Palestinian Economic Viability

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INTRODUCTION

When the Oslo peace process was first launched, everyone stood ready, anxious to capitalize on the "peace dividends." The 1993 Declaration of Principles (DOP) and 1994 Paris Protocol fueled joint Palestinian and Israeli optimism for a prosperous economic future. Both saw in economic cooperation mutual benefit. The Paris Protocol seemed to support a prevailing notion that "mutual respect for each other's economic interests, reciprocity, equity and fairness" would result in economic "spill-over effects" that could also strengthen the peace process. Unfortunately, while both Parties substantially emphasized improving Palestinian economic conditions at the signing of the DOP, as a *key* to peace, only the Israeli economy reaped the large peace dividends.

The Palestinian economy has been a casualty of the peace process, as demonstrated by a consistent decline in performance, which preceded *Al-Aqsa intifada*. This was not because Palestinians do not have rich human and financial resources inside and outside the Palestinian territories; or because the Palestinian Authority failed to formulate macroeconomic policies, especially with regards to trade, and failed to create the regulatory framework necessary to improve investment; or, necessarily, because Israel had insisted that structural bilateral relations with the Palestinians remain largely unaltered, maintaining the *de facto* customs union in place, pending final status talks. Israel's antagonistic conduct held back the Palestinian economy.

Israel treated Palestinians as an adversary not a partner. It rejected cooperation and coordination on economic policies, contrary to the Paris Protocol's operative assumption. Israel actively utilized Palestinian economic dependency as leverage in the negotiations' political track, imposing frequent and long-term closures while citing security fears. It also continued to build West bank settlements at a rapid rate to diminish the Palestinian economy's prospects of growing and becoming self-reliant. These Israeli policies and practices hindered the Palestinian economy's ability to forge relations with other trading partners.

Moreover, since Al-Aqsa intifada erupted, Israel has continued to make the Palestinian economy pay a price it cannot afford. Israel's "permanent" closures suffocate the Palestinian economy, retarding the prospects of economic development as closures produce staggering poverty and unemployment rates. Palestinian gross national income per capita has fallen to nearly half of what it was two years ago. More than fifty-percent of the Palestinian workforce is unemployed. Physical damage resulting from the conflict by the end of 2002, has amounted to $930 million. September 2000 and December 2002, Palestinian exports and imports declined by a third of what they were. Investments contracted from an estimated $1.1 billion in late 2000 to $150 million in 2002. Overall, Palestinian national income losses during the intifida have exceeded $5.4 billion, the equivalent of one full year of national income prior to the violence. Still, amidst this grim economic outlook and Israel's counterproductive behavior, hope must persist. An alternative scenario not predicated on hope is disaster, i.e. total Palestinian economic collapse.[1]

Recent experience demonstrates that Palestinian economic growth and development cannot occur as long as Palestinians lack jurisdiction, border control, territorial integrity and contiguity, control over national resources, and unhindered access to outside markets. Put another way, *what is required now to achieve Palestinian economic development and growth is a viable Palestinian economy.* This paper offers a summary of Palestinian economic performance, past and present, to probe the requirements of viable Palestinian economy moving towards growth and sustainable development. Then, this paper identifies Palestinian economic growth imperatives and economic viability threats, followed by an itemization of future challenges, and concludes with possible short and medium-term steps to facilitate economic rebound.

[1] All statistics used in this paragraph are supplied by "Twenty-Seven Months – Intifada, Closures and Palestinian Economic Crisis, An Assessment," World Bank, May 2003.

I. *A 1967-2000 Synopsis of Palestinian Economic Realities and Performance*

Israeli policies and actions following Al-Aqsa intifada did not generate the current Palestinian economic crisis; thirty-some years of occupation and interim arrangements, which continue to breed Palestinian economic dependency, did. Efforts continue to make right what Israeli policies (1967-1993) have made certain: rapid and total economic dependency that precluded industrial development, restricted private sector growth, hampered land and water usage, transferred resources to Israel, and neglected the public sector. After the West Bank and Gaza Strip were occupied in 1967, Israel integrated the poor and small Palestinian economy. At the time, Israel's economy was approximately ten times the Palestinian economy's size. By 1972, the Israeli economy had completely absorbed the Palestinian economy. Because the two economies greatly differed in size and structure (one was a large, advanced and rich economy, and the other a small, underdeveloped and poor economy), the Israeli economy disproportionately affected the Palestinian economy and shaped its development. This generated two opposing forces impacting Palestinian economic development: "polarizing-effect" (favorable repercussions) and "backwash-effect" (negative repercussions).

Increased demand for Palestinian products, a diffusion of technology and knowledge, along with other benefits from being close to Israel's large market, led to subcontracting, joint ventures, and coordination in tourism and other matters. This resulted in positive economic growth. Income and economic activity increased because of new employment and trade opportunities. A reduction in low productive agricultural employment, including cycle unemployment, and more intensive marketization, particularly in rural areas, further provided for fast growth rates.[2] Cumulatively, this expansion in economic activity increased income, saving and investment, especially investment in residential construction.

On the other hand, the Israeli economy's efficient, large-scale industries out-competed the inefficient small-scale Palestinian industries. As a result, many small-scale industries disappeared, while others were confined to producing low-skilled goods. Further, the Israeli economy attracted Palestinian labor and capital. A sizable segment of the labor force that did not seek jobs in Israel immigrated to neighboring countries and beyond. Still, had it been only for these two opposing forces at work, the Palestinian market would have continued to grow. Increased Palestinian economic activities would have gradually corrected the distorted labor market, decreasing the number of Palestinians seeking daily work in Israel. In turn, this would have generated a process whereby Palestinian income was created endogenously in internal productive sectors, instead of exogenously.

However, Israel did not leave Palestinian economic growth to the market's polarization and spread-effects forces. Israeli policies and practices subordinated the Palestinian economy. Israel restricted Palestinians from using natural resources, engaging in productive economic activity, and creating a Palestinian public sector. Fearing that Palestinians would compete with Israeli manufacturers, Israel did not invest or industrialize in West Bank and Gaza Strip. It also restricted what Palestinians could do. Israel made the free movement of Palestinian workers into Israel, coupled with free export of Israeli goods to the West Bank and Gaza Strip, the most important features of Israeli-Palestinian economic relations. As for Palestinian goods into Israel, those experienced significant trade barriers, especially agricultural goods. Not only was the

[2] In the 1970s, the WBGS were among the top ten fastest growing economies in the world when GNP growth was measured. The GDP expansion was also large by international standards. However, this growth was a productive of another important factor: skilled Palestinians were increasingly finding employment in the Gulf. Boosted remittances from Palestinian workers and transfers from oil-rich countries acted to counter-balance weaker economic opportunities in Israel in the late-seventies and early-eighties. Therefore, although Israel's growth slowed following the 1979 oil shock, and the process of labor substitution away from low productivity toward employment in Israel decreased, the Palestinian economy's rapid growth continued, albeit at a lesser rate.

Palestinian economy denied developing an economic infrastructure to become self-reliant, but also it was diverted from other Arab and foreign markets to rely solely on Israeli goods.

As a result, the Palestinian economy only initially benefited from integration. After the collapse of the regional oil boom, and while employment in Israel remained flat, declining employment opportunities and decreasing Gulf work remittances replaced economic growth, causing economic stagnation from the early-1980s until 1987. An economic decline shortly followed after the first Palestinian intifida erupted. This negative performance was compounded by the first Gulf war as many Palestinians their lost jobs in Kuwait, Saudi Arabia, and other Gulf countries. Until 1993, the intifada's related strikes and economic activity repression, along with the effects of the first Gulf War, continued this output decline. Further political and economic uncertainty plagued the West Bank and Gaza Strip. A recovery in 1992, prompted by drawdowns of savings and expectations of peace, was followed by a renewed decline in 1993.

Although the peace process created new political and economic forces that impacted the Palestinian economy fundamentally, the occupation's negative affects were left structurally untreated. So was the policy framework that created weak domestic productive activities. The asymmetrical market relations with Israel and other countries (codified in the Paris Protocol) that caused a bias towards labor export (and raised domestic wages); the regulatory restrictions that held back the expansion of the private productive sector; the fiscal compression and institutional under-development that led to under-provision of public goods; and the restricted access to natural resources continued, frustrating positive Palestinian economic performance.

Therefore, the Palestinian economy did not perform well during the peace process. Real GNP per capita income dropped by more than 17% between 1994-1996. Unemployment soared in 1996 to over 28%. In 1996-1997, GDP showed negative growth. In 1998, out of the Palestinian population 37% of Gaza Strip population and 15.4% of the West Bank were living under poverty, earning less than $2.1 a day. Although in 1999 to early 2000, the Palestinian economy registered a 6.1% positive growth, this pleasing anomaly was whipped-out because of Israeli closures and restrictions on travel, following the start of Al-Aqsa intifada. Palestinian growth patterns (1967-2000) strongly suggest that but for Israel's policies and actions, the Palestinian economy could have transformed its growth potential into reality. Unfortunately, Israel's actions have been and still remain the insurmountable obstacle.

II. Growth and Development Imperatives: Palestinian Economic Viability

The Oslo Accords reflected Israel's conviction that Palestinian economic growth and prosperity can be achieved without defining border and territorial sovereignty. Ten years of experience tells that this is not true. Settlements, closures, and Separation Walls tell us this is not true. Palestinian growth and development require geographical contiguity, territorial sovereignty over land and resources, defined borders, and uninterrupted access between the West Bank and Gaza Strip, and between the West Bank and Gaza Strip and the outside world. These cannot remain under Israel's control. Therefore, Palestinians need a viable economy.

"Viability" essentially entails, from an economic viewpoint, the concrete possibility of continued production. An economy is viable when human, financial, and physical resources are available and can be used to self-sustain, grow, and increase the welfare of inhabitants living within its area. Achieving these goals or making progress on them constitutes economic development. Successful economic development requires an economy to have the ability to decide on trading partners and have control over natural resources and the movement of labor and goods. All of which are important means to achieve sustained Palestinian growth and development.

Despite that Palestinians and Israelis generally agree that the West Bank and the Gaza Strip will comprise future Palestine's territory, this only clarifies geographical scope in general terms. Stating that the Palestinian economy includes the West Bank and Gaza does not elucidate geographical contours and borders. Such clear territorial sovereignty is important to defining a state's jurisdiction and scope of intervention, which, in turn, permits actors, whether individuals, firms, or governments, to evaluate the countable resources and where they can invest and with whom they can trade.

Although many discount borders in an increasingly globalized world, where freedom of trade and flows of finances and information continue to erode clear territorial jurisdiction, established borders remain attributes of a viable economy that must exist before an economy can partake in globalization. This becomes clear in the Palestinian context when one attempts to speak of a Palestinian economy with more than 140 settlements dividing the West Bank and Gaza strip and encircling its cities, thereby preventing any territorial or economic integration within and between these two territories. Difficulty in speaking about economic growth is further manifested because Jerusalem, a vital physical and economic link between the West Bank's north and south, is not part of the Palestinian economy. In addition, not much can be done about furthering trade, an important vehicle of Palestinian growth, before defining clearly borders with Israel, Jordan, and Egypt. Finally, regional integration cannot become the motor of growth it is capable of while Palestinian territorial sovereignty remains unclear. Palestinians need territorial control. The lack of territorial control represents the proximate cause of Palestinians' economic crisis today. Recent experience and this conclusion lead to identifying four Palestinian economic growth imperatives.

First, the Palestinian economy must disengage and reorient. It must move away from Israel's economy to avoid an adverse path dependency and have the ability to institute a development strategy that is not vulnerable to Israeli closures. At present, the Palestinian economy is challenged structurally and in terms of long-term pressures. Its steep vulnerability to the immediate shocks of war and drastic falls in income, stemming from its prolonged dependence on the Israeli economy and the lack of clear alternatives for economic partners in times of strife, cannot continue.

Second, the Palestinian economy requires physical contiguity between the West Bank and the Gaza Strip (uninterrupted movement of goods and people). On the ground, this requires a passage from the West Bank to Gaza under full Palestinian sovereignty. Initially, this would entail access to the Gaza Port[3] and Airport[4] from the West Bank, as well, as access to Jordan and Egypt border crossings. A Palestinian economy must have complete access to external border points with Jordan and Egypt without third party interference.

Third, the Palestinian economy must become economically stable. This requires having built-in mechanisms that ensure employment alternatives and job creation in the domestic labor market and various external markets. The Palestinian economy must keep unemployment at a minimum. In addition, individual earnings must reflect the cost of living. Per capita GNP must meet an individual's basic needs and/or the family unit in the economy. Otherwise, declining living standards, poverty, and dissatisfaction will fuel continued political instability.

Finally, the Palestinian economy requires economic infrastructure, i.e. legal and institutional infrastructure, as well as, trade and economic services. The physical infrastructure covers road and highway networks, the Gaza Sea Port, cargo facilities in the Gaza airport, Rafah and Al-Karamah crossing points into Egypt and Jordan, an airport in the West Bank, as well as, basic

[3] Although work was started on the Gaza Port, the Israeli government has prevented completion of the port work, and has recently destroyed all of the infrastructure that had been put in place to construct the port.
[4] After the start of the Intifada, the Israeli army fully destroyed the runways at the Gaza Airport and rendered it unusable.

utilities (Water, Electricity, Solid and Liquid waste management and telecommunications). Such infrastructure should be under Palestine's full control, and, therefore, free from external interference.

III. Palestinian Economic Viability Threats: Israeli Antagonistic Conduct

Israeli measures to crush Al-Aqsa intifada and impose a political solution on the Palestinian People have, in devastating the Palestinian economy, proven the vulnerability of a development strategy that relies so heavily on Israel. Closures, territorial fragmentation, settlements, and the Separation Wall threaten Palestinian economic viability.

Israeli “closures" refer to restrictions for “security purposes” on the free movement of Palestinian goods and labor across borders, as well as, within the West Bank and Gaza Strip. Because of closures, the internal movement of goods in the West Bank has been seriously interrupted. Significant difficulties and delays have increased transaction costs and other related costs. This, in turn, increases the prices of goods for Palestinians (at a time when income is much less, and many Palestinians are unemployed), thereby increasing the cost of Palestinian products and making them less competitive vis-à-vis Israeli and other products. The same occurs with the movement of goods to and from West Bank and Gaza Strip and Israel, as well as, the West Bank and Gaza Strip and the world.

Fragmented territorial jurisdiction denies the Palestinian Authority the ability to steer Palestinian economic development in growth direction. As a result, the Palestinian Authority could not carry out urban or market development plans for the whole West Bank and Gaza Strip. Pursuant to the Oslo Accords, Israel has given the Palestinian Authority limited territorial control divided into Zones A, B, and C. These Zones are not all connected. Moreover, Israel remains in full control of Zone C, which constitutes 70% of the territories while the Palestinian Authority has control of 17.2% of the West Bank and 85% of the Gaza Strip, before the events of 2000. In practical terms, these meant the Palestinian Authority could only register land in areas A and B and decide on the nature of investment only in those areas. It also made it impossible to create efficient economic projects. For example, the Palestinian Authority could not build roads joining various villages, nor could it ensure market access to goods in all areas. More importantly, the lack of a secure and safe passage between the West Bank and the Gaza Strip led to duplication in production and acute waste in resources. This has pushed firms to shift production to low value products that respond to market needs rather than producing high value products oriented to international markets.

Israel’s settlement policy further exacerbates the problem of territorial integrity. Settlement construction grew by over 10% since 1995, thereby outpacing construction in Israel. Such settlement growth, particularly in the north and south of the West Bank and Gaza Strip, prevents links between various Palestinian areas and deprives the Palestinian economy of both water and land, while simultaneously increasing Palestinian economic dependence on Israel. It also hinders long-term investments because of the political uncertainty surrounding how the settlement issue will be resolved. Further, settlements encourage developing inefficient and segmented consumption and production. Finally, coupled with the closure policy, the settlement policy contributes to territorial separation between the West Bank and Gaza Strip to the extent that one may be compelled to conclude that a Palestinian state is only permissible in the Gaza Strip, while the West Bank has been further made reliant on Israeli’s economy.

The Separation Wall that Israel is currently building has the same affect on the viability of the Palestinian economy as settlements and closures, if not more. One of the most significant steps associated with separation was the replacement of Palestinian labor working in Israel with foreign labor.[5] In addition to the labor crisis, the Palestinian Environmental NGO's Network (PENGON) reports that the barrier has caused tremendous problems involving: irrigation of farmland, crops, imports and exports (goods and services), schooling, healthcare, and severe environmental damage. Even now, PENGON has documented that the Separation Wall takes various forms consisting of electric fences (accompanied by trenches, roads, cameras, trace paths for footprints, and buffer zones) to concrete walls standing eight meters high with watchtowers placed intermittently. All the above bolsters the Palestinian choice to disengage and re-orient from Israel.

IV. Challenges for the Future

Creating a viable Palestinian economy capable of interacting at the regional and global levels requires disengagement. As such, certain steps to disengage from the extreme dependence on the Israeli economy must be taken. The need for greater market diversification had been a Palestinian priority throughout the interim period, and trends towards integration with the Israeli economy had already been reversed prior to the recent events. Indeed, studies have repeatedly emphasized the need for strengthening the bases of autonomous Palestinian economic decision-making and domestic economic restructuring as prerequisites for mutually beneficial regional and multilateral cooperation. However, such a policy direction has become more urgent because of the impending collapse of the Palestinian economy.

As the Palestinian economy seeks to disengage, the following challenges present themselves:

- Minimizing Palestinian merchandise trade dependency on the Israeli market and Israeli re-exporters and importers;
- Investing in infrastructure projects to fulfill such needs and create employment, keeping in mind that the majority of Palestinians working in Israel were in the field of construction;
- Expanding agricultural development and market access possibilities;
- Creating workers' training programs to increase skill level and competitiveness;
- Creating a well-developed multi-modal transport system, which is necessary for a viable Palestinian trade system, by focusing on: (1) Cargo facilities on the land border points with Jordan, Egypt and Israel (Rafah, Al-Karamah, and crossing points with Israel); (2) Airport and Seaport facilities (cargo and cooling facilities) and interim cargo handling arrangements through neighboring Jordanian and Egyptian ports; (3) and upgrading major trade access routes and trunk roads;
- Establishing warehouses at Palestinian ports;
- Creating Palestinian owned public utilities (i.e. water, electricity, telecommunications, and energy) to reduce the risk of being cut off by Israel; and
- Exploring other regional markets (Arab markets and otherwise), as well as, international markets.

Pursuing the disengagement policy creates further challenges. Simultaneously, the Palestinian economy must labor to create alternative strategic markets by integrating into the international trading system. Such Palestinian economy reconstruction entails:

[5] The Palestinian labor force working in Israel, which accounted for a quarter of total Palestinian work force, specialized in low-productivity construction and agriculture sector jobs. See, Basim Makhool, "Economic growth and employment in the West Bank and Gaza Strip", Arab Economic Journal, 27:11, Spring 2002.

- Restructuring the Palestinian industry to meet the requirements of alternative export markets, with particular emphasis on industrial and technological upgrade for exports to European and North American markets (since exports to regional markets and Africa can be accomplished at existing levels of industrial production and standards);
- Creating a Palestinian foreign trade regime that takes into account WTO compatibility, as well as, principles of open, transparent, modern, and liberal trade regimes;
- Halting the decline in output and income, along with restoring confidence;
- Improving education to build a human resource base with solid technological skills;
- Improving technology-based production;
- Creating procedures to implement preferential and free trade agreements with regional and international partners; and
- Pursuing Palestinian participation in the Multilateral Trading System of the WTO.

V. Short and Medium-term Solutions

Recognizing that Israel's territorial control has thus far hindered Palestinian economic growth, certain steps can be taken now to assist in an economic rebound. In this regard, both the Palestinian Authority and the International Donor Community (Donors) play a large role. Short-term solutions mainly rest on the Donors shoulders. Donors must use political and economic pressure to influence Israel to:

- End the curfew policy;
- Cease building settlements;
- Stop building the Separation Wall; and
- Enact full economic sanctions against products originating from illegal Israeli settlements in the West Bank and the Gaza Strip.

In medium to long-term action, the Donors have a major role as guarantors of a viable Palestinian economy. The challenges enumerated above should guide the Donors actions. Assisting in creating trade and infrastructure projects to be able to meet the challenges of an emerging Palestinian state, as well as, the challenges of re-structuring and re-orientation. For this purpose, three areas of specific importance are:

- Physical infrastructure – road networks, sewage and water systems, the Gaza Airport and sea port, as well as, cargo facilities at both;
- Institution building – the Palestinian economic regime described requires the building of strong, efficient, and effective public Palestinian institutions, which can execute a national Palestinian trade policy. Emphasis should be placed on the Customs Administration and the institutions that deal with the regulatory and operational aspects of trade. Finally, another institution that needs strong support is the Palestinian standards institute, which comprises another arm of the implementing bodies of the National trade policy;

- Trade regime and other constraints under the Paris Protocol – the Palestinian trade regime, as articulated in the Paris Protocol, provides an inadequate basis for efficient Palestinian economic growth because it mainly reflects the commercial interests of the much larger and stronger Israeli economy. For example, the customs envelope provides that Israel decides external tariff rates, excise tax rates, quality and safety measures. This rendered Palestinian trade policies effectively identical to those of Israel, making it impossible for the PNA to revise the level of taxes upward or downward in most cases. The Palestinian economy needs more freedom than what the Paris Protocol provides.

VI. Conclusion

The difficulty of creating sustainable Palestinian economic development is underestimated. People often fail to recognize the scope of the problem. Israel's economic policy as an occupier, to fully integrate both economies while denying Palestinians the economic infrastructure needed for self-reliance, created a problem interim agreements have been unable to cure. The crux of the matter is a viable Palestinian economy. Palestinians must have control over borders and territory, and have jurisdiction to formulate and implement macroeconomic policies. Even if a political process is in progress, foreign investors are reluctant to invest when the political situation is so uncertain. Settlement expansion, Separation Wall, and internal and external closures restrict investors from acting on business opportunities. Moreover, Israel's occupation has long denied Palestinians of seaports and airports, with closures further denying the use of theirs, thereby eliminating all convenient venues for exporting products. Because of closures, high transaction costs make Palestinian products uncompetitive regionally and globally. Because of the lack of borders, substantial limits exist on what the Palestinian Authority can offer countries with regard to Palestinian markets access. The Palestinian economy simply cannot develop under these conditions.

At present, Palestine has absolutely no control over its economic future. Palestine's eventual emergence into statehood may turn out to resemble other states that gained independence during the de-colonization era. With no economy, Palestinians will remain dependent on Israel. Miserable standards of living and lack of economic opportunity will continue to fuel radicalism, making Israel tense. Security concerns may overcome notions of peace and lead to violence spiraling out of control. We have seen it many times. Can we afford this risk? Without a viable Palestinian economy the two-state solution will always be in jeopardy.