



Palestine Economic Policy Research Institute

Enhancing The Capacity of the Palestinian Economy

Towards a Palestinian Developmental Vision

Fadle Mustafa Al-Naqib

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- ♦ Identifying developmental challenges and priorities and enhancing applied research.
- ♦ Providing technical support to PNA bodies (executive and legislative), the private sector, and NGOs to enable them to function more effectively and enhance good governance.
- ♦ Promoting the participation of civil society institutions in socio-economic policy formulation and decision-making.
- ♦ Broadening public debate on socio-economic issues and ensuring oversight of public performance.
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Summary

This study proposes to outline a general framework for Palestinian development based on the reality of the existing Palestinian economic situation and taking into account the Al Aqsa Intifada. The framework will provide the theoretical tool required to establish the foundations for sustained independent Palestinian development.

This study is divided into three parts. The first section focuses on the conditions that have accompanied the establishment of Palestinian self-rule and the assumption by the PNA of powers and responsibilities in various parts of the West Bank and Gaza Strip. The second section focuses on the fundamentals of the developmental process and the role played by the state in this process, as exemplified by the experience of successful countries. The third section focuses on the Palestinian developmental process, its background and its various stages.

A summary of these three dimensions is presented below:

Part I: The PNA, the Peace Process, and Developmental Vision

All the facts indicate that the efforts made to rebuild and revitalize the Palestinian economy during the interim period (1994-2000) were achieved at a high cost and failed to meet the aspirations of the Palestinian people. Important reasons for this failure include the absence of a Palestinian political and developmental vision taking into account the nature and limitations of the interim period, the lack of clear and specific objectives for the restructuring of the Palestinian economy or a program designed to rectify the distortions perpetrated under occupation, and the absence of instrumental procedures operating within specific schedules to realize stated objectives in a gradual and cumulative manner.

Repeatedly, these shortcomings are attributed to the fact that the PNA has no control over Palestinian natural resources (land, water, and borders) and has no power to implement all its economic policies. Strictly speaking, this is not true. A comprehensive program of development needs three components:

1. Objectives
2. Available resources
3. Strategies, policies, and detailed plans for the realization of these objectives.

The PNA can legitimately claim that the fact that it has neither complete control over its natural resources, nor the power to adopt the necessary policies required for unimpeded action, limits its capabilities and obstructs its freedom of action. It can also claim that, as a result of these undeniable facts, it has had to lower the ceiling of its objectives and expectations that were greatly inflated to promote the peace process. However, this does not prevent the adoption of a developmental economic program capable of rectifying the distortions resulting from occupation and restructuring the economy.

The true factors are both subjective and objective. The subjective factors may be divided into two types: unintentional factors pertaining to the absence of a culture of long term strategic planning amongst the Palestinian leadership, and intentional factors in which the Palestinian leadership does not seem to be really interested in committing itself to a comprehensive program with specific, measurable objectives since this is perceived as limiting its freedom of action.

Objective factors relate to the nature of the interim period and its limitations as well as the contradictions inherent in the signed agreements that determine the relationship between the PNA and Israel.

On the one hand, the PNA was committed to agreements it had signed with Israel based on the assumption of cooperation and coordination. It was as a result of these that the PNA was able to win the support of the international community and receive aid from donor countries. On the other hand, the PNA was committed to supporting the Palestinian people and their national aspirations. This made it necessary to oppose Israeli practices that conflicted not only with the spirit but also with the letter of the signed agreements and which represented a continuation of the policies of occupation and colonization. The PNA could not, therefore, produce a developmental program based on cooperation with Israel in the economic sphere while ignoring other Israeli practices against Palestinian interests (confiscation of land, intensification of colonization activities, border closures, and siege, etc.). Nor was the PNA able to produce a developmental program based on resistance and struggle against the Israeli occupation for, had it done so, it would have lost international support and financial aid.

Two types of practice characterize this conflict in Israeli-Palestinian relations. The first aims to reduce economic dependency on Israel and includes encouraging direct imports from different countries to reduce the

volume of imported goods through Israeli middlemen, and the signing of commercial agreements with Arab and other countries in an effort to diversify trade relations. The second practice aims to promote economic relations with Israel through the establishment of common border industrial areas and the creation of monopolies linked to the Israeli market (oil, cement, etc.).

The Al Aqsa Intifada

Two realities have emerged from the Al Aqsa Intifada:

- ✧ The reality that relations with Israel will remain turbulent for some time. The Palestinians will struggle for liberation and self-determination until Israel recognizes the Palestinian state and its legitimate rights over all the Palestinian Territories occupied since 1967 and the right of refugees to return. As long as Israel continues to adhere to its Zionist ideology of expansion, colonization, and negation of the legitimate rights of the Palestinian people, the relationship with Israel will be one of conflict, strife, and violence.
- ✧ Thus, it would be inappropriate to continue with the research methods that have been used to date. These methods have operated on the assumption that there are various possible political scenarios and each has its economic scenario. In reality there is only **One Scenario** that already exists on the ground: the very concrete fact of the continuation of the struggle that dominates Israeli-Palestinian relations. It follows that what is required are economic policies that enable the Palestinian people to continue the struggle against occupation, lowering the costs of resistance while making the occupation costly for Israel. More specifically, such economic policies would prevent the Israeli practice of creating 'facts' intended to reinforce the occupation and would force Israel to honor its commitments and submit to the resolutions made by the international community. Only then will Israel return to the negotiating table and recognize the economic and political necessity of ending the occupation of the Palestinian Territories. This, and only this, would provide the necessary base for a political settlement that brings permanent peace.

The adoption of such policies requires a clear developmental vision based on the existing difficult conditions under which the Palestinian people are living. This vision would endeavor to allow the Palestinian people to develop their own economy and would define the objectives of a

Palestinian national project: the achievement of independence, the repair of distortions in institutional structures inherited from the occupation, and the establishment of the foundations for sustained economic growth. This vision would profit from the successful experience of other countries in economic development.

Part II: The Fundamentals of Economic Development and its Application in the Palestinian Case

II.i Colonial inheritance and the concept of path dependence

Many empirical studies have demonstrated that the distortions caused by colonialism continue in the colonized country after independence. In fact, these distortions have the tendency to linger indefinitely unless a political and administrative decision is taken to systematically demolish the economic structures and institutions built by and organically connected with all the colonial interests.

Applying this to the Palestinian situation, we see clearly the distortions that have been caused by the Israeli occupation. The most important of these are:

1. Geographical Distortions
 - ✧ The radical reduction of Palestinian control in the West Bank (including Jerusalem) and the Gaza Strip. These distortions include the illegal confiscation of land and the illegitimate expropriation of both water and mineral resources.
 - ✧ The building of colonies all over the Palestinian Territories and populating these colonies with large numbers of Jewish settlers.
 - ✧ Constructing by-pass roads to connect these colonies with the Israeli state inside the Green Line, thus carving the Palestinian Territories into bits and geographically isolating Palestinian communities.
2. Structural Distortions
 - ✧ The occupation has separated the growth of income from the growth of domestic production and rendered the former increasingly dependent on the Israeli economy. This is the income generated from almost one third of the Palestinian labor force working in Israel.
 - ✧ Distortions in prices and wages, severing the link between these and the market forces of supply and demand in the local economy.

- ✧ Distortion of international trade and commerce by restricting these to imports and exports to and from Israel.
3. Distorting the infrastructure of the Palestinian economy and linking it with that of Israel.
 4. Distortion of the interests of groups and individuals.

These include importers from Israel, industrialists who act as subcontractors with Israeli companies, and Palestinian workers employed in Israel.

These distortions have collectively made the Palestinian economy completely dependent on that of Israel, resulting in a lack of equilibrium in the Palestinian economy. This is reflected in a wide gap between resources (greater investment than savings and greater imports than exports) and the absence of any equilibrium in the employment market (supply is greater than demand).

To demonstrate the size of this gap, we built a very simplified mathematical model capturing the main features of the Palestinian economy at present. It concentrates on the gaps in resources and the employment market. The model assumes that Palestinians have total control over their land and water and enjoy complete freedom in adopting appropriate economic policies. The table below shows that the eradication of these gaps would require a very long period of time (between 36 to 67 years). This demonstrates the need to restructure the economy to liberate it from the colonial heritage of the occupation.

Table (1)

S	g	t	NT/Y0	Xt-Mt/Yt	*NT/Y0
0.10	0.043	67.68	18.57	-0.13	92.89
0.15	0.052	55.51	18.35	-0.13	61.17
0.20	0.062	47.05	18.19	-0.13	45.49
0.25	0.071	40.83	18.08	-0.13	36.16
0.30	0.080	36.66	17.99	-0.13	29.98

* S1=S2=S3

II.ii The role of the state in the developmental process

Literature on economic development distinguishes three types of state in the Third World:

1. The Predatory State. The most prominent characteristics of this state are:
 - It has no interests beyond the individual interests of its government officials.
 - Every government official has his own price.
 - The most powerful instruments of the state are those of the police, army, and the repression apparatus.
 - Rent seeking activities.
 - Zaire and some small South American countries provided illustrative examples of such a state in the seventies.

2. The Developmental State. The characteristics of this state may be defined as follows:
 - This state promotes the economic process and is capable of transforming a backward state into a progressive one.
 - The institutions of this state enjoy the property of an embedded autonomy. By embedding we mean that the state institutions superintending the economy come from the various economic sectors and not from outside them.
 - Independence refers to the power of the state to formulate a national plan for societal development and not one that is dominated by the interests of individuals, group of individuals, or certain classes.

This type of state is exemplified by Japan in the fifties and sixties and South Korea and Taiwan in the eighties and nineties.

3. The Intermediate State. This state has the following characteristics:
 - The coexistence of two kinds of institutions: some similar to those of the Developmental State and some similar to those in the Predatory State.
 - This state succeeds in certain achievements and in providing some important services to citizens but it is incapable of designing a comprehensive national program of economic growth and development.

Most Third World countries have governments of this type.

In the Palestinian situation, the fundamental challenge lies in the modality to be used in making the transition from the conditions prevailing in the Intermediate State to the conditions that give rise to the Developmental State. It may be argued that there is now a vigorous national debate concerning the need to reform PNA institutions to qualify for the role of the Developmental State. This reform, demanded by the Palestinian people, must not be confused with the current deceptive demand made incessantly by the American administration and Israel for structural reform in the PNA. This has nothing in common with the national aspirations for reform of the Palestinian people, nor with democracy, transparency, or accountability. On the contrary, the demand made by the Israelis and the Americans is simply a pretext for their real designs; to put pressure on the PNA to abandon the Intifada and struggle for national independence and force the Palestinians to submit to conditions dictated by Israel and implemented by the American administration.

Popular Palestinian demand for reform and tackling corruption is aimed at extracting the PNA from the contradictions with which it has been grappling and make it capable of functioning coherently and effectively to end occupation, achieve independence, and establish the foundations of sustained economic growth and development.

It appears as though it is incumbent on the PNA to provide a definitive solution to the problem concerning the nature of the interim period that the Palestinian people have to go through. Is it a period for building the Palestinian state or a period for national liberation?

The prevailing objective conditions clearly indicate that the PNA must respond to these questions simultaneously. The interim period must be regarded as a period of national liberation until complete independence is achieved and, at the same time, it must be regarded as a period of state building. What this means is that the economic situation will remain the same until the establishment of a state in the Palestinian Territories occupied in 1967 and that conditions of conflict rather than cooperation will continue.

Such an economy must meet three conditions:

- ✧ Economic activity must be directed towards an austere pattern of consumption. This means banning the import of luxury goods.
- ✧ Giving incentives to saving and investment in the local economy, especially in local production, to increase the productive and

absorptive power of the economy to create employment for Palestinian workers.

- ✧ Economic activity must also be directed towards the production of sufficient quantities of food products. This must be done within a legal framework designed to do the following:

- prevent monopoly
- fight inflation
- ensure just competition and equality of opportunity
- distribute costs fairly
- provide public transportation to alleviate the high cost of living and guarantee a decent living for those sectors of society who are less fortunate.

Part III: The Role of Productive Sectors

Agriculture

In many Third World countries, the disproportionate importance given to the process of industrialization has led to the neglect of agriculture. It is argued that it is the industrial sector that is capable of effecting economic growth and that agriculture is incapable of accomplishing this objective. But the experience of many countries that have successfully industrialized shows that the role played by agriculture in fact complements that of industry and that, historically, agriculture has played a fundamental role in the industrialization process. From the supply side, agriculture supplies the industry with the necessary input of workers to expand. From the demand side, the agricultural sector functions to absorb new industrial goods. Neither can be achieved unless agricultural productivity is increased through the greater use of capital and technology in agriculture. With this in mind, let us now consider the Palestinian situation. It is a fact that the agricultural sector has been neglected ever since the establishment of the PNA, which has almost exclusively concentrated on the development of three sectors - services, tourism, and commerce. Current conditions dictate that attention must now be turned to the development of agriculture in the short and intermediate term simply because of its vital importance in expanding the capacity of the Palestinian economy. Agriculture is the only sector currently able to provide sufficient quantities of basic food and absorb manual workers.

In the short term, agriculture could absorb some of the labor force previously employed in Israel. These workers could be employed in land reclamation and in a more efficient organization of the olive harvest. In the intermediate term, the importance of agriculture lies in producing agricultural commodities for the agro-industry and other commodities that have competitive advantage (early crops).

Industry

Even this indisputably vital sector has received inadequate attention from the PNA. For example, the PNA failed to adopt policies designed to encourage investment in industry and provide the necessary incentives. On the contrary, the commercial and financial policies adopted by the PNA actually contributed to reducing the competitive power of this crucial sector of the economy. The importance of focusing more vigorously and resolutely on producing some of the goods and products imported from Israel must be recognized. The most important of these are those food products and simple consumer products that are produced in Israel for the Palestinian market. In the intermediate term, once the PNA can start rebuilding what was destroyed by Israeli aggression, the industrial sector should produce all the items required for the reconstruction process, as well as other related products. Attention must also be given to information technology.

Tourism

In tourism, although Palestine has distinctive and competitive features, its successful development is contingent upon stability. What this means is that investment in and expansion of the tourism sector, though indisputably necessary, must, nevertheless, be delayed until an environment of stability and security prevails. In the current circumstances, efforts must be concentrated on maintaining the existing level of investment and maximizing its returns.

Part IV: The Role of Human Capital

Following the Second World War, a belief prevailed that material investment and accumulation of capital constituted the engine of economic growth and development and that, therefore, poorer states that invest a substantial part of their national income would be capable of catching up

with richer states. This is the essence of the theory known as the Convergence Theorem. In practice, the opposite occurred and the gap between poor and wealthy states increased. This showed that the role of capital accumulation, although very important, is not as central as was believed. A number of studies have established that the real engine of growth and development is that of human capital and that the accumulation of material capital is a result of the developmental process and not its cause.

In the Palestinian Territories, the situation of human capital is poor. Only 4% of GDP is invested in education, falling between what intermediate states invest in education (5.5%) and that invested by poor nations (3.5%). Higher education conforms to the pattern followed by most Arab countries, focusing on quantitative, horizontal expansion and ignoring the importance of qualitative and in-depth expansion.

Basic requirements must be met during the period of enduring and outlasting the Israeli occupation. It is crucial to remember that the cadre of the teaching profession live under the poverty line. University professors have not received more than half their salaries for months.

There is also a dire need for an immediate program to improve academic conditions as education constitutes one of the fundamental components of existence and resistance and discourages emigration.

In the intermediate and long term, national priorities must be reorganized so that funds allotted to education are substantially increased. It is impossible to effect any development with 4, 5, or even 6 per cent of national income allotted to education. The majority of these funds will be used for teachers' salaries leaving little to improve conditions in schools. Developed countries allocate more than 10% of their national income to education.

The same argument applies to health and social security which are vital sectors and the allocation of sufficient funds is of extreme importance in both the short and the long term.

Part V: The Role of International Trade

1. The experience of most developing countries of regional economic integration through trade agreements (free trade zones, customs unions) indicates that regional integration fails because the

economically powerful countries profit at the expense of the economically weak nations. Successful economic integration, as in East Asia, has shown that success comes from the coordination of development policies and rationalizing production at regional level.

2. In the Palestinian case, the central issue is to liberate the Palestinian economy from its complete dependence on the Israeli economy and diversify and develop international economic and commercial relations, particularly with neighboring Arab countries. This would prevent Israel from continuing to monopolize Palestinian international trade.

Part VI: Just Distribution of Income

A long-standing belief has prevailed that the beginnings of economic development are usually accompanied by a worsening of distribution of national income and that distribution improves only when national income attains a certain level. Experience has shown that this belief is erroneous for it has proved to be the case that just distribution of income promotes the developmental process from the very beginning since it promotes education and, consequently, human capital. The just distribution of national income also increases investment and consequently competition in the financial market, which, in turn, increases the potential of converting savings into investment. It also increases purchasing power to consume new industrial products. Finally, it reduces crime and security expenses.

In the Palestinian case, various signs indicate that the gap continues to grow between the different social layers and the different regions: between Gaza and the West Bank; between the north, the south, and the central region; and between rural areas, cities, and refugee camps. Moreover, surveys of public opinion revealed that there is a general feeling amongst Palestinian citizens that the gap between the rich and the poor is growing, that the middle class is shrinking, and that the developmental programs of the PNA do not bring benefits to society.

At present, priority must be given to resistance and survival. It is essential to give top priority to a program for emergency aid to those who are affected in any way as a result of Israeli aggression. It is also necessary to expand social networks and health insurance programs. At the same time, there must be a program of austerity for PNA institutions.

In the intermediate term and long term, the tax system must be reformed to ensure an equitable distribution of the tax burden based more on consumption and property taxes. Reform of government expenditure in line with the stated objectives of development is also an important priority.