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REPORT ON UNCTAD'S ASSISTANCE TO THE PALESTINIAN PEOPLE*

Prepared by the UNCTAD secretariat

Executive summary

The development prospects of the economy of the occupied Palestinian territory today face unprecedented challenges. In the economic domain, there appears to be little momentum left to sustain the achievements of the Israel–Palestine accords since 1993. The Palestinian Authority (PA) has reached a perilous position with regard to its financial solvency and ability to deliver the services for which it was designed. In 2006 the vulnerable Palestinian economy has had to cope with a significant reduction in donor aid, and its institutional infrastructure has been at risk of erosion and dysfunction. Meanwhile, renewed confrontations and restrictive measures have added to an economic decline at least as severe as that of 2000–2002. These new constraints complement long-standing adverse conditions affecting the economy, engendered by prolonged occupation and conflict. In such circumstances, projections imply an economic decline that will result in the halving of per capita incomes from their pre-2000 levels, unemployment of half of the Palestinian workforce and extension of poverty to two out of three households. Notwithstanding dire conditions on the ground, de-formalization of the economy and the new conditionality affecting aid, development experience in adversity provides important lessons for economic management in the current conflict situation. There are policy measures and initiatives to which the Palestinian people can resort in order to avert economic collapse. The United Nations, including UNCTAD through its technical assistance and policy advice, and its international partners in Palestinian development need to continue to help the Palestinian people withstand this latest humanitarian and economic crisis, and even overcome it as they have done before.

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Chapter I

THE PALESTINIAN ECONOMY IN 2006: BACK TO THE PAST

1. Beset by the latest series of shocks since the Palestinian territory of the West Bank and Gaza Strip was first occupied by Israel four decades ago, the Palestinian economy in 2006 is highly vulnerable,[1] being subject to a process of "de-development" that recent events have only accelerated and deepened. The "viability" of the Palestinian economy, a sine qua non for realizing the vision of a State of Palestine coexisting peacefully with Israel in a post-occupation era, has been challenged. In addition to the threatened breakdown of central government functions, including vital social services, and donor restrictions following the election of a new Palestinian Authority (PA) Legislative Council, there appears to be little momentum left to sustain the achievements of the Israel–Palestine accords since 1993. At the economic level, the functioning of the Protocol on Economic Relations between the two sides and its continuing relevance are in question. In such an uncertain context, the international community can realistically hope to achieve only so much when it comes to assisting the Palestinian people in economic and social fields, as mandated by the United Nations General Assembly and as demonstrated by the work of its agencies.

2. As an international agency that has examined regularly for the past two decades the challenges facing the development of the Palestinian economy, UNCTAD has been able to derive lessons from past events and experiences, so as to better understand current economic developments and how to best deal with them, including through technical assistance activities. It is hard to discern today a major transformation of the broad outlines of the Palestinian economic predicament as it has evolved since first series of shocks, which began with the first Palestinian uprising in 1988.

3. Indeed, it is regrettable that the core issues determining Palestinian economic prospects before the 1993 accords still predominate today.

- In 1986, the UNCTAD secretariat's report to the Trade and Development Board noted pressing problems such as the narrowing local resource base, overdependence on external sources of income, sectoral imbalances, lower productive investment and unfavourable flows of trade and labour. Dealing with these issues remains at the top of the Palestinian development agenda today.

- In the same year, the occupied territory was faced with the prospect of an Israeli initiative to impose "unilateral autonomy" or "devolution" of certain functions to the Gaza Strip ("Gaza first"). A new unilateralism affecting the economy has now taken precedence in Israeli–Palestinian relations, beginning with the Israeli disengagement in Gaza in 2005.

- Already in 1987, the secretariat's report to the Board was stressing the need for "bold efforts" and a "conscious strategy aimed at developing the economy of the occupied territories…guided by a set of objectives that reflect the aspirations of the Palestinian people". Nearly two decades later, a new generation of international and Palestinian efforts is called for, rooted in the imperatives of Palestinian State-formation.

- The first Palestinian uprising led to a range of measures to cope with heightened confrontation, including strategies for "economic survival", "disengagement from the

Israeli economy", "safeguarding and promoting domestic economic sectors and institutions" and enhanced "self-reliance". The severity of the current crisis calls for innovative, unconventional and even unprecedented measures to sustain and protect an embattled economy.

- The secretariat reported in 1992 that "while these efforts have met with some success, especially as 'trial runs' for more comprehensive and balanced development endeavours, their overall impact…remain[s] dwarfed by the scale of economic and social deterioration in the occupied territory". In 2006, the bar of expectations must be kept realistically low when envisaging the economic governance capacity of a fragile and isolated PA and its ability to deliver an economic development, reform or institution-building programme.

- Today, as in the period after 1988, "the flow of all financial transfers from outside, including international aid, has been increasingly subjected to strict restrictions, while vigorous and arbitrary collection of heavy taxes, duties and fines, and cutbacks in expenditures on social services have created great pressures on all sectors of Palestinian society".

- As noted in 1989, "the vulnerability of the Palestinian domestic economy and its inability to withstand the effects of volatility in the external and domestic economic environment, along with its distorted and unarticulated structure, has left it unprepared to face the pressures that confront it". New dependencies entrenched since 1993 demonstrate the persistence of such structural weaknesses.

- In 1993, the secretariat reported that "the economy of the territory has become increasingly isolated, thus constraining the efforts of the Palestinian people to create an independent economy along with its requisite institutional framework". The new facts on the ground, accentuated in 2006, render such an outcome even more uncertain as PA institutions were marginalized and their international isolation increased.

4. This brief recapitulation of enduring and recurrent features of the Palestinian development dilemma serves to set the stage for the following review of the most recent developments affecting the war-torn Palestinian economy, and of some immediate prospects as identified in UNCTAD research and policy analysis. It also serves as a reminder that without urgent attention to the core issues affecting Palestinian economic performance, the adverse path of dependence that emerged under Israeli occupation will only deepen and further imperil the prospects for sustained development of the Palestinian economy. UNCTAD and its international partners in Palestinian development need to continue to help the Palestinian people withstand this latest humanitarian and economic crisis, and even overcome it as they have done before.

Chapter II

NEW CHALLENGES FOR THE WAR-TORN PALESTINIAN ECONOMY: DE-FORMALIZATION AND INTERNATIONAL ISOLATION

A. Economic recovery reversed

5. With Israeli restrictive measures at their height in the occupied Palestinian territory in 2002, its economy bottomed with a real gross domestic product (GDP) per capita not observed since the 1970s and a real GDP less than the level of the previous five years.[2] From such a low point the economy began to rebound in 2003. However, while the depressed economy resumed its growth path, productive capacity continued to shrink as a result of tight mobility restrictions, the destruction of physical capital and the loss of almost one fifth of the West Bank's agricultural land to the Israeli separation Barrier. Nevertheless, despite these conditions, the Palestinian people, with the full engagement of the international community, managed to survive and restart economic growth.

6. However, recent political and economic developments are generating a new regression of the economy more debilitating than that of 2001–2002, with manifestations of poverty unknown since occupation began in 1967. Following the Palestinian legislative elections in January 2006, the Israeli authorities decided to withhold the tax and customs revenue collected on behalf of the PA. Subsequently, most traditional donors ceased direct support to the PA. Furthermore, Arab financial support has been slow in reaching the PA, owing to new restrictions on transferring funds to Palestinian banks.[3] A comparison with developments between 1999 and 2002 suggests a volatile situation. Between 1999 and 2002, real GDP declined by about 15 per cent, despite the fact that donor support doubled from an average of half a billion dollars annually prior to 2000 to more than one billion dollars since 2001 in order to address the impact of intensified Israeli measures. Today, with the cessation of aid, a deeper economic decline than that recorded for 2002 is expected, with unprecedented unemployment, poverty rates and social strife.

7. Recently revised official estimates of Palestinian national accounts data indicate that the Palestinian economy started to recover in 2003 from the low point of 2002 (table 1). It is estimated that GDP achieved a growth rate of about 5 per cent in 2005, by when GDP had surpassed its 1999 level. However, these figures reflect a war-torn, but resilient, economy recovering from a strong external shock through recourse to increased dependence on external support to make up for the gap created by warlike conditions. Most of the growth in the past three years has been driven by annual injection of net current transfers (mainly donor funds) of about $1.3 billion, or some one third of annual GDP.

8. But economic growth has not been sufficiently vibrant to bring real income per capita back to its 1999 level. Despite the estimated 7.7 per cent recovery in real gross national income (GNI) per capita between 2002 and 2005, it was still about 25 per cent below the $1,860 recorded in 1999. As a result, poverty continues to widen and deepen. Recently released data indicate that 60 per cent of Palestinian households experienced falling income between 1999 and 2005, 52 per cent of which lost more than 50 per cent of their usual income. During this period median household monthly income dropped by almost 40 per cent to reach about $355 per month at the end of 2005. This is about $122 below the official poverty line and $30 lower than the absolute (deep) poverty line of $385. The overall

household poverty rate has consequently grown from 61 per cent in the last quarter of 2004 to 66 per cent by the second quarter of 2006. Meanwhile, households appear to have exhausted coping strategies, and even before the 2006 shock, about 67 per cent of households were in need of emergency humanitarian assistance, while 37 per cent were food-insecure. Households are also becoming heavily indebted, with 65 per cent reliant on informal borrowing in order to subsist.

Table 1. Palestinian economy (West Bank and Gaza Strip):[a] Key indicators, selected years

	1995	1999	2002 rev.	2003 rev.	*2004 prel.*	*2005 est.*
Macroeconomic performance						
Real GDP growth (%)	6.1	8.6	-3.8	8.5	***6.3***	***4.9***
GDP (million $)	3 225	4 201	3 619	3 998	***4 655***	***4 929***
GNI (million $)	3 699	4 932	3 835	4 251	***4 884***	***5 119***
GDP per capita ($)	1 380	1 478	1 146	1 221	***1 372***	***1 398***
GNI per capita ($)	1 583	1 736	1 215	1 298	***1 440***	***1 452***
Real GNI per capita growth (%)	7.9	4.1	-8.9	6.2	***1.5***	***-0.1***
Domestic expenditure (% of GDP)	151.8	163.0	145.8	150.2	***150.7***	***154.5***
Population and labour						
Population (million)	2.34	2.84	3.16	3.27	***3.39***	***3.53***
Unemployment (% of labour force)[b]	26.6	21.2	41.3	33.4	***32.5***	***28.9***
Total employment (thousand)	417	588	477	564	***578***	***633***
In public sector	51	103	115	119	***131***	***145***
In Israel and settlements	50	127	49	55	***50***	***63***
Fiscal balance (% of GDP)						
Government revenue	13.2	23.8	8.2	19.1	***20.5***	***21.9***
Current expenditure	15.3	22.5	27.6	31.4	***32.0***	***34.3***
Total expenditure	25.5	29.8	28.2	32.3	***32.8***	***35.1***
Recurrent balance	-2.1	1.3	-19.4	-12.3	***-11.5***	***-12.4***
Overall balance	-12.3	-6.0	-20.0	-13.2	***-12.3***	***-13.3***
External trade						
Exports of goods and services (million $)	499	684	420	433	***482***	***665***
Imports of goods and services (million $)	2 176	3 353	2 130	2 404	***2 751***	***3 352***
Trade balance (% of GDP)	-52.0	-63.6	-47.2	-49.3	***-48.7***	***-54.5***
Trade balance with Israel (million $)	-1 388	-1 766	-1 149	-1 370	***-1 623***	***-1 943***
Trade balance with Israel (% of GDP)	-43.0	-42.0	-31.8	-34.3	***-34.9***	***-39.4***
Imports from Israel /PA private consumption (%)	56.5	54.5	43.6	43.4	***44.6***	***51.5***
Total PA trade with Israel/total Israeli trade (%)[c]	3.7	3.7	2.1	2.2	***2.2***	***2.4***
PA trade with Israel/total PA trade (%)[c]	78.8	68.0	69.0	69.1	***70.3***	***70.1***

Sources: Historical data from the Palestinian Central Bureau of Statistics (PCBS); 2005 data are estimated by the UNCTAD secretariat on the basis of recently released PCBS data (*Preliminary Estimates of Quarterly National Accounts (First Quarter 2006)*, Ramallah, PCBS, May 2006) and IMF–World Bank fiscal estimates (World Bank *West Bank and Gaza Update.* West Bank and Gaza Resident Mission, World Bank, April, 2006). Israeli trade data are obtained from the Israeli Central Bureau of Statistics (*Monthly Bulletin of Statistics*).
[a] All data exclude east Jerusalem. [b] Unemployment rates include discouraged workers according to the ILO relaxed definition (PCBS, 2006). [c] Total Palestinian and Israeli trade data refer to goods, and non-factor and

factor services.

9. The prolonged crisis has led to expansion of informal sector activities to compensate for lost jobs in Israel and local markets. Meanwhile, the disruption of commercial networks has further fragmented the economy, with each community pursuing limited objectives and dissipating meagre resources, without coordination with similar efforts of other localities. This is particularly the case of the West Bank, where Israeli restrictive measures have become most severe and where there has been a breakdown of economic relations between districts and between urban and rural communities, as well as between employers and employees and producers and markets. The processes of economic de-formalization and fragmentation are underscored by increased reliance on in-kind payments, traditional barter and credit as cash- strapped enterprises struggle to make ends meet.

10. Even prior to the most recent downturn, unemployment had stayed high owing to the erosion of capital stock and agricultural productive capacity. The unemployment rate in 2005 was about 29 per cent, with 260,000 jobless, down from 33 per cent in 2004. For the fourth year in a row the Palestinian economy managed to increase the number of those employed, with more than half of this increase generated by the private sector. However, given the status of the economy and low investment rates, the cost of employment growth was a loss in labour productivity. The latter issue should be given attention through the design of programmes to improve the productivity of sectors capable of absorbing employment in a crisis situation, such as the agriculture sector, which was able to employ proportionally a larger number of workers relative to its contribution to GDP.

11. While the fragmented coping strategies and disintegration of the formal sectors weaken the household and private sector capacity to survive the prolonged crisis, as reported previously, between 2000 and 2005 the Palestinian economy was deprived of about one third of its capital stock as a result of the destruction of public and private physical capital and overuse and poor maintenance. This loss does not include damage to Palestinian agricultural productive capacity in the West Bank as a direct result of the construction of the Israeli Barrier. The United Nations Office for the Coordination of Humanitarian Affairs (UNOCHA) provides a detailed account of the Barrier's overall impact on the Palestinian people. In total, the lives of more than half a million Palestinians living within one kilometre of the Barrier will be affected. The impact of the Barrier and settlement activities on Palestinian agriculture continues to be substantial, undermining the sector’s productive and employment absorptive capacities. The construction of the Barrier has led to the confiscation of more than 23,000 hectares (230 sq. km) of the West Bank's most fertile land, representing slightly less than 15 per cent of all West Bank agricultural land, and loss of control over 49 Palestinian water wells.

12. The accelerated erosion of capital stock and agricultural productive capacity has created an interactive mechanism that ultimately leads to a reduction in the domestic production of the Palestinian people and thus a contraction in their ability to feed themselves. Consequently, there is increased dependence on external support as a source of income and on imports (especially from Israel) to satisfy consumption. This is reflected by the persistently high domestic expenditure (absorption) to GDP ratio, estimated in 2005 at about 155 per cent. This indicates that 55 per cent of domestic expenditure is not produced domestically, and therefore covered from net imports or by a growing trade deficit. The latter increased from $1.7 billion in 2002 to $2.7 billion in 2005, as imports surged and exports faltered.

13. Meanwhile, the share of the trade deficit with Israel in the total Palestinian trade deficit increased from 67 per cent to 72 per cent; this indicates that the deficit with Israel grew faster than the deficit with the rest of the world. The large deficit with a single trading partner reflects another aspect of the vulnerability of the Palestinian economy to shocks from that partner. While Palestinian trade with Israel is an insignificant proportion of total Israeli trade, trade with Israel represented about 70 per cent of total Palestinian trade. The cumulative total trade deficit with Israel in 2000–2005 was 33 per cent greater than total net current transfers received from the rest of the world during the same period. While the average annual trade deficit with Israel was above $1.5 billion, the average of net current transfers was below $1.2 billion per year. This means that all the funds received from the international community during the ongoing crisis were not sufficient to pay for the unbalanced trade with Israel.

14. From another angle, table 1 indicates that the estimated 2005 trade deficit is equivalent to 54.5 per cent of GDP, of which the deficit with Israel accounts for 39.4 per cent of GDP. This means that for every dollar produced domestically, 55 cents constitute an outstanding liability to the rest of the world, including 40 cents to the Israeli economy. In this connection, previous secretariat recommendations are pertinent with regard to the importance of reducing Palestinian dependence on the Israeli economy through (a) increasing domestic investment; (b) promoting consumption of domestically produced products; (c) supporting national productive sectors; (d) diversifying trading partners; and (e) increasing international support to the Palestinian people in order to maintain minimum levels of income required for sustaining economic recovery. Also, the Palestinian economy must be prepared to cope with new unilateral measures that could have implications for economic relations with Israel and for Palestinian national economic security interests.

15. Neither the existing Palestinian policy framework, as stipulated by the 1994 Paris Protocol, nor the fragile fiscal position it created provides Palestinian decision makers with the most basic policy instruments to implement recommendations such as those stated above. On the contrary, the present situation eliminates practically all policy space, leaving allocation of the limited domestically raised public revenue (about one quarter of total revenue in 2005), allocation of tax revenue from imports (if released by Israel) and a narrow margin of borrowing from the national banking sector. Guiding the allocation of donor funds is increasingly out of reach to Palestinian policymakers. This process is now more subject than before to donor agendas and involves a highly complicated and decentralized negotiation and implementation process, which requires national capacity not currently available. It is therefore important to seek all options to expand policy instruments at the disposal of Palestinian policymakers, and appropriate that the parties seriously review their economic relations, especially the trade, fiscal and monetary arrangements that they agreed in 1994.

B. Impact of decreased international aid

16. As mentioned above, Israel and most donors have introduced a number of measures in response to the outcome of the Palestinian elections and the formation of a new PA Council of Ministers. In March, Israel suspended transfer of tax revenue on Palestinian imports collected by Israel on behalf of the PA. In 2005, this revenue source averaged around $60 million per month, representing two thirds of total Palestinian public revenue. The Israeli authorities also announced that security checks on Palestinian borders would be further tightened, thus generating new pressures on Palestinian trade with and employment in Israel. In 2005, while total Palestinian goods and non-factor service trade flows were estimated at

around $4 billion, Palestinian employment in Israel and its settlements generated an estimated $190 million of net factor income. In the meantime almost all traditional donors suspended budgetary support and development aid to the PA, which totalled about $800 million in 2005. Humanitarian and emergency assistance ($400 million in 2005) may be expected to continue in 2006, although a slowdown in delivery is anticipated.

17. These new conditions are a reminder of those that prevailed between 2000 and 2002, when the economy lost 15 per cent of its GDP, with the important difference that this time donor support will decrease by up to a half instead of doubling, as was the case previously. The objective of this section is to quantify, on the basis of reasonable assumptions, the expected impact of these new realities. The analysis draws on the UNCTAD macro-econometric model of the Palestinian economy to evaluate three scenarios.

- ***Baseline scenario.*** The benchmark scenario against which two alternative scenarios are compared considers a situation in which the economy will continue to follow the trend of 2002–2005. It assumes that (i) Israel continues to transfer revenue from tax on Palestinian imports at the 2005 rate, and therefore there is no cut in public expenditure; (ii) goods mobility restrictions will be reduced in line with the Agreement on Movement and Access of 15 November, 2005 between Israel and the PA; (iii) labour mobility constraints are maintained, reflecting the Israeli closure policy and separation Barrier; and (iv) net current transfers will decline by 10–20 per cent annually in 2006–2008 to reflect a reduction in donor support as the economy grows.

- ***Reduced aid scenario I.*** This scenario considers a situation in which donors partially reduce budget support and development aid to the PA, and Israel does not withhold all taxes collected on behalf of the PA. The scenario assumes (i) a 30 per cent cut in all public expenditure below the levels assumed in the baseline scenario in 2006 and 2007; (ii) an increase of up to 150 per cent in goods mobility restrictions above baseline levels; (iii) a 10 per cent increase in labour mobility restrictions above baseline levels; and (iv) a reduction of up to 30 per cent in net current transfers below baseline levels.

- ***Reduced aid scenario II.*** This scenario considers a more severe situation in which the following are assumed: (i) a 50 per cent cut in all public expenditures; (ii) a 200 per cent increase in goods mobility restrictions; (iii) a 20 per cent increase in labour mobility restrictions; and (iv) a 50 per cent reduction in net current transfers.

18. Table 2 presents the simulation results of the three scenarios. According to the baseline assumptions, the economy continues to grow by about 9 per cent annually and employment increases by more than 100,000 workers in the period 2006–2008. However, this is not enough to bring gross national disposable income (GNDI) per capita back to its 1999 level (figure 1) or to reduce the unemployment rate below the 20 per cent mark (figure 2). This scenario suggests that while increasing donor support and reducing mobility restrictions promote positive outcomes, they are not sufficient to place the Palestinian economy on a path of sustained recovery. What is really required is to provide decision makers with a range of policy instruments to allow them to use efficiently any available stimulus to manoeuvre the economy onto a sustainable path.

Table 2. Impact of reduced aid: Projections for the Palestinian economy

	Real GDP – 1997$ million					**Real GNDI* per capita – 1997$**		
	Baseline scenario	**Reduced aid**					**Reduced aid**	
		Scenario I		**Scenario II**		**Baseline scenario**	**Scenario I**	**Scenario II**
Year	**Level**	**Level**	***Loss***	**Level**	***Loss***			
2002	3 839					1 613		
2005 est.	4 646					1 690		
2006	5 030	3 995	*1 035*	3 410	*1 620*	1 663	1 296	1 082
2007	5 583	3 836	*1 747*	3 023	*2 560*	1 718	1 217	956
2008	6 019	5 374	*645*	4 836	*1 184*	1 753	1 680	1 547
Cumulative loss			***3 428***		***5 364***			
	Employment – thousands					**Unemployment rate** – %**		
	Baseline scenario	**Reduced aid**					**Reduced aid**	
		Scenario I		**Scenario II**		**Baseline scenario**	**Scenario I**	**Scenario II**
Year	**Level**	**Level**	***Loss***	**Level**	***Loss***			
2002	477					41.3		
2005 est.	632					28.9		
2006	698	608	*90*	553	*146*	26.7	36.9	43.0
2007	756	592	*164*	502	*254*	25.0	42.0	51.4
2008	805	731	*74*	674	*131*	23.1	30.9	36.8
Cumulative loss			***328***		***531***			

* Gross national disposable income includes net factor income and net current transfers.
** According to ILO relaxed definition, which includes discouraged workers.

19. The simulations of reduced aid scenarios I and II show the range of possible outcomes for a war-torn economy that lacks goods and labour mobility; suffers from an eroded productive capacity; is dispossessed of the very external support that was introduced to reduce the impact of warlike conditions; and is now deprived of almost all policy instruments, including borrowing from the local banking sector or even accumulating arrears. Even in the less severe case the prospects are alarming. If these conditions were to be sustained through 2007, the economy would shrink by 18 per cent, returning to its lowest level (in 2002), and unemployment would return to 2002 levels. Real GNDI per capita could plummet to about $1,200, a level not witnessed for a generation. The cumulative cost to the economy in 2006–2008 is $3.5 billion of potential GDP and 328,000 job-years in potential employment loss.

Figure 1 . GNDI per capita , 1997$

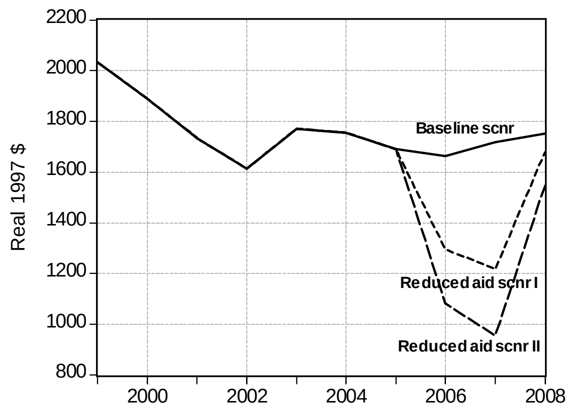
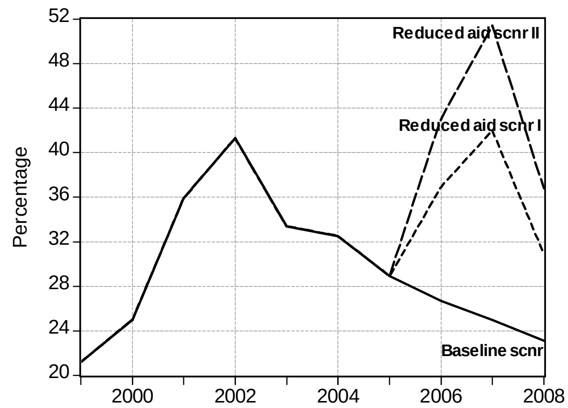


Figure 2 . Unemployment rate (percentage)



20. Reduced aid scenario II reveals a bleaker picture. The economy is expected to be 35 per cent smaller by the end of 2007 than in 2005 and even 21 per cent smaller than in 2002. GNDI per capita is expected to fall to lower than $1,000 per year, less than half of its 1999 level. More than 50 per cent of the Palestinian labour force would be unemployed. The economic cost of such a scenario is tremendous. During 2006–2008, potential GDP loss could accumulate to $5.4 billion, well above GDP in 2005. Potential employment loss could reach 531,000 job-years during the same period, or 84 per cent of the total number of jobs available in 2005. Even if the full return of donor support and the relaxation of mobility restrictions by 2008 are assumed, potential GDP and employment losses would continue to accumulate. This suggests that conditions similar to those now emerging have harmful long-lasting effects on the economy that do not go away once adverse conditions are alleviated.

21. The main message of this analysis is that cutbacks in donor support to the Palestinian people, coupled with further tightening of the Israeli measures and withholding of Palestinian tax revenues, will create another round of "de-development" much deeper than that of 2002, from which the economy has yet to recover. Poverty and a deteriorating humanitarian situation in the occupied Palestinian territory could reach unprecedented levels and would last much longer than the term of any single Government, irrespective of its political programme. Added to this is the risk of the Palestinian Government's losing its managerial and technical capacity, the development of which the donor community has supported intensively since 1994. This same capacity is one of the essential elements required for the sovereign functioning of the Palestinian State that is envisioned.

Chapter III

AREAS FOR URGENT POLICY ACTION

22. Once again, the prospects of the Palestinian economy are hostage to political constraints and emergency needs generated by protracted conflict. Development issues have taken a back seat and donors are focused on alleviating human suffering and finding alternative channels to the PA for disbursing funds. The private sector is regarded as the ultimate recipient of funds for job creation, with United Nations agencies, together with non-governmental organizations (NGOs), being similarly regarded in relation to channelling emergency humanitarian assistance. Israeli banks have restricted their dealings with Palestinian commercial banks, which in turn have begun to withhold services to PA employees. Meanwhile the Quartet has initiated the establishment of a temporary international mechanism (TIM) for disbursing emergency humanitarian aid, designed to allow resumption of aid without working through PA Ministries.

A. Responding to Palestinian national development objectives and priorities

23. For its part, the PA has stressed the need to resume development efforts. However, with attention consistently diverted to the escalating humanitarian crisis, Palestinian policymakers are simply too drained to even seek a consensus as regards the optimal approach to setting the economy on the path of sustained recovery. Simply put, the Palestinian capacity to set any development or aid agenda is constrained as never before, while the donor community and international agencies are engaged more intimately than before, though from a distance and according to their own priorities, in Palestinian financial administration and governance.

24. The updated Medium Term Development Plan (MTDP) provides a coherent reference framework for guiding the allocation of international aid at the project level for the period 2006–2008. It considers the status quo of protracted conflict to be its "operative scenario", and seeks to link relief operations to long-term development objectives. In particular, it advances a set of intermediate objectives to be implemented as stepping stones to achieving the objective of establishing an independent, democratic Palestinian State with a modern economy. These include accelerating economic growth through support of the private sector and attaining higher levels of social protection and equity in income distribution. The MTDP warns that it is "impractical to assume that attention can be given exclusively to trade liberalization and that the mitigation of poverty will occur as a result". Rather, measures should focus on "mitigating poverty, protecting and developing productive capacity, and…addressing imbalances that have resulted from the Israeli occupation". It considers employment generation to be the key vehicle for a "successful combination of economic stability and sustainability in the medium-term".

25. In an effort to strike a balance between addressing the newest phase of the crisis and strategic development needs, the PA Ministry of Planning (MoP) recently proposed an "Emergency Support Programme" for the current year. The programme is an extension of the MDTP, which is still considered to be a reference framework for guiding Palestinian development efforts.[4] The programme groups emergency needs under five clusters at an estimated cost of $1.8 billion — namely, budgetary support, maintaining basic services, emergency humanitarian assistance, social assistance and job creation. It also identifies three "principles" for ensuring aid effectiveness in the Palestinian context. The first is concerned

with the focus of aid, which should avoid "stand alone" humanitarian assistance and seek to link relief to development efforts, so as to avoid a "self-perpetuating cycle" of poverty and aid dependence. The second relates to aid disbursement channels, which should strengthen and not "de-capacitate" PA institutions. The third principle relates to the role of aid in the Palestinian context of prolonged occupation and protracted conflict.

B. Formalizing the informal sector as a means of addressing unemployment and poverty

26. In the new circumstances, efforts to address pressing unemployment and poverty should focus on enhancing the economy's coping strategies at the household and enterprise levels, working through the informal sector that has been expanding as a survival mechanism for lost job opportunities in Israel and local markets. This sector is becoming a salient feature of the Palestinian economy, and if it proliferates, it will prove difficult for it to be re-formalized once the economy recovers.

27. The mainstream view of the informal sector is that it falls within the domain of social policy, State regulations and legal reform.[5] Such a view does not account for the complexity of the informal sector, which comprises a wide range of activities that cannot be lumped together in one category. Not all informal enterprises are established as a response to poverty. Globalization and transnational corporations have encouraged the expansion of this sector even in developed countries. In the Palestinian case, de-formalization has been imposed by conflict and artificially stunted growth of the formal private sector. The conventional view also ignores the linkages between the formal and informal sectors, which render them vulnerable to economic policy, as well as the fact that in the informal sector, households and enterprises are often closely intertwined since owners use earnings to maintain the livelihoods of their families.

28. The informal sector should therefore be at the core of Palestinian economic policy and donor support, with a clear understanding of the types of activities it comprises. A useful "functional typology" of informal activities according to Portes and Haller identifies three types of informal economies: the first involving subsistence activities for *survival*; the second entailing *dependent exploitation* activities geared towards reducing production costs of formal enterprises; and the third featuring activities that aim at accumulating capital for *growth*. In this context, a three-pillar approach could be developed, with the first pillar focusing on integrating informal sector development into macroeconomic policy. This can be done through such measures as sequencing economic liberalization, VAT exemptions, and providing subsidies to NGOs and other intermediaries to ensure that the poor have access to public services.[6] The second pillar involves fostering enterprises' productive capacity (e.g. credit programmes), and the third entails strengthening support institutions catering for this sector. A complement of this approach requires legal reform in order to protect the entitlements of the poor.

C. The inevitability of a new trade regime

29. The urgent need to reconsider the existing trade regime, as defined under the terms of the Paris Protocol, is becoming a truism. Previous studies by the secretariat and other sources have shown how this regime has aggravated the economy's structural weaknesses and long-standing dependence on Israel, entailing high levels of customs duties, tariffs and fees, in addition to cumbersome customs and overland transport procedures. This has effectively

locked the Palestinian economy into *adverse path dependence*, institutionalized under occupation, by giving rise to *polarization effects*. This is evidenced in the economy's confinement in low-skill, labour-intensive activities, and its chronic inability to accommodate the growing labour force. This path dependence was reinforced by the export of labour services to Israel, which has set in motion a dynamic similar to *Dutch disease* through wage levels. Moreover, the existing trade regime is imposing on the Palestinian economy all the costs of trade liberalization inherent in WTO membership, despite the fact that it has access to few of its benefits. Trade policy is also at the core of the *policy of asymmetric containment*, whereby — together with fiscal, monetary and labour policy — it maintains Palestinian compliance with the security-first logic of the political process by applying one-sided sanctions.

30. The widespread economic crisis has highlighted the weaknesses of the existing trade regime, generating a national debate on the optimal trade policy for the emerging Palestinian State. As a recent UNCTAD study highlights,[7] Palestinian policymakers should avoid hasty liberalization, since it is not always the case that trade liberalization directly reduces poverty. Trade expansion is the outcome of several policies and is a lengthy process that requires years, if not decades, of intensive preparations. Rather, trade policy should be rooted in a national economic vision, following a development-driven approach to trade that also enables the economy to cope with accelerating structural changes engendered by liberalization. Tariff levels and dispersion should be based on an analysis of the economy's structure and salient features, and take into account the impact of tariff levels on fiscal policy. Reducing tariff levels could deprive the PA of important sources of revenues at a time when it is becoming increasingly dependent on foreign aid.

D. Managing limited fiscal policy space

31. Development experiences show that fiscal policy has an important role to play in the recovery of war-torn economies.[8] This is not least because public revenues tend to be the primary source of funds for kick-starting the economy, given the depletion of private sector funds and the difficulties in attracting foreign direct investments. However, in this case, revenue mobilization is constrained not only by the erosion of the tax base but also by the lack of economic diversification and by growing de-formalization, rendering direct taxation of limited benefit. While Israel's release of Palestinian tax funds is certainly necessary in order to ease the fiscal crisis, reliance on indirect taxation remains limited by the economy's depleted supply capacity and the constraints on trade activities under Israeli restrictive measures.

32. This means that in the short term the PA has no choice but to rely on international aid for financing its expenditures, while seeking to utilize to the maximum available fiscal instruments. The PA should also establish clear priorities based on a comprehensive assessment of emergency humanitarian needs. It would not be advisable to avoid cutting down allocations for social services, since this will only aggravate the humanitarian crisis. By the same token, if a rapid return to pre-2005 budget patterns becomes feasible, the PA should avoid a dramatic reduction in its wage bill, as this will impact negatively on aggregate demand. More important still is to link the aid effort to the Palestinian budgetary process and national development priorities, otherwise the PA risks undermining aid effectiveness and increasing aid dependence. In this context, the PA should focus on revitalizing its tax collection capacity and expanding its tax base through policies to facilitate the transformation of the economy towards technology-intensive products with higher value added.

E. A development-driven approach to public sector reform and the role of aid

33. Establishing vigorous and transparent public sector institutions remains another important requisite for overcoming the economic crisis and establishing the envisioned Palestinian State. However, rather than tackling immediate institutional bottlenecks, the PA reform agenda (as elaborated until 2005) describes where the PA hopes to end up once it achieves statehood. As such, it overwhelms Palestinian policymakers with a multitude of best practices that only sovereign States can handle and whose implementation usually requires the lifetime of more than one Government. Reform efforts should be geared to responding to the strategic imperatives of Palestinian national sovereignty, and not to reforming public institutions intended for a transitional phase. Efforts should be based on a national economic vision, with a view to creating the necessary institutions for achieving immediate and long-term development objectives.

34. More than at any time in the past, international aid is becoming a critical requisite for averting a humanitarian catastrophe. However, while the quantity of aid is important, it is the quality of aid that matters most. More aid is better if and only if it is non-distorting — that is, if it assists the recipient Government in implementing non-distorting policies or removing internal and/or external distorting constraints. Aid policies should be based on the Palestinian people’s vision of a future national economy, with a view to overcoming distorting constraints on development. This means that in order to be non-distorting, aid should seek to dismantle the policy of asymmetric containment or support specific strategies aimed at reducing Palestinian vulnerability to it. This includes supporting the PA budget and avoiding top-down approaches to aid disbursement, which involve replacing PA institutions with NGOs or private sector institutions. Otherwise, years of institution-building efforts will have been in vain and the prospects of establishing a viable Palestinian economy undermined. This renders technical assistance for institution building in the current conditions almost as imperative as humanitarian or budget support.

35. As the World Bank and UNOCHA have explained, in addition to dampening an already dwindling demand, further delays in covering the PA wage bill will deprive Palestinians of basic services because NGOs and private sector institutions lack the capacity to replace the PA. Donors are also warned that they are running the risk of dissolving Palestinian public institutions, fuelling insecurity and transforming the Palestinian civil service into a new category of social hardship cases. Already, PA employees have been included in food relief programmes by UNRWA and the WFP. Moreover, the banking sector is witnessing an unprecedented crisis in its relations with increasingly desperate clients, with several banks being forced to close some of their branches.

36. Finally, while the Quartet's TIM promises to avert a humanitarian catastrophe and growing insecurity, it is important that it remain **temporary**. It should not be institutionalized or become a permanent feature of aid disbursement, particularly in view of the already complex arrangement for aid coordination. It should remain **international** and not be internalized as a Palestinian reference framework for guiding fiscal decisions, nor should it serve as a substitute for Palestinian fiscal policymaking processes, as this will undermine the linking of relief to strategic development objectives. Also, it should remain a **mechanism** and not become a standing policy tool for conditioning donor aid to the Palestinian people.

Chapter IV

MILESTONES IN UNCTAD ASSISTANCE TO THE PALESTINIAN PEOPLE

37. Since 2001, UNCTAD's programme of technical assistance to the Palestinian people has been geared to addressing acute economic needs, while creating dynamic synergies between rehabilitation, reconstruction and long-term development objectives. This has been achieved by using research and analysis to inform decisions on the design and focus of technical assistance activities. This entails undertaking quantitative and qualitative analysis, including a review of successful development experiences, in the search for innovative solutions to the unique problems facing the Palestinian economy. The UNCTAD secretariat also uses technical assistance activities to ensure that its research work is in tune with the complex Palestinian reality and to promote consensus on pertinent issues.

38. In this context, and in close consultation with Palestine, UNCTAD has intensified its technical assistance activities to enable development gains to be accumulated at both programme and project levels. In so doing, the secretariat has also maintained close contacts with relevant international organizations, including the United Nations Development Programme (UNDP), the United Nations Relief and Works Agency for Palestine Refugees (UNRWA), the United Nations Special Coordinator for the Occupied Territories (UNSCO), the International Labour Office (ILO) and the World Bank, as well as research centres and civil society institutions.

39. The UNCTAD programme of technical assistance to the Palestinian people is divided into four clusters: (i) development strategies and trade policy; (ii) trade facilitation and logistics; (iii) public finance modernization and reform; and (iv) enterprise, investment and competition policy. Projects under each cluster are designed to serve the ultimate objectives of bolstering Palestinian institutional development and policymaking capacity, and contributing to the establishment of a pro-private sector environment.

40. The programme is managed by the Assistance to the Palestinian People Unit (APPU), which draws on the capacities and experience of the secretariat in carrying out its activities. The latter rely on voluntary contributions, provided by bilateral, multilateral and United Nations system funding sources. Moreover, and in accordance with paragraph 35 of the São Paulo Consensus, the secretariat has continued to make available temporary resources to retain the third professional staff member attached to APPU since 2001, thus enabling it to maintain intensified assistance in line with the Bangkok Plan of Action. The secretariat has further enhanced its selective and flexible operational mode in order to circumvent the adverse field conditions and to sustain steady progress in operational activities. As shown below, the year 2006 has witnessed the achievement of important milestones in a number of areas.

41. With the completion of technical assistance activities in the area of Palestinian Customs modernization (ASYCUDA-Phase II), funded by the European Commission (EC), the ASYCUDA++ prototype has been installed in the Customs headquarters and at three pilot sites. Moreover, the ASYCUDA team has been playing a central role in ensuring Palestinian Customs' responsiveness and preparedness for statehood. The team has continued to modify and adapt the prototype system to address emerging needs at the Rafah Border since November 2005. Outputs have included the following: (i) Special Procedures for Clearing Vehicles; (ii) Special Taxation Rules for Cigarettes and Samples; (iii) a Master Plan for

preparing Palestinian Customs to assume new responsibilities; (iv) procedures for establishing a trade corridor between the West Bank and Gaza Strip; (v) a Risk Management System for facilitating trade and enhancing security at the Al-Muntar/Karni crossing; and (vi) full online reporting on Customs clearance activities at the Rafah Border. Also, Customs revenue has been boosted by Rafah Border operations, which are expected to permit commercial traffic before the end of 2006.

42. However, exploitation of the ASYCUDA system to its full potential is undermined by newly emerging resource constraints. The Phase III project, which will see the system's complete rollout, remains unfunded as of mid-2006; and the cohesion of the ASYCUDA national team and the momentum of work are increasingly uncertain. Further delays in addressing the resource gap risk undermining Palestinian Customs operations, at a time when it is becoming a critical element of Palestinian readiness to assume sovereign responsibilities at main border and crossing points.

43. Steady progress has also been made in the area of *trade facilitation and logistics* within the context of the EC-funded *Establishment of the Palestinian Shippers Council* (PSC) project. The PSC has been officially launched, with the establishment of two regional offices in the West Bank and Gaza, to address the urgent needs generated by the protracted conflict and to support Palestinian long-term trade development efforts. Moreover, a Preparatory Committee bringing together traders from the West Bank and Gaza was created to guide the project and ensure national ownership at an early stage. In addition, the secretariat fielded an UNCTAD expert team mission in April to conduct induction workshops and to assist the PSC in developing its organizational structure and designing its services.

44. To date, the PSC has attracted over 30 founding members from across the Palestinian territory. Its list of achievements include the launching of a quarterly newsletter and its regularly updated website (www.psc.ps), dissemination of trade-related information to its members and the establishment of working relations with relevant local, regional and international private and public organizations. The PSC has also addressed problems reported by members and has already secured extra free storage days for Palestinian goods from Israeli port operators.

45. The secretariat has achieved another milestone in the area of *development strategies* and *trade policy* with the completion of activities under the *Integrated framework for Palestinian macroeconomic, trade and labour policy* project, funded by the International Development Research Center (IDRC) of Canada. Palestinian capacity has been developed and the integrated simulation framework has been installed in several PA ministries as well as in the Palestinian Monetary Authority, the Palestinian Central Bureau of Statistics and the Palestinian Economic Policy Research Institute (MAS). A comprehensive economic-demographic database was also developed, together with analyses of alternative policy options. Follow-up activities in May included a training workshop for Palestinian professionals on economic modelling and policy assessment, and a general meeting with Palestinian stakeholders and donors to discuss the results of the project. Two research publications emanating from the project will be published in late 2006.

46. Technical assistance activities in the area of *public finance reform and modernization* have proceeded under the *Capacities in Debt Monitoring and Financial Analysis (DMFAS)* project, which is funded by the Government of Norway. This involves

building Palestinian policy capacity in the area of debt, public finance and medium-term planning.

47. In addition to the *Preparations for ASYCUDA project*, *EMPRETEC Palestine* is another example of how the lack of funds threatens to reverse years of institution building, even in the private sector. Relaunched in 2005, the programme focuses on supporting small and medium-size enterprises by building institutional capacity for establishing a dynamic private sector and internationally competitive SMEs. To date, it has graduated 123 EMPRETECOs, 16 per cent of whom are women, representing leading industries and services across the West Bank. Moreover, 10 EMPRETECOs have started their own businesses and 13 have expanded or reopened existing operations. Of these, three succeeded in obtaining bank loans. The project was maintained throughout the period from April 2005 to June 2006 with funding by the ILO through the Palestinian Fund for Employment and Social Protection (PFESP). However, funding shortfalls in 2006 have obliged the secretariat to suspend project activities again, especially Phase II, which involves extending *EMPRETEC Palestine* to Gaza.

48. The secretariat may soon also have to curtail activities under the Investment Retention Programme, which was launched in 2004 with funds from the Government of Norway and will be completed in 2006. Efforts are now focused on using the results of a 2005 needs assessment survey to complete a Palestinian investment retention strategy in cooperation with the Palestinian Investment Promotion Agency (PIPA). However, plans to design sector-based investment promotion programmes under a Phase II proposal are impaired by funding shortfalls.

49. UNCTAD’s ability to ensure a proper response to emerging Palestinian needs remains hampered by Israeli restrictions on mobility and by UN security guidelines affecting field access of UNCTAD staff members, experts and project personnel. Programme sustainability in volatile conditions is particularly undermined by the lack of predictable extrabudgetary resources. To date, and despite the secretariat's appeals to the donor community, several projects remain unfunded. This shortfall comes at a time when UNCTAD projects are demonstrating their growing relevance and are establishing themselves as important tools for linking relief to development.

Notes

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

[2] This report draws inter alia on data from the Palestinian Central Bureau of Statistics (PCBS), the United Nations Office for Coordination of Humanitarian Affairs (UNOCHA), the United Nations Special Coordinator in the Occupied Territory (UNSCO) and World Bank publications from 2005 and 2006 that are not specifically sourced owing to UN documentation length limits.

[3] Commercial banks operating in the Palestinian territory have been warned that transferring funds to the PA could subject them to legal liability under the United States' anti-terror legislation.

[4] The previous MTDP covers the period 2005–2007, and has been updated to address the new realities of 2005/2006.

[5] World Bank. *Working in an Integrated World: World Bank Development Report*. New York, Oxford University Press, 1985; De Soto, H. *The Other Path*. New York, Harper & Row, 1989; De Soto, H. *The Mystery of Capital*. New York, Basic Books, 2000; Portes, A and Haller, W. *The Informal Economy*. Working Paper 03-05, Center for Migration and Development, Princeton University, Princeton, 2002.

[6] Chen, M, Jhabvalva, R and Lund, F. *Supporting Workers in the Informal Economy: A Policy Framework*. International Labour Organization, Geneva , 2002.

[7] *The Palestinian War-Torn Economy: Aid, Development and State Formation*. UNCTAD/GDS/APP/2006/1, New York and Geneva, 2006.

[8] Addison, T and Mansoob Murshed, S. The Fiscal Dimensions of Conflict and Reconstruction. Helsinki, Finland, World Institute for Development Economics Research, 2000.

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