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# ECONOMIC DEVELOPMENTS IN THE WEST BANK AND GAZA SINCE OSLO*

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The performance of the Palestinian economy in 1994–2000 was uneven, but for the period as a whole, real per capita income declined despite the mobilisation of substantial amounts of foreign aid and despite considerable progress in establishing a basic institutional framework. This paper argues that economic growth and private investment, in particular, have been adversely affected by closures, by uncertainties about political developments and the direction of policies and policy reforms, by problems of governance, and by the excessive transportation and transaction costs related to the intensification of the permits system.

When the possible establishment of 'a Palestinian entity with economic sovereignty' was considered by a group of Palestinian, Jordanian, Israeli, and American economists in 1993, before any inkling of the Oslo negotiations had reached them or the public, they assumed or recommended:[1]

- that the economy would be dominated by the private sector, with markets as the principal guide to the allocation of resources;
- the eventual establishment of free trade in goods and capital among the Israeli, Jordanian, and Palestinian economies, with free trade between Israel and the Palestinian economy being attainable within a matter of months;
- that for the Palestinian economy to prosper, at least 100,000 Palestinian workers should be allowed to work in Israel, as job opportunities in the West Bank and Gaza developed;
- that a Palestinian economic administration be set up, with a separate authority responsible for the management of the financial system, including the chartering and supervision of new banks;
- that arrangements be made for Israel to transfer taxes paid by Palestinians to the new authority, and that government spending in the occupied territories – especially on infrastructure – expand; and
- that foreign aid would have to play a large part in the economic development of the new entity.

Shortly after the conclusion of the Oslo Accords, the World Bank (1993) published a study of the economic prospects for the West Bank and Gaza, that included six medium-term scenarios with different assumptions regarding labour opportunities in Israel, progress in the peace process, and the amount

* The views expressed here are those of the authors and not necessarily of the IMF. We would like to thank David Burton, Salam Fayyad , David Cobham, Thomas Baunsgaard and anonymous referees for helpful comments on an earlier draft of this paper. We draw here on Alonso-Gamo *et al.* (1999).

[1] The reference is to the project 'Securing Peace in the Middle East', organised by the Institute for Social and Economic Policy in the Middle East, at Harvard in 1992–3. For the report of the group, see Fischer *et al.* (1994).

of capital inflows. Their projections for the growth of real Gross National Income[2] per capita ranged from 4% per annum to minus 3%.

In the event, growth in the Palestinian economy in the seven years after Oslo has been close to the more pessimistic of the World Bank's scenarios. The key question examined in this paper is why the Palestinian economy has grown so slowly, despite large inflows of foreign aid and the establishment of a coherent economic administration. The economic developments of the last seven years are set out in Section 1; in Section 2 we seek to identify the key factors that have contributed to the disappointing growth performance; challenges for the period ahead are discussed in Section 3.[3] We present concluding remarks in Section 4.

## 1. The Facts

Data on the Palestinian economy are of uneven quality. The quality of the data has improved since the establishment of the Palestinian Central Bureau of Statistics (PCBS) in 1994, and, of the current data on economic activity, labour market data are of the highest quality, being based on internationally accepted standards and available on a timely basis, while balance of payments data remain particularly weak.[4] Also, a consistent set of national accounts data is not yet available for 1994–9. We nonetheless have to rely on the available data, entering qualifications where we have doubts about the conclusions to which the data point.

Despite data weaknesses, it is clear from Table 1 that the expectations that prevailed in 1993 have not been met. While real GDP in 1999 is estimated at about 20% above the 1993 level, per capita GDP has declined by almost 8%, numerically a result of the very rapid rate of population growth.[5] However, gross disposable income per capita (GNI plus net current transfers) measured in dollars was slightly higher (by about 4%) in 1999 than in 1993, reflecting the significant amounts of aid received by the Palestinian economy. In 2000, before the turmoil and closures that occurred in the fourth quarter, GDP growth was projected at 5% in real terms, which would have allowed an increase in real per capita GNI of 1%. However, because of the severe disruption to the domestic economy in the fourth quarter together with the

[2] Gross National Income is equal to GDP plus net factor income (in this case, primarily labour income) from abroad.

[3] Diwan and Shaban (1999) examine some of the same questions. Their evaluation is generally more pessimistic than that presented in this paper; that must in part be due to the fact that their analysis appears to have been completed earlier than this one, with most data series in their volume running only to 1996.

[4] The data we use were published by the authorities in their Economic Policy Framework—Progress Report of May 31 2000 (Palestinian Authority, 2000). Also, Chapter 2 in Alonso-Gamo *et al.* (1999) discusses the quality of economic data in the West Bank and Gaza.

[5] Part of this population increase, which exceeded the 1993 projections, was due to immigration. Assuming that the per capita incomes of immigrants were on average higher in the West Bank and Gaza than in their previous residences, this would mean that the growth rate of per capita income for the people living in the Wast Bank and Gaza in a particular year was higher than the growth rate of per capita income as conventionally measured.

Table 1

*West Bank and Gaza: Selected Indicators, 1994–2000*

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000A | 2000B |
|---|---|---|---|---|---|---|---|---|
| | (Annual percentage change, unless otherwise indicated) | | | | | | | |
| Income, employment, and inflation | | | | | | | | |
| Real GDP growth[*] | 8.5 | −2.4 | −3.2 | 4.8 | 7.0 | 6.0 | 5.0 | 1.5 |
| Real GNI per capita growth[*] | −4.9 | −9.6 | 9.0 | 3.4 | 7.7 | 3.3 | 0.8 | −8.3 |
| Unemployment rate (in percent of labour force) | 15.1 | 18.2 | 23.8 | 20.3 | 14.4 | 11.8 | 10.0 | 15.0 |
| Employment in Israel (in percent of total employment)[†] | 18.0 | 16.2 | 14.1 | 17.1 | 21.7 | 23.1 | 21.9 | ... |
| Inflation (CPI), year-on-year | 14.0 | 10.0 | 8.4 | 7.6 | 5.6 | 5.5 | 3.2 | 2.8 |
| | (In percent of GDP) | | | | | | | |
| Investment[*] | | | | | | | | |
| Gross capital formation | 29.2 | 36.3 | 32.7 | 36.8 | 35.0 | 32.9 | 32.8 | ... |
| Private | 23.2 | 25.4 | 23.1 | 26.8 | 26.1 | 26.1 | 26.2 | ... |
| Public[‡] | 6.0 | 9.2 | 6.7 | 6.8 | 6.0 | 5.0 | 5.3 | ... |
| Change in inventories | 0.0 | 1.6 | 2.9 | 3.1 | 2.9 | 1.8 | 1.4 | ... |
| Fiscal operations | | | | | | | | |
| Revenue[§] | 7.9 | 11.8 | 18.9 | 21.6 | 22.0 | 23.4 | 21.9 | 21.9 |
| Current expenditure[‖] | 8.8 | 13.6 | 22.9 | 22.7 | 21.4 | 22.3 | 22.4 | 26.3 |
| Total expenditure[‖] | 14.7 | 22.9 | 29.6 | 29.5 | 27.5 | 27.3 | 27.4 | ... |
| Recurrent balance[‖] | −0.9 | −1.9 | −4.0 | −1.1 | 0.6 | 1.1 | −0.5 | −4.4 |
| Recurrent balance[**] | −0.9 | −1.9 | −4.0 | −1.0 | 2.5 | 1.3 | −2.4 | ... |
| Overall balance[‖] | −6.8 | −11.1 | −10.7 | −8.0 | −5.4 | −3.9 | −5.5 | ... |
| | (In millions of U.S. dollars, unless otherwise indicated) | | | | | | | |
| Balance of Payments[††] | | | | | | | | |
| Exports of goods and services[*] | 456 | 611 | 653 | 661 | 730 | 740 | 814 | ... |
| Import of goods and services[*] | 1,433 | 2,089 | 2,509 | 2,735 | 3,169 | 3,398 | 3,590 | ... |
| Net factor income[*] | 575 | 535 | 469 | 606 | 828 | 914 | 944 | ... |
| Current transfers[††] | 559 | 553 | 594 | 385 | 354 | 385 | 482 | ... |
| Current account balance[††] | 157 | −390 | −793 | −1,083 | −1,256 | −1,358 | −1,350 | ... |
| Donor financing[‡‡] | 612 | 547 | 647 | 654 | 553 | 609 | 601 | ... |
| Of which: development plan[‡‡] | 484 | 416 | 512 | 513 | 400 | 449 | 430 | ... |
| Donor financing (in percent of GNI)[‡‡] | 15.4 | 13.2 | 15.8 | 14.7 | 11.6 | 11.9 | 13.4 | ... |

*Sources*: Palestinian Authority, Palestinian Central Bureau of Statistics (PCBS); Ministry of Finance; Ministry of Planning and International Cooperation (MOPIC); and IMF staff estimates and projections.
*Note*: 2000A refers to IMF staff projections made before the crisis, 2000B is IMF staff projections made in December 2000.
* IMF staff estimates based on data from the PCBS.
† Includes workers without permits and workers in Israeli industrial zones.
‡ Includes investment through UNRWA and NGOs where the financing is recorded by MOPIC.
§ Includes revenue transferred to accounts outside the control of the Ministry of Finance.
‖ On a commitment basis.
** On a cash basis.
†† IMF staff estimates based on data from the PCBS and MOPIC. Balance of payments data are particularly weak.
‡‡ Total donor financing includes disbursements through the development plan plus donor support for UNRWA's operational budget. The development plan refers to all aid recorded by MOPIC.

almost complete loss of labour income from Israel, real per capita GNI is likely to have fallen sharply, possibly on the order of 6% from its level in 1999.

Because the quality of these data is weak, especially for 1994, it is probably safest to say that from 1994 to 1996, the per capita GDP of Palestinians declined, while there has been a substantial recovery since then, most notably in 1998, associated with the decline in the frequency and length of border closures, and increase in Palestinian employment in Israel. In 2000, there was solid economic growth up until the fourth quarter of the year when income and output deteriorated sharply. In addition, and importantly, it appears likely that, since 1993, the quality of life has improved as a result of the large-scale investments in infrastructure that has taken place – for infrastructure had previously been of such a low quality as to impact adversely on living standards.

The budget of the Palestinian Authority (PA) started out in significant deficit, even on current expenditures (Table 2). The authorities were successful in mobilising increasing amounts of revenue from the domestic economy, while transfers of taxes collected by Israel on behalf of the PA also increased over time. One of the important failures throughout 1994–9 was that a significant amount of revenue controlled by the PA was not paid into the Finance Ministry, being rather under the direct control of the President. It is now known that a large part of this money went to finance investments in commercial operations through the Palestinian Commercial Services Company (see below). But we do not know how much has been used on current expenditures, and the budget data – which assume no such expenditure – could look quite different depending on the extent of such use. By 1998 the reported Palestinian budget showed a surplus on current expenditures and foreign aid was financing virtually all public sector capital expenditures. However, concealed within this statistical picture is a worrying trend of increasing recourse to domestic arrears. And it should also be emphasised that it is the estimated *current* budget that is balanced, and that public investment expenditures are almost entirely financed by aid.

The Palestinians received aid amounting to almost 14% of GNI per annum over the six years, 1994–9 (Table 1). Donor disbursements (excluding to finance UNRWA's current operations) over the five-year period 1994–8 of $2.3 billion exceeded the $2.2 billion pledged for that period at the first donor conference held in 1993. Disbursements in 1999 are estimated at $449 million. Almost 90% of the aid in 1994–9 was provided in the form of grants (see Table 3). The United States (15%) was the largest single donor, with the EU and its member countries together providing 42% of the total. More than half of the aid was for current spending, including technical assistance and job creation, and the rest was devoted to investment projects.[6]

The Palestinian unemployment rate increased after 1993, peaking at 24% in

[6] We define aid for investment as the sum of the items public investment, equipment, and in-kind in the reports from the Ministry of Planning and International Cooperation (MOPIC). This is also the definition used by the Palestine Monetary Authority in the balance of payments.

Table 2

*Fiscal Operations of the Palestinian Authority, 1994–2000*

(In million NIS)

| | 1994 | 1995 | 1996 | 1997 | 1998 | Prel. 1999 | Budget 2000 |
|---|---|---|---|---|---|---|---|
| Revenue[*] | 807 | 1,280 | 2,185 | 2,848 | 3,280 | 4,093 | 4,068 |
| Domestic | ... | 477 | 846 | 1,136 | 1,220 | 1,508 | ... |
| Tax | ... | 326 | 571 | 728 | 852 | 1,037 | ... |
| Nontax | ... | 151 | 274 | 408 | 368 | 472 | ... |
| Revenue clearance | ... | 802 | 1,339 | 1,712 | 2,060 | 2,584 | ... |
| Current expenditure (on a commitment basis) | 895 | 1,482 | 2,647 | 2,994 | 3,188 | 3,902 | 3,968 |
| Wage bill | ... | 916 | 1,286 | 1,622 | 1,774 | 2,147 | 2,371 |
| Nonwage | ... | 584 | 1,204 | 1,352 | 1,412 | 1,732 | 1,597 |
| Foreign financed[†] | ... | ... | 157 | 20 | 2 | 23 | ... |
| Recurrent balance (commitment basis) | −89 | −202 | −463 | −146 | 92 | 191 | 100 |
| PA financed capital expenditure | 0 | 0 | 0 | 0 | 0 | 0 | 100 |
| Recurrent balance plus PA financed capital expenditure (commitment basis) | −89 | −202 | −463 | −146 | 92 | 191 | 0 |
| Change in the stock of arrears | 0 | 0 | 0 | 18 | 288 | 42 | 0 |
| Recurrent balance plus PA financed capital expenditure (cash basis) | −89 | −202 | −463 | −128 | 380 | 233 | 0 |
| Foreign financed capital expenditure[‡] | 364 | 587 | 773 | 905 | 896 | 991 | 1,688 |
| Overall balance (cash basis) | 276 | 385 | −1,235 | −1,003 | −517 | −758 | −1,688 |
| Financing | ... | ... | 1,235 | 1,033 | 517 | 758 | 1,688 |
| Banking system, net[§] | ... | ... | 255 | −183 | 213 | −33 | 0 |
| Foreign financing | 394 | 994 | 1,197 | 1,043 | 907 | 1,014 | 1,688 |
| Net revenue diversion | ... | ... | ... | ... | −329 | −325 | 0 |
| Excise revenues diverted | ... | ... | 437 | 548 | 598 | 616 | 0 |
| Excise revenue transferred back | ... | ... | ... | ... | 269 | 290 | 0 |
| Other non-bank financing | ... | ... | ... | ... | ... | ... | 0 |
| Residual[‖] | ... | ... | ... | ... | −274 | 102 | 0 |

*Continued overleaf*

*Sources*: Ministry of Finance, Ministry of Planning and International Cooperation (MOPIC), Palsetinian Monetary Authority, and IMF staff estimates.
* Includes revenues transferred to accounts outside the control of the Ministry of Finance and profits from the PMA.
† Refers to PA recurrent expenditure directly financed by donors, including for job creation. Preliminary estimates.
‡ Based on MOPIC data and refers to disbursements. Preparations are underway to improve the donor questionnaire to get a better estimate of actual public investment outlays. Using disbursement data adds to the statistical residual.
§ Institutional coverage of monetary accounts is broader than that of the budget.
‖ The residual up to 1999 refers among other things to differences in institutional coverage of the monetary accounts, and bank float. See also footnote 4.

Table 3
*Aid Disbursements to the West Bank and Gaza, 1994–99*
(In million US dollars)

| | 1994* | 1995* | 1996* | 1997* | 1998† | 1999† | 1994–9 |
|---|---|---|---|---|---|---|---|
| Disbursements through the development plan‡ | 484 | 416 | 512 | 513 | 400 | 449 | 2,775 |
| EU (member countries, EC and EIB) | 151 | 187 | 253 | 216 | 158 | 207 | 1,171 |
| Of which: European Commission | 40 | 67 | 73 | 63 | 17 | 22 | 282 |
| USA | 85 | 68 | 64 | 69 | 61 | 80 | 426 |
| Japan | 82 | 59 | 77 | 71 | 72 | 7 | 369 |
| Arab countries and Arab Fund | 104 | 12 | 21 | 44 | 3 | 50 | 235 |
| Other | 62 | 90 | 96 | 114 | 107 | 105 | 574 |
| Grants | 482 | 391 | 489 | 447 | 342 | 341 | 2,494 |
| Loans | 2 | 25 | 22 | 66 | 58 | 108 | 281 |
| Disbursements outside the development plan§ | 127 | 131 | 135 | 141 | 153 | 160 | 847 |
| Total disbursements | 612 | 547 | 647 | 654 | 553 | 609 | 3,622 |
| *Memorandum item*: | | | | | | | |
| Public investment | 66 | 335 | 195 | 275 | 284 | 176 | 1,331 |

*Source*: MOPIC , UNRWA, selected donors, and IMF staff estimates.
* MOPIC report December 1999.
† MOPIC report March 2000.
‡ Includes all disbursements recorded by MOPIC.
§ UNRWA's recurrent budget.

1996, but fell sharply thereafter to 8.8% in June 2000.[7] The turmoil and closures in the fourth quarter of 2000 have led to a dramatic increase in the unemployment rate, possibly to over 30% at the end of the year. Table 4 presents a decomposition of changes in employment and unemployment in 1994–2000, which shows that shifts in employment in Israel were the major factor explaining changes in the unemployment rate. The labour force has grown at the remarkable average annual rate of almost 6%, presenting a challenge that even a growing economy would have had difficulty accommodating. The pressure in the labour market stemming from this labour force growth was compounded by a sharp reduction in the number of Palestinian workers in Israel and the settlements from about 116,000 (roughly one third of the labour force) in 1992 to about 55,000 (11% of the labour force) in 1996.[8]

The decline in unemployment from its peak in early 1996 to its low in the second quarter in 2000 reflects mainly the recovery in employment in Israel and settlements to about 130,000, but also growth in employment in the local Palestinian private sector and continued expansion in public sector employment. Public sector employment increased from 31,140 in 1994 to around 110,000 in mid-2000. The initial expansion in public employment was to some extent justified on the grounds that the PA, as it took over responsibilities from the Israeli Civil Administration, expanded the range of public services and that it took over responsibilities for some services previously provided by NGOs, and civil security in certain areas. The increase after 1996, however, cannot be justified on these grounds, and the excessive expansion represents one of the main fiscal problems for the PA. Also, despite the positive developments in the last three years (until the turmoil and closures), for the period as a whole, the local private sector only generated job growth at a rate of around 2% per year on average.

Private consumption per capita over the period reflects the evolution of unemployment, with sharp compressions in 1995–6 and a strong recovery in 1998–9. The data show a rather high, but essentially stagnant, level of private investment over the period, as a percentage of GDP. Private investment is heavily dominated by construction, primarily reflecting the rehabilitation and expansion of the housing stock. The demand for housing is fuelled by the rapid population growth, including the large inflow of returnees in 1994–5. There is no evidence of real growth in private investment outside of construction in 1994–7, but indications are that it probably increased in 1998 and 1999. Public investment increased from about 6% of GDP in 1993 and 1994 to approximately 9% in 1995, contributing to an important — and highly visible on the ground — improvement in physical infrastructure. Public investment has since declined as a percentage of GDP to around 5% in 1999. No data are available for 2000.

[7] The dependency ratio, at 6–7, is exceptionally high, a reflection of both an extremely young population and low female participation. In addition, wage earnings are the main source of income for many. Accordingly, changes in the unemployment rate are likely to have more of an impact on well-being than in most countries.

[8] The data on employment in Israel and settlements includes Palestinians working in Israeli industrial zones.

Table 4
*Palestinian Labour Force, 1994–2000*
(Annual average)

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000* |
|---|---|---|---|---|---|---|---|
| | (In thousands) | | | | | | |
| Population | 2,218 | 2,348 | 2,461 | 2,560 | 2,658 | 2,758 | 2,848 |
| Labour force | 464 | 485 | 522 | 554 | 576 | 599 | 642 |
| Unemployment | 70 | 88 | 124 | 114 | 76 | 71 | 56 |
| Employment | 394 | 397 | 398 | 439 | 500 | 529 | 585 |
| In West Bank and Gaza | 323 | 333 | 342 | 364 | 392 | 406 | 455 |
| Of which: PA | 31 | 52 | 70 | 81 | 91 | 100 | 110 |
| Of which: other | 292 | 281 | 272 | 283 | 301 | 307 | 345 |
| In Israel and its settlements | 71 | 64 | 56 | 75 | 108 | 122 | 130 |
| | (Annual percentage change) | | | | | | |
| Population | 6.1 | 5.9 | 4.8 | 4.0 | 3.8 | 3.8 | 3.8 |
| Labour force | 7.8 | 4.6 | 7.5 | 6.1 | 4.1 | 4.0 | 5.5 |
| Unemployment | 141.4 | 26.2 | 40.6 | −8.0 | −33.5 | −7.0 | −21.3 |
| Employment | −1.8 | 0.7 | 0.1 | 10.5 | 13.8 | 5.7 | 9.1 |
| In West Bank and Gaza | 9.6 | 3.0 | 2.6 | 6.6 | 7.6 | 3.8 | 9.2 |
| Of which: PA | 10.0 | 66.2 | 34.3 | 16.4 | 11.9 | 10.0 | 13.8 |
| Of which: other | 9.5 | −3.8 | −3.2 | 4.1 | 6.3 | 1.9 | 7.9 |
| In Israel and its settlements | −33.4 | −9.6 | −12.8 | 34.0 | 44.3 | 12.7 | 8.6 |
| | (Composition of labour force growth)† | | | | | | |
| Labour force | 7.8 | 4.6 | 7.5 | 6.1 | 4.1 | 4.0 | 5.5 |
| Unemployment | 9.5 | 4.0 | 7.4 | −1.9 | −6.9 | −0.9 | −2.5 |
| Employment | −1.7 | 0.6 | 0.1 | 8.0 | 11.0 | 5.0 | 8.0 |
| In West Bank and Gaza | 6.5 | 2.1 | 1.8 | 4.3 | 5.0 | 2.6 | 6.3 |
| Of which: PA | ... | 4.4 | 3.7 | 2.2 | 1.7 | 1.6 | 2.2 |
| Of which: other | ... | −2.4 | −1.8 | 2.1 | 3.2 | 1.0 | 4.1 |
| In Israel and its settlements | −8.3 | −1.5 | −1.7 | 3.7 | 6.0 | 2.4 | 1.7 |

*Sources*: IMF staff estimates based on data from the PCBS and ICBS.
* As of June 2000.
† Change in employment and unemployment relative to the previous year's labour force, in percent.

Balance of payments data are especially poor, as it is inherently difficult to monitor the movement of goods between the West Bank and Israel, and we note them here mainly for completeness. The available data indicate that net exports made a negative contribution to growth during this period: while exports grew fast, imports grew by more. The tourism sector, often seen as an important future source of income, has expanded significantly in recent years in terms of number of guest nights, thanks to a significant increase in the number of hotels and, in 1999, due to millennium celebrations in Bethlehem. The trade deficit was financed by substantial inflows of foreign aid, capital inflows from Palestinians living outside the West Bank and Gaza, and, more recently, a recovery in labour income from Israel.

## 2. Why Was the Outcome Worse Than Expected?

The optimistic scenario of seven years ago was based on the demanding but not impossible set of assumptions specified in the introduction. Although some of those conditions were met, some of the most important were not. We take up in turn: foreign aid; intensified restrictions on economic activity and trade (including through closures) in the West Bank and Gaza; slow progress in institution building and improving governance; and weaknesses in the Interim Agreement as well as the lack of implementation of some of its aspects.

### 2.1. *Foreign Aid Has Been Substantial*

Support from the donor community has been generous, greater than initially expected. In 1994–9, total aid disbursements amounted to about $2.8 billion or almost $200 per capita per year, making the West Bank and Gaza one of the largest recipients of aid in the world on a per capita basis (together with Israel and Jordan). While in the initial years a large share of donor disbursements went to cover the deficit on the PA's recurrent budget, and to finance technical assistance and other current expenditures, investment support took off in earnest in 1995. Total disbursements for investment projects amounted to about $1.3 billion in 1994–9, as the need to finance current expenditures diminished and the PA's capacity to implement investment projects grew. Although disbursements for investment declined in 1999, the aid effort for the six-year period as a whole has been formidable and it is certainly not responsible for the disappointing growth performance.

### 2.2. *Intensified Restrictions, Closures, and Loss of Labour Income From Israel*

By contrast, the assumptions on the freedom of trade in goods and services between the Palestinian economy and Israel, and with Jordan, turned out not to be valid; indeed the Palestinian economy has not only suffered from lack of adequate access to world markets, but also, and probably more importantly, from restrictions on the movement of goods and people between the West Bank and the Gaza Strip and at times even among cities and villages in the West Bank. This negative environment has been the result of the permits system and the intensification of controls, including periods of closure which Israel has imposed often in response to security incidents or at times when the risk of security incidents was perceived to be high.[9]

The most important impact of the intensification of restrictions since 1993 has been the reduction in the number of Palestinians allowed to work in Israel. Fischer *et al.* (1994) argued that continued large labour flows from the West Bank and Gaza to Israel would be essential in the early stages of Palestinian economic development, for it would take time and investment for the demand for labour in the Palestinian economy to grow. However, as the political situation deteriorated in 1995–6 and the number of permits issued fell and

[9] Palestinians need to apply for permits to enter Israel, including to travel between the Gaza Strip and the West Bank. Palestinians who commute daily to work in Israel or the settlements need work permits. The permits system has been strictly enforced since 1993; before the Gulf War, movement between the West Bank and the Gaza Strip was much less restricted; by now the two areas are virtually separated.

closures increased, the employment of Palestinians in Israel and the settlements declined sharply, and the Palestinian economy entered a deep recession. Conversely, the recovery in 1997–9 was associated with an increase in the number of permits issued and a reduction in closures (especially in 1998).[10] The turmoil and closures that began in late September 2000 have again caused a collapse of the Palestinian economy.

The intensification of restrictions has led to excessive transportation and transaction costs, and closures have also added high volatility and unpredictability in production and trade. The resulting fragmentation of the Palestinian economy contributed to the dominance of very small businesses, and, in many instances, has forced firms to duplicate functions in Gaza and the West Bank. By increasing risk, it has also tended to reduce investment in new technologies and activities.[11]

Closures have exerted both a direct and an indirect effect on Palestinian income, in the first instance reducing labour income and disrupting trade flows, investment, and domestic production, but also having multiplier effects. To illustrate the effect from the loss of labour income alone, roughly 120,000 Palestinians worked in Israel and the settlements in 1999 and earned a daily net wage of around NIS 107 (about $25). Labour income from Israel would be about $750 million (assuming 20 working days per month), or about 18% of GDP. The first order effect from the loss of labour income due to a ten-day closure would thus be about $30 million, or about 0.7% of GDP. To this should be added the costs from disruptions to trade, investment, and production, and the multiplier effects on GDP.

According to UNSCO, closures were in effect 17 days in 1993, 64 days in 1994, 84 in 1995, 90 in 1996, 57 in 1997, 14 in 1998, and 7 in 1999.[12] Before the recent crisis, the number of closure days was expected to be roughly the same in 2000 as in 1999, but in the event, the West Bank and Gaza was subject to a comprehensive closure during most of the fourth quarter. Overall economic developments mirror the pattern of closures, with the economy experiencing a deep recession in 1995 and 1996 when the incidence of closures was most intense, and again in late 2000. The economic recovery in 1997–8 was associated with a decline in the number of days with closures.

Table 5 presents an illustrative calculation of the direct and indirect impact on GDP from the variations in labour income, assuming a multiplier of 1.2 (since the economy is very open, the multiplier is unlikely to be large). Labour income, as defined here, is almost entirely the wage earnings from Palestinians commuting to Israel and the settlements for work, and in this period fluctuations in these earnings reflect the incidences of closures. The direct and

[10] It is important to note that the permits system has different effects from those of closures. The permit system raises transactions costs of doing business significantly and thereby reduces the level of economic activity and probably also hampers growth; while closures for a time stop all movement of people and goods between Israel and the two regions as well as between the West Bank and the Gaza Strip. This not only has direct costs, but also increases uncertainty.

[11] See the chapter by Kanaan in Barnett *et al.* (1998) for an extensive discussion of the effect of uncertainty on investment in the West Bank and Gaza.

[12] Information on closures was obtained electronically from UNSCO in Gaza.

Table 5

*Illustration of the Impact of Changes in Labour Income on GDP Growth*

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|
| Real GDP growth, percent | 8.5 | −2.4 | −3.2 | 4.8 | 7.0 | 6.0 |
| Labour income from Israel (US$ millions) | 439 | 407 | 346 | 480 | 677 | 748 |
| Change in labour income (US$ millions) | −273 | −31 | −62 | 134 | 197 | 70 |
| Multiplier | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 |
| Effect from change in labour income, in percent of GDP | −9.7 | −1.0 | −2.0 | 4.2 | 6.0 | 2.0 |

*Source*: IMF staff estimates based on data from the PCBS.
*Note*: Labour income as defined here (balance of payments definition) refers to wage income earned by Palestinians commuting to Israel and settlements for work. It does not include transfers received from Palestinians living abroad.

indirect effects from the loss of labour income (due to closures) go some distance towards explaining the difference between the predicted and actual levels of output in 1994–9, but it is clear that other factors must have played an important role as well. Note that this calculation is based only on the effects from the loss in labour income, and does not capture any direct and indirect effects from the disruptions to trade and production due to closures, which would certainly amplify the impact.[13] In late 2000, in addition to closures, the Palestinian economy was affected by the turmoil more generally which disrupted economic activity in major commercial centers like Hebron, Nablus and Ramallah.

### 2.3. *Slow Progress in Institution Building*

A major achievement of the last seven years has been the development of a basic Palestinian institutional framework, with the creation of policy institutions such as the Ministries of Finance, Economy and Trade, and Planning and International Cooperation, and the Palestine Monetary Authority (PMA), the adoption of a range of laws and regulations, including the Organic Budget Law and the PMA Law, and with other laws in the final stages of preparation.[14] While good progress has been registered in some important areas, particularly fiscal revenue collection[15] and in the provision of banking services, institution

[13] In addition, the latter effects are non-linear, increasing with the duration of the closure, since longer closures lead to permanent loss of perishable export products and are more likely to lead to loss of export orders for manufacturers.

[14] For a general discussion of the importance of institutions, see North (1991) and Bates (1996), and for estimates of their importance for growth in other countries, see Barro (1991), Barro and Sala-i-Martin (1995), and Knack and Keefer (1995).

[15] It should be noted that revenue transfers from Israel accounted for 63% of the fiscal revenues of the PA in 1999.

building has lagged in others, including expenditure management, governance, and legal and regulatory reform.

The Palestinian Ministry of Finance has been successful in increasing tax revenue collection. Revenue from the clearance system with Israel still accounts for over 60% of PA revenue, but domestically collected revenue has increased from approximately 4% of GDP in 1995 to 9% of GDP in 1999. The strong revenue growth allowed the PA in early 1999 to reduce the corporate income tax to a flat 20%, an important step toward improving the business environment. At the same time, the PA reduced the tax rates and the number of income tax brackets of personal income tax to four (5%, 10%, 15%, and 20%). Expenditure management remains a serious problem, however, with actual expenditure allocations only weakly reflecting the priorities of the PA. All areas of budget preparation, monitoring and execution need significant strengthening. A particular concern is the seemingly uncontrolled expansion of PA employment in recent years which is crowding out needed expenditure in the areas of education, health and investment. Also, as mentioned, large amounts of excise revenue did not go to the Ministry of Finance in the period 1994–9 although the budgets were prepared and approved on the assumption that it would. The ensuing liquidity problems for the Ministry of Finance contributed to a significant accumulation of budgetary arrears in 1998 and 1999 at the same time as it exhausted its credit lines with domestic banks.

The PMA was set up in 1994, after the signing of the economic protocol. It does not, at this time, issue its own currency and, in the absence of scope for an independent monetary policy, has concentrated on the development of a Palestinian banking sector, with the establishment of a regulatory framework to promote an efficient and sound banking system. The number of banks operating in the West Bank and Gaza increased from two at the end of 1993 to 23 in mid-2000, and the number of branches from 13 to 114. Private sector deposits have increased from an insignificant level to $3.5 billion (equal to 60% of gross national income) in September 2000. This has allowed banks to increase lending—mainly short-term—to the local economy with credit growth averaging almost 40% a year in real terms since 1995 (the period for which PMA data are available). This is a vigorous pace by any standard, probably as fast as could have been achieved without undue risk to the quality of bank loan portfolios.

The question arises as to whether developments in the past six years might have been more favourable had the West Bank and Gaza had its own currency. The answer is most likely no. Certainly there is no evidence that the lack of a Palestinian currency has constrained growth in bank deposits or credit. Rather, the current arrangement with three convertible currencies, the shekel, the Jordanian dinar, and the dollar, circulating freely has worked reasonably well. It has provided an open exchange regime, crucial for a small economy which relies on trade and transfers of money from abroad. In the context of nascent policy institutions (including the PMA), a fledgling banking supervisory system, and continued weak fiscal expenditure management, it would have been extremely difficult to establish a sufficient degree of credibility in the stability of a new currency to persuade people to switch from the shekel, the JD and the dollar. When a new currency is introduced, it should be done in a way and at a time that assure confidence, and since the current arrangement is working reasonably well and a critical mass of requisite institution-building is yet to be secured, there is little economic justification to press for rapid movement on this front.[16]

### 2.4. *Private Sector Development and Economic Governance*

During the period 1994–9, the PA sent mixed signals about its resolve to establish a market economy with a level playing field and strong protection of property rights: several public monopolies are in effect; the government is still closely involved in commercial operations in an (until recently) non-transparent manner; as mentioned not all revenue (also until recently) was accounted for in the budget; and regulations remain cumbersome and obscure. Excessive red tape, bureaucratic inefficiency, and the perception of poor governance and financial mismanagement are likely to have deterred investors, domestic as well as foreign, during this period. Significant delays have also occurred in establishing a transparent and independent legal and regulatory system.[17]

*These are critical issues, which if not dealt with urgently, will inflict serious damage on the medium- and long-term development of the Palestinian economy.* In the spring of 2000, the PA dealt with two of these issues. In April it consolidated all tax revenue under the Ministry of Finance, and in June it made public key information from the external audit of the Palestinian Commercial Services Company, including a list of equity holdings. The authorities are now working on a comprehensive privatisation plan and on the elaboration of operational guidelines to ensure that the management of public assets conforms with international best practices. These are all very important actions that will help allay concerns over governance. The authorities are also working on a broad array of laws, including the Banking Law, Industrial Estates Law, and Competition Law, that should eventually improve the regulatory environment, but the limited capacity to prepare and process these laws, as well as the slow ratification process, has slowed down reforms. Needless to say, it will take more than laws to change the business climate in the required way.

These weaknesses have, in addition to the impact of closures and other impediments to trade, affected the investment climate in the period under review. Despite the robust growth in bank credit, there has been only very limited growth in long-term credit that could be associated with fixed invest-

[16] The most suitable monetary arrangement is likely to be a currency board. That is in all but two respects similar to the current situation: first, the PMA would obtain seigniorage in a currency board arrangement; and second, it would be necessary to decide to what currency to peg. As a technical matter, it is possible to imagine a currency board peg to a basket of currencies, but the arrangement then would lose the essential simplicity that is one of its main virtues.

[17] The report *Strengthening Palestinian Public Institutions* prepared by an Independent Task Force sponsored by the Council of Foreign Relations provides a description of governance issues in the West Bank and Gaza (Sayigh and Shikaki, 1999).

ment; the bulk of banks' claims on the private sector are in the form of overdrafts or very short term credits (up to six months), particularly trade credits. The slow growth in long-term credit to the private sector can to a large extent be attributed to the unfavourable climate for investment, with excessive uncertainty and transactions costs. Without effective protection of property rights both banks and investors are reluctant to undertake long-term commitments. In particular, the lack of a system for collateralisation of movable and fixed assets and the absence of clear land titles reduce banks' willingness to supply long-term credit. For banks and investors in general it is less risky to engage in short-term commercial transactions, which are largely reversible, than in transactions relating to long-term investment projects which are largely irreversible.[18]

### 2.5. *Shortcomings of the Interim Agreement and Delays in its Implementation*

Despite its promising preamble, the Interim Agreement is deficient in ways that may not have been fully appreciated initially. Especially on trade matters, it leaves many issues open to interpretation and negotiation.[19] This put the PA at a disadvantage, given the virtually total dependency of the West Bank and Gaza on the much larger Israeli economy, and the asymmetry between the two parties, with Israel having the means to impose sanctions or withhold tax revenue.

Nonetheless, the main problem lies not in the design of the Interim Agreement, but in its implementation. The general difficulties of movement among the West Bank, Gaza and Israel, and the frequent restrictions—often imposed for security reasons—on the movement of goods and people between the West Bank and the Gaza Strip have prevented the Palestinian economy from exploiting fully the benefits from open access to the Israeli market. These interruptions, whatever their cause, reduced the reliability of exports, thereby undermining export growth. In addition, trade and trade diversification have suffered from the lack of basic infrastructure, most notably access to an airport and seaport. The opening of the Gaza International Airport in late 1998 should help facilitate trade and business activities in Gaza once it operates like a regular airport.[20] The delay in opening the seaport, mentioned in the Interim Agreement, which is probably more important for trade than the airport, has likewise hampered growth, as has the absence of free passage between Gaza and the West Bank.

[18] See Bates (1996) for a more general discussion of this issue.

[19] Under the Interim Agreement, the West Bank and Gaza is in a de facto customs union with Israel (the quantitative restrictions that applied to a few agricultural commodities were lifted in 1998) and the West Bank and Gaza had, with some exceptions (lists A1, A2, and B), to adopt Israel's trade regime. It has been argued that Israel's standards and sanitary and health regulations, which apply to the West Bank and Gaza, in effect constitute nontariff trade barriers.

[20] The Gaza Airport operates under tight restrictions and it cannot yet operate cargo flights.

## 3. Looking Ahead

In sum, both external and internal factors have contributed to the disappointing economic performance of the Palestinian economy in the last five years. On the external side, the problem has not been a shortfall of aid, the amounts of which have exceeded initial expectations. Rather, the main problem has been restrictions on trade and the movement of people, the poor access of the economy to potential trading partners, and frequent closures, generally for security reasons. Although the regime of closures depressed profitability in all sectors (and hence private investment and growth), trade, which should have acted as an engine for growth, was the most directly affected—notwithstanding which there seems to have been a remarkable increase in exports. The effects of these adverse external factors have been exacerbated by the weak institutional environment in the West Bank and Gaza, including a lack of transparency.

However, we should not overstate the disappointments. The PA, through its own efforts and with generous external assistance, has made real progress since its creation: in establishing a functioning economic administration; in improving the collection of taxes; in improving its ability to implement public investment projects; and in developing the physical and, perhaps more importantly, institutional infrastructure of the economy, including on the legal and regulatory side.

For the immediate future, the key priority is to restore growth in the Palestinian economy and to recover the loss in output and income stemming from the recent turmoil and closures. To this end, it is crucial that Palestinian workers be allowed to return to their jobs in Israel (very similar to the recommendation made back in 1993 and mentioned in the Introduction) and that trade flows be allowed to flow without disruption. For the medium-term, *the essential economic challenge is to produce growth in per capita income and reduce unemployment, in the context of a rapidly growing labour force.* Because of the changing age composition of the population, the labour force is expected to grow at about 4% per year over the medium-term, assuming no net migration. While a return of Palestinian employment in Israel is crucial in order for the Palestinian economy to recover and for unemployment to come down, it is doubtful that Palestinian employment in Israel will expand much beyond the level recorded before the crisis when roughly 130,000 Palestinians commuted daily to work in Israel and the settlements. Thus, the expansion in the labour force over the medium-term will have to be met mainly by job creation in the West Bank and Gaza. Furthermore, the Palestinian public sector is close to overextending itself and indeed a key policy priority for the coming years is to rein in the rapid expansion in public sector employment.

Accordingly, employment in the private sector in the West Bank and Gaza would have to grow by about 7% per year just to absorb the inflow of new workers, let alone to reduce the rate of unemployment. This compares with estimated job growth in the private sector of less than 2% per year on average in 1994–9.

Higher employment growth will require both more investment and more output growth in the Palestinian economy. Labour force growth can itself contribute to growth, provided labour markets are sufficiently flexible, and provided the climate for investment is right. Other regions that have experienced similar demographic developments have often been able to absorb the increase in the labour supply at higher levels of productivity and without an increase in unemployment.[21]

Empirical studies have found the following four factors to be important for medium- and long-run growth: (i) rule of law, governance, and quality of institutions; (ii) fiscal policy; (iii) openness to trade; and (iv) infrastructure investment. These factors are far more important for growth than, say, the shortage of natural resource endowments,[22] and recent performance in each area has already been discussed. Future performance on these dimensions—the first two of them largely under the control of the PA, the other two requiring cooperation from Israel[23] and the donors—will determine how successfully the Palestinian economic challenge will be met.

Although these factors typically tend to affect investment and growth mainly over the longer run, they are sufficiently important—particularly free trade in goods and free movement of people—that they will also affect the short- and medium-term growth outlook. Of course, many other factors, including economic growth in Israel and other export markets could affect short-term growth performance.

### 3.1. *Rule of Law, Governance and Institutions*

We have already indicated that developments in this area are at a critical juncture. Of particular concern are: (i) the operations of the PA itself; and (ii) the legal and regulatory environment.

- The rapid expansion of the PA and its involvement in the economy, including through monopoly companies, create uncertainty about its resolve to build an economy in which the private sector can flourish in fair competition. The PA has recently taken important steps to make its own financial operations more transparent, including by bringing all tax revenues under the control of the Ministry of Finance and by having its commercial operations audited and the results from this audit made public. These actions are an important contribution to improving the perceptions of governance in the PA.

[21] Bloom and Williamson (1999) argue that in East Asia, a similar rise in the share of the population at working age is estimated to have contributed about 1.5–1.9 percentage points to annual per capita income growth in 1965–90. See also Ben-Porath (1986) for the Israeli case, where high rates of immigration and labour force growth have been associated with higher rates of economic growth.

[22] See, eg, Barro (1991), Barro and Sala-i-Martin (1995), and Fischer (1993). Also, a common finding is that countries with large resource endowments in fact tend to grow slower than those without natural resources (eg, Barro and Sala-i-Martin (1995)). The healthy long-run performance of the Israeli economy presents further evidence that the absence of natural resources is not a critical constraint.

[23] The need for a better economic agreement with Israel will be one of the key issues in the final status negotiations.

It will be important for the PA to build on this progress and deal with issues such as financial mismanagement and the perception of corruption, to avoid an erosion of trust in policy makers and in the credibility of policies, which would be bound to have negative effects on the growth of the economy. To this end, it will be important to strengthen the capacity and policy independence of key policy institutions such as the Ministry of Finance.

- It is also urgent to speed up the establishment of a legal and regulatory framework supportive of private sector led growth. Laws, once prepared, need to be adopted more quickly; once approved, they should be implemented forcefully, to ensure a fair and level playing field in the economy, protect property rights, and encourage competition. To this end, it is critical to strengthen the judiciary system and its independence.

### 3.2. *Fiscal Policy*

Concentration on the recurrent budget tends to obscure the fact that the donors are at present financing all Palestinian public investments, of about 5% of GDP in 1999.[24] Even under the most optimistic circumstances, foreign assistance will not cover all required investment in infrastructure in the West Bank and Gaza over the coming years. So far most assistance has been in the form of grants, but given the relatively high per capita income level of the West Bank and Gaza, aid is likely to shift gradually away from grants toward loans. Furthermore, a surplus on the recurrent budget[25] even beyond that required to contribute to investment is needed given the large implicit liabilities that have accumulated in the pension system, and the many social services that today are provided by NGOs and the UNRWA but which the PA may have to take over in the near future.[26]

In order to ensure a surplus on the recurrent budget, the PA would have to maintain the strong revenue performance in recent years by consolidating the improvements in tax administration. The ratio of fiscal revenue to GDP (at around 22%) compares well with countries at a similar level of development, and a further increase could risk discouraging private investment. The emphasis should thus be on containing the level of current expenditure (consumption) which is already high and growing fast.[27]

[24] This includes investments undertaken by UNRWA.

[25] Empirical studies have found that government saving (the surplus on the current budget) is positively and significantly related to growth through its effect on raising national saving and investment (e.g., Barro and Sala-i-Martin (1995), Fischer (1993) and Sachs and Warner (1997)). Fischer (1993) estimated that a 1% GDP improvement on the budget balance, raises annual per capita output growth by about a quarter of a percent.

[26] For example, the PA is operating only about three quarters of the schools, and provides about 60% of hospital beds, with the rest provided by NGOs, the private sector or UNRWA.

[27] Some empirical studies have found that for a given level of per capita income, a higher level of government consumption can be harmful to economic growth, unless it is on education in which case it can be positive for growth. For example, Barro and Sala-i-Martin (1995) found that government consumption (on non-education) has a negative impact on growth.

It will also be important to make the composition of expenditure more conducive to economic growth. Rapid population growth will continue to create demands for more spending on education, health, and social assistance over the medium-term, and it is important that the budgets allow for increased real outlays in these areas. To these ends, it is critical that the PA arrest the expansion in public sector employment, which now exceeds what can reasonably be justified on the grounds that the PA has assumed new responsibilities. Public sector employment in the West Bank and Gaza is high compared with other countries in the region, especially given that many basic governmental services are provided by donor financed NGOs in the West Bank and Gaza. Curbing and possibly reversing public sector employment growth is crucial for fiscal sustainability.

### 3.3. *Free Flow of Goods and People Within the West Bank and Gaza and Free Trade with the Rest of the World*

Openness is critical for the development of a small economy like that of the West Bank and Gaza—and in the Palestinian case, it may be even more critical, for the economy has long operated under severe constraints on its trade.[28] For the future, the West Bank and Gaza would benefit most from a liberal and nondiscriminatory trade regime. It will also be crucial to keep trade access as open as possible with Israel, the largest economy in the region and the country in the region with which the scope of trade for the West Bank and Gaza seems greatest. The final status discussions focus on replacing the current customs union with a free trade arrangement, and this should help ensure continued close economic integration, but it will be important to minimise the additional transactions costs caused by the establishment of a customs border between the two economies. Also, whatever future trade arrangement is chosen, it will be important to find a way to prevent trade flows remaining hostage to changes in the security situation. To stimulate trade diversification, the establishment of a sea port in Gaza is crucial. Free passage between the West Bank and Gaza would also contribute significantly to growth. It is also striking how little trade has developed between Jordan and the West Bank and Gaza.

### 3.4. *Public Investment*

Although the infrastructure in Gaza and also the West Bank has improved greatly since 1993, there is scope for further progress. While a large part of future infrastructure investment is likely to be mostly financed by donors, the PA should encourage participation by the private sector, if not in financing at least in implementation of the projects. There remains a need for the PA to improve the institutional framework for infrastructure investment, in particu-

[28] Sachs and Warner (1997) list openness to trade as *the single most important* factor in explaining differences in growth rates across countries.

lar to improve coordination among the various agencies and ministries with overlapping jurisdictions in this area.

## 4. Concluding Remarks

While economic growth in the West Bank and Gaza has disappointed the expectations of seven years ago, and has not kept pace with population growth, a great deal has been achieved—most notably the establishment of a functioning economic administration, and significant improvement in the physical infrastructure supported by substantial inflows of foreign aid. However, private investment has so far failed to serve as the engine of growth: it has been discouraged by uncertainties about political developments and the direction of policies and policy reforms, by problems of governance, by closures, and by the excessive transportation and transaction costs related to the intensification of the permits system.

Good institutions and policies, together with a significant reduction in restrictions on internal and external trade, are key factors for growth. Their implementation will take time and effort, and depend on ongoing political negotiations and developments. But enough has been achieved to suggest that more rapid and sustainable growth is within reach for the Palestinian economy, provided the right policies, including full transparency of fiscal, financial, trade, and industrial policies, and the right institutional framework for the domestic economy and its international setting are established.

*International Monetary Fund*

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