

## Reforming the Economic Policies in Palestine: Towards Equitable and Sustainable Growth

### A Research Paper

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**Presented on behalf of the Palestinian General Federation of Trade Unions at  
the Global Labor University Conference 2014 “Inequality within and among  
Nations: Causes, Effects, and Responses” in 15-17 May, Berlin, Germany**

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## Abstract

The Palestinian economy is still fragile and it endures structural distortions and gaps, leaving it vulnerable to shocks. Second, the Palestinian economy is substantially fragmented and isolated from the global markets; while it is highly exposed to Israel and international aid.

These impediments necessitate a reconsideration of the Palestinian economic model, together with the resulting policies. To reinvigorate the economy, policy-maker should consider policies that rectify the trajectory of the economy wherever possible, of course within the volatile surrounding political developments. Perhaps, the policies taken by the successive Palestinian governments have created, and sometimes perpetuated, the gaps and structural distortions in the Palestinian economy. These policies could neither alleviate the burdens nor distribute them equitably. They did not also help the public sector, the private sector and individuals in the face of successive crises, and they did not expand their economic choices.

This paper seeks to:

1. Diagnose holistically and systematically the major imbalances and distortions in the Palestinian economy and their repercussions on the living standards of the Palestinians and the state of social justice in Palestine. In this sense, the paper provides a description and analysis of the features of the economic and social policies pursued by the successive Palestinian governments, and the role of these policies in actuating the course of the performance of the national economy.
2. Develop recommendations in the short and long terms, so as to reform economic policies currently in place. This would enable the national economy, increase options, ensure a dignified life for citizens, and re-distribute wealth and income among different groups of the society in a just and equitable way.

The data and analysis provided in this paper provides clear evidence that the Palestinian economy has been functioning under adversity mainly resulting from the Israeli continued occupation and from the limited resources and policy options the government has in managing that economy. This is not to say that social and economic policies; trade, fiscal and employment policies in particular; have been conducive. To the contrary, they were inappropriate and may

have deepened the historical distortions and imbalances. On top of these imbalances was the inequitable distribution of income and wealth among different society classes. Poor has become poorer and rich has become richer. In addition, the growth in the economy may be characterized as unsustainable and heavily dependent on public spending which in turn has been dependent on international aid.

This paper offered a number of reforms in economic policies under the status quo scenario. These reforms are assumed if implemented to overcome some of the imbalances, but they definitely will not put the economy on the track of sustainable development as long as the Israeli occupation and related adverse policies continue.

## 1. Introduction

Every phase of the development of the Palestinian political and economic scene between 1994 and 2012 had invited a considerable debate, arguably triggering several questions within local circles and beyond over the appropriateness of economic policies applied. The questions are mainly centered on the prospects of the Palestinian economy under the existing obstacles, available opportunities and potential headways. In particular, the debate was focused on several issues associated with policy options that might help in building a robust national economy that can meet the challenges and the current developments in the political scene- an economy that can ultimately lead to the establishment of an independent, contiguous and viable state.

These questions have gained special momentum because of two main reasons. **First**, it is the economy that is at stake; and all are aware that the economy is one of the major domains of conflict with the Israeli occupation. In that sense, this economy can be either a lever of resistance and liberation or a burden that could raise the cost of development. With the increasing likelihood of an open political confrontation with Israel (and perhaps with some of Israel's Western allies) as a result of the Palestinian factions volition to achieve a national reconciliation and /or because presumably the Palestinian leadership might renounce negotiations (one sign of this is the Palestinian bid for an observer status in the United Nations), economic concerns have resurfaced. These concerns are mainly related to **first** the ability of the Palestinian National Authority (PNA) to bear the brunt of any financial consequences or repercussions that might arise from this confrontation; and **second** the ability of the national economy to withstand any pressure to offer painful political concessions. Indeed, a strong Palestinian economy is the first line of defense that can safeguard the Palestinian national project in the face of the Israeli expansionist project. During the past two decades, we have seen many real experiences where the economy proved to be capable of maintaining states and striking a balance between international political powers.

The **second** reason behind that momentum of debate is the breadth and width of the financial squeeze that hit the PNA hard and led to economic and social disorders. This has also triggered much debate in search for solutions.

In the past two years, the Palestinian National Authority has experienced an excruciating financial crunch which has been worsened by several socioeconomic imbalances that affected all walks of life for a large segment of the Palestinian society, especially vulnerable groups. The distressing crises sparked popular protests led by trade unions. Responding to these protests, the Palestinian government had in 2012 launched a 'National Economic and Social Dialog' aiming to comprehensively diagnose the causes and consequences of the crisis and to identify the appropriate measures to address it and contain its repercussions. However, several rounds of dialog between concerned parties have not yet succeeded in achieving the pre-identified goals. They also failed to produce an all-inclusive strategic document that sets priorities or a national socioeconomic action agenda that can reform policies and programs that have- according to observers, trade unionists and politicians-deepened the distortions and imbalances in the Palestinian economy.

Though the dialog rounds succeeded in addressing some of the issues (such as the adoption of the Minimum Wage Law and the amendment of some articles of the Income Tax Law of 2011), key issues- such as the establishment of an integrated system of social protection, restructuring of fiscal policy (both the tax system and public spending) and the overall restructuring of the economy and trade policies- remained untouched. Therefore, the next step is to conceptualize a strategic vision about the outline of the economic and social policies needed to transpose the public institutional system from an autonomy into an independent state that provides a decent life for all its citizens. **It is no longer acceptable for unions, associations and academic experts to merely remain critical of the government policies. Rather, they should initiate and contribute to the drafting of the national reform agenda to meet the incidental and chronic challenges facing the Palestinians in the occupied territory.**

### 1.1 Objectives

This paper seeks to:

1. Diagnose holistically and systematically the major imbalances and distortions in the Palestinian economy and their repercussions on the living standards of the Palestinians and the state of social justice in Palestine. In this sense, the paper provides a description and analysis of the features of the economic and social policies pursued by the successive

Palestinian governments, and the role of these policies in actuating the course of the performance of the national economy.

2. Develop recommendations in the short and long terms, so as to reform economic policies currently in place. This would enable the national economy, increase options, ensure a dignified life for citizens, and re-distribute wealth and income among different groups of the society in a just and equitable way.

## **1.2 Research Methodology**

To achieve the objectives of this paper, the research methodology applied consists of several procedures, namely:

1. A comprehensive review of regulatory framework and economic policies in Palestine, and the ensuing results.
2. A review of development literature and studies that tackled the relationship between development and the economic and social policies. The purpose of that review was to develop a theoretical framework for the quantitative analyses that examined the economic and social situation in Palestine.
3. Holding four seminars (in the north of the West Bank, in the central West Bank, in the southern West Bank, and in Gaza) with stakeholders to view and discuss the outstanding issues and agree on possible solutions.
4. Holding a final workshop with the participation of all concerned parties (the government, the private sector, trade unions and associations, political parties and others) to explore the initial reflections concluded in the study, so as to discuss, approve and submit these reflections to the Palestinian decision-makers.

2. Literature Review- The relationship between economic policies and Development

Nowadays, economic growth is barely a means rather than an end of achieving sustainable development. If growth means a steady increase in the real GDP or GDP per capita, then development should involve an all-inclusive shift in the economic, social and political conditions- a shift that seeks to ensure decent life for citizens. Modern literature on development reveals the evolution of the concept over the past few decades. Until the seventies of the last century, development was seen as only an economic phenomenon. With the exception of some



minor other indicators, growth rate in the gross national income was the main (and even the only) indicator to measure development and compare it levels across different countries. This notion, however, came under severe criticism in the 1990s, especially when economists saw that the high growth rates in GDP for a number of developing countries have not achieved better welfare standards for the majority of their citizens. In many cases, high development parameters were associated with an increase in unemployment and poverty rates and a widening gap between the rich and the poor. In that period, new terms started to emerge, and these reflected dissatisfaction with the use of growth rates as the sole indicator of development. Examples of these terms include "growth without development", "inequitable growth" and "blind growth" (Bhagwati, 1985). This dissatisfaction sparked debate on the concept of development and the best alternatives to measure it. A new approach, thus, started to materialize— one that links development to the fundamental rights of individuals , particularly the "right to a decent work" (Poulson,1994). Other approaches tried to establish a link between development and political variables such as democracy, civil liberties, political pluralism and decentralization , as well as a number of other social variables.

Nonetheless, these criticisms do not, by any means, neutralize the fact that economic growth is a necessary condition (though not sufficient) to achieve development. In fact, the relationship between them is not spontaneous, since a rapid economic growth might co-occur with slow development, or the other way round. By the same token, one of them may reinforce or hamper the other. It is, thus, incumbent on decision-makers to avoid developing policies that foster growth that does not provide **new jobs, or that that augers well for the rich at the expense of the poor, or that which does not lead to an improvement in the level of basic social services, or that which is not accompanied with an increase in the citizens' social and political participation.** As such, spanning the gap between economic growth and development requires a response to the fundamental rights of members of the community. What is urgently needed is a growth that creates permanent employment opportunities and improves wages- eventually reducing poverty and improving living standards (Srinivasan,2001).This is consistent with the ILO and the UNDP goals; namely increasing opportunities of decent work for the poor and marginalized people, such that the growth achieved would have a role in the fight against poverty (ILO, 2009).

To achieve this kind of economic growth, governments tend to implement balanced economic and social policies, both at the macro and sectoral levels. **The efficient and effective policies are those that put growth in the service of sustainable development.**

## **2.1 Reducing unemployment- a key target of economic policies**

Since people want permanent jobs and fair wages, one of the main objectives of the overall economic policies is to achieve full employment or reduce unemployment. Because of the high economic and social costs at the individual and the societal levels, unemployment is one of the severe economic problems facing the industrial economies and developing countries alike. The most prominent costs of unemployment are:

**First:** Direct economic costs (Sloman,1998). These involve:

1. Opportunity cost: The national economy foregoes output that would have been otherwise produced if the currently unemployed had been employed. Unemployment, thus, represents a direct loss in GDP .
2. The government's loss of taxes (income, sales and value added taxes) that would have been collected from the unemployed if they had been employed. High unemployment rates lead to a decline in the standard of living and thus a decrease in the level of spending- ultimately leading to a reduction in government revenues from taxes.
3. An increase in unemployment rates leads the government to maximize its subsidies (cash and in-kind) to the unemployed persons .
4. When people stay unemployed for a long period, they lose the necessary skills which directly affects the size of potential and real output.

**Second-** Social costs: Poverty is sometimes associated with an increase in crime rates, undermining of civil peace, in addition to the sense of alienation and deprivation poor people experience.

By now, we have seen that unemployment has adverse implications that go beyond the effects on the individual- casting detrimental ramifications on the overall economy and impacting the

economic and social structures, making the goal of reducing unemployment and increasing employment opportunities a priority for any development policy.

Though all economists agree that unemployment is a far-reaching problem, the causes of this problem and ways to address it are still controversial. Some schools believe that the unemployment problem should be left intact, claiming that the free market mechanisms are capable of resolving it. Others believe that governments should actively intervene through economic policies that aim at promoting economic growth that ensures more job opportunities and achieves the objectives of social and economic development. The approaches to reducing unemployment can be classified into three main groups:

1. **Increasing the rate of economic growth:** A number of economists and experts from the International Labor Organization advocate for adopting economic policies designed to increase the rate of economic growth. They believe that such policies would increase the saving and accumulation rates (arguing that growth rates have always been accompanied with an increase in the demand for labor force).

2. **Reducing the cost of work:** Some experts and technocrats contend that the wages inability to adapt to the shocks that have occurred in industrialized countries will increase the cost of wages and, thus, weaken the competitiveness of the local products in the global market, which leads to high unemployment rates. Therefore, reduction of wages can lower production costs, reduce prices and increase sales, and thus strengthen the incentives for business investment plans to increase production and hire more workers.

3. **Modifying the conditions of the labor market:** A large number of experts and economists still loyal for classical economics which attributes unemployment to the 'inflexible labor markets' (inflexibility of wages pursuant to supply and demand conditions) and that the rigidity of these markets is a result of intervention of trade unions and their intransigence, as well as the intervention of governments in the labor market through legislation that restricts the effectiveness of supply and demand. These experts, thus, believe that addressing unemployment requires an adjustment of policies and conditions that govern labor markets. To achieve this kind of elasticity, proponents of this school provide some suggestions:

- Abolition of the laws of the minimum wage.

- Modifying the system of unemployment subsidies and reducing the projects of social security benefits in order to strike a balance between compensatory incomes paid to the unemployed and the need to drive them to find a job.
- Increasing the policies of training and re-training of the unemployed– so as to help them develop their skills in line with modern technology needs.
- Encouraging early retirement in order to create new jobs.
- Developing information systems for labor markets to help those who seek job opportunities and help businessmen who are looking for these jobseekers.

The second and third suggestions, in particular, were mainly made for industrialized countries that may have the mature conditions for the effective application of the mechanisms of supply and demand in the framework of a free market economy. These two suggestions lack the scientific background and do not involve executive mechanisms. More importantly, they strip workers of their rights, and they are only inapplicable in some cases and different industries. Therefore, they are unreliable elements in the fight against unemployment. **This necessitates adopting a different perspective which focuses on economic and social policies that are capable of enhancing the chances of comprehensive and sustainable development.**

## **2.2 Economic policies from a development perspective**

Lately, the correlation between economic policies and the requirements of sustainable development has gained momentum. This is probably a result of the fact that the concept of development objectively entails a greater and more effective role for the state or the authority than that given by the theories of neo-liberals in terms of the growth in the rates of domestic income or gross national income apart from the way this growth translates into an equal improvement in the living conditions of the individuals. From the contemporary development perspectives, the state's role is not restricted to achieving economic growth. This role now entails the management of the impact of this growth through a range of instruments, policies, guidelines and regulatory framework that would contribute to the distribution of the benefits of this growth to all citizens, who create development and guarantee its sustainability.

In this sense, if some of these policies seek to stimulate economic growth, others must be tailored to the fair distribution of growth in wealth to all segments at all levels, particularly through securing the "right to work", which is a basic human right provided for in the relevant international conventions. Under 'economic development policies', we can find a number of tools, guidelines and government plans at the macro and sectoral levels. These tools affect, directly or indirectly, the performance of the national economy, as illustrated by a number of development indicators.

Economic policies are those pursued by the government to achieve certain economic and social objectives, including achieving economic growth, reaching full employment, reducing inflation, realizing financial and monetary stability, and ensuring social and economic justice through equal opportunities and equitable distribution of income and wealth. To achieve this, the state employs many economic policy tools, notably the **fiscal policy, monetary policy, foreign trade policy, employment and human resources development policy, and social protection policy.**

The implementation of these policies to achieve the desired economic goals is a daunting job because these goals usually involve inherent contradictions. Sometimes two goals cannot be achieved at the same time (for example: increasing the income vs. fixing prices, or increasing the income vs. reducing the deficit in the balance of payments). Achieving one of these goals in a certain period of time will necessarily be at the expense of the other goal. This suggests that there should be a trade-off between the goals– yielding positive results for certain groups but adverse implications on other groups (Naqeeb, 2002). This also applies to economic policies designed to increase employment and reduce unemployment, where such policies (in addition to their desired economic results) might lead to inexpedient results- such as a hike in prices and inflation in the short term (Habib,1994). That is why when formulating policies, policy-makers should set priorities, suggest tools for implementation and determine a timeframe for achieving the desired goals.

Development studies agree that the bridge between economic growth and human development is job opportunities (UNDP, 1996). The desirable economic growth is that which creates good jobs

with adequate wages. More importantly, these opportunities should be distributed fairly and evenly without gender, political affiliation, ethnic or religious profiling.

**The ongoing discussion about the economic theory might by now help us derive those policies that would auger well for the economic growth- one that increases job opportunities and achieves the socioeconomic development goals. Below is a brief review of the macroeconomic policy instruments, components and implications.**

### **Fiscal Policy**

The fiscal policy of any government is reflected in the annual budget that the government submits to the legislative authority for approval. Once it is approved, it has the force of law. The budget, thus, is a tool by which the government implements its comprehensive development plans. The size and structure of revenues and expenditures affect the macro-economic performance (and they are influenced by this performance). That is why the budget variables are considered the tools of fiscal policy which seeks to progressively achieve the general and specific objectives of the socioeconomic developmental plans in the short, medium and long terms. The general budget should not only account for rigid figures of expenditure and revenue, but also for the approach adopted by the government to manage the public affairs at various levels. It is also assumed that the annual budgets reflect the developments in the financial performance of the government and the overall economic performance, on the one hand, and deign the future economic/social policy orientations, on the other hand (Abdekarim et al.,2002).

Through the development of the budget, the government aims to achieve a set of goals (Dawood, 2002):

- Allocation of resources in line with the principle of efficiency: The government plays the role of the producer that produces public goods that the market cannot produce (national parks, building roads, defense tasks, etc.). The government also works as a regulator (the enactment of laws that support some activities and levy taxes on other activities).
- The distribution of income in line with the principle of justice: This role is usually related to revenues. The government designs a tax system based on revenue that is more or less commensurate with income.

- Achieving economic stability through the development of budgets that fit with the macroeconomic variables (unemployment, inflation and economic growth).

The budget success in achieving the desired goals is contingent on a number of factors, notably (1) the level of democratic practice in the political regime; (2) the level of the organizational and institutional infrastructures, since the allocation of financial resources is not a sufficient condition for the success of projects or activities. Rather, the resources must be managed efficiently to ensure optimal utilization; and (3) the degree of overlap or integration in the powers of the public executive and legislative agencies in the management of the budget in its various stages, as well as the level of the participation of civil society organizations and the private sector in discussions about the budget.

In spite of the global reform efforts (which seek to restructure laws and regulations that govern the local economy towards reducing the role of government and promote freedom and openness in line with the trends of globalization), history has revealed that governments still have a substantial role in the provision of services and public goods that market forces cannot provide. Governments also have a critical role in formulating and implementing macroeconomic policies aim at achieving overall growth and development in line with the re-distribution of wealth and social justice (Tiwari,1999).

Within this approach, many countries worldwide have witnessed community-based initiatives to democratize the process of formulating and implementing the governmental budgets– an attempt to gradually make them focused on the basic rights of the people. These initiatives come against the backdrop of repeated conferences held under the guidance and sponsorship of the UNDP on the status of economic and social development in the world (Cagatay et al., 2000). One of the most prominent results of these conferences is what came to be known as the 20/20 initiative, in which participating countries pledged to allocate 20% of official development assistance and 20% of public spending to basic social services programs.

In light of the foregoing discussion, we can safely conclude that through examining the developments of the public budget of any country, it is easy to evaluate this country's fiscal

policy. As we seek to evaluate economic policies in terms of their contribution to the sustainable economic development that is responsive to the citizens' fundamental rights, we can develop some indicators that help us in determining whether these policies are development-oriented. This will be made possible through the assessment of the two sides of the budget (revenue and expenditure) separately.

**Public expenditure** is a term that refers to the total types of spending and transfers by the government (i.e. the various ministries, departments and central authorities which do not produce goods and services for the purpose of selling in the market) (Darraz and Hijazi, 1998). Budgetary public expenditure involves current spending and regular capital expenditures. The government's tendency to increase public spending (expansionary fiscal policy) is one of the elements that directly increase national income level (output), thus stimulating economic growth. What is significant, however, is not the size of spending, but the quality of spending and the nature of the activities and economic and social sectors that benefit from it.

The issue of the size of spending is a matter of public choice that is subject to voting by the representatives of the people. On the contrary, the question of the structure of expenditure is one of the fiscal policy options; hence the interest in the formation of government spending in terms of current and capital expenditure (Dawood, 2002). Public expenditure can be examined either in terms of administrative classification ( current and capital) or in terms of the target group classification (the share of social services and other sectors).

The administrative classification informs the size and the share of current expenditure, salaries, wages, operating expenses and transferring expenses, on the one hand, and the share of capital and developmental spending, on the other. The target group classification helps in identifying the nature of the activities and socioeconomic sectors that benefit from expenditure (such as social, cultural, media, security, and internal supervision services, as well as public administration, finance and economic development).

One of the common notions about public expenditure is that an augmentation of the share of current expenditure, specifically the share of salaries and wages, is economically and



developmentally undesirable, whereas capital expenditure and developmental capital spending reinforce employment opportunities and attract local and foreign investment— eventually contributing to the achievement of economic and social development. Some studies, however, have warned of excess focus on capital spending , arguing that it may be misleading if governments overreact that kind of spending. Devarajan, Swaroop and Zou (2007) used annual data from 43 developing countries for twenty years. The data involved different variables: the growth rate of per capita real GDP, the ratio of government spending to GDP, the ratio of current expenditure to total spending, the ratio of capital expenditure to total expenditure, the ratio of military spending to total spending, as well as the ratios of health spending, education spending, transportation spending and communications spending to the total expenditure. The study concluded with significant results: the current expenditure has a positive impact on the rate of growth in per capita income; the influence of the share of capital spending was found negative (in the short-term); while the level of government spending, in general, was statistically insignificant. Perhaps, this is a result of the fact that the greater the spending, the greater the need to finance this spending from taxes and borrowing, which negatively impacts the economy. The study also found that the components of capital spending (health, education, communications and transportation ) adversely affect the growth rate of per capita real gross domestic product (Dawood, 2002).

Other studies, however, argue that the increase in government spending in developing countries has a positive effect that outweighs the negative impact that may arise from the principle of 'crowding out', in which an increased funding of public spending leads to a rise in interest rates and a surge in the prices of commodities, which, in turn, engenders a decline in the level of private sector investment. Still, there are several criteria that are already in place to monitor the performance of the public sector and compare it with some of the most important and successful experiences (Dawood, 2000 ):

- The public expenditure's allocation to physical capital; i.e. the investment in basic infrastructure facilities such as roads, railways, airports, telecommunications, media, electricity, gas and water: This kind of investment boosts the productivity of the private sector and lowers operating costs, and thus optimizes economic returns.

- The share of capital spending on human capital, including spending on education, health, social security and welfare: The more spending on human capital, the higher productivity of the workforce. This, in turn, improves the profits of the private sector and increases its competitiveness .
- The share of spending allocated to support governmental consumption and projects: The government-owned enterprises lack efficiency and they squander the already limited resources. Other items of spending involve supporting the prices of some commodities such as food, water and electricity, which is a transgression of optimal consumption.
- Tax expenditure is one indicator that constructively influences investment. Examples on tax expenditure involve the Investment Promotion Law and the Law of the industrial cities (where investors are given tax and customs breaks). This spending is detrimental in the sense that it erodes tax revenue, but it stimulates private investment and enables the local economy to hire a larger number of the labor force.

It is noteworthy that the process of controlling the budget's spending allocations is as important as determining the sizes of these allocations. Global experiences reveal that allocating financial resources to the different items of spending cannot adequately achieve the goals effectively and efficiently, and that the poor management of the budget is one of the main factors that create deficits and weaken the efficiency of public services (Rajkumar, 2002). The budgetary system should be comprehensive— one that designates the agencies responsible for financial control and management in the executive and legislative branches to ensure the highest possible degree of transparency, integrity and accountability.

**Public revenues** involve three main categories:

1. Direct and indirect tax revenues that the government collects under special laws from individuals, organization and businesses based on their investment, production and consumption . There taxes mainly include income, value added, customs, excise, production and others.
2. Non-tax revenues from the surplus of public enterprises (service and productivity projects), public services, fees and others.

3. Nonrefundable foreign subsidies and grants received by the government in the form of cash or in kind. Though the government does not repay them, yet it might need to commit itself to implementing policies and economic and social programs in line with the priorities of the donor countries and institutions.

Tax policies are particularly important in financing government expenditures and in achieving the goals of economic and social development (through the development of tax systems that redistribute income in line with the principle of justice and stimulate private investment). To achieve this, the actual tax burden (i.e. the ratio of actual collection to GDP) must not exceed the economy's assumed tax capacity (the maximum revenue that can be collected through taxes-taking into account the size and structure of national production, the amount of public expenditure and the level of productivity, again taking into consideration the ability of individuals to pay taxes and the government 's ability to levy and collect them). A tax burden that fits with the economy's status is one of the most important conditions for creating a stimulating and competitive environment for private sector activity, achieving the goal of overall economic development, creating jobs and increasing employment opportunities in particular.

Meanwhile, the equitable distribution of the tax burden (along with its size) must be taken into consideration, since a tax burden might be commensurate with the economy's tax capacity, but at the same time unevenly distributed among different groups of taxpayer. A tax burden might be concentrated on vulnerable groups in the community, which widens the social gaps and highly concentrates wealth in few hands. It is also important to consider tax exemptions and deductions, which may not suit the investment needs of the local economy or may give exemptions for projects that do not rely on labor intensity or those that do not utilize modern technology. In order to achieve its objectives, a tax system must consider a number of principles ( Kharabsheh , 1996):

1. Implementing the principle of progressive taxation in order to:
  - Preclude the concentration of wealth in the hands of a few, and redistribute it in an equitable way.
  - Levy a progressive taxation system based on the ease of earning income.
  - Encourage the establishment of public shareholding companies.

2. Developing fair tax rates (after checking tax capacity and tax burden) that fit with capabilities of the taxpayer.
3. Creating a favorable investment climate that stimulates local and foreign investment, especially in real productive sectors such as agriculture and manufacturing.
4. Improving national savings to meet investment needs.
5. Stimulating commodity and service export.

We should add that the effectiveness of management of public revenues must not only be measured by the extent to which they are increasing in size, but also in terms of the compliance of such management with a clear and well-thought plan that links revenue indicators with macro-economic indicators. More importantly, it is critical to consider the impact and structure of these revenues on social justice and public welfare. An ineffective management might collect larger amounts of public revenues by focusing on vulnerable economic sectors and marginalized social groups that can easily comply with the taxation system- such as workers and employees in the public and private sectors– a tax of the type termed 'source discount' (Casanegra and Bird, 1992).

### **Monetary Policy**

Monetary Policy is the second main tool of macroeconomic policy that is used by the government through the management of the monetary, credit and banking systems of the state.

The three main tools of monetary policy are:

- Open market operations: Selling and buying government bonds and bills, with different maturities and forms.
- Discount Rate: This represents the interest rate which the Monetary Authority imposes on bank loans. It is also known as the basic interest rate on loans of no risk .
- Required Reserve: This involves the change of compulsory reserve requirements on deposits with banks and other financial institutions, according to the prevailing economic situation in the country (shrinkage or growth)

These tools can determine the quantity of money flowing into the market, which affects the various financial and economic variables, such as interest rates, exchange rates and prices of

financial assets and real assets (Samuelson and Nordhaus, 1995). Certainly, a monetary policy will never be effective without a formal national currency.

Just like in the case of the fiscal policy, the monetary authority might adopt a monetary policy that contributes to realizing the main goals of sustainable development, reducing unemployment and fixing prices. The aggregate demand of the economy can be influenced through an expansionary monetary policy, where this expansion lowers interest rates in the financial market, which, in turn, stimulates consumer spending and investment. This expansionary strategy increases aggregate demand, and thus production . On the contrary, in the case of a steady inflationary growth, the central bank resorts to a contractionary policy which slows down the economy.

### **Foreign Trade Policy**

The Foreign Trade Policy involves tariffs, quotas for imported or exported goods, indirect taxes, and currency exchange rate policy which aims at developing foreign trade and promoting export. A government can pursue trade policies that contribute to the achievement of sustainable development and increase employment opportunities. This can be materialized through assisting entrepreneurial sectors in enhancing their competitiveness at home and abroad. The government can foster this competitiveness by providing preferential incentives and temporary protectionist procedures for certain sectors with comparative advantages. However, this is not always the case, since the freedom to pursue such procedure by states has lately been restricted by globalization tendencies, including trade relations. Foreign Trade Policy also significantly overlaps with the fiscal and monetary policy of the state.

### **Employment and social protection policies**

The majority of development economists agree that human resources- not physical capital or natural resources- represent the main factor that determine the level of social and economic development in a given country (Todara,1994). They also believe that the quality of employment (knowledge, skills and organization) is one of the most substantial elements of economic development . Indeed, it is possible to buy or borrow other production components (production

goods, raw materials or technology) from the global market. A country can also afford the latest communication devices, computers and power generation equipment, but these technologies can only be operated and maintained by skilled workers (Samuelson and Nordhaus, 1995). Arthur Lewis and Max Millikan highlight the importance of developing human resources, particularly education, owing to the following reasons (Attiyah, 2001):

1. Human investments are long-term investments that need a period of time longer than the period required for building factories and laboratories. It is possible to establish a factory within five years, but we need twenty-five years to have a professor, a scientist or a scholar, therefore we must give priority to developing human resources in order to achieve economic results in a timeframe that suits the requirements of the development of other resources across the various economic growth stages.
2. Data from developed countries reveal that renovation in the process of development has a key role in increasing the volume of production. The data also show that an increased productivity and an improved size of the national income barely account for 50 percent of productivity (in physical terms), while the other significant half is accounted for by human capital (evidently because of invention and innovation occasioned by scientific, technical and educational development). Gerald Meyer outlines three educational areas that should be prioritized: the provision of agricultural extension services, industrial skills training, and training on supervisory and managerial skills that produce people with managerial knowledge and skill.

Policies of employment and those of developing human resources, as well as policies related to social protection, involve improvements to education, health, training programs, technical and vocational rehabilitation, care systems, public social services, job creation programs, supporting wages, employment services and self-employment. All of these fall within the framework of improving the quality of the workforce and promoting employment opportunities.

In this regard, economic planners in developing countries focus on the following programs: **First:** Improving education and reducing illiteracy through the development of the educational system in such a way that meets the requirements of economic development. The expansion of educational opportunities at all levels contributes substantially to economic development. The

2002 Arab Human Development Report highlights three strategic directions for building a robust human capital:

- Full diffusion of the basic education, prolonging the duration of compulsory education to at least 10 years, and steadily expanding the scope of education in later stages.
- Developing a continuing system of adult education- a system that is flexible and develops regularly in order to effectively fight illiteracy, on the one hand, and implement a system of continuing education for graduates of the educational institutions, on the other.
- Forging methods within all levels of education to ensure the upgrade of the quality of education – eventually establishing a trajectory of modernity, excellence and creativity as a means of acquiring knowledge and modern technology in Arab societies.

**Second:** Constructing and operating an integrated system of social protection that is regulated by a legislative framework. Such a system must make sure that all things are in place to provide for decent life. The system is made up of three components: (1) social security in cases of retirement, old age or inability to work, (2) an effective, comprehensive health insurance system, (3) unemployment insurance.

**Third:** Controlling disease and improving health and nutrition services through the provision of appropriate health care services.

**Fourth:** Programs of professional development-oriented training, including a wide range of training activities and courses that focus on new skills that improve productivity and cost-efficiency: Such training might include communication, computer, organizational and managerial skill, as well as methods of conserving resources and increasing output.

**In short, it appears that the success of any comprehensive development process depends on a range of economic and social policies, which evokes an important question regarding the policies the Palestinian National Authority implemented during the past two decades, and how these policies influenced the process of economic and social development.**

3. An Overview of the Palestinian Economy- a distorted economy for an authority with incomplete sovereignty

Since Israel took control of the West Bank and the Gaza Strip in 1967, the iniquitous Israeli policies have created numerous distortions and structural imbalances in the Palestinian economic and social structure. Within the forceful, unequal relationship between the two parties, Israel made the occupied territory a source of cheap labor that serves the Israeli labor market, on the one hand, and a destination for its products, on the other. Meanwhile, Israel imposed restrictions on many different aspects of Palestinian economic activity, especially the industrial sector. Further, it has drained the financial resources of the Palestinians through the imposition of arbitrary tax policy on individuals and businesses. This has weakened the Palestinian economy's chances to grow and develop production bases, and ultimately its ability to absorb Palestinian labor (that has been constantly growing). These systematic policies have eventually stripped the economy of its ability to meet the needs of the local market and created a subordinate economy that strives to fill the demand gap in the local market through imports from Israel.

Israel, thus, has become the only trade partner of the occupied Palestinian Territories (oPt), which dismantled the Palestinians of export opportunities that might have been available, particularly to Arab and Muslim countries, let alone the squandered opportunities of importing raw materials, machinery and other production requirements from these countries. Worse still, the natural resources have been depleted by Israel (particularly land and water). These policies have engendered structural imbalances, particularly:

- **Profound distortions in production structures:** These imbalances are particularly evident in the low contribution of the productive sectors to GDP, employment and exports. The sectors that have mainly incurred grand losses are industry, agriculture and construction—though residential construction has expanded rapidly, but without an infrastructural base.
- **Imbalances in the Palestinian labor market:** The local labor market is no longer able to generate enough jobs to absorb the ever-increasing job seekers. Meanwhile, the distorted overdependence on the Israeli labor market has been perpetuated. As a result of the rewarding wages for Palestinians in the Israeli market, the relationship between production and income in the Palestinian territory has been undermined. The public demand in the economy has increased, yet it was not combined with a parallel increase in production, which led to the dependence on imports to meet consumption needs .



- **Distortions in Palestinian economic relations with international markets**, especially the Arab and Muslim worlds, on the one hand, and Israel, on the other: Israel, thus, has become the only trade partner of the Palestinian economy, which stripped the Palestinians of export opportunities that might have been available, particularly to Arab and Muslim countries, let alone the squandered opportunities of importing cheap raw materials, machinery and other production requirements from these countries.
- **Imbalances in resources and public utilities**: Palestinian natural resources have always been subject to systematic processes of confiscating by the occupation authorities.
- **Distortions in the social fabric**: New relationships and interests ( between individual/groups who benefit from the status quo and whose interests are closely linked to the Israeli economy) have been established.

These distortions and their negative effects have been worsened by the inability of the Palestinian National Authority to formulate and implement a clear vision to overcome these distortions, as well as its inability to play the role of a national lever during the transitional phase of development. **Perhaps, one of the most important reasons for the inaptitude of the PNA to take action is its incomplete sovereignty over economic policy instruments (fiscal, monetary and trade), border crossings and natural resources.**

The PNA is half-fledged and it does not enjoy full sovereignty, and therefore it could not break the cuffs of dependency on the Israeli economy and heavy reliance on external sources (foreign aid, work in Israel, etc.). In this regard, the UNCTAD report (2008, p 1) argues that it is inaccurate to merely associate the deterioration in the Palestinian economy with political and security reasons. The truth is that the fundamental issues that determine the Palestinian economic prospects have not changed over the previous four decades; they continued and even intensified. The most prominent feature in this regard is the PA's narrow margin of economic policy under the provisions of the 1994 Paris Protocol which is based on the Oslo Interim Accords. This agreement has entrenched the Palestinian economy's structural distortions which began to accumulate in 1967, when Israel took control of the West Bank and the Gaza Strip.

The key economic policy tools and natural resources remained in the hands of the Israelis, while

the Palestinian efforts were mainly focused on coping with the results of losing the control over these tools within the de facto occupation system (Barghouthi, 2011; and Haniyeh, 2012).

Some argue that the main problem rests in the development model applied by the Palestinian Authority and the donors- a model which is an upshot of the Oslo peace process, with some parties very keen on keeping such a process alive as long as possible. The model assumes that the Israeli occupation is an external factor that is out of control, and therefore we must accept its existence and pursue developmental efforts within the space it allows- as if the context of life in the Palestinian territory is a post-colonial reality (Tabr, 2012). That is why we find some voices which believe that sustainable development under occupation is not possible (Sane', 1992; and Khalidi, 2011); hence the need to adopt an alternative development model capable of accomplishing self-reliance, confronting the occupation and achieving social justice so as to achieve independence where occupation has no place.

In spite of the significant achievements the PNA made in its efforts of building the administrative institutions, rehabilitating infrastructure, enacting legislation that governs life in the West Bank and Gaza and stimulating trade and investment, the cost of these achievements was relatively high because the efforts were always restricted by Israel' arbitrary policies and in the absence of an appropriate development program for building and restructuring the Palestinian economy. The economic and social indicators throughout the period that followed the establishment of the PNA in 1994 reveal the fragility of the Palestinian development and the structural distortions in the economy. It is now crystal clear that the Israeli occupation in all its manifestations is the leading cause of Palestinian economic crises, and overlooking that fact would lead to efforts that only address the symptoms of the problem rather than providing radical solutions.

From 1994 to 2006, four key interconnected factors controlled the performance of the Palestinian economy:

1. Transition agreements signed with Israel.
2. The hegemony of the Israeli occupation- creating a fait accompli status that touched all aspects of life in the OPT, thus breaching all agreements signed with the Palestinian side.

3. The volume and nature of international aid.
4. Policies adopted by the successive Palestinian governments in the management of the national economy.

In 2006, a new factor (and probably the most important one) started to influence the economic landscape in the Gaza Strip: the Israeli strict blockade. Worse still, the Palestinian internal political and institutional split of 2007 (between the West Bank and Gaza) has added a new destructive factor.

The bottom line for now is that achieving substantial and sustainable development in the Palestinian territory requires a significant change in one of these factors, particularly reconsidering the principles of political and security relations with Israel. The Palestinian economic situation will remain fragile, distorted and exposed to external shocks and crises as long as these factors continue to exist. Needless to say, these factors vary in degree and scope in terms of their impact on the Palestinian economy and how they shape its characteristics and features.

Unsurprisingly, the policies adopted by the successive Palestinian governments have the least influence on the trajectory of the economy at the operational and strategic levels– probably due to the narrow margin the agreements with Israel have given the PA, on the one hand, and the Israeli daily abusive practices (in transgression of the already inequitable agreements), on the other.

The successive governments had only a limited margin regarding the formulation and implementation of trade policy independent of the Israeli economy, since the two economies belong to one customs area. The PA's monetary policy was also shackled by the agreement due to the lack of a national currency in circulation in the local markets. In terms of fiscal policy, however, the Palestinian government has a free hand in managing public spending and setting the rates and brackets of direct taxes (income and property); yet its ability to develop policies that manage indirect taxes ( VAT and customs duties) is minimal. That is why the fiscal policy might be the appropriate field where the PA can direct the trajectory of the economy under the current disabling circumstances. Adopting wise and balanced policies that govern the

development process and drive growth is particularly significant given the pressures Israel exerts on the Palestinian economy.

4. Palestinian economy: The model, the policies and the results

World's development initiatives during the last three decades revealed that achieving the objectives of development does not only depend on wealth, geography and population, but also on the integrity of the economic model, the resulting choices and good governance. Evidently, all countries that failed to provide these factors did not succeed in achieving its development goals, regardless of their poverty, richness in natural resources, population, area or geographical location. On the other hand, the countries that managed to build good governance; adopted an appropriate economic model; developed a vision based on scientific analysis of the environment and strengths; and engaged all development partners have succeeded in the face of economic and social challenges and managed to put their economies on the path to sustainable development.

The PNA is a new bureaucracy and the Palestinian development experience is nascent (about two decades). In the transitional period after Oslo, the political and national challenges overlapped with national development challenges at various levels in the West Bank and Gaza, let alone the responsibilities of building the PNA's institutions. For such a relatively short period, it might not be wise to make a comprehensive assessment of the effects of the long-term economic policies taken by the PNA. It is also important to reiterate that the Palestinian National Authority did not have full freedom in the selection of various economic policy instruments during the interim period.

#### **4.1 Economic model in the Palestinian Basic Law**

The "public rights and freedoms" chapter- Part II of the Palestinian Amended Basic Law of 2005 (approved by the Palestinian Legislative Council) provides in Article 21 that:

1. The economic system in Palestine shall be based on the principle of free market economy. The Executive Authority may establish public companies which shall be organized in accordance with law.

2. The freedom of economic activity is guaranteed. The law shall organize its supervising rules and limitations.
3. Private property shall be protected and, shall not be expropriated except in the public interest, and for a fair compensation in accordance with the law, or pursuant to a judicial order.
4. Confiscation of movable and immovable property shall be in accordance with a judicial order.

**The previous discussion has so far shown that the Palestinian legislator has failed to establish a link between the principles of a free economy (which was thrown away by the countries originated it)<sup>1</sup> and the principles of social justice and equal opportunity.** Perhaps a combination of the principle of the free initiative in a competitive economy and social security (i.e. the social market economy approach)\*\* is the one that can adequately operate in the Palestinian economy. This approach adapts to a large extent to directions, visions and priorities contained in the comprehensive plan of development (which was developed by a team of Palestinian experts led by Dr. Yousef Al Sayegh in 1993 and adopted at that time by the PLO). It also identifies with the general principles contained in the Declaration of Independence, which received an unanimous ovation from PLO's factions in Algeria in 1988.

It could also be argued that the Palestinian adoption of this approach may have limited the PNA' ability to address the structural imbalances and distortions in the Palestinian economy and restrained the chances to achieve adequate economic empowerment of the Palestinian community in the face of the frequent Israeli and international pressures. The PNA, therefore,

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<sup>1</sup> The German constitution does not have an explicit statement on a particular economic model. It, however, allows any economic style as long as it abides by the policies included in the Constitution, especially fundamental rights. Yet, by implementing the principles of the state of social solidarity, it excludes the pure free-market economy. The Basic Law envisions a social state of law (social state) where the market economy can ensure the basic laws that provide freedoms. The social state entails amendments to the rights, and involves arrangements to ensure the market is operative. It also provides for social and political links, as well as principles of redistribution of income and wealth. This means that the Basic Law accounted for the two elements of the social market economy, namely the competitive free-market and social security (Encyclopedia of the social market economy (in Arabic), 2006: 11).

\*\* It should be noted that the social market economy approach, which tries to establish a link between the principle of freedom of the market and the principle of social balance, is not incompatible with the cooperatives system which is based on small producers' collective ownership, especially in agriculture. That is because the cooperatives system has many advantages in terms of its ability to aggregate small fragmented holdings, making it easier to benefit from the economies of scale and introduce modern technology; thereby increasing productivity, reducing production costs, improving the competitiveness of the products, generating income and creating jobs and equity for large numbers of the population.

needs a different economic approach that fits with the unique status of the oPt and is harmonious with the principles of justice and good governance. It is incontestable that the Palestinian economic predicament still exists and it might even escalate in spite of the brag about the alleged achievements.

#### **4.2 Palestinian Economic Policies**

In its quest for restructuring and rebuilding the national economy (which endured Israel's destructive policies for decades), the PNA developed and applied a set of regulations and policies which primarily aimed at addressing the deteriorating public utilities and the eroded infrastructure. These policies focused on combating unemployment and poverty in the West Bank and Gaza Strip. The Palestinian Authority has accounted for these economic and social goals in its development plans, in general budgets, as well as in the regulatory framework approved by the Legislative Council. The Basic Law (the interim constitution ), which has lately been endorsed by the Palestinian president, states in one of its articles that the PA should exert efforts to ensure the right of citizens to work, together with other basic rights. At the same time, the donor aid has helped in creating an enabling environment to reconstruct the Palestinian economy and achieve growth and development.

Though such efforts have yielded remarkable achievements (in terms of infrastructure and institutional and legal structures and infrastructure, as well as consolidating the private sector's role), they apparently failed in creating favorable conditions for sustainable growth that creates enough jobs, alleviates the economy's stagnation and saves it overdependence on external factors (specifically Israel and international aid ). These efforts have also failed to generate sufficient income to meet the basic social needs of the growing population. In some accounts, the cost of the achievements is relatively high given the lack of a comprehensive development vision used as a guideline in the reconstruction process, as well as the absence of appropriate mechanisms to ensure transparency, oversight and accountability in the management of public money. To what extent was the PA able to employ stimulating economic policies for real sustainable development, and thus strengthen the national economy 's ability to secure the right of individuals to get jobs commensurate with their abilities and desires? How can the PA develop

these policies in the short and long terms so as to reinforce the positive impact of these policies on the economic empowerment of individuals and institutions?

### **First: The PNA's fiscal policy**

A state's financial policy is the backbone of economic policy, especially in the Palestinian territory. The fiscal policy is essentially based on two essential tools: public spending and taxes. Fiscal policy is accounted for in the government's general budget– reflecting the economic and social choices of the government. The state uses public spending and taxes to achieve economic stability, job creation and growth rates; raise the standard of living of citizens; redistribute income and wealth; and establish a reasonable level of social balance. An in-depth examining of the PNA's budgets over the past years gives an insight into how the PA has never adopted a systematic, deliberate fiscal policy that enjoys a high degree of stability and certainty. There are many decisions that are random, overhasty, impulsive and selective. The fiscal policies of the PNA have been forged in response to the prevailing political, social and economic situations. They are, thus, not well-thought policies based on a systematic understanding of the challenges and the resulting actions of intervention within a national agenda.

That said, we now provide a brief overview of the key features of the PNA's fiscal policy (Sbeih, 2011):

**1. The dominance of current expenditure over the structure of public expenditure:** Budgetary data reveal that current expenditure depletes public spending. They also show that development expenditure (investment ) is minimal, and that current government spending is increasing over time (rising from 81% on average during 1995-1999 to 91% during 2005-2012) – suggesting that the development expenditure was declining, especially in times of crises where the PA would incur more transferring costs (e.g. at times of Israel's aggression or closure).

The distribution of public expenditure in the PA's general budget discloses inefficiency in the allocation of the already limited resources, such that current spending and investment spending are allocated disproportionately. The dominance of current spending and the steady increase of its

share expose the consuming character of the economy and the inadequacy of investment spending (that is necessary for capital formation), especially in infrastructure projects that stimulate private sector investment and magnetize foreign savings, thus reducing the cost of private investment, improving the investment climate and enhancing the competitiveness of local production.

## **2. The bill of wages and salaries dominating the government current spending**

The bill of wages and salaries dents more than 50 % of the total current expenditure, (revealing an imbalance between this budget item and other items of current spending). This bill depleted about 24% of GDP in 2008 and 2009, but fell slightly to 22 % in 2012.

When transferring expenses (i.e. unproductive but necessary for social and political considerations, such as subsidies the Ministry of Social Affairs provides to the Palestinian households living in extreme poverty) are added to the wage bill, the latter swells to more than 70% of total expenditure, which restricts the flexibility of fiscal policy. These data expose job inflation and underemployment, which implies low employment possibilities– a phenomenon that requires wise policies aiming at improving employment opportunities in non-governmental sectors.

## **3. Concentration of public expenditure in governance and social sectors<sup>2</sup>**

Naturally, the governance sector is required to establish what is needed for investment stability, while the social sector is required for human development. However, their allocations are overdone, such that they deplete about 85% of total public expenditure (mostly in the form of current consumption expenses). At the same time, the allocations for infrastructure and economic sectors are marginal. The allocation of the infrastructure sector has even declined from 4% in the 2009 draft budget to 2% in the 2013 draft budget. The economic sector, though very vital, had a share of only 2% of the total public expenditure in 2012, which in that year stood at \$ 3.5 billion.

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<sup>22</sup> Governance sector involves a number of institutions and ministries, including the Office of the President, PLO institutions , the Central Election Commission, the Legislative Council, the Council of Ministers, Financial and administrative Control Bureau, Ministry of Interior and National Security, the General Personnel Council, Ministry of Justice, Ministry of Foreign Affairs, Negotiations Affairs Department, Supreme Judicial Council and others. The social sector, on the other hand, includes the Ministry of Education and Higher Education, Ministry of Health, Ministry of Women's Affairs, Ministry of Social Affairs, Ministry of Labor, the Radio and Television, Ministry of Culture, Ministry of Awqaf, Ministry of Prisoners Affairs and others.



Meanwhile, the share of the agriculture sector was barely 1% of total public spending in the 2012 budget.

#### **4. International aid is the main source that finances public expenditure**

Palestinian public spending relies heavily on foreign aid. Development expenditure, in specific, is fully dependent on donor funds. Government current spending is also dependent on grants that support the current budget (representing 17.5% in 2005 and 61.0% in 2008 of total actual current expenditure). Concurrently, there is a significant change in the structure of foreign aid: a rising trend regarding supporting the current budget and a declining trend concerning financing development expenditure.

Unmistakably, overdependence on foreign aid has adverse implication, most importantly the correlation between international aid and paying public employees' salaries, and the interrelationship between delivering social subsidies and the flow of aid. Further, dependence on international assistance encourages the tendency to consume, thereby increasing the gap between domestic savings and investment<sup>3</sup>.

#### **5. Indirect taxes beyond Palestinian control**

Under the Paris Economic Protocol of 1994, the Palestinian Authority may not amend the rates of indirect taxes and customs duties on imported goods and domestic production, save for within a boundary of two percentage points (plus or minus) with regard to VAT. The PA may only adjust taxes and customs duties on the goods mentioned in B, A2, A1 lists. These goods are either those exempted from taxes or enjoy low taxes in the Israeli taxation system. In all other cases, the Israeli rates (and their amendments) shall constitute the minimum that the Palestinian Authority must apply.

#### **6. The Correlation between public revenues and clearance revenues**

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<sup>3</sup> Pearson correlation coefficient between grants supporting the current budget and the domestic savings gap totaled 0.890, while the morale level was 0.000- suggesting a significant statistical correlation (Majid Sbeih: Savings gap and policies taken to span such a gap in the Palestinian economy between 1994 and 2009, *Journal of Al Quds Open University for Research and Studies*, No. 23, Volume II, June 2011).

The majority of clearing revenue with Israel involves customs duties, value-added tax, fuel tax and income tax (which is deducted from the wages of Palestinians working in Israel and Israeli settlements). Under the Paris Economic Protocol, Israel will transfer to the Palestinian Authority a sum equal to 75% of the income taxes collected from Palestinians employed in Israel, and the amount of income taxes collected from Palestinians employed in the settlements. The Protocol also holds that the Government of Israel will collect all types of taxes and fees on transactions between Israel and the Palestinian territory, and then transfer the allocations to the PA after deducting 3% as collection services, while taxes and fees are settled according to the clearing system specified in the protocol.

### **7. Indirect taxes dominating tax revenues**

Available data indicate that indirect taxes are the backbone of tax revenues, accounting for 91% on average, while the share of direct taxes (income, profits and property) are minimal, representing only 9% on average. This distribution is very much related to social justice and equity in setting tax burdens within the population. That is to say, direct taxes can be levied progressively depending on the size of income and its source, taking into account personal circumstances and the estimated capacity of the taxpayer), and therefore they are considered more democratic and equitable than indirect taxes, which the poor find burdensome (Mahjoub, Public Finance, 1979: 245).

### **8. Palestinian taxation system widens the gap between the rich and the poor, and it is partial in the distribution of the tax burden**

The Palestinian tax system suffers inherent deficiencies which weaken its potentials to achieve equity in the distribution of the tax burden and reduce disparities in the distribution of income and wealth. These flaws are manifested in several forms:

- **A regressive tax system:** As we previously explained, indirect taxes represent 90% of total tax revenue, while direct taxes (which are supposed to take into account the personal circumstances of the taxpayers) constitute a scant 10%.

Indirect taxes (such as VAT) are termed 'blind' since they do not differentiate between the rich and the poor, whereby they are levied on spending and consumption, and are

described as regressive taxes<sup>4</sup> and less equitable for the poor (UNCTAD, Policy Alternatives for Palestinian Sustained Development and State Formation, 2009: 12).

- **The absence of quality taxes on consumption** (a tax that differentiates between essential goods and luxury goods): Spending on essential goods represents a significant proportion of total spending for poor families and low - income people. On the contrary, spending on essential goods among rich families constitutes a small percentage of the total spending. In fact, the bulk of indirect taxes comes from fees imposed on essential goods, suggesting that the unjust tax system is incompatible with the collection target; i.e. it does not take into account the capacity of taxpayers (it is even disproportional). Further, indirect taxes hit particularly the poor since poor families allocate greater portions of their income for consumption (suggesting that their tendency to consume is larger than that of the rich).

This inequality can be attenuated by levying quality taxing on consumption, such that the government may reduce the tax burden on essential goods, provide tax breaks or support these commodities (such as bread, medicines and fuel) and raise taxes on luxury goods ( Mahjoub: Public Finances, 1979: 244).

- **Low progression in the Palestinian Income Tax Law**

The Palestinian income tax system takes a downward trend: between 1995-1998, the PA reduced tax rates for West Bank's higher-income individuals (from 48 %) and shareholding companies (from 38.5 %) to 20% for both individuals and companies. The first Palestinian income tax law (No. 17, 2004) reduced this tax to 16 %, then to 15% in the amended Income Tax Law (No. 2, 2008). This law had further been amended again at

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<sup>4</sup> A regressive tax takes a larger percentage from low-income people than from high-income people. It is usually applied uniformly. This means that it hits lower-income individuals harder. It is regressive in nature, and less equitable to the poor because it dents a high percentage of the incomes of poor families, especially if imposed on essential goods. For example, suppose that a family's income is \$ 1000, and it consumes a certain commodity whose value-added tax is \$ 20, this means that the tax rate is 2% of this family' income, while if another family's income is \$ 500, and it consumes the same commodity, the tax rate on this commodity is 4%.

the end of 2011.

The amendments primarily involved broadening income tax base (which was further inequitable in terms of the distribution of tax burdens). Below are some key observations:

**First**, tax rates and brackets were retained, and the system maintained its progressive character. The brackets remained the same (3) and the tax rates remained unchanged. The only amendment was changing the currency of calculating taxes (the Israeli shekel instead of the U.S. dollar).

Article (16) of Law No. (8) of 2011 on income tax states that:

1. Tax shall be levied on the taxable income of any natural person according to the following brackets and rates:
  - a. From 1 to 40,000 shekel - 5%
  - b. From 40,001 to 80,000 shekels- 10%
  - c. In excess of 80,000 shekels- 15%
2. A rate of 15 percent shall be levied on the taxable income of any legal person.
3. A rate of 5 percent shall be levied on the life insurance premiums collected by life insurance companies. A such, the tax rate on life insurance companies from 15% (in the amended Income Tax Law No. (2) of 2008) to 5% in Law No. (8) of 2011.

### **Second: Broadening the income tax base**

Under Law No. (8) 2011 (issued as a decree), new incomes have (which previously enjoyed exemptions) have been included, namely:

1. Farmers' income.
2. Paid end-of-service gratuity, where beneficiaries are entitled to more than one month salary for each year served.
3. Any extra income for retirees.
4. Capital gains arising from the sale of land and real estate .
5. (75%) of the profits of buying and selling stocks and bonds.
6. (5 %) of the income generated from deposit interests, commissions and profits of deposits used in interest-free investment banks and financial.

The law also regulated cooperatives in terms of their profitable activities. It dealt with such cooperatives as public companies, subject to income tax.

In light of the foregoing discussion about Income Tax Law No. 8 of 2011, several highlights can be derived:

1. The Law retained the tax rates and brackets found in the previous law, which means that it kept the progressive taxation minimal.
2. The Law put the rich and the poor in the same boat in terms of the minimum tax exemption (thirty thousand shekels), and it did not distinguish between different higher-bracket taxpayers (all of them pay the same tax rate (15%) on the extra income that exceeds eighty thousand shekels). This procedure is a blatant violation of the philosophy of direct tax (which is supposed to take into account the personal circumstances of the taxpayers).  
Further, the income tax law levied a rate of 15% on all legal persons without taking into consideration the size and source of income (small firms and large firms pay the same rate).
3. The law constrained cooperatives' activities, making profit-making cooperatives subject to income tax.
4. The law did not take into consideration the different geographical areas or the nature of economic activity. Probably it was wise to provide affirmative actions for disadvantaged areas and those hit by the annexation wall and settlement expansion, or making the agricultural sector and other productive activities stand out.

**Conclusion:** The regressive nature of the Palestinian Income Tax Law harms the equitability in the distribution of the tax burden. Thus, it might be sensible to improve the principle of progressive taxation in order to achieve social justice and support the treasury coffers with funds generated from levying progressive taxes on speculations and short-term sales. The government needs also to consider the source and size of income, so that tax exemptions and deductions can be safely tailored to productive sectors, cooperative housing and low-income earners, especially in vulnerable areas affected by the annexation wall and settlement expansion. The debate about taxes should not, however, question the mandatory nature of taxes (for all individuals and companies subject to taxation must pay taxes that the state

needs in its efforts to achieve the economic, social and political objectives). The discussion should, rather, focus on issues of social justice and equity in the distribution of the tax burden, which should be levied according to tax capacity, which eventually contributes to empowering development of the local economy. Because the higher the weight in the economy, the larger the duties, the private sector is required to assume its socioeconomic responsibility and bears the bulk of the tax burden.

## **9. Limited role of the fiscal policy in controlling imports and increasing demand for domestic production**

This inadequacy is well presented in a number of indicators:

- **Fiscal policy in the public revenue side**

Rather than relying on domestic production in the generation of tax revenues to finance the public treasury, the Palestinian general budget depends heavily on tax and customs duties levied on imports, especially from or via Israel. This has deepened the general budget's tendency to rely on tax revenues and customs duties to respond to the pressures on government current spending, thus yielding a fiscal policy unable to control and reduce imports (Jaafari and Ardah, 2002). This suggests that the fiscal policy, under the pressure of financing current expenditure, has given priority to the financial target at the expense of economic and social development goals.

- **Fiscal policy in the public expenditure side: an expansionary policy**

The historical development of the Palestinian budgetary spending between 1995 and 2010 reveals that the Palestinian governments maintained an expansionary fiscal policy in public spending- a policy that is mainly found in recession and unemployment conditions, and when the private sector investment is minimal (so as to improve aggregate demand and supply and increase employment).

However, the expansionary policy (under weak productive capacity, low competitiveness of local products and the inability of the national economy to keep pace with the growth in public spending) led to heavy reliance on imports to meet the growing government expenditure, and to respond to the ever-increasing demand for public investment inputs.

This, in turn, slashed the ability of government spending to increase GDP or employment opportunities (since the bulk of public expenditure is used to pay for imports).

These fiscal policies occasioned adverse effects, primarily:

1. An increased reliance on imports to meet domestic demand, especially final consumption goods: Imports depleted more than 50 percent of the final consumption spending, and more than 70% of GDP.
2. A rise in the trade balance deficit (goods and services): In 1995, the deficit was 1.7 billion dollars, but it rose to 2.7 billion in 1999. In 2000, it was \$ 2.3 billion, and in only two years it increased to \$ 2.4 billion. Similarly, it swelled from \$ 2.3 billion in 2005 to 3.7 billion in 2009 (Palestinian Central Bureau of Statistics, National Accounts, A Series). The deficit in the trade balance posted an annual growth rate of 12.3% between 1995 and 1999; 1.4% between 2000 and 2004; and 13.2% between 2005 and 2011 .
3. A steady increase in the deficit of the public budget: In 2007, the total deficit stood at about \$ 1.4 billion, and it rose to \$ 1.8 billion in 2009 before dropping to \$ 1.6 billion in 2012. The ratio of total deficit to GDP climbed from 9.5 % for the period 1995-1999 to 20.0% for the period 2000-2004, and then swelling to 28.0% for the period 2005-2009 before declining to 20% in the period 2010-2013.
4. The general budget relies heavily on taxes and customs levied on imports rather than depending on taxes levied on domestic production and direct taxes— especially after many producers in the food, pharmaceuticals, shoes and apparel industries turned to be importers from or via Israel, particularly from Southeast Asian countries (Jaafari and Ardah, 2002). Data from the Ministry of Finance show that over the past few years, local tax revenues represented an average of 27% of total tax revenue, while clearing revenues (mainly from value added tax and customs duties) constituted 73% of total tax revenue.

## **Second: Monetary Policy**

Due to the absence of a national currency, the Israeli shekel is the main approved currency for trading (though the Jordanian dinar and the U.S. dollar are significantly traded in the Palestinian market). As such, interest rates, exchange rates and level of inflation are the responsibility of the central banks of these countries. The Palestine Monetary Authority, thus, is incapable of employing monetary policy tools to manage the local economy. Its role is rather restricted to

controlling the banks operating in the West Bank and Gaza Strip and ensuring the safety and stability of their financial positions, as well as making sure that these banks comply with the PMA's instructions informed by the legislation in force.

Lately, the PMA has focused on establishing a legislative, institutional and regulatory framework for the Palestinian banking system, and building the capacity of its own staff members in order to perform their tasks effectively. In this regard, the Monetary Authority has issued dozens of instructions that help banks manage their financing and investment operations with the lowest possible degree of risks. The PMA also developed a code of banks governance, hoping that it would help these banks to hedge against operational risks in accordance with the definitions of the Basel Committee. Further, in its endeavors to grow into a central bank, the PMA made major amendments to the Banking Law of 2002, which was approved and issued as a presidential decree in 2011.

It could be argued that the Monetary Authority has been able to build and develop an effective policy that maintains the stability of the banking system and strengthens confidence in it, thus boosting its role through inducing nearly \$ 7 billion of deposits and re-pumping nearly \$ 3 billion into the economy in the form of credit facilities and direct/indirect investments. Some critics, however, believe that such credit expansion policy might trigger a default on households and institutions' payments of debts, thus threatening stability, especially in times of crises.

### **Third: Trade policy**

As we mentioned earlier, the PA has a restricted ability in developing and managing its trade policies. This is a result of (1) the continued Israeli control over the border crossings; and (2) the single customs block that couples the Palestinian and Israeli economies, restraining the Palestinian side's ability to control customs duties levied on most imported goods. Further, the Palestinian side has very limited power to amend the VAT rate on goods and services (a margin of only 2% plus or minus the rate in Israel).

Perhaps, the Palestinian government adopted (or forced to adopt) a policy of excessive (sometimes chaotic) free trade, such that import and export operations are not subject to control



or stated boundaries. However, one can also argue that the Palestinian governments encouraged imports from various destinations in an effort to ensure the greatest possible tax revenue. Unfortunately, this was at the expense of the domestic products and it increased the vulnerability of the Palestinian economy to external shocks and pressures.

Recently, the Ministry of National Economy has taken some procedures that would outline the nature of the trade policy. For example, it established that the Palestinian markets should be free of settlement products (and developed instantaneous procedures to enforce its decision). Another decision relates to increasing tariffs (a maximum of 35%) for a list of goods (to be named later) imported directly from international market or indirectly (through Israeli intermediaries) to protect national industries. This decision has sparked heated debate in the concerned economic circles. Some believe that this decision aims at increasing taxes, and, therefore, it will not protect national industries and will adversely impact poor consumers.

In its concerted efforts, the Ministry of Economy (in collaboration with the private sector and local community) has finally drafted a national strategy to support export. Apart from these few policy initiatives, the PA has never developed a full-fledged policy of trade.

#### **Fourth: Employment and economic protection policy**

In light of the adverse economic conditions prevailing in the Palestinian territory and the unprecedented unemployment rates, several initiatives were made to alleviate the hardship of Palestinian households. The initiatives mainly focused on helping the unemployed find jobs that ensure them the basic needs. However, these initiatives may not be considered as part of an approved policy (or even a step in the search for a policy). Below, we outline two major initiatives:

##### **A - Unemployment assistance and employment program**

Initially, this program was run by the Ministry of Finance. During implementation, there were many incidences of infringements, notably providing subsidies to some people who did not meet the criteria (e.g. merchants, full-time employees and personnel from security services). These infringements led the Council of Ministers to issue Decree No. (8) for 2003, according to which

a committee was formed to manage the program. The committee encompassed representatives from the Ministry of Labor, the Ministry of Finance, the Ministry of Social Affairs and the Ministry of Agriculture, as well as one or more representatives of the labor sector (to monitor the process of selecting beneficiaries and endorse the list of names to benefit from the program). This committee, together with the Ministry of Labor, outlined the scope of work and criteria (and determinants) for selecting beneficiaries.

Endorsing a recommendation made by the Minister of Labor and Social Affairs, the Council of Ministers decided to change the interim unemployment program into an unemployment assistance and employment program run by the Social Welfare Fund (social safety network). As outlined by the Council of Ministers, this program broadly seeks to reduce unemployment through creating job opportunities for unemployed jobseekers for a temporary period (two months), thus changing the relief perspective into development orientation. About 50,000 people from the West Bank and the Gaza Strip benefited from the program. Each person who was unemployed but willing to provide social services when asked to do so (during the specified timeframe) received NIS 500 paid once. At the same time, each person who was unemployed but willing to work for at least 15 days a month (during the specified timeframe) received NIS 750. Further, the married person received an allowance of NIS 150 per month.

To ensure adequate transparency in the implementation of the program and providing services to the most vulnerable people, many steps have been taken:

1. The selection process depends on the Palestinian labor database according to the criteria approved by the Council of Ministers. Several indicators are used (employment status, dependency, disability, marital status, sex, education, age), and given weights specified in the selection equation. The criteria are based on how unemployment rates are distributed with relation to these indicators.
2. To further ensure the accuracy of the information, field research teams (that received training in labor directorates in the Palestinian governorates) were tasked with verifying and filtering potential beneficiaries through house visits and consulting with local credible institutions, such as local councils.

3. Selected lists of potential beneficiaries are sent to the Ministry of Finance to make sure that the candidates do not receive financial allocations from other sources or work in one of the PA's agencies.
4. To achieve economic benefit, ensure the true intentions of the job seekers and give them the opportunity to receive training and gain experience, beneficiaries who wish to work will then be hired in governmental, private or civil local institutions.
5. Housewives who never worked before are not allowed to register for the program. When doing so, they are considered assistance seekers rather than job seekers. Meanwhile, individuals in need are referred to the Ministry of Social Affairs.
6. Students are not allowed to register, except for those studying in Al-Quds Open University (after verifying the number of credits they have already registered in the respective academic semester).

Through this program, the Ministry of Labor hired nearly 200,000 from the West Bank and the Gaza Strip until the end of December 2005 out of 500,000 unemployed persons included in the labor market database. This program, however, was terminated by early 2006, when Hamas formed the government, leading donors suspend aid that the program had used to fund its operations.

### **B – Palestinian Fund for Employment and Social Protection**

In August 2003, the Arab Labor Organization endorsed a bill that urged the ILO to contribute to establishing an effective 'Palestinian Fund for Employment and Social Protection.' The ILO responded positively and started a feasibility study to assess the viability of the Fund. PA's institutions, in turn, were very enthusiastic about the proposal.

The feasibility study identified a number of goals for the Fund:

- Availing financial resources and securing support for the design and implementation of solutions in order to promote the growth of social and human capital and enhance the development of the private sector.
- Creating various products and services that seek to provide new employment opportunities for the unemployed.

- Improving the skills of the workforce in order to increase competitiveness in local and regional labor markets.

Concerning the financial resources, the ILO estimated that the initial phase would be financed through international donors (so as to reinforce the peace process) and Arab donors (to show solidarity with the of the Palestinian people). The Fund needs an estimated annual budget of \$ 90 million.

The Fund is run by a Commission that enjoys an independent legal personality as well as technical, financial and administrative flexibility, enabling it to perform its duties in a decentralized manner. The Commission sticks to a proven governance structure, represented by a Board of Directors and an Executive Committee to develop policies. The actual management of the commission is the responsibility of the Executive Manager (who, by virtue of his/her position, will be a member in the Board of Directors and Executive Committee). The Board of Directors (13-15 members) develop guidelines regarding operation, determine the annual budget and approve disbursement of funds. The Executive Committee (no more than 5 members) assesses projects before being submitted to the Board of Directors, develops guidelines for projects approved by the Board of Directors, and conducts correspondence with donor agencies. To ensure transparency, audit arrangements have been put in place, where the Fund is audited each fiscal year by independent auditors.

To provide a legal framework for the Fund, the Palestinian president issued the presidential Decree No. 9 (of 2003) on the establishment of the "Fund for Employment and Social Protection" which enjoys independent legal entity and financial position. According to the Decree, the Fund (through supporting productivity and service projects) shall provide financial and technical resources that contribute to developing human resources and businesses in the Palestinian territory, and create job opportunities responsive to the needs of the communities.

The Fund is grant-based (receiving aid from individuals, Arab and foreign governments, and international and local institutions and organizations). These funds are used to implement projects and finance its operation as specified in the PNA's general budget. The funds are subject to regulations pertaining to the management of public funds. The assets of the Fund are

deposited in a bank nominated by the Board of Directors. The disbursement arrangements will be made as per the financial regulations. The Fund will prepare financial monitoring reports for the projects under implementation and for operating costs and activities.

The Fund encountered several impediments, including its inability to operate in an institution-like manner, as well as the dearth of individual financial resources that could have, otherwise, kept it operative without international support. Other problems pertain to implementation, particularly the inaccuracy of data about the target group, which, in many cases, led to providing services for non-eligible people. Therefore, the fund stopped working shortly after launch, but was revived in 2011, but with a very limited scope.

As for the social protection, in spite of the frequent talk about the need to develop and institutionalize a system of social protection in the oPt, the current system is still ineffective in terms of legislation, financial resources and institutional framework. Social welfare continues to rely on subsidies and grants rather than on the principles of citizenship and inherent rights citizens are entitled to. There are no adequate social security systems, unemployment protection programs, or an effective health insurance system that provides high quality services for affordable costs. Responding to the popular protests (led by trade unions) which broke out in mid-2012 over the government decision to raise VAT and fuel prices, the government endorsed the recommendation made by the Committee of Wage Policies, thus setting the minimum wage at NIS 1450 a month. This decision, however, was not approved by the Palestine General Federation of Trade Unions, saying such an amount does not ensure a decent life for the working class. As such, the minimum wage law is still debatable. Though it was supposed to come into force in January 2013, it has yet to be applied and still lacks implementing regulations.

**Having reviewed the PNA's economic and social policies within the Palestinian unique social, political and economic landscape, it might now be legitimate to ask about the implications of these policies and how they influenced the performance of the Palestinian economy during the past few years.**

## 5. The performance of the Palestinian economy and the challenges it faces

### 5.1 **Fluctuating, non-development-oriented, unsustainable growth**

As we argued earlier, the Israeli occupation policies have weakened the relationship between labor productivity and wages, damaged the relationship between production and consumption, impaired the industrial diversification, and rendered the Palestinian economy dependent on small and medium enterprises which cannot respond to the steady increase in labor supply. After posting the world's highest growth rate in 1999, the Palestinian economy's indicators declined dramatically after the outbreak of Al-Aqsa Intifada in the last quarter of 2000. In 2001 and 2002, GDP fell significantly, resulting in excessive increase in the unemployment rate (25-35%), remaining at these serious levels until early 2005. Indeed, the economic situation in the Palestinian territory saw some gradual improvement during 2004 and 2005 and GDP started to show oscillatory growth rates between 2006 and 2007. In 2008, it posted a growth rate of 5.9% (base year= 1997)<sup>5</sup>, while the per capita GDP was \$ 1,340.4. Such growth may have even been greater if it had not been dwindled by the sharp decline in GDP in the fourth quarter of the same year following the Israeli attack on the Gaza Strip and the resulting damage. GDP continued to grow during 2009, 2010 and 2011<sup>6</sup> with an average of 6-7%. Meanwhile, the per capita GDP saw a significant improvement (\$ 1,600). However, the per capita GDP remained below the figure reported in 1999 (\$ 1800 ). In 2012, the growth slackened due to the decline in international aid and, therefore, government spending. It is also attributed to the uncertainty of the political landscape locally and regionally.

It is worth noting that this growth in the last two years came primarily from the Gaza Strip following the relative ease of the blockade and the thriving tunnels trade, thus expediting the implementation of the infrastructure reconstruction projects by international and local organizations, and stimulating construction and real estate development sector. However, per capita GDP in Gaza remained 40% less than in the West Bank.

Nevertheless, the growth in the past four years did not have essential influence on unemployment

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<sup>5</sup> Macroeconomic framework and public finance, the International Monetary Fund, third assessment report. The annual report, MAS: 2009.

<sup>6</sup> The Economic and Social monitor. Issue No. 22 (2011). Published jointly by MAS, the Palestinian Central Bureau of Statistics and the Palestine Monetary Authority.

and poverty rates and on living standards in the oPt. The main driver of that growth was government spending (which significantly depends on international aid rather than on private investment). Therefore, there is a strong argument that this growth is not sustainable and non-development-oriented (World Bank, 2012).

## **5.2 Persistence of unemployment and poverty**

Unemployment rates in the Palestinian territory between 1995 and 2012 were extremely volatile, subject to political and economic conditions prevailing locally and regionally. The Israeli closure regime and blockade were decisive factors influencing the rates of employment and unemployment. When closure is placed on the oPt, the number of Palestinians employed in Israel and the settlements declines significantly, thus increasing unemployment rates dramatically (Sbeih: The Palestinian labor force in Israel and the Settlements, 2011: 34). In spite of the relatively high rates of economic growth reported in the past four years, unemployment rate remained high in the Palestinian territory (22 %). This rate in the Gaza Strip, however, is much higher than in the West Bank. By age, unemployment rate among young people (35%) in the West Bank or Gaza is higher than among other age groups (Palestinian Central Bureau of Statistics, Q3 2012).

As such, poverty rates remained high in the entire Palestinian territory, though these rates are higher in the Gaza Strip. Despite the downward trend of poverty indicators during the period 2004-2011, rates of poverty in all Palestinian areas are still high (the highest reported in 2007 (31.2 %) and the lowest posted in 2011 (21.9%)). Indicators of macro-economic performance in the oPt during the past three years attest the view that high growth rates can be achieved without sustainable development. This growth could not also bridge the development gaps between different geographical areas or different segments of the society. This phenomenon can be described as 'jobless growth' or a growth that cannot create enough jobs for the labor force entering the labor market. Worse still, the consumption ability continued to decline as a result of hikes in prices since 2007, with the nominal daily wage remaining unchanged (70 shekels a day) between 2008 and 2012, while real wages continued to drop during that period.

### 5.3 Internal imbalance: chronic deficit in the general budget

Current and developmental deficit in the PA's budget constitutes one of the major structural imbalances. For better understanding of these distortions, we might need to consider three key aspects of the financial position of the PA:

**The first aspect:** An increase in the current deficit, but a decrease of its GDP ratio (dropping from 28 % in 2007 to 15 % in 2012). On the other hand, the ratio of the total deficit (current + capital) to GDP remained unchanged during that period (20% on average). This ratio is very high compared with some Arab countries, posting 4.75% in Jordan, 3.5% in Mauritania and 11.3% in Lebanon between 2005 and 2006 (PMA, Economic indicators in Arab countries, [www.pma.ps](http://www.pma.ps)).

**The second aspect:** Reliance on foreign aid and grants to finance the budget deficit: During the past few years, this aid financed about 83% of the current deficit. The development budget, on the other hand, relied almost entirely on foreign aid.

**The third aspect:** Bloated public debt, which by the end of 2011, totaled about \$ 5 billion, including \$ 2 billion as domestic debt (bank loans and commercial debt); \$ 1.2 billion as external debt; and \$ 2 billion as outstanding dues owed to the retirement and pension fund. This debt represents more than 40% of GDP, the ceiling set by the law of public debt in article 5. Arguably, high domestic public debt has adverse effects that are detrimental to the private investment because it raises the interest rate on loans and reduces loans available to investments (the impact of competition), particularly because these loans are used to finance current expenditure (and not investment). Bloated debt also negatively affects the well-being of generations to come.

Probably, the swollen deficit in the PNA's budget is a result of the drop of Gaza's revenues that used to flow to the PNA' treasury in Ramallah. Gaza Strip 's contribution to government revenues dropped from 28% in 2006 to 2% in 2011. Meanwhile, the PNA continued to pay the salaries and expenses of the government sector in the Gaza Strip, which represented about 39% of the total public expenditure.

Broadly speaking, the PNA and the Palestinian economy have fallen victims to a chronic problem that might be termed "low level of financial sustainability." This serious problem is



likely to persist in the foreseeable future, especially in light of Israeli government's decision to withhold tax revenues (\$ 120 million per month: about two-thirds of total public revenues) following Palestine's bid for observer membership in the UN. This arbitrary decision will undoubtedly deepen the PA's financial bottleneck , which began to unravel in the past few months, leaving the PA unable to pay the wage bill regularly. If this situation continues, it will engender far-reaching socioeconomic impacts. To address this crisis, the Palestinian government started in early 2012 amending tax rates and brackets, a move that sparked large scale protests from the Palestinians whose socioeconomic conditions were already declining. The government acquiesced and revoked some modifications. This said, now it is likely that the PA has only one option to address this crisis: getting Arab states to disburse a monthly amount of \$ 100 million which they previously pledged within the financial safety net.

#### **5.4 Imbalance between savings and investment**

The Palestinian economy inherently suffers from a profound gap between savings and investment, such that domestic savings cannot cover the gross domestic investment (gross capital formation). During the period 1994-2012, available national savings were very low or even below zero (2003 and 2004) compared to the size of gross domestic investments. National accounts data indicate that the final consumption expenditure outweighs the gross domestic product (GDP) and depletes the bulk of gross national income – suggesting first an economy's dominant consumption character and second inadequate savings in the national disposable income. This situation further compounded indebtedness of most Palestinian households, forcing them to borrow from banks to bridge the gap between their earnings and the growing living needs.

#### **5.5 Growth of the services and trade sectors at the expense of productive sectors**

National accounts data (1994-2011) reveal that the share of services and trade sectors in the oPt's GDP is ever-growing at the expense of commodity production sectors. The data show that the

percentage contribution of commodity production sectors<sup>7</sup> to GDP fell from 39.0% for the period 1994-1999 to 30.5 % for the period 2000-2004, and then down to 26.6 % for the period 2005-2011. On the contrary, the percentage contribution of the services sector<sup>8</sup> rose from 61.0 % to 69.5 % and then to 73.4% for the three periods, respectively (making the oPt economy service-based). This picture is even more somber in the Gaza Strip, where the share of commodity production sectors fell from 34.2 % for the period 1994-1999 to about 28.3 % for the period 2000-2004, and then to 21.5 % for the period 2005-2011. In contrast, the role of services and trade sectors continued to grow (representing more than 75 percent of GDP during the period 2005-2011). One of the negative sides of this phenomenon is the restricted ability of the economy to create employment opportunities. Another adverse effect is the growing probability of the economy's exposure to external shocks and inconsistencies.

The productive sectors, especially agriculture, have never been on the priority list, or at least they have never received special attention from donor programs, development plans or PA's general budgets. The structural shift in the Palestinian economy (towards service-based economy) rendered it dependent on imports of consumer goods (especially from Israel) to meet the domestic demand.

## **5.6 A growing deficit in the balance of trade (goods and services)**

Palestinian national accounts outline the main features of the balance of trade:

1. An increasing deficit in the balance of trade with relation to GDP (constituting 54.0% of GDP in the period 2005-2011). The volume of imports of goods and services surged to a landmark \$ 4 billion, while exports hovered around \$ 500 million end of 2011. This ratio is considerably high compared to neighboring Arab countries such as Jordan, with an average

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<sup>7</sup> Commodity production sectors, in this context, involve agriculture, fishing, mining, manufacturing, water and electricity supply, and construction.

<sup>8</sup> The services sector includes the activities of the public administration and defense; wholesale and retail trade; transport, storage and communications; financial intermediation; hotels and restaurants; real estate and leasing activities; education, health and social work; personal and social activities; and household services.

of 38.5 % for the period 2005-2007 (PMA, Economic indicators in Arab countries, [www.pma.ps](http://www.pma.ps)).

2. Low percentage of exports with relation to GDP: This share hovered between 12% -16 % on average in recent years compared to a high proportion of imports (70.0% - 73.0 %), suggesting that the Palestinian economy is import-oriented in the first place. The high ratio of imports to GDP means a high proportion of domestic income leakage, which lowers domestic demand, eventually negatively influencing the growth of GDP under the spending multiplier effect.
3. Israel is the largest trading partner: Available data show a high geographical concentration of Palestinian foreign commodity trade. Commodity exports to Israel (or via Israel) represented more than 90% of total commodity exports, while exports to the Arab countries was barely 5% (mostly with Jordan, Egypt and Saudi Arabia). The Palestinian imports of goods from or via Israel constituted about 80% of total merchandise imports.

Two points can be concluded from these figures. First, the Palestinian economy is still fragile and it endures structural distortions and gaps, leaving it vulnerable to shocks. Second, the Palestinian economy is substantially fragmented and isolated from the global markets; while it is highly exposed to Israel and international aid.

These impediments necessitate a reconsideration of the Palestinian economic model, together with the resulting policies and programs. To reinvigorate the economy, policy-maker should consider policies that rectify the trajectory of the economy wherever possible, of course within the volatile surrounding political developments. Perhaps, the policies taken by the successive Palestinian governments have created, and sometimes perpetuated, the gaps and structural distortions in the Palestinian economy. However, the negative impact of these policies might not be as significant as the factors discussed previously in this paper. Still, these policies could neither alleviate the burdens nor distribute them equitably. They did not also help the public sector, the private sector and individuals in the face of successive crises, and they did not expand their economic choices.

6. The required economic policy reforms

The future Palestinian landscape, in terms of relations between political factions as well as the relationship with Israel and the international community, will have a dramatic impact on the economic situation of both public and private sectors. For the purposes of this paper, the envisaged policy and economic options build on the status quo scenario. This does not mean that there is no possibility of occurrence of other scenarios which will lead to strategic changes in the structure and performance of the Palestinian economy if they occur.

### **Base case scenario: impasse and uncertainty**

According to this scenario, the Palestinian political scene will remain the same in the foreseeable future (without dramatic changes) whether in terms of national reconciliation, structuring of the Palestinian political system, or relationship with Israel and the international community.

### **Conceivable economic policies under this scenario**

These potential policies are limited and they have a regulatory nature (regulating markets and internal economic relations) with no impact on the core strategic trajectory of the Palestinian economy. These policies might be best operative in the areas of fiscal policy and overhauling some sectoral policies to restore economic balance and achieve greater social justice.

### **First: In terms of fiscal policy**

It must be emphasized first that international aid may not continue to flow forever (at least within the current pace), and therefore it should not constitute a stable element in the strategic development. Rather, it should be viewed as temporary and, thus, Palestinians should maximize the benefit from it and continue to search for ways to dispense with this aid gradually. Indeed, the PA' dependence on international aid started to recede in the past two years. Though this tendency to dispense with international aid is justified politically and economically, some people still believe that this aid is necessary to compensate the Palestinians for the loss they incur because of the Israeli occupation. Consequently, they argue, this aid should continue as long as the occupation exists. The government has set an ambitious goal, and perhaps unrealistic: dispensing with this aid by the end of 2013. However, international aid is expected to remain an important component in financing the overall budget deficit in the next three years.

### **Why a new fiscal policy needed now?**

- The gradual decline in the size and pace of aid since the end of 2010 triggered a severe financial crisis that has had adverse implications.
- Most importantly, this crisis led many people to question the financial sustainability of the PA, and issues of alternatives resurfaced. The debate focuses on what fiscal policy the PA should take when such aid is no longer flowing.
- The attempt to reestablish the fiscal policy is particularly important within the process of building the Palestinian state (with an increasing likelihood of confrontation with Israel, and perhaps with some major donors).
- Some Palestinian circles have concerns about the likelihood that some donor countries and Israel might use aid and clearance transfers in such confrontation.

### **Features of the envisaged fiscal policy**

To resolve a financial crisis, a state has limited options:

- Increasing local revenues (tax and non-tax) either through expanding the capacity of the domestic economy, improving tax collection by broadening the horizontal base of taxes, or by reducing tax evasion and leakage.
- Austerity in public expenditure: re-scheduling expenditure according to priorities or through improving the efficiency of spending to save the economy unneeded spending. We should be careful, however, not to confuse austerity with rationalization.
- Additional borrowing within applicable laws and regulations, either from the banking market or financial market.
- Soliciting Arab and international emergency aid.

### **Which of these options should the PNA take (in light of the current situation)?**

- Increasing local revenues is an adequate option, but to a specific extent (e.g., we cannot assume a tax burden of 75 % of GDP to finance the entire current expenditures). Most importantly, the PA must consider the principles of "justice" and "economic stimulus" when it considers increasing revenue. The recent amendments to the Income Tax Law are attempts to increase local revenues. However, such amendment will not yield significant increases in revenues due to the inherent distortions in the Palestinian tax system which focuses on indirect taxes, particularly VAT and customs duties (on consumption) at the expense of direct taxes (income and wealth).

- Austerity is a pressing option that involves economic and moral benefits. However, this option often triggers public opposition. In the Palestinian case, this option is further restricted by the unique features of current spending.
  - Additional borrowing is not currently available due to many reasons:
    1. The public debt law (article 5) sets a ceiling for the public debt (40% of GDP).
    2. Overreliance on domestic borrowing has negative economic effects: the public sector would compete with the private sector on the scant available financial resources.
    3. The expansion of domestic borrowing from banks increases credit concentration risk.
  - Borrowing through issuing bonds in a private placement or public offering might be possible and attractive, especially when it targets the rich Palestinians in the Diaspora. These bonds can be based on both economic and financial returns, but the process requires either an amendment to the debt law or achieving adequate economic growth.
  - Soliciting additional aid (regular aid and emergency aid) might be possible from Arab and Muslim countries, but it might be unattainable from international donors if the peace process is stalled or if relations with Israel are strained.
  - It is probably imperative at this stage to negotiate with the Quartet and other international parties about mechanisms that oblige Israel to regularly transfer the clearing revenues to the PA's treasury without equivocation or political pressure. Perhaps, the PA can demand the presence of an international sponsor (state or institution that guarantees the continuous flow of these revenues) as a condition to return to the direct negotiations with Israel.
- To sum, though all of these options are necessary for a sustainable, effective national fiscal policy, none alone can adequately achieve this goal.

**Second: In terms of macroeconomic and Sectoral policies**

- Fixing distortions in the labor market by absorbing the majority of the Palestinian labor force within the Palestinian economy, particularly in the private sector: This requires mobilizing the Employment Fund and designing policies aiming at increasing the productivity of Palestinian workers by focusing on the export of high value-added goods and services (rather than exporting Palestinian labor). This, in turn, requires developing the human capital,

improving labor productivity, offering training and rehabilitation programs, and developing the higher education system to meet the needs of the labor market.

- Reducing the dependency of the Palestinian economy on the Israeli economy and developing economic and trade relations with Arab and Muslim countries: In this context, we might need to recall the Paris Protocol and whether it should be amended (through negotiations with Israel) or frozen until reaching a new agreement. Should the Palestinians demand (through the Quartet or other international players) that Israel fully abide by this agreement until reaching a final arrangement of the political and security relations with Israel in the framework of a final, just, all-out resolution? The researcher tends to argue for the latter option. Amending the Protocol requires direct negotiations with the Israelis— a move that undermines the insistence of the Palestinian leadership not to enter into negotiations unless its conditions are taken into consideration. Arguably, the problem is not essentially about the Paris Protocol; rather it concerns this Protocol's political and security references provided for in the Oslo Accords. As such, the amendment of the Protocol's provisions (even on the Palestinian terms) will never have significant benefits as long as Israel controls the land, resources and border crossings, and as long as it continues its arbitrary measures of restricting movement within the oPt on security grounds. Thus, separating the development of economic relations with Israel from the progress in the peace process is unreasonable. The assumption that economic relations can be developed regardless of progress in the peace process proved to be untrue, especially in times of crises. Further, assuming that Israel has a goodwill also proved untrue, in all stages of relationships.

- **Supporting institutions that provide social services to vulnerable and poor groups**

The social safety nets and other social networks are necessary to maintain social coherence, especially in light of the growing numbers of the poor within the deteriorating economic conditions. Increasing the allocations of the Ministry of Social Affairs should be a priority, since with adequate funds the Ministry can increase the target groups (especially families affected directly by the Israeli arbitrary actions) and improve its operation' efficiency. The Ministry has also a role to play: rather than merely focusing on humanitarian assistance, it

should focus on empowering the targeted families by helping them establish income-generating projects. Other necessary actions include:

- ✓ Providing health insurance for low-income individuals for nominal fees, along with providing medicines at subsidized prices.
- ✓ Establishing an unemployment protection fund (a joint effort by the government, employers and employees).
- ✓ Developing, on a regular basis, special programs for emergency employment.
- ✓ Contributing to designing training programs for non-skilled workers.
- ✓ Fighting inflation and supporting basic goods and services.
- ✓ Reconsidering the minimum wage law (making it more equitable and responsive to the needs of the working class) before it enters into force.
- ✓ Expediting the process of establishing labor courts which are supposed to settle disputes between workers and employers quickly and efficiently.

**• Supporting national products and fortifying them with the requirements of survival and resilience through:**

- ✓ Supporting agricultural inputs through tax breaks or direct subsidies.
- ✓ Steering production according to the needs of the domestic market rather than the foreign market (i.e. import substitution rather than increasing exports).
- ✓ Consolidating the role of agricultural cooperatives that help Palestinian farmers to survive and grow.
- ✓ Providing temporary protection for the nascent national industries (through a well-thought policy of customs).
- ✓ Monitoring imports of goods and ensuring they comply with national standards and specifications.
- ✓ Applying the government's decree of prioritizing domestic products in government procurements (provided that these products meet the requirements of the Palestinian specifications and standards), even if the prices are 15% higher than imported products.
- ✓ Reconsidering the recent amendments to the Investment Promotion Law: The amendment raised the capital that benefits from tax exemption from \$ 100,000 to \$ 250,000– contrary to



recommendations of all related studies and reports (which believe that the government should provide tax incentives for small and medium businesses, together with large companies).

- ✓ Reconsidering tariffs on imported goods (reducing fees on basic goods and raising them on products that strongly compete with local products– especially those coming from Israel and China). This also applies to VAT rates.
- ✓ Launching campaigns aiming at getting rid of the settlement products from the local market and encouraging community-based initiatives to boycott Israeli products that have Palestinian alternatives.
- ✓ Developing technical support programs (in collaboration with the private sector) for industrial facilities to enable them to raise the quality of their products and reduce their cost (thus increasing their competitiveness in local and international markets).

**• Intensifying reform efforts at all levels (judicial, administrative and institutional) and fighting corruption and wasting public resources.**

## 7. Conclusion

The data and analysis provided in this paper provides clear evidence that the Palestinian economy has been functioning under adversity mainly resulting from the Israeli continued occupation and from the limited resources and policy options the government has in managing that economy. This is not to say that social and economic policies; trade, fiscal and employment policies in particular; have been conducive. To the contrary, they were inappropriate and may have deepened the historical distortions and imbalances. On top of these imbalances was the inequitable distribution of income and wealth among different society classes. Poor has become poorer and rich has become richer. In addition, the growth in the economy may be characterized as unsustainable and heavily dependent on public spending which in turn has been dependent on international aid.

This paper offered a number of reforms in economic policies under the status quo scenario. These reforms are assumed if implemented to overcome some of the imbalances, but they definitely will not put the economy on the track of sustainable development as long as the Israeli occupation and related adverse policies continue.

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