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The Palestinian Economy

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Over the last year the improvement in economic conditions in the West Bank, alongside the deteriorating situation in the Gaza region, has received increasing media attention. The difference between the economic situations in these regions reflects the fact that the Palestinian areas of the West Bank are controlled by the Palestinian Authority (PA) while Gaza is controlled by Hamas. In the West Bank there is a government headed by the reformist Prime Minister Salam Fayyad, and the PA continues to receive Western economic aid. In addition, the security situation has improved greatly: there is active US involvement in training Palestinian security forces as well as cooperation between those forces and Israel, which as a result of the improved security has lifted many of the barriers and other restrictions on mobility in the West Bank. In contrast, Gaza is subject to a blockade: there is no free movement over its borders and imports are tightly restricted. Little of the damage sustained in the December 2008-January 2009 war has been repaired. Egypt's construction of an underground wall along its border with Gaza threatens the smuggling operations not only of weapons but also of goods with economic value. As a result, two Palestinian economies have emerged under competing leaderships.

What has Prime Minister Fayyad done in the economic sphere to earn international praise? First he has declared his intention to create a competent and capable public sector that will work with the private sector. The public sector, according to his vision, will provide high quality services and value for money and the private sector will be encouraged to undertake initiatives. Second, Fayyad has placed all public investments under the oversight of the Ministry of Finance. Third, the budgetary system has been reformed so that there are links between planning and budgeting, with greater transparency on the activities being financed. A computerized accounting system is

being introduced for ministries in order to improve audit and control of spending. In addition, internal audit functions are being developed and a government Audit and Administrative Control Bureau is being created. International accounting standards are also being adopted. A strict government employment policy has been followed, wage rates have been virtually frozen, and measures have been implemented to improve the payment of utility bills. All this will enable the PA administration to work effectively with the private sector, in strong contrast with the past. Fayyad's overall aim is to create an economy that no longer relies on the export of labor to Israel.

The West Bank economy is growing and for the first time in years, it experienced positive real growth, estimated at seven percent in 2009. This meant that income per capita also rose. This should be placed in the context of an economy recovering from years of protracted conflict during which per capita GDP fell by nearly a third since 1999.

According to estimates by the Palestinian Central Bureau of Statistics (PCBS), in the early part of 2009 (the most recent period for which there are detailed figures) most of the growth took place in two sectors: real estate, renting, and business services; and community, social, and personal services, both of which grew by more than 24 percent. Public administration grew by nearly nine percent and construction by over 10 percent. Meanwhile, mining and manufacturing grew by only two percent and agriculture fell by more than 17 percent. This suggests that higher output was based on donor-funded sectors such as health, education, and public administration rather than private investment in productive sectors such as manufacturing, agriculture, and tourism. However, growth in donor-related public sector activity may be the prelude or precondition for that in the private sector: that is certainly Fayyad's intention.

Since growth appears to be driven more by the enormous inflows of donor assistance than by improvements in investor confidence, there is a danger that it will not be sustained. In 2008, foreign aid to the PA rose by nearly 80 percent from the 2007 level, reaching almost \$1.8 billion, equal to 30 percent of GDP. In the first eight months of 2009, donor funding for the recurrent expenses of the PA was over \$950 million and was likely to have exceeded \$1.1 billion for the year as a whole. The PA has used these funds to pay salaries, cover operating costs, and help provide compensation to families that have suffered from last year's Israeli military operation in

Gaza. This large amount of aid has increased consumption and stimulated economic growth. The 2009 budget called for about \$535 million in development and but actual allocations have been reported at only around \$120 million for the first six months of the year. There are no published estimates of private investment.

Unemployment in the West Bank fell from 20 percent in the first quarter of 2009 to 16 percent in the second quarter. The labor force participation rate in the West Bank rose by one percent. Unpaid family labor increased in the second quarter, rising from 8.6 to 10.8 percent of the West Bank work force, again probably reflecting seasonal agricultural employment. The share of underemployed workers continued to fall. Notwithstanding these improvements, high unemployment, particularly amongst the younger segments of the population, remains perhaps the biggest challenge for the PA. Finally, adding discouraged workers to those officially listed as unemployed increases the unemployment rate to 21 percent.

Israel has eased the flow of Palestinian traffic between major West Bank cities, and the reduction of time required for Palestinians to gain access to these cities. Since April 2008, it has removed 147 roadblocks and checkpoints; approved agricultural vehicle movement in the Jordan Valley; allowed access to seven West Bank cities by Arab citizens of Israel; provided 5,000 overnight permits for Palestinians working in Israel; and extended the operating hours of the Allenby Bridge crossing between the West Bank and Jordan. This is part of Israel's policy of encouraging economic development in the West Bank.

However the expansion of alternative roads is a major burden for the Palestinians in terms of land loss and the fragmentation of West Bank territory. These roads reconnect Palestinian communities that were disconnected due to the restricted access of Palestinians to a main road, or due to the obstruction of a road by Israel's separation barrier blocking free movement between the West Bank and Israel. They emphasize the exclusion of Palestinians from the primary road network and thus undermine the West Bank's territorial contiguity. The paving of these roads entails the expropriation of private and publicly-owned land, thus further shrinking the space available for Palestinian development. In addition, as of Autumn 2009, there were still 613 Israeli roadblocks within the West Bank obstructing the movement of Palestinians, including

limiting access to East Jerusalem.

While the PA and the Israeli government are pursuing parallel strategies designed to improve the economy, their aims are different. In September 2009, the PA issued a document calling for economic independence (from Israel) in order to attain independence within two years. The Netanyahu government sees economic improvements as a prelude to peace talks and hopes that they will reduce the pressure for political change. Currently, it is negotiating with the Obama Administration to try and prevent the US from setting a two-year limit on those talks, which the US seeks to restart forthwith.

Fayyad's measures are based on two profound changes in the Palestinian political economy. The first is the attempt to create a clean administration that will encourage the private sector, in strong contrast to the Arafat legacy of corruption and complete dependence of the private sector on connections in the governmental administration. The second is the revision in the philosophy behind the Paris economic accords that accompanied the Oslo agreements. The Paris accords were designed to guarantee Palestinian access to Israeli labor markets. Hamas terrorism effectively destroyed that agreement and the new policy is designed to provide employment in the Palestinian territories. This is also a challenge to Israel: with a functioning economy and an end to terrorism in the West Bank, many countries are likely to recognize an independent Palestinian state even if it has not negotiated a peace agreement with Israel. This could lead to elements of de facto independence.

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