Development Under Adversity
The Palestinian Economy in Transition

SUMMARY

Edited by
Ishac Diwan and
Radwan A. Shaban
Development Under Adversity
The Palestinian Economy in Transition

SUMMARY

Edited by
Ishac Diwan and
Radwan A. Shaban

Palestine Economic Policy Research Institute (MAS)
and the World Bank
Acknowledgments

This report is produced jointly by the Palestine Economic Policy Research Institute (MAS) and the World Bank. The report has been written by the following core team:

MAS
Radwan Shaban, Task Manager
Osama Hamed

World Bank
Ishac Diwan, Task Manager
Ali Khadr

Martha Sipple was the editor, Isabelle Schnadig provided data support, and photography was provided by Miriam Sushman.

The report has relied extensively on studies carried out by MAS and the World Bank. The core team was assisted by specialists in the WBGS and abroad, many of whom prepared background papers for this report. Research for this report has relied extensively on analysis of raw data sets of labor force, expenditure, and demographic surveys carried out and made available to us by the Palestinian Central Bureau of Statistics.

The Palestine Economic Policy Research Institute, or Mahad Abhath As-Syasat Al-Iqusiyyeh Al Filistiyn (MAS), is an autonomous national research institute established in May 1994 to engage in applied economic research and provide expert analysis of policies and strategies critical to the development of the Palestinian economy. Research output has included numerous publications on banking and monetary policy, fiscal policy, trade policy, poverty, social security, industrial development, general development, and analysis of statistics. MAS hosts conferences and workshops to encourage debate on economic policy issues. A full-time unit continuously monitors economic conditions and publishes regular reports in the MAS Economic Monitor. Data provided by MAS on the various areas of the Palestinian economy are used extensively in this report. For more information on the activities of MAS, visit the website at www.palecon.org.

Cover photos: Students at Al Rabid primary school in Shlet Radwan, Gaza City; and workers passing through Erez checkpoint.
Contents

Acknowledgments ii
Definitions and Terms v
Introduction 1

Recent Economic Record: Frustrated Development and an Economy Increasingly Below Its Potential 2
  High and Increasing Levels of Poverty 2
  Excessively High and Widely Fluctuating Unemployment Rates 3
Border Closure and Permit Policies 4
  Permanently More Costly Transactions at the Border with Israel 4
  Permit Policy: Sharp Deterioration in Employment in Israel 5
  Unpredictable Border Closure Policy 5
Larger Public Sector and Lower Private Sector Activity 7
Liabilities Depressing the Palestinian Economy 8
  Legacy of a Long Occupation 8
  The Infrastructure Gap 9
  Increased Uncertainty in the Interim Period 9
Structural Assets 10

Strategic Choices Facing the Palestinian Economy 13
Economic Structure and International Relations 13
  Free Access: Moving People and Goods 13
  Trade Policy Options 14
An Efficient and Compassionate State 16
  A Better Civil Service 16
  Raising Revenues and Avoiding Fiscal Deficits 17
  Effective Stabilization Policies 19
Taking Advantage of Social Capital and New Technologies 20
  Legal Framework 20
  Partnerships with NGOs 21
  Private Delivery of Infrastructure 21
  Leveraging Human Capital through Information Technology 22

A Sectoral View: Policies to Generate Growth 23
Private Sector Development 23
  Agriculture and Industry 23
  Housing 24
Tourism: Constraints Amidst Potential 25
# Definitions and Terms

## Acronyms and Initials

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG</td>
<td>Consultative Group on the West Bank and Gaza Strip</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FTAs</td>
<td>Free trade agreements</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross domestic product</td>
</tr>
<tr>
<td>GIE</td>
<td>Gaza Industrial Estate</td>
</tr>
<tr>
<td>GNP</td>
<td>Gross national product</td>
</tr>
<tr>
<td>ICA</td>
<td>Israeli Civil Administration</td>
</tr>
<tr>
<td>ICBS</td>
<td>Israeli Central Bureau of Statistics</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle East and North Africa region</td>
</tr>
<tr>
<td>MIGA</td>
<td>World Bank’s Multilateral Investment Guarantee Agency</td>
</tr>
<tr>
<td>NGOs</td>
<td>Non-governmental organizations</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OPIC</td>
<td>Overseas Private Investment Corporation</td>
</tr>
<tr>
<td>PA</td>
<td>Palestinian Authority</td>
</tr>
<tr>
<td>PADICO</td>
<td>Palestinian Development International Company</td>
</tr>
<tr>
<td>Paltel</td>
<td>Palestinian Telecommunications Company</td>
</tr>
<tr>
<td>PCBS</td>
<td>Palestinian Central Bureau of Statistics</td>
</tr>
<tr>
<td>PEA</td>
<td>Palestinian Electricity Authority</td>
</tr>
<tr>
<td>PLO</td>
<td>Palestinian Liberation Organization</td>
</tr>
<tr>
<td>PMA</td>
<td>Palestinian Monetary Authority</td>
</tr>
<tr>
<td>PPP</td>
<td>Purchasing power parity</td>
</tr>
<tr>
<td>RWB</td>
<td>Remaining West Bank excluding East Jerusalem</td>
</tr>
<tr>
<td>RWBGS</td>
<td>Rest of West Bank and Gaza Strip excluding East Jerusalem</td>
</tr>
<tr>
<td>UNRWA</td>
<td>United Nations Relief and Works Agency</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>VAT</td>
<td>Value-added tax</td>
</tr>
<tr>
<td>WBGGS</td>
<td>West Bank and Gaza Strip</td>
</tr>
</tbody>
</table>

## Weights and Measures

<table>
<thead>
<tr>
<th>Unit</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BCM</td>
<td>Billion cubic meters</td>
</tr>
<tr>
<td>DWT</td>
<td>Deadweight tonnage</td>
</tr>
<tr>
<td>kg</td>
<td>Kilogram</td>
</tr>
<tr>
<td>km</td>
<td>Kilometer</td>
</tr>
<tr>
<td>MCM</td>
<td>Million cubic meters</td>
</tr>
<tr>
<td>Mw</td>
<td>Megawatts</td>
</tr>
</tbody>
</table>

## Currency

<table>
<thead>
<tr>
<th>Currency</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>JD</td>
<td>Jordanian dinar</td>
</tr>
<tr>
<td>NIS</td>
<td>New Israeli shekel</td>
</tr>
<tr>
<td>US$</td>
<td>United States dollar</td>
</tr>
</tbody>
</table>

*All dollar figures are expressed in current US dollars unless otherwise specified.*

## Agreements

<table>
<thead>
<tr>
<th>Agreement</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annex 5</td>
<td>Economic Annex to the Interim Agreement</td>
</tr>
<tr>
<td>Declaration of Principles</td>
<td>Israeli-Palestinian Declaration of Principles on Interim Self-Government Arrangements</td>
</tr>
<tr>
<td>Cairo Agreement</td>
<td>Agreement on the Gaza Strip and the Jericho Area</td>
</tr>
<tr>
<td>Early Empowerment Agreement</td>
<td>Agreement on Preparatory Transfer of Powers and Responsibilities</td>
</tr>
<tr>
<td>Economic Protocol</td>
<td>Protocol of Economic Relations</td>
</tr>
<tr>
<td>Gaza-Jericho Agreement</td>
<td>Agreement on the Gaza Strip and the Jericho Area</td>
</tr>
<tr>
<td>Hebron Protocol</td>
<td>Protocol Concerning the Redeployment in Hebron</td>
</tr>
<tr>
<td>Interim Agreement</td>
<td>Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip</td>
</tr>
<tr>
<td>Oslo Agreement</td>
<td>Israeli-Palestinian Declaration of Principles on Interim Self-Government Arrangements</td>
</tr>
<tr>
<td>Oslo II Agreement</td>
<td>Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip</td>
</tr>
<tr>
<td>Paris Protocol</td>
<td>Protocol of Economic Relations</td>
</tr>
<tr>
<td>Taba Agreement</td>
<td>Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip</td>
</tr>
</tbody>
</table>
Introduction

This is an executive summary of a book that analyzes some key strategic choices facing the emerging Palestinian economy in the short and medium terms. The book reviews economic developments since the 1993 signing of the Declaration of Principles on Interim Self-Government Arrangements (Declaration of Principles or Oslo Agreement), identifies the underlying structural assets and liabilities of the economy, and explores options that would allow the economy to capitalize on its potential assets and reduce the negative impact of its areas of weakness.

Since the signing of the Oslo Agreement, the economic situation has continued to deteriorate. The decline in household incomes, a sharp increase in unemployment, and the general broadening of poverty pose serious challenges for economic sustainability. Given the loss of jobs abroad, the most pressing economic challenges are to remove some of the constraints facing domestic production. Ultimately, an advantageous resolution of political uncertainties—control of borders, access to natural resources, and management of territory—is necessary for the economy to embark on a path of strong and sustained growth. But there are policies that can be implemented immediately which would generate noticeable economic improvements in the short and medium terms.

The book outlines three specific areas of policy change that can foster stabilization and encourage growth in the Palestinian economy in spite of existing political difficulties: (i) freeing access to external markets, the opening of new trade channels to the world, and diversifying away from disproportionate reliance on Israel in trade and delivery of services; (ii) creating a governance system with an efficient civil service, minimal fiscal deficits and suitable tools for stabilizing the economy; and (iii) taking advantage of a dynamic private sector and resourceful non-governmental organizations (NGOs) in the delivery of health, education, welfare, and infrastructure services.

The donor community can help greatly in implementing such a development framework with support for investment projects, especially those that facilitate free and diversified access to outside markets; support the move toward a lean and efficient governance system; and encourage all the parties to overcome the obstacles to development.
Recent Economic Record: Frustrated Development and an Economy Increasingly Below Its Potential

The Palestinian economy is increasingly less able to sustain jobs and incomes for its people. In contrast to the initial rosy economic scenarios that were projected early in the peace process and despite the assistance of the international donor community, the standard of living has continued to fall in the midst of massive unemployment and rising poverty.

The central story of the West Bank and Gaza Strip (WBGS) economy in the past few years is one of deterioration, even though positive developments have also occurred since 1993 with the transfer of some areas of authority to the Palestinian Authority (PA). Positive developments include the setup of a functioning civil service that has managed to collect taxes and deliver services in various fields such as health, education, and public utilities, along with efforts to develop and enforce the legal system. In response to removal of the regulatory restrictions, the banking system has managed to grow rapidly and collect a substantial amount of deposits within a few years.

However, the overall deterioration is reflected in lower income levels, greater unemployment, and increased poverty (Figure 1). It is difficult to trace the exact transformations of the economy because macroeconomic data are not available for the period 1995–97. However, the newly established Palestinian Central Bureau of Statistics (PCBS) has collected data at the household level that allows us to trace economic outcomes. Based on analysis of the Palestinian Expenditure Consumption Survey that was carried out in 12 rounds over the period October 1995–September 1996 on 4,800 households, the average per capita consumption expenditure in the WBGS was $1,431 annually ($1,519 in the West Bank and $1,214 in Gaza Strip) during the last three months of 1995. In comparison to private consumption expenditure obtained from Israeli national accounts, real per capita average expenditure in the 1995–96 survey period is about 15 percent below its average for the years 1992–93. The post-Oslo period of border closures comes on the heels of large negative shocks generated by the Intifada after 1988 and the Gulf War in 1990–91; as a result, real per capita expenditure has continued to deteriorate over more than a decade, and is now at its lowest level for any year since 1980.

High and Increasing Levels of Poverty
Given a poverty level of $650 per capita annually (less than $2 per day), approximately one-fifth of the WBGS population was poor at the end of 1995. The incidence of poverty is greater in Gaza Strip, where more than 36.3 percent of the population was poor at the end of 1995. Since 1995, the situation seems to have deteriorated considerably with harsher labor market conditions having a direct impact on poverty.

Figure 1. Collapse of Living Standards in the WBGS

<table>
<thead>
<tr>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
</tr>
<tr>
<td>Poverty rate (end 1995)</td>
</tr>
<tr>
<td>Unemployment rate (spring 1996)</td>
</tr>
<tr>
<td>Decline in Palestinian employment in Israel</td>
</tr>
<tr>
<td>Decline in per capita real consumption (1992–96)</td>
</tr>
</tbody>
</table>

Source: Diwan and Shaban (1998) and based on PCBS data.
Recent Economic Record: Frustrated Development and an Economy Increasingly Below its Potential

The profile of poverty reveals the nature of hardship. An average family with a regularly employed person at the going wage rate should be able to avoid poverty. The high incidence of poverty is rooted in rising unemployment and the repeated and severe shocks from border closures. The closures prevent workers from reaching their jobs and inhibit private sector expansion and job creation. Poverty is more widespread among those living in refugee camps. The refugee camp rate of poverty at the end of 1995 was 31 percent compared to 17 percent for urban and rural households. Refugee camp households rely on labor earnings as the major source of livelihood, and thus, are more severely affected by labor market shocks and downturns.

Excessively High and Widely Fluctuating Unemployment Rates

The hope of the official actors in the peace era was that domestic job creation by an export-oriented private sector would expand domestic employment quickly, transforming the Palestinian economy from labor-exporting to commodity-exporting. However, political factors in the post-Oslo period have suffocated export-oriented private sector development. When the closure policy is implemented, Palestinians workers, businessmen, and merchandise can be delayed suddenly and for long periods at the border. Palestinian employment in Israel has declined continuously since 1992 in response to the permit and closure policies. At the same time, employment of non-Palestinian foreigners from East European and South Asian countries in Israel has increased substantially (Figure 2). While this substitution has reduced the impact of the loss of Palestinian workers to Israeli employers, overall employment opportunities have not expanded over such a short-time period to create jobs for the displaced workers. As a result, unemployment has increased to very high levels, and Palestinian employment opportunities in Israel have been permanently reduced.

According to the two labor force sample surveys, the PCBS estimates that the rate of unemployment was 18.2 percent in September–October 1995 and 28.4 percent in April–May 1996. Given the strict definition of unemployment used by the PCBS and in the absence of any unemployment insurance, these rates are extremely high. Even with such a strict definition, the unemployment rate in the WBGS is higher than all 57 economies analyzed in the World Bank's World Development Report 1995.

Out of roughly one-half million workers in the labor force, 92,000 were unemployed in September–October 1995 and 149,000 in the April–May 1996. Notably, the magnitude of unemployment fluctuates widely over a

Figure 2. Substitution of Palestinian Workers with Foreign Workers in Israel

<table>
<thead>
<tr>
<th>Number of workers in thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>1990</td>
</tr>
<tr>
<td>1991</td>
</tr>
<tr>
<td>1992</td>
</tr>
<tr>
<td>1993</td>
</tr>
<tr>
<td>1994</td>
</tr>
<tr>
<td>1995</td>
</tr>
<tr>
<td>1996</td>
</tr>
</tbody>
</table>

Note: Number of foreign workers refers to permits issued and is obtained from the Israeli Ministry of Labor.

Figure 3. Index of Average Weekly Hours of the Labor Force, 1980–96

<table>
<thead>
<tr>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>110</td>
</tr>
<tr>
<td>100</td>
</tr>
<tr>
<td>90</td>
</tr>
<tr>
<td>80</td>
</tr>
<tr>
<td>70</td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td>50</td>
</tr>
</tbody>
</table>

Note: Index for 1980 is set to 100. Average weekly hours of labor force in 1980 was 43.3 in the West Bank and 43.7 in Gaza Strip.
Source: 1980–94 data are based on ICBS; 1994 data were not collected in Gaza Strip; and 1995–96 data refer to fall and spring of these years, respectively, and are based on PCBS.
short-time period. Various PCBS surveys indicate that, on average, approximately 20 percent of the labor force is unemployed during "normal" periods. However, this rate suddenly jumps to 30 percent during border closures when Palestinian workers are prevented from reaching their jobs in Israel. In the Gaza Strip, these rates are even higher during periods of border closure.

A high rate of unemployment is usually associated with substantial underemployment of labor resources. To assess the quantitative underutilization of labor, we constructed an index of the average weekly hours worked by the average person in the labor force. The index captures both open unemployment and underemployment of the existing labor force. Due to the predominance of part-time jobs and the disruptions caused by closures, curfews, and strikes, the index turns out to be much more revealing than the straight unemployment figures. This index is set at 100 for 1980 (corresponding to 43.3 hours in the West Bank and 43.7 hours in Gaza Strip).

Figure 3 illustrates the decline in average hours worked for the 1980–96 period. The economy was operating close to full employment in the early 1980s, exporting workers to Israel and the Gulf countries. Then, an unstable environment during the Intifada led to a drop of the index to 72 in 1988, implying that 28 percent of existing labor force potential was not utilized. The index improved in the early 1990s but then dropped unambiguously over 1992–96. By spring 1996, only 63 percent of the West Bank and a mere 55 percent of Gaza Strip's available labor force potential was utilized.

**Border Closure and Permit Policies**

The permit and closure policies that Israel has implemented since 1993 constitute a major new constraint and challenge to economic development in the WBGS. Economic losses from the resulting interruptions to labor and trade flows with Israel have been very large, and have contributed substantially to a reduction in the standard of living, and an increase in unemployment and poverty.

Since 1993, security checkpoints have been created along the borders separating Israel and East Jerusalem from the remaining West Bank (RWB) and Gaza Strip. Permits are required by all Palestinians who cross these borders, whether to work in, travel to, or move through Israel and East Jerusalem. The border checkpoints have considerably slowed the mobility of goods and people and have increased transaction costs. Israel has closed various borders—between the West Bank and Gaza Strip, between the West Bank or Gaza Strip and Israel or the rest of the world, and between various cities of the West Bank—for varying lengths of time. These policies have been particularly costly to the Palestinian economy given its deep integration with the Israeli economy since the 1967 occupation.

*Permanently More Costly Transactions at the Border with Israel*

The erection of border controls in 1993 and introduction of the permit system for Palestinians sub-
Substantially restricted and increased the cost of mobility of Palestinian workers and goods across borders with Israel, increasing delivery costs, interrupting the production process, and increasing production and operation costs. During the three decades of occupation, the WBGS developed economic structures based largely on open labor and goods markets. The initial situation in 1992, before the imposition of the permit policy, reflects these economic structures: one-third of the labor force was employed in Israel, 90 percent of imports came from or through Israel, and 80 percent of exports went to or through Israel. Given these conditions, the sudden and sharp reversal of "openness" and the accompanying very high transaction costs have had a major negative impact on the economy.

Permit Policy: Sharp Deterioration in Employment in Israel

The number of permits issued by Israel to Palestinians has declined and workers have often been unable to use these permits during periods of border closure. As a result, Palestinian employment in Israel declined from an annual average of 116,000 in 1992 to 28,100 in 1996. The Israeli economy has been adjusting by importing workers from East European and South Asian countries in such numbers as to substantially replace Palestinian workers. This could imply a permanent loss of employment opportunities in Israel even if the political situation permits a larger number of Palestinians to seek such employment. Palestinian earnings from work in Israel collapsed from an estimated 25 percent of GNP in 1992 to 8 percent in 1995, and to 6 percent in 1996 (Figure 4).

Unpredictable Border Closure Policy

The shocks from the border closure policy have occurred with increasing frequency (Figure 5) and uncertain duration, causing additional loss of labor income, increased unemployment, declining sales and profitability, loss of perishable goods and services, and creating incentives to adjust toward lower value-added activities. Officially, these closures are related to security concerns, but their economic cost, both direct and indirect, is devastating, thereby potentially creating a bigger security threat in the future. Farmers who converted large land areas to higher value products (i.e., strawberries and carnations in Gaza Strip for Israeli and European markets) were hit hard during border closures due to spoilage. They are now converting back their production to lower-value crops that are in higher demand domestically or more easily stored. Firms that export—to Israel, the West Bank, the Gaza Strip, Jordan, or the rest of the world—or rely on imported inputs, face reduced production and find it hard to survive in the confines of a minuscule market.

Figure 4. Evolution of the Percentage of Palestinian Labor Force Employed in Israel and Net Worker Remittances as Percentage of GNP

<table>
<thead>
<tr>
<th>Employment in Israel as percentage of Palestinian labor force</th>
<th>Worker remittances as percentage of GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>35</td>
</tr>
<tr>
<td>1991</td>
<td>30</td>
</tr>
<tr>
<td>1992</td>
<td>25</td>
</tr>
<tr>
<td>1993</td>
<td>20</td>
</tr>
<tr>
<td>1994</td>
<td>15</td>
</tr>
<tr>
<td>1995</td>
<td>10</td>
</tr>
<tr>
<td>1996</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: ICBS and World Bank.

Figure 5. Increasing Incidence of Border Closure

Percentage of closure days per year

Source: Based on data in chapter 4, Diwan and Shaban (1998).
Box 1. Cost of Border Closure and Permit Policies

The estimated losses to the WBGS economy arise from (i) the direct loss of income by Palestinian workers in Israel; (ii) the indirect impact of reduced expenditure on total production and income through the multiplier effect; and (iii) the disruption to trade leading to long-term losses in export markets and interruptions to the flow of imports, thereby disrupting domestic production and supply.

The most immediate macroeconomic impact of closure is the loss of earnings by Palestinians working in Israel, which is counted in the aggregate demand under "foreign income from abroad." The depressive wider impact of this income loss depends on the extent to which households smooth their consumption over time, which depends on their perception of how transitory or permanent the income loss is. This analysis assumes that consumption adjusts by half as much as the income loss. The reduction in consumption expenditure depresses aggregate demand (production and income), an effect that is known as the multiplier effect of the initial reduction in expenditure. Based on previous analysis of Palestinian consumption behavior and aggregate demand, the multiplier size is taken to be 3 in this exercise.

In addition to the direct and indirect impact of income losses of those working in Israel, the Palestinian economy suffers from trade disruptions, which could lead to loss of export markets and disruption in the domestic supply of goods and services linked to imports. Limitation of information and data make it difficult to estimate the losses resulting from trade. For purposes of this estimation, it is assumed that such losses equal 10 percent of the value of exports and 5 percent of the value of imports during the period of closure. The magnitude of economic losses from closure depends on the benchmark against which the economy is compared. Here, we estimate loss relative to a situation characterized by the labor and trade flows prevailing in 1992, prior to the imposition of permit and border closure policies. Computation of the cost of closure is shown in the table below.

<table>
<thead>
<tr>
<th>Total Cost of Border Closure and Permit Policies, 1993–96</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>GNP (in millions of dollars at 1995 prices)</td>
</tr>
<tr>
<td>Closure days/year</td>
</tr>
<tr>
<td>Percentage of days under closure</td>
</tr>
<tr>
<td>Losses (millions of dollars at 1995 prices)</td>
</tr>
<tr>
<td>Losses (percent of GNP) due to closure and permit policies</td>
</tr>
</tbody>
</table>

Source: Authors' computation, see Diwan and Shaban (1998), chapter 4 for details.

Infrastructure projects and large investments that require imported inputs have been severely slowed down. Recently, there has been an escalation in the use of closures for political motives. In August 1997, following the explosion of two suicide bombs in Jerusalem, Israel resorted not only to labor and goods closures, but also withheld tax clearances due to the PA, making a return to "normality" contingent on certain political conditions. The PA responded by banning the import of certain "non-essential" goods from Israel (the WBGS is the second largest export market for Israeli goods after the United States).

The economic cost of decreased and interrupted mobility of workers and goods is a concept difficult to define precisely, and even more difficult to esti-

Workers loading and unloading goods at Al Muniar (or Karmi) crossing. The back-to-back system may require goods moving between the West Bank and Gaza Strip to be loaded on three separate trucks for a journey of less than 100 miles.
Recent Economic Record: Frustrated Development and an Economy Increasingly Below Its Potential

Empirically, our estimate takes into account the loss of labor income as a result of reduced Palestinian employment in Israel and builds in a very rough measure of the indirect impact through lower spending levels of households, and the costs to businesses from interruptions in the flow of exports and imports at the border. The combined cost of the permit and border closure policies is estimated at about $850 million in 1995 and $1 billion in 1996 (in 1995 prices and compared with the situation prevailing in 1992) (Box 1).

Over the period 1993–96, total costs of permit and border closure policies are estimated at about $2.8 billion, about the size of one year’s GDP, and nearly twice the sum of disbursed donor aid over the same period.

LARGER PUBLIC SECTOR AND LOWER PRIVATE SECTOR ACTIVITY

Despite early emphasis in the peace process on the importance of export-oriented private sector growth, the recent record demonstrates a weakening role of the private sector. The establishment of PA institutions and pressures to solve the high unemployment problem through public sector employment have resulted in a rapid expansion of the public sector.

The private sector has sustained the greatest losses from the labor and trade cut-offs as a result of permit and closure policies. Even with a significantly expanded financial and banking sector, the private sector as a whole has declined. Private investment has slowed down, and domestic production and export have not fully offset the drop in employment in Israel. This unfavorable development is largely related to the atmosphere of uncertainty created by the closures. Businesses have been hurt by the general reduction in aggregate demand and the increased difficulty in trade and finance. Closures have not only depressed overall investment, but have also led to a reduction in the overall efficiency of investment as production activity becomes increasingly autarkic, using local inputs to produce goods for the local market.

At the same time, the public sector has grown dramatically, with growth dominated by hiring personnel rather than investing in infrastructure projects. Government recurrent expenditures nearly tripled between 1993 and 1996, jumping from $258 million to $779 million. The number of civil servants more than tripled, from 22,000 to 75,000 over the same period. Yet, infrastructure investment amounted to less than $70 million per year, i.e., less than 2 percent of GDP per year, which was much less than originally anticipated. On average, developing countries invest 4 percent of GDP in infrastructure, with a high of 6 to 8 percent of GDP in the rapidly growing economies of East Asia. Clearly, the present levels are low by international standards and, if not stepped up, will severely constrain future economic growth. The pressure to hire may be understandable given the massive unemployment situation, but it is also unsustainable and could generate a low-paid and inefficient public sector that risks becoming a burden on the economy for years to come. A strategy that places little in public investment and supports a larger-than-needed civil service in the midst of a weakened private sector, not only fails to invest in the future, but also taxes future growth.

Growth in the public sector was made possible with access to two new sources of funds: donor aid and tax clearances. Over 1994–96, $1.5 billion in donor aid was disbursed, mainly channeled through the public sector. Of these funds, $450 million was allocated for budgetary and transitional support of the PA. The tax-revenue clearances on cross-border transactions amounted to $25 million in 1994, $267 million in
LIABILITIES DEPRESSING THE PALESTINIAN ECONOMY

In addition to the negative shocks of permit and closure policies, the Palestinian economy must grapple with important structural weaknesses related to a history of occupation and a future ridden with uncertainties. In particular, the under-development of the physical infrastructure keeps labor productivity down; and the uncertainty related to the continuing conflict with Israel over land and sovereignty further depresses private activity. The Economic Protocol has reduced—but not eliminated—the fiscal leakage through a system of clearance of VAT and excise taxes, after Israel deducts a 3 percent administrative fee.

Legacy of a Long Occupation
Domestic production in the WBGS has been weak, and the economy generally relied on exporting its workers to Israel and the Gulf countries during the 1970s and 1980s. The number of Palestinian workers employed in the WBGS in the mid-1980s was at the same level a decade and half earlier, despite rapid increases in the size of the labor force over the period. Structural weaknesses in the Palestinian economy arose from four key factors that remain serious constraints to future growth and job creation.

- Asymmetric market relations with Israel. Manual labor and manufacturers had fairly free access to Israel, as did skilled labor elsewhere; but the expansion of agriculture and manufacturing were restricted. All goods had limited access to much of the region due to restrictions on trade with Jordan, practical difficulties in trading through Israel, and inadequate infrastructure. There were no restrictions on imports from Israel; but for imports from the rest of the world, the economy operated under the Israeli trade regime that was extremely protectionist until the mid-1980s.
- Expansion of the private sector, particularly medium and large firms, has been held back by regulatory restrictions—especially investment approvals required by the Israeli Civil Administration (ICA), an uncertain legal and tax framework, and political
The formal financial system was literally shut down until it reopened in 1993. These conditions have caused a bias toward the export of labor.

- **Fiscal compression and institutional under-development** have led to the under-provision of public goods. Spending on public goods has been low due to low tax receipts, a close-to-balanced budget practice by the ICA and municipalities, and the inability of utilities to borrow to invest (in contrast to international practice). Public sector revenues were low at 16 percent of GDP—partly because a portion of Palestinian tax payments, perhaps as much as 10 percent of GDP, accrued to the Israeli treasury.

- **Restrictions on access to natural resources.** Administrative limitations on surface and aquifer water harvesting have meant stagnation in water usage for Palestinian agriculture. During the 1980s and early 1990s, agricultural production was also hampered by the loss of land to settlements and to urbanization in the Jordan Valley—traditionally and currently irrigated lands. The lack of clear zoning regulations and public land utilization policy has created a barrier to industrial expansion.

### The Infrastructure Gap

Compared to other countries at similar levels of income, the provision of infrastructure services is seriously deficient in the WBGS (Table 1) due to years of neglect and under-investment.

- **Transport.** Virtually all the major roads were constructed before 1967 and have received minimal or no maintenance. International transportation (ports and airports) are entirely under Israeli control.

- **Electricity.** Per capita supply is significantly lower than for other countries in the region. Supply is almost entirely supplied by the Israel Electric Company and there are very large system losses as the assets have been allowed to depreciate.

- **Telecommunications.** There are just over three fixed phones for every 100 persons and one mobile phone for 100 persons. All neighboring countries, including Egypt, have a higher phone penetration ratio.

- **Water.** Water consumption per head is much lower than in neighboring countries, and water quality has been deteriorating. With depleting aquifers, sea water seepage in the Gaza Strip has rendered the water brackish. Water supply is substantially dependent upon the Israeli company, Mekoroth.

- **Sanitation.** Only 25 percent of households are connected to sewerage networks. Collection, treatment, and disposal of sewage are growing problems. The networks, where they exist, are under great strain and a major health hazard.

### Increased Uncertainty in the Interim Period

It is difficult to do business in the WBGS. Instead of the regulatory restrictions that stilled investment under occupation, a multidimensional uncertainty seems to be discouraging private investors in the current phase.

- **Unclear responsibilities.** The transitional arrangement has created an awkward mismatch between responsibility and authority for the PA. The PA has taken

### Table 1. Comparing Infrastructure Services in the WBGS

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (million)</th>
<th>Per capita income (US $)</th>
<th>Electric supply (kw per 100 people)</th>
<th>Electric power system losses (percent)</th>
<th>Households with sanitation (percent)</th>
<th>Number of phones (per 100 people)</th>
<th>Meters of paved roads (per 100 people)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>55.0</td>
<td>650</td>
<td>21.0</td>
<td>14.0</td>
<td>50</td>
<td>4.3</td>
<td>59</td>
</tr>
<tr>
<td>Jordan</td>
<td>3.9</td>
<td>1,120</td>
<td>25.0</td>
<td>19.0</td>
<td>100</td>
<td>7.0</td>
<td>170</td>
</tr>
<tr>
<td>WBGS</td>
<td>2.4</td>
<td>1,450</td>
<td>13.0</td>
<td>30.0</td>
<td>25</td>
<td>3.1</td>
<td>80</td>
</tr>
<tr>
<td>Lebanon</td>
<td>4.0</td>
<td>2,500</td>
<td>32.0</td>
<td>n.a</td>
<td>n.a</td>
<td>9.3</td>
<td>n.a</td>
</tr>
<tr>
<td>Syria</td>
<td>13.0</td>
<td>2,800</td>
<td>30.0</td>
<td>n.a</td>
<td>63</td>
<td>4.1</td>
<td>180</td>
</tr>
<tr>
<td>Israel</td>
<td>5.1</td>
<td>13,500</td>
<td>82.0</td>
<td>4.0</td>
<td>100</td>
<td>37.1</td>
<td>266</td>
</tr>
<tr>
<td>Mauritius</td>
<td>1.1</td>
<td>2700</td>
<td>33</td>
<td>14</td>
<td>100</td>
<td>9.6</td>
<td>190</td>
</tr>
<tr>
<td>LMICS&lt;sup&gt;a&lt;/sup&gt;</td>
<td>1,132.6</td>
<td>1,620</td>
<td>21.3</td>
<td>12.4</td>
<td>—</td>
<td>7.9</td>
<td>—</td>
</tr>
<tr>
<td>OECD</td>
<td>—</td>
<td>19,710</td>
<td>82.6</td>
<td>7.3</td>
<td>—</td>
<td>45.1</td>
<td>—</td>
</tr>
</tbody>
</table>

<sup>a</sup> Lower middle income countries.

Development Under Adversity: The Palestinian Economy in Transition

over important legislative and administrative responsibilities, but overall security and foreign relations are entirely under Israeli control. While the PA can license a business in the West Bank or Gaza Strip, it is Israel that largely controls the movement of goods and people, including workers and managers.

- **Territorial fragmentation.** In the transitional period, the WBGS has been cut into a number of separate economic units, breaking up an already small domestic market into even smaller ones. Transport between the northern and southern parts of the West Bank is seriously hampered by the Jerusalem bottleneck. The Gaza Strip and the West Bank are almost completely disassociated due to lack of safe passage. When internal closure is applied, each of the West Bank urban centers is cut off from other urban as well as neighboring rural communities.

- **Elusive permanent settlement.** The Palestinian-Israeli agreements provide no definitive solutions to the separation of the WBGS and Israel. In fact, the PA and Israel hold widely different views on these issues, with uneven powers to implement such views. There is also a wide gap between the call for economic cooperation as articulated in some official Israeli declarations and in the Oslo II Agreement on the one hand, and the actions taken on the ground which have hindered economic development in the WBGS on the other. As a result, at this stage, nobody can convincingly tell a prospective foreign investor under which he/she would be operating in the future; how easy it would be to export to Jordan, the Gulf, the European Union (EU), the US or Israel; how much Israeli competition he/she would be exposed to on the domestic market; and whether the WBGS will have its own currency and foreign exchange regulations. These are vital concerns for all new investors, particularly for export industries where the WBGS has the best chance to attract foreign direct investment.

- **PAs attitude vis-à-vis the private sector.** Experience has been mixed so far. In spite of recent practices that raise doubts about the PAs attitude vis-à-vis the private sector, such as permitting state monopolies and government delivery of private services, official declarations and documents as well as a number of practices favor free trade and private sector-oriented policies.

**STRUCTURAL ASSETS**

The Palestinian economy is operating way below its potential. It has some important assets which are only partially utilized in the current circumstances. In the right environment and with the right mix of strategies and policies, it could thrive and become a leader in the region.

- **The people.** The WBGS has a high-quality human resource base, as implied by the average years of schooling of the adult population (Table 2). There is no shortage of entrepreneurial talent or professional skills. The private sector is highly resourceful with a demonstrated ability to operate under challenging conditions.

- **Financial capital.** There are plenty of private capital resources ready to be invested in the WBGS if the business environment and policy framework are conducive. The emergent banking industry attracted deposits in excess of $1.7 billion by the end of 1996, much of which is yet to be invested domestically. Many of the successful businessmen in the Arab world are of Palestinian origin, who have already demonstrated great interest in investing in the WBGS.

- **Social capital.** There is a vibrant and well-organized civil society. Many institutions were formed during occupation to deliver public services, that were not adequately provided by the ICA. NGOs, universities, and hospitals have played a major role in delivering services in health, education, agriculture, and welfare aid to poor families.

- **International networks.** Successful Palestinian entrepreneurs in Europe and the US can help the Palestinian economy through networks and international contacts, whether for markets, expertise, technical know-how, or capital. The expatriate Palestinian community will be key in developing the tourist and construction sectors (Box 2).

- **Culture.** The unique religious and cultural heritage of the WBGS offers the potential for developing into an important tourism center. The tourism industry
Table 2. General Development Indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>West Bank(^a)</th>
<th>Gaza Strip</th>
<th>WBGS Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male life expectancy</td>
<td>70</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Female life expectancy</td>
<td>73.5</td>
<td>73.5</td>
<td>73.5</td>
</tr>
<tr>
<td>Average years of schooling for 15+ years</td>
<td>8.0</td>
<td>8.3</td>
<td>8.1</td>
</tr>
<tr>
<td>Literacy rate for 15+ years (percent)</td>
<td>83.4</td>
<td>84.9</td>
<td>83.9</td>
</tr>
<tr>
<td>Female literacy rate 15+ years (percent)</td>
<td>75.3</td>
<td>78.7</td>
<td>76.4</td>
</tr>
<tr>
<td>Male enrollment rate for 6–15 years (percent)</td>
<td>91</td>
<td>89</td>
<td>90</td>
</tr>
<tr>
<td>Female enrollment rate for 6–15 years (percent)</td>
<td>92</td>
<td>90</td>
<td>91</td>
</tr>
<tr>
<td>Infant mortality rate (per 1000) in 1995</td>
<td>25</td>
<td>32</td>
<td>28</td>
</tr>
<tr>
<td>Infant mortality rate (per 1000) in 1980</td>
<td>50</td>
<td>59</td>
<td>54</td>
</tr>
<tr>
<td>Child mortality rate (per 1000) in 1995</td>
<td>32</td>
<td>41</td>
<td>36</td>
</tr>
<tr>
<td>Child mortality rate (per 1000) in 1980</td>
<td>67</td>
<td>81</td>
<td>73</td>
</tr>
<tr>
<td>Total fertility rate (children per woman)</td>
<td>5.61</td>
<td>7.44</td>
<td>6.24</td>
</tr>
<tr>
<td>Family size</td>
<td>6.7</td>
<td>7.81</td>
<td>7.06</td>
</tr>
<tr>
<td>Refugees (percent of total)</td>
<td>27.0</td>
<td>64.0</td>
<td>40.0</td>
</tr>
<tr>
<td>Female-headed households (percent)</td>
<td>7.8</td>
<td>6.3</td>
<td>7.0</td>
</tr>
</tbody>
</table>

\(^a\) Figures do not include Jerusalem.

Source: Extracted and computed from various tables in PCBS (1996a).

...was the mainstay of the West Bank economy in 1967. Since then, it has suffered serious setbacks due to the unsettled political and security situation. With peace and the normalization of relations in the region, tourism and related industries can become a major source of foreign demand for Palestinian labor services, especially if cooperative arrangements can be developed with neighboring countries to promote tourism on a regional basis.

- **Newcomer's advantage.** As Palestinian economic management is a newcomer to the world of development policy, it can learn from the mistakes of others in policy formulation and implementation. This should save the economy setbacks from the failed policies adopted by other developing countries, such as expanding public sector employment to reduce unemployment, using price controls to keep the prices of food items low to urban consumers, or using state agencies to deliver private goods.

- **East-West link.** Given the geographic location of the WBGS and Palestinian experience in trading with both the Israeli and Arab economies, it could become a significant transit point for future trade within the region. The free trade agreements (FTAs) signed with the EU and the US should also make the WBGS an attractive economy to set up export-oriented industries.

- **No debts, good tax system.** Unlike most other developing economies, the Palestinian economy has not had to deal with the burden of a crushing external debt. It has succeeded in establishing a fiscal base that is relatively large by regional and even international standards (20 percent of GDP in revenues). Sound macroeconomic conditions can, however, be swiftly lost by imprudent policies, especially if the public sector expands excessively as a way of reducing the unemployment problem.

- **International sympathy.** Given the strong international interest in resolving the Palestinian-Israeli conflict, there are good prospects for attracting international official assistance to help overcome infrastructural bottlenecks and deficiencies. While much of the aid disbursed so far has gone toward ameliorating deteriorating conditions in the short-term, the international community would most likely continue to wait for a peace agreement before committing large-scale resources to long-term projects.

![Waiting room at a Palestinian primary care clinic.](image-url)
Box 2. Palestinian Diaspora

Diaspora Palestinians are estimated to number 4.5 million—nearly twice the population of the WBGS. There are an additional 0.8 million Palestinian citizens in Israel. Two waves of refugees and these refugees' descendants largely constitute the Diaspora Palestinian community. The first wave occurred in 1948 with the establishment of the state of Israel, and the second with the 1967 occupation of the WBGS. While there are large concentrations of Diaspora Palestinians in Jordan, Lebanon, and Syria, the community is widespread, extending to Europe, North and South America, and Australia.

The Diaspora Palestinian community has come to be recognized for its entrepreneurial and hard-working ethics as well as its leadership, managerial, and specialized skills in business, banking, engineering, medicine, and government planning. Expatriate Palestinian entrepreneurs include a wealthy elite that forms an international network operating out of such centers as London, Athens, Cyprus, Riyadh, Qatar, Amman, Brooklyn, Detroit, and Boston.


Estimates of this wealthy elite's combined assets are between $40 and $80 billion. The elders of the overseas community, now mostly in their 60s and 70s, command the greatest personal wealth, much of it built on petrodollars in the Gulf region and on construction and property development in Europe and the United States. The younger expatriates, mostly in their 40s and 50s, include a large number of highly educated professionals, such as academics, doctors, engineers, and managers, who hold top positions in corporations and are prominent in banking, both in Europe and the Middle East.

Well before the beginning of the peace process, wealthy Palestinian expatriates were channeling funds into the WBGS. A lot of the funds went to educational and humanitarian activities, such as contributions to universities and hospitals. The biggest conduit for private aid was the Geneva-based Welfare Association with more than 100 of the richest Diaspora Palestinian businessmen as members.

Support long-term infrastructure needs in the interest of improving overall conditions.

In view of these strong structural assets, the Palestinian economy has been operating below its potential. This can be illustrated by comparing its levels of skills and income with other countries. Figure 7 shows for 102 countries how increasing educational levels are associated with higher levels of income. The average level of schooling years of the WBGS adult population was 8.1 years in 1995. Given the average relation between schooling and per capita income, one would expect a per capita GNP level of a little more than $10,000, adjusted for purchasing power parity (PPP). Given very conservative PPP adjustment factors, the Palestinian economy is operating at one-third to (at most) one-half of its potential, considering its stock of human capital.

The implications of this substantial underutilization of human resources and, more generally, of many of its main assets is clear. Given the right environment and the right policy, the economy could generate substantial growth rates within a short-time period, without pushing against the constraint of labor quantity or quality. The removal of regulatory constraints, the establishment of supporting institutions and infrastructure, and reduced uncertainty should, therefore, help generate a significant supply response. Free from the legacy of high debts, inefficient public enterprises, or a revenue base that is too small given needed public expenditures, public policy can focus on creating the framework conducive for development.

Figure 7. Per Capita GNP Increases with Education Level: 102 Countries in 1990, but WBGS Income Level Is Far Below Potential

PPP-adjusted per capita GNP ($)

Average years of schooling of adult (15+ years) population

Note: WBGS average years of adult schooling was 8.1 years in 1995.
Strategic Choices Facing the Palestinian Economy

A reorientation of the Palestinian economy is needed to sustain jobs and incomes during the current period of political instability, and to lay the basis for a take-off when a political solution emerges. To make an impact, three strategic concerns will need to be addressed simultaneously: how to diversify external economic relations and depend less on goods and services provided by Israel; how to set-up a good system of governance that can ally fiscal responsibility, efficiency, and compassion; and how to utilize existing social capital to help deliver core public services more effectively, including health, education, welfare, and infrastructure.

Economic Structure and International Relations

The WBGS is heavily dependent on Israel for infrastructure services and trade. Diversifying the sources of services, through internal development and creating the ability to purchase them from other countries in the region, will permit cheaper and more reliable services in the long term. Certain internal investments, especially in trade infrastructure, may make sense in light of the diversification motive even when they appear sub-optimal when viewed by themselves. The trade regime must also be adjusted to allow for more diversified international trade relations. The benefits of diversification will occur not only to the WBGS but also to Israel in increased stability and security.

For an economy as small as the WBGS, the development of strong linkages with external markets is essential for economic survival. Yet, as a result of high transaction costs at the border, trade has fallen dramatically in the past few years. Macroeconomic data have not been collected scientifically since 1994, but rough estimates made by the International Monetary Fund (IMF), the World Bank, and the Palestinian Ministry of Finance reveal that merchandise exports were nearly cut in half between 1992 and 1996, from 11 to 6 percent of GDP, and imports fell from 46 to 38 percent of GDP.

Any development strategy will, therefore, need to be built on better trade infrastructure and improved trade agreements. Access to outside markets must become more secure and the border must operate efficiently. The success of any trade strategy will depend on diversification (making trade less dependent on any one source) and on widening access to new markets in Arab countries, in Israel, in the industrialized countries, and in the emerging Asian and Eastern European countries.

Admittedly, both the infrastructure for trade (i.e., ports, airports, bridges, roads) and the trade regime (i.e., customs unions, free-trade area, non-discriminatory regime) can be only partially improved within the bounds of the existing agreements with Israel. The economic agreement itself is in force during the five-year transitional period, and economic relations beyond that will be defined after the permanent status issues are resolved. Therefore, an important aspect of the discussion is whether a change in the economic agreement itself should be pursued before then to improve outcomes during the transition.

Free Access: Moving People and Goods

Trade and tourism are likely to become dominant economic activities in the future: the relatively small size of the economy makes it heavily dependent on international commerce, and the deep historical and religious significance of the region makes it a major tourist attraction. Consequently, the free movement of goods and people is essential, and this requires a political agree-
ment and expanded investment in transportation infrastructure. Such investment includes a network of roads, efficient land, sea, and air links, and border infrastructure. The need to diversify trading routes and enhance competition among service providers is underscored by the likelihood that closures will continue.

Whatever trade regime ultimately emerges, expanded options for trade, the movement of people, and new transportation linkages are required to and from the rest of the world, as well as within Gaza Strip, within the West Bank, and between the Gaza Strip and the West Bank. At present, all movement in and out of the WBGS to the rest of the world must take place through ports of entry located in Israel, Jordan, and Egypt. Over 90 percent of Palestinian trade passes through the Israeli ports. Under the Oslo II Agreement, "equal treatment" was to be accorded to Palestinian exporters and importers at these points of entry and exit. In practice, besides the port fees, goods from or to the WBGS are typically subject to stringent security checks and long delays at border crossings.

Besides direct routes to the outside world (such as a port and airport in Gaza Strip; Box 3), the crossover points through Egypt and Jordan could be used to expand options for trade. However, these routes are in a state of disrepair and lack access roads and supporting infrastructure. The rehabilitation of these crossover points, i.e., Karameh bridge, Damiah bridge, or Rafah crossing, present immediate lower-cost options. Investments in border administration and infrastructure must also be made.

Direct access to outside markets from Palestinian areas of control will provide increased options to traders, business people, tourists, and internationally mobile workers, and hence reduce the uncertainty of access from the WBGS to the outside world. Two projects under active preparation are a port and an airport in the Gaza Strip. In the past, there has been some concern that the port and airport require large investments and hence may not be economically justified for a small economy. Most small economies the size of WBGS typically do have their own port and airport because they have no other choice. It has been argued that it would be better for the WBGS to use the highly developed facilities in Israel. That argument loses force, however, in view of the serious uncertainties associated with using Israeli facilities even under normal conditions, and especially at times of border closure. Direct international access from Gaza Strip and the West Bank, consequently, has an important "option value." If a free economic zone is to be created, direct access to a port is undoubtedly essential. To Israel, the benefits occur in the form of reduced expenditures on security checks of goods and people moving through Ben Gurion, Ashdod, and Haifa.

Trade Policy Options

To a large extent, the Palestinian trade regime has already been anchored by the FTAs signed with the EU and the US in 1996. But in the short to medium term, the rules for trading with Israel remain crucial. Indeed, while a major reorientation in trade should occur over time, any sharp cut in trade with Israel would have large short-run costs, as recent experience with permit and closure policies illustrates. Therefore, it is better if diversification is based on a strategy of expansion rather than restriction.

The Economic Protocol signed in 1994 in Paris between the Palestinian Liberation Organization (PLO) and Israel regularized the existing trade relation and improved some of its aspects. First, there is no customs border between the WBGS and Israel. Subject to Israeli quality standards, trade between the WBGS and Israel is mostly free (the only exceptions are five agricultural goods with quotas until 1998). Second, customs revenues and VAT raised on goods coming from third countries are partially returned to the Palestinians. The VAT operates on a destination basis, i.e., the VAT on imports from Israel is remitted by the Israeli treasury to the PA. Third, trade relations with third countries—tariffs, standards, quotas—are largely determined by Israeli policies, albeit with some limited exemptions.

The choice of an optimal trade relationship with Israel is complicated by the uncertain political outlook. In a peaceful environment, there would be large gains to free trade with Israel, but this arrangement has devastating negative impact under repeated closures.

- Under ideal border conditions, free trade with Israel seems very much in the interest of the Palestinian economy. In spite of several disadvantages, its major attraction for Palestinian producers is that the Israeli tariff structure is particularly protectionist in sectors
Strategic Choices Facing the Palestinian Economy

Box 3. The Gaza Port and Airport

The Gaza port is to be located five kilometers south of the Gaza City border. According to the PA, the plan is to provide international access to traders all over the WBGS and to industrial estates in the immediate vicinity and, possibly, establish a free trade zone for the assembly of light manufactured goods.

In the first phase, a 600-meter berth in deep water plus a petroleum products berth are planned. The berths and the harbor basin would be protected by a 700-meter long and 11-meter deep breakwater. At the end of the first phase, the port would be able to receive small container vessels with a maximum size of 15,000 deadweight tonnage (DWT). Port equipment is expected to be elementary, including mobile cranes. A multipurpose container terminal with the ability to handle larger vessels will be constructed in the second phase. In the third phase, the breakwater will be expanded and a multipurpose terminal will be constructed in the center of the harbor basin to handle even larger vessels (50,000 to 70,000 DWT). Upon completion of the third phase, the port will be able to function as a major transshipment facility.

Costs for the first phase are expected to be about $60 million for the port and $40 million for supporting land development, equipment, and rail facilities for cargo movement. Various European donors have indicated an interest in financing this phase. Operations are likely to be undertaken through a management contract.

In contrast to the proposed Gaza port, construction of the physical infrastructure for a new airport at the southeastern edge of the Gaza Strip is largely completed. The airport includes terminal buildings and a runway capable of accommodating Boeing 747-400 long-haul jets. Funding for this work, which cost about $20 million, was made available mainly by Egyptian commercial banks. However, operation of the airport continues to be delayed pending approval by the Israeli authorities, who have cited security concerns. Such concerns have also been cited for delaying the clearance to import essential equipment for airport operation as well as three aircraft which have been provided by donor countries as part of their assistance programs.


where the Palestinians have a strong export potential: agriculture and labor-intensive manufacturing (e.g., shoes, garments, furniture).

- But while trade preferences accorded by Israel under free trade are valuable on paper, their value is negligible under repeated closures since agricultural exports are highly perishable and industrial subcontracting requires a high degree of predictability.

Indeed, under the current arrangement, the Palestinian economy is not taking advantage of the theoretical opportunities offered by free trade. Agriculture is shifting from high-value crops (i.e., strawberries and flowers) to less valuable but also less perishable and less risky ones (i.e., potatoes and onions). Gazan firms specializing in subcontracting have cut their business in half over 1995. In 1996, total exports to Israel were estimated at $200 million. By some estimates, the figure could have been $600 million in the absence of closures. But at the same time, the preferences accorded by the Palestinians to Israel involve real costs. A system with zero tariffs for all imports, for example, would allow Palestinian importers to purchase goods from third parties at prices cheaper than from Israel. However, giving up a preferential trade agreement with Israel, and with it the preferential treatment for Palestinian exports, would be extremely costly in the short to medium term. It would impose on Palestinian exports to Israel (80 percent of total WBGS exports) the high levels of protection that Israel applies to third countries.

The choice of an optimal trade relation with Israel should thus be partially dictated by expectations about the frequency of future closures. Unless new ways are found to isolate security issues from the passage of goods and people between the WBGS and Israel, a more

Construction of the Gaza airport is nearly completed, but operation of the airport continues to be delayed pending approval by the Israeli authorities.
independent trade relation may be preferable from a Palestinian economic point of view. Improvement within the current agreement would be boosted by increased Israeli cooperation on issues such as improved revenue-sharing systems, a more fluid border, increased trade independence with neighboring countries (in terms of longer lists of allowable goods and larger quantities), and larger labor flows. The alternative of renegotiating the agreement would be more attractive, however, if the current situation does not improve.

In the context of this difficult dilemma, is an FTA with Israel which falls short of an agreement on third-country relations (i.e., a customs union) a good intermediate solution? Such a strategy would maintain open trading relations with Israel, but would potentially avoid the protectionist aspects of Israel’s trade regime, especially in regional trade. Taxes that now leak to Israel could be collected at the (new) customs border. A strategy of free trade with third parties would improve the bargaining position of Palestinian trade negotiators, perhaps resulting in more efficient operations at the border with Israel. However, several other problems must be dealt with for the FTA solution to become attractive (i.e., the low value added of Palestinian industry and geographical separation of the West Bank and Gaza Strip).

One possibility worth investigating seriously is to turn the Gaza Strip into a free trade zone (and also the West Bank as soon as the border situation allows it). This would send a strong signal to the world that Gaza is open for business, and government is out of the business of trade. Together with its large and relatively skilled labor force, such an initiative would make the Palestinian economy very attractive as an export platform to the US and EU. Because almost no customs revenue is presently collected on manufactured imports, there would be little effect on fiscal revenues.

**An Efficient and Compassionate State**

The second strategic issue concerns the evolution of the Palestinian governance system. With its rich civil society and high level of skills, Palestinian society has the potential to break the regional mold and jump to a modern state that is efficient and compassionate at once. While the public sector’s track record has not been long, there are indications that it may move toward the regional mold. Establishing a modern system of governance is needed so that fiscal deficits are kept in check, expenditure and revenues are managed efficiently and fairly, and the negative effect of shocks on the poor is reduced.

**A Better Civil Service**

The desirability of developing an efficient public sector militates strongly in favor of curbing any further growth in recurrent expenditures and identifying cost savings through expenditure rationalization. As a first step, it is important for policy makers to articulate the range of services to be provided and paid by government, under its prevailing financial constraints, based on a detailed underlying blueprint of the role of the state.

An equally important—but frequently overlooked—requirement for effective public sector performance is having the tools to translate policy decisions into practice. Such tools include an effective budgeting process (embedded with appropriate incentives for spending ministries and agencies to remain within budgetary ceilings), devices for monitoring budget execution and detecting over-runs, and an effective cash management system for processing payments. Despite the substantial progress in building up revenue administration, expenditure management capacity in the PA’s Ministry of Finance has been slow to develop. By and large, annual
budgeting has thus far been viewed as a formality by the spending ministries and agencies. Not until June 1996 was a circular issued to announce the start of the annual budget cycle (for 1997) and to give directives for the exercise. Even the budgeting exercise for 1997 remains confined largely to ministries’ and agencies’ recurrent budgets. Significantly, the capacity for monitoring budget execution, early detection and correction of slippages, auditing, and cash management remains limited. Although several measures to enhance expenditure management capacity are either planned or under implementation, in many cases they occur with outside technical assistance. These include bringing financial comptrollers in the spending ministries and agencies under the authority of the Ministry of Finance, and consolidating the existing multiplicity of cash management channels into a single account. There is also the need to consolidate the accounts of PA revenues, so that they include all revenue sources, such as petroleum excise tax revenue from Israel under the clearance system.

The incentive structure for the civil service is not presently geared toward ensuring optimum staff performance. Only when the extent of government’s responsibilities for service provision have been clearly spelled out will optimal organizational designs, staffing levels, and profiles for government structures become easier to specify. There is now a serious risk that continued recruitment at the same pace as in the recent past will threaten medium-term fiscal stability. Even a cursory look at the PA’s present organizational structures and personnel management policies suggests that there is much room for streamlining and greater cost-effectiveness. Substantially better results and greater cost-effectiveness could likely be achieved through consolidation of, or clearer distinction among, the mandates of the various ministries and agencies.

Raising Revenues and Avoiding Fiscal Deficits
Despite grave problems in revenue collection during the first few months of self-government in Gaza Strip and Jericho, it is generally acknowledged that by late 1995 revenue administration had been placed on a sound footing, with progress in capacity-building reflected in consistently higher-than-projected revenue collection by the PA, especially via the revenue clearance mechanism provided for under the Economic Protocol (Figure 8). But tax collection ratios, which stood at a respectable 21 percent of GDP on an annualized basis in late 1996, can still be improved. Several issues remain unresolved or under implementation, such as the development of formal work rules and instructions for revenue administration staff, reconnection of Gaza Strip’s revenue administration facilities to the ICAs’ computerized former taxpayer records, and strengthening the management of customs administration.

In the face of mounting donor fatigue vis-à-vis recurrent cost funding, it is unlikely that any further grant assistance will be made available for this purpose—barring some large and adverse political shock. While near-term prospects for increasing revenue are modest, demands on expenditure are likely to continue to grow. Unchecked expenditure growth would risk generating large public sector deficits and crowding out potential private investment. In the absence of demonstrated capacity for macroeconomic management and in the present climate of political uncertainty, prospects for foreign commercial borrowing and domestic non-bank borrowing are likely to be limited. This would mean forcing reliance on substantial additional borrowing from the domestic banking system and a further build-up of payments arrears.

The concerns about the sustainability of the fiscal accounts are exacerbated by the fact that all public expenditure needs are not fully provided for in the PA’s ongoing or planned spending patterns. At least six areas can be cited where costly public sector intervention may be required.

The 88-member Palestinian Legislative Council, along with the President of the PA, were elected in January 1996 to hold office for an interim period of up to five years.
Figure 8. Evolution of Fiscal Revenue and Expenditure
Millions of U.S. dollars


- The risk of closure-induced shocks to revenue and, to a lesser extent, expenditure is significant. Direct losses in fiscal revenue include income tax on lost earnings in Israel, customs, excise, and/or VAT on the difference between normal and closure-restricted flows of goods and services imported into the Palestinian self-government areas. Indirect (or second-round) losses include tax and possibly non-tax revenue losses stemming from the general decline in economic activity triggered by the loss of factor income earned in Israel and of export revenue, and by the disruptions in domestic production as a result of interruptions in intermediate import supplies. Public expenditure is also affected by periods of closure if desirable stabilization policies are put in place. Indeed, in the face of continuing risks of closures, more significant reserves need to be built in the future.

- Public investment expenditure will need to be funded, at least in part, from central budgetary resources once the presently exclusive reliance on donor funding is no longer feasible. Public funds will also be required for operating and maintenance costs. The need for integrated recurrent and capital budgeting is acquiring greater importance as the focus of public investment activity shifts increasingly from rehabilitation to the construction of new infrastructure.

- Presently, a large share of revenues comes from Israel in the form of tax clearances (over 60 percent in 1996). This means that the Palestinian treasury, to a large extent, is relying presently on Israeli tax collectors. Local tax-raising capacity will have to be built up to maintain the same coverage (especially on VAT and income tax collection) if less Palestinian workers go to Israel in the future, or if less trade transits through Israel.

- The public sector functions still to be transferred to the PA during the Interim Agreement period are in zones B and C of the West Bank. While the recurrent expenditure increases associated with these remaining transfers will be small, they nevertheless can be significant.

- The paucity of quality and funding sources for municipal services provided by local authorities may call for inter-governmental fiscal transfers over the medium term to support service improvement and extension.

- The United Nations Relief and Works Agency (UNRWA) runs parallel systems of education and health care for the refugee population in the WBGS and neighboring countries. At the very least, integration of the operating costs of these systems into the PA's budget will arise as a serious option over the medium term. Besides improvements at the margin related to better institutional performance, major increases in revenue are unlikely over the next few years, barring changes in the revenue-sharing formulae with Israel which would require renegotiation of parts of the present Economic Protocol. If such renegotiation were to prove politically feasible, at least two areas merit serious attention:

  - The present revenue-sharing formula for customs duties on imports, based on the destination principle, allocates to the Palestinian treasury a share of revenue calculated on the basis of recorded import flows that are explicitly designated for final use in Palestinian self-government areas. Palestinian officials frequently point out that a significant leakage occurs under this formula, which according to a recent study amounted to 4 to 6 percent of GDP (or around $125 million) during the 1994–96 period. The leakage is due to the high proportion of indirect imports (that is, imports into Israel which are sold to final users in the WBGS but which are not explicitly designated as such at the initial point of entry).

  - The second area concerns seigniorage revenue—the real resources appropriated by a governing authority as it increases the money (currency) base in the
Strategic Choices Facing the Palestinian Economy

19

Because the prevailing Interim Agreement rules out near-term issuance of a Palestinian currency, no independent seigniorage can be generated for the Palestinian treasury. Moreover, there is no provision for allotting a share of the seigniorage collected by Israel to the Palestinian treasury under the present currency union arrangement. It has been estimated that a defensible formula for sharing seigniorage on the shekel might yield some 2 to 5 percent of GDP annually in additional revenue to the PA.

Employment Generation Schemes. The main policy instrument to mitigate the economic impact of closures has been the implementation of numerous employment generation schemes. Most of these schemes, however, have been used primarily as anti-poverty programs, and none were designed specifically as built-in stabilizers. Some performed simple tasks that do not create permanent assets, which enabled them to transfer a relatively high share of their budgets to the poor. In particular, the World Bank Direct Hire program and the UNRWA Emergency Employment program managed to ensure that $1 of every $1.50 allocated reached the poor. Other programs attempted to create assets as well as help the poor, which diluted their effectiveness as an anti-poverty program. UNRWA's Shelter Rehabilitation program, for example, spent $3 to $6 for each dollar received by the poor.

To serve as an effective built-in stabilizer, these programs should involve simple tasks that can be implemented directly by local municipalities or farmed out using standard contracts covering more than one period, which would shorten their time lags. The inputs used should be produced domestically or easily and inexpensively stockpiled, thus making the program less vulnerable to closure. It should also be possible to change the coverage of the program without causing serious disruptions in its operation. Possible tasks that can be performed include forestation programs, soil preservation, street sign installation, access road construction, and garbage disposal.

Unemployment Insurance for Workers in Israel. It is not prudent at the moment to set up an unemployment insurance for all Palestinian workers since the PA does not presently have the resources to finance it, the organizational capacity to manage it, nor the infrastructure needed to compile the extensive and timely data it requires. However, an effective mechanism to mitigate the economic impact of closure is to provide unemployment insurance for Palestinian workers in Israel. Limiting this program to unemployment as a result of border closure would keep

Effective Stabilization Policies

A crucial policy choice for Palestinian society concerns the extent and manner in which closure shocks are smoothed. In the face of massive shocks, stabilization policies can achieve very little. The effects of closure-related shocks can be decreased significantly only if the economy becomes more diversified in its trade relations. But given the vulnerability of the economy to external shocks, stabilization policies still need to be developed to relieve the pain of the most vulnerable in society.

Civil service employment is not a good instrument for stabilization. In the past few years, the expansion of public service has, to a large extent, become a means of smoothing the negative shocks that have hit the Palestinian economy. Clearly, part of the public sector increase stems from the phased transfer of public sector functions. A strong case can be made for some new recruitment (on top of employees inherited from the ICA) in order to provide for enhanced delivery of public services that were widely perceived to have been substandard under occupation; to fill senior staff ranks in the civil service, which under the ICA had been confined to Israelis; and to carry out functions (mainly those relating to public order and security) for which no ready-made apparatus was bequeathed by the ICA. There is evidence that the extra recruitment has now brought public sector employment to a level that should amply fulfill public sector functions under a market economy blueprint.

Rather than relying on public sector employment, there is an important role for insurance programs and targeted policies of stabilization to offset the most deleterious effects of transitory shocks on the poor. The deployment of an unemployment insurance system for Palestinians working in Israel could be considered. For long border closures, indirect effects are also important, and so transfers/local employment schemes—more finely linked to closures—would be preferable on welfare grounds. Export insurance schemes can also be explored, especially if this helps bring donors into the negotiating picture with Israel.

- Employment Generation Schemes.
- Unemployment Insurance for Workers in Israel.
it manageable and avoid potential moral hazard problems. This program would cover all WBGS workers who have permits to work in Israel at the beginning of each year. Premiums collected should be the major source of funds for the program. The program should be able to draw funds from Israel and donors, particularly during long closures. Given the frequency of closures, it would need to collect a relatively high premium.

- **Export Insurance Program.** Insuring exporters against some losses resulting from border closure helps the export-oriented sector and removes an important barrier to greater private investment. Shipping delays due to closure cause liquidity problems as well as financial losses resulting from damages to the exported goods. Liquidity problems and other financial troubles caused by closure can be alleviated by an export insurance program. The program would insure exporters against financial losses caused by the failure to ship on a timely basis due to closure or other Israeli restrictions, by damage to the goods at the border, or even by the loss of a contract due to delays at the border. Covered exporters prevented from shipping by Israeli restrictions would be paid by the program on the date the shipment was supposed to take place. Setting up an export insurance program can help to expand credit by enhancing the value of an exporter’s balance sheet as a source of information about financial performance.

- **Monetary Stabilization.** The potential for monetary stabilization is limited by the size of shocks and by the absence of stabilization instruments. An independent currency would allow the Palestinian Monetary Authority (PMA) to reduce the impact of monetary shocks emanating from Israel or Jordan, and act as a lender of last resort. However, the issuance of an independent currency is constrained politically by bilateral Palestinian-Israeli negotiations. It is also economically advisable to avoid the issuance of an independent currency until after a track record of fiscal discipline has been established, in order to improve the chances of public acceptability of the currency.

In the absence of a currency, the PMA should avoid taking any action to limit the free circulation of the three currencies in the market (Jordanian dinar, Israeli shekel, and US dollar) since currency substitution by the private sector provides a stabilizing element against imported monetary shocks. The PMA also needs to find mechanisms to fulfill its function as lender of last resort in order to stabilize the banking system against any bank run. Since the PMA cannot issue currency and does not have a credit line from the central banks whose currencies are circulating, building monetary reserves is essential. The PMA also needs to regulate and supervise the banks very thoroughly to ensure proper operation and to protect deposit safety. One activist policy for the PMA to adopt is to vary the amount of liquidity in the banking system by moving reserves in and out of the local banking system as a way to offset shocks to the economy. The implementation of this policy, however, requires careful consideration and substantial strengthening of the PMA’s institutional capacity.

**Taking Advantage of Social Capital and New Technologies**

The third strategic dimension concerns the ability of Palestinians to take advantage of a rich tradition of civil society and dynamic NGOs, the newcomer advantage, and new technologies, to form effective partnerships in sectors ranging from health and education to the provision of infrastructure.

**Legal Framework**

A first requisite to encourage private activity (for profit and not-for-profit) is a transparent and independent legal system to settle disputes between private sector agents and to protect these agents from undue government intervention in economic affairs. The present legal environment requires significant improvement if the WBGS is to become an attractive place for investors. Needed improvements include avoiding intervention in legal affairs and resolving conflicts between different layers of legal codes that are on the books. Immediate attention is needed to secure legal protection against expropriation and confiscation of foreign investment property, and legal guarantees that ensure the repatriation of capital and profits. The cre-
ation of special economic zones can provide an island of short-term protection until the system is improved (Box 4). Other measures can encourage the development of sectors that are more robust to political turmoil, i.e., housing and other types of infrastructure with a large pent-up demand. Such measures include the registration of land and moveable assets, designing leasing laws, and reforming the rent control laws.

**Partnerships with NGOs**

In education, welfare, and especially health, it would be advantageous for the public sector to enter into partnerships with NGOs and tap into existing managerial capacity. In commissioning NGOs to deliver health services or providing them with charitable or tax-exempt status, it is important for the PA to develop the appropriate regulatory framework. After all, NGOs, as special interest groups, may have a conflict of interest with the overall public good. The challenge then is to create accountability mechanisms in a framework that fosters both competition and the free flow of information, since effective competition among NGOs can only be sustained by mechanisms that help the market evaluate performance and make choices. This means that the mechanisms through which various service providers compete must be built, for example, procurement based on competitive bids, or client choice and voucher systems. In addition, public disclosure of funds through client surveys, investigative journalism, and public citizen policing are needed to ensure accountability.

**Private Delivery of Infrastructure**

The private sector could provide some of the investments required for infrastructure. Global trends indicate that private actors can engage in broader fields of public interest if the proper regulatory system is in place. Such efficient governance systems are decentralized, with an emphasis on competitively contracting out infrastructure to private companies and nongovernment citizen groups. The provision of public goods is safeguarded by mechanisms that foster accountability and contested markets.

The first step toward private sector involvement has already taken place in the water sector. The newly established regional water and sanitation authority in Gaza Strip awarded a four-year management contract to an international operator through competitive bidding. In telecommunications, a private company, Palestinian

---

**Box 4. Industrial Estates**

A series of industrial zones has been planned to help jump-start industrial development in the WBGS by establishing closure-free movement of goods and labor in a legal and regulatory environment attractive to potential investors. The estates would, in effect, sidestep the many obstacles that presently impede employment, investment, exports, and business transactions through the WBGS.

The Gaza Industrial Estate (GIE) is designed to be the first phase in a broader program of industrial estate development. The GIE is the first of the export-oriented border estates, targeted primarily but not exclusively at export markets. A German-funded project in Jenin is the second such estate. Municipal industrial estates (with a proposed project for Nablus initially) constitute the third dimension of the program. These municipal estates focus on the domestic market, are designed to provide facilities for small workshops in local areas, and incorporate a policy dimension to address newly enforced municipal zoning requirements.

The GIE is a pioneer project—the first of a series of industrial zones. The total cost of the project is estimated at $64 million, of which $34 million is expected to come from private sector investors, including the developer (PADICO), local private sector investors, the International Finance Corporation (IFC) and the European Investment Bank. The remaining budget of $30 million for technical assistance and off-site infrastructure components will be covered by the donor community. When used at its full capacity, the GIE could have 17,000 permanent jobs, with an additional 20,000-30,000 jobs created indirectly for services and other manufacturing operations.

Project viability will hinge on a number of critical success factors. In particular:

- **Security and Access Agreement.** The success of the zones is dependent on political and legal agreements of a binding nature that will insulate these zones from border closures. Negotiations are underway to formulate security procedures and agreements of access to and from the GIE site to ensure complete closure-free operation.

- **The Policy Environment.** Significant progress has been made recently in advancing the legal framework and institutional arrangements to assure transparency, efficiency, and investor confidence. Further progress is still required in gaining legislative approval for the investment law and the industrial and free zones law.
Telecommunications Company (Paltel), was awarded an exclusive franchise for rebuilding and operating both the fixed and mobile phone systems in the WBGS for a 15-year period, with a non-exclusive franchise for another 15 years. In electricity, the Palestinian Electricity Authority (PEA) is presently negotiating the development of a power generating plant in Gaza Strip under a 20-year build-operate-transfer contract with a private company that will ultimately provide 215 megawatts (Mw) of power. The principle of creating incentives for performance is being adopted. In the Gaza Strip water supply management contract, compensation has been tied closely to performance. In the Gaza power plant, the price paid for electricity received will evolve according to a pre-specified formula, in the spirit of price cap regulation. Operation and maintenance costs will be tied to a cost of living index, and the energy cost will be tied to a world energy price index.

Besides incentives, private provision of infrastructure also requires building sufficient regulatory capacity to ensure that societal interests are met. Where competition is effective, service providers have the right incentives to price in a socially desirable manner. Hence, regulation should be limited to non-price issues, such as safety and environmental protection. Where market power exists however, a price regulatory mechanism needs to be put in place.

Beyond this, institutional innovations and mechanisms need to be conceived and put in place for planning, regulation, project implementation, and coordination. The benefits of an umbrella structure, such as a US-style regulatory commission are worth considering. A commission would serve two functions. It would establish common principles of regulation across sectors and insulate the regulatory process from political interference. Political insulation occurs as the commissioners, appointed for fixed terms, are responsible ultimately to the legislature. Some economies may be realized by coordinating the activities of regional electricity and water utilities.

There are likely to be economies in joint billing and collection, saving both on software development and collection costs as well as in joint network planning, i.e., laying of pipes and cables, and maintenance.

**Leveraging Human Capital through Information Technology**

An unusually high level of human capital could be leveraged through the use of modern information technologies. Conversely, since Palestinians do not possess any significant natural resources, the future of the Palestinian economy will be determined largely by the capacity to construct a knowledge-based economy. Such technologies would not only support domestic transactions, but also international linkages. In particular, the possibility exists of developing trade in a variety of services. The pillar of such an economy is a modern telecommunications infrastructure. Looking ahead, the development of information technology capabilities would open up a series of possibilities for the economy.

- As a Middle East financial center, it could tap into the resources of specialized Palestinian bankers, provide a safe haven for investors, integrate regional stock markets, and serve as a center for currency trading and clearing credit-card obligations.
- By encouraging information processing industries, it could exploit decreasing long-distance telecommunications costs to enter new markets in off-shore information processing and software engineering (as in Barbados and India).
- As a high-skill hub for professional services, it could provide legal services, insurance, investment banking, consulting, education, specialized medical treatment, advertising, and software development.
- It would give a boost to the tourism sector that requires significant infrastructure, including modern communications for hotels, resorts, and restaurants in the historic sites.
A Sectoral View: 
 Policies to Generate Growth

The implications of the three principles for a sustainable economy—diversification of external relations, an efficient and compassionate state, and capitalizing on strong social capital and new technologies—vary across the sectors of activity. Diversification is crucial for finance, industry, and agriculture. While good governance is important across the board, it is crucial for education. Partnerships between the state, the private sector, and civil society are key for mobilizing dynamic activity in health, tourism, housing, and infrastructure.

Private Sector Development

Substantial investment funds can be mobilized from Diaspora Palestinians and international sources, and the WBGS could attract significant foreign investment under the right circumstances. It is difficult to imagine a sustained private-sector boom in the current circumstances of political turmoil and border closures. However, important forces that depress private investment in the short term can be removed by well-crafted policies.

Agriculture and Industry

Water is a scarce resource in the West Bank, and a very scarce resource in Gaza Strip where the groundwater resources are over-exploited and becoming increasingly contaminated. Present availability of renewable water resources (based on the Oslo II Agreement) is only 115 cubic meters per capita per year—among the lowest in the world (Table 3). While a favorable final status settlement would provide more water to the WBGS, water resources will be extremely limited and will pose a serious constraint for the economy. This challenge requires re-thinking economic growth patterns and changing attitudes vis-à-vis water.

Agriculture is clearly very important to the Palestinian economy. Yet, an implication of overall water scarcity is that agriculture is unlikely to play a leading role in terms of rapid and sustainable expansion of its output and jobs creation. Presently, WBGS agriculture uses, on average, 70 percent of all extracted water (strikingly, in Gaza Strip, it uses 150 percent of annually renewable water resources), and the sector contributes about 15 percent to GDP. By comparison, industry and construction consume about 13 percent of available water resources and contribute about 25 percent to GDP. The value added per unit of water is therefore much higher in industry. Typical value added by irrigated agriculture in the region varies between $0.15 and $0.30 per cubic meter of water, while value added by most industries can be as high as $30 to $50 per cubic meter of water used. To ensure future economic growth, less water should go to agriculture, and more should go to industry. But less water use in agriculture does not necessarily mean lower agricultural outputs. Converting current irrigation practices to more efficient methods could protect and consume less of the

Table 3. Regional Water Resources

<table>
<thead>
<tr>
<th>Country</th>
<th>Resources (BCM per year)</th>
<th>Consumption (BCM per year)</th>
<th>Resources (cubic meters per capita per year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Israel</td>
<td>2.1</td>
<td>1.9</td>
<td>375</td>
</tr>
<tr>
<td>Jordan</td>
<td>0.8</td>
<td>1.0</td>
<td>213</td>
</tr>
<tr>
<td>Lebanon</td>
<td>4.8</td>
<td>0.8</td>
<td>1,200</td>
</tr>
<tr>
<td>Syria</td>
<td>5.5</td>
<td>3.3</td>
<td>385</td>
</tr>
<tr>
<td>WBGS</td>
<td>0.2</td>
<td>0.2(^b)</td>
<td>115</td>
</tr>
</tbody>
</table>

\(^a\) Billion cubic meters.
\(^b\) Actual Oslo II allocations (interim) are 264.5 million cubic meters (MCM) (248 MCM renewable and 16.5 MCM from Israel).

available fresh water resources. Nevertheless, given the large share of the labor force in agriculture, the required future adjustment is considerable.

In these circumstances, industry and services will have to play a leading role. Given the size of the economy and the constraints on the export of labor, focus must be on the export of goods and services. Trade policy will have to open up new growth opportunities based on comparative advantage. Advantages include a relatively sophisticated and hard-working labor force; a strategic geographical position; and a relatively open economy with little industrial base at risk, and whose revenue base does not rely on customs duties. Given these advantages, policy can play a facilitating role.

There are three economic patterns of production, presented below in order of increasing sophistication, that ought to be considered.

- **Strategy A**: Labor-intensive Growth—low- and medium-skilled exports to the West, starting with Israel and expanding to the rest of the world, especially the EU and US. Labor-intensive value-added industries would build on the existing base of $400 million in potential exports to Israel (in the absence of closures). Labor-intensive activities require continued openness to Israel and increased openness to richer markets in the Organization for Economic Cooperation and Development (OECD). The recent signing of FTAs with the US and the EU will help such a strategy. It is possible to envision a quick expansion of manufacturing for exports to the EU and US if the infrastructure for trade was to improve, especially in the Gaza Strip.

- **Strategy B**: Gateway to the West—transforming raw and semi-finished unskilled labor-intensive regional products into more valuable exports. Undertaking activities with higher value-added would take advantage of the Palestinian strategic geographic and cultural positioning to make use of arbitrage opportunities between East and West. A strategy of gateway to the West requires large improvements in trade infrastructure, but it also has higher payoffs. Its premise is that neighboring countries need time before they can afford to open up. If the WBGS could trade freely with these countries, its economy would be able to exploit its free access to the OECD, adding value to labor-intensive regional manufactured goods for the benefit of the region as a whole.

The West Bank could develop a strategic trade alliance with Jordan, and the Gaza Strip with Egypt. Free trade with these regional partners would be necessary. So, such a strategy cannot be followed within the existing agreement with Israel. Gains would also be available if the four economies were to get closer, as long as the WBGS remains less regulated and, therefore, more attractive as a location that can access all these markets.

- **Strategy C**: Gateway to the East—transformation of western technologies and the adaptation of technologically intensive goods to fit better the specific needs of the neighboring Arab countries. The gateway to the East strategy provides a challenging vision for the medium term: to transform Western technologies for regional needs. It is the most demanding in terms of human resource development and modern infrastructure. It also requires open trade relations with both the West and the region, but integration with these markets needs to be deeper, extend to services, and provide protection of intellectual property rights. Such a strategy would take advantage of rising skills and cultural advantages, and could encompass sectors ranging from telecommunications to the information industry and finance. From this perspective, links with Israel and the OECD, and links with the region should be viewed as complementary, as the ability to develop links with the rest of the region is made more valuable by deep links with Israel and the OECD.

**Housing**

Traditionally, domestic savings and investment in the WBGS have been relatively high, but most of this investment has been concentrated in housing (Figure 9). Investment in housing exploded with the start of the peace process, causing land prices to skyrocket, but the sector started to falter by 1996. Most new construction has been in residential housing at the upper end of the market, with new apartments bought by relatively well-to-do returnees or the small new professional class of public servants and bank employees. However, demand is potentially greater and much more robust to political uncertainties at the middle and lower end of the market. There are serious crowding problems among low-income households, particularly in refugee camps.
Before this potential can be realized, improvements are needed in financial markets, in the legal framework, and within the construction industry:

- Housing finance, which plays an important role in facilitating the purchase of dwelling units in most countries, hardly exists in the WBGS. The emergence of a market necessitates, among other things, the establishment of better land titling, a functioning law system that supports mortgage lending and financial sector development, and setting up a housing insurance fund to cushion against the unhedgeable political risk components. Effort on all these fronts has started.

- Efficiency gains must be realized in the construction industry. The WBGS house price-to-income ratio is around 10, which is significantly higher than other countries at a comparable level of development (4 in Jordan, 5 in Israel and Egypt). Changes are needed on the regulatory and institutional fronts, including defining and monitoring norms in the construction business and improving zoning practices. Here too, efforts are underway, but they are constrained by institutional weakness at the municipal level.

- The share of rental units in the housing stock is very low—only 4.9 percent in the Gaza Strip and 11.4 percent in the West Bank, as a result of the rent control laws. A complete repeal of the rent control law, however, is not politically feasible at present. A more realistic approach would be to allow owners of new rental units to increase rent by the rate of inflation.

- The increase in housing costs and the incidence of poverty in the last few years has made housing unaffordable for a significant segment of the WBGS population without some assistance. One effective approach is to provide cash-based housing assistance. Several donor-driven projects now underway are planning to give lower-income households (that do not earn sufficient income to cover basic needs) rent vouchers or a loan subsidy.

Tourism: Constraints Amidst Potential

The WBGS has great potential as a tourist destination because of its religious, historical, archeological, natural, and cultural attractions. The number of tourists to the WBGS has increased substantially in the last few years. By 1995, the annual number of visitors to the Church of Nativity in Bethlehem and archeological sites of Jericho reached one million and 300,000, respectively. Yet, the role of tourism in the economy is presently very limited. In 1995, total revenues of the tourism sector in the West Bank and Gaza Strip, excluding East Jerusalem (RWBGS), were around $26 million, compared to $155 million in East Jerusalem and $2,930 million in Israel.

The limited contribution of the tourism sector to the economy is not surprising, given its stagnation in the last three decades of political uncertainty and Israeli restrictions. Since 1967, for example, the number of hotels remained approximately the same in East Jerusalem. During the same period, the number of licensed guides in the WBGS dropped sharply. By 1996, the number of guides in East Jerusalem was down to 47, compared to 154 in 1967, and most of these guides were licensed before 1967. In the RWBGs, the number of guides in 1996 was only 24, of whom 18 were licensed before 1967 and the other 6 were licensed recently by the PA. Israeli restrictions also have inhibited the establishment of tourist bus companies in the WBGS, where no such companies were licensed over the three decades of occupation. Hence, efforts to increase the contribution of tourism to the Palestinian economy in this transition period should focus on increasing the competitiveness of the WBGS tourism sector to enable it to capture a higher share of the combined WBGS-Israel market.

The long-term prospects of the WBGS tourism sector will be highly influenced by the permanent politi-
The establishment of foreign branches in the WBGS was the main reason for such a rapid expansion of banking over the past two years. In expanding their operations, foreign banks were able to rely on their head offices for technical and managerial support and for training new employees. This expansion took place at a time when bank supervisory capacity in the WBGS was extremely limited. The role of home offices abroad in supervising their branches provided the WBGS banking system with badly needed help in maintaining safety and stability in the system. But while foreign branches will no doubt continue to serve an important function in the future, their dominant role cannot be maintained indefinitely. Eventually, the PMA should require foreign banks to convert their operations in the WBGS into subsidiaries. However, the conversion should be done gradually to avoid disrupting the banking system. In the meantime, the PMA should work closely with the home regulatory authorities of foreign branches, particularly the Central Bank of Jordan, to develop a common strategy for supervising foreign branches.

Adequate regulation and supervision are key to stability and confidence in the banking system. Bank regulators usually institute failure-prevention measures, failure-containment mechanisms (i.e., deposit insurance and discount lending), and monitoring devices. Since the WBGS presently does not have deposit insurance and the availability of discount loans is limited, it is difficult for regulators to contain individual bank failures. It is thus appropriate that bank regulation focus on failure prevention. This requires imposing strict capital adequacy rules, relatively high liquidity ratios, and restrictions on acquiring risky assets, such as real estate and stocks. Most of these measures have been promulgated by the PMA, but there is a need for continuous supervision to ensure compliance and sound banking practices.

Domestic lending by banks operating in WBGS is very limited and the majority of credit extended by them is in the form of overdraft facilities. At the end of 1996, total credit accounted for merely 19 percent of total assets and 24 percent of total deposits, and the share of short-term lending in total credit was 65 percent. The
main factors that inhibit long-term lending are the lack of acceptable collateral, political and economic uncertainties, and credit rationing by branches of foreign banks. In this context, commercial banks can be encouraged to provide long-term credit by increasing the availability of collateral and setting up a mortgage insurance program and a secondary mortgage facility.

- The most effective way to increase the availability of collateral is to establish clear property rights to land. With the registration process frozen since 1967, only 30 percent of the land in the West Bank and 90 percent in Gaza Strip is registered. Land registration can now be resumed in the Gaza Strip and in some of the West Bank (in zone C, the resumption of land registration is still contingent on Israeli approval). The PA can also increase the availability of collateral by registering tractors, other agricultural tools, and industrial machinery. The PA further needs to introduce legal reforms that make it easier for lenders to foreclose in the case of non-payment.

- Mortgage lending by commercial banks is presently negligible. If such lending is to be seriously considered by banks in the present economic environment, mechanisms for reducing credit and liquidity risks must be instituted. Credit risk can be reduced by the newly created mortgage insurance program. Liquidity risk can be alleviated by setting up a secondary mortgage facility.

- The PMA should avoid imposing minimum lending requirements on banks in the greater interest of deposit safety. The PMA should carefully explore the implications of dual reserve requirement policies before resorting to policies that reward domestic lending or impose a cost on placing funds outside the WBGS, such as reducing the reserve requirement on the portion of deposits lent locally.

**Financing Micro-entrepreneurs**

Despite their recent decline, lending NGOs still have an important role to play in the WBGS financial system. Unlike other NGOs, such as those involved in health and education, lending NGOs serve a function that has not been assumed by the PA. Lending NGOs extend loans to small enterprises that lack collateral and credit history and, therefore, are not of interest to commercial banks. If small enterprises are to become sustainable, they must find ways to become less dependent on subsidies. To do so, lending NGOs may have to eliminate most of their interest subsidies, as some already have done. They also may have to find ways to minimize default risk without relying entirely on collateral. One achievable option is to make use of the group risk-sharing method, which was pioneered by the Grameen Bank in Bangladesh and recently implemented by UNRWA and Save the Children. The UNRWAs Solidarity Group Lending program, offering working-capital loans to women micro-enterprise owners, consistently has had 100 percent repayment rates since its inception in 1994. Technical and managerial assistance is provided to small borrowers, especially to those likely to suffer from market discrimination.

**The Emerging Financial Market**

While there is still no bond market in the WBGS, a new stock market opened recently. The role of equity in the Palestinian financial system had been limited in the past to over-the-counter trade in a handful of public companies, most of which are family-controlled. In the future, equity can potentially play a substantially larger role in spreading risks more broadly. While there are presently around 50 joint stock companies in the WBGS, most of which have been established in recent years, this still accounts for less than 1 percent of all establishments. Established in 1997, the Palestinian stock exchange can play an important role in stimulating demand for equity. Centralized trading provided by the exchange for listed companies will increase the liquidity of their stocks and their appeal to investors. Listed companies are required to publish annual balance sheets, which will significantly increase the ability of potential stock holders to evaluate their riskiness.

Pension funds and insurance companies, which account for a significant share of investable funds in many countries, do not presently play important roles in the WBGS financial system and their roles are not expected to increase significantly in the near future. The insurance business is dominated by auto insurance which does not generate long-term investable funds; life insurance hardly exists. Pension funds do not represent a major source of investment funds. The pensions of civil servants are financed on a pay-as-you-go basis, and the UNRWA employees' fund is invested entirely outside the
WBGS. In the private sector, very few firms have any kind of pension fund for their employees and existing pension funds are invested mostly in bank accounts. In the absence of sufficient retirement benefits from the workplace, children and other family members represent the main source of financial support for the present generation of retirees. This type of inter-generational support, however, may not be as viable in the future because of changing family structures and decreased job opportunities abroad. In this environment, serious consideration should be given to setting up a national social security system. This would also provide a major source of long-term investable funds, provided that it is kept financially independent from the central government.

Large holding companies have emerged recently as an attempt by large investors to deal with the difficult conditions. Several large funds were established starting in 1993, mainly by Palestinian businessmen from the Diaspora, e.g., the Akkad Group and PADICO (Box 5). These funds share various characteristics. They have managed to provide a broad base of risk-sharing for the investments undertaken. Typically, the funds take a 25-percent share, another 25 percent is sold over-the-counter to the public, and the remaining 50 percent is received from banks in the form of medium-term loans. This structure provides enough risk capital to ride a quite rocky investment climate, yet manages to attract many large investors by coordinating their actions into long-term investment plans. The funds also reduce risk by diversifying across various sectors of the economy, especially in infrastructure, construction, tourism, and at a much smaller scale, manufacturing.

Infrastructure provision is characterized by important risks, including expropriation, the ability to convert and transfer currency, and regulatory reversals that render the enterprise financially not viable. In the WBGS, the risks associated with setbacks to the peace process are an additional, perhaps, critical concern. These risks limit entry of private providers even where large profits potentially can be made. Thus, risk mitigation and management must form a crucial element of government and donor strategies. A transitional mechanism for attracting finance to infrastructure, and one that significantly leverages donor sources, is a co-financing facility. Such a facility which utilizes concessional resources to share risks with the private sector was used in Pakistan for financing private power investments, and in Sri Lanka for all infrastructure investments. Another possible mechanism to mitigate risk is to provide private investors with guarantees. Such guarantees have been offered in most countries where private financing of infrastructure has occurred (including in some developed countries such as Australia) to provide assurances to private sponsors and lenders against country and policy risks. The most promising route for the WBGS is to rely on guarantees provided by multinational institutions, such as the World Bank's Multilateral Investment Guarantee Agency (MIGA), and by bilateral agencies, such as export credit agencies and specialized insurance entities, such as the Overseas Private Investment Corporation (OPIC).

Box 5. PADICO

The Palestinian Development International Company (PADICO) has emerged since 1993 as the largest private sector investment company in the WBGS with over $1 billion in planned investments by the end of the decade. PADICO was founded by some of the most prominent Diaspora Palestinian businessmen, and two of the main Palestinian banks, the Arab Bank and the Cairo Amman Bank (holding 10 percent and 5 percent of shares, respectively). PADICO's mission statement, as articulated by its founders, is "the furtherance and development of the Palestinian citizen on the Palestinian soil as a national objective and sacred task." The company has an aggregate value of $200 million that was offered in a public subscription in June 1994. PADICO was set up as a holding company in which its investors own 49 percent of the various subsidiary operating companies while local investors and banks hold the remaining 51 percent.

The primary aim of PADICO is to invest directly or through subsidiary companies, joint ventures, mergers or affiliations with other companies in diverse projects that will help rebuild the economic infrastructure of the WBGS, while providing reasonable financial returns to company shareholders. PADICO's current investment strategy includes projects in tourism, real estate and housing, industry and manufacturing, including industrial estates; finance; power generation; and telecommunications.

DEVELOPING HUMAN RESOURCES

There are important growth opportunities in education and health—two sectors that are essential for long-term growth. In both sectors, there is a need for reform and modernization. The role of the state is crucial since market forces are unlikely to lead to an ideal situation. A focus on a systems view—with partnerships between providers and beneficiaries, grounded in a regulatory framework, enforcement mechanisms, and feedback loops—will be crucial to successful development in the education and health sectors.

Education

The population and labor force of the WBGS is highly educated by regional standards, with relatively high literacy rates at 84 percent for those 15 years or older (different rates by gender, urban/rural, or refugees, are primarily attributable to differences among older members of the population). In contrast, the Middle East and North Africa (MENA) region, as a whole, has an estimated adult literacy rate of only 57 percent.

The major challenge of the education system is to continue to ensure high access to primary and secondary education for the rapidly increasing number of students. More importantly, as the Palestinian economy reorients itself to the export of goods and services, it is the quality of educating workers that must be emphasized. To move forward on the quality front, the educational system needs reforms that define such an objective, and develop the processes of governance, finance, and management to serve these objectives efficiently. Several key factors present challenges for improving and managing the system.

- The average student:teacher ratio is 46:1, with average class size in the high thirties at all levels. These are acceptable figures by international standards. Faced with high unemployment, the greatest danger is that the PA will use the civil service, including the teaching force, as a jobs program. The case of Egypt shows how disastrous this policy can be. With wages so low, Egyptian civil servants often have to work two or three jobs, having little commitment to their civil service job. Teachers, not infrequently, supplement their incomes with well-paid private lessons, an income source that operates as a disincentive for quality teaching in the public schools.
- In relation to students from other countries, Palestinian students perform relatively poorly in the more complex cognitive processes of problem-solving and integration. The main goal of an educational policy directed toward the future is to achieve the qualitative reform to match labor force needs. Palestinians need to be competent across the range of occupations that correlate to manufacturing and service opportunities for their economy to become attractive as a commercial center for the Middle East. As enterprises change in response to the demands of international customers, traditional pedagogy begins to fail, especially in creating the higher-order cognitive skills valued in new workplaces. In organizing teaching and learning that better fits the skill requirements of new workplaces, there is a need to place more responsibility on the student for his or her learning.
- Since the West Bank and the Gaza Strip use different curricula and secondary school leaving examinations, curriculum and textbooks pose several problems. In the interest of creating a Palestinian identity, it is critical to integrate the curriculum for the two territories. It is not efficient, however, for Palestinians to create their own curriculum and textbooks for subjects in which country-specific experiences are less relevant, such as mathematics and the sciences. The education system needs to deliver a curriculum that instills in students the foundation skills and higher-order cognitive thinking skills.

Palestinian students at a mixed government primary school.
required to implement a long-term economic development strategy.

- The PA inherits a sector with a history of diversified funding and provision at all levels of education. In several MENA countries, all levels of the education system are seriously distorted and quality is visibly compromised because governments have been reluctant to diversify funding and provision between the public and private sectors, especially at the expensive post-secondary level. Pressures could cause the PA to make similar mistakes. The donor community is already reducing its support of the university sector. The decline in NGO funding and political tensions between the NGO sector and PA could result in displacing NGOs as providers and financiers. An important challenge is to continue to encourage that diversity, especially at post-secondary levels.

What are the ingredients of success? The first step in a reformist package is to develop a long-term strategy that sets goals, priorities, and accountabilities. Most countries in the region define accountability in the education sector as following rules and regulations. The lack of focus on student learning is particularly damaging. Setting up an accountability system requires performance objectives, measurable indicators of their achievement, a system of positive and negative incentives, and the political will to enforce sanctions. Establishing a financing framework for the system is also a high priority. Financing decisions for the post-secondary level can create student incentives and fiscal pressures that distort the compulsory and secondary levels and undermine their quality. Public finance for the tertiary level needs to be kept as limited and targeted as possible.

Another challenge for the institutional infrastructure is to acquire and maintain the human and physical assets that the system needs to produce learning. Major inputs include teachers, school buildings, curricular frameworks with associated textbooks and teacher guides, and equipment. The efficient use of teachers and the quality of their knowledge and teaching practice are two main issues. There is an urgent need to determine whether net savings can be realized by increasing the teaching loads, increasing teacher salaries in compensation for the additional work, and reducing the rate at which new teachers are hired to meet enrollment pressures. Teacher quality is a very serious problem that will take years to solve. Teacher quality is a function of the selection standards for entering pre-service training, the quality of that training, and the quality of in-service professional development. For entry into teaching, national teacher licensing examinations to assess both content knowledge and pedagogic practice must be introduced. Good credentialling assessments, once developed, rather than accreditation procedures, could provide more effective standard-setting signals to universities and community colleges that prepare future teachers.

To be able to face these challenges, the education system will have to change from a maintenance mode to a continuous improvement mode with appropriate incentives and feedback loops. Quality reforms have a particular and difficult political economy, especially when compared with reforms that increase access to education. Increasing access requires adding inputs—building new schools, hiring more teachers, and purchasing more textbooks and equipment. This kind of reform usually enjoys broad political support, as the benefits are visible, broadly distributed, rapid, and fairly certain. However, as quality reforms take much longer, their results are less visible and much less certain. Implementing quality reforms places greater demand on the system's management capacity. It also requires changes in classroom behavior of thousands of teachers, which underlines the importance of teacher training and incentives.

Health

The health conditions of Palestinians are good in relation to the prevailing income levels and to countries at comparable levels of development. According to the PCBS demographic survey, the infant mortality rate for those less than one-year old was 28 deaths per thousand live births in 1995 (Table 2). These rates were cut in half during the 1980–95 period, are now comparable to Jordan, and are lower than in most MENA countries. Similarly, the child mortality rate for those less than five years-old stood at 36 deaths per thousand in 1995, down from 73 deaths per thousand in 1980. These low mortality rates are reflected in a fairly high life expectancy at birth, which stood over 70 years—higher than most MENA countries, and comparable to that of upper middle-income economies.
This favorable situation is the result of an emphasis on primary care at the household level for the past two decades. This has been achieved in spite of low investment in and poor quality of public infrastructure in water supply, solid waste disposal, and sanitation facilities. Whether health indicators can be maintained (or improved) is a serious challenge. The high population growth rate implies a rapidly increasing demand for health services, especially in primary health care for mothers and children. The NGO sector has managed to satisfy key needs in the past. Yet, both the primary care NGO clinics and the Jerusalem hospitals are marginalized in the new environment. Border closures have increased in intensity and frequency and pose special difficulties, especially for some of the key institutions located in East Jerusalem. Finally, there are important choices that arise with public sector involvement in the health system, which have implications for the budget, as well as for the delivery system, insurance coverage, and costs.

Currently, at least half of the West Bank and one-third of Gaza Strip’s population do not have health insurance of any type, not even basic insurance. A household is covered by the government health insurance if it has a member that is a government employee, a worker in Israel, a social welfare recipient, or ex-detainee. Refugee households are covered for basic services by UNRWA. Only a small number of people—not exceeding 2 percent of the population—have private insurance. The self-insured households are particularly vulnerable in the face of major shocks to their incomes. But there is no simple solution. In particular, broadening the mandate of public insurance will not work given the implied fiscal costs. Instead, interventions to help the poor should be finely targeted, and possibly subcontracted to specialized NGOs.

The government-run system which covers civil servants is already losing money, and its deficit is increasing, with insurance premiums and co-payments covering only 40 percent of the PA’s health expenditure in 1995. In the interest of the sustainability of the system, some improvement needs to be made in raising the premium and user fees, and controlling costs. Generally, there are four broad areas in which costs should be controlled: (i) use of medication and drugs for treatment should be reduced from currently excessive levels; (ii) expensive treatment abroad, especially in Israeli hospitals, should be limited in favor of building local capacity; (iii) expansion of hospital facilities should be examined in the context of long-term planning; and (iv) expansion in secondary and tertiary care should not come at the cost of reduced primary health care.

The health sector is rich in its diversity and institutional structure. Health care—an industry that accounts for about 8–9 percent of GDP—is provided by four major groups: the PA spends 31 percent of total health care, UNRWA 12 percent, NGO providers 17 percent, and the private sector 40 percent. In the past, the NGOs have generally filled a need not satisfied either by the government or UNRWA. NGOs have provided curative and preventive services in primary health care clinics targeted to communities not well served by the official providers. In addition, the NGOs are a major provider of secondary health services.
through six general hospitals, and the only Palestinian hospital providing tertiary services is the Al-Makassed Hospital in East Jerusalem.

However, the NGOs suffered serious setbacks following the 1991 Gulf War, which effectively eliminated external Arab support. The establishment of the PA in 1994 caused donors to divert their support to the PA and UNRWA. As a result, NGO clinics in the rural West Bank declined from 210 in 1992 to 145 in 1994, and to 128 in June 1996. Rather than build new capacity to deliver health services in the public sector, it would be advantageous for the public sector to enter into partnerships with NGOs and tap into existing managerial capacity. In commissioning NGOs to deliver health services, it is important for the PA develop the appropriate regulatory framework.

The difficulties in mobility resulting from border closures create further challenges for the management and delivery of health services. The most dramatic impact of permit and closure policies is the difficulty in accessing Palestinian hospitals in East Jerusalem which, with 546 beds, provide essential secondary- and tertiary-care services. During periods of “total closure,” the entry of WBGS medical staff to Jerusalem is much more uncertain even with the proper Israeli-issued permits. The entry of patients is even more difficult. This places the health needs of the WBGS population at great risk. Closures doom the long-run financial viability of the Jerusalem hospitals. Bed occupancy and the number of outpatients decline substantially during periods of total closure, causing financial losses to these hospitals. For example, bed occupancy at Al-Makassed Hospital in Jerusalem declined from 63 percent in March 1995 (a period of no border closure in the West Bank) to 30 percent during the March 1996 closure. The number of outpatients fell by 53 percent over the same period. The separation and difficult access between the RWBGS and Jerusalem will likely produce new hospitals and medical facilities throughout the WBGS. This hospital expansion however would likely doom the financial viability of the Jerusalem hospitals that have served the Palestinians for many years.
Risks and the Role of Donors

With strong assets but equally burdensome liabilities, the Palestinian economy is on a knife's edge between take-off and collapse. Much will depend on the evolution of the peace process. However, in the meanwhile, donor strategies can make a big difference in stabilizing the economy and allowing it to sustain the livelihood of households. Three areas of concentration need to be addressed simultaneously: (i) long-term finance to support infrastructure reconstruction, and especially in new forms that draw in private sector participation; (ii) support for the WBGS' need for free access to the outside world and improved transportation and communications; and (iii) support that builds a lean and efficient public sector.

The range of possible economic outcomes is wide and heavily leveraged on the fluid political situation. This is reflected in wide gyrations in attitudes toward the peace process. According to relatively accurate attitude surveys, expectations have swung between very optimistic and very pessimistic several times in the past four years. Under good circumstances, it is perfectly realistic to expect the economy to leap-frog and become a high-tech center in the Middle East, attract back Palestinian Diaspora skills and capital, and link up with the East and West. At the other end of the spectrum, the continuation of the present status quo could produce a socio-economic disaster.

- The main risk for the WBGS economy is the continuation of the present status quo, particularly with respect to restrictions on the mobility of people and goods across borders. Unless a massive amount of jobs is created in Israel, domestic production will need to absorb the unemployed and new entrants in the job market. However, this cannot occur under the current border situation. Without jobs abroad, and under the impossibility of creating jobs inside, the standard of living for the WBGS population is doomed to decline.

- Without renewed emphasis on public sector modernization and effective institution-building, there is a risk of deteriorating governance, with further weakening in the rule of law, and a more fragmented civil society, especially in light of deteriorating economic and political conditions. This would lead to reduced investment and would keep Diaspora Palestinians out. An important related risk is that the PA, with the help of donors, would try to reduce unemployment by creating a low-wage, large civil service, like the Egyptian strategy. This could ultimately corrupt the education system as well.

Both sources of risk would make the WBGS a poor assisted economy, with a fragmented internal market cut off from the rest of the world. Social dislocations and limited economic opportunities could generate out-migration, especially of the educated, and scare off capital. Ultimately, donor assistance would be dissipated on short-term support (or it would stop) and infrastructure would remain in shambles, eliminating the chances for sustained long-term growth.

In these circumstances, the donor community has important roles to play in financing reconstruction; ensuring free access of the economy and free mobility of people and goods; helping to find a solution to the jobs dilemma, either within the Palestinian economy, or in Israel; and helping the civil service sector and civil society to adopt better forms of organization.

In the past, the donors' role has been much too biased toward resolving short-term financial crises. Donors have responded to negative shocks (notably closures) by shifting assistance to emergency efforts, such as jobs creation and public sector recurrent costs, to cushion their impact. The expenditure and time
required to set up the PA have also been larger than expected. The need for recurrent budget and other short-term support over a much longer period and in larger amounts than originally envisioned is mirrored by a delay in the flow of donor support for investment. As a result of the donors' obliging response to short-term crises, the impact on living standards from large negative shocks has been partly mitigated. At the same time, a unique opportunity to lay the foundation for sustained medium-term economic growth seems to have been lost.

**Short-term Support versus Investment**

An important issue concerns the right future balance in donor financing between short-term support and investment. In the absence of new negative shocks, the need for recurrent support will be lower and may even disappear altogether as the PA further consolidates its revenue collection effort and starts to produce surpluses. The critical issue is the extent to which future shocks should be smoothed. Theoretically, there is a strong case for a tilt toward lower consumption and higher investment support.

- It is not feasible in the long-run to compensate households for the reduction in income from loss of employment in Israel through subsidies. Rather, the only way of generating future incomes in a sustainable way is to raise investment.
- Security checks are now concentrated at the border (in the past under the ICA they were more diffuse). As a result, borders are now less porous. This increases the urgency of projects that connect the WBGS to the rest of the world and that foster more efficient operations at the border.

It is not evident that the bias against investment has been due solely (or mainly) to higher demand for short-term support. Disbursements for investment projects would have been low even without the concurrent increase in disbursements for consumption-oriented activities because of the underlying impediments facing the implementation of investment projects. The shift away from infrastructure was also due to the difficulties faced by projects. On the ground, the investment program has been slowed down by Israeli-imposed closures and by institutional weaknesses on the Palestinian side. In addition, a host of crucial projects has not even started because long-term investment projects are almost always subject to controversy between the PA and Israel. In particular, the construction of a Palestinian port and the implementation of the agreed "safe passage" between the West Bank and Gaza Strip have not yet started. While an airport in Gaza Strip has been built, it cannot operate until Israel approves the security arrangement and management procedures of the facility.

Similarly complex issues arise in relation to physical access to external markets, the modalities of border crossing, and the operation of trans-border industrial estates. A host of issues relating to water and land rights underlying many project proposals are inherently sensitive. While donor financial support of these key projects is essential, the active involvement of the donor community in overcoming the political obstacles for implementing these projects is required as well.

While smoothing large negative shocks remains an important objective, the donors' focus should now be squarely set on removing impediments to the implementation of public investment projects. In the absence of progress in the peace process, donor disbursements may slow down, as has apparently happened in the first half of 1997. But increasingly, more clarity and resolution on where the peace process is going is required to sustain the donor effort. Without progress on the resolution of key political issues, it will be difficult to avoid reticence among the donor community toward supplying subsidies that allow an unstable political situation to continue.

A related issue is whether donors will renew funding commitments as the initial five-year period for which pledges were made approaches. In the near future, donors will have to take a collective decision on a renewal of funding commitments as the five-year pledge period (1994–98) draws to a close. In the interim, the Consultative Group on the West Bank and Gaza Strip (CG) meeting in late 1997 did result in new pledges as a last push toward the final status in the peace process. Ideally, these donor pledges should closely reflect the PA's investment plan as outlined in the Palestinian Development Plan, which is now underway.

The sustainability of donor assistance will also depend on the evolving relations between donors, the PA, and the private sector. A crucial issue is how to sup-
port investment projects to ensure sustained growth and poverty alleviation without relying solely on public finance. The challenge will be to assist and encourage the private sector to undertake projects, with donors offering complementary finance, political risk guarantees, or insurance. Likewise, more attention should be given to building capacity within the PA to ensure a capable entity with the means to foster and complement private sector-driven growth. Also critical is the reform and redynamization of a host of organizations that were managed merely on a day-to-day basis during the occupation rather than with a long view. These include central and local government institutions that manage expenditures and raise revenue; a legal apparatus to enforce contracts and defend property rights; a well-regulated and confidence-inspiring financial sector; a flexible and fair labor market; well-formulated regulations that allow for efficient private provision of public goods and services; and effectively performing health and education systems that take advantage of NGO activism.
Bibliography

BACKGROUND PAPERS


REFERENCES


Note: The complete bibliography for the book, Development Under Adversity: The Palestinian Economy in Transition, accompanies this Summary.


Lahmeyer International and Verbund-Plan. 1995


United Nations. 1996. "Local Aid Coordination in the West Bank and Gaza Strip." Presentation to Informal Ad Hoc Liaison Committee Meeting, Washington, DC.


AGREEMENTS

Agreement on the Gaza Strip and the Jericho Area, between the Government of the State of Israel and the Palestinian Liberation Organization, 4 May 1994, Cairo.


The Israeli–Palestinian Interim Agreement on the West Bank and the Gaza Strip, between the Government of the State of Israel and the Palestinian Liberation Organization, 28 September 1995, Washington, DC.


Development Under Adversity
The Palestinian Economy in Transition

Table of Contents for Book

Foreword by Nabeel Kassis, Director, Palestine Economic Policy Research Institute (MAS)
Foreword by Joseph Stiglitz, Senior Vice President and Chief Economist, The World Bank

Part I. Recent Developments: New Constraints and Frustrated Developments

Chapter 1 Introduction and Background
   Ishac Diwan, The World Bank
   Radwan A. Shaban, MAS and Georgia Institute of Technology

Chapter 2 Worsening Economic Outcomes Since 1994 Despite Elements of Improvement
   Radwan A. Shaban, MAS and Georgia Institute of Technology

Chapter 3 Recent Political Developments
   Rex Brynen, McGill University

Chapter 4 The Harsh Reality of Closure
   Radwan A. Shaban, MAS and Georgia Institute of Technology

Part II. Policies for Growth and Job Creation under Adverse Conditions

Chapter 5 Private Investment
   Osama Hamed, MAS

Chapter 6 International Economic Relations: Access, Trade Regime, and Development Strategy
   Ishac Diwan, The World Bank

Chapter 7 Financial Intermediation
   Osama Hamed, MAS

Chapter 8 Fiscal Management
   Ali Khadr, The World Bank

Chapter 9 Shocks and Stabilization
   Osama Hamed, MAS

Chapter 10 Donor Assistance
   Ali Khadr, The World Bank

Part III. Building the Enabling Environment for Long-term Growth

Chapter 11 Improving the Education System
   Sue Berryman, The World Bank

Chapter 12 Managing the Growth of the Health Sector
   Mustafa Barghouthi, Health Development Information Project
   Jean Lennock, Health Development Information Project
   Radwan A. Shaban, MAS and Georgia Institute of Technology

Chapter 13 Infrastructure for Growth
   Ashoka Mody, The World Bank and University of Pennsylvania

Annex
Bibliography
Index
### Order Form

**CUSTOMERS IN THE UNITED STATES**

Complete this coupon and return to:
The World Bank
P.O. Box 960
Herndon, VA 20172-0960, USA

To have your order shipped faster, charge by credit card by calling (703) 661-1580 or send this completed order coupon by facsimile by dialing (703) 661-1501.

**CUSTOMERS OUTSIDE THE UNITED STATES**

Contact your local Bank publications distributor for information on prices in local currency and payment terms. You can find a complete list of distributors at our Internet address—www.worldbank.org/html/extpb/distdir.htm

If no distributor is listed for your country, use this order form and return it to the U.S. address.

---

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Title</th>
<th>Stock #</th>
<th>Price</th>
<th>Total Price</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Development Under Adversity: The Palestinian Economy in Transition</td>
<td>14418</td>
<td>$30.00</td>
<td></td>
</tr>
</tbody>
</table>

*SHIPPING AND HANDLING* charges are $5.00 per order. If a purchase order is used, actual shipping will be charged. For air mail delivery outside the United States, add $13.00 for first item plus $6.00 for each additional item.

**CHECK METHOD OF PAYMENT**

- Enclosed is my check payable to the World Bank.
- Charge my
  - VISA
  - MasterCard
  - American Express

Credit card account number

Expiration date Signature (required to validate all orders)

- Bill me. (Institutional customers only. Purchase order must be included.)

**PLEASE PRINT CLEARLY**

Name

Address

City State Postal Code

Country Telephone
Palestine Economic Policy Research Institute (MAS)
and The World Bank