and the emigration of a sizable segment of its labour force to the neighbouring economy.

Both theoretical analysis and empirical studies suggest that the polarization effects are likely to be dominant in the early stages of integration. Under normal circumstances, the dynamics of integration display a pattern of divergence followed by convergence. In the early stages, the large economy, with a more developed manufacturing sector, enjoys increasing returns to scale, which tends to wipe out small industries and handicraft production in the small economy, and consequently the gap widens between the two economies. In later stages, a switch occurs in the dynamics, as the increasing costs in the large economy and the external diseconomies produced by congestion, begin to outweigh the benefits of greater efficiency and higher return to capital and labour. Investment in the small economy becomes more attractive. As a result the poor economy starts to grow faster than the rich, narrowing the gap.

Had economic relations between the two economies been confined to the dynamics of normal uncontrolled market forces, the gap between per capita incomes would have widened in the first years of the occupation, and then become smaller. What happened in fact, as evidenced from Table 1.2, was the opposite. The pattern was one of a slow convergence during the first two decades of occupation followed by divergence. The Palestinian GDP per capita grew from 11 per cent of that of Israel to 14 per cent in the second half of 1970s, but then, the ratio declined continuously. At the start of interim period it was already below its level 25 years ago and since 2000 has plunged further, to half its level of 30 years ago.

The reason for this abnormal pattern is that the economic relationship between the two economies was not just confined to the working of the polarization and spread effects operating through the market. The policies practiced since the start of the occupation, which increased in intensity and aggressiveness in the mid-1970s, reinforced the effects of polarization and diminished the spread effects. Most of the convergence experienced in the 1970s was driven by income increase generated from exporting Palestinian labour to Israel. However, over the long term this, along with the restriction imposed on the flow Palestinian exports of goods and services, has distorted the labour market, with the ultimate result of a reduction in domestic labour productivity.

Table 1.2 - Pattern of Convergence – Divergence -- Real GDP per capita (1995 $)

Year (a)	**Israel (1)**	**WBG (2)**	**Ratio (2) / (1)**
1968-1969	8,137	904	0.11
1975-1976	10,964	1,543	0.14
1980-1981	12,019	1,599	0.13
1985-1986	12,743	1,708	0.13
1990-1991	14,170	1,407	0.10
1995-1996	16,458	1,361	0.08
1997-1998	16,821	1,484	0.09
1999-2000	17,310	1,528	0.09
2001-2002	16,908	1,244	0.07
2003-2004	16,755	1,169	0.07

Source: Israeli data obtained from the World Bank's World Development Indicators. Palestinian data: 1994–2003 from Palestinian Central Bureau of Statistics (PCBS) after rebasing to 1995; 1968–1993 from UNCTAD database – compiled from the Israeli central Bureau of Statistics (ICBS).

(a) An average of two years is taken to neutralize variations in the Palestinian GDP caused by the cyclical nature of the olive crop. Data for 2004 are UNCTAD's estimates.

The result of a growth accounting analysis, presented in Table 1.3, indicates that in the 1970s, the first decade of the occupation, between 56 and 77 per cent of the growth could be attributed to the growth of capital per worker, and between 44 and 23 per cent was attributed to growth in total factor productivity (TFP). But, starting in 1980, the growth in productivity became negative, setting the stage for the switch towards divergence. Thus, the income generated by Palestinians working in Israel benefits the economy in the short term and can have adverse effects in the long-term. Indeed, empirical studies have shown that the distortion they cause has resulted in artificially high wages in the domestic economy, raising the cost of production and reducing Palestinian competitiveness in neighbouring markets.[10] It has also resulted in reducing the return on education, and increasing unemployment among the educated (Angrist, 1995).

Exporting of labour to Israel impacts the Palestinian domestic economy in two ways that tend to reinforce each other.

- On the demand side, the increased income generated from wages earned by working in Israel increases aggregate demand in the domestic economy without parallel increases in production. Thus, the increase in demand for traded goods is met by increases in imports, and the increase in demand for non-tradable goods is met by an increase in prices.

- On the supply side, induced higher wages in the domestic economy that do not reflect domestic productivity gains dampen agriculture and industrial production. This is due to higher production costs, falling profitability and loss of competitiveness in foreign markets.

Thus, from both sides, demand and supply, the impact of exporting labour to Israel gives rise to a dynamic similar to the "Dutch Disease". This dynamic has reinforced adverse path dependence, distorting the development of the Palestinian economy, and inhibiting its growth. As was emphasized above, the negative impact of this adverse path dependence did not stop once the conditions that have created it ceased to exist. Quite the contrary, its negative impact continued to operate even during the interim period after 1993.[11]

Table 1.3 clarifies this point. The highest growth took place during the 1970s. However, that was transitional and not sustained in the following decades, as it was mainly driven by capital accumulation and not productivity improvement. TFP contribution to growth declined from 44 per cent in the first half of the 1970s to 23 per cent in the second half of the decade. In the 1980s the situation worsened as the growth of TFP became negative to the extent that it outweighed the positive impact of the increase in the capital labour ratio. In the interim period, TFP maintained its negative contribution to growth, registering -11.7 per cent in 1995-2000 and -41.7 per cent in 2001-2004. All the increase in output (GDP) per worker in the period that experienced positive growth (1995-2000) was totally driven by increments in capital per worker (117 per cent). This behaviour of TFP further explains the pattern of convergence-divergence that characterized the relationship between the two economies since 1967. As discussed in the next section, the inhibiting mechanism elaborated above continues to be reinforced by a multitude of constraints that root the Palestinian economy deeper in a path of dependence away from a path of sustained development.

Table 1.3 - Sources of growth in the Palestinian economy*

Period	Average annual growth rate (in per cent)			Contribution to growth	
	GDP/worker	Capital/worker	TFP	Capital/worker	TFP
1973-1975	7.16	8.40	6.53	56.3	43.7
1976-1980	4.51	8.34	2.55	76.6	23.4
1981-1985	-2.06	3.29	-4.79	219.0	-319.0
1986-1990	-0.04	1.01	-0.58	236.3	-136.3
1991-1994	-11.86	-10.98	-12.31	-47.1	-52.9
1995-2000	0.82	3.06	-0.32	111.7	-11.7
2001-2004	-5.29	-6.52	-4.66	-58.3	-41.7

* These results are based on the simulation of the growth accounting model presented in Annex I.

D. Fundamental constraints to development

Absence of national sovereignty

Since the signing of the Israeli-Palestinian Declaration of Principles (DoP) in 1993, the oPt has been viewed as a separate political and economic entity in discussions of economic performance and constraints. While this reflects Palestinian aspirations, it is markedly in opposition to the economic and political realities of the interim period. If anything, the developmental constraints facing the Palestinian people are predominantly determined by the fact that *they do not have their State*. The issues of the borders of the Palestinian State, the status of Israeli settlements in the oPt, the status of Jerusalem and the return of Palestinian refugees remain unresolved as the parties have yet to agree on a date for restarting the final status negotiations. Furthermore, the area of land under the PA's full civil jurisdiction in the West Bank is limited to only 3 per cent. At the same time, and as explained before, the Palestinian economy remains subject to Israeli control measures, while the Israeli-Palestinian peace accords have maintained the arrangements that governed Palestinian commercial relations with Israel during the pre-1994 period.

The protracted conflict has created new realities not envisaged by the DoP and subsequent agreements. At present, the Road Map, as presented by the Quartet (the European Union, Russian Federation, the United Nations and the United States of America,) to the PA and Israel in 2003, offers the only perceived political path to salvaging the ailing peace process. The Road Map (UN Security Council, 2003) is meant to be a "performance-based and goal-driven roadmap, with clear phases, timelines, target dates, and benchmarks aiming at progress through reciprocal steps by the two parties in the political, security, economic, humanitarian, and institution-building fields". Its "destination" is a final and comprehensive settlement of the Israeli-Arab conflict, leading to the emergence of an "independent, democratic Palestinian State living side by side in peace and security with Israel and its other neighbours" based on the relevant UN Security Council Resolutions.[12]

Recently, Israel's unilateral disengagement was perceived as a possible step towards implementing the Road Map. Israeli forces withdrew from the Gaza Strip and removed settlers and military bases from four West Bank Jewish settlements in September 2005. However, Israel has maintained control of Gaza borders, its coastline and airspace. Palestinian development options are further curtailed in the face of the Israeli settlement activities, land confiscations, recurrent border closures and, since 2002, the construction of the separation barrier, all of which are seen to diminish the perspectives for a territorially contiguous, viable State. Needless to say, such conditions of conflict, political instability, an elusive sovereignty and much-promised statehood have taken a growing toll on the PA's ability to ensure any governance, much less aspire to the corruption-free, best-practice model against which the PA is often measured, both internationally and by the Palestinian people.

Strategy of asymmetric containment

As indicated above, Palestinian development perspectives are constrained by mobility restrictions on Palestinian labour and goods to Israel, and from/to and within the oPt. This situation is framed by the "security first" logic underlying the Oslo Agreements and the subsequent Road Map. Within this framework, collection by Israel collection of Palestinian customs duties and VAT on imports effectively gives it control over significant parts of Palestinian public revenues, as demonstrated when they were repeatedly withheld or reduced (between 2001-2003). These and other economic aspects of the Oslo Agreements were justified on the ground of short-term expediency and the need to ensure compliance by the Palestinian side, *before* greater sovereignty was transferred. However, the prolonged interim period — originally intended to end by 1999 — has shown that the institutionalization of these measures has inflicted a heavy toll on the Palestinian economy in the context of what has been termed a policy of "*asymmetric containment*" (Khan, 2004). By *design*, these measures are serious enough in their potential ability to harm Palestinian interests through the *threat* of asymmetric pressure, when Israel deems that a given situation constitutes a case of security non-compliance by the Palestinians.

While the post-Oslo institutional set-up features some integration aspects, these are mainly shaped by the asymmetric containment policy. An examination of Palestinian–Israeli economic relations since 1967, and even since 1994 shows that integration has been mainly restricted to the use of unskilled Palestinian labour in low value-added and non-strategic activities in the construction, manufacturing and agricultural sectors. Moreover, although there has been some Israeli investment in industries such as the garments industry in the oPt, they remained very limited in scope and technological content.[13] The most prominent Israeli-Palestinian "joint ventures" since the 1990s have been the same instances of monopolistic collaboration in certain key commodities (e.g. petrol and cement).

Within this strategic framework, the growth implications for the Palestinian economy are strikingly different than those inherent in a strategy of integration because the economic arrangements, particularly movement restrictions, inevitably maintain the vulnerability of the Palestinian economy to the political and/or security needs of Israel. The Palestinian economy continues to lack the autonomy to develop economic strategies that could eventually challenge asymmetric containment. During periods of political crisis, the economy takes a precipitous nose dive as the institutional mechanisms of asymmetric containment are intensified.

Israel could have opted to ensure Palestinian compliance with its security concerns through a system of *incentives* that seeks to deepen economic integration between the two economies. Such incentives could have involved reducing restrictions on labour movements, and a reduction of formal and informal restrictions on mobility of the other factors of production. This would have also meant increased transfer of technology, with Israeli firms investing in Palestinian high value-added and technology-intensive activities. However, such a cooperative economic relationship, very much the dream of the "new Middle East" of the post-Oslo period, remains an elusive goal.

Nonetheless, it seems that while the constraints imposed on the Palestinian economy since 2000 could soon subside, they should nevertheless be incorporated into any analysis of development options for salvaging the Palestinian economy. The critical question is whether the containment policy is invulnerable to external pressure and/or donor support to reduce Palestinian vulnerability to asymmetric containment. This is explored in detail in Chapter IV.

Israeli settlements and the separation barrier

In addition to the social and economic ramifications of Israeli settlements in the occupied territory, fully documented elsewhere,[14] a related constraint on Palestinian economic development is the separation barrier, which Israel started to build in 2002. While the barrier revealed adverse effects on Palestinian socio-economic conditions, its full impact has yet to be realized. It effectively imposes new economic borders with the oPt, which do not correspond to the 1967 borders referred to in relevant UN resolutions. The barrier encircles the northern West Bank cities and surrounding areas of Jenin, Qalqilya and Tulkarem, the central cities of Ramallah, northern Bethlehem, Jerusalem and their vicinity and the southern areas covering cities such as Bethlehem, Hebron and areas around them, creating an enclosed-zone of Palestine territory between the United Nations Armistice line (the Green Line) and the barrier. These areas cover some 142,640 acres, representing around 10 per cent of the area of the West Bank (including Jerusalem).[15] These areas will be enveloped with a system of fences, ditches, razor wire, groomed trace sands, electronic monitoring systems and patrol roads which people and goods are authorized to pass through certain gates during limited, irregular hours.

According to the most recent published maps, when completed, the barrier will be 670 km long, of which only 20 per cent will run along the Green Line. Its effective length will be twice that of the Green Line (315 km), since 85 per cent of the barrier intrudes into the West Bank to a depth of 22 kilometres in some areas. The cities of Qalqilya, Bethlehem, Tulkarem and Jerusalem will be surrounded or divided by 8-meter high concrete slab segments connected to form a wall.

Around 50,000 Palestinians living in 38 villages and towns will be confined to areas situated between the Green Line and the barrier, of which some 5,000 will live in "closed areas" or "enclaves", totally surrounded by the barrier. The rest will either live in "semi-enclaves", surrounded by the barrier and connected with the rest of the West Bank by only one route, and "closed areas", between the barrier and the Green Line. Palestinians living outside these enclaves and closed areas as well as those living outside the wall should apply for permits to reach their jobs and farms, while those living in closed areas should obtain special permits to maintain their residency rights. These permits are valid for up to six months and can only be used to cross a single designated gate.

The barrier's construction has also led to the confiscation of around 27,055 hectares (270 sq. km) of land by February 2004, including some of the most fertile areas in the West Bank (WB), as well as 49 wells. In addition to this the destruction of physical infrastructures, leaving 22 per cent of the West Bank areas surrounding the barrier without road and water networks, and nearly 50 per cent of the residents without access to health services. Actually, the barrier is effectively setting the limits to the development prospects of the West Bank, isolating enterprises from their main export and local markets and increasing the risks associated with new investments. The construction works have forced 952 enterprises to shut down by the end of March 2004. Border villages in the northern parts of the WB have been particularly affected, with 31 per cent unemployment rate in July 2004.

Limited domestic markets and remoteness from mainstream trade

The economy of the West Bank and Gaza (WBG) is small with a high degree of openness, where foreign trade represents more than 80 per cent of GDP. However, more than 85 per cent of this trade are imports for direct consumption. The economy is also highly dependent on capital inflows. In the last five years the main source of external resources was the aid extended by the international community to partially cover emergency and relief needs in response to the recent crises. Prior to 2000, the source of capital inflows was donor development support and workers' remittances.

This external dependence has contributed to the high degree of income volatility which has been aggravated by the concentration of exports in a narrow range of products, deteriorating terms of trade of these exports in global markets and a limited number of trade partners. This vulnerability is further aggravated by diseconomies of scale in most Palestinian industries that significantly reduce the efficiency of allocating the limited resources available, and therefore undermine export competitiveness.

Hence, the urgent need to address the unfavourable market access conditions facing Palestinian exports and to diversify these exports. Effectively, the oPt is *de facto* landlocked with no ports, despite the fact that Gaza has a sea coast. It is unknown when and under what conditions the seaport development project may resume. Meanwhile, Gaza's small International Airport ceased to operate in 2000. In any case, it was hardly able to accommodate significant passenger flows, and was not equipped for commercial transport. Presently the airport is in urgent need of major rehabilitation and reconstruction. However, this cannot be commenced without Israel's agreement. In addition, continued Israeli control of the main borders and transport routes even after the Gaza disengagement, causes Palestinian trade to be totally dependent on political considerations and misfortunes of the peace process.

At present, Palestinian trade transits mainly through Israeli port facilities. However, Israeli security measures and cumbersome customs and overland transport procedures at the main borders have rendered trade activities prohibitively expensive. A recent UNCTAD study estimated that costs to Palestinian traders are at least 30 per cent higher than those accrued by their Israeli counterparts. Products originating in Gaza destined to Jordan face prohibitive costs (UNCTAD, 2004b). These figures highlight the challenge of expanding exports under exaggerated transaction costs and poor market access conditions.

Obstructed regional and global integration

The need to re-orient the Palestinian economy toward more balanced relations with Israel through enhanced regional integration cannot be over-emphasized. In particular, regional integration is considered as a stepping-stone towards greater participation in global trade, leading to such gains as increased inward investment and transfer of technologies, in addition to improved terms of trade. However, despite the common border with Egypt and Jordan, the degree of regional integration with these and other Arab countries remains minimal (UNCTAD, 1998).

The prohibitive trade-related transaction costs facing Palestinian exports aside can be explained by institutional and policy drawbacks at the regional level. In the case of Egypt and Jordan, the trade agreements that had been concluded up to that date did not support the growth prospects of Palestinian regional trade. These agreements limit the application of preferential treatment accorded to Palestinian exports to specific products within limited quantities. Only with the gradual adoption by most Arab countries of the Arab Summit's decision in 2000 to grant Palestinian exports duty- and quota-free access, have the market access potentials in the region improved, though remaining under-utilized so far. Other obstacles are the absence of a cohesive strategy at the regional level for guiding national development efforts towards greater specialization among the Middle East and North Africa (MENA) countries, and weak sectoral complementarities within the region and therefore few incentives to regional export competition (UNCTAD, 2004b).

Public policy space

While the donor community has been active since 2000 in promoting reform of PA institutions, the limited availability of policy instruments places the PA at a great disadvantage in addressing the above-mentioned distortions and structural weaknesses, in shaping its own reform priorities, or even in manoeuvring the economy out of an ongoing regression. Public finance is extremely thin and the budget is in chronic deficit. The PA is effectively locked in a situation of increased dependence on official development assistance for financing current and capital expenditures. Donors covered 80 per cent of the 2004 current deficit and are the sole financer of capital expenditure that represented only 2.5 per cent of total public expenditure in the same year (UNCTAD, 2005).

Further undermining the PA's development efforts is its weakened institutional capacity, with ministries still struggling to recover from gradual erosion of their jurisdiction since 2002. In addition to this are Israeli restrictive measures that prevent staff from reaching their workplaces, rendering it difficult to coordinate efforts both within and between the West Bank areas and Gaza. Insecurity is yet another element, diverting the PA's attention away from development efforts to emergency humanitarian needs and continued crisis management.

Underlying these constraints is the limited policy space available to the PA in accordance with the Paris Protocol. By its terms: the PA has adopted the tariff structure of the more sophisticated Israeli economy, with minor exceptions; the PA applies the Israeli VAT rate with the option to increase or decrease it by 2 per cent on a limited number of goods; Israel collects tariffs and VAT on Palestinian imports on behalf of the PA; and the PA does not have the option to issue a national currency. Accordingly, Palestinian policymakers do not have any instruments for monetary, exchange rate and trade policies, or even a complete set of fiscal policy instruments. The PA retains only limited control over tax and budgetary management, since the largest part of public revenue is determined by Israeli rates that do not suit the war-torn structure of the Palestinian economy. Furthermore, the clearance of such revenue from the Israeli side to the PA is subject to Israeli political decisions. In a sense, the economic policy space available to the PA is practically reduced to a one-sided fiscal policy (expenditure allocation), less than that enjoyed by regional or municipal governments in more developed economies.

II. PALESTINIAN INSTITUTION BUILDING

A. Overview of achievements prior to the 2000 crisis

Despite the challenge of establishing pre-state apparatuses in the interim, uncertain environment between 1994-2000, the PA achieved significant progress in creating basic institutional and regulatory frameworks for operating the economy in the areas under its jurisdiction. Key accomplishments on the eve of the 2000 crisis included the: establishment of the much-needed physical infrastructures, including Gaza airport; the pillars of a new institutional and regulatory framework to govern economic activities[16]; and efforts to expand Palestinian export markets and develop domestic productive and services sectors.

The Palestine Liberation Organization (PLO) signed several trade agreements with new partners for the benefit of the PA. These agreements provide most of Palestinian industrial exports with duty-free access to a number of countries, including the United States of America, the European Union (EU), the European Free Trade Association (EFTA) and the Arab Free Trade Area (AFTA). Recently, Turkey has also signed a free trade agreement with the PLO. The PA had also shown a strong commitment to strengthening and improving the performance of public institutions well before the outset of the crisis and the increased donor involvement in the issue. In 1999 the PA established an inter-ministerial committee to modernize public institutions, and launched the National Trade Dialogue Project (NTDP) to foster public-private partnership for development.

These accomplishments would not have been possible without steady flows of international community's assistance, with an average of around half a billion dollars in total disbursements per year prior to the 2000 crisis. Throughout the period 1994–2000, the oPt received foreign aid amounting to $3 billion, equivalent to around 14 percent of GNI per annum and $175 per capita (UNCTAD, 2003a). Most of this assistance was in the form of concessionary loans with generous grace periods, long repayment periods and low interest rates (Bennett *et al*., 2003).

Nonetheless, much more remains to be done in terms of economic upgrading. Most notable in the area is legal and judiciary reform and the consolidation and updating of fragmented diverse legal codes (Israeli military orders, outdated Ottoman, British, Jordanian and Egyptian laws).[17] Moreover, the physical infrastructures are still weak: the road network is in a state of disrepair; the oPt is yet to have an electrical grid under its own control and overland crossing points are in poor condition with limited loading capacity, support facilities, public utilities and service stations for cargo vehicles. Meanwhile, the economy's development path continues to be shaped by a distortive trade regime. The PA has yet to formulate a comprehensive development strategy to elaborate the general commitment to poverty reduction alongside trade and financial liberalization and the creation of a viable private sector and export-led development.

The limited instruments available for the PA to manage its economy aside, the lack of political stability caused by the continued delays in implementing the signed agreements and the firmness of unilateral Israeli measures, have rendered it difficult for the PA to focus on economic policy. The interim period was characterized by a somewhat ad-hoc approach to economic policy formulation and implementation. The PA's nascent capacity was divided between the competing and demanding tasks of building for statehood and of managing and reviving a devastated and distorted economy, while at the same time accommodating competing regional, clan, class and political interests. PA rent creation and management did not exist in a void or for parasitic purposes, but were expressly linked to maintaining a political system that needed to span and contain the above challenges.

At the planning level, national expertise in the area of policymaking remains in short supply. The PA continues to rely on the support of international development institutions in the design of its economic policies. At the implementation level, the impact of development programmes is undermined by different competence levels within and between Ministries, thin executive capacity in translating priorities and goals into coherent action and limited budgetary process capacity. This has been causing delays in service delivery and increasing fiscal constraint. Policy implementation and formulation is also impeded by the weak separation of executive and judicial powers, in addition to a frail court system with a limited number of experienced judges.

To address these limitations at an early stage, the PA, in collaboration with the International Monetary Fund (IMF), introduced a range of reform measures in mid-2000 within the context of the "Economic Policy Framework" (EPF) and the establishment of a ministerial committee to enhance transparency in public finance management as the main requisite for stimulating growth. However, there was no emphasis on issues related to the economy's weak productive capacity. Key measures initiated by this framework included:

- consolidating PA revenues into a single account;
- limiting PA employment expansion;
- centralizing payrolls within the Ministry of Finance (MoF);
- establishing an internal audit of PA assets;
- establishing the Palestinian Investment Fund (PIF) to manage the PA's assets and commercial activities in the oPt and abroad and to privatize the PA's holdings; and
- anchoring public debt management within the MoF.

B. Major Palestinian development and reform initiatives since 2000

The economic crisis since 2000 created a widening consensus among Palestinian policymakers and the private sector on the urgent need for a new development vision to reduce economic dependence on Israel, address the new economic realities generated by the protracted conflict and build public sector institutions guided by principles of transparency, efficiency and accountability. Palestinians are also reconsidering efforts to foster the economy's resilience, particularly the necessity of moving beyond a narrow focus on humanitarian emergency needs and recurrent infrastructure rehabilitation. As pointed out by the PA Ministry of Planning (MoP), "experience over the last five years has shown that the successive implementation from one year to another of emergency and relief plans, which are decoupled from development needs, leads to dependency and donor fatigue" (PNA-MoP, 2004a).

These concerns along with renewed, though reserved, hopes in the renewal of a peace process stimulated a number of development plans by the PA, especially since 2004. However, as noted below, these plans do not provide a coherent economic development strategy. Rather, they reflect an evolving debate that is yet to produce clear outlines, much less a consensus, on the optimal strategy for setting the economy on the path of sustained development. The debate also reflects a complex policymaking process, involving in addition to the PA, the private sector, international institutions and donor countries. This indicates yet another constraint facing the PA, namely the need to account for the priorities, interests and development views of donors. Actually, there is no a priori reason that donor priorities should coincide with those of the PA in the short, medium or even the long term, either for political reasons or simply for technical aspects related to individual donor institutional strength, programme structure or budgetary situation.

The Medium-term Development Plan

Initiated by the PA Ministry of Planning (PNA-MoP, 2004a), the Medium-term Development Plan (MTDP) provides a new, coherent, strategic framework for guiding the allocation of official development assistance (ODA) over the period 2005-2007. It embarks from a cautious optimism in the future of the peace process and emphasizes economic growth, linking relief efforts to long-term development objectives, poverty reduction, development of social capital, and the strengthening of State institutions. It has been followed by a more focused and elaborate MTDP 2006-2008, which is only expected to be available in early 2006.

The MTDP depicts development efforts as proceeding within the context of a "delayed progress scenario", characterized by a decline in the number of Palestinians working in Israel, delayed easing of movement restrictions and delayed access to Palestinian productive assets. As such, it focuses on "what is achievable" under the current conditions and groups priority areas under five programme clusters with an estimated cost of $4.5 billion over a four-year period, as follows:

(i) Social, human and physical capital development to enhance capacities (35 per cent of total costs);

(ii) Budget support (29 per cent);

(iii) Creating an enabling environment for private sector growth (16 per cent);

(iv) Social protection to address economic vulnerability (13 per cent); and

(v) Institution building for good governance (7 per cent).

These proportions can be expected to have altered somewhat in the 2006-2008 version of the MTDP, owing to revised priorities in the wake of the Gaza disengagement.

The programmes comprise a wide range of projects that were chosen for their immediate importance and sustainability. These reflect a deliberate effort to mainstream poverty reduction as a crosscutting theme within the context of a holistic approach that goes beyond cash and in-kind assistance, in addition to addressing regional disparities. Each cluster includes a set of criteria for targeting the most affected regions and communities, while ensuring that selected projects contribute to improving the access of the poor to social services, especially health and education, in addition to providing them with sustainable sources of income. In this regard, the Plan emphasizes reducing unemployment as "the vehicle par excellence" for alleviating poverty, and calls upon donors to support sectors with the highest employment generation potential, particularly agriculture, food processing industries, ICTs and tourism. Furthermore, it stresses the need to base these projects on a sector specific development strategy, and linking them to the PA budget process.

A Framework for Palestinian Socio-Economic Development under Current Conditions

The policy orientations guiding the implementation of the MTDP are set out in MoP's "Framework for Palestinian Socio-Economic Development under Current Conditions" (PNA-MoP, 2004b). The Framework stresses poverty alleviation as its "overarching goal". It divides priority sectors into two sub-categories according to the economy's immediate and long-term needs. The first category comprises sectors that should form the focus of development efforts in the short term as the major tool for reducing poverty. These include agriculture and other sectors catering to domestic demand, such as pharmaceutical and food processing industries. As explained by the framework, these sectors "have stronger potential for growth and job creation than export-oriented sectors under current conditions". Furthermore, they are well placed to attract investments, having witnessed a significant reduction in their wage levels as a result of the decline in the number of Palestinian workers in Israel. Another sector designated as a priority is the ICT sector owing to its ability to generate jobs even under Israeli movement restrictions.

The framework also proposes specific measures to support these sectors in the short-term, including: procurement of local products for donor funded poverty alleviation programmes; granting priority treatment to labour-intensive public investment projects; providing loan guarantees for new investments in the industrial sector; and subsidizing the purchase of fertilizers and animal feed through the provision of vouchers for purchasing locally produced animal feed. The aim is to create an outlet for these products, while enhancing backward and forward linkages within the food-processing sector. Other support measures involve export promotion through improving market access conditions to Arab markets. However, in light of current circumstances these measures are considered as secondary options, exports can only play a limited role as an engine of growth.

In the long run, efforts should focus on promoting export-oriented industries for stimulating growth, especially as the limited size of local markets excludes the possibility of relying on import substitution as an engine of growth. While the Framework does not identify the sectors for or the modalities of public support, it stresses regional integration as the major vehicle for promoting exports. In this respect, it emphasizes the importance of "reconnecting" the Palestinian economy with Arab markets. As such, the PA "should not enter into any new economic agreement with Israel that would constrain it from strengthening its economic relations with the Arab countries upon achieving statehood. This rules out extending the current Palestinian-Israeli economic arrangement, as well as entering into a new customs union with Israel, in order to liberate the economy from the Israeli tariff structure". At the same time, the PA should maintain openness to foreign investment and trade and ensure compliance with the multilateral trading system, since "joining the World Trade Organization (WTO) is crucial for Palestinian long-term development".

Trade and investment policy

Trade and investment policies are articulated in separate unofficial policy documents by the Ministry of National Economy (MoNE). A keystone to these documents is an emphasis on trade openness as the main engine of growth, in addition to "voluntary" compliance with WTO rules and regulations as the critical element in enhancing export growth and global competitiveness (PNA-MoNE, 2003 and 2004). According to these documents, the starting point for revitalizing the Palestinian economy is to "develop a competitive market economy, open to trade and investment and with an attractive tax regime to encourage inward investment, growth and employment generation, savings, improvement in living standards and prosperity".

This means that in the long run, the Paris Protocol should be replaced by an autonomous trade regime that is "fully WTO compatible, including all the requirements for transparency, predictability, non-discrimination and accountability, as outlined in the requirements for qualifying to be a member of the WTO". This will help improve the investment climate, leading to increased productivity levels and allowing for "shifting production and export structures towards higher value-added and technology-intensive sectors" (PNA-MoNE, 2003). In this regard, much importance is attached to "re-orienting trade relations with Israeli markets towards higher value-added commodities", in addition to strengthening regional integration, particularly through establishing transit agreements with Israel, Jordan and Egypt (PNA-MoNE, 2004).

These policy orientations are reflected in a number of draft laws,[18] and future trade policy options considered by the PA MoNE within the context of the Economic Policy Programme (EPP),[19] mainly funded by UK-DFID. Policy documents emerging from this Programme recommend, *inter alia*, a non-discriminatory trade policy (NDTP) based on uniform, low tariff rates, since this would help the future Palestinian State increase administrative efficiency and remove distortions from tariff protection. On the other hand, Economic Policy Programme (EPP) studies warn that a National Trade Dialogue Project (NTDP) may negatively impact trade relations with Israel, as the latter may retaliate by applying tariff barriers on 96 per cent of Palestinian exports. It is also argued that this option may neutralize any incentive for Israel to negotiate bilateral agreements with Palestine, including sectoral and free trade agreements.

Prior to that, the World Bank's groundbreaking contribution to this debate (World Bank, 2002) had already concluded that a NDTP with a one time, across-the-board trade liberalization at a low average tariff rate would be the most efficient configuration for a future Palestinian trade regime. However, the report urges not to resort to what it called "protectionist" measures, as these could lead to macroeconomic instability. The report further suggests that a NDTP would mean "a real separation from Israel" with a much smaller number of Palestinians working in Israel. While this would reduce worker remittances, it would allow the level of Palestinian wages to "align with their real productivity rather than the higher wages in the Israeli market." This should increase domestic competitiveness, favouring the long-term emergence of an export-led economy relying on its own internal dynamism, fuelled by innovation, competition and integration into other world markets". At the same time, the report attached much importance to re-establishing commercial cooperation with Israel for ensuring the Palestinian economy's long-term sustained growth. It argues that the NDTP's full potential being achieved is contingent on a certain number of Palestinians working in Israel over the next 10 years. Otherwise, a modified CU with Israel that allows for fewer restrictions on the flow of Palestinian goods is likely to be preferable.

It should be noted, however, that applying a low, uniform-tariff NDTP, could deprive the PA from taking advantage of the special and differential treatment (SAT) accorded to developing and/or least developed countries in their negotiation for WTO accession. Therefore, while a NDTP could be the preferable option for the PA as compared to the CU, its tariff structure should be carefully assessed to support future industrial policies, and its introduction should be synchronized and sequenced with initiatives to rehabilitate productive capacity and expand and diversify Palestinian export markets.

The MoNE concurs with the MoP on the need to embark on revitalizing the economy's depleted supply capacity through linking emergency relief efforts to development objectives. However, in contrast to the MoP, it considers the development of export-oriented industries as the vehicle for achieving this end. In this context, the Ministry has proposed an action plan for addressing growth bottlenecks at the micro- and meso-levels, particularly those stemming from (PNA-MoNE, 2004):

(i) enterprises' poor management skills, limited access to external finance, and high production costs, particularly the costs of labour and inputs;

(ii) the lack of supporting business and trade services (such as marketing and quality inspection);

(iii) the prohibitive transaction costs generated by Israeli closure policy, movement restrictions, and cumbersome overland transport procedures; and,

(iv) the lack of trade related infrastructures.

The thrust of this policy revolves around enhancing regional and international integration, streamlining trade-related procedures and creating the necessary institutions for promoting trade facilitation. Much importance is attached to restoring trade relations with Israel, using the Paris Protocol as a baseline and its faithful implementation as a key requisite for kick-starting recovery.

Reform agenda

With limited results from the introduction of the Economic Policy Framework (EPF) in May 2000, whose implementation was interrupted by events on the ground, the first "100 Days Reform Plan" was launched in 2002 (PNA, 2002). The latter also attached great importance to improving fiscal management but went a step further in that it articulated specific measures for improving public sector performance in additional domains, including governance, public security, the judiciary, religion and culture. These measures involved:

- promoting the separation of powers between the legislative, the judiciary and the executive branches;
- streamlining the civil service;
- modernizing line ministries;
- enforcing full fiscal accountability;
- deepening the national dialogue;
- engaging Palestinian civil society in the reform process; and
- creating a predictable and transparent legal environment.

To ensure implementation, line Ministries were called upon to use the Plan as a reference framework when preparing their work plans. Moreover, the reform portfolio was attached to the newly created Prime Minister's Office and Ministerial Reform Committee (MRC) was created to handle related activities. The MRC is supported by the Reform Coordination Support Unit (PNA-RCSU), which reports to the Prime Minister's Office, and is responsible for implementation follow-up, coordination of reform initiatives and liaising with donors.

Despite the protracted conflict, the PA managed to achieve some progress in implementing the reform agenda as regards:

- establishment of the Central Treasury Account (CTA);
- transfer of PA commercial and investment portfolios to the Palestinian Investment Fund (PIF);
- creation of an internal audit department within the MoF;
- consolidation of all payroll functions within the MoF;
- monitoring of civil service wage bill inflation; and
- establishment of an orderly, transparent budgetary process.[20]

Furthermore, a National Reform Committee (NRC) was established in 2003 to provide a forum for public oversight of the reform agenda. The NRC submits its recommendations to the MRC, brings together 25 members, representing the Palestinian Legislative Council (PLC), academics, civil society leaders and businessmen.

Another area where the PA has achieved significant progress is the reform of the Customs Administration within the context of a comprehensive programme that involves: the development of a Palestinian Customs Law; the establishment of a modern Customs Administration system; adopting coherent ICT systems and policies for trade facilitation; and the institutionalization of international best practices in Customs Administration. Progress to date has entailed the installation of ASYCUDA at the PA Customs Headquarters as the backbone of the envisaged modern Customs Administration; the creation of a national team of experts for managing the project; and the establishment of four pilot sites in Jericho, Bethlehem Al-Ram and Rafah Customs offices. The system has also been enhanced to enable the PA to generate accurate reports on revenues collected by the Israeli Customs administration, ensure full and proper payment of the revenue due and prepare for full handover of Customs operations.

Meanwhile, preparations are underway for a full system roll-out as of 2006. This will involve linking all international entry points electronically, centralizing the monitoring of different customs activities under a single roof, and going live at all Customs offices. This will allow the PA to increase the level of Customs control with limited field presence, while reducing the costs associated with trade transactions and tax handling. Through streamlining Customs clearance and inspection procedures, the system provides built-in measures for ensuring transparency.

Despite the above and other lasting institutional achievements, the tasks ahead remain formidable given their complexity and the need for new legislation. These include income tax law, the unification of the pension system and the achievement of a fully operational internal and external audit system. Moreover, the PA's institutional and managerial capacity remains weak with inadequate resources to attract top domestic expertise, and lacks inter-ministerial coordination mechanisms and proper budgetary accounting and reporting systems. For example, the PA does not publish auditing and financial statements and donor-funded projects are yet to be well integrated into the PA budget (World Bank, 2004b).

More recently, efforts centred on implementing the "One-Year Reform Action Plan", from September 2004 to September 2005 (PA-RCSU, 2004). The Plan expands on the scope of the "100 Days Reform Plan" with further improvement of public sector performance envisaged in more domains, notably local government, education and economic management.[21] The last set of measures reiterates the key role of the MTDP as a guiding framework for revitalizing the Palestinian economy, and ranks the establishment of a market economy high on the Palestinian development agenda. Specific measures concentrate on strengthening private sector institutions, developing the legal framework, supporting Palestinian export-oriented industries, simplifying business procedures and enhancing the capacity of the Land Authority.

Palestinian civil society: private sector, NGOs and academia

Within the context of the MTDP, the Palestinian Private Sector Coordinating Council (PPSCC, 2003) has proposed a two-fold approach to economic development that involves protecting local industries, while promoting increased participation in foreign trade. Key proposals advanced by the private sector's White Papers involve:

(i) supporting the development of import substitution industries and export oriented industries;

(ii) providing direct and indirect support to exports;

(iii) integrating the Palestinian economy with regional markets;

(iv) granting preferential treatment to national products in government procurement; and

(v) protecting domestic markets from dumping.

As regards trade relations with Israel, the white papers propose a "pragmatic approach" that takes into account the economy’s long-term strategic interests. "This means that future agreements should take into account the differences in the two economies’ performance and stage of development, ensure reciprocity and provide clear mechanisms for dispute settlement". These types of recommendations were also echoed in the work of Palestinian research institutions.[22] However, the emphasis is more on delinking the Palestinian economy from that of Israel through promoting regional and global integration.

Civil society is also actively involved in the PA reform programme, spearheaded by NGOs such as the Palestinian Coalition for Accountability and Integrity (AMAN) - the Palestinian Chapter of Transparency International,[23] and the Palestinian Independent Commission for Citizens’ Rights (PICCR). Both are members of the NRC and publish regular evaluations of the PA reform process.[24]

In the area of the Palestinian economic relations with Israel and development strategies, civil society has also contributed through the work of the Palestinian Economic Policy Research

Institute (MAS). Naqib and Atyani (2003) argue that the balance of the dynamic impacts is crucial for the relationship between the small Palestinian economy and the wealthier Israeli economy. Their analysis suggests that the Palestinian economy benefited from its relationship with Israel only in the first decade after the occupation in 1967, but the relationship soured thereafter, with major decline in almost all Palestinian productive sector and growing reliance on Israel. The reason for this reversal in the economic relationship was not only due to market polarization but also to the Israeli policies in the oPt. As a consequence, the Palestinian economy has become an economy characterized by two growing disequilibria: a resource gap and labour market imbalance, and a large and unhealthy dependence on external sources.

Naqib and Atyani further examine the economic consequences of an Israeli unilateral separation and argue that this would lead to dividing the West Bank and Gaza Strip into isolated “bantustans”. In the last part of the study, they explore the prospects for future Palestinian-Israeli relations reached through negotiations. Their recommendations include the prospect for a future economic agreement not tied to security issues with provisions for a third party arbitrator. The agreement should also give the Palestinians full control over foreign investment in the territories, including full control of borders, airports and seaports as well as its economic relations with the outside world, with a non-discriminatory trade policy arrangement with Israel.

As for the Palestinian development strategy, Naqib (2003b) argues that the efforts made to rebuild the Palestinian economy during the interim period failed to meet the aspirations of the Palestinian people. He explains this failure by the absence of a political and developmental vision and a programme to rectify the distortions perpetrated under occupation, in addition to the lack of instrumental procedures with specific schedule to realize stated objectives in a gradual and cumulative manner. He maintains that the interim period must be regarded as a period of national liberation until complete independence is achieved, and at the same time, it must be regarded as a period of state building. From that he implies the continuation of an economic situation under conditions of conflict rather than cooperation, until the establishment of a Palestinian State in the territories occupied in 1967.

To cope with such conditions, he calls for an economy that must meet three conditions:

(i) economic activity must be directed towards an austere pattern of consumption;

(ii) providing incentives to savings and investment in the local economy and production; and

(iii) economic activity must be directed towards the production of sufficient quantities of food products.

In this framework, he highlights the role of agriculture, industry and tourism and emphasizes the importance of building human capital and the need for a just distribution of income. As for the role of international trade, Naqib argues that the central issue is to liberate the Palestinian economy from its complete dependence on the Israeli economy and to develop international economic and commercial relations, particularly with neighbouring Arab countries.

C. Merging immediate and long-term development interests

The previous analysis suggests a multiple challenge facing Palestinian development efforts, whereby recovery and reconstruction must proceed under:

(i) adverse conditions of conflict;

(ii) intensified, systematic mobility restrictions;

(iii) lack of full national sovereignty;

(iv) an ambitious, if not unrealistically wide, reform agenda; and

(v) the limited policy space available to the PA to manage the economy, and its now systemic dependence on foreign aid.

This means that the coming phase of economic rehabilitation and "peace-building" in the region cannot simply take as its goal a return to the pre-crisis situation. At the same time, humanitarian and relief assistance should no longer be addressed in isolation from long-term development needs, especially in light of the debilitated supply capacity. The PA and the international community should work together within a framework led by a Palestinian socio-economic development vision capable of relieving the poorest from the dire impact of the economic siege, while at the same time reducing dependence on imports from Israel and expanding markets for Palestinian exports.

Thus in the short term, efforts should focus on enhancing the economy's resilience in the face of the crisis. In this respect, the pressing problems of poverty and unemployment should rank high on the Palestinian development agenda. In so doing, it is of paramount importance for the PA, with the support of the donor community, not only to target its employment generation schemes to the sectors that are able to absorb the shock and employ the labour released from the Israeli market, but also to design appropriate programmes to increase productivity in these sectors.

Furthermore, considering the magnitude of the challenges ahead, the restoration of the PA's capacity to manage the economy and to maintain basic social and public services should be accorded priority treatment. Needless to say, achieving these objectives requires constant efforts to dismantle, or at least constrain, the system of movement restrictions and policy of closure, as opposed to designing hi-tech "facilitation" measures to accommodate and ultimately, legitimize them. Indeed, the ability of PA institutions to operate without Israeli intervention at least in areas under PA jurisdiction is a prerequisite for implementing any sustained development effort.

As will be discussed in Chapter IV, in the context of the limited legitimate economic policy options, restrictions affecting daily economic management and a shrinking horizon for political settlement, PA rent creation and management strategies were pursued to expand policy space, using a variety of instruments, more or less efficiently monitored and focused. In the light of the persistence and intensification of constraints, it is not surprising that the *quality of PA governance* during the period of interim self-government could only deteriorate and that it came to be viewed so harshly by observers, donors and evidently by the Palestinian people themselves in the course of the Palestinian legislative election.

Until 2000, when the benefits of economic cooperation and integration, however limited, could still be discerned, both donor and public tolerance levels towards mismanagement and public sector corruption remained high as the promises of the peace process were still plausible. However, as income levels have since plunged, poverty has became commonplace and the meagre political gains of the previous decade became evident, the quality of PA governance weakened under the constant pressure of confrontation, crisis-management and the threat of bankruptcy. While the details of this aspect of PA governance have been documented elsewhere (Hilal and Khan, 2004), suffice it to say here that this issue appears of marginal, or lesser, significance when compared to the overriding binding constraints referred to above.

In the long term, efforts should focus on re-orienting the Palestinian economy away from the "*path dependence*" established under occupation. This requires enhancing the economy's supply capacity through a restructuring process that allows for greater specialization in capital and technology intensive products, strengthening domestic markets, in addition to diversifying Palestinian export markets and sources of supply. The following chapters develop the above themes accordingly.

III. PALESTINIAN REFORM, DEVELOPMENT POLICY AND AID CONDITIONALITY

Reforming, and more pertinently *forming*, the institutions required for the efficient operation of the PA is without doubt an essential step towards the establishment of the envisioned Palestinian State. "Reform" is a complex process and involves many alternatives and options, and usually draws on national experience, other developing countries success stories and/or recommendations of international institutions. However, what is even more essential than the process itself is the national development vision that guides the reform and institutional building *priorities*. This chapter focuses on the orientation of the Palestinian reform effort to date, its driving factors, priorities and its appropriateness to the challenges that it is supposed to tackle.

A. Public sector reform: end or means

While some attribute the PA's reform efforts to intense international scrutiny, there is little doubt that there is a solid Palestinian constituency for reform. This is manifested in the active involvement of civil society in the reform process, growing public and media debate and the PA's recurrent reform agendas since 2000. As previously shown, the declared goals of such initiatives include establishing participatory, consensus-oriented, accountable and transparent policymaking processes; improving efficiency and effectiveness at the implementation level; and ensure responsiveness to the economy's development needs.

Efforts thus far have focused mainly on the budget/revenue/expenditures sector of public finances, with observers urging the PA to foster further transparency and accountability. While the PA did initiate sustained efforts in these and other areas, its current policy is based on the premise that it must reform and renew public institutions and policies and achieve "good governance" *before* the State of Palestine can enter the community of nations. In other areas where the PA has initiated sustained efforts that were more geared to *state formation goals* (such as customs reforms), these are rarely presented as evidence that the PA is pursuing its own priorities when it comes to some areas of governance. The PA continues to *reform* public institutions intended for a transitional, self-government phase, instead of responding to the imperative of forming the *appropriate* institutions to govern the future Palestinian State. It is then reasonable to expect that the State that will eventually emerge will respond more to the considerations of interim solutions, rather than *the strategic imperatives of Palestinian national sovereignty* as envisioned by the international community, not to mention the Palestinian people themselves.

Indeed, the PA reform agenda, in its broadest shape does not include measures to tackle immediate problems in as much as it describes where the PA hopes to end up once it achieves statehood and is able to comprehensively address the spectrum of reform goals. The list of institutional reforms is extremely ambitious, and best summarized in PA "commitments" announced at the London Meeting on strengthening the PA in March 2005. Attempting to attain such sweeping goals can overwhelm the PA with a multitude of best practices that only sovereign states can handle and which usually take the lifetime of more than one government. At present the PA does not possess the administrative capacity, human resources and political capital needed to complete this vast agenda of reforms. Furthermore, this list does not determine priorities, thereby spreading efforts thinly over a range of areas. Add to this the fact that the entire reform agenda is fraught with uncertainty owing to the lack of political stability.

This assessment should not be understood as an attempt to negate the importance of addressing the PA's internal problems of governance. Rather, the issue is whether these institutional reforms are feasible at this point in time and whether they should be considered as pre-conditions for Palestinian statehood. This is especially important in light of the fact that many of the problems that require reform are induced and/or perpetuated by occupation and a distorting trade regime (Khan, 2004; Hilal and Khan 2004).

Instead of focusing solely on reforming the PA, reform efforts should incorporate a vision and measures that contribute to the formation of a viable Palestinian State. The PA needs to set out the goals, policies and institutions for an independent, democratic and modern State, including an economic road map to statehood to ensure cohesion between immediate and strategic goals, sectoral and macro targets, as well as national objectives and global conditions. This can be most usefully done in the context of a national consensus-building exercise, which identifies clear development priorities and goals consistent with current realities. Furthermore, the PA needs to involve grassroots representatives of civil society in economic policymaking processes in order to ensure proper targeting of the poor.

B. Approach to development and trade reforms

As discussed in the previous Chapter, the past period has witnessed renewed efforts to revitalize the Palestinian economy and reduce dependency on Israel. It seems, however, that there exist two approaches with somewhat different orientations:

- On the one hand, the Palestinian MTDP, accords priority treatment to poverty reduction and advocates a developmental approach to relief and reconstruction operations. As seen in Chapter II, the Plan attempts to guide the allocation of aid according to national priorities, and focuses mainly on coordinating development efforts at the project level.

- On the other hand, much of the "conventional wisdom" on Palestinian reform in the area of trade, implies or insists on rapid liberalization and integration into the world market. In this regard, economic policy prescriptions by Palestinian and international sources have followed standardized solutions that address a textbook reality.[25] As if the economy of the West Bank and Gaza were a normal developing economy that suffers from mere government intervention and market distortion. Trade liberalization is emphasized as an engine of growth, where a WTO-compatible trade regime is considered to be *the* paramount element in enhancing the economy's export capacity and competitiveness, with little or no emphasis on how to revive a crippled production capacity.

The first approach recognizes the widespread poverty and the debilitating condition of the Palestinian economy and the need to revitalize the retracted supply capacity. The second approach, however, does not acknowledge that the Palestinian economy suffers from distortions created by decades of occupation, years of destruction and a path of unbalanced development that mainly supplies cheap manpower and low-value-added processes to the economy of the occupying power. It also fails to address these distortions as a prerequisite for *any* trade regime to have an impact.

This narrows socio-economic development primarily to trade expansion, where the latter is pursued as an end in itself, not as a means to poverty reduction and sustained development. Industrial and other economic policies are not considered as effective instruments for accelerating income growth. This has rendered a rather simplistic approach to relief and development. The tasks of solving the economy's pressing problem of poverty and revitalizing its depleted supply capacity are not directly addressed, but are left to free market mechanisms to be resolved them in the future, once a liberalized trade institutional set-up is put in place.

The importance of international trade for stimulating sustained income growth cannot be over-emphasized. Trade expansion is a lengthy process that requires intensive preparations that should proceed even under adverse conditions. However, it would be premature to stress export promotion and import liberalisation as the top priority objective at this stage of the Palestinian economy's de-

development. An exclusive-focus on trade liberalization and the assumption that poverty can be reduced through its trickle-down effects could be counter-productive. Palestinian enterprises are too weak to withstand increased competition in global or even domestic markets and are likely to remain as such long after the achievement of a political settlement.

At issue is not whether Palestinian enterprises are well placed to increase and diversify exports, but how best to address the pressing problem of poverty and rehabilitating productive sectors of the economy. As such, the policy focus should be on reducing poverty while nurturing supply capacity, eliminating occupation-related distortions and laying the ground for the economy's sustained recovery, where trade is an integral component. Therefore, the focus should be on the required policies for achieving this, and how trade can play a supportive role therein. The role of trade is to provide a vent for productive surpluses, in addition to financial resources to cover imports that are required for industrial development. As UNCTAD's recent LDCs report suggests, the relationship between trade openness, trade integration, growth and poverty reduction is far from mechanical or linear (UNCTAD 2004c, Chpt. 8). In this context, it is imperative to disentangle three issues:

- First, it is not always the case that trade liberalization directly reduces poverty. Dollar and Kraay (2001), Wade (2004), UNCTAD (2004c), and Rodriguez and Dani (1999) have pointed out that there are methodological problems and conceptual shortcomings to arguments that indicate a direct positive relationship between openness and growth.[26] Comparative experience (UNCTAD, 1997) shows the risks and uncertainties generated by indiscriminate trade liberalization, particularly the negative impact on local enterprises' growth prospects as a result of increased competition and imbalances in the global trading system that have inflated wage inequalities within tradable sectors as a result of trade liberalization. UNCTAD (2003c) suggests that not all developing countries that have successfully increased their share in manufactured exports witnessed concomitant increases in income levels. Their exports continue to be concentrated in resource-based and labour-intensive products that score low on productivity and, as such, have a limited impact on GDP.[27] At the same time, reducing poverty requires going beyond the necessary but insufficient, condition of accelerating economic growth. Empirical evidence (Osmani 2004) shows that there is no consistent relation between growth and poverty reduction, and that even under faster growth, policies specifically targeting poverty are required.

- Second, it is the wider approach towards lifting balance of payments constraints, and not just trade liberalization that can ensure faster economic growth resulting in poverty reduction. This would allow an increase in public revenue and expenditure, and therefore expand the government ability to extend basic services. If anything, across-the-board liberalization risks aggravating budgetary constraints through reducing trade tax revenues. This is highly relevant to the Palestinian case, where at least 25 per cent of the PA revenues are generated from imports, with customs duties estimated at 6.0 per cent of GDP in 2004,[28] down from 6.7 per cent in 1999 (Bennett 2003). It would be difficult to replace lost trade-related revenue with other types of indirect or direct tax, at least in the coming years. Given soaring poverty rates, the business community's weak structure, and the PA's small tax base, it is extremely difficult, if not impossible, to raise income taxes.

- Third, it should not be forgotten that trade policy is but one element of development policy. The latter also draws on fiscal, monetary, exchange rate and industrial policies (most of which are not available to Palestinian policymaker), and an enabling environment to ensure a positive response to incentives. Particularly important in this regard are policies which promote the development of productive capabilities through capital investment, skills acquisition, organization change and technological modernization.

This means that to facilitate a powerful role for trade in reducing poverty, Palestinian efforts should be rooted in a *development-driven approach to trade rather than a trade-driven approach to development*. Efforts should focus on addressing the economy's structural weaknesses. Expanding trade should be addressed through a longer-term sequenced approach. Gains related to improved efficiency, economies of scale and productivity, while important, are additional benefits that require time to mature, not least in view of the economy's permanent vulnerability and political uncertainty. Indeed, comparative experience shows that the more diversified an economy's structure, the greater the role of trade in achieving growth and in reducing poverty. In other words, as UNCTAD (2004c, Chapter II) suggests, international trade can best serve as a vehicle for poverty alleviation when the economy matures, and trade policy is only useful when it is part of an integrated policy package.

Without a careful assessment of the *future potential* of different sectors and the supportive policy they might need, it would be imprudent to accept unconditional openness to trade when the Palestinian economy is in a position to benefit from the special and differential treatment accorded to LDCs.[29] Indeed, the all-important considerations of pace and sequencing the compliance process, which are at the heart of developing countries negotiating agenda at the WTO, are not reflected in the policy papers prepared by the PA. Nor is there any mention of the accession process timeframe, both in terms of making use of an observer period, as well as the period between submitting a memorandum and concluding negotiations and the various exceptions and grace periods that the emerging State could benefit from under the WTO rules. Instead, compliance is presented as a single undertaking, already partially effected owing to the CU with Israel, with no prioritization. Such a negotiating stance could undermine the future Palestinian State’s economic potential through pre-judging the type of obligations that it would accept if it pursues negotiating accession to the WTO.

This trade-driven approach to development has also rendered an exaggerated emphasis on Israel as the predominant and inevitable trade partner in any future trade regime. Although the resumption of Palestinian-Israeli trade relations gains much importance for kick-starting recovery, it should not constitute an overriding element when devising an economic strategy. This is particularly in view of the replacement of Palestinian with foreign labour and the structural changes in the Israeli economy (towards more value added and IT sectors), implying a lesser demand for Palestinian skills.

If anything, current Palestinian economic dependence on Israel does not reveal the economies’ potential comparative advantages or incentive structure. Rather, it is the outcome of a trade regime that has inflated cost structures and impeded improved productivity. Furthermore, a large number of the industries that have survived the past five years were able to do so either because there is a great need for their output in the Israeli market or because they were industries that survived due to local market capacity. In other words, the present structure of the Palestinian economy emerged under the conditions created over decades of occupation and certainly does not imply a *future configuration* of sectors that could flourish under a more independent policymaking set-up that responds first and foremost to Palestinian imperatives, with less distortive influence from Israeli policies and measures.

Finally, the PA policy documents come in contrast to the Palestinian Private Sector Coordinating Council white papers (PPSCC, 2003) that warn against the negative consequences of across-the-board economic liberalization on the devastated economy. Those papers also stress the need to re-orient trade relations with Israel to allow for a better servicing of national development objectives, and ensure proper protection of Palestinian enterprises. This begs the question as to the extent to which the principal of public-private partnership is actually implemented in the Palestinian context.

C. Donors, reform, policy and national ownership

As alluded to in the previous chapter, PA renewed development efforts since 2002 involved adopting policy prescriptions proposed, or at least influenced, by donor institutions and specialized development agencies, with limited participation or feedback from all stakeholders at the grass root level. No doubt that the PA's limited capacity in economic policymaking is to a great extent responsible for such a vulnerability to donor influence, in addition to the differential competence levels within and between Ministries, thin executive capacity in translating priorities and goals into coherent action and severe budgetary constraints. The continuous restructuring of line Ministries is another factor, implying that there is little institutional memory of previous development efforts.

While international institutions play an important role in enabling the PA to draw on successful development experiences, the direct involvement of those with either funding and/or political role in Palestinian economic policymaking processes runs the risk of undermining national ownership and policy responsiveness. Indeed, to all intents and purposes, the policy package advanced by these sources is hard to differentiate from prescriptions emerging from the "Washington Consensus", commencing with the conventional wisdom that economic liberalization, privatization to the full and good governance provide the optimal, if not sufficient, framework for growth.

Across-the-board trade liberalization and rapid integration are depicted as beneficial for the devastated Palestinian economy as for any similar-sized developing economy, and therefore instrumental for reducing poverty. Incidents of market failure (e.g. the conservative lending policies of commercial banks) are treated separately within the context of institutional development efforts, which focus on creating modern physical infrastructures, strengthening market support institutions and developing the legal framework. Likewise, failures in policy reform, poor public management and rent seeking are interpreted as instances of institutional failure, to be addressed through effective governance structures that provide incentive systems to cope with such failures.

While acknowledging the merits of open economies, this policy package is hardly responsive to the specificities of the Palestinian economy's needs. Such prescriptions were designed for sovereign developing and transitional economies that were actively seeking to phase out protectionist measures and reduce the public sector's heavy involvement in commercial activities through state-owned enterprises. The problems facing the emerging Palestinian State are strikingly different from these economies. Palestinians do not have a well-established government, and enterprises are marginalized by a trade regime that is geared to protect their Israeli counterparts.[30] Indeed, the development challenges facing Palestinian policymakers stem more from the lack of political sovereignty, and an externally imposed structure that has relegated the economy to subordination and dependency, than from distortions and inefficiencies created by government intervention.

Nonetheless, the weight of developments on the ground, the economy's present debilitated condition and the depleted supply capacity, have imposed themselves and obliged all parties to be aware of the urgent need to increase development assistance in the aid portfolio while maintaining relief efforts underway since 2001. However, this envisaged reallocation of international support to the Palestinians is not free of *conditions*. A number of PA's performance indicators, especially in the area of governance, are tied to the resumption of development assistance, while at the most recent donor's meeting held in London in December 2005, renewed budget support was made contingent on stricter adherence to wage control by the struggling PA. Aid, especially for infrastructural development, is also linked to easing Israeli restrictions (a condition beyond the control of the PA). This case-specific, somewhat unconventional, *conditionality* was implicit in recent reports prepared by the World Bank, at the request of the PA, Israel and donors, to review various aspects of Israel's disengagement from Gaza (World Bank, 2004c). The reports call, in a first phase, for immediate "easing of internal closures throughout the West Bank and removing restrictions on the movement of cargo across borders". However, they argue that easing closure will not revive the Palestinian economy unless "accompanied by a credible Palestinian security effort" and a "reinvigorated programme of Palestinian reform, designed around measures that will create an investor-friendly business environment".

In this context, the World Bank reports defined 18 key "benchmarks" for measuring progress in achieving the above-mentioned prerequisites, which are consistent with the obligations that the PA and Israel are expected to fulfil under the Road Map. In particular, these include consolidating the PA security apparatus and improving the institutional performance in the areas of democratization and the rule of law, fiscal management, transparency and accountability. The World Bank has also proposed a number of projects to assist the PA achieve progress against these benchmarks, in addition to the transfer of settlement assets to the PA, in the following areas:[31]

- *Trade facilitation*: easing Israeli restrictions on the flow of Palestinian goods and labour across main border crossings in Gaza, reconnecting the West Bank with Gaza, establishing a Roll-on, Roll-off port facility in Gaza, reconstructing Gaza airport and restoring internal movement in the West Bank;
- *Emergency humanitarian needs*: repairing homes, granting conditional cash transfers to the poorest of the poor;
- *Restoring growth*: reclaiming agricultural land, restoring the movement of goods in and out of the Gaza Industrial estate, introducing qualified industrial zones, generating employment through infrastructure projects, municipal environment clean-up, drilling for natural gas and rehabilitating damaged road networks;
- *Private sector development*: establishing a loan guarantee fund, micro-finance schemes and insurance against risk, in addition to enacting core commercial laws; and
- *Good governance*: fighting corruption, improving budget management, human resource development, legal and judicial reform

If significant progress could be achieved, then "a major new donor effort would be justified and a donor pledging conference should be called". The argument is that "quantum increases" in levels of donor developmental assistance would be "wasted" in today's distorted policy environment, and would do little to attract private investment, which is needed to sustain any recovery process. Other than the November 2005 agreement on certain issues affecting movement through Rafah and Karni, little progress has been possible in the other component of the Bank's recovery programme.

In addition to direct conditionality, donor support can also be influenced by the policy recommendations of international institutions, especially with regard to the future economic relations with Israel. These recommendations are mostly based on studies that do not consider the economy’s full potential beyond existing relations and beyond industries that survived under occupation and dependence. In addition, they are largely prepared by international experts with limited national ownership, or at best with narrow national debate. Typical examples in this regard are the EPP (London School of Economics, 2004) and World Bank (2002) studies discussed above. Specifically the World Bank’s study, which was completed a year before Israel's strategy of separation was launched, states:

> "Any future peace accord and related economic agreement will need to isolate political variables from the economic sphere, in order to avoid repeating the current situation in which economic objectives are undermined by competing constituent demands in an unsettled political environment. But under any scenario, Israel will continue to be a very important partner for the West Bank and Gaza".

In addition to the concerted donor efforts to assist the PA in responding to the imperatives of the Gaza disengagement, attention is currently centred on supporting the PA reform agenda as presented to the donor community in early March 2005 during the London Meeting.[32] The agenda, entitled "Palestinian Authority's declaration on institutional renewal", is in line with the “One-Year Reform Action Plan”, outlining priority measures in the areas of governance, security and economic development. The Meeting ended with a declaration that emphasizes the international community’s support of the PA’s preparations for statehood, with specific commitments under the aforementioned reform areas. The declaration also attaches great emphasis on reforming PA institutions, stating that the PA's "sincere commitment to a viable plan to meet the benchmarks of good governance should open the way to donor governments providing renewed support in Palestine". The donor community also remains closely involved in the PA reform process through the "Task Force on Palestinian Reform" (TFPR), which brings together the Quartet members and four key donor representatives (Norway, Japan, the World Bank and the International Monetary Fund). Established in 2002, the TFPR is supported by seven thematic Reform Support Groups on elections, financial accountability, judiciary, legislative process, market economics, local government, public administration and civil service reforms.

Donor concerns about the failing Palestinian fiscal situation intensified following the Palestinian Legislative elections of January 2006, as a range of new political uncertainties added to an already critical budgetary position. The PA budget deficit of around $700 million at the end of 2005, expected to grow by at least $50 million each month afterwards, has emerged as a pressing issue which risks generating additional conditions for continued aid. The following Chapter will further elaborate on donor support and its influence on development and policy formulation. The Chapter will also focus on the imperative of linking relief, rehabilitation and reconstruction to development in the case of Palestine.

IV. INTERNATIONAL AID: REFORM, RELIEF, REHABILITATION TO DEVELOPMENT

This Chapter introduces the concept of *distorting* and *non-distorting* development aid and attempts to relate it to the Palestinian case. It further focuses on the type of international aid extended to the Palestinian people before and after 2000, and highlights the imperative of linking all types of aid in a framework that aims at achieving the long-term objectives of a socio-economic development vision.

A. Distorting and non-distorting development and aid/relief

The relationship between aid and development depends not just on the types of aid that are being offered, but also on the development policies and programmes targeted by the aid. Certainly some international aid to developing countries addresses special problems, such as natural disasters, diseases or environmental degradation, whose alleviation can only save lives and promote recovery or development. But when attempting to identify of *aid that does not distort development* it is necessary to address two separate but related issues. First, the meaning of a *non-distorting* development policy has to be defined. Secondly, the non-distorting nature of aid strategies has to be determined by examining whether aid helps or hinders developmental policies, or helps to overcome constraints on the implementation of such policies.

The first issue is by no means a straightforward question, since there are important questions about how to define distortion in different contexts. The conventional economics paradigm may be used to provide a simple answer to this question: *public economic policy is distorting if it distorts a competitive market or allows distortions to continue*. As Anne Krueger (1990) pointed out, both are important because government failures could happen not only because of acts of *commission* where the state increased distortions in the market, but also because of acts of *omission* where the state failed to remove distortions.

While it was important to point out the importance of both commission and omission, more recently, the competitive market paradigm has been questioned in terms of its adequacy for informing policymaking in developing countries. *One* set of questions emerged in the light of the experience of rapidly growing developing countries over the last century that did not conform to many of the requirements of these models. An examination of this historical experience suggests that economic policy can assist development by helping to overcome the technological, political and market constraints that a developing country faces. A *second* set of questions arises in conflict situations where economic policy has to be a *second-best response* to exogenous constraints that cannot be changed in the short-run.

In both cases, *developmental responses* by the state can require interventions that help overcome these constraints by creating new rents or managing existing ones better. These policies can be more or less successful even though they remain far from the theoretical ideal of a competitive market. Indeed the latter may be a misleading benchmark for evaluating development policy in these contexts. But Krueger’s observation is still relevant in that development policy can once again be distorting not simply by creating distortions that reduce development potential, but also in failing to remove distortions that already exist. Thus, non-distorting development policy requires a more pragmatic definition, such as: *an economic policy that helps a developing country accelerate development by overcoming specific constraints or distortions that might otherwise exist.*

This definition suggests that development policies under conflict conditions can at best be ranked in terms of their contribution to *relieving developmental constraints*. In comparing policies, it is possible to discuss which is more likely to help overcome critical constraints affecting development in each specific case. The issue of aid and relief can then be addressed in that context.

Non-distorting relief can be defined either as a policy of aid that assists in the implementation of developmental state policies or that assists in the removal of distorting constraints. Thus, aid could be non-distorting if a resource-constrained developmental state was attempting to implement non-distorting developmental policies and aid simply provided additional resources allowing accelerated progress. In this case, aid would be non-distorting if it did not attempt to change the state's developmental policies, but only helped to accelerate their implementation.

On the other hand, if a state is not able or willing to address critical developmental constraints, the question of non-distorting aid becomes more complicated. In this case, if aid simply provides more resources to such a state, it may have little effect on development. Such an aid strategy would be *distorting by omission*. However, the issue of non-distorting aid or relief is more complicated owing to the difficulty of identifying *viable* ways where aid could have been *less distorting* by helping to overcome some of the constraints that were restraining overall development. If there were *no* viable ways in which aid could help to change some of the binding internal or external constraints, the best strategy would simply be to alleviate some of the human costs of constrained development. Aid would once again be non-distorting under these circumstances, and take the form of relief. The degree to which a particular aid strategy is distorting thus depends on the *constraints on development in a specific country*, the developmental strategies of the state and on whether the constraints can be addressed by external actions or influence.

B. Rent creation and state management capacities

The definition of policy-induced distortions most often used in international economic policymaking derives from a simplistic reading of mainstream economic theory. Economic policy is defined as *non-distorting* if it ensures that markets are *competitive* and *free* from restrictions and artificial rents. This in turn is arguably sufficient to ensure that resources are allocated to maximize efficiency. However, important qualifications in mainstream economic theory make this model insufficient as a guide for policy, particularly in contexts of development and even more so in contexts of conflict. The experience of rapidly developing countries in the last century has shown that development can be dramatically accelerated if states have the capacity to tackle market failures, accelerate the acquisition of technology and solve or manage political conflicts. Overcoming these constraints involves, amongst other things, the capacity to create and manage rents of different types (Stiglitz 1996, Aoki, Kim and Okuno-Fujiwara 1997, Khan and Jomo 2000, and Hilal and Khan, 2004).

Development policies have to be judged for their adequacy given the specific technological, political and infrastructural constraints faced by a particular country, and the institutional and political capacity of the state to manage the rents and interventions through which these constraints are being tackled. If rents were being created and *effectively managed* to overcome these constraints and accelerate development, developmental policies could be *non-distorting* even if markets were not rent-free. Indeed, the *absence* of rents in such a context could be judged to be *distorting* because it would signal the absence of intervention to deal with serious market failures, technological backwardness or political crises.

On the other hand, if state intervention created *damaging or dysfunctional rents*, or failed to manage the allocation of rents appropriately, interventionist government policies would indeed be further *distorting* the Palestinian development path. Thus, to identify whether state policies were distorting or not requires going beyond the simple question of asking whether markets were sufficiently competitive and rent-free, a condition which is neither necessary nor sufficient for *non-distorting* development.

To identify the types of rents and rent-management capacities that would be necessary for accelerating development in a particular context, the most important developmental constraints faced *should first be identified*. Possible developmental alternatives can then be compared with the rent creation and management that is actually observed, to determine whether current government policies are distorting or not. For instance, if maintaining political stability required rent creation, as the Palestinian experience suggests, it would be of concern to see if the *state's rent-management capacities* allowed it to allocate these rents in a way that maintained political stability at the lowest economic cost. Similarly, if technological backwardness was deterring investment, *targeted rent-creation* may be considered a viable mechanism for attracting and enhancing investment. In these cases, it would be necessary to look at the state's political and institutional capacity to allocate these rents in ways that *promoted developmental goals*, and its capacity for *disciplining rent-recipients*.

At the other end of the spectrum, rent creation may be very damaging for the economy. Dominant unproductive groups may *create and capture rents* (in the name of political stabilization, traditional lobbies or infant industries) while the state is *unable to discipline or manage* the allocation of these rents. In some cases, powerful internal groups with an interest in maintaining damaging rents may have captured the state. In other cases, the state may simply lack the institutional and regulatory structure appropriate for managing the rents required. In yet other cases, a government may lack the political capacity to change binding external constraints, a feature that seems relevant in the case of Palestinian pre-state formation. In these cases, states fail to overcome existing constraints, and in the worst cases, they may *create unproductive rents* that effectively *create further constraints* on development.

Once the most pressing constraints on development and the degree to which the state is addressing them have been identified, a *second question* can be addressed: the types of aid and relief policies that are non-distorting in that context. The relatively simple case is one where the state is already following more or less appropriate developmental policies but needs assistance to accelerate the implementation of these policies. The more difficult cases are those where the state is *failing to adequately address internal or external developmental constraints*. In these cases, the definition of non-distorting aid and relief is more complicated. These more difficult cases are far more common in developing countries, and particularly in countries suffering from internal or external conflicts, where donors' political interests are highly influential. Here, a wide range of factors that drive distorting government policies may be observed, and without an analysis of the specific drivers of these policies it is not useful to identify what non-distorting aid and relief strategies should be.

So is it feasible that donor aid be targeted with some reasonable expectation about its impact on development, and under what conditions? If it is *unlikely* that external actions or the exercise of influence can do much to change the internal or external constraints obstructing development, non-distorting aid and relief can at best hope to identify a number of ways in which the general population can be assisted with coping strategies. By making such an implicit assumption, Stewart and Fitzgerald (2000) argue that *reducing the human costs of conflict* should be the immediate priority of aid, rather than conflict resolution, which must remain a long-term goal.

While this argument is robust in cases where the drivers of conflict are largely internal, it may be argued that there are important qualifications to it if the conflict is driven largely by a foreign occupation and where both sides to the conflict are dependent in different ways on external support and aid. In such a situation, the critical question is whether there are *feasible strategies of aid* that could weaken these external constraints. If there *were* such strategies, for aid to be non-distorting, it would have to achieve these goals.

But it may be that *no* aid strategies can undermine the internal and external constraints on development. This would be another case where the Stewart and Fitzgerald *human-cost-reduction strategy of relief would be non-distorting*, because it would reduce human costs without doing anything that could change the duration of the conflict, and therefore of underdevelopment. Given the significant role of external constraints in driving both the conditions of this particular conflict and the constraints affecting economic development, a discussion of distorting aid and development has to look at the interplay of all these factors.

C. Relief and development assistance: pre- and post-2000

As poverty deepened in the occupied Palestinian territory since 2001, the donor community responded with a substantial increase in its support to help the Palestinian people to cope with rising relief and emergency needs. As a result, disbursements doubled from an average of $528 million per year in 1999-2000 to over $1 billion per annum in the period 2001-2004 (Table 4.1). Not only were the increased funds totally allocated to relief and emergency assistance, but a substantial portion of what was previously pledged for development assistance was redirected to relief and emergency purposes. The share of development assistance in total ODA dropped from 88 per cent prior to 2000 to an average of only 28 per cent in the following four years. Much of what is categorized as development assistance has been, in fact, emergency assistance in infrastructure and social sectors, especially health (UNCTAD 2003a and 2003b).

As for the distribution by major category of development assistance, the pressure of conditions on the ground has also led to changes in its sectoral allocation. The inadequate share of what could be described as productive sectors (agriculture and enterprise development) declined from 7 per cent in 2000 to 3 per cent in 2002. The share of agriculture dropped to below half a percentage point of total development assistance in 2002. Although, these trivial shares already reveal inconsistency in the allocation of donor fund, the degree of inconsistency becomes abundantly clear when focusing on their shares of total donor support. Table 4.2 shows that while funds disbursed to agriculture declined from $9.8 million per year in 1999-2000 to $7.6 million per year in 2001-2004, funding of enterprise development dropped from $20.4 million to $13.5 million. In terms of their share in total donor support, the minimal 1.8 per cent received by agriculture in 1999-2000 dropped by more than half to 0.7 per cent in 2001-2004. The decline in the share of enterprise development was even larger; it decreased from 3.9 per cent to 1.3 per cent.

Table 4.1 – Donor Support to the PA by major category
($ million)

Category	1999-2000			2001-2004		
	Total	Annual average	Share in total (in per cent)	Total	Annual average	Share in total (in per cent)
Development	930.5	465.2	88.1	1163.2	290.8	28.4
Emergency	99.0	49.5	9.4	1186.0	296.5	29.0
Budget Support	27.2	13.6	2.6	1742.1	435.5	42.6
Total support	1056.6	528.3	100.0	4091.2	1022.8	100.0

Data compiled from the PA Ministry of Planning database, Directorate of Aid Management and Coordination at http://db.mop.gov.ps/amc/. Data include support to UNRWA. However, some of the donor fund may have not been reported and registered. Therefore, the figures in the table could be below what was actually disbursed. Data do not include fund directly disbursed to NGOs.

Table 4.2 – Donor support: total, agriculture and enterprise development
($ million)

Year	Total	Agriculture		Enterprise development	
	Ann. avg.	Ann. Avg.	Share (in per cent)	Ann. avg.	Share (in per cent)
1999-2000	528.3	9.8	1.9	20.4	3.9
2001-2004	1,022.8	7.6	0.7	13.5	1.3

A comparison between Tables 4.3 and 4.4 highlights the degree of inconsistency between donor support sectoral allocation and emerging needs on the ground. After September 2002, agriculture became a major economic shock absorber for the shattered economy, as its share in domestic employment increased from 12.6 per cent in 1999 to almost 16 per cent in 2004. During the same period its share in development assistance (not total assistance) reached a low of 0.4 per cent in 2002 but increased after that to 2 per cent in 2004. Comparing the share of manufacturing in domestic employment with the share of enterprise development in development assistance reveals an inconsistency similar to that of agriculture, but of a lesser extent. However, it is worth noting that these inconsistencies were already featured in the sectoral allocation of donor support before 2000, but became more apparent after the switch to emergency and relief assistance.

Framing these inconsistencies in the context of the issues raised in the previous section suggests the possibility of a distorting aid and development pattern prior to 2000, which has become more distorting after the escalation of conflict and the tightening of Israeli measures and the associated switch from development to relief assistance. This is further explored in the next section.

Table 4.3 – Development assistance to the PA and its sectoral allocation

Year	Total dev. assistance ($ million)	Sectoral allocation (in per cent)				
		Agriculture	Enterprise development	Infrastructure	Human Resource Dev.	Others
1999	474.4	2.5	3.6	37.5	21.9	34.5
2000	456.1	1.7	5.2	46.4	16.2	30.5
2001	318.0	7.0	4.2	36.9	27.2	24.7
2002	229.4	0.4	2.6	33.2	38.0	25.8
2003	359.2	0.6	4.6	32.2	16.7	46.0
2004	256.6	2.0	7.1	25.1	17.1	48.7

Table 4.4 – Palestinian employment and its sectoral allocation

Year	Employment (thousands)		Sectoral allocation of domestic employment (in per cent)					
	In Israel	Domestic	Agric., hunting & fishing	Mining, quarrying & manufact'g	Construc'n	Commerce, hotels & restaurants	Transport. storage & communic'n	Services & other
1999	127.0	461.0	12.6	15.5	22.1	17.0	4.7	28.1
2000	110.2	486.8	13.7	14.3	19.7	17.5	4.9	29.9
2001	65.9	442.1	11.7	13.9	14.5	19.6	5.6	34.7
2002	46.9	439.1	14.9	12.9	10.9	21.1	5.5	35.7
2003	52.5	538.2	15.7	12.5	13.1	20.1	5.8	32.8
2004	48.1	558.8	15.9	12.7	11.7	19.9	4.9	34.9

D. Imperatives of linking non-distorting relief to non-distorting development

Using the framework discussed above, it is possible to identify some specific problems in examining non-distorting development and aid policies in the Palestinian context. Since the signing of the Oslo Agreements in 1993, the Palestinian territory has often been treated as a politically separate entity in discussions on economic performance and constraints. This may partially have reflected Palestinian aspirations, but has not actually been in accordance with the economic and political facts associated with occupation since 1967 (Abed 1988, Hamed and Shaban 1993), much of which remained in force after Oslo. Notwithstanding the proactive role of the PA in trying to address public and donor concerns on governance during the period (Shaban and Jawhary 1995, Diwan 1999, Zagha and Zomlot 2004), the reality of lack of sovereignty was further highlighted in developments since 2000 (IMF 2003).

It is apparent today, if it wasn't a decade ago, that the greatest developmental constraints facing the occupied Palestinian territory are predominantly related to the fact that the Palestinian people do not have a state. The Palestinian territory has effectively remained since 1967, and even since 1994, under the economic and political control of an occupying power. The latter has in turn hardly recognized any long-term *responsibility* for the growth or development of the Palestinian economy, notwithstanding the *perceived common interests* of economic cooperation in the 1994-2000 period. The development potential of the Palestinian economy has therefore depended on the trade regime, fiscal and monetary policies and labour mobility criteria, which the occupying power can regulate in the light of its own sovereign interests.

While a number of governance failures within the PA are widely considered to have been *avoidable* and can be traced to internal political processes, other cases of apparent governance failures during 1994-2000 were *directly induced by the external constraints* under which the PA laboured (Khan 2004, Hilal and Khan 2004). Indeed, many of the unconventional rent creating activities of the PA that attracted much attention were arguably *useful for attracting investments* into a territory that lacked any secure future. These aspects of internal governance have been the subject of a number of reforms to improve the transparency and accountability of the executive following the developments since 2000 that led to the PA's near collapse. Progress appears to have been made in improving these aspects of governance since 2003.

But the external factors that have been by far the most important constraints on development, and which *arguably drove the PA to take some unconventional rent-creation measures*, remain in place with critical implications for Palestinian development strategies. Indeed, despite progress in *reform of the PA*, economic decline has been consistent since 2000. This simple contrast highlights the relative importance of *internal and external constraints* in determining the growth performance of the Palestinian economy.

The most significant operational constraints on Palestinian economic freedom follow from the "security first" route enshrined in the Oslo Agreements and the subsequent Road Map. The logic of this route is that Israeli security requirements can override critical issues affecting the economy, territory and political sovereignty of the Palestinian territory. As long as security first remains the foundation of the peace process, these imperatives will remain supreme until Israeli security requirements have been met. The PA has until now had no alternative but to accept considerably less than normal sovereignty for a now-prolonged interim period featuring significant limits to its economic autonomy.

External economic and political constraints are in turn closely connected. For instance, maintaining control over Palestinian borders implied Israeli collection of Palestinian customs dues, and therefore Israeli control over significant parts of Palestinian tax revenues and trade agreements. These and other economic features of the Oslo Agreements are well known and were justified by the Israeli side in terms of either short-term expediency or the need to ensure compliance by the Palestinian side, *before* greater sovereignty was transferred. However, after the Israeli disengagement from Gaza in September 2005, these arrangements are effectively subject to revision. It is not clear whether this will lead to more sovereignty for the PA in both the West Bank and Gaza, or a different type of external constraint. In any event, any discussion on developmental constraints has to evaluate alternatives that may emerge under the different scenarios.

Furthermore, in the context of the policy of a relation of *asymmetric containment*, maintaining Palestinian compliance could take the form of creating institutional mechanisms that inflict *one-sided sanctions in case of non-compliance with external requirements*. The viability of this policy stems from systems of control over labour mobility, trade, borders, fiscal revenues and internal and external population movements. A containment policy may be justified from an Israeli security perspective or even from a donor's financial management and public accountability perspective. But from a Palestinian development viewpoint, restrictions affecting most aspects of economic activity are seen as the key factors behind the vulnerability of the Palestinian economy. And from the perspective of assessing aid and development strategies, the critical question is whether the strategy is immune to external pressure or to donor support for specific strategies aimed at *reducing Palestinian vulnerability to asymmetric containment*. These external constraints, and their ability to withstand intervention, have to be incorporated in any analysis of Palestinian development options.

Therefore, what constitutes *non*-distorting development and aid in the Palestinian context depends on how binding the determinants of asymmetric containment are. If donors cannot do anything to challenge the feasibility of the strategy of asymmetric containment, *relief for the most vulnerable sections* of the Palestinian population may be the best aid strategy. If on the other hand, donor strategies could have reduced the feasibility of such a strategy and thereby enabled the Palestinian economy to perform better, the failure to do so is a *failure of omission* that contributes to the growing distortion of the Palestinian economy.

It would be incorrect for donors to assume that little can be done to reverse the existing external constraints on the Palestinian economy or to limit any future extensions of restrictions. Donor strategies can seek to minimize the risk of inadvertently following distorting aid and development policies. Aid can offer a way to support the management of Palestinian economic development in the context of an ongoing asymmetric conflict over territory and sovereignty. At the same time, the *unique importance of external constraints in the context of this specific conflict should be featured in any aid strategy*. This implies a need for donors and the PA to exert all possible efforts to *limit the extension of asymmetric containment* strategies as a necessary part of economic recovery and long-term development.

E. Alternative approaches to aid in the Palestinian context

It is only recently that the Washington Consensus has been revisited by the World Bank in its recent *"Economic Growth in the 1990s: Learning from a Decade of Reform"* (2005), at an opportune moment in the Palestinian development debate, when decisive policy directions have yet to emerge. In his review of this World Bank publication, Dani Rodrik highlights one of its key findings, namely that:

> "reform efforts need to be selective and focus on the *binding constraints* on economic growth rather than take a laundry-list approach à la Washington Consensus…. Even though countries may face situations in which many constraints need to be addressed simultaneously, the report judges these situations to be rare: 'In most cases countries can deal with constraints sequentially, a few at a time' (p. 16)" (Rodrik, 2006).

Such a sober reminder of the need to deal with the *specificities of the Palestinian development dilemma* in a special way can only help spur a more realistic policy approach in the new circumstances of 2006. The discussion so far can help explain why aid has had a marginal role in development in the Palestinian case, particularly in the post-2000 period. The specific characteristic of the Palestinian situation is that asymmetric economic control facilitates compliance with security and political goals. This means that attempts to foster economic development for the envisioned State of Palestine face the problem of having to deal with an externally imposed institutional architecture that arguably *seeks* to maintain, and certainly does maintain, the vulnerability of the Palestinian economy.

As a result, successful developmental policies in the Palestinian context can be *expected to be unorthodox* owing to a unique set of externally imposed constraints. It is not surprising that during the period of relatively high growth at the end of the 1990s, the PA's ability to create rents for expatriate investors played an important role in partially compensating for the uncertainty due to the unclear political future of these territories (Hilal and Khan 2004). The capacity of a state to create rents for investors only makes sense if there are specific constraints that need to be overcome. These can be technological (as discussed in Amsden 1989, and Aoki, Kim and Okuno-Fujiwara 1997), or political, as in the case of Palestine (Khan 2004). In such circumstances, *destroying or even failing to develop these capacities* is significantly damaging.

If aid policy could have affected the effectiveness of containment, failing to do so creates a serious distortion. This is potentially much more important than just a matter of terminology that defines some strategies as distorting. While aid as pure relief could have been non-distorting in circumstances where constraints were truly exogenous, the same relief strategy can be *damaging* if it accepts and reinforces coping strategies that lead to the economy de-formalization and a weakening of the PA's already limited developmental capacities. This is because some types of relief-based responses can make the Palestinian economy *more vulnerable* to containment in the future. Thus, concern with the role of aid as relief has to be distinguished from the argument put forward by Steward and Fitzgerald (2000) that relief and development may reinforce one another in conflict situations. This is in general a plausible argument, but in this specific context, relief is unlikely to weaken the forces driving the conflict, and may instead make the specific strategy of containment *more viable* in the future by allowing attrition of PA developmental capacities.

Such a critical perspective can help Palestinian policymakers and aid donors to think through the developmental implications of traditional relief strategies, such as prioritizing the provision of emergency food, medical supplies and even budget support. In this case, traditional relief strategies do not seem to undermine development constraints. If anything, by prioritizing this form of aid, a structural change of the Palestinian economy towards low productivity agricultural activities and informal sector activities may be inadvertently facilitated.

This line of enquiry is *not an argument against traditional relief* in a context of extreme human hardship. It would be an equally grave error to believe that by suspending relief anything would happen to change the constraints the Palestinian economy faces. There is no question that in the immediate future, humanitarian relief and/or budget support must continue to account for a major part of actual aid deliveries. *But this does not necessarily mean that humanitarian relief and budget support should be a strategic priority*. As long as conflict and political instability are predominant, the Palestinian people in the occupied territory will be forced to continue adjusting to the low standard of living which they are already experiencing. Even if closures are partially relaxed, subsequent improvements in living standards are likely to be vulnerable to political uncertainty.

Thus, vital as they may be, instruments such as humanitarian aid and budget/wage support have to be recognized as inadequate for making a lasting dent in Palestinian poverty and economic vulnerability in a context of asymmetric containment. Nor is the Stewart and Fitzgerald mechanism likely to work here, whereby relief aid undermines the war economy that is the source of economic deprivation. *Rather, a long-term relief strategy for the Palestinian economy has to be devised, and it is this that may be viewed as non-distorting aid.*

The preceding discussion of the logic of the relationship between non-distorting development and non-distorting aid from the Palestinian perspective suggests that Palestinian developmental strategies must at the very least incorporate the following components.

- *First*, they have to involve a political commitment on the part of the donors, the international community and the PA to push back or *at least* contain the progress of asymmetric containment. This is not just desirable in itself; the degree to which this can be achieved will determine the feasibility of other closely connected parts of the strategy;

- *Second*, until a reversal of asymmetric containment is possible, the most promising strategy from the Palestinian perspective is to promote state capacities for developing, to the greatest extent possible, higher productivity sectors in industry, agriculture and services. The focus here should be to learn pragmatically from the successful rent-creation and rent-management experiences of developing countries that overcame specific constraints through targeted interventions. These lessons cannot be directly transported, but the experience of 1994-2000 suggests that creating rents for investors in the Palestinian territory could play a part in such a strategy. This in turn requires state capacities to discipline and monitor rent-recipients along the lines of developmental state experiences;

- *Thirdly*, non-distorting aid and technical advice can then play a vital role in assisting the development of intermediate to high technology export-oriented industries.

In the Palestinian situation, concepts and tools such as *subsidies, import-substitution and industrial policy* should not be summarily dismissed as being irrelevant, outdated or even distorting. Indeed, aid can assist in helping to identify the available skills and the most appropriate high productivity industries and agricultural sectors that could benefit from a targeted subsidy strategy or joint public-private partnerships. Agriculture too could benefit from targeted subsidies to compensate for disruptions caused by Israeli controls over Palestinian water supplies and to enhance technical capacity. Aid has a further critical role to play in repairing and enhancing the physical infrastructure required for exports and trade. In some cases, this physical infrastructure has to be rebuilt and repaired. In other cases, *donor engagement* will be needed to allow unimpeded Palestinian trade flows to the outside world, as was briefly attempted in the wake of the Israeli disengagement from Gaza.

Such an approach may be ambitious, but there is little that suggests that occupation and the strategy of asymmetric containment is likely to be phased out any time very soon, even though it may take different forms and intensity. Relief has to be redefined as a long-term development strategy and the composite steps on this developmental path have to be taken even if they take time to implement. The following Chapter further outlines a framework to link relief and aid to long-term development, and highlight its importance for realizing the objectives of a Palestinian socio-economic vision, even under restrictive conditions.

F. Possible outcomes in the Palestinian case

Figure 4.1 summarizes the general features of the discussion. Internal and external constraints determine whether economic policies are “distorting” the developmental potential of the economy. If existing economic policies are developmental, aid can distort development if it deliberately or otherwise constrains these developmental policies (outcome A). If aid has no effect on economic policy but simply provides resources, it is non-distorting under these circumstances. Aid can then help to accelerate the implementation of developmental policies (shown as outcome B). The more typical case is the complex one where economic policies are inadequate in addressing important internal or external constraints on development.

Here the critical question is whether aid can help to change these internal or external constraints. If aid could help to overcome these constraints but fails to do so or makes them worse, it can be distorting (outcome C). On the other hand, aid is clearly non-distorting if it helps to overcome some of these constraints and thereby accelerate development (D). Finally, if aid cannot feasibly change any of the binding internal or external constraints on development, it would be unrealistic to categorize aid as distorting simply because it failed to achieve what was unachievable. In this case, aid could at best offer relief to a population in distress. Consequently, aid should now be classified as non-distorting because it cannot make the situation any worse, and could reduce the human costs of conflict or under-development (scenario E).

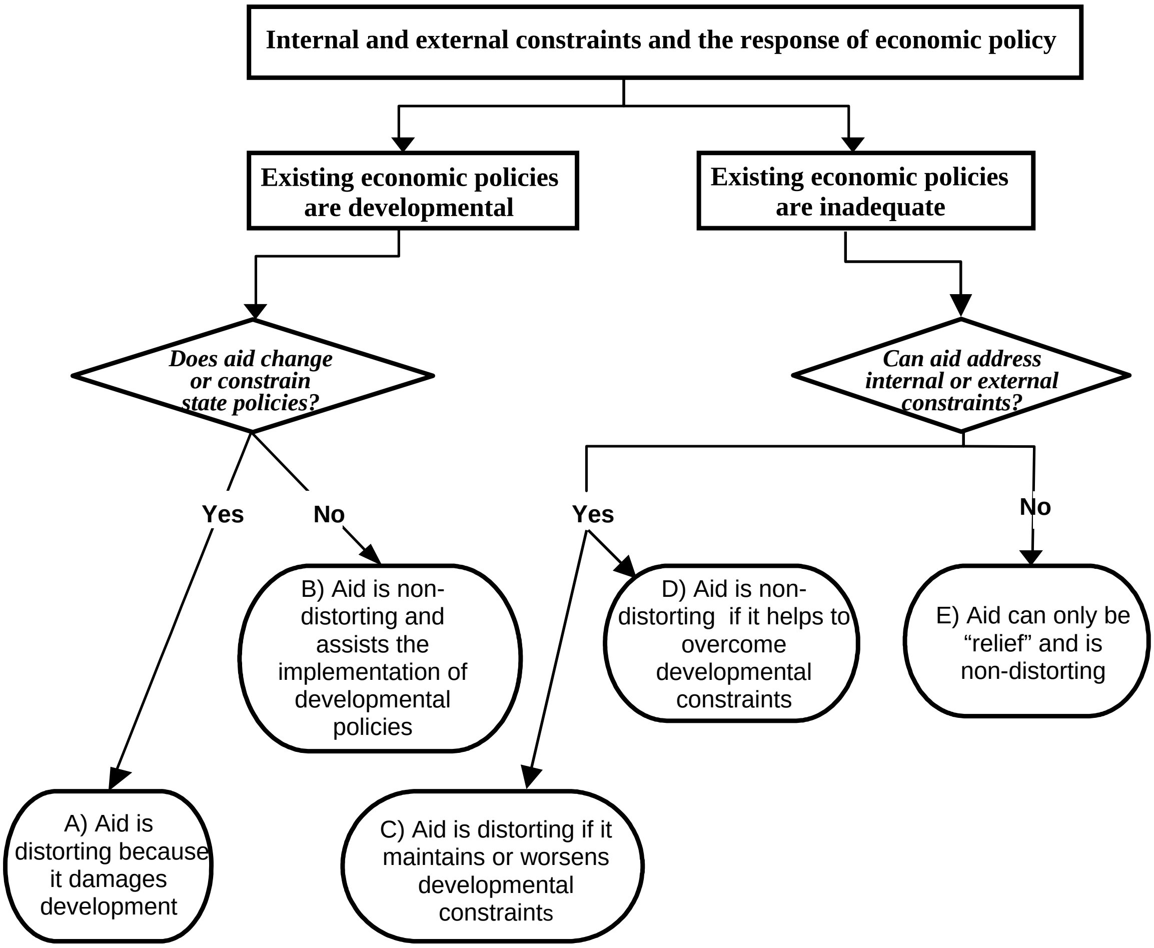
Clearly, Stewart and Fitzgerald are referring to scenarios D and E when they discuss the possibility of non-distorting aid. However, the preceding discussion points out other possibilities that should be considered. Even if aid cannot help to overcome constraints on development, it can still change these constraints for the worse. Thus, it is important to carefully distinguish between cases like (E) where aid is truly only relief and those like (C) where aid does not improve the situation but may even *worsen* the constraints on development. Sometimes even aid as relief can have this effect if it intensifies external or internal forces constraining development.

The framework suggested in Figure 4.1 thus distinguishes between a number of different possibilities. Aid that can successfully reduce the human costs of conflict and yet be non-distorting is either pure relief (outcome E), or aid that assists increase the resilience of a war economy thereby making eventual developmental interventions more likely (outcome D). Framing the discussion of the preceding chapters within this schematic context can be useful in attempting to better comprehend the Palestinian policy reform and aid relationship and its future path. While the Palestinian experience since 2000 seems to most resemble the (E) outcome, it has yet to be seen whether increased donor and international engagement in 2006 will move the situation towards the outcome (D) or (C).

In the Palestinian case, there is a significant risk that aid may induce outcomes like C, unless very careful attention is given to the effects of aid on developmental constraints. Otherwise, it can inadvertently worsen the constraints on development, even while it provides essential relief to a hard-pressed Palestinian population that is increasingly reduced to enclave economies and informal sector activities because of sustained restrictive measures. These are serious possibilities in the Palestinian case because the constraints on Palestinian economic development have been largely external, and aid has an asymmetric effect on these constraints. On the one hand, donor intervention could influence these constraints over time, but serious pressure on Israel from *its* aid donors and trading partners is generally ruled out. On the other hand, if the external constraints set by Israel are taken as immutable (e.g. settlements) Palestinian survival strategies may inevitably involve an informalization of the economy and a consequent weakening of the PA's capacity to push conventional development strategies. To the extent that the declining developmental potential of the Palestinian economy could have been avoided by rethinking aid strategies, existing aid strategies may inadvertently play a distorting role.

In this context, the PA needs to carefully consider proposals of international support on a massive scale or further institutionalisation of prolonged budget support to ensure that it is non-distorting aid which identifies relief activities and other programmes that do not damage the long-term potential of the Palestinian economy. This is a challenge for which the PA and the donor community have to be adequately prepared, especially in the new environment of 2006.

Figure 4.1 - Distorting and non-distorting aid and development



V. VISION AND PRIORITIES: TOWARDS AN ECONOMY FOR A VIABLE STATE

The preceding analysis shows that the development predicaments facing the Palestinian economy stem from its distorted growth trajectory. In particular, the *path dependent* approach, combined with asymmetric containment, the war-torn economy's depleted supply capacity and the impact of settlement and separation policies have set in motion a cycle of *de-development*. However, most of the strategic policy options that the PA was consistent to look at the economy's needs under a conducive, investment and trade-friendly environment that does not actually exist. Furthermore, these policy options implicitly assume that the economy's structural weaknesses and soaring poverty rates will automatically fade away via the trickle-down effects of free market operation, as a more liberalized trade regime will encourage industrial restructuring and an increase in productivity and income. This is predicated as possible even *without lifting the external constraints* that hamper growth prospects.

However, it has also become evident that sustained economic recovery requires either:

- dismantling the policy of asymmetric containment; or

- pursuing a strategy to deal with it and related distortions as external constraints in the short term, while at the same time working towards their elimination in the long run.

Although the latter option may not lead to a high-growth and sustained recovery, it does at least promise a path towards halting and possibly reversing the ongoing cycle of de-development by placing the war-torn economy on a footing from which it can cope with these constraints. This in turn will require going beyond the conventional economic policy wisdom and tailoring the development process to the economy's present distinctive features and institutional set-up. Such an approach needs to be concrete in detailing policies for poverty reduction, with specific programmes that clearly link all types of aid, including relief, to long-term development objectives and a state-formation agenda. Above all this approach has to be clearly identified as a means to achieve a Palestinian vision to drive both domestic and international support measures towards the establishment of a democratic, contiguous and economically viable State of Palestine.

A. National socio-economic vision with priorities

The moment is still opportune for the PA to rethink the existing economic policy framework: the trade regime, the process of regional integration, dependency on the Israeli economy, the management and allocation of donor funds and the process of donor coordination. These elements have to be integrated in a manner that at once serves Palestinian economic development and strategic national security interests towards a *vision* of national socio-economic development. A well-defined national development policy that reflects the aspirations of different strata of Palestinian society will facilitate the task of setting economic, social and institutional reform priorities.

From the economic development viewpoint, the vision would allow setting sectoral priorities, with focus on a limited number of sectors or subsectors to achieve time-bound developmental quantitative objectives (employment and income). This approach could also be applied to set priorities in the social sectors. As for the institutional formation process, a development vision with priorities would make clear to policymakers the types of institutions required to achieve the established goals and the most urgent elements of this process, including a priority agenda for law making, regulatory framework and sectoral reform.

Such a vision should guide the government to those fiscal, industrial and trade policies most appropriate to achieving priority socio-economic objectives and to supporting the growth of priority sectors/industries. In addition, the vision and its policy-priorities would reinforce the national ownership of donor-funded projects and programmes, enhance the Palestinian negotiating position with donors and help to reduce long-term dependence on donor assistance. Furthermore, it would allow the PA to play a leading and determining role in the allocation of donor support (to priority sectors). In short, the vision would help the Palestinian people *achieve their socio-economic targets at the least possible cost*.

B. Vision building: binding objectives

It seems reasonable to expect that the Palestinian people will continue to receive support from the international community, even if the peace process does not produce any immediate tangible results. Donor funds to the PA in the next few years might fluctuate in magnitude and type (emergency, budget support or development), depending on political/security progress and humanitarian conditions on the ground. However, by a conservative estimate this support will most likely approximate to the $1 billion a year disbursed in the last four years. Indeed, in the context of discussions surrounding the December 2005 donors (AHLC) meeting in London, annual needs and potential pledges are thought to amount to between $1.5 to 2 billion a year. Regardless of the outcome of eventual negotiations between Israel and Palestine, these funds should be considered as *national resources* and should be allocated in accordance with national development aspirations. This should be done in a manner that would allow the Palestinian people and their productive capacity to withstand the distorting impact of occupation, while at the same time achieve accumulation towards medium- and long-term economic goals.

Another issue the PA has to deal with is the excessive leakage of international aid out of the domestic economy, and specifically to Israel. Palestinian dependence on the Israeli economy is clear from the ratio of Palestinian imports from Israel to GDP. Between 2001 and 2004, it registered 46 per cent on average. Meanwhile the Palestinian trade deficit with Israel averaged $1,452 million per year (and represented 68 per cent of the $2,147 million average annual total trade deficit). From the trade deficit-finance angle, these figures suggest that, during the period 2001-2004, the equivalent of the total sum of funds received from the international community (around $1 billion annually) were insufficient to finance the lopsided bilateral trade balance with Israel. The rest of the deficit of ($395 million per year) was covered by net factor income from abroad (mainly remittances of Palestinian workers in Israel). Another revealing angle from which to view this leakage is the ratio of the Palestinian trade deficit with Israel to Palestinian GDP, which averaged 38 per cent in the period 2001-2004; i.e. for every dollar generated by the domestic economy, 38 cents were allocated to covering obligations to the Israeli economy.

The implication for Palestinian development and employment generation programmes is significant as it cannot be expected under the present circumstances that the income multiplier of donor funds injected into the Palestinian economy would have a tangible positive domestic impact, but it would be felt more in the Israeli economy. It is important to emphasize here that this should not be seen as a reason for the international community not to meet its obligations to the Palestinian people. Quite the opposite, the Palestinian economy needs additional support to withstand and recover from the ongoing crisis. However, the PA and the international community should work together within a Palestinian socio-economic development vision capable of protecting the poorest from the dire impact of the ongoing economic siege, while at the same time reducing dependence on imports from Israel and expanding markets for Palestinian exports.

Taking into consideration the above discussion and the sectoral pattern of development assistance for the period 1999-2004, it is crucial that the PA sets its development objectives, and resource allocation process, to maintain the largest part of available resources (relief or development funds) within the domestic economy. One way of achieving this is by modifying the sectoral pattern of development assistance observed in 1999-2004 and allocating more funds to relatively intensive labour industries. Specifically, agriculture and other sectors with higher employment generation capability should receive a higher proportion of donor development assistance, be it technical, financial or other support. However, the proposed switch should be associated with specific programmes to raise the productivity of labour intensive sectors, while at the same time increasing their employment absorption.

Hence, regardless of the substantive orientation of the national vision, it is important to continue to focus on the fundamental task facing the Palestinian economy, namely: the need to adopt *a strategy aimed at removing the dynamic created by the long period of distortion* and creating an environment in which the private and public sectors can perform their normal functions. This task involves three interrelated objectives:

(1) *Closing the resource gap in the Palestinian economy*. As indicated above, the Palestinian economy currently suffers from a chronic incapacity to generate more than two thirds of its national income. The yearly total domestic absorption (domestic consumption and investment and government expenditures) is more than 1.5 times the economy's total production (GDP). Imports fill this gap and are financed by the income generated by Palestinians working in Israel and increasingly by foreign assistance. Closing this gap requires revitalizing the economy's contracted supply capacity to expand the productive sectors (agriculture and manufacturing) so as to contribute up to half of GDP[33] and create enough employment capacity to replace the export of labour with the export of goods and services.

(2) *Integrate the Palestinian economy into regional and world markets and end its dependence on one predominant trade partner*. Obviously, a relationship between two neighboring economies, in which measures taken by one can cause the other to lose the income of one third of its labor force, and interrupt 70 per cent of its imports and 90 per cent of its exports, is simply untenable. The disproportionality – in what might be called the cost of dissociation – renders the current Palestinian-Israeli economic relationship inherently unstable and must be corrected if sustained economic growth is to be achieved. From the Palestinian perspective, this requires a gradual and explicit reversal of activities that either skew the economic relationship in favour of Israel or consolidate its polarization effects. As stated earlier, Palestinian efforts should be rooted in a *development-driven approach to trade rather than a trade-driven approach to development.*

(3) Adopt a strategy of sustainable growth grounded in poverty reduction, equity, and social security considerations and continuous narrowing of the income gap between the urban and the rural areas. In addition to social and economic problems common to most developing countries (such as rapid urbanization, excessive non-productive public sector, deteriorating terms of trade) Palestinian society suffers from other problems brought about by prolonged occupation and war. These include worsening income distribution, the economic marginalization of a sizeable portion of the population (especially in refugee camps and rural areas), and the shift in economic activities from production of traded to non-traded goods and the expansion of the informal sector. *These problems do not just fade away once a normal security situation is restored,* but continue by the force of the negative path dependence they created. Reversing this path requires deliberate policy actions targeting certain communities, areas and social strata with the expressed objective of affirmative action promoting social equity, fairness and safety.

Guided by these considerations and objectives, we now turn to the challenges that need to be tackled immediately and in the longer term.

C. A framework for linking relief and aid to development

The concept of *linking relief and aid to development calls for the allocation of relief, emergency and development assistance funds in a persistent manner that aims to achieve development accumulation, no matter how slow or intermittent, towards achieving long-term objectives of a national vision*. Within this context, this approach requires identifying sectoral and sub-sectoral priorities, with focus on a very limited number of sectors or subsectors to achieve time-bound developmental quantitative objectives (employment and income). Once the objectives have been achieved in the first set of priorities, a second set can be tackled.

Criteria for priority sector candidates

It is important that priority sectors are capable of halting economic contraction, maintaining or increasing levels of employment and reducing the level of economic resource leakage to the outside world. Hence, these priorities would be able to cope with the present conditions and maintain and expand the existing productive capacity and economic base, which should form the foundation for any development under more stable conditions in the future. As a start, the process of priority setting should focus on the sectors and subsectors that have survived the conditions of the last five years and have been able to continue operation and maintain employment levels. In general, a prioritized sector under the "linking relief to development approach" should:

- Be capable of creating sustainable employment opportunities even after the end of the support programme;
- Have strong backward (especially natural resource) and forward linkages;
- Be strategically important for the economy and society at large;
- Favour capital investment which is relatively resistant to destruction and has low replacement cost; and
- Be capable of exporting or establishing strong local market presence, even under the present conditions.

On the basis of the above framework, a number of sectors and branches could be considered candidates for priority subsectors, including certain agricultural products and manufacturing branches and natural resource-based industries, as well as information technology services and related high-tech industries. Such sectoral priority will then facilitate the process of prioritizing infrastructure rehabilitation and reconstruction activities. It should be emphasized that fulfilling all the criteria does not mean that a priority sector will assume its role and produce the expected result through aid and investment alone, which is a necessary but not sufficient condition for the success of the *linking approach*. Success requires increases in both the domestic supply of and demand for the products of priority sectors in response to the support programme. This in turn requires supporting the supply side through increasing productivity, upgrading human and physical capital and technology transfer; and at the same time promoting the demand for domestic production through incentive programmes and/or campaigns to encourage their consumption.

Integration of economic and social priorities and resource allocation

Linking relief to development should also include the social sectors where a set of complementary priorities needs to be set in health, education, local communities, welfare and social safety nets. The priorities in the social sectors and productive sectors should complement and strengthen one another. For example, educational priorities should include supplying the skills and qualifications required to achieve the objectives of the priorities in the productive sectors. Also social safety nets programmes (especially employment generation) could be concentrated in priority productive sectors. As for food, housing and medicine needs of the poor, these should be met to the extent possible by the domestic productive sectors. The geographic distribution of the population should also be factored into programming activities. However, to maintain a minimum decent human life for the population, it is necessary that some funds are put aside to satisfy basic needs (nutrition, housing, health, education) before allocating resources to priority growth sectors.

The next step is to rank priorities (both productive and social) and corresponding aid programmes in a descending order. Remaining (non-relief) resources are allocated, as available, to achieve time-bound targets. In this regard, it should be emphasized that the number of priority sectors financed in each funding cycle should be maintained to the minimum, as this will make the implementation, assessment and follow-up more focused and therefore make it easier to achieve the targets. There are a number of linking mechanisms that could be used in a sub-sector or industry-specific way, such as:

- reduced interest rates and tax breaks;
- micro- and small-enterprises financing schemes;
- workers' training and upgrading;
- technology transfer;
- factors of production subsidies;
- wage sharing; and
- labour, trade and industrial programmes and policies.

The programme choice naturally depends on the condition, nature and technology of the priority sector. But they should be specialized, selective and directed specifically to the sector concerned and grouped under what could be termed *distortion correction schemes*. Here, the PA could benefit from the successful experience of other developing and least developed countries.

In addition, it is important to stress on the fact that Palestinian communities and their economy have sustained a five-year economic siege. No doubt that donor support has helped, but this survival was to a great extent driven by internal factors. UNSCO (2005) surveyed the coping measures adapted by the producers, workers and local communities in the West bank in the past five years, and provided a number of recommendations to take full advantage of the adaptation strategies. UNSCO's report recommends that:

> "… great care should be given by policymakers and aid providers in terms of which adaptation or coping strategy to support."
>
> "Initiating intervention that seek to ensure that the positive potential of community adaptation and the lessons learned of community vulnerability analysis are transformed and harnessed into a longer term sustainable development process."

It is therefore important to study the crisis-specific coping mechanisms that local industries, traders and communities have innovated and adapted to survive the economic siege (i.e. success stories under the present distorted conditions). These viable modes of self-sufficiency and accumulated experiences should be improved and transferred to other communities and applied in other relevant industries and should be the base for a sustainable recovery even if the current conditions do not improve in the near future.

This approach, along with programmes to develop high value-added industries with good chance of survival under the present conditions should form the nucleus of a socio-economic vision with specific national and sectoral objectives. The PA should also benefit more from and take greater ownership of the research work conducted on the Palestinian economy by national and international research and development institutions since the beginning of the crisis and even since the establishment of the PA.

Social capital

The previous discussion focuses on physical and human capital accumulation. To take advantage of such accumulation there is a need to invest in social capital, i.e. the system of legal and institutional framework promoting investment rather than consumption and productive rather than rent-seeking activities. This type of capital was neglected in the occupied Palestinian territory since 1967. It is an essential element of linking aid to development as it increases the efficiency of aid by promoting transparency, accountability and participation. The accumulation of social capital requires the development of three types of institutions: (a) a system to supervise external support; (b) a financial system; and (c) a judiciary system.

a) *The supervision of external support* requires the establishment of an independent body reporting directly to the legislative council and comprising PA line ministries, representatives from the private sector, NGOs, academia and civil society. The main task of this body is to ensure that the priorities, objectives and mechanism of linking aid to development is determined in a participatory approach and that the allocation of donor funds is in line with the linking process and serves the Palestinian socio-economic development vision.
b) *The financial system* should ensure that the burden of development is shared fairly, and that donor funds are allocated and distributed in a manner that promotes equitable income distribution through a just transfer and tax system. It should also ensure that donor funds are utilized properly, efficiently and directed to the priority activities.
c) *The judiciary system* should be independent and efficient to maintain the rights of all citizens and therefore promote domestic investments, productive activities and efficient management of public rent.

The formulation of the national socio-economic vision, the choice of priority sectors and their quantitative objectives, and the medium-term development planning process should be based on a participatory approach encompassing government and civil society. This process could be coordinated by the Ministry of Planning and supported by an Inter-Ministerial Development Group in close partnership with civil society.

In order to integrate planning and fiscal functions, this may require setting up a new organizational unit within the Ministry of Planning (MoP) and close coordination with the Ministry of Finance (MoF) budget formulation, as has been recognized at the December 2005 AHLC meeting. The aim would be: (i) to lead and coordinate the participatory and consensus-building process of formulating the national vision and its priorities; (ii) to interactively link this process to the design, implementation, evaluation and revision of the MTDPs; and (iii) to merge medium-term development priorities and expenditures with more immediate budgetary needs and imperatives. Such a collaboration mechanism between MoP, MoF and civil society would greatly increase national ownership of the MTDP and rationalize the budgetary process. It would also improve the overall governance of the planning process and allow the PA to play *the* leading role in the donor coordination process, as well as in allocating donor funds in an efficient way to achieve the aspirations of the Palestinian people.

D. Role of the Palestinian State in trade and development policy

Analysis elsewhere suggests that achieving sustainable reduction in poverty can be best achieved through a two-pronged strategy, which seeks to restructure the economy and deepen the labour market. This strategy should feature a gradual approach to trade liberalization, accord priority to technology intensive activities to stimulate technological progress and promote labour-intensive activities as the main vehicle for reducing poverty in the short-term.

In designing such a strategy, the envisioned State of Palestine could draw on the experiences of East Asian countries which have succeeded in achieving rapid economic growth against a background of deep economic crisis and political strife. These countries adopted time sensitive strategies that promoted a limited number of sectors at a given period. These sectors included both capital-intensive and low-skilled, labour intensive industries, in addition to activities associated with the production of intermediate and capital goods to promote technological progress.

An examination of these strategies reveals a two-track approach with export-oriented industries operating on free-trade principles, functioning side by side with protected industries. The strategies were mainly geared to address incidents of market failure, particularly those associated with investments in new technologies.[34] Their overriding aim was to establish a "rent creation plus discipline" for marshalling the corporate sector to serve long-term development objectives (Evans, 1999).

This discipline was created by establishing "profit-investment nexus" in priority sectors through a mixture of fiscal policies and incentives, which raised profits beyond their free market levels (Akyüz *et al*, 1999). This entailed across-the-board and sector-specific tax exemptions and depreciation allowances, in addition to measures for managing competition, such as restrictions on market entry. The impact of this policy mix was enhanced by measures to suppress consumption, particularly during the initial stages of the industrialization process, through imposing restrictions on the import of luxury goods and capital outflow. Furthermore, to promote exports the governments created an "export-investment nexus" alongside the profit-investment nexus, in a limited number of sectors. This was achieved through the provision of export subsidies, and the protection of infant industries. Key measures included the withdrawal of tax exemptions on the import of intermediate and capital goods and granting higher investment tax credits to industries purchasing locally produced machinery. The industries also received tax incentives and direct financial subsidies for enterprise training, based on national training programmes.

These measures were supported by mechanisms to ensure proper use of rents. For example, the Republic of Korea and Taiwan Province of China implemented an export targeting system at the industry, product and firm levels to force enterprises into expanding their activities. Export targets were set by associations representing enterprises and industry in concert with the government, and were enforced through punitive and publicity measures, such as access to subsidized credit and import licenses and prizes. These measures were rolled back upon the industries' success in establishing themselves in global markets and bureaucrats were held responsible for meeting export targets in their respective industries (Lall, 2003).

East Asian countries were also selective in attracting foreign direct investment (Lall, 2003; Wade, 2004; and Tambuan, 2004). With the exception of China, foreign direct investment (FDI) was allowed in a limited number of sectors where it was deemed necessary for technology access and exports. Moreover, FDI was directly managed by governments to ensure the diffusion of technology among local industries. For example, the Republic of Korea and Taiwan Province of China restricted technology imports in internalized forms (via FDI) and promoted those in externalized forms (e.g. licensing) through promoting joint ventures, screening import technologies and bargaining over local content agreements. Indonesia closed certain sectors to FDI by imposing restrictions on modes of entry; deployed local content and subcontracting policies to reduce import dependency and promote linkages between TNCs and SMEs; and imposed the requirement of active contribution in local community development programmes on foreign mining companies. In the three cases, restrictive measures were of a temporary nature to prevent negative externalities, and enable enterprises to acquire skills and competitiveness. Moreover, local enterprises were closely monitored to ensure their active engagement in technological development.

This approach comes in contrast to the more liberal regime of Malaysia and Thailand that relied heavily on FDI for promoting export-oriented industries. Although these countries have established themselves among the main exporters of high technology exports, their exports are concentrated in simple assembly and finishing. The two countries have yet to develop their technological capability, with domestic industries lagging behind the TNC-dominated export sectors and are heavily reliant on external sources for obtaining capital and intermediate goods. This casts doubts over the sustainability of such growth, particularly given the globalized nature of TNCs.

Needless to say, while sharing a common approach to industrialization, East Asian countries exhibited substantial differences at the policy level. For example, the Republic of Korea and Taiwan Province of China, in the same manner as Japan before them, made extensive use of trade protection and industrial policy. In contrast, Singapore adopted a more conventional approach to trade policy, but made extensive use of industrial policy (Rodrik, 2004). Whatever the policy mix these countries were able to develop strong profit-investment nexus and the export-investment nexus in priority sectors, which allowed for creating new areas of specialization and contributed to expanding industrial technological capabilities. This also allowed establishing dynamic interactions between domestic savings, exports and investments, which were critical for financing the restructuring process. Indeed, as industries developed, domestic savings outstripped investment growth both in absolute terms and as a proportion of GDP, rendering a minimal reliance on net capital inflows for financing the restructuring process.

However, the extent to which the PA can draw on the East Asian development model is rendered difficult by the evolving multilateral trading system that has limited the policy space at the national level, particularly in relation to exercizing industrial policy. Moreover, assuming that Palestinian strategic economic interests are served by WTO accession, the emerging Palestinian State will face tremendous pressures to open up the economy further and faster than may be desirable during any future WTO accession process. The experiences of other developing countries show that in addition to complying with all WTO rules, an acceding country must respond to an individual member country's request for further concessions to obtain support of its application. Such requests, known as 'WTO-plus', are centred on rapid opening-up to international investors in services and manufacturing and the removal of barriers to imports. Countries that have failed to defend their interests are either struggling to implement stringent obligations, with far reaching repercussions on their development prospects, or are trying to re-negotiate their schedule of commitments.

Nonetheless, ample scope remains for industrial policy under the multilateral trading system, again assuming that Palestine is to accede to the WTO, and much depends on Palestine's ability to make use of existing windows of opportunity when designing its economic policies. LDCs, for example, can be exempted from the prohibition of subsidies as long as they remain in these categories and certain thresholds, based on shares of world markets for products benefiting from export subsidies, are not reached. Non-actionable subsidies can also be applied, including those that are intended to promote basic research, agriculture and regional development. Moreover, to the extent that tariff rates remain unbound or bound at ceiling levels above currently applied rates, they can be increased to protect infant industries. More importantly, there are many policy measures that remain outside the scope of WTO negotiations such as government provision of information to exporters. This means that many of the policies identified earlier with the dynamic profit-investment nexus can still be implemented under WTO membership, including general fiscal concessions to corporate savings and investment, and differential taxes (VAT and excise tax) on domestic consumption and production (Akyüz *et al*, 1999).

In sum, the East Asian development model shows that industrial restructuring cannot be achieved without an interventionist state. However, this should not be understood as an attempt to call for the government to take the roll of the private sector. Rather, the point to be stressed here is the need for a reference policy framework that guides the private sector and aligns development efforts at the macro- and micro-levels around the economy's growth bottlenecks at a given period time. This framework should go beyond the ensuring macro-economic stability to addressing market failures through creating economic rents. Such a strategic context for Palestinian trade and development policy appears today more imperative than at any point in the recent past. Its feasibility remains very much contingent on breaking the hold of asymmetric containment, while designing relief and rehabilitation policies and programmes that promote *non-distorting and sustainable development.*

ANNEX I - GROWTH ACCOUNTING

This Annex elaborates the simple model used to account for the source of growth of the Palestinian economy in the West Bank and Gaza.

The Model

Assuming an economy with a Cobb-Douglas production function:

$$(1) \qquad Y(t) = K(t)^{\alpha} \, [A(t)\, L(t)]^{1-\alpha}$$

Where α › 0; and Y, K, L, and A denote, capital, labour and an index of technological progress, respectively. AL is referred to as effective labour, thus, technological progress is of labour augmented of Harrod-neutral type.

Assuming that K, L, and A change over time at constant rates, and taking the log of (1) and differentiating with respect to time yields:

$$(2) \qquad (\dot{Y}/Y) = \alpha\,(\dot{K}/K) + (1-\alpha)\,(\dot{L}/L) + (1-\alpha)\,(\dot{A}/A)$$

Where a dot over a variable denotes the derivative of that variable with respect to time. Subtracting $(\dot{L}/L)$ from both sides, we get:

$$(3) \qquad (\dot{y}/y) = \alpha\,(\dot{k}/k) + (1-\alpha)\,(\dot{A}/A)$$

where y, k, denote output per worker and capital per worker respectively. Thus, equation (3) implies that the growth rate of output per worker = α (growth rate of capital per worker) + total factor productivity (TPF). The later represents the efficiency with which the production function transforms the whole set of factors into output. It depends on a number of factors, including “the state of human capital, state of human knowledge, specific accumulated know-how and experience, efforts and management skills of producers/entrepreneurs.” (Van Dan Berg 2001),

GDP, domestic workers and capital stock data from UNCTAD database were used to simulate equation (3) over the period 1972-2004. As for α (elasticity of GDP with respect to capital), it is assumed to be 0.338, as was estimated by the World Bank (2002; p.121). The result of the simulation is reported in Table 1.3, Chapter I.

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END NOTES

[1] In accordance with the relevant General Assembly and Security Council resolutions and decisions, references in this report to the occupied Palestinian territory(ies) pertain to the Gaza Strip and West Bank, including east Jerusalem. For purposes of brevity, the term "Palestinian territory(ies)" is also used as appropriate. Furthermore, use of the term "Palestine" refers to the Palestine Liberation Organization, which established the Palestinian Authority (PA) following its 1993-1994 accords with Israel. References to the "State of Palestine" are consistent with the vision expressed in the said Security Council resolutions and the "Road Map". Unless otherwise mentioned, data on the Palestinian economy in this document apply to the Gaza Strip and West Bank, excluding east Jerusalem.

[2] Average exchange rate of the New Israeli Shekel (NIS) to the US dollar was 4.086 in 2000 and 4.49 in 2004.

[3] According to the International Labour Organization (ILO) relaxed definition of unemployment which includes discouraged job seekers.

[4] PCBS 2004b and 2004c.

[5] For example, Palestinian manufacturers paid 35-40 per cent more tax (on production and net assets) than their Israeli counterparts. The Israeli government also introduced military orders requiring permits and health checks on Palestinian exports of processed food and certification that the produce would not create Israeli surpluses (Shadid,1988:125&127).

[6] For example, until 1998 part of Palestinian agricultural exports to Israel were subjected to quotas but there were no quotas on Israeli exports to the oPt.

[7] Various American and European organization sponsored projects investigating the future economic relationship between Israel and Palestine once a settlement has been reached. One such project that received widespread attention issued a report that became known as the Harvard report and subsequently published as a book by Fischer *et al* (1994). Both the World Bank and the IMF sent missions to the Palestinian Territories and issued various publications containing analysis of the economic conditions and policy recommendations. While most of these publications followed the logic contained in the so-called “Washington Consensus”, UNCTAD publications, which have examined all economic aspects of the Israeli occupation, presented different policy recommendations emphasizing the need to dismantle the legacy of occupation first and strengthen Palestinian institutions before integrating the Palestinian economy into world markets (see UNCTAD 1994 and 1996).

[8] Israel has since liberalized its trade regime by cutting its tariff rates by a considerable amount. But it still has strong NTBs, especially a very stringent product standard which is recognized by Israeli economists as designed to protect Israeli producers rather than Israeli consumers. See Naqib (2003a).

[9] For analysis of the spread and polarization effects see: Thirlwall (1994) and Krugman (1998).

[10] For a detailed discussion of these issues, see Makhool (1966) and Awartani (1994).

[11] This does not imply that all Israeli policies and measures practiced during the occupations stopped during the limited period of self-rule. All policies related to land confiscations, expanding Jewish settlements and sovereignty over borders remained intact. However, The Palestinian Authority had some control over economic affairs.

[12] UN Security Council Resolution 242 (1967) advances the land for peace formula as the basis for solving the conflict, while Resolution 338 (1973) calls the two parties to cease hostilities and terminate all military activity immediately. Resolution 1397 (2002) affirms a vision of a region where two States, Israel and Palestine, live side by side within secure and recognized borders.

[13] For detailed discussion on these issues, see Khan (2004), Hilal and Khan (2004), and Zagha and Zomlot (2004).

[14] Data and information presented in this section obtained from: UN (2005); OCHA (2005d); OCHA (2004); PCBS (2004b); PCBS (2004d); and PCBS (2004e).

[15] 1 acre=0.4 hectares = 10,000 sq. metre.

[16] A number of laws with a direct bearing on economic and trade activity have been published in the Official Gazette, these include the: Public Works and Bidding Law; Public Procurement Law; Natural Resources Law; Amendment of Money Changers Law; Supervision and Stamp of Gold and Precious Metals Law; Industrial Zones Law; Labour Law; Investment Promotion Law; Environment Law; Palestinian Monetary Authority Law; Law for the Formation of the Insurance and Pensions Fund; Commercial Agency Law; Law for the Establishment of the Palestinian Energy Authority; Apartments, Condominiums and Stores Ownership Law; Law for the Establishment of the Palestinian Water Authority; Communication and Telecommunication Law; Animal Husbandry Law; and the Public Budget and Financial Affairs Law.

[17] On the eve of the renewed conflict, the Palestinian Legislative Council (PLC) was yet to issue such key laws as the Capital Markets Authority Law; Income Tax Law amendments; Chambers of Commerce Law; Insurance and Securities Law; Competition Law; Foreign Trade Act; Intellectual Property Law; and Customs Law.

[18] These include the Palestinian Foreign Trade Act (FTA), and laws on intellectual property, technical barriers and sanitary and phytosanitary measures, customs, competition and government procurement.

[19] Initiated in 1996 the EPP involves over 40 studies for informing the PA's decisions on future trade policy, including permanent status trade agreement with Israel. It was coordinated by the London School of Economic (LSE), with funding from the European Commission and UK-DFID.

[20] The Palestinian Legislative Council (PLC) reduced the number of new positions to 2,772 in the 2003 budget. Between December 2002 and May 2003, the civil service expanded by 2,595 positions on a net basis (Bennett, 2003).

[21] The other domains included in the pan are financial accountability, Judiciary and the rule of law, public administration and civil service, security and local and national election. The measures advanced in the plan are in line with those identified in the "100 days reform plan".

[22] See for example, MAS, 2003.

[23] Transparency International (TI) is an international non-governmental organization devoted to combating corruption at the national and international levels. Its secretariat is based in Berlin, Germany, and has over 90 independent chapters across the globe. For further details, visit TI at: www.transparency.org.

[24] For further details visit AMAN at: www.aman-palestine.org, and PICCR at http://www.piccr.org.

[25] See London School of Economics (2004), World Bank (2002), and PNA Ministry of National Economy (2003, 2004).

[26] Some of these use trade/GDP ratios and average tariff cuts for measuring trade openness, and consider only those countries with rising trade/GDP ratios and tariff cuts over time as “globalizers”. As such, poor countries with high but not rising levels of trade to GDP are excluded from the category of the globalized countries. If they were included, their poor performance will cast doubt over the validity of the proposition that more globalization leads to accelerated growth and reduced poverty. Indeed, a cursory examination of the economic performance of countries reveals a “mismatch” between the trade regime and GDP growth.

[27] UNCTAD (2003), Trade and Development Report, New York and Geneva: United Nations.

[28] This estimate is based on the monthly revenue reports of the first 9 months in 2004 posted on the MoF website http://www.mof.gov.ps/Reports-E.htm.

[29] In its resolution 43/178 of 20 December 1988, the United Nations General Assembly extended to the oPt the same preferential treatment accorded the least developed countries, pending the elimination of the Israeli occupation and the assumption of full control by the Palestinian people over their national economy without external interference.

[30] According to Naqib (2003a) Israel has since liberalized its trade regime by cutting its tariffs rates by a considerable amount. But, recognized by Israeli economists, it still has a strong non-tariff barriers with a very stringent product standard to protect Israeli producers rather than Israeli consumers.

[31] The World Bank advanced a host of measures for revitalizing the Palestinian economy in separate “technical papers”, which propose: the use of modern technologies and administrative measures at main borders; reviving the Palestinian Industrial Estates Programme to facilitate Palestinian trade with Israel and third countries; and the creation of a supportive business environment through legal and administrative reform, which facilitate the enterprises’ access to finance and eliminating red tape.

[32] This was a one-day meeting on 1 March 2005, to mobilize international support for Palestinian reforms, and “demonstrate political support for the work of the PA and help it prepare for disengagement and to implement the Road Map”. It was attended by officials from 23 countries, in addition to six international organizations.

[33] The agricultural and manufacturing sectors currently contribute less than 30 per cent to the Palestinian GDP, whereas countries with comparable GDP per capita usually have more than 50 per cent of their GDP derived from these two sectors, see Van Den Berg (2001).

[34] In fact, these countries tolerated some inflationary pressures for the sake of restructuring their economies towards products with higher value-added (Akyüz, 1999).