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Development and State Formation**



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**Policy Alternatives for Palestinian
Sustained Development and State Formation***

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EXECUTIVE SUMMARY¹

The Protocol on Economic Relations between the Government of the State of Israel and the Palestinian Liberation Organization, representing the Palestinian people (Paris Protocol) has determined since 1994 the economic policy framework of the Palestinian Authority. It is more aligned to the needs of the Israeli economy, with little regard to the Palestinian economy's developmental needs. It has effectively limited the space of Palestinian policymaking to the expenditure side of fiscal policy, which is less policy space than that enjoyed by local Government in many countries. Expanding the range of economic policymaking is crucial for reversing economic decline and countering the structural fragility of the Palestinian economy caused by decades of occupation and, in particular, the past eight years of intensified Israeli closure policy and mobility restrictions.

The cost of closure to the Palestinian economy is substantial. It is estimated that over the period 2000–2005, the economy lost more jobs than the total number it was actually able to produce in 2005. The cumulative gross domestic product (GDP) loss from 2000 to 2005 is estimated to be in the range of \$8.4 billion, twice the size of the economy in 1999. More detrimental are physical capital losses: it is estimated that the Palestinian economy has lost, and not replaced, at least one third of its pre-2000 physical capital. This has further intensified the structural distortion of the economy and contracted its domestic supply capacity, not only in the short term but more significantly in the long term.

Against this background, this study aims to contribute to the debate on the nature of economic policies required for the rehabilitation, recovery and long-term growth of the Palestinian economy. The analysis is based on simulations of UNCTAD's macroeconometric model (Integrated Simulation Framework or ISF) to quantify and assess different policy options that could provide Palestinian negotiators and policymakers with insights into the type and range of policy space needed for sustained economic growth.

The present economic policy framework denies the Palestinian Authority the most basic fiscal, monetary, trade and exchange rate policy tools for managing an overly exposed economy. The model simulation of the status quo in the baseline scenario demonstrates that a reduction in the intensity of closures and a return to the relative pre-2000 stability would not suffice to replace the eroded productive capacity, remedy the Palestinian economy's deep structural problems and produce growth that could meaningfully reduce unemployment. Lifting the closure imposed on the occupied Palestinian territory is essential for the recovery of the Palestinian economy, yet more is needed to place the economy on a path of sustained development. There is a critical need to empower Palestinian policymakers with a full range of economic policy instruments to realize the Palestinian development vision.

Policy simulations of alternative fiscal, monetary, exchange rate (national currency), trade and labour policies predict better economic results than the baseline policy framework. The simulation suggests that integrating all these policies into one package would lead to full employment by 2012. While this may seem overly optimistic and difficult to envisage in the present circumstances, it confirms that a considerable reduction in unemployment would be possible if the Palestinian Authority were empowered with the necessary policy instruments. The assessment of the integrated package confirms that the present Palestinian economic

¹ A summary of the main findings of this paper appeared in UNCTAD (2008).

policy framework, still shaped by the Paris Protocol, is incapable of responding to the challenges of the economy and its eroded productive capacity. Furthermore, it shows that a wider range of instruments for designing and implementing economic policy would enable the Palestinian Authority to help lay the grounds for sound long-term development.

The complete and full implementation of such an integrated policy package requires an end to occupation, beginning with the lifting of Israeli closure policy and mobility restrictions and, as envisaged by relevant United Nations resolutions, movement towards the establishment of a sovereign Palestinian State with full national ownership of economic policies. Nonetheless, significant and urgent progress can be achieved even under the present political conditions and prior to the establishment of a sovereign Palestinian State, if Palestinian policymakers gain access to an expanded array of economic policy instruments. In other words, the difficulty of achieving economic progress under the current constraints does not mean that development-oriented efforts under occupation are futile. It is critical that Palestinian policymakers persist in trying to address the limiting aspects of the existing policy framework and to lay the bases for sovereign economic institutions and policymaking.

The international community can contribute by directing financial and technical aid to the Palestinian Authority in ways that ensure the expansion of its policy options as well as the correction of the pervasive structural distortions. The international community can also play its role in bringing an end to over four decades of occupation and the restrictive Israeli measures affecting the economy that render long-term development in the occupied Palestinian territory extremely difficult, and short-term gains easily reversible.

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ABBREVIATIONS

BL	baseline scenario
CDX	number of closure days per year
FNCTR	foreign net current transfers
GATT	General Agreements on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
ILO	International Labour Organization
ISF	Integrated Simulation Framework for Palestinian Macroeconomic, Trade and Labour Policy
JEC	Joint Economic Committee
MFN	most favoured nation
PCBS	Palestinian Central Bureau of Statistics
PMA	Palestinian Monetary Authority
PNA	Palestinian National Authority
VAT	value added tax

I. INTRODUCTION

The economy of the occupied Palestinian territory, already burdened by the legacy of prolonged occupation, has been faced with insurmountable problems since the outbreak of the second Palestinian uprising (intifada) in September 2000. It has been confronted with creeping geographical fragmentation under the tight Israeli closure policy, the construction of a Separation Barrier that significantly reduces available agricultural land, uncertain public revenue and donor aid, eroded productive capacity, and weak government and institutional capacity overwhelmed by having to engage with a demanding array of donor agendas. With increasingly restrictive Israeli security measures, the Palestinian economy has witnessed the erosion and destruction of public and private physical capital, along with tight restrictions on the mobility of Palestinian labour and goods from, to and between the West Bank and Gaza. These conditions have intensified the longer-term occupation-related structural distortions, and economic and social stress, causing a sharp fall in real investment, unprecedented rates of unemployment and poverty and rapid decline in all economic indicators. The Palestinian economy has been driven closer to the point of collapse and has effectively been transformed into a fragmented, war-torn economy (UNCTAD, 2008; 2006a; 2003).²

A. Economic policy space: the Palestinian context

This study argues that it would be inaccurate to attribute this regression solely to political or security conditions. Indeed, the core issues limiting Palestinian economic prospects have not changed over the last four decades but have in fact persisted and worsened (UNCTAD, 2006b). Most notable in this respect is the limited economic policy framework available to the Palestinian Authority under the terms of the Protocol on Economic Relations between the Government of the State of Israel and the Palestinian Liberation Organization, representing the Palestinian people (Paris Protocol) signed in 1994. This framework has locked in the economic structural distortions and fragilities that began with the Israeli occupation of the West Bank and the Gaza Strip in 1967, and has perpetuated the dependence of the Palestinian economy on that of Israel.

Though widely considered to be a form of customs union, the Israeli–Palestinian economic relationship is arguably more of an economic union (however imperfect), insofar as both the Israeli and Palestinian economies share the same Israeli monetary, fiscal and trade regimes.³ While the Paris Protocol formalized a common external tariff and the free movement of factors of production between the two sides, one of the main advantages of a customs union for a smaller, weaker economy is a revenue-sharing formula that compensates for inadequate trade creation and excessive trade diversion. This feature is totally lacking in the Paris Protocol. Hence, the Palestinian Authority’s ability to respond to the challenges of reviving a war-torn economy is constrained by the limited policy tools its policymakers have to design and implement effective policies and to lay the foundations for recovery and sustained growth. While the implementation of Palestinian Authority reforms, the lifting of closure, sustained foreign aid and the revitalization of Palestinian productive capacity are necessary conditions for recovery, they are not sufficient to achieve long-term growth.

² Most of the UNCTAD studies on the Palestinian economy are posted on: <http://www.unctad.org/palestine>

³ The nature of the Israeli-Palestinian economic relationship going back to before the 1948 mandate has been explored in Khalidi (2008).

To develop the conceptual framework for “policy space”, UNCTAD (2004a) points out that:

The increasing interdependence of national economies in a globalizing world and the emergence of rule-based regimes for international economic relations have meant that the space for national economic policy, i.e. the scope for domestic policies, especially in the areas of trade, investment and industrial development, is now often framed by international disciplines, commitments and global market considerations. It is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space. It is particularly important for developing countries, bearing in mind development goals and objectives, that all countries take into account the need for appropriate balance between national policy space and international disciplines and commitments.

The Palestinian economy, subsumed as it is under the Israeli economic policy framework, has been exposed to the range of the challenges of globalization, but with limited national economic policy instruments and without any recourse to remedial measures, except through those exercised by Israel in its own global economic relations. This study, however, does not only refer to the policy space discourse centred around issues of global interdependence, international institutions and their impact on policy options available to a normal, sovereign developing country. The horizon of policy space discussed here is more specifically focused on the limits imposed on Palestinian policymakers by the lack of sovereignty to design and pursue policies relevant to the capacities, challenges, and aspirations of the Palestinian people and their eventual assumption of sovereignty over the territory of their presumptive State. To this day, the Palestinian Authority has no sovereignty over borders, land, water, natural resources or movement of people and goods within its territories and through its territorial waters or airspace. A combination of the absence of sovereignty, geographical fragmentation, restrictions on public sector development and a range of structural economic distortions makes formulating and executing coherent public policies a daunting task. Nor does the Palestinian Authority have a national currency to pursue appropriate monetary and exchange rate policies. What remains for the Palestinian Authority from the policy toolkit of a typical sovereign State in a globalized world are limited and vulnerable fiscal policy instruments.

B. Methodology

To assess the impact of the existing and alternative policy frameworks on long-term economic development, this study simulates the UNCTAD macroeconomic model “Integrated Simulation Framework for Palestinian Macroeconomic, Trade and Labour Policy” (ISF) to quantify the Palestinian economy’s long-term prospects under different policy assumptions. Specifically, the analysis compares the future outcomes of the present economic policy framework – the baseline scenario – to different policy scenarios that assume expanded policy options with the availability of fiscal, monetary, trade and labour policy instruments to Palestinian policymakers.

As discussed in detail in UNCTAD (2006c), the baseline scenario assumes that the occupied Palestinian territory would return to the economic environment that existed after the establishment of the Palestinian Authority in 1994 and prior to the intensification of Israel’s restrictive measures and closure policy in 2000. The key assumption of the baseline scenario is a gradual advance towards more stable political conditions, with fewer mobility restrictions than have been witnessed to date, similar to those prevailing during the period 1994–2000. It is also assumed that the occupied Palestinian territory would receive more international

financial support, and that the trade, monetary and fiscal arrangements between the Palestinian Authority and Israel and with third parties would return to those operative under the Paris Protocol as implemented during 1994–2000.

The assessment of the baseline scenario indicates that continuing to implement the Paris Protocol as the institutional framework for economic policymaking would not significantly improve the Palestinian economy's performance, as it would continue to deny the Palestinian Authority the policy space needed to reduce unemployment and improve Palestinian society's welfare. The simulation of the baseline scenario confirms the view among a growing number of economic experts that the protocol has proven detrimental to strategic Palestinian developmental needs, however useful (or inevitable) it might have been for the five-year transitional period for which it was designed.

C. Objective

Because the existing economic framework has been structurally unable to provide the necessary conditions for sustained growth, and therefore alternatives need to be considered, this study seeks to take a fresh look at how and why the framework established in the Paris Protocol failed to meet Palestinian development aspirations or needs. This study also provides some guidance as to where the Palestinian economy is heading in the long run if the economic policy and institutional arrangements remain as they are, and identifies alternative options that policymakers have, or need to have, to position the economy on a path of sustainable development. Accordingly, the purpose of this study is not only to assess and rank different policy options, but more importantly to formulate a set of policy recommendations that can provide Palestinian decision makers and negotiators with strategic insights into the type and range of policy instruments necessary for sustainable economic growth and developing the envisaged Palestinian State.

These alternative policy recommendations are premised on a marked expansion of the Palestinian Authority's policy space in its economic relations with Israel and the rest of the world. This would provide its policymakers with the tools for reversing economic decline and remedying structural deficiencies. While the study offers recommendations for each studied policy area – fiscal, monetary, trade and labour – that could be implemented on their own, it also shows the advantages of bundling all the alternatives into one package where different measures could complement and reinforce one another.

The investigation is developed over the following five chapters. The next chapter sets the stage for the simulation of the alternative policy options by providing a snapshot of the difficulties the Palestinian economy faces as a result of the Israeli closure policy, and quantifies the economic and employment costs of this policy over the period 2000–2005. Subsequent chapters quantify, assess and rank alternative options and offer recommendations.

In the area of macroeconomic policy, the current framework is not conducive to pursuing a developmental fiscal policy that would raise aggregate demand and increase public investment to “crowd in” private investment. The alternative policy scenario, however, offers a range of fiscal interventions that could help stimulate the economy, such as increasing public investment and government transfers. In addition, the alternative scenario proposes a “distortion correction scheme” aimed at reversing the structural distortions and addressing the eroded productive capacity, through, for example, lower interest rates for private investors in strategic sectors, direct production subsidies and/or tax cuts. The impact of introducing a

national currency is also considered. The right to issue a national currency would enable the Palestinian Monetary Authority (PMA) to emerge as a central bank with the ability to align exchange and interest rate policies with the Palestinian economy's needs and stage of development. However, it should be emphasized that the objective is not to call for the immediate introduction of such a currency. Rather, the goal is to highlight the possible benefits of having the full range of monetary and exchange rate policies. This could encourage the Palestinian Authority and the PMA to intensify efforts to be allowed to issue a Palestinian currency and to do so whenever it is advantageous to the Palestinian economy. At the same time there is a need to develop the capacities and fiscal framework required to manage a credible currency.

As for trade policy, the baseline scenario, which represents the existing quasi-customs union, shows a moderate improvement in Palestinian trade performance. However, the unemployment rate does not fall significantly, the extreme trade dependence on Israel is not reduced, and there is no diversification in trade partners. The alternative trade policy scenario examines the impact of two other trade regimes – most favoured nation (MFN) and free trade policy. As an accompanying measure to improve Palestinian trade performance, with particular regard to the weak export base, both trade policy alternatives assume the introduction of distortion correction schemes aimed at reducing the artificially high transaction and production costs that Palestinian exporters face. While both policy options produce better results compared to the existing quasi-customs union with Israel, the MFN scenario shows an edge over the free trade scenario. However, trade policy reform alone will not substantially enhance Palestinian trade performance. Additional strategies are necessary to directly target the export sector where the Palestinian economy has comparative advantages and/or potential competitive advantages.

In the area of labour policy, the baseline scenario shows the effects of “asymmetric regulation”. That is, while the largely wage-inelastic supply of Palestinian labour to Israel continues to be regulated and restricted by Israel's closure and permit policies, the Palestinian Authority does not regulate the labour market, thus leaving Palestinian labour dependent on external factors beyond its control. To assess the potential of a proactive Palestinian Authority labour market policy, the alternative scenario considers a subsidy (wage-sharing) and tax scheme to generate employment in the domestic market, while at the same time reducing dependence on the Israeli market.

Building on the findings of the simulations of the alternative policy scenarios, an integrated policy package for the Palestinian economy is considered, where measures from the macro, trade and labour policies are combined. The policy package demonstrates the potential of the Palestinian economy if it were allowed to develop free of the existing political and economic constraints along a trajectory that respects its special post-conflict circumstances, while gradually aligning it with international disciplines and commitments. The package projects a much more robust Palestinian economy with a GDP that is 25 per cent larger than that produced by the baseline scenario in 2015. In this sense, the package provides Palestinian economic planners and negotiators with insights into the type and range of policy instruments they need to manage and develop the sovereign economic institutions of the internationally envisaged Palestinian State. While the task of exiting the current predicament into a medium-term horizon of stable recovery understandably remains the top preoccupation of today's policymakers, the challenges of building tomorrow's Palestinian State call more than ever for bold and far-reaching thinking and planning to ensure a developmental future for the Palestinian people after decades of de-development under occupation.

II. THE COST OF ISRAELI OCCUPATION AND CLOSURE POLICY

UNCTAD studies since the 1980s have demonstrated the enduring impact of Israeli occupation on the prospects for the Palestinian economy's development. This includes both directly induced costs in the form of structural distortions and the loss of land and natural resources, as well as lost growth opportunities at different periods and in a variety of sectors. An accurate estimation of the accumulated cost of Israeli occupation since 1967 is beyond the scope of this study, and remains a task for negotiators to tackle in the context of an eventual permanent peace settlement. However, the direct costs engendered by the current phase of the Israeli–Palestinian conflict are more amenable to quantification for the purposes of charting alternative future development paths.

Since the outbreak of the second intifada in 2000, heightened Israeli restrictions on the movement of Palestinian goods and people have become permanent features of Palestinian economic life. Israeli closure policy involves the strict control of borders between Israel and the occupied Palestinian territory that also blocks the latter's access to international markets, closure between the West Bank and the Gaza Strip, closure of the borders of the West Bank with Jordan and the Gaza Strip's border with Egypt, and internal closures within the West Bank and the Gaza Strip that restrict movement within and between these areas (ILO, 2007; World Bank, 2008). The negative knock-on effects of this policy manifest themselves in all sectors of the Palestinian economy and society and the Palestinian Authority through the impact of prohibitive transaction costs and a degraded, smaller economy. The resulting drastic economic regression and structural distortion led to an upsurge in both poverty and unemployment to levels unseen since 1967.

A. The less restrictive closure scenario

While the impact of closure policy on Palestinian economic and social indicators is monitored and updated regularly by a number of international organizations, with annual data for total closure days published regularly since 1993, no systematic attempt to quantify its economic cost has been undertaken so far. This chapter attempts to fill this void by quantifying the cost over the 2000–2005 period. Such an estimation is important as it enables the subsequent analysis to compare the benefits that would accrue to the Palestinian economy from lifting closure restrictions under different policy options.

The approach entails employing the Integrated Simulation Framework (ISF) model to examine two in-sample scenarios. The first (baseline) scenario reproduces all the model's endogenous variables on the basis of the exogenous variables' actual historical values.⁴ The second (reduced closure) scenario attempts to show how the Palestinian economy would have performed had the Israeli closure policy been less restrictive, by assuming historical values for all exogenous variables except for two: (a) the number of closure days per year during which Israel fully or partially prohibited the movement of labour and goods within/from/to the West Bank and the Gaza Strip (CDX) and (b) foreign net current transfers (FNCTR – primarily donor aid). The reduced closure scenario replaces the historically recorded numbers of CDX with 40 days per year to account for the assumption of some movement towards

⁴ Endogenous variables, such as GDP, private consumption and trade balance, are those influenced by the economy's exogenous variables. There are two types of exogenous variables: (a) policy variables determined by policymakers, such as interest rates, public investment and tax rates, and (b) external variables determined outside the national economy such as CDX, international financial support and GDP of other countries.

political stability, with lower restrictions on the mobility of goods and labour.⁵ As for the FNCTR, the reduced closure scenario also assumes levels lower than actually registered for the 2000–2005 period. The rationale for this assumption is that the substantial increase in the FNCTR levels between 2000 and 2005 directly reflects the response and attempts of the donor community to mitigate the impact of heightened closure, and other punitive measures, on the Palestinian economy. Table 2.1 shows the actual and assumed levels of CDX and FNCTR.

It is important to point out that the reduced closure scenario and CDX do not take into account the impact of the Israeli Separation Barrier. The construction of the Barrier, which started in 2002, is now 60 per cent complete. All but 10 per cent of the planned 725-kilometre Barrier encroaches the occupied Palestinian territory, rather than being built along the pre-1967 borders. Many of the West Bank cities are completely surrounded by the Barrier. In its summary of the direct adverse economic impact of the Barrier, the United Nations Office for the Coordination of Humanitarian Affairs (OCHA) (2007) indicates that a stringent permit system limits producers', farmers' and workers' access to their workplaces. When these permits are granted, individuals are allowed access to their work through designated gates that operate only a few hours a day. Some gates open to Palestinians only seasonally/weekly, while others are never open to them. The movement of equipment and material, such as tractors, factors of production and livestock is restricted to specific gates. Transportation costs have increased considerably due to the longer distances required to reach designated gates, as the Barrier severs the existing traditional roads. As noted previously by UNCTAD (2007), the Barrier has especially eroded the agricultural sector's already limited natural resource base, as some of the most fertile land was confiscated or remained in the "seam-zone" between the wall and the 1967 borders. Access to almost 15 per cent of the West Bank agricultural land will be lost when the Barrier is completed. Had the economic impact of the Barrier been included in the reduced closure scenario, the cost of closure and other Israeli measures would have been much higher than that reported in tables 2.2 and 2.3.

Table 2.1. Assumptions for the reduced closure simulation

	Number of closure days per year		Net current transfers 1997 \$ million	
	Actual	Assumed	Actual	Assumed
1995	102	102	410	410
1996	138	138	459	459
1997	85	85	395	395
1998	48	48	374	374
1999	12	12	403	403
2000	64	40	560	424
2001	210	40	991	445
2002	260	40	1 174	467
2003	130	40	1 497	490
2004	220	40	1 400	515
2005	180	40	1 268	541

⁵ The Office of the United Nations Special Coordinator for the Middle East Peace Process (UNSCO) monitored the number of closure days in Gaza for 1993-2002. The closure days in Gaza are also applicable to the West Bank. The figures for 2003-2005 are extrapolated based on statistical historical relationships. They are assumed to be 15-50 per cent less than the 2002 level, when closure peaked.

B. The employment cost of closure

Table 2.2 shows the employment cost of the tightened Israeli closure policy during the 2000–2005 period by comparing the results of the baseline and the reduced closure simulations. During this period, the model suggests that the cumulative loss to the Palestinian labour force amounts to over 311,000 job-years in the domestic economy between 2000 and 2005 and 324,000 job-years in the Israeli market over the same period. This brings the total cumulative Palestinian employment loss to more than 636,000 job-years over six years. This is more than the total number of jobs the Palestinian economy was actually able to produce in 2005. Figure 2.1 shows the difference between Palestinian employment in the baseline scenario and the reduced closure scenario. These results not only prove how volatile and vulnerable Palestinian employment in Israel is to adverse political conditions, they also suggest that a strategy to generate new employment opportunities in the domestic labour market should rank high on the Palestinian Authority's agenda. Chapter V considers such a strategy.

C. GDP and the structural cost of closure

Closure, checkpoints and the Separation Barrier impact the economy through multiple channels. They limit producers' access to imported inputs required for production and maintenance of the capital stock while also blocking access to export and local markets, which hampers delivery to customers within and outside the occupied Palestinian territory. Closure feeds a vicious circle in which the resulting loss in income constrains output from the demand side, while uncertainty and higher cost of imported inputs, transportation and storage constrain output from the supply side. This loss is magnified by the loss in economies of scale associated with the decreased volume of production. The loss of Palestinian jobs in Israel also hampers growth by reducing aggregate demand inside the occupied Palestinian territory.

Closure not only affects the economy in the short run, it has serious long-run effects because it increases the actual and perceived risk of investment inside the occupied Palestinian territory, and thereby discourages potential investment. Carnation and strawberries, two of the Gaza Strip's main agricultural exports, are a case in point. Due to closure, carnation farmers exported only one fifth of the 45 million flowers produced in 2007; the remainder was used as animal feed. As result they lost about \$6.5 million. In the same season, strawberry exporters lost \$7 million to Israel's closure policy, which is widely recognized as one of the most critical factors limiting the Palestinian economy (PNA, 2008; World Bank, 2008; ILO, 2007).

The cumulative economic cost of six years (2000–2005) of tight closure policy is estimated to be around \$8.4 billion. To put this in perspective, this loss is twice the size of GDP in 1999, or more than one third of the GDP that would have been produced in these six years had there been less closure.⁶ In 2002, the gap between the GDP level in the baseline scenario and that of the reduced closure is greatest, reflecting the impact of the highest number of annual closure days. The cost of the closure policy in terms of lost output is depicted by figure 2.1a, which illustrates the difference in GDP in the baseline (closure) scenario and the reduced closure scenario.

Table 2.3 summarizes the impact of closure on GDP, the share of each sector in the economic loss and changes in economic structure. The service sector bears the brunt of the losses with

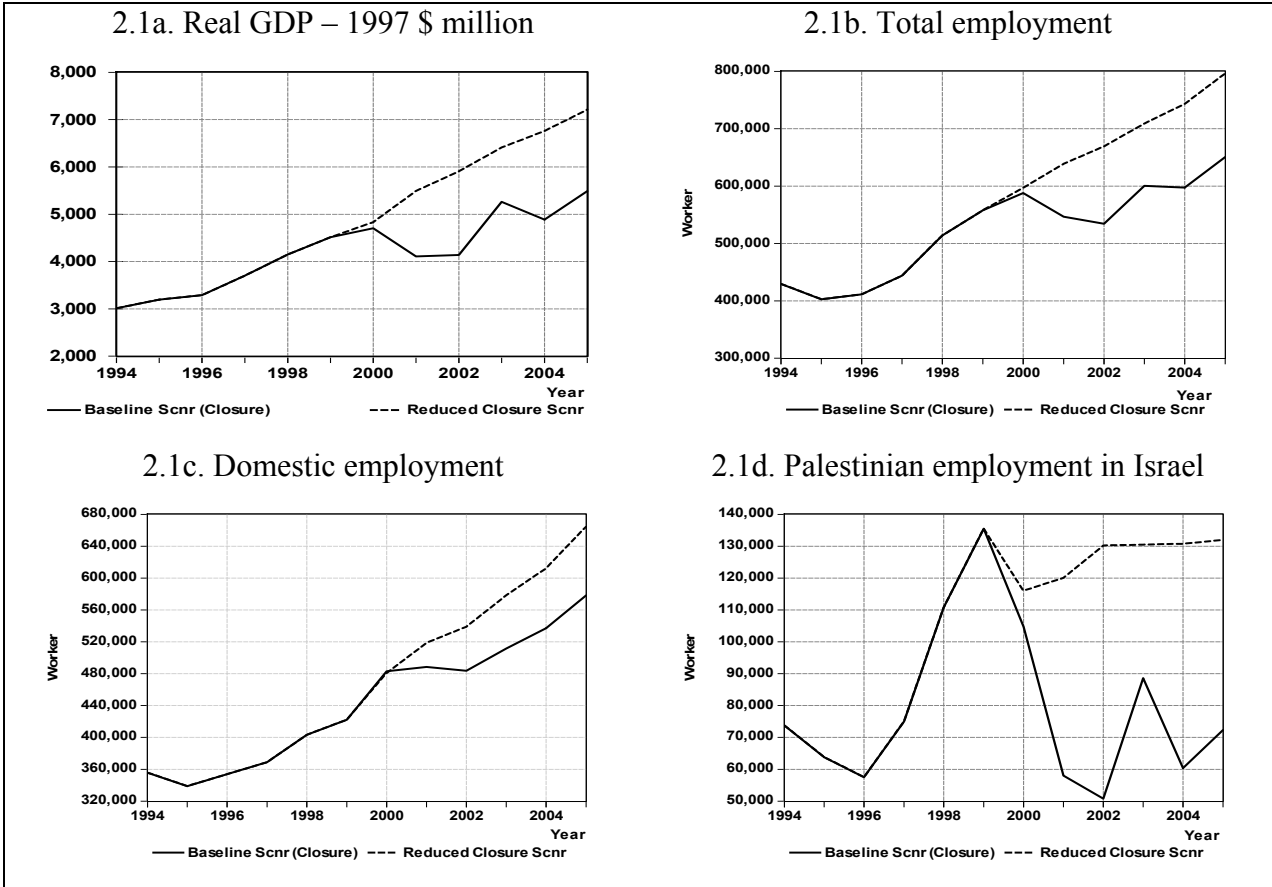
⁶ The Palestinian Authority (2008) and the World Bank (2008) estimate that had the economy continued to grow at the 1995-2000 average, GDP in 2007 would have been double that of 1995, whereas it actually grew by only 36 per cent.

56 per cent of the cumulative loss in output, followed by industry with 22 per cent, agriculture with 17 per cent and construction with 5 per cent. As for the relative contribution of each sector to GDP, the difference between the baseline and the reduced closure scenarios is negligible.

Table 2.2. Employment cost of closure policy – job/year

	Domestic employment				Palestinian employment in Israel				Total	
	Baseline	Reduced closure	Loss	% to reduced closure	Baseline	Reduced closure	Loss	% to reduced closure	Loss	% to reduced closure
2000	483 125	480 792	2 332	0.5	104 724	116 017	-11 293	-9.7	-8 961	-1.5
2001	488 436	518 749	-30 313	-5.8	57 985	120 068	-62 083	-51.7	-92 396	-14.5
2002	483 584	538 952	-55 369	-10.3	50 767	130 229	-79 462	-61.0	-134 831	-20.1
2003	511 664	578 407	-66 743	-11.5	88 608	130 512	-41 904	-32.1	-108 647	-15.3
2004	536 894	612 371	-75 478	-12.3	60 402	130 776	-70 374	-53.8	-145 852	-19.6
2005	578 333	664 502	-86 169	-13.0	72 341	131 972	-59 631	-45.2	-145 800	-18.3
Cumulative (job-year)			-311 739				-324 748		-636 487	

Figure 2.1. Impact of closure policy on Palestinian GDP and employment



Although there is no substantial difference in the sectoral structure of GDP in the two scenarios, a number of important observations can be made. The relative contribution of

agriculture in the baseline scenario decreased by 3.5 per cent over 2000–2005, while it fell by 2.5 per cent in the reduced closure scenario. Similarly, while the relative contribution of industry to GDP increased only by 0.6 per cent in the baseline scenario, it rose by 2.1 per cent in the reduced closure scenario. On the other hand, the relative contribution of services to GDP in the baseline scenario grew by 5.9 per cent but would have increased by only 3.3 per cent had there been reduced closure. Over the same period the share of construction in GDP fell by 3 per cent in the baseline scenario and by 2.9 per cent in the reduced closure scenario. This suggests that the intensified closure regime imposed on the Palestinian economy from 2000 onwards, together with the destruction of much of the economy’s productive capital, led to a structural shift in the economy. This shift is characterized by a decline, or at best a stagnation, in the relative contribution of the productive sectors (agriculture and industry) to GDP and a corresponding increase in the relative contribution of the service sector.

The relative increase in the service sector is not a result of increased levels of demand for services and formal employment, but rather a response to the acute unemployment crisis in which the sector (especially in its informal part) acts as a refuge for underemployment and self-employment. The structural shift means that the Palestinian economy was engaged in less international trade than otherwise and therefore could not realize the economic benefits of trade that a small open economy can achieve by specializing in the production of goods in which it has comparative advantages and by reaping the benefits of greater economies of scale that international trade could make possible.

Table 2.3. Economic cost of Israeli security and closure measures

	Capital stock loss	GDP (1997 \$ mill.)				Distribution of economic loss – %				Impact on economic structure – %									
		BL ^a		RC ^b		Loss	% to LC	economic loss – %				Agr.		Ind.		Const.		Serv.	
		BL	RC	Agr.	Ind.			Const.	Serv.	BL	RC	BL	RC	BL	RC	BL	RC		
2000	-236	4 374	4 514	-140	-3.1	22	18	7	53	12.4	12.7	16.2	16.3	7.5	7.5	63.9	63.5		
2001	-905	3 834	5 274	-1 440	-27.3	16	22	7	55	9.2	11.2	16.3	17.7	6.7	6.8	67.8	64.3		
2002	-889	3 889	5 711	-1 823	-31.9	19	22	5	54	10.1	13.0	16.0	17.9	4.2	4.3	69.7	64.8		
2003	-852	4 972	6 160	-1 188	-19.3	15	23	5	57	10.0	11.0	17.7	18.7	4.5	4.5	67.9	65.8		
2004	-676	4 329	6 325	-1 996	-31.6	17	22	5	56	9.9	12.2	16.5	18.2	4.5	4.5	69.1	65.1		
2005	-110	4 999	6 808	-1 809	-26.6	14	23	5	58	8.9	10.2	16.8	18.4	4.5	4.6	69.8	66.8		
Total	-3 667			-8 396		17	22	5	56										

^a BL: Baseline scenario

^b RC: Reduced closure scenario

D. Physical capital losses

The productive capacity of the Palestinian economy was subjected to extensive degradation as physical infrastructure and private and public property were destroyed (including agricultural land, trees, factories, machines, buildings and other productive assets). Closure compounded the loss by forcing producers to overuse the remaining capital stock to satisfy fragmented and isolated local markets, while at the same time blocking or delaying imports needed to maintain and repair the existing capital stock. The latter was thus left to deteriorate and decay at much faster rates than normal. As shown in table 2.3, it is estimated that during 2000–2005 the cumulative physical capital loss in the occupied Palestinian territory is in the range of \$3.7 billion, or equivalent to one third of the pre-2000 capital stock, estimated at \$11.2 billion in

1998 (World Bank, 2003).⁷ This explains the substantial losses in productivity and real wages experienced in the past few years, as the economy managed to absorb more workers while operating with two thirds of its capital stock.

The deterioration of physical capital and productive assets has serious negative effects in the long run. Lower capital stock leads to weaker long-term growth, decreased labour productivity, and also reduced real wages and savings. Poverty will therefore persist. Persistent accelerated degradation will make it difficult for the Palestinian Authority to increase transfers to the marginalized and poorer sections of society, because reduced output and real wages means a smaller tax base. This in turn limits the ability of the Palestinian Authority to raise enough tax revenues to finance social transfers and public investment needed to crowd in private investment in a high risk environment. It is critical to keep in mind that without replenishing the Palestinian capital stock with more than what has been lost, employment generation programmes will most likely lead to nothing but further reduction in productivity and real wages.

Another important observation from the previous analysis is that even under less restrictive closure and mobility conditions and with sustained GDP growth, employment opportunities in the domestic economy and in Israel would have been insufficient and the structure of the economy would have continued to be distorted. As the following chapters demonstrate, even a return to the pre-2000 level of closure would not eliminate the structural fragility of the Palestinian economy. This highlights the importance of formulating alternative policies to put the economy on a path of sustainable growth and development.

⁷ In addition to the direct destruction of physical capital, it is assumed that the depreciation rate increased from the historical average of 5 per cent to 8 per cent, reflecting overuse of the capital stock and lack of maintenance.

III. MACROECONOMIC POLICY

During the period of direct Israeli military rule (and later the Civil Administration) of the occupied West Bank and the Gaza Strip, the tax system was aligned to a large extent to the demands of the Israeli economy (Baxendale, 1989). Following the establishment of the Palestinian Authority in 1994, the tax system as implemented under the terms of the Paris Protocol continued to reflect the needs, interest and developmental stage of the much larger and more advanced Israeli economy. For all practical purposes, the fiscal and monetary policy instruments available to the Palestinian Authority are restricted to expenditure allocation, which is a more limited policy space than that available to local Governments in many countries.

This chapter highlights the limitations placed upon the Palestinian Authority's existing fiscal framework, in particular the dependence on external budget support and on Israeli political decisions for the transfer of the tax revenues collected by Israel on behalf of the Palestinian Authority.⁸ Furthermore, this chapter elaborates on the macroeconomic consequences of the absence of a national Palestinian currency, which denies the Palestinian Monetary Authority (PMA) an important means to control the monetary base and manage the economy. For macroeconomic policy to foster comprehensive development and reconstruction, the Palestinian Authority's dependence on resources and currencies beyond its control has to be reduced, and its tax structure has to be reformed.

A. The restricted economic policy framework

While the Paris Protocol allows the Palestinian Authority to set income tax rates and tariffs on a number of imported goods within certain limits, it does not permit the introduction of a comprehensive fiscal system that would enable Palestinian policymakers to respond effectively to their economy's specific development needs. Notably, the economic agreement requires the Palestinian Authority to align the value added tax (VAT) rate to that of Israel irrespective of the vast difference between the two economies.⁹ As a consequence, the Palestinian Authority's existing fiscal framework limits the scope for the resource mobilization that would allow a satisfactory delivery of public goods and encourage private investment. In addition, the absence of monetary policy – in a conventional sense – further narrows the slim public revenue base by depriving the Palestinian Authority of seigniorage revenues that would otherwise accrue through the issuing of a national currency.¹⁰

⁸ The Paris Protocol grants Israel the right to collect taxes, on behalf of the Palestinian Authority, on customs duties and VAT imposed on Palestinian imports from or via Israel. The clearance of these revenues to the Palestinian Authority has been very irregular since the outbreak of the second intifada in 2000. The Protocol also allows Israel to collect taxes and other deductions on the incomes of Palestinians working in Israel. However, the assessment of the magnitude and clearance of these funds has not been considered until now.

⁹ A differential of one percentage point lower or higher between the two regimes is permitted by the Protocol.

¹⁰ Seigniorage is the net revenue derived from issuing a currency, i.e. the difference between the face value of currency issued and its production and circulation costs. This revenue is normally used by Governments to finance part of their expenditure. A Government can raise seigniorage revenue without inflationary consequences if the increase in money supply is in line with growth in the economy and the demand for money. Sometimes Governments issue even more money to raise revenue: the resulting inflation is referred to as the "inflation tax".

As further elaborated below, the present fiscal and monetary system does not equip the Palestinian Authority with even the most basic tools to pull the economy out of the externally precipitated decline, or even to adopt simple stabilization policies or to deal with the ongoing economic regression. As a result, the Palestinian economy is left exposed, and remains highly vulnerable, to external economic shocks emanating from its asymmetric dependence on Israel and the global economy at large.

The Palestinian Authority's widening fiscal deficit is primarily the result of the impact of closure on economic activity, the loss of at least one third of the Palestinian economy's physical capital, and consequently, the substantial reduction in the Palestinian Authority's tax base and revenue. The deficit, which stood at \$484 million in 2000, grew steadily to \$1 billion by 2005, equivalent to 17.0 per cent of GDP. With a VAT rate at 14 per cent and GDP losses estimated at \$8.4 billion (in 1997 dollars; see table 2.3) over the period 2000–2005, VAT losses total about \$1.2 billion. The Palestinian Authority's fiscal position was further weakened by Israel's repeated withholding of the tax revenues it collects on its behalf.¹¹ This source is the cornerstone of the Palestinian Authority's public finances, representing between 60 and 70 per cent of its total revenue. The frequent interruption of the flow of such substantial resources not only reduces available public revenues, but more importantly, makes it extremely difficult for policymakers to plan and implement a coherent public expenditure policy (UNCTAD, 2008). In 2002 when Israel withheld customs and value added tax (VAT) revenue clearance from the Palestinian Authority, Palestinian public revenues dropped by 66 per cent. With the resumption of transfers, total revenue jumped from \$300 million in 2002 to \$1.2 billion in 2005, but collapsed again to \$358 million with the withholding of clearance revenue in 2006 (PNA, 2008). Yet, even in the event of revenue clearance, the arrangement of revenue transfer – and Israel's contesting of the definition of what constitutes taxable imports – further restricts the Palestinian Authority's tax base and constitutes a fiscal leakage (Kanafani, 2001).

The structural defects of the fiscal system are exemplified by the Palestinian Authority's heavy reliance on indirect taxes, mainly VAT and import taxes. These account for 80 to 90 per cent of total tax revenue, and about 10 to 15 per cent of GDP. In fact, the greatest source of tax revenue is the VAT, which is a proportional tax and thus inherently regressive. In contrast, direct (income and profit) taxes account for no more than 1 to 2 per cent of GDP. The absence of reasonable property and wealth taxes reinforces the regressive nature of the tax system, as does the absence of capital taxation. The heavy reliance on indirect taxes has negative consequences for the efficiency of fiscal policies and macroeconomic stability, as it impedes the automatic stabilization functions of the tax system. Given this composition of tax revenues, the tax system also loses its ability to facilitate equitable income distribution.

On the monetary side of the economy, the banking sector witnessed remarkable growth since the establishment of the Palestinian Authority in 1994, not least as a consequence of the removal of the restrictions on the operation of Palestinian or Arab banks that existed until 1993. By 1996, the number of bank branches operating in the Palestinian economy jumped from 13 in 1993 to 71 (Hamed, 1999). The operations and financial conduct of banks are monitored by the PMA, which was established in 1994. Although the PMA has some functions that are comparable to that of central banks, it cannot act as a lender of last resort and does not have the right to issue national currency. Thus policy tools that can be used for

¹¹ The delay of the transfer of clearance revenues did not start in 2000. For instance, in 1996 and 1997, Israel delayed the transfer of the Palestinian Authority's clearance revenue for several months, thereby putting severe pressure on the Palestinian Authority's liquidity. See Arnon A and Weinblatt J (2001).

such purposes as the adjustment of the exchange and interest rates, as well as open market operations, are not part of the portfolio of instruments available to the PMA.

The PMA can exercise limited influence over the monetary base by using certain instruments such as the management of government deposits, reserve requirements for commercial banks, limited open market operations and the discount window. These instruments are only potentially effective in the very short run and can only have a modest impact. Furthermore, as stated earlier, the absence of a national currency deprives the Palestinian Authority of seigniorage revenues and constitutes a resource transfer from the occupied Palestinian territory to the countries whose currencies are used in the Palestinian economy, namely Israel, Jordan and the United States of America. The transitional phase seigniorage revenues are likely to be substantial but there is no agreement as to their steady State levels. Cobham (2004) indicates that in the case of the Palestinian Authority, seigniorage revenues could range between 0.3 per cent and 4.2 per cent of gross national income. Accordingly, the cumulative seigniorage loss between 1995 and 2007 could be anywhere between \$178 million and \$2.5 billion. These estimates do not take into account transitional phase seigniorage, which is expected to be far more substantial.

The Palestinian Authority's current arrangement combines some of the worst aspects of the two polar-type exchange rate regimes. The absence of a national currency renders monetary policy ineffective, as is the case in fixed exchange rate regimes. On the other hand, the presence of three currencies used in the Palestinian economy (the new Israeli shekel, the Jordanian dinar and the United States dollar) imposes excessive risk on investors, banks and consumers, who have to contend with the fluctuations of the three exchange rates. As explained by Naqib (2002), with almost free capital mobility and very little trade between the Palestinian and Jordanian economies, fluctuations in the Jordanian dinar are transmitted to the Palestinian economy through the capital account. At the same time, with most of Palestinian trade being with Israel, fluctuations of the new Israeli shekel affect the Palestinian current account through exports to, and imports from, other countries, which amounts to approximately one third of all Palestinian trade. Thus, a depreciation of the new Israeli shekel increases the cost of imports of intermediate goods and consequently the costs of Palestinian production. Exports, in turn, benefit little from such a depreciation, considering the various barriers on Palestinian exports imposed by Israel (Hamed, 1999). Effectively, the exchange rate risk of these three currencies stifles development prospects by discouraging long-term investment, which the Palestinian economy badly needs.

With several currencies in place, commercial banks are less able to perform their function of transforming debt maturities, as currency mismatching is part of many portfolios. This can in turn be costly when commercial banks find themselves with more liabilities denominated in an appreciated currency than assets denominated in that currency. This extra risk discourages commercial banks from transforming maturities by accepting short-term deposits and extending longer-term loans. This puts further downward pressure on the overall amount of long-term loans extended to the private sector. Debtors, on their side, often do not possess financial securities, mortgages or other suitable assets to offer as collateral to mitigate the high risk commercial banks face.

Despite a relatively adequate savings rate in the Palestinian economy, credit extension and thus investment are dampened by the rational, risk-averse behaviour of commercial banks. As a consequence, domestic credit extended by local banks to the Palestinian private sector lags significantly behind that of neighbouring countries and is about one sixth of the world

average.¹² Therefore, building the credibility of the PMA and entrusting it with more policy tools towards the right to issue a Palestinian currency would significantly improve the investment environment and long-term development prospects in the occupied Palestinian territory.

B. Macroeconomic policy in the baseline scenario

This section quantifies the development prospects of the Palestinian economy under the current (baseline) fiscal and monetary policy frameworks. As UNCTAD (2006c) discusses in detail, the baseline scenario assumes that the Palestinian Authority's macroeconomic policy space will continue to be regulated and restricted by the Paris Protocol. As such, the baseline scenario assumes the persistence of three main factors inhibiting an effective macroeconomic policy:

- (a) A regressive tax system that relies heavily on indirect taxes, as well as the Palestinian Authority's dependence on Israeli goodwill to transfer the VAT revenues Israel collects on its behalf;
- (b) The allocation of significant public expenditure resources to recurrent items with only minor allocation to development expenditure;
- (c) The absence of a national currency and therefore the unavailability of monetary policy instruments.

Table 3.1 and figure 3.1 show how the Palestinian Authority's fiscal situation would evolve under these assumptions. Although government expenditure as a percentage of GDP is expected to fall gradually from almost 34 per cent in 2008 to 29 per cent in 2015, the budget deficit as a percentage of GDP, at 9 per cent, remains high at the end of the forecasting period. The decline in the public deficit reflects the response of the economy to the initial increase, and then gradual reduction of donor support. The resulting economic growth boosts government revenue by expanding the tax base and thereby reduces the budget deficit as government consumption, investment and transfers grow by very modest amounts because the Palestinian Authority is assumed to continue along a conservative fiscal policy path.

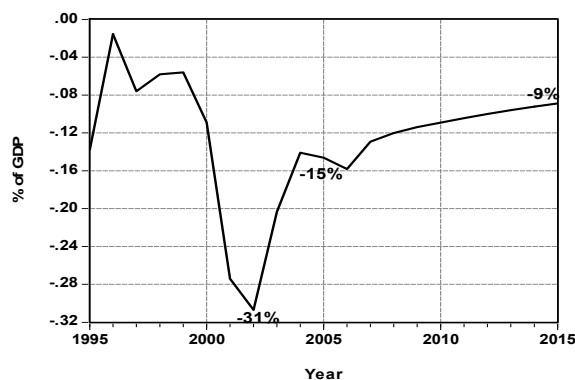
This pattern is also reflected in the trend of government revenues, which falls over the forecasting period from 22 per cent to 20 per cent of GDP. This relative decline in the share of public revenue in GDP under the baseline scenario would weaken the Palestinian Authority's ability to launch sufficiently vigorous investment schemes. In fact, the ratio of public investment to GDP falls from 6.0 per cent in 2008 to 5.5 per cent in 2015. Similarly, government transfers do not expand to support economically marginalized sections of society under this scenario as they fall from 5.2 per cent of GDP in 2008 to 5.0 per cent in 2015. This paucity of transfer payments implies that poverty, inequitable income distribution and social stress would continue to be problems in the occupied Palestinian territory.

¹² For example, in 2003, the domestic credit to the private sector was 24.9 per cent of GDP for the Palestinian economy, 60.6 per cent in Egypt and 73.5 per cent in Lebanon (PMA, 2005).

Table 3.1. Fiscal policy indicators in the baseline scenario as percentage of GDP

	Government revenue	Government expenditure	Budget deficit	Government investment	Government transfers
2008	21.9	33.9	-12.0	6.0	5.2
2015	20.2	29.1	-8.9	5.5	5.0

Figure 3.1. Government budget balance in the baseline scenario



C. Alternative fiscal policy instruments

As the baseline scenario shows, the existing macroeconomic policy arrangement for the Palestinian Authority does not equip policymakers with the necessary policy tools to respond to even mild external shocks. Nor does the structure of the tax system lend itself to improving the revenue base in order to boost development expenditure needed for comprehensive reconstruction and rehabilitation. This section provides insights into the responsiveness of the economy to changes in single policy variables, such as VAT, income tax and variations in public expenditure. The following section examines the impact of a fiscal policy package that combines changes in public investment and government transfers, and goes on to assess the impact of introducing a national Palestinian currency.

Reduced VAT rate

Table 3.2 summarizes the responses of main economic indicators to changes in different, individual fiscal policy variables. These responses are measured in per cent changes relative to the baseline scenario in the indicated years. The exercise of reducing the VAT rate by one per cent seeks not only to assess the impact of reducing the heavy reliance on indirect taxes, but also to evaluate the effect of such a reduction on investment and the productive capacity of the Palestinian economy.

As expected, the one per cent reduction of the VAT rate boosts the economy with 3.2 per cent and 2.8 per cent increases in, respectively, private consumption and private investment over the level projected for the baseline scenario in 2015. The rise in consumption and investment activities would in turn induce a higher demand for labour, hence leading to a fall in unemployment by 1.4 per cent in 2015, compared to 19.1 per cent in the baseline scenario. As a result, the simulated VAT reduction causes GDP to exceed the baseline scenario level by 2.8 per cent in 2015. As for the impact on the trade balance, the reduction of 1 per cent of

VAT rate would have a marginal but positive impact, with the trade deficit as a percentage of GDP reduced by 0.2 per cent throughout the simulation period.

With respect to the public deficit, the impact is rather marginal. In the short term, VAT reduction would have a negative impact on the budget balance, but this effect would subsequently be mitigated by increased tax revenue resulting from the policy's stimulating effects on output and employment. In the final year of the simulation period, the budget deficit-to-GDP ratio would be 13.4 per cent, which is merely a half percentage point greater than the one predicted in the baseline scenario. Thus, in the long term, the reduction of the VAT rate is expected to be fiscally neutral. Yet, even this marginal negative impact on the public deficit could be eliminated if the decision to reduce the VAT rate is accompanied by a programme to expand public and private investment, and therefore expand the Palestinian Authority's tax base, which would more than counteract any loss in public revenues.

Table 3.2. Effects of different fiscal policy instruments
Percentage change from baseline projections

	GDP		Private consumption		Private investment		Unemployment rate – %		Trade balance % of GDP		Budget balance % of GDP	
	2008	2015	2008	2015	2008	2015	2008	2015	2008	2015	2008	2015
Baseline Level^a	6 019	8 042	5 300	6 851	1 344	1 873	15.6	19.1	-39.1	-32.5	-12.0	-8.9
VAT 1% reduction	+1.6	+2.8	+2.0	+3.2	+1.6	+2.8	-0.9	-1.4	+0.2	+0.2	-0.8	-0.5
Income Tax 1% reduction	+1.0	+1.7	+1.6	+2.7	+1.2	+2.4	-0.6	-1.1	+0.2	+0.3	-0.7	-0.5
Public invest^t 10% increase	+0.6	+1.2	+0.3	+0.9	+2.8	+3.5	-0.3	-0.7	-0.6	-0.5	-0.3	-0.2
Cost of inves^t 10% reduction	+1.1	+2.7	+0.5	+1.8	+8.3	+11.8	-0.7	-1.7	-1.0	-0.9	-1.5	-1.5
Gov. transfers 10% increase	+0.7	+1.3	+0.9	+1.4	+0.7	+1.3	-0.3	-0.6	+0.1	+0.1	-0.3	-0.2

^a Baseline GDP and private consumption and investment are measured in real 1997 United States dollars.

Decrease in income tax rate

Instead of reducing the VAT rate, Palestinian Authority policymakers could consider reducing the income tax rate by one per cent. While this would run counter to the need to increase the reliance on direct taxes which is already minimal (1.9 per cent in 1999), such a policy could still stimulate the economy by encouraging aggregate private savings, investment and consumption. As expected, a cut in the income tax rate would worsen the budget balance. As shown in table 3.2, directly following the tax reduction, the budget deficit as a percentage of GDP exceeds the baseline scenario level by 0.7 percentage point. However, as the stimulating effects of this cut gain hold in the economy, the fiscal cost declines. The income tax cut increases disposable income and hence stimulates private consumption by 2.7 per cent above the level of the baseline scenario in 2015. The combined effects of the increase in consumer demand and the decrease in the cost of production following the cut in the income tax rate would manifest itself in higher levels of private investment and therefore reduced unemployment. Overall, by the last year of the simulation, the income tax cut would boost GDP by 1.7 per cent above the level in the baseline scenario.

Increase in public investment

This exercise explores the economy's response to an increase in the level of public investment by a target 10 per cent above the level assumed in the baseline scenario. While the increase in public investment is a necessary component of any comprehensive economic reconstruction programme, it should be used to target sectors and projects that would crowd in private investment in order to magnify their contribution to economic recovery.

Table 3.2 shows that the increase in public investment would crowd in private investment, which would exceed the baseline scenario level by 3.5 per cent in 2015. This indicates that the private sector would respond well to an increase in public investment. In 2015 the boost in investment would increase GDP by 1.2 per cent above the level of the baseline scenario, and reduce unemployment slightly below the baseline level. More investment activity and reduced unemployment would also lead to higher private consumption. The cost of this policy intervention, relative to its benefits, is rather small. While both the trade and public deficits, as a percentage of GDP, would be slightly higher than the level projected in the baseline scenario by 2008, this negative impact would gradually decrease to reach marginal proportions by the end of the simulation period.

Investment promotion programme

As part of the strategy to revitalize the Palestinian private sector, the Palestinian Authority could consider a programme aimed at stimulating private investment in capital-intensive activities. Such a focus is necessary to reverse the structural distortions and decline of productive capacity. Stimulating private investment in capital-intensive sectors might well require a concerted government policy to reduce the cost of production in the Palestinian economy, which has been artificially inflated by Israel's restrictive measures. This section assesses the response of the economy to what could be termed a "distortion correction scheme", which aims at reducing the cost of non-construction investment. This reduction is accounted for in the simulation by a 10 per cent reduction in the baseline non-construction investment price deflator, which could be achieved through a number of incentives, such as lowering interest rates, time-bound production subsidies or tax cuts.

Table 3.2 shows that this proposal would increase private investment by 11.8 per cent above the baseline scenario in 2015. This demonstrates that once the price distortions caused by the occupation are lowered or removed, a government programme to reduce the cost of investment would significantly boost private investment, and help revitalize the private sector into a motor for growth. As a result, by the end of the forecast period, private consumption and GDP are expected to exceed their levels in the baseline by 1.8 per cent and 2.7 per cent, respectively, and unemployment is expected to be 1.7 per cent lower than the baseline scenario. The cost of this policy is a marginal rise in the budget and trade deficits percentage of GDP, which surpass their baseline level by 1.5 per cent and 0.9 per cent in 2015.

Increase in government transfers

The Palestinian Authority may also consider policies targeting the marginalized sections in society to accelerate their socio-economic integration. To assess the impact of this policy, this simulation examines the effect of a 10 per cent increase in government transfers above the level assumed in the baseline scenario. As the results in table 3.2 show, while the cost of such a policy would be small, the economy's response is positive. Private consumption would rise

gradually, exceeding the level in the baseline scenario in 2015 by 1.4 per cent. Increased demand for consumption goods would boost investment by 1.3 per cent above the baseline scenario, and reduce unemployment by 0.6 per cent below its baseline level at the end of the simulation period. The marginal and gradually declining costs in terms of public deficit suggest that an increase in government transfers should be contemplated by Palestinian Authority policymakers because, in addition to addressing the socially desirable goal of reducing poverty, it stimulates the economy by raising aggregate demand. At the end of the simulation period, the budget deficit as a percentage of GDP is higher than in the baseline scenario by merely 0.2 per cent, while the trade balance registers a modest improvement.

D. Fiscal policy scenario

As previously indicated, policy options available under the existing macroeconomic policy framework are insufficient to place the Palestinian economy on a path of sustainable economic growth. On its own, the private sector would not generate the necessary investment to create sufficient jobs and rebuild its productive capacity. An expansionary fiscal policy could accelerate economic recovery by increasing public investment and introducing targeted measures to reduce the cost of investment and crowd in private investment. Simultaneously, in view of current levels of unemployment and poverty, the Palestinian Authority should consider an increase in government transfers to the economically marginalized sections of the Palestinian society, particularly those who would not immediately benefit from an economic recovery. Moreover, an expansionary fiscal policy could raise aggregate demand and therefore motivate the private sector to increase domestic production. The challenge is therefore to seek a fiscal policy mix that achieves these goals at the lowest possible cost in terms of budget and external deficit. This section proposes an alternative fiscal policy package where some of the baseline assumptions are changed as follows:

- (a) 10 per cent increase in public investment;
- (b) 5 per cent increase in government transfers;
- (c) Introduction of a “distortion correction scheme” targeting non-construction investment and leading to a 10 per cent reduction in the non-construction investment price deflator.

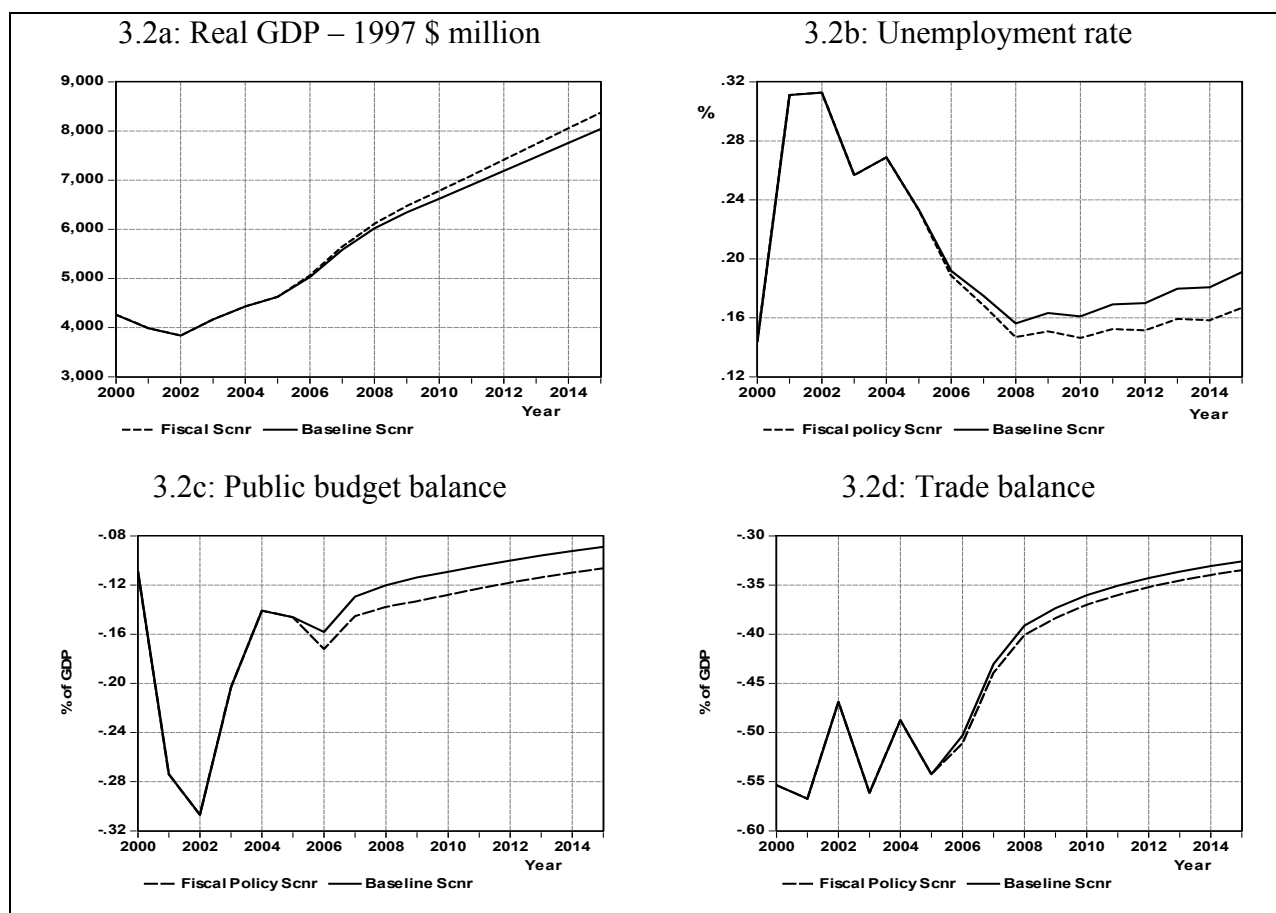
This specific policy scenario is just an example to demonstrate that there is considerable room for economic improvement if the Palestinian Authority is allowed an expanded fiscal policy space. Further research may consider different fiscal policy formulations. Table 3.3 and figure 3.2 show the impact of the suggested fiscal policy package on the main economic variables. The comparison between this scenario (FP) and the baseline (BL) indicates that this package would increase the 2015 GDP level by 4.2 per cent above the BL level, to reach \$8.376 billion and reduce the unemployment rate by 2.4 percentage points to 16.7 per cent. The stimulating effects of such a policy mix show up as higher levels of private consumption and investment, by 3.0 per cent and 13.7 per cent respectively in 2015.

The cost of this improvement is a 1.0 per cent increase in the trade deficit-to-GDP ratio, and a 1.7 per cent increase in the public deficit-to-GDP ratio. This suggests that while there is a need to pursue an aggressive expansionary fiscal policy to increase income and reduce unemployment, the sustainability of this policy will depend on increasing the sources of public revenue and improving the efficiency of tax collection. In this regard, the present arrangements for setting the rates of VAT and import tariffs as well as their collection by the Israeli authorities need to be reconsidered.

Table 3.3. Impact of fiscal policy on major economic indicators

	GDP 1997 \$ million		Unemployment rate – %		Public balance % of GDP		Trade balance % of GDP		Private consumption 1997 \$ million		Private investment 1997 \$ million	
	BL	FP	BL	FP	BL	FP	BL	FP	BL	FP	BL	FP
2008	6 019	6 114	15.6	14.7	-12.0	-13.8	-39.1	-40.1	5 300	5 350	1 344	1 457
2015	8 042	8 376	19.1	16.7	-8.9	-10.6	-32.5	-33.5	6 851	7 077	1 873	2 129

Figure 3.2. Impact of fiscal policy package on major economic indicators



E. National currency scenario

The abundant literature on the Palestinian economy has not given much attention to the issue of introducing a Palestinian national currency. While this is due to the fact that the Paris Protocol does not grant the Palestinian Authority this right for economic and institutional reasons that were pertinent 15 years ago, the most overriding consideration has been and remains the absence of sovereignty. Nonetheless, a limited number of papers have discussed this subject. Based on early research by UNCTAD on the subject, Naqib (1999), for instance, considers a currency union with Jordan with a currency board as a possible interim arrangement, while Cobham (2004) and Beidas and Kandil (2005) argue that a fixed exchange rate regime would be desirable at least in the initial stage. This section sheds more light on the possibility of expanding the Palestinian monetary and exchange rate policy space, by simulating the impact of introducing a national currency.

Regardless of whether the introduction of a national currency has been a political question tied to the Palestinian Authority's status as a "self-governing" entity since the 1994 Paris Protocol and to the negotiations with Israel on sovereignty, it should be emphasized that the merits of a national currency and the associated ability to execute an independent monetary and exchange rate policy are, to a large extent, significant for the economic policy of a sovereign State. Carrying out a coherent monetary policy is a complex task that requires considerable human and institutional capacities as well as fiscal discipline to safeguard against egregious error and policy abuse, which can wreak havoc on an economy. In the Palestinian case, neither the attendant policymaking capacities nor the political sovereignty conditions to underpin an independent monetary policy are in place. Hence a national currency should be considered as a strategic goal towards which momentum has to be built. In this context, the literature on the subject, including this paper, should be regarded as part of the theoretical and policy aspects of a national currency aimed at building such a momentum by informing policymakers and shaping the debate when the political and fiscal conditions are right and the required capacities are in place.

Establishing the credibility of a new national currency is a challenging task anywhere, but especially so in the occupied Palestinian territory, which lacks a well-established Palestinian central bank with a policymaking track record of independence from political and fiscal pressures. There seems to be a consensus so far that a currency board, with minimum monetary policy discretion, could be an initial arrangement to build up credibility and inspire confidence in the new currency. If the new currency is backed by foreign exchange reserves, under a currency board, seigniorage would be equivalent to the interest revenue on such reserves. However, the rigidity of currency boards increases the risk of exchange rate misalignment, making fiscal discipline and coherent macroeconomic policies all the more important. Indeed, the successful introduction and proper management of a currency requires an overall macroeconomic management and institutional capacity over and above the particular domain of monetary policy.

That being said, this paper highlights the cost to the Palestinian economy of continuing to use the monetary and exchange rate policies of the more advanced and structurally different Israeli economy, with the intention of suggesting remedial actions that can be taken to mitigate this cost. For example, as this section demonstrates, devaluing an assumed Palestinian currency would achieve a real exchange rate below that of the new Israeli shekel, which in turn would improve the trade balance, private investment, GDP and employment, and would stimulate the agricultural and manufacturing sectors. Prior to the introduction of a currency, the benefits of real exchange rate devaluation could be realized by taxing imports and using the tax revenue to subsidize and promote exports. Accordingly, the loss of Palestinian competitiveness resulting from using the overvalued new Israeli shekel could be used to justify such tax/subsidy schemes, and when negotiating trade agreements.¹³

To model this approach, the simulation presented here considers the impact of a 50 per cent devaluation of the assumed currency under a fixed exchange rate regime by changing the domestic prices of imports and exports, which would affect the economy through the tradable goods sector. In theory, devaluation improves the trade balance by increasing exports and

¹³ From the Palestinian perspective, the loss of competitiveness resulting from using the overvalued new Israeli shekel suggests a peculiar syndrome that could certainly generate all the evils of Dutch disease, with an even more damaging impact because of the absence of resource boom benefits that could partially compensate for the loss.

reducing imports, as exporters get higher local currency revenues from a given export volume while imports shrink due to the higher local currency price of imports. In other words, devaluation acts like a subsidy to exports and a tax on imports. Hence, the impact of the 50 per cent devaluation is simulated by assuming a 50 per cent rise in imports' price deflator and a corresponding 50 per cent reduction in exports' price deflator relative to their values in the baseline scenario.

As table 3.4 and figure 3.3 show, a devalued Palestinian currency would have positive effects on the economy's major indicators. The simulation result indicates that the trade deficit would be 1.5 percentage points below its level in the baseline. The devaluation would improve the competitiveness of the Palestinian tradable goods sector and stimulate the production of locally produced import substitutes. This would also have the potential of correcting the structural distortion of the economy, as it would increase the share of the agriculture and manufacturing (tradable goods) sectors in GDP relative to the service and construction sectors.

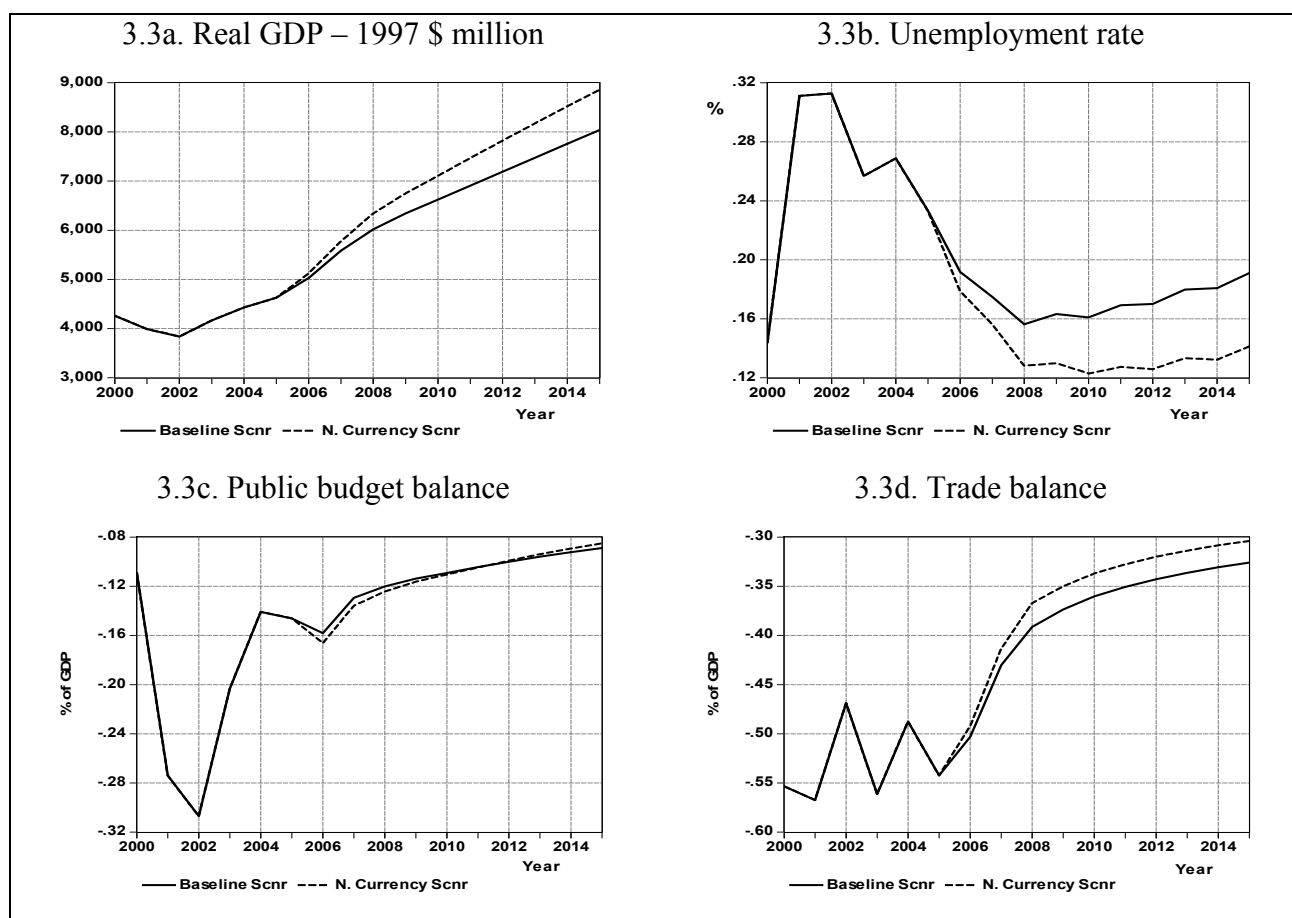
The positive impact of the devalued Palestinian currency would also manifest itself in increasing levels of private investment and consumption. At the end of the simulation period, private investment would be 11 per cent above the baseline, whereas private consumption would increase by 9 per cent. GDP is expected to increase by 1.4 per cent above the baseline scenario in 2015, and the budget deficit, as a percentage of GDP, would decrease by 0.4 percentage points. Unemployment rate is expected to be 5 percentage points less than the baseline prediction.

However, until the introduction of a national currency, the Palestinian Authority could achieve some of the benefits of currency devaluation by various schemes to subsidize exports and tax imports. In this sense, the simulation of the effects of a devalued hypothetical currency provides valuable and obvious lessons to Palestinian Authority policymakers in the area of fiscal policy. Finally, it is worth noting that the actual benefits of the introduction of a Palestinian currency are likely to exceed the simulated benefits described above. The simulated benefits do not take into account the positive effects of eliminating the risk and high transaction cost inherent in the present use of three currencies. Nor do they take into account seigniorage revenues and the potential benefits of empowering the Palestinian Authority policymakers with the interest rate policy tool, which they can use to encourage investment and achieve other policy goals.

Table 3.4. Impact of national currency on major economic indicators

	GDP 1997 \$ million		Unemployment rate – %		Public balance % of GDP		Trade balance % of GDP		Private consumption 1997 \$ million		Private investment 1997 \$ million	
	BL	NC	BL	NC	BL	NC	BL	NC	BL	NC	BL	NC
2008	6 019	6 342	15.6	12.8	-12.0	-12.4	-39.1	-36.7	5 300	5 511	1 344	1 418
2015	8 042	8 861	19.1	14.1	-8.9	-8.5	-32.5	-31.0	6 851	7 524	1 873	2 079

Figure 3.3. Impact of national currency on major economic indicators



F. Recommendations

The existing Palestinian fiscal and monetary policy framework is restricting the potential of the Palestinian economy. It exhibits many structural shortcomings and limits the options available to policymakers. The framework makes economic reconstruction efforts and longer-term development extremely difficult. A comprehensive reform package is desperately needed to address these limitations. The effectiveness of the tax system could be strengthened by increasing reliance on direct progressive taxation, restructuring the property tax and introducing new taxes. The equitable aspect of the system could be enhanced by imposing high excise taxes on luxury goods, especially imported ones, and exempting items that figure prominently in the consumption basket of poor households. Efficiency gains could be achieved by improving tax collection and registration of taxable income entities.

An expansionary fiscal policy could play a particularly important role in revitalizing the economy. Even though growth is being constrained by the currently weak demand, an expansionary fiscal policy also needs to be accompanied by other supportive measures such as increasing the financial sector's ability to extend loans to finance the development process. The Palestinian Authority will also have to rely on external support for implementing new and reformed policy measures. This highlights the importance of donors' support in expanding the Palestinian Authority's fiscal policy space. Aid efforts need to be intensified, with not only an increase in amounts but also a broader focus. Admittedly, it may be difficult to implement all the recommended measures concurrently in view of the Palestinian Authority's weakened

institutional capacity, hence the need for prioritizing and sequencing to build on reform measures already initiated.

At present, however, the Palestinian Authority has come under pressure to manage the public deficit by controlling the relatively high and growing wage bill. However, the recurrent crises have made the expansion of public employment an imperative for the Palestinian Authority, constituting an effective, if only second-best, strategy for breathing life into the Palestinian economy.¹⁴ The argument behind the need to downsize the number of Palestinian Authority employees or their remuneration follows from concerns over the sustainability of current spending levels and the assumption that government savings resulting from such a move would be primarily used to service the Palestinian Authority's debts to the private sector. In turn, the private sector is assumed to use repayment to increase investment activities. However, on its own, while reducing the burden on the Palestinian Authority's budget, downsizing the public sector would not necessarily boost investment activities in the Palestinian economy. This is because there is no guarantee that the chain reaction in which repayment leads to investment would occur; rather, in light of the current economic and political environment, investors are more likely to remain wary of the high risk of investment. Thus, until the political situation becomes stable enough to enable the private sector to initiate sufficient investment and job creation, reducing public sector employment will translate into higher unemployment and lower aggregate demand and output.

The alternative policy recommendations presented here do not prioritize the reduction of the wage bill, but call for putting people back to work and increasing the welfare of the Palestinian people. The overriding economic policy priority should be that of increasing aggregate demand through public and private investment to rehabilitate and develop the eroded productive capacity. GDP levels can be raised and unemployment reduced by public investment crowding in private investment. Investment needs to be supported by policy measures aimed at reducing its extremely high cost, artificially inflated price distortions, territorial fragmentation and decimated infrastructure and productive capacity. At the same time, a simultaneous increase in government transfers is recommended to bolster vulnerable groups in society who might not immediately benefit from an economic recovery. Over the longer run, increased economic activity would stabilize the Palestinian Authority's fiscal position by increasing tax revenue and reducing government transfers.

As for the monetary arrangement, there is a strategic need to build momentum to empower the PMA and develop its capacity to assume independent functions and responsibilities akin to a fully-fledged central bank, along a carefully sequenced but determined path. A comprehensive reform of the monetary arrangement should aim to achieve the following four strategic (medium- to long-term) objectives. First, it should empower the PMA to raise seigniorage revenue from the issuing of national currency and the management of a high-powered money base (currency in circulation and commercial banks' reserves). Second, the new monetary arrangement should allow the PMA to use monetary policy to absorb external shocks through adjustment in prices and interest rates to minimize the negative effects on the real side of the economy. Third, it should instil trust in both the stability of prices and the soundness of the financial system, which are necessary for fostering domestic and foreign investors' confidence in the economy. Finally, the new monetary arrangement should aim at supporting

¹⁴ While the wage bill of the Palestinian Authority is above the regional average, the ratio of public employees to total population is below the regional average (World Bank, 2006).

a reorientation of trade flows away from Israel towards Arab countries and the rest of the world where favourable trade deals can be negotiated and access to markets guaranteed.

To achieve these goals, the PMA should proceed along two parallel tracks. The first track should be directed towards increasing its discretionary power in preparation for the issuing of a national currency and for assuming the function of a lender of last resort. The second track should focus on coordinating monetary and exchange rate policies with neighbouring Arab countries in line with other integrative steps related to trade and factor mobility.

IV. TRADE POLICY

Since 1967 Palestinian trade performance has been determined by its relationship with Israel. Immediately after the occupation of the West Bank and the Gaza Strip in 1967, Israel imposed its external trade and fiscal regimes on the occupied Palestinian territory in what has been described alternately as an involuntary, de facto, semi/quasi- or hybrid customs union. Effectively, this entailed a process of annexing the less developed Palestinian economy to its own. The flow of Palestinian labour and goods to Israel was allowed within the context of non-reciprocal restrictions, and imports to the occupied Palestinian territory were subjected to Israeli tariff structure and quotas. Palestinian producers became increasingly cut off from their traditional trading partners in the Arab world and had no choice but to reorient trade towards the Israeli economy.

Given the different size, cost structure and standards of living of the two economies, according to standard trade theory, the growth path of the Palestinian economy would normally converge towards that of Israel. However, the playing field between the occupied Palestinian territory and Israel has been far from level. According to UNCTAD (2006a and various previous studies) and other observers such as Hamed and Shaban (1993), the effective customs union distorted trade patterns to the benefit of the Israeli economy. Israeli traders benefited from high State subsidies, import quotas and a policy aimed at eliminating competition coming from Palestinian enterprises. Palestinian exports, both to Israel and the rest of the world, were hampered by non-tariff barriers and delays caused by cumbersome overland transport and security procedures, in particular for goods that could potentially harm existing Israeli market shares (Awartani, 1994 and Shadid, 1988). In addition, most raw materials and intermediate goods had to be imported at higher prices from Israel. Cheaper imports from other countries were either prohibited or rendered too expensive by extremely high transaction costs ensuing from Israeli measures. As a result, Palestinian exporters lost much of their competitive edge, while Israeli products had unhindered access to Palestinian markets (Roy, 1987).

A. Trade aspects of the Paris Protocol

On paper, the new regulatory framework for Israeli–Palestinian trade established under the Paris Protocol represents a compromise solution between both parties' interests in a form that includes elements of both a customs union and a free trade area. While the agreement allows for the free movement of capital and goods, the issue of Palestinian labour movement into the Israeli economy was shrouded by vague and indefinite declarations (see chapter V on labour policy).¹⁵ For Palestinian negotiators, however, the agreement did incorporate some Palestinian interests and allowed for a few positive changes to the imposed regime regulating Palestinian trade until 1993. For instance, the new trade arrangement gave the Palestinian Authority the freedom to enter into bilateral trade agreements with other countries and the right to determine independently – within limits – the tariff rates for a limited number of import items. Most critically from the public finance angle, the protocol established a revenue clearance mechanism by which Israel transferred on a monthly basis revenues accruing from trade taxes applicable to identified occupied Palestinian territory-destined imports passing through Israeli-controlled customs borders.

¹⁵ For a detailed discussion of trade-related aspects of the Paris Protocol see UNCTAD (2000).

More than any other aspect of the Paris Protocol, the trade regulations have been subject to extensive debate. Those who viewed the agreement favourably argued that although the protocol limited the Palestinian Authority's trade policy space by setting a common external tariff, the Palestinian economy could still benefit from access and proximity to the larger, technologically more advanced Israeli economy (Abed, 1996; Diwan and Panagariya, 1997). The argument is that the worsening of the Palestinian trade performance was not related to the design of the economic arrangement per se, but rather, was caused by the poor implementation of the agreement and the lack of an effective monitoring body.

However, those on the other side of the argument emphasize that the above position is premised on a key assumption, namely open borders for goods and labour – an assumption that did not occur, as restrictions on the movement of goods and labour have risen steadily since 1994, and significantly since 2000. The argument here is that the Paris Protocol, and in particular its trade-related aspects, hinder rather than help rebuild the Palestinian economy (El-Jaafari and Elmusa, 1995). Moreover, the counterfactual – a fully implemented Paris Protocol with no closure inhibiting Palestinian access and movement – would still impact Palestinian trade negatively for a number of reasons grounded in standard trade theory, all attesting to the preponderance of market imperfections affecting the supposedly advantageous common external tariff in this case.

First, quantitative restrictions placed on Palestinian imports ostensibly follow Palestinian “market needs” as determined by the Joint Economic Committee (JEC).¹⁶ As there is no reliable way or data to accurately estimate Palestinian “market needs”, limiting imports to the occupied Palestinian territory constitutes interference in the operation of market mechanisms. Indeed, disagreement arose over actual market needs once Palestinian imports from alternative sources began to replace imports from Israel. Moreover, these quantitative limits nurtured monopolistic and price-distorting practices by Palestinian importers with favourable links with Israeli, Jordanian or Egyptian markets (Nasr, 2004).

Second, despite the gradual Israeli trade liberalization in the 1990s, Israeli producers still benefit from an array of subsidies and other non-tariff barriers that leave Palestinian industry and agriculture at marked disadvantage, particularly in areas where Palestinian producers could potentially capture some Israeli market shares. As documented by the secretariat of the General Agreements on Tariffs and Trade (GATT), Israel still applies non-tariff trade barriers in the areas of labelling and packing as well as phytosanitary and veterinary standards in agriculture to protect Israeli industry (GATT, 1995; Schiff, 2002).

Third, the arrangement of Israel transferring the tax and clearance revenues it collects on behalf of the Palestinian Authority resulted in significant revenue losses due to Israel's interpretation of what constitutes imports and which customs duties would be charged. Given the obstruction, and therefore the delay, in the clearance of Palestinian imports through Israel, Palestinian companies tried to bypass the additional costs related to these delays by working with Israeli trading agents who order goods on their behalf and then ship them (without

¹⁶ The JEC was responsible for overseeing the implementation of the Paris Protocol. It rarely met and was ineffective. The JEC was subordinated to the Joint Civil Affairs Coordination and Cooperation Committee (CAC), which was founded to oversee the transfer of responsibilities from the Israeli Civil Administration to the Palestinian Authority. The Israeli side of the CAC was composed of members of the Israeli Ministry of Defence. Thus, it appears that economic considerations were overridden by Israel's security concerns. See Zaghera A and Zomlot H (2004).

adding any value) to the occupied Palestinian territory as imports from Israel (indirect imports). Approximately 60 per cent of Palestinian imports from/through Israel were imported in this manner. Under the normal provisions of a customs union, goods that are imported in this manner should still be counted as Palestinian imports from a third country and accordingly, customs duty should accrue to the Palestinian Authority. Israel, however, does not recognize these goods as proper Palestinian imports, arguing that their final destination, or point of consumption (the occupied Palestinian territory in this case), is not clearly specified (Jawhary and Shaban, 1995).

Finally, and most importantly, the trade provisions of the protocol failed to alter the asymmetric relations that evolved under decades of occupation and merely institutionalized the dependence created through the quasi-customs union (Arnon and Weinblatt, 2001; Kanafani, 2001). As reported in Bulmer and Dessus (2004), trade dependence on Israel, measured as the value of Palestinian goods exported to Israel divided by the Palestinian gross national product (GNP), has actually increased since the implementation of the Paris Protocol. This trade dependence is exacerbated by the fact that 60 per cent of Palestinian imports from third countries are conducted through Israeli. The resulting higher costs of transactions and of indirect imports reduce investment: they raise the cost of production in the occupied Palestinian territory by increasing the price of imported intermediate goods and worsen welfare level by making consumer goods more expensive.

The asymmetric nature of the Israeli–Palestinian customs union, and its negative impact on the Palestinian economy as a whole, is reflected in Palestinian trade figures. Between 1970 and 1993, the occupied Palestinian territory exported and imported approximately two thirds of its trade to and from Israel. Moreover, while exports as a percentage of GDP gradually declined, the share of imports gradually rose, causing a persistent trade deficit throughout this period. The chronic trade deficit, much of which was owed to Israel, amounted to around one third of GDP. It was mainly financed by wages earned by Palestinians working in Israel and remittances from those working in other countries, predominantly Arab Gulf States.

The negative impact of the trade agreement underlying the protocol was exacerbated after the establishment of the Palestinian Authority in 1994. The dispute resolution potential of the JEC machinery was never seriously explored, owing to both a lack of Israeli interest in empowering the JEC beyond a purely administrative role, and the inadequate Palestinian negotiation capacity and weight to fully exploit all aspects of the agreement. The increasingly unilateral nature of Paris Protocol's implementation further intensified after 2000 as a result of the systematic tightening of external and internal closure of the occupied Palestinian territory and the gradual disempowerment of the Palestinian Authority in its economic relations with Israel. The situation made it extremely difficult for Palestinian traders to ship exports and imports to and from external markets.¹⁷ The trade deficit, which has always been relatively high and was persistently over 50 per cent prior to 1994, has steadily increased. It reached its highest ever level in 2007 at \$3.4 billion, representing more than 66 per cent of GDP, with more than two thirds of this deficit owed to trade with Israel (UNCTAD, 2008). The deficit increase was also driven by the degradation of productive capacity and the resulting inability of domestic producers to meet local demand, which heightened dependence on imported consumer goods, mostly from Israel. The 2007 trade deficit with Israel is equivalent to almost 90 per cent of total net current transfers (mainly donor support) (UNCTAD, 2007).

¹⁷ With no sovereignty over external borders and no access to sea and airports, the Palestinian economy is effectively landlocked (UNCTAD, 2004b).

B. Trade performance in the baseline scenario

The baseline simulation indicates that although trade performance is expected to improve with political stability, it would do so under the same conditions of distorted trade patterns and limited trade partners. Looking back at Palestinian trade performance since the establishment of the Palestinian Authority, it is evident that the policy framework was incapable of equipping the Palestinian economy with an institutional capacity to lessen its dependence on the Israeli economy and reduce the chronic trade imbalance. The Palestinian trade performance simulated in the baseline scenario assumes the status quo, whereby:

- (a) Trade between the Palestinian Authority and Israel is not subject to tariffs;
- (b) The Israeli trade regime applies to Palestinian trade, with the exception of limited exports to Egypt and Jordan;
- (c) The Israeli tariff structure applies to Palestinian imports from third countries;
- (d) Israel collects, on behalf of the Palestinian Authority, VAT and tariffs on Palestinian imports from third parties.

Under these assumptions, Palestinian trade would experience an improved but restrained performance over the simulation period. As shown in table 4.1, the trade deficit is expected to decline from 39.1 per cent of GDP in 2008 to reach 32.5 per cent in 2015. The trade deficit with Israel falls too, from 24.5 per cent in 2008 to 19.7 per cent at the end of the simulation period. The reduction in the total trade deficit is mainly the result of a decline in the import-to-GDP ratio. Table 4.1 also shows that under the assumption that Israel transfers the customs revenues it collects on behalf of the Palestinian Authority without delay or reduction at current levels of revenue capture/leakage, the public deficit is projected to decline from 12.0 per cent in 2008 to 8.9 per cent in 2015.

On the other side, the export-to-GDP ratio falls from 11.2 per cent in 2008 to 10.0 per cent in 2015. The problem of the declining export share is not confined to the baseline scenario, as it also falls in the two alternative trade scenarios presented further below. This serves as a reminder that irrespective of the Palestinian trade regime in place, technological improvement and modernization of the export sector should be a key policy objective to raise the international competitiveness of Palestinian enterprises and achieve a sustainable trade balance.

Overall, despite the rise in the GDP level to \$8 billion by 2015, the forecasted baseline performance remains insufficient to improve unemployment, which is projected to increase to 19.1 per cent in 2015, indicating structural problems with the tradable goods sectors that require special attention. This corroborates the UNCTAD (2005, 2006a) argument that the existing strategy follows a trade-driven approach to development rather than a development-driven approach to trade. In other words, instead of a development policy that aims at trade liberalization, what is needed are trade and industrial policies that address the economy's structural difficulties and therefore allow trade to contribute to achieving the Palestinian development vision.

C. Alternative trade regimes

The proposed alternative policy scenarios involve assessing two trade regimes against the present baseline framework. The most distinctive alternatives, the most favoured nation

(MFN) regime (also sometimes referred to as non-discriminatory trade policy) and the free trade regime will be considered, to demonstrate the impact of changing the trade regime on the main economic indicators.¹⁸

Assumptions for the most favoured nation trade policy

The MFN policy regime assumes that an autonomous tariff rate would be applied to all Palestinian imports regardless of their origin.¹⁹ This means that the same tariff applied to Palestinian imports from Israel would also be applied to Palestinian imports from the rest of the world. This basic principle of non-discrimination is enshrined in Article I of the GATT and requires that all imports from any country be treated on the same basis as that given to the most favoured other country. Accordingly, simulating the MFN policy in the Integrated Simulation Framework (ISF) model is done by assuming a gradual increase in the average tariff rate on imports from Israel from its current zero level to the average tariff on a typical Palestinian basket of imports from the rest of the world (16.6 per cent) in 2011. Similarly, the MFN simulation assumes that Israel will gradually increase its tariff rate on imports from the occupied Palestinian territory from their current zero level to its average tariff rate on imports from the rest of the world (8.3 per cent) in 2011.

To enhance the competitiveness of Palestinian exports, the MFN simulation also assumes that the Palestinian Authority would introduce distortion correction schemes to reduce exports' production cost. This would reduce export prices (cost) to 83.4 per cent of the baseline scenario level in 2011.²⁰ Finally, the technical implementation and running of an MFN regime would require an increase in public employment, which is assumed to rise gradually to half a percentage point above the baseline level in 2011.

Assumptions for the free trade policy

An alternative trade policy would be to seek a free trade agreement with Israel. This would maintain the free-of-tariff trade between Israel and the occupied Palestinian territory but would give a sovereign Palestinian State the autonomy to change the tariff structure on imports from the rest of the world, as well as the sovereignty to negotiate and implement any other trade agreement with a third country. This alternative scenario aims at diversifying Palestinian import sources by replacing part of its imports from Israel by substitutes from the rest of the world. Therefore the free trade simulation assumes that the present average tariff on imports from countries other than Israel is reduced by half. This is reflected by the gradual reduction in this average tariff rate from 16.6 per cent down to 8.3 per cent in 2011. Likewise,

¹⁸ A turning point in the World Bank's trade policy recommendation to the Palestinian Authority is the study by Astrup and Dessus (2001) in which they simulate elements of Palestinian trade reforms. The findings presented here corroborate that of Astrup and Dessus, namely that a non-discriminatory trade policy is superior to the current quasi-customs union and a free trade agreement with Israel, which implies costly rules of origin.

¹⁹ According to the WTO rules, MFN means that all trading partners should receive the same treatment. However, some exceptions are permitted such as the establishment of a free trade area or customs union by a group of countries. For simplicity, the MFN scenario proposed here does not consider any of these exceptions. However, it should be noted that if the envisaged Palestinian State joins the WTO, it could take advantage of the special and differential provisions granted to the least developed countries. Hence, the Palestinian Authority could set the tariff rate on imports above the assumed 16.6 per cent.

²⁰ Export prices in this sense refer to the price index that determines the cost of production of Palestinian exports. It should not be confused with world price of exports, which cannot be influenced by a small trading economy. The distortion correction scheme assumes a reduction in the cost of baseline exports by 16.6 per cent, which is equivalent to the average Palestinian tariff assumed in the MFN scenario.

tariffs of third countries (excluding Israel) on imports from the occupied Palestinian territory are also assumed to decline to half their level in the baseline scenario by 2011. However, it should be noted that if the envisaged Palestinian State were to join the WTO and take advantage of the special and differential treatment accorded to least developed countries, tariffs on the occupied Palestinian territory's imports from other countries could be higher, while third countries' tariffs on imports from the occupied Palestinian territory could be lower.

As in the MFN scenario, to boost Palestinian exports the Palestinian Authority is assumed to gradually introduce distortion correction schemes to reduce baseline export prices by 16.6 per cent in 2011. Finally, the implementation and management of the free trade policy would also require an increase in public employment above the level assumed in the baseline scenario. Public employment is assumed to increase gradually until 2011 when it would be 0.7 percentage point above the baseline scenario.²¹ This assumption is justified because a shift away from the current arrangement towards free trade requires the Palestinian Authority to build trade management capacity and employ personnel to carry out the new policy.

D. Impact of the most favoured nation trade policy

As table 4.1 indicates, the implementation of the MFN policy and the introduction of the distortion correction scheme would not impose an additional burden on the public budget. The results suggest that the ratio of public deficit-to-GDP would decline from 7.9 per cent in 2008 to 5.6 per cent in 2015, a development that is certainly helped by the change in the tariff structure that would increase public revenues. The MFN policy would also reduce the Palestinian trade deficit-to-GDP ratio from the 35.5 per cent projected for 2008 to 32.0 per cent in 2015, largely as a result of the decline of the import-to-GDP ratio. The trade deficit with Israel declines too, from 24.4 per cent in 2008 to 19.2 per cent in 2015.

The MFN scenario also projects a substantial increase in GDP to \$8.5 billion in 2015. The initial effect of the change in the trade regime on unemployment is quite positive with its rate registering 13.9 per cent unemployed in 2008. However, over time unemployment rises to 16.0 per cent in 2015, once more confirming that trade policy, important as it is, cannot be a substitute for a comprehensive development strategy aimed at the expansion and modernization of productive capacities.

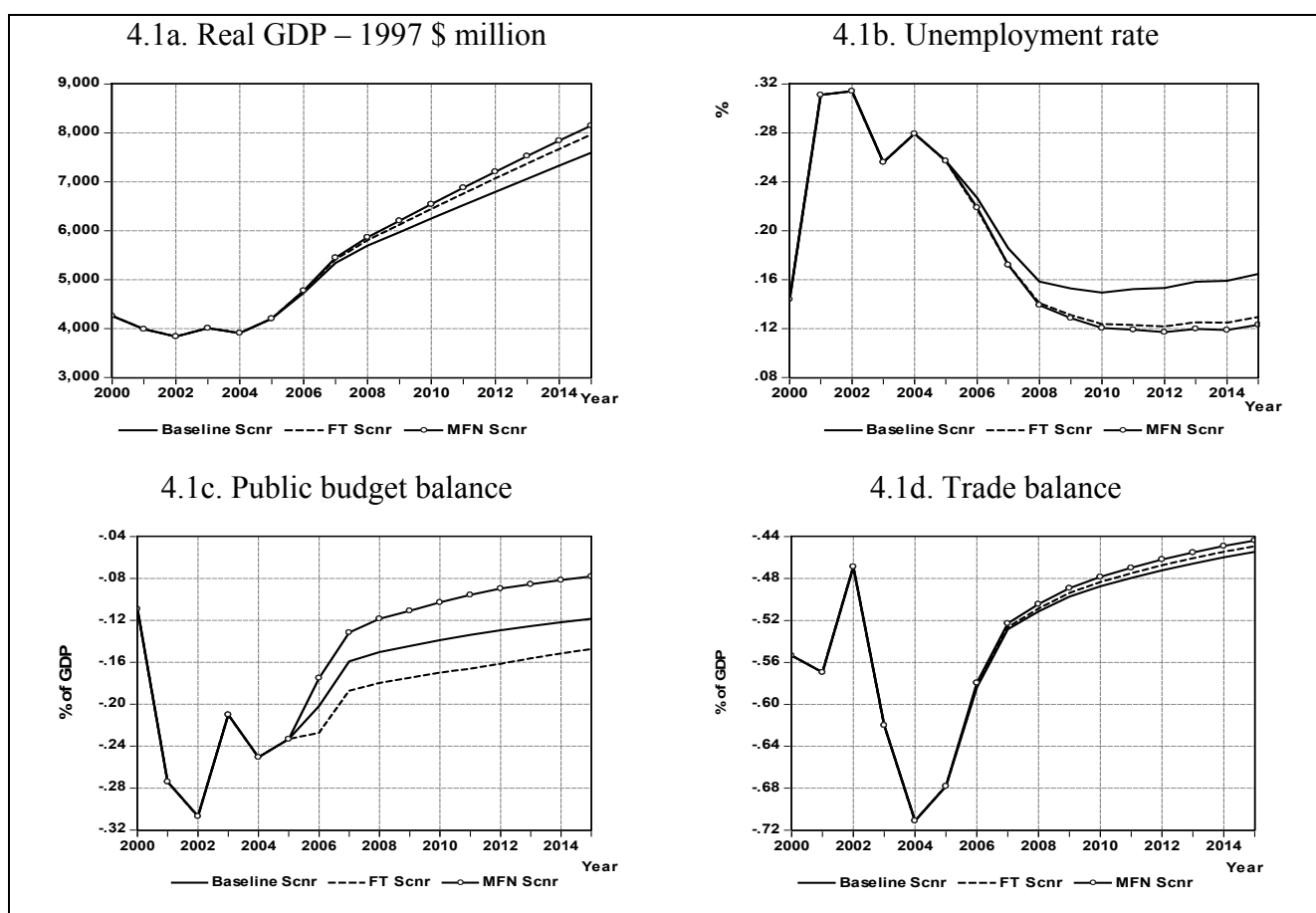
Despite the positive economic changes this policy would bring, the export share in GDP remains as low under the MFN scenario as in the baseline. It declines marginally from 10.4 per cent in 2008 to 9.4 per cent in 2015. In fact, exports grow during the period, but less than GDP. Over and above GDP growth, the declining export ratio can be explained by the distorting impact of the occupation on Palestinian trade patterns, coupled with the more recent erosion of productive capacity, which has retarded the export sector disproportionately. To improve trade performance, it is therefore necessary to adopt additional strategies to directly support export activities in areas with comparative advantages or potential competitive advantages. Overall, the MFN scenario brings about diversification of trade partners, higher GDP, higher volume of exports and a lower rate of unemployment. It is therefore superior to the baseline.

²¹ Public employment in the baseline is estimated at 172,000. The most favoured nation policy assumes that 775 additional employees would be needed to implement and manage the policy while the free trade policy requires an additional 1,152 public employees.

Table 4.1. Impact of alternative trade policies on major economic indicators

	Baseline scenario		Most favoured nation scenario		Free trade scenario	
	2008	2015	2008	2015	2008	2015
GDP (1997 \$ million)	6 019	8 042	6 189	8 539	6 134	8 380
Unemployment rate	15.6	19.1	13.9	16.0	14.4	16.9
Exports (% of GDP)	11.2	10.0	10.4	9.4	11.2	9.8
Imports (% of GDP)	50.9	42.6	45.8	41.4	50.1	42.1
Trade deficit (% of GDP)	39.1	32.5	35.5	32.0	38.9	32.3
Trade deficit with Israel (% of GDP)	24.5	19.7	24.4	19.2	24.4	19.8
Public deficit (% of GDP)	12.0	8.9	7.9	5.6	14.4	11.0

Figure 4.1. Impact of alternative trade policies on major economic indicators



E. Impact of the free trade policy

Table 4.1 suggests that a move from the current framework to a free trade arrangement with Israel and the introduction of distortion correction schemes would not burden the public budget. However, while the budget deficit falls to 11.0 per cent in 2015, it is hardly surprising that the budget deficit is twice the size of that simulated in the MFN scenario. Under the free

trade scenario, GDP rises to \$8.38 billion in 2015 leading to a 16.9 per cent unemployment rate compared to 19.1 per cent in the baseline.

The trade deficit in the free trade simulation would decline from 38.9 per cent in 2008 to 32.3 in 2015. Similar to the MFN scenario, this decline is mainly the result of faster GDP growth and a decline in the import-to-GDP ratio. The trade deficit with Israel also falls, to 19.8 per cent in 2015. As with the MFN policy, a change in the Palestinian trade regime alone would not guarantee a faster expansion of the export base: the export-to-GDP ratio declines from 11.2 per cent in 2008 to 9.8 per cent in 2015. Moreover, it is expected that the Palestinian Authority's ability to change the tariff structure in trade with countries other than Israel could also bring beneficial changes in the pattern of trade.

F. Evaluation of the alternative trade regimes

Table 4.1 and figure 4.1 summarize the changes in main economic indicators for all three trade scenarios. Even by the static measures of relative costs and benefits of the alternatives both immediately and in the longer term, any alternative trade regime would be superior to the baseline scenario judging by almost all major economic indicators. Even the export-to-GDP ratio is marginally higher in the baseline only due to the relatively low GDP denominator. GDP and unemployment are the two main economic indicators for which the differences between the various simulated trade policies are most noticeable. In the free trade scenario, GDP exceeds the baseline level in 2015 by 4.2 per cent and, consequently, results in a 2.2 per cent reduction in the unemployment rate that year. As for the MFN scenario, GDP is larger than the baseline and free trade projections in 2015 and the unemployment projection is less.

Based on the above, and the significantly lower public deficit-to-GDP ratio, the MFN policy seems to be superior to both the baseline scenario and the free trade policy. However, while the differences in the projections of GDP level, public deficit and the unemployment rate are noticeable, the quantifiable advantages of one regime over another are not as evident for all other indicators. For instance, while the trade deficit as a percentage of GDP for the MFN policy is 0.5 per cent lower than the baseline in 2015, the reduction in the case of the free trade scenario compared to the baseline is 0.2 per cent. The minor differences in the various trade indicators are largely due to the fact that the simulated results in all scenarios are based on the historical trend of worsening trade indicators, economic structure and the shrinking of productive capacity in the Palestinian trade sector, making it difficult to reap the benefits of positive change in trade policy. Therefore, the benefits of trade policy reform are more likely to manifest themselves fully when accompanied by policy measures aimed at replacing and expanding the damaged Palestinian productive capacity, alongside other components of the expanded policy space needed for sustained development.

Table 4.1 also shows that the Palestinian trade deficit with Israel does not change much in the three scenarios. This is not surprising since the MFN and free trade scenarios make the simplifying assumption of a uniform tariff on imports from Israel and the rest of the world. In reality this need not be the case as Palestinian policymakers would have the option of designing an appropriately differentiated tariff structure that could reduce trade dependence on Israel. Such a tariff structure, combined with the removal of the various Israeli security and physical barriers imposed on Palestinian trade would eliminate, or at least reduce, trade dependence on Israel and enhance Palestinian integration in other Arab, regional and global markets.

A further argument in favour of the MFN option, as opposed to the free trade policy, is that it could not only potentially reduce the asymmetric dependence on Israel and diversify trade partners, it would also provide the Palestinian Authority with much needed customs revenues. As shown in table 4.1, the public deficit would reach 5.6 per cent of GDP in 2015, the lowest among all simulated trade policy scenarios. This currently lacking additional public revenue could be used for implementing measures aimed at expanding the eroded Palestinian productive capacity.

G. Recommendations

Since the Israeli occupation in 1967, various measures taken by the Israeli Civil Administration have distorted Palestinian trade patterns and weakened its performance by creating a number of non-tariff trade barriers that hinder Palestinian competitiveness. The economic effects of the involuntary customs union have created a dependency path upon which the Palestinian economy remains trapped to this day. The extreme dependency on the Israeli economy has resulted in a chronically high imports-to-GDP ratio, a weak export base and large trade and public deficits.

Despite the existence of some positive trade-related provisions in the Paris Protocol, such as allowing the imposition of tariffs on some imports and some Palestinian Authority control over customs and excise revenues, the arrangement has failed to alter the dependence of Palestinian trade on Israel, and has institutionalized it instead. In the words of the Palestinian Economic Policy Research Institute (MAS), this predominance of Israel in Palestinian external trade has “mortgaged” the Palestinian economic future to the fate and development path of the Israeli economy. The overall effect of the trade arrangement has been to deepen economic dependence on Israel and to inhibit Palestinian efforts to diversify trade partners, shift towards high value added exports and ultimately integrate into the Arab, regional and global trading systems.

Although Israeli measures led to a less than full implementation of the Paris Protocol, the protocol’s distorting impact can be attributed not only to a lack of implementation, but, more importantly, to the deficiencies in its design and its trade-related provisions. This is exemplified by an imposed VAT rate and a tariff structure that do not suit the developmental needs of the Palestinian economy. Furthermore, the practice of Israel collecting customs duties on behalf of the Palestinian Authority has politicized the transfer of important fiscal resources, and further undermined the Palestinian Authority’s fiscal base. These resources are frequently withheld, preventing them from becoming a predictable source of income for the Palestinian Authority. Not only does this make budget planning extremely difficult, but it also deprives the Palestinian Authority of using fiscal policy tools to manage and stimulate the economy and inhibits any medium-term planning.

If the baseline policy framework prevailed under a sovereign Palestinian State, trade performance would improve, but along continued patterns of dependency on the Israeli economy and a weak export base. The trade arrangement would remain inappropriate for launching a comprehensive development strategy as exemplified by the weak spin-off benefits of improved trade performance on employment. A reform of the existing trade regime, therefore, should list high on the Palestinian Authority’s policy agenda, both for strategic and immediate purposes. At least as demonstrated by this simulation exercise, it is clear that any alternative to the current framework could deliver immediate positive results, even in Year 1 after independence. Indeed, a clear, deliberate but cautious break with the past

would appear to be as important as any other prerequisite for achieving the vision of a viable Palestinian State living peacefully alongside Israel and for ensuring its sovereignty in all aspects.

However, it should follow a development-driven approach to trade, so that trade policy serves economic development objectives. Trade reform should aim at gradually eliminating trade dependency on Israel by diversifying exports and export markets and steering trade patterns towards higher value added products. It should also aim at reintegrating the Palestinian economy into the regional economy and building new trade relations with the rest of the world. Linked to these aims is the need to establish, under Palestinian sovereignty, seaports and airports, and intensify efforts to physically reconnect the West Bank and the Gaza Strip, since external integration would be more beneficial if simultaneously accompanied by efforts to undo internal fragmentation.

A reformed trade regime, coupled with a distortion correction scheme that lowers costs to Palestinian producers and compensates for decades of discrimination against Palestinian exporters by Israel, the main trading partner, would generate important economic benefits. Given the freedom to import raw materials and intermediate goods at lower prices, Palestinian exporters could regain competitiveness, achieve export growth and realize significant economies of scale.

Between the two proposed alternative trade regimes, the MFN regime is shown to be superior to the free trade regime. Many of the Palestinian Authority's trade problems stem from the predominance of Israel as its main trading partner, and the free trade option is less capable of addressing this asymmetry. The MFN policy option provides the Palestinian Authority with the tools to reverse the path of extreme trade dependency on Israel. The positive impact of the MFN policy on GDP growth, public balance and employment provides an environment more conducive to rehabilitating and expanding productive capacity, building up an industrial base and gradual integrating the Palestinian economy into the Arab, regional and global economy.

V. LABOUR POLICY

A. The Palestinian labour market

Following the Israeli occupation of the West Bank and the Gaza Strip in 1967, Palestinian labour flows to Israel became one of the main channels through which the occupied Palestinian territory was integrated into the Israeli economy (Arnon et al., 1997). Palestinian labour flows to Israel, which remained largely unregulated by Israeli authorities until 1991, rose gradually from 5,000 in 1968 to 115,000 in 1992, the latter being the highest number of Palestinians working in the Israeli economy prior to the establishment of the Palestinian Authority. This figure was surpassed by 1999, with the number of workers reaching over 135,000. Between 1967 and 1993, approximately one third of the Palestinian labour force was employed in Israel, generating nearly a quarter of the GNP (Farsakh, 2002).

Palestinian dependence on the Israeli economy as an outlet for excess labour was primarily the result of various measures put in place by the Israeli Civil Administration. Although for Palestinians, employment in Israel offered higher wages than domestic employment, it has been driven by push (labour release) factors related to the inability of the domestic economy to produce enough jobs for the growing labour force. Palestinian labour transfer to Israel was largely confined to low-skill, physically demanding work, faced institutionalized discrimination and provided little job security or legal recourse (Lewin-Epstein and Semyonov, 1987). While the flow of Palestinians commuting to work in Israel was a structural feature of the Israeli–Palestinian economic relationship until 2000, its significance, and indeed its fate, has become less certain in the wake of the unilateral Israeli separation policies pursued since. This process is to be differentiated from the migration of higher-skilled Palestinian labour to Arab countries in the Gulf and elsewhere especially until the early 1990s, which has been a source of migrants’ remittances in the past and could conceivably find renewed favour under future arrangements.

The purpose of this chapter is to simulate the long-term consequences of these distortions to the Palestinian labour market, and to propose alternative strategies to mitigate the structural imbalances and bolster the economy’s capacity to generate domestic jobs. The importance of this exercise is to show that alternatives for the Palestinian labour market exist, which could encourage the Palestinian Authority to consider a new direction for Palestinian labour policy.

An important impetus for such a strategy is provided by the fact that the labour-related articles of the Paris Protocol have effectively become obsolete. This is due not only to their limited implementation and weak enforcement mechanisms, but also follows directly from Israel’s unilateral separation from the Palestinian economy. Formally, the protocol envisaged a free movement of capital and goods, with both sides supposed to cooperate in determining the magnitude of Palestinian labour flows into Israel. In practice, however, Israel unilaterally decided on the number and sectoral allocation of Palestinian workers permitted to enter its labour market, thus making the flow of labour into its economy contingent upon political objectives, and regulated by a strict work permit system, with direct consequences for Palestinian income and poverty levels (Zagha and Zomlot, 2004).

While institutionalized through the 1993 Oslo Accords, it is important to recognize that Israel’s separation from the Palestinian economy, and thus the lessening of its need for Palestinian labour, began prior to the Oslo process. The policy of closure and restrictions on

labour mobility was introduced in the early 1990s, but was intensified after the Palestinian Authority was established in 1994 (Abdullah and Woodcraft, 1999). In 1991, Israel introduced a permit system for Palestinian workers to regulate their flow into its economy. While the actual number of workers was always higher than the number of granted permits, the permit system, together with the recurrent implementation of closure in the occupied Palestinian territory, resulted in a fluctuating and gradually declining number of Palestinians working in Israel (Bulmer, 2003). The mass immigration of new Israeli citizens from the former Soviet Union in the 1990s was the first major factor that changed the terms of Israeli demand for Palestinian labour. In the wake of heightened Israeli security concerns towards the end of that decade, the Israeli economy was able to reduce demand for Palestinian labour with minimal disruption to its own needs by concomitantly increasing the employment of foreign workers, predominantly from East European and East Asian countries (Amir, 2000).

Given its dependence on the Israeli labour market, the easing/tightening of restrictions on Palestinian labour mobility translates directly into more/less employment in Israel and consequently less/more unemployment in the Palestinian economy. Hence, it directly affects income, consumption, investment, government revenues, etc. (Egger, 2005).²² The consequences of dependency on the Israeli labour market were abruptly felt with the dramatic decline of Palestinian labour access to the Israeli market that followed the outbreak of the second intifada in September 2000.

Using the International Labour Organization relaxed definition of unemployment, which includes discouraged workers, unemployment stood at 25 per cent in 2000 but climbed to more than 41 per cent two years later. Since then, it has fluctuated but remains high. Recent figures put the unemployment rate close to 30 per cent (table 5.1). The deteriorating economic situation has also caused an unprecedented rise in poverty levels. Using household consumption data, nearly 48 per cent of Palestinian households were estimated to be poor in 2005. If income data is used, poverty affects nearly 70 per cent of the population of the occupied Palestinian territory (PCBS, 2006).

Table 5.1. Palestinian employment indicators (thousands of workers)

	2000	2002	2003	2004	2005	2006
Labour force	695	694	758	790	827	872
Employed	562	447	517	528	579	597
Unemployed	98	217	194	212	194	206
Unemployment (%)	25.0	41.3	33.4	32.5	29.0	29.6

The continuous shrinking of productive capacity and creeping deformatization, as well as the decline of Palestinian labour flows into Israel, have left a deep mark on the structure of the Palestinian economy and the sectoral distribution of employment. The agricultural and service sectors acted as shock absorbers as they increased employment of workers relative to other sectors over the last decade. At the same time, the employment share of the sectors where labour productivity is relatively higher, construction and manufacture, has fallen. The deterioration of the economy and decline in productivity are illustrated by a 10-year comparison of the agricultural and manufacturing sectors. Between 1996 and 2006,

²² OCHA (2005) and Shaban (1999) have also documented the debilitating effects of these restrictions on the Palestinian labour market and the economy as a whole.

agricultural output declined by 19 per cent despite employing 80 per cent more workers than it did in 1996. Similarly, manufacturing value added declined by 7 per cent and yet employment increased by 3 per cent over the 10-year period (UNCTAD, 2007).

In the absence of proactive policies to reverse the labour market imbalances and structural distortions, several factors suggest further deterioration of the Palestinian economy's ability to provide sufficient jobs. First, the loss of one third of its capital stock since 2000 has significantly reduced the economy's ability to generate employment. Second, incomes that were regularly earned in Israel in previous decades have diminished substantially due to restrictions imposed on Palestinian labour flows to Israel. Third, high population growth will put further pressure on the labour market, as it is expected to increase labour supply by 4.4 per cent until 2010 (Davodi and von Allmen, 2001). Solving the Palestinian unemployment problem requires coordinated investment programmes targeting sectors and enterprises where employment generation and labour productivity are highest.

On the other hand, foreign aid has become predominantly restricted to short-term emergency needs and budgetary support, both of which have minimal multiplier effects on local production due to the "consumption of imports" nature of these expenditures. According to UNCTAD (2006b), over the 2000–2005 period the estimated \$7.5 billion cumulative trade deficit with Israel exceeded the net current transfers (mainly donor grants) by one third.²³ This means that all the funds received from the international community during the ongoing crisis were not sufficient to pay for unbalanced trade with Israel. To counter the high dependency on both Israel and external assistance, and to reduce unemployment, Palestinian productive capacity should be revived and strengthened so that it can meet local demand. Without a shift towards more dynamic sectors and the expansion of productive capacity, injecting more aid would not generate enough jobs to cause a substantial reduction in unemployment. Donor-financed quick-impact job generation schemes, for all their humanitarian importance, are no substitutes for long-term labour market strategy. What is needed is to inject these schemes with long-term developmental content.

B. Labour market in the baseline scenario

While the baseline scenario simulation presented below cannot take political events fully into account, it is assumed that the "asymmetric regulation" of the Palestinian labour market will continue. That is, while the Palestinian labour market is largely unregulated by the Palestinian Authority, the supply of Palestinian labour to the Israeli market continues to be controlled by the Israeli permit system, the Israeli disengagement from the Gaza Strip, the pattern of Israeli settlements and the construction of the Separation Barrier in the West Bank, regardless of the possibility that the number of closure days could eventually decline as a result of political settlement. As shown in table 5.2, the baseline scenario forecasts a gradual rise in unemployment from 15.6 per cent in 2008 to 19.1 per cent in 2015.

Furthermore, in the absence of support programmes that would assist enterprises in rebuilding their eroded productive capacity and upgrading production technologies, the baseline scenario predicts no significant increase in labour productivity. Indeed, while the baseline scenario predicts that real labour productivity will grow from \$7,669 in 2008 to \$8,227 in 2015, it considerably lags behind the productivity of \$9,893 registered in 1999. To counterbalance the

²³ UNCTAD (2008) estimates that the occupied Palestinian territory's trade deficit with Israel in 2007 is equivalent to 90 per cent of total net current transfers (mostly donor support).

negative impact on productivity, an active labour market policy should involve programmes combining targeted investment efforts, enterprise support and skill development for the labour force. The urgent need for active labour market policies is further accentuated by the sectoral distribution of the labour force simulated in the baseline scenario (table 5.3).

At the end of the forecast period, the industrial and construction sectors register only a marginal increase in their relative contribution to employment, rising by 0.2 and 0.7 percentage points, respectively. With a decline in the relative contribution of the agriculture sector by 2.2 percentage points in 2015, the dominance of the service sector increases as its employment share rises by 1.3 percentage points. This, however, is not a reflection of a meaningful increase in productive activities. Rather, job seekers who cannot find formal, productive employment join the service sector as a coping mechanism. This gives rise to disguised unemployment, underemployment and lower labour productivity which impedes real wage growth. Ultimately, this will lead to even more low-skilled jobs in low value added activities and further economic deformatization. To counteract these adverse effects, the Palestinian Authority should pursue policies that generate more employment and at the same time increase labour and capital productivity to raise real wages and reduce poverty.

Table 5.2. Unemployment and labour productivity in the baseline scenario

	Unemployment rate	Labour productivity (1997 \$)
2008	15.6	7 669
2015	19.1	8 227

Table 5.3. Sectoral contribution to total employment in the baseline scenario

	Agriculture	Service	Construction	Industry
2008	14.2%	64.9%	8.6%	12.3%
2015	12.0%	66.2%	9.3%	12.5%

C. Sectoral employment generation schemes

Due to the structural weakness of the Palestinian economy, it is obvious that the labour market, on its own, is incapable of reducing unemployment in a significant manner. Therefore the alternative policy scenario seeks to generate sufficient domestic employment and, at the same time, lower the structural dependence on the Israeli market to absorb excess Palestinian labour. As the baseline scenario shows, the key challenge to the Palestinian policymaker is to pursue policies that increase employment and productivity and address the structural imbalances in the labour market.

The Palestinian Authority could consider implementing domestic employment promotion programmes such as sectoral wage-sharing schemes, or any other measures that subsidize employment by reducing the wage paid by employers while workers receive the market rate. This would raise income and aggregate demand, and consequently stimulate output and reduce unemployment. These schemes could be financed through a special fund, or they could

be financed by the collection of a tax on employment in Israel. The advantage of the latter is that the employment generation schemes would not increase reliance on donors and would have a neutral impact on public finance, while discouraging structural dependence on employment in the Israeli market.

However, this approach is politically sensitive as it burdens those able to find work in the Israeli market. Therefore, it is critical to sequence domestic employment generation schemes and the proposed tax. Tax on employment in Israel could be triggered once the schemes have already generated enough domestic jobs to absorb those seeking employment in Israel. The benefits of the suggested policy can be achieved equally well using other funding sources, including foreign aid or budget reallocation. This could be combined with efforts to negotiate collective agreements for temporarily moving specific categories of skilled and semi-skilled Palestinian labour to regional, Arab and even European markets. The basic idea, however, is to set the stage for a sustained recovery in the domestic labour market, which would also lead to the elimination of employment dependence on the Israeli market over time, and replace it with a more diversified range of potential destination sources for Palestinian migrant labour released through the natural process of development.

Therefore, the alternative labour policy simulation assumes the launching of a wage-sharing scheme one year prior to the introduction of any tax on employment in Israel. The fund required for the scheme would increase gradually to reach \$285 million in 2015, representing 3.5 per cent of GDP. This fund would be financed from the revenue of a tax on employment in Israel that would eliminate the net (after tax) wage differential in the domestic and Israeli market by the end of the forecast period. Hence, the simulation introduces a tax on employment in Israel one year after the introduction of the wage-sharing scheme. The rate of this tax increases gradually to reach 38 per cent in 2015. As the policy simulation results show below, the revenue raised from the incremental increase in the tax would be sufficient to finance domestic employment programmes capable of employing more Palestinian workers than were previously employed in Israel.²⁴

To shed light on the potential for generating sectoral employment, the following discussion assesses the response of Palestinian employment to allocating the total employment generation fund to individual sectors: agriculture, industry and services. The discussion also evaluates the impact of the tax on Palestinian employment in Israel. The subsequent section introduces a policy package for the labour market where the employment generation fund is allocated across sectors to allow for some sectoral balance. All of these policy alternatives are financed from the revenue of the tax on Palestinian employment in Israel.

Impact of sectoral employment programmes

Table 5.4 shows the impact on the unemployment rate when the employment generation fund, collected from the revenues of the tax on employment in Israel, is sequentially allocated fully to a single sector: agriculture, industry and services. Throughout the simulation period, the difference in the level of unemployment between the baseline scenario and the three sectoral scenarios is striking. In 2015, the unemployment rate would have declined substantially for all three scenarios. However, the extent of the decline varies depending on which sector is

²⁴ It should be noted that the number of Palestinians employed in Israel, and hence the tax revenue, are sensitive to political changes. Therefore the precise amount of this revenue at any given moment is hard to predict, but as far as this study is concerned what is critical is the wage-sharing scheme and not the source of funding.

targeted. The unemployment rate decreases the most when all wage subsidies are allocated to the agriculture sector. In this case, unemployment would be 8.9 per cent compared to 19.1 per cent in the baseline scenario in 2015. In contrast, the service scenario has the weakest, but still substantial, impact on the unemployment rate, with 11.6 per cent in 2015. The industry scenario falls in between, with unemployment dropping to 10.9 per cent.

Since this simulation assumes a rise in domestic employment that is not accompanied by an equivalent rise in investment, the impact of the proposed wage subsidies on labour productivity will necessarily be negative. In all three sectoral scenarios productivity falls. In the agriculture scenario labour productivity in 2015 is projected to be 17.6 per cent lower than the baseline scenario, and productivity drops by 16.6 per cent in the service scenario and 15.4 per cent in the industry scenario.

Impact of tax on employment in Israel

Increasing taxes on wages often functions as a disincentive to work and is thus likely to increase unemployment. In the case of Palestinian employment in Israel, however, such a tax would not lead to a significant reduction in employment because Palestinian employment in Israel is not driven by the wage differential but mainly by push factors, namely the lack of employment opportunities in the domestic economy. Palestinian employment in Israel is rather wage-inelastic: if the relative wage offered to Palestinians working in Israel decreased by 1 per cent, employment in Israel would decline only marginally, by 0.014 per cent in the short run and 0.025 per cent in the long run (UNCTAD, 2006a). Therefore, a 38 per cent tax on wages earned in Israel, with its revenues fully used to finance domestic employment schemes, would only marginally reduce employment in Israel compared to its level in the baseline scenario. For the whole simulation period, employment in Israel would decline by no more than 839 jobs or 1.4 per cent below the baseline level.

Table 5.4. Impact of sectoral employment programmes on unemployment and labour productivity

	2008	2015
Baseline scenario		
Unemployment – %	15.6	19.1
Labour productivity – 1997 \$	7 669	8 227
Agriculture scenario		
Unemployment – %	9.4	8.9
Labour productivity – 1997 \$	6 687	6 783
Industry scenario		
Unemployment – %	10.9	10.9
Labour productivity – 1997 \$	6 810	6 957
Service scenario		
Unemployment – %	11.4	11.6
Labour productivity – 1997 \$	6 858	6 858

Table 5.5. Impact of employment programmes on sectoral employment in 2015

Change in sectoral employment	Agriculture scenario	Industry scenario	Services scenario
Agricultural	24.5	12.5	13.6
Industry	6.6	9.2	5.7
Construction	7.6	7.6	7.6
Services	10.3	8.1	7.2
Total employment	10.9	8.4	7.5

Table 5.5 shows the changes in employment by sector, as a result of a wage subsidy to one particular sector. Compared to the baseline scenario, the number of people employed increases in all three sectoral scenarios. The extent of the rise in employment varies depending on which sector is targeted by the wage subsidy. Compared to the baseline scenario in 2015, total employment expands the most if the agriculture sector is targeted, rising by 10.9 per cent or 107,000 jobs. Under this scenario, employment in agriculture registers the highest improvement, with a 25 per cent increase in the sector's employment as compared to the baseline in 2015. Service sector employment follows, improving by 10.3 per cent, while construction and industrial employment rise by 7.6 and 6.6 per cent, respectively. When the industrial sector is targeted, total employment rises by 8.4 per cent, or 82,000 jobs, with employment in the agricultural sector registering the highest positive response to an industrial sector wage subsidy. A similar result is obtained when the subsidy is dedicated to the services sector alone.

Further analysis of these results shows the industrial sector scenario to be superior in its capacity to generate employment indirectly in the rest of the economy. Each job created in the industrial sector creates 6.6 jobs in other sectors of the economy compared to 2.8 and 0.5 jobs in the cases of agriculture and services, respectively. These positive indirect employment effects reflect the existence of substantial spillover and sectoral linkages in the Palestinian economy. Rising employment and income in the subsidized sector generates employment in other sectors by increasing the demand for goods produced by these other sectors, providing inputs and increasing savings that other sectors can use to finance investment. The results in tables 5.4 and 5.5 highlight the strong backward and forward linkages of the agricultural and industrial sectors and their capacity to generate employment indirectly. Policymakers should recognize the strategic importance of these sectors and take it into account when contemplating unemployment reduction policies.

The benefits of such sectoral employment schemes, however, do not have to come at the cost of reduced labour productivity if accompanied by complimentary vocational training programmes and targeted microlevel enterprise support. With rising employment and steadily improving labour productivity, the poverty rate would decline and a virtuous circle of sectoral linkages and spillover would propel the economy towards sustainable development.

D. Labour policy package

The successful planning and implementation of such labour market strategies requires the establishment of strong links between public and private institutions. Experiences of other countries demonstrate the critical importance of such links for the success of government-led employment and investment promotion programmes (Amsden, 2003). This ensures that,

within and across sectors, existing forward and backward linkages are utilized and new ones are created. The selection criteria for such programmes should be the sector's potential for growth and employment generation. In addition, sectors and industries that increase the use of domestic inputs can contribute more significantly to employment and growth, and should be favoured (PNA, 2005).

Given these considerations, the proposed policy package for the labour market follows the rationale of the three alternative sectoral scenarios presented in the preceding section. To balance the impact across all sectors and exploit economy-wide linkages, it is proposed to allocate the employment generation fund across the three sectors in the following manner: 40 per cent to the service sector and 30 per cent to each of the industrial and agriculture sectors. Figure 5.1 and table 5.6 show the impact of the labour policy package scenario on the main economic variables.

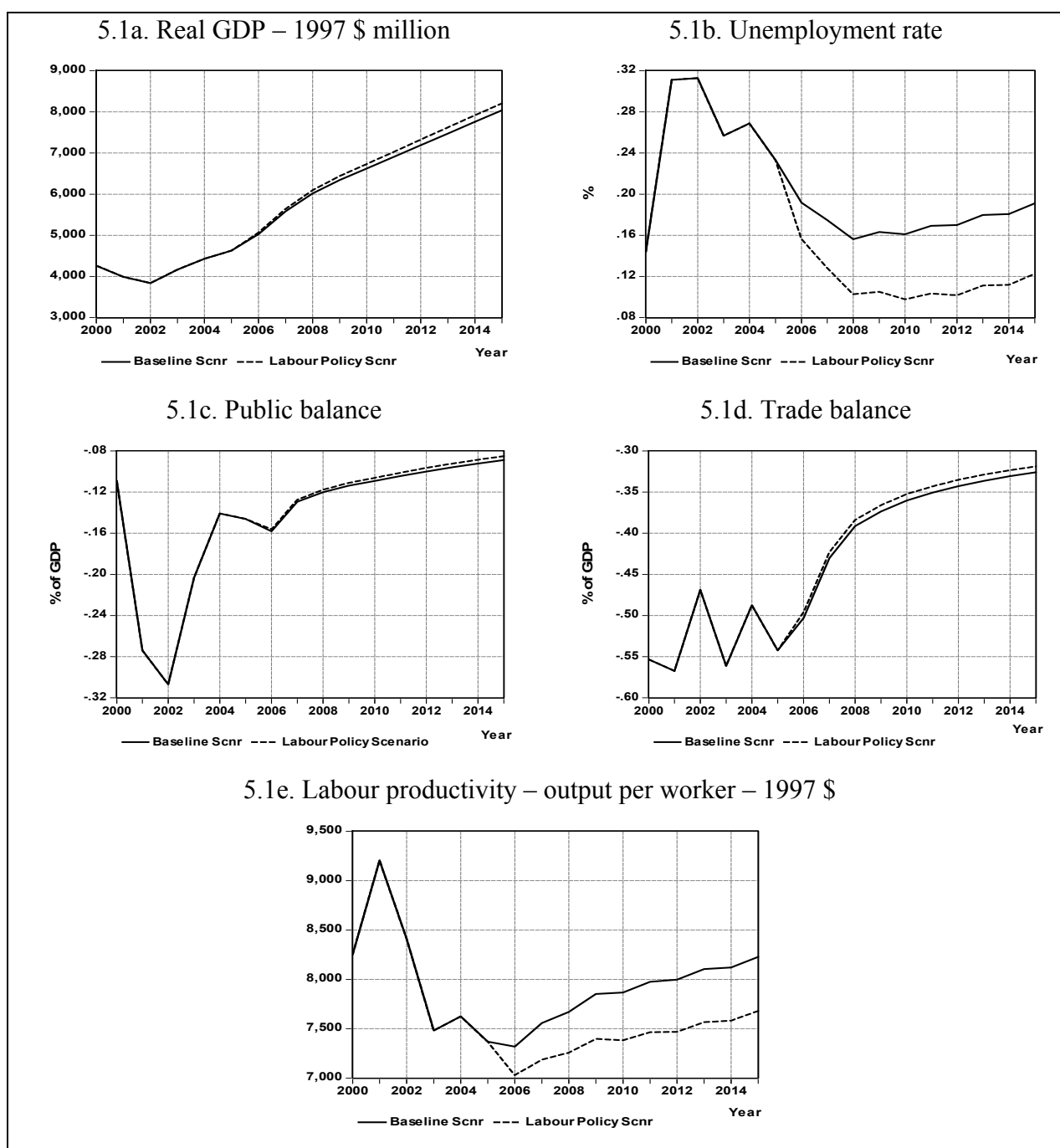
As expected from an employment generation programme, the largest positive impact is shown in the fall of the unemployment rate to 12 per cent from the baseline 19 per cent in 2015. However, the loss in labour productivity mitigates the potential rise in aggregate demand. Hence GDP is only 2 per cent larger in 2015 than the level projected in the baseline scenario. As shown in figure 5.1, and tables 5.4 and 5.6, the simulation predicts that labour productivity declines in all scenarios compared to the baseline. This is not surprising given the decimation of the capital stock of the Palestinian economy since 2000. Labour productivity depends on the level of physical capital, technology and labour skills (human capital), all of which have been battered in the course of the ongoing conflict. However, if the labour policy package is accompanied by efforts to rehabilitate and upgrade the capital stock and technology and to implement labour training programmes, a decline in labour productivity can be avoided.

It is encouraging to note that carrying out the labour policy package scenario worsens neither the public nor the trade balance. In fact both indicators improve between 2008 and 2015, with the public and trade deficits as a percentage of GDP falling by 3.3 and 6.5 percentage points, respectively.

Table 5.6. Economic indicators under labour policy package

	GDP	Unemployment rate	Productivity (1997 \$)	Public balance (% of GDP)	Trade balance (% of GDP)
2008	6 096	10.3	7 256	-11.8	-39.1
2015	8 208	12.3	7 679	-8.5	-32.6

Figure 5.1. Impact of labour policy package on major economic indicators



E. Recommendations

Israeli policies implemented after the occupation of the West Bank and the Gaza Strip have effectively severed the historical ties between the Palestinian economy and the neighbouring Arab countries, while at the same time preventing any meaningful integration with the much larger Israeli economy. This has reduced the Palestinian economy's ability to generate enough jobs for its growing labour force, thus making a large proportion of Palestinian workers dependent on unskilled jobs in Israel. Although jobs in Israel paid higher wages, labour movement to Israel was primarily driven by push factors rather than pull factors. Instead of

remedying the structure of dependency, the labour related articles in the Paris Protocol institutionalized it, as Palestinian policymakers in 1994 had no options for providing alternative employment for over 100,000 workers and could not envisage how to break the structural dependency within the customs union framework. Indeed, the protocol gives Israel de facto power to decide on the size of labour flows, and hence the potential to use the number of work permits issued as political leverage. While this permit system has regulated the supply of Palestinian labour to the Israeli market, the domestic labour market remained largely unregulated and unsupported, even after the establishment of the Palestinian Authority.

As a result of significant increases in public and private investment and international support, the period 1994–1999 witnessed increased but erratic levels of employment in the occupied Palestinian territory. However, this relative improvement masked the deep-seated structural distortions of the Palestinian economy only temporarily, as they resurfaced dramatically after the outbreak of the second intifada in 2000, with a substantial increase in unemployment.

In addition to the high population growth that adds more pressure on the labour market and wage levels, the Palestinian economy's war-torn conditions have substantially impaired its productive capacity in the widest sense, from the capital stock and human resources to social capital. Concerted policy action is needed to reverse this decline, modernize the capital stock and sustainably improve the employment situation. As the results in the baseline scenario show, the status quo of the Palestinian labour market would reduce unemployment in the long run but it would still remain too high.

The alternative policy recommendations for the Palestinian labour market are bold but appropriate for the severity of the challenges facing it and the economy as a whole. A targeted employment generation scheme is advantageous for a number of reasons. First, it would reduce the cost of production to employers and thus provide incentives to create new jobs. At the macro level, it ensures that idle resources are utilized, existing forward and backward linkages are further exploited, and new linkages are created. Second, domestic employment creation would reduce the structural dependence on the Israeli labour market. The employment generation schemes, sequenced before and financed by a tax on Palestinian employment in Israel, would ensure that Palestinians who stop working in Israel would be able to find domestic employment. Finally, the benefits of such a scheme would be achieved at no cost to the external and internal balances. However, implemented alone, such a domestic employment scheme would not improve labour productivity. This risk should be addressed by programmes aimed at upgrading labour force skills and promoting investment to expand the eroded production capacities with relevant new technologies. The consolidation of proactive labour policies with other improvements in the Palestinian macroeconomic and trade policy space, in a coordinated manner that enhances positive trade-offs and reduces negative externalities, is the focus of the final step in this simulation of an alternative policy framework for a sovereign Palestinian State.

VI. INTEGRATED POLICY FRAMEWORK

Building on the findings of simulating alternative macroeconomic, trade and labour policies, this chapter considers a policy framework that combines instruments from all three policy scenarios. While the outcomes of each of these have separately shown superior results to those of the baseline scenario, bundling all policy alternatives into one package would create important synergies and dynamics that would speed recovery and balance the different elements and prerequisites for sustainable growth. More importantly, the policy framework includes a set of specific instruments to tackle the structural weaknesses of the Palestinian economy by creating the conditions for improving productive capacity, reducing unemployment and lessening structural dependency on the Israeli economy.

To unleash dynamic growth and sustainably improve social welfare, the policy package consists of:

- (a) A public investment programme that crowds in private investment;
- (b) Fiscal measures to reduce the cost of investment and production and provide incentives to replace and expand productive capacity;
- (c) A self-financing domestic employment generation scheme;
- (d) A change in the trade regime that, in due course, would be supported by monetary policy and ultimately by a national Palestinian currency and exchange rate policy.

Without such a broad policy platform, which entails a range of conventional development policy measures that have proven to be effective in other situations even if not widely practiced today, it is not clear how Palestinian political independence and statehood alone will make for a growing Palestinian economy. Indeed, the institutions that would be required to design, introduce, manage and eventually phase out such a package of interrelated policies for a new State have been precluded by the existing economic framework. These are the same nuts and bolts of economic governance whose operation will be critical for ensuring viability and whose exercise will reflect true sovereignty more effectively than any of its symbols or trappings.

The full implementation of such an integrated policy package may be difficult to envisage in the current context, but it would be feasible if certain political developments took place: first, an end to the Israeli closure policy and restrictive measures, including establishing economic-geographical contiguity between the Gaza Strip and the West Bank; second, genuine commitment and political progress towards the establishment of a viable, sovereign Palestinian State as called for by the relevant United Nations resolutions; and third, encouraging the Palestinian Authority to seek sufficient policymaking space to decide independently on the right mix, sequencing and management of policies to reconstruct the economy.

However, this does not mean that nothing could be achieved prior to the fulfilment of these requirements. In fact, significant economic progress can be achieved prior to the establishment of a sovereign Palestinian State – under an improved version of the current circumstances – if policymakers have access to policy tools, closure begins to be relaxed and aid continues at adequate and predictable levels. It is therefore incumbent upon policymakers preparing for statehood to seek to expand the range of policy instruments at their disposal and be prepared to use them to rebuild the economy. In this sense, this integrated policy

simulation aims to provide Palestinian negotiators with insights into the type and range of policy space and instruments necessary for revitalizing the economy and achieving sustainable economic growth in the envisaged Palestinian State.

Although the proposed policy framework consists of detailed policy prescriptions and interventions, its illustrative nature should be emphasized. Contingent on the concrete reality faced by a Palestinian Government, policy variables could be changed and measures could take different shapes and vary in magnitude. Even in such a case, the policy package simulation is still relevant as it approximates results that can be reasonably expected from economic policy reforms similar to the ones proposed here. Admittedly, the policy package and the likelihood of its implementation are based on assumptions that might be seen as too optimistic, especially under occupation and in an uncertain environment. However, such a view is inevitably rooted in viewing the predicament of the Palestinian economy, and the political conditions that have created it, as permanent features with which it will continue to struggle, regardless of the shape of a possible political settlement emanating from the current conditions.

Whether or not such pessimism is justified, the policy package simulation has a dual purpose: first, to sketch a scenario for 2015 that shows the potential of the Palestinian economy if it were allowed to break free from existing political and economic constraints. Second, highlighting the immense gap between the potential of the Palestinian economy approximated by the simulated results and the current bleak conditions underscores the key conclusion of this study: that the Palestinian Authority needs a significantly expanded policymaking space so that it can directly address the developmental needs of the Palestinian people. The comparison of a series of alternative scenarios to the baseline has consistently revealed that any one of them produces better results than current trends would. This should in turn put to rest once and for all the implicit assumption underlying most economic analyses that the economic policy status quo, perhaps in some superficially modified form, is optimal or at least preferable to an exploration of new and conceptually different policies. The feasibility of the latter might seem hard to imagine in the Palestinian context, but their existence is *sine qua non* for a sovereign Palestinian State's future development.

As demonstrated below, if Palestinian policymakers were enabled to implement appropriate policies, the occupied Palestinian territory could be transformed over a decade from a war-torn, fragmented economy into a viable national economy, open to and integrated with its neighbours, on a sustainable growth path, providing enough jobs for its labour force, with a higher level of social welfare and reduced dependency on international aid.

A. Elements of the integrated policy package

Based on the features of the policy alternatives discussed in the previous chapters, the proposed integrated policy package features the following measures:

- (a) In the external sector, a most favoured nation policy is assumed. In line with the WTO preferential treatment granted to many least developed countries, the tariff on imports from Israel is assumed to increase from the current zero level to reach 20 per cent in 2011, while the average tariff on imports from other countries would increase by 3.4 per cent above the existing level. Similarly, Israeli tariffs on Palestinian imports are

assumed to reach 8.3 per cent in 2011 and remain at that level thereafter.²⁵ In addition, it is assumed that, to promote Palestinian exports, a distortion correction scheme has been introduced. In the simulation, this takes the form of a policy to reduce the price (cost) of Palestinian exports, to 83 per cent of their baseline level by 2011;

- (b) In the area of monetary policy, the policy package simulates the introduction of a national currency and considers the impact of a 50 per cent devaluation by the end of 2008 and a fixed exchange rate regime until the end of the forecast period in 2015. This devaluation is simulated by assuming a 50 per cent reduction/rise in the prices of Palestinian exports/imports;
- (c) As for the fiscal policy, public investment and government transfers are assumed to increase by 10 and 5 per cent, respectively, above the level in the baseline. Furthermore, an investment distortion correction scheme to promote private investment, covering all but construction investment, is introduced by reducing the investment price deflator to 85 per cent of its baseline level by 2011;
- (d) Labour policy would consist of domestic employment generation schemes in the form of a wage-sharing scheme financed from the revenue of a tax on employment in Israel. The tax rate would rise gradually to reach 38 per cent in 2012.²⁶ The sectors benefiting from the wage-sharing programme would be agriculture, industry and services. Each of the first two would receive 30 per cent of the fund generated from the revenue of the proposed tax, and the third sector would receive the remaining 40 per cent.

B. Outcomes

Table 6.1 and figure 6.1 show the results of the policy package and compare them with the baseline scenario. With the described policy package in place, the Palestinian economy would experience rapid and sustained improvement. In the policy package scenario, the GDP level would increase by 24 per cent from \$6.61 billion in 2008 to \$9.942 billion in 2015, compared to \$8.042 billion projected in the baseline. The higher GDP leads to a higher level of social welfare, with GDP per capita increasing from \$1,607 in 2008 to \$1,886 in 2015, which is 24 per cent higher than the baseline in the same forecast period.

The unemployment rate registered at the end of the simulation period further highlights the strength of the policy package. It involves strengthened backward and forward linkages boosting domestic production and employment, which in turn create new sets of linkages. As a result, the proposed policy package would lead to full employment by 2015. In contrast, the baseline unemployment rate in the same year is over 19 per cent. While the simulated unemployment rate of 0.5 per cent may seem overly optimistic and difficult to envisage in the current conjuncture, this pessimism is not necessarily warranted. With no expanded policy space such as those assumed here, the World Bank (2008) suggests that a combination of “some limited” reforms, aid flows and closure relaxation could lead to double digit growth rates by 2011. Supporting this short-term perspective with the proposed long-term orientation of the policy package would naturally lead to growth more robust and sustained than projected by the World Bank. Such growth can bring the economy close to full employment. At minimum, the simulated unemployment confirms that a considerable reduction in unemployment is possible if the necessary policy instruments are available.

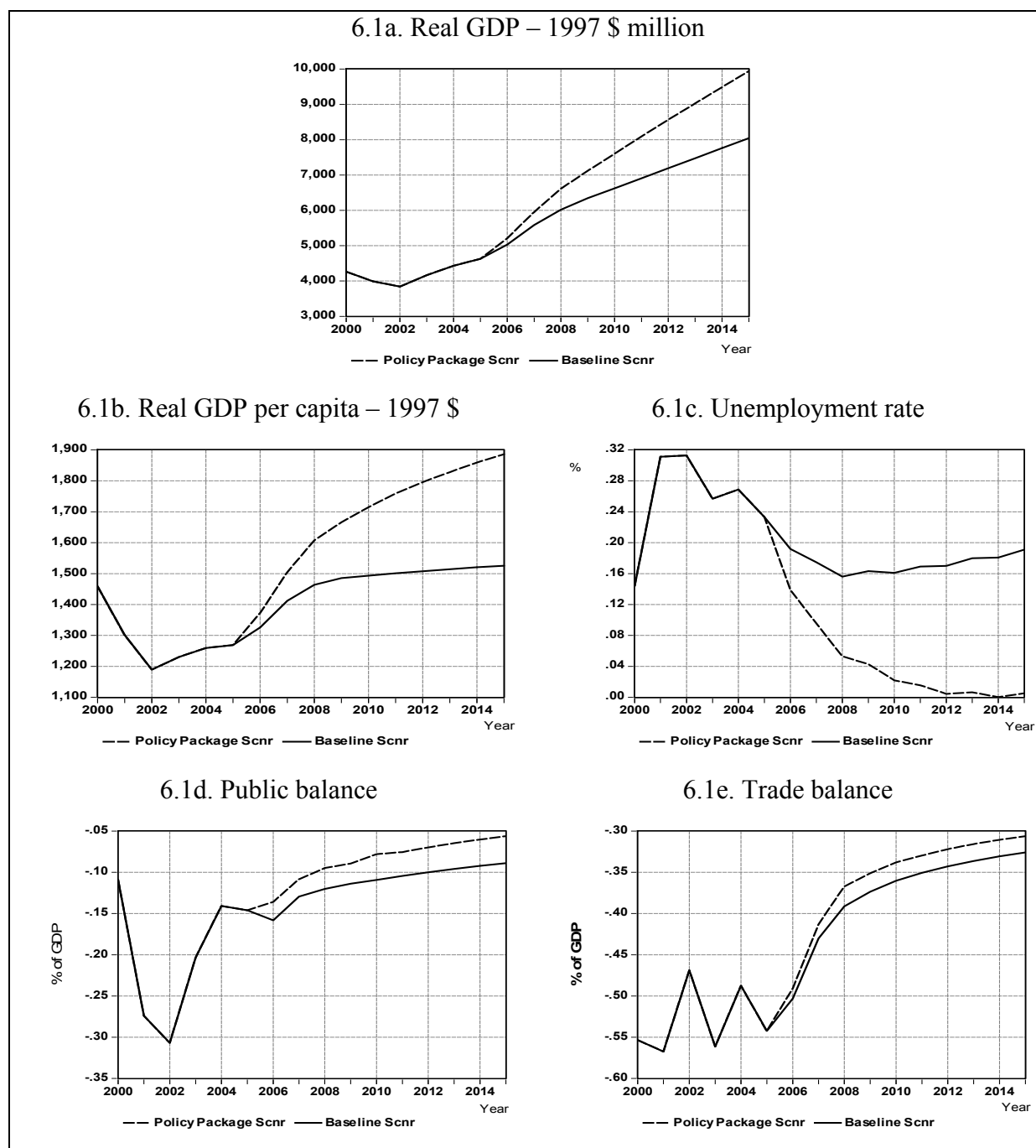
²⁵ 8.3 per cent is Israel’s average tariff rate on imports from the rest of the world.

²⁶ The 38 per cent tax eliminates the wage differential between the domestic and Israeli market.

Table 6.1. Economic indicators in the baseline (BL) and policy package (PP) scenarios

	2008		2015		% change in 2015
	BL	PP	BL	PP	
GDP – 1997 \$ million	6 019	6 610	8 042	9 942	23.6
GDP per capita – 1997 \$	1 464	1 607	1 526	1 886	23.6
Unemployment rate – %	15.6	5.3	19.1	0.5	18.6
Public deficit – % of GDP	12.0	9.5	8.9	5.6	3.3
Trade deficit – % of GDP	39.1	36.7	32.5	30.6	1.9

Figure 6.1. Impact of integrated policy package on major economic indicators



As elaborated in previous chapters, there are costs for the proposed policy alternatives. While the labour and trade policy scenarios would have a neutral or small impact on public finance, the proposed fiscal policy would come at the cost of a greater public deficit compared to the baseline. These combined initial costs for the budget balance notwithstanding, the economic growth induced by the policy package would improve the fiscal balance. In the last year of the simulation, the public deficit is 5.6 per cent, below the 8.9 per cent in the baseline.

However, the simulation of the integrated package suggests that the Palestinian economy would still have a rather high marginal propensity to import. In 2015, the trade deficit would fall by only 1.9 per cent from the 32.5 per cent in the baseline. Inevitably, while the MFN trade policy would facilitate the gradual diversion of trade away from Israel, much of this trade deficit would continue to be owed to Israel. In other words, the structural and technological dependence on Israel as captured by the ISF model is so deep that a change in the Palestinian trade regime alone would not reduce it. Hence, the issue of economic and technological dependency on Israel will require special attention from Palestinian economists and policymakers to create structural changes that would ultimately reduce this dependence.

The simulation in the policy framework projects a very different Palestinian economic future than the baseline would be able to achieve. It is cognizant of the various obstacles that would stand in the way of its implementation. However, it does affirm that the present institutional arrangement for Palestinian fiscal, monetary, trade and labour policies is singularly incapable of responding to the challenges of the economy and its eroded productive capacity. Instead, it entrenches the Palestinian economy on a path of poverty, insufficient job creation, low economic growth, and dependence on Israel and foreign aid.

Palestinian policymakers must be aware of what the Palestinian economy is capable of achieving, and should strive to acquire the policy space necessary to implement the policy package, or a variation thereof. An expanded policy space would empower the Palestinian Authority and allow it to adopt a comprehensive economic policy that could integrate fiscal, investment, trade, monetary, exchange rate and labour policies in a unified framework so that the synergies necessary to launch dynamic growth are in place. This requires a different institutional framework regulating Palestinian and Israeli economic relations, long discussed but to little effect. Equally important, however, is the active support of the international community in designing a development policy framework that best suits the Palestinian reality without introducing conditionalities that can only complicate an already overwhelming challenge needlessly – and without result.

C. Conclusions

Although the economic fragility of the occupied Palestinian territory has been exacerbated by tight Israeli closure policy and war-like conditions since 2000, it is the very absence of a meaningful set of economic policies that renders the Palestinian Authority largely incapable of dealing with the economy's serious problems and challenges. The analysis presented here demonstrates the fallacy of the widely-held belief that a return to the relatively less volatile pre-2000 environment, combined with security reform, fiscal prudence and vigorous private sector revival, will alone provide sufficient conditions for sustainable development. A reduction in the intensity of closures that brings them to the 1993–1999 levels, while a highly welcome improvement, will not be enough to remedy the Palestinian economy's deeply rooted structural problems. Lacking the necessary minimum toolkit of sovereign economic institution building and decision-making, a Palestinian Government, and hence the wider

Palestinian public, would remain a passive spectator to the actions of economic forces beyond its influence.

Under the existing policy framework, the Palestinian economy will continue to be trapped on a path of low growth, economic dependency on Israel and reliance on foreign aid. While most experts have questioned the effectiveness of the Paris Protocol and the policy framework it has created, a coherent vision of alternatives is still lacking. This is largely due to the insufficient attention paid to research and analysis and Palestinian capacity-building needs in the area of economic policy making and implementation.

It would be ironic indeed, if after decades of war and Israeli occupation, an Israeli–Palestinian political settlement were to take shape that, while delivering statehood, did not attend to the parameters of the economic balance of power between the parties and ignored the need for an equally bold “economic settlement”. This study argues that if Palestinian policymakers are empowered with the full range of economic policy tools, a new policy framework could help the Palestinian economy tap its potential and generate sustainable economic development that is quantitatively and qualitatively superior to what the existing policy framework can deliver. By reviewing a number of alternatives, this study has provided insights and proposed a more suitable framework that the Palestinian Authority could introduce even before permanent status issues are decided.

Based on the fiscal, monetary, trade and labour policy instruments presently available to Palestinian policymakers, the simulation of the baseline predicts modest improvement in the medium to long run. In contrast, the simulations of the alternative policy recommendations would not only enable the Palestinian Authority to play a greater and more constructive role in running the Palestinian economy, but also address the problem of the eroded productive capacity at the root with targeted public investment programmes to crowd in private investment.

The comparison between the simulation results of the baseline and the alternative policy scenarios underscores the need to reform and expand the existing economic policy framework, including the right to issue a Palestinian national currency at a suitable point in time. While each individual policy alternative produces much better economic results than the status quo, integrating all policy alternatives in one package would produce superior results with a substantial positive impact on the long-term growth of the Palestinian economy. The integrated package would facilitate the economy’s transformation, in a relatively short period of time, from a fragile, dependent and fragmented economy to a dynamic one with a reasonably high and growing level of national income. Such a transformation would greatly reduce the Palestinian Authority’s chronic reliance on foreign aid.

The need to merge policy alternatives to reinforce their complementarities and to create synergies is obvious when considering Palestinian trade. Because of the structure of the Paris Protocol and the limited ability to mainstream economic policy due to the particularities of the Palestinian situation, trade policy has been seen as the national development strategy. However, trade policy on its own can neither significantly improve Palestinian trade performance, nor produce sufficient spillover effects for the economy as a whole. Reform of the trade regime is not, and should not be, the main focus of economic development, for the right trade regime is but one element of a comprehensive development strategy. Sustainable economic development also depends on sound fiscal, monetary, exchange rate and industrial policies.

The proposed integrated policy package is geared to turning the low-income, donor-dependent and war-torn Palestinian economy into a middle-income economy enjoying sustainable growth. It would reduce the one-sided dependence on Israel by facilitating the diversification of trade partners and patterns. The eroded productive capacity would also be replaced and expanded by a mix of public investment, incentives for private investment and sector-targeted support programmes to foster domestic employment and production. Finally, the package would not only strengthen existing linkages, but would also create new ones and would thereby unleash dynamic growth over the longer term.

To support the emergence of a sovereign and viable Palestinian State, all parties involved should share responsibility and meet their obligations. The Palestinian Authority should continuously seek and negotiate for the expansion of the policy instruments at its disposal, maximize the use of the space presently available for policymaking, improve coordination of all institutions involved in economic decision-making and streamline its planning and implementation capacity to formulate a coherent new national economic vision. The international donor community should continue its financial and technical support to the Palestinian economy, strengthen its political commitment to establishing a sovereign Palestinian State and support the expansion of the range of policy tools available to the Palestinian Authority and its ownership of economic policy reforms. Finally, the Israeli authorities should reconsider the effectiveness of the closure policy and mobility restrictions imposed on the West Bank and the Gaza Strip and remove the various barriers that, over the years, have undermined the economic development of the occupied Palestinian territory.

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