THE STRUCTURAL CHALLENGES OF PALESTINIAN ECONOMIC DEVELOPMENT

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The second Palestinian *intifada* has sealed the fate of Oslo. Moreover, Israel's economic relations with the West Bank and Gaza continue to deteriorate, as peace negotiations remain suspended. As a result, 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 work force is unemployed. Physical damage resulting from the conflict, up until August 2002, has amounted to $728 million. Between June 2000 and June 2002, Palestinian exports declined by almost a half, and imports by a third. Investment contracted from an estimated $1.1 billion in late 2000 to $19 million to date. Overall, Palestinian national income losses during the *intifada* have exceeded $5.4 billion, the equivalent of one full year of national income prior to the violence. Although the proximate cause of the current Palestinian economic crisis is Israeli closures because of security concerns prompted by the violence, this wave of violence will too subside.[1] However, sustainable Palestinian economic growth will requires more than an end to violence. It requires a three-tiered approach that addresses the structural challenges of Palestinian governance, bilateral relations with Israel, and multilateral relations with the Donor Community and other entities.

The private sector is the engine of the Palestinian economy. As such, sustainable Palestinian economic growth necessitates strengthening the environment in which the private sector operates. Recently, under tremendous international pressure, and as a condition for statehood, the Palestinian Authority (PA) has adopted a serious and comprehensive reform program that aims at weeding out corruption by enforcing full fiscal accountability, creating a predictable and transparent legal environment, and building a modern, merit-based civil service. Carrying out these reforms will pave the way for sustainable economic growth in the West Bank and Gaza; however, change in Palestinian structural governance alone will not suffice. The Palestinian economy cannot develop without political stability complemented by Israeli cooperation, Donor assistance, and market opportunity. This essay first addresses the structural challenges of Palestinian governance, followed by those facing economic relations with Israel, and concludes with a discussion of structural challenges in Palestinian multilateral relations.

1. Structural Challenges of Palestinian Governance

Palestinians need to address the structural challenge of how its government relates to the economy and to society. At the start of Oslo, and significantly into the peace process, Palestinian public demand for democracy and accountability was weak because Palestinians understood the PA to be transitional in nature. Also, although the Israeli army had pulled out of densely populated areas, they remained, albeit less visibly, in the West Bank and Gaza, as did settlements. These factors, at the time, forced national Palestinian responsibility to mean unconditional support of the Palestinian leadership and its infant, the PA, so as to not weaken the domestic front.

[1] Both sides have already exhibited signs of fatigue as demonstrated by an increasing Palestinian constituency calling to a halt the violence, and Sharon's statement on how Israel cannot continue to live fearing suicide-bombers and Kassam rockets.

As a result of perceived general public Palestinian apathy, the PLO/PA leadership did not feel pressured to reform its ways. Many high level PLO leaders also served as members of the Palestinian Legislative Counsel (PLC) or the PA cabinet, between which Jurisdictional issues remained unclear. The legacy of informal decision-making carried into the PA bureaucracy, significantly contributing to Arafat and about thirty of his loyalists (who were not accountable to either the PA or PLO legislative bodies) having, in affect, all the real power. Moreover, the PLO/PA did not declare a clear public mandate, and it rarely communicated to the Palestinian public about actions taken or future conducts. Palestinians were left in the dark; still they remained passive, being hopeful for peace and a better living. Now the mood and expectations of Palestinians and the international community have changed.

Palestinians and the international community no longer tolerate the PA's trade monopolies, heavy intervention in the economy, and lack of commercial laws, all of which contributes to the ramped corruption. Internally, a general consensus has developed among Palestinian civil society, the PA, and the PLC, in support of reform. A recent poll found that eighty-four percent of Palestinians believe that the Palestinian Authority is corrupt, while only eight percent believe it is not corrupt. The poll also found that twenty-eight percent of Palestinians trusted Fatah the most, while another twenty-eight percent said they trusted Islamic factions the most (including Hamas and Islamic Jihad). Only four percent said they trusted other factions, such as the PFLP or the PLO. More importantly, however, the poll found that thirty-percent said that they did not trust any figure. Economic development cannot exist in an environment that lacks so much confidence in the government.

Externally, the international community has long recognized the PA's bad governance, but only recently has it become so intolerant as to demand reform. The International Task Force on Palestinian Reform (the so-called "Quartet plus four" consisting of the EU, Russian, US, and the UN, plus Japan, Norway, the IMF, and the WB) created a local task force to monitor implementation of set benchmarks by which progress is to be measured. Areas of reform include: (1) financial accountability; (2) ministerial and civil reform; (3) market economics; (4) judiciary/rule of law; (5) local government; (6) civil society; and (7) democratic elections. Without sustained and consistent progress in reform, Donors will restrict assistance and provisional Palestinian statehood will remain stalled. This has prompted gradual structural progress in the area of Palestinian governance, for example, PA's new transparency of accounts and responsible financial management.[2] Another example is the decreased power of Yasser Arafat, which was recently divided up between the Prime Minister, Mahmoud Abbas, and a newly sworn in Palestinian Cabinet. Progress, however, in other areas like the legal and judicial reform domain, is still unsatisfactory.

Existing laws are ambiguous, complex, and unpredictable for continued business in the territories. To cultivate an environment conducive to private investment, the PA must create an appropriate legal framework for commercial activity and an effective, independent judicial system to implement and uphold laws and regulations, contracts, and

[2] The new Palestinian Financial Minister controls the $1 billion in donor assistance.

property rights. These measures are necessary to attract investors because they significantly reduce uncertainty and related costs of doing business. Creating a firm foundation of "economic legality" by providing laws, rules, and regulations that are not only consistent with global norms, but that are also widely disseminated and available to the public, provides a reliable environment by reducing risk, encouraging businesses entities to act on economic opportunity.[3]

Having acknowledged the need to combat corruption and to transform itself into a democratic, modern and accountable instrument of statehood, the PA must continue to deliver results. Because Palestinian economic development mandates a strong and active private sector, it is absolutely imperative that the PA completes the preparation of the legal framework for the private sector to flourish. However, these objectives and developments only address the issue of governance. Palestinian economic development will remain an unfulfilled hope unless structural relations with Israel permit Palestinian economic development.

2. Challenges of Structural Relations between Israel and Palestinians

The structural challenge that must be addressed between Israel and Palestinians consists of two parts: (1) rejecting the Paris Protocol of 1994, which formalizes the *de facto* customs union with Israel that existed since 1967[4], and (2) creating a sustainable political process that recognizes Palestinian economic development (not "security") as *the* key to peace. For Palestinians, the Paris Protocol was a trade-off. Palestinians accepted high tariffs on imported products, passing the costs on to Palestinian consumers, in order to gain free movement of goods into Israel, an inward flow of capital, and access into Israel's labor market. As a result of recent violence that erupted between the Parties, however, the free movement of goods and human capital has been pitted against Israel's security concerns, even though it is well understood that Palestinian economic development depends on borders remaining open and a sustainable peace process depends on the economic development of the West Bank and Gaza.

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[3] Commercial legislation that has already been passed includes the *Agency Law, Investment Encouragement Law, Industrial Zones Law, Domestic Arbitration Law, Condominium Law,* and *Labor Law*. Additional draft laws that are necessary but await parliamentary consideration and presidential endorsement include the *Income Tax Law, Competition Law, Company Law, Intellectual Property Law, Securities Law (Capital Markets Authority Law), Insurance Law, Secured Lending and Leasing Law, International Commercial Arbitration Law, Rental Law, Pension Law, Banking Law, Provident Funding Law, Mutual Funds Law, and Accounting and Auditing Law.*

[4] In 1967, Israel adopted a protectionist / de-development policy of the West Bank and Gaza. Because Israel feared competition to Israeli manufacturers, it did not investment in the Palestinian Territories or attempt to industrialize it. Instead, Israel took advantage of high Palestinian unemployment after the war, which coincided with the Israel's economic boom that resulted in urgent need for working hands, especially in the agriculture and construction sectors, which made the movement of Palestinian workers into Israel the most important feature of Israel-Palestinian economic relations. By the end of 1972, Israel had achieved its objective of full economic integration: Palestinian labor moved freely into Israel and Israeli goods were exported freely to the Palestinian Territories; in addition, Palestinian goods were sold in Israel, although Israel imposed significant trade barriers, for example on Palestinian agricultural goods. As a result, the Palestinian Territories today lack an economic infrastructure to become self-reliant.

The *intifada* demonstrates the vulnerability of a development strategy which relies so heavily on labor exports to Israel. Current closures, stringent inspection routines, and Israel's use of non-tariff barriers leave no hope for economic development because they inhibit exporting and deter foreign investment. They make Palestinians unable to export competitively priced goods to the rest of the world. Israel should therefore cooperate with the Palestinians to reach an alternative economic relationship that is less vulnerable to violence.

A recent World Bank analysis shows that a proactive policy of export development, in which a more open and less discriminatory trade regime is adopted, would result in higher income by 2010 than a return to previous levels of employment in Israel. Although the report found that gains from trade would take time to materialize, and restoring access to Israeli labor market would certainly be the quickest way to boost incomes for a large number of ordinary Palestinians, this is not favorable for sustainable Palestinian economic growth. A return to pre-September 2000 employment levels for Palestinians in Israel seems unlikely (because of how much both peoples have been radicalized and because Israel is currently building a wall to separate from the West Bank and Gaza). Moreover, returning to the Paris Protocol not only risks perpetuating a high level of Palestinian economic dependence on Israel, but also hinders the emergence of a more diversified development strategy. However, as already mentioned, such a policy shift requires Israel's active cooperation to succeed, and is thus part and parcel of a political *rapprochement.*

As an economic giant, Israel has long shaped economic relations with Palestinians, using its large bargaining power. Israel must change its antagonistic approach to Palestinians for the West Bank and Gaza are to develop economically, thus providing an opportunity for peace. Benjamin Franklin once said that whenever you are faced with a choice between liberty and security, to choose liberty. Otherwise, you will end up with neither. Israel should head Mr. Franklin's advice and recognize that only peace with the Palestinians will provide it liberty.

3. Challenges of Multilateral Structural Relationships – Regional/Global

Finally, market opportunities and financial assistance are needed for Palestinian economic development. Several reasons exist for the degree of help that the Palestinian economy requires. All of these stem from Israel's economic policy as an occupier, to fully integrate both economies while denying Palestinians the economic infrastructure needed for self-reliance. Even if there were a political process in progress, foreign investors (an important source of capital that could substitute for Israeli capital) are reluctant to invest when the political situation is so uncertain. 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. The result of high transaction costs is that Palestinian products cannot compete regionally or globally. In addition, because Palestinians do not control any borders, substantial limits exist on what the PA can offer countries with regard to access to

Palestinian markets. The Palestinian economy simply cannot develop under these conditions.

To counter this problem, *extremely* preferential treatment of Palestinian products is required. The word "extremely" emphasizes that although it is necessary for a Palestine to join the WTO, more needs to be done. The Donor Community must continue its flow of capital to the PA.[5] Although such assistance has limited power to influence economic development under the circumstances of the conflict, it cushions the impact of the crisis and protects the economy from total collapse. The Donor Community must also help create market opportunities. For example, individual states can eliminate tariffs and restrictions on Palestinian products, in a manner similar to what the US did when it "slipped" the PA under the Free Trade Agreement with Israel. Although the likelihood of this occurring is uncertain, it seems necessary for success.

The difficulty of creating sustainable Palestinian economic development is underestimated. People often fail to recognize the scope of the problem. All three discussed structural challenges are interconnected, and thus, to have sustainable Palestinian economic growth, we need activity on all levels. Palestine has absolutely no control over its economic future. Eventually, it will obtain political independence but have no economy. In this sense, Palestine's emergence into statehood resembles other states that gained independence during the decolonization period. With no economy, Palestinians will remain dependent on Israel. However, a return to the Paris Protocol is asking for Palestinian economic failure twice. Miserable standards of living and lack of economic opportunity will continue to fuel radicalism, which, in turn, will make Israel tense; security concerns may overcome notions of peace and lead to violence spiraling out of control, as was experienced during the Oslo peace process. Can we afford this risk? Without Palestinian economic development the two-state solution will always be in jeopardy.

[5] Donor disbursements doubled after the second *intifada* broke out. In 2002, those disbursements amounted to $1,052 million.