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President Wolfensohn - Briefing Book for President's Meetings - Meeting Material
Speeches - Luncheon Meeting - Joseph Stiglitz - December 9, 1997

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WBG Archives

Luncheon Meeting: Mr. Joseph Stiglitz

Tuesday, December 9, 1997

1:00 - 2:00 p.m.

JDW Private Dining Room

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Document Log

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Edit

Print

A. CLASSIFICATION

- ☒ Meeting Material
- ☐ Trips
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B. SUBJECT: LUNCHEON MEETING: MR. JOSEPH STIGLITZ (B) (N)
(Confirmed) // TIME: 1:00 - 2:00 P.M. // VENUE: JDW'S PRIVATE DINING ROOM

// CONTACT: LUCIE @ 33774 // IN ATTENDANCE: JDW, STIGLITZ
(ONE-ON-ONE) // 12/03 CIHAT (2) // EXC: MM // LFG (11/18)

Brief includes:

- Draft Report: Development Under Adversity: The Palestinian Economy in Transition, Palestine Economic Policy Research Institute and WB, Oct. 30
- Briefing Note to JDW from MM, Dec. 9
- World Development Report 1997: The State in a Changing World: Media Analysis and Dissemination Report, Jul. 30
- Brief: Confronting AIDS Launch, Media Coverage
- Letter to JDW from J. Stiglitz re: Speech by J. Stiglitz: Development Under Diversity, The Palestinian Economy in Transition, Dec. 8

DATE: 12/09/97

C. VPU

Corporate

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- ☒ EXT
- ☐ LEG
- ☐ MPS
- ☐ OED
- ☐ SEC/Board
- ☐ TRE

Regional

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- ☐ EAP
- ☐ ECA
- ☐ LAC
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- ☐ SAS

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- ☐ CFS
- ☐ DEC
- ☐ ESD
- ☐ FPD
- ☐ FPR
- ☐ HRO

Affiliates

- ☐ GEF
- ☐ ICSID
- ☐ IFC
- ☐ Inspection Panel
- ☐ Kennedy Center
- ☐ MIGA

D. EXTERNAL PARTNER

- ☐ IMF
- ☐ UN
- ☐ MDB/Other IO
- ☐ NGO
- ☐ Private Sector

- ☐ Part I
- ☐ Part II
- ☐ Other

E. COMMENTS:

Development Under Adversity?

The Palestinian Economy in Transition

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

October 30, 1997 * Draft

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:

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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, as listed in the bibliography. In addition, research for this report has relied extensively on analysis of raw data sets of the labor force surveys, expenditure survey, and demographic survey carried out and made available to us by the Palestinian Central Bureau of Statistics. Martha Sipple was the editor, and Isabelle Schnadig provided data support.

The Palestine Economic Policy Research Institute, or *Ma'had Abhath As-Syasat Al-Iqtisadiyeh Al-Filistini* (MAS), is an autonomous national research institute that was established in May 1994 to engage in applied economic research, and to provide expert analysis of policies and strategies critical to the development of the Palestinian economy. MAS's research output has included numerous publications in the areas of banking and monetary policy, fiscal policy, trade policy, poverty, social security, industrial development, general development, and first readings in PCBS's statistical publications. MAS has also organized numerous workshops that have been summarized in *MAS Policy Notes* and in local media. MAS's monitoring unit has already published its first issue of the *MAS Economic Monitor*. One of its important resources is a quality social science library. MAS's in-depth research findings in the various areas of the Palestinian economy are used extensively in this report. For more information on MAS's research output visit the website at: www.palecon.org.

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Definitions & Terms

Acronyms and initials

AHLC	Ad Hoc Liaison Committee
CG	Consultative Group on the West Bank and Gaza
CPRS	Center for Palestine Research and Studies
CU	customs union
EAP	Emergency Assistance Program
EGS	employment generation scheme
EIP	export insurance program
EU	European Union
FTAs	free trade agreements
GIE	Gaza Industrial Estate
GCC	Gulf Cooperation Council
ICBS	Israeli Central Bureau of Statistics
IEC	Israel Electric Company
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
JEDCo	Jerusalem Electricity Distribution Company
JLC	Joint Liaison Committee
JSC	Joint Security Coordination and Cooperation Committee
JTIC	Jerusalem Tourist Investment Company
LACC	Local Aid Coordination Committee
LDC	less developed countries
LMICs	lower middle-income countries
MENA	Middle East and North Africa
MEDB	Middle East Development Bank
MIGA	Multilateral Investment Guarantee Agency
MEHE	Ministry of Education and Higher Education
MHE	Ministry of Higher Education
MIP	mortgage insurance program
MOE	Ministry of Education
MOH	Ministry of Health
NGO	non-governmental organization
O&M	operation and maintenance
OECD	Organization for Economic Cooperation and Development
OPIC	Overseas Private Investment Corporation
PA	Palestinian National Authority
PADICO	Palestinian Development International Company
Paltel	Palestinian Telecommunications Company
PARC	Palestine Agricultural Relief Committees
PCBS	Palestinian Central Bureau of Statistics
PEA	Palestinian Electricity Authority
PECDAR	Palestinian Economic Council for Development and Reconstruction

PIIC	Palestine Industrial Investment Company
PLO	Palestinian Liberation Organization
PMA	Palestinian Monetary Authority
PPP	purchasing power parity
PRCS	Palestine Red Crescent Societies
PREC	Palestine Real Estate Company
PSEC	Palestine Securities Exchange Company
PWA	Palestinian Water Authority
REDWG	Regional Economic Development Working Group
RWB	West Bank exclusive of East Jerusalem
RWBGS	West Bank and Gaza Strip exclusive of East Jerusalem
RWG	Refugee Working Group
SACU	Southern African Customs Union
SMF	secondary mortgage facility
SWG	Sectoral Working Groups
TAP	Tripartite Action Plan on Revenues, Expenditures and Donor Funding for the Palestinian Authority
VAT	value-added tax
UIP	unemployment insurance program
UNDP	United Nations Development Programme
UNRWA	United Nations Relief and Works Agency
UNSCO	United Nations Special Coordinator Office
US	United States
WBGS	West Bank and Gaza Strip
WTO	World Trade Organization

Agreements

Annex 5	Economic Annex to the Interim Agreement
Declaration of Principles	Israeli-Palestinian Declaration of Principles on Interim Self-Government Arrangements
Cairo Agreement	Agreement on the Gaza Strip and the Jericho Area
Early Empowerment Agreement	Agreement on Preparatory Transfer of Powers and Responsibilities
Economic Protocol	Protocol of Economic Relations
Gaza-Jericho Agreement	Agreement on the Gaza Strip and the Jericho Area
Hebron Protocol	Protocol Concerning the Redeployment in Hebron
Interim Agreement	Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip
Oslo Agreement	Israeli-Palestinian Declaration of Principles on Interim Self-Government Arrangements
Oslo II Agreement	Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip
Paris Protocol	Protocol of Economic Relations
Taba Agreement	Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip

Weights and measures

BCM	billion cubic meters
DWT	deadweight tonnage
kg	kilogram
km	kilometers
MCM	million cubic meters
Mw	megawatts

Currency

JD	Jordanian dinar
NIS	New Israeli shekel
US\$	United States dollar

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

Development Under Adversity?

Executive Summary

This report analyzes some key strategic choices facing the emerging Palestinian economy in the short and medium term. The report 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 report 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 the 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.

A.

**RECENT ECONOMIC RECORD:
FRUSTRATED DEVELOPMENT AND AN ECONOMY
INCREASINGLY BELOW ITS POTENTIAL**

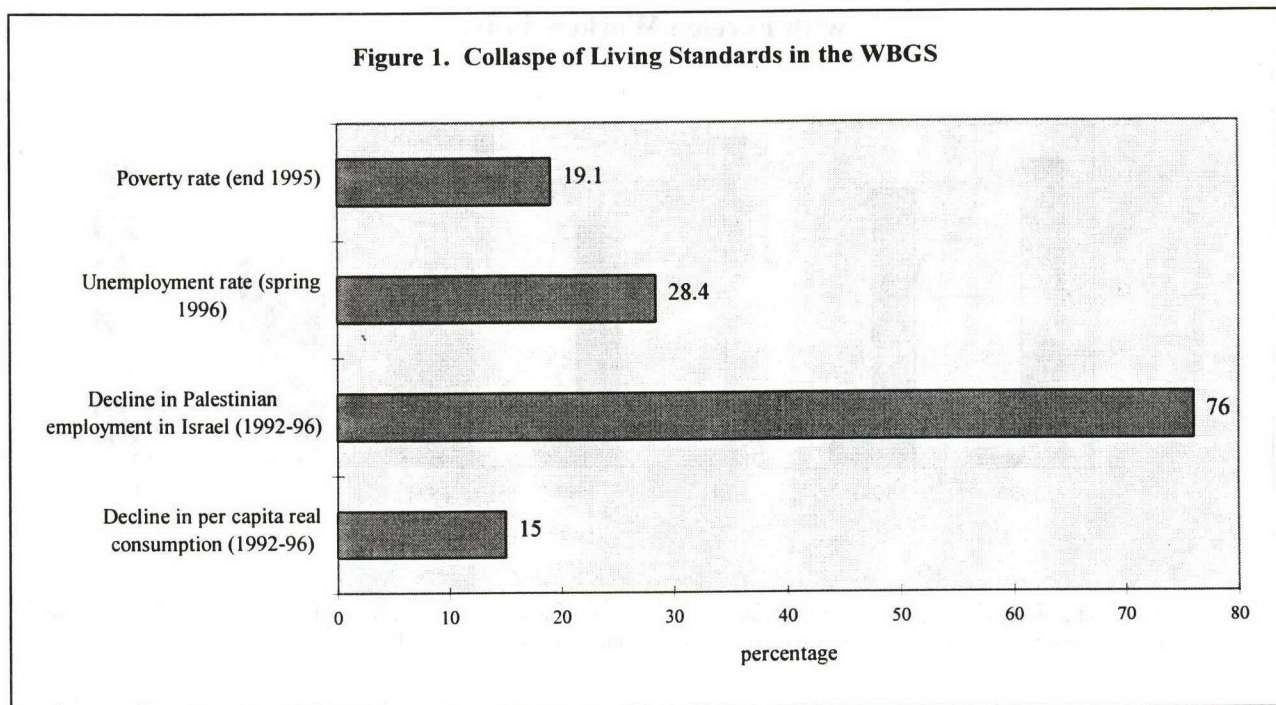
The Palestinian economy is increasingly less able to sustain jobs and incomes for its people. In contrast to the initial rosy economic scenarios that were projected early in the peace process and despite the assistance of the international donor community, the standard of living has continued to fall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

But 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 1995-1996 survey period is about 15 percent below its average for the years 1992-1993. 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 1990-1991; 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.

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.

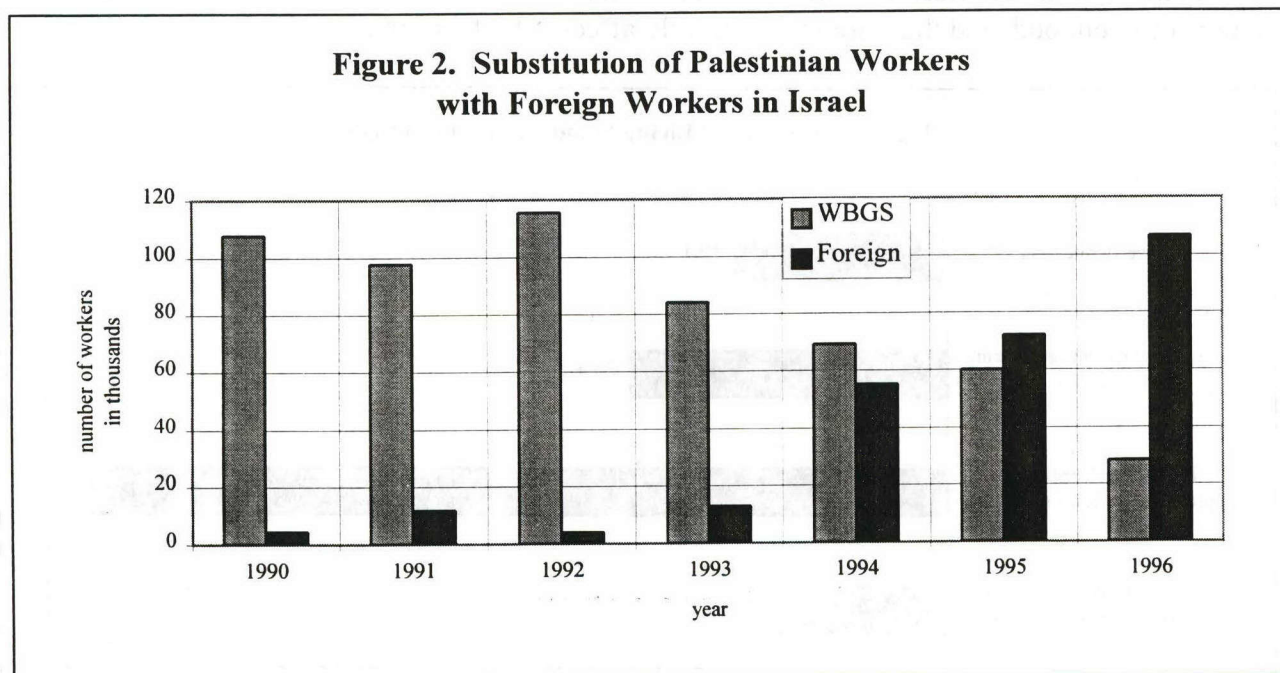


Sources: Chapter 1 and based on PCBS data.

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 fast, 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 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 continuously declined since 1992 in response to the permit and closure policies. At the same time, employment of non-Palestinian foreigners from South Asian and East European 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 WBS is higher than all 57 economies analyzed in the World Bank's *World Development Report 1995*.

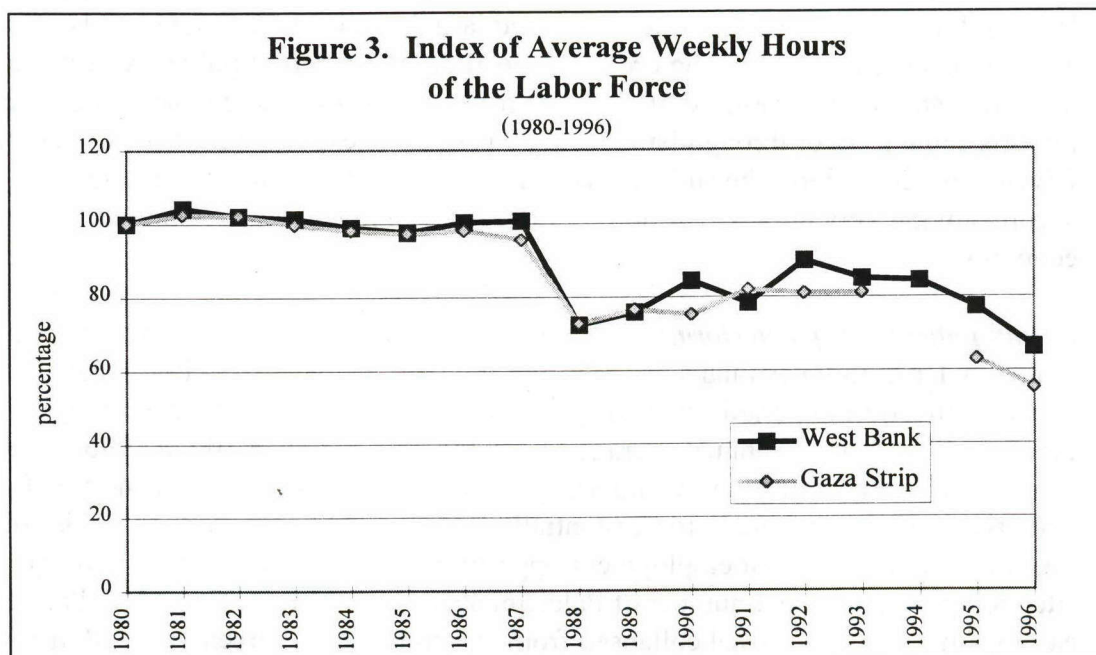


Sources: Israeli Central Bureau of Statistics (ICBS) for Palestinian employment up to 1994, and PCBS for 1995-1996 Palestinian employment. Number of foreign workers refers to permits issued and is obtained from the Israeli Ministry of Labor.

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 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 1980-1996 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 1992-1996. 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.



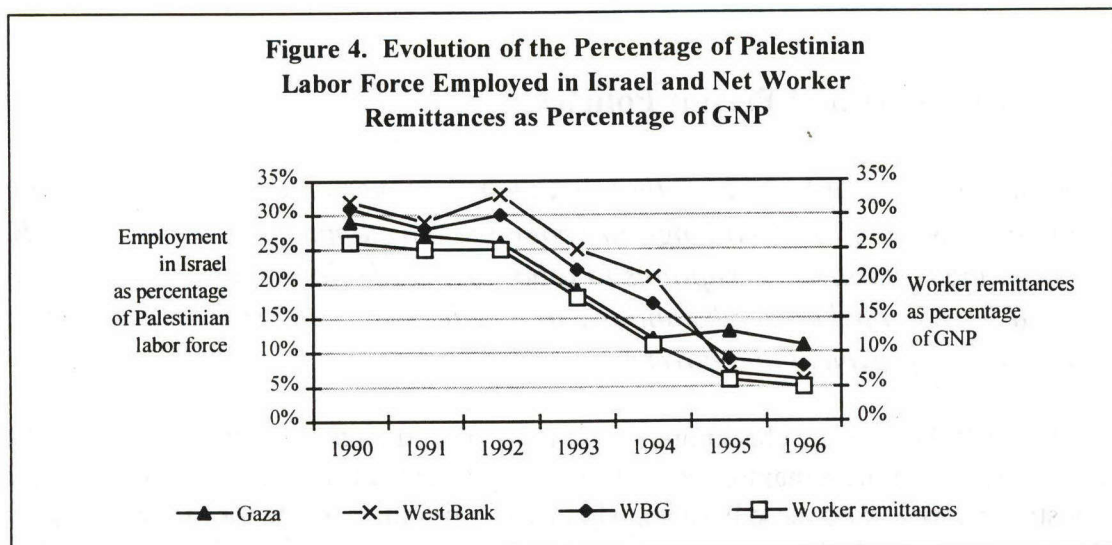
Note: Index for 1980 is set to 100. Average weekly hours of labor force in 1980 was 43.3 in the West Bank and 43.7 in Gaza Strip. Sources: 1980-1994 data are based on ICBS; 1994 data were not collected in Gaza Strip; and 1995-1996 data refer to fall and spring of these years, respectively, and are based on PCBS.

1. 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 of 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 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 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).

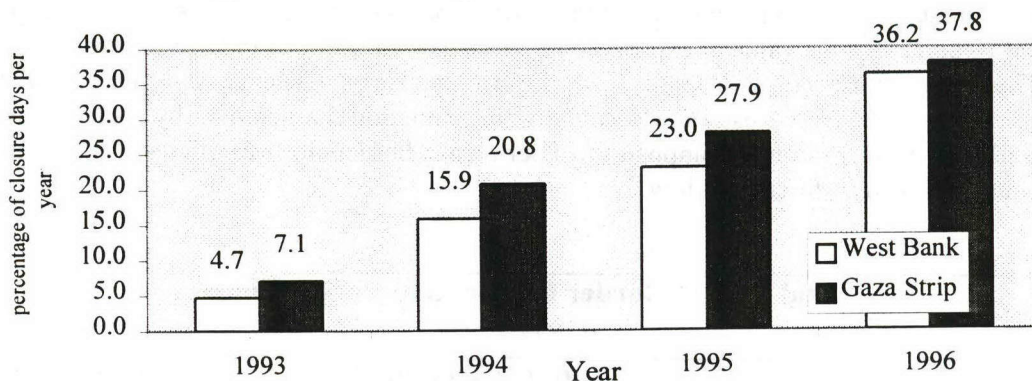


Sources: ICBS and World Bank.

- Unpredictable border closure policy.** The shocks from the border closure policy have occurred with increasing frequency (Figure 5) and of 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. 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 (US)).

Figure 5. Increasing Incidence of Border Closure



Source: Based on data in Chapter 3.

The economic cost of decreased and interrupted mobility of workers and goods is a concept difficult to define precisely, and even more difficult to estimate 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 1993-1996, 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.

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 of 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.

Total Cost of Border Closure and Permit Policies (1993-1996)								
	Rest of West Bank				Gaza Strip			
	1993	1994	1995	1996	1993	1994	1995	1996
GNP (in \$ millions at 1995 prices)	3,226.6	3,124.1	2,926.9	2,951.2	1,168.3	1,120.0	1,189.7	1,152.8
Closure days/year	17	58	84	132	26	76	102	138
% days under closure	0.047	0.159	0.230	0.362	0.071	0.208	0.279	0.378
Losses (\$ millions at 1995 prices)								
Closure & Permit Policies	137.4	337.8	434.1	500.9	146.4	351.8	412.9	456.1
Losses (% of GNP)								
Closure & Permit Policies	4.3	10.8	14.8	18.2	12.5	31.4	34.7	39.6

Source: Authors' computation, see Chapter 3 for details.

2. Larger Public Sector and Lower Private Sector Activity

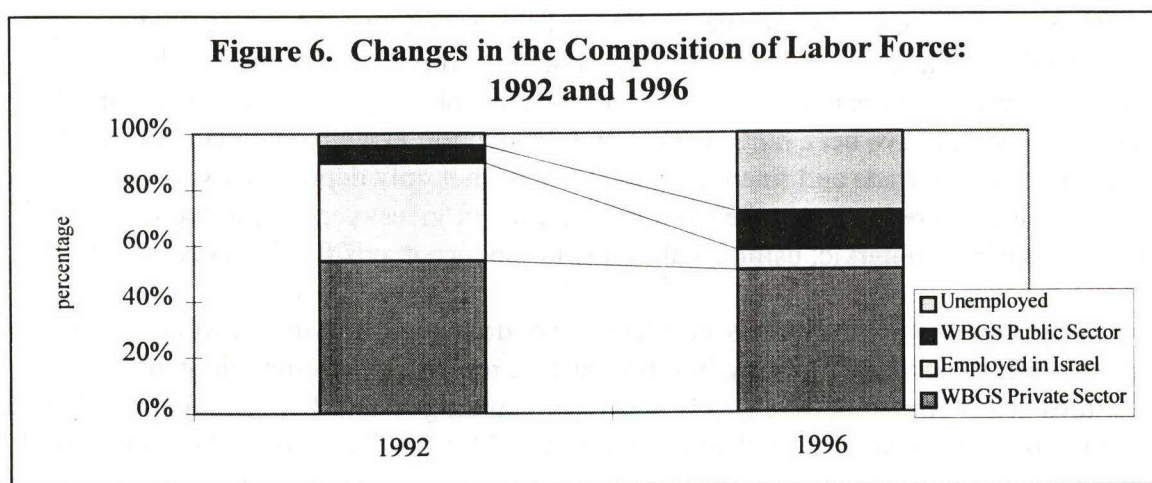
Despite early emphasis in the peace process on the importance of export-oriented private sector growth, the recent record demonstrates a weakening role of the private sector. The establishment of PA institutions and pressures to solve the high unemployment problem through public sector employment have 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 was 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. By placing little in public investment and simultaneously supporting a larger-than-needed civil service in the midst of a weakened private sector, this strategy 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 clearance. Over 1994-1996, \$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 clearance on cross-border transactions amounted to \$25 million in 1994, \$267 million in 1995, and \$423 million in 1996 (over 60 percent of total revenues in 1996). In the past, these taxes paid by Palestinians leaked to the Israeli treasury. This anomaly was partially corrected in the 1994 Protocol of Economic Relations (Economic Protocol or Paris Protocol). Several types of taxes paid by Palestinians, but currently collected by Israel, are now remitted to the PA—in particular, the value-added tax (VAT) on goods consumed in the WBGS, and income taxes on income earned in Israel.

These large transformations are best illustrated by the changing composition of the labor force (Figure 6). The share of employment in Israel has been cut from one-third of the Palestinian labor force in 1992 to less than 10 percent in 1996. As a result of building the PA institutions (including the police force) and partly in response to unemployment pressures, the public sector employment share of the labor force has more than doubled, increasing from 6 percent in 1992 to 13.5 percent in 1996. Depressed levels of private sector activity have led to a reduction in the private sector's employment share in the labor force. Despite the growth in public sector employment, the inability of the private sector to create jobs needed by those prevented from working in Israel and new entrants into the labor force has resulted in skyrocketing unemployment.



Sources: 1992 data based on ICBS; 1996 data based on PCBS labor force survey in April-May 1996.

3. 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), an uncertain legal and tax framework, and political risks. 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 Israeli Civil Administration 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.

Table 1. Comparing Infrastructure Services in the WBGS*

Country	Population (million)	Per capita income (US \$)	Electric supply (kw per 100 people)	Electric power system losses (%)	Households with sanitation (%)	Number of phones (per 100 people)	Meters of paved roads (per 100 people)
Egypt	55.0	650	21.0	14.0	50	4.3	59
Jordan	3.9	1,120	25.0	19.0	100	7.0	170
WBGS	2.4	1,450	13.0	30.0	25	3.1	80
Lebanon	4.0	2,500	32.0	N.A.	N.A.	9.3	N.A.
Syria	13.0	2,800	30.0	N.A.	63	4.1	180
Israel	5.1	13,500	82.0	4.0	100	37.1	266
Mauritius	1.1	2700	33	14	100	9.6	190
LMICs**	1152.6	1,620	21.5	12.4	--	7.9	--
OECD	--	19,710	82.6	7.3	--	45.1	--

* Data are for the years 1992-1994.

** Lower middle income countries.

Sources: World Bank (1994c); International Yearbooks of Telecommunications Statistics, Electricity Statistics; Road Statistics; KPMG report on telecommunications, and internal World Bank reports.

Increased Uncertainty in the Interim Period. It is difficult to do business in the WBGS. Instead of the regulatory restrictions that stifled 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 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 because of 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, with uneven powers to implement such views, on these issues. 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 foreign trade, foreign exchange, and monetary regime 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.
- *PA's attitude vis-à-vis the private sector.* Experience has been mixed so far. In spite of recent practices that raise doubts about the PA's 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.

4. 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, which were not adequately provided by the Israeli Civil Administration. NGOs, universities, and hospitals have played a major role in delivering services in health, education, agriculture, and welfare aid to poor families.

Table 2. General Development Indicators

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

* Figures for the West Bank in this table do not include Jerusalem.
Source: Extracted and computed from various tables in PCBS (1996a).

- ***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 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.

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 in 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.

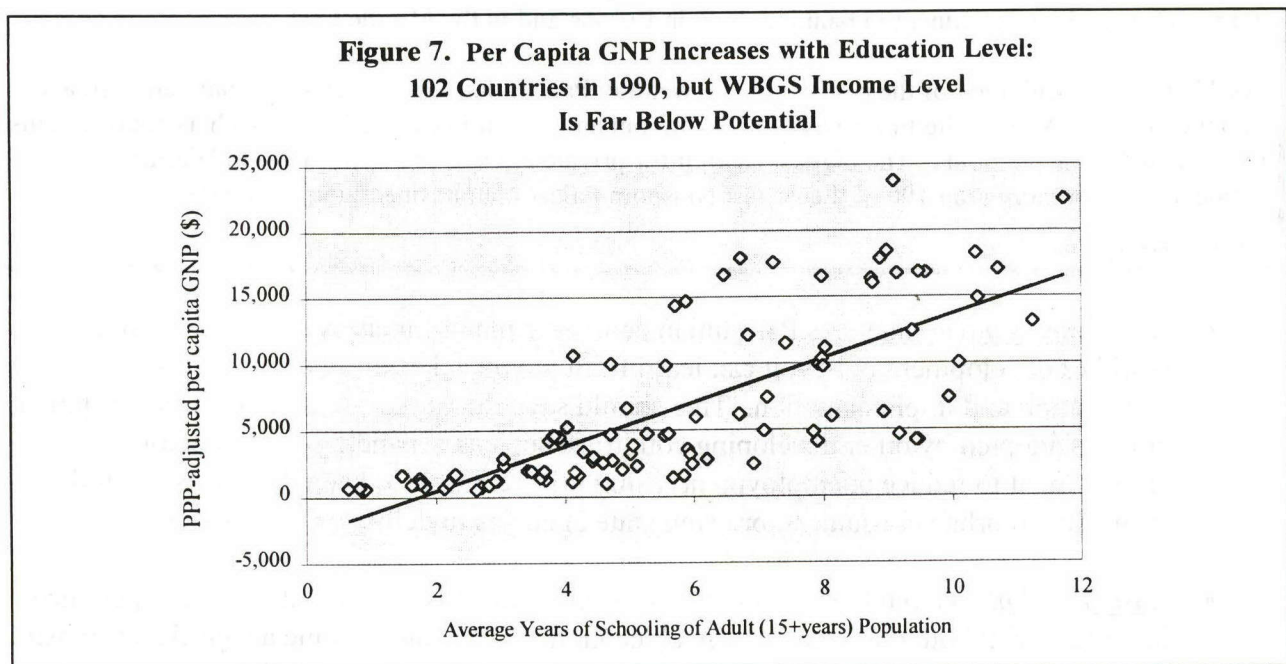
Source: Abu-Ghaida (1996).

- *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 support long-term infrastructural 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 is 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.



Note: WBGS average years of adult schooling was 8.1 years in 1995.

Source: Data from Barro and Lee (1996).

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.

B. 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.

1. 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.*, port, airport, 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. As a consequence, the free movement of goods and people is essential, and this requires a political agreement 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.

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 much larger vessels would be constructed in the second phase. In the third phase, the breakwater would be expanded and a new 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 would 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 in 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.

Source: Mody (1996).

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 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 1999). 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 where the Palestinians have a strong export potential: agriculture and labor-intensive manufacturing (*i.e.*, shoes, garment, 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 back 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 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 a 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) custom 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 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 custom revenue is presently collected on manufactured imports, there would be little effect on fiscal revenues.

2. 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.

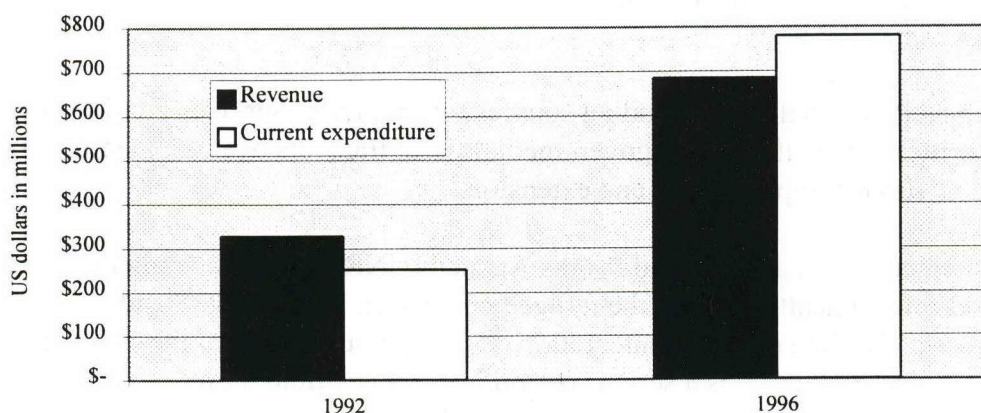
The incentive structure for the civil service is not presently geared toward ensuring optimum staff performance. Only when the extent of government's responsibilities for service provision have been clearly spelled out will optimal organizational designs, staffing levels, and profiles for government 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 Israeli Civil Administration's 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.

Figure 8. Evolution of Fiscal Revenue and Expenditure



Sources: Annex (Table 7) and World Bank 1994-96 GDP estimates.

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 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 is to a large extent 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.

But 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 the significant leakage which occurs under this formula, which according to a recent study amounted to 4 to 6 percent of GDP (or around \$125 million) during the 1994-1996 period. The leakage is due to the high proportion of indirect imports (*i.e.*, 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 economy. 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.

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 Israeli Civil Administration) in order to provide for enhanced delivery of public services that were widely perceived to have been sub-standard under occupation; to fill senior staff ranks in the civil service, which under the Israeli Civil Administration 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 Israeli Civil Administration. There is now evidence that the extra recruitment has by 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. 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 Ministry of Social Affairs Assistance program, the World Bank Direct Hire program, and the UNRWA Emergency Employment program have managed to ensure that \$1 of every \$1.50 allocated has actually 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 would 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 domestically produced 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 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 (the Jordanian dinar, the Israeli shekel, and the 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.

3. 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 also needed to secure legal protection against expropriation and confiscation of foreign investment property, and legal guarantees that insure the repatriation of capital and profits. The creation 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 with 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, *e.g.*, 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. Some of the investments required for infrastructure could be provided by the private sector. 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 non-government citizen groups. The provision of public goods is safeguarded by mechanisms that foster accountability and contested markets.

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 primarily 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 20-30,000 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 at the present time to formulate security procedures and agreements of access to and from the GIE site to insure complete closure-free operation.
- *The Policy Environment.* Significant progress has been made recently in advancing the legal framework and the 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.

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, 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 largely determined 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.

C.

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.

1. 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 a re-thinking of economic growth patterns and a change in attitudes vis-à-vis water.

One dramatic implication is that agriculture is unlikely to remain the mainstay of the Palestinian economy in the future. 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. In order to have economic growth in the future, 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. Conversion of current irrigation practices to more efficient methods could protect and consume less of the available fresh water resources. Nevertheless, given the large share of the labor force in agriculture, the required future adjustment is considerable.

Table 3. Regional Water Resources

Country	Resources BCM* per year	Consumption BCM per year	Resources cubic meters per capita per year
Israel	2.1	1.9	375
Jordan	0.8	1.0	213
Lebanon	4.8	0.8	1,200
Syria	5.5	3.3	385
WBGS	0.2	0.2**	115

* billion cubic meters

** Actual Oslo II allocations (interim) are 264.5 million cubic meters (MCM) (248 MCM renewable and 16.5 MCM from Israel).

Source: World Bank (1995a).

In these circumstances, industry and services will have to play a leading role, and given the size of the economy and the constraints on the export of labor, the 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.

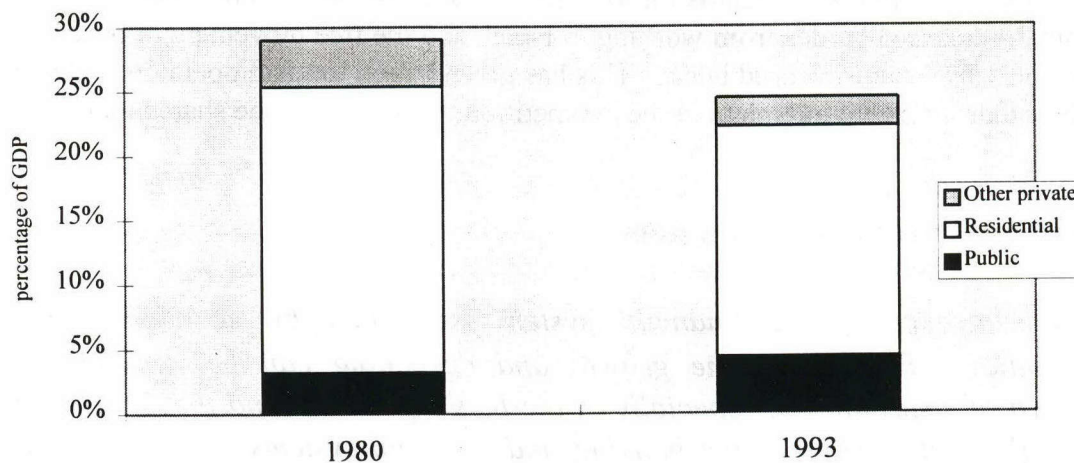
- *Strategy C: Gateway to the East*—transformation of western technologies and the adaptation of technologically intensive goods to fit better the specific needs of the neighboring Arab countries. The gateway to the East strategy provides a challenging vision for the medium term: to transform Western 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 raising 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 side 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; indeed, there are serious crowding problems among lower-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.

Figure 9. Composition of Total Investment as Share of GDP



Source: World Bank.

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 political settlement. One policy area that will greatly affect the short-term competitiveness of the tourism sector is the implementation of the Palestinian-Israeli agreement regarding the mobility of tour guides and bus companies. According to these agreements, tour buses are supposed to move freely between PA-controlled areas and Israel, and tour guides that meet standards agreed upon by both sides are supposed to be honored in each other's territories. So far, however, common standards for tour guides have not been established, which effectively prevents PA-licensed guides from working in Israel, and the free movement of buses has been enjoyed only by Israeli-licensed buses. This has given Israeli tourism operators a clear advantage over their Palestinian counterparts in the competition for tourists in the shared market.

2. Financial Sector Development

The development of the financial system is limited by economic and political uncertainties. However, some growth and deepening can be achieved before the resolution of uncertainties, especially in the banking system and the equity market, with policies that better monitor the banking and financial systems, encourage savings, and boost the provision of long-term credit and risk-sharing opportunities.

Banking. The Palestinian financial system has expanded substantially in the last three years. The expansion was particularly large in the banking sector, which sharply increased its deposits from \$220 million in 1993 to \$1.7 billion in 1996. However, while the deposit base has reached Middle Eastern standards, it remains low compared to more efficient settings, e.g., Lebanon has a deposit to GDP ratio that is three times higher. The banking system has been much more effective in mobilizing deposits than in channeling these deposits to local borrowers. At the end of 1996, the loan-deposit ratio for the WBGS banking system was only 0.24. While it is not realistic to expect this ratio to reach the 0.6 to 0.8 levels observed in other countries in the

region prior to the successful conclusion of final status negotiations, a significant increase in lending can be achieved even in the present political environment if certain policy actions are taken.

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, but 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. But the WBGS presently does not have deposit insurance and the availability of discount loans is limited, thus making it 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 its 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.
- There is substantial pressure on the PMA from the business community and policy makers to impose minimum lending requirement on banks in order to expand domestic credit. In the same vein, the PMA should resist such pressure 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 the Palestine Agricultural Relief Committees (PARC). The UNRWA's 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. In the WBGS where about 60 percent of the agricultural labor force is female, PARC serves as a good example. It has provided small, low-interest loans to female farmers since 1994 with the group-lending model and utilizes an extensive rural outreach program to strengthen and mobilize their capabilities in income-generating projects.

The Emerging Financial Market. While there is still no bond market in the WBGS, a new stock market has just opened. 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. There are presently around 50 joint stock companies in the WBGS, most of which have been established in recent years, but this still accounts for less than 1 percent of all establishments. The recently established 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, 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 facility utilizing 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 were 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.

Source: Zwaiter and Abdou (1996).

3. 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 as market forces are unlikely to lead to an ideal situation; and a focus on a systems view—with partnerships between providers and beneficiaries, grounded in a regulatory framework, an enforcement mechanism, and feedback loops—will be crucial to success.

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, 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. But it is not efficient for the 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 will need to deliver a curriculum that instills in students the foundation skills and higher-order cognitive thinking skills they need 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 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 two main issues are the efficient use of teachers and the quality of their knowledge and teaching practice. 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 who 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 the 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 1980-1995 period, are now comparable to Jordan, and are lower than in most countries of the region. 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 that of most countries in the Middle East, 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, 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 the insurance premia 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, by providing 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 6 general hospitals, and the only Palestinian hospital providing tertiary services is the Al-Makassed Hospital in East Jerusalem.

But the NGOs suffered serious setbacks following the 1991 Gulf War, which effectively eliminated external Arab support, and with the establishment of the PA in 1994 which caused donors to divert their support to the PA and UNRWA. As a result, the number of 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 challenges for the management and delivery of health services. The most dramatic impact of the 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.

D.

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 very 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 are created in Israel, domestic production is needed 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.
- Unless there is a renewed emphasis on public sector modernization and effective institution-building, there is a risk of deteriorating governance, with further weakening of the rule of law, and a more fragmented civil society, especially in the presence of deteriorating economic and political conditions. This would lead to reduced investment and would keep the 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, ultimately corrupting 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, with social dislocations and limited economic opportunities generating out-migration, especially of the educated, and scaring off capital. Ultimately, donor assistance would be dissipated on short-term support (or it would stop) and infrastructure would remain a shambles, eliminating the chances for sustained long-term growth.

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

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 Israeli Civil Administration 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 of those 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 also inherently sensitive. While donor financial support of these key projects is essential, the active involvement of the donor community in overcoming the political obstacles to the implementation of 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, some 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 keep going.

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 may 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 support 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.

* * *

Part A

Recent Developments: New Constraints and Missed Opportunities

With the signing of the Declaration of Principles in September 1993, there were high hopes for a quick resumption of economic growth. These expectations were based both on the existence of a number of strong structural advantages in the Palestinian economy and society, and on the fact that for a variety of reasons, growth had remained below potential prior to the onset of the peace process.

Yet, in spite of a significant donor effort, the economic situation has deteriorated markedly since the beginning of the peace process in 1993. Unemployment and poverty have emerged as major problems, amid a rapidly growing public sector, a slowing of private investment, and a collapse in trade flows. Palestinian policy makers have had to operate under a constraining framework in implementing the Palestinian-Israeli agreements—beginning with the PA's inception in 1994 and extending through a series of enlargements of its spheres of influence. Much more constraining, however, has been the day-to-day reality of closures, the diminishing porosity of the WBGS borders, and the reduced ability to travel to, work in, and trade with Israel. Increased difficulties in business operations and heightened strategic uncertainty regarding the feasibility of a permanent settlement, have stifled private investment.

These difficulties are taxing economic development, and require all efforts to concentrate on stabilization, institutional growth and the donor process. In light of the recent experience of ongoing cycles of closure, economic decline, and violence, Palestinian policy makers will not be able to foster the kind of ambitious economic vision to which the population aspires unless the prevailing political, policy, and institutional frameworks undergo deep transformations.

Chapter 1

Worsening Economic Outcomes Since 1994 Despite Elements of Improvement

The peace process has been widely expected to substantially improve the economic conditions of Palestinians in the WBGS. Some improvement has been witnessed in the creation of new institutions of governance, the boom in financial and construction sectors, and the establishment of many new firms. Yet, reality has dashed expectations. The standard of living has declined, poverty has increased, and unemployment rates are higher than ever. These outcomes have been accompanied by a decline in per capita GNP and GDP, interruptions to trade, a decline in investment, and the sudden and substantial reduction in the employment of Palestinians in Israel.

Introduction

With the signing of the Declaration of Principles in September 1993, there were high expectations of rapid economic growth that would improve living conditions in the WBGS. There were several reasons for optimism. It was anticipated that the PA would adopt policies more favorable toward local economic development than the policies of the Israeli Civil Administration. The financial sector would be permitted to develop and play a key role in facilitating investment and transactions. Legal and regulatory obstacles to development would be eliminated, inducements for private enterprise would be introduced, and public sector services and infrastructure would be improved and expanded. These developments would take place with the generous support of donor countries. Moreover, the Palestinian-Israeli partnership for peace was expected to generate friendlier Israeli policies toward Palestinian economic development.

Indeed, in September 1993, about two-thirds of the WBGS population believed that the peace process would improve their economic conditions (Box 1.1). These expectations were somewhat tempered in the first year after the Declaration of Principles due to (i) difficulties encountered in negotiating the May 1994 Agreement on the Gaza Strip and Jericho Area (Cairo Agreement or Gaza-Jericho Agreement) to transfer powers in the Gaza Strip and Jericho; (ii) challenges in creating Palestinian capacity for economic management and institutions of governance; and (iii) slow initial speed in disbursing foreign aid. In June 1994, approximately 31 percent of the West Bank and 45 percent of the Gaza Strip population still believed that their economic conditions would improve as a result of the peace process. Only 15 percent of the West Bank and 8 percent of the Gaza Strip population believed that the peace process would leave them economically worse off.

Between October 1994 and March 1995, 40 to 52 percent of the respondents reported that their economic situation and standard of living had deteriorated in the aftermath of the implementation of peace process. The dashing of economic expectations is particularly frustrating to Palestinians given the solid economic performance of the Israeli economy (Box 1.2). While emphasis was placed on improving the Palestinian economic conditions at the time of signing the Declaration of Principles, the Israeli economy has benefited significantly from the peace dividend, while the Palestinian economy was allowed to collapse.

This chapter documents the frustration of these expectations in the period since the September 1993 Declaration of Principles (also referred to as the Oslo Agreement). This period has been accompanied with deteriorating living conditions as reflected in increased and high rates of poverty, and in extremely high and widely fluctuating unemployment rates. The chapter also analyzes the decline in economic indicators (per capita GNP and GDP, investment, trade, and employment) that contributed directly to the deteriorating living conditions, as well as the few areas where improvements were achieved despite all odds.

Box 1.1 Palestinian Public Opinion on Economic Improvements

The Center for Palestine Research and Studies (CPRS) in Nablus, the West Bank, has been carrying out opinion polls on the political and socio-economic conditions in the WBGS since September 1993. Twenty-six public opinion polls were conducted between September 1993 and March 1996.

The opinions polls illustrate that around the time of signing the Declaration of Principles, about two-thirds of the population of the West Bank (65.6 percent) and the Gaza Strip (65.4 percent) expected the implementation of the Declaration of Principles to improve Palestinian economic conditions. The fraction of people believing that their economic situation would improve was much less in June 1994 (after signing the Cairo Agreement), and stood at 31.4 percent in the West Bank and 45.1 percent in the Gaza Strip. Yet, the fraction of people who reported their economic condition improved since the implementation of the peace process ranged only between 3.9 percent and 13.3 percent in the West Bank and between 10.8 percent and 15.7 percent in the Gaza Strip.

Despite early high expectations of economic improvement, the fraction of people reporting their economic situation to have worsened since the implementation of the Declaration of Principles ranged between 35 and 52 percent in the West Bank and between 48 and 57 percent in the Gaza Strip. In comparison with the West Bank, the Gaza Strip has higher portions of people whose economic situation has either improved or worsened.

In repeated public opinion polls, unemployment and job availability were recorded as the most critical concern among a host of socio-economic and cultural factors, such as violence, repression, and moral decay and religious abandonment. This primary concern for employment was repeated in the October 1993, May 1994, and December 1995 polls.

The shocks that influence the region are reflected in the optimism and pessimism regarding future economic and political developments.

Source: CPRS, public opinion polls, various, 1993-1997.

Selected Survey Results

Below are the survey results concerning economic development taken from the various public opinion polls of the CPRS. (All figures are represented in percentage of respondents.)

Expectations and Reality of Economic Improvements

Q.: *Will the proposed Palestinian-Israeli agreement improve economic conditions in the WBGS?*
(September 10-11, 1993) answering yes: 65.4 in Gaza Strip; 65.6 in West Bank; 65.5 in WBGS

Q.: *With the implementation of self-government, do you believe that your standard of living _____?*
(June 30, 1994)

	<u>Total</u>	<u>West Bank</u>	<u>Gaza Strip</u>
Will improve	36.0	31.4	45.1
Will worsen	13.0	15.5	8.1
Other	51.0	53.1	46.8

Q.: *Following the peace process and implementation of autonomy in the Gaza Strip and Jericho, my economic situation and standard of living has:*

	<u>Total</u>	<u>West Bank</u>	<u>Gaza Strip</u>
(September 29-October 1, 1994)			
Improved	9.2	7.5	11.8
Worsened	40.8	35.6	48.5
Other	50.0	56.9	39.7
(March 16-18, 1995)			
Improved	8.4	3.9	15.7
Worsened	52.7	52.0	53.8
Other	38.9	44.1	30.5
(August-September 1995)			
Improved	9.8	9.2	10.8
Worsened	43.5	35.9	57.0
Other	46.7	54.8	32.2
(March 1997)			
Improved	12.6	13.3	11.3
Worsened	51.9	49.3	56.5
Other	35.5	37.4	32.2

Pessimism/Optimism about Political and Economic Conditions

Q.: *Taking into consideration the political and economic conditions facing the occupied territories and the current Palestinian-Israeli negotiations, are you optimistic or pessimistic about the future?*

percentage of respondents in WBGS

	<u>Optimistic</u>	<u>Pessimistic</u>	<u>Not Sure</u>
February 19, 1994:	39.0	36.7	24.3
March 20, 1994:	20.5	51.2	28.3
May 31, 1994: ^a	66.4	21.4	12.2
March 16-18, 1995:	49.1	31.9	19.0
August-September 1995:	49.5	28.8	21.7
June 28-30, 1996: ^b	34.4	27.6	38.0
March 6-9, 1997:	64.5	29.7	5.8

a. "Optimistic" category includes "optimistic to a limited degree." Question is slightly different in this poll.

b. Question is modified to state "following the success of Likud party and its leader, Netanyahu, in the Israeli elections. The "not sure" category includes those stating "no change has taken place in the peace process."

Box 1.2 Impressive Economic Performance in Israel

The Israeli economy has enjoyed a growth spurt since the late 1980s. GDP rose 42 percent since 1990, at an annual average of 6 percent. The growth rate of real GDP reached 6.5 percent in 1994 and 7.1 percent in 1995; per capita GDP growth rate reached 4.0 and 4.3 percent in these two years, respectively. A wave of immigrants, increasing the population by about 12 percent, has contributed to this growth. Also, the prospects for a political settlement of the Arab-Israeli conflict contributed to a rise in investment.

The Israeli economy has managed to reap substantial economic benefits from this peace process. It has experienced improved trade relations with countries that were boycotting Israel in the past, improved creditworthiness that lowers the international cost of borrowing, and a substantial inflow of private capital.

The Israeli rate of unemployment declined from over 11 percent in 1992 to less than 6 percent in 1995. This was due to a sharp rise in employment in both private and public services. The total number of employed persons rose from 1,610,000 in 1990 to 2,094,000 in 1995. New immigrants accounted for about 235,000 and Israeli veterans accounted for about 245,000 of that increase. At the same time, the employment of Palestinians decreased sharply while the employment of foreign workers increased.

The stock of capital increased by 35 percent and labor input increased by 43 percent. Investment increased rapidly and was partly responsible for the deteriorating balance of payments. The sustained growth was accompanied by a rise in the deficit in the balance of payments. The financing of the external imbalance was carried out through loans guaranteed by the US government and through private capital inflows. The latter constituted about \$6.5 billion in 1995.

Sources: Arnon (1996) and ICBS.

Deteriorating Living Conditions

Declining Standard of Living: Real Per Capita Consumption Expenditure Declined by 15 Percent. Perceptions of a deteriorating standard of living are borne out by the statistical evidence. National accounts have been compiled by the Israeli Central Bureau of Statistics (ICBS) up to 1993, and by the Palestinian Central Bureau of Statistics (PCBS) for 1994, and are not yet available for more recent years. However, nationally representative household surveys conducted by the PCBS can be utilized to make very credible measurements of the evolution of the standard of living in the WBGS. The following conclusions are based on analysis of the Palestinian Expenditure Consumption Survey that was carried out in 12 rounds over the period October 1995 to September 1996 (Box 1.3).

- The average per capita consumption expenditure in the WBGS was \$1,431 annually (\$1,519 in the West Bank and \$1,214 in the Gaza Strip) during the October 1995-September 1996 period.
- In comparison to private consumption expenditure obtained from Israeli national accounts, real per capita expenditure in the 1995-1996 survey period declined by about 15 percent from its average for the years 1992-1993 for the WBGS. Coming on the heels of the large

shock cause by the *Intifada* after 1988, real per capita expenditure is now at its lowest level for any year since 1980.

- The decline in real per capita consumption expenditure has been much steeper for the West Bank, which witnessed a decline of 26 percent from the 1992-1993 average to the 1995-1996 survey period. In contrast, real per capita expenditure has not changed very much in the Gaza Strip.

Box 1.3 Palestinian Central Bureau of Statistics

The Palestinian Central Bureau of Statistics (PCBS) is the official central agency responsible for compilation and production of data on the Palestinian economy and society. Within a few years of operation, it has established itself as a professionally managed agency that aims to fulfill the statistical needs of policy makers and scholars. PCBS has already published numerous useful reports on demography, education, labor force, expenditure patterns, and consumer price indices. PCBS is planning to conduct a census of the population soon. PCBS publications are used extensively in this report. Summaries of PCBS publications can be found on their website at www.pcbs.org.

In 1994, the PCBS conducted a comprehensive census of establishments, which became the basis for economic surveys in construction, manufacturing, services, and internal trade. These surveys, along with proper estimation of the value-added in agriculture, provide the basis for computation of national accounts. These surveys are collected annually, starting in 1994. Until such a time that the PCBS publishes the official statistics on national accounts, there will be a fair amount of guesstimation of GNP and GDP. Exercises in guesstimating GNP and GDP over the 1994-1996 period have been conducted by the World Bank, the International Monetary Fund (IMF), and the United Nations Special Coordinator Office (UNSCO). The generated figures have a substantial margin of error attached to them, and should be treated with extreme caution.

A more fruitful analysis of recent economic development would rely on household surveys. In this area, the PCBS has already completed three large nationally representative types of surveys. A large demographic survey of about 15,000 households was conducted in mid-1995. Two rounds of labor force sample surveys were conducted in September-October 1995 and April-May 1996, each consisting of a little more than 7,000 households. Beginning in summer 1996, labor force sample surveys were collected on a quarterly basis. A detailed household expenditure survey of around 4,800 households was collected in October 1995-September 1996.

This report relies on detailed analysis of the raw data of the demographic survey along with the first two rounds of the labor force sample survey and the first three months of the expenditure survey. The analysis provides an interesting perspective on the impact and adjustment of economic shocks at the household and individual levels.

The greater decline in the standard of living in the West Bank in comparison to the Gaza Strip can be explained by the fact that the majority of the Palestinian civil service institutions, including the police force, were set up in the Gaza Strip. In addition, the expansion of PA powers over urban centers of the West Bank started at 1995, following signing of the Oslo II Accords.

Thus, the Gaza Strip had a greater proportion of government expenditure and donor money than the West Bank. This cushioned the decline in consumption expenditure to a greater extent in the Gaza Strip than the West Bank. Nevertheless, inequality in the Gaza Strip remains higher than the West Bank (Box 1.4).

- The sharp decline in average consumption expenditure would have been much greater if it were not for the economic aid that has cushioned the shocks to the Palestinian economy. By March 1997, \$2.714 billion had been committed to specific forms of expenditure by the donor countries and \$1.527 billion has been disbursed.

While this analysis indicates disturbing reductions in incomes, it also points to moderate levels of inequality. The overall Gini coefficient (of per capita expenditure) for the WBGS is 0.378, which is relatively low by international standards. But, inequality in the Gaza Strip is unambiguously higher than in the West Bank. There is reason to believe that inequality is on the rise, given the trends emerging from land price speculation, the inequality in land ownership, and the increasing wage inequality due to diverging trends in the returns to schooling (Box 1.4).

High and Increasing Levels of Poverty. One of the disturbing economic outcomes in the WBGS since 1993 is the high level of poverty. Mostly, this has occurred as a result of worsening labor market conditions. Given a poverty level of \$650 per capita annually (less than \$2 per day), approximately one-fifth (19.1 percent) of the WBGS population was poor at the end of 1995. This is indeed large, and implies that about one-half million of the estimated 2.5 million Palestinians are poor. The incidence of poverty is greater in the Gaza Strip, where more than one-third (36.3 percent) of the population was poor at the end of 1995, amounting to about 350,000 people. In the West Bank, roughly one out of ten people were poor, constituting approximately 150,000 people. Since 1995, the situation seems to have deteriorated much more.

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 incidence of poverty is very much tied to the softness in the labor market and the repeated and severe shocks from border closures. These 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 their livelihood, and thus, are more severely affected by economic shocks and downturns that have usually stemmed from the labor market.

Excessively High and Widely Fluctuating Unemployment Rates. The working hypothesis of the official actors in Palestinian economic development in the peace era is that domestic job creation by the export-oriented private sector would improve employment. These jobs would gradually attract Palestinian workers from Israel, thus transforming the Palestinian economy from labor-exporting to commodity-exporting. However, political considerations in the post-Oslo period have created an environment that is suffocating to export-oriented private

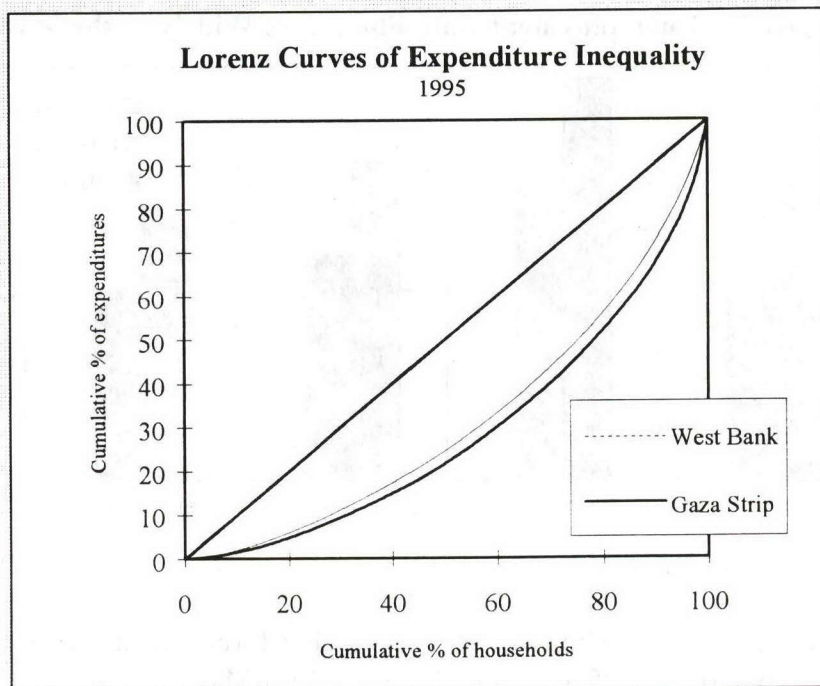
Box 1.4 Should Policy Makers Worry about Inequality?

The high levels of poverty in the WBGS do not stem from extreme inequities in the distribution of income and wealth, and are mostly a reflection of the soft labor market. Analysis of the October-December 1995 rounds of the expenditure survey suggests that inequality is relatively low in comparison to other developing countries. The Gini index of per capita consumption expenditure is 0.378 and the coefficient of variation is 87 percent in the WBGS.

In general, inequality in the WBGS is moderate, as inequality indices are on the low end in comparison with comparable lower-middle income countries. The Gini index of consumption expenditure for comparable lower-middle income countries is 0.392 in Morocco, 0.434 in Jordan, 0.387 in Algeria, 0.402 in Tunisia, and 0.449 in Peru. The Gini index of income is 0.327 in Kazakhstan and 0.596 in Guatemala.

While this suggests that inequality should not necessarily be a top concern for Palestinian policy makers, the trends in the land and labor markets are likely to generate increasing inequality over time. The land price speculation following the peace process, the difficult supply of land due to zoning regulations, and breakup of the West Bank into several areas of overlapping jurisdictions are factors likely leading to greater inequality in wealth over time. Also, the increasing returns to school are creating greater inequities in the labor market.

Another aspect of inequality is the Gaza Strip economy, which has a greater level of inequality than the West Bank. The Gini index of inequality in the West Bank is 0.355 while that of the Gaza Strip is greater and stands at 0.395. The Lorenz curves of expenditure inequality illustrate the greater level of inequality in the Gaza Strip, as its Lorenz curve of consumption expenditure inequality is closer to the line of perfect inequality, in comparison to that of the West Bank.

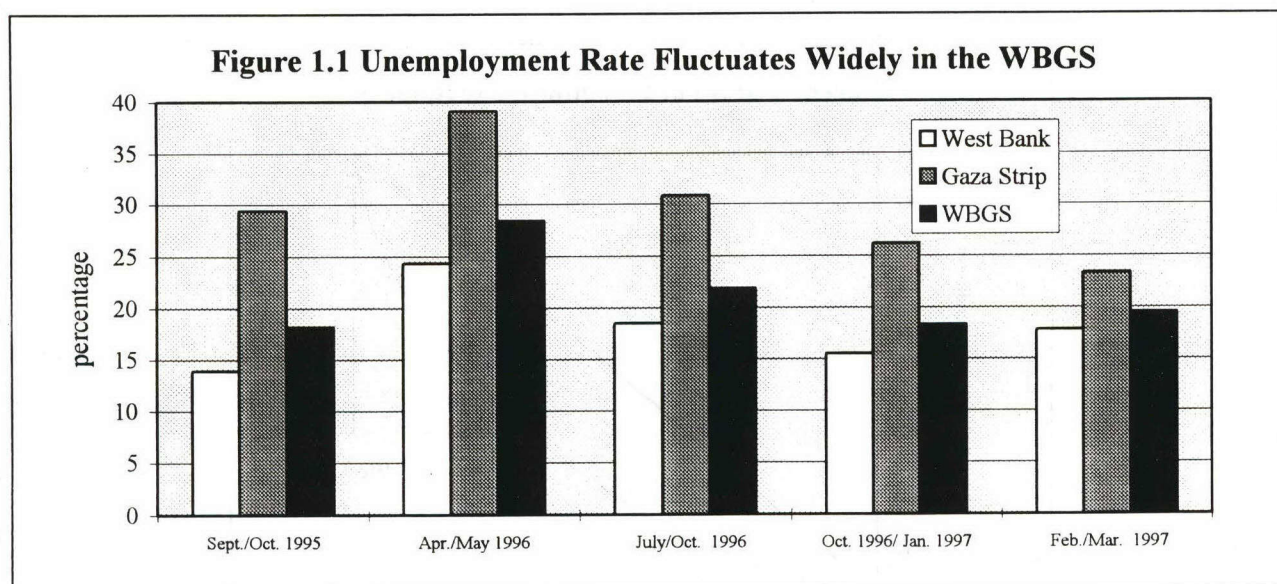


Source: Shaban (1997) and based on PCBS expenditure data.

sector development. This environment, where Palestinians are suddenly shut out of their jobs in Israel, has generated high and widely fluctuating unemployment rates. Employment is considered the most important socio-economic concern by those polled in the surveys (Box 1.1).

The measurement of the rate of unemployment in the WBGS is controversial. The most reliable (and probably lowest) estimates are those reported by the PCBS, which uses nationally representative household surveys and follows the rigorous definition of (and receives technical advice from) the International Labor Organization (ILO). According to this definition, someone is unemployed if he or she has not worked at all (not even one hour), was available for work, and sought employment during the reference week. In many countries, surveys use the simpler method of self-declaration of the respondent, resulting in higher rates than would be implied by the ILO definition. The method used by the PCBS was more strict and, thus, explains the discrepancy between popularly reported unemployment figures and those reported by the PCBS.

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



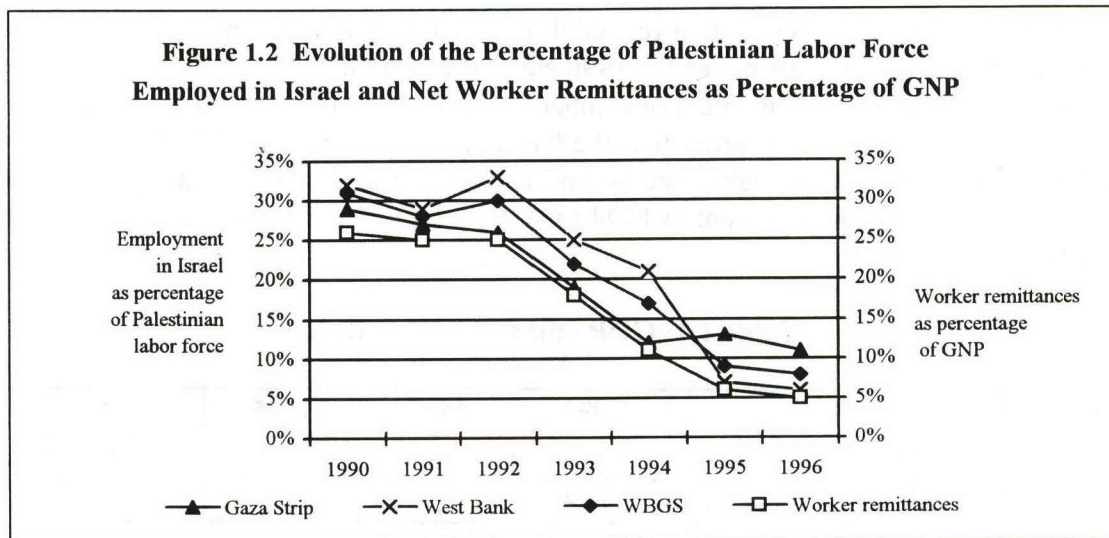
Source: PCBS various labor force sample surveys.

Out of roughly one-half million workers in the labor force, the unemployed numbered 92,000 in September-October 1995 and 149,000 in the April-May 1996 period. Thus, the magnitude of unemployment fluctuates widely over a short-time period. The 10-point increase in the rate over a six-month period between September-October 1995 and April-May 1996 is a case in point. The difference between the two periods is the strictness with which the borders were closed against the movement of Palestinian workers and goods. Figure 1.1 shows how the unemployment rate widely fluctuates over a short time period. These variations are largely driven

by the border closures imposed by Israel. These wide short-run fluctuations have placed a large number of workers into a risky employment situation.

Sharp Deterioration in Employment in Israel and Low Absorption of Returning Labor.

Palestinian employment in Israel declined from an average of 116,000 to 28,100 in 1996. The number of permits issued by Israel to Palestinians has declined, and workers are often unable to use these permits during periods of border closures (see Chapter 3). The Israeli economy has been adjusting by importing workers from Eastern European and Southern 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 employment. As a result, 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 1.2).



Simultaneously, about 50,000 jobs were created in 1993-96 in the public sector, of which 30,000 were in the police force and 20,000 in central ministries and education. Private employment, on the other hand, did not appear to have grown much. Industry fared poorly, mainly as a result of border closure and the low investment rate. The growing sectors of the economy were agriculture, a traditional shock absorber, especially in the West Bank, with low productivity at the margin, and construction, a relatively capital-intensive activity. New entrants to the job market amounted to about 80,000 and at least 20,000 returnees in the 1993-1996 period. In the same period, approximately 100,000 jobs were lost. These combined figures reflect a deficit of 150,000 jobs.

Deteriorating Economic Conditions

The decline in living conditions reflects the overall economic deterioration that has taken place in per capita GDP and GNP, the substantial reduction in Palestinian employment in Israel, and the decline in investment and interruptions to trade. These negative developments have had a

particularly strong impact given the dependence of the Palestinian economy on the export of labor and on trade with Israel.

Decline in Per Capita Incomes: Estimated at 30 percent since 1993. Since the signing of the Declaration of Principles and the redeployment in the Gaza Strip and the cities of the West Bank, data on the overall Palestinian economy have become sparse and incomplete. Although the PCBS, which took over the Israeli Central Bureau of Statistics data collection in the WBGS in 1994, recently started publishing reports on various aspects of the economy, there is still no information available on the Palestinian economy at the national level for 1995 and 1996 (Box 1.4). Until official statistics based on sectoral surveys are published by the PCBS, “guesstimating” GDP and GNP is bound to be subject to a large error component, given the shortage of real data available to make such estimation. With small variations in the assumptions, one can get divergent views on the trends in GNP and GDP.

Current estimates suggest that real GDP per capita grew by 8 percent in 1994 and fell by 1 percent in 1995. Tentative estimates for 1996 suggest a real GDP decline of about 5.6 percent. To appreciate these figures, one must remember that in even years, a bountiful olive production usually adds about 5 percent of growth to the Palestinian economy. Real GNP per capita (which, in addition to domestic output takes account of income earned abroad, notably in Israel) fell sharply in both areas from 3 percent in 1994 to -1.5 percent in 1995, and perhaps -7 percent in 1996 (Table 1.1).

Table 1.1 GDP and GNP Growth Rates
(percentage)

	1993	1994	1995	1996
Real GDP per capita	- 5.6	8.0	-1.0	-5.6
Real GNP per capita	-14.4	3.0	-1.5	-7.0

Source: World Bank/IMF guesstimates for 1994-1996 and ICBS for 1993.

Dramatic Fall in Trade. As a result of repeated closures and high transaction costs at the border (delays and the use of convoys for transport of merchandises to Israel), trade seems to have dipped since the beginning of Palestinian self-government. Rough guesstimates indicate that merchandise imports fell from 61 to 48 percent of GDP between 1992 and 1995 (by nearly 21 percent). Similarly, exports seem to have fallen from 14 to 12 percent over the same period (by 14 percent).

Stagnant Public Investment and Limited Private Investment. In 1993, public investment amounted to about \$126 million, or 5 percent of GDP. Despite the high priority accorded to the reconstruction in 1995, public investment was \$189 million (again, 5 percent of GDP, all financed by donors). This stagnation reveals the difficulty of setting up functioning implementation mechanisms as well as the complications donors have experienced in delivering on their pledges. Of great concern is the steep fall in private investment—from \$529 million (21 percent of GDP) in 1993 to an estimated \$320 million (a mere 8 percent of GDP) in 1995. Up to 90 percent of this investment was personal savings for housing construction (which represented 89 percent of total investment in the Gaza Strip in 1993). There appears to have been no

corporate response to Palestinian self-government in 1994 and 1995, in spite of huge potential investments contemplated by large Palestinian companies such as the Palestinian Development International Company (PADICO).

Even as the fiscal situation recently improved in terms of revenue performance and expenditure restraints, the budget deficit remains important. Since 1994, the PA has given priority to the establishment of fiscal and economic institutions that have taken charge of key Israeli Civil Administration functions. Under the Israeli Civil Administration, fiscal expenditures were relatively low by international standards (12-14 percent of GDP). Under the PA, however, central administration expenditures have risen rapidly, with the rising wage bill. In contrast, PA revenue collection has been efficiently managed, is probably close to its potential level, and is unlikely to appreciably increase in relation to GDP.

Fiscal developments in 1995 were more favorable than initially anticipated, as a result of strong revenue performance and expenditure restraint. As a result, the recurrent deficit for 1995 and 1996 was about \$100 million per year (3 percent of GDP). Recurrent expenditure grew as a result of emergency programs related to the prolonged border closures and the continuous rapid growth in the civil service.

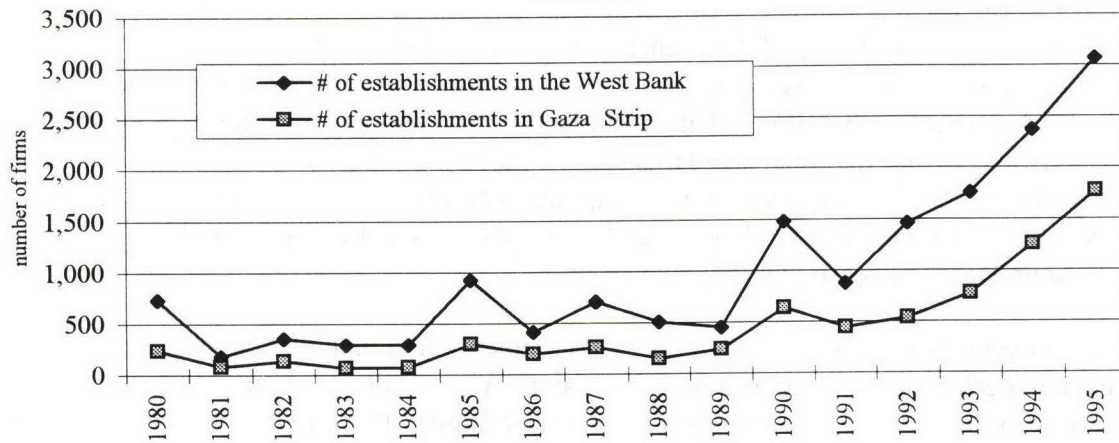
Areas of Relative Economic Improvement

While overall performance of the Palestinian economy recently has been dismal, there are areas of relative progress. Hopes for and expectations of an improved economy and political situation have stimulated interest from the private sector to start looking into possible investments—particularly from local and Diaspora Palestinians. The financial sector has expanded rapidly in recent years, albeit from a negligible base, in the number of banks and in total deposits. The housing sector witnessed a boom (tapering off in 1996-97), with a greater concentration of housing activity in the Gaza Strip and the larger cities of the West Bank, especially Ramallah. Institutions of administration and economic management have been established, albeit with difficulties, and should be ready to play the role of creating the environment needed for private sector development.

Strong Private Sector Interest Demonstrated by Large Number of Newly Registered Companies But Not Investment Yet. A low number of new firms were registered throughout the 1980s and early 1990s, due mostly to the repressive regulatory environment under the Israeli Civil Administration. Since 1994, however, there has been an increase in registered establishments. The number of firms registered in 1994 to mid-1995 (3,028 in the Gaza Strip and 5,442 in the West Bank) is much larger than the total for the entire decade of the 1980s (1,745 in the Gaza Strip and 4,846 in the West Bank) (Figure 1.3). Reflecting the potential interest of local and Diaspora Palestinians in the private sector, several large shareholding companies have been set-up to invest in various sectors. These large companies leverage their capital to establish several specialized companies in conjunction with the public and support from the banks. Several companies have already been established by wealthy local and Diaspora Palestinians, and a stock exchange recently opened in Nablus to help mobilize resources and improve the efficiency of financial intermediation.

Figure 1.3 Number of Firms Registered by Year in the WBGs

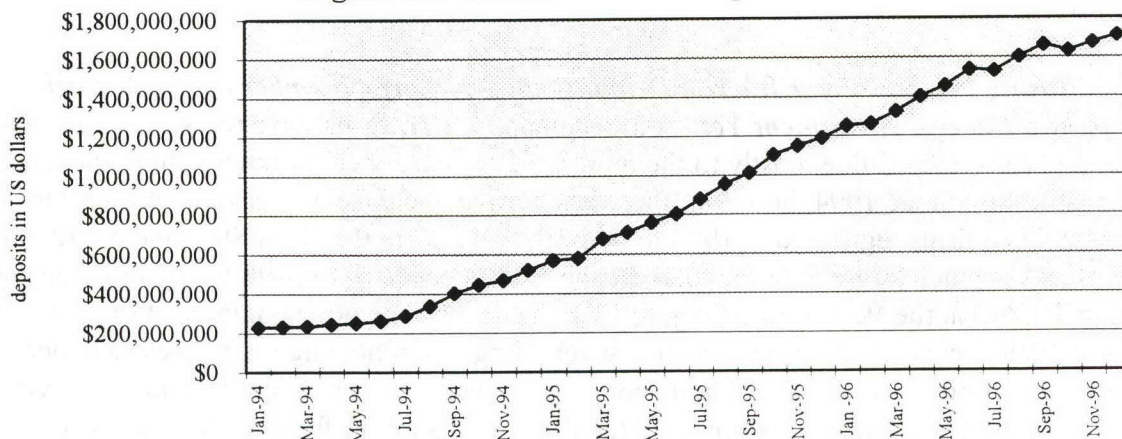
1980-1995



Source: Shaban (1996).

The Banking Sector is Ready for the Next Take-off. Since 1993, the banking sector had an impressive record of expansion. The Arab banking sector largely was regulated out of existence during most of the Israeli occupation years. At the end of 1993, and following a period of regulatory liberalization, there were two Arab banks operating. The Bank of Palestine had 5 branches in the Gaza Strip and the Cairo-Amman Bank had 8 branches in the West Bank. By the end of 1996, there were 17 banks with 71 operating branches. Figure 1.4 demonstrates the growth in bank deposits. Total deposits grew from a very low level of \$219 million at end 1993 by more than sevenfold, to a little more than \$1.7 billion at end 1996. The average growth rate

Figure 1.4 Growth in Bank Deposits



Source: MAS and PMA data files.

of bank deposits during this period is 6 percent per month. The fraction of bank deposits to GDP increased from approximately 7 percent at end 1993 to a little more than half of GDP at end 1996. Clearly, these rapid growth rates are not sustainable in the long-run and they have begun to slow down, as the deposit base is approaching its normal size in relation to size of the economy. While lending is still low, the banking sector has matured during this short period, and is well-positioned to play a key role in Palestinian economic development once the demand for credit picks up.

The Construction Boom. The construction sector also experienced rapid growth in the past few years, fueled by optimism about political and economic development. However, during periods of strict and prolonged closure, this sector has been affected negatively by a lack of available supplies (*i.e.*, cement, steel) that are imported from or through Israel. By 1997, the boom in construction had tapered off.

Establishment of Institutions of Governance. Palestinian economic management has come a long way in the past three years. Authority has been transferred in several areas, and institutions of governance have been set up. However, the nascent Palestinian public administration has faced numerous difficulties. These difficulties emerge from the need to integrate the Palestine Liberation Organization (PLO) cadres who moved back to the WBGS, lower-level Palestinian staff inherited from the Israeli Civil Administration, and local activists and intellectuals many of whom operated within the non-governmental organization (NGO) sector earlier. Difficulties remain, particularly in terms of definition and application of the exact role of the public and private sectors, decentralization, and coordination among the public sector entities. The tax authority has managed to increase revenue collection. The Palestinian Economic Council for Development and Reconstruction (PECDAR) has supervised the disbursement of significant funds and set up an effective works program. The security forces have improved public safety and the general situation of law and order. The courts are working better since the Palestinian police is utilized to enforce the laws. Palestinians do not have to be home by sunset as was the practice before the transfer of authority to the PA. There is a renewed sense of freedom that permits individuals to go out to Gaza Strip's beaches or Ramallah's parks and restaurants late into the evening.

* * *

The signing of the Declaration of Principles was accompanied by high hopes for improvement and reconstruction of the Palestinian economy. While some segments of the economy have experienced improvement, overall, the WBGS has been a casualty of the peace process. Economic activity has stagnated, with a substantial decline of per capita incomes. Private investment has not materialized, trade has been interrupted, and Palestinian employment in Israel has been sharply cut. These conditions have been responsible for the prevalence of very high poverty and unemployment rates. Undoubtedly, these poor economic conditions would have been worse if it were not for the donor aid that cushioned their impact.

This state of the Palestinian economy is particularly disappointing when compared to the performance of the Israeli economy, which has seen improvement through the 1990s (Box 1.2). While the Israeli economy has benefited from a large peace dividend, the Palestinian economy has

been heavily taxed by the peace process. Economic activity in the WBGS is struggling in spite of the political process, rather than being assisted by it. If economic deterioration were to continue, it could lead to greater dissatisfaction with and opposition to the peace process.

Bibliographical Note: This chapter is based on the background papers of Shaban (1997), Al-Qudsi and Shaban (1996), Arnon (1996), and Shaban (1996). Other references include CPRS (1997), Gotlieb (1996); PCBS (1996c), Shaban and Al-Botmeh (1995), UNSCO (1996a), and World Bank (1995b).

Chapter 2

Recent Political Developments

The success of the ongoing phase of the peace process depends on it being a transitory one. If this is not the case, economic conditions will likely stagnate as a consequence of closures and political uncertainty. Conversely, if political progress is forthcoming, development efforts will be facilitated and donor assistance programs will be better able to focus on building infrastructure and promoting sustainable development. Palestinian economic policy-making will benefit from the expansion of territorial and functional authority. Private sector confidence and foreign investment will be encouraged by a more stable political climate. The Palestinians—as well as others in the Middle East—would be able to harvest the fruits of peace and greater regional cooperation.

Introduction

On September 13, 1993, the PLO and Israel signed in Washington an undertaking to “put an end to decades of confrontation and conflict, recognize their mutual legitimate and political rights, and strive to live in peaceful coexistence and mutual dignity and security to achieve a just, lasting and comprehensive peace settlement and historic reconciliation.” By any measure, the changes worked out between the two parties in the Israeli-Palestinian Declaration of Principles on Interim Self-Government Arrangements (Declaration of Principles or Oslo Agreement) and subsequent agreements have been both historic and far-reaching. Israel has withdrawn its military forces from most of Gaza Strip and from major population centers in the West Bank with the exception of East Jerusalem and parts of Hebron. A democratically elected Palestinian Legislative Council and duly appointed PA have assumed the tasks of government in these areas. Progress in Palestinian-Israeli peacemaking also has helped to spur the pace of regional political reconciliation, evident—until the 1996 change in the Israeli government—in growing political and economic interaction among the countries of the region.

However, the success of the interim phase depends very much on it being a transitory one. Throughout the region, and especially between Palestinians and Israelis, expectations have been substantially raised by the prospect of peace. Failure to satisfy these expectations could result in a political backlash. Opponents of peace—who have shown themselves willing to use violence to derail the process—stand ready to manipulate and mobilize such discontent. In turn, the collapse of the peace process would almost inevitably fuel more extremism and fan the flames of even greater violence.

This chapter will discuss how the political process has moved forward with successive agreements as envisioned under the Declaration of Principles. In reviewing the main events, phases, and arrangements, the chapter presents the impact of political progress on development efforts, the economic benefits that emerge from an expansion of Palestinian territorial and functional authority, and the effect that postponement of targeted phases has on private sector confidence and foreign investment.

The Peace Process

The peace process began with the convening of the Madrid Peace Conference in October 1991, co-chaired by the United States and the Soviet Union and based on the United Nations Security Council Resolutions 242 and 338. Direct bilateral discussions subsequently followed between Israel and the Palestinians, Jordan, Syria, and Lebanon. With very substantial issues between them, the ten rounds of Palestinian-Israeli negotiations from 1991 to 1993 proved slow and difficult.

Multilateral working groups were initiated in Moscow in January 1992 on key issues of regional concern: regional economic development, refugees, water, the environment, arms control and regional security. The multilateral track of the peace process brought regional parties together and fostered some modest new forms of cooperation. The Regional Economic Development Working Group (REDWG), sponsored by the European Union (EU), organized a series of international activities and established a monitoring committee as well as a permanent secretariat in Amman.

Perhaps the most visible manifestation of increased economic contact across the region, among governments and private sectors, has been the Middle East and North Africa (MENA) economic summits, held in Casablanca in October-November 1994, in Amman in October 1995, and in Cairo in November 1996. At the Casablanca meeting, participants agreed to establish the Middle East Development Bank for the region, and discussions are still continuing. The Refugee Working Group (RWG), sponsored by Canada, addressed the issue of Palestinian refugees, with work on databases, child welfare, public health, human resource development, economic infrastructure, and family reunification. The groups on water and the environment, chaired by the United States and Japan, respectively, sponsored a variety of activities focused on these critical areas. These efforts included the 1994 multilateral Bahrain Environmental Code of Conduct for the Middle East, and the Declaration on Principles for Cooperation on Water-Related Matters, signed by Israel, Jordan and the PLO in February 1996. In general, however, progress in the multilaterals has been slow, incremental, and very much tied to the pace of bilateral political negotiations.

The Declaration of Principles. It was in this context that the PLO and Israel embarked, with Norwegian facilitation, on parallel but less public discussions. These discussions ultimately bore fruit in the form of the Declaration of Principles, which was formally signed by the PLO and Israel on September 13, 1993.

Central to the Oslo Agreement was mutual recognition between the PLO and Israel. The two parties pledged to begin permanent status negotiations in 1996, which would include the most difficult and important issues between them: borders, Israeli settlements (Box 2.1), security arrangements, refugees, and Jerusalem (Box 2.2). In the meantime, they agreed to negotiate transitional arrangements for Palestinian elections and interim self-government. These arrangements would begin with the withdrawal of Israeli forces from the Gaza Strip and the West Bank town of Jericho and surrounding areas, and the establishment of a Palestinian authority in

these areas. Additional Israeli redeployments would occur at a later date, prior to Palestinian elections.

Table 2.1 Peace Process Agreements

Date Signed	Title	Key Provisions and Target Dates
October 1991	Madrid Peace Conference	▪ Inaugurates two separate yet parallel tracks of negotiations (bilateral & multilateral) to achieve just, lasting and comprehensive peace settlement, based on UN Security Council Resolutions 242 and 338 ▪ Ten rounds of negotiations follow from 1991-1993
September 13, 1993	Declaration of Principles on Interim Self-Government Arrangements (Declaration of Principles, Oslo Agreement, DoP)	▪ Sets out overall framework for interim period and Palestinian self-government in WBGS ▪ Mutual recognition of the PLO and Israel ▪ Pledge to begin permanent status negotiations ▪ Hold Palestinian elections by June 1994 ▪ Sign Gaza-Jericho Agreement in December 1993 including arrangement for safe passage ▪ Sign Early Empowerment in July 1994
April 29, 1994	Protocol on Economic Relations (Economic Protocol, Paris Protocol)	▪ Codifies economic relations between WBGS and Israel for the interim period in monetary, fiscal and trade relations ▪ Later incorporated as Annex IV of Gaza-Jericho Agreement and still later as Annex V of the Interim Agreement
May 4, 1994	Agreement on the Gaza Strip and the Jericho Area (Cairo Agreement, Gaza-Jericho Agreement)	▪ Establishes framework for transfer of power and responsibilities to PA ▪ Agree on Israeli withdrawal from Gaza Strip and Jericho ▪ PA assumes authority in Gaza Strip and Jericho in all spheres except those related to final status issues
August 29, 1994	Agreement on Preparatory Transfer of Powers and Responsibilities (Early Empowerment Agreement)	▪ Israel transfers authority in the West Bank to PA in education and culture, health, social welfare, tourism, direct taxation, and VAT on local production (in December 1994) ▪ Parties to explore possible expansion of transfer of powers to other spheres
October 30 - November 1, 1994	Middle East and North Africa Economic Summit, Casablanca	▪ Agree to establish Middle East development bank for the region ▪ Agree to establish regional tourist board
August 27, 1995	Protocol on Further Transfer of Powers and Responsibilities	▪ Israel transfers authority in the West Bank in agriculture, census and statistics, energy, insurance, labor, local government, postal services, and trade and industry

Date Signed	Title	Key Provisions and Target Dates
September 28, 1995	Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip (Interim Agreement, Oslo II Agreement, Taba Agreement)	▪ Confirms expanding territorial and functional control of PA, including police ▪ Details composition of Palestinian Legislative Council ▪ Hold Palestinian elections in January 1996 ▪ Additional Israeli redeployments were to occur in intervals of 6 months (September 1996), 12 months (March 1997) and 18 months (September 1997). ▪ Sign protocol for redeployment in Hebron in March 1996 ▪ Recognition of Palestinian water rights ▪ Provides for coordinating mechanisms in security, legal, judicial, and economic fields ▪ Did not contain provisions for a "safe passage" between the West Bank and Gaza Strip, as provided in Oslo Agreement ▪ Commence permanent status negotiations no later than May 1996
October 23-31, 1995	Second MENA Economic Summit, Amman	▪ Agree to establish Bank for Economic Cooperation and Development, based in Cairo, to promote private sector development and infrastructure projects ▪ Establish Middle East-Mediterranean Travel and Tourism Association ▪ Establish Regional Business Council
February 1996	Declaration on Principles for Cooperation on Water-related Matters	
April 22, 1996	Amendment of PLO Charter	▪ Palestinian National Council voted to amend Charter and delete clauses that contradict the agreements signed
November 1996	Third MENA Economic Summit, Cairo	▪ Discuss, among other things, permanent status negotiations
January 17, 1997	Protocol Concerning the Redeployment in Hebron (Hebron Protocol)	▪ Pushed back timetable of Interim Agreement redeployments, with the first to occur in March 1997 and the third by mid-1998. ▪ Permanent status negotiations to resume within two months after signing Hebron Protocol
May 5, 1996 - March 1997	Permanent Status Negotiations	▪ Address borders, settlements, security arrangements, refugees, Jerusalem, water, sovereignty ▪ Scheduled to start in May 1996; interim period originally intended to end in May 1999 ▪ Despite formal opening in May 1996, substantive negotiations postponed to March 1997 under Hebron Protocol

Source: Israeli Ministry of Foreign Affairs.

By securing mutual political recognition between the PLO and Israel, the agreement represented a breakthrough, setting the stage for more direct and intensive negotiations. Moreover, the Oslo Agreement was a careful experiment in forward-looking constructive ambiguity. It sought to create a productive political process (focused on immediately achievable objectives) without prejudicing the political ambitions of either party or predetermining the ultimate outcome of negotiations. It was hoped that through such interim confidence-building measures and a growing volume of cooperative interaction, new future possibilities would emerge for a comprehensive and mutually acceptable resolution of the Palestinian-Israeli conflict.

Implementing the Declaration of Principles: The Gaza-Jericho Agreement, the Economic Protocol, and Early Empowerment. The first of these transitional arrangements, the Agreement on the Gaza Strip and the Jericho Area (referred to as the Cairo Agreement or Gaza-Jericho Agreement) of May 1994, established the framework for both Israel's withdrawal from Gaza Strip and Jericho, and the creation of the PA. Annex IV of this agreement, the Protocol of Economic Relations, was signed a few days earlier in Paris. Referred to as the Paris Protocol (or Economic Protocol), it codified the economic relations between the PA and Israel during the interim period in the fields of monetary, fiscal, and trade relations.

Under the agreement's terms, the Palestinian Monetary Authority (PMA) was mandated to oversee the local banking system and manage official foreign currency reserves. However, the PA was not authorized to establish its own currency. The main novelty of the Economic Protocol was that taxes paid by Palestinians, formerly accruing to the Israeli treasury, would be remitted to the Palestinian treasury. The protocol also formalized the existing trade regime as a customs union with some exceptions. Specific procedures were outlined for remitted tax revenues to be returned to the Palestinians for value-added tax (VAT), customs revenues, and other levies raised on goods coming from third countries.

The VAT clearances provided the largest single source of revenue for the PA in 1995 and 1996. In 1996, VAT clearances amounted to \$223 million. The VAT operates on a destination basis (*i.e.*, the VAT on imports from Israel is remitted by the Israeli treasury to the PA). The VAT and other revenue clearances remitted to the PA in 1996 were \$423 million—and may grow further in the future as remaining difficulties with tariff revenues and excise taxes on imports from Israel are resolved. There is no customs border between the WBGS and Israel and, subject to Israeli quality standards, trade between the WBGS and Israel is presumably free. The only exceptions are five agricultural goods with declining quotas over a five-year period. As it turned out, however, the border remained mostly closed for Palestinian exports to Israel. Trade relations with third countries—tariffs, standards, quotas—are largely determined by Israeli policies, albeit with some limited exemptions. Free trade agreements (FTAs) have since been negotiated with the EU and the US, and with ten other countries, including Arab countries in the Gulf.

Finally, the parties committed themselves to attempt to maintain normal labor movement between their territories (consisting almost entirely of Palestinian workers traveling to Israel). The Economic Protocol states: "Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and

conditions of labor movement into its area.” In practice, this provision has not prevented periodic closure of the WBGS.

Box 2.1 Israeli Settlements in the WBGS

According to unofficial Israeli sources, in 1992 there were 136 settlements in the West Bank with 130,000 inhabitants and 17 settlements in Gaza Strip with 4,000 to 5,000 inhabitants. The UN has taken the position that Israeli settlements in the WBGS have no legal validity and should be dismantled. According to the Declaration of Principles, the settlements constitute one of the final status items to be negotiated between the PLO and Israel.

In order to attract settlers, the Israeli government has offered a number of incentives, *i.e.*, direct housing subsidies, land at discounted prices, mortgages at reduced rates, free hookups to utilities and municipal services, and higher schooling subsidies than in Israel. Israeli budgetary allocations for building settlements are not clear, but several sources report allocations to be as much as \$20 billion over the past 25 years.

Infrastructure in the settlements, *i.e.*, telecommunications, water, and electricity grids, is fully integrated into Israeli national systems and operated by the national agencies. Over the past 25 years transport systems were built to link settlements to Israeli metropolitan areas. With implementation of the Interim Agreement, the Israeli government built numerous roads for settlers to by-pass PA-controlled areas in order to travel to other settlements or to Israel. This road-building process led to a loss of additional land by Palestinians. While the settlement issue is to be resolved during the final status phase, intensified settlement activity has been threatening progress in Palestinian-Israeli negotiations.

Israel’s withdrawal from Gaza Strip and Jericho, and the establishment of the PA occurred later in May 1994. New negotiations followed on the immediate transfer of additional areas of responsibility to the PA (“early empowerment”) as well as the eventual redeployment of additional Israeli forces from areas in the West Bank. In August 1994, the parties signed the Agreement on Preparatory Transfer of Powers and Responsibilities (Early Empowerment Agreement), whereby Israel undertook to transfer authority in the West Bank over education and culture, health, social welfare, tourism, direct taxation, and VAT on local production. In August 1995, a subsequent Protocol on Further Transfer of Powers and Responsibilities brought about the transfer of authority in eight additional areas (agriculture, census and statistics, energy, insurance, labor, local government, postal services, and trade and industry).

The Israeli-Palestinian Interim Agreement: Oslo II. These measures set the stage for a political landmark—the Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip (known as the Oslo II Agreement, the Interim Agreement, or Taba Agreement), signed in Washington in September 1995. The lengthy and detailed agreement confirmed the process of expanding the territorial and functional control of the PA. The agreement contained a number of core elements related to redeployment, transfer of jurisdictional and functional control, governance, water rights, taxation, and coordinating mechanisms.

Israel agreed to withdraw its military forces from the six Palestinian cities (defined as zone A), which includes Tulkarem, Qalqilya, Jenin, Nablus, Ramallah, and Bethlehem. In addition, special arrangements would be negotiated for the city of Hebron, followed by Israeli redeployment from that city. Israel further agreed to the redeployment from other populated areas of the West Bank (zone B), including some 450 Palestinian towns and villages. Together, zone A (comprising 3 percent of the territory of the West Bank) and zone B (comprising 27 percent of the West Bank) contain the majority of the Palestinian population. The remaining areas which cover most of the territory (including agricultural land, the Jordan Valley, nature reserves, areas with lower population density, Israeli settlements, and designated military areas) were assigned to zone C (Figure 2.1).

[Insert Figure 2.1 Map of West Bank and Gaza Strip under Oslo II]

It was further agreed that “in order to maintain the territorial integrity of the West Bank and the Gaza Strip as a single territorial unit, and to promote their economic growth and the demographic and geographical links between them,” the parties would protect the “normal and smooth movement of people, vehicles, and goods within the West Bank, and between the West Bank and the Gaza Strip.” Territorial control of Jerusalem was not addressed in the agreement, as that issue was reserved for final status negotiations.

Simultaneous with the initial redeployment, all civil powers and responsibilities in zones A and B (about 40 spheres, including those covered by the previous early empowerment agreements) were transferred to the PA. In zone C, the PA was granted functional civil jurisdiction in areas not relating to territory. Moreover, powers and responsibilities relating to territory gradually would be transferred to Palestinian jurisdiction, except for areas that were reserved for final status negotiation, *i.e.*, settlements.

The Oslo II Agreement detailed the composition of an elected Palestinian Legislative Council and its executive authority, including a directly and popularly elected president. Subsequent to the initial redeployment of Israeli forces, Palestinian elections were to be held under international supervision throughout the WBGS. Under special arrangements, it was agreed to allow Palestinians of Jerusalem to vote in the elections. The president and Palestinian Legislative Council were to hold office for an interim period of up to five years.

The PA also assumed responsibility for internal security and public order (civil policing) in zone A. In zone B, the Palestinian police are to be responsible for public order, with Israel retaining “overriding responsibility for security.” Under the Oslo II Agreement, Israel retained full security control of zone C, and committed itself to additional military redeployments over 18 months and the transfer of additional powers and responsibilities to the Palestinian police. It was agreed that the maximum number of Palestinian police would be 18,000 in Gaza Strip and 12,000 in the West Bank.

The Oslo II Agreement explicitly recognized Palestinian water rights in the West Bank—albeit, subject to definition in final status negotiations—and included water issues related solely to Palestinians in areas where civil jurisdiction was transferred to the PA. It was also agreed that the

Palestinians would be permitted to develop some additional water resources in agreed areas to meet the shortfall in water requirements.

The Economic Annex to the Interim Agreement (Annex 5) comprised the earlier 1994 Economic Protocol that was part of the Cairo Agreement, and added more detailed clauses regarding the clearance of import tax revenues from Israel to the PA, and the implementation of direct and indirect taxation. It contained a number of specific confidence-building measures, as well as an annex devoted to cooperation programs.

Finally, the Oslo II Agreement provided for a host of coordinating mechanisms. Chief among these was Joint Liaison Committee, previously established under Article X of the Declaration of Principles. A Joint Security Coordination and Cooperation Committee was established in the security field, together with Joint Regional Security Committee and Joint District Coordination Offices. The Legal Committee addressed legal and judicial cooperation, and provided a vehicle for Israel to raise concerns arising from Palestinian legislation. Unlike a similar committee established under the Gaza-Jericho Agreement, the Legal Committee had no power to delay or veto contentious Palestinian legislation. The Joint Civil Affairs Coordination and Cooperation Committee—which brings together Joint Regional Civil Affairs Subcommittees for each of the West Bank and Gaza Strip, and District Civil Liaison Offices in the West Bank—is responsible for facilitating cooperation in civil areas. Finally, the agreement continued the Joint Economic Committee originally established by the 1994 Economic Protocol.

Following Israeli redeployment, Palestinian elections were held in January 1996 throughout the WBGS for the president of the PA and the 88-person Legislative Council. International observers judged the elections to have been “an accurate expression of the will of the voters.” The overwhelming majority of elected candidates supported the peace process, signaling Palestinian hopes for an end to decades of conflict. In April, the Palestine National Council, the political arm of the PLO, met in Gaza Strip to formally amend the PLO Charter, eliminating those clauses contrary to the spirit of Oslo. In May 1996, final status talks were formally opened, although the onset of substantive negotiations was delayed by forthcoming Israeli general elections. Prior to the elections, the Labor Party revised its electoral platform so as to eliminate its previous opposition to Palestinian statehood.

Despite the successful implementation of the initial stages of Oslo II, serious challenges continued to confront the peace process. In November 1995, Prime Minister Yitzhak Rabin was assassinated by an Israeli extremist opposed to the peace process. In February and March 1996, during the run-up to Israel’s general elections, the Palestinian Islamist group Hamas launched four suicide bombings in Jerusalem and Tel Aviv, following the assassination of one of its leaders. Israel responded by imposing its most severe closure ever on the WBGS, including restrictions on travel between areas of the West Bank. This resulted in substantial Palestinian economic losses through foregone wages and exports, price increases, a steep rise in local unemployment, and shortages. International development projects were severely disrupted. For its part, the PA responded to these events with stepped-up security measures against militant groups.

In May 1996, a new government under Prime Minister Benjamin Netanyahu and a Likud-led coalition was elected in Israel. Netanyahu voiced opposition to any future establishment of Palestinian sovereignty and expressed support for additional Israeli settlement activity in the West Bank. Following the elections, these elements were reflected in government policy. However, the Israeli government did declare its commitment to previously signed Palestinian-Israeli agreements, and expressed its hope for achieving peace and security in cooperation with the PA.

The Hebron Redeployment. One immediate test of the peace process came over the issue of Hebron. Under Oslo II, Israeli redeployment from much of the city had been slated to occur in March 1996. Implementation, however, was delayed by the Peres government. Subsequently, the Netanyahu government insisted on renegotiation of its agreement with the PA. This delayed the process still further, until a new accord was reached in January 1997.

Appended to the new Protocol Concerning the Redeployment in Hebron (the Hebron Protocol) were a number of agreed minutes and notes. These included several mutual undertakings by the parties, including commitments by Israel to negotiate the establishment of a Gaza port and airport, as well as “safe passage” between the West Bank and Gaza Strip, already over two years behind schedule. The final status negotiations were to restart in March 1997. Furthermore, the Oslo II timetable for additional Israeli redeployments was relaxed considerably. A letter from US Secretary of State Warren Christopher to Prime Minister Netanyahu suggested that “the first phase of further redeployments should take place as soon as possible, and that all three phases of the further redeployments should be completed within twelve months from the implementation of the first phase of the further redeployments but not later than mid-1998.” This was a delay of approximately one year. Israel argued that the scope of such redeployments should be at its sole discretion, a view apparently endorsed by the United States. The Palestinian position is that the specifics of redeployment are to be agreed between the two parties and are not to be determined unilaterally by Israel.

Some argued that the Hebron Protocol demonstrated the commitment of the Netanyahu government to the Oslo process. Others pointed to the postponement of redeployment, the ability of Israel to determine and sharply limit the scope of future withdrawal, Israeli unilateral measures in and around Jerusalem, and intensification of Israeli settlement activity as suggesting a continued drift away from the Oslo process. The Hebron Protocol identified some of the constraints hampering socio-economic development (*i.e.*, mobility and transportation links), but not others (*i.e.*, divided control and existing economic agreements). Moreover, while the agreement pledged continued negotiations on the former, it contained no guarantees that progress would be forthcoming.

Looking Ahead: The Political Economy of Transition

In summarizing the process of Palestinian-Israeli peace-building to date, two essential points should be taken into account when looking toward the future. First, the development community must expect the unexpected. Unanticipated acts of political violence, closures, and major changes in government policy all have affected development programs to date, and are

likely to do so in the future. As a consequence, it is essential to build flexibility and responsiveness into program design from the outset.

A second essential point concerns the deliberately phased nature of the peace process. The granting of interim Palestinian autonomy in areas of the WBGS was intended to set the stage and improve the climate for the final status negotiations. Certainly, the extended duration of the transition and its yet undetermined outcome has created political vulnerabilities. Further, it increases the risk that interceding unforeseen events—whether accidental or deliberate expressions of political rejection by opponents of the peace process—could stall negotiations. Indeed, the unforeseen has often interceded. However, the Oslo process did manage to bring

Box 2.2 The Issue of East Jerusalem

The 1948 war led to the partition of Jerusalem into eastern and western parts. At the end of the 1967 war, East Jerusalem was occupied by Israeli forces. Under occupation the Jerusalem city limits were expanded by Israel to include some surrounding areas of the West Bank. Israel annexed the expanded city on July 30, 1980. Palestinian residents of Jerusalem were given the option of obtaining Israeli citizenship, although very few have chosen to do so.

Actions taken by Israel were considered invalid by the United Nations, which called upon Israel to refrain from taking any action that would alter the status of Jerusalem. Although the international community has not recognized the Israeli annexation of East Jerusalem, Israel continues to exercise authority over the area. The Palestinians insist that East Jerusalem is part of the West Bank in accordance with the 1967 borders and that Israel should withdraw from all areas occupied during the 1967 war in compliance with UN resolutions. In the Declaration of Principles, the PLO and Israel agreed that the future of Jerusalem was one of the issues to negotiate during the permanent status phase.

There are important economic links between the RWBGS and Jerusalem. Decisions concerning Jerusalem have important implications for economic prospects and priorities. The following are among the most important.

- The tourist potential of the West Bank is critically dependent on the ancient religious sites of Jerusalem.
- Major north-south transportation links in the West Bank pass through Jerusalem.
- The only tertiary-care hospital and some of the best secondary-care hospitals available to the West Bank population are located in East Jerusalem.
- East Jerusalem houses most Palestinian marketing facilities as well as social and cultural infrastructure.
- Qalandia airport, a potential outlet for linking the West Bank with regional airports, is within annexed Jerusalem.
- Parts of East Jerusalem are an integral part of the power network covering the region from Ramallah to Bethlehem.

Jerusalem's economic significance is highlighted in the face of permit and closure policies. Palestinians living in other parts of the West Bank and Gaza Strip have been denied the services of Jerusalem's health and educational institutions. Mobility of Palestinians and goods between the northern and southern parts of the West Bank and into and out of Jerusalem have been severely constrained.

about a quantitative shift in the nature of interactions between the Palestinian and Israeli political leadership, as well as between the Israeli and Palestinian peoples.

The need to achieve further progress in the peace process is imperative. Neither the Declaration of Principles nor the current pattern of limited Palestinian autonomy in the WBGS was designed to serve as the outline of a final settlement. The specific provisions of the Oslo II Agreement allow the PA to manage the main government-controlled sectors of the economy (*i.e.*, health, education, the tax system). However, it provides for only partial control over policy instruments and without the full ability to make important strategic choices (*i.e.*, with respect to the type of fiscal instruments or the choice of external economic relations). The current territorial arrangements—the patchwork quilt of zones A, B and C, arranged in declining degrees of Palestinian authority—are complex and unwieldy. Such dimensions severely complicate Palestinian institution-building and administrative development and hinder the implementation of infrastructure projects. The spring 1996 “super closure” aggravated this further by restricting movement within the West Bank and by further isolating the West Bank from Gaza Strip.

* * *

Against this backdrop, there is the danger that negotiations will become stuck in the transitional phase. For Palestinians, the “interim” may come to seem “interminable.” Current territorial and political arrangements increasingly resemble a bantustan-like form of political containment, rather than a way-point on the road to a just and lasting peace. Should this happen, violence is likely to grow, with delirious effects on Palestinian-Israeli relations. Providing a bitter foretaste of this, in September 1996, following the opening by Israel of a tunnel adjacent to Al-Haram Al-Sharif in Jerusalem, clashes between the Israeli army and Palestinian demonstrators and police left more than 100 persons dead. In the regional sphere, existing multilateral initiatives would be imperiled.

A more promising route would involve continued improvement upon, and expansion of, the existing Interim Agreement, coupled with progress toward the resolution of final status issues. Palestinian support for the peace process would be consolidated by the assumption of a growing degree of self-determination and a sense that core issues are being addressed. Regionally, progress in the peace process would also serve to facilitate multilateral initiatives and promote general improvement in the quality and quantity of Israel’s relations with other Arab countries.

Bibliographic Note: The overall framework for Palestinian self-government in the WBGS is set out in the Declaration of Principles. Provisions for the first step in the transfers of powers and responsibilities are detailed in the Gaza-Jericho Agreement and the accompanying Economic Protocol. Provisions for partial, pre-Interim-Agreement transfer of powers and responsibilities in the West Bank outside of Jericho are specified in the Agreement on the Preparatory Transfer of Powers and Responsibilities. The framework for Palestinian assumption of remaining powers and responsibilities in the West Bank (along the lines of the Gaza-Jericho blueprint) is laid out in the Interim Agreement. The special arrangements governing Hebron are detailed in the Hebron Protocol.

Chapter 3

The Harsh Reality of Closure

The integration of the Palestinian and Israeli economies has been challenged by the labor permit and closure policies. Since March 1993, Israel requires a permit for every Palestinian crossing the joint borders. The border closure policy has been repeatedly implemented in response to or anticipation of political violence. The short-term costs of the permit and closure policies are substantial: Palestinian employment in Israel has been reduced and subjected to greater shocks and fluctuations, and firms have reduced production and sales and have become more insular. The long-term impact of the closure policy is very detrimental to the economy, generating low levels of investment, inefficient investment decisions, limited investment in public infrastructure, and distorted institutional development in the public sector. With jobs outside the WBGS disappearing and the closure policy taxing domestic production, Palestinian standards of living are in a free fall and depend increasingly on foreign assistance. To prevent more serious hardship, domestic production has to be encouraged. This will require that the economic borders between Israel and the WBGS be insulated from political shocks and Palestinian access to the outside world be direct, free, and credible.

Introduction

With the beginning of the peace process, it was natural for the Palestinian economy to start reducing its overwhelming dependence on Israel in the areas of trade and labor. It was hoped that this would be achieved gradually as trade links with new markets reduce Israel's share of trade and lead to expanded domestic production. Reconstruction of the Palestinian economy would, in turn, increase the demand for local labor and reduce Palestinian dependence on the export of labor to Israel.

However, the imposed separation between the two economies has been driven by political considerations. As such, it has been sudden and bumpy and has created serious dislocation in the Palestinian economy. This chapter documents the phenomenon of border closure, provides estimates on resulting aggregate losses, and analyzes its impact on households, firms, private investment, and government operations.

The Permit and Border Closure Policies

The 1967-1987 period is characterized by effectively open access of Palestinians and Israelis to each other's towns. Beginning with the *Intifada* in late 1987, Israeli civilians have largely shied away from Palestinian urban centers to avoid the prospect of hostility. Palestinian access to Israeli territories was limited for the first time during the Gulf War, and Palestinians laborers were required to obtain work permits to enter Israel from 1991 onward. Since March 1993, Palestinians of the rest of the West Bank and Gaza Strip (RWBGS) have been denied entry to Israel and Jerusalem unless they have an Israeli-issued permit. Fixed roadblocks were set up by the Israeli army at the major crossing points between the RWBGS and Israel and Jerusalem to enforce these restrictions. While the permit policy has prevented the majority of Palestinians from casual entry into Jerusalem and Israel, it was not necessarily effective—at least initially—against the entry of workers seeking jobs, particularly from the West Bank, where the borders with Israel are long and porous. Moreover, there is no effective

enforcement for compliance at the Israeli establishment level (*e.g.*, construction site or farm). The actual number of Palestinians working in Israel at any one time has often deviated substantially from the number of work permits issued. For example, in 1992, the number of issued work permits was around 70,000, while the actual number of Palestinians working in Israel was around 116,000 workers. However, this situation has been reversed with the increased intensity and policing of border closures.

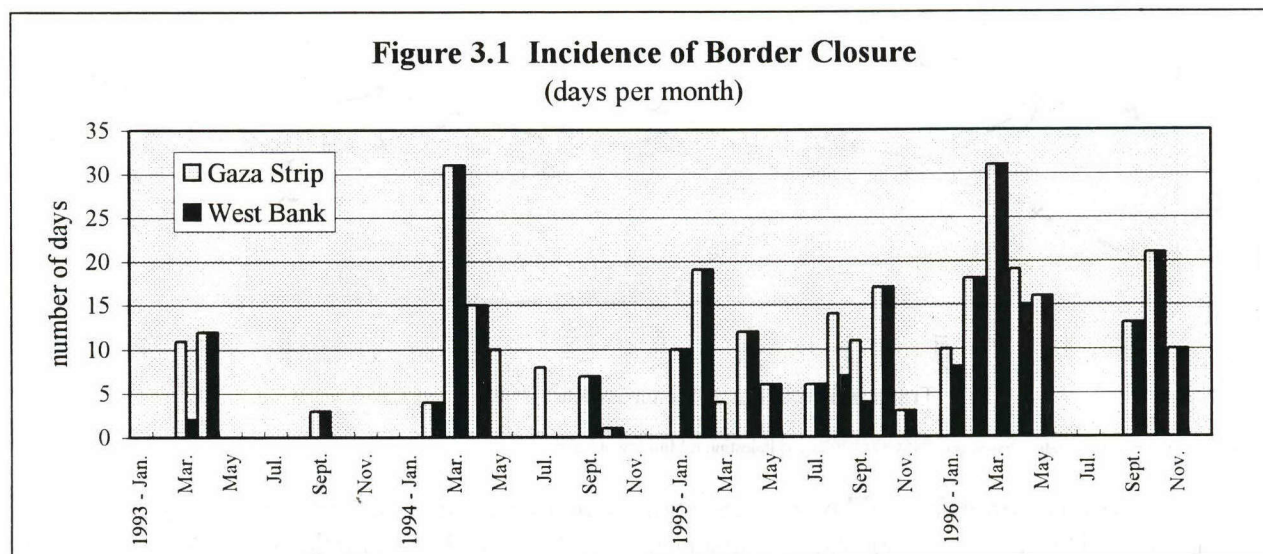
The introduction and enforcement of the permit policy in March 1993 heralded a new era of controlling Palestinian access to Jerusalem and the Israeli labor market. Then, border closure policy was imposed for specified or unspecified periods after violent events in Israel. In a period of border closure, even Palestinians with valid work permits are denied entry into Israel. Moreover, each episode of border closure has usually been accompanied by increasingly stiffer conditions, such as longer delays at crossing points, more thorough searches, and increased patrols for random checks on potential violators. Under these conditions, actual Palestinian employment in Israeli establishments was substantially less than the number of work permits issued to Palestinian workers. In 1996, the estimated number of average actual employment (10,300 from the Gaza Strip and 18,700 from the West Bank) was two-thirds of the average number of issued work permits (18,700 for the Gaza Strip and 23,600 for West Bank workers).

Figures 3.1 traces the frequency of border closures, reflecting the number of days of closure on a monthly basis. The days of border closure applied to the West Bank were 17 in 1993, 58 in 1994, 84 in 1995, and 132 in 1996. Gaza Strip has seen a larger incidence of closures, as the number of closure days reached 26 in 1993, 76 in 1994, 102 in 1995, and 138 in 1996. Figure 3.1 illustrates two clear aspects of border closures. First, the RWBGS has been subject to border closure for increasingly longer periods over the 1993-1996 period. Second, the business community or workers cannot anticipate the incidence, frequency and duration of any episode of border closure. The latter aspect adds a substantial element of risk, over and above the actual impact of these shocks.

Jerusalem and the Rest of the West Bank. Since the application of the permit policy, it has not been possible for the majority of Palestinians to enter Jerusalem. During a border closure, even permit-holding Palestinians from Gaza Strip and the RWB are not allowed to enter Jerusalem. Preventing entry into Jerusalem physically separates the RWB into two halves, where people cannot move from one part to the other since all reasonable routes between the northern and southern parts of the West Bank pass through Jerusalem. As the economic links of East Jerusalem are primarily with the West Bank, economic activity in East Jerusalem is devastated during periods of border closure. The health and education sectors are particularly affected, since Jerusalem houses the major hospitals that serve the entire West Bank. Patients, doctors, students, and teachers cannot reach their institutions during periods of border closure (Box 3.1).

Limitation on Movement of Goods. The limitations on Palestinian mobility during closures largely constrain the mobility of goods and factors of production. Vehicles owned by and registered in the RWBGS are generally denied entry into Jerusalem and Israel. During periods of closure, permits are largely made invalid. Thus, a border closure inhibits the movement of individuals and prevents Palestinian cars and trucks from crossing borders into Israel. The only vehicles that can move between these various areas are Israeli-owned and operated or those owned and operated by Jerusalem Palestinians. Such limitations interrupt Palestinian trade substantially, whether it is with or through

Israel or whether it is internal trade between the West Bank and Gaza Strip or between different parts of the West Bank. Closures also prevent Palestinian expeditors from reaching Israeli territory and, thus, restrict the clearance of Palestinian imports and exports (factors of production or finished goods) through Israeli custom ports.

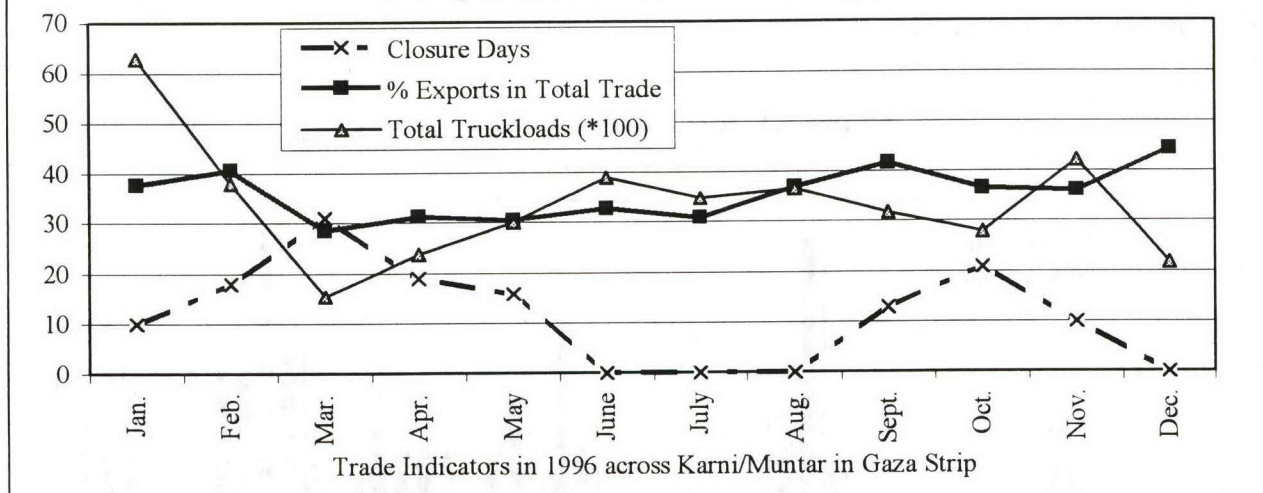


Source: Authors' computation based on data from Palestinian Ministry of Labor.

Limitations on the movement of goods result in a decline in total trade with or through Israel. Generally, during closures Israeli exports to the Palestinian areas decline, but Palestinian exports decline much faster. This asymmetry in the application of border closure is reflected in Figure 3.2. The magnitude of trade has traditionally been measured in relation to the number of truckloads moving across the borders. Figure 3.2 is based on the monthly number of trucks moving through the Karni/Muntar crossing point between Gaza Strip and Israel (the only crossing point where the 1996 figures for movement of trucks are disaggregated by the direction of movement of goods). The figure clearly illustrates that as the incidence of closure increases in a given month, total trade (exports plus imports) declines, and Palestinian exports decline faster than Israeli exports. The correlation coefficient between the number of monthly closure days and the total number of trucks crossing the Karni/Muntar checkpoint in 1996 is -0.38 . The correlation coefficient of closure days with the share of exporting trucks in total truck movement is -0.32 during the same period.

Internal Closure. A new concept of "internal" border closure emerged following the implementation of the Oslo II Agreement, when authority over the majority of West Bank urban centers was transferred to the Palestinians in fall 1995. During periods of internal closure, Palestinians cannot move from one urban center to another within the West Bank or even to and from the surrounding villages. As a result, West Bank urban centers have become small isolated islands, surrounded by the Israeli army, with practically no mobility in or out of these towns. Internal closure was applied following a sequence of suicide bombs in February-March 1996, and after violence erupted when Israel opened a tunnel in the old city of Jerusalem in September 1996. Obviously, the imposition of internal closure is the most economically devastating form of border closure applied to date.

Figure 3.2 Total Trade Declines with Closure, but Exports Decline Faster than Imports



Source: Authors' computation based on UNSCO (1997) and Palestinian Ministry of Labor.

Increased Intensity of Closure. Each time borders are sealed the conditions under which the borders would be selectively opened are harsher than in the past. For example, West Bank cars were initially allowed to enter Gaza Strip with the proper permit. Then, this became impossible, and only cars with Israeli license plates were permitted to enter Gaza Strip. Currently, Israeli Arabs and Jerusalem residents with Israeli-license plates are not permitted to enter Gaza Strip. Thus, travelers with required permits must walk across the Gaza Strip borders. Back-to-back movement of goods is the norm now. Goods have to be unloaded from one truck to another truck at the Gaza Strip-Israel border. Moreover, the inspection process of individuals and permitted vehicles (*e.g.*, vehicles with diplomatic plates or senior-level Palestinian policy makers) has become much more time-consuming and more intrusive over time.

Macro Impact of Closure and Permit Policies in the Short-run

The 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 permanent losses in export markets and interruptions to the flow of imports, thus disrupting domestic production and supply.

The most immediate macroeconomic impact of closure is the loss of earnings of Palestinians working in Israel, which is counted in the aggregate demand under "foreign income from abroad." The depressing 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

Box 3.1 The Human Cost of Closure

In addition to the substantial economic losses, there have been substantial human losses arising from closure. To enter Jerusalem or Israel, the required permit is issued from one day (*i.e.*, for medical personnel) to a maximum of three months. It usually takes one week to three months to obtain. Often, applications for a permit are denied. The process of granting permits is not transparent and lacks any meaningful opportunity for appeal.

The restrictions on people's movement, which varies in intensity depending on the episode of closure, can be quite punishing for RWBGS residents. During periods of border closure, Palestinians are denied access to Israel. Any Palestinian wishing to travel to a non-Arab country needs a one-day permit to go to Jerusalem or Tel-Aviv to apply for a visa, and needs to apply for a second permit to enter Israel if he or she plans to fly out of Ben Gurion airport in Tel Aviv. Some Palestinian professionals recruited from the Gulf countries to work in key technical positions within the PA in the Gaza Strip could not tolerate the "prison-like" restrictions on their mobility in and out of the Gaza Strip, and some have left their positions. Restrictions on movement are also harmful for the majority of Palestinian worshippers who are denied entry to East Jerusalem and, thus, prevented from religious practice at Jerusalem's Muslim and Christian holy sites.

Medical treatment is also severely obstructed by the closure policy. Doctors, health workers, and patients have to obtain permits to reach medical facilities in Jerusalem and Israel. Permits are often denied or not renewed. During closures, emergency passes—that, in theory, should allow health workers to cross Israeli checkpoints—are often not issued. Even if issued, they have not been recognized on numerous occasions. Ambulance access during emergencies is far too restrictive given the urgent needs and limited medical facilities in the RWBGS. Only 6 ambulances from the Gaza Strip and 5 from the West Bank have permits to enter Israel. Only 3 ambulance drivers have 24-hour permits and 8 additional drivers have restricted daytime permits. Even these ambulances and drivers are often delayed for up to 3 hours for security checks or turned back at checkpoints. During periods of internal closure in the West Bank, the situation is most severe, as medical workers cannot report to work, practically freezing medical care. At least 9 people died during the first 10 days of the spring 1996 closure as a direct result of delayed or denied access for patients in critical condition at the checkpoints.

Education is also severely affected by closures. In May 1995, Israel passed regulations prohibiting the issuance of permits for study in Jerusalem to any Palestinian not previously registered in an educational institution there. This prevents entry of any new students, endangering Jerusalem's educational institutions, which have served Palestinians for decades. During closures—which covered 41 percent of the days in the 1995-1996 school year in the West Bank—students and teachers who had permits were prevented from reaching their Jerusalem schools. Gaza Strip students registered at West Bank universities (often in specialties not available at Gaza Strip's universities) must obtain an Israeli permit to reside in the West Bank, which is issued initially for a three-month period. Then they must renew it for the last month of the semester. But permits can be canceled at any moment, leaving the students vulnerable to arrest. All permits were canceled three times in a single semester during the 1994-1995 academic year, requiring students to seek new permits. Valid individual permits can be confiscated by soldiers at checkpoints and permits may never be granted or renewed. Many students from Gaza Strip were arrested in the West Bank on the grounds of invalid permits.

Source: Mostly based on Human Rights Watch/Middle East (1996).

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 the permit and closure policies 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. It is reasonable to use the year 1992 as a benchmark since it reflects the pre-peace process employment level, and as such could be considered the “normal labor movement” that Israel committed to maintaining in the 1994 Economic Protocol.

Computation of the cost of closure is shown in Table 3.1. The fraction of days that Gaza Strip was subjected to closure was 7.1 percent in 1993, 20.8 percent in 1994, 27.9 percent in 1995, and 37.8 percent in 1996. The fraction of days of closure applied to the RWB was 4.7 percent in 1993, 15.9 percent in 1994, 23.0 percent in 1995, and 36.2 percent in 1996. Two clear conclusions emerge from Table 3.1. First, closure has been significantly more costly for Gaza Strip than for the RWB. Second, the cost of closure has increased over the 1993-1996 period, whether measured in absolute amount or as a ratio of GNP. The sum of losses from border closure only in the RWBGS was equal to 1.7 percent in 1993, 4.2 percent in 1994, 5.4 percent in 1995, and 7.3 percent of GNP in 1996. The RWBGS cost of both closure and permit policies in relation to the 1992 situation, and as a percent of the combined GNP, amounted to 6.5 percent in 1993, 16.3 percent in 1994, 20.6 percent in 1995, and 24.2 percent in 1996.

Table 3.1 Total Cost of Border Closure and Permit Policies
(1993-1996)

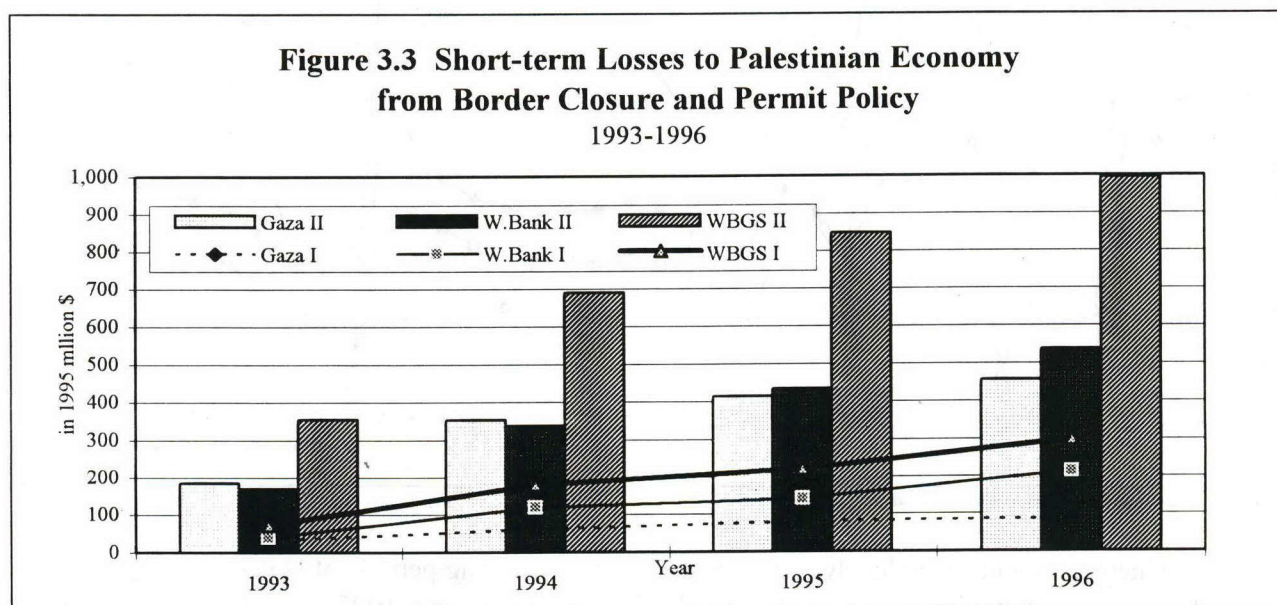
	Rest of West Bank				Gaza Strip			
	1993	1994	1995	1996	1993	1994	1995	1996
GNP (in \$ millions at 1995 prices)	3,226.6	3,124.1	2,926.9	2,951.2	1,168.3	1,120.0	1,189.7	1,152.8
Closure days/year	17	58	84	132	26	76	102	138
% days under closure	0.047	0.159	0.230	0.362	0.071	0.208	0.279	0.378
Losses (\$ millions at 1995 prices)								
Closure Policy Only*	40.6	119.1	141.5	198.7	32.5	60.6	79.8	84.8
Closure & Permit Policies**	137.4	337.8	434.1	500.9	146.4	351.8	412.9	456.1
Losses (% of GNP)								
Closure Policy Only*	1.3	3.8	4.8	7.2	2.8	5.4	6.7	7.6
Closure & Permit Policies**	4.3	10.8	14.8	18.2	12.5	31.4	34.7	39.6

* The cost of closure policy only is measured in relation to the declining flows of labor as a benchmark.

** The cost of closure and permit policies utilizes the labor and trade flows of 1992 as the benchmark.

Source: Authors' computation.

In absolute amounts, the cost of border closure only is large (Figure 3.3). The cumulative losses over the 1993-1996 period reached \$775 million for the closure policy only and reached \$2,815 million for both the closure and permit policies (in 1995 dollars). These cumulative losses amounted to 20 to 70 percent of one year's GNP, respectively. The higher cost estimate is about twice the amount of donor assistance that was disbursed over the same period.



I: Cost of border closure only.

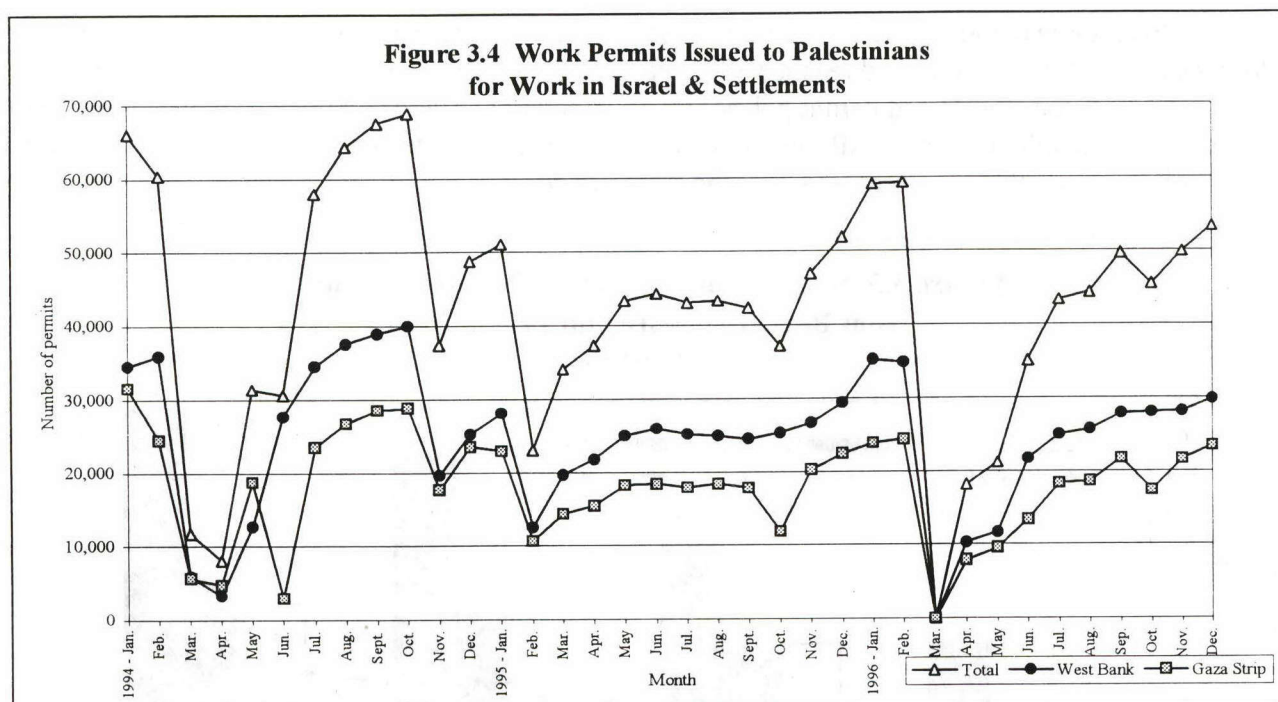
II: Cost of border closure and permit policies.

Source: Authors' computations.

Labor Market Impact

Since 1993, Palestinians are required to have an Israeli-issued permit to be able to work in Israel. The number of these permits has declined and has been subject to monthly fluctuations in response to the political environment (Figure 3.4). Yet, the number of workers who actually obtain employment has generally deviated from the number of permits. In the early 1990s, the number of Palestinian workers in Israel exceeded the number of permits issued to Palestinians, often by a large margin. The situation changed after the establishment of the PA. The number of workers actually employed in Israel is much less than the number of permits issued to Palestinians. For example, the estimated average number of Palestinian workers in Israel in 1996 was lower than the average number of permits by 25 percent in the West Bank and 45 percent in Gaza Strip. This discrepancy stems directly from the increased application of closure over the 1994-1996 period.

Unemployment Rate Increases During Border Closure. The immediate impact of closure is that Palestinian workers cannot reach their jobs in Israel, even if they have a work permit. In some cases in the West Bank, these workers may get to their work location, bypassing Israeli checkpoint by walking through mountainous areas or around checkpoints, often with help from their Israeli employers. But this has become increasingly more difficult due to increased policing of the borders and increasingly harsh punishment applied to Palestinians who are caught violating the Israeli ban on entry.

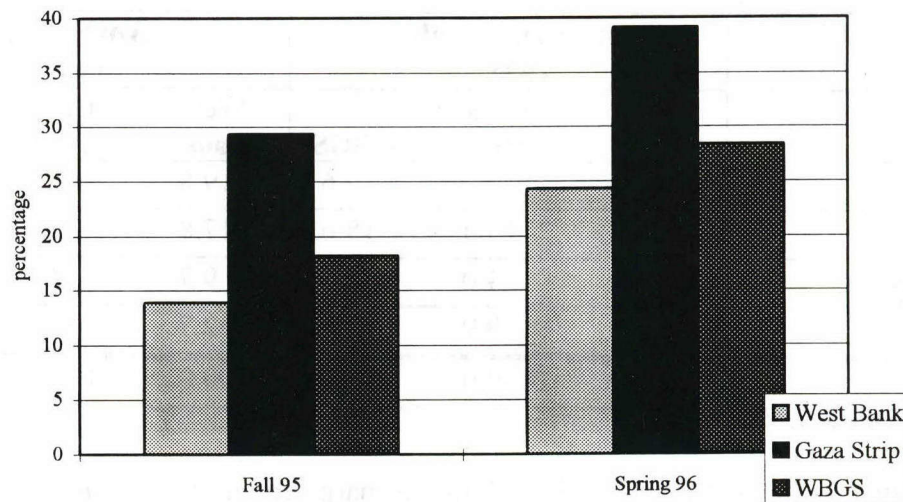


Source: Israeli and Palestinian Ministries of Labor.

Unemployment immediately increases in the WBGS during periods of closure, on top of an already very high unemployment rate. During the September-October 1995, the rate of unemployment was 18.3 percent. It reached 28.6 percent during the harsher period of closure in April-May 1996 (Figure 3.5). Between these two periods, the number of unemployed workers increased by 38,000 in the West Bank and 19,000 in Gaza Strip. This suggests that the increase in unemployment in response to border closure is of the same magnitude as the actual number of Palestinian workers in Israel during periods of non-closure. Clearly, some Palestinian workers working in Israel find and obtain employment opportunities in the domestic labor market during a closure period. But the impact of this adjustment is nullified by the indirect increase in unemployment as a result of reduced employment opportunities in the domestic Palestinian economy. Thus, unemployment increases during a closure period by the number of Palestinian workers unable to reach their jobs in Israel.

Labor Force Participation Rate Increases. The labor force participation rate appears to increase during periods of closure. In general, the impact of increased unemployment on labor force participation is subject to two opposing trends. First, the discouraged worker effect causes people to drop out of the labor force, discouraged by the lower probability of finding a job. Second, the income loss to the household from unemployment may lead to more members searching for and potentially obtaining paid jobs. The effect of income loss to the household appears to outweigh the discouraged worker effect, leading to higher labor force participation during a period of increased unemployment as a result of border closure. The strength of the income loss effect is a result of the cumulative effect of negative shocks in the 1990s that have depleted household assets and limited their ability to smooth out the negative shocks (see household adjustment in the next section). Moreover, the increase in labor force participation during a closure period is characteristic of females as well as males.

**Figure 3.5 Unemployment Rate
Increases During Closure**



Source: PCBS (1996d and 1996e).

The evidence on increased labor force participation as a result of closures can be discerned from two separate sources. First, in comparing the two PCBS surveys, the labor force participation rate for the population aged 15 years and older increased from 39.0 percent in September-October 1995 to 42.2 percent in April-May 1996 when closure was harsher and unemployment was higher. Second, in comparing the labor force participation rate for the West Bank across weeks of the September-October 1995 survey, it is obvious that labor force participation rates are lowest for weeks with no closure, and highest during the weeks of full closure.

Sectoral Distribution of Employment is Affected. The sectoral distribution of employment is also affected by closures (Table 3.2). In the West Bank, employment in the construction and manufacturing sectors are reduced while agriculture operates as a shock absorber where laborers work on family farms or in some form of agricultural activities during periods of closure. In Gaza Strip, jobs in construction are lost largely as a result of difficulties in obtaining raw materials.

Two types of evidence can be presented to illustrate the effect on sectoral distribution. First, the agricultural share of employment in the West Bank increased from 14.7 percent in September-October 1995 to 19.8 percent in April-May 1996. Second, the micro data analysis reveals that the fraction of rural West Bank residents working in agriculture increased significantly by 0.094 during weeks of partial closure and by 0.125 during periods of full closure. The fraction of West Bank employment declined from 19.9 to 17.8 percent in manufacturing and from 12.8 to 9.7 percent in construction between September-October 1995 and April-May 1996, respectively. The micro evidence is consistent with the decline in the manufacturing employment during closures; the fraction of employment in manufacturing significantly declined by 0.011 in periods of partial closure and by 0.014 in periods of full closure. The micro evidence on construction employment is less clear, as it seems to be related to the nature and length of the closure and whether the import of construction materials is affected or not.

Table 3.2 Sectoral Distribution of Domestic Employment in the WBGS
(Excluding Employment in Israel & Settlements)

Sector	September-October 1995			April-May 1996		
	West Bank	Gaza Strip	WBGS	West Bank	Gaza Strip	WBGS
Agriculture	14.7	10.7	13.6	19.8	10.2	17.3
Industry	19.9	15.4	18.6	17.8	15.8	17.2
Construction	12.8	14.0	13.1	9.7	7.4	9.1
Services	52.6	59.9	54.7	52.7	66.7	56.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: PCBS (1996d and 1996e).

Nominal and Real Wages Decline. With the sharp drop in the demand for labor during a border closure period, the real and nominal wage rate drops, reflecting labor market flexibility and an absence of institutional impediments. For example, with deteriorating labor markets between September-October 1995 and April-May 1996, the average nominal daily wage fell for males from 44.6 to 41.5 shekels in Gaza Strip and from 58.5 to 49.4 shekels in the West Bank. This amounts to a 7-percent and 16-percent reduction in the nominal wages over a 7-month period in Gaza Strip and the West Bank, respectively. Given an inflation rate of 6 percent in each area, the real wage rate dropped by 13 percent in Gaza Strip and 22 percent in the West Bank from November 1995 to May 1996.

Household Adjustment

The loss of earnings during periods of closure necessitates some adjustments by households in terms of the relation between income, wealth, and expenditure. Analysis of the results of a small sample of 300 households in Gaza Strip reveals that the average household income declined by 22 percent during the prolonged closure beginning in February 1996, in comparison to the period preceding that closure. The fraction of households (with sample average household size of 9.4 persons) with a monthly income less than 600 NIS increased from 31 percent before the closure to 48 percent during closure. Households that are most severely affected are those with some members working in Israel. The income loss severely affects workers who depend on the transport or industrial sector, where employment is negatively affected during period of closure. Prolonged periods of closure also affect those working in the construction sector.

It is expected that households would smooth their consumption pattern and their consumption expenditure would not be subject to the wide fluctuations of their incomes. The consumption smoothing is carried out through drawing down household savings (*i.e.*, sale of jewelry, accumulating debt), adjusting consumption patterns to reduce consumption expenditure while maintaining basic nutritional needs, and obtaining relief from welfare agencies or relatives and neighbors.

When facing a sudden drop in income, expenditure levels can be maintained by drawing down the household financial savings. A sale of jewelry usually indicates serious hardship, given the difference in the sale and purchase price of jewelry. According to Table 3.4, 30 percent of Gaza Strip households were forced to draw down their financial savings or sell their jewelry to finance current consumption during the prolonged spring 1996 closure.

Alternatively, households finance current consumption through indebtedness, mostly to shopkeepers and relatives who account for roughly one-half and one-third of total debt, respectively. The fraction of sample households financing their consumption through borrowing doubled from 28 percent before the spring 1996 closure to 56 percent during the closure. In addition to increasing the number of indebted households, indebtedness intensified, as the average debt of these households increased by 19 percent during the closure in comparison to the period preceding the closure.

One obvious way for households to face an income shortfall is to reduce their consumption expenditure. The evidence in Table 3.3 suggests that households did not reduce their consumption of flour, a basic need, but reduced the consumption of the relatively expensive goods such as meat and eggs by 30 percent and 22 percent, respectively, during the closure period in comparison to the prior period. Thus, the average household would maintain adequate caloric intake, but the protein intake is likely to suffer during periods of closure.

Table 3.3 Household Adjustment During Spring 1996 Closure

	Before Closure	During Closure	Percentage Change
Average monthly income (NIS per household)	1,130	884	-21.8
% of households with monthly income < 600 NIS	31.0	48.0	54.8
% of households with no working adult	13.8	24.7	79.0
Fraction of households borrowing money (%)	28.0	56.3	101.1
Average debt of the indebted households (NIS)	1,028	1,225	19.2
% of households forced to use savings or sell jewelry	8.7	30.0	244.8
% of households receiving assistance		17.4	
Patterns of monthly household consumption:			
Average meat consumption (kg per household)	5.3	3.7	-30.2
Average egg consumption (# per household)	105.0	82.0	-21.9
Average flour consumption (kg per household)	106.7	106.9	0.2

Source: Authors' computation based on survey by Ard El Insan of 300 households in Gaza Strip.

Household consumption is also maintained through the assistance provided by the formal social safety net (*i.e.*, UNRWA, Ministry of Social Welfare) and the informal network of relatives, neighbors, and the Zakat committees. Roughly 17 percent of the sample households received such emergency assistance during the spring 1996 closure. More than half of those receiving assistance obtained it through the informal safety net of relatives, neighbors, and the Zakat committees.

Impact on Firms

The impact of closure on firms in the industrial and service sectors is strongly negative. The integration of the Palestinian economy with the Israeli economy ever since the 1967 occupation implied very strong links between Palestinian and Israeli firms, whether in procuring inputs or supplying output. Closure has increased the cost of operations to such a level that trade between the West Bank and Gaza Strip and with Israel has become very costly and risky. The longer-run impact of recurrent and unpredictable closures would force the Palestinian areas to move toward a closed economy (autarky), with production aimed at the local market using local inputs. This outcome can be avoided only if there is a credible commitment to permit the free movement of goods and individuals between the WBGS and Israel, or if the Palestinians are permitted to freely access international markets directly through the Gaza port and airport (that are not yet open for operation) along with free movement through a corridor connecting the West Bank and Gaza Strip.

Closure affects firms in several ways. It interrupts the production process, delays the procurement of raw materials and intermediate inputs, interrupts the movement of workers and personnel, and increases the cost of delivering goods and services to customers. Further, closure makes it very difficult to market the output and assure customers of reliable delivery, resulting in a loss of market share. It also increases the financing cost of doing business since it becomes difficult to send company personnel to collect receivables and bad debt. At the same time, closure induces Israeli suppliers of inputs to demand advance payment for RWBGS firms' purchases. The net result is that sales decline, inventories build up, and operating costs skyrocket.

Declining Sales and Competitiveness. Table 3.4 documents the decline in sales for selected firms representing various industrial activities following the spring 1996 closure. The decline in sales is quite steep, ranging from 9 percent to 90 percent, and averaging 57 percent. Part of the decline in sales in the WBGS is a reflection of the reduction in aggregate demand that follows the closure. In the presence of effective demand for products, some firms suffer from a reduction in sales because they are unable to deliver the goods to the customers, due to difficulties in transporting manufactured goods to the customer or in concluding the sale since moving personnel and customers across borders with Israel is restricted. The above factors are usually associated with excess inventories held by an establishment, as is the case with industrial activities such as food processing, leather, and textiles. However, some firms are also likely to suffer substantial reduction in production and sales if there is an interruption in the delivery of key inputs which are imported either from Israel or through Israel, *i.e.*, chemical, pharmaceutical, metals, and construction firms. Clearly, establishments in these industries can build up their inventories of inputs or outputs, at a substantial cost, to reduce the impact of closure. This, however, would be fruitful only if the demand for their products and services is local and is relatively immune to closure conditions.

Difficulties in marketing Palestinian goods in Israel ultimately lead to a reduction in the Israeli market share for Palestinian firms. The cost of moving goods across borders increases and the unpredictability surrounding the timing and feasibility of deliveries adds to the cost of trade with Palestinian firms. For example, the Israeli market share in the output of the Reem Sports Shoes company declined from 50 percent in 1993 (prior to closures) to 10 percent in 1996.

Table 3.4 Impact of Spring 1996 Closure on Sales of Selected Firms

Firm	Normal Sales	During Closure	Percentage Decline
Reem Sports Shoes (1000 NIS/month)	180	40	78
Al-Shorouq Carton Industry Co. (1000 NIS/month)	150	73 in March 96	51
		136 in April 96	9
Aweida Food Products (1000 NIS/month)	500	140	72
Palestinian Tractor Co. (1000 NIS/month)	850	200	76
National Palace Hotel Restaurant (1000 \$/month)	27	13.2	51
Riziq Textile Co. (1000 NIS/month)	225	157	30
Nasser Oriental Trading & Manuf. Co. (1000 NIS/month)	1000	100	90
Silvana Co. (1000 NIS/day)	65	20	69
Jordan Chemical Lab (1000 NIS/month)	500	300	40

Note: Figure for "during closure" refers to March and April 1996.

Source: Derived from case studies on the impact of closure on firms, assembled by Mattin and Palestinian Trade Promotion Organization (1996).

Border closures are applied asymmetrically. Palestinian goods are largely prevented from entering Israel or going through Israel, while Israeli goods continue to flow into Palestinian areas, particularly the West Bank. While it is possible for some Palestinian firms to marginally increase their market share at the expense of Israeli firms, the overwhelming impact of the asymmetry in border closure is the decline in the market share and size of Palestinian firms. This has weakened Palestinian firms and made them less competitive.

Increased Costs of Production and Operation. In addition to the reduction in sales, the major impact of closure is a substantial increase to firms' costs of production and operation. Inventory costs increase as a result of the undesired accumulation of inventories—inputs or outputs—or as a result of planned higher levels of inventories designed to mitigate the impact of the shocks. Financing costs increase, as it becomes difficult to move personnel across borders to collect payment and bad debt. Moreover, many Israeli suppliers have started demanding advance payment during closures instead of payment upon receipt to protect themselves from collection difficulties. The liquidity problems that arise from increased financing difficulties are known to banks that tighten their credit line or become unwilling to extend additional credit in face of such difficulties. In principle, the increased inefficiency in the payment system that arises from closure is certainly bound to reduce profitability and the size of production. This risky environment is well known to commercial banks that have become even more conservative in extending credit to private businesses, reducing the maturity of any credit, and raising the cost of credit to firms. Commercial banks keep a higher liquidity ratio during closure periods in order to meet increased demand on withdrawing deposits.

Transportation costs for moving goods across borders increase substantially as a result of border closure. For example, the transportation cost for a truckload of goods between the West Bank and Gaza Strip was around NIS 500 in 1993, but it reached NIS 1500 in 1996. The substantial increase arises from newly imposed rules that require goods to be unloaded at the border from one truck to another. 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 that is usually less than 100 miles.

Box 3.2 Trade in Perishable Goods and Closure

Production of tradable goods that are perishable is probably affected the worst by the border closure policy. While the cost of trading non-perishables increases, perishable food and agricultural commodities can be destroyed during a closure period—a loss that cannot be compensated at a later stage. Investment in tradable high-value agricultural production in Gaza Strip is heavily penalized by the closure policy. Moreover, the closure policy generates peculiar outcomes where the price of perishable food is substantially different in the geographically close markets of the West Bank, Gaza Strip, and Israel during closure periods.

The required back-to-back shipping of goods and extended delays negatively affect product quality. Sylvana, a major chocolate factory in the West Bank, practically lost its Gaza Strip market for one of its traditional products following the spring 1996 closure. Boxes of chocolate had to be loaded on three separate trucks using the back-to-back mechanism and utilizing the services of an Israeli company in the intermediate step. About 20 to 30 percent of the shipped chocolates were damaged as a result of loading and unloading and extended border delays.

Investment in the production of tradable but perishable agricultural commodities is proving disastrous to Palestinian farmers. The story of the production of strawberries and carnations in the northern areas of Gaza Strip is illuminating. Both crops are high-value and were introduced to Gaza's farmers through the Department of Agriculture of the Israeli Civil Administration. The crops are marketed through the Israeli AGREXCO export company, mainly to Western Europe. Israeli companies provided seedlings and technical assistance and marketed the product. The production of these high value-added crops in Gaza Strip makes economic sense as these are labor-intensive crops, require year-round labor input, and have a value of the output per water usage that is higher than traditional food crops. Gaza Strip's weather is conducive to their cultivation and production during seasons when competing producers in Europe and North Africa cannot supply them. Production of these crops expanded rapidly, especially in the early 1990s. Currently, about 1,000 dunum (one dunum = 1,000 square meters) in Gaza Strip is cultivated with carnations, which require green houses. About 75 percent of Israel's export of strawberries are produced in Gaza Strip.

Closure is proving to be disastrous for the marketing of carnations and strawberries, since two Israeli export companies usually fly these goods into Europe from an Israeli airport. Extended delays at the border for security checks, limited movement of trucks, and expensive refrigerated storage facilities are making it very difficult for farmers to cover their costs of production. During the 1995-1996 season, an estimated 15 million stems of carnations were lost due to closure-related reduction in export (at a farmer loss of approximately \$2 million). Clearly, the investment made by farmers to transform their land to high value-added export crops, purchase green houses, and acquire the requisite skills needed to produce these crops has placed them in financial difficulties during the 1995-1996 and 1996-1997 seasons. Continuation of the current closure policy without alternative direct export routes will ultimately force these Palestinian farmers out of production for export and into production for domestic consumption.

Another outcome of border closure is the wide variation in prices of perishable commodities among the markets of the West Bank, Gaza Strip, and Israel. For example, the low supply of Israeli tomatoes in summer 1995 made their price skyrocket in Israel and the West Bank from around NIS 2-3 to around NIS 10 shekels per kg. But the excess supply of Gaza Strip tomatoes were prevented from entry into Israel (and hence the West Bank), which made their price in Gaza Strip drop to unusually low levels.

There have been numerous instances of spoilage of perishable goods (*e.g.*, food, chocolate) in the transportation process (Box 3.2). To the extent that some inputs are imported and some outputs are exported, closure increases the cost of clearance, storage, and shipping since company staff are unable to do the work. Firms have had to rely increasingly on Israeli agents for shipping and clearance at higher costs. During periods of closure, delayed delivery of goods is bound to increase the storage cost at Israeli ports.

Some firms react to reduction in sales by laying-off workers, reducing the number of shifts of operation, or reducing the duration of the operation schedule. To the extent that workers have job-specific skills, firms are more likely to keep such employment intact and to continue paying the workers' wages in order to save the cost of training new workers when sales begin increasing again.

Long-term Impact on Growth

Beyond the short-run impact on the economy, border closures will also have a less obvious yet detrimental impact on long-run economic development through lower levels of investment and reduced efficiency of investment. While related, these are two separate effects and both imply lower rates of economic growth.

Low Levels of Investment. Border closure policy can largely explain the difference between the substantial interest of local and Diaspora Palestinians to invest in the economy and the actual low levels of investment that have materialized to date. First, the strong interest is based on a rosy scenario of long-term economic development; but the demand for investment has diminished under closure policy because of an overall decline in aggregate demand. Second, closure generally interrupts sales and increases operating costs, thus reducing overall profitability and reducing the incentive for new investment. Third, investment is deterred by the increased risk arising from uncertainty in the timing, duration, and intensity of closures—an uncertainty which is over and above the strategic uncertainty resulting from the interim status of the political situation and the lack of clarity on the permanent status of the WBGS. Fourth, border closure has reduced public investment due to a diversion of donor funds allocated to projects that are largely aimed at income-maintenance and budgetary support to cushion the impact of closures. To the extent that investment in public infrastructure is complementary to private investment, lower levels of private investment would also result from the inability to upgrade the public infrastructure.

In addition to the above factors that curtail the demand for investment, closure reduces the supply of funds available for investment and increases the cost of such funds. Within an environment of closures, commercial banks have become much more conservative in their lending practice than they may otherwise be, leading to lower debt-financed investment levels.

Reduced Efficiency of Investment. In addition to the low levels of investment, the wrong investment decisions are likely to be made in the context of border closures. Instead of developing into an export-oriented economy, the signals sent by the closure policy drive the economy into localized autarky, with production aimed at the local market. This arises from the differential impact of border closure on firms depending on the importance of tradables in their inputs and output.

**Table 3.5 Difficulties Encountered by Firms During Closure
by Location of Inputs and Markets**

A Firm Located in the West Bank

Inputs	Market			
	West Bank	Gaza Strip	Israel	Abroad
West Bank	minimal	delivery	delivery	delivery
Gaza Strip	access	access + delivery	access + delivery	access + delivery
Israel	access	access + delivery	access + delivery	access + delivery
Abroad	clearance + access	clearance + access + delivery	clearance + access + delivery	clearance + access + delivery + clearance

A Firm Located in Gaza Strip

Inputs	Market			
	West Bank	Gaza Strip	Israel	Abroad
West Bank	access + delivery	access	access + delivery	access + delivery
Gaza Strip	delivery	minimal	delivery	delivery
Israel	access + delivery	access	access + delivery	access + delivery + clearance
Abroad	clearance + access + delivery	clearance + access	clearance + access + delivery	clearance + access + delivery + clearance

Categories of difficulties: access = delivery of inputs to firms is interrupted or becomes very costly
 delivery = delivery of output to customers is interrupted or becomes extremely expensive
 clearance = difficulties are encountered in customs clearance either for imports or exports

As Table 3.5 illustrates, firms least affected by border closure are those that utilize local material and sell their product in the local market. Indeed, to the extent that these firms face some external competition, they may even benefit if the external competitor is unable to deliver the goods to the local Palestinian market. Firms that usually sell their products in markets across borders would suffer reduction in sales and market share, while firms that need imported inputs would suffer higher inventory costs or sustain interruptions to the production process. The more open to external trade the firm is, the more costly is the closure policy. This is an ironic outcome, given that the economic vision accompanying the peace process and donor assistance revolve around moving the Palestinian economy from exporting labor to exporting goods and services that utilize Palestinian labor. Investment decisions based on this vision have been heavily penalized by the implementation of the closure policy. In the face of these realities, firms may decide to mitigate the impact of the closure by locating the production process in the same location as inputs and product market. New investment activities would produce goods for the domestic Palestinian market or services consumed in the region, *i.e.*, tourism. Industries that produce export goods would attract very little investment. To the extent that

this occurs, the Palestinian economy would move toward autarky, with limited trade with the outside world. Indeed, the non-contiguity of the West Bank and Gaza Strip generates additional peculiarities. To the extent that each of the West Bank and the Gaza Strip is an important market for a firm's product, then the firm may have to invest in two separate plants to cater to the West Bank and Gaza Strip markets separately. This adjustment would create a closed economy that has little trade with the outside world and limited trade between the West Bank and Gaza Strip.

The closed-economy outcome would prevent the WBGS from reaping substantial benefits from the international division of labor that accompanies world international trade. This would result in low and stagnant levels of income. Skilled and educated workers are likely to be punished more severely from the limitation of international trade, since their skills would be less utilized by the market. This would be particularly damaging to the Palestinian economy, given the abundant endowment of educated workers. The low and stagnant levels of income, coupled with reduced benefits for educated workers, would push workers to seek better employment opportunities by migration. The resulting situation would generate dissent and strengthen the opposition to the political process.

The permanent resolution to the political process may encourage and protect free trade between the West Bank and Gaza Strip, between these areas and Israel, and with the outside world. This scenario would clearly provide a bright framework for long-term prospects of the Palestinian economy. But closures have harmed the economy by inducing inefficient and inappropriate investment that is not well suited for competition and free trade. For example, a firm that establishes two plants to serve the geographically separate markets of the West Bank and Gaza Strip may find it more efficient to bring both lines of production under one roof. Also, a firm that may have invested to meet domestic Palestinian demand may find itself unable to compete with lower-priced and superior Israeli or foreign products. The firm may decide to give up on the Israeli or world market because transportation difficulties may have lost a substantial opportunity.

Impact on the Government

Border closure has affected government operations by reducing revenues, increasing expenditure on income maintenance and job expansion, and shifting the priorities of donor assistance away from public investment to short-term budgetary and income support. With the negative impact on income and production levels, closure has generated revenue losses for the PA. This impact is hard to trace given the incremental transfer of revenues from the Israeli to Palestinian authorities, and given the difficulty in assigning the government revenues to specific time periods of accrual.

More obvious is the impact of border closure on increasing PA expenditures, such as welfare programs to mitigate increasing levels of poverty. A significant part of the increased public expenditure is due to the substantial increase in public sector employment, some of which may be accounted for by the desire to alleviate the impact of high unemployment.

The presence of general border closure presents challenges to the operation of the PA, whose offices are located in the geographically non-contiguous areas of the West Bank and Gaza Strip. Coordination between the offices in the two areas is substantially more difficult and costly as officials are restricted from moving freely between the two areas. Only high-level ministerial staff can acquire

permits to travel between the two areas. Often, they take on the additional arduous tasks of coordination among the offices between the two areas, taxing their time and increasing the overall cost of government operations. Staff training, workshops, and any type of government operation has to be done twice—once in the West Bank and once in Gaza Strip. The extreme difficulty in mobility for most government officials creates the additional danger of having two government bodies develop and/or implement different policies in the two areas.

Border closure has also negatively influenced the implementation of the official assistance program of donor countries. Reduced revenues and greater expenditures have increased PA budget deficits, which has increased the demand for donor budgetary support at the expense of investment in public infrastructure. An additional component of donor aid has been re-oriented away from long-term development projects toward employment generation projects that can be implemented quickly with an immediately visible impact of alleviating unemployment and poverty. Further, the delivery of donor assistance has often been interrupted by closures as imported goods face difficulty in clearance or as aid workers' mobility is hampered.

* * *

The recent negative performance of the Palestinian economy can largely be attributed to the sudden disengagement of the Palestinian and Israeli economies as a result of permit and closure policies. On normal days, the number of Palestinian workers in Israel has been reduced from its height in the early 1990s, Palestinian goods can move between the West Bank and Israel and between the West Bank and Gaza Strip, but at much higher costs than in the period preceding the peace process. During periods of border closure, Palestinians workers are not permitted to commute to or through Israel and the cost of moving goods becomes exorbitant. The periods of border closure have increased in intensity, duration, and occurrence over the past four years.

Continuation of the closure policy in the next few years will only perpetuate negative economic outcomes. Private investment will be deterred, and firms will increasingly adjust their investment to the local market. The optimal policy would be to open up the border, allow for open employment of Palestinians in Israel, and assure the free and uninterrupted movement of goods within WBGS, between the West Bank and Gaza Strip, and between the WBGS and Israel. If this is deemed impossible, more structural solutions will have to be found that allow the Palestinian economy to function in spite of minimal links to Israel.

Bibliographic Note: This chapter draws on the background papers of Arnon (1996), Pissarides (1996), and Abu Dagga (1996). Additional sources include PCBS labor force surveys, Iyyada, Hannon, and Ard El Insan (July 1996), Human Rights Watch/Middle East (July 1996), UNSCO (1997), and Mattin and Palestinian Trade Promotion Organization (1996).

Part B

Policies for Growth and Job Creation under Adverse Conditions

In the long term, the Palestinian economy cannot grow on a sustainable basis in the absence of a favorable resolution of the peace process. In the next few years, the economy is likely to remain vulnerable to external shocks and political uncertainty, and stabilization policies will not be sufficient to meet the job creation challenge. In order to build a solid basis for growth in spite of the ups and downs of politics, Palestinian society can, however, take advantage of its unused assets—the skills and capital of its population and Diaspora, a broad array of profitable investment opportunities, and the goodwill of the international donor community.

To nurture these assets toward their potential, a good policy framework should be designed to:

- ◆ diversify away from heavy economic reliance on Israel;
- ◆ remove artificial constraints in order to allow the economy to jump closer to its potential;
- ◆ foster more risk-sharing among the WBGS, the international donor community and financial markets; and
- ◆ avoid myopic temptations with large social costs down the road.

The PA has sufficient authority to implement many of the policies identified throughout Part B of the report. Although, some of the policies—such as changes in trade regime, taxation, or land zoning—hinge on further negotiations with Israel or resolution of the final status issues.

Chapter 4

The Job Creation Challenge

The Palestinian economy faces three substantial challenges in job creation: to reduce the high level of unemployment and underemployment, to create sufficient jobs for a rapidly expanding labor force, and to create quality jobs that fully utilize the high-skill content of the labor force. These challenges have to be confronted in a difficult environment characterized by the drop in Gulf demand for educated Palestinian labor, particularly following the 1990-1991 Gulf War, and the rapid decline and increased uncertainty of jobs for unskilled labor in Israel. In addition, the economy will need to create jobs for Palestinians returning to and resettling in the WBGS, following agreements on the displaced and refugees. In the right political environment and policy framework, the Palestinian economy can meet the challenge of creating sufficient good jobs for its labor force.

Introduction

In the future, the economy in the WBGS will have to rely on domestic job creation instead of exporting its workers to neighboring countries. The challenge is significant: out of a labor force of around one-half million workers, there are between 100,000 to 150,000 unemployed workers depending on the degree of openness of Israeli borders; and there are roughly 30,000 new entrants to the labor force annually. Potential returnees would create additional demand for jobs. These needs significantly exceed the number of jobs that the PA can create in the civil service sector or that donors can finance in infrastructure and social services projects. Moreover, recent shocks are likely to be permanent, so new jobs will have to be sustainable. Clearly, private sector-led development is the only answer for such sustainable development. This chapter sets the stage for the exploration of job-creating policies addressed in the rest of Part B. It documents the need for a large number of jobs by considering the implication of high unemployment, fast population growth, and a highly educated labor force.

High Unemployment and Underemployment

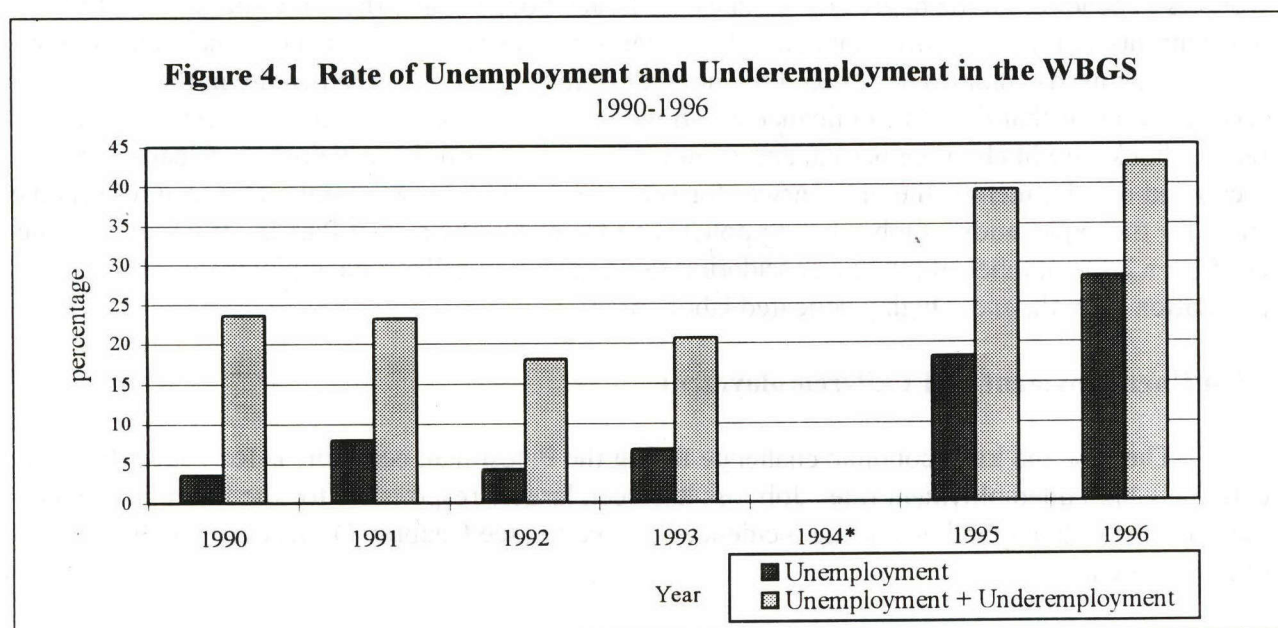
The first and key economic challenge facing the Palestinian economy is to reduce the extremely high unemployment rate. Job loss has been largely responsible for the rapid decline in the standard of living and increasing incidence of poverty (see Chapter 1). But how high is unemployment?

Popularly reported figures place the rate of unemployment in a range between 40 to 60 percent of the labor force. But given the strict international standard developed by the International Labor Organization (ILO) and adopted by the PCBS, the rate of unemployment reached 18.2 percent in September-October 1995 and 28.4 percent in April-May 1996. These figures are based on large nationally representative and scientifically conducted surveys. The results suggest that out of roughly one-half million individuals in the labor force, 92,000 and 149,000 individuals were seeking work but were unable to work even for one hour during the

survey weeks in fall 1995 and spring 1996, respectively. More recent PCBS labor force surveys suggest that the unemployment rate averages around 20 percent during “normal” times, and increases to 30 percent during periods of border closure. By international standards, these rates are extremely high and few countries experience such high unemployment. Clearly, unemployment has increased since the early 1990s.

A high rate of unemployment is usually associated with substantial underemployment of labor resources. With the soft labor market, some work only part-time, less than 35 hours per week. The combined rate of unemployment (zero hours) and underemployment (1 to 34 hours per week) reached 39.3 percent in September-October 1995 and 42.7 percent in April-May 1996 (Figure 4.1). The average weekly working hours of the underemployed is 21 hours during each survey period. Assuming full-time employment entails 35 hours of work, the average loss of potential labor time is equal to 40 percent for the average underemployed worker. Combining the lost labor time of the unemployed and underemployed, the Palestinian economy underutilized its potential labor resources by 27.2 percent in September-October 1995 and by 34.1 percent in April-May 1996.

The nature of unemployment is also revealing. There is the usual unemployment of new entrants into the labor force. But closures have forced many experienced Palestinian workers to become unemployed. Of those who work in Israel, rates of unemployment tend to be lowest for workers whose educational levels exceed secondary school.



* There are no data for 1994 covering the WBS as authority was being transferred to the PA.
Sources: For 1990-1993, ICBS (1995); for 1995-1996, PCBS (1996d and 1996e).

The high rate of unemployment and softness in the labor market is closely tied to the incidence and intensity of poverty. Households with a non-working head are substantially more likely to fall under the poverty line in comparison to households with a working head. In addition, the presence of a larger number of unemployed workers in the household increases the incidence of poverty.

Rapidly Increasing Population and Labor Force

The second challenge to the Palestinian economy in terms of job creation is the rapidly increasing labor force, as a direct result of high rates of population growth and an expected increase in the rate of labor force participation. While previous population and labor force growth was accommodated by external or commuter migration, this is no longer possible, as illustrated in the next section on structural dislocation of the labor market.

Rapidly Growing Population. According to PCBS estimates and projections, the current population of the WBGS exceeds 2.5 million people, and it is expected to exceed 3 million by the year 2000. The mid-year population projections are indicated in Table 4.1. The implied population growth rate is approximately 5.4 percent per annum over the remainder of this century. This high rate of population growth is an outcome of a high rate of natural increase and a moderate rate of return migration associated with the peace process.

Table 4.1 Population Projections
(in thousands)

Year	West Bank	Gaza Strip	Total
1992	1,272	747	2,019
1993	1,323	788	2,110
1994	1,395	843	2,238
1995	1,485	905	2,390
1996	1,572	963	2,535
1997	1,661	1,023	2,684
1998	1,752	1,085	2,837
1999	1,846	1,150	2,996
2000	1,925	1,210	3,134

Source: PCBS, 1994.

The natural rate of population increase in the WBGS is the highest rate in the world currently. This is a direct outcome of a very high fertility rate and a rapidly declining mortality rate over the past two decades. The overall natural rate of population increase is estimated at 3.9 percent per annum in 1994. This rate is much higher in the Gaza Strip, at 4.6 percent per annum, than in the West Bank, at 3.4 percent per annum. The 1995 PCBS demographic survey of 15,000 households found the total fertility rate (number of children born to a woman through her reproductive cycle) to be 5.61 in the West Bank and 7.44 in the Gaza Strip, for an average of 6.24. Fertility rates continue to be high despite a sharp decline in mortality rates. Infant and child mortality rates were halved during the period 1980-1995. The infant mortality rate declined from 54 to 28 per thousand, while the child mortality rate (below age 5) declined from 73 to 36 over this period (see Table 12.1 in Chapter 12). Much of the decline in mortality rates is attributed to an overall emphasis on primary care and the proliferation of NGOs that delivered primary care health services to a significant portion of population over this 15-year period.

The combination of a high fertility rate and a rapidly declining and low mortality rate have resulted in a high natural growth rate. Moreover, part of the expected population increase is due to return migration and the influx of PLO members and their families in the wake of setting up the PA. In 1994, return migration was at a rate of 3.3 percent of the total population size. Thus, the population projections in Table 4.1 reflect somewhat moderating fertility rates and take into account a moderate increase in the population due to family re-unification and return migration.

The high rates of fertility and natural population increase imply a very wide base in the population pyramid (see Figure 1 in the Annex). This is expected to imply fairly high growth rates in the labor force in the medium term and substantially increase the demand for public services, particularly in the fields of education and health.

Rapid Labor Force Increase: 30,000 Workers per Year. The labor force is expected to grow rapidly over the remainder of the 1990s and into the first decade of the 21st century. The wide base of the population pyramid reflects that 45 percent of the West Bank and 50.3 percent of the Gaza Strip are under the age of 15. Of the adult population (15 years and over), the overall labor force participation rate is 42.3 percent in the West Bank (71.3 percent for males and 13.3 percent for females), and 38.6 percent in the Gaza Strip (67.6 percent for males and 9.3 percent for females). The combined labor force participation rate for the adult population of both areas is 41.2 percent (70.1 percent for males and 12.1 percent for females). The labor force participation rate has the usual inverted U-shape with age, and is substantially higher for those with an educational level exceeding secondary school, in comparison with the rest of the population. The relation between education and labor force participation is particularly strong for females.

Table 4.2 Projections of Size of Labor Force
(in thousands)

Year	West Bank	Gaza Strip	Total
1995	324	159	483
1996	343	169	512
1997	363	178	541
1998	383	188	571
1999	404	198	602
2000	423	207	630

Source: Shabaneh (1996), Table 8.

Given the labor force participation rates and population projections, Table 4.2 provides projections of the labor force size through the end of the decade. The Palestinian labor force is expected to reach 630,000 in the year 2000. This implies that roughly 30,000 Palestinians will join the labor force each year until the end of the decade (20,000 in the West Bank and 10,000 in the Gaza Strip). These projections are conservative and should be taken as a lower bound estimate for the expected increase in the size of the labor force for two reasons. First, the female labor force participation rate currently is quite low by regional standards and is expected to increase rapidly as opportunities increase for females. Second, the high and increasing rate of education is expected to increase the labor force participation rate for both males and females, with a stronger impact for females.

The Highly Skilled Labor Force

The third challenge facing the economy is to create jobs in the skilled and semi-skilled categories. Compared to countries in the MENA region, the educational level of the Palestinian labor force is quite high. This is largely an outcome of the high levels of educational attainment of the population as a whole. For example, the average years of schooling of the adult population is 8.1 years in the WBGS, in comparison to 6.2 years for the MENA region (see Table 11.3 in Chapter 11).

Reflecting the positive correlation between education and labor force participation rate, the educational level of the labor force (an average of 9.4 years of schooling) is higher than that of the population as a whole. One-tenth of the labor force has completed university education, one-fifth has post-secondary education, and one-half has at least ten years of schooling. Despite somewhat lower educational levels in the population as a whole, the educational achievement of females in the labor force is higher than that of males by 0.7 years. Those with post-secondary school education constitute 39 percent of female workers in contrast to 18 percent for male workers. The educational level of the labor force in the Gaza Strip is slightly higher than that in the West Bank.

Moreover, schooling of the labor force is expected to continue to increase, given the higher educational attainment of younger cohorts of labor force in comparison to the existing stock of labor force. The average years of schooling for the 25-34 year-old cohort is 10.5 years, 9.8 years for the 35-44 year-old cohort, and 9.4 for the labor force as a whole.

Increased educational achievement was accompanied by a declining rate of return to education during the 1980s. But this trend was reversed with the establishment of the PA. A worker with one additional year of schooling received a 4-percent increase in labor earnings in 1980, on average, and holding other things equal. While the rate of return to schooling declined to 1.7 percent by 1991, it increased to 4.5 percent in 1996. These changes in the rate of return to schooling are explained by the labor market shocks affecting Palestinian employment: a decline in the demand for educated workers in the Gulf countries during the 1980s, and the recent collapse in the Israeli demand for unskilled workers.

Gender and Labor Force Participation

Growth in the labor force size is likely to be larger than reflected by simple extrapolation. Female labor force participation is expected to increase due to three main factors. First, increased education levels are expected to lead to higher rates of female participation. While female literacy is lower, such gender differences disappear with the enrollment rate for the younger population (see Chapter 11). Closing the education gap and increasing levels of education will undoubtedly lead to increased female participation in the labor force. Second, economic sectors that have a higher concentration of female labor have been expanding in the past few years, and are likely to continue to grow. These sectors include public sector employment, financial services, health and education, among others. Third, increased economic hardship has been associated with increased

female labor participation. For example, during closures when unemployment increases, PCBS labor force surveys indicate that female (and male) labor force participation increases. The increased participation illustrates the domination of the depressed income effect over the potential discouraged worker effect.

In addition, better statistical methodology is likely to better capture the female labor force participation. To illustrate, the female labor force participation rate of females in 1993 as measured by the ICBS was 1.8 percent in the Gaza Strip and 9.5 percent in the West Bank. In 1995, these rates were measured by the PCBS to be 7.6 percent in the Gaza Strip and 12.8 percent in the West Bank. While part of the increase may reflect a real change in female participation, the short period separating the two measurements leads us to conclude that the increase is due to better probing in the field and greater cooperation of the households. Nonetheless, even the PCBS measures are likely to under-represent the true extent of female participation. Female participation in the informal sector is likely to go undetected, because of the inherent difficulty in measuring informal work activity. Also, many females are likely to be involved in activities outside home-making on a temporary or seasonal basis. To the extent that labor force surveys utilize one week as a reference week for measuring work, much of this intermittent and seasonal work is likely to go undetected.

Structural Dislocation of the Labor Market

The labor market in the WBGS faced two major shocks in the 1990s. The first was the elimination of the Gulf countries as a source of demand for new educated Palestinian workers, following the 1990-1991 Gulf War. The second and more serious shock was the rapid drop in the demand for existing unskilled Palestinian workers in Israel, and the increased riskiness of such employment beginning with the interim period of the Palestinian-Israeli peace process. These shocks have affected different segments of the labor market differently. Elimination of the Gulf demand affected the growth of employment of educated and skilled workers, but its impact on the existing stock of Palestinian workers in the Gulf is fairly limited. The drop in Israeli demand for Palestinian workers is more serious since it forces a large number of workers employed in Israel to seek employment in the WBGS. The sum of the two shocks has proven to be quite large and difficult for the Palestinian economy. The large magnitude of the shocks in relation to the total labor market is compounded by a legacy of constrained development and the difficulties arising from high strategic uncertainty and closure-related constraints. The result has been the large unemployment and under-utilization of labor resources.

Elimination of the Gulf Market as a Potential Source of Demand. Since the 1990-1991 Gulf War, the possibility of employment in the Gulf countries for new Palestinian graduates has basically disappeared. This shock followed a decade of declining demand for new graduates in Jordan and the Gulf Cooperation Council (GCC) countries. The impact of this shock has been particularly hard for the better-educated Palestinians, who traditionally sought employment there.

Jordan and the Gulf countries slowly absorbed a large number of workers from the WBGS in the 1970s and, to a lesser extent, in the 1980s (Box 4.1). Palestinian migrants to these

Box 4.1 Phases of Growth and Stagnation

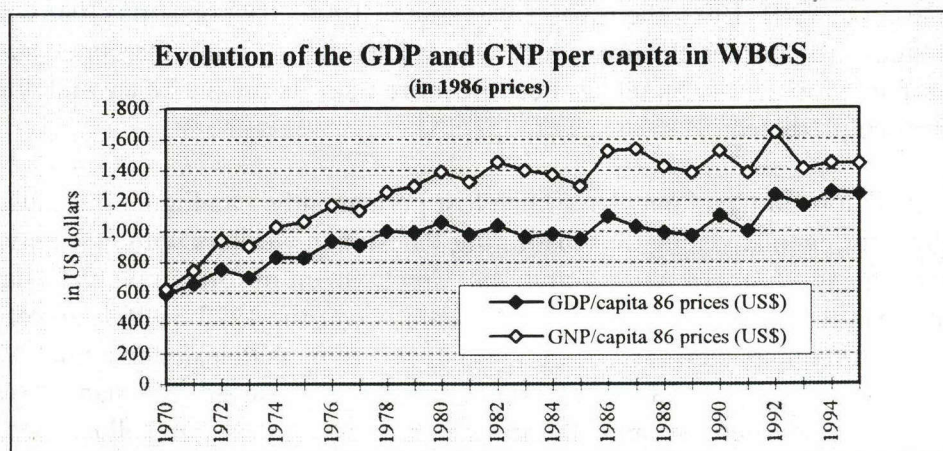
A sequence of external shocks has contributed to a skewed pattern of development for the WBGS domestic economy. The pattern of growth since 1967 can be broken into four phases.

Phase I — 1967 through mid-1970s. Rapid growth was driven by integration with Israel and the start of the Gulf oil boom. The opening of the Israeli market to manual Palestinian labor, new trade, and technological opportunities brought rapid growth in domestic production. From regional context, WBGS growth in GNP per capita in the 1970s was more than double Israel's growth rate, but was only slightly greater than rates in neighboring Arab countries.

Phase II — mid-1970s through early 1980s. Slightly less rapid growth continued to be fueled by remittances from the Gulf and by foreign transfers through the second phase. Per capita income reached a peak in 1980 at \$1,400 (in 1986 prices). The WBGS overall growth rate exceeded Israel's, but this is not unusual when integrating with a larger, richer, and more technologically advanced neighbor. While growth in Israel slowed in the mid-1970s, income and output in the WBGS continued to increase.

Phase III — early 1980s until Intifada in 1987. This phase is characterized by stagnation and declining employment opportunities. The collapse of the regional oil boom prompted a decline in worker remittances from the Gulf. While continued growth in Israel provided a cushion from the regional slowdown, employment in Israel was virtually flat in the mid-1980s. After the start of the *Intifada*, employment in manufacturing and services declined. This decline was offset by a rise in construction employment in response to a housing boom in Israel resulting from a surge in immigration. Recession and near hyperinflation in Israel had a serious impact on the 35 percent of the Palestinian labor force employed in Israel, and on the majority of Palestinian trade linked to the Israeli economy. Internal constraints became more binding once work opportunities abroad declined, leading to increased pressures to employ workers at home.

Phase IV — late 1980s until 1993. Output declined as the *Intifada* continued due to strikes and repression of economic activity. Political and economic uncertainty prevailed. A recovery in 1992, apparently fueled by drawdowns of savings and expectations of peace, was then followed by a renewed decline in 1993.



Source: ICBS and World Bank.

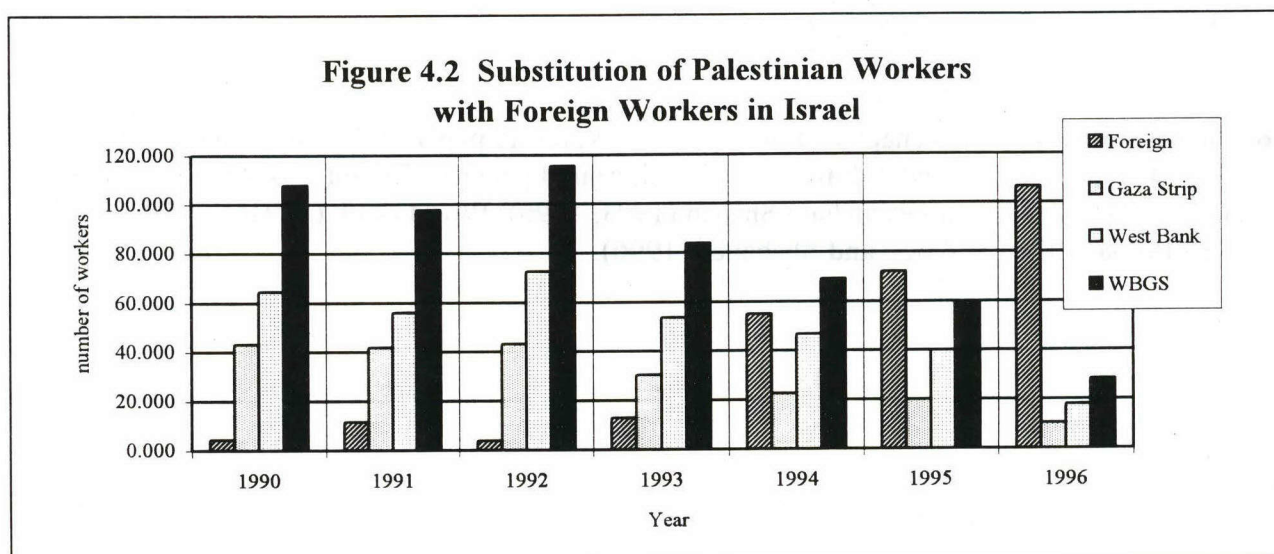
countries are usually dropped from the computation of the labor force. By the early 1990s, their cumulative number was estimated at more than 100,000 workers. The recent PCBS demographic survey lends support to this estimate. The reported number of first-degree relatives (parent, sibling, son or daughter, and spouse) of the interviewed household heads who were living outside historical Palestine in Jordan, other Arab and non-Arab countries, reached 20.5 percent of the sample individuals living in the WBGS. If this proportion is used to estimate the size of the migrant labor force, it would be around 100,000 migrant workers living abroad. It is important to realize that the number of Palestinian migrants into the GCC countries slowed down from the mid-1980s onward, due to increasingly restrictive policies in the GCC countries that attempted to limit the number of expatriates, particularly Arab workers, and due to increasing competition from cheaper labor from Southern Asia.

While a more favorable political arrangement would permit absorbing some Palestinian workers in the GCC countries, the overall pressures facing the GCC labor markets make this an insignificant and unreliable possibility from the Palestinian labor market perspective. The GCC labor markets are operating within an environment of increasing unemployment among nationals and policy changes that limit the size of expatriate employment.

Permanent Reduction in Employment in Israel and its Increased Riskiness. The average number of Palestinian workers in Israel dropped successively but rapidly from 116,000 workers in 1992 to 84,000 in 1993, 69,000 in 1994, 60,000 in 1995, and 28,000 in 1996 (see Figure 1.2 in Chapter 1). Current rates are about two-thirds below the 100,000-worker level that Israel implicitly committed to maintain in the Economic Protocol. In a four-year period, Israel reduced its employment of Palestinian workers by 88,000, more than one-fifth of the Palestinian labor force.

The shock in the Israeli demand for Palestinian employment has manifested itself in three separate ways. First, since 1991 when work permits were introduced, the number of permits issued to Palestinians has declined (see Figure 3.4 in Chapter 3). Second, the strictness of general border closure has increased since March 1993, reducing the number of workers without permits. Indeed, while the actual number of workers may have exceeded the number of permits by a substantial margin in 1991-1992, the reverse was true in 1996. The reason is that work permits are often invalidated by border closure, which was applied during more than one-third of the days in 1996. Third, employment in Israel has become more risky as the incidence and duration of closures cannot be predicted.

Palestinian jobs in Israel may have been lost permanently. As Figure 4.2 illustrates, the Israeli economy has been adjusting by substituting Palestinian workers with foreign workers from Eastern European and Southern Asian countries. Employment of foreign workers has increased at a faster rate than the decline of Palestinian workers. Over the 1992-1996 four-year period, work permits for foreigners increased from 4,000 to 107,000, as Palestinian actual employment in Israel declined from 116,000 to 28,000 workers. It is widely believed that many foreigners are working in Israel without permits, making their size larger than the figures illustrated in Figure 4.2. Foreign workers can be found in the very same jobs in which Palestinians used to work.



Sources: ICBS for Palestinian employment up to 1994, and PCBS for Palestinian employment in 1995 and 1996. Number of foreign workers refers to permits issued, with data obtained from the Israeli Ministry of Labor.

Thus, while the initial impetus for reducing Palestinian employment in Israel was political in nature, the loss may be permanent for both political and economic factors. Politically, violence is unlikely to disappear in the region in the near future, and restricting Palestinian access to employment in Israel has become a knee-jerk political response by the Israeli government, regardless of its political philosophy. Economically, Israeli employers have adjusted by substituting foreign workers for Palestinian workers. Employment of Palestinians has become more costly due to the risk element of workers being able to reach their jobs on any given day.

* * *

A prerequisite for transforming the Palestinian potential into sustainable development for the future is the resolution of the long-standing political, security and governance issues affecting the region. A settlement should release for development major resources, both financial and human, now being spent to cope with the actual or perceived administrative obstacles, security threats, and inequities. More importantly, by removing the strategic uncertainty and the perception of risk, the political settlement should unleash the financial and entrepreneurial resources of the private sector, both domestic and expatriate, for long-term investments in the WBGS economy.

In the meanwhile, there are no easy solutions. While public sector employment has indeed increased over the past two years, it has probably reached its growth limit. Any substantial increase in public sector employment will create non-sustainable budgetary burdens, and could distort the labor market for private sector development. Moreover, employment generation schemes can only address the suffering that results from the widespread unemployment at the margin. Rather, various structural policies that can open up new growth opportunities in the short to medium term, in spite of a difficult political situation, will have to be pursued. The following chapters explore what can be done in terms of attracting investment, facilitating

financial intermediation, improving the trade regime, ensuring fiscal stability, smoothing negative shocks, and improving the donor process.

Bibliographic note: This chapter draws on the background paper of Al-Qudsi and Shaban (1996). The section on gender draws on the background paper by Birzeit's Women's Studies Center (1997). Other sources include Shaban (1993, 1996), World Bank (1993a), ICBS (1995), PCBS (1996a, 1996d, 1996e), and Shabaneh (1996).

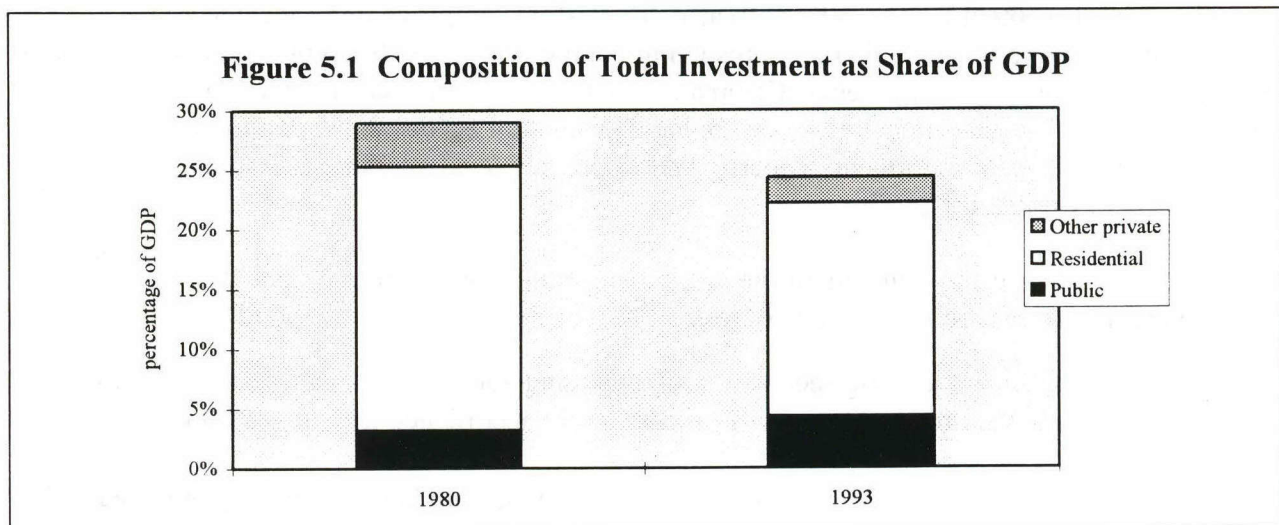
Chapter 5

Private Investment

Under favorable political circumstances, the WBGS could attract substantial investment from local entrepreneurs, Palestinians in the Diaspora, and foreign investors. In the short to medium term, the most promising areas of growth are infrastructure, and especially telecommunications-related sectors; housing; and tourism. The main source of growth for the housing sector is natural population increase and possibly, returnees. In infrastructure, growth would be driven by the need to catch up, following years of neglect. The growth potential of the tourism sector is contingent on the ability to increase its share in the combined WBGS-Israel tourism market.

Introduction

Traditionally, domestic savings and investment in the WBGS have been relatively high, but most of this investment has been concentrated in housing. This was due to a combination of forces: a high level of risk requiring high precautionary savings; financial and regulatory repression, with taxes on local businesses that discouraged productive investments; and low public investments, a consequence of fiscal compression and significant tax leakage to the Israeli treasury (Figure 5.1).



Source: Annex (Table 3).

The signing the Oslo Agreement generated a great deal of optimism about the capacity of the private sector to absorb accumulated savings of WBGS residents and to attract Diaspora investments. To date, however, this has not materialized. Private investment has been falling over the last three years, and the housing sector, which absorbed most of private investment in recent years, is showing signs of slowing down. The main difference between the present and the pre-1993 situation is that investment is currently weighted down by uncertainties about the future

rather than by regulatory repression. However, good policies can manage to unlock investments in some sectors. This chapter focuses on the short- and medium-term impact that private investment has on the construction, infrastructure, and tourism sectors.

In addition to historically high investment in housing, a second potentially large private growth area is in utilities and collective infrastructure, such as electricity, telephone, water, trash collection, and the construction of large projects (*i.e.*, ports, airport). In all these sectors, donor assistance has not managed to make a large difference. The challenge is to find the arrangements that will allow for the blending of donor support (preferably linked to capital with high leverage to political risks) and private sector investment where the key advantages include flexibility and more efficient management.

A third possible growth area is tourism. The tourism sector currently captures extraordinarily low revenues compared with its immense potential in a land filled with historical relics and unusual geological formations. Events such as Bethlehem 2000 could attract millions. Lower regulatory restrictions now provide the opportunity to try and win back some of the tourism production (*i.e.*, hotels, buses) that was dominated by Israel in the past.

Legal and Regulatory Framework

A transparent and independent legal system promotes investment by providing efficient mechanisms for settling disputes between private sector agents and by protecting these agents from undue government intervention in economic affairs. The present legal environment needs significant improvement for the WBGS to attract investors. Improvements include avoiding political intervention in legal affairs and resolving conflicts between different layers of legal codes (*i.e.*, Israeli military orders as well as Ottoman, British, Jordanian, and Egyptian codes). Immediate attention is also needed to secure legal protection against expropriation and confiscation of foreign investment property, and to provide legal guarantees that insure the repatriation of capital and profits.

While most of the elements of the investment framework require urgent attention by the PA, several initiatives are already in progress.

- The court system is being reconstructed, including adoption of a civil procedure law. Courts will need to clarify areas of jurisdiction in accordance with judicial levels.
- In the property rights regime, a new apartment ownership law is being implemented and a registration system for movables is underway.
- New banking laws and regulations as well as a new intellectual property law are being drafted.
- A number of ministries are assessing existing laws in the economy through field surveys and databases.

Box 5.1 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 focus primarily 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 \$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 20-30,000 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 at the present time to formulate security procedures and agreements of access to and from the GIE site to insure complete closure-free operation.
- *The Policy Environment.* Significant progress has been made recently in advancing the legal framework and the 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.

Special tax incentives may or may not be effective in encouraging investment. If tax incentives are deemed necessary, these incentives should be well targeted. It would be advisable to modify the present draft of the PA law to make it more effective in stimulating investment. First, emphasis should be shifted from tax holidays (which recent experience in developing countries has shown to be ineffective in attracting investors) to tax credits and investment allowances. Second, incentives should be performance-based rather than registration-based, as in the present draft. Third, all decisions for granting and canceling incentives should be based on clear criteria and guidelines. In contrast, the present draft gives substantial discretionary power to the bureaucrats in charge of implementing the law.

Clearly, the above is a tall order that can only be implemented over a considerable period of time. In the meantime, it would be desirable to enact some short-term measures that stimulate investment and help to overcome the critical employment problem. One widely used measure for this purpose is the creation of special economic zones (Box 5.1). 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.

Barriers to Growth in Agriculture

The industrial sector has experienced some expansion in the transition period. For example, industries catering to domestic consumption (*i.e.*, food processing) expanded after years of retarded growth under Israeli administrative restrictions. But, restricted access to international markets and uncertainty about the future are major barriers to investment in the industrial sector. Lack of market access inhibits the development of export-oriented industries, which represent a major potential source of growth in the WBGS (see Chapter 6).

This has led some to recommend a larger role for agriculture. However, the prospects of the agricultural sector are even less promising. Export barriers in the short term and limited access to land and water resources in the long term inhibit agricultural growth. Land use in 40 percent of the Gaza Strip and 74 percent of the West Bank is still controlled by Israel. Israeli-controlled areas are vulnerable to expropriation for settlement and by-pass road construction. Farming in some of these areas, such as regions of the Jordan Valley, is restricted for security reasons. Barriers to export are prohibitive. Most WBGS agricultural products are still not allowed to enter Israel despite the provisions in Economic Protocol to gradually phase out all barriers to trade in agricultural products between the WBGS and Israel. Regional and international exports are inhibited by cumbersome customs procedures and closures.

In the long term, a permanent political settlement that results in Palestinian control of WBGS water and land resources will no doubt enhance the prospects for agriculture. Such a settlement can also improve WBGS access to regional and international markets. Nevertheless, the long-term growth potential of the WBGS agricultural sector is very limited because of water scarcity.

Economic development means growing water demand from agricultural and industrial production, population increase, rising living standards, and preservation of environmental sustainability. Any economic growth will substantially increase water demand. However, current available renewable water resources in the WBGS (based on the Oslo II Agreement) is only 115 cubic meters per capita per year—among the lowest in the world (Table 5.1). Regardless of the final status settlement, water resources will be extremely limited in both the West Bank and the Gaza Strip and will pose a serious constraint for the economy, even with minimal growth scenarios. This requires a re-thinking of economic growth patterns and a change in attitudes vis-à-vis water. One dramatic implication is that agriculture is unlikely to remain the mainstay of the Palestinian economy in the future. At present, 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 use about 13 percent of available water resources and contribute about 25 percent to GDP. The value added per unit of water is 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. In order to have economic growth in the future, 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. Conversion of current irrigation practices to more efficient methods could protect and use less of the available freshwater resources. Nevertheless, given the large share of the labor force in agriculture (20 to 25 percent), the required future adjustment is considerable.

Table 5.1 Regional Water Resources
(1995)

Country	Resources BCM* per year	Consumption BCM per year	Resources cubic meters per capita per year
Israel	2.1	1.9	375
Jordan	0.8	1.0	213
Lebanon	4.8	0.8	1,200
Syria	5.5	3.3	385
WBGS	0.2	0.2*	115

* billion cubic meters

** Actual Oslo II allocations (interim) are 264.5 million cubic meters (MCM) (248 MCM renewable and 16.5 MCM from Israel).

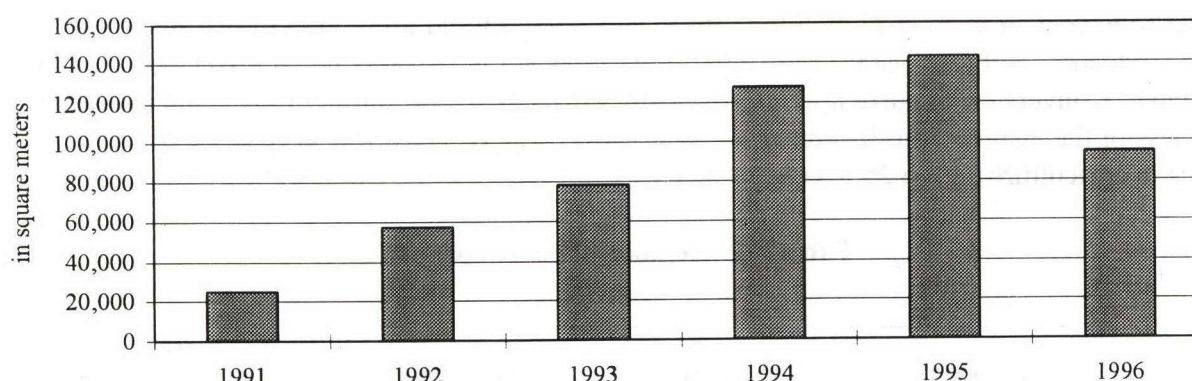
Source: World Bank (1995a).

Translating Potential Housing Demand into Actual Units

Investment in housing exploded with the start of the peace process, causing land prices to skyrocket. But by 1996, it started to falter as indicated in Figure 5.2 by the sharp drop in building permits in 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, university professors, and bank employees. While there is still a demand for expensive residential housing, mainly in the Palestinian Diaspora, its potential is largely dependent upon political improvements. Demand is potentially thicker and much more robust to political uncertainties at the middle and lower end of the market. However, before this potential can be realized, improvements are needed in financial markets and in the legal framework. In addition, efficiency gains must be realized in the construction industry.

Measured by floor area per person, the WBGS does not seem to have a serious housing crisis. The median usable space in the WBGS is around 15.1 square meters, which is about average for countries at a comparable level of development (Table 5.2). This figure, however, masks crowding problems among lower-income households, particularly in refugee camps. Based on a 1995 PCBS demographic survey, 34.7 percent of all households in the Gaza Strip and 26 percent in the West Bank have more than three persons per room. Comparable figures for refugee camps are 41.1 percent for the Gaza Strip and 31.1 percent for the West Bank.

**Figure 5.2 Building Permits Issued
by the City of Ramallah**
(1991-1996)



Source: MAS data files

High Demand and Limited Supply. Housing prices in the WBGS are relatively high. The most common measurement for the relative cost of housing is the house price-to-income ratio, defined as the ratio of the median free-market price of a dwelling unit and the median annual household income. In the WBGS, there is hardly any market for existing housing units because of cultural factors, limited mobility, and the lack of well-defined property rights to a significant share of the housing stock, particularly in the West Bank. Hence, it is justifiable to use the selling price of newly built units in calculating the house price-to-income ratio. The WBGS house price-to-income ratio is around 10, which is significantly higher than other countries at a comparable level of development (Table 5.2)

Table 5.2 Housing Indicators for Selected Countries in the Region

	Egypt	Morocco	Jordan	Tunisia	Turkey	WBGS	Algeria	Israel
GNP per capita (1990)	\$600	\$950	\$1,240	\$1,440	\$1,630	\$1,700	\$2,060	\$16,680
Floor area per person (square meters)	12.00	6.00	10.00	6.47	17.00	15.10	8.54	24.80
House price/income	6.67	7.15	3.39	6.11	5.03	10.00	11.70	5.03

Source: All figures in this table are based on Mayo (1995), except the house price / income for the WBGS which was estimated by the authors.

The share of rental units in the housing stock is very low. It is only 4.9 percent in the Gaza Strip and 11.4 percent in the West Bank. In addition, housing finance, which plays an important role in facilitating the purchase of dwelling units in most countries, hardly exists in the WBGS. The limited availability of rental units and the effective absence of housing finance makes it difficult for households to smooth housing consumption, which, in turn, decreases the probability of translating potential housing demand into actual demand.

Enormous Potential Demand for Housing. In the short term, a high natural population and a decreasing family size could generate a strong housing demand. The number of housing units needed to accommodate the natural population increase and the decline in family size for the period 1997-2000 is estimated at around 217,000. The housing needs in this period will be much larger when taking into consideration the need to replace units removed from the housing stock due to deterioration or lack of suitability, and the need to reduce overcrowding. In the long term, a permanent political settlement may result in the return of a substantial number of Diaspora Palestinians and the resettlement of Palestinian refugees, creating even more demand for housing. If potential demand is translated into the production of new housing units, the housing sector could be a major source of economic growth in the long term as well as short term.

In the long term, the absorption of Diaspora Palestinians and the resettlement of refugees will present serious challenges to the housing sector. It could require the construction of new cities and major investments in infrastructure. This would require enormous financial resources and a quantum leap in construction management and know-how. Possible sources of finance are mortgage loans from the domestic financial sector, commercial investments by Diaspora Palestinians, financial compensation obtained by resettled refugees, and international aid. The technical expertise in construction can be provided by Diaspora Palestinians, some of whom are major players in the regional construction market, particularly in the Gulf (see Executive Summary, Box 2). However, major expansion of mortgage lending by commercial banks and other financial institutions will be contingent upon the success of the permanent settlement to increase political stability. A substantial contribution of financial resources and technical expertise by Diaspora Palestinians will also depend on the effectiveness of the permanent settlement to integrate these Palestinians in the WBGS body politic. Finally, the feasibility of building new cities will be determined by the size of the land mass controlled by the PA under the permanent settlement.

Enhancing the Housing Market. In the short term, the high natural population growth rate in the WBGS and the decrease in the average family size may not necessarily translate into the production of new housing units unless measures are taken to relax some of the supply and demand constraints that currently inhibit the development of the housing sector. On the demand side, potential demand for housing by many households cannot be translated into actual demand because of insufficient income or the lack of long-term financing. On the supply side, the construction of new housing units is inhibited by rent control laws and Israeli zoning restrictions.

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. Lower-income households that do not earn sufficient income to cover basic needs could receive rent vouchers. Housing assistance to moderate-income households could be in the form of a loan subsidy. The loan subsidy could be either a lump sum applied towards the down payment or an interest rate subsidy paid out in installments directly to the lending bank. To qualify for the loan subsidy, the household should be able to provide around 80 percent of a one-year income applied toward the down payment, plus a monthly mortgage payment that requires up to 25 percent of the household

income. The household contribution to the down payment may be saved over several years, thus giving the lending bank valuable information to use in evaluating the household's creditworthiness.

The present economic and political environment in the WBGS makes commercial banks and other financial institutions reluctant to commit significant financial resources to mortgage lending because of high credit and liquidity risks. This limits demand for housing even among households that can afford a house. A significant increase in mortgage lending cannot be expected in the present environment without instituting mechanisms to reduce liquidity and credit risks. Some reduction in credit risk could be achieved by providing banks with partial credit insurance. Liquidity risk could be reduced by creating a secondary mortgage facility that provides banks with long-term funds (see Chapter 7).

The rent control laws limit the supply of rental housing in the WBGS. Generally, these laws entitle the tenant to remain in the rented property after the lease period expires, and the rental terms (including the rent payment) legally continue to bind the parties indefinitely. This is supposed to make housing affordable to the poor. Recent evidence, however, indicates that the main beneficiaries of rent control are not the poor. The poverty rate is much lower among renters than the WBGS population as a whole. Based on a poverty line of \$650, only 5 percent of renters in the WBGS are poor, compared with the overall poverty rate of 19 percent. Meanwhile, rent control laws depress investment in the construction of new rental units and make it unprofitable for current owners to maintain or renovate them. 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.

Israeli restrictions make it extremely difficult for Palestinians to obtain building permits in more than 70 percent of the West Bank and almost 40 percent of the Gaza Strip, where zoning is still under Israeli control. In the Gaza Strip, PA control over zoning is limited to areas that fall under its exclusive security control. In the West Bank, it covers areas under the PA's exclusive security control, referred to as zone A in the Oslo II Agreement, as well as areas in which the PA shares security control with Israel, referred to as zone B. Limited PA control over zoning has increased demand for land in the rest of the WBGS, resulting in higher land prices and construction costs. The relaxation of zoning rules in the Israeli-controlled areas of the WBGS, therefore, is essential to the development of the housing sector in the transition period.

Attracting Private Investment in Infrastructure

For a small economy such as the WBGS, infrastructure acquires a special importance. Trade links as well as communications with the rest of the world are particularly important. Studies show that export growth is associated with rapid growth in telecommunications services. Foreign investment is similarly attracted by a good infrastructure.

The infrastructure in the WBGS is deficient and unreliable due to years of neglect under Israeli occupation. In the 1980s and 1990s, levels of investment in infrastructure were minimal, ranging from \$20 to \$30 million per year. To some extent, these low expenditures reflect the fact that much of the responsibility for infrastructure supply lay with Israeli providers, thereby

eliminating the need for some direct expenditures in the WBGS (*i.e.*, power generation and international telecommunications switching equipment). However, lack of maintenance and general neglect has resulted in huge technical losses, which in turn, has increased prices to consumers (see Chapter 13).

In the last two years, a number of infrastructure rehabilitation projects were financed by donors. Total investment in these projects in 1995 was around \$60 million, which represents under 2 percent of WBGS' GDP. Much of the investment under these projects went to water and sanitation, where health needs are urgent and environmental benefits are significant. While investment in infrastructure in the last two years represents a quantum leap over expenditures over the last decade, it is still inadequate if the WBGS is to attract significant foreign investment and expand the role of exports in its economy. If the average for developing countries is accepted as the target for ongoing infrastructure investment in the WBGS and if an additional 1 percent of GDP is allocated to continued rehabilitation to make up for past neglect, then annual investment in infrastructure should be between 4 to 5 percent of GDP. This presently amounts to \$140 to \$175 million.

Private Infrastructure. The private sector could contribute some of the investment required for infrastructure. The extent of private sector financing will depend on the form in which the private sector participates in infrastructure delivery and, hence, in risk-taking. For example, in electricity and telecommunications, the private sector could be induced to bear most of the costs. In water, on the other hand, the private sector might be limited to a management contract.

The first step toward private sector involvement has already taken place with the newly established regional water and sanitation authority in the Gaza Strip, which awarded a four-year management contract to an international operator through competitive bidding. In telecommunications, a private company, the Palestinian Telecommunications Co. (Paltel), was awarded an exclusive franchise for rebuilding and operating 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 the Gaza Strip under a 20-year build-operate-transfer contract with a private company that will ultimately provide 215 Mw of power.

Private provision of infrastructure 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, a price regulatory mechanism needs to be put in place. An increasingly popular form of price regulation is setting price caps, which calls for capping prices at a pre-specified level. In contrast with the rate of return method (traditionally used to regulate infrastructure providers with market power), price caps tie the provider's return to performance.

The principle of creating incentives for performance is already being adopted for infrastructure projects in the WBGS. Compensation has been tied closely to performance in the

Gaza Strip water supply management contract. In the Gaza Strip 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 (O&M) costs will be tied to a cost of living index, and the energy cost will be tied to a world energy price index.

Financing Infrastructure. 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 co-financing facility can serve as a transitional mechanism for attracting finance to infrastructure and significantly leveraging donor and government sources. Such a facility, utilizing 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. Leveraging is achieved by supplying a limited portion of the project financing, *e.g.*, 25 percent, on average. Private sponsors provide the equity, the facility is the source of subordinated debt, and private lenders provide the senior debt. Thus, a dollar of money from the facility can leverage another three dollars of private money for effectively structured projects. The subordinated debt is provided at market interest rates (although for both Pakistan and Sri Lanka, the grace period and overall loan maturity is much higher than would be available from the market).

Another possible mechanism to mitigate risk is to provide private investors with guarantees provided by multinational institutions, such as the World Bank and the Multilateral Investment Guarantee Agency (MIGA), and by bilateral agencies, such as export credit agencies and specialized insurance entities, *i.e.*, the Overseas Private Investment Corporation (OPIC). The additional security offered by these international agencies is required when private sponsors and lenders are reluctant to take country risk.

Leveraging Human Capital through Information Technology. Given the high-skill level of the Palestinian economy, there exist large profit opportunities in the knowledge-based sectors. Conversely, since Palestinians lack significant natural resources, the future of the Palestinian economy will be largely determined by the capacity to construct a knowledge-based economy. 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 resource 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.

Increasing the Competitiveness of the Tourism Sector

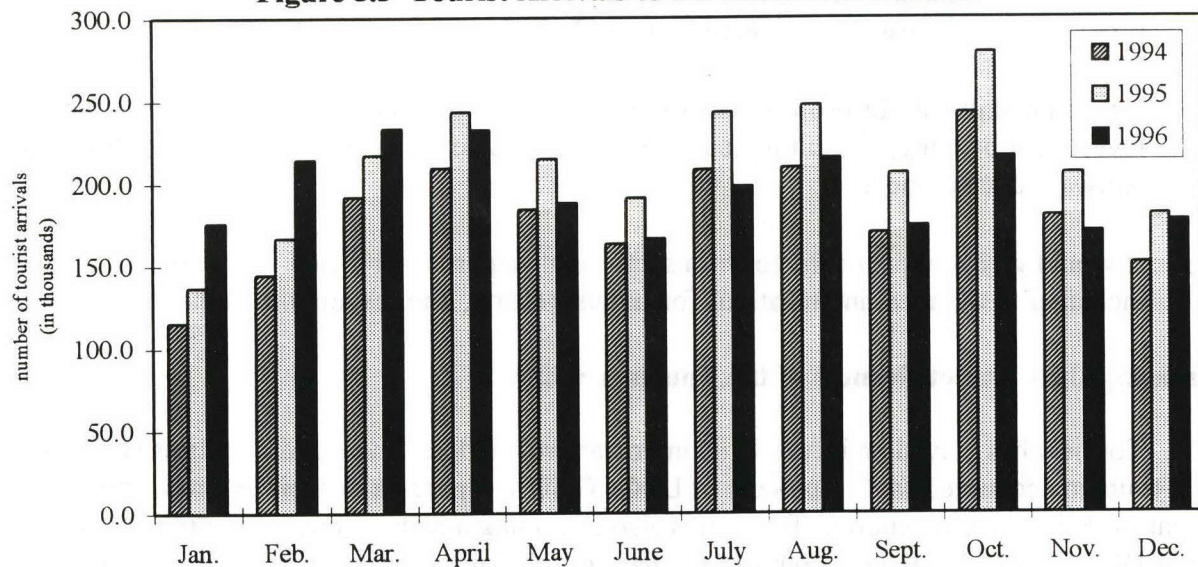
Tourism has played an increasingly important role in less developed countries (LDCs). In 1991, tourism accounted for 2.4 percent of LDCs GNP, 8.5 percent of their exports, and 39.8 percent of their services exports. Tourism is also becoming a major source of employment in many LDCs. In some island economies, the share of tourism in total employment is as high as 50 percent.

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 WBGS economy is presently very limited. In 1995, total revenues of the tourism sector in the WBGS, excluding East Jerusalem, was around \$26 million, compared to \$155 million in East Jerusalem and \$2,930 million in Israel.

The tourism sector's limited contribution to the WBGS economy is not surprising, given its stagnation in the last three decades as a consequence of political uncertainty and Israeli restrictions. Since 1967, for example, the number of hotels has remained approximately the same in East Jerusalem. During the same period, the number of licensed guides in the WBGS has 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.

The WBGS and Israel represent a single tourism market. While this market has expanded substantially in the last few years, its size is highly sensitive to political tensions. Such sensitivity was most apparent in the sharp decline in the number of tourists following the series of suicide bombings in Israel in March 1996 (Figure 5.3). The WBGS' share in total revenues of the combined market is a function of the competitiveness of its tourism sector with Israel's. All

Figure 5.3 Tourist Arrivals to the Combined Market



Source: ICBS, Tourism and Hotel Services Quarterly, several issues.

tourist sites in the WBGS are within a one-hour drive from Israel. Without boarder formalities, tourists can visit WBGS sites on one-day excursions and spend their overnights and most of their expenditures in Israel and many of them do just that. This is apparent in the disproportionality between the number of visitors to major WBGS tourist sites and the WBGS' share in total revenues of the combined market. In 1995, the Church of Nativity in Bethlehem and the historic sites of Jericho were visited by 40 percent and 10 percent of total tourists to the combined market, respectively. In the same year, the WBGS' share in total revenues of the combined market was only 1 percent.

Policies and Prospects. The long-term prospects of the WBGS tourism sector will be highly influenced by the permanent political settlement. First, if it results in a significant reduction in political tensions in the region, the flow of tourists to the combined market may increase substantially. Second, the final status negotiations are supposed to determine the status of East Jerusalem, which historically has been the nerve center for the Palestinian tourism sector. Since 1967, the development of Palestinian tourist establishments in East Jerusalem has been severely restricted by Israeli licensing procedures and other institutional barriers. Inhibiting the development of tourism, these measures have been compounded in the last three years by Israeli restrictions on the travel of WBGS residents to East Jerusalem. If the final status negotiations end these restrictions and allow East Jerusalem to resume its leading role in the Palestinian tourism sector, its long-term prospects will be enhanced enormously. Third, the final status negotiations are supposed to determine the status of the Dead Sea areas of the WBGS. These areas, which can provide the Palestinian tourism sector with an important source of growth, are presently classified as part of zone C, giving Israeli authorities control over developing them. If these areas are to come under PA control, they could serve as an asset of great potential in health tourism, as shown by recent Israeli experience. Fourth, a permanent political settlement could lead to a significant increase in Muslim tourism. This segment of market, which historically

played an important role in the Palestinian tourist industry, has disappeared almost completely since 1967.

In the short term, the WBGs tourism market will continue to be integrated with the Israeli market. With Israeli control over WBGs borders and continued political uncertainties, Palestinian policy makers will have little influence over the combined market. Hence, efforts to increase the contribution of tourism to the Palestinian economy in the 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.

One policy area that will greatly affect short-term competitiveness is the implementation of the Palestinian-Israeli agreement regarding the mobility of tour guides and bus companies. According to these agreements, tour buses are supposed to move freely between PA-controlled areas and Israel, and tour guides that meet mutually agreed-upon standards are supposed to be honored in each other's territories. So far, however, common standards for tour guides have not been established, which effectively prevents PA-licensed guides from working in Israel, and the free movement of buses has been enjoyed only by Israeli-licensed buses. This has given Israeli tourism operators a clear advantage over their Palestinian counterparts in the competition for tourists in the shared market.

Improvement of the WBGs infrastructure is another important area in which policy actions can make the tourism sector more competitive. The current state of the infrastructure in the WBGs presents a serious constraint to the development of the tourism sector. Water supply disruptions are common, particularly in the summer, and power outages are frequent. This causes additional expenses in water truck containers and power generators, and lowers the standard of services provided by tourist establishments. Telephone lines are difficult to get. The two newest hotels in Bethlehem, for example, managed to obtain only four lines each to cover office, fax, and guest use, which is highly inadequate for the size of the hotels.

* * *

Unlike most developing countries, capital does not represent a serious constraint to the economic development of the WBGs. However, large-scale investments cannot be expected before there is a significant improvement in political stability. Under a proper investment climate, accumulated savings of WBGs residents (most of which are presently invested abroad either directly or through the domestic banking system) could provide a major source of funds. Substantial investment funds can also be mobilized from Diaspora Palestinians, and the WBGs could attract significant foreign investment because of its relatively well-educated labor force and its ability to establish strong market links with other countries in the Middle East. But it is difficult to imagine a sustained boom in investment that could support a long period of growth in the current circumstances of political turmoil and acute uncertainties for future conditions. Yet, important forces that depress private investment in the short term can be removed by well-crafted policies. Removing those constraints would allow for a burst of growth to stimulate jobs and prepare the ground for a period of sustained growth—which can start once, and if, the peace process converges further.

These changes rely heavily on the regulatory and institutional fronts, such as defining and monitoring norms in the construction business and improving zoning practices to lower construction costs; establishing better land titling and a functioning law system to allow for mortgage lending and financial sector development; and setting up a housing insurance fund to cushion against the unhedgeable political risk components.

Bibliographical Note: The section on housing draws from Abdulhadi (1992), Mayo (1995), World Bank (1996c), and Foreign Investment Advisory Service (1995). The section on infrastructure draws from Mody (1996). The section on tourism draws from Khano and Sayre (1997).

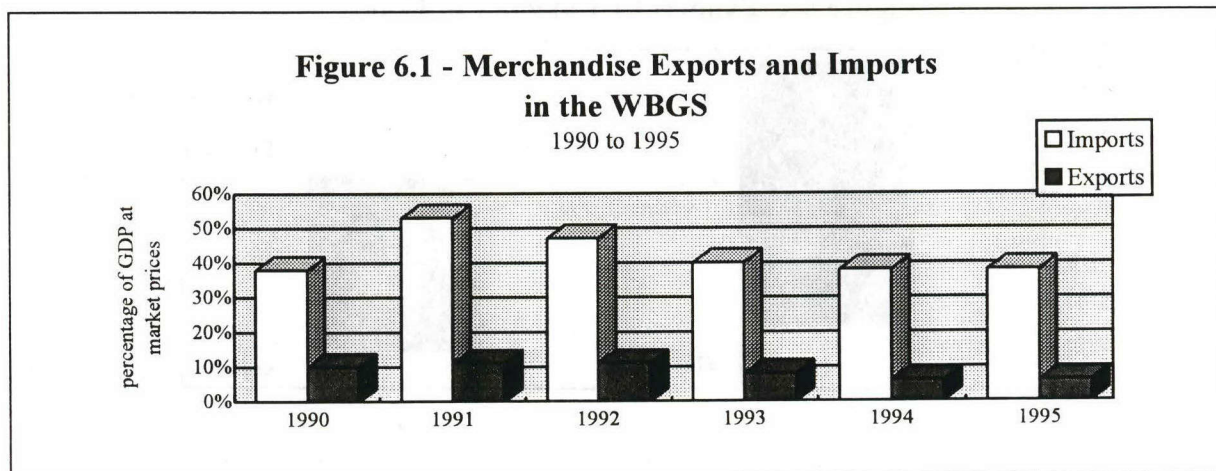
Chapter 6

International Economic Relations: Access, Trade Regime, and Development Strategy

For an economy as small as the WBS, the development of strong linkages with external markets is essential. Three guiding principles will be key for the future. First, free access between the West Bank and the Gaza Strip and to outside markets must be secured, and the border must operate efficiently. Second, the success of any trade strategy ultimately depends on how far new markets can be opened up, in the region, in Israel, and in the OECD. Diversification should be based on a strategy of expansion rather than restriction. Third, while a major reorientation in trade should occur over time, any sharp cut in trade with Israel would have large short-run costs.

Introduction

In recent years, trade fell dramatically as a result of repeated closures and high transaction costs at the border. Merchandise exports were nearly cut in half, from 11 to 6 percent of GDP between 1992 and 1995. Imports also fell, from 46 to 38 percent of GDP over the same period (Figure 6.1).



Source: ICBS and World Bank.

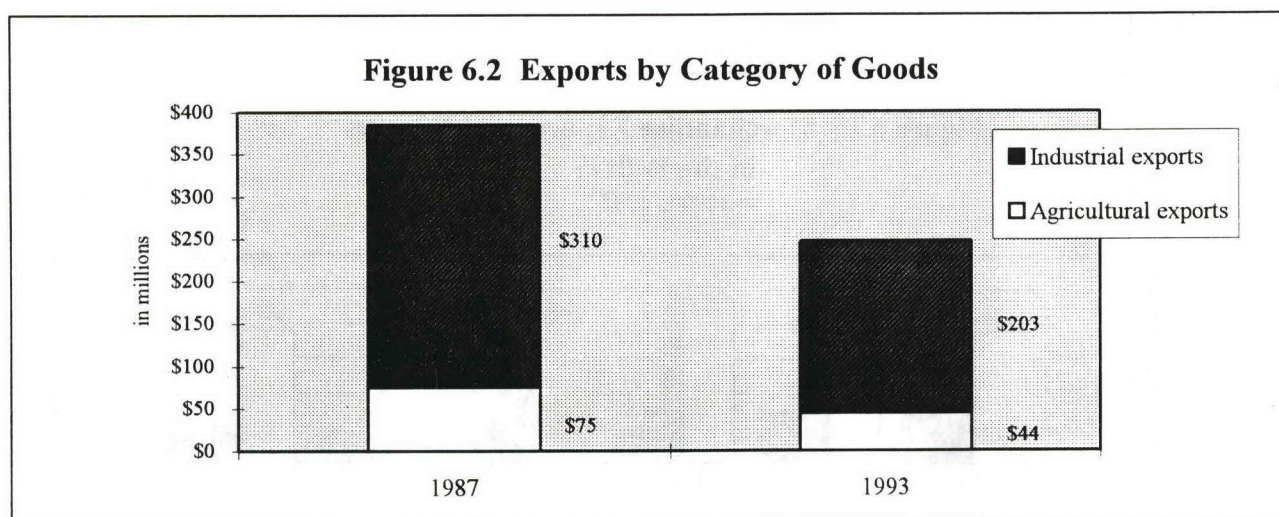
The recent cut-off with Israel leaves the Palestinian economy caught in a difficult predicament. Starting with the occupation in 1967, a one-sided customs union (CU) has resulted in a preponderance of trade with Israel at the expense of other partners. The resulting unbalanced structure of trade is proving to be extremely costly in the face of the repeated border closures and creating a difficult policy dilemma since any sudden redirection of trade away from Israel will be extremely costly in the short term.

This chapter discusses the choices facing Palestinian society as it tries to define the required infrastructure and the preferred policy regime to facilitate and regulate its international

trade. Admittedly, both the infrastructure for trade (*i.e.*, port, airports, bridges, roads) and the trade regime (*i.e.*, customs union, free-trade area, non-discriminatory regime) can be only partially improved within the bounds of the existing agreements with Israel. An important aspect of the discussion is whether a change in the economic agreement itself should be pursued when the final status negotiations start.

From 1967 to the Economic Agreement of 1994

In 1967 the WBGS had no relations with Israel. After the occupation, the Palestinian economy was cut-off from its traditional trading partners and a completely different set of economic relations were created with access to the much larger economy of Israel. This brought huge increases in the movement of both labor and goods. Over time, up to one-third of the WBGS labor force came to be employed in Israel. At the same time, a large share of the Palestinian labor force found employment in the Gulf during the oil boom and elsewhere. In the same period, trade with Israel expanded significantly. There are four particularly striking aspects of the pattern of trade: (i) the large size of the trade deficit (35 percent of GDP in 1993); (ii) its concentration in industrial products (70 percent of exports in 1987—the last date at which good trade statistics were collected) (Figure 6.2); (iii) its orientation toward Israel, which amounted to 90 percent of imports and 70-plus percent of exports in 1987; and (iv) the sharp decline in labor and exports during the *Intifada* beginning in 1987.



Source: El-Jafari (1995).

These trade patterns—export of labor rather than goods, export of industrial rather than agricultural goods, and trade relations dominated by the relation with Israel—were due to the incentive structure that prevailed under occupation. Palestinians have been free to sell skilled labor to the Gulf and unskilled labor and manufactured goods to Israel (but expansion of manufactures was restricted). Palestinians have faced difficulties in other trade, due to the repression of domestic production, restrictions on agricultural exports to Israel, and weak trading networks to the rest of the world. In addition, the Arab boycott, by preventing the export of Palestinian goods with Israeli content, effectively eliminated all Palestinian manufactured exports to neighboring countries. There were no restrictions on imports of Israeli goods. But for imports

from the rest of the world, the economy operated under the highly protectionist Israeli trade regime. In the absence of these restrictions, the patterns of trade would have looked very different. Various modeling exercises have shown regional trade and trade with Asia would have been much larger, and trade with Israel much smaller, in the absence of the CU. By some estimates, imports from Israel may have been lower by as much as half.

By the mid-1980s when the growth in labor movement started to taper off, manufactured exports started to rise, reaching a high point in the late 1980s (at about \$400 million per year or 20 percent of GDP). Initially, these exports represented mainly subcontracting-type business with low value added, in labor-intensive industries such as shoes, garments, or plastics. After a dip related to the beginning of the *Intifada*, the early 1990s saw an expansion in exports, particularly to Israel, which was facilitated by Israel's attempt to revitalize the Palestinian economy and offer inducements to new investors. For example, the Hebron-based shoe production came to represent perhaps as much as half the Israeli shoe market by the early 1990s.

The Economic Protocol signed in 1994 in Paris between the PLO and Israel both regularized the existing trade relation and improved some of its aspects.

- There is no customs border between the WBGS and Israel and, subject to Israeli quality standards, trade between the WBGS and Israel is mostly free. The only theoretical exceptions are five agricultural goods with quotas until 1999 (but effectively hard to enforce given the non-existence of a customs border).
- Trade relations with third countries—tariffs, standards, quotas—are largely determined by Israeli policies, albeit with some limited exemptions (see below).
- Custom revenues and VAT—but not other levies—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.

Characteristics of the Economic Protocol

Instead of the expansion expected under the Economic Protocol, trade flows have collapsed in recent years. This was mainly due to repeated closures, but also to flaws in the agreement, some of which—but not all—can be corrected within the existing framework. There are four main weaknesses: the disposition of the tariff revenues, the need for improved policy independence toward trade with third parties, problems in access to the Israeli market, and difficulties in access to third countries.

Tax Leakage. In the current system, the VAT is treated on a destination basis, meaning that the Palestinian treasury receives VAT on goods consumed in the WBGS (and produced in Israel or in another country). A clearance system that operates on a transaction basis has been set up to collect these revenues and transfer them to the PA. In 1996, the VAT and other tax clearances were the largest single source of revenue to the PA, amounting to 65 percent of total tax revenues, or 14 percent of GDP.

However, the Economic Protocol does not foresee the return of purchase taxes paid to Israel. The treatment of customs and purchase taxes paid at the border on goods imported from third countries and that end up in the WBGS is also problematic (see Chapter 8). Those revenues are remitted to the PA only when the shipment identifies a firm in the WBGS as the final destination. This means that revenues on imports that are resold to WBGS firms via Israeli wholesalers, or directly to Palestinian consumers, or that are imbedded as inputs in Israeli products, are not remitted to the PA and leak instead to Israel. The extent of these leakages is unknown but could be as large as 5 percent of GDP.

In order to try to collect some of the lost revenue, the PA has begun to oblige Palestinian distributors to buy directly from abroad (through a system of control of distributors) some of the goods with high tariffs or with high purchase tax. This is good from a revenue collection point of view (perhaps as much as \$100 million, or 15 percent of 1996 revenues, could be raised on cigarettes, alcohol, and electrical products alone). However, this system runs a risk of being captured by distribution monopolies if the import permits are not distributed in a competitive fashion.

While more drastic solutions require a customs border between Israel and the WBGS, a solution that still falls within the general framework of the existing agreement is provided by the revenue-sharing agreement under the Southern African Customs Union (SACU), which comprises South Africa, Lesotho, Swaziland, and Namibia. In the SACU, trade policy is determined by South Africa, all border taxes are collected in a common revenue pool, members other than South Africa receive 1.4 times their share in total consumption within the union, and South Africa receives the residual. The agreement is easy to apply because it is based on a macro formula, and it compensates the smaller members for accepting a trade policy designed for the benefit of South Africa.

Policy Independence. On the positive side, the trade agreement locks in a relatively open trade regime. In the past few years, Israel has liberalized much of its manufactured trade regime. There is free trade in manufactured products with both the US and Europe (the destination of 85 percent of Israeli exports). Tariffs on trade from other countries average 8 percent for intermediate goods, and 12 percent for final products. All quotas have been removed, including in agriculture (in accordance with the results of the Uruguay Round). Protection remains highest in agriculture, textiles, garment, furniture, and shoes. There is also high tariff escalation resulting in high rates of effective protection on consumer goods. The use of high excise or purchase tax on imports (revenues from taxes are about five times more than from custom duties) and quality standards (especially on food items) remain important instruments of non-tariff barriers. Services have not yet been liberalized as much.

To a large extent, the Palestinian trade regime has already been anchored by the FTAs signed with the EU and the US in 1996. However, in the short to medium term, the rules for trading with Israel and the rest of the world remain crucial. From the Palestinian point of view, the Israeli trade regime has several disadvantages compared to an ideal regime chosen independently by the WBGS. Imports are not allowed from countries that do not have trading

relations with Israel, including Arab countries. Quality standards in the current regime are perceived to be above what would be desirable given Palestinians income levels. Even in the midst of border closures (when Israel's closing of the border led to meat shortages in the Gaza Strip), meat could not be imported from Egypt because of quality standards restrictions.

The current situation allows, at best, for limited trade policy independence with respect to trade with third parties. While there are common tariffs in trade with third countries, the Economic Protocol allows for some exceptions. For a few goods whose market can be easily monitored (*i.e.*, cars that need to be registered, gasoline with a different color), the PA can set tariff rates independently and import quantities that are not restricted (provided these goods are not marketed in Israel). For a longer list of goods (*i.e.*, basic food, gasoline, cement, construction material, cars, and some investment goods), tariffs can be set independently only on some pre-specified quantities ("Palestinian estimated needs").

The Palestinians have already begun to exercise this latter option. Ten bilateral trade agreements have been signed to date. In a recent agreement with Jordan, the tariff rate was set to zero on most of the allowed list. There have also been other attempts at reducing the constraints imposed by the agreement. Some goods were added to the list, and some quantities were increased. New regulations for Arabic packaging are used to prevent leakages to Israel and create a virtual border.

Trade with Israel and Border Closures. Border closures hinder Palestinian exports to Israel, not imports from Israel. Because of this, the policy of border closures effectively eliminates the potential gains that the Palestinian economy could derive from the existing free trade agreement with Israel. Even if the Palestinians had free access to the rest of the world and could redirect trade to other markets during closures, a preferential trade agreement under these conditions would end up one-sided and not be in their favor.

This is because an FTA or CU is a discriminatory trade relation between two economies where there is an exchange of preferences with each side giving the other advantages over other competitors. Whether such an exchange is in the interest of the WBGS depends on how the value of the preferences given by the WBGS to Israel compare to the preferences Israel gives to the WBGS.

Under ideal border conditions, free trade with Israel offers important advantages for the Palestinian economy. Indeed, an attractive feature of the agreement is that the Israeli tariff structure is particularly protectionist in the sectors where the Palestinians have a strong export potential: agriculture and labor-intensive manufacturing (*i.e.*, shoes, garment, furniture). The large value of these preferences explains why the Economic Protocol was expected to allow for rapid job creation (agriculture in the short term, and labor-intensive industry in the longer term).

But while these preferences are important on paper, their value has turned out to be almost negligible under repeated closures since agricultural exports are highly perishable, and industrial subcontracting requires a high degree of predictability. In the current arrangement, expectations of future closures affect productive behavior negatively. For example, agriculture is

shifting back 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 (see Box 3.2 in Chapter 3). Gazan firms specializing in subcontracting have cut business in half over 1995.

At the same time, the preferences accorded by the Palestinians to Israel involve real costs. The alternative to the CU, such as a system with non-discriminatory tariffs for all imports, would allow Palestinian importers to purchase goods from third parties at prices cheaper than Israel and/or raise extra custom revenues. The value of these preferences is not negligible given the size of the trade deficit with Israel (a larger deficit means larger preferences) and the relatively high level of tariffs applied to the goods (mainly consumption goods) that Israel exports to the WBGS. The WBGS represents the third largest market for Israeli exports after the EU and US, amounting to 10-15 percent of Israel's exports.

Border Closures and the Necessity of Open Access to Third Countries. While trade with Israel has suffered under border closures, there has been little substitution to other sources. Even though imports from Jordan and Egypt jumped significantly (from \$20 to \$80 million between 1993 and 1996), this was insufficient to compensate for the lost trade with Israel. The lack of trade infrastructure inhibits large quantities of goods from entering either directly (there are no ports or airports in the WBGS), or through Egypt and Jordan (where crossing points have old infrastructure and limited capacity). Also, exporting to and through these countries remains restrictive, partly because the Palestinians are not in a position to reciprocate.

The possibility that closures will remain a fact of life and the need to enhance competition among service providers make it necessary to consider diversifying trading routes. Investment in security infrastructure is also needed. This means that besides direct routes (Gaza port and airport), increased capacity for going through Egypt and Jordan is needed, and investments in border administration and infrastructure must also be secured. Such policies do not run against the interest of Israel. If the WBGS has free and good access to the rest of the world, only then can Israel not afford to use closures as a security measure.

Free Access: Moving People and Goods

In the future, the movement of goods and people is central to the well-being of the Palestinian economy. Whatever trade regime that ultimately occurs, new transportation linkages are required to and from the rest of the world, as well as within the Gaza Strip, within the West Bank, and between the Gaza Strip and the West Bank (see Chapter 13).

At present, all movement in and out of the WBGS to the rest of the world must take place through ports of entry and exit located in Israel, Jordan, and Egypt (Table 6.1). The most developed of these ports—and the passage for over 90 percent of Palestinian trade—are in Israel. As part of 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, thus, long delays.

Of the crossover points to Jordan, only two of the bridges, the Karameh (King Hussein or Allenby) Bridge and the Damiah (Prince Mohammed) Bridge, are presently functioning—but in a limited fashion. The bridges are in a state of disrepair and security checks restrict the number of trucks (presently 35 per day) that can be handled at these ports. The land crossing to Egypt at Rafah is limited also by the lack of access roads and supporting infrastructure.

Table 6.1 International Ports of Entry and Exit

Border Country	Name of Port or Border Crossing	Conveyance	Port Fee
Israel	Ben Gurion	Air	2.5 percent of CIF value
	Ashdod	Sea	2.5 percent of CIF value
	Haifa	Sea	2.5 percent of CIF value
Jordan	Karameh (Allenby) Bridge	Land	None
	Damiah Bridge	Land	None
	Sweimah Bridge	Land	None
Egypt	Rafah Crossing	Land	None

Source: The Small Business Support Project (1996) and the PA (1995).

Expanded options for trade and the movement of people are clearly required. The rehabilitation and enhancement of the crossover points to Jordan and Egypt present the immediate lower-cost options. The physical rehabilitation of the Jordan-West Bank bridges is the first step and can be accomplished for about \$60 million. However, further development of access and infrastructure that permit speedy customs checks—freeways to the bridges, warehousing facilities, customs check points—will require at least an equal expenditure. Eventually, if trade flows grow, two additional bridges may be needed.

Direct access from Palestinian areas of control will provide increased options and, hence, greater comfort to traders, tourists, and internationally mobile workers. Two projects under active consideration are a port and an airport in the Gaza Strip. In the past, there has been some concern that the port and airport require “lumpy” investments and, hence, may not be economically justified for a small economy such as the WBGS. 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 the use of Israeli facilities even under normal conditions and especially at times of border closure. Direct international access from the Gaza Strip, consequently, has an important “option value.” In addition, if a free economic zone is to be created, direct access to a port is virtually 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.

However, to be useful, the port and airport at Gaza must provide effective facilities, especially for traders. This implies the ability to handle large ships and bulk cargo speedily and without damaging the goods. According to present plans, port capacity is to be built in phases (Box 6.1). The initial phase is expected to require an investment of about \$60 million for port

development and at least \$40 million for associated infrastructure. On completion, vessels up to 15,000 DWT will be able to use the port. Expenditures on airport development are likely to be of the same magnitude. Though initially donor-financed, private financing can be expected for the second and third phases.

Box 6.1 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 much larger vessels would be constructed in the second phase. In the third phase, the breakwater would be expanded and a new 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 would 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 in 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.

Source: Mody (1996).

Trade Regime and Development Strategy

In order to assess the existing trade agreements and to propose improvements, it is necessary to form views about the broader development and strategic options facing the Palestinian economy. At the outset, one principle will clearly be key. The major goal of trade policy in the WBGS will have to be attracting investment into the economy. This would require, first and foremost, trading rules that are credible and stable. If this is not possible, the establishment of a clear policy path is needed so that investors can form expectations with high chances of being realized. Beyond this, trade policy will have to open up new growth opportunities based on comparative advantage. With limited natural resources, the focus will

have to be on manufactured products. Advantages include a relatively sophisticated and hard-working labor force; a strategic geographical position; a relatively open economy with an industrial base that has shown resilience and can sustain foreign competition; and a revenue base that does not rely on customs duties (the main fear of foreign competition is mainly in agriculture).

Given these advantages and the starting conditions, there are three main (non-exclusive) types of industries that are likely to grow. These also correspond to successively more sophisticated and skill-intensive stages of development.

- *Strategy A: Labor-intensive growth.* Low- and medium-skill exports to the West, starting with Israel and expanding to the rest of the world, especially the EU and US.
- *Strategy B: Gateway to the West.* Transforming raw and semi-finished, unskilled labor-intensive, regional products into more valuable exports.
- *Strategy C: Gateway to the East.* The transformation of western technologies and the adaptation of technologically intensive goods to fit better the specific needs of the neighboring Arab countries.

Strategy A would build on the existing base of \$400 million in potential exports to Israel in recent years, in the absence of closures. This requires continued openness to Israel, and increased openness to richer markets in the OECD. This would militate for the continuation of a free trade relation with Israel (at least until Israel becomes more open multilaterally), and will be helped by the recent signing of FTAs with the US and the EU. Under the current regime, 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.

Strategy B is more difficult in terms of prerequisites. It 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 ally itself with Jordan, and the Gaza Strip with Egypt. Free trade with these regional partners would be necessary, and so such a strategy cannot be followed within the existing agreement with Israel. These 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 provides a challenging vision for the medium term and is the most demanding in terms of human resource development and modern infrastructure. Similar to strategy B, it 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 raising skills and cultural advantages, and could encompass sectors ranging from telecommunications to the information industry and finance.

One important question is whether there is a trade-off between links with Israel and the OECD, and links with the region. From an economic perspective, the two approaches are complementary as the ability to develop links with the rest of the region is made more valuable through deeper links with Israel and the OECD.

Which Trade Regime with Israel?

The choice of an optimal trade relation with Israel is complicated by the uncertain political outlook. In a peaceful environment, there are likely to be large gains to a CU with Israel; but such an agreement would become one-sided and sub-optimal with repeated closures. On the other hand, moving to an independent and non-discriminatory trade regime would improve the situation if the border was nonporous; however, it would have negative effects compared to free trade under workable border arrangements. In the context of this difficult dilemma, is an FTA with Israel that falls short of an agreement on third-country relations (*i.e.*, a CU) a good intermediate solution?

There are several positive aspects to an FTA. Such a strategy would maintain open trading relations with Israel, but would potentially avoid protectionist aspects of Israel's trade regime, especially in trade with the region, that are ill-suited to the high value-added strategies discussed above. By allowing for the establishment of a customs border, such a strategy would help avoid the tax leakage, and would allow for a lowering of quality standards. Taxes that now leak to Israel can be collected at the (new) custom border. Revenue would rise even if the tariff rates to third countries are set at zero because it would allow to recapture the much larger purchase and excise taxes. Simulations suggest that under an FTA with Israel and zero tariffs to third countries, Palestinian revenues could rise significantly. Finally, 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.

However, several problems must be dealt with for the FTA solution to become attractive.

- A potentially costly problem concerns the low value added in the Palestinian economy. In an FTA, free trade only applies to goods that have a minimum share of domestic content (*i.e.*, 40 percent). Trade preferences given to Israel, in which the share of domestic value added in goods is large, could be much more valuable than those accorded to the WBGS if only a few such goods exist. This may not seem problematic for several traditional exports (*i.e.*, stones, agriculture, shoes) where the share of domestic value added is large. In textiles, however, some form of derogation would be needed.
- An FTA has the same weakness as the current system with respect to border closures. To reduce this problem entails reducing the preferences accorded to Israel. This can be done without losing the preferential access to the Israeli market by reducing the tariffs that apply to third parties. If tariffs are set to zero, free trade with Israel would not entail any costly preferences. Indeed, there would be no preferential relation anymore.

- An FTA would free tariffs to third parties, which would then come under the influence of lobby groups, with potentially very high costs to consumers. One solution is to use some commitment mechanism to bind these rates. Such a mechanism is provided by the World Trade Organization (WTO) through potential trade agreements with other parties (in particular, the US, EU, other Arab countries), or by the establishment of free trade zones.
- Finally, moving to an FTA would involve renegotiating the economic agreement. The issues of Jerusalem, the settlements, and the geographical separation of the West Bank from the Gaza Strip complicate such an agreement. However, these issues do not make it impossible to achieve an independent trade regime with low leakages, especially for the Gaza Strip.

While these difficulties are real, so are the current difficulties, and those that would be encountered when moving to the third alternative—a non-discriminatory trade regime that would treat all trade partners similarly, including Israel. Indeed, giving up a preferential trade agreement with Israel and the preferential treatment for Palestinian exports would be extremely costly in the short to medium term. It would expose Palestinian exports to Israel (80 percent of total WBGS exports) to the relatively large protection that Israel imposes on third countries. Yet, while the current system is likely to be advantageous when borders are open, it is also very costly when border closures become more frequent. 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.

Such a choice will be partially dictated by expectations about the frequency of future border closures. Repeated closures of the recent past are rendering the current trading relation with Israel inadequate. Unless new ways are found to isolate security issues from the passage of goods and people between the WBGS and Israel, a more independent trade can be preferable from a Palestinian economic point of view. The choice of improvement within the current agreement, which could be the only short-term choice, 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 if the current situation does not improve.

One daring possibility worth investigating seriously is a free trade zone in the Gaza Strip (and in the West Bank as soon as the border situation allows it). This would involve renegotiations with Israel, but for positive and forward-looking economic reasons, rather than defensive purposes. Turning the Gaza Strip into a free trade zone would send a strong signal that Gaza is open for business. It would send the message loud and clear that there is no room for rent-seeking activity, monopoly behavior, or special treatment, because the government is out of the business of trade. Together with its large and relatively skilled labor force, such an initiative would make the Gaza Strip very attractive as an export platform to the US and EU (and because nearly no custom revenue is presently collected on manufactured imports, there would be little effect on fiscal revenues).

* * *

In the past three decades, the Palestinian economy exported mainly people to the expanding labor markets of Israel, the Gulf countries, and other parts of the world. Presently, regional labor demand has tapered off, probably permanently. In the future, the WBGS economy will not be able to grow in a sustainable fashion unless it manages to increase substantially its export of goods and services.

In this context, the choice of a trade regime becomes more important. The outcome of the recently signed FTAs with the US and EU will be determined in the years to come. For these agreements to be useful, however, rapid improvement in the physical trade infrastructure is necessary. The existing trade relations with Israel also need to be improved in order to allow for a mix of greater tax collection, lower consumer prices, and greater policy independence.

One important choice is whether the optimal mix is better achieved by marginal changes within the existing agreement, or by a renegotiation of the agreement, including the setting of a custom border. But as a matter of principle, the WBGS probably stands to gain most, and to acquire greater security, not through seeking economic "independence" in an autarkic sense, but through playing a role in interdependent networks in the region—linking both to Israel and the Arab world.

Bibliographical Note: The analysis in this chapter is based on the background papers of Panagariya and Diwan (1997), Kanafani (1996), Arnon (1996), and El-Jafari (1995). The estimates of fiscal leakage are from Jawhary (1995). The chapter also draws on work by Halevi and Kleinman (1994) and Mody (1996).

Chapter 7

Financial Intermediation

The development of the financial system in the WBGS is limited by economic and political uncertainties. Yet, much more growth and deepening can be achieved under the current circumstances, especially in the banking system and the equity market. The banking system has grown dramatically in the last three years and managed to attract substantial deposits. Bank lending, however, is still very limited. Mechanisms that can increase lending in the present political climate include setting up an adequate banking regulatory system, initiating measures to increase availability of collateral, and establishing a mortgage insurance program and a secondary mortgage facility to encourage mortgage lending. The potential of the equity market as a source of risk capital is demonstrated by the strong demand for new stock issues. The opening of a local stock market is likely to play an important role in realizing this potential.

Introduction

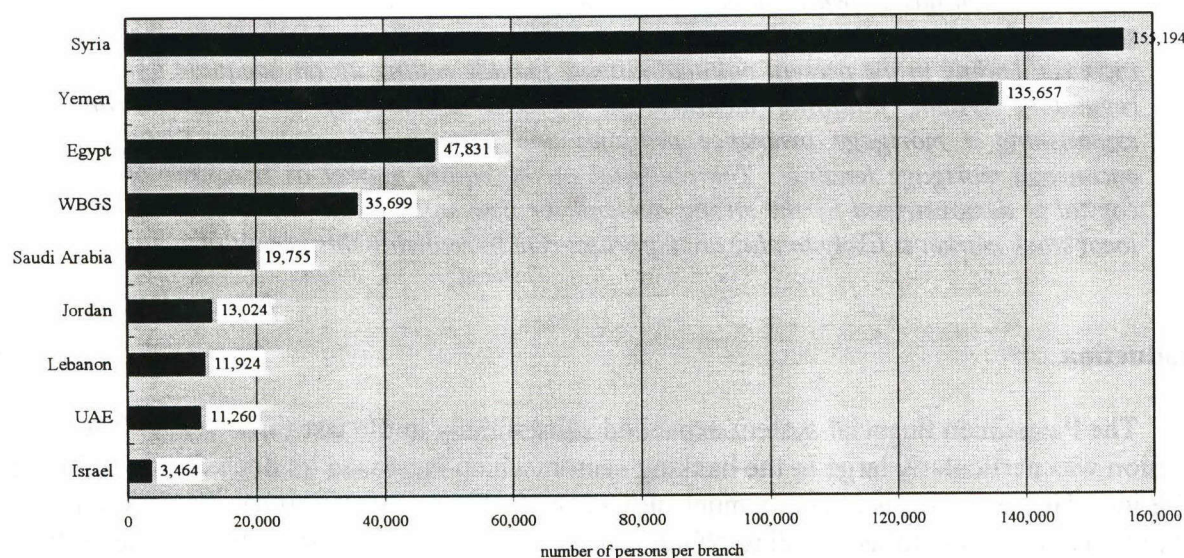
The Palestinian financial system expanded substantially in the last three years. The expansion was particularly large in the banking sector, which increased its deposits sevenfold in this period. However, loans rose at a much slower pace. Some expansion has also taken place in the equity market. In contrast, lending NGOs, which accounted for most lending in the WBGS before 1994, saw a decline in their relative weight in the financial system.

The banking system expansion was remarkable. By the end of 1996, the number of bank branches in the WBGS reached 71, compared to 13 at the end 1993. This translates into 35,699 persons per branch, which is average by Middle East standards, but certainly high compared to the potential in the WBGS (Figure 7.1). (Lebanon has relative concentration that is three times higher.) The jump has affected nearly all households. At the end of June 1996, 14.7 percent of people over 18-years old had deposit bank accounts (20.3 percent in the West Bank and 6.4 percent in the Gaza Strip). Urban residents held the most, followed by those in rural areas, and lastly, those in refugee camps.

The WBGS banking system has been much more effective in the last three years in mobilizing deposits than in channeling these deposits to local borrowers. At the end of 1996, the loan-deposit ratio was only 0.24. The ratio has remained low because the demand for loans is constrained by political and economic uncertainties and institutional limitations. Under any circumstances, lending could not have been expected to keep up with the rapid growth in deposits. While it is not realistic to expect the loan-deposit ratio to reach the 0.6 to 0.8 levels observed in other countries in the region before successful conclusion of final status negotiations results in decreasing political uncertainty, a significant increase in lending can be achieved even in the present political environment if certain policy actions are taken to improve the institutional framework.

This chapter covers the main issues confronting the Palestinian financial sector. Can appropriate policy take advantage of expanding bank deposits to increase bank lending? How can the financial sector increase the maturity of lending in order to foster long-term investment? What is the role of the nascent stock market in encouraging a broader sharing of risks?

Figure 7.1 Persons per Branch in the Middle East



Source: Hamed (1996).

Issues in Banking

Regulation and Supervision. Considering the number of branches per capita and the number of adults with bank accounts, the banking system still has room to expand. Bank expansion, however, should be gradual so as to give the Palestinian Monetary Authority (PMA) (presently in charge of bank regulation in the WBGS) the chance to develop its regulatory regime and to build sufficient supervisory capacity.

Adequate regulation and supervision are instrumental to achieving stability and confidence in the banking system. To ensure bank safety and stability, bank regulators usually institute failure-prevention measures, such as asset restrictions, capital adequacy, and reserve requirements. Knowing that preventive measures cannot eliminate bank failures completely, regulators also set up failure-containment mechanisms, such as deposit insurance and discount lending to prevent limited failures from destabilizing the banking system. To ensure compliance with bank regulations, regulators require commercial banks to provide them with regular financial reports and conduct frequent site examinations to check on compliance with regulations.

The WBGS presently does not have deposit insurance and the availability of discount loans is limited, thus making it difficult for regulators to contain individual bank failures. Hence, bank regulation should focus on failure prevention. This requires imposing strict capital adequacy

rules, relatively high liquidity ratios, and restrictions on foreign-currency exposures as well as on acquiring risky assets, such as real estate and stocks. To be effective, these regulations should apply equally to all financial institutions that accept deposits from the public, including Islamic banks (Box 7.1).

Box 7.1 Islamic Banking

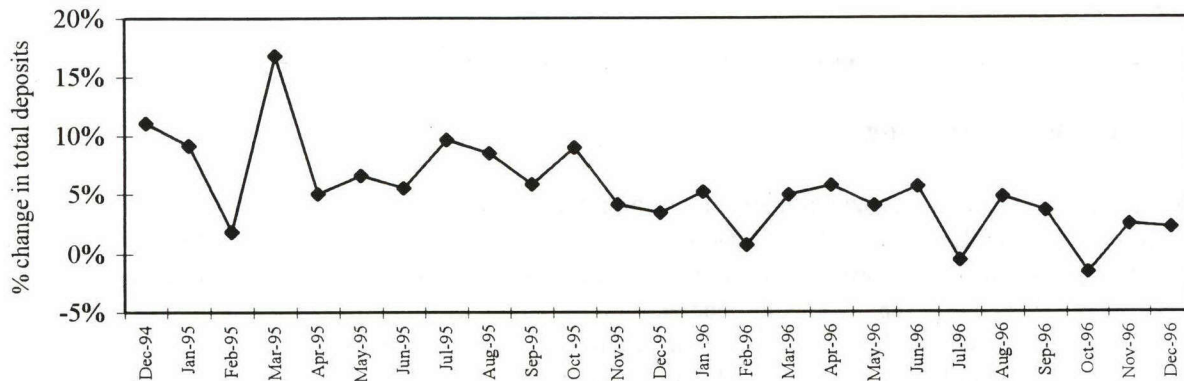
The operations of Islamic financial institutions can be divided into two major categories: Murabaha and Mudaraba. Murabaha is basically a cost-plus-resale contract in which the Islamic financial institution buys the goods that the borrower wishes to acquire and sells them to the same person at an agreed-upon higher price. This can be easily accommodated under the regulatory approach advocated in this report. The most common Murabaha-based operations are in consumer and international trade finance. In comparison, with Mudaraba operations, the provider of capital agrees to finance a project to be carried out by an entrepreneur on a profit-sharing basis at predetermined ratios. This involves a high degree of risk and should not be conducted by Islamic banks, if they are to be allowed to accept deposits from the public. This type of operation should be conducted instead by Islamic investment companies that cater to customers who are willing to accept a high degree of risk. Islamic banks operating in the WBGS should limit their operations to Murabaha and Islamic institutions involved in Mudaraba should not be allowed to collect deposits from the public.

Source: Hamed (1996).

The lack of deposit insurance and the high level of political risk ultimately constrain the growth of the local deposit base (Figure 7.2). So far, growth in bank deposits has been very high since 1993. By the end of 1996, total deposits in the WBGS banking system were \$1,711 million, compared to \$219 million at the end of 1993 (see Chapter 1, Figure 1.4). The deposit-GDP ratio at the end of the same month was 0.535, which was much lower than other countries in the region, such as Jordan (0.825), Kuwait (0.771), Israel (0.734), and Egypt (0.728). If this ratio is to become equal to Jordan's, total bank deposits in the WBGS can potentially reach \$2,640 million. However, this is not expected to happen before successful conclusion of final status negotiations since political uncertainties encourage many WBGS residents to maintain bank accounts abroad.

The Role of Foreign Branches. The phenomenal growth of the banking system was made possible by the importation of banks and regulation from abroad. As a result, it is dominated by foreign branches. At the end of 1996, only 4 of the 17 banks operating were locally chartered and only 20 of the 71 branches were locally chartered. The dominance of foreign banks is particularly strong in the West Bank, where they accounted for 42 of the 49 branches in operation at the end of 1996.

**Figure 7.2 Percentage Change in Total Deposits
from Previous Month**



Source: MAS data files.

The establishment of foreign branches was key in the development of banking in the WBGS. In expanding their operations, foreign banks were able to rely on their head offices for technical and managerial support and for training new employees. Without foreign branches, it would not have been possible for banking services to expand nearly as fast as they did in the last three years. The expansion took place at a time when the bank supervisory capacity in the WBGS was extremely limited. In such an environment, 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.

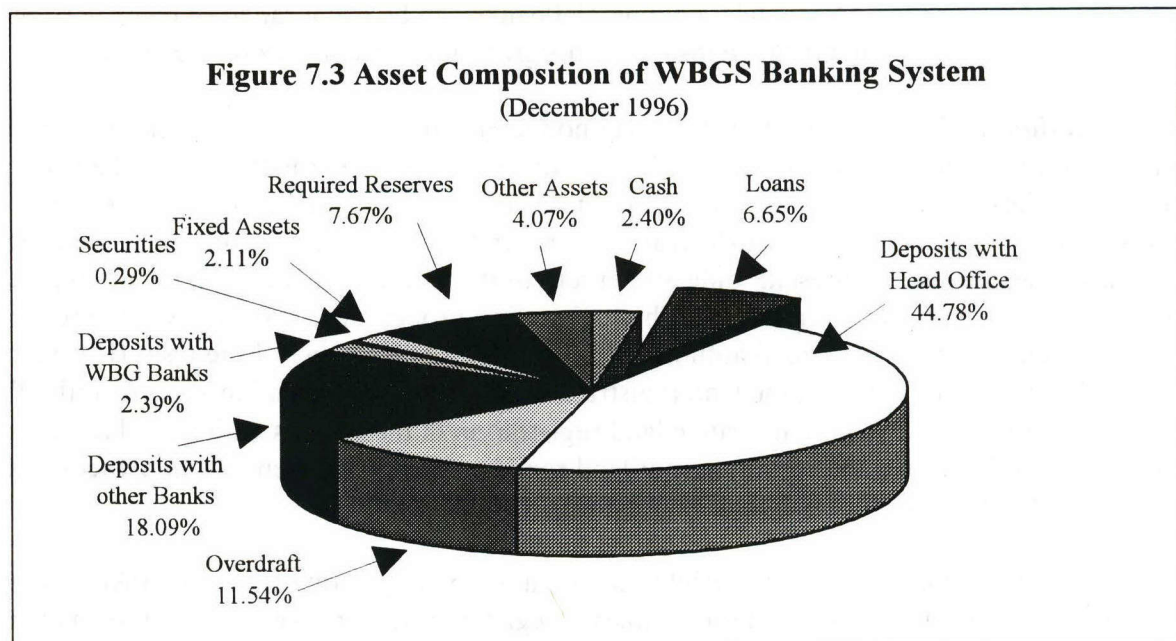
However, the dominance of foreign banks places a number of challenges on the development of the banking system.

- Decision makers for the foreign branch are usually located at the bank's head office, which makes it less likely for them to receive direct and timely information about political and economic changes affecting the local market. The foreign branch usually keeps a significant share of its assets as deposits with the head office and tends to depend on its head office as a source of liquidity, thus inhibiting the development of a domestic interbank market.
- Because foreign branches have access to borrowers outside the WBGS, they may delay their investment in the risk assessment system necessary to extend credit in the WBGS, making it less likely for them to lend there. The negative impact of access to foreign borrowers on lending in the WBGS may continue even after the foreign branch sets up a risk assessment system because of what is referred to in economic literature as credit rationing. Under credit rationing, when credit conditions are tight, lenders tend to give preference to their long-term customers at the expense of new customers who lack track records with the lender. This may result in rationing limited credit to established customers abroad at the expense of new local customers.

- Foreign banks present serious challenges to bank regulators. Regulating foreign branches is not an easy task even under the best of circumstances due to problems related to transfer pricing and the ability of the foreign branch to avoid regulations by swapping assets with operations abroad. Such regulation in the WBGS is particularly difficult because of the absence of a national currency.

While foreign branches will no doubt continue to serve an important function, their dominant role cannot be maintained indefinitely. Eventually, the PMA should require foreign banks to convert their operations in the WBGS into subsidiaries. To avoid disrupting the banking system, the conversion should be done gradually. In the meantime, the PMA should reduce dependence on foreign branches by encouraging locally chartered banks. Such encouragement, however, should not in any way compromise the safety and stability of the banking system. 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.

Size and Maturity of Loans. Domestic lending by banks operating in WBGS is very limited and the majority of credit extended is in the form of overdraft facilities. At the end of 1996, total credit (outstanding loans and overdrafts) accounted for merely 19 percent of total assets and 23.9 percent of total deposits. At the same time, the share of overdraft facilities of total credit was 64.4 percent (Figure 7.3).



Source: MAS data files.

The low lending ratios in the WBGS are caused by both demand and supply factors. On the demand side, political and economic uncertainties inhibit investment and hence demand for credit. On the supply side, domestic lending is hampered by the limited availability of collateral. A significant decrease in uncertainties cannot be expected before a successful conclusion of final status negotiations. Thus, lending ratios cannot be expected to reach the levels of neighboring

countries before then. In any case, lending cannot possibly be expected to keep up with the rapid growth in deposits.

There is substantial pressure on the PMA to implement policies that result in increased bank lending. To the extent that some increase in lending can be achieved in the present environment, it should be carefully implemented without endangering the safety of deposits. The PMA should be more conservative in its approach than is usually the case, given its inability to act as a lender of last resort in case of a banking crisis. In particular, quantitative restrictions in the form of minimum lending ratios should be avoided as they force banks to provide bad loans, endangering bank deposits. Collateral enhancement mechanisms are the most effective policy to increase lending in the current environment. A market-oriented policy that needs to be carefully explored is whether to use changes in the reserve requirement on deposits lent in the WBGS as a means of affecting the share of deposits lent internally.

A substantial increase in the average loan maturity is possible only if a parallel increase in deposit maturity takes place, which is not expected without a significant decrease in political uncertainty. The average loan maturity can be increased without an increase in deposits maturity only if a mechanism for hedging against unexpected change in interest rates is created given the need to guard against possible sudden withdrawals caused by political instability. Normally, hedging is done by using futures and options market instruments or interest rate swaps. None of these hedging instruments is presently available on the WBGS markets and the situation is unlikely to change soon. Meanwhile, commercial banks can be encouraged to provide some long-term credit by setting up a mortgage insurance program and a secondary mortgage facility.

Collateral Enhancement. Present economic uncertainties limit the appeal of cash-flow lending to firms. In this environment, increasing the availability of collateral and enhancing its value to lenders is essential for expanding credit. The most effective way to increase the availability of collateral is to establish clear property rights to land, which represent the main asset for many Palestinians. At present, only 30 percent of the land in the West Bank and 90 percent in the Gaza Strip are properly registered. The registration process that was to cover the remaining land has been frozen by the Israeli authorities since 1967. The signing of the Oslo II Agreement put the PA in a position to resume land registration in the Gaza Strip and in zone A of the West Bank. Therefore, the PA should resume land registration in these areas without delay. In zones B and C of the West Bank, the resumption of land registration is contingent on the Israelis, and all efforts should be made to obtain their cooperation.

The PA can increase the availability of collateral by registering tractors, other agricultural tools, industrial machinery and other movables. Registered tractors are attractive to banks as collateral because of their marketability. Tractor registration can use the existing automobile registration system. Registering industrial machinery is more problematic because of its limited marketability and the need for a special registration system.

Apart from increasing the availability of collateral, the PA needs to introduce legal reforms that make it easier for lenders to foreclose in the case of non-payment and to engage in leasing. The PA should negotiate with neighboring countries, especially Israel, about the priority of claims

on properties sought by debtors in more than one country. This is particularly relevant to automobiles, which can move easily across borders and, thus, be subject to confiscation. The PA needs to control the export of industrial machinery to protect against moving those registered as collateral outside the country. Finally, a law for securities and leasing would be useful.

Dual Reserve Requirement. Normally, the ability of banks to acquire foreign assets is constrained by the need to avoid foreign-exchange risk since the bulk of their liabilities are usually denominated in local currency. This constraint does not apply to banks operating in the WBGS due to the absence of a national currency. In addition, foreign banks, which dominate the WBGS system, have access to the borrower base of their head offices abroad. This reduces the pressure to set up the risk assessment system needed to enlarge their WBGS borrower base. But is there a way to effectively encourage banks to increase their domestic lending?

One policy suggestion is for the PMA to reward domestic lending or impose a cost on placing funds outside the WBGS, by reducing the reserve requirement on the portion of deposits lent locally or used in acquiring other local assets. This could be done either through a straight-forward reduction in the required reserve ratio on deposits lent locally, or an equivalent subsidy financed by PMA income from investing required reserves (straight-forward reduction in the reserve ratio below the ratio in Israel is not possible for NIS under the Economic Protocol). However, other views propose that a modest subsidy to domestic lending: would not provide major encouragement to such activities; may result in higher bank profits rather than lower borrowing costs; may create incentives for banks to classify operations in such a way as to benefit from the subsidy without necessarily increasing their domestic lending; and would increase the riskiness of deposit base, thereby encouraging disintermediation. The validity of these arguments requires serious empirical analysis. But careful consideration of the potential outcomes should be exercised before dual reserve requirement policies are implemented.

Mortgage Lending Instruments. 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 its credit and liquidity risks must be instituted. Credit risk could be reduced by the newly created mortgage insurance program (MIP). Liquidity risk could be alleviated by setting up a secondary mortgage facility (SMF).

The MIP should provide insurance covering default loss on residential mortgage loans extended by commercial banks. To maintain an incentive for proper underwriting and risk management by the lenders, the coverage provided by the MIP should be partial. If it is to be viable, the MIP will require an ongoing subsidy to cover catastrophic risks, such as prolonged closures, in addition to start-up costs. The premiums charged cannot be expected to cover more than the program's operating expenses and "normal" risk.

Initially, the SMF should provide banks with long-term funds through loans collateralized by their mortgage loan portfolio. To minimize the SMF's credit risk and to insure a net injection of funds into the housing sector, these loans should be over-collateralized. Over time, the SMF may also be able to stimulate mortgage lending by serving as a source of liquidity through loan purchasing. An initial source of funds for the mortgage facility could come from donors, probably

as loans to the PA. The SMF, however, should eventually be able to raise its own funds by issuing bonds and obtaining bank loans.

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 have done already. They also may have to find ways to minimize default risk without relying solely 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 the Palestine Agricultural Relief Committees (PARC). The Grameen Bank, which targets rural women farmers lacking access to credit, demonstrated extremely high rates of punctual repayment. This lending mechanism organizes borrowers into small groups and requires each group member to bear collective responsibility for default by any of its members. By doing so, most of the default risk is shifted from the lender to the borrower. This motivates borrowers to use local information, unavailable to the lender, to exclude bad risk, and uses peer pressure among members to ensure payment. The UNRWA's 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. In the WBGS where about 60 percent of the agricultural labor force is female, PARC has been providing small, low-interest loans to female farmers since 1994 with the group-lending model and utilizes an extensive rural outreach program to strengthen and mobilize their capabilities in income-generating projects.

The Emerging Financial Market

While there is still no bond market in the WBGS, a new stock market has just opened. 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 the high-risk environment of the WBGS. One of the most promising areas of growth for the equity market is infrastructure. However, a substantial investment by private companies in infrastructure in the present political environment requires guarantees by donors or international organizations (see Chapter 5).

There are presently around 50 joint stock companies in the WBGS, which account for less than 1 percent of the number of establishments. The stocks of these companies are not listed on any stock exchange, which reduces their liquidity and hence their appeal to investors. Consequently, these stocks do not change hands frequently and, when they do, the sale often has to be arranged by the company itself.

More than half of existing stock companies were established in the last three years. Demand for equity in 1994, 1995, and the first half of 1996 was strong and many of the stock issues that floated in those two years were oversubscribed. In contrast, companies that attempted to raise funds on the equity market in the second half of 1996 faced a weaker market (Table 7.1). Even a company like Paltel, whose stock was heavily oversubscribed when it was first issued in 1995, experienced some difficulty in collecting the second installment on the stock price.

**Table 7.1 Demand and Supply for Stocks in the WBGS
1993-1996**

Company Name	Issue Date	Total Supply (JD)	Total Demand (JD)	Total Subscription Ratio (4/3) (%)
Palestinian Investment & Development Co.	Sept. 93 - Oct. 93	6,000,000	7,500,000	125
Arab Investors	June 94 - July 94	12,000,000	9,452,328	79
Palestinian Cement Co.	June 94 - Sept. 94	6,000,000	3,300,000	55
Beit el-Mal el-Falastini	Sept. 94 - Nov. 94	10,000,000	11,400,000	114
Eastern Co. for Chemicals	Nov. 94 - Dec. 94	750,000	900,000	120
Palestine Industrial Investment Co.	Dec. 94 - Jan. 95	3,750,000	3,750,000	100
Palestinian Telecommunications Co.	Oct. 95 - Oct. 95	18,750,000	36,943,354	197
Palestine Islamic Bank	Apr. 96 - May 96	1,965,100	1,961,000	100
Jerusalem Building & Investment Co.	May 96 - June 96	3,600,000	3,253,320	90
Palestine International Bank	June 96 - Sept. 96	14,000,000	9,743,127	70
Arab Hotel Establishment Co.	July 96 - Jan. 97	10,000,000	2,500,000	25

Source: MAS data files.

The recently established 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 hence their appeal to investors. Listed companies will be required to publish annual and semiannual balance sheets according to standards set by the exchange. This will significantly increase the ability of potential stock holders to evaluate the risk of investing in these companies. The shares of a listed company will be traded in the first six months at the previous year's average sale price. Thereafter, the stock price will be determined by supply and demand, subject to a daily limit on variability (which provides accurate value of stock at any point time). This increases the value of stocks as collateral as well as their appeal to investors. Stock prices will be available electronically, which makes the information easily available to Diaspora Palestinians, who represent a major potential source of funds for the equity market.

The stock market will increase the access of small investors to stock ownership in a place where less than 0.5 percent of people over 18-years old own stocks. Increased access, however, will carry some risk. The lack of experience in financial portfolio management due to the effective absence of financial institutions in the last three decades may result in excessive risk-taking by some small investors. This could result in massive flight from stocks during price declines, affecting public confidence in the stock market as well as the rest of the financial system, and thus

resulting in financial disintermediation. Therefore, some temporary restrictions on the access of small investors to the stock market might be necessary.

Other Financial Institutions

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 financial system and their roles are not expected to increase significantly in the near future. The insurance business is dominated by auto insurance, which is a cash-flow business that does not generate long-term investable funds. In comparison, life insurance, which provides a major source of long-term funds in many countries, hardly exists. Pension funds do not presently represent a major source of investment funds. While central government employees are entitled to pensions when they retire, these pensions are financed by the annual budget on a pay-as-you-go basis. In comparison, UNRWA employees are covered by a provident fund that pays them a lump sum at the end of service. However, the fund's portfolio does not include any investment in the WBGS. In the private sector, very few firms have some 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 presently represent the main source of financial support for the present generation of WBGS retirees. This type of inter-generational support, however, may not be as viable for the next generation of retirees because of changing family structures and decreased job opportunities in the Gulf, where a significant share of family financial support had originated in the last four decades. In this environment, a serious consideration should be given to setting up a national social security system. Apart from providing a stable source of retirement benefits, a social security system can provide a major source of long-term investable funds for the Palestinian economy, provided that it is kept financially independent from the central government. This should probably be the case given fiscal conditions of the PA.

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 businessman from the Diaspora, *i.e.*, the Akkad Group, PADICO (Box 7.2). These funds share various characteristics. They have managed to provide a broad base of risk-sharing for the investments undertaken. The funds typically take 25 percent, another 25 percent is sold over-the-counter to the public (and traded in the recently opened stock market), and the remaining 50 percent is received from banks in the forms of medium-term loans. This structure provides enough risk capital to ride a rocky investment climate, manages to attract many investors in coordinating their actions into large and long-term investment plans, and at the same time provides large shareholders with incentives to monitor the project carefully. The funds reduce risk by diversifying across various sectors of the economy, thereby providing an important source to the shareholders that are still unable to use the emerging stock market to diversify their holdings (especially infrastructure, construction, tourism, and at a much smaller scale, manufacturing).

Box 7.2 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 200,000 shares with an aggregate value of \$200 million that were 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 hold the remaining 51 percent. This structure was chosen in order to allow local entrepreneurs and businessmen in the WBGS to participate to the fullest extent possible.

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 the following sectors.

- *Tourism:* PADICO owns 35 percent of the shares in the newly founded Jerusalem Tourist Investment Company (JTIC) with capital of \$25 million. JTIC intends to build hotels, resorts, and tourist villages in WBGS.
- *Real estate and housing:* PADICO co-founded the Palestine Real Estate Company (PREC) with \$22 million in capital. PREC seeks to invest in the acquisition and development of real estate and land for various uses, giving priority to building housing complexes outside municipal boundaries.
- *Industry and manufacturing, including industrial estates:* PADICO owns 49 percent of the Palestine Industrial Investment Company (PIIC) at \$22 million in capital. PIIC aims to invest in new light, medium, and heavy industries as well as expand qualified existing industries.
- *Finance:* PADICO formed the Palestine Securities Exchange Company (PSEC) with the mission to establish the first Palestinian securities exchange.
- *Power generation:* PADICO submitted to the PEA a proposal for the development of a power plant, and has a 25-percent stake in the new \$50-million company which is to spearhead the power plant project.
- *Telecommunications:* Paltel was established in May 1995 by the PA and a group of private investors including PADICO, at initial capital of approximately \$50 million.

Source: Zuaiter and Abdou (1996).

The development of the WBGS financial system is limited by economic and political uncertainties. While a decrease in these uncertainties cannot be accomplished before a permanent political settlement is reached, some growth and deepening of the financial system can be achieved before then, especially in the banking system and the equity market, both of which have expanded in the last three years. To improve on this progress, policies as discussed in this chapter, need to be put in place in order to boost the financial markets and encourage more financial intermediation in spite of the high levels of political risk permeating the system. Possible actions that can increase lending include building an efficient regulatory system, taking measures to increase the availability of collateral, and instituting disincentives to discourage banks from the acquisition of foreign assets. There is also a need for a tighter regulation of banking, a stronger court system, the development of land registration, further gains in availability of vehicles for risk-sharing, and the emergence of larger financial market players. The equity market can potentially have a more important financial role than the debt market under the existing risk level in the WBGS. However, despite its recent expansion, the equity market is still very small and presently shows signs of weakness. The opening of the Palestinian stock exchange in 1997 provided the equity market with an important mechanism for realizing its potential.

Bibliographical Note: The section on commercial banks draws heavily from the background papers of Hamed (1996), Hamed and Khano (1995) and Hamed and Shaban (1995). For housing finance, see World Bank (1996c); and for PADICO, see Zuaiter and Abdou (1996).

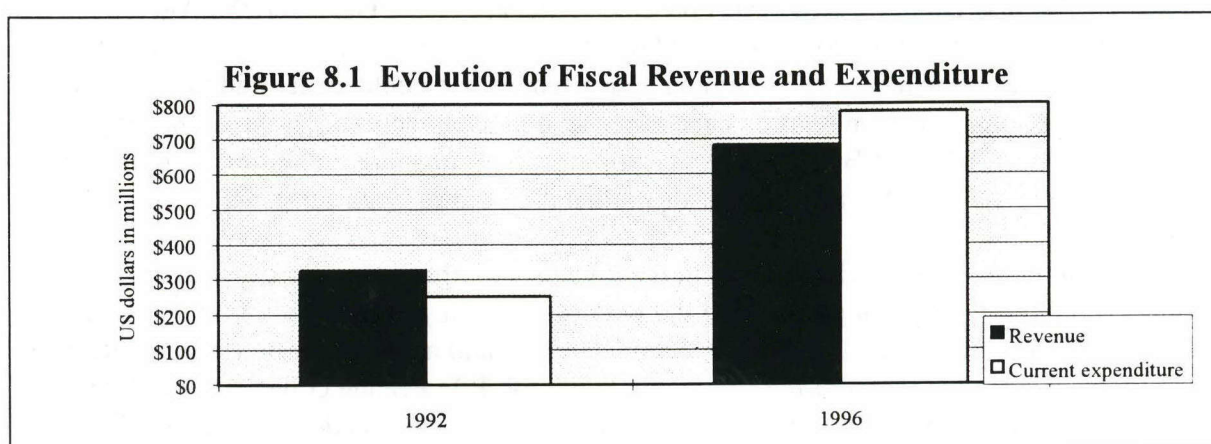
Chapter 8

Fiscal Management

The PA's budgetary revenue and expenditure outcomes since September 1993 have been strongly influenced by extraneous events. Looking ahead, there is an emerging risk that recurrent expenditure, which has expanded rapidly, will not be covered by revenue. Tightened expenditure management through policy measures to limit further increases in public sector employment will be necessary to avoid the emergence of fiscal imbalances. Intensified capacity-building efforts will be needed to put in place public expenditure management tools and to improve civil service incentives. The design of revenue collection instruments also warrants attention, although major design changes are unlikely to be feasible in the near term.

Introduction

In 1992, the year before the Declaration of Principles, central administration of the WBGS was in the hands of the Israeli Civil Administration. It reported collecting \$328 million in revenues, spent \$252 million on salaries and other recurrent items, invested \$59 million on public projects (much more than in preceding years when the annual average fluctuated around \$30 million), and employed 18,000 civil servants. The budget was in surplus by \$17 million. In contrast, in 1996 the PA was a much larger concern. It received \$684 million in revenues (more than twice the collection of the Israeli Civil Administration), spent \$779 million on salaries and other recurrent expenditures (more than three times more), and invested \$160 million (almost three times more). Its public employees numbered more than 75,000 by end-1996 (over four times more). A little under half were in the newly created police force, implying that the number of PA civilian employees was more than twice that of the Israeli Civil Administration (Figure 8.1).



Sources: Annex (Table 7).

Two major sources of revenue not previously featured in the central budget enabled this significant expansion to occur so rapidly. First, the erstwhile tax leakage (historically an average of nearly 10 percent of GDP) now accrues to the PA in the form of tax clearances remitted by the Israeli treasury. These amounted to \$420 million in 1996 (61 percent of total revenues). Second,

much larger levels of donor financing have been made available; in 1996 this amounted to \$293 million (the full amount of the 1996 fiscal deficit) of which \$160 went to finance capital expenditure with the remainder being shared between financing current expenditure (\$84 million) and direct employment generation (\$49 million).

This chapter reviews the circumstances under which this huge expansion took place. It examines the fiscal revenue and expenditure structures, considers how revenues can be increased, and explores how the quality of expenditures can be improved. Attention is then focused on the issue of civil service and the sustainability of expenditures at current levels. The chapter closes with a discussion of local government finances.

From Takeover to Maturity

A key feature of fiscal outcomes has been their disproportionate subjection to extraneous factors, though outcomes have also been shaped by the policy stances adopted by the PA. The PA's fiscal operations since inception can be properly interpreted only when set against the evolving and often turbulent Palestinian-Israeli relations with its phased transfer of powers and responsibilities and increasingly frequent border closures. Fiscal outcomes and the prospects for medium-term sustainability of public finances have been substantially influenced by the PA's discretionary actions—in particular, the massive recruitment of public service personnel and its capacity-building in revenue administration and expenditure management.

Transfer of Public Sector Functions under the Agreements. The stepwise increases in the PA's recurrent expenditure and revenue between mid-1994 and late 1995 are largely due to the discrete transfer of responsibility for public service provision and revenue-raising from the Israeli Civil Administration to the PA.

The process of gradual Palestinian empowerment was set in motion by the Declaration of Principles. The first concrete step in this process (pursuant to the Gaza-Jericho Agreement and the adjoining Economic Protocol) was the May 1994 transfer of virtually all functions of government to Palestinian control, including responsibility for public order and internal security (but notably excluding foreign relations and external defense functions) in the Gaza Strip and in the Jericho area of the West Bank. However, the transfer was more limited or, as in the case of Israeli settlements, altogether absent in a substantial area of the Gaza Strip.

When the PA was established, its initial level of monthly recurrent expenditures was around \$10 million, comprising *inter alia* the payroll of the approximately 7,000 Palestinian employees inherited from the Israeli Civil Administration and a 9,000-strong (largely returnee) police force. Under the terms of the Economic Protocol, PA revenue collection was largely confined to the same tax and non-tax instruments previously employed by the Israeli Civil Administration, with little leeway to vary indirect tax rates. Revenue collection proved insufficient to cover expenditures, in part owing to a sharp dip resulting from disorderly transfer of revenue administration. Even by late 1994, domestic revenue collection in the Gaza Strip and Jericho was averaging only about \$3.6 million per month.

A second milestone in the Oslo process, pursuant to the Early Empowerment Agreement, was the PA's December 1994 assumption of jurisdiction over six areas of public service in the West Bank, including health, education, social affairs, tourism, and the administration of direct taxation and VAT (confined for the moment to domestically produced goods and services). The immediate budgetary implication was a jump in PA recurrent expenditures by \$6 million per month, mainly to cover salaries of some 17,000 employees inherited from the Israeli Civil Administration payroll.

At the same time, monthly revenues increased by some \$5.4 million, reflecting a smooth transfer of the tax administration functions, though falling slightly short of Israeli negotiators' stated intent for balancing expenditure transfers with those of added revenue collection instruments. The additional revenue came mainly from the income tax and VAT. Property tax revenues were also transferred, although these continued to be collected by the Israeli Civil Administration for remittance to the Palestinian treasury. With a growing monthly recurrent expenditure level and recovering revenue collection in the Gaza Strip and Jericho, total expenditures and revenues were \$110 million and \$63 million, respectively, for the PA in the first quarter of 1995. Under the Protocol on Further Transfer of Powers and Responsibilities, in August 1995 eight additional public sector functions (commerce and industry, insurance, gas and petroleum, postal services, labor, local government, census and statistics, and agriculture) entailed a further increase in recurrent expenditures and, to a lesser extent, revenues.

The most recent component of the Oslo Accords—the September 1995 Interim Agreement, to which was annexed a slightly revised Economic Protocol—provided for the transfer to the PA of all remaining public sector functions in the West Bank (along the lines of the Gaza-Jericho blueprint), with the exception of those relating to water and sewerage. This transfer was to apply to zone A (major urban areas populated by Palestinians) and zone B (adjoining areas) by the end of 1995, and to zone C (rural and other areas) during the 18 months following the election of the Palestinian Legislative Council in January 1996. (The distinction between zones A and B is that Israel retained functions relating to public order and security in zone B, while these were transferred to the PA in zone A.)

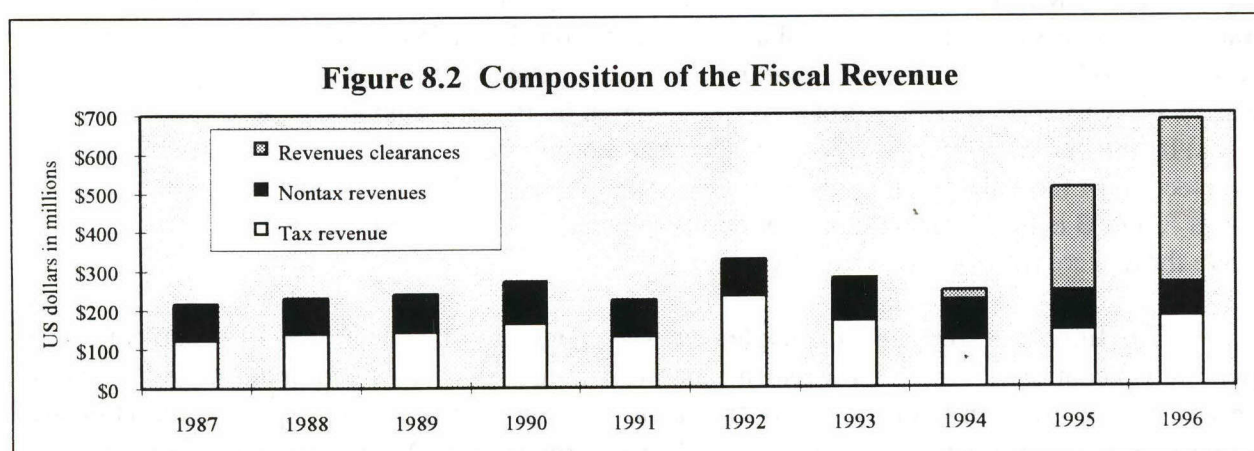
The Interim Agreement was implemented roughly on schedule in late 1995 and early 1996 (with the exception of Hebron, for which separate arrangements remained under negotiation and only came into effect in January 1997). In practice, the jump in recurrent expenditures associated with the transfer of functions in zones A and B under the Interim Agreement was relatively modest. In part, this was because the only major function remaining to be transferred was public order and security in zone A. The PA had geared up for this by recruiting additional personnel for the Palestinian police force in the preceding months. The administration of remaining revenue instruments and entitlement to the revenue collected was also transferred, and provisions for the clearance of revenue from customs duties, excise taxes, and VAT on West Bank imports went into effect. Initially, these transfers yielded an average of some \$3 million in additional “domestic” revenue and \$4 million in revenue from clearances per month.

Extraneous influences notwithstanding, revenue and expenditure trends have also been significantly shaped by the PA's fiscal policy stances as well as by institution-building efforts to

strengthen revenue administration and expenditure management. For an itemized breakdown of the PA's fiscal operations, see Tables 7 and 8 in the Annex.

Fiscal Revenues

Capacity-building efforts in revenue administration and expenditure management (and in a few cases, slow progress therein) have helped to shape revenue and expenditure trends. Despite grave problems in revenue collection during the first few months of self-government in the Gaza Strip and Jericho, it is generally acknowledged that by late 1995 revenue administration was on sound footing, with progress in capacity-building reflected in consistently higher-than-projected revenue collection by the PA. The good revenue performance can be ascribed to both the domestic tax collection effort and the revenue clearance mechanism provided for under the Economic Protocol with Israel. Of course, tax collection ratios, which stood at a respectable 21 percent of GDP on an annualized basis in late 1996, can probably still be improved upon, *e.g.*, through more comprehensive audit and enforcement activities. In 1996, tax revenues collected in the WBGS by the PA were as high as what was collected by the Israeli Civil Administration in 1993, at about \$170 million (Figure 8.2). While this implies that the revenue collection effort is satisfactory, it also suggests potential for further increases through strengthened administration, given that the PA has political legitimacy which its predecessor lacked. However, major increases in revenue should probably not be expected. An exception arguably arises in connection with trade-related taxes, as discussed below, but this is due more to the design of the system than its administration.



Sources: IMF/IBRD Joint Mission (1995), World Bank (1996b).

In particular, there has been significant progress in the organization, staffing, and equipping of revenue administration departments; coordination and negotiation with the Israeli authorities on issues relating to the transfer of taxpayer information and revenue clearances, resolving outstanding arrears, credits, and enforcement issues; and on some measures to strengthen customs administration and enforcement. Of course, several issues remain unresolved or under implementation, such as the development of formal work rules and instructions for revenue administration staff, reconnection of the Gaza Strip's revenue administration facilities to the Israeli Civil Administration's computerized former taxpayer records, and strengthening the management of customs administration.

Budgetary Transparency. Certain revenue sources accruing to the PA are not subject to regular budgetary controls of the Ministry of Finance, prompting questions about the disposition of the funds. For example, transfers of petroleum excise revenue from Israel under the clearance mechanism and some domestically collected excise revenue have taken place through channels not directly controlled by the Ministry of Finance. Similarly, profits from quasi-private monopolies that distribute several key commodities in the Gaza Strip (*i.e.*, petroleum products and cement) accrue at least in part to the PA. However, no such receipts are recorded in the budgetary accounts, and their disposition is likewise not publicly disclosed. Promisingly, in response to concerns expressed by several donors at the December 1996 Ad Hoc Liaison Committee meeting, the PA undertook to consolidate all revenue accounts under the control of the Ministry of Finance by March 1997, to audit dividend income accruing to the PA from “commercial” operations, and to discontinue the PA’s participation in such operations by end-1998.

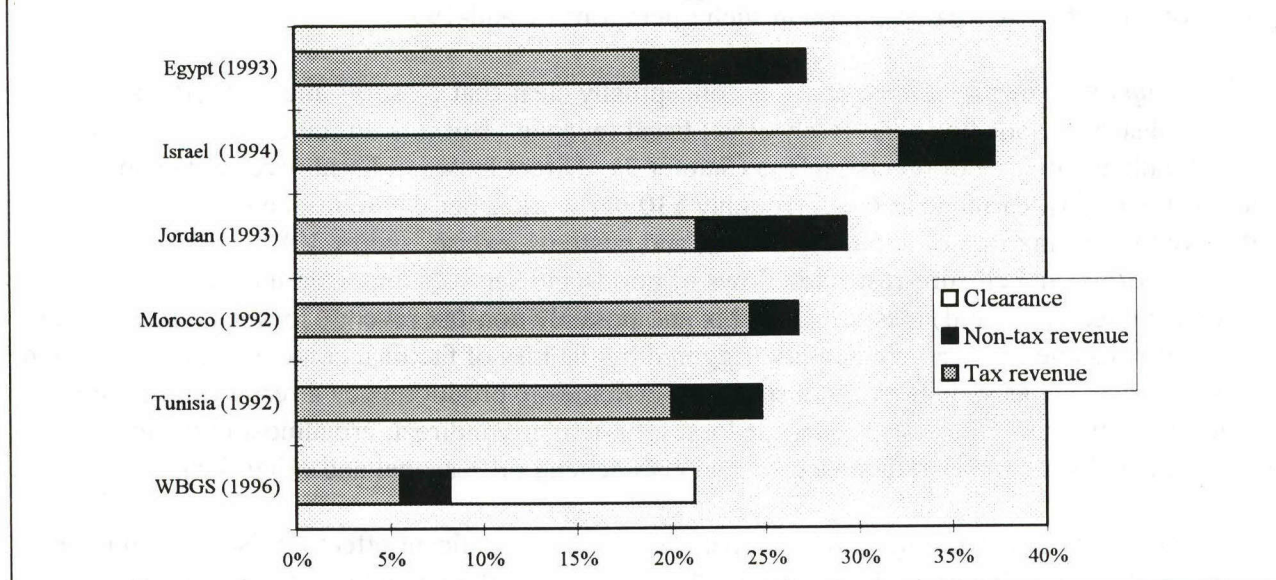
Impact of Border Closures. It is conceptually clear that closures and restrictions on merchandise and labor flows adversely affect fiscal revenue. But it is difficult to estimate the impact with any degree of precision (see Chapter 3). Direct losses in fiscal revenue include income tax on lost earnings in Israel (roughly \$30 per worker per day multiplied by the marginal effective income tax rate of about 7 percent); and customs, excise, and/or VAT on the difference between normal and closure-restricted flows of goods and services imported into the WBGS. 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, as well as by the disruptions in domestic production as a result of interruptions in intermediate import supplies. Revenue losses, particularly indirect, are almost certainly characterized by a complex lag structure, and also depend on seasonal and other factors.

It is clear that prolonged closure spells have had a significant effect on fiscal revenue. For example, revenue in the second quarter of 1996, which bore the impact of a long and severe period of closure beginning in late February, was about 7 percent below first-quarter revenue. As one would expect, the bulk of the reduction was in clearance transfers generated on factor service and merchandise trade with Israel, with the largest fall occurring in health fees, income taxes, and VAT. While significant, the decline in second-quarter revenue is relatively modest compared with estimates of the fall in output and income during the closure period. At first blush this may appear to be due to the consumption-based nature of the bulk of taxes collected (coupled with a tendency for consumption-smoothing to occur in the face of output and income fluctuations). But on closer inspection, the mitigation in tax revenue decline can be attributed partly to the revenue administration capacity-building efforts that were being implemented in early 1996. Such efforts include the introduction of tax enforcement measures, the establishment of large taxpayer units, and the implementation of issue-oriented auditing.

Revenue Collection and Financing Potential. Against this backdrop, total revenue stood at about one-fifth of GDP on an annualized basis as of late 1996. Projections for 1997 are at roughly the same ratio. As shown in Figure 8.3, which presents a regional comparison of fiscal revenue by category as a percentage of GDP, this ratio is already a respectable one by developing country standards. However, it can probably be improved upon at the margin through further improvements in revenue collection efficiency. For example, while comparable in absolute size to

the revenues collected under Israeli control, “domestic” revenue collection in 1996 was below the Israeli Civil Administration’s collection ratios in early 1990s. Given the PA’s political legitimacy, there should be scope to spread the tax net through more comprehensive tax collection enforcement as well as by means of a public awareness campaign that educates potential taxpayers on the link between the provision of public services and revenue collection. However, aside from possible improvements in revenue collection at the margin, truly major increases in revenue over the next few years are unlikely, barring significant changes in the design of the tax system and other revenue collection instruments, or in presently applicable revenue-sharing formulae.

Figure 8.3 Fiscal Revenue by Category and as Percentage of GDP



Sources: Government Finance Statistics Yearbook (1995).

Any such changes would, of course, be predicated on re-negotiating parts of the Economic Protocol with Israel. In the event that such re-negotiation proves politically feasible, at least two areas would merit attention. The first is the revenue-sharing formula for customs duties on imports in the prevailing quasi-customs union with Israel. The present formula, 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 the WBGS. Palestinian officials frequently bemoan the significant leakage which occurs in practice when administering this formula, *i.e.*, the shortfall in revenue accruing to the PA vis-à-vis what ought to accrue to it under the destination principle. The leakage is reportedly due to the high proportion of indirect imports (*i.e.*, 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 PA recent attempted to capture a larger share of customs revenue by requiring that certain goods offered for sale in the Palestinian market be imported through licensed agents—to ensure that the imports are recorded as direct. Although these efforts have met with some success, it is argued that the customs revenue yield could be increased by several percentage points of GDP if the present revenue-sharing formula were abandoned in favor of a presumptive formula based on estimates of the

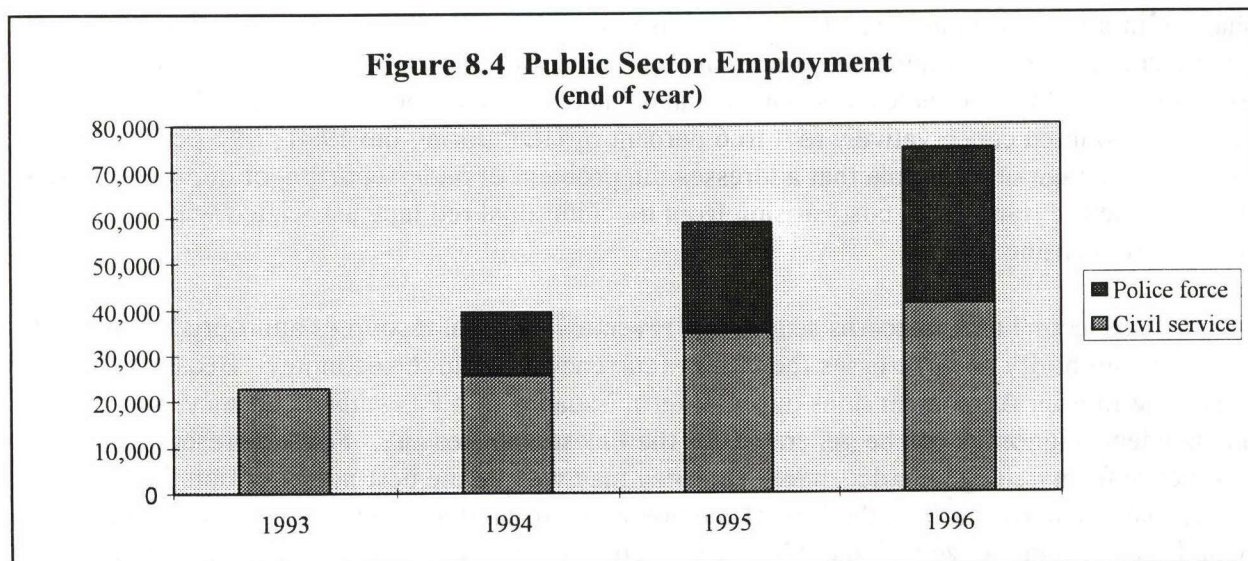
share of imports into Israel intended for final use in the WBGS. Using a presumptive macroeconomic-level formula based on that used in the Southern Africa Customs Union to estimate potential customs revenue for the Palestinian treasury, one study argues that the annual leakage amounted conservatively to 4 to 6 percent of GDP during the 1994-1996 period. A further advantage of a formula that addresses the problem of underreporting of imports is that it would avoid the transaction costs arising from the additional red tape associated with broadening the import licensing system.

The second area concerns seignorage revenue—the real resources appropriated by a governing authority as it increases the money (currency) base in the economy. Because the prevailing Interim Agreement rules out near-term issuance of a Palestinian currency, no independent seignorage can be generated for the Palestinian treasury. For the present, continued abstinence from issuing an independent currency may well be the best policy option for Palestinian policy makers, particularly in the face of the prevailing fiscal duress and the temptation that this would create to monetize deficits. However, there is no provision for allotting a share of the seignorage collected by Israel to the Palestinian treasury under the present currency union arrangement. As a point of interest, it has been estimated that a defensible formula for sharing seignorage on the shekel might yield between 0.2 and 5 percent of GDP annually in additional revenue to the PA.

Expenditure

Several administrative decisions have raised budgetary expenditures in recent months, but none as much as the continuing public sector employee recruitment. The creation of two new ministries in mid-year 1996—the Ministry of Supply and the Ministry of Higher Education—entailed start-up and additional operating costs, as did the start of Legislative Council operations early in the year. The longer-term implications for the budget of these administrative changes remains uncertain. For example, it is unclear whether or not the creation of the Ministry of Higher Education will eventually lead to the incorporation of university budgets into the central budget.

Wage Expenditures. Within the rubric of recurrent expenditures, wage expenditures have grown particularly rapidly. At year end-1996, the number of public sector employees at the central level (*i.e.*, excluding employment by municipalities and village councils, and those hired directly under donor-funded job creation programs) stood at 75,047, a 28-percent increase since the beginning of January 1996 (Figure 8.4). Of the end-1996 figure, 41,020 individuals were employed in the civil service (mainly in education and health), and 34,027 were in the various branches of the Palestinian security services. At about 13.5 percent of the labor force (11 percent for the West Bank and 19 percent for Gaza Strip), the relative size of public sector employment at the central level is significant even by regional standards (Box 8.1). As of late 1996, the wage bill (on an annualized basis) was over \$400 million, or some 12 percent of GDP. Moreover, the projected recurrent expenditure level at \$866 million in 1997 (some 57 percent of which consists of wage payments at a total of \$495 million) assumes added recruitment of 6,700 employees (3,700 in the civil service and 3,000 in the security services), suggesting further increases in public sector employment ratios ahead.



Source: World Bank (1996b).

Clearly, part of the increase in the number of public sector employees stems from the context of phased transfer of public sector functions and the associated bequest of personnel previously employed by the Israeli Civil Administration. A strong case can also be made for some new recruitment (on top of employees inherited from the Israeli Civil Administration) in order to (i) provide for enhanced delivery of public services that were widely perceived to have been sub-standard under occupation; (ii) staff senior ranks of the civil service, which under the Israeli Civil Administration had been confined to Israelis; and (iii) fulfill functions (mainly those relating to public order and security) for which no ready-made apparatus was bequeathed by the Israeli Civil Administration. In addition, the *de facto* restrictions on mobility between the West Bank and the Gaza Strip for all but the most senior officials makes some duplication of employee functions, and thus staffing ratios, inevitable.

Nevertheless, there is growing concern that the extra recruitment has by now brought public sector employment (at least in terms of the aggregate number of employees) to a level that should amply fulfill public sector functions under a market economy blueprint. A related issue concerns the incentive structure for the civil service, which at present is not geared toward ensuring optimum performance among staff. There is a serious risk that continued recruitment at the same pace as in the recent past will threaten medium-term fiscal stability and/or compromise the PA's ability to provide for adequate O&M allocations and thus service provision.

Public Sector Organization. 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. There are several functions for which the mandate has been spread across more than one ministry or agency. These include economy-wide development strategy formulation and public investment planning, coordination and monitoring of donor assistance flows, environmental monitoring and regulation, overall coordination and regulation of NGO activities, and overseeing the implementation of civil works in public works projects. Although the issue of the overlapping functions is currently being addressed, substantial efficiency gains and

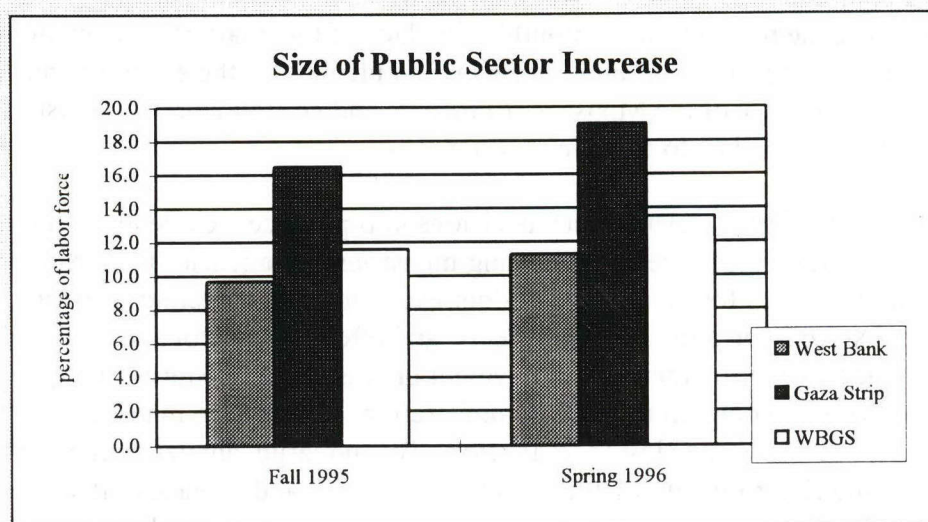
Box 8.1 Rapid Expansion in Public Sector Employment, 1994-1996

The public sector has grown rapidly in the wake of the progressive transfer of authority to the PA. Public sector growth since mid-1994 has taken place in several stages. Part of its structure and staff were initially inherited from Israeli Civil Administration, notably in the areas of education, health, and social welfare. But the erstwhile under-provision of public services necessitated a substantial increase in the size of the civil service. The PA's newly acquired security responsibilities required the introduction and subsequent expansion of the Palestinian police force.

Public sector employment grew from 35,000 employees (including 12,000 police staff) in October 1994 to over 49,000 (including 19,000 police staff) in October 1995. Extension of the PA's authority in fall 1995 resulted in additional increases in subsequent months. By January 1996, government employment stood at 59,000, and increased further to about 75,000 by the end of 1996. While a substantial fraction of the increased public employment is accounted for by returning cadres of the PLO, the increase has also helped provide employment opportunities for WBGS residents.

The PCBS labor force surveys provide an independent assessment of the relative size and recent evolution of public sector employment, as depicted below. Public sector employment stood at 13.5 percent of the total labor force in April-May 1996, an increase of 1.9 percent of the labor force from seven months earlier. Public sector employment is more significant in the Gaza Strip, standing at 19 percent of total labor force and 30 percent of the employment. In the West Bank, it amounts to 11 percent of the total labor force and 15 percent of employment in April-May 1996. This is roughly double the size of the public sector in October 1994.

A substantial fraction of the increase is clearly defensible given the numerous responsibilities acquired by the PA, the undersized public sector inherited from the Israeli authorities, and the restrictions on mobility between the West Bank and the Gaza Strip for most PA staff. But substantial additional increases are difficult to sustain, given the budgetary pressures on the PA. Any further public sector expansion as a way of addressing labor market pressures would be ineffectual in reducing unemployment and counter-productive to private sector job creation. Even if the public sector continued to expand at the same rapid pace, such expansion would be insufficient even to absorb new entrants into the labor force, estimated at some 30,000 persons each year.



Source: World Bank.

greater cost-effectiveness could be achieved through clearer distinction among the mandates of the various ministries and agencies.

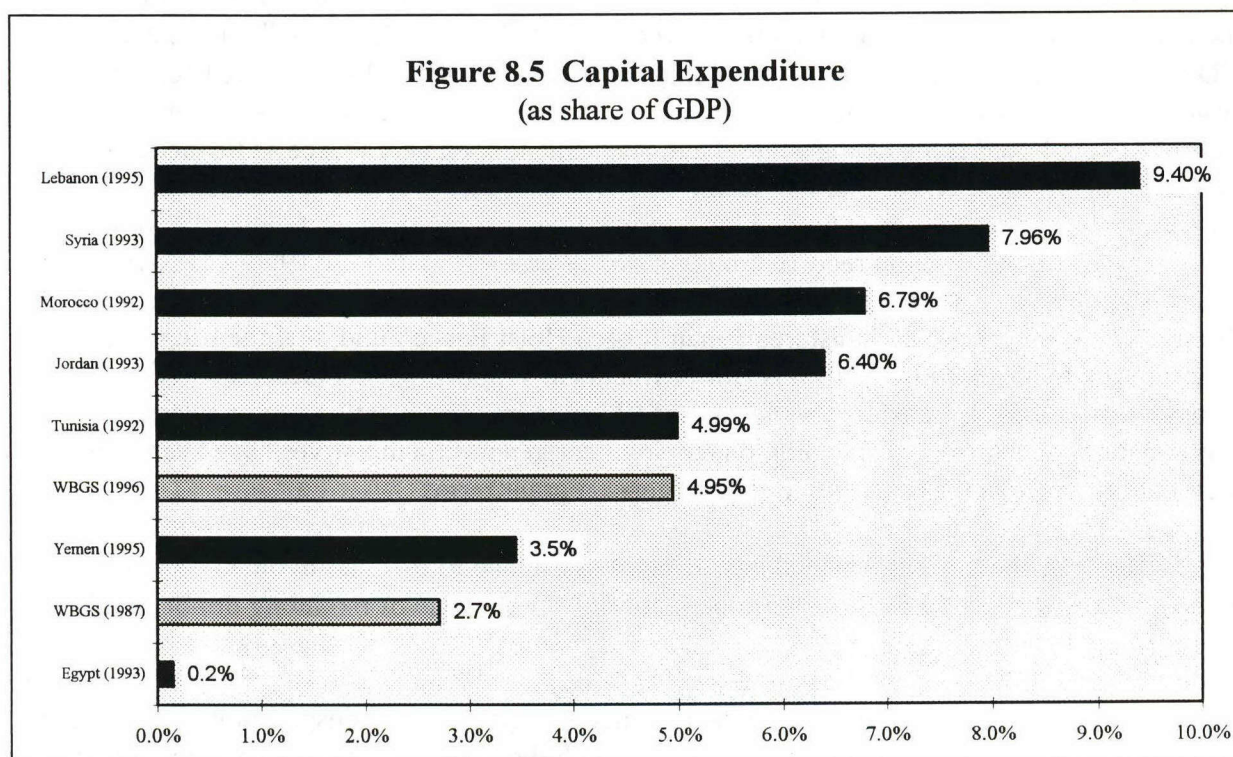
Expenditures and Border Closures. Public expenditure has also been affected by periods of closure. During and after the prolonged closure that began in February 1996, the PA spent almost \$25 million on employment generation initiatives through the end of the year. These were entirely financed by donor grant funds through the World Bank-administered Johan Jorgen Holst Peace Fund and were not strictly on-budget—the bulk of job creation expenditures were undertaken by the Palestinian Economic Council for Development and Reconstruction (PECDAR), whose expenditure, while consolidated with general budget expenditures *ex post* in Ministry of Finance reports, is not subject to budgetary procedures under Ministry of Finance oversight in the same way that line ministries are. However, job creation programs clearly entailed public expenditure of a relief nature. Expenditure on job creation projects by UNRWA and the United Nations Development Programme (UNDP), as well as by bilateral donors, was also significant (about \$24 million over the year). Again, however, these expenditures were not strictly on-budget in the sense of having been subject to regular budgetary procedures under Ministry of Finance oversight. In addition, at the height of the March 1996 closure, the PA spent more than \$5 million to secure supplies of staple foods and to alleviate hardship among needy households.

Public Investment. Over the period 1993-1996, public investment has hovered at about 5 percent of GDP in the WBGS, a relatively modest sum by regional standards (Figure 8.5). Of total public investment, substantially less than half, or no more than \$50-60 million (1.5-2 percent of GDP) was invested in new major infrastructure projects. The remainder went toward rehabilitation, upgrading, or extension of existing infrastructure (see Chapter 13).

Expenditure Management. 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 the installation of a computerized Government Financial Management Information System (now underway), initiating the preparation of monthly (in place of the quarterly) expenditure reports of the PA's ministries and agencies; 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.

The tools needed to translate policy decisions into practice include an effective budgeting process (with appropriate incentives for spending ministries and agencies to remain within budgetary ceilings), devices for monitoring budget execution and detecting overruns, an efficient cash management system for processing payments, and effective control and auditing mechanisms to foster compliance with procurement and payment processing procedures. Despite the substantial progress in building up revenue administration, expenditure management capacity in the Ministry of Finance has been slower to develop. By and large, annual budgeting has until recently been viewed as a formality by the spending ministries and agencies. It was not until June 1996 that a formal circular was issued to signal the start of the annual budget cycle (for 1997) and to give directives for the exercise. (Although PA-wide budgets for 1994-96 were produced by

the Ministry of Finance and notionally allocated among the PA's various ministries and agencies, it is doubtful whether individual ministries' plans were tightly geared to abide by any well-defined expenditure ceilings.) Even the budgeting exercise for 1997 remains confined largely to ministries' and agencies' recurrent budgets. While a public investment program for 1997 was prepared in fall 1996 for presentation to the donor community (on funding from whom virtually all public investment continues to rely), preparation of the program was not mirrored by a formal capital budgeting process by the prospective implementing agencies under the direction of the Ministry of Finance. Progressive integration of public investment plans with a formal capital budgeting process is being targeted in 1998 and subsequent years.



Sources: Government Finance Statistics Yearbook (1995), ICBS data, and World Bank estimates.

Auditing and control mechanisms are likewise in the process of being strengthened. The Auditor-General's Department, established by presidential decree in 1994, has the mandate to monitor the use of public funds in order to ensure adherence to proper standards of accountability. Its first formal report, dated May 23, 1997, provided an overview of the limited auditing and control work for varying periods since the establishment of the department, confined mainly to the Gaza Strip branches of most PA ministries and a fraction of the large number of other public institutions, municipalities, village councils, and public associations within the department's audit responsibility, also mainly in the Gaza Strip. While the report has not been publicly released, there has been substantial media reporting to the effect that more than \$300 million has been subject to mismanagement or misuse. The limited scope of coverage of the report was criticized and its methodology of estimating this money has been disputed by some PA officials—who argued that much of this money represents lost opportunities for generating revenues or reducing expenditures. Yet, the findings of the report have been taken seriously by the PA as a whole. A national independent committee was appointed to investigate the content of

the Auditor-General's report. The committee submitted its internal findings to the President of the PA in July 1997. In addition, the Legislative Council carried its own oversight of the operations of the PA and released its critical report in August 1997. The sequence of financial control and investigative work illustrates a widespread recognition within the PA of the importance of accountability in the management and disposition of public funds, and of strengthening mechanisms of financial control.

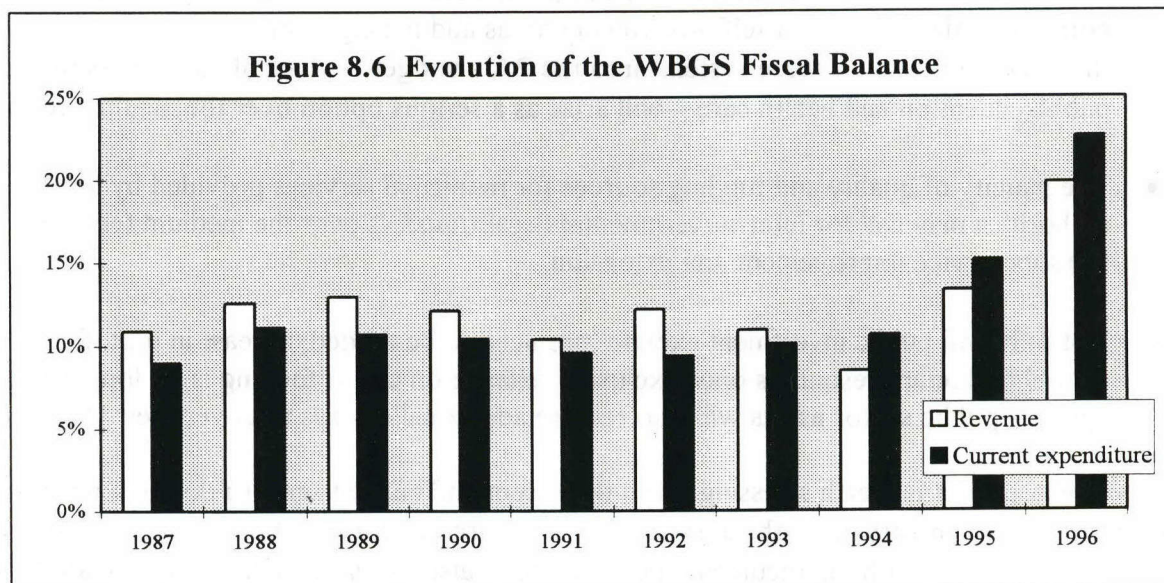
Deficit

The non-negligible recurrent budget deficits that have characterized fiscal outcomes since the PA's inception—about \$65 million (2 percent of GDP) in 1994, \$67 million (2 percent of GDP) in 1995, and an estimated \$95 million (3 percent of GDP) in 1996—have been financed largely by grant assistance from donor countries. Domestic commercial bank overdrafts (chiefly from the Gaza-based Bank of Palestine) have also been tapped as a source of financing and especially of liquidity. Over one-half of the 1994 recurrent deficit, and approximately twice the full 1995 recurrent deficit, was funded by external donors through grant funding. Likewise, almost the entire \$95-million recurrent budget deficit now estimated for 1996 was covered by donor grant funding. Over half of the total 1994-96 recurrent cost funding was made available through the World Bank-administered Johan Jorgen Holst Peace Fund, and the balance through a mechanism administered by UNRWA (for payments in support of the Palestinian police force), or through bilateral bank transfers (in the case of EU support for education sector salaries). Investment expenditure and spending on employment generation initiatives have been funded in their entirety by donor assistance, to date largely on grant terms.

Happily, the bountiful availability of grant assistance to date has avoided—or at least deferred—any threat of a medium-term debt burden. In the face of mounting donor fatigue vis-à-vis recurrent cost funding, however, it is unclear how much, if any, further grant assistance will be made available for this purpose. At the same time, donor willingness to support the PA's budget appears responsive to adverse political developments. For example, despite mounting fatigue over the preceding months and growing concern with the opacity of certain off-budget operations, many donors proved willing to put their reservations aside and mobilize a total of \$35-\$40 million in additional recurrent budget and employment creation support in the month following the outbreak of Palestinian-Israeli clashes in late September 1996.

Notwithstanding the difficulties associated with forming reliable point-estimates of “steady-state” revenue and expenditure levels, a central question concerns whether expenditures may be close to—or, indeed, may already exceed—their maximum “sustainable” level. As of late 1996, monthly recurrent expenditures alone stood at about \$67 million (on an annualized basis, close to one-quarter of GDP) (Figure 8.6), already an above-average ratio in relation to many comparable countries. For 1997, the Ministry of Finance (with IMF assistance) projects a recurrent (both wage and non-wage) expenditure level of \$866 million, again roughly one-quarter of projected GDP. The projected revenue (\$814 million) and deficit (\$52 million) figures hinge on the assumptions of average Palestinian employment in Israel of 35,000 individuals and of real GDP growth of some 5.5 percent during 1997. These assumptions are reasonable as a baseline (and the actual outturn on employment flows in Israel has compared favorably with them), although past experience suggests that they are subject to considerable downside risk. As of end-

May 1997, budgetary outcomes were still pointing to a small surplus in budgetary operations, mainly because expenditures had been held in check during the first quarter of the year pending approval of the 1997 budget by the Legislative Council. However, the expected trend over the remainder of the year is one of emerging deficit.



Note: Certain revenue accruing to the PA following the 1994 Economic Protocol were not counted as revenue prior to 1994.
Sources: Annex (Table 7) and World Bank 1994-96 GDP estimates.

Against a backdrop of modest near-term prospects for increasing revenue, demands on expenditure are likely to continue to grow. Unchecked expenditure growth would, however, risk generating large public sector deficits and crowding out potential private investment. In addition, once the present grant and concessional funding from donor sources dwindles, it may simply not be feasible to finance sizable public sector deficits without threatening macroeconomic stability. 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 forces a reliance on substantial additional borrowing from the domestic banking system and a further build-up of payments arrears.

The risk of closure-induced shocks to revenue and, to a lesser extent, expenditure appears more significant. In January 1997, the Hebron Protocol paved the way for deployment of Palestinian security forces in much of the city. The only transfers of public sector functions to the PA yet to occur during the Interim Agreement period are in zones B and C of the West Bank. It is reasonable to assume that the recurrent expenditure increases associated with these remaining transfers will be minor. Zone C is sparsely populated, and the PA's structures—particularly its security forces—have been gearing up for some time to take on a widening of their areas of jurisdiction.

Fiscal Fragility. Expenditure and revenue directly attributable to further transfers of public sector functions are likely to be minor over the remainder of the period covered by the Interim Agreement. However, concerns about the sustainability of fiscal operations arise from the fact that not all potential public expenditure needs are fully provided for in the PA's ongoing or

planned spending patterns. As a result, it would be unrealistic to expect that future growth in expenditure can be kept in line with real income growth. At least three factors can be cited where costly public sector intervention may be required at some time in the future.

- UNRWA runs parallel systems of education and health care for the refugee population both inside the Palestinian self-government areas and in neighboring countries. Integrating the operating costs of these systems into the PA's budget—which already bears the cost of public education and health care—will arise as a serious option over the medium term.
- 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.
- Not only will public investment expenditure need to be funded, at least in part, from central budgetary resources once exclusive reliance on donor funding is no longer feasible, but new public sector assets will also require additional outlays to cover their O&M costs.

The last point is worth stressing given the recent and current scale of donor support for public investment. In particular, the absence of a structured investment budgeting exercise—one that is fully integrated with the recurrent budget cycle—raises a serious risk of inadequate planning and provision for the future O&M requirements. Global experience indicates that in cases where public investment expenditure is improperly integrated into the recurrent budgeting exercise (as is often the case when public investment programs are donor-driven), the result is often a build-up of the public sector's capital stock to levels beyond what can be sustainably operated and maintained in the medium term. In the WBGS, the disconnect between recurrent and capital budgeting has probably fostered only modest bias to date, given that much public investment has been concentrated on rehabilitating and upgrading existing infrastructure (which, significantly, was in a deteriorated state due to inadequate O&M in the past). However, the need for integrated recurrent and capital budgeting is acquiring greater cogency as the focus of public investment activity shifts increasingly from rehabilitation to construction of new infrastructure.

Local Government

Traditionally, local government entities in the WBGS (which comprise 28 municipalities, 82 village councils, and 347 villages headed by a *Mukhtar*) have varied considerably in terms of service provision and revenue-raising capability. As a rule, however, their consolidated deficits have not been significant. Municipalities serve the urban population, which comprises roughly two-thirds of the total WBGS population. Municipalities provide services such as local roads, street lighting, pest control, public libraries, fire protection, solid waste collection, and in many cases water, sewerage, and electricity services. Revenue sources include the property tax (collected at the central level and remitted to municipalities); fees on construction and other activities, and in many cases rental income on municipal properties; sewerage connection charges; and water and electricity tariffs. Any capital (or “development”) expenditures undertaken by municipalities traditionally had to be covered by a recurrent budget surplus or by donor assistance, either directly or (since 1994 only) through a central-level intermediary such as

PECDAR. Prior to the PA's assumption of central-level governing powers, but not since, capital transfers from the central level (*i.e.*, the Israeli Civil Administration) were funded by a surplus in recurrent budget operations at that level.

For illustrative purposes, in 1993 a sample of six municipalities (Ramallah, Hebron, Jericho, Nablus, Gaza, and Khan Younis), which account for roughly half of the urban population covered by municipalities in the WBGS, posted revenues totaling some 2.5 percent of GDP. Their recurrent expenditures amounted to some 2.1 percent of GDP, but almost three-quarters of this amount represented payments to Israeli bulk suppliers of electricity and water. Thus, what is in effect a retailing function inflates the true expenditure (and service provision) picture. Development expenditures amounted to less than one-third of one percent of GDP.

Inter-governmental Fiscal Relations. An essential building block of sound medium-term fiscal management is a framework ensuring fiscal discipline among local government entities, including a clear set of rules covering fiscal relations between the central and local government entities. In choosing which level of government (central, regional, or local, for example) to deliver a given public good or service, key considerations include lowering enforcement costs, improving service provision, and encouraging institutional-learning and demand management. The classic argument in favor of decentralized provision of certain public services at the local government level is that such provision offers potential for better accountability and responsiveness to beneficiaries. Typically, functions that are decentralized to municipal government include local road construction and maintenance, local police, fire protection, primary and secondary education, street lighting and cleaning, water supply and sanitation, trash collection and disposal (landfills), and land use and zoning. Municipal governments also typically set broad standards to determine land use patterns in urban areas, *e.g.*, green space, water courses, public transport networks, commercial areas, and industrial and residential areas (including the distances between them, factoring in buffers for noise and view). The common trait of such services is that their benefits—in contrast to those of such services as national defense—are largely captured by the immediate community.

Successful delivery of high-quality services by local government entities hinges on the capacity to raise resources to fund them, as well as on local institutional capacity and discretion. Funding mechanisms for the services provided by local governments include user fees and charges (where beneficiaries can be identified and there are no significant externalities associated with the service in question), taxes on local residents, and transfer payments from the central level of government. Unlike the tradition in the WBGS, revenue-generating utilities are typically managed by an autonomous authority to separate commercial service provision from political influences. Providers of utility services (not municipal governments in the WBGS) typically collect the utility charges.

The conceptualization, design, and implementation of a framework for sound inter-governmental fiscal relations and municipal finance, which was initiated shortly after the start of self-government in the WBGS, now needs to be accelerated. The first key component of the framework is to articulate the service provision responsibilities of local governments as part of an overall blueprint of the public sector's role vis-à-vis the private and NGO sectors. Another is to empower local governments to provide quality services by reviewing and codifying their revenue

entitlements (possibly including transfers from the central level of government), and by developing their capacity for economic and financial management as well as the capacity of the central-level supervisory structure (the Ministry of Local Government). Many elements of this framework are already well underway, including the drafting of a new Local Government Law and a pilot capacity-building initiative for certain municipalities.

* * *

The desirability of limiting public sector deficits militates strongly in favor of curbing any further growth in recurrent expenditures and identifying cost savings through expenditure rationalization where possible. As a first step, it is important for policy makers to articulate the range of services to be provided and paid by government, as well as the split of responsibilities for service provision between its central and local levels, under prevailing financial constraints, based on a detailed underlying blueprint of the role of the state. Once the extent of government's responsibilities for service provision have been clearly spelled out, optimal organizational designs and staffing levels and profiles for government structures become easier to specify. Second, civil service personnel management policy, in particular, warrants a careful examination. Third, an essential building block of sound medium-term fiscal management is a framework ensuring fiscal discipline among local government entities, including a clear set of rules covering fiscal relations between the central and local government entities. Finally, among the most important—but frequently overlooked—requirements for effective expenditure management are the tools to translate policy decisions into practice. Such tools include an effective budgeting process (with appropriate incentives embedded therein 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, much still remains to be done in this area.

Bibliographical Note: The chapter's data is based on documents from the Palestinian Ministry of Finance publications as well as IMF and World Bank reports (see bibliography for detailed references). Information and recommendations on the revenue system are mainly drawn from the work of Abed and Tazi (1994, 1995, 1996). On revenue, the chapter is partly based on Naqib (1996). On the prevailing revenue-sharing formula for customs, see Jawhary (1995). On potential seignorage revenue from shekel circulation, see Hamed and Shaban (1993), and Arnon (1996). On public sector employment, see World Bank (1996b).

Chapter 9

Shocks and Stabilization

The WBGS economy is highly vulnerable to external shocks, many of which have caused large aggregate fluctuations. Important sources of shocks are border closures, changes in external demand for Palestinian labor, and unexpected changes in Jordanian and Israeli monetary policies. A permanent political settlement could result in a significant decrease in the vulnerability to closure-related shocks by ensuring the WBGS with direct access to international markets. Such settlement could also reduce WBGS's vulnerability to monetary shocks by enabling it to issue its own currency or enter into a monetary union with a neighboring country or countries. In the meantime, some reduction in vulnerability to closure can be achieved by setting up built-in stabilizers, such as an export insurance program, an unemployment insurance program for Palestinian workers in Israel, and employment generation schemes. Similarly, the disruptive effects of monetary shocks can be minimized by maintaining the circulation of multiple currencies and by varying the portion of required reserves placed by the PMA with the domestic banking system.

Introduction

The volatility of macroeconomic indicators of the WBGS economy has been substantial, even in comparison to other small open economies. To what extent can Palestinian policy makers stabilize the economy from the impact of shocks? Given its enormous exposure to external shocks, it will be difficult to stabilize the impact of numerous shocks under all circumstances, especially if integration in the regional and international labor and trade markets continues to be a key characteristic of the economy. Even if the Palestinians had full state powers over economic matters and borders, it would be difficult to stabilize the impact of fluctuations of remittances from expatriate Palestinians.

However, coping with the shocks would be substantially improved in the post-transition period, if the PA could issue its own currency and control access of people and goods to the outside world. The vulnerability of the economy to closures and monetary policy shocks could decrease significantly after a permanent political settlement is reached. Closure-related shocks could become less severe if the settlement gives the Palestinians control over their borders, allowing them direct access to international markets.

Given the PA's limited power over stabilization tools, the potential for reducing fluctuations in the interim period is quite limited. However, some improvement can be made. This chapter first documents the economy's vulnerability to external shocks. It then explores built-in stabilizers to improve the economy's adjustment to border closures, *i.e.*, export insurance, unemployment insurance for workers in Israel, and employment generation schemes. The next section turns to examining mechanisms of monetary stabilization—in the short-run without currency and in the long-run when the PA can issue its own currency. While it is unrealistic to expect policy makers to be able to smooth shocks of the magnitude that have hit the Palestinian

economy in recent years, the policies recommended here could mitigate the wide fluctuations that currently characterize the economic aggregates in the WBGS.

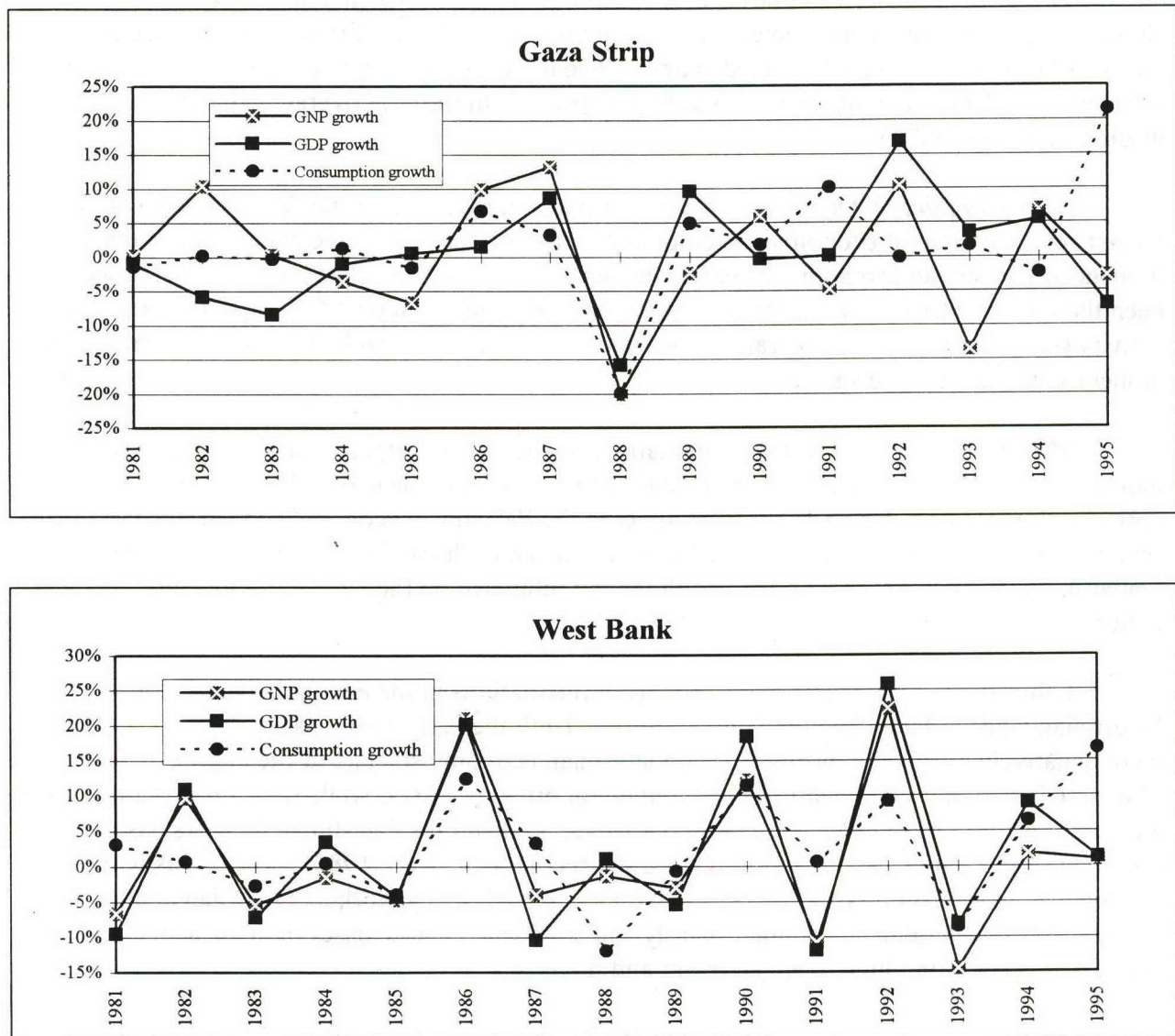
Vulnerability to Shocks

Aggregate indicators of overall economic activity exhibit substantial annual fluctuations (Figure 9.1). This trend is primarily an outcome of three factors: (i) the economy's exposure to risk is substantial, more than most small open economies; (ii) shocks over the past three decades have significantly influenced the shape of its economic development; and (iii) the economy lacks effective built-in stabilization instruments. While the scope of discretionary policy-making has improved with the transfer of many authorities and responsibilities, the challenge of stabilization is substantial in comparison to the actual and potential instruments available to the PA.

Enormous Exposure to External Risk. The WBGS is highly vulnerable to external shocks. Even by the standards of small open economies, the exposure of the Palestinian economy to external shocks is very large relative to the economy's size. This arises from skewed development and the asymmetric relations with Israel, which have made the WBGS economy primarily an exporter of labor and importer of consumer goods from or through Israel. The economy's excessive exposure to shocks stems from the following factors.

- The export of labor is large relative to the size of labor force. By the early 1990s about half of the potential labor force was employed either in Israel or abroad in Jordan and Middle Eastern oil-exporting countries.
- As a result of labor export, remittances are quite large relative to total income, making the gap between GDP and GNP very large even by the standards of major labor-exporting economies. The ratio of GDP to GNP ranged between 74 to 84 percent during the 1980-1993 period (see Table 1 in Annex). The GDP/GNP ratio rarely falls below 90 percent for other labor-exporting economies.
- The size of external trade is large. The ratio of imports to GDP ranged between 56 and 72 percent during the period 1980-1987. The reliance of the Gaza Strip on imports is much higher, as its imports/GDP ratio ranged between 82 and 96 percent during the 1980-1987 period.
- The Palestinian economy does not have its own currency, and the exchange rates of the Jordanian and Israeli currencies—used by the Palestinians—have been subject to wide fluctuations due to macroeconomic instability in the respective countries.
- The two-year cycle of the olive crop, which represents a significant fraction of the West Bank's GDP, leads to substantial fluctuations in production and income.

Figure 9.1 Per Capita GNP, GDP and Consumption Growth Rates



Note: 1995 data is a World Bank estimate.
Source: Data from ICBS and PCBS.

- Palestinian policy makers do not have control over the movement of people and goods into, out of, and between the areas under PA control.
- The unresolved final status of the WBGS has increased the uncertainty as well as sources for potential shocks in the interim period.
- Policy-making can be a potential source of shocks until some credibility is established over the government's philosophy toward the role of markets. Will the PA support the operation of free competitive markets, as its declarations assert, or will the PA move to nurture state-owned enterprises and monopolies that deliver private goods and services?

These sources of shocks have to be taken into account over and above other standard shocks facing small open economies, *i.e.*, fluctuations in the terms of trade, internal changes in tastes or behavior, or weather-related shocks. The impact of the numerous shocks that have affected the WBGS economy is reflected in the large fluctuations in overall economic activity, as illustrated in Figure 9.1.

Harsh Impact of Shocks. Beyond their sheer number, these shocks have had a large impact on the course of economic development. Box 9.1 catalogues the major shocks that have influenced Palestinian economic development since the mid-1970s. The most disruptive shock has been the total border closure of the mid-1990s, which affects practically all aspects of economic activity (see Chapter 3). In general, various shocks can be classified by their sectoral impact as monetary, labor, or trade shocks.

Monetary shocks result from fluctuations in real money supply caused by changes in monetary policy in Israel and Jordan. Israel's high inflation in the early 1980s and Jordan's currency depreciation during 1988-1989 affected the Palestinian economy and led to substantial seigniorage losses. Agreements signed by the PA make both Israeli and Jordanian currencies legal tender in the WBGS, yet the PA has absolutely no influence on the course of monetary policy in either Israel or Jordan.

Labor market shocks have resulted from fluctuations in the external demand for Palestinian labor in Israel and the Gulf countries. Until the early 1980s, labor demand shocks were negatively correlated, providing the Palestinian economy stability at the aggregate level. The Israeli economy was negatively affected by oil price increases, while the Gulf economies were affected positively by such development. However, demand for Palestinian workers has not grown in the Israeli or Gulf economies since the second half of the 1980s. The 1990s witnessed the collapse of the labor export market. Kuwait sent back many workers to Jordan and the WBGS, and Israeli demand dropped sharply and suddenly. These losses of labor demand seem permanent, generating high unemployment and poverty.

The trade regime was re-oriented in 1967, when the Palestinian and Israeli economies were cut from their natural markets in the Arab world. As a result, the WBGS developed an overwhelming majority of its trade with Israel. The trade regime can be somewhat re-oriented under the 1994 Economic Protocol, but the major shock is the collapse of trade. Both external and internal trade have been disrupted substantially by border closures, causing extreme difficulty of access to goods.

Closure-related Shocks. Since 1993, permit and closure policies have created a substantial source of new shocks to the Palestinian economy. Border closure has been imposed often, unexpectedly, and for unknown duration. This has prevented the free movement of people and goods between the WBGS and the rest of the world, as well as within the WBGS (see Chapter 3). The major macroeconomic impacts of border closure are summarized below.

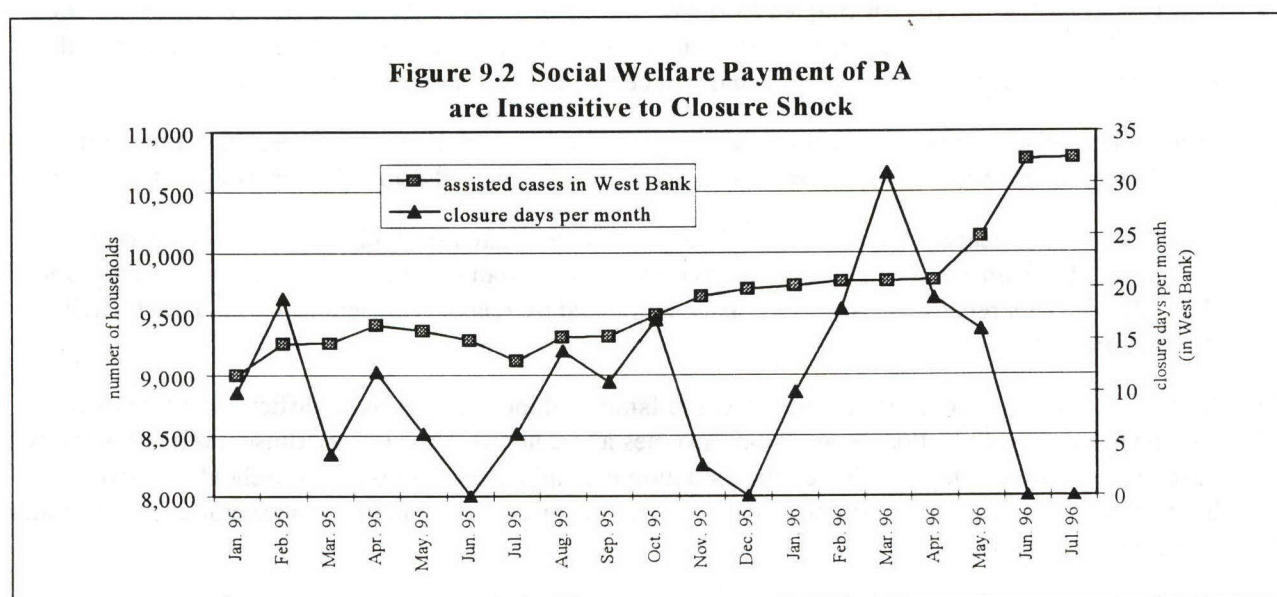
Box 9.1 Vulnerability and Shocks

The WBGS economy is characterized by an unusual dependence on external sources of growth, making it very vulnerable to external shocks. While the shocks of the 1970s and early 1980s often were in opposite directions and, therefore, did not generate large fluctuation in the overall level of activities, the changes that have occurred in the last few years—from the Gulf war to the much-reduced Palestinian labor demand in Israel—add up to a large and probably permanent adverse change in the external sources of income. Some of the main economic shocks include:

- The slowdown in Israeli growth in the mid-1970s after the first oil shock led to weaker demand in the dominant market for both labor and goods.
- The boom in the Gulf countries, following the dual oil price increases in 1974 and 1979, led to increased demand for skilled Palestinian labor (providing a steady stream of remittances) and contributed to substantial levels of transfers from Palestinian and other Arab sources overseas. This helped pick up the slack from Israel's economy that was suffering from the oil price increase.
- The collapse of oil prices in the early to mid-1980s contributed to stagnation in the Gulf demand for Palestinian workers and started a period of stagnation in the WBGS.
- Israel's high inflation was imported into the WBGS in the early 1980s.
- The *Intifada*, starting at the end of 1987, contributed to reducing labor demand in Israel (except in construction) and labor supply from the WBGS. Economic activity was slowed due to strikes, periodic border closures, and the increased enforcement of claims for taxes.
- The Jordanian withdrawal of public sector salary payments after 1988 and the devaluation of the JD during 1988-1990 hit many West Bank Palestinians hard, who traditionally have used JDs for savings.
- The 1990-1991 Gulf war with Iraq led to drastic short-run effects with the 40-day border closure in early 1991. Other effects include permanent losses from the expulsion of Palestinians from several Gulf states, and the loss of Arab grants and reduced transfers to the cash-starved PLO.
- Immigration of Jews from former Soviet countries to Israel in the 1990s increased the demand for Palestinian labor for new home construction, offsetting the reduced demand in industry and services.
- Expectations of a peace settlement in 1992 fueled a small boom, especially in property, generally reckoned to be financed by drawdowns in savings of Palestinian families with relatives returning from the Gulf. Savings repatriation may have been facilitated by relaxed restrictions by the Israeli Civil Administration.
- Since 1993, increased cut-off in employment in Israel and increasingly more difficult border porosity has caused a sharp reduction in both labor incomes and domestic product. Because unskilled workers have been mostly employed in Israel, the reduction in employment hit poorer households relatively hard. Since then, per capita incomes have been cut, in spite of a booming public sector and large donor assistance.

- Closure damages the reputation of Palestinian firms in foreign markets, which reduces the likelihood of investment in WBGS export-oriented industries.
- Closure reduces the income and consumption of Palestinian workers in Israel and those working in export-oriented industries, which results, through the multiplier effect, in a significant decline in GDP. This, in turn, increases investment risk in industries that cater to the domestic market and reduces PA tax revenues.
- Closure increases the variability of WBGS money supply, which is determined mostly by the balance of payments.
- Closure inhibits bank lending, forcing banks to hold excess liquidity and decrease the value of past performance of firms as a source of information for risk assessment purposes.

Lack of Effective Built-in Stabilizers. Presently, there are no effective built-in stabilizers to mitigate the impact of shocks on the local economy. While income taxes are progressive with a potential for automatic stabilization, these taxes account for a very small share of PA tax revenues. The non-progressive VAT accounts for much of the rest of public sector revenues, which rules the tax system as an effective built-in stabilizer. Moreover, the progressivity of the tax system is not expected to increase significantly in the foreseeable future due to constraints imposed by economic agreements with Israel. Unemployment insurance, which serves as a built-in stabilizer in many countries, is presently not available in the WBGS. A comprehensive unemployment insurance program should not be expected soon due to financial and institutional limitations. The current PA welfare program does not serve as a built-in stabilizer because it is targeted at the permanently poor, *i.e.*, households lacking the capacity to work, and thus its budget does not change with economic conditions (Figure 9.2).



Source: MAS data files.

Built-in Stabilizers for Border Closure-related Real Shocks

The real shocks that result from border closure have had a serious economic impact on the Palestinian economy. Reputation damage to WBGS exporters caused by closures is hard to repair in the absence of direct access to international markets. In contrast, some decrease in closure-related variability of output, employment, and money supply can be achieved if appropriate built-in stabilizers are put in place. Possible built-in stabilizers to help reduce such variability include an export insurance program, an unemployment insurance program for WBGS workers in Israel, and employment generation schemes. It is important to stress that while these programs are in the right direction, their impact is expected to be minor in comparison to the overwhelming impact of the border closures, as extensively analyzed in Chapter 3.

An unemployment insurance program (UIP) stabilizes aggregate demand by reducing fluctuations in the purchasing power of WBGS workers in Israel. To make it self-financing, the benefits of an UIP should be limited in duration. An export insurance program (EIP) decreases investment risk and hence overall economic activity. Unlike the UIP, the EIP may have to be subsidized, especially during long closures. Well-targeted employment generation schemes (EGS) channel transfers during long closures to people directly affected by closures, such as Palestinian workers in Israel who exhausted their UIP benefits, as well as those affected by closures indirectly. To pay for the EGSs and to subsidize the EIP, a stabilization fund should be set up as part of the PA's annual budget, funded in an initial amount of about 3 to 5 percent of the total budget. Starting the stabilization fund is consistent with the policy recommendation of keeping overall expenditure under control.

Export Insurance Program for Mitigating the Impact of Trade Shocks. Export-oriented development is essential for the economy of the WBGS. Insuring exporters against some losses resulting from border closure would help the export-oriented sector and remove one potential barrier to greater private investment. Various countries establish export-import banks to provide credit to ensure timely payment by foreign buyers. The MIGA insures against political risk, such as unexpected restrictions on currency transfers, expropriation, war, and civil disturbance. WBGS exporters no doubt face potential loss from non-payment and civil disturbance. Nevertheless, the main deterrents to exports and foreign investment in the WBGS are constant delays and interruptions to international market access caused by closure and other Israeli restrictions.

Shipping delays due to closure may cause liquidity problems and a loss of reputation for Palestinian exporters as well as financial losses resulting from damages to the goods being exported. While a reputation loss for exporters is hard to repair, liquidity problems and other financial troubles caused by closure can be alleviated by an EIP. The EIP would collect premiums from covered exporters. The EIP would focus mainly on financial losses caused by the failure to ship on a timely basis due to closure or other Israeli restrictions. Covered exporters prevented from shipping by Israeli restrictions would be paid by the EIP on the date the shipment was supposed to take place, subject to proper documentation. The payment would be treated as an interest-free loan for the duration of the delay. Should the delay result in damaging the goods, or loss of the contract, the exporter would be compensated for the losses incurred. Setting up an

EIP also can help to expand credit by enhancing the value of an exporter's balance sheet as a source of information about financial performance.

Unemployment Insurance for Workers in Israel. It is not prudent to set up an UIP for all Palestinian workers at present. The PA does not 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. An effective mechanism for mitigating the economic impact of closure is to provide unemployment insurance for Palestinian workers in Israel. Limiting the program to unemployment as a result of border closure would keep it manageable and avoid potential moral hazard problems. The UIP would cover all WBGS workers who have permits to work in Israel. Eligibility should be determined at the beginning of each year regardless of Israeli policy changes toward permits within the year. Most of the data needed by the program can be obtained from Israel, thus eliminating the need for building a separate information system, which is one of the most expensive and time-consuming building blocks of an UIP.

Premiums collected would be the major source of funds for the program. The program, however, should be able to draw funds from Israel and donors, particularly during long closures. Given the frequency of closures, the program is expected to have a relatively high premium. In view of the wide gap between wages earned by Palestinians working in Israel and wages in the WBGS, this may not represent a problem in the labor market. Because closure risk cannot be hedged domestically, premiums collected from members should be invested abroad until needed during closures.

Employment Generation Schemes Activated During Closure Periods. The main policy instrument to mitigate the economic impact of closures has been the implementation of numerous EGSs. 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 did not create permanent assets, which enabled them to transfer a relatively high share of their budgets to the poor. Others attempted to create assets as well as help the poor, which diluted their effectiveness as an anti-poverty program.

Over \$90 million was spent on implementing EGSs during the 1993-1996 period. Table 9.1 presents a summary analysis of some key projects, in terms of their budgets, the amount of money in the form of wages for unskilled workers that reached the poor, and the relative cost of delivering one dollar to the poor. The higher the cost of materials and administering the project, the higher is the relative cost of delivering aid to the poor. The variation in the cost of the projects reflects the inherent trade-offs in EGSs. At one extreme is the World Bank's Direct Hire Program that emphasized quick disbursement of money to the poor unemployed in the wake of the spring 1996 closure without attention to the creation of assets. The other extreme is illustrated by the UNRWA's Shelter Rehabilitation Program which emphasized the creation of better housing to the poor and, thus, ended up transferring a smaller fraction of the total budget directly to the poor in the short-run.

Table 9.1 Relative Effectiveness of Employment Generation Schemes in WBGS

Area	Program	Budget (\$)	Net benefit to the poor (\$)	Relative Cost (\$)
West Bank	UNRWA Shelter Rehabilitation Program	\$11,000,000	\$3,751,582	\$2.90
	World Bank Direct Hire Program	2,704,630	1,628,725	1.70
Gaza Strip	UNRWA Shelter Rehabilitation Program	7,000,000	1,070,873	6.50
	Sectoral Working Group Program	15,200,000	2,387,908	6.30
	World Bank Direct Hire Program	1,603,333	1,154,400	1.40
	UNRWA Emergency Employment Program	5,000,000	3,247,296	1.60
General	Maharashtra Employment Generation Program	-	-	1.80
	Ministry of Social Affairs Assistance Program	-	-	1.60
	Uniform Transfer	-	-	5.00

* Relative cost is the cost of getting one dollar into the hands of the poor.

Source: Al-Botmeh and Sayre (1996).

The record of EGSs as permanent job creation and anti-poverty programs in developing countries is not encouraging and should not be used to for these purposes. Such schemes should be used exclusively as a built-in stabilizer instrument. To serve as an effective built-in stabilizer, an EGS should have the following characteristics.

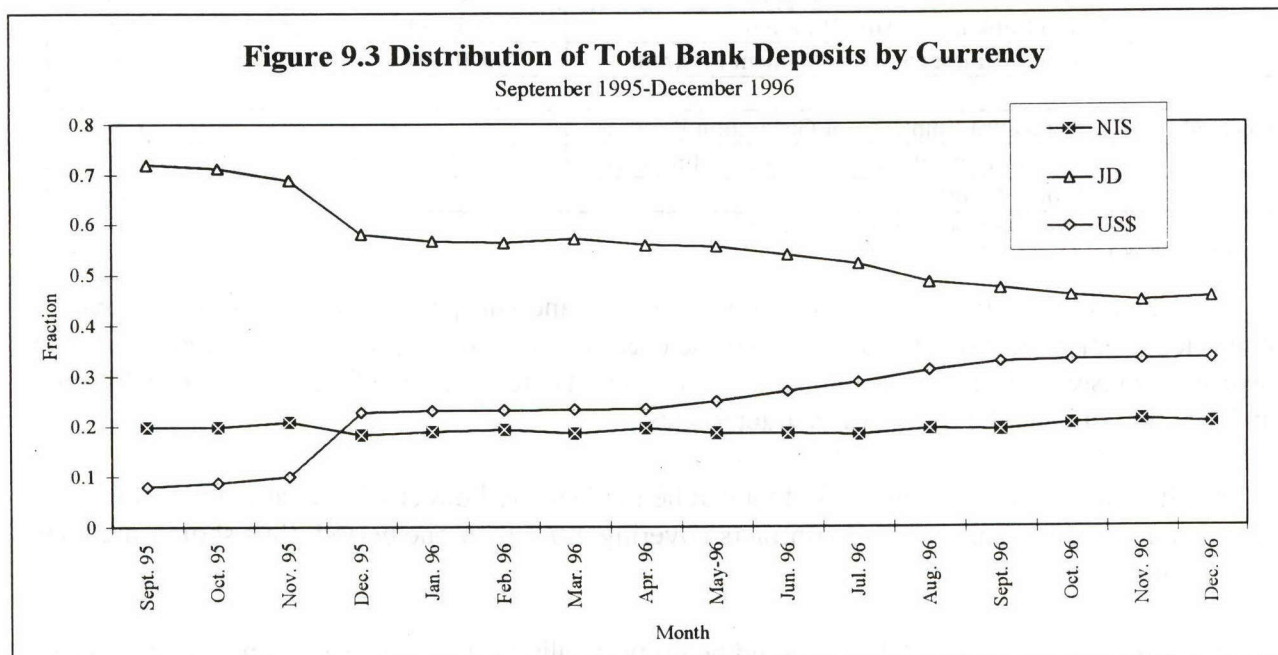
- It should involve simple tasks that can be implemented directly by local municipalities or farmed out using standard contracts covering more than one period, thus shortening their time lags.
- The inputs used in the EGS should be domestically produced or easily and inexpensively stockpiled, thus making the program less vulnerable to closure.
- It should be possible to change the coverage of the EGS without causing serious disruptions in its operation.

Possible tasks that can be performed by an EGS include forestation programs, soil preservation, street sign installation, access road construction, and street cleaning. This may make it unpopular with policy makers and the public-at-large, who tend to prefer permanent asset-creating EGSs, such as road construction programs.

Monetary Stabilization in the Short-run and Long-run

This section explores the impact of monetary shocks on economic fluctuations and explores the potential for monetary stabilization with and without a Palestinian currency. The PA's right to issue its own currency was one of the issues that was left unresolved by the Economic Protocol. Until this issue is resolved, the PA should initiate discussions with the Israeli government aimed at reclaiming the NIS seigniorage generated in the WBGS.

In the absence of a national currency, three main currencies circulate in the WBGS: the NIS, the JD and the US dollar. Of these three currencies, the NIS has established itself as the primary medium of exchange in both the West Bank and the Gaza Strip. The dominant store of value in the Gaza Strip is the US dollar. In contrast, the JD is presently the favorite store of value in the West Bank. However, the role of the JD as a store of value in the West Bank has been diminishing lately in favor of the dollar. This is apparent in the steady increase in the share of dollar-denominated deposits in West Bank total bank deposits at the expense of the JD in the last few months (Figure 9.3).



Source: MAS data files and the PMA.

In the absence of a national currency, the WBGS money supply is determined mostly by the balance of payments. In view of frequent closure, the balance of payment, and hence the money supply, cannot be expected to be very stable. The instability of money supply can result in serious disruptions to the real economy, at least in the short term. The absence of a national currency also deprives the WBGS economy of its seigniorage revenues, limits the ability of the PMA to act as a lender of last resort and eliminates the foreign exchange rate as a policy tool in making adjustments to changes in the terms of trade. Such absence also makes the WBGS vulnerable to monetary shocks caused by unexpected change in money supply in Israel and Jordan. An unexpected change in Israeli money supply is transmitted to the WBGS through changes in the trade balance, and in the purchasing power of the NIS-denominated deposits at the local banking system. A Jordanian money supply change is transmitted mainly through changes in the size of assets of the WBGS banking system invested in Jordan and in the purchasing power of the JD-denominated deposits. While empirical estimation of WBGS money supply changes caused by the different channels is not possible at this time due to lack of data, their time paths are well established by economic literature. This enables us to determine the impact of monetary shocks on the money supply at different stages of the adjustment process. A monetary expansion

in Israel, for example, results first in an increase of WBGS money supply because of increased demand for Palestinian goods and labor services. Later on, higher prices and currency depreciation resulting from monetary expansion reduce the WBGS money supply. While this reduction may end up canceling the earlier increase, money supply fluctuations caused by monetary policy shocks can cause serious disruptions to the real economy.

Monetary Stabilization with Own Currency. If the long-run political settlement empowers the PA to issue its own currency, then it may choose to issue it or enter into a formal monetary union with a neighboring country (most likely Jordan) or countries. If it opts for its own currency, the PA can do that either through a currency board that issues coins and notes only if backed by foreign exchange, or through a central bank that has some discretionary money creation power. A currency board enables the PA to reclaim parts of the seigniorage revenues that are currently lost to the countries of the currencies that circulate in the WBGS. It will also reduce the vulnerability of WBGS real money supply to unexpected change of money supply in these countries. A central bank with the power to create money will have, in addition, the resources to serve as a lender of last resort and will be able to use exchange rate policy to make adjustments to external shocks. These added benefits, however, come at the expense of losing the monetary and fiscal discipline built in the currency board arrangement (Box 9.2). Hence, the economy is best served if a record of fiscal prudence and sustainable public finances are solidly established before any discretionary money creation power is given to a central bank. Such practice helps to improve the acceptability of the currency and to avoid budget deficit-driven inflation.

Monetary Stabilization without Own Currency. In the interim period, the PMA cannot effectively utilize traditional stabilization instruments. Open market operations are not presently feasible because of the absence of government securities. Changing the required reserve ratio is available as a policy instrument, but its effectiveness is extremely limited. The PMA cannot impose reserve ratios that are significantly higher than those in effect in the home countries of circulating currencies as a means to avoid deposit flight. In addition, the Economic Protocol does not allow the PMA to impose reserve ratios on NIS deposits that are lower than those imposed by the Bank of Israel on comparable deposits.

The PMA should not place any restrictions on currencies in circulation in the WBGS, in terms of their number or exchangeability. Maintaining the multiplicity of currencies in circulation will reduce the impact of external monetary shocks on the WBGS money supply through market-driven currency substitution as well as facilitate the future introduction of a Palestinian currency. For such introduction to take place without causing political and economic conflicts with neighboring countries, the WBGS needs to minimize its dependence on a single currency. Moreover, the circulation of hard currencies, such as the US dollar, facilitates the accumulation of the foreign reserves needed to back a future Palestinian currency.

Box 9.2 Currency Boards

A currency board is a foreign exchange system under which notes and coins are issued only if backed by foreign reserves denominated in a stable currency. The currency board establishes a fixed exchange rate between its currency and the reserve currency, and maintains unlimited convertibility between them. The reserves of the currency board usually consist mostly of high-quality interest-bearing assets. Since the currency board does not pay interest on its notes and coins, it earns a profit (seigniorage) that is equal to the difference between the interest earned on its reserves and the board's operating costs.

By design, a currency board has no money creation power. Hence, it cannot be used as a tool of inflationary government finance, making the finance of government expenditure more transparent since it has to come either from taxes or borrowing. The lack of money creation power does not allow the currency board to serve as a lender of last resort to the domestic banking system or to sterilize temporary shocks to the terms of trade. The inflation and interest rates in a currency board country are determined mostly by those in the reserve currency country.

Yet, a government with weak fiscal conditions may be tempted to break away from this pure case of a currency board by printing money without having the full backing of foreign reserves. Given the reputation cost, governments may not carry out this measure unless other methods of financing their deficits are extremely costly. A currency board does not provide complete protection from inflationary finance. Thus, a minimal level of fiscal discipline and a good track record in budgetary management is needed for the success of a currency board.

A related concern is that foreign reserves back up high-powered money—notes and currency in circulation. But bank deposits, created through the money multiplier, have no such backing. A massive withdrawal of short-term bank deposits can trigger the collapse of a currency board. The establishment of a currency board, therefore, should be preceded by building sufficient bank regulatory and supervisory capacity to ensure stability of the banking system.

Source: Wijnbergen (1996)

One possible activist policy for the PMA to adopt is to vary the amount of liquidity in the banking system by moving the PMA's reserves in and out of the local banking system as a way to offset shocks to the economy. For example, during an economic slowdown, the PMA would move some of its foreign investment to be loaned to the local banking system, increasing their ability to lend to their customers. The domestic placement ratio, which is the fraction of PMA reserves loaned to the local banking system, would similarly be reduced if the PMA's objective is to reduce liquidity in the banking system. The full implications of this policy and its exact mechanics should be explored in greater depth. Moreover, this policy can only be implemented if the supervisory and regulatory capacity of the PMA is substantially enhanced to keep the possibility of the need to rescue any bank, a highly improbable event. Thus, the implementation of this policy requires careful consideration and substantial strengthening of the PMA's institutional capacity.



The WBGS economy is highly vulnerable to external shocks. Some of the external shocks presently experienced by the economy, such as fluctuations in worker remittances, will no doubt continue into the post-transition period. The vulnerability of the economy to closure and monetary policy shocks can be decreased significantly if and when the Palestinians improve control over their borders, allowing them direct access to international markets. Vulnerability to monetary policy shocks can be reduced if a Palestinian currency is introduced, or by having a balanced monetary union between the WBGS and another country or countries.

In the meantime, the PA can help minimize the economic impact of monetary policy shocks by placing no restrictions on currencies in circulation. Moreover, the PMA can explore the full implications of adopting a policy of varying the fraction of its reserves placed domestically, once its regulatory and supervisory capacity are strongly enhanced. It can also set up a number of built-in stabilizers that minimize the impact of closures on the economy, such as an EIP, UIP for Palestinian workers in Israel, and closure-triggered EGSs. Given potentially long and intense episodes of closure, these insurance programs should have a large compensation element and, therefore, be heavily subsidized by external sources. Contributions by Israel would create virtuous incentives to minimizing the border closures.

Bibliographical Note: The section on employment generation schemes draws from Al-Botmeh and Sayre (1996). The monetary stabilization section is based on Hamed (1997). The box on currency boards draws on a background paper by Wijnbergen (1996).

Part C

Building the Enabling Environment for Long-term Growth

There is a pressing need for Palestinian policy makers to focus immediately on the underpinnings of sustainable economic growth. The resolution of politics is obviously necessary for long-term growth. But sustainable growth will also require the reform and redynamization of a host of organizations that, under conditions of occupation, were managed on a day-to-day basis rather than with a long-term view. An enabling environment for growth would include central and local government institutions that efficiently 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, good regulations that allow for efficient private provision of public goods and services, and well-functioning health and education systems that auspiciously utilize NGO activism. If these fundamentals are right, growth would occur if, when, and as, the political situation starts improving and, hopefully, as a political resolution is reached.

Three sectors that are essential for long-term growth stand out in terms of their need for reform and modernization. These are the education and health systems, and infrastructure. In all these sectors, a focus on a systems view — with partnerships between providers and beneficiaries, a regulatory framework, an enforcement mechanism, and feedback loops — will be essential.

Chapter 10

Donor Assistance

The peace process has been supported by a substantial donor assistance effort. By March 1997 about \$1.5 billion had been disbursed by donors of the \$3.4 billion cumulative post-Oslo pledges. In terms of overall flows, there is little evidence that donors have fallen short on delivering the amounts promised. While there is room for improving the effectiveness of institutional structures for donor coordination, local structures are highly developed and on balance have helped avoid major misallocations in the use of donor assistance. Nevertheless, in terms of composition, the balance of donor assistance has been tilted more heavily than originally expected in favor of short-term support for budgetary and other forms of consumption-oriented needs. This trend is partly the result of donor efforts to offset negative shocks. While this underscores donors' flexibility, short-term support intended to mitigate the impact of closures may have partly displaced projects that address medium- and long-term needs. Furthermore, the shocks have made the implementation of development projects more difficult. So, it is not evident whether the slow disbursement of donor funds for investment has been caused by diverting funds to short-term needs or whether it is due to the impact of other extraneous factors.

Introduction

In October 1993, at the Conference to Support Middle East Peace, the international community committed itself to jump-start the Palestinian economy and pledged to spend \$2.4 billion over the ensuing five years. Additional pledges, contributed by 38 countries and several international organizations, have since raised total pledges to \$3.4 billion. About three quarters of the assistance pledged is on grant terms; the remainder consists of loans, mostly on concessional terms. With 2.5 million Palestinians in the WBGS, these pledges translate to \$270 per person per year for 1994-1998. Actual disbursements for the period 1994-1996 have been lower, at \$195 per person per year. This illustrates the difference between pledges made by the donor community and actual disbursements.

This chapter examines the impact of donor assistance on economic development in the WBGS by examining what has happened with aid flows in the post-Oslo period. The analysis compares expectations and realities, reviews the reasons behind the shortfall, and offers suggestions for improving the effectiveness of donor assistance in the future. In particular, the chapter evaluates the balance between trends in support of consumption-oriented activities and in support of investment underpinning longer-term development potential.

The Flow of Post-Oslo Donor Assistance

Numerous obstacles notwithstanding, the donors have managed to achieve satisfactory disbursement levels and have successfully established a number of institutions for channeling assistance. Unlike the experience in many developing countries, donors have made an unusual effort in coordination, giving rise to a variety of complex but functional structures and institutions. Initiatives and institutions have been formulated by donors and the PA to try to improve coordination. These include the Consultative Group on the West Bank and Gaza Strip (CG), the Ad Hoc Liaison Committee (AHLC), the Joint Liaison Committee (JLC), and the Local Aid Coordination Committee (LACC) with its various Sector Working Groups (SWGs). In addition, the United Nations Special Coordinator's Office (UNSCO) has a mandate to coordinate UN agencies and facilitate processes on the ground (Box 10.1). Also, to enhance the speed and responsiveness of its operations, the World Bank devolved decision-making authority to its resident representative in the WBGS.

These donor assistance coordination mechanisms took about one year to set up. The delay can be attributed to initial weaknesses in coordinating the receipt of aid on the Palestinian side, given that no ready-made apparatus was bequeathed by the Israeli Civil Administration. In addition, at the time of the Declaration of Principles, donors were caught by surprise and had little time to prepare projects and their approach to aid. Therefore, urgency was balanced by donors' demand for accountability, transparency, and efficiency. Despite initial delay in coordinating the aid effort, by mid-1995, appropriate mechanisms to share information and, to a lesser extent, to formulate development policy and prioritize investments, were in place to permit a smoother flow of assistance.

Donor assistance had an unexpected impact on institution building in the PA. The large inflow of aid coincided with the establishment of PA ministries and public agencies and, perhaps unavoidably in a transitional phase, led to competition between PA agencies and ministries to address donors directly. This resulted in an institutional setup with some overlapping functions, *i.e.*, with regard to the establishment of donor coordination and project implementation functions. Only recently have there been visible efforts to ensure the consolidation in the PA of economy-wide policy functions such as public investment priorities and coordination of donor assistance.

The flow and composition of donor assistance has evolved somewhat differently than was originally envisaged. In 1994, donor assistance responded to political and economic developments as the transitional arrangements outlined in the Declaration of Principles were gradually implemented. In January 1994, the Johan Jorgen Holst Peace Fund (Holst Fund) was established under World Bank administration to channel donor contributions toward recurrent expenditure support in the PA's start-up phase. Throughout 1994, considerable attention was given to the budget deficit and to developing a process for channeling assistance that would assure accountability. By end 1994, annual disbursements had reached a level of \$497 million, with \$253 million for short-term (budget and start-up) support, \$167 million for public investment, and \$77 million for technical assistance.

Box 10.1 Institutional Structures for Donor Coordination

Ad Hoc Liaison Committee. The AHLC, chaired by Norway, meets two or three times a year, bringing together key donors (the EU, Japan, Saudi Arabia, and the US), the PA, and the Israeli government, with the World Bank as secretariat. The AHLC was established by the Multilateral Steering Group of the Multilateral Talks on Middle East Peace in October 1993 as the principal coordination mechanism on policy matters related to the development program in the WBGS. More recently, the AHLC has assisted coordination of the activities of the PA, Israel, and donors with the aim to resolve Palestinian fiscal difficulties through fair burden- and revenue-sharing and, more generally, to facilitate longer-term development of the Palestinian economy. These objectives and plans are outlined in the *Tripartite Action Plan on Revenues, Expenditures and Donor Funding for the Palestinian Authority* (TAP), initially signed in April 1995 and revised in January 1996.

Holst Fund. Administered by the World Bank, the Holst Fund has received funding from 25 donors. The Holst Fund, closely associated with the AHLC, has been a primary instrument for channeling donor support to fund the PA's recurrent budget and start-up expenses. More recently, the Holst Fund has served as a key funding instrument for employment generation initiatives to offset the loss of Palestinian jobs in Israel. Between 1994 and July 1997, it disbursed a cumulative total of \$236 million.

Ministerial Meetings. Two ministerial-level pledging conferences on assistance to the Palestinians have been held—one in October 1993 in Washington, DC, chaired by the US, and one in January 1996 in Paris, chaired by France. Both meetings featured elaborate pledging sessions.

Consultative Group. The CG, chaired by the World Bank, brings together more than 30 active donors providing funds to the WBGS. The group met in December 1993, October 1995, and November 1996. The CG meetings, which are technical in nature, provide participants with the opportunity to discuss policies, investment priorities and proposed projects, and potential co-financing arrangements. The CG meetings have also been used to mobilize commitments to specific priority projects. At the fall 1997 meeting, the CG will review implementation of the 1997 Palestinian Public Investment Program and preview public investment funding needs for 1998 and beyond.

Joint Liaison Committee. In November 1994, the AHLC established the JLC, comprising the PA, Israel, and major donors to provide a forum for discussing assistance policy and practical matters related to enhancing the effectiveness of donor assistance. Since then, the JLC has developed the capacity to formulate practical strategies to respond to donor or bilateral needs, as well as deal with policy matters of immediate concern for project implementation.

Local Aid Coordination Committee. To accelerate the development effort, the AHLC decided to devolve greater responsibility for aid coordination to donor representatives in the WBGS. As a first step, the LACC was established. The LACC is composed of the PA and approximately 30 donors, including Israel, who are represented locally. The LACC is chaired jointly by UNSCO, the World Bank's WBGS representative, and the Norwegian Representative in the WBGS who also represents the chair of the AHLC. As one of its first actions, the LACC in December 1994 agreed on the establishment of 12 Sector Working Groups which seek to improve operational coordination and sector planning. However, the effectiveness of the SWGs has been restrained by the limited number of technical experts or decision-makers who are represented locally.

In 1995, the planned implementation of many large-scale investment projects was delayed and much of the donor support continued to cover recurrent expenditure. At the outset, the PA had not been expected to require budgetary support beyond 1994. However, the initial expectations had not taken into consideration how long it would take to set up a mechanism for transferring revenue clearances from Israel to the PA in a timely manner. Further, to smooth the unanticipated adverse effects of increasingly frequent closures, donor support was channeled into works programs and labor-intensive rehabilitation projects to mitigate closure-related income losses. By end-1995, disbursements for the year amounted to \$442 million, with \$210 million for short-term support, \$144 million for public investment, and \$88 million for technical assistance.

Box 10.2 Donor Arithmetic: Pledges, Commitments, and Disbursement

A *pledge* refers to a general indication of intent by a donor to provide financial support of a given amount within a time frame which may or may not be well-defined. A *commitment* refers to a binding undertaking to provide funding of a given amount within a well-defined time frame for a specified purpose, *i.e.*, support for an investment project or the PA's recurrent budget. Clearly, the exact point at which a pledge becomes a commitment is a matter of contextual judgment, but pledges are not necessarily translated into commitments the same year. A *disbursement* is defined as the donor having transferred the funds to the implementing agency. Actual disbursement of funds *from* the implementing agency can involve further delays.

To date, the largest pledges have come from the EU and the European Investment Bank (\$658 million), the US (\$500 million), Japan (\$233 million), Saudi Arabia (\$200 million), the Netherlands (\$153 million), Norway (\$150 million), Germany (\$149 million) and the World Bank (\$230 million). See Tables 15-17 in the Annex for a complete breakdown of donor assistance by pledges, commitments, and disbursements for 45 donors.

Status of Total Donor Pledges, Commitments, and Disbursements

(January 1994 to March 1997)

in million US\$

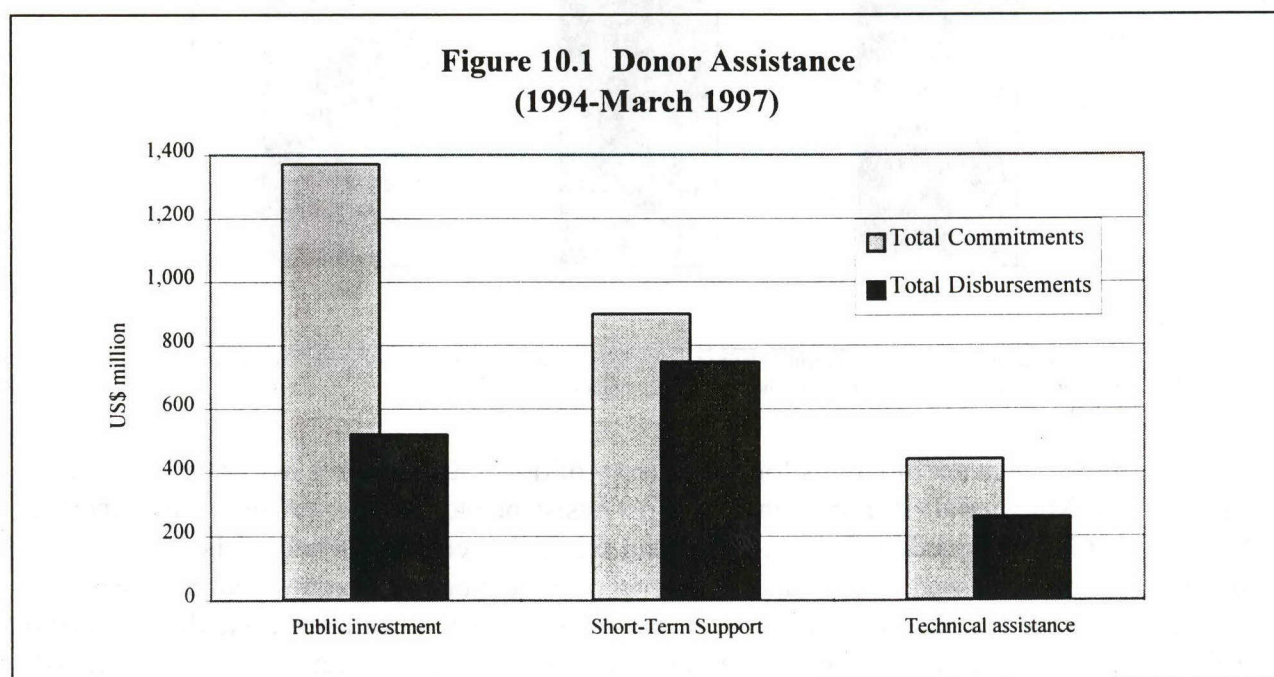
Donor Assistance	Total Pledges	Total Commitments	Total Disbursements
Grants	2,652	2,349	1,461
Loans and Guarantees	785	365	66
Public Investment*		1,373	519
Short-Term Support		900	746
Technical Assistance		442	262
Total	3,437	2,714	1,527

*Note: For purposes of the analysis, public investment is defined as public investment projects, private sector support, capital assets supplied in kind, and rehabilitation of capital assets under employment generation programs.

Sources: MOPIC and World Bank estimates.

In 1996, a similar pattern of disbursements favoring consumption over investment continued under continuing closures and lack of movement on large-scale public investment projects. Subtler tensions underlying Palestinian-Israeli political relations contributed to delays in the implementation of investment projects, and thereby to the flow of donor funding. For example, a major factor behind the delay in “breaking ground” for the proposed Gaza port (which as of mid-1997 had still not occurred), despite long-standing donor commitments to fund the port, has been Israel’s insistence on a prior agreement detailing security arrangements that will govern the transit of merchandise and passengers once the port is operational. Similar factors have affected completion of the proposed Gaza airport project, of which a runway is already functional. By end-1996, disbursement for the year amounted to \$528 million, with \$267 million for short-term support, \$183 million for public investment, and \$78 million for technical assistance.

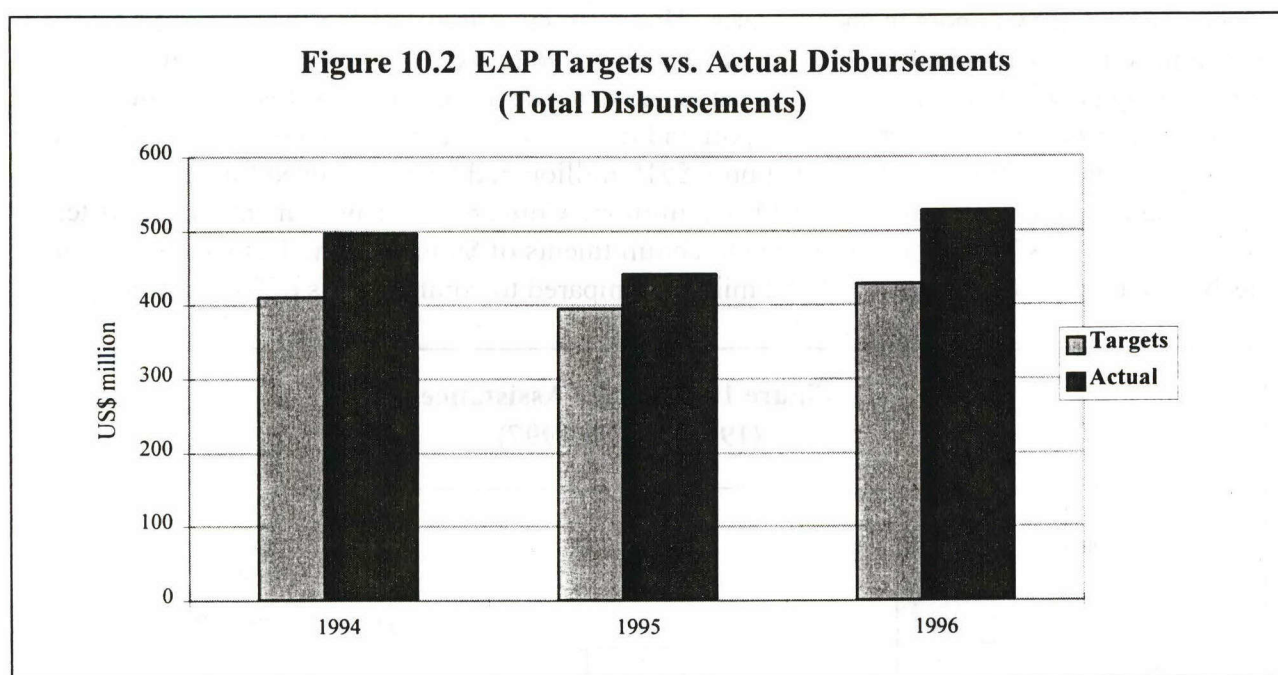
By end March 1997, \$2,714 million (about 80 percent of the cumulative pledges) had been committed by donors to specific uses. However, cumulative disbursements, at \$1,527 million, were less than half the amount of funds pledged (Box 10.2). Not surprisingly, the greatest lag between commitments and disbursements was in the public investment category, while disbursements for short-term support and technical assistance have been more in line with commitments. Figure 10.1 shows that only \$519 million had been disbursed for public investment, against commitments of \$1,373 million. Conversely, disbursements for short-term support stood at \$746 million compared to commitments of \$900 million. Disbursements for technical assistance amounted to \$262 million compared to commitments of \$442 million.



Note: For purposes of the analysis, public investment is defined as public investment projects, private sector support, capital assets supplied in kind, and rehabilitation of capital assets under employment generation programs.

Source: MOPIC (1997)

In accounting for genuinely unanticipated factors that have slowed or otherwise affected donor disbursements, it is a useful exercise to select two sets of targets established on behalf of the donor community at different points in time for comparison with actual outcomes. One set of targets is in the Emergency Assistance Program for the Occupied Territories (EAP), prepared by the World Bank immediately after the October 1993 donor conference and endorsed by donors at the December 1993 meeting of the CG. The EAP was prepared in response to donor requests for the World Bank to provide the analytical framework and technical underpinning to make effective use of the assistance pledged by donors. Among its other elements, the EAP embodies a three-year (1994-96) expenditure program intended to be funded by donor contributions. The program comprises public investment projects, support for the private sector (chiefly through the provision of long-term finance), start-up expenditure support, and technical assistance. Figure 10.2 shows EAP targets in comparison to actual disbursements for the three-year period.



Note: For purposes of the analysis, public investment is defined as public investment projects, private sector support, capital assets supplied in kind, and rehabilitation of capital assets under employment generation programs.
Source: MOPIC (1997)

A more recent set of targets for the delivery of donor assistance is associated with the January 1996 Ministerial (Donor) Conference on Assistance to the Palestinians. The Tripartite Action Plan (TAP), signed by the PA, Israel, and the AHLC chair on behalf of the donors, called for: (i) improved PA fiscal performance and revenue collection; (ii) commitment by Israel to cooperate with the PA in revenue clearance and “do its utmost” to enhance trade flows in and out of the WBGS; and (iii) disbursement of donor funds to cover the PA recurrent deficit until end-1996 and quick-disbursing job creation activities. In particular, the TAP undertook to disburse a total of \$500 million (of which \$75 million was to be directed toward recurrent budget support for the PA) during 1996 to ongoing and new activities. Many of the new activities consisted of

priority investments that formed a “core investment program,” which had been deliberated and endorsed by donor representatives at the previous CG meeting in October 1995.

In aggregate terms, actual disbursements have easily kept pace with the EAP and TAP targets, despite more adverse circumstances than originally envisioned. With an estimated cost of closure in 1996 of \$945 million, the magnitude of the shock about offsets revenues from tax clearances, at \$420 million, plus donor support, at \$528 million (see Chapter 3). In the absence of donor support to employment generation programs, the closures would in all likelihood have had a more severe impact on unemployment and welfare than was experienced. Likewise, without the donor budget contributions and IMF technical assistance, the PA would have been financially crippled. Therefore, donor assistance has not fallen short in the aggregate. However, in terms of composition, actual disbursements have been tilted more heavily in favor of short-term support than originally expected.

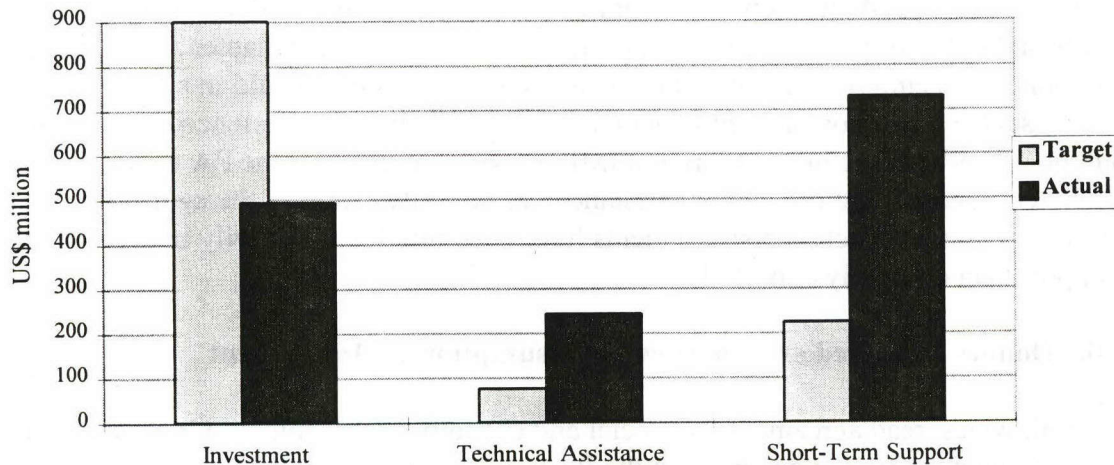
Have the Donors Delivered on Promises? Consumption vs. Investment

With widespread agreement that social and economic development for Palestinians was a necessary element for further advances in the Palestinian-Israeli negotiations under the Oslo framework, in October 1993 the donors set twin goals: (i) to support continuation of negotiations for a comprehensive settlement throughout the transitional period; and (ii) to marshal substantial resources to meet immediate and longer-term development needs of Palestinians. It was expected that short-term assistance would have an immediate, visible impact on economic prospects and living standards while longer-term assistance would lay the basis for sustained growth and labor absorption.

The donor effort has been criticized for falling short of fulfilling its promise, with delays in committing funds and sluggish performance in implementing projects being the rule rather than the exception. In reality, unforeseen events, including acts of violence and delays in peace process negotiations, have complicated planning and implementation of donor assistance plans. Border closures, especially in the Gaza Strip, have severely slowed project implementation. Investment projects have been particularly difficult to implement under conditions of closure, with delays resulting from the induced shortages in materials and impediments to the movement of local personnel involved in project implementation. The consequences of border closures—increased unemployment, reduced production, and diminished trade flows—have directed continued attention on emergency measures to the detriment of longer-term priorities.

Comparing the composition of disbursement with the targets set in the EAP (Figure 10.3), investment support was below the target by almost half, while disbursements for short-term support exceeded the target by almost three times. The EAP foresaw start-up support needs of no more than \$176 million in 1994 (the year the PA was established), declining to \$40 million in 1995 and \$27 million in 1996, and confined in the latter years to incremental support to NGOs. Donors contributed well over \$700 million for short-term support between the beginning of 1994 and end-March 1997.

**Figure 10.3 EAP Targets vs. Actual Disbursements
(by Category)**



Note: For purposes of the analysis, public investment is defined as public investment projects, private sector support, capital assets supplied in kind, and rehabilitation of capital assets under employment generation programs.

Source: MOPIC (1997)

Given the predominance of short-term support, compared with original expectations, it is not surprising to find claims that support funding for investment projects has been slow to arrive. However, it is not clear that higher-than-expected disbursements for short-term support was the direct or, indeed, sole cause of the lower-than-expected disbursements for investment projects. Weaknesses in institutional structures and rigidities in established procedures on both the donor and Palestinian sides have been a factor in delaying donor assistance for investment projects. For instance, investment support might have flowed faster with the earlier establishment of a local donor forum for collective examination and discussion of priority investment proposals and financing needs with Palestinian counterparts. If it had been more effective, such a forum could also have played a role in pooling funding intentions for larger-scale, longer-term investment. It is also likely that assistance would have flowed faster if a single Palestinian ministry or agency had been unambiguously designated from the outset to draw up and periodically update a set of investment priorities for donor funding, as well as to match priorities with donors' funding plans and monitor the flow of donor contributions, as the Ministry of Planning and International Cooperation now does. However, even if more efficient Palestinian and donor coordination structures had been in place early on, the relative inexperience of the newly established implementing agencies in the numerous dimensions of project preparation and implementation (*i.e.*, procurement and accountability requirements) was bound to entail some delay in the flow of funding.

The main reasons behind the low disbursements for investment lie elsewhere. To a large extent, the overrun in short-term support needs relative to original targets has been the result of factors outside the control of Palestinian policy makers. Budgetary shortfalls have occurred mainly due to the loss of revenue and greater expenditure needs as a result of closures. Donors have tried to direct disbursements at consumption in order to smooth shocks to the Palestinian economy. At the same time, the move toward consumption-oriented support has been accentuated by certain Palestinian policy decisions, notably concerning the rapid expansion of public sector employment (see Chapter 8).

The donors have responded to negative shocks (notably closures) by shifting assistance to emergency efforts, such as job creation and public sector recurrent cost, to cushion their impact. Among other issues, the AHLC has focused on a succession of funding crises, dealing with two kinds of emergencies: shortages of funds for Palestinian public sector salaries (both civilian and police) and the financing of employment generation programs. Two events can be singled out to illustrate this point: (i) in June 1994, the AHLC decided to redirect a considerable amount of already-committed funds to meet the urgent but temporary requirements for PA start-up and recurrent costs; and (ii) in November 1994, the AHLC decided to accord equal priority to maintaining living conditions as to fiscal problems, turning job-creation activities into a permanent feature of donor assistance.

The investment program has also had to face a host of difficulties. Investment projects have become more difficult to implement on the ground due to closure-related delays and hindrances. Long-term investment projects are almost always tied to ongoing or future negotiations, and hence are subject to controversy between the PA and Israel. Estimates regarding the pace of the peace process have often proven wrong, with agreements generally taking longer to negotiate than first anticipated. The question of East Jerusalem, for example, has complicated economic discussions from time to time. The construction of a port and airport facilities, as well as implementation of the agreed "safe passage" between the West Bank and Gaza Strip, have implications for both the degree of autonomy enjoyed by the PA and Israeli security. As such, these developments are bound up in bilateral political negotiations. 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 also inherently sensitive.

Looking toward the future, it is not expected that much short-term support, especially for the PA's recurrent budget, will be required over the remainder of 1997 or in future years as revenue collection efforts are further consolidated. Current projections foresee a recurrent budget deficit of substantially less than the \$52 million originally projected for 1997. In addition, about \$10-\$15 million is expected to be disbursed from the Holst Fund for employment generation activities over the course of 1997, of which \$3 million was disbursed during the first three months of the year. Therefore, focus should now shift to removing impediments to the implementation of public investment projects to ensure that the donor effort will help lay the foundations for medium-term economic growth.

The post-Oslo experience suggests that more donor assistance should be directed toward investment, for two key reasons. First, the closure policy will likely remain as a permanent feature. Borders are now less porous than in the past due to changes in Israeli internal security arrangements. Security checks are now concentrated at the border, while in the past under the Israeli Civil Administration they were more diffuse. This increases the cogency of projects that connect the WBGs to the rest of the world (*i.e.*, operation of the port and airport), and of those that foster more efficient border operations for access to outside markets. Second, the partial loss of labor market opportunities in Israel is also a permanent feature. It is not feasible in the long-run to compensate households for the reduction in income from employment in Israel through subsidies. Rather, the only way of generating future incomes in a sustainable way is to raise investment.

Without the resolution of key political issues, however, the donor community and the private sector will be reluctant to supply the required investment capital. Arguably, donor efforts to assist economic development in the WBGs have been negated by the fallout from tense Palestinian-Israeli relations. Some clarity and resolution on where the peace process is going is therefore required to sustain the donor effort. This requires recognition of the intricate link between the evolution of the politics of the peace process and the economic means that donors apply to sustain the development process. The uncertainty surrounding political developments may also require donors to rethink their strategies in order to provide for cases where the political situation does not improve, high unemployment continues, incomes continue to fall with very little productive investment, and significant fiscal pressures return. In such a situation, the appropriate donor response may be to focus on basic public infrastructure rehabilitation, employment generation, welfare provisions, and basic human resource development until large-scale infrastructure projects and private sector support activities can be undertaken.

A related issue concerns the availability and terms of funding. In the near future, donors will have to take a collective decision on a renewal of funding commitments as the initial five-year pledge period (1994-98) draws to a close. In the interim, the CG meeting in late 1997 may 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 on which work is now underway. However, the terms and conditions of future donor assistance may be less generous than those of the original donor pledges of late 1993. It could be contemplated, for example, that an increasing share of donor assistance will take the form of loans (with varying degrees of concessionality) rather than grants as in the first round of donor pledges. This could impose an unforeseen financial burden in the medium to long term that needs to be taken into account by the PA when drawing on further donor assistance.

* * *

The need for recurrent budget and other short-term support over a much longer period and in larger amounts than originally envisioned has been mirrored in a delayed flow of 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, but a unique opportunity to lay the foundations for sustained medium-term economic growth is being lost. However, it is not evident that the disbursements of funds for investment projects have been lower than expected solely because of the higher disbursements for short-term support. It could be argued that disbursements for investment projects would have been low even without the concurrent increase in disbursements for consumption-oriented activities. This argument hinges on the underlying impediments facing the implementation of investment projects. In any case, further analysis is required to determine the impact of donor assistance on economic development of the WBGS.

In the future, it is unlikely that the donor community will show the same willingness to provide short-term financial support; perhaps the need for such support will also be lower as the PA further consolidates its revenue collection effort. Rather, the post-Oslo experience suggests that more donor assistance should be directed toward investment. To generate sustained future increases in income, investment must rise. Without the resolution of key political issues, however, it will be difficult to avoid reticence among the donor community and the private sector, toward supplying the required investment capital. Some clarity and resolution on where the peace process is going is therefore required to sustain the donor effort. The opportunity and challenge for donors now is to step in and guide the peace process more firmly. A related issue is whether donors will renew funding commitments as the initial five-year pledge period draws to a close. For its part, the PA needs to assess carefully the financial burden imposed on future generations if new funding is provided on less generous conditions than during the first round of pledges.

Looking beyond donor assistance, the real issue is how to support 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, *i.e.*, with donors offering complementary finance or by offering political risk guarantees or insurance. Likewise, more attention should be given to building capacity within the PA to ensure a capable system of governance with the means to foster and complement private sector-driven growth.

Bibliographical Note: This chapter relies upon data provided by MOPIC (1997), the Tripartite Action Plans, UNSCO-World Bank (1996), UNSCO (1996c), and Hooper (1996).

Chapter 11

Improving the Education System

Although the population and labor force of the WBGS are highly educated by regional standards, the education sector faces four major challenges. One is to maintain the high enrollment rates at the primary and lower secondary levels in the face of high total fertility rates for both the Gaza Strip and the West Bank. The second is to secure efficiencies by avoiding common policy mistakes and seizing opportunities that the newness of the Palestinian educational enterprise allows. The third is to reorient classroom learning so as to prepare students for WBGS's participation in the global economy. The fourth is to build the institutional infrastructure required to manage these challenges effectively. Institutional issues are especially critical since the education sector has the largest share of the strained government civilian budget.

Introduction

Of the civilian sectors, the education sector accounted for the largest share (19 percent) of total budgeted expenditures for 1996. Teachers in the basic and secondary educational levels totaled 21,600 in the 1995-1996 academic year, constituting 4.3 percent of the labor force. The quality of policy-making and policy implementation in this sector is of critical consequence. The sector absorbs a significant share of the public investment and recurrent budget and serves as an important instrument for economic growth and poverty alleviation. This chapter examines the major challenges facing policy makers in the education sector, including access, quality, and efficiency. It also examines how the institutional infrastructure can build an education system that will evolve over time in ways that best serve its beneficiaries. Except for a discussion of financing for tertiary education, this chapter is restricted to pre-tertiary education (grades 1-12) and, therefore, to the Ministry of Education (MOE).

The Education System

Authority Over the Educational System. Authority over the WBGS education system is divided among three auspices: the PA, UNRWA, and the private/NGO sector. The PA assumed control of all schools under Israeli jurisdiction (except East Jerusalem) by August 1994. When the status of the Palestinian refugees is resolved, the PA will assume financial, policy, and operational responsibility for schools currently under UNRWA auspices.

Upon transfer of authority, the Ministry of Education and Higher Education (MEHE) was established and successfully negotiated the transition from the Israeli Civil Administration. In 1996 the MEHE split into the MOE, responsible for pre-tertiary education, and the Ministry of Higher Education (MHE), responsible for post-secondary education. Table 11.1 shows the educational responsibilities that the PA assumed from the Israelis. It excludes schools in East Jerusalem, where the jurisdiction is split among the Israeli government, private/NGOs (including the Wakf), and UNRWA. Table 11.2 presents the distribution of students among the auspices in

1995-96. It includes students in UNRWA and private/NGO schools in East Jerusalem, but excludes those in Israeli-controlled schools.

**Table 11.1 Auspices for the WBSG Educational System:
Number of Schools by Level***
(1993-94)

Level	AUTHORITY		
	PA	UNRWA	Private/NGOs
Preschool	0	13	453
Basic (Grades 1-10; ages 6-15)	739	254	70
Secondary (Grades 11-12; ages 16-17)	253	NA (close to 0)	41
Vocational Training Centers	NA (not 0)	NA (not 0)	NA (not 0)
Two-Year Colleges	3	4	13
Universities			8

Note: Figures for UNRWA and private/NGOs include Palestinian institutions in East Jerusalem while figures for the PA are limited to the RWB.
Source: PCBS (1995).

Table 11.2 Number of Students by Auspices and Level in the WBSG*
(1995-1996)

LevelTotal		AUTHORITY								
		PA			UNRWA			Private/NGO		
		Subtotal	Gaza Strip	West Bank	Subtotal	Gaza Strip	West Bank	Subtotal	Gaza Strip	West Bank
Kindergarten Primary	44,838	0	0	0	0	0	0	44,838	1,123	43,715
Basic (1-10)	605,780	395,411	106,829	288,582	174,284	129,612	44,672	36,085	2,890	33,195
Secondary (11-12)	50,054	45,618	19,381	26,237	0	0	0	4,436	742	3,694
Total	700,672	411,029	126,210	314,819	174,284	129,612	44,672	85,359	4,755	80,604

* Figures exclude East Jerusalem students enrolled in Israeli-controlled schools, but include those enrolled in UNRWA and private/NGO schools in East Jerusalem.

Source: PCBS and MOE (1995-96), Table 6.23.

As Table 11.1 shows, private/NGO education exists at all levels, but is concentrated proportionally at levels that make good economic sense: pre-school, vocational education, community colleges, and universities. Private/NGO education has a particular history and meaning in WBSG. "Private/NGO" means that no public Palestinian agency has financed the provision. However, from the point of view of students and their families, most private education was virtually free. Charitable organizations and donors funded most of the private/NGO education. Local and international NGOs provided education at all levels, and were essentially the sole providers at the pre-school level. Prior to the Gulf War, about 60 percent of the community colleges and all of the universities were funded with contributions from other Arab nations that the PLO channeled through the Council on Higher

Education. These transfers declined precipitously after the Gulf War, leaving Council-funded institutions in dire financial straits. After the Oslo II Agreement, international donor organizations picked up a substantial share of the costs for community colleges and universities. Although these institutions have responded by raising fees and taking other revenue-generating actions, financing the post-secondary level has yet to be rationalized.

High Literacy Rates. Palestinians have relatively high literacy rates: 84 percent for those 15 years or older (Table 11.3). The rates differ between males and females (91 and 76 percent, respectively), but this difference is primarily attributable to literacy differences between older men and women. There is virtually no difference in literacy rates between the West Bank and Gaza Strip. The difference among the cities, refugee camps, and villages (87, 84, and 81, respectively) is, again, primarily attributable to differences among older members of the population. In contrast, in 1995 the MENA region, as a whole, had an estimated adult literacy rate of only 57 percent.

Table 11.3 Comparative Indicators of Educational Attainment
in percentage

Indicator	WBGS	MENA
Literacy Rate:		
Age 15-19	97	79
Age 15+	84	57
Primary School Enrollment:		
Males	91	104
Females	92	91
Preparatory School Enrollment:		
Males (Age 12-14)	90	NA
Females (Age 12-14)	92	NA
Secondary School Enrollment:		
Male + Female (Age 12-17)	NA	56
Males (Age 15-17)	68	NA
Females (Age 15-17)	64	NA

Sources: PCBS (1996a), World Bank (1996d).

High Enrollment Rates. Gross enrollment rates are high, especially at the primary and preparatory, or lower secondary, levels (about 90 percent for the West Bank, Gaza Strip, refugee camps, cities, and villages). Enrollment rates drop to about 65 percent at grades 11-12. Males have higher enrollment rates than females at the upper secondary level in the refugee camps and villages, but equal rates in the cities. In contrast, the MENA region has an average gross enrollment rate of 97 percent for primary school (ages 6-11) and 56 percent for lower and upper secondary schools (ages 12-17). Since upper-secondary enrollment rates are lower than the lower-secondary level in all countries, the WBGS is clearly achieving better gross enrollment rates at the post-primary level than MENA as a whole. Completion rates for 15-19 year-olds were 93 percent for primary school and 63 percent for lower secondary school. Forty-four percent of the

20-24 year-olds completed upper secondary school, and 20 percent of the 25-34 year-olds held post-secondary degrees.

Box 11.1 International Assessment of Educational Progress

In 1991 the International Assessment of Educational Progress measured the performance of 13-year old students in science and mathematics. Jordan participated in this assessment in 1991. The same tests were administered to 13-year olds in the West Bank in 1992 and in UNRWA schools in Gaza Strip in 1993.

Of the 15 countries which assessed comprehensive samples of students, including Korea, Taiwan, Hungary, Switzerland, the Soviet Union, Israel, Canada, France, and the United States, Jordan scored the lowest in terms of average percent correct on both mathematics and science. Students in the West Bank and UNRWA students in Gaza Strip scored below Jordanian students. West Bank students in private/NGO schools performed significantly better than those in the schools under the Israeli Civil Administration, who performed somewhat better than students in UNRWA's West Bank schools. Although both Jordan and the West Bank use the Jordanian curriculum, *Intifada*-related school closures for several years prior to the assessment undoubtedly depressed the scores of West Bank students. At the same time, Jordanian students scored poorly relative to other countries, especially in mathematics, without *Intifada*-related closures affecting the schools. These results indicate general weaknesses in the Jordanian curriculum and pedagogy used in both areas.

More important are the results for different cognitive processes. Both tests assessed a grasp of concepts and facts and the use of knowledge and principles to solve complex problems. The problem-solving skills are particularly important in internationally competitive economies, which involve continuous change and the need to manage unfamiliar situations. On average, students from all countries that participated in the international assessment performed less well on the problem-solving items than on the conceptual understanding and knowledge items. In mathematics their average problem solving score was about 90 percent of their average score for conceptual understanding; in science, the integration score was 94 percent of the knowledge score. However, the performance gaps between the knowledge versus problem-solving items was greater for both the Jordanian and West Bank students: about 80 percent in mathematics and about 75 percent in science.

Sources: NCERD (1993), UNRWA & NCHRD (1994).

Quality of Education. Quality is defined here as student performance relative to WBGS's curricular goals (the Egyptian curriculum in the Gaza Strip and Jordanian in the West Bank) and relative to that of students in other nations with which WBGS must ultimately trade and compete. Available evidence indicates that the WBGS education system is not well organized to develop the foundation skills and higher-order cognitive thinking skills that students will need.

Although there are no data for assessing the performance of WBGS students relative to WBGS's curricular goals, Box 11.1 reports their performance relative to that of students in other countries. The secondary school exit examinations in mathematics and biology were also analyzed for Tunisia, Morocco, Iran, Lebanon, Jordan, and Egypt. West Bank schools use the Jordanian curriculum; Gazan schools, the Egyptian. If these examinations in fact reflect the content and performance expectations embedded in these countries' curricula, then these analyses

tell us something about the knowledge and skills that WBSG students are expected to learn. The results for these six countries were compared to those for the French *baccalaureate* examinations.

In mathematics, the MENA tests indicate a conception of school mathematics as a subject largely devoted to the recognition and repetition of definitions and theorems and the performance of algorithms and other routine procedures. Tasks evaluating examinees' abilities in problem-solving were largely absent from the MENA mathematics tests, whereas the French *baccalaureate*, in addition to the performance expectations typical of the MENA tests, assessed students' abilities to solve, predict, verify, generalize, and apply mathematical principles to real world problems.

In biology, all of the MENA tests evaluated a very large array of topics—many more than those evaluated in tests in the French sample. Given their broad scope, it is not surprising that these tests had very limited performance expectations, concentrating on understanding and remembering simple facts, with some attention to the use of understanding scientific principles to develop explanations. In contrast, the French *baccalaureate* did not assess simple information, but rather focused on complex information, thematic information, abstracting and deducting scientific principles, constructing and using models, designing investigations, and interpreting investigation data.

Getting the Efficiencies Right by Avoiding Costly Mistakes

As new ministries, the MOE and MHE can avoid the policy mistakes made by many MENA (and other) countries that have led to serious inefficiencies. An example of getting it right is the joint MOE, MHE, and Ministry of Labor strategy for vocational/technical education. The plan will save money by eliminating duplicative programs and improving economies of scale. It anticipates establishing a single training system to be used by students after they complete grades 10 or 12 and by adults, including experienced workers. There are plans for a system of training centers, each organized around an occupational "family." Each center will use modularized curricula, allowing the center to customize a trainee's program by selecting modules relevant to that trainee's needs.

Maintain Access at the Lowest Cost. The WBSG has respectable enrollment rates at all levels, but very high fertility rates, especially in the Gaza Strip, which will severely challenge the system's ability to maintain, let alone improve, access. In 1994, the total fertility rate was 5.61 in the West Bank and 7.44 in Gaza Strip, for a combined average of 6.24. These rates are among the highest in the world. In comparison, the total fertility rate for the MENA region was 4.5.

Meeting the rising demand for education will require substantial increases in school spaces and the number of teachers. The cumulative percent increase in the number of school spaces from 1995 to 2020 for the total system for ages 6-11 is 96 percent. For 12-14 year-olds, it is 115 percent; for ages 15-17, 123 percent; and for 18 and above, 192 percent. The student population for grades 1-12 will double in this 25-year period, increasing 106 percent. If a doubling of enrollments translates into doubling the number of schools, the physical plant will have to increase from its 1,357 schools in 1993-94 to about 2,700 schools by the year 2020. Meeting enrollment

growth for grades 1-12 even by the year 2000 will require an additional 330 schools (see Table 14 in Annex). These enrollment projections have significant implications for system costs, demanding a substantial investment budget.

The MOE has adopted a policy of single-shift schools—about 18 percent of its schools are currently double shift. However, population pressures on the schools should trigger a reconsideration of the single-shift policy. Double-shift schools make more efficient use of the physical plant, and the WBGS has been able to run double-shift schools without compromising annual instructional time. Single-shift and double-shift schools operate the same number of hours per day, and annual instructional time for 13-year olds is at the high end of the range compared to OECD and East Asian nations. Double-shift schools certainly pose difficulties, *e.g.*, children, especially girls, walking home in the dark in the winter. However, there are ways to eliminate or reduce such problems, such as creating a rota of adults who meet the children and supervise their transit from the school to the home.

Maintain Diversified Funding and Provision of Education. The PA inherits a sector with a history of diversified funding and provision at all levels of education. The challenge is to continue to encourage that diversity, especially at post-secondary levels. In several MENA countries, all levels of the education system are seriously distorted and quality visibly compromised because governments have been reluctant to diversify funding and provision between the public and private/NGO 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. One of the several policy challenges confronting the newly created MHE will be to craft a technically and politically sophisticated strategy that mixes public and private financing and that can easily accommodate greater private financing as the economic situation improves.

Do Not Use the Teaching Corps as a Public Sector Jobs Program. 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. The Egyptian civil service is bloated and sclerotic. Overstaffing makes it impossible to compensate each civil servant adequately. With wages so low, 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.

A second efficiency issue that involves teachers is weekly teaching loads. At the primary grades, WBGS teachers teach 26 classes of 45 minutes per week for a total weekly teaching load of 1,170 minutes. Relative to teaching loads in 19 countries, this is a fairly light load. In a survey of advanced countries, the number of teaching minutes per week ranged from a low of 1,000 minutes for Japan to a high of 1,830 minutes for the United States—a difference of 10 instructional hours per week. For WBGS an obvious analysis is 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 have to be hired to meet enrollment pressures.

Improving the Quality of the System

Sustainable growth of the Palestinian economy critically depends on an export-oriented development strategy (see Chapter 6). Palestinian wages are too high in comparison to China, India, or Indonesia for the economy to compete in unskilled labor-intensive production. The alternative is to develop the economy into a competent center that serves as an entry to Arab markets, producing goods and services to meet regional and international demand. Moving into the higher-wage regional and international market presents WBGS suppliers with a particular profile of customer demand. International customers expect a large, varied, and continuously improving basket of goods and services, fast delivery of orders, high and consistent quality, and low prices. In response, suppliers have to place a high premium on the diversification of goods and services, accelerated product and process innovation, speed, low cost, and high and consistent quality. To meet these requirements, employers usually have to change the organization of work and hire workers with different and higher levels of skills.

Competing successfully in regional and international markets requires conducive economic policies, good infrastructure, political stability, and high levels (and low variance) of skills throughout the occupational structure. If Palestinians are competent across the range of occupations that are needed to support manufacturing and service opportunities, then their economy can become more attractive as a commercial center for the Middle East. A model is Singapore, which, in conjunction with other key economic policies, strategically used educational and training investments, especially in the less- and medium-skilled occupations, to produce spectacular economic growth.

The WBGS education system will have to change the classroom learning situation if young Palestinians are to acquire the foundation skills and higher-order cognitive thinking skills required to support this long-term economic development strategy. Higher-order cognitive skills refer to skills such as problem-solving, integration, and knowing how to learn. These skills turn out to be particularly important in internationally competitive economies, which involve continuous change and the need to make judgments in unfamiliar situations.

Traditional pedagogy and its learning consequences fit the skill requirements of command and control, hierarchical organizations structured around the performance of narrow and repetitive tasks that allow little discretion. 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. There is an alternative paradigm for organizing teaching and learning that better fits the skill requirements of new workplaces. This paradigm places more responsibility on the student for his or her learning; focuses on the processes by which answers are reached, not just on finding the right answers; uses context to give intuitive meaning to abstract ideas; and stresses experience in using principles effectively. Table 11.4 compares the two alternative organizations of work and the two pedagogic paradigms.

Table 11.4 Matches between Workplaces and Pedagogies

Traditional Arrangements		New Arrangements	
Workplace	Pedagogy	Workplace	Pedagogy
Passive order-taking in a hierarchical work organization; Heavy supervision to control workers	Teachers as experts convey knowledge to passive learners	Workers are expected to take responsibility for identifying and solving problems and for adapting to change by learning	Under teacher support and guidance, students assume responsibility for learning, in the process developing knowing-how-to-learn skills
Emphasis on limited responses to limited problems and on getting a task done	Emphasis on facts and getting right answers	Workers deal with non-routine problems that have to be analyzed and solved	Focus is on alternative ways to frame issues and problems
Focus on the specific task independent of organizational context or business strategy	What is to be learned is stripped of meaningful context	Workers are expected to make decisions that require understanding the broader context of their work and their company's priorities	Ideas, principles, and facts are introduced, used, and understood in meaningful context

Source: Berryman (1996).

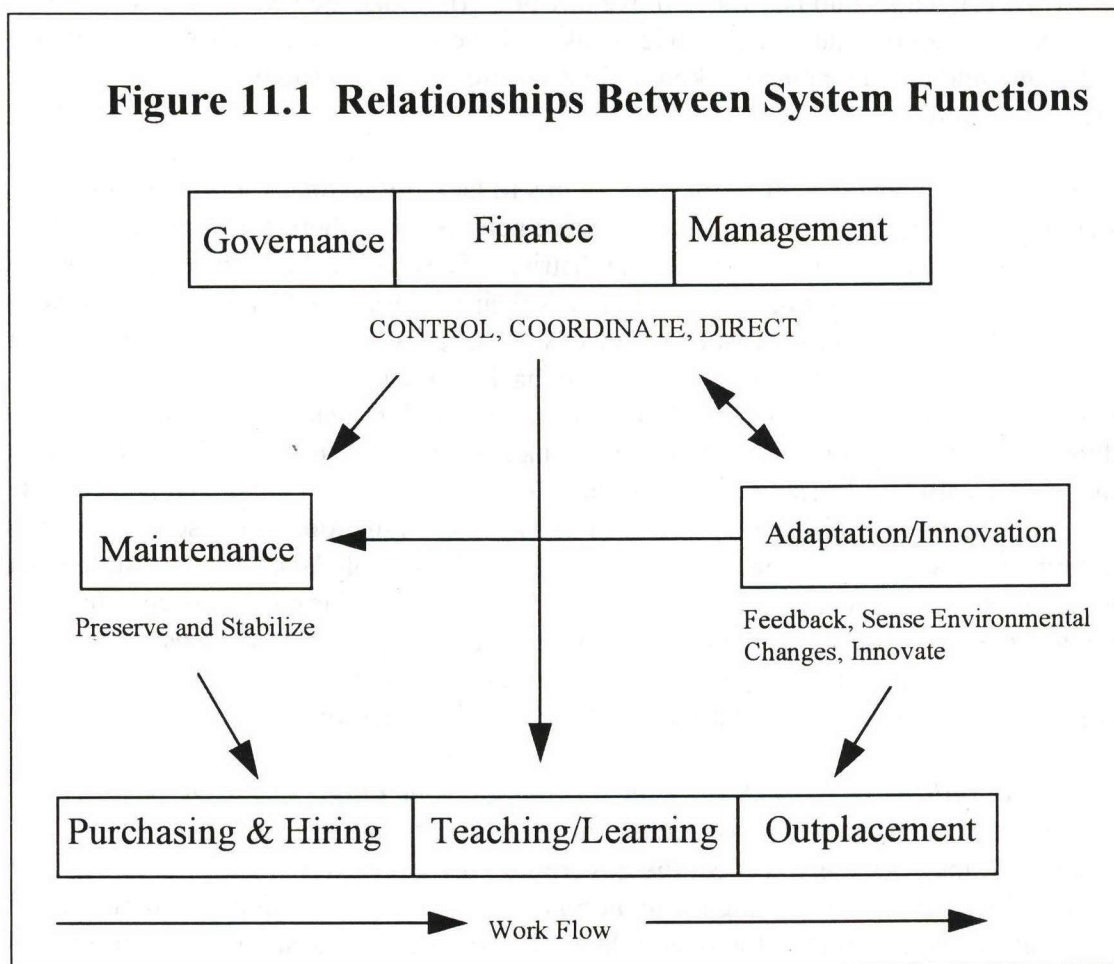
Quality reforms have a particular and difficult political economy, especially when compared with reforms that increase access to education. Increasing access requires adding inputs—building new schools, hiring more teachers, and purchasing more textbooks and equipment. This kind of reform usually enjoys 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 demands on the system's management capacity for a longer period of time. It also requires changes in the classroom behaviors of thousands of teachers, which implies adjustments to teacher training and incentives.

The first step in a reformist package is to develop a long-term strategy that sets goals, priorities and accountabilities. It is against the demands of such a package that the institutional weaknesses in the WBSG educational system are revealed.

Improving the Institutional Structure of the Education System

The Israeli Civil Administration acted as a passive caretaker and administrator for that part of the WBSG educational system under its control. To secure efficiencies and to produce the type of quality education needed to successfully compete internationally in high-value activities, the education system will have to change from a maintenance mode to a continuous improvement mode.

Figure 11.1 displays functions that can be used to assess the institutional status and challenges facing the MOE. Not surprisingly, the analysis shows that the performance of all functions is handicapped in various ways and to differing degrees and reveals an accountability framework that is organized around conformity to rules and regulations.



Source: Berryman (1996)

The primary function of the governors of the system is to establish goals. The selection of goals should emerge out of a national goal-setting process that develops consensus among the stakeholder groups. Given the recent transfer of authority, it is not surprising that the WBGS lacks clear goals for its educational system. The new curriculum center has initiated public debates and discussions about curricular goals. However, a general goal-setting process has not been conducted. Such a process requires trustworthy data for the education sector as well as the capacity to monitor progress toward achieving goals. Sound data are invaluable for building consensus, resolving disagreements, pinpointing major problems, selecting goals, and setting performance targets. When data are organized as indicators, they can be used to measure progress toward meeting those targets. Although relevant data are now being collected, some of the most policy-relevant data are still missing, *i.e.*, information on student learning achievements.

To organize resources effectively, set priorities, and measure the system's performance in relation to its goals, management needs a competent policy-making capacity, performance feedback mechanisms, and an accountability framework that focuses actors in the system on its goals. Effective policy-making requires good statistical indicators and competent policy analysis and policy planning capacities. Although the MOE is beginning to develop this infrastructure, collectively the top leadership has yet to move out of a crisis management mode. Routines that ensure systematic, rather than ad hoc, policy-making have yet to be established. Until policy makers demand and use the policy-making infrastructure, the infrastructure itself will not be developed effectively.

Thus far, the management framework seems to lack the feedback loops that monitor how the system is performing and that trigger corrective actions when there are gaps between standards and performance. For example, the district offices have school inspectors, but teacher evaluations are not linked to training that improves their performances, and school evaluations are not linked to effective technical assistance services for schools. The sector is therefore impaired in its capacity for adaptation and innovation. Feedback mechanisms include: (i) management information, *i.e.*, enrollment trends, number of teachers and their teaching specialties, expenditures, and completion of scheduled maintenance activities; (ii) education indicator data, especially data on student learning outcomes; and (iii) evaluations of managerial and educational initiatives, *i.e.*, the decentralization of selection management functions to the school levels or the introduction of a new fourth grade curriculum. The MOE not only lacks data on student learning, but also lacks expertise in evaluating initiatives. The Jordanian reform experience shows how critical evaluative feedback is for tracking the implementation and consequences of change initiatives. On the basis of evaluations, some initiatives were terminated. Others were restructured to take account of problems identified by the evaluations.

Accountability Framework Focused on Student Learning. The MOE should start to plan an accountability framework that focuses at least on student learning. The sector's accountability framework has to reflect the governors' key goals, which have yet to be established. However, since learning is the ultimate point of any educational system, it can be presumed that this will be one of the overarching objectives for the system. Most countries in the region define accountability in the sector as following rules and regulations. A lack of focus on student learning is particularly damaging. In its absence, it becomes easier to use the education system for ends inconsistent with the main purposes of the system. Even efforts to improve student achievement tend to become converted into administrative processes and rules.

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. All players in the system—the MOE, ministerial under-secretaries and directors, ministerial, provincial, and local administrators, school directors, teachers, faculties of education, international organizations, donors, and NGOs—should be held accountable for meeting the performance objectives. The primary accountability for most actors should be for student learning, with special accountability criteria for functions such as finance or procurement. However, until national assessments of student learning become routine, an accountability framework organized around student learning obviously cannot be created.

Establishing a Financing Framework is a High Priority. The MOE has yet to establish modern budget planning processes and a trained staff that will let them handle issues such as estimating the immediate and long-term financial impact of alternative cost-saving options or assessing the recurrent cost implications of proposed investments. The MOE and the MEHE should work closely on an overall financing framework for the sector. 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.

Improving Teacher Quality and Curriculum. Another challenge for the institutional infrastructure is establish ways of acquiring and maintaining the quality of the human and physical assets required to produce learning. Major inputs include teachers, school buildings; curricular frameworks with associated textbooks and teacher guides, and equipment.

Improving the quality of the current teaching force should be one of the highest priorities for both the MOE and the international donor community. The MOE accurately views teacher quality as a very serious problem that will take years to solve. The current teaching force is seriously under-qualified, having received virtually no professional development under the Israeli Civil Administration. Thus, teachers' skills and knowledge, which initially were not that strong, have not been refreshed and updated. There is also substantial out-of-field teaching. For example, the MOE estimates that about 37 percent of its science teachers have had no special training in science. Mathematics runs a close second to science.

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, the MOE should consider introducing national teacher licensing examinations that assess both content knowledge and pedagogic practice. The international literature shows that teachers' skills and knowledge are much better predictors of student learning than teachers' years of education. Good credentialling assessments, once developed, provide effective standard-setting signals to universities and community colleges who prepare future teachers. If too many graduates of particular pre-service programs fail the credentialling examinations, those programs will suffer enrollment declines.

Since the West Bank and 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. The MOE's effort to integrate the territories' curricula around the newly revised Jordanian curriculum was met with political resistance from Gaza Strip. It is not efficient for the Palestinians to create their own curriculum and textbooks for subjects in which country-specific experiences are less relevant, such as mathematics and the sciences. However, to solve the integration problem, it seems politically necessary. Given the political need to develop a Palestinian curriculum, the Curriculum Center has chosen to involve stakeholders in curricular decisions. It is important to address the issue of performance expectations that the new curriculum would set in light of optimal development of the human capital which is consistent with the strategy of economic development.

Setting priorities for school equipment is complicated. Simple equipment such as blackboards, maps, charts, globes, manipulatives, and sports equipment is relatively inexpensive, needs little maintenance, and might be funded by community and donor contributions. However, investments in more expensive resources, such as computer laboratories, science laboratory equipment, and libraries, should be carefully analyzed in light of goals. Millions of dollars have been wasted in both developed and developing countries on these resources because one or more conditions for their effective use have not been met.

* * *

The education sector faces institutional challenges that will take years to solve and whose solutions have to be sequenced. The first step is the development of a long-term strategy that sets priorities and accountabilities. Medium-term priorities seem to be: the development of systematic policy-making processes within the MOE; the construction of a unified Palestinian curriculum with performance expectations associated with the building of skills and knowledge key for economic, as well as democratic, development; the creation of feedback mechanisms—especially of student learning assessments; and a broad and intense attack on the problem of teaching quality.

Bibliographical Note: This chapter is based on the background papers of Berryman (1996) and Abu-Duhou (1996). Data is drawn from PCBS (1995, 1996a) and World Bank (1996a). Other references include Valverde, Schmidt, and Bianchi (1996); Claudet (1996); US Department of Education, National Center for Education Statistics (1993); and Nelson and O'Brien (1993).

Chapter 12

Managing the Growth of the Health Sector

The health status of the Palestinian population is generally good compared to prevailing income levels. Infant and child mortality are low, life expectancy is high, and moderate and severe malnutrition are rare. The challenges to the health sector include ensuring financial sustainability in a difficult political and economic environment, managing the ongoing institutional transformation, and guaranteeing access to quality health services for a rapidly growing population while improving overall efficiency of the sector. A prerequisite for meeting these challenges is to involve key stakeholders in developing a strategy for the health care sector.

Introduction

The health conditions of the Palestinians in the WBGS are good in relation to the prevailing income levels and to countries at comparable levels of development. According to the PCBS demographic survey of 15,000 households, the infant mortality rate for those less than one-year old was 28 deaths per thousand live births in 1995 (25 per thousand in the West Bank and 32 per thousand in the Gaza Strip). Relatively low infant and child mortality rates are reflected in a fairly high life expectancy at birth, which stood at 70 years for males and 73.5 years for females in both the West Bank and Gaza Strip—higher than most countries in the Middle East, and comparable to upper middle-income economies, such as South Korea (Table 12.1).

The good health status in the WBGS is the result of an emphasis on primary care at the household level for the past two decades (Box 12.1). 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. The proliferation of non-profit NGOs contributed to improvements in health by fulfilling health care needs not provided by the government or UNRWA.

While the current status of health conditions is favorable for the level of development in the WBGS, achievements in this area are fragile. Whether health indicators can be maintained (or improved) is a serious challenge for the economy as a whole. The high population growth rate, epidemiological transition, and introduction of advanced medical technology implies a rapidly increasing demand for increasingly expensive health services which could have severe financial implications. On the delivery side, the health system needs to enhance its macro efficiency by maximizing the use of excess capacity in various subsectors and improve the efficiency and quality of services provided at the individual facility level. For example, bed occupancy rates in Ministry of Health (MOH) hospitals are 84 percent compared to 64 percent in NGO hospitals and 24 percent in NGO maternity clinics. The border closures have increased in intensity and frequency and pose special difficulties for the transformation of the Palestinian health care system, with its traditional premier institutions located in East Jerusalem.

Table 12.1 Health Indicators

	West Bank	Gaza Strip	WBGS	Egypt	Morocco	Jordan	Tunisia	South Korea
Life expectancy at birth (years)	71.7	71.7	71.7	62	65	70	68	71
Infant mortality rate (per 1000)	25	32	28	52	56	32	40	12
Maternal mortality rate (per 100,000)			70-80	--	--	132	139	30
Total fertility rate	5.6	7.4	6.2	3.5	3.5	4.8	5.2	1.8
Access to piped water (percentage)	71.4	96.3	79.6	86	--	99	--	78
Access to public sewer (percentage)	19.2	48.7	28.9	--	63	70	72	100

Sources: PCBS (1996a) and World Bank (1996d).

Box 12.1 Disease Patterns

The substantial improvement in mortality rates and life expectancy is largely a result of successful immunization programs that have controlled childhood communicable diseases. The high levels of literacy and education have also contributed significantly to utilizing health care services (e.g., immunization programs) to improve health outcomes.

Seventy percent of child deaths result from infectious disease, predominantly to the respiratory system. Diarrhea is the second cause of death among children. The high prevalence of infectious diseases among children is related to overcrowding and poor environmental conditions. Only 28.9 percent of households had access to piped public sewers (19.2 percent in the West Bank and 48.7 percent in the Gaza Strip) (Table 12.1). Many of these sewers are poorly maintained and may be a major contributor to the spread of disease. Among adults, 37 percent of deaths resulted from cerebrovascular, coronary heart disease, and cancers. This reflects the progress of the epidemiological transition to the "modern" diseases common in high-income economies.

Maternal health is of special importance given that the fertility rate in the WBGS is among the highest in the world. The total fertility rate of a woman through her reproductive years stood at 5.61 children in the West Bank and 7.44 children in the Gaza Strip, with a combined average of 6.24 children. MOH data suggest that maternal death is the third largest cause of death among women of reproductive age. According to the 1995 demographic survey, the maternal mortality rate was between 70 to 80 per 100,000. Hypertension caused by pregnancy (eclampsia), post-partum hemorrhage, and chronic diseases associated with pregnancy, are the leading causes of maternal mortality. The fraction of home births without professional attendance is 31.6 percent in the Gaza Strip and 40 percent in the West Bank.

Source: Barghouthi and Lennox (1997).

System of Delivering Health Services

Health care is provided by four major groups: the MOH, UNRWA for refugees, non-profit NGOs, and for-profit private sector practitioners and companies. The total recurrent expenditure on health was estimated at about \$250 million in 1995, with the MOH spending 31 percent of the total, UNRWA 12 percent, NGO providers 17 percent, and the private sector 40 percent.

PA Ministry of Health Services: Building a Secondary and Tertiary Care Structure. In May 1994, the MOH took over the responsibility for health services in the Gaza Strip and Jericho and, at the end of 1994, in the remainder of the West Bank with the exception of Jerusalem. The MOH provides selected primary care services such as ante-natal care, vaccinations, and treatment for children under 3-years old free of charge to all Palestinians. In addition, primary health care services are provided (free at point of delivery) to those enrolled in the government health insurance scheme through MOH network of facilities (Table 12.2).

Table 12.2 Health Institutions by Auspices

	MOH		UNRWA		NGOs	Private
	1995 level	new addition	1995 level	new addition	non- profit	for- profit
West Bank						
Primary care						
Primary care	178	6	22	13	176	?
Maternal & child clinics	9	--	0	--	--	--
Health rooms/posts	74	--	12	--	--	--
Secondary care						
General hospitals	9	6	1	0	6	--
General hospital beds	706	--	43	20	321	--
Maternity hospital beds	--	--	--	--	170	79
Psychiatric hospital beds	320	--	--	--	--	--
Gaza Strip						
Primary care						
Primary care	29	7	11	4	31	?
Maternal & child clinics	--	--	6	1	--	--
Health rooms/posts	--	--	1	--	--	--
Secondary care						
General hospitals	5	--	0	1	1	--
General hospital beds	865	--	50*	250	80	--
Maternity hospital beds	--	--	--	--	--	--
Psychiatric hospital beds	--	--	--	--	--	37

* contracted

Source: Barghouthi and Lennox (1997).

Most government primary health care clinics are staffed by a part-time general practitioner with nursing and ancillary staff. The general practitioner provides curative services (usually two days per week), while nurses and midwives provide a range of preventative services including ante-natal care, well-baby clinics, and vaccination programs. Eighty-two percent of the doctors working in government clinics are general practitioners who rotate among clinics (Table 12.3).

Table 12.3 Medical Workers in WBGs*

	MOH (1995)	UNRWA (1995)	NGOs (1993)	TOTAL
West Bank				
Doctors	451	52	392	895
Nurses	1,031	176	214	1,421
Technical	243	70	204	517
Gaza Strip				
Doctors	541	57	129	700
Nurses	912	184	124	1,220
Technical	252	70	96	415

* Excludes the for-profit private sector.
Source: Barghouti and Lennock (1997).

The MOH provides secondary level services through nine hospitals in the West Bank (with 706 general beds) and five hospitals in the Gaza Strip (with 865 general beds). Tertiary level services and certain advanced diagnostic techniques are purchased by the MOH on behalf of insured patients from non-governmental hospitals in WBGs, Israeli hospitals, and from Egyptian and Jordanian hospitals. In 1995, \$14 million was spent in the purchase of such treatment.

UNRWA Health Care: Basic Services under Extreme Stress. The health care services provided by UNRWA are largely limited to primary care. UNRWA faces extreme financial pressure as its resources are seriously limited in light of a rapidly growing eligible population. UNRWA is expanding its health centers with support from the donor community to meet some of the increasing demand for its services. A key challenge to UNRWA is its long-term future, given its anticipated integration into the MOH services. But this integration cannot be achieved until the status of refugees is settled in the final status negotiations.

UNRWA directly provides free primary health services (including drugs) to the refugee population through its facilities. These health clinics provide a full range of preventative, curative, and community health care services. All health centers and health posts provide special clinics for diabetes and hypertension, while all health centers in the Gaza Strip and half of those in the West Bank provide dental services. Maternal and child health services are also provided free to non-refugees.

Most doctors employed by UNRWA are general practitioners. The number of clinics and doctors is extremely low relative to the target population, resulting in the lowest time per consultation among health subsectors. Typically, a doctor would see 101 patients per day. Thus,

the quality of UNRWA medical care is perceived to be low in comparison to other health subsectors.

UNRWA's secondary and tertiary health services are very limited and usually contracted out to other hospitals with a co-payment from the patient. At these hospitals, refugees co-pay 25 percent of the cost of treatment. In Al-Makassed Hospital the co-payment is reduced to 10 percent if they are recognized hardship cases. These contracted hospitals include Al-Ahli in the Gaza Strip and Hebron, Itihad in Nablus, Palestine Red Crescent Society in Ramallah, and Augusta Victoria in East Jerusalem. The UNRWA runs a 43-bed hospital in the West Bank, and is expected to run the 250-bed European hospital, under construction, in the Gaza Strip before eventually turning it over to the MOH.

Fragility and Decline of NGO Health Services. In the absence of adequate health services during the period of occupation, many NGOs started offering health care services as a not-for-profit activity. Prominent among these are the Palestine Red Crescent Societies (PRCS), Patients' Friend Societies, Women's Union Societies, and grassroots health organizations that are closely related to the major Palestinian political factions. Their number expanded rapidly throughout the 1980s and particularly after the onset of *Intifada*. Supported by external funding from Palestinians and others in the Gulf, from the PLO, and from international organizations, the NGOs succeeded in doubling the number of health care clinics that provided basic services in the WBGS during the *Intifada* years.

The NGO health subsector suffered a serious setback following the 1990-1991 Gulf War, which effectively eliminated external support—private and PLO. The establishment of the PA in 1994 caused the donors to divert financial support from the NGOs to the MOH and UNRWA. As a result, the number of NGO clinics in the rural West Bank declined from 210 in 1992 to 128 in June 1996.

The NGOs have generally filled a need not satisfied either by the government or UNRWA, by providing curative services in primary health care clinics targeted to underserved communities. For example, NGO clinics have the highest number of specialty doctors of all providers, *e.g.*, specialty clinics in diabetes, obstetrics and gynecology, ophthalmology and dermatology are available in about 25 percent of NGO clinics in the West Bank.

NGOs also provide secondary and tertiary care. The preeminent Palestinian tertiary center is the Al-Makassed Hospital in East Jerusalem, with 250 beds, providing general and advanced surgery including cardiovascular, neurosurgery, plastic surgery, and gynecology. Al-Makassed is the main referral hospital for the West Bank.

Private Sector on the Rise. The private for-profit health sector runs private clinics and specialized private hospitals (particularly maternity hospitals), and also provides technically advanced health services, such as computerized tomography (CT) and magnetic resonance image (MRI) scanning and invitro fertilization. Many solo private-sector health practitioners also work full-time in the government, UNRWA, or NGO sector. While the size of the private sector is difficult to estimate, it appears that the private sector's role in service delivery has grown since the

establishment of the PA. Large private health care companies have been formed, and have started to buy out the operations of financially strapped NGO health providers. The PA supports the growth of private sector health since these companies provide health services to the MOH at a cost lower than Israeli providers or referring patients to Jordan and Egypt.

Improving Efficiency and Quality of Care

Over the past two decades, the health care system has been largely driven by an overall emphasis in primary care, due mainly to the significant involvement of grassroots NGOs and the UNRWA. In recent years, the PA has placed more emphasis on expanding hospital capacity. This policy is intended to correct the limited investment in secondary and tertiary care under Israeli occupation and to reduce costly reliance on Israeli hospitals. But the vacuum left by the declining role of NGOs could leave a significant fraction of the population—especially the poor—with reduced access to basic services.

The development of a rapidly growing unregulated private sector could exacerbate the emerging duality in the health care system: a low quality system (accessible to all) focusing increasingly less on preventive care as the PA places increased emphasis on secondary and tertiary care, and a high quality system focusing on curative treatment that caters mainly to richer segments of the population. These developments could ultimately result in deteriorating aggregate health indicators for the population, as the rather impressive outcomes in the past may be largely attributed to wide access to primary care services (Box 12.1). The need for primary care and preventive care remains high. For example, to address the epidemiological transition in a cost-effective manner, preventive approaches directed to non-communicable disease such as cardiovascular disease and cancer need to be developed and implemented so as to reduce the number of individuals who would require more expensive curative care.

In this context, the balance of public funds expended between primary and secondary/tertiary care needs to be carefully evaluated. In the West Bank, the MOH currently spends one-third of its budget on primary care and two-thirds on hospital care, translating into \$29 million on primary care facilities and \$70 million on hospital expansion and construction. In 1994-1995, UNRWA spent 47 percent of its West Bank budget and 65 percent of its Gaza Strip budget on primary care, with the remainder allocated for hospital care. While UNRWA's operations in the Gaza Strip appropriately emphasize primary care, it appears that the government's investment and recurrent budget should maintain previous emphasis on primary care facilities, if previous health outcomes are to be maintained. With the decline in NGO funding, particularly in the West Bank, expansion in secondary and tertiary health facilities should emphasize the involvement of the private sector.

An alternative approach to direct expansion of the government-run health system would be to explore the purchasing of health services from the NGOs and private sector. This would increase the overall macro efficiency of the system as it would make use of the excess capacity in the NGO subsector—including their previous experience and special knowledge of community needs. However such public/private collaboration requires the development of appropriate regulatory and monitoring mechanisms to address financial performance, *i.e.*, appropriate use of

tax and customs exemptions, user evaluations, client surveys which are accessible to the press and the public, and professional accreditation review. These instruments should be complemented by feedback mechanisms to help institutions upgrade their capacity and improve performance. It is suggested that during the transition phase in the WBGS, the creation of accountability mechanisms should not be heavily dependent on a rigid legal system. Formulating an NGO law is a governance challenge best done through the integration of appropriate stakeholders, so that the law is "owned" and transaction and enforcement costs are kept low.

It is suggested that a unified licensing system be established for all health professionals and institutions both in the public and private sector (including NGOs) in the medium term. The MOH, in collaboration with professional associations, should be responsible for monitoring the quality and efficiency of services provided using consistent and transparent indicators. Wide publication of such indicators could provide information that would help the market evaluate performance and make choices which could stimulate quality-based competition among various providers. Collection of such transparent indicators and client surveys could help to depoliticize NGOs by introducing objective performance-based measures. Investigative journalism and public citizen policing may be among the least costly and most effective enforcement instruments to ensure accountability for services provided.

Paying for Health Services

Estimates of the total expenditure on health range between 8 to 9 percent of GDP, or a little less than \$100 per capita per year. MOH expenditure accounted for about one-third of total health expenditure in 1996 while direct household expenditure accounted for about 40 percent in the same period. MOH's 1996 revenues were derived from the general tax revenues (63 percent), Government Health Insurance Program (27 percent) and co-payment and fees collected at facilities (10 percent).

The relative importance of insurance premiums to MOH expenditure has declined. This is largely related to the PA decision to lower the premium levels significantly to encourage expansion of insurance coverage (coverage increased from 20 percent in 1993 to 50 percent in 1996). Although enrollment rates have increased overall, certain categories such as contributions for workers in Israel has declined (Table 12.4). The resulting shortfall has been increasingly covered by PA's general revenue. Given the worsening economic situation and rising unemployment, it is unlikely that total revenues from the health insurance program would rise significantly. Thus, any increasing recurrent costs related to expansion of the system would need to be covered by increasing general revenue allocations to the MOH.

At present the Government Health Insurance Scheme functions essentially as a earmarked tax-collection mechanism for health services (all funds collected are transferred to Ministry of Finance) to supplement the general revenues. Other essential functions of an insurance agency or a third-party payer (*i.e.*, the contracting of services with the providers; the designing, costing and evaluating the benefits packages for the covered population; and fund management) are performed, to a limited extent, by various departments and committees within the MOH. Thus,

the linkages between revenue collection and resource allocation decisions appear to be relatively weak.

• **Table 12.4 Changes in the Cases Enrolled in Government Insurance Scheme (1994-1995)**

Category	Gaza Strip			West Bank		
	Jan. 1994	Dec. 1995	% change	Jan. 1994	May 1996	% change
Voluntary	9,000	18,624	107%	8,000	18,228	128%
Government Employees	8,000	17,748	122%	16,000	25,464	59%
Workers in Israel	23,000	16,000	-30%	46,000	10,376	-77%
Police Officers	0	18,000		0		
Social Welfare Cases	12,000	15,109	26%	12,000	15,123	26%
Ex-Prisoners	0			0	6,782	
Total	52,000	85,481	64%	82,000	75,973	-7%

Sources: Israeli Ministry of Health (1994); Palestinian Ministry of Health (1996a, 1996b); and information from Health Insurance Department.

Certain groups, such as non-refugee poor or uninsured families, are facing greater financial difficulties in accessing health care. Moreover, there are certain aspects of the existing insurance system which are likely to present major obstacles to expanding coverage, maintaining solidarity, and protecting access to care for the poor. They include: (i) the relatively low ceiling on monthly insurance premium payments (\$22) which establishes a regressive system of revenue collection and limits the contributions from the well-to-do; (ii) the voluntary nature of participation in the social insurance system that allows the well-to-do and low-risk population groups to "opt out" of the system; and (iii) the high unemployment rate. The MOH requires better information on the characteristics of the insured and uninsured population in order to evaluate the redistribute effects of its financial policies. For example, at present there is no analysis available on the socio-economic profile of the uninsured population. Private insurance appears to be limited to richer Palestinians as less than 2 percent of population is covered.

Controlling Costs

Controlling the cost of the health care system is critical given the rapidly increasing demand for expensive health services. It appears that there are three broad areas of concern: (i) expenditure on pharmaceuticals is rapidly rising; (ii) expansion of hospital facilities and advanced medical technology may result in significant long-run recurrent operating costs; and (iii) limiting expensive treatment abroad, especially in Israeli hospitals, in favor of building the local capacity.

In examining the MOH expenditure categories, about 21.5 percent of total expenditure is spent on drugs and medication. Pharmaceuticals account for 36 percent of total health expenditure, as private providers rely excessively on prescribing drugs. In order to rationalize overall health expenditure, major pharmaceutical reform is essential, *i.e.*, the introduction of standard protocols or essential drug lists.

The current hospital bed per population ratio is 1.2 per thousand in the WBGS (including East Jerusalem), at 3,127 beds. Plans for constructing new hospitals in Jericho, Nablus, and the Gaza Strip, and expanding existing hospitals (with donor assistance) would increase that the number of beds by at least 1,190 to reach 4,317, resulting in a ratio of 1.7 beds per thousand population. This expansion should reduce the cost of treatment abroad. However, at current operational costs and without improving the quality of health care services, the expansion in hospital bed capacity will substantially increase operating costs by up to \$19 million per annum (almost 20 percent of MOH's 1996 expenditure) according to one estimate.

The cost of patient treatment abroad must also be controlled. The MOH paid \$14.1 million for treatment abroad in 1995, accounting for 18.2 percent of the total MOH recurrent expenditure. Although half the cases were referred to Al-Makassed Hospital in Jerusalem in 1995 and an additional number of cases were referred to the PRCS hospital in Cairo and the Arab Heart Surgical Center in Amman, the bulk of expenditure went to Israeli hospitals. Expenditure at the Israeli Hadassah hospital amounted to \$10.1 million or 71 percent of all expenditure on treatment abroad.

Impact of Closures on Palestinian Health System

The difficulties in movement resulting from permit and closure policies (see Chapter 3) create challenges for the management and delivery of health services. The training of health care professionals is undermined and the cost of such training is increased, as health professionals cannot move between the two regions with ease. Communication between staff of the MOH in the Gaza Strip and the West Bank is difficult at best, which creates obstacles for devising the right policies for the whole Palestinian economy. When policies are adopted, the two regions could differ in the timing or actuality of their implementation. For example, the system of vital statistics (birth, death, hospital registration) is working effectively in the Gaza Strip but not in the West Bank.

The most dramatic impact of the permit policy is the difficulty for Palestinians to access NGO hospitals in East Jerusalem. There are four Palestinian hospitals in East Jerusalem, with 546 beds, that provide essential secondary services. The Al-Makassed Hospital is the main teaching hospital and the only tertiary-level hospital for Palestinians. Sixty percent of its patients are from the RWB. It provides a number of services that are not available in other hospitals such as plastic and cardiothoracic surgery, and employs some of the most experienced medical staff. The St. John's Hospital is the only ophthalmic hospital for West Bank residents and 85 percent of its patients come from the RWB. For the last 28 years, Augusta Victoria Hospital has been the main secondary health care facility for the refugee population of the West Bank. Problems such as serious burns, oncology problems, cardiovascular surgical problems, and pediatric surgical problems can only be treated at the Palestinian hospitals in East Jerusalem or at Israeli hospitals. The West Bank medical staff of Jerusalem hospitals and RWBGS patients may be issued special permits to report to the medical facility in Jerusalem. These permits are for a short duration, with uncertain renewability, and may not necessarily be issued for patients (see Box 3.1 in Chapter 3).

During periods of closure, the entry of WBGS medical staff to Jerusalem is much more uncertain even with the proper Israeli-issued permits. Sometimes, medical staff may be allowed to enter but without their vehicles. The entry of patients is even more difficult. This places the health needs of the WBGS population at great risk. Bed occupancy and the number of outpatients decline substantially during closure, causing financial losses to these hospitals. For example, bed occupancy at Al-Makassed Hospital 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 between the West Bank and Gaza Strip, and the difficult access to Jerusalem is likely to result in the proliferation of new hospitals and medical facilities throughout the RWBGS. This raises questions about the overall efficiency of delivering health care services by numerous small units. Hospital expansion in the WBGS is likely to have a negative impact on the financial viability of the Jerusalem hospitals that have served the Palestinians for many decades. The evolving strategy for the health care system must weigh in economic terms, the cost of irreversible investment that is built on the assumption of lack of access.

* * *

The health sector in the WBGS is rich in its diversity and institutional structure. Yet, this structure is facing serious challenges that should be addressed in a comprehensive framework. The NGO health providers have expanded the delivery system and satisfied many important needs. The Jerusalem hospitals have served the Palestinians when investment in expensive new hospitals would not find funding or permission from the Israeli Civil Administration. Yet, both the primary care NGO clinics and the Jerusalem hospitals are marginalized in the new environment, but for different reasons. The strengthening of the government role in the delivery of health services is essential, and it only makes economic sense for the for-profit private sector to increase its role in delivering health care. Yet, there is a danger in the new environment that some of the fundamental achievements of the Palestinian health system would be reversed. To preserve and strengthen existing health levels, it is essential to improve the overall governance of the health care system and ensure its financial sustainability.

Bibliographic Note: This chapter draws extensively on the background paper by Barghouthi and Lennox (1996). It also uses information from World Bank (1993, 1996d, 1997) and PCBS (1996a and 1996b).

Chapter 13

Infrastructure for Growth

Major expansion in infrastructure is needed in the WBGS to support economic growth. A meaningful strategy for its development should be guided by specific local needs. Four critical principles emerge. First, it is vital to establish links to move people and goods to the rest of the world and within the WBGS. Second, a forward-looking strategy could make it possible to exploit modern information technologies to complement existing human capital. Third, provision of inputs to production and to livelihood (electricity, water, and telecommunications) is urgently needed. Fourth, the sources of infrastructure services must be diversified, including reducing reliance on Israel, in order to diminish risks and make possible competition among suppliers.

Introduction

Compared to other countries at similar levels of income, the provision of infrastructure services is seriously deficient in the WBGS. In the 1990s, there has been virtually no expansion of infrastructure services. It has fallen behind in per capita terms. Years of neglect and under-investment have resulted in a deficient and unreliable infrastructure. Large parts of the infrastructure stock are unused because of system losses or disrepair. The quality of services is poor and deteriorating. The provision of infrastructure and, hence, its prospects continue to be predominantly in Israeli hands.

A necessary, but modest, effort at rehabilitating the infrastructure began in 1993. But in 1995 and in 1996, infrastructure investment amounted to only \$50-60 million annually, translating to less than 2 percent of GDP. 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 economic growth. This chapter discusses infrastructure needs in transportation, electricity, communications, and water, along with some of the principles that should guide the development of these sectors.

Palestinian Infrastructure in an International Perspective

Transport. Many measures can be used to compare infrastructure stocks and services across countries. The WBGS road network is just over 2,000 kilometers (km) in length, with 750 km of main roads, 550 km of regional roads, and 850 km of local roads. Virtually all the major roads were constructed before 1967 and have received minimal or no maintenance. International transportation (ports and airports) are almost entirely under Israeli control. The exceptions are the bridges to Jordan and the Rafah crossing to Egypt (see Chapter 6).

Electricity. Over 95 percent of WBGS households have electricity connections. Those not connected tend to live in remote communities. However, connection does not necessarily imply an adequate or steady supply of electricity. At present, the WBGS has access to about 300 megawatts (Mw) of supply, almost entirely supplied by the Israel Electric Company (IEC). Certain village communities not connected to the grid use local generators. Per capita supply is significantly lower than for other countries in the region (Table 13.1). Effective supply to consumers is even smaller because of very large system losses that have apparently increased in the past few years as the assets have been allowed to depreciate.

Telecommunications. Though not an immediate hazard—as with the severely under-provided sanitation services—restricted access to telecommunications presents a major limitation for growth. With 78,000 phones, there are just over three phones for every 100 persons. Due to the extreme shortage of conventional phones, 25,000 mobile phones are in use (about one mobile phone for 100 persons). Even Egypt with a much lower per capita income has a higher phone penetration ratio. As shown on Table 13.1, there are almost 10 phones for 100 persons in Mauritius, a rapidly growing economy, heavily dependent on trade and foreign investment.

Prior to the peace process, telecommunication services were supplied by the Israeli company, Bezeq. The Israeli Civil Administration in the Palestinian areas controlled the local access to service. Since 1993, the control of the local loop is with the newly formed Ministry of Communications of the PA. However, most long-distance services, even within the Palestinian areas, and all international services, continue to be provided by Bezeq. The lack of phones is already proving a constraint to investment. In Ramallah, obtaining a phone connection is a major undertaking and has deterred investors. In Gaza City, the most modern hotel was operating with one phone line as of August 1996. If the vision of an information society is to be seriously pursued, and if trade in services is take off, basic phone service needs a major boost.

Table 13.1 Comparing Infrastructure Services in the WBGS*

Country	Population (million)	Per capita income (US \$)	Electric supply (kw per 100 people)	Electric power system losses (%)	Households with sanitation (%)	Number of phones (per 100 people)	Meters of paved roads (per 100 people)
Egypt	55.0	650	21	14	50	4.3	59
Jordan	3.9	1120	25	19	100	7.0	170
WBGS	2.4	1450	13	30	25	3.1	80
Lebanon	4.0	2500	32	N.A.	N.A.	9.3	N.A.
Syria	13.0	2800	30	N.A.	63	4.1	180
Israel	5.1	13500	82	4	100	37.1	266
Mauritius	1.1	2700	33	14	100	9.6	190

* Data are for the years 1992-1994.

Sources: World Bank (1994c); International Yearbooks of Telecommunications Statistics; Electricity Statistics; Road Statistics; KPMG report on telecommunications, and internal World Bank reports.

Water. As with electricity, over 90 percent of WBGS households are connected to water supply. But the volume of water supplied has been declining over the 1990s. Water consumption per head is much lower than in neighboring countries (*e.g.*, less than 90 liters per

capita per day in the WBGS compared to 140 and 280 liters in Jordan and Israel, respectively). Also, water quality has been steadily deteriorating. With depleting aquifers, sea water seepage in the Gaza Strip has rendered the water brackish. The entry of sewage, fertilizers, and other chemicals into the water system continually damages the water quality. Though not quite to the same extent as in electricity, water supply is substantially, and increasingly, dependent upon the Israeli company, Mekoroth. Israel restricts the digging of new wells by Palestinians. New sources within the WBGS can be tapped by Mekoroth, which then supplies distributors in the Palestinian areas. For example, in 1974, the Jerusalem Water Undertaking purchased virtually no water and produced about 1.3 MCM of water. By 1994, purchased water amounted to 5.0 MCM, almost all from Mekoroth, while water production had gone up to 2.6 MCM.

Sanitation. The most serious immediate problem is the state of sanitation services. The share of households connected to sewage networks is small by all standards, at 25 percent. Collection, treatment, and disposal of sewage are growing problems. The networks, where they exist, are under great strain and are liable to burst frequently, risking people's health and causing severe disruption to the movement of goods and people as roads are flooded.

Beyond Rehabilitation: Strategic Investments and Sector Organization

Since rehabilitation has such high economic returns, efforts to restore existing infrastructure stocks must necessarily be a part of any long-term strategy for infrastructure development. As the emergency restoration is brought to a close and normal operations resume, the present rehabilitation would convert into routine but essential maintenance, which has similarly high economic returns.

Effort must begin, in parallel, to undertake new investments. On average, developing countries spend 4 percent of their GDP on basic infrastructure investments (*i.e.*, transportation, electricity, communications, and water). This is over and above the regular maintenance expenditures. In rapidly growing economies, such as those in East Asia, infrastructure investments of 6 to 8 percent of GDP have been common. If the average for developing countries is accepted as the target for ongoing infrastructure investments in the WBGS and if an additional one percent of GDP is allocated to continued rehabilitation to make up for past neglect (calculated at between 4 and 5 percent of GDP), infrastructure investments would need to rise to between \$140 million and \$175 million a year. Such expenditures, while reasonable for most economies, would represent a quantum leap from the current level of \$50-60 million.

To prioritize the investments, certain special features of the WBGS and the vision of economic development in these territories, needs to be taken into account.

- The relatively small size of the economy makes it heavily dependent on international commerce. At the same time, the deep historical and religious significance of the region makes it a major tourist attraction. As a consequence, trade and tourism are likely to be dominant economic activities. The movement of goods and people within the territories

requires a network of roads and the movement across international borders requires land, sea, and air links (see Chapter 6).

- WBGS is heavily dependent on Israel for infrastructure services. 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-run. Certain internal investments may appear sub-optimal when viewed by themselves. However, the benefits of diversification will occur not only to the WBGS but also to Israel as the multi-sourcing capability will reduce the huge transactions costs associated with bilateral negotiations on mechanisms of delivery.
- An unusually high level of human capital could be leveraged through the use of modern information technologies. 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.
- A chronic water shortage is aggravated by a growing population and rising incomes. At the same time wastewater transport, collection, treatment, and disposal requires substantial new investments.

In all cases, an efficient strategy would be to move from the more modest to the more ambitious. Infrastructure investments are sometimes thought of as providing a “big push” to accelerate growth. Not only is that strategy often wasteful, but the resources simply do not exist to implement any grandiose plans.

Transport: Moving Goods and People

Linking the Gaza Strip and West Bank with a “Safe Passageway.” Today, the economies of the Gaza Strip and West Bank are almost completely disassociated due to the lack of transportation links. For many Palestinian policy makers this passageway has the highest priority among transportation projects. The Declaration of Principles requires the establishment of safe passage of persons and transportation.

However, no progress has been made on implementation despite its urgency. Discussions about possible options have drifted over the past few years. An early feasibility study is required of the various options floated. Should the connection be elevated or not as it passes through Israeli territory? Should it be a motorway or a high-speed rail? What should be the connection points on both sides? Other questions of a contractual nature have been raised. Will ownership of the passageway be Israeli because it passes over Israeli territory? Would it make sense for the management to be in private hands, possibly with a joint Palestinian-Israeli company? What security mechanisms would be acceptable to minimize the risk of closure with its disruption to commuters and businesses? While this project is under discussion, safe passing for authorized persons and vehicles through heavily secured, existing Israeli roads is likely to be permitted.

Mobility within the WBGS. Under the Emergency Assistance Program (EAP) rehabilitation of roads was initiated and such rehabilitation is expected to continue for the coming years. The focus of the rehabilitation has been on internal village roads and rural access roads. Inter-urban road rehabilitation and investment are only beginning.

A major artery through the Gaza Strip, Road No. 4, is planned to connect Israel at the Erez crossing point in the north, with Egypt (Rafah) in the south. A part of Road No. 4 coincides with the Salah-E-Din Road. Construction bids for a 12-km stretch of the Salah-E-Din Road are to be invited shortly and construction is likely to begin in the coming months. The estimated cost of this phase is \$20 million. A second phase, covering about 35 km will cost \$40 million. This phase would include a bypass around Gaza City and would also provide a link to the proposed Gaza port. Using the present alignments, the construction would strengthen the existing structures and widen the road to four lanes in certain stretches, especially near the border with Israel. In addition, a Gaza Strip coastal road has been under discussion. In its grander version, this road would connect Al Arish in Egypt and Ashdod in Israel. The economic value has been less evident while the potential environmental impact has been a source of concern.

Planning for inter-urban roads within the West Bank is conditioned by the Oslo II Agreement. Under the Interim Agreement, the West Bank has been divided into three zones. Zone A, consisting of six key municipalities (Jericho, Nablus, Jenin, Tulkarem, Ramallah, and Bethlehem), is under the political jurisdiction and security control of the PA. In zone B, an area surrounding zone A, the PA has administrative jurisdiction but security control is in the hands of Israeli authorities. In zone C, which is presently the large bulk of the land area, Israeli authorities have both administrative and security control. For this reason, much of the early effort has been devoted to rehabilitating roads *within* areas of Palestinian control, focusing on internal village roads and certain rural access roads. Planning for inter-urban transportation requires a level of coordination between the Palestinian and Israeli authorities that has not yet materialized.

The Interim Agreement also contains a “principle of graduality,” which requires the periodic transfer of areas from zone B to zone A and from zone C to zone B until full Palestinian authority—“final status”—is achieved. This mechanism and the associated forums could be used to determine coordination procedures on a West Bank road network that would permit the PA to commence serious network planning. Candidate projects include: (i) reinforcing and broadening from one to two lanes a 136-km north-south link connecting the cities of Nablus, Ramallah, Jerusalem, Bethlehem, and Hebron; and (ii) an east-west link from the Israeli border, passing through Tulkarem and Nablus to Jordan across the Damiah Bridge.

Electricity: Powering Homes and Businesses

Evidence indicates that electricity consumption is low relative to income levels and has apparently been falling. To fulfill a large demand from businesses and households for efficient, secure, and reliable electricity networks, a progressive strategy is required to:

- restore existing distribution networks;
- construct new networks to support the development of regional distribution utilities;
- build new transmission networks linking the regions, and an associated dispatch capacity;
- build new generation capacity; and
- invest in international interconnections.

An institutional strategy is required to underpin these investment plans. In keeping with modern trends, the sector needs to be “unbundled” into the distribution, transmission, and generation segments.

Virtually all power consumed in the WBGS is supplied by the IEC. In the Gaza Strip, the power is supplied to the Palestinian Electricity Authority (PEA), which is responsible for distributing the electricity. In the West Bank, the IEC negotiates power supply with individual municipalities, except in the case of the Jerusalem Electricity Distribution Company (JEDCo.), a shareholder-owned utility, which serves Jerusalem, Jericho, Bethlehem, Ramallah, and Al Bireh. Power is supplied by the IEC at a flat rate of about \$0.07 per kilowatt hour. This rate reflects the technical complexity of supply to small, dispersed communities and reveals the weak bargaining position of the Palestinians, given virtually no alternatives.

Due to rapidly growing demand and very limited investments in past years—including only small rehabilitation expenditures under the EAP—the investment requirements in the power sector are considerable (Table 13.2). Rehabilitation focused principally on local distribution networks is expected to require upward to \$40 million per year for the next three years. In addition, substantial new investments in transmission and generation are required and will need to be spread over the next three to five years.

Distribution: Rehabilitation and Investment through Regional Utilities. The PEA estimates that immediate rehabilitation needs of the distribution system to be \$100 million in the West Bank and \$30 million in the Gaza Strip. The distribution networks have been managed by the municipalities and the assets have deteriorated over time. New substations are required in the Nablus, Hebron, and JDECo. areas, and various substations need to be upgraded. In addition, automatic voltage regulation to prevent large drops in voltage is needed. Also, new interconnections within the existing jurisdictions are required to manage more efficiently the distribution. As with roads, such rehabilitation would need to convert to ongoing, regular maintenance to prevent future asset depreciation.

Presently, the electricity network is designed principally to receive power from Israel. Power at low voltage is supplied to individual municipalities, resulting in substantial system losses. The municipalities are technically isolated from each other, so effective load management is not possible. Consolidating municipalities into regional utilities will permit greater technical efficiencies and increase administrative and managerial efficiency. Moreover, utilities of a certain critical size are much more likely to attract private investments than are small municipal networks.

Table 13.2 Investments in the Power Sector

Project	Description	Estimated Cost
Distribution network rehabilitation	Replacement and upgradation of substations, introduction of automatic regulators, additional switching devices, new interconnections between locations to optimize supply management	Over three years: Gaza Strip: \$30 million West Bank: \$100 million Continuing investment thereafter of \$30-50 million per year
Regional distribution networks	Add new capacity to optimize networks and support: (a) three planned, regional utilities in the north, center, and south of the West Bank and (b) a network for the Gaza Strip	Gaza Strip: \$50 million West Bank: \$100 million
National transmission capacity	Capacity to link and dispatch power sources to regional distribution networks	\$150 million
Independent power generation	New generation capacity	Gaza Strip: \$250 million West Bank: (still a concept) \$400 million (estimate)
International interconnections	Egypt-Gaza Strip Gaza Strip-East Jerusalem-Hebron West Bank-Jordan	\$150 million

Source: PEA (1996) and PA (1995).

Based on geographical conditions and demand projections, one proposal is to create one utility for the Gaza Strip and three West Bank “regional” utilities in the north, center, and south. These utilities would be responsible for sourcing electricity, dispatching and transmitting, and distributing to households and businesses. Such utilities would require the construction of new transmission facilities to link the principal locations in their respective regions. This will require the right-of-way to lay the lines. As with the development of the road network, obtaining and establishing the rights-of-way will require Israeli permission to cross zonal boundaries within the West Bank.

The challenge ahead lies in managing the interests of municipal governments, for whom electric power distribution has been a lucrative business in the past. These interests could be met by making the municipalities shareholders in their utility along with rotating membership of the utility’s board. Once such a structure is in place, and when an independent, commercially operating distribution utility becomes a reasonable prospect, then private investment will become attractive. Strategic private investment by an internationally experienced operator combined with public shareholding should be possible to implement.

Transmission and Dispatch. A national grid will be required to link the various sources of power from the IEC to the independent power generators in the WBGs, and to receive power from international interconnections. The manager of the grid will ensure that power is efficiently distributed according to prevailing supply and demand conditions at particular times in the day.

A Palestinian Grid Company—possibly under private ownership—will be required to undertake the necessary investments and manage the transmission and dispatch operations.

Power Generation Capacity. Should a small economy such as that of the WBGS invest in its own power generation capacity? Is the demand large enough to support an efficiently sized plant? The numbers suggest the answer to be a positive one. As noted, the WBGS has access to about 300 Mw of power through the IEC in Israel. A study by the consulting firm, Kennedy and Donkin, shows a huge pent-up demand, which is evident even from the basic figures presented in Table 13.1. If power consumption in the WBGS is to reach Egyptian levels in per capita terms, generation capacity needs to increase to 450 Mw. Hence, an extra 150 Mw could be used immediately. Population and income growth over the next five years will likely require 250 Mw or more, if peace allows rapid growth.

The Palestinian strategy in this context appears to be one of procuring power from multiple sources. The supplies from the IEC will continue, though at lower levels. New generating capacity should be created within the WBGS. In the longer term, interconnections to networks in Egypt and Jordan will provide an extra source of power. Links to other sources could increase the efficiency with which capacity is used and, equally importantly, create a measure of competition between the different sources of power, allowing the Palestinians to procure power at lower costs.

The PEA presently is negotiating the development of a power generating plant in the Gaza Strip under a 20-year build-operate-transfer contract with a private sponsor. In the first phase, two gas turbines of 40 Mw each will provide 80 Mw of power. These will be augmented with additional gas turbines and a steam turbine to create a combined-cycle, 215-Mw plant. The goal was to have the first phase completed by February 1997 and the second phase by March 1998.

Contract negotiations for the Gaza power plant are still underway. The present state of discussions, however, indicate some noteworthy features. First, the cost of the power is to be \$0.047 per kilowatt hour, compared to \$0.07 paid to the IEC. If realized, the price of power also compares favorably with the power being procured in the Philippines, which has the most extensive private power program in the developing world. Second, a more intriguing feature of the contract is the lack of a commitment to buy the full (or substantial) capacity of the plant. All private power contracts in developing countries have the so-called “take-or-pay” feature—or more accurately, the “take-or-pay anyway” requirement. Private sponsors and lenders require a commitment that even if the power is not required, payment will be made to pay back the lenders and provide some equity return. For the Gaza plant, the take-or-pay requirement does not presently exist, thus allowing for the possibility that no payment need be made if the power is not needed. Furthermore, it is likely that the private sponsors will be able to sell excess capacity to the IEC.

Two hurdles need to be crossed before the Gaza power plant is a reality. First, permission is required from Israeli authorities for the construction of the plant. Second, as in other countries, the government has taken on the obligation of providing the sponsors with the

land. The chosen site of the plant, near the proposed Gaza port, is private property and cash compensation would make the costs prohibitive. It is expected that the owners of the preferred site would be compensated with government land of equal value.

International Interconnections. Interconnections of networks in Egypt, the Gaza Strip, Israel, the West Bank, and Jordan are expected to bring significant benefits, which include:

- the capacity to exchange power on a daily, weekly, monthly, or seasonal basis because of different load patterns in different areas, thereby reducing overall demand for reserves and hence generation capacity;
- the consumer benefits from greater continuity in services (reduced load shedding) and the ability to recover more rapidly from disturbances to the network; and
- greater interconnection, for technical reasons, which reduces network losses.

Interconnections linking the WBGS to Israel, Egypt, and Jordan are still at an early stage of conceptualization. While a *prima facie* case exists for the interconnections, detailed technical planning, identifying sites for interconnection, and performing feasibility studies of alternative options are required. But obtaining of right-of-way is of critical importance. The Gaza Strip-West Bank link could, in principle, use the same right-of-way as the safe passageway. Once established, this interconnected network could further integrate into the more ambitious schemes being planned in the Middle East.

Telecommunications

The fundamental requirement for an information economy is a substantial and efficiently functioning telecommunications network. It is often tempting to compare the WBGS with Singapore and Hong Kong, as model small economies, based on international trade and investment, and supported by a world-class communications infrastructure. While that vision is a distant one at the present time, one lesson that is relevant immediately is the need to invest in modern telecommunications. Once such a network is in place, several creative opportunities to build on such a network are likely to arise, with little or no government involvement. Since telecommunications is extremely attractive to private investors, the PA's primary objective should be to ensure efficient new entry by multiple providers into the sector.

The economics of telecommunication networks is quite different for the local loop (which provides the connection from the nearest switch to the customer), for domestic long-distance services, and for international services. On top of this basic network is an overlay of services that typically requires additional investment in hardware and software.

Until the mid-1980s, the entire communications network was regarded as a "natural monopoly" and hence thought to be best provided by a single operator. The advent of wireless

technologies (permitting transmission using microwaves, radio waves, and satellites) has led to increased competition in long-distance communications, including international communications.

The local loop has remained a monopoly in most countries. But clearly, the trend is toward increasing competition. Even in the local loop such competition can occur because radio-based technologies and cable networks can offer an alternative conduit. Most importantly, regulators are no longer able to keep pace with changing technologies and the innovative opportunities they offer. As a consequence, a policy of open entry to all segments of the network (with due regard for preventing fly-by-night operators) is increasingly becoming the benchmark.

Infrastructure investments in WBGS must be guided by the vision of this open network, where a *prima facie* basis exists for allowing all new entrants to establish new networks or lease lines to provide services. Only then would it be possible for the WBGS to exploit the several new opportunities afforded by international developments in technologies and organizational structures. In particular, links to international consortia offering global services will provide alternative channels to the rest of the world, reducing the dependence on Israel.

To reach Jordanian levels of telephone usage, the WBGS requires another 100,000 phones, which could be readily absorbed into the economy. Another 75,000 telephones will be required to reach the current phone spread in Mauritius. To reach the phone density of Singapore, about one million telephones will need to be installed. If about 25,000 new phone lines are to be installed every year, an expenditure of between \$25 and \$35 million will be required.

Two hurdles lie in the way of achieving rapid telecommunications expansion. Early resolution of these considerations must be a priority for peace negotiators and Palestinian policy makers. First, all policy options are directly or indirectly constrained by Israeli regulations. Even domestic long-distance services are provided by Bezeq. For international services, Bezeq provides the only gateway, on onerous terms. For any progress, and especially to attract private, competitive suppliers, greater operational flexibility and choices will be required. Second, a certain degree of confusion presently prevails on the policy of new entry into the sector. While the telecommunications legislation appears to provide the openness required, discussions are ongoing to award an exclusive franchise to a single company for a 10-year period (with a non-exclusive franchise for an additional 15 years). The lack of clarity in this regard is damaging not only for urgently needed investment in the sector, but may ultimately have wider adverse implications. The private company expecting to receive the exclusive license, Paltel, has raised \$70 million through a public share offering, but does not yet have the license to operate.

Water: A History of Shortage

The most scarce resource, and one for which there are the fewest immediate solutions, is water. Sources of water supply are under Israeli control and the development of new supplies require extensive negotiations. As a consequence, the dependence on Israeli sources, principally through Mekoroth, is high and increasing.

The Palestinian Water Authority (PWA) has been established to determine strategy and policy in the sector. However, since any discussion of the basic problem of long-term water supply appears to be on hold, the focus has been on: (i) continued rehabilitation of the existing networks; (ii) restoring management capacity to deliver water through an innovative management contract for water supply in the Gaza Strip; (iii) laying the basis for creating regional water utilities, parallel to the regional electric utilities; (iv) planning modest desalination plants; and (v) planning and implementing investments in sewage collection and treatment.

As in other sectors, rehabilitation needs are enormous. Some rehabilitation has occurred under existing programs and will continue under multilateral initiatives (*i.e.*, the World Bank-coordinated Municipal Development Project) and with bilateral assistance. The rates of return to such rehabilitation have been estimated to be very large.

The institutional structure to channel these expenditures and future investments is being considered. A step in that direction is the amalgamation of municipal authority to deliver water and sanitation services in the Gaza Strip. A management contract has been awarded to an international operator for a four-year period, during which time significant new capacity is expected to be built, both in physical distribution and managerial strengths. The contract was awarded through an international competitive bidding process with payment linked to performance, which imposes tight incentives on the contractor.

The consolidation of municipal authorities into regional utilities is planned also for the West Bank, as with electric power, for the north, center, and south. The economic logic for such consolidation is the same as for the electric power sector. A similar institutional structure that makes the municipalities shareholders and board members, is being proposed.

New planned investments include small desalination plants in the Gaza Strip, where brackish water needs to be rendered potable. The major new investments will likely occur not in water supply but in water and sewage treatment where it is urgently needed. Over the next three to five years, these investments could amount to a few hundred million dollars.

Regulating Private Infrastructure

An entire Palestinian commonwealth and a global network of private sector investors are available to provide the raw materials for new partnerships that can enable growth. Global trends indicate that private actors can get into increasingly broader fields of public interest if the proper regulatory system can be put in place. Efficient governance systems of this sort are decentralized, with an emphasis on competitively contracting out infrastructure to private companies and non-government citizen groups. The provision of public goods is safeguarded by mechanisms that foster accountability and contested markets.

Infrastructure partnerships consist of users and providers of services where users can exercise varying degrees of voice or exit. Some sectors, such as urban transport, are typically high voice-high exit. If public transport is too expensive, people carpool or bicycle to work. The power

sector is typically low voice-low exit and can hold users prisoner. Appropriate accountability mechanisms to ensure fair pricing, and quality service standards are required in these areas.

Many OECD countries have recently corporatized or privatized or simulated market dynamics for core government activities through the funder-provider models. In New Zealand, most central services have been eliminated as the public sector competitively bids out government agencies as business units, *e.g.*, road construction was out-sourced by the Minister of Transportation, conditioned on performance. In Laos, a weak public sector limited its role to steward and regulator, working in partnership with the private sector. Lacking full blown regulatory agencies and mature legislature or independent judiciary, client surveys provide sound regulatory and enforcement mechanisms, and introduce information and accountability mechanisms to help government regulate private public utilities and quasi-public NGOs. Simulated market mechanisms, which can help to ensure peak performance and fair pricing despite monopoly conditions, include renewing contract bids every several years, performance evaluation through user surveys, referendum with broadly published findings, establishing price caps that are readjusted over time, and enacting various commissions to assure quality control relative to health and environmental standards. One or two start-up pilot projects of this nature could begin to introduce the lessons within well-defined areas, *i.e.*, power generation, telecommunication, and/or water supply and, perhaps, later in the social services domain. With the right incentives, the governance framework can improve regulation and enforcement.

The increasingly popular method to ensure fair pricing in monopoly conditions is price caps. Instead of restricting the rate of return of a provider with market power, prices are capped at a pre-specified level based upon a study of cost accounting, pricing, and willingness to pay. Where prices are capped, the provider has the incentive to operate as efficiently as possible. In practice, the periodic revisions in level of the cap requires an implicit measurement of the rate of return to the provider. Chile offers the practice whereby every five years a new firm evaluates the telecommunications service and the law ensures that its findings will provide the benchmark for monopolies. This mechanism builds in flexibility for adjustments and the law cannot be breached since an independent judiciary can take the issue to court, if government intervenes.

Among important and precedent-setting initiatives of the past three years has been the harnessing of private enterprise for public utility provision, such as the PEA's effort to negotiate a 20-year build-operate-transfer contract with a private sponsor for a power generating plant in the Gaza Strip. Among its noteworthy features is the reduced cost of power generation (at \$0.047 per kilowatt hour versus \$0.07 paid to the IEC). The price paid for power generation will evolve according to a pre-specified formula, in the spirit of price cap regulation. The operations and maintenance costs will be tied to a cost of living index and the power component will be tied to a world power price.

The challenge of price regulation, however, will increase over time. For many sectors, including telecommunications and electric power, the basic determination of tariff structures needs to be undertaken. The benefits of an umbrella structure, such as a US-style regulatory commission are worth considering. The 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.

Beyond this, institutional innovations and mechanisms need to be conceived and put in place for planning, regulation, project implementation, and coordination. 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 collections costs as well as in joint network planning, *i.e.*, laying of pipes and cables, and maintenance. Creating incentives for performance, which is already being adopted for the Gaza Strip bulk water supply management contract, ties compensation to performance. But most municipalities do not know the maintenance and asset depreciation costs they incur. The scarcity factor in the supply of water is an even more refined concept that plays no role in current pricing.

* * *

While significant opportunities exist for growth, so do many challenges. For several years there was little investment in infrastructure in the WBGS. In 1995, a program of much needed infrastructure rehabilitation did commence, but only at a level of 1 to 2 percent of the GDP. To compensate for years of asset depreciation, and to meet the needs of future growth, a significant increase in infrastructure investment is needed to reach the average for developing countries—about 4 percent of GDP.

The key challenge will be to build increasingly sophisticated institutions to ensure efficient investment in infrastructure. An important element of institutional capacity will be the need to coordinate the activities of agencies and ministries with overlapping jurisdiction—an inevitable necessity in complex infrastructure projects. Equally, a lack of coordination among donors is liable to create sub-optimal investments while fostering divisions within the PA (see Chapter 10). The financial role of the PA and donors will need to evolve from full responsibility to being a catalyst. Related challenges include the ability to negotiate contracts with the private sector in a transparent manner, diversifying the sources of infrastructure services, and measuring the impact of stepped-up investments on the environment. Since few options exist to mitigate external hazards, additional instruments such as shared guarantees that distribute risk among donors may be effective in obtaining comfort levels for investors and commercial bankers. In all these regards, the initial steps have been made and significant international experience exists from which Palestinian policy makers can draw.

Infrastructure development, economic growth, and the peace process can powerfully reinforce each other. The ability to expand infrastructure is conditioned by the continued legacy of Israeli occupation. While the easing of this legacy and its associated restraints is permitting some new investment, further relaxation of the limitations need to occur to stimulate growth.

Bibliographic Note: The chapter is based on Mody (1995). It also used information from Lahmeyer International and Verbund-Plan (1995), World Bank (1994c); International Yearbooks of Telecommunications Statistics, Electricity Statistics, Road Statistics; and the KPMG report on telecommunications.

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Table 1: Production

		West Bank and Gaza Strip													
<i>in US\$ million</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>GDP at market prices</u>		<u>1,249</u>	<u>1,157</u>	<u>1,219</u>	<u>1,283</u>	<u>1,225</u>	<u>1,161</u>	<u>1,788</u>	<u>1,991</u>	<u>1,828</u>	<u>1,859</u>	<u>2,238</u>	<u>2,161</u>	<u>2,686</u>	<u>2,557</u>
<u>GDP at factor costs (in US\$)</u>		<u>1,058</u>	<u>948</u>	<u>1,009</u>	<u>1,042</u>	<u>989</u>	<u>945</u>	<u>1,544</u>	<u>1,703</u>	<u>1,826</u>	<u>1,720</u>	<u>2,126</u>	<u>2,011</u>	<u>2,449</u>	<u>2,521</u>
Agriculture		312	279	264	244	184	188	475	317	520	347	449	328	477	344
Construction		191	172	186	200	175	161	247	310	295	295	334	312	406	411
Industry		78	69	73	81	77	76	129	156	146	137	167	174	211	215
Public, Service Community		171	153	160	188	205	165	183	214	218	233	272	286	297	302
Others		307	274	326	330	347	356	509	706	648	708	904	910	1,058	1,248
GDP at factor costs		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture		0.29	0.29	0.26	0.23	0.19	0.20	0.31	0.19	0.28	0.20	0.21	0.16	0.19	0.14
Construction		0.18	0.18	0.18	0.19	0.18	0.17	0.16	0.18	0.16	0.17	0.16	0.16	0.17	0.16
Industry		0.07	0.07	0.07	0.08	0.08	0.08	0.08	0.09	0.08	0.08	0.08	0.09	0.09	0.09
Public, Service Community		0.16	0.16	0.16	0.18	0.21	0.17	0.12	0.13	0.12	0.14	0.13	0.14	0.12	0.12
Others		0.29	0.29	0.32	0.32	0.35	0.38	0.33	0.41	0.35	0.41	0.43	0.45	0.43	0.50
Net Factor Income		242	274	311	389	343	227	354	523	675	663	769	708	898	552
<u>GNP at market prices</u>		<u>1,491</u>	<u>1,431</u>	<u>1,530</u>	<u>1,673</u>	<u>1,568</u>	<u>1,388</u>	<u>2,143</u>	<u>2,514</u>	<u>2,503</u>	<u>2,522</u>	<u>3,007</u>	<u>2,869</u>	<u>3,584</u>	<u>3,109</u>
<u>Memo items</u>															
Share of GDP/GNP		0.84	0.81	0.80	0.77	0.78	0.84	0.83	0.79	0.73	0.74	0.74	0.75	0.75	0.82
GDP per capita in US\$		1,045	951	981	999	925	851	1,271	1,363	1,208	1,193	1,367	1,252	1,477	1,345
GNP per capita in US\$		1,247	1,177	1,231	1,302	1,185	1,017	1,523	1,721	1,654	1,618	1,837	1,662	1,970	1,636

		Gaza Strip													
<i>in US\$ million</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>GDP at market prices</u>		<u>332</u>	<u>365</u>	<u>357</u>	<u>390</u>	<u>333</u>	<u>319</u>	<u>429</u>	<u>553</u>	<u>399</u>	<u>544</u>	<u>589</u>	<u>603</u>	<u>691</u>	<u>726</u>
<u>GDP at factor costs (in US\$)</u>		<u>330</u>	<u>296</u>	<u>284</u>	<u>301</u>	<u>261</u>	<u>240</u>	<u>345</u>	<u>433</u>	<u>447</u>	<u>468</u>	<u>522</u>	<u>528</u>	<u>635</u>	<u>649</u>
Agriculture		68	61	46	49	36	46	73	77	89	84	93	94	103	93
Construction		77	69	66	70	57	46	75	95	102	103	102	97	136	141
Industry		28	25	25	29	25	22	36	60	50	54	64	71	78	79
Public, Service Community		71	64	65	75	82	66	72	85	100	102	118	120	136	133
Others		86	77	81	78	61	60	89	117	106	125	146	147	182	204
GDP at factor costs		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture		0.21	0.20	0.16	0.16	0.14	0.19	0.21	0.18	0.20	0.18	0.18	0.18	0.16	0.14
Construction		0.23	0.23	0.23	0.23	0.22	0.19	0.22	0.22	0.23	0.22	0.19	0.18	0.21	0.22
Industry		0.09	0.09	0.09	0.10	0.10	0.09	0.11	0.14	0.11	0.11	0.12	0.13	0.12	0.12
Public, Service Community		0.22	0.22	0.23	0.25	0.31	0.28	0.21	0.20	0.22	0.22	0.23	0.23	0.21	0.20
Others		0.26	0.26	0.28	0.26	0.23	0.25	0.26	0.27	0.24	0.27	0.28	0.28	0.29	0.31
Net Factor Income		107	127	137	183	161	97	161	235	264	219	293	269	299	181
<u>GNP at market prices</u>		<u>439</u>	<u>492</u>	<u>494</u>	<u>574</u>	<u>494</u>	<u>415</u>	<u>590</u>	<u>788</u>	<u>663</u>	<u>763</u>	<u>882</u>	<u>872</u>	<u>990</u>	<u>907</u>
<u>Memo items</u>															
Share of GDP/GNP		0.76	0.74	0.72	0.68	0.67	0.77	0.73	0.70	0.60	0.71	0.67	0.69	0.70	0.80
GDP per capita in US\$		711	760	730	770	636	588	764	948	657	862	884	858	925	922
GNP per capita in US\$		940	1,024	1,010	1,131	943	766	1,052	1,352	1,091	1,209	1,324	1,241	1,325	1,152

Table 1: Production - *continued*

	West Bank													
<i>in US\$ million</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>GDP at market prices</u>	<u>917</u>	<u>792</u>	<u>862</u>	<u>893</u>	<u>892</u>	<u>843</u>	<u>1,360</u>	<u>1,438</u>	<u>1,429</u>	<u>1,315</u>	<u>1,649</u>	<u>1,558</u>	<u>1,995</u>	<u>1,831</u>
<u>GDP at factor costs (in US\$)</u>	<u>728</u>	<u>652</u>	<u>725</u>	<u>740</u>	<u>727</u>	<u>705</u>	<u>1,199</u>	<u>1,270</u>	<u>1,378</u>	<u>1,252</u>	<u>1,603</u>	<u>1,482</u>	<u>1,815</u>	<u>1,872</u>
Agriculture	244	219	217	195	148	141	403	241	430	263	356	234	373	251
Construction	114	103	120	130	117	114	173	214	193	193	232	215	270	270
Industry	49	44	47	52	52	54	93	96	96	83	103	104	134	137
Public. Service Community	99	89	95	113	123	98	111	129	118	130	154	166	161	170
Others	221	198	245	251	287	297	420	589	542	583	758	763	876	1,044
GDP at factor costs	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.34	0.34	0.30	0.26	0.20	0.20	0.34	0.19	0.31	0.21	0.22	0.16	0.21	0.13
Construction	0.16	0.16	0.17	0.17	0.16	0.16	0.14	0.17	0.14	0.15	0.14	0.15	0.15	0.14
Industry	0.07	0.07	0.07	0.07	0.07	0.08	0.08	0.08	0.07	0.07	0.06	0.07	0.07	0.07
Public. Service Community	0.14	0.14	0.13	0.15	0.17	0.14	0.09	0.10	0.09	0.10	0.10	0.11	0.09	0.09
Others	0.30	0.30	0.34	0.34	0.39	0.42	0.35	0.46	0.39	0.47	0.47	0.52	0.48	0.56
Net Factor Income	135	147	174	206	183	131	193	288	411	444	476	439	599	371
<u>GNP at market prices</u>	<u>1,052</u>	<u>939</u>	<u>1,036</u>	<u>1,099</u>	<u>1,074</u>	<u>973</u>	<u>1,553</u>	<u>1,726</u>	<u>1,840</u>	<u>1,759</u>	<u>2,125</u>	<u>1,997</u>	<u>2,594</u>	<u>2,202</u>
<u>Memo items</u>														
Share of GDP/GNP	0.87	0.84	0.83	0.81	0.83	0.87	0.88	0.83	0.78	0.75	0.78	0.78	0.77	0.83
GDP per capita in US\$	1,259	1,076	1,143	1,149	1,115	1,024	1,607	1,639	1,577	1,418	1,698	1,522	1,861	1,644
GNP per capita in US\$	1,444	1,276	1,373	1,413	1,343	1,183	1,836	1,966	2,031	1,897	2,188	1,951	2,420	1,978

Source: ICBS and World Bank estimates.

Table 2: Real Income and Production

	West Bank and Gaza Strip													
<i>Real prices, index year 1980</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP indexes	1.00	0.93	1.01	0.98	1.03	1.03	1.36	1.20	1.20	1.21	1.44	1.39	1.71	1.69
GNP indexes	1.00	0.97	1.09	1.08	1.09	1.06	1.29	1.35	1.30	1.29	1.50	1.44	1.80	1.61
GDP per capita indexes	1.00	0.91	0.97	0.91	0.93	0.90	1.16	0.98	0.95	0.93	1.05	0.96	1.12	1.06
GNP per capita indexes	1.00	0.95	1.04	1.01	0.98	0.93	1.10	1.10	1.02	0.99	1.10	0.99	1.18	1.01
	Gaza Strip													
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP indexes	1.00	0.98	0.96	0.94	0.99	1.02	1.28	1.23	1.08	1.21	1.28	1.34	1.62	1.68
GNP indexes	1.00	1.03	1.16	1.20	1.20	1.16	1.32	1.55	1.29	1.31	1.46	1.47	1.73	1.57
GDP per capita indexes	1.00	0.96	0.92	0.87	0.89	0.88	1.07	0.98	0.83	0.90	0.89	0.89	1.01	1.00
GNP per capita indexes	1.00	1.00	1.11	1.11	1.07	1.00	1.10	1.24	0.99	0.97	1.03	0.98	1.08	0.93
	West Bank													
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP indexes	1.00	0.91	1.03	1.00	1.04	1.03	1.39	1.19	1.25	1.21	1.49	1.40	1.74	1.69
GNP indexes	1.00	0.94	1.06	1.03	1.05	1.03	1.28	1.28	1.30	1.29	1.51	1.42	1.82	1.62
GDP per capita indexes	1.00	0.90	0.99	0.93	0.95	0.91	1.20	0.98	1.00	0.95	1.12	1.00	1.18	1.10
GNP per capita indexes	1.00	0.93	1.02	0.97	0.95	0.91	1.10	1.06	1.04	1.01	1.14	1.01	1.24	1.06

Source: ICBS and World Bank estimates.

Table 3: Expenditures

West Bank and Gaza Strip														
<i>In shares of GDP</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Consumption</u>	<u>1.01</u>	<u>1.08</u>	<u>1.03</u>	<u>1.10</u>	<u>1.12</u>	<u>1.14</u>	<u>1.04</u>	<u>1.10</u>	<u>1.17</u>	<u>1.13</u>	<u>1.14</u>	<u>1.25</u>	<u>1.18</u>	<u>1.18</u>
Private	0.91	0.97	0.92	0.97	0.97	1.03	0.96	1.00	1.06	1.02	1.02	1.14	1.08	1.07
Public	0.10	0.11	0.11	0.13	0.14	0.11	0.09	0.10	0.11	0.11	0.11	0.11	0.10	0.11
<u>Investment</u>	<u>0.29</u>	<u>0.26</u>	<u>0.29</u>	<u>0.26</u>	<u>0.25</u>	<u>0.24</u>	<u>0.28</u>	<u>0.27</u>	<u>0.23</u>	<u>0.26</u>	<u>0.27</u>	<u>0.29</u>	<u>0.30</u>	<u>0.24</u>
Private	0.29	0.24	0.24	0.22	0.21	0.22	0.20	0.24	0.16	0.25	0.22	0.27	0.25	0.21
Public	0.00	0.04	0.04	0.04	0.05	0.04	0.03	0.05	0.03	0.02	0.02	0.03	0.03	0.05
Variation stocks	0.00	-0.02	0.01	-0.01	-0.01	-0.02	0.04	-0.01	0.03	-0.01	0.02	-0.02	0.02	-0.02
<u>Resource Balance</u>	<u>-0.30</u>	<u>-0.34</u>	<u>-0.32</u>	<u>-0.35</u>	<u>-0.37</u>	<u>-0.38</u>	<u>-0.32</u>	<u>-0.37</u>	<u>-0.40</u>	<u>-0.39</u>	<u>-0.40</u>	<u>-0.54</u>	<u>-0.48</u>	<u>-0.43</u>
<u>Memo item</u>														
<i>Real prices, index base 1980</i>														
Private consumption per capita	1.00	1.02	1.03	1.01	1.01	0.98	1.10	1.14	0.98	0.99	1.07	1.12	1.19	1.12
Gaza Strip														
<i>In shares of GDP</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Consumption</u>	<u>1.07</u>	<u>1.03</u>	<u>1.06</u>	<u>1.13</u>	<u>1.27</u>	<u>1.33</u>	<u>1.33</u>	<u>1.20</u>	<u>1.57</u>	<u>1.16</u>	<u>1.25</u>	<u>1.38</u>	<u>1.28</u>	<u>1.18</u>
Private	0.94	0.90	0.93	0.99	1.09	1.21	1.22	1.09	1.39	1.02	1.12	1.24	1.16	1.06
Public	0.13	0.13	0.14	0.14	0.18	0.12	0.11	0.11	0.18	0.14	0.14	0.15	0.13	0.12
<u>Investment</u>	<u>0.29</u>	<u>0.32</u>	<u>0.31</u>	<u>0.30</u>	<u>0.30</u>	<u>0.26</u>	<u>0.27</u>	<u>0.29</u>	<u>0.05</u>	<u>0.29</u>	<u>0.26</u>	<u>0.25</u>	<u>0.32</u>	<u>0.32</u>
Private	0.29	0.29	0.28	0.25	0.25	0.23	0.23	0.25	0.00	0.26	0.24	0.23	0.28	0.23
Public	0.00	0.03	0.04	0.04	0.05	0.03	0.04	0.05	0.05	0.03	0.02	0.02	0.04	0.09
Variation stocks	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
<u>Resource Balance</u>	<u>-0.36</u>	<u>-0.34</u>	<u>-0.37</u>	<u>-0.42</u>	<u>-0.56</u>	<u>-0.59</u>	<u>-0.59</u>	<u>-0.50</u>	<u>-0.62</u>	<u>-0.45</u>	<u>-0.52</u>	<u>-0.63</u>	<u>-0.60</u>	<u>-0.50</u>
<u>Memo item</u>														
<i>Real prices, index base 1980</i>														
Private consumption per capita	1.00	0.99	0.99	0.99	1.01	1.00	1.06	1.10	0.87	0.91	0.93	1.04	1.03	1.05
West Bank														
<i>In shares of GDP</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Consumption</u>	<u>0.99</u>	<u>1.11</u>	<u>1.02</u>	<u>1.08</u>	<u>1.06</u>	<u>1.07</u>	<u>0.96</u>	<u>1.06</u>	<u>1.06</u>	<u>1.12</u>	<u>1.09</u>	<u>1.21</u>	<u>1.14</u>	<u>1.18</u>
Private	0.90	1.00	0.91	0.96	0.93	0.96	0.87	0.97	0.97	1.02	0.99	1.11	1.05	1.08
Public	0.08	0.11	0.11	0.12	0.13	0.11	0.08	0.10	0.09	0.10	0.10	0.10	0.10	0.10
<u>Investment</u>	<u>0.29</u>	<u>0.23</u>	<u>0.28</u>	<u>0.24</u>	<u>0.24</u>	<u>0.24</u>	<u>0.28</u>	<u>0.26</u>	<u>0.28</u>	<u>0.25</u>	<u>0.27</u>	<u>0.30</u>	<u>0.29</u>	<u>0.21</u>
Private	0.29	0.21	0.22	0.20	0.19	0.22	0.20	0.23	0.21	0.24	0.22	0.29	0.24	0.20
Public	0.00	0.04	0.04	0.05	0.05	0.04	0.03	0.05	0.03	0.02	0.02	0.03	0.03	0.04
Variation stocks	0.00	-0.03	0.02	-0.01	-0.01	-0.02	0.05	-0.02	0.04	-0.01	0.03	-0.03	0.03	-0.02
<u>Resource Balance</u>	<u>-0.28</u>	<u>-0.34</u>	<u>-0.30</u>	<u>-0.32</u>	<u>-0.30</u>	<u>-0.31</u>	<u>-0.23</u>	<u>-0.32</u>	<u>-0.34</u>	<u>-0.37</u>	<u>-0.36</u>	<u>-0.50</u>	<u>-0.44</u>	<u>-0.40</u>
<u>Memo item</u>														
<i>Real prices, index base 1980</i>														
Private consumption per capita	1.00	1.03	1.04	1.01	1.02	0.98	1.12	1.16	1.04	1.03	1.15	1.17	1.27	1.18

Source: Statistical Abstract of Israel, 1981-1994, ICBS

Table 4: Trade

		West Bank and Gaza Strip													
<i>In current US\$</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Export of GNFS</u>		<u>375</u>	<u>436</u>	<u>422</u>	<u>416</u>	<u>318</u>	<u>305</u>	<u>421</u>	<u>439</u>	<u>259</u>	<u>202</u>	<u>278</u>	<u>303</u>	<u>365</u>	<u>245</u>
Merchandises		343	403	391	382	289	272	380	385	209	156	228	246	299	236
Non-factor services		32	33	32	34	29	33	41	54	50	46	50	57	66	9
<u>Import of GNFS</u>		<u>749</u>	<u>829</u>	<u>813</u>	<u>871</u>	<u>770</u>	<u>750</u>	<u>992</u>	<u>1178</u>	<u>988</u>	<u>929</u>	<u>1179</u>	<u>1470</u>	<u>1647</u>	<u>1333</u>
Merchandises		665	737	729	785	686	668	890	1051	676	632	843	1139	1232	1138
Non-factor services		84	92	85	86	84	82	102	127	312	297	336	331	415	195
Balances															
<u>Resource Balance</u>		<u>-374</u>	<u>-393</u>	<u>-391</u>	<u>-455</u>	<u>-452</u>	<u>-445</u>	<u>-571</u>	<u>-740</u>	<u>-729</u>	<u>-727</u>	<u>-901</u>	<u>-1167</u>	<u>-1282</u>	<u>-1088</u>
Trade Balance		-321	-334	-338	-403	-397	-396	-510	-666	-467	-476	-615	-893	-933	-902
NFS balance		-53	-59	-53	-51	-55	-50	-61	-74	-262	-251	-286	-274	-349	-186
<i>As shares of GDP</i>															
Export of GNFS		0.30	0.38	0.35	0.32	0.26	0.26	0.24	0.22	0.14	0.11	0.12	0.14	0.14	0.10
Merchandises		0.27	0.35	0.32	0.30	0.24	0.23	0.21	0.19	0.11	0.08	0.10	0.11	0.11	0.09
Non-factor services		0.03	0.03	0.03	0.03	0.02	0.03	0.02	0.03	0.03	0.02	0.02	0.03	0.02	0.00
Import of GNFS		0.60	0.72	0.67	0.68	0.63	0.65	0.55	0.59	0.54	0.50	0.53	0.68	0.61	0.52
Merchandises		0.53	0.64	0.60	0.61	0.56	0.58	0.50	0.53	0.37	0.34	0.38	0.53	0.46	0.45
Non-factor services		0.07	0.08	0.07	0.07	0.07	0.07	0.06	0.06	0.17	0.16	0.15	0.15	0.15	0.08
Balances															
Resource Balance		-0.30	-0.34	-0.32	-0.35	-0.37	-0.38	-0.32	-0.37	-0.40	-0.39	-0.40	-0.54	-0.48	-0.43
Trade Balance		-0.26	-0.29	-0.28	-0.31	-0.32	-0.34	-0.29	-0.33	-0.26	-0.26	-0.27	-0.41	-0.35	-0.35
NFS balance		-0.04	-0.05	-0.04	-0.04	-0.04	-0.04	-0.03	-0.04	-0.14	-0.14	-0.13	-0.13	-0.13	-0.07

Table 4: Trade - continued

		Gaza Strip													
<i>In current US\$</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Export of GNFS</u>		<u>165</u>	<u>210</u>	<u>202</u>	<u>194</u>	<u>116</u>	<u>119</u>	<u>157</u>	<u>180</u>	<u>88</u>	<u>51</u>	<u>76</u>	<u>96</u>	<u>106</u>	<u>65</u>
Merchandises		154	198	190	181	105	106	140	157	67	31	48	71	77	63
Non-factor services		11	12	12	13	11	13	17	23	21	20	28	25	29	2
<u>Import of GNFS</u>		<u>286</u>	<u>335</u>	<u>335</u>	<u>359</u>	<u>304</u>	<u>307</u>	<u>412</u>	<u>454</u>	<u>337</u>	<u>295</u>	<u>380</u>	<u>478</u>	<u>520</u>	<u>426</u>
Merchandises		261	310	310	332	279	281	378	412	223	200	269	355	366	353
Non-factor services		25	26	25	26	25	25	34	42	114	95	111	123	154	72
Balances															
<u>Resource Balance</u>		<u>-120</u>	<u>-125</u>	<u>-133</u>	<u>-165</u>	<u>-188</u>	<u>-188</u>	<u>-255</u>	<u>-275</u>	<u>-249</u>	<u>-244</u>	<u>-304</u>	<u>-383</u>	<u>-414</u>	<u>-361</u>
Trade Balance		-107	-112	-120	-152	-175	-175	-238	-255	-156	-169	-221	-285	-289	-291
NFS balance		-14	-14	-13	-13	-13	-12	-16	-20	-93	-75	-83	-98	-125	-70
<i>As shares of GDP</i>															
Export of GNFS		0.50	0.57	0.57	0.50	0.35	0.37	0.37	0.33	0.22	0.09	0.13	0.16	0.15	0.09
Merchandises		0.46	0.54	0.53	0.46	0.31	0.33	0.33	0.28	0.17	0.06	0.08	0.12	0.11	0.09
Non-factor services		0.03	0.03	0.03	0.03	0.03	0.04	0.04	0.04	0.05	0.04	0.05	0.04	0.04	0.00
Import of GNFS		0.86	0.92	0.94	0.92	0.91	0.96	0.96	0.82	0.84	0.54	0.64	0.79	0.75	0.59
Merchandises		0.79	0.85	0.87	0.85	0.84	0.88	0.88	0.75	0.56	0.37	0.46	0.59	0.53	0.49
Non-factor services		0.08	0.07	0.07	0.07	0.07	0.08	0.08	0.08	0.29	0.17	0.19	0.20	0.22	0.10
Balances															
Resource Balance		-0.36	-0.34	-0.37	-0.42	-0.56	-0.59	-0.59	-0.50	-0.62	-0.45	-0.52	-0.63	-0.60	-0.50
Trade Balance		-0.32	-0.31	-0.34	-0.39	-0.53	-0.55	-0.56	-0.46	-0.39	-0.31	-0.38	-0.47	-0.42	-0.40
NFS balance		-0.04	-0.04	-0.04	-0.03	-0.04	-0.04	-0.04	-0.04	-0.23	-0.14	-0.14	-0.16	-0.18	-0.10

Table 4: Trade - continued

		West Bank													
<i>In current US\$</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Export of GNFS</u>		<u>209</u>	<u>226</u>	<u>220</u>	<u>222</u>	<u>202</u>	<u>186</u>	<u>264</u>	<u>259</u>	<u>171</u>	<u>151</u>	<u>202</u>	<u>207</u>	<u>259</u>	<u>180</u>
Merchandises		189	205	201	201	185	166	240	228	142	125	180	175	222	173
Non-factor services		20	21	20	21	18	19	24	31	29	26	22	32	37	7
<u>Import of GNFS</u>		<u>463</u>	<u>494</u>	<u>478</u>	<u>512</u>	<u>466</u>	<u>443</u>	<u>580</u>	<u>724</u>	<u>651</u>	<u>634</u>	<u>799</u>	<u>992</u>	<u>1127</u>	<u>907</u>
Merchandises		404	428	419	453	407	387	512	639	453	432	574	784	866	785
Non-factor services		60	67	60	59	59	57	68	85	198	202	225	208	261	123
Balances															
<u>Resource Balance</u>		<u>-254</u>	<u>-268</u>	<u>-258</u>	<u>-290</u>	<u>-264</u>	<u>-258</u>	<u>-316</u>	<u>-465</u>	<u>-480</u>	<u>-483</u>	<u>-597</u>	<u>-784</u>	<u>-868</u>	<u>-727</u>
Trade Balance		-215	-223	-218	-252	-222	-220	-272	-411	-311	-307	-394	-608	-644	-612
NFS balance		-39	-45	-40	-38	-42	-38	-44	-54	-169	-176	-203	-176	-224	-116
<i>As shares of GDP</i>															
Export of GNFS		0.23	0.29	0.26	0.25	0.23	0.22	0.19	0.18	0.12	0.11	0.12	0.13	0.13	0.10
Merchandises		0.21	0.26	0.23	0.23	0.21	0.20	0.18	0.16	0.10	0.10	0.11	0.11	0.11	0.09
Non-factor services		0.02	0.03	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.01	0.02	0.02	0.00
Import of GNFS		0.51	0.62	0.55	0.57	0.52	0.53	0.43	0.50	0.46	0.48	0.48	0.64	0.56	0.50
Merchandises		0.44	0.54	0.49	0.51	0.46	0.46	0.38	0.44	0.32	0.33	0.35	0.50	0.43	0.43
Non-factor services		0.06	0.08	0.07	0.07	0.07	0.07	0.05	0.06	0.14	0.15	0.14	0.13	0.13	0.07
Balances															
Resource Balance		-0.28	-0.34	-0.30	-0.32	-0.30	-0.31	-0.23	-0.32	-0.34	-0.37	-0.36	-0.50	-0.44	-0.40
Trade Balance		-0.23	-0.28	-0.25	-0.28	-0.25	-0.26	-0.20	-0.29	-0.22	-0.23	-0.24	-0.39	-0.32	-0.33
NFS balance		-0.04	-0.06	-0.05	-0.04	-0.05	-0.04	-0.03	-0.04	-0.12	-0.13	-0.12	-0.11	-0.11	-0.06

Source: Based on Statistical Abstract of Israel, 1981-1994, ICBS.

Table 5: Income from Abroad

West Bank and Gaza Strip														
<i>In current US\$</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Net Factor income	<u>242</u>	<u>274</u>	<u>311</u>	<u>389</u>	<u>343</u>	<u>227</u>	<u>354</u>	<u>523</u>	<u>675</u>	<u>663</u>	<u>769</u>	<u>708</u>	<u>898</u>	<u>552</u>
Receipts	372	407	459	560	490	368	526	714	692	682	794	737	930	586
Payments	130	133	149	171	147	141	172	191	17	19	25	29	32	34
Net current transfers	<u>111</u>	<u>112</u>	<u>107</u>	<u>104</u>	<u>93</u>	<u>71</u>	<u>77</u>	<u>128</u>	<u>-64</u>	<u>-54</u>	<u>-21</u>	<u>278</u>	<u>11</u>	<u>14</u>
Receipts	167	174	172	183	165	108	122	188	18	9	3	278	11	14
Payments	56	62	65	79	73	38	45	60	82	63	24	0	0	0
Net capital inflows	<u>-21</u>	<u>-7</u>	<u>26</u>	<u>38</u>	<u>-16</u>	<u>-147</u>	<u>-139</u>	<u>-89</u>	<u>-118</u>	<u>-118</u>	<u>-153</u>	<u>-181</u>	<u>-373</u>	<u>-522</u>
Memo items														
Average Exchange Rate (N	0.01	0.01	0.02	0.06	0.29	1.18	1.49	1.59	1.60	1.92	2.02	2.28	2.46	2.83
As shares of GDP														
Net Factor income	0.19	0.24	0.25	0.30	0.28	0.20	0.20	0.26	0.37	0.36	0.34	0.33	0.33	0.22
Receipts	0.30	0.35	0.38	0.44	0.40	0.32	0.29	0.36	0.38	0.37	0.35	0.34	0.35	0.23
Payments	0.10	0.12	0.12	0.13	0.12	0.12	0.10	0.10	0.01	0.01	0.01	0.01	0.01	0.01
Net current transfers	0.09	0.10	0.09	0.08	0.08	0.06	0.04	0.06	-0.04	-0.03	-0.01	0.13	0.00	0.01
Receipts	0.13	0.15	0.14	0.14	0.14	0.09	0.07	0.09	0.01	0.00	0.00	0.13	0.00	0.01
Payments	0.05	0.05	0.05	0.06	0.06	0.03	0.02	0.03	0.04	0.03	0.01	0.00	0.00	0.00
Net capital inflows	-0.02	-0.01	0.02	0.03	-0.01	-0.13	-0.08	-0.04	-0.06	-0.06	-0.07	-0.08	-0.14	-0.20
Gaza Strip														
<i>In current US\$</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Net Factor income	<u>107</u>	<u>127</u>	<u>137</u>	<u>183</u>	<u>161</u>	<u>97</u>	<u>161</u>	<u>235</u>	<u>264</u>	<u>219</u>	<u>293</u>	<u>269</u>	<u>299</u>	<u>181</u>
Receipts	152	176	190	252	221	154	234	310	270	226	302	278	303	193
Payments	45	49	53	68	61	57	72	74	6	7	9	9	4	12
Net current transfers	<u>51</u>	<u>54</u>	<u>51</u>	<u>46</u>	<u>45</u>	<u>39</u>	<u>43</u>	<u>56</u>	<u>-30</u>	<u>-23</u>	<u>-12</u>	<u>100</u>	<u>4</u>	<u>5</u>
Receipts	75	82	79	80	77	54	61	81	0	0	0	100	4	5
Payments	24	28	28	35	31	15	18	25	30	23	12	0	0	0
Net capital inflows	<u>37</u>	<u>56</u>	<u>55</u>	<u>65</u>	<u>18</u>	<u>-51</u>	<u>-51</u>	<u>17</u>	<u>-15</u>	<u>-48</u>	<u>-23</u>	<u>-14</u>	<u>-111</u>	<u>-175</u>
As shares of GDP														
Net Factor income	0.32	0.35	0.38	0.47	0.48	0.30	0.38	0.43	0.66	0.40	0.50	0.45	0.43	0.25
Receipts	0.46	0.48	0.53	0.64	0.66	0.48	0.55	0.56	0.68	0.42	0.51	0.46	0.44	0.27
Payments	0.14	0.13	0.15	0.17	0.18	0.18	0.17	0.13	0.02	0.01	0.02	0.01	0.01	0.02
Net current transfers	0.15	0.15	0.14	0.12	0.14	0.12	0.10	0.10	-0.08	-0.04	-0.02	0.17	0.01	0.01
Receipts	0.23	0.22	0.22	0.21	0.23	0.17	0.14	0.15	0.00	0.00	0.00	0.17	0.01	0.01
Payments	0.07	0.08	0.08	0.09	0.09	0.05	0.04	0.05	0.08	0.04	0.02	0.00	0.00	0.00
Net capital inflows	0.11	0.15	0.15	0.17	0.05	-0.16	-0.12	0.03	-0.04	-0.09	-0.04	-0.02	-0.16	-0.24

Table 5: Income from Abroad - continued

		West Bank													
<i>In current US\$</i>		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
<u>Net Factor income</u>		<u>135</u>	<u>147</u>	<u>174</u>	<u>206</u>	<u>183</u>	<u>131</u>	<u>193</u>	<u>288</u>	<u>411</u>	<u>444</u>	<u>476</u>	<u>439</u>	<u>599</u>	<u>371</u>
Receipts		219	231	269	308	269	214	292	405	422	456	492	459	627	393
Payments		84	84	96	103	86	83	99	117	11	12	16	20	28	22
<u>Net current transfers</u>		<u>60</u>	<u>58</u>	<u>56</u>	<u>58</u>	<u>48</u>	<u>32</u>	<u>34</u>	<u>72</u>	<u>-52</u>	<u>-40</u>	<u>-12</u>	<u>178</u>	<u>7</u>	<u>9</u>
Receipts		92	92	93	102	89	54	61	106	0	0	0	178	7	9
Payments		32	35	37	44	41	23	26	34	52	40	12	0	0	0
<u>Net capital inflows</u>		<u>-59</u>	<u>-63</u>	<u>-29</u>	<u>-26</u>	<u>-33</u>	<u>-95</u>	<u>-89</u>	<u>-106</u>	<u>-121</u>	<u>-79</u>	<u>-133</u>	<u>-167</u>	<u>-262</u>	<u>-347</u>
<i>As shares of GDP</i>															
Net Factor income		0.15	0.19	0.20	0.23	0.21	0.16	0.14	0.20	0.29	0.34	0.29	0.28	0.30	0.20
Receipts		0.24	0.29	0.31	0.35	0.30	0.25	0.22	0.28	0.30	0.35	0.30	0.29	0.31	0.21
Payments		0.09	0.11	0.11	0.11	0.10	0.10	0.07	0.08	0.01	0.01	0.01	0.01	0.01	0.01
Net current transfers		0.07	0.07	0.06	0.06	0.05	0.04	0.03	0.05	-0.04	-0.03	-0.01	0.11	0.00	0.00
Receipts		0.10	0.12	0.11	0.11	0.10	0.06	0.04	0.07	0.00	0.00	0.00	0.11	0.00	0.00
Payments		0.03	0.04	0.04	0.05	0.05	0.03	0.02	0.02	0.04	0.03	0.01	0.00	0.00	0.00
Net capital inflows		-0.06	-0.08	-0.03	-0.03	-0.04	-0.11	-0.07	-0.07	-0.08	-0.06	-0.08	-0.11	-0.13	-0.19

Source: Based on Statistical Abstract of Israel, 1981-1994, ICSB.

Table 6: Direction and Composition of Trade

West Bank and Gaza Strip														
<i>In current US\$</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Exports														
Agricultural exports to Israel	50	45	34	40	24	25	30	49	19	15	32	34	36	22
Agricultural export to Jordan	48	50	65	46	47	49	43	42	22	22	23	29	27	20
Agricultural export to others	10	7	6	7	4	5	2	4	3	2	3	3	3	2
Industrial exports to Israel	176	241	224	245	163	151	258	245	131	70	124	138	185	178
Industrial exports to Jordan	57	51	59	42	50	37	52	43	26	20	30	27	34	16
Industrial exports to others	5	2	2	2	1	6	4	3	2	3	6	6	6	9
Imports														
Agricultural imports to Israel	89	90	74	79	97	88	119	135	82	74	92	130	155	141
Agricultural imports to Jordan	48	50	65	46	47	49	43	42	22	22	23	29	27	20
Agricultural imports to others	10	7	6	7	4	5	2	4	3	2	3	3	3	2
Industrial imports to Israel	482	577	572	624	519	514	682	811	523	483	645	871	880	885
Industrial imports to Jordan	4	8	7	8	7	7	9	11	12	11	14	13	13	8
Industrial imports to others	94	66	62	52	54	50	66	79	42	43	58	63	54	54
Gaza Strip														
<i>In current US\$</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Exports														
Agricultural exports to Israel	23	24	17	17	8	10	14	34	2	4	7	10	9	6
Agricultural export to Jordan	27	26	34	23	14	17	19	22	7	7	9	12	13	11
Agricultural export to others	10	7	6	7	4	5	2	4	3	2	3	3	2	1
Industrial exports to Israel	94	134	133	134	79	70	132	96	29	16	25	44	53	44
Industrial exports to Jordan	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Industrial exports to others	2	0	0	0	0	4	3	1	1	2	3	3	3	1
Imports														
Agricultural imports to Israel	31	32	30	27	35	34	49	48	26	23	31	46	51	51
Agricultural imports to Jordan	27	26	34	23	14	17	19	22	7	7	9	12	13	11
Agricultural imports to others	10	7	6	7	4	5	2	4	3	2	3	3	2	1
Industrial imports to Israel	185	251	251	267	220	225	299	333	175	157	210	285	290	285
Industrial imports to Jordan	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Industrial imports to others	49	25	22	20	17	17	22	25	15	17	24	25	22	15

Table 6: Direction and Composition of Trade*- continued*

<i>In current US\$</i>	West Bank													
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Exports														
Agricultural exports to Israel	26	22	17	23	16	14	16	15	17	10	25	24	28	16
Agricultural export to Jordan	21	23	31	24	34	32	25	20	15	15	14	17	14	9
Agricultural export to others	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Industrial exports to Israel	82	107	91	111	83	81	126	149	102	54	98	95	132	134
Industrial exports to Jordan	57	51	59	42	50	37	52	43	26	20	30	27	34	16
Industrial exports to others	3	2	2	2	1	1	2	2	1	1	3	3	3	8
Imports														
Agricultural imports to Israel	58	57	44	52	63	54	70	87	56	51	61	84	104	90
Agricultural imports to Jordan	21	23	31	24	34	32	25	20	15	15	14	17	14	9
Agricultural imports to others	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Industrial imports to Israel	298	326	321	357	298	289	383	478	348	327	435	586	591	600
Industrial imports to Jordan	4	8	7	8	7	7	9	11	12	11	14	13	13	8
Industrial imports to others	45	41	41	32	37	33	44	54	27	25	34	38	32	39

Source: El-Jafari (1995b).

Table 7: Fiscal Accounts

		West Bank and Gaza Strip									
<i>In current US\$</i>		1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
<u>Revenue</u>		<u>216</u>	<u>230</u>	<u>241</u>	<u>271</u>	<u>225</u>	<u>328</u>	<u>279</u>	<u>269</u>	<u>511</u>	<u>684</u>
Domestic revenue											
Tax revenue		122	139	142	164	130	233	170	132	144	179
Nontax revenues		95	91	99	107	95	95	109	112	100	86
Revenues clearances		0	0	0	0	0	0	0	25	266	420
<u>Current expenditure</u>		<u>179</u>	<u>203</u>	<u>199</u>	<u>234</u>	<u>207</u>	<u>252</u>	<u>258</u>	<u>334</u>	<u>578</u>	<u>779</u>
Wage bill civil service		0	0	0	0	0	0	0	44	194	247
Wage bill police service		0	0	0	0	0	0	0	30	110	156
Other current expenditures		179	203	199	234	207	252	258	260	274	426
Interest payments		0	0	0	0	0	0	0	0	0	3
<u>Current balance</u>		<u>37</u>	<u>27</u>	<u>42</u>	<u>37</u>	<u>18</u>	<u>76</u>	<u>21</u>	<u>-65</u>	<u>-67</u>	<u>-95</u>
(excl. employment generation prog.)											
Employment generation programs		0	0	0	0	0	0	0	0	0	49
<u>Current balance</u>		<u>37</u>	<u>27</u>	<u>42</u>	<u>37</u>	<u>18</u>	<u>76</u>	<u>21</u>	<u>-65</u>	<u>-67</u>	<u>-144</u>
(excl. employment generation prog.)											
Capital expenditures		54	26	26	37	32	59	126	45	189	160
<u>Overall balance</u>		<u>-17</u>	<u>1</u>	<u>17</u>	<u>0</u>	<u>-15</u>	<u>16</u>	<u>-104</u>	<u>-110</u>	<u>-256</u>	<u>-304</u>
Financing		0	0	0	0	0	0	104	118	325	293
Domestic Financing		0	0	0	0	0	0	0	8	0	0
Foreign financing		0	0	0	0	0	0	0	109	325	293
of current expenditure		0	0	0	0	0	0	0	109	136	84
of employment generation program		0	0	0	0	0	0	0	0	0	49
of capital expenditures		0	0	0	0	0	0	0	0	189	160
Residual discrepancy (financing gap or surplus)		17	-1	-17	0	15	-16	0	-8	-69	11
<i>As shares of GDP</i>		1987	1988	1989	1990	1991	1992	1993			
<u>Revenue</u>		0.11	0.13	0.13	0.12	0.10	0.12	0.11			
Domestic revenue											
Tax revenue		0.06	0.08	0.08	0.07	0.06	0.09	0.07			
Nontax revenues		0.05	0.05	0.05	0.05	0.04	0.04	0.04			
Revenues clearances		0.00	0.00	0.00	0.00	0.00	0.00	0.00			
<u>Current expenditure</u>		0.09	0.11	0.11	0.10	0.10	0.09	0.10			
Wage bill civil service		0.00	0.00	0.00	0.00	0.00	0.00	0.00			
Wage bill police service		0.00	0.00	0.00	0.00	0.00	0.00	0.00			
Other current expenditures		0.09	0.11	0.11	0.10	0.10	0.09	0.10			
Interest payments		0.00	0.00	0.00	0.00	0.00	0.00	0.00			

Table 7: Fiscal Accounts*- continued*

<u>Current balance</u> (excl. employment generation prog.)	0.02	0.01	0.02	0.02	0.01	0.03	0.01
Employment generation programs	0.00	0.00	0.00	0.00	0.00	0.00	0.00
<u>Current balance</u> (excl. employment generation prog.)	0.02	0.01	0.02	0.02	0.01	0.03	0.01
Capital expenditures	0.03	0.01	0.01	0.02	0.02	0.02	0.05
<u>Overall balance</u>	-0.01	0.00	0.01	0.00	-0.01	0.01	-0.04
Financing	0.00	0.00	0.00	0.00	0.00	0.00	0.04
Domestic Financing	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Foreign financing	0.00	0.00	0.00	0.00	0.00	0.00	0.00
of current expenditure	0.00	0.00	0.00	0.00	0.00	0.00	0.00
of employment generation program	0.00	0.00	0.00	0.00	0.00	0.00	0.00
of capital expenditures	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Residual discrepancy (financing gap or surplus)	0.01	0.00	-0.01	0.00	0.01	-0.01	0.00

Sources: Israeli Civil Administration from 1987 to 1993; IMF/PA from 1993 to 1996.

Table 8. Fiscal Operations of Palestinian Authority, May 1994 - December 1996

(in millions of US\$ unless otherwise indicated)

	1994 May-Sep ^{1/}	1994 Q IV ^{2/}	1994 Total	1995 Q I	1995 Q II	1995 Q III	1995 Q IV ^{6/}	1995 Total	1996 Q I ^{7/}	1996 Q II ^{8/}	1996 Q III ^{9/}	1996 QIV ^{10/}	1996 Total
Revenue	20.95	30.74	51.69	63.10	104.28	124.10	133.40	424.88	160.30	148.30	186.10	189.50	684.20
Domestic revenue	10.09	16.28	26.37	30.40	37.78	47.30	43.00	158.48	57.50	60.70	69.60	76.80	264.60
Tax revenue	3.53	9.23 ^{2a/}	12.76	22.40	26.53	29.30	30.00	108.23	40.30	40.50	47.40	50.60	178.80
Nontax revenue	6.56	7.05	13.61	8.00	11.25	18.00	13.00	50.25	17.20	20.20	22.20	26.20	85.80
Revenue clearances	10.86	14.46 ^{2b/}	25.32	32.70 ^{3a/}	66.50 ^{4a/}	76.80 ^{5a/}	90.40	266.40	102.80	87.60	116.50	112.70	419.60
Current expenditure	52.63	63.97	116.60	103.10	106.70	127.30	154.80	491.90	166.40	195.40	201.30	216.10	779.20
Wage bill civil service	22.17	21.39	43.56	43.30	47.90	48.70	53.90	193.80	58.80	58.30	61.50	67.90	246.50
Wage bill police service	13.66	16.33	29.99	23.70	19.50 ^{4b/}	25.90	41.40 ^{6a/}	110.50	32.20	36.10	42.30	45.40	156.00
Nonwage budgetary expenditure									72.40 ^{7a/}	78.00 ^{8a/}	91.50 ^{9a/}	102.80 ^{10a/}	344.70
Other current expenditure	16.80	26.25	43.05	36.10 ^{3b/}	39.30 ^{4c/}	52.70 ^{5b/}	59.50 ^{6b/}	187.60	3.00	23.00 ^{8b/}	6.00 ^{9b/}	0.00 ^{10b/}	32.00
Current balance (excl. employment generation prog.)	-31.68	-33.23	-64.91	-40.00	-2.42	-3.20	-21.40	-67.02	-6.10	-47.10	-15.20	-26.60	-95.00
Employment Generation Programs (foreign-financed)		0	0.00	0	0	0	0	0.00	1.70	17.70	22.40	7.40	49.20
Current balance (incl. employment generation prog.)	-31.68	-33.23	-64.91	-40.00	-2.42	-3.20	-21.40	-67.02	-7.80	-64.80	-37.60	-34.00	-144.20
Capital expenditure		0	0.00	20.00	25.20	33.20	110.90	189.30	11.00	42.00	58.00	49.00	160.00
Overall balance	-31.68	-33.23	-64.91	-60.00	-27.62	-36.40	-132.30	-256.32	-18.80	-106.80	-95.60	-83.00	-304.20
Financing	5.28	67.64	72.92	75.50	29.20	44.10							
Foreign financing	5.28	59.44 ^{2c/}	64.72	73.30	63.30 ^{4d/}	66.10	121.80 ^{6c/}	324.50	12.70	128.30	79.40	72.40	292.80
Of current expenditure	5.28	59.44	64.72	53.30	38.10	32.90	10.90	135.20	0	68.70	-1.00	16.00	83.70
Of employ't gen. prog.	0	0		0	0	0	0	0.00	1.70	17.70	22.40	7.40	49.20
Of capital expenditure	0	0		20.00	25.20	33.20	110.90	189.30	11.00	42.00	58.00	49.00	160.00
Domestic financing	0.00	8.20	8.20	2.20	-34.10	-22.00							
Residual discrepancy	26.40	-34.41	-8.01	-15.50 ^{3c/}	-1.58	-7.70						83.00	
Memorandum items:													
Revenue (% of GDP)			1.6					11.1					19.8
Current Expenditure (% of GDP)			3.7					12.8					22.6
of which: Wage Expenditure			2.3					7.9					11.7
Current Balance (% of GDP)			-2.1					-1.7					-2.8
GDP (US\$ millions)			3160					3837					3451
Exchange rate (NIS/US\$)	3.01	3.02	3.01	3.01	2.98	3.01	3.03	3.01	3.12	3.22	3.18	3.19	3.18

Notes to Table 8. Fiscal Operations of Palestinian Authority, May 1994 - December 1996

- 1/ Gaza and Jericho only.
- 2/ Includes revenue and expenditures of the Gaza Strip and Jericho, and newly inherited spheres in the West Bank as specified under "early empowerment" which took effect in December 1994.
- 2a/ In the West Bank, tax collection by the PA started in December 1994 and covered only income tax and VAT on domestic production.
- 2b/ Gaza/Jericho component includes retroactive amounts of VAT for the period May-October 1994 as well as amounts remitted on account of petroleum excises, and a disbursement order of US\$1.5 million issued on December 3, 1994 but actually drawn on January 3, 1995.
- 2c/ Includes financing prior to the November 30, 1994 AHLC meeting and new donor funding agreed in the "Understanding" signed at the meeting.
- 3a/ Includes US\$18.54 million transferred to the Bank of Palestine. These deposits were held as a reserve to cover the outstanding overdraft of the Ministry of Finance to domestic commercial banks.
- 3b, 4c, 5b & 6b/ A reduction in the amounts is shown vis-a-vis earlier estimates. This is due to a change in previous assumptions regarding the disposition of petroleum excise clearances. It had previously been assumed that these revenues were reflected one-for-one in expenditures during the same year.
- 3c/ Minus sign indicates surplus.
- 4a/ Includes petroleum excise clearances transferred to an extra-budgetary account not controlled by the Ministry of Finance at Bank Leumi (US\$6.5 million). Also includes US\$17.1 million transferred to the Bank of Palestine. These deposits were held as a reserve against outstanding overdrafts of the Ministry of Finance to domestic commercial banks.
- 4b/ Wages of police inside Gaza/Jericho for the month of June were paid in the third quarter and wages for May were paid in the fourth quarter.
- 4d/ Includes disbursement of new donor financing pledged in Paris on April 27, 1995 under the Tripartite Action Plan.
- 5a/ Second and third quarter VAT clearances include clearances for the West Bank for the first quarter of the year.
- 6/ Includes eight additional spheres in the West Bank.
- 6a/ Includes one month's delayed police wages from the second quarter.
- 6c/ Includes a lump sum transfer (US\$4 million) by Israel to cover part of the wage costs associated with the eight spheres.
- 6d/ Data on the net claims of the PA on the banking system are incomplete.
- 7/ Estimates of revenue include excise tax collections transferred to bank accounts outside the control of the Ministry of Finance. Estimates of expenditure may underestimate the PA's actual spending levels as the estimates do not include expenditure financed from excise tax collections.
- 7a/ Includes expenditure on emergency programs associated with the border closures.
- 7b/ Data on the net claims of the PA on the banking system are incomplete.
- 8/ Estimates of revenue include excise tax collections transferred to bank accounts outside the control of the Ministry of Finance. Estimates of expenditure may underestimate the PA's actual spending levels as the estimates do not include expenditure financed from excise tax collections.
- 8a/ Includes expenditure on emergency programs associated with the border closures and additional unbudgeted expenditures that are not included in the 1996 draft budget.
- 8b/ Closure-related expenditures from accounts not directly controlled by the Ministry of Finance.
- 8c/ Data on the net claims of the PA on the banking system are incomplete.
- 9/ Estimates of revenue include excise tax collections transferred to bank accounts outside the control of the Ministry of Finance. Estimates of expenditure may underestimate the PA's actual spending levels as the estimates do not include expenditure financed from excise tax collections.
- 9a/ Includes expenditure on emergency programs associated with the border closures and additional unbudgeted expenditures that are not included in the 1996 draft budget.
- 9b/ Closure-related expenditures from accounts not directly controlled by the Ministry of Finance.
- 9c/ Data on the net claims of the PA on the banking system are incomplete.
- 10/ Estimates of revenue include excise tax collections transferred to bank accounts outside the control of the Ministry of Finance. Estimates of expenditure may underestimate the PA's actual spending levels as the estimates do not include expenditure financed from excise tax collections.
- 10a/ Includes expenditure on emergency programs associated with the border closures and additional unbudgeted expenditures that are not included in the 1996 draft budget.
- 10b/ Closure-related expenditures from accounts not directly controlled by the Ministry of Finance.
- 10c/ Data on the net claims of the PA on the banking system are incomplete.

Table 9: Revenues of the Palestinian Authority, 1996*(in millions of US\$)*

	1996 Q I		1996 Q II		1996 Q III		1996 Q IV		Q I to Q II		Q II to Q III		Q III to Q IV	
	in US\$	% of total	in US\$	% of total	in US\$	% of total	in US\$	% of total	change in US\$	% change	change in US\$	% change	change in US\$	% change
Total revenue	160.40	100	148.40	100	186.10	100	189.50	100	-12.0	-7	37.7	25	3.4	2
Domestic tax revenue	40.30	25	40.50	27	47.40	25	50.70	27	0.2	0	6.9	17	3.3	7
Income tax	12.10	8	13.50	9	10.40	5	16.40	9	1.4	12	-3.1	-23	6.0	58
VAT	14.80	9	12.70	9	18.00	9	20.30	11	-2.1	-14	5.3	42	2.3	13
Customs duties	4.50	3	4.50	3	9.50	5	4.60	2	0.0	0	5.0	111	-4.9	-52
Property tax	0.20	0	0.50	0	0.10	0	0.10	0	0.3	150	-0.4	-80	0.0	0
Excises	8.70	5	9.30	6	9.40	5	9.30	5	0.6	7	0.1	1	-0.1	-1
Other	0.00	0	0.00	0	0.00	0	0.00	0	0.0	0	0.0	0	0.0	0
Revenue Clearances	102.90	64	87.70	59	116.50	64	112.70	59	-15.2	-15	28.8	33	-3.8	-3
Customs duties	13.90	9	21.80	15	25.50	14	25.20	13	7.9	57	3.7	17	-0.3	-1
VAT	55.80	35	40.40	27	62.30	34	58.30	31	-15.4	-28	21.9	54	-4.0	-6
Petroleum excise	25.30	16	23.40	16	26.00	14	25.70	14	-1.9	-8	2.6	11	-0.3	-1
Income tax	1.70	1	0.40	0	0.50	0	1.40	1	-1.3	-76	0.1	25	0.9	180
Health fees	2.10	1	0.80	1	1.20	1	2.10	1	-1.3	-62	0.4	50	0.9	75
Other	4.10	3	0.90	1	1.00	1	0.00	0	-3.2	-78	0.1	11	-1.0	-100
Nontax revenues	17.20	11	20.20	14	22.20	11	26.10	14	3.0	17	2.0	10	3.9	18
Transportation fees	5.60	3	5.40	4	3.90	1	7.70	4	-0.2	-4	-1.5	-28	3.8	97
Health insurance	3.40	2	3.30	2	2.50	2	3.40	2	-0.1	-3	-0.8	-24	0.9	36
Health fees	2.10	1	1.90	1	2.60	2	2.80	1	-0.2	-10	0.7	37	0.2	8
Other nontax revenues	6.10	4	9.60	6	13.20	7	12.20	6	3.5	57	3.6	38	-1.0	-8

Table 10: Size of Palestinian Population, Labor Force and Employment

<i>in '000'</i>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total population without Jerusalem 1/	1,196	1,216	1,243	1,285	1,323	1,365	1,407	1,461	1,514	1,559	1,637	1,726	1,819	1,901	2,015	2,151	2,280
Total population with Jerusalem 2/	-	-	-	-	-	-	-	-	-	-	-	-	2,019	2,110	2,238	2,390	2,535
Gaza Strip	467	480	489	507	524	542	561	583	608	631	666	703	747	788	843	905	963
West Bank without Jerusalem	728	736	754	777	800	823	846	878	906	927	971	1,024	1,072	1,113	1,172	1,246	1,317
East Jerusalem 2/	-	-	-	-	-	-	-	-	-	-	-	-	200	210	223	239	254
Pop aged 15+ without Jerusalem 3/	652	658	661	692	712	734	731	752	766	787	823	856	882	927	1,026	1,135	1,203
Population aged 15+ with Jerusalem	-	-	-	-	-	-	-	-	-	-	-	-	982	1,032	1,144	1,266	1,343
Gaza Strip	248	253	252	268	272	287	285	291	301	311	326	339	351	369	404	450	479
West Bank without Jerusalem	403	405	409	424	440	448	446	461	465	476	497	517	532	557	621	685	724
East Jerusalem	-	-	-	-	-	-	-	-	-	-	-	-	99	105	118	131	140
Total Labor Force without Jerusalem 4/	255	253	269	277	291	296	318	336	342	343	365	372	398	405	428	438	464
Total Labor Force with Jerusalem	-	-	-	-	-	-	-	-	-	-	-	-	445	452	481	482	518
Gaza Strip	114	117	118	121	124	130	135	144	143	143	154	159	170	172	173	176	187
West Bank without Jerusalem	141	137	151	156	167	166	183	192	199	200	212	212	229	233	254	262	277
East Jerusalem 5/	-	-	-	-	-	-	-	-	-	-	-	-	46	47	53	44	54
Total Employment without Jerusalem 6/	252	252	262	273	283	286	309	329	333	331	352	344	382	378	385	349	324
Total Employment with Jerusalem	-	-	-	-	-	-	-	-	-	-	-	-	426	422	430	387	364
Gaza Strip	114	117	114	120	123	128	133	142	140	140	148	153	164	164	167	121	114
West Bank without Jerusalem	139	136	148	153	161	158	176	187	193	191	204	190	218	214	218	228	210
East Jerusalem 5/	-	-	-	-	-	-	-	-	-	-	-	-	44	44	46	39	41

1/ To adjust the population number for 1980 to 1991 to the most recent results provided by PCBS, the total population for 1980-1991 was recalculated taking 1992 as the base year (PCBS, Demographic Survey, December 1994, minus the population of East Jerusalem) and using the same annual growth rates as those observed by ICBS for 1980 to 1992 for Gaza Strip and West Bank individually.

2/ The Population of East Jerusalem (about 254,387 in 1996, according to PCBS, Small Area Population Revised Estimates for 1996) was estimated for 1992 to 1995 using the same annual growth rate as that observed in the West Bank during that period.

3/ The population aged 15+ was estimated using the same ratio (i.e., pop. aged 15+/total pop) as ICBS used for 1980 to 1993. For 1994, the ratio was estimated by Bank staff and for 1995 & 1996, the ratio was given by PCBS (Labour Force Survey, press release)

4/ Total LF was estimated using 1995 as the base year (PCBS, Labor Force Survey). ICBS annual growth rates for Gaza Strip and West Bank separately were used to derive the annual LF from 1980 to 1994. For 1996, the LF growth rate was assumed to equal the population growth rate.

5/ LF East Jerusalem was estimated using the same participation rate (LF/pop aged 15+) as those observed for the WB.

6/ Total employed was estimated as the same proportion of the total LF as that observed by ICBS for the period 1980 to 1993.

For 1994, the ratio was estimated by Bank staff and for 1995 & 1996, the ratio was given by PCBS (Labour Force Survey, press release)

Table 11: Distribution of Labor Force and Employment

West Bank and Gaza Strip																	
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Unemployment rate (%)	0.01	0.01	0.03	0.01	0.03	0.03	0.03	0.02	0.03	0.04	0.04	0.07	0.04	0.06	0.10	0.20	0.30
Adjusted Unemployment Rate 1/	0.05	0.01	0.03	0.01	0.03	0.07	0.05	0.02	0.13	0.11	0.07	0.12	0.08	0.10	0.14	0.25	0.35
Employment by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.27	0.25	0.26	0.25	0.23	0.23	0.24	0.22	0.26	0.23	0.26	0.25	0.25	0.23	0.21	0.13	0.16
Industry	0.17	0.16	0.15	0.16	0.16	0.16	0.17	0.17	0.16	0.16	0.14	0.15	0.15	0.15	0.14	0.17	0.17
Construction	0.09	0.10	0.10	0.10	0.10	0.11	0.11	0.11	0.10	0.12	0.11	0.10	0.11	0.15	0.14	0.21	0.12
Others	0.47	0.49	0.49	0.49	0.50	0.50	0.49	0.51	0.48	0.50	0.50	0.50	0.48	0.47	0.51	0.49	0.55
Employment in Israel 2/ (% of Total employed)	0.30	0.30	0.30	0.32	0.32	0.31	0.31	0.33	0.33	0.32	0.31	0.28	0.30	0.22	0.17	0.09	0.08
Employment in Israel by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.14	0.13	0.13	0.12	0.14	0.16	0.16	0.15	0.15	0.14	0.12	0.12	0.09	0.10	0.15	0.17	0.17
Industry	0.21	0.18	0.18	0.19	0.18	0.18	0.18	0.18	0.15	0.13	0.10	0.08	0.06	0.06	0.08	0.10	0.10
Construction	0.47	0.51	0.53	0.50	0.48	0.48	0.48	0.46	0.50	0.53	0.60	0.68	0.74	0.73	0.64	0.63	0.63
Others	0.18	0.18	0.17	0.19	0.19	0.19	0.19	0.22	0.20	0.20	0.18	0.12	0.11	0.11	0.13	0.09	0.09
Wage Index	0	0	0	122	116	106	122	0	0	133	131	130	127	135	78	0	0
Wage Index Workers in Israel	0	0	0	123	107	99	123	0	180	182	174	184	185	202	113	115	0
Average Hours Worked in WBG	43	44	44	43	43	43	43	43	32	34	36	38	39	40	40	42	0
Average Hours Worked in Israel	45	46	46	45	44	45	45	44	33	35	37	37	39	35	18	19	0
Gaza Strip																	
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Unemployment rate (%)	0.00	0.00	0.03	0.01	0.01	0.01	0.01	0.01	0.02	0.02	0.04	0.04	0.03	0.04	0.04	0.31	0.39
Adjusted Unemployment Rate	0.03	0.00	0.03	0.01	0.01	0.05	0.05	0.01	0.14	0.12	0.10	0.09	0.08	0.09	0.08	0.36	0.45
Employment by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.19	0.18	0.18	0.19	0.17	0.18	0.17	0.16	0.19	0.18	0.20	0.22	0.21	0.20	0.16	0.11	0.11
Industry	0.19	0.17	0.15	0.15	0.17	0.16	0.18	0.18	0.16	0.14	0.11	0.13	0.13	0.13	0.10	0.15	0.16
Construction	0.07	0.08	0.09	0.08	0.09	0.08	0.08	0.08	0.08	0.13	0.11	0.10	0.12	0.15	0.11	0.18	0.09
Others	0.55	0.57	0.59	0.57	0.58	0.57	0.57	0.58	0.57	0.56	0.57	0.56	0.54	0.52	0.63	0.56	0.64
Employment in Israel (% of Total employed)	0.30	0.31	0.32	0.33	0.33	0.33	0.33	0.32	0.32	0.28	0.29	0.27	0.26	0.19	0.12	0.13	0.11
Employment in Israel by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.18	0.16	0.17	0.17	0.20	0.22	0.22	0.21	0.22	0.19	0.16	0.18	0.15	0.15	0.26	0.24	0.24
Industry	0.21	0.18	0.17	0.19	0.18	0.19	0.17	0.19	0.14	0.11	0.09	0.06	0.04	0.03	0.10	0.13	0.13
Construction	0.44	0.50	0.51	0.47	0.45	0.42	0.45	0.42	0.48	0.53	0.62	0.70	0.75	0.77	0.64	0.62	0.62
Others	0.17	0.16	0.15	0.17	0.17	0.17	0.16	0.18	0.16	0.16	0.13	0.07	0.05	0.05	0.00	0.00	0.00

Table 11: Distribution of Labor Force and Employment - continued

	West Bank																
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Unemployment rate (%)	0.02	0.01	0.02	0.02	0.04	0.05	0.04	0.03	0.03	0.04	0.04	0.10	0.05	0.08	0.14	0.13	0.24
Adjusted Unemployment Rate	0.06	0.01	0.02	0.02	0.04	0.08	0.06	0.03	0.13	0.11	0.06	0.14	0.07	0.11	0.19	0.17	0.28
Employment by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.33	0.31	0.32	0.30	0.29	0.27	0.29	0.26	0.31	0.26	0.30	0.28	0.29	0.25	0.25	0.13	0.19
Industry	0.15	0.16	0.16	0.16	0.16	0.16	0.16	0.17	0.16	0.17	0.16	0.17	0.17	0.17	0.17	0.18	0.18
Construction	0.11	0.12	0.11	0.11	0.11	0.12	0.13	0.12	0.11	0.11	0.11	0.11	0.11	0.15	0.17	0.23	0.13
Others	0.41	0.42	0.41	0.43	0.44	0.44	0.43	0.45	0.42	0.45	0.44	0.45	0.43	0.44	0.41	0.45	0.50
Employment in Israel (% of Total employed)	0.29	0.29	0.29	0.31	0.31	0.30	0.29	0.34	0.33	0.34	0.32	0.29	0.33	0.25	0.21	0.07	0.06
Employment in Israel by Sector	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Agriculture	0.10	0.09	0.09	0.08	0.10	0.11	0.11	0.10	0.10	0.10	0.09	0.08	0.06	0.08	0.11	0.11	0.11
Industry	0.21	0.18	0.18	0.18	0.18	0.17	0.18	0.18	0.16	0.14	0.11	0.09	0.07	0.07	0.08	0.08	0.08
Construction	0.50	0.53	0.54	0.53	0.51	0.52	0.51	0.48	0.51	0.54	0.58	0.67	0.74	0.70	0.64	0.64	0.64
Others	0.19	0.20	0.19	0.20	0.21	0.20	0.21	0.24	0.23	0.22	0.22	0.16	0.14	0.15	0.18	0.18	0.18

1/ ratio: (total unemployed + temporarily absent) / total employed persons.

2/ ICBS for 1980 to 1993; PCBS since 1994.

Table 12: Size of WBS Civil Service and Police Force

	Civilian Employees			Police Force			Total Public Sector Employees
	Gaza/ Jericho	West Bank	Total	Gaza/ Jericho	West Bank	Total	
December 1993	7,376	15,403	22,779				22,779
December 1994	8,500	17,000	25,500	14,000	0	14,000	39,500
January 1995	12,160	16,700	28,860	16,000	0	16,000	44,860
February 1995	11,800	16,800	28,600	18,000	0	18,000	46,600
March 1995	12,500	17,000	29,500	18,000	0	18,000	47,500
June 1995	13,000	17,100	30,100	18,000	0	18,000	48,100
August 1995	13,400	17,300	30,700	19,000	0	19,000	49,700
September 1995 ^{1/}			33,100			19,500	52,600
			31,900			20,700	52,600
December 1995 ^{2/}			34,800			24,000	58,800
March 1996 ^{2/}			36,700			26,700	63,400
June 1996 ^{2/}			38,400			30,200	68,600
September 1996 ^{2/}			38,900			32,600	71,500
December 1996			41,020			34,027	75,047

1/ Disaggregation into Gaza/Jericho and West Bank not available; different figures cited in different IMF reports.

2/ Disaggregation into Gaza/Jericho and West Bank not available.

Table 13: Demographic Indicators for the WBS in 1996

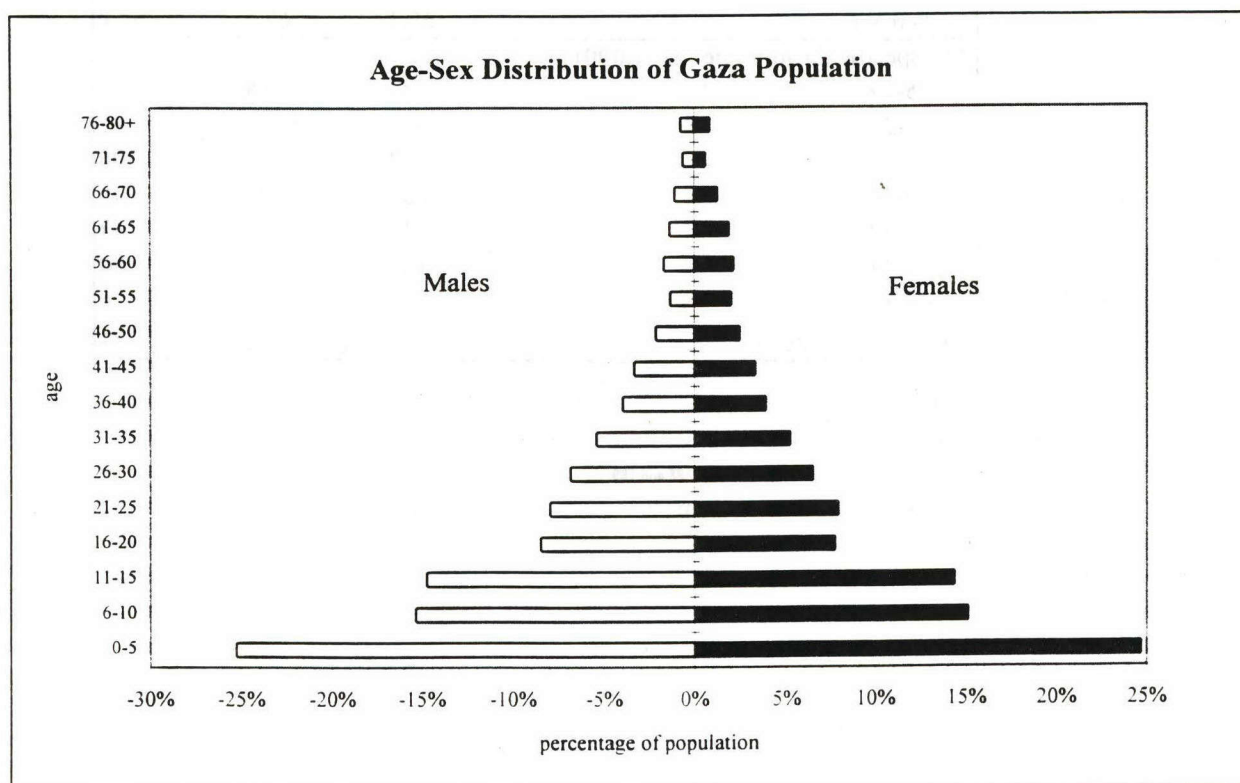
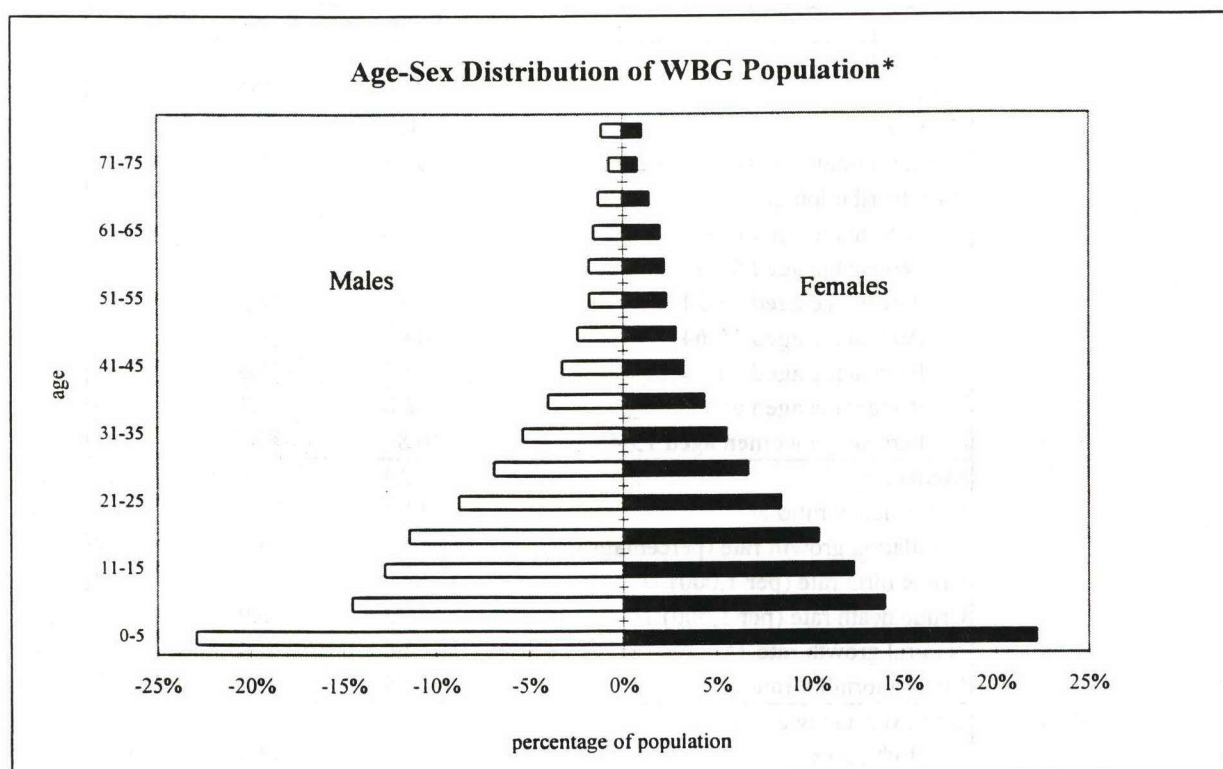
	Gaza Strip	West Bank	WBS
Population ('000) 1/	843	1,395	2,238
Male	425	703	1128
Female	418	693	1111
Sex ratio (males per 100 females) 2/	103.8	105.6	104.96
Age distribution 2/			
Percentage aged 0-4	21.1	17.9	19
Percentage aged 5-14	29.2	27.1	27.9
Percentage aged 15-24	19	21.1	20.4
Percentage aged 15-64	46.9	51.3	49.7
Percentage aged 60+	4.5	5.6	5.2
Percentage aged 65+	2.8	3.7	3.4
Percentage women aged 15-49	40.82	44.83	43.37
Median age 2/	14	16	16
Dependency ratio 2/	113.2	95.1	101.3
Population growth rate (percentage) 1/	8.2	6.7	7.2
Crude birth rate (per 1,000) 1/	52.4	41.2	45.4
Crude death rate (per 1,000) 1/	6.5	6.9	6.7
Natural growth rate 1/	4.6	3.4	3.9
Infant mortality rate 1/	35	38	37
Life expectancy at birth 1/			
Both sexes	68.2	67.5	67.8
Male	68.2	67.5	67.8
Female	68.2	67.5	67.8
Age specific fertility rate (per 1,000) 3/			
15-19	144	98	114
20-24	340	274	297
25-29	347	274	300
30-34	289	239	246
35-39	231	160	183
40-44	123	71	90
45-49	5	7	6
Total fertility rate 3/	7.44	5.61	6.24

Sources:

1/ Demographic Survey 1994

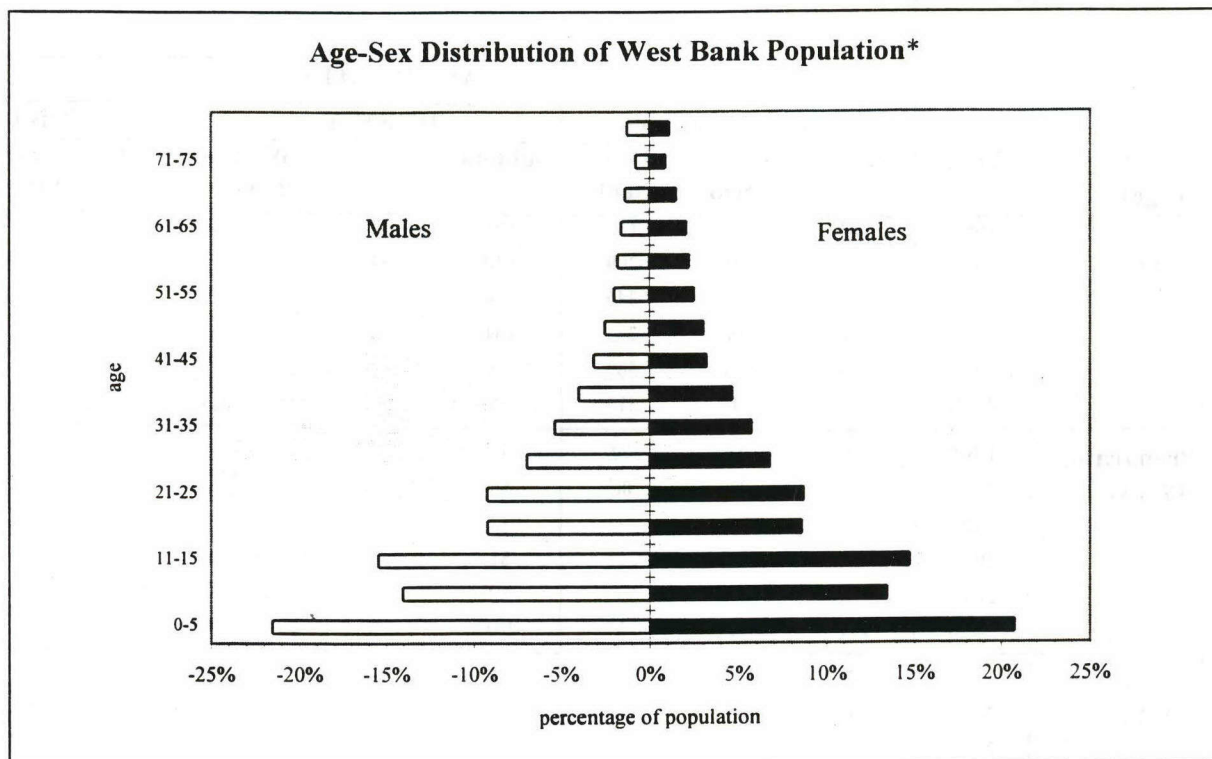
2/ Demographic Survey, March 1996, pp. 188 and 189.

3/ Demographic Survey, March 1996, p. 132.

Figure 1: Age-Sex Distribution of Population

* Does not include Jerusalem.

Figure 1: Age-Sex Distribution of Population - *continued*



* Does not include Jerusalem.
Source: PCBS (1996a).

Table 14: Projected Gross Enrollments by Authority, Level and Age for the WBGS,*
1995-2020 (in thousands)

Level (age)	Year	AUTHORITY								
		Palestinian Authority			UNRWA			Private		
		Subtotal	Gaza Strip	West Bank	Subtotal	Gaza Strip	West Bank	Subtotal	Gaza Strip	West Bank
Primary (6-11)	1995	217	54	162	101	73	28	17	2	15
	2000	279	70	209	130	94	36	21	2	19
	2005	329	82	246	154	111	43	25	3	23
	2010	351	88	263	164	118	46	27	3	24
	2015	404	101	303	189	136	53	31	3	28
	2020	425	107	319	199	143	55	33	3	29
Preparatory (12-14)	1995	92	21	72	46	33	14	5	0	5
	2000	111	25	86	56	39	17	7	0	6
	2005	143	32	111	72	51	22	8	0	8
	2010	161	36	125	81	57	24	9	1	9
	2015	176	39	136	89	62	26	10	1	10
	2020	199	45	155	101	70	30	12	1	11
Secondary (15-17)	1995	92	39	53	1	1	0	7	1	6
	2000	107	45	62	2	2	0	8	1	7
	2005	130	55	75	2	2	0	9	1	8
	2010	167	71	96	2	2	0	12	2	10
	2015	172	73	99	3	3	0	12	2	11
	2020	205	87	118	3	3	0	15	2	13
Total for Pre-Tertiary Levels	1995	401	114	287	149	107	42	29	3	26
	2000	497	140	357	188	135	53	36	4	32
	2005	602	170	432	228	163	64	43	5	39
	2010	680	195	484	248	178	70	49	5	43
	2015	752	214	538	280	201	79	54	6	48
	2020	830	239	592	302	217	86	59	6	53

* Figures do not include Jerusalem.

Sources: PCBS (1995), Tables 7.23 and 7.24, pp. 138-39; World Bank Population Projections; PCBS (1996a), Table 3.1.3.9, p. 89.

Table 15: Total Donor Assistance to WBGS, 1994-1996*(in US\$ million)*

	Total	Total 1994-1996		
	Pledges (94-98)	Pledges	Commitments	Disbursements
Algeria	10.00	7.00	4.00	4.00
Arab Fund (AFSED)	100.00	110.00	110.00	0.00
Australia	13.01	13.01	13.01	12.64
Austria	20.00	13.00	9.36	6.57
Belgium	20.51	20.51	17.20	8.80
Brunei	6.00	6.00	6.00	6.00
Canada	33.89	33.98	33.98	26.65
Cyprus	2.20	2.20	2.20	0.00
Czech Republic	3.00	3.00	3.00	0.00
Denmark	61.47	61.47	61.47	37.83
Egypt	6.30	6.30	6.36	5.54
European Union	300.00	310.72	310.72	177.42
European Inv. Bank	300.00	130.00	150.50	0.00
Finland	15.78	15.78	16.86	6.68
France	65.00	65.00	54.37	24.53
Germany	92.98	92.98	92.98	58.38
Greece	16.10	16.10	16.10	15.50
Iceland	1.30	0.90	0.00	0.00
India	2.00	2.00	1.00	0.00
Indonesia	5.00	4.00	2.00	0.00
IFC	70.00	48.75	18.75	0.00
Ireland	5.00	4.72	4.32	2.77
Israel	74.50	44.50	25.00	10.50
Italy	80.00	62.00	69.50	28.30
Japan	256.13	256.13	209.00	192.52
Jordan	12.61	12.61	12.61	8.83
Kuwait	25.00	25.00	22.00	22.00
Luxembourg	5.91	5.91	5.91	0.60
Netherlands	120.65	120.65	113.83	36.86
Norway	150.00	140.57	140.57	109.48
Qatar	2.56	2.50	2.50	2.50
Republic of Korea	13.54	3.54	3.14	0.60
Romania	2.88	2.88	2.88	1.80
Russia	0.00	0.00	0.00	0.00
Saudi Arabia	200.00	215.00	205.00	82.50
Spain	51.47	51.47	51.47	49.98
Sweden	69.53	69.53	66.87	43.69
Switzerland	70.17	70.17	70.17	49.74
Turkey	52.00	52.86	2.86	2.86
UNDP 1/				0.00
UNRWA 1/				0.00
United Arab Emirates	25.00	15.00	15.00	15.00
United Kingdom 2/		0.00		19.08
United States	500.00	232.16	232.16	225.80
World Bank	140.00	140.00	140.00	51.93
TOTAL	3,001.49	2,489.89	2,324.62	1,347.87

1/ To be treated as conduit or channel of assistance.

2/ The United Kingdom does not provide annual commitments.

Table 16: Annual Donor Assistance to WBS, 1994-1996

(in US\$ million)

	1994			1995			1996		
	Pledges	Commitments	Disbursements	Pledges	Commitments	Disbursements	pledges	Commitments	Disbursements
Algeria	4.00	4.00	4.00	3.00	0.00	0.00	0.00	0.00	0.00
Arab Fund (AFSD)	30.00	30.00	0.00	10.00	10.00	0.00	70.00	70.00	0.00
Australia	4.84	4.84	6.06	4.67	4.67	4.66	3.50	3.50	1.91
Austria	4.48	3.59	3.59	5.14	2.39	2.39	3.38	3.38	0.60
Belgium	3.49	3.49	3.49	10.96	7.65	4.45	6.06	6.06	0.86
Brunei	1.00	1.00	1.00	5.00	5.00	5.00	0.00	0.00	0.00
Canada	13.73	13.73	7.74	13.59	13.59	10.08	6.66	6.66	8.83
Cyprus							2.20	2.20	0.00
Czech Republic							3.00	3.00	0.00
Denmark	42.98	42.98	15.33	0.34	0.34	16.33	18.15	18.15	6.17
Egypt	5.30	5.33	5.33	0.00	0.03	0.03	1.00	1.00	0.18
European Union	101.94	101.94	46.09	80.10	80.10	59.30	128.68	128.68	72.04
European Inv. Bank	0.00	0.00	0.00	32.50	32.50	0.00	97.50	118.00	0.00
Finland	2.81	2.81	2.50	3.87	3.87	1.94	9.10	10.18	2.24
France	24.00	16.00	15.10	24.00	19.47	5.67	17.00	18.90	3.76
Germany	24.07	24.07	10.68	27.85	27.85	19.49	41.06	41.06	28.21
Greece	15.00	15.00	15.00	0.10	0.10	0.00	1.00	1.00	0.50
Iceland	0.50	0.00	0.00	0.40	0.00	0.00	0.00	0.00	0.00
India	0.50	0.00	0.00	0.50	0.00	0.00	1.00	1.00	0.00
Indonesia	1.00	0.00	0.00	1.00	0.00	0.00	2.00	2.00	0.00
IFC	18.75	18.75	0.00	30.00	0.00	0.00	0.00	0.00	0.00
Ireland	1.00	0.60	0.52	1.12	1.12	1.15	2.60	2.60	1.10
Israel	15.00	6.50	6.50	15.00	4.00	4.00	14.50	14.50	0.00
Italy	18.50	18.40	11.65	18.50	21.10	6.65	25.00	30.00	10.00
Japan	100.00	89.83	89.83	100.00	63.04	63.04	56.13	56.13	39.65
Jordan	8.83	8.83	8.83	3.78	3.78	0.00	0.00	0.00	0.00
Kuwait	25.00	22.00	8.00	0.00	0.00	14.00	0.00	0.00	0.00
Luxembourg	0.00	0.00	0.00	0.13	0.13	0.13	5.78	5.78	0.47
Netherlands	31.92	31.92	16.55	18.13	11.30	9.59	70.61	70.61	10.72
Norway	34.42	34.42	30.07	43.15	43.15	34.29	63.00	63.00	45.13
Qatar	2.50	2.50	0.00	0.00	0.00	2.50	0.00	0.00	0.00
Republic of Korea	0.26	0.06	0.00	0.28	0.08	0.60	3.00	3.00	0.00
Romania	1.80	1.80	1.80	1.08	1.08	0.00	0.00	0.00	0.00
Russia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Saudi Arabia	100.00	100.00	30.00	100.00	90.00	37.50	15.00	15.00	15.00
Spain	11.94	11.94	10.65	25.33	25.33	17.53	14.20	14.20	21.80
Sweden	10.50	10.50	3.07	20.49	17.82	10.99	38.55	38.55	29.63
Switzerland	31.44	31.44	19.90	14.43	14.43	14.31	24.30	24.30	15.53
Turkey	2.00	2.00	2.00	25.00	0.00	0.00	25.86	0.86	0.86
UNDP 1/									
UNRWA 1/									
United Arab Emirates	5.00	5.00	5.00	10.00	10.00	10.00	0.00	0.00	0.00
United Kingdom 2/			9.62			7.14			2.32
United States	90.43	90.43	87.23	74.10	74.10	69.40	67.64	67.64	69.18
World Bank	30.00	30.00	2.60	20.00	20.00	22.17	90.00	90.00	27.17
TOTAL	818.90	785.68	479.70	743.54	608.02	454.32	927.45	930.93	413.85

1/ To be treated as conduit or channel of assistance.

2/ The United Kingdom does not provide annual commitments.

Table 17: Donor Assistance by Category and Year, 1994-1996

<i>in US\$ million</i>	1994		1995		1996		1994-1996		Ratio
Category	Commitment	Disbursement	Commitment	Disbursement	Commitment	Disbursement	Commitment	Disbursement	
Public Investment	281.570	143.365	273.288	123.388	419.240	152.208	974.098	418.961	43.01014888
Technical Assistance	136.292	76.983	100.034	88.491	104.829	78.094	341.155	243.568	71.39511366
Transitional&budgetary Support	198.874	171.942	132.303	118.578	168.947	158.293	500.124	448.813	89.74034439
Employment generation	27.601	12.847	10.591	13.122	38.794	36.080	76.986	62.049	80.59777102
Others	98.926	91.628	110.684	98.172	165.552	103.247	375.162	293.047	78.11212223
TOTAL	743.263	496.765	626.900	441.751	897.362	527.922	2,267.525	1,466.438	64.67130462

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Agreement on the Preparatory Transfer of Powers and Responsibilities, between the Government of the State of Israel and the Palestinian Liberation Organization, August 29, 1994, Erez.

Declaration of Principles on Interim Self-Government Arrangements, between the Government of the State of Israel and the Palestinian Liberation Organization, September 13, 1993, Washington, DC.

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, September 28, 1995, Washington, DC.

Protocol Concerning the Redeployment in Hebron, between the Government of the State of Israel and the Palestinian Liberation Organization, January 17, 1997, Jerusalem.

Protocol on Economic Relations - Annex IV of the Gaza-Jericho Agreement, between the Government of the State of Israel and the Palestinian Liberation Organization, April 29, 1994, Paris.

Lunch with Joe Stiglitz

Tuesday, December 9, 1997

1:00 - 2:00 p.m.

MC-C1 Dining Room



Below are listed several topics that may come up during your monthly one-on-one lunch with Joe Stiglitz:

1. East Asia Crisis: *Update on current situation and Bank response including:*

- Recent meeting in Kuala Lumpur
- Bank-Fund Collaboration in Korea and Indonesia
- Next meetings: Korea, Thailand
- EDI Policy Seminars (joint with IMF) at Asian Forum with follow-up in Korea, Philippines, Thailand, Malaysia
- Staffing for financial sector work

2. World Development Report

- Reaction to 1997 Report on "The State in a Changing Role" (**Attachment I**)
- Update on 1998 WDR on Knowledge
- Future WDRs -- 1999 (Future Development Agenda); 2000 (Poverty)

3. Other

- AIDS Research Report -- press coverage (**Attachment II**)
- West Bank/Gaza -- follow-up to report on Palestinian economy
- Second Japan Research Fair -- Intellectual Collaboration

WORLD DEVELOPMENT REPORT 1997: 'THE STATE IN A CHANGING WORLD' MEDIA ANALYSIS AND DISSEMINATION REPORT

July 30, 1997

This analysis is prepared by the News Bureau in EXTME for internal use by the External Affairs Department. The analysis is intended to give a quick overview of media perception of the Bank's work during periods of intense media exposure, and should not be regarded as exhaustive. Ideally, it should help to identify areas in which efforts to engage the media would likely be rewarding.

SOURCES AND METHODS

The articles included in this review cover the period from June 25, 1997 through July 9, 1997, and were retrieved from EXTME'S on-line news service, and from US, European, and Asian newspapers (see Annex 3) and broadcast outlets (see Annex 2).

The arguments in this year's *World Development Report (WDR)* required a careful media strategy aimed primarily at accurate reporting of the Bank's position on the question of state intervention in the economic life of nations. EXT strategy was also aimed at favorable reporting of the Bank's research on this issue and of the Bank's lending policies in general. As the *WDR's* arguments were sound and intrinsically positive, however, it could be assumed that favorable coverage would necessarily follow from accurate reporting.

Accordingly, articles were reviewed primarily for accuracy, and only secondarily for favorability. Articles were considered accurate if they repeated the

report's findings without implying the following distortions:

- the Bank supports, or has found evidence in support of, ideologies of 'big government';
- the Bank has found economic evidence in support of state ownership or control of production;
- the *WDR's* argument is inconsistent with the Bank's commitments, given the Bank's efforts in the past to push market reforms and 'dismantle' the state;
- the *WDR's* findings on corruption are inconsistent with Bank practice, given the Bank's failure to recognize the problem in the past.

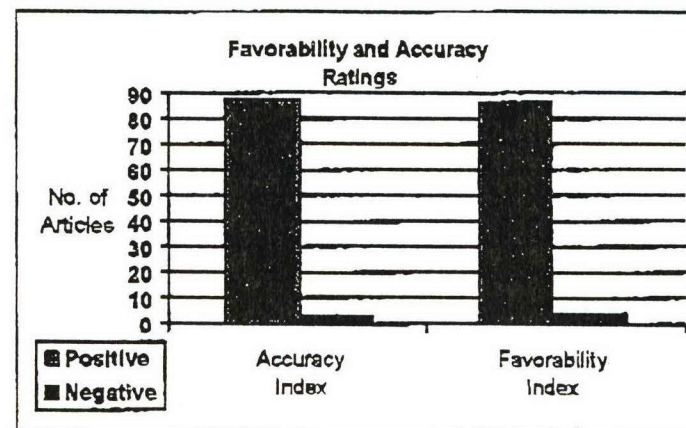
Articles were considered favorable if they reflected the broad emphasis placed by both the report and the media campaign on *effective* government, if they signalled approval of the *WDR's* reliance on a wider set of development indicators than economic ones, or if they signalled approval of the Bank's readiness to examine its lending policies critically.

OVERVIEW OF COVERAGE

Over a two-week period, EXTME retrieved a total of 90 newspaper articles and facilitated 23 broadcasts on *WDR 1997*. The vast majority of articles and broadcasts were lengthier and more analytical than most hard news reports, indicating a depth of journalistic interest in the report's findings.

Interest in the *WDR* was evenly distributed among the US, European, and Asian media, with the most appreciative commentary coming from the European papers.

As the chart shows, *WDR* press coverage was both accurate and favorable, indicating that the message was strong and that outreach efforts were highly effective. Certainly, the close correspondence between the ratio of accurate to inaccurate articles (87 to 3) and that of favorable to unfavorable articles (86 to 4) shows that the report's arguments were both well-examined and well-received.



That the richness of those arguments was not lost in EXT's efforts to generate general media interest in the report should be evident from the content of the coverage. (See section below.)

LEADING ISSUES

The favorable media response to *WDR 1997* can be attributed to the clarity and timeliness of its message, and to the analytic framework the report offered for evaluating the effectiveness of states. While the urgent need in many countries to strengthen—rather than to either expand or contract—the role of states in delivering social goods was widely acknowledged by key electorates in recent months, the *WDR* provided a sound quantitative method for analyzing issues frequently dismissed as ideological.

The report's timeliness was foregrounded in the press release (see Annex 1), which pointed out that "at a time when many countries are debating whether the state should be at the center of national life, the World Bank says an 'effective state' is the cornerstone of successful economies, and without it, economic and social development is impossible"—an introduction that was widely quoted in the media coverage.

The emphasis on the delivery of social goods, rather than on purely economic ones, also clearly helped to generate favorable coverage. Mr. Wolfensohn's remark in his foreword to the report, also foregrounded in the press release, that "a minimalist state...would do no harm, but neither could it do much good" was also widely quoted in the coverage, and many articles reprinted the five key government tasks identified by the report without objections. The Bank's call for the maintenance of "an effective macroeconomic policy environment," which has provoked much cynical commentary in the past, was taken as one commonsensical measure among others. Indeed, the disparity between the report's conclusions and what was perceived as the Bank's enthusiasm for market forces and minimal government in the past was mentioned only in passing as an irony that did not detract from the merits of the report.

The point that a mix of market and government intervention is indispensable was very well taken.

Quibbles were few and tended to be minor: the *Globe and Mail* (6/26), for instance, noted with some ambivalence that the *WDR* "this year is using indexes based on subjective material such as interviews with business leaders to argue that corruption and a lack of credibility in the bureaucracy or the judiciary hinder economic growth." And a *New York Times* (7/28, p.A18) editorial that did not cite the *WDR* but which referred to its arguments regarding governance cautioned that "the [Bank and the IMF] know what to tell governments about cutting their budgets. Making a judicial system work better is a foggier process. These reforms often require an overhaul of a nation's political culture, a task outside the scope of the World Bank or IMF or the skills of a staff now largely made up of economists," but concluded that "fortunately, the new focus at the Bank and the IMF reflects a growing consensus...that effective government matters."

On the whole, the *WDR* was welcomed by the most influential commentators as a sound proof of common-sense approaches to social policy. The *Financial Times* (7/7), which covered the *WDR* extensively, even cited the report for its relevance to the intellectual history of economics, saying that it "showed how and why institutions and history needed to be integrated more fully" into the discipline. And both the *New York Times* editorial and a *Washington Times* (7/3, p.A17) op-ed by Anders Wijkman of the UNDP, although neither piece focused on the report, relied on the main arguments of the *WDR* as crucial to the debate on aid effectiveness. (See Annex 4.) Clearly, the report's practical and theoretical merits were very well conveyed to the press.

CONFRONTING AIDS LAUNCH

The strategy for the *Confronting AIDS* launch employed a phased, campaign-style approach, culminating with World AIDS Day on December 1 and two regional AIDS conferences in Lima, Peru and Abidjan, Côte D'Ivoire.

Media coverage of *Confronting AIDS* was several times greater than for any of the previous Policy Reports. We anticipate that coverage will continue as a result of the regional events in December and planned media activities in India and Vietnam.

The launch involved close cooperation between the Bank, UNAIDS and the European Commission AIDS Taskforce, and within the Bank between DEC, EXT and HDD.

EVENTS

September 25, 1997: Fourth International Congress on AIDS in Asia and the Pacific, Manila. Mead Over attended and presented the findings of the report.

November 3, 1997: *Confronting AIDS* Launch

Geneva Press Conference: Peter Piot, Executive Director of UNAIDS, hosted the press briefing by Lyn Squire, Director of Development Policy, and Mead Over, co-author of the report. Lieve Franssen, director of the European Union AIDS Task Force, also participated.

Washington Press Conference: Joseph Stiglitz, Richard Feachem and Martha Ainsworth, co-author of the report, briefed the media. About 30 broadcast and print journalists attended.

November 25, 1997: Joseph Stiglitz delivered a speech on the report's messages to an event in Brussels organized by the European Commission, attended by members of the European Parliament and representatives from developing countries. About 200 people attended.

November 26, 1997: Washington press briefing on the report for LAC journalists as a curtain-raiser for World AIDS Day and the LAC conference in Lima. Participants included Martha Ainsworth, Alexandre Abrantes (LCC7A) and Jose Antonio Izazola, coordinator of the regional initiative for AIDS and STD control, SIDALAC.

December 1: World AIDS Day

Washington: Speakers at a National Press Club event included Lyn Squire; Peter Piot, UNAIDS; Peter Lampsey, Director, AIDS Control and Prevention Project, Family Health International; and Sandra Thurman, Director, White House Office of

National AIDS Policy. Squire introduced the Bank's Public Service Announcement (PSA) on HIV/AIDS produced jointly by EXTIM, HDD and DECRG. External partners in the World AIDS Day event included USAID, PAHO, National Council on International Health, AIDSCAP, American Association for World Health, UNAIDS and Health Technical Services.

Moscow Press Conference: Tayana Loginova, health specialist from the Moscow Resident Mission, briefed Russian media on the report.

December 3-6, 1997: LAC regional AIDS conference, Lima. Martha Ainsworth and Mead Over presented the findings of the report in a speech. They also met with AIDS policymakers in a reception to promote the report.

December 7-11, 1997: Africa regional AIDS conference, Abidjan. Martha Ainsworth and Mead Over delivered the plenary session speech on the role of government in AIDS and development.

AIDS Econ Website

In partnership with UNAIDS, the Bank established a website (www.worldbank.org/aids-econ/), managed by EDI, to inform the media, academia and the general public about the economic implications of HIV/AIDS.

RESULTING PRESS COVERAGE

EXTME retrieved more than 45 print articles from Part I and II media, including most major US papers, which discussed or mentioned the Bank's report. EXT arranged interviews for the authors and others with more than 18 broadcast outlets, including a live interview with Martha Ainsworth on CNN International's evening news segment.

EXTME also distributed the Bank's AIDS print PSAs to 317 English-language newspapers and magazines. 200 radio stations in the top 100 US markets have agreed to air the AIDS radio PSA. 146 television broadcasters and 52 television broadcasters in 41 other Part I and II countries, spanning every region, are airing the television PSA in one of five languages—English, French, German, Spanish or Russian. This includes four international networks: CNN Español, CNBC Europe, CNBC Asia and CNN International, which has exposure in more than 190 countries.

In addition to this note, a full Dissemination Report on the launch is forthcoming from EXTME. Please see the attached indices for a partial list of print articles and electronic media activity.

Index of Broadcast Hits

Although it is impossible to track all the broadcast media coverage which resulted from the release of "Confronting AIDS", the following is a list of the media outlets which produced a story on the report as a result of efforts by EXTME:

Outlet	Comments
TELEVISION	
APTV	used Bank's b-roll
CNN International "World News"	Live interview with Ainsworth on evening news
German TV syndicate	used Bank's b-roll
Univision	used footage from press conference and b-roll
Worldnet TV	used footage from press conference and b-roll
CNN Spanish	
BBC French service	interview with Mead Over
Voice of America/East Asia	interview with Mead Over
NBS TV (Russia)	interview with Tayana
RADIO	
ABC Network (US)	interview with Ainsworth, ran story throughout the day
Australian Broadcasting Worldservice	interview with Ainsworth
BBC Worldservice "Newshour"	interview with Ainsworth, highest rated BBC program
BBC Africa Division	interview with Ainsworth
BBC Radio 4	interview with Macdonald
BBC local radio network	interview with Macdonald
CBS Network (US)	interview with Ainsworth, ran story throughout the day
CNN Network (US)	interview with Ainsworth, ran story throughout the day
Deutsche Welle/Africa	
Deutsche Welle/Russia	interview with Maria Vannari, used Banks audio
Feature Story (Europe, Africa syndicate)	
Pacifica Radio (US syndicate)	interview with Macdonald
Radio France International	
Radio Free Asia	
Radio Free Europe	used Bank's audio
Radio New Zealand	
South African Broadcasting	interview with Macdonald
UN Radio	interview with Ainsworth
UN Radio/Asia	
UN Radio/Russia	interview with Maria Vannari
Voice of America Worldservice	
Voice of America/East Asia	interview author TBA
Voice of America/Geneva	interview with Mead Over
Voice of America/Russia	interview with Maria Vannari
Voice of America/Thailand	used sound from press conference
Voice of America	two unspecified regions came to press conference
WTOP (US)	soundbites of Ainsworth
HIVinsite Website	interview with Mead Over, including book review

Index of Articles

Date	Periodical	Title and Author
November 3, 1997	Reuters	<i>Governments can contain AIDS spread, study says</i> by Stephanie Nebehay
	Agence France-Presse	<i>China, India, eastern Europe can avert HIV epidemic: World Bank</i>
	Bloomberg	<i>World Bank Asks Government to do More to Stop AIDS</i> by Jeremy Pelofsky
	Associated Press	<i>Report Recommends AIDS Prevention</i> by Harry Dunphy
	Xinhua	<i>World Bank Urges More AIDS Prevention Efforts in Developing Countries</i>
	Buffalo News	<i>World Bank sees threat of AIDS exploding in Eastern Europe</i> (AP)
	Toronto Star	<i>AIDS: It's getting worse, 23 million people now infected in global epidemic, new report says</i> by Katherine Kenna
November 4, 1997	New York Times	<i>AIDS Surge is Forecast for China, India and Eastern Europe</i> by Lawrence Altman
	Washington Post	<i>AIDS Study Emphasizes Prevention Worldwide</i> by David Brown
	USA Today	<i>Report warns of AIDS Explosion outside of Africa</i> (Wire stories)
	Washington Times	<i>AIDS epidemic ready to spread</i> (AP)
	Globe and Mail	<i>World Bank highlights need for programs to fight AIDS</i> (NYT)
	Daily Telegraph	<i>World Bank spurs fight against AIDS</i> by Gordon Martin
	The Oklahoman	<i>World Bank Pushes AIDS Prevention</i> (AP)
	Miami Herald	<i>Emphasis on AIDS prevention urged</i> (AP)
	Lexington Herald-Leader	<i>Leaders told to help stop AIDS</i> (AP)
	Minneapolis Star-Tribune	<i>World Bank stresses need for AIDS prevention</i> (AP)
	Houston Chronicle	<i>World Bank supports major offensive against AIDS</i> (NYT)
	*Atlanta Journal-Constitution	<i>Eastern Europe Could Face Huge AIDS Outbreak</i> (Wire stories)
	Portland Press Herald	<i>Agency urges AIDS action in developing countries</i>
	Casper Star-Tribune (Wyoming)	<i>Report: AIDS may explode in Eastern Europe, elsewhere</i> (AP)

	Japan Times	<i>Report warns of AIDS explosion in Eastern Europe (AP)</i>
	Mainichi Shimbun	Japanese language
	Nihon Keizai Shimbun	Japanese language
	Sankei Shimbun	Japanese language
	Asahi Shimbun	Japanese language
	The News (Pakistan)	<i>World Bank report identifies priority areas for AIDS control</i>
	Dawn (Pakistan)	<i>30 million people infected by HIV, says report</i>
	The Hindu (India)	<i>World Bank for greater efforts to check AIDS</i>
	Hindustan Times (India)	<i>AIDS threatens to reverse progress</i>
	Asia Pulse	<i>Asia set to dominate world HIV picture: World Bank</i>
	Deutsche Press-Agentur	<i>India yet to formulate policy on combatting AIDS, admits official</i>
	Moscow Times	<i>Drug users said crucial to aids fight by Bronwyn McLaren</i>
	Les Echos	<i>Neuf malades du sida sur dix vivent dans le tiers-monde (Wire brief)</i>
November 6, 1997	Frankfurter Allgemeine Zeitung	<i>Weltbank warnt vor Ausbreitung des Aids-Virus in Osteuropa</i>
	Suddeutsche Zeitung	<i>Ausbreitung von Aids in Osteuropa befürchtet</i>
November 7, 1997	Le Monde	<i>90 % des séropositifs vivent dans les pays en voie de développement by Jean-Yves Nau</i>
November 19, 1997	AIDS Weekly	<i>Governments can contain AIDS spread by</i>
November 21, 1997	Asia Week	<i>Is Asia's Number Really Up by Catherine Shepherd</i>
	Lancet (UK)	<i>World Bank reports on priorities for HIV and AIDS</i>
November 23, 1997	New Nation (Bangladesh)	<i>Bangladesh and some countries at earl stage of HIV epidemic: New World Bank study</i>
November 25, 1997	Arbeiderbladet (Norway)	<i>Aids undergraver u-landsøkonomien</i>
November 27, 1997	International Herald Tribune	<i>Prevention to Combat AIDS by Joesph Stiglitz</i>
November 28, 1997	Philadelphia Inquirer	<i>Developing nations urged to fight hard against AIDS (AP)</i>
November 29, 1997	Moscow Times	<i>Shutting door on AIDS by Jean-Paul Grund and Philip Coffin</i>
December 1, 1997	Christian Science Monitor	<i>Mixed Global Progress Against AIDS by Scott Baldauf</i>

The World Bank
Washington, D.C. 20433
U.S.A.

JOSEPH E. STIGLITZ
Senior Vice President
Development Economics and Chief Economist

December 8, 1997

Dear Jim,

I am sending you a copy of the report about the West Bank and Gaza Strip, *Development Under Adversity*, that you requested in our conversation last week. I am also enclosing a copy of the speech I gave at the conference about the report. The report is the joint work of the World Bank and a Palestinian think tank, the Palestine Economic Policy Research Institute.

As I told you on the phone, the Palestinian economy has deteriorated since the Oslo agreement to the point where per capita expenditure is now at its lowest level for any year since 1980. One of the main reasons for this regress is the intensified Israeli harassment of the Palestinian economy. This border closures and other restrictive policies are increasingly being used as a political tool to extract political concessions from the Palestinians, rather than as a security measure. The consequences of these measures were very evident in my recent mission to the West Bank and Gaza Strip. I wanted to give you a few examples of what I saw and heard:

- So far this year the border has been closed on 36 percent of the days; a steady increase from only 5 percent in 1993. The enclosed report estimates that the economic losses from border closures between 1993-96 are substantially larger than the sum of disbursed aid over the period.
- Only 28,000 Palestinians are now working in Israel. In 1992, 150,000 Palestinians worked in Israel. The difference has been made up by a huge influx of foreign workers.
- The delays and inspection procedures make it virtually impossible for the Palestinians to export time-sensitive goods, like flowers and strawberries. Consequently, many promising export industries have been shut down and farmers have reverted to low-value crops such as potatoes and onions for local consumption.
- I visited the Gaza airport which is virtually complete but has not been given permission to be used, even for exports.
- I heard frequent complaints about delays in importing basic capital equipment.

If the peace process is to be successful and durable we must continue to put pressure on the Israeli government not to undermine the nascent Palestinian economy.



Joe

Attachments (2)

Development Under Adversity? The Palestinian Economy in Transition

Joseph Stiglitz, Senior Vice President and Chief Economist
The World Bank
November 22, 1997
Conference on Development Under Adversity (Gaza)

I would like to start by thanking the organizers of this conference -- the hard working people in MAS and in the World Bank resident office who have put together this event today. I also want to thank all the participants for being here.

I will be summarizing the main findings of a comprehensive report on the health and challenges of the Palestinian economy since the beginning of the peace process. I want to note from the outset that the report was written in collaboration between a local think tank, the Palestine Economic Policy Research Institute -- MAS is the Arabic acronym -- and the World Bank, with the participation of many other groups, in the public service, in the private sector, and in NGOs. Most chapters have been discussed in workshops organized by MAS. These workshops -- I am told -- witnessed heated discussions and debates, and the main conclusions of each were summarized in the press here. So this is not just another report written by a distant international organization. It is rather a process of self-discovery and civic participation led by the Palestinian society with the assistance of the Bank. It is a model for how our work at the Bank should be done. It has focussed on the economics of a vital policy issue.

The main points that come out of this report are that the Palestinian economy has enormous potential, but that it has been operating far below its potential. And the situation has continued to deteriorate since the 1993 signing of the Declaration of Principles on Interim Self-Government Arrangements, commonly known as the Oslo Agreement. 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 an important message that emerges is that there are policies that can be implemented immediately by the Palestinians and the donors which would generate noticeable economic improvements.

My remarks today will have four parts. I will first describe the disappointing performance of the Palestinian economy in the last few years. Second, I will describe why I think the Palestinian economy has so much potential. Third, I will discuss some of the steps that can be taken to achieve this potential. Finally, in the last part of my talk I will address the role and responsibility of the international community.

THE RECENT ECONOMIC RECORD

First, I will discuss the recent economic record. Many of us were hopeful that the signing of the Oslo Agreement in 1993 would usher in a new period of peace and prosperity for the Israelis and the Palestinians. For Israel, the economic gains have been considerable. But for the Palestinians, the promised advances have been frustrated by the setbacks and disappointments of the last 4 years.

The Palestinian economy weakened beginning with the *Intifada* after 1988 and the Gulf War in 1990-91. Per capita expenditure has continued to fall through the peace process. As a result, real per capita expenditure is now at its lowest level for any year since 1980. At the end of 1995, approximately one-fifth of the population of the West Bank and the Gaza Strip were living in poverty. Since 1995, the situation has probably gotten worse.

The declining income and increasing poverty is a reflection of the major underutilization of resources by the Palestinian economy. The most dramatic manifestation of the massive shortfall from potential is the high and rising unemployment rate which now reach about 20 percent in periods of open border, and up to 30 percent when the border is closed. The shortfall is even greater if we take into account the underemployment resulting from the predominance of part-time jobs.

The *Development Under Adversity* report documents the degree to which the permit and closure policies that Israel has implemented since 1993 have led to a decline in employment in Israel. In 1992, an average of 116,000 Palestinians worked in Israel; in 1996 the number had dwindled to 28,100. This was the result both of a reduction in the number of permits issued by Israel to Palestinians and also the sharp increase in border closures, which were in effect for more than one-third of 1996. The closures and travel

restrictions have also reduced trade -- with negative effects on investment and economic activity -- and slowed down the implementation of infrastructure projects. The report estimates that the total cost of permit and border closure policies over the 1993-96 period was \$2.8 billion, about the size of one year's GDP, and nearly twice the sum of disbursed donor aid over the same period.

THE POTENTIAL OF THE PALESTINIAN ECONOMY

I would next like to discuss the potential of the Palestinian economy. The last decade has been disappointing because the Palestinian economy has not lived up to its potential. But the heartening news is that the economy has enormous potential for future success.

The most important asset any country has is its people. It takes much more time to build a high-quality work force than it does to build infrastructure and factories. And the Palestinian economy is blessed with excellent people. Its general development indicators -- including life expectancy, literacy, and child mortality rates -- are among the best in the Middle East and North Africa region. The average adult in the West Bank and Gaza Strip has spent 8.1 years in school. 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. At most, the Palestinian economy is operating at one-third, or maybe as much as one-half, of that level.

In addition to these human assets, the Palestinian economy has substantial financial potential. 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. Also many of the successful Palestinian businessmen spread throughout the Arab world have demonstrated their eagerness to invest in the West Bank and Gaza Strip economy.

Although it is difficult for economists to quantify, we should not underestimate the importance of a vibrant and well-organized civil society. Non-governmental organizations (NGOs), universities, and hospitals have played a major role in delivering services in health, education, agriculture, and welfare aid to poor families.

The Palestinian economy has a number of other structural assets that are described

in the report, including the potential for significant tourism, an extensive international network, a geographical location at the intersection of East and West, no debts and a good tax system, and widespread international sympathy.

Taken together, these assets mean that given the right environment and the right policies, the Palestinian economy could generate substantial growth rates in the near future.

POLICY PRIORITIES FOR THE PALESTINIAN ECONOMY

I would like to discuss some of the right policies, which is the third topic of my remarks this morning. The *Development Under Adversity* report outlines three specific areas of policy change that can foster stabilization and encourage growth in the Palestinian economy in spite of the existing political difficulties that I alluded to earlier. These are:

- First, opening markets abroad by opening up new trade channels and diversifying away from disproportionate reliance on Israel in trade and delivery of services.
- Second, creating a governance system with an efficient civil service, an investment-oriented public expenditure program and suitable tools for stabilizing the economy.
- And finally, taking advantage of the dynamic civil society and the resourceful NGOs in the delivery of health, education, welfare, and infrastructure services.

I will discuss these three policies areas in turn.

Opening markets abroad and diversifying international relationships

First, opening markets abroad and diversifying international relationships. The Palestinian economy 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 over the long term. 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 West Bank and the Gaza Strip but also to Israel in the form of increased stability and security.

For an economy as small as the Palestinian economy, 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 – with merchandise exports falling more than 50 percent between 1992 and 1996.

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. This would require better infrastructure for trade (*i.e.*, port, airport, bridges, Gaza/West bank passage, new roads) and a freer trade regime. Existing agreements with Israel affect decisions about both these dimensions and may however limit what can be accomplished in the short term.

Efficient and compassionate governance

Second, the Palestinians have the chance to build an efficient and compassionate governance system. Since the Oslo Agreement, the Palestinian Authority has established 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. Although progress has been made, some worrying signs have emerged. And much more needs to be done.

Between 1993 and 1996, the number of civil servants more than tripled, from 22,000 to 75,000. Some of this growth is warranted by the responsibilities of the Palestinian Authority. Also, it is understandable that the Authority would try to shore up employment at a time of shrinking job opportunities in Israel. But given the extremely scarce resources it is important for the Palestinian Authority to set priorities in its spending, and especially in its recurrent expenditures. Currently, the budget process – including procedure for formulating spending priorities, monitoring budget execution, and managing cash and payments – is woefully inadequate. By and large, annual budgeting has thus far been viewed as a formality by the spending ministries and agencies. Unless it improves its budgeting process, the Palestinian Authority will not produce the public expenditure program that the West Bank and Gaza Strip so

desperately need.

An important part of this expenditure program is public investments in infrastructure. Over the last 4 years, infrastructure investment amounted to less than \$70 million per year, or less than 2 percent of GDP per year. This has fallen far short of initial expectations, and is less than half of the developing country average.

The resulting infrastructure gap is enormous. Virtually all of the major roads were constructed before 1967 and have received minimal or no maintenance. The supply of electricity per capita is significantly lower than that of other countries in the region and is often disrupted. There are only 3 fixed phones for every 100 persons, compared to 7 per 100 in Jordan and 9 per 100 in Lebanon. In all of these areas the West Bank and Gaza Strip are still highly dependent on Israel. Much more infrastructure investment is required to support a vibrant and export-oriented private sector.

Taking advantage of social capital

So far I have discussed ways the Palestinian Authority can act as a complement to markets by supporting trade and diversification and setting priorities for public spending, especially in infrastructure. Now I would like to discuss the third and final area of policy, how the Palestinians can take advantage of their social capital – the rich tradition of civil society and the many dynamic NGOs.

I will discuss three important areas.

First, establishing a sound legal framework. A first requisite to encourage private activity (for profit and not-for-profit) is a transparent and independent legal system that facilitates contracting. The present legal environment requires significant improvement if the West Bank and Gaza Strip 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.

Second, working with NGOs to deliver basic services. 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 Palestinian Authority 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 with 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.

And finally, encouraging the private delivery of infrastructure. Some of the investments required for infrastructure could be provided by the private sector. Global trends indicate that private actors can engage in broader fields of public interest if the proper regulatory system is in place. Wherever possible, the provision of public goods should be safeguarded by mechanisms that foster accountability and competition. And where market power exists, regulation will be essential. The report discusses the promising initial steps that have been taken in a few areas, including water, electricity, and telecommunications.

THE ROLE OF DONORS

I have so far outlined some of the strategic priorities for the Palestinian Authority. I would now like to turn to my fourth and final topic, the role of donors. Donors can make a big difference in stabilizing the economy, alleviating poverty, and laying the foundations for sustained growth.

In the past, donors have been drawn into a series of short-term financial crises caused by negative shocks (notably closures) and the expenditure and time required to set up the Palestinian Authority. Looking forward, it is essential that the balance shift toward investment, particularly long-term finance to support infrastructure reconstruction and sustainable delivery of social services. This will be challenging: Political uncertainty, border closures, and institutional weaknesses on the Palestinian side, all create obstacles to implementing long-term projects. And as the initial five-year pledge period draws to a close, donors need to review their role and hopefully, renew their funding commitments further into the future.

CONCLUDING REMARKS

In concluding my remarks this morning, I would like to say that the Palestinian economy faces great adversities. But, it also has great potential. In the 4 years since the Oslo Agreement, the adversity seems to have been getting the better of the potential. The most important obstacles to the development of the Palestinian economy are political: the extreme uncertainty and instability that have plagued the peace process. But economics can also make a difference. All of us – including international organizations, Israel, the Palestinian Authority, NGOs, and the people of the West Bank and Gaza Strip – must work together to build the preconditions for successful economic development. This development is an essential if the region is to achieve what has so far been so elusive: stability, security, and peace.

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