Palestine Economic Policy Research Institute (MAS)

The Palestinian Economy: The Road to a Better Future

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This important MAS Conference has put forth a title that is, in my view, ambitious, timely, and appropriate. Its aim is no less than the challenging task of articulating a *'New Vision for the Revival of the Palestinian Economy'* at a time of a worrisome stagnation in Palestine and unprecedented turmoil and violence in the Arab region. It is also timely because the Oslo Accords and the associated Paris Economic Protocol (henceforth the 'Oslo Framework'), which had shaped political and economic developments since the early 1990's, have both long passed their expiration dates. Indeed, the time has come to take a fresh look and to seek a new framework for the future of the Palestinian economy.

I. The Oslo Framework: Economic Outcomes

The Oslo Framework, as was amply noted at the time, is a deeply defective agreement, and developments since then have only confirmed early forebodings. The Framework granted limited autonomy for Palestinians in the West Bank and Gaza Strip. And, even within this severely constrained definition, economic development in the Occupied Palestinian Territory (OPT) was made contingent upon safeguarding the security of all Israelis, including the settlers. In the meantime, Israel retained all the levers of power, including effective and ultimate control over the entire territory so defined. This in turn meant that Israel retained the ability to restrict or shut down economic activity in the OPT if it felt that its own security, as defined by it alone, became somehow threatened.

It is no surprise therefore that the economic outcome of the Oslo Framework after 23 years has been so modest, even given the Palestinian people's well recognized resilience, adaptability and resourcefulness. Real GDP growth over the period fluctuated widely as periods of calm were disrupted by breakdowns of security and serious economic setbacks. As a result, while growth of real GDP at times leapt to annual rates of around 10%, it was negative in some years as well, so that the average annual growth since the early 1990's has been around 4.5%. With population growth averaging 3.5% annually, real per capita GDP for both the West Bank and Gaza Strip for the period was rather modest.

Furthermore, with income and wealth distribution steadily shifting towards the higher percentiles, the typical Palestinian household hardly felt any improvement in living standards. For the population of Gaza Strip, the outcome was distinctly worse than in the West Bank as the per capita GDP differential widened by 52% between 1994 and 2015. This was reflected, in part, in the poverty rates which, in 2015, were 40% in Gaza Strip and 18% in the West Bank.

To be sure, progress since Oslo has been made on several fronts in the earlier years that witnessed the return of the Palestinian political leadership and large numbers of Palestinians from exile, the creation of Palestinian state institutions to replace the offices of the Israeli administration, and large inflows of official financial aid and substantial private sector capital. Growth rates picked up rapidly and incomes rose even more dramatically as work in Israel attracted large numbers of Palestinian workers and the inflow of remittances surged. Improved political and economic conditions facilitated long-delayed investments in physical and social infrastructure and spurred private sector activity. Moreover, the budding political legitimacy of the PA's institutions vastly improved business and consumer sentiment, boosting aggregate demand and economic growth. Budget revenues surged and enabled the PA to revive and build new institutions while funding long-delayed reforms, notably in education and health.

However, improvements in the early years did not last, because of inappropriate policies and actions on the part of the Palestinian Authority that did not foster economic growth. However, by far the most decisive factors that impeded genuine developments in the OPT derived from Israel's repressive occupation and deepening expropriation and colonization of Palestinian lands.

This brought about heightened violence and large-scale destruction of Palestinian property, disrupting economic activity and choking off growth. With time, as economic and political prospects under the Oslo Framework dimmed, they ushered in the economic stagnation and political malaise that prevails today. The situation is indeed worrisome and calls for change.

II. A New Vision?

i. Requisites

Looking ahead, current conditions do not bode well for the future. Unemployment remains exceptionally high and chronic; it is particularly severe in Gaza Strip (38% in 2015) and, more generally among the more (potentially) productive segments of the labor force, the age group 18-34-years old, more than half of whom remain unemployed according to the IMF. Heavy dependence on already declining external assistance, notably to fund the rising government spending, has become difficult to sustain. Public opinion polls clearly indicate wide dissatisfaction, frustration and even despair, especially as immediate prospects look dim.

From a broader perspective, the so called ‘peace process’ is essentially dead, the expansion of Israeli settlements on Palestinian land continues unabated, and the outlook for the vaunted two-state solution continues to dim as the Palestinian issue cascades down the list of priorities that preoccupy the international community.

The need for a ‘new vision’, as the theme of this conference suggests, is therefore real and urgent. The question is ‘what kind of vision?’.

A good starting point for clarifying a ‘new vision’ may be to recall some of the lessons learned from international experience with growth and development policies in the post-WWII period. While this experience is rich and the lessons are often contested, one can extract a few principles on which there has been substantial agreement. These may be summarized in *three requirements* that have proven to be decisive in the achievement of high and sustained rates of growth, and generally successful socio-economic development. These requirements are also consistent with the more recent developments in economic research, especially advances in indigenous growth theories and in institutional economics.

- The first requirement is having a competent, cohesive and effective state structure capable of safeguarding the country’s sovereignty and maintaining internal security and political order. The state should also be capable of protecting basic rights of both individuals and groups acting peacefully in the political, economic, social, cultural and religious domains, including the right of advocacy and free speech. To ensure political legitimacy, the government charged with carrying out the functions of the state must enjoy the confidence and support of the people, a condition that tradition has shown can best be satisfied through democratic processes. Government agencies also need to be reasonably transparent and accountable to the people or to their elected representatives.

- A related requirement is that the institutions and agencies of the state carrying out their responsibilities under the law must be competent, must be true to their assigned mission and effective in carrying it out, accountable for their policies and actions and free of corruption (in the sense of being influenced by personal or self-serving political considerations). These institutions include the legislature, the judiciary system, the regulatory agencies, civil society institutions and media organizations.

- Finally, in terms of the organizing principles for the economic system, free markets (with certain important qualifications) have been found to be the most effective vehicle for allocating resources efficiently. However, market forces should not be totally free and unbridled as there is an important role for the state in ensuring their proper functioning. In addition to what was noted above, the role of the state includes the establishment of a safe and secure environment for investment and business activity, the protection of property rights, the provision of a fair and effective regulatory environment, combating corruption, and fostering the equitable distribution of the benefits of growth, including the social protection of the disadvantaged.

These of course are optimal conditions and it is rare that a country satisfies all requirements for long. In the case of Palestine, these conditions are met only partially. More critically, Palestine lacks sovereignty and is therefore severely handicapped in achieving vibrant and sustained economic development even if other conditions were to be satisfied. . In particular, Palestine lacks control, *inter alia*, over its own resources and physical borders, its internal and external security, all movements in and out of its territory, incomplete control over some of its institutions, has no currency of its own, and depends on transactions with Israel as its major trading partner while lacking the authority to sign bilateral or multilateral trade and investment agreements with other sovereign countries.

ii. The Political context

Given the circumstances in Palestine, the formulation of a ‘new vision’ for the Palestinian economy must by necessity be cast within a political context. With this in mind, the focus of economic policy would be to reinvigorate growth over the short-to-medium term, while laying the foundations for sustaining high and equitable rates of growth over the long term. Moreover, material repercussions the Israeli occupation has on the economic outlook, would need to be addressed as an integral part of the economic program.

Another, separate dimension of the ‘political context’ is the internal political situation in Palestine, some aspects of which could act as a drag on economic growth. The economic reform and revival program therefore would also need to include efforts to address those aspects. In this connection, there are essentially *two major impediments*.

The *first* is the hardening division within the Palestinian political factions which, among other things, deepens the separation and divergence between the West Bank and the Gaza Strip and undermines any national effort to pursue peace with justice. The *second* is the ossification of the political arrangements created by the Oslo Framework, a condition that has severely limited the margin for independent action by the Palestinian Authority, both in the economic and political domains. A few words on these two important issues:

- *The internal political fracture*, reinforced by physical separation, has hardened since 2007 and could reach the point of becoming intractable. This not only damages the chances for the achievement of a just and lasting peace in Palestine, it also deepens the divergence between the two populations as new generations grow apart under different political, economic and social conditions.

  This political rupture can only be healed with the achievement of genuine reconciliation and national unity, leading to the full integration of the economies of the West Bank and the Gaza Strip. This would need to be accomplished in conjunction with the reinstatement of a democratic process that brings forth a legitimate national legislature and properly constituted organs of local government.

  In addition to all the other benefits that this grand reconciliation and economic integration would bring about, it would have a material positive impact on the economic prospects for the Palestinian economy, including for the finances of the PA. The economic benefits could be particularly significant if the integration of the two economies were to coincide with a political agreement that, *inter alia*, provides a physical link between the two areas and enables *external* trade and investment via a seaport in Gaza.

- *The Aging of the Oslo Political Framework:* the other overarching political issue that continues to weigh heavily on the prospects for the reinvigoration of economic growth is the ossification of the political framework created by the Oslo Accords which itself was designed as a limited interim arrangement. The Accords left the end game undefined and, in particular, failed to incorporate an explicit reference to a two-state solution, the outcome that is now firmly accepted by the international community.

  I won't get into the thickets of a political debate in my speech as it is not the central topic of this conference. However, in the absence of a resolution of the adverse political situation, I contend that there are still initiatives that the Palestinian Authority can take itself to reform and renew its present institutional and policy structures in order to enhance the PA's effectiveness in general, but especially in its engagement with and oversight of the program for economic reform and revival.
  These political issues deserve to be addressed independently and on their own. However, this is not the place to do so. What this paper attempts to do is to address those aspects of the larger and more complex political environment that have a direct and material impact on the immediate economic prospects of the Palestinian economy.

III. A Program for Economic Reform and Renewal

In what follows I present a comprehensive program of economic reform and revival with specific proposals aimed at shifting the growth trajectory of the Palestinian economy to a higher, and more sustainable level.

It is important to note, at the outset, that the program's potential for achieving the upward shift in the growth path is critically dependent on putting in place and faithfully executing a structural and institutional reform program. This program would be anchored by the twin initiatives of *political renewal* and *economic reform* and the two initiatives must be pursued simultaneously and in combination. Political renewal, as outlined above, is a necessary condition for the success of the economic reform and revival program, for without legitimate political support, economic policy initiatives would quickly lose their credibility and, ultimately, their effectiveness. The required reforms, both the political and economic, are difficult and would be painful in the short term, but they are absolutely essential and, indeed, are becoming urgent.

It may be worth pointing out that the starting point for any effort to raise the growth rates and to enhance social equity is to recognize the critical importance of structural and institutional reform as the essential prerequisite for the success of economic policy. Therefore, difficult as they may appear, changes in the policies and institutions of the Palestinian Authority as well as in the prevailing business conditions are essential for the success of the economic reform and revival program. This also means that the timely and effective implementation of the needed structural reforms would require the full engagement of the political leadership and the infusion of new energy and resources into economic policy-making.

i. ***Addressing specific economic aspects of the political environment***

A comprehensive economic reform and revival program must by necessity address certain aspects of the prevailing political and security situation that directly impact the performance of the Palestinian economy. Among the issues to be addressed in this context are the following:

- *West Bank and Gaza Strip Integration:* The achievement of national unity and the integration of the economies of the West Bank and Gaza Strip, as noted earlier, would greatly enhance the economic prospects of both areas. Pending the achievement of this national goal, ways and means need to be developed through which the risks and costs of doing business in the two areas are minimized. Going further, the business community in both areas need to give priority to projects and activities that promote closer integration (such as through partnerships, joint ventures etc.) for the benefit of both communities.
- *Recovery of Funds from Israel*: The Palestinian Authority should intensify its on-going efforts to recover all the funds illegally retained by Israel. These include uncollected VAT revenues on indirect imports and on bilateral trade with Israel, undervaluation of Palestinian imports by Israeli intermediaries, equalization revenues and other leakages.

The transfer of the stock of accumulated pension funds of Palestinian workers' in Israel (totaling about $670 million by 2015), should also be pursued.

- _Area 'C':_ The PA should insist on expanding Palestinian economic activity into Area 'C', estimated at about 62% of the area of the West Bank, which, according to World Bank estimates, could increase Palestinian GDP by a third.
- _The Joint Economic Committee:_ Finally, the PA could explore the potential benefits (and possible drawbacks) of reviving the *Joint Economic Committee* for negotiating and settling economic and financial issues impacting the Palestinian economy, possibly under an international oversight mechanism to ensure Israel's compliance with agreed outcomes.

ii. Policies to promote social and technological development

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- *Female participation* in the Palestinian labor force is only 16%, according to the World Bank, a rate that is significantly below the Arab World average (24%) and especially low given other human development indicators for the country. For lower middle income countries, a group within which per-capita income levels place Palestine, the average ratio is close to 40%, according to the ILO, while in the high-income countries the rate is generally in the range of 50%-55%. Male participation rates in Palestine are around 70% and are in line with international norms. Females of working age, including educated females, therefore, likely represent the single most underutilized resource in the economy.

  Greater mobilization of females into the workforce would inject an element of dynamism into the Palestinian economy and would have a pivotal impact on raising the *potential rate of growth,* a critical objective in the economic reform and revival program. The challenge, however, is that low participation of females has been a sign of weak demand rather than supply constraints. Therefore, unless jobs are created in sufficient numbers to absorb both male and female workers coming into the labor force, it is difficult to see how female participation would rise from present levels.

  A steady increase in female participation would therefore be feasible if the reform program were to spur a massive increase in public and private sector investment as indicated elsewhere in this paper. In such circumstances, employment policies could be deployed to encourage female participation which, over a sustained period, should attain a rate of 30% over the medium term. This would represent a healthy improvement but would still be significantly below Palestine's peers. Such a change would lift the combined (male and female) participation rate from around 45% at present to around 52%, a level that is comparable to e.g. Lebanon and Morocco, but is still below the average of 59% for lower middle income countries.

- *Education:* The educational system in Palestine has undergone notable reforms but progress has been slow and uneven. Educational reform will require the allocation of more resources but also improved designs of curricula, qualification of teachers and social policies to support innovation and experimentation for better outcomes. Methods that have proved successful in certain educational institutions could be generalized more broadly throughout the system. Closer collaboration between educators and the private sector is needed to help identify needed skills and build school curricula and training programs in line with the changing market demand for labor. Needless to say, educational reform, essential as it is for expanding the opportunities for economic and social progress, is a long-term project. Nonetheless, it is important to double the efforts of those engaged in this enterprise because of the urgency of the task.

- *Science and Technology:* Given the paucity of natural resources in Palestine, future growth will need to come from higher-skilled labor force and the deployment of new technology in order to spur productivity growth. To this end, it may be time to explore the establishment of a *National Science and Technology Fund*, to be funded by both the public and private sectors. Proper incentives should be given to the private sector (e.g. through raising the limit of eligibility for tax deductions related to expenditures on research and development) to encourage investment in appropriate technologies and in skill formation. Currently most high-income countries spend between 2.5%-3.5% of GDP on R&D(Korea and Israel spend the most, nearly 4%) according to the OECD. Along with the accompanying reforms outlined here, Palestine should aim to lift its ratio of R&D spending from negligible levels at present to approach 2.5% of GDP by 2025.

iii. Economic and financial reforms

- *The Business Environment:* Laws and regulations affecting business formation and the general conduct of business could be reviewed with a view to streamlining and modernizing them. This could best be pursued through the creation of a *Joint Public-Private Sector Commission* with a broad mandate to making the business environment conducive to investment, trade and finance while safeguarding consumer rights and protections. The mandate could include the reform of business taxation and regulation, a review of existing laws governing the settlement of disputes, more expeditious collection of debt and the resolution of bankruptcies (possibly through the establishment of a system of specialized commercial tribunals), facilitating business consolidation, and strengthening judicial processes affecting business activity.

- *Fighting Corruption:* Laws and regulations could also be reviewed with a view to strengthening on-going efforts to fight corruption and the abuse of public office for personal benefit or to the advantage of connected persons. Transparency in public finances, especially in government, should be enhanced and government agencies and officials should be made accountable to duly constituted bodies. This may best be put into effect through the enactment of an Organic Budget Law with effective legislative oversight.

- *Fiscal Reforms:* From the start, policy makers in the PA have been challenged in their efforts to balance the fiscal accounts. This is due to several factors, the most important of which are the binding constraints of the Oslo framework and the continuing Israeli occupation that has deprived the PA of the authority to take full charge of its economy and has thereby undercut its ability to achieve budgetary independence. As the Palestinian productive capacity remains below its potential, the tax base and overall budget revenues remain constrained. At the same time, expenditure obligations continue to grow in line with the population growth and the rising cost of the social safety net, itself being made exceptionally large as a result of the suppressed economic growth and higher unemployment.

  Secondly, in part due to these exceptional circumstances but also because of what may be at times inappropriate policies, the costs of public sector employment (wages and salaries plus employee benefits) have been allowed to grow considerably, and stand at present at nearly 16% of GDP, more than double the average for developing countries. With the scarcity and instability of job opportunities in the private sector (in large part because of volatile security conditions) the PA has long been perceived as employer of last resort and public sector employment as a social safety net. As a result, rising benefits and a steady upward drift of the salary structure have abnormally inflated the compensation costs of public sector employees.

  Third, as a result of the above, the PA has had to rely on external financial assistance and on recourse to domestic bank borrowing to bridge the gap. While external budget support has declined from its peak of 27% of GDP in 2008, in large part due to stringent austerity measures, it remains high at just over 6% at present. Bank borrowing has continued to rise and stands at over $1.5 billion, all of which should be considered ‘foreign debt’ given that the PA does not issue a currency in which it contracts its debt. Neither of these options is inherently sound policy and, in the end, they may not be sustainable.

  Finally, the PA’s obligation to allocate almost all available financial resources to current spending (mainly the wage bill) has also compromised its ability to direct spending to investment in public goods to the extent needed. In recent years, public investment has fluctuated around only 2%-4%of GDP annually, a level that is clearly less than adequate to build and maintain the required physical, social and institutional infrastructure in the country. Therefore, even at its present level, the deficit may not be sustainable and pressures on the PA to increase spending are bound to mount at a time when the PA is also called upon to increase allocations to the capital budget.

In view of the above, fiscal reforms take on particular importance as it becomes increasingly urgent to reduce the cost of the public sector and alter the employment incentives of incoming labor force participants to seek employment in the private sector. At the same time, fiscal reforms would help generate the public savings needed to fund the government's share in the augmented national investment program (the combined public and private). Among the measures that could be explored in this regard are the following:

- Undertake a comprehensive and thorough review of government employment with the aim of defining the 'optimal size' of the civil service and public sector employment more generally. In the meantime, institute policies to freeze or at least limit the growth of public sector employment (compensating for the possible 'cuts' through the reassignments of personnel) for the medium term.
- Through attrition or the implementation of a carefully-designed early retirement schemes, gradually reduce the structural size of the total public employees' compensation costs, over the medium term, to be in line with those in comparable developing countries, i.e. about 8% of GDP.
- Along with other measures to improve the fiscal accounts, (e.g. recovering funds from Israel mentioned earlier, collecting taxes on indirect imports, taxes and fees in Gaza Strip and, subject to political approval, taxes and fees in Area C), strengthen tax administration through improved usage of existing technology, enhancing staff capacity to reduce evasion and improve compliance.
- As budget savings are realized from the various measure, begin shifting resources to the capital budget for investment in infrastructure, health and educational facilities as well as to advanced skill formation and to research and development.
- Establish a *medium term framework* for the preparation of the budget and improve coordination with *the Palestine Investment Fund's (PIF)* investment plans and priorities. This becomes especially important as the Ministry of Finance's outlays on investment in development projects become more significant.

The ultimate result of the proposed fiscal and other supportive measures would be to further reduce the fiscal deficit to around 3% over the medium term. At this level and with improvements in revenue collection, the PA should be able to increase the capital share of spending from current levels (2%-4% of GDP) to a range of 8%-10% of GDP over the same time horizon.

- *The Banking Sector:* The banking sector has been a formidable pillar of the Palestinian economy in the past decade. In the face of enormous challenges, it has shown remarkable resilience while continuously strengthening its capital base and expanding its assets. However, a good part of this asset growth has been in credit to the government while private credit is heavily concentrated in 'non-productive' sectors such as real estate and government employees loans.

In view of the special conditions of the Palestinian economy, it being extremely resource poor, banks should explore ways in which they can co-finance, in collaboration with the business community (and perhaps expatriate Palestinians), innovative ventures and business start-ups aimed at creating new opportunities for growth and job creation in the economy. These activities could possibly receive government back-up guarantees in the initial stages as a part of the re-orientation of government resources towards investment in R&D and in targeted skill formation for high-value activities.

IV. Transforming the Relationship with the Donors

i. Understanding the relationship

Following the signing of the Oslo Accords in 1993, the international donor community made a commitment of a $2.3 billion aid package to help finance the newly created Palestinian Authority. The PA has remained dependent on official external assistance ever since. Lacking sovereignty to qualify for borrowing from multinational institutions or from capital markets, the PA's external financing has had to be in the form of direct grants, an exceptional situation that has prevailed for more than a generation. For most of this period, the funds were used for general budget support with only a small share allocated to finance development projects.

The cumulative size of the aid the PA has received to date for budget support only(i.e. aside from reconstruction grants committed during emergencies) likely exceeds$25 billion since the PA's inception. The annual levels of support, however, have been on the decline for several years and the trend is likely to continue. In part, this is due to a steady improvement in the PA's own efforts at budgetary control in recent years. The decline is also due to rising donor fatigue in the face of more stringent budgetary conditions in the donor states themselves, as well as rising and more urgent demands for resources from other parts of the Middle East region.

External budget support for 2015amounted to $0.8 billion, nearly 90% of which was to support current spending. Separately, reconstruction aid for Gaza Strip following the 2014 war was pledged at $3.5 billion, of which less than half has been disbursed by mid-2016.

Except perhaps during the first few years of PA's existence, the relationship with the donor states has never been truly healthy and, if anything, appears to have become more strained with the passage of time. This is not surprising, and may indeed be understandable as the PA's needs for budget support, even with the recent decline, have persisted longer than had been expected, and donor states' circumstances have also changed over this period. After all, it had been assumed by both sides that Oslo would be an interim arrangement leading to a permanent solution to the Palestinian/Israeli conflict. A fresh look at the whole arrangement between the donors and the PA may therefore be useful.

In this context, it is important to identify two distinct and separate causes for the PA's continued reliance on external support. The first reason, a structural one, derives from the failure of the international community to achieve a resolution of the Israel/Palestinian conflict leading to the establishment of a sovereign and independent Palestinian state. This has deprived the PA of its ability to establish its control over its economy and resources and thereby assume full responsibility for its own economic and financial viability. Hence the need for international financial support.

The second cause may be related to the PA's own possible actions and policies in managing the fiscal accounts. In this regard, and to be fair, the PA's performance has not fallen short of what can be expected. For example, the PA's tax effort (i.e. its ability to collect domestic revenues)is currently in the range of 19%-22% of GDP, a level that is comparable to that of other countries in a similar or even higher income group. And yet, the PA runs a budget deficit which, even after all recent improvements and reforms, remains unsustainable.

To be sure, additional fiscal reforms to raise revenues and reduce spending are needed, suggesting that the deficit could be further reduced. On the opposite side of the argument, however, the PA needs to increase its level of investment spending considerably to provide for the economy's basic needs. This means that regardless of its efforts, the PA could still be running a structural deficit as long as Palestine is deprived of its sovereignty over its resources and its economy, a situation that keeps the country's productive capacity sub-optimal, and hence, government finances inadequate.

The above analysis suggests a possible approach to a restructuring of the relationship between the PA and the donors. This could take the form of a *grand bargain* by which the PA would be responsible for implementing structural and institutional reforms that would raise its fiscal performance to internationally acceptable levels, while the donors, for their part, would commit to help finance these reforms and then gradually reduce their budget support to minimal levels. As a working hypothesis, these levels could be viewed as commensurate with the shortfall in Palestinian finances arising from the donor community's inability to achieve a peaceful settlement securing Palestinian independence and therefore economic viability.

Once a Palestinian state has been established with full control of its economy and all of its resources as a sovereign state, donors would be freed of their obligations to finance the PA under *this arrangement* and the associated external financial assistance could then begin to be phased out.

iii. Reforms to be undertaken by the Palestinian Authority

As outlined earlier in the paper, fundamental fiscal reforms are inherently difficult and at the start, could be especially costly, even if over time they would save money and provide efficiency benefits for the economy as a whole. In the context of the grand bargain with the donors, the centerpiece of the envisaged structural reforms would be fiscal reforms to reduce the need for external budget support, especially for the current budget. The reforms would include civil service reforms which have become critical given the size of the compensation bill and perceived over employment in the government sector. As noted earlier, this reform, however, can only be politically feasible if: (a) more funds are made available to finance the release of public sector employees through early retirement and termination packages following a comprehensive review of public sector employment, and (b) if accompanied by a massive public investment and retraining program (itself a costly effort) to help create jobs on a scale that would ameliorate the adverse impact of the civil service reform while helping to reduce existing unemployment.

More specifically, key reforms in this context could include the following:

- *Civil Service Reforms:* Rationalizing the size and restructuring the compensation structure of the civil service are among the most transformative and difficult reforms undertaken by governments anywhere. In Palestine, the task is even more daunting given the economy’s weak capacity to create private sector jobs as alternatives to public employment and the destabilization to prevailing political culture that such a task would entail. However, the availability of external funds to support such a program could make it more achievable.

- *Augmented Development Program:* Concomitant with the civil service reform, an augmented development and (especially for Gaza Strip) reconstruction program would be launched and sustained for several years. The object would be to speed up the reconstruction in Gaza Strip and make up for the shortfall of investment and job creation that had prevailed in both the West Bank and Gaza Strip for many years before. The augmented investment program, which could engage the private sector as well, would aim to create job opportunities for the large numbers of the currently unemployed but also for incoming job seekers joining the labor force and thus help forestall a possible rise in unemployment in the future. The new development program could build on and expand the PA’s own plan for 2014-16 already in place. Funding would of course be needed for this program as well.

- *Large-scale Training and Rehabilitation Program:* This program constitutes an essential component of the structural reforms to be undertaken to reorient public finances in a developmental direction. The program would require support from the donors which, by the very nature of the program, would be in the form of financing as well as through engagement of donor institutions and personnel. The program clearly takes time to plan and implement and should therefore be viewed, along with other components discussed here, as a medium to-long-term endeavor.

iii. Donors’ response

These structural reforms are ambitious and would be exceptionally challenging in any circumstances. In the case of Palestine, they would be daunting indeed and the costs would be considerable. The difficulties would of course be eased if sufficient funding became available, at least during the first few years of implementation, until the benefits of the reforms begin to be felt in improvements in economic conditions and prospects.

In this regard, donor support for the reform program would be critical, and even as large the costs may be up front, these may not be altogether unfeasible if they are seen as financing structural reforms with long-term benefits that could reduce future aid. Indeed, this approach may even be attractive to donors as, after 3-5 years of funding structural reforms, donor obligations to finance the PA would be materially and permanently reduced to a mutually recognized and acceptable amount that is much smaller than at present.

On this basis, the PA should explore the possibility of striking a grand bargain with the donors whereby current levels of support would be augmented substantially at first, perhaps doubled or more, and sustained at this level for a period of 3-5 years, but they would then be allowed to decline gradually over several years until they are reduced to the amount corresponding to the donors' international obligations as indicated above. If in the meantime or once an independent Palestinian state is established, obligatory donor assistance could cease altogether(although donors could continue to support Palestinian development beyond that point if they wished to do so on a voluntary basis).

V. Transforming the Relationship with the Palestinian Expatriate Community

The Palestinian expatriate community has always been a source of important political, cultural and financial support for Palestinians in the homeland. This support has taken many forms, notably in unrequited transfers for family support, for contributions to charitable organizations and for educational and developmental institutions, in addition to project finance and joint ventures with domestic investors. These financial flows are important and should continue.

However, a deeper connection needs to be forged between the expatriate community and Palestine and this should take the form of a full partnership whose mission would be to institutionalize an enduring bond to Palestine to help underpin economic progress and, ultimately, achieve national independence. Setting up this partnership should be a private-public effort and it should be based on a clear and coherent long-term strategy that would not only link expatriate Palestinians to their homeland but would also give expatriates a direct stake in its future.

To be effective and enduring, this effort may need to be formalized within an institutional framework, possibly through the creation of a *Palestine National Fund* that would mobilize investment resources for Palestine. The Fund, which could be incorporated abroad, would have most of its employees in Palestine. The Fund would initially be capitalized by the three partner groups: the PA (through the PIF), the resident private sector, and the expatriate community. The Fund would establish 'state-of-the-art' governance and accountability structures and would be professionally staffed and managed.

Mechanisms would be developed and agreed for the identification and funding of investment opportunities to be financed by the Fund. The Fund could in turn partner with other development organizations and institutions interested in investing in Palestine. While in the initial phases the Fund would provide needed financing from its own capital, it could also seek added financing from multilateral organizations (such as the International Financial Corporation of the World Bank), Arab regional organizations or, eventually from capital markets, possibly with guarantees from regional Arab organizations or other sovereign sponsors.

VI. Enlarging the Channels of Economic Exchange with Third Countries

Given the captive nature of the Palestinian economy, most trade still takes place with or via Israel, and this state of affairs has always limited the Palestinian economy's ability to expand its export markets. Palestine continues to record a trade deficit with Israel which, while it has declined in recent years, exceeds 40% of GDP. Nonetheless, the dominance of Israel in Palestinian trade has declined as Palestinian traders have sought to diversify their markets. Thus the share of 'direct' trade with third countries has grown from 14% in 1995 to about 35% in 2006 and to nearly 50% in 2014. This suggests a real potential for further growth.

External trade for Palestinians has to take into account Israel's obstructionist policies for both imports and exports. Therefore, the potential for trade with third parties will not happen unless the effort is pursued with vigor and is accompanied by political initiatives supported by a robust international consensus. It is therefore urgent that all avenues for expanding the opportunities for trade, and possibly investment, with third countries be explored.

In this context, building a port in Gaza Strip would be a pivotal component of such a strategy, a fact that raises the urgency of ending the political rupture between Gaza Strip and the West Bank. Such a facility would deepen the integration of the two economies, thus enhancing the economic benefits to the entire Palestinian community.

VII. The Outcome: A Revitalized Polity and A Reinvigorated and Growing Economy

The reform and revival program set out above is intentionally ambitious and wide-ranging. The challenges facing the Palestinian people are formidable. In the face of the continued encroachment of Israeli settlements and the tightening grip of Israeli security on the OPT, and the near paralysis of the Palestinian political leadership, a deepening sense of resignation has prevailed in Palestine of late. The Palestinian society is menaced by the onset of a troubling malaise, while the economy is faced with the risk of stagnation and even poorer prospects in the years to come. Add to that the receding visibility of the Palestine problem in the political discourse of the international community and the prospects Palestinians face turn even darker.

A new sense of urgency is needed. Ideally, a just and enduring solution to the Palestinian/Israeli conflict could be envisaged and this would provide for the establishment of an independent and sovereign Palestinian state along with a satisfactory solution to all other outstanding issues. However, casting the discussion in terms of what can be achieved in the short-to-medium term, an ambitious and comprehensive program of political renewal and economic reform as detailed in this paper would go some way towards materially improving the Palestinian condition and its immediate prospects.

As set out in this paper, the program would require first and foremost energizing the political leadership with the infusion of new blood and a revised mission that is more attuned to the new realities on the ground, in the region and internationally. In terms of the specific subject this paper addresses, namely, economic reform and revival, the new mission implies the launch of a mobilization drive on a national scale, with support from regional and international powers, designed to push out the boundaries of the Oslo Framework to create the needed space for reinvigorated growth and equitable social development.

Even with this enormous effort, it is not clear that the Palestinian economy would achieve the objectives that would satisfy the Palestinian people's yearning for peace and progress. But it is also clear that anything less than what is proposed here would simply produce the usual incremental, and easily reversible improvements. In particular, a more modest effort would fail to raise Palestinian economy's potential growth on a sustainable basis and would therefore not bring about the hoped for qualitative improvements in living standards or in the prospects for a better life.

To summarize, the elements of the program for reform and revival of the Palestinian economy include:

- A new drive to mobilize all available resources—human, political, diplomatic and international--to neutralize the adverse effects on the Palestinian economy emanating from the continued Israeli occupation and from the constraints of the Oslo Framework as interpreted and applied by Israel. The new drive would also seek to bring new blood into the Palestinian political leadership with a special focus on the economic reform and revival program, and to end the rupture in the political leadership.
- A thorough overhaul of laws, rules and regulations governing the business environment with a view to facilitating investment and growth. This should help spur investment from both local and expatriate sources with the objective of raising the national investment ratio (both private and public) from the current 16%-18% of GDP to a range of 30%-35% by 2025.
- Implementing structural reforms in public finances so as to reduce the deficit to sustainable levels and to shift spending priorities from the current to the capital components with a special focus on productive physical, social and institutional infrastructure, on new skill formation and on research and development.
- Deepening the role of the banking sector in financing economic activities with the support of special mechanisms and incentives given by the PMA to foster the growth of SMEs and innovative, technologically-rich economic activities.
- In terms of relations with the international community, the program calls for restructuring the relationship with the donors through a grand bargain as outlined above, for transforming the

relationship with the expatriate Palestinian community to help establish an institutionalized partnership for investment and growth, and for exploring opportunities for bilateral trade directly with third countries in various regions of the world.

In addition to these specific policy measures, it is hoped that the creation of new opportunities and drivers for economic growth will make it possible to pursue other progressive social policies, notably to deepen the reform of the educational system and to enhance the role of females in society and the economy including through a rise in the female participation rate in the labor force. This, together with an increase in the investment ratio and the improved productivity brought about by the higher technological intensity of production, should result into an upward shift in the potential growth path of the Palestinian economy.

The successful implementation of this reform and revival program, and under reasonable assumptions deriving from current and historical performance of the Palestinian economy, and from international growth experience, and assuming no major politically-driven setbacks, the growth rate of the economy should rise from the current average of about 3.5% to a range of 7%-9% annually for a decade or more.[1] This implies that the Palestinian economy could double in size by 2025 while per-capita GDP could rise by nearly 70%, from the current $2,700 to around $4,600 by then.

VIII. Some Implications

The economic reform and revival program envisaged in this paper is ambitious and, in the circumstances, would be immensely difficult to execute in its entirety. However, what the proposed program sets out, is a clear strategy with specific policy components that can be implemented, in whole or in part, with distinctly positive results for growth and social development in Palestine.

The essential, core idea in the program is the absolute necessity of reform as a starting point for adopting and executing economic, social and financial policies. Sound policies can be easily dissipated to no effect if they are placed at the disposal of weak or corrupt institutions or if they are introduced in an environment where incentives are skewed and accountability for success or failure is disabled. Reform therefore is of the essence.

[1] These growth projections are back of envelop calculations using a standard Cobb-Douglas production function with assumptions about annual average increases in the key inputs: labor, capital, and TFP. Labor should grow faster than in the past decade because of the assumption of a higher participation rate of females and growth of capital should also accelerate because of the higher investment rates. Only a small improvement of TFP is assumed as the higher capital intensity of production (which all else remaining equal, should boost productivity) will be offset to some extent by higher growth of the labor input thus compromising the potential growth of the marginal productivity of labor.

The program also reflects a *new vision* which envisages the Palestinian economy doubling in size by 2025 and where economic growth, having been anchored in fundamental reforms and the mobilization of available resources, becomes sustainable and capable of lifting Palestine, in a little over a decade, into the mid-range of middle income group of countries.

Other, more specific implications could include the following.

- The high and sustainable growth would enable the PA to begin to provide the population with more public goods including better education, public facilities and programs, and an improved social safety net. Through a judicious mix of taxes and entitlements, the PA would be able to ensure that growth is also inclusive and is being more equitably shared.
- Benefiting from high rates of growth, the tax base would expand and the PA would be able to reduce the fiscal deficit to sustainable levels or altogether eliminate it. Equally important would be the dispensation with external budgetary assistance, except for the portion representing the international obligations of the donors, and even this portion would, for the most part be directed to investment projects. The PA would also have the resources to continue investing in productive public goods such as education and training as well as in science and technology.
- The Palestinian expatriate community would be brought into the national enterprise of economic revival as effective stakeholders with voice and representation in an institutional setting.
- With the accomplishment of fundamental reform and conditional on its economic success, the PA would enhance its standing and credibility not only domestically, but also with the international community. This could translate into a more effective (and better resourced) representation in the international arena in the diplomatic, cultural and possibly in the political domain as well.

Finally, it is important to be reminded that the economic reform and revival program set out in this paper is articulated within the bounds of the ‘political status quo’, although the program also assumes that these bounds would be subject to continuous outward push by all peaceful and legitimate means possible.

Nevertheless, the successful implementation of the program and the transformative results it would bring about could set the PA into a far more favorable position to fundamentally alter this status quo and finally pave the way for the achievement of national self-determination in an independent and sovereign state in Palestine.

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