United Nations TD/INF.43

United Nations Conference on Trade and Development

Distr.: General
1 February 2012

English only

Thirteenth session
Doha, Qatar
21–26 April 2012
Item 8 of the provisional agenda
Development-centred globalization:
Towards inclusive and sustainable growth and development

UNCTAD XIII Special Event – Sustaining the Palestinian economy under occupation: The role of Arab cooperation

Issues note prepared by the UNCTAD secretariat

I. The unfulfilled hopes of the Oslo Accords

1. The signing of the Oslo Accords between the Palestinian Liberation Organization (PLO) and Israel, and the establishment of the Palestinian Authority (PA) in 1994, ushered in an era of high expectations. Over the following half decade, the occupied Palestinian territory (OPT) witnessed a period of unprecedented economic growth, with real GDP growing at an annual average rate of 8.5 per cent, combined with a substantial increase in public and private investment. This was sufficient, during the period 1995–1999, to reduce unemployment by 11 percentage points and increase GDP per capita by an annual average of 4.3 per cent. UNCTAD estimated some 20 years ago that if output growth would continue along its pre-1990 trend, real GDP per capita in the OPT would almost double by 2010. At that moment, there appeared to be real reasons to believe such an outcome to be plausible.

2. However, after the eruption of the second Palestinian intifada in 2000, this growth came to an abrupt halt and most of the gains of the preceding years have since vanished. The year 2000 was a watershed. It witnessed the intensification of the Israeli closure policy and the implementation of other measures that restrict the movement of people and goods within, to and from the OPT. Subsequent years have witnessed the destruction and erosion of Palestinian productive capacity and the transformation of the economy from one driven by private sector investment and a proactive public sector, to one degraded by warlike conditions, highly reliant on foreign aid and public sector employment. Pressing and chronic humanitarian and relief needs have overwhelmed the economy, consumed much of the available resources, and left little resources to expand investment and rebuild the degraded infrastructure and productive base. Meanwhile, the Palestinian economy is

isolated from its Arab regional hinterland and from international trade and economic exchanges, in the shadow of the richer, more advanced Israeli economy.

3. This issues note takes stock of some of UNCTAD's key research findings since Accra (UNCTAD XII) and highlights the main challenges to and prospects for Palestinian economic development under occupation and key elements of a strategy for building a viable economy to underpin the future sovereign Palestinian State as called for by relevant United Nations resolutions.[1]

II. Restrained economy operating well below potential

4. Despite a two-decade-old peace process, no permanent status agreement is on the horizon to lay the foundation for peace and prosperity for the Palestinian people and their neighbours. Instead of the envisioned "peace dividend", an atmosphere of chronic conflict has persisted, resulting in technological regression and inflicting a heavy toll on the Palestinian economy, while the loss of land and natural resources to Israeli settlements continues unabated.

5. In the aftermath of the second intifada, Israel began construction of the 709 km "Separation Barrier" and tightened restrictions on the movement of Palestinian people and goods within, to and from the OPT. These restrictions fostered uncertainty and reluctance on the part of private sector investors to invest at the scale necessary for reviving the economy and to make up for the steep decline in standards of living that has taken place during the last decade. As a consequence, and with the loss of around one third of Palestinian productive base since 2000, the economy continues to perform below its potential. Per capita GDP in 2010 was still 30 per cent below its level of a decade ago.

6. The confidence of Palestinian as well as foreign investors is hampered not only by the actual access and movement restrictions in place, but also by the artificially inflated transaction costs of trade and other economic activities conducted under conditions of occupation. Sustained private sector-led revival therefore has as a prerequisite not only the removal of all restrictions on Palestinian access to internal and external markets, but also requires the elimination of the additional transaction costs and securing full Palestinian control of international trade and external economic relations.

III. Policy space for economic recovery and sustained growth

7. Beyond the stimulus to aggregate demand that it provides through the public sector payroll, the PA has few means at its disposal to create an enabling environment for economic growth. To reverse the downward spiral of the Palestinian economy, UNCTAD has proposed a comprehensive, multi-faceted strategy. Key elements of this approach include empowering the PA with the necessary policy space and tools it hitherto lacks which, under the current terms, are not sufficient to lay the foundations for recovery and sustained growth. UNCTAD has argued over the years that approaches to Palestinian economic development that do not take into account the PA's lack of sovereignty over borders, natural resources, land, water or the movement of people and goods within its territories can, at best, achieve limited results.

[1] See the last four reports on UNCTAD assistance to the Palestinian people – TD/B/58/4, TD/B/57/4, TD/B/56/3 and TD/B/55/2 – and Khalidi and Taghdisi-Rad (2009). *The economic dimensions of prolonged occupation: Continuity and change in Israeli policy towards the Palestinian economy.* UNCTAD/GDS/2009/2.

8. As far as fiscal policy tools are concerned, the PA can effectively do only a few things other than allocate public expenditure. On the revenue side, the PA has little control over the rates of the value added tax or tariff, and has to deal with highly unpredictable foreign aid and Israeli goodwill to transfer the customs and tax revenue it collects on its behalf, which accounts for about two thirds of its tax revenue. Lack of a national currency renders monetary and exchange rate policies inaccessible. As such, the PA has no recourse to use exchange rate policy to achieve external balance, deal with external shocks, or boost the competitiveness of Palestinian producers.

9. The dismal record of the past few years validates UNCTAD's contention that the present framework for Palestinian economic policies is singularly incapable of responding to the challenges of the economy and its eroded productive capacity. It also reinforces the momentum which confines the Palestinian economy on a path of poverty, low economic growth, insufficient job generation, and aid-dependence.

IV. Trade deficit, structural deformation and distorted tradable goods sector

10. UNCTAD's research has analysed the sources of the large and persistent Palestinian trade deficit and dependence on trade with and via Israel, which accounts for around three quarters of Palestinian trade. This economic dependence can be traced back to complex economic, political and logistical factors arising from prolonged occupation and the landlocked situation of the OPT. The lack of a seaport and airports and the constraints on trade with and through neighbouring Egypt and Jordan, despite a competitive cost structure, have effectively concentrated Palestinian trade within Israel's orbit. The unbalanced trade relationship has rendered Palestinian economic development subservient to Israeli economic and political imperatives, often masked under "security requirements". This imposed dependency has persisted, despite strong potentials for trade with other countries and the signing of trade arrangements with many partners.

11. UNCTAD contends that a key impediment to Palestinian development is the distorted tradable goods sector, whose expansion has been stunted by the destruction of the productive base, high transaction costs and an uncompetitive exchange rate, as a result of using the Israeli currency. The combined effects of these factors have put Palestinian producers at marked disadvantage in domestic as well as external markets. This has weakened development by forestalling the cumulative effects of growth and the long-term learning effects that result from sustained production activities. It has also deepened the dependency on aid and remittances, which together exceed 60 per cent of GDP, as the main sources of foreign exchange and aggregate demand. This in turn has created structural deformations by halving the contribution of the industrial and agricultural sectors to GDP between 1995 and 2010.

V. Governance and the limits of reform and development under occupation

12. In the unfavourable environment that restrains private sector capacity to produce jobs and increase its contribution to public revenue, in recent years, the PA has implemented deep fiscal reforms in pursuit of fiscal sustainability. These reforms aim at achieving transparency, accountability, improving budget preparation and control processes, increasing the efficiency of tax collection and improving the overall PA public financial management.

13. However, recurrent crises, the Israeli closure policy and security measures, and the ensuing deterioration of the economic and humanitarian situation heaped pressure on an already grim fiscal scene by lowering tax revenues and increasing the need for emergency spending. For instance, in 2009, the PA spent more than $1.4 billion on rehabilitating Gaza following the Israeli military operation there, a sum greater than the entire external budget support it received from donors.

14. UNCTAD stresses that reaching a sustainable budget deficit will remain elusive under occupation, and will remain so unless the Palestinian people gain access to their natural resources and the PA is enabled to exercise jurisdiction over the whole OPT. Latest data show that despite ongoing fiscal reforms, aid dependence persists and the PA's fiscal position remains precarious. In 2010, domestic tax revenue covered only 15 per cent of total spending, while public investment spending remained below 10 per cent of the total spending and about 4 per cent of GDP.

15. Under conditions of occupation, settlement and economic blockade, the livelihoods of poor households and social cohesion should not be sacrificed at the altar of an elusive fiscal sustainability. To avoid the perils of one-size-fits all fiscal policy prescriptions, the role and design of fiscal policy under conditions of occupation call for serious consideration by economists and policymakers to generate a strong consensus that advances the strategic needs and development priorities of the Palestinian people.

16. Despite these challenges, as early as 2001 UNCTAD emphasized that the PA demonstrated competence in management of public finances and delivering services in an unfavourable environment, and was ready to assume sovereign national governance functions. Its continuing positive track record in this regard leaves no doubt that the Palestinian people are ready to assume all the functions expected of a sovereign State.

VI. Public revenue instability and indirect imports from Israel

17. A major source of fiscal instability is rooted in Israeli control over tax and customs clearance revenue that it collects on behalf of the PA and which it has recurrently interrupted its transfer for unilateral considerations. This is especially destabilizing to the PA and the economy as a whole, since clearance revenue represents 60–70 per cent of total revenue. Such unpredictability makes fiscal planning and policy implementation difficult, undermines the PA's ability to pay private contractors and threatens its ability to pay the salaries of more than 150,000 public employees.

18. Withholding of clearance revenue is not the only factor of uncertainty that constrains Palestinian fiscal policy space. As far back as 2004, UNCTAD noted that a significant portion of what is officially recorded and treated as Palestinian imports from Israel are actually goods produced in other countries and then re-exported to the OPT. This was confirmed in a study by the Bank of Israel published in 2010 indicating that these "indirect imports" are significant, and represent at least 38 per cent of Palestinian imports from Israel. Customs revenue from these "indirect imports" is captured by the Israeli authorities and not transferred to the PA as it should be. Revenue from this source could significantly increase Palestinian public resources and have a positive impact on the economy's ability to generate employment and reduce poverty.

19. In its latest report, UNCTAD underscored the significance of the fiscal loss and has suggested an operational data transparency mechanism to accurately distinguish *bona fide* imports from Israel from "indirect imports". This entails the reconsideration of the entire revenue clearance arrangement in place to overcome the negative fallout of the information asymmetry of the two sides. Moreover, UNCTAD highlighted the need for action and further research on Palestinian revenue leakage from a wider perspective, including

purchase tax on Palestinian imports from and through Israel, smuggling from Israel and settlements and rules of origin.

VII. The Palestinian economy in occupied Jerusalem

20. In its 2011 Report to the Trade and Development Board, UNCTAD provided a snapshot of the economic dimensions of the exclusion of East Jerusalem from the rest of the OPT and stressed that the cohesion and integration of the economy of the future independent Palestinian State requires reconnecting East Jerusalem with the rest of the Palestinian economy.

21. With the occupation of East Jerusalem in 1967, a gradual segregation ensued between the city and the rest of the OPT, not to mention with western Jerusalem, to which it was annexed in 1967. For centuries, East Jerusalem has been the centre of political, economic, cultural and religious life for the Palestinian people. However, since its occupation in 1967, it has been facing an array of restrictions that reinforce and accelerate its segregation from the Palestinian economy. Since then, the Israeli authorities took a series of measures to alter the character of the city, including settlements built within annexed East Jerusalem, and the construction of the Separation Barrier. As a result, while West Bank residents cannot access the markets of the city, Jerusalemites lost the easy access to the relatively cheap products from the West Bank, such as pharmaceutical, dairy and meat products banned since 2010 from entering East Jerusalem. Other goods have to go through crossing points, where cumbersome transport procedures raise their cost to East Jerusalem consumers. Moreover, Israeli zoning and building restrictions hinder the construction of educational and health facilities, creating substandard conditions of the educational infrastructure and pressure on the already overburdened health system.

22. The narrowly defined cost to the Palestinian economy of the exclusion of East Jerusalem from PA jurisdiction is estimated at up to $680 million. If, for instance, the East Jerusalem economy were included in Palestinian national accounts, 2010 GDP would have been $8.3 billion rather than the $7.6 billion that excludes East Jerusalem. However, this conservative estimate does not take into consideration the multiplier effect which could further expand the Palestinian economy if East Jerusalem is reintegrated into the Palestinian economy and severed trade and inter-industry linkages are re-established.

VIII. The way forward: A new economic and trade orientation

23. As indicated above, data from the Bank of Israel indicate that most of what is reported as Israeli exports to the OPT does not come from Israel but is actually goods transiting through its ports. This has enormous implications for the debate about economic integration and trade orientations of the future Palestinian State. The evidence shows that the OPT does not necessarily benefit from trade and related economic integration with Israel at the scale suggested by the official narrative, and that Palestinian dependency is not on the Israeli economy per se, but rather on the stranglehold that occupation maintains over Palestinian trade with the world. The emerging facts about the true nature of Palestinian trade, if anything, indicate that the OPT's economic future is to be found as much, if not more, in its Arab hinterland, and the rest of the world, than with Israel. Therefore, framing the Palestinian development policy debate in terms of the optimal trade regime with Israel is a risky approach for a small economy that needs large-scale reconstruction, growth and development.

24. UNCTAD has argued that achieving sustainable Palestinian development requires empowering the PA with the policy tools available to sovereign States. No less important is

revisiting the policy framework so as to expand Palestinian policy space, lifting mobility restrictions, promoting identified strategic sectors and building core State functions and capacities and territorial reintegration of hitherto fragmented Palestinian territory. Moreover, large-scale public investment programmes are needed to rebuild infrastructure, expand and revitalize the eroded productive capacity, and create an enabling environment for the private sector. In this respect, developing the Palestinian export sector and market opportunities is a key condition for sustained improvement in Palestinian standards of living. Strengthening the export sector should proceed hand in hand with building the capacity to domestically produce goods that are hitherto imported by designing appropriate supporting polices that compensate for the effects of more than four decades of occupation that have stunted the Palestinian tradable goods sector.