



Palestine Country Profile

The Road Ahead for Palestine

**Economic Research Forum, Egypt
Institut de La Méditerranée, France**

FEMISE Coordinators

February 2006



This report has been Prepared with financial assistance from the Commission of the Communities and the Arab Fund for Economic and Social Development. The opinions expressed herein are those of the authors and therefore in no way reflect the official opinions of the Commission nor the Arab Fund.



Economic Research Forum

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Preface

This is the fifth issue in the Country Profile series covering Palestine, in addition to Egypt, Jordan, Turkey and Syria.

The Country profile project is jointly coordinated by the Economic Research Forum (ERF) and the Institut de La Mediterranee (IM), and funded by contributions from the European Commission [within the framework of the Forum Euro-Mediterraneen des Instituts de Sciences Economiques (FEMISE)] and the Arab Fund for Economic and Social Development (AFESD). The AFESD is also financing three additional country profiles: Bahrain, Oman, and Yemen.

The profiles are designed to analytically monitor the transition of the countries covered and provide an in-depth review of the macroeconomic and financial performance; trade relations and trends; an assessment of governance; and an analysis of the labor markets and human development. The main objective is to provide "home grown" policy recommendations that would assist policy-makers of those countries to plan ahead for growth and development.

The present profile sheds light upon the updated features of the Palestinian economy at this stage, and highlights its most crucial challenges such as unemployment, under performance and immaturity of the financial sector as well as the sharp decrease in the gross national and disposable income. It suggests remedies and reforms to the economic problems facing the country.

In this respect, the profile provides a base line for looking ahead. As such, it addresses an audience of researchers, policy-makers, the private sector, and donors.

The Profile has been the subject of a debate during a Seminar held in Cairo on 29th of August 2005. The seminar was inaugurated by a representative of the Secretary General of the Arab League and the Palestine Minister of Labor. In addition to authors and discussants, the seminar gathered representatives of the Palestinian academia, private sector, and government, as well as representatives of the UN offices in Palestine such as UNDP and UNFPA.

ERF hopes that this volume fills a gap in the knowledge of the Palestinian economy, and provides a useful contribution to the challenges facing the development of this economy.

Samir Radwan
Managing Director
Economic Research Forum

Executive Summary

1. Macroeconomic Overview

The Palestinian economy witnessed significant economic development since the advent of the PNA in 1994 and up to the year 2000, when the second Intifada erupted. Historically, the value of GDP in Palestine increased from 440 million dollars in 1968 to 2,238 million in 1992, and then jumped to 4,562 million dollars in 1999. With the commencement of the second Intifada in 2000, the level of GNP has decreased significantly by approximately 20% during the subsequent years, and continued to do so until 2004 when the GNP level returned to its 1999 level. While the GNI lost about 38% for the same period (Sabri, 1994; PMA, 2005, World Bank, 2003). The 2001 - 2002 period was the most critical period in Palestine as expressed in both economic and political aspects. However, since 2004, there are signs indicating a weak recovery. Subsequently, GDP may have a positive rate of growth in 2005.

The consumer price index was established in 1995 at 100 points. After nine years at the end of 2004, the price index reached 145 points, with an average annual inflation rate of 5%. The transport and communication costs witnessed the highest inflation rate as compared to other cost of living items. The inflation rate in the West Bank is higher than that in the Gaza Strip by 13 points. The unemployment rate ranged between a minimum of 12% in 1999 and a maximum of 31% in 2002, with an average rate of 22% during the PNA era. This means that from the total labor force living in Palestine about 170,000 workers are unemployed. The trade balance deficits reached two billion dollars however, and due to the international aid offered to the PNA government, the current account deficit decreased from 1,577 million dollars in 1999 to 373 million dollars in 2003 (PMA, 2005, PMA, 2004).

Nevertheless, during the ten years of the PNA

era, the government has taken a more significant role in the economy. This includes its' role in the total consumption, new investments, in recruiting more labor for the public sector, and in contributions to the gross domestic product. The incoming remittances increased in the last few years due to an increase in external aid to support the PNA budget. The incoming remittances had increased about 80% during the period 1997 to 2004, of which two thirds of this increase belonged to government activity. When the PNA emerged in 1994 public employment was at 30,000 employees increasing to 133,000 employees in 2004 (Sabri, 2003; PNA law of budget of 2005a), forming an increase of about 343% in public employment.

2. Fiscal Policy

The fiscal policy includes multiple ways of financing public services. Considering the Palestinian situation, various bodies participate in this service besides the PNA government. For example, the UNRWA agency, which offers free goods and services to Palestinian refugees, the NGOs, which have a significant role in offering social, health and free or subsidized education services, and finally, UN firms and international aids that render funds for the purpose of financing public services and enhancing infrastructure of the PNA.

The revenues of PNA come from various resources including local and international aids. The first contributed item to the PNA budget is the VAT tax, followed by customs, then the international aids and non-tax revenues which were recorded as the third and fourth most important sources of PNA budget respectively.

The PNA did not issue governmental bonds, and it does not have a national currency, which forbids it to get revenues from seigniorage. The PNA does not own land or property from

which to gain revenues, as it controls only 2% of the West Bank, while the remaining other areas are designated areas under the control of Israel.

The PNA played a minor role in the revisions of the tax system that currently exists in Palestine, revisions necessary because of the restrictions imposed by Israel (the occupier) through the Paris Protocol agreement. Accordingly, the present tax system continued to be the same whether in type, purpose, or procedures as to what existed for the last three decades, with one exception: the issuance of a new income tax law in 2005. Today there are various taxes imposed in Palestine including the income tax, five types of indirect taxes and various types of local taxes. These tax schemes raise major issues. For example the majority of the tax revenues are collected by Israel (the occupier) causing the PNA to lose a significant share of revenues. The VAT is a comprehensive tax imposed on all goods and services with no exceptions. There is controversy over the legality of the indirect taxes that are applied in parallel with those executed in Israel and without being legislated by the PNA. In addition, the references of the existing tax systems belong to four different jurisdictions.

Since 1994, the public services are funded by the centralized budget of the PNA which takes the role in financing basic activities including economic activities, social services, justice, security, and other public services. The PNA budget expenditures are classified into four groups: payroll costs, operational costs, transfer costs and capital expenditures. The security and social functions received the larger share of the allocated PNA government budget.

The idea to offer international aids, started in 1993, was to rebuild the infrastructure of the new emerging Palestinian State. The annual international aids ranged between \$250 million to \$650 million yearly during the last eleven years. The international aids are paid either directly through the PNA budget, through one of its ministries, through the PECJAR Institute, which is the official reconstruction public organization, through the UNDP, through the

World Bank offices in Jerusalem for supervision and implementation, or through UNRWA or through the Palestinian NGOs.

The external debt of the PNA increased from \$17 million in 1995 to \$1,010 million in 2005. In the last ten years, the initiation of, the contracting for, and administration of the loans were neither systematic nor legal and in contradiction with the basic Palestinian laws as stated in Article 83. In addition, contracting a loan should be conducted under the supervision of the Palestinian Monetary Authority as stated by its law, Article 35. Thus, there is a need to consider having a knowledgeable and exclusive department for debt management.

To examine the performance of the PNA fiscal policy, various positive as well as negative aspects can be found. The number of recruited employees to the public sector increased by more than three times since the PNA emerged and reached about 133,000 employees, in addition to the emergency programs attached to the PNA budget that absorb an average of about 13,000 employees yearly in the job creation projects that have been implemented in the last few years. Some believe that there is a need to change policy and reduce the number of public employees or at least freeze it at its current level, because it creates a burden on the small retirement system of the PNA, and creates an inefficient and crowded working environment.

In addition, the PNA has a commitment to provide free and compulsory education up to the tenth grade, and full medical insurance coverage for children up to three years of age. It offers a subsidized health insurance program in voluntarily basic, subsidizes higher education and finances colleges of education. On the other side, there is no connection between the annual government budget and the economic plans prepared by other government authorities, such as that just published in May, 2005 by the Ministry of Planning, and known as the Medium Term Development Plan for 2005. In the last two years, a financial reform program has been implemented including the unifying

of the treasury account which provides a single pool of funds for all PNA transactions, the establishment of the Palestinian Investment Fund to include all business activities and assets owned by the PNA, the transferring of revenues collected from petroleum and cigarettes fees to the PNA budget, the incorporation of the majority of independent government institutes to the related ministries, the unifying of all payrolls of PNA employees under the Ministry of Finance including security employees, and the addition of a new law of the financial and managerial control published in February 2005.

Finally, there is a need to reform the fiscal policy of the PNA. This includes the restructuring of tax departments, reorganizing and legalization of indirect taxes, issuance of a Palestinian customs law, unification of local taxes imposed on local councils, consideration of social aspects in the application of VAT, and clarification of the income tax base. Additional reforms are to incorporate all employees into a united retirement system, implement the new law of retirement which was issued in 2005, transfer the headquarters of PIF and its investments to Palestine, incorporate other public funds to the PNA budget, publish financial statements to all public funds in annual basis, offer final statements of annual budgets to Palestinian Legislation council, comply with budget organizing law in preparation and implementation of the government budget, apply proper measures of internal control to government accounting system, and unifying budget financial transactions into one currency.

3. Financial Policies Issues

In spite of the generally unstable political and economic situation that exists in Palestine, the financial sector has witnessed a positive increase in the last ten years in four groups: First: The banking system, which includes 22 Arab, foreign, and Palestinian banks with 135 branches (PMA, 2005). Second: Insurance sector, which includes nine insurance corporations and deals with general insurance activities such as accidents, health, and life and loan guarantee insurance. Third: Other financial institutions including moneychangers

and microfinance firms. Fourth: The Palestinian stock exchange market dealing only with par-value common shares of twenty-five Palestinian corporations and one foreign corporation among six private corporations operating as registered brokers.

The size of bank operation in Palestine has grown significantly in the last decade, as expressed by owner equity and total assets. The major activity of banks is granting loans and other credit facilities such as overdraft services, discounting of commercial bills and financing imports. In spite of the significant increase in credit advances during the last period, it is still low compared to the value of deposits held by the banks. As for deposits, they have increased to \$ 3,976 million in February 2005, which are equivalent to 90% of the Palestinian GDP, and represent more than most of the Arab states. However, there are some negative issues attached to the banking system in Palestine such as checks refused due to insufficient funds, the high percentage of bad loans, the high margin between interest paid on deposits and interest earned on credit facilities, and the low share of medium and long-term financing.

The Palestinian Monetary Authority (PMA) established in January 1994, aimed to work as the central bank of the PNA. However, with the absence of a national currency, the PMA has little to do regarding currency exchange rates, or stating interest rates using other possible monetary measures. In addition, the PMA, until now does not hold any government assets, funds, or accounts. Accordingly, the remaining functions of the PMA are to conduct clearance of checks, monitoring of and controlling the operation of banks working in Palestine, and organizing the moneychangers market. The PMA uses various measures to control major activities of the banking system in order to assure minimum risk and serve the Palestinian economy. The compliance of the banking sector with the PMA stated measures has not yet materialized, especially with regard to the stated limits on the collected fees and charges. In addition, the PMA does not interfere in the interest rates and leaves it to banks,

resulting in a big spread in interest or the difference between rates paid on deposits and those collected on credits.

The Palestinian Securities Exchange (PSE) was incorporated as a private shareholding company in February, 1997. The listed corporations choose voluntarily to have their stocks traded inside the market, otherwise the trading of shares for the rest of Palestinian corporations are traded outside the market through transactions approved by the board of directors of the respected corporations as stated by the existing corporate law of 1965. The Palestinian stock exchange trades only in common par value shares, at one level of secondary market. In addition, neither corporate nor government bonds exist in the Palestinian market. The stock market in Palestine has passed the initial stage of development but is still far from being considered a success story.

In conclusion, the performance of the Palestinian financial sector is still in the immature process and its role is limited. It is confined to 10% of the total liabilities of the Palestinian private sector. The negative aspects of the financial system are presented in various aspects: it is a short term credit, it is attracted to commercial and service businesses while ignoring the agriculture and industrial sectors, and the majority of its assets are located outside Palestine, rather than being invested in local investments. Finally, other financing alternatives and instruments such as the use of bonds by industrial and housing business corporations, use of pension funds, failure to attract direct foreign investment or cash inflow channeled through primary stock market do not exist in the Palestinian financial sector.

Recommendations regarding financial policy in Palestine may be drawn. For example, to consider investments in local corporations as part of the minimum requirements of credit to deposit ratio imposed by the PMA; to encourage banks to invest in both primary and secondary markets in Palestine; to change the present legal entity of the PSE to a non-profit organization owned by insiders known as stakeholders; to issue the proposed law of

companies and law of insurance; to expand the Palestinian stock exchange functions by adopting the concept of cross listing of companies in other Arab stock markets and to consider the possibility of using international public offerings by newly established Palestinian corporations.

4. Trade Issue

Israeli impediments and restrictions (NTB's) has limited the benefits that can be attained from the bilateral agreements signed by the Palestinian National Authority (PNA) with other Arab and foreign countries. During the period 1996-2002, the Palestinian trade deficit reached a peak of \$3,093 million in 1999. By 2000, the calculated trade deficit was \$1,448 million, a 50% decline from the 1999 level. This reduction in trade deficit can be attributed to many factors. However, the sharp decrease in the Gross National Disposable Income (GNDI) is a primary cause behind the continuous reduction in merchandise and service imports. On the other hand, merchandise exports went down by 30% in the course of 1999-2002. A decline in the trade deficit does not; therefore, this indicates an improvement in the performance of the Palestinian economy.

The competitiveness of Palestinian exports is hampered by lower productivity of the Palestinian labor force as well as higher wages which are determined partly by wages offered to Palestinians working in Israel. The diversification index for Palestine reveals that Palestinian exports seem to be less diversified than those of neighboring countries. In the last few years, global demand factors have contributed to a negative trend in Palestinian exports assuming the 1996 shares of export groups remained constant. But relaxing this assumption and calculating the competitiveness index (change in market share times global imports) has shown that for the bulk of Palestinian exports there has been a decline in market shares too.

The technology content of Palestinian exports can, for the most part, be characterized as resource based and low technology. Medium

technology share comes next followed by the high technology share which is the smallest of the three groups. The distribution pattern of technology content shares for world exports from largest to smallest is: medium technology, high technology and low technology, resource based. Uncompetitive and weak agro-processing industry has overtime, led to increased imports of food and agricultural products. Despite the reduction in GNDI imports of those products there was an increasing trend during 2000-2003. In contrast, exports of farm and food products tended to decline during that period. Unstable prices in the domestic markets in particular, showed variations for such products produced locally. On the other hand, prices for imported products have been increasing overtime (imported inflation).

The PNA should focus on removing the NTBs imposed by Israel on the Palestinian economy. It has been considered a necessary condition to liberalize Palestine trade in order to be engaged in regional and international markets. The reliance of the Palestinian trade on a single market, in both exporting and importing, has led to a concentrated production in certain sectors and activities that fall within the interests of Palestinian main trade partner, namely Israel. Therefore, the diversification of production and exports that matches the demand in the neighboring countries could reduce Israel's monopoly of the Palestinian market. On the Palestinian side, a number of measures should be taken to develop the performance of Palestinian trade. Despite the bilateral agreements signed between the PNA and neighboring and foreign countries, the benefits from those agreements are still limited. Much remains to be done by the PNA in order to reduce the administrative burdens and transaction costs. In addition, institutional facilities are needed to expand trade policies in order to promote exports on one hand and to rationalize imports on the other. Furthermore, the current relationship between trade and domestic and foreign private investments needs to be modified and put on the right course. It is obvious that trade liberalization will attract the private sector to invest in diversified products for potential export markets. However,

both private and public sectors need to establish joint institutions that are necessary to create adequate and efficient marketing facilities.

5. Governance and Institutional Issues

As a result of the Oslo Accords, The Palestinian National Authority was created in the West Bank and Gaza Strip on May 4, 1994. On January 27, 1996, the legislative body of the Palestinian Authority, known as the Palestinian Legislative Council was elected in the first general political elections, both presidential and legislative, in the West Bank and Gaza. The outcome of the elections was that the late Yasir Arafat was elected president of the Palestinian Authority together with 88 members of parliament known as Palestinian Legislation Council. The Palestinian National Authority has an institutional design permitting the existence of a mixed system of governance headed by the president and an appointed prime minister. The Palestinian political system is designed to be one of a constitutional democracy based on the principle of separation of powers as stated in the Declaration of Independence (1988) that calls for a parliamentary system of government and the independence of the judiciary.

The Palestinian government has initiated serious reform programs, and prepared the scene for the coming elections in January 2006. Despite the major complexities imposed by the occupation, the main participants in the Palestinian society, i.e., the public sector (the legislature, the executive, and the judiciary), the civil society, and the private sector, have stated their strong commitment for good governance, transparency, and political pluralism.

6. Labor Issues

The Palestinian society is distinguished by its youthfulness. For example, 46.1% of population was less than 15 years of age in 2004. Birth rates are one of the highest in the world which will eventually lead to an increasing number of new entrants to the labor market and more pressure on the labor market to create new jobs. However, population growth tended to

gradually decline in both the West Bank and Gaza Strip during the period 1997-2004. The labor force participation rate (LFPR) in the PT is relatively low but increased slowly during the period of 1972-2004 and the size of the labor force increased steadily at a rate of 6.1% annually. A considerable difference exists in the LFPR between male and female labor force.

The private sector is the main employer counting for about 70% of all employees, followed by the public sector (20%) and the remaining (10%) work in Israel. The role of the Israeli market as an outlet for the Palestinian workers has been shrinking in recent years and expected to diminish further. The service sector is the main economic activity in terms of employment. Wage employees formed about 61% of those employed. Unemployment rate in the PT dropped significantly up to 11% at the end of the third quarter of 2000 but jumped significantly due to the Israeli siege. The burden of unemployment is not identical among the unemployed groups in terms of gender, education, age and location. 87.5% of the unemployed are males. The largest portion of the unemployed are uneducated with 80.1% of them having less than thirteen years of formal education. Also, among the educated unemployed 83.1% are women. Most of the unemployed are unskilled laborers, 78% of them working in construction and agriculture.

The PNA and the international community initiated many activities and projects to alleviate unemployment after the year 2000. However, the private sector is the major pillar in any solution to the unemployment problem. The absorption capacity of the Palestine economy was 62% in 1999. The most important sectors in terms of their absorption capacity are: services, construction, transportation, industry. Direct export of labor to the Gulf Countries (assuming it is politically accepted) is not expected to play a major role in alleviating unemployment.

A wage gap of 19% exists between the West Bank and Gaza and it is expanding overtime in real wages. Similar gaps exist between Palestinians working in the PT and Palestinians working in Israel. A gender wage gap exists

in the PT. Public sector wages are determined by the civil servant law scale, while private sector wages are subject to market conditions. The PNA does not interfere in wage setting in the private sector. Labor markets are regulated by a set of laws, primarily the labor law and the civil servant law which regulate public sector employment. Also, the PNA formed the Ministry of Labor in 1994 to handle labor market issues. There were about 40 thousand children working in the PT at the end of March 2004, representing 3.1% of all children aged 5-17 years. Most of the child laborers are involved in agricultural activities, trade, restaurants, and hotels. Two thirds of working children work as unpaid family members.

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Chapter I

Fiscal policy and Performance

1. Introduction

The government mainly offers the public services to residents without discrimination including non-marketable goods and services, and a free or subsidized selected goods and services. To apply this definition within the Palestinian context, and to consider the current political situation, we found various bodies offering these services besides the PNA government: the UNRWA agency, which offers free goods and services to the Palestinian refugees, the NGOs which have a significant role in offering social, health, free or subsidized educational services and finally, international aids and UN firms that render funds for the purpose of financing public services and enhancing infrastructure of the PNA. Within this content, this chapter will discuss the fiscal policy of the PNA.

2. Taxation Policy

2.1 Historical background

The first tax system in Palestine started during the Ottoman rule in which there were three rural taxes mainly the Werko (% of the capital value of land), and the Tithe and Animal tax (El-Eini, 1997). While the first central indirect tax was imposed during British mandate in Palestine in 1927, as for income tax, it was reorganized in Law No. 13 of 1947, which imposed tax on income with a rate of 25% for companies and progressive rates in personal income. During the British mandate, between 1939 and 1944, the tax revenues contributed to 57% of the Palestinian Budget which reached about 162 million dollars. During this period, the indirect taxes formed more than four times of that generated from direct tax (Himadeh, 1938; Horowitz and Hinden, 1938; Palestine Gazette, 1946 and Nathan et al., 1949). In 1967, the tax system in the West Bank was different from that imposed on the Gaza Strip.

The Jordanian tax laws were imposed in the West Bank and Jerusalem, while the Palestinian tax law that existed during the British mandate continued in Gaza Strip. After the occupation in 1967, the occupier in both the West Bank and Gaza Areas issued military orders, which replaced the Jordanian and Palestinian official Gazette. The new military orders stipulated that the present tax laws of income, property tax, and customs would continue unless further changes were stated by other military orders. After that, major changes started to be implemented from 1975 up to 1990, in which there were more than 200 military orders issued to change tax rates, types and procedures in both the West Bank and Gaza Strip. The major changes included imposing the indirect tax known as VAT, changes in income tax brackets, collections procedures, and other changes regarding local taxes rates (Sabri, 1986 and Sabri 1994).

2.2 Present situation

Due to the imposed restrictions by the occupier through the Paris Protocol agreement, the PNA plays a minor role in the revision or remodeling of the tax system that exists in the newly emerged state. Accordingly, the present tax system continues to be the same whether in type, purpose or procedures as what has existed during the last three decades, with one exception of the issuance of a new income tax law in 2005. Today there are various taxes imposed in Palestine including income tax, five types of indirect taxes, and various types of local taxes.

2.2.1. Direct taxes

Up until the end of the year 2004, two different income tax laws existed in the West Bank and Gaza Strip namely the Jordanian income tax law of 1964 and the Palestinian income tax law of 1947. At the beginning of 2005, a new

income tax law was publicized in the February 2005 edition of the Palestinian Gazette stating proposed implementation for the beginning of 2005. Issuing this law may unify income tax law between the West Bank and Gaza Strip for the first time. It includes taxes imposed on payroll, and taxes imposed on self-employed income using a progressive rate ranging from between 8% and 16%. For corporate income, the tax rate declined from 25% to one flat rate of 16% as presented in (Table 1.1). The returns of income tax in Palestine are immaterial and never exceed 10% of the total collected tax during the last ten years. The average annual collected income tax was about 50 million dollars in the last decade. In 2004, the value of the direct tax was about 59 million dollars as compared to 752 million dollars for indirect tax. Of the total, one half of income taxes are collected from the payroll of employees, and 46% from company business profits, while only 5% collected come from self-employed income (PNA of law of budget 2005a).

Table 1.1- Summary of Types and Rates of Central Taxes Prevailing in Palestine as in September, 2005

Taxes	Rates
Income Tax	
1. Self-employed income	8% to 16%
2. Payroll income	8% to 16%
3. Corporation income	16%
Indirect Tax	
4. VAT on all goods and services	16 %
5. Purchase tax on selected goods	Various rates (50% average)
6. Customs duties	0 -200% based on goods
7. Excise on some produced goods	30% in average of sale value
8. Supplementary tax	10% -100%
9. Fees in Petroleum products	20% to 60% plus VAT
10. Excise on tobacco, wine	Average rate 50% of value
11. Vehicle registration tax	2% of value (\$100- 3500) @

Source: Compiled by the authors

2.2.2. Indirect taxes

The general situation of the indirect taxes remain as it has been in the last three decades due to the restrictions imposed on possible changes in rates and types of indirect tax during the transitional period. Civil Affairs Protocol and its appendices as they pertain to indirect taxes provided for those restrictions in article six of Paris Protocol (IPA, 1995). It stipulated that the PA should impose the same

indirect taxes including the VAT, purchase tax, and customs duties on both domestic and imported products, with possibility of reducing the VAT rate from 17% to 15% (Sabri 2004). Today, there are various types of indirect taxes imposed in Palestine as shown in (Table 1.1) and which produce the majority of the return of local revenues for the Palestinian central budget. These types are:

The VAT: The major indirect tax item is the value added tax (VAT) imposed on the West Bank and in Gaza in 1976. It is a comprehensive tax imposed on all transactions related to goods or services including medical services and basic needs. The tax rate is now 17% of the total sales value of goods and/or services. The collection of the tax is the responsibility of the supplier of the goods or services. The financial institutions and non-profit organizations are also obliged to pay 6% of the total payroll as VAT on a monthly basis. The VAT is the main source of revenue for the Palestinian government budget. It has contributed to about 38% of total collected taxes in the year 2004 as shown in (Figure 1.1).

The Customs Duties is the second indirect tax which is levied on commodities imported from outside the state immediately upon arrival to the country's port and entry therein. Thus, the government collects plentiful proceeds besides creating some sort of protection for domestic production. Customs duties are levied according to fixed percentages based on types of goods and country of origin. Customs duties in Palestine are subject to the same policies, rates and laws of customs applicable by the occupier and are collected by them in accordance with the applicable rates. The customs revenues formed about 30% of the total taxes in the year 2004. The third indirect tax is the excise tax which is imposed on selected locally produced products at a rate that ranges from between 10% to 30% of wholesale values such as soap, beauty products, detergents, soft drinks, cosmetics, tobacco, salts, and intoxicating drinks. Taxes on alcoholic beverages reach 75% and are collected from the producer, where taxes on cigarettes reached up to 55% of the wholesale price. There is also tax on

fuel and petroleum products that range between 8%-145% based on the type of product.

The Purchase Tax is the fourth type of indirect tax which is levied on some imported commodities such as tobacco, cigarettes, cars, and some electronic appliances. It equals the production tax imposed on some commodities that are locally produced when commodities are subject to charges of domestic production, or when they are protected (Sabri, 1998). Finally, the Supplementary Tax is the last indirect tax and is applied when the value of imported commodities is low, accessing a certain percentage to the purchase price before being subjected to custom duties and VAT. This percentage ranges from between 10% and no more than 190%. The values of purchasing tax and the supplementary tax are included with the VAT tax.

Figure 1.1 - shares of types of taxes imposed on PNA in 2004

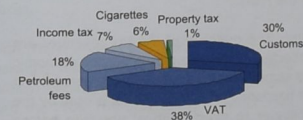


Table 1.2 - Local taxes and rates as existed in 2005

Municipality Taxes	West Bank	Gaza Strip
18. Property tax	17% of rent value	15%
19. Education tax	7% of rent value	Not existed
21. Craft licenses	\$ 10 - \$ 250 a year	Not existed
22. Business licenses	\$ 18 - \$3500 a year	\$ 10 - \$ 1500
Local Villages Taxes		
23. Poll tax (head tax)	\$ 4 per person	Not existed
24. Rural property	\$ 6 per dunum of land	15% of building rent
25. Business licenses	\$ 15 - \$90 a year	\$ 5- \$ 50

Source: Compiled by the authors

2.2.3. Local taxes

The local councils in Palestine are authorized to impose certain taxes to finance their activities. Today, there are about four types of taxes that exist in the West Bank including property taxes, double license fees, and educational tax, which is imposed on residents

of municipalities, and three other and different types of taxes imposed on the residents of village councils. In the Gaza Strip, there are two local taxes imposed on residents of municipalities and varying other types of taxes for local village councils. Table 1.2 summarizes the local tax types and rates in Palestine, as they exist in 2005. The tax rates are different in the West Bank from those imposed in the Gaza Strip, and are stated based on the rent value of the property, or per person, or based on the size of the business firms. The education tax is imposed by West Bank municipalities at a rate of 7% of the rent value. It has a separate budget and is run by a special committee to supervise its spending for educational purposes.

The value of collected local taxes is immaterial compared to the total allocated budget of local councils and municipalities. It forms only 0.19% of the GDP as compared to 1.13% of the GDP in the OECD developed countries (World Bank, 1999b). However, the property tax is still the main local tax in both the West Bank and Gaza Strip forming about 25% of the total municipalities' revenues, and representing the first source of income to cover expenditures to provide local services.

2.3 Organizational structure of tax management

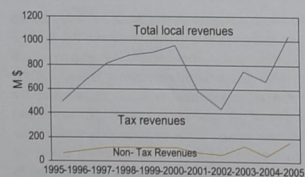
The tax authority in the West Bank is divided into three organizational divisions; the income tax department, the customs department which is responsible for all non-direct taxes, and the financial department which is responsible for a part of the local taxes including property and licenses taxes. Other departments such as the transportation department collect taxes on vehicle. All tax departments in various districts report monthly estimations and actual collections to the tax officers. The situation in Gaza Strip is similar to that in the West Bank except that they have two divisions, which are the income tax department and the customs and VAT department. In addition, tax departments use different financial and filing systems for the same taxpayers. Accordingly, there is an urgent need to restructure tax management and unify its departments (Income

tax department, department of VAT and duties, customs, and the financial department) into one department.

2.4 The performances of the Tax system

An examination of the main tax system reveals that its role is to collect revenues to finance the government budget. It should be noted that the tax system produces the majority of total local revenues of the PNA. The value of collected taxes began at 426 million dollars in 1995 and reached a boom point of 847 million dollars in 1999, and is expected to regain that level in 2005. Figure 1.2 indicates the increasing trend of tax revenues from 1995 to 2005 (Sabri, 2003; PNA law of budget 1997-2004 and 2005a). It indicates that about 87% of the total local revenues produced by the tax collections during 11 years, compared to 13% for non-tax revenues. To compare that with the average collected taxes in Arab states, which was about 26% in 2003 (UAER, 2004), it shows that the tax productivity in Palestine is three times higher than the average among Arab states. In addition, the collected tax revenues formed about 20% of the total Palestinian GDP in 2004 as compared to 8% in the Arab states in 2003 (UAER, 2004).

Figure 1.2 - Tax and non-tax revenues in the PNA Area



However, the majority of taxes are collected through VAT and customs duties. The collected income tax ranged from 1% - 2% of the GDP during the period of 1996 to 2002, while the indirect taxes ranged from 13% - 17% of the Palestinian GDP for the same period (IMF, 2003a). However, the low share of income tax compared to the indirect taxes applies to all periods since its imposition by British mandate.

The low yield of the Palestinian income tax compared to the much more high yields of the VAT taxes (as the main source of government revenue) is not a unique situation. This phenomenon is found in the majority of south Mediterranean Arab states (Nashashibi, 2002). The indirect taxes serve only one function, which is to generate revenues in order to finance the expected expenditures, while other functions of a tax system including social aspects are not served. Accordingly, to fulfill the concept of justice in the tax system, there is a need to redesign the VAT rate to exclude basic needs, medicines and other basic services or to at least have a discriminatory multi-rate system ranging from 0% to 20% instead of a fixed rate of 17% to support the consideration of other societal functions and needs.

2.5 Issues in the taxing system

There are major issues that can be raised regarding the present tax system as existed in the PNA:

First: The majority of the tax revenues are collected by the occupier under the economic agreement known as the Paris Agreement and as happened in 2001 and 2002 is used by the occupier to exert political pressure before handing over the collected funds to the Palestinian treasury. Accordingly, there is an urgent need to liberate Palestine from this practice and give this job to the PNA. During the last ten years, the taxes collected by the occupier included customs and VAT taxes, forming more than two-thirds of the total taxes collected.

Second: The second issue is related to the loss of significant revenues from the VAT taxes due to a so-called customs union system. Imposed on the PNA due to economic negotiations, it turned out to be a one sided customs union. The lost revenues of VAT imposed taxes on goods normally imported to Israel but were re-exported to the West Bank and Gaza were estimated by the World Bank at 174 million dollars yearly (World Bank, 2002). Accordingly, there is a need to release the PNA from the customs union and build an independent

relationship with other Arab states.

Third: The VAT is a comprehensive tax imposed without exceptions on all goods and services. This is considered unfair for low-income families that form one-third of the Palestinians. This means that families, which borrow to meet their basic needs have to pay taxes on the borrowed money after it has been spent. In addition, the VAT does not exclude the basic needs and uses one tax rate of 17% for all commodities and services.

Fourth: The legal issue of indirect taxes. There is a controversy over the legality of indirect taxes that are applied in parallel with those executed in Israel without being legislated by the PNA. Actually, the PNA has not provided for legal coverage for the indirect taxes currently in force. In addition, tax rates and instructions undergo continuous changes without due notice to Palestinian taxpayers (Sabri, 2004). Therefore, there is a need to issue a decree that determines and defines effective indirect taxes.

Fifth: The references of the existing tax systems belong to four different jurisdictions, including British mandate, Jordan, the Israeli occupations, and the PNA. The only tax law, which was issued by the PNA, is the new income tax law issued in February, 2005. Other indirect tax laws and local tax laws are imposed and stated before the initiating of the PNA law. For example, the VAT, customs, and purchasing tax are stated and still under the control of the occupier, while other indirect taxes belong to Jordanian or British mandated laws. Local laws are referred to either Jordanian laws or British laws as shown in (Table 1.3). Accordingly, there is a need to update, reissue and legalized such laws.

Sixth: Logistical difficulty for the collection of VAT: Taxpayers frequently claim that the tax authority limits their business activities due to its control over clearing bills, which are mandatory to assure the collection of VAT. Meanwhile, departments within VAT believe in tight control over the clearing of bills as a guarantee to prevent tax evasion; a problem

that will genuinely continue to exist throughout the interim stage until the Palestinian economy is liberated.

Table 1.3 - Jurisdictions Reference for taxes imposed in Palestine

Types of Taxes	Legal Reference
Income Tax	Palestinian Law
VAT	Occupier military orders
Purchasing tax	Occupier military orders
Customs	Occupier military orders
Tax on selected products	Jordanian law
	British Mandate law
Other duties on production	Occupier military orders
Local taxes in Gaza Strip	British Mandate law
Local taxes on West Bank	Jordanian Law

Seventh: The following notes may be found about the newly issued income tax law (PNA, 2005b). For example, there is a need to restate Article No 2 of the income tax law No. 12 of 2004 (PNA, 2005b), in order to define the income tax base, which is still ambiguous. A decision needs to be made regarding whether or not the Palestinian taxpayer should pay on income generated outside Palestine. The exemption of farmers has been restricted according to special regulations, which may create additional problems to this sector which is already suffering the most from the occupier. The tax brackets for payroll income of employees should include a partial exemption such as previously existed up to the end of 2004 in order to make a balance with self-employed income who have the opportunity to deduct expenditures. Presently, both are subject to the same brackets and tax rates.

3. Government Budget

3.1 Introduction and background

The British administration initiated the first Palestinian budget when it issued Article 28 to regulate financial and public affairs. The annual budget used to prepare Article 28 was issued by the high commissioner in an ordinance form, and published in the Palestine Gazette. The total expenditures for a quarter century (1920-1944) were about \$ 415 million. The major expenditure items were security, defense and general administration which formed between

55% to 68% of the total expenditures, public works formed between 15% to 25%, education and health formed 9% and agriculture formed between 4% to 7%. The total expenditures budget for the year 1946 was about \$ 80 million. The major revenues under British mandate came from indirect taxes (AMCI, 1991; Horowitz-Hinden, 1938; Nathan et., al., 1949). In 1948, the West Bank became a part of the Kingdom of Jordan, bringing the West Bank share of public expenditures to a range of between \$ 24 Million in 1959 and \$ 37 million in 1966. The public budget in Gaza Strip was under Egyptian administration. During the Israeli Occupation, under section 17 (Sabri, 1994), the government expenditures budget in Palestine was articulated by Israeli officers and based on an organizational structure referred to as civil administration for the purpose of integration into the Israeli Defense Ministry budget.

Since the 1994, public services are funded by the centralized budget of the PNA. It takes the role in financing the basic activities including economic activities, social services, justice, security, and other public services. The Governmental sector is comprised of the different ministries, institutions, and commissions. The PNA government budget is organized in nine groups including, general administration, security, financial management, foreign affairs, economic development, social services, cultural services, transportations, and communication services and distributed among sixty-two responsible cost centers. The importance of these centers varies as expressed by their allocated resources and number of employees.

For example, about 80% of the total government employees are working in three ministries: Ministry of Security and Internal Affairs, Ministry of Education and Ministry of Health (PNA, Budget law of 2005a). Besides these responsibility centers, administration of the PNA budget is organized based on four major expenditure items. However, there are no other classifications used to present budget statements, such as programs and projects classifications which could be more useful in the planning, controlling, and evaluating

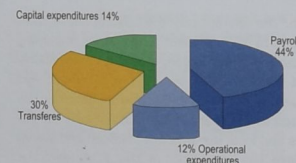
processes. The first official Palestinian budget during the Palestinian National Authority era was presented to the Palestinian Legislation council in 1997, taking into consideration that budgets for the years 1995 and 1996 were only partial statements for actual expenditures of government activities. The size of the central government budget doubled twice between 1992 and 1995, increasing from 426 million dollars in 1995 to 964 million dollars in 2000, and it is expected to increase to 2292 million dollars in 2005 as presented in (Table 1.4).

Table 1.4 - Palestinian Government Budget

Years	M \$
1980	89
1991	286
1995	426
2000	964
2003	1283
2004	1581
2005	2292

Sources: PNA laws of budget (1997-2004; 2005a); Sabri, 1994

Figure 1.3 - Distribution of Palestinian Budget Expenditures in 2005



3.2 Analysis of budget expenditures

3.2.1. Payroll expenditures

Payroll costs represent the highest share of the budget expenditures. It formed about two-thirds of the current expenditures during the last three years, and formed about 44% of the total current and capital expenditures during the year 2005, as presented in (Figure 1.3) that shows the distribution of budget expenditures during the year 2005. In addition, the cost of payroll will increase with the implementation of the 1998 Civil service law which includes all public employees. The partially implementation of this law caused an increase of 15% to the payroll bill in 2003

(IMF, 2004). The high payroll cost comes from the fact that the number of public employees increased significantly from 1994 to 2004.

3.2.2. Transfers expenditures

Transfers cost represents the second budget expenditures item and forms about 30% of the total expenditures with a value of 623 million dollars in 2005. It includes the retirement payroll for public employees enrolled in the West Bank retirement system, the subsidiary cost item for local municipalities and councils, and cash and subsidies for the provision of commodities and cash payments to cover families with special needs or particularly difficult circumstances. The transfers cost item has also witnessed a significant increase due to the pay out of utilities bill payments due by municipalities and other public agencies and which were deducted directly by the occupier from the collected VAT taxes. Since the starting of the second Intifada, the municipalities have faced difficulty in collecting electricity and water bill payments from residents, thus causing the central government to cover the shortages (IMF, 2004). The utility bill for municipalities was about 147 million in 2003. The PNA government attempts to keep municipalities from collecting the cost of utilities from the residents of the cities and villages. Moreover, this budget expense item is expected to increase when the government applies the retirement age requirement at 60 years, which will cause the payroll bill for retired employees to increase significantly.

3.2.3. The operation expenditures

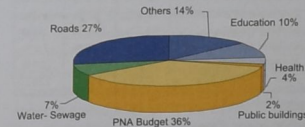
The third expenditures item are related to operation costs, which comprise about 12% of the total expenditures. This item includes the rent expenses for government facilities, utilities, and supplies. For some ministries such as the health ministry, because it includes the costs for medicine and medical supplies the operation costs item reached about one third of total expenditures.

3.2.4. The capital expenditures

The capital budget of the PNA is financed in

two ways. A small part is financed by the PNA budget revenues while the majority of capital projects are financed by the international aids through various ministries or through a specialized institute which was established in 1993 under the name of the Palestinian Economic Council for Development & Reconstruction (PECDAR). The value of the annual capital budget ranged between 200 and 500 million dollars financed by both international aids and the PNA budget, with an average annual value of about 300 million dollars. The capital budget during the last ten years allocated for expenditures to support main infrastructure and road project costs, including water projects, public buildings, schools, hospitals and health centers. For example, the total amount of projects implemented through PECDAR totaled \$633 million from 1993 to 2001 (PECDAR, 2001). As shown in Figure 1.4, the capital projects implemented over the last ten years by PECDAR included road's network improvement and rehabilitation forming about 27% of the total allocated capital expenditures followed by public building, educational facilities, water-sewage projects, and health facilities respectively.

Figure 1.4



PECDAR Projects based on sectors from 1993 to 2001 (633 \$ M)

3.3 Functional classification of expenditures

The PNA budget services has eight various functions including security, financial management, economic development, foreign affairs, social services, cultural services, transportation and general services. However, the allocated expenditures for the stated functions vary. In general, security and social functions received the large share of the allocated budget, followed by financial

management including serving the public debt and retirement's expenditures, which formed about one quarter of the total expenditures. Other functions including economic development, cultural services, foreign affairs, and transportation received only from 1% to 3% of the total allocated budget. The social services still represent the highest share among the eight functions, and reached about 40% of the total expenditures in 2005. This ratio is higher than the average ratio among Arab countries which was about 30% of the total expenditures in 2003 (UAER, 2004).

In addition, the distribution of budget based on related functions is shifting towards more social services and less administration costs as indicated in (Table 1.5). It shows that both the security and public administration share decreased by around 4%, while social services increased by around 12% during the last three years.

Table 1.5 - The share of public services of PNA budget

	2005	2004	2003
Public administration	5.1%	5.4%	9.4%
Security	24.1%	27.3%	27.2%
Financial management	23.6%	27.6%	27.3%
Foreign affairs	1.7%	1.5%	1.1%
Economic development	2.1%	2.5%	3%
Social services	40.9%	32.9%	29%
Cultural services	1.7%	2%	2.2%
Transportations	1.7%	0.8%	0.9%
Total In Million \$	2080	1581	1283

Source: (PNA, 2005a).

4. Analysis of Revenues

4.1 Introduction

The revenues of PNA come from various resources including local revenues as well as from international aids and other sources as shown in (Table 1.6), and representing the important of revenues items of PNA during the last ten years. It shows that the first contributed item of the PNA budget was the VAT tax, the second was customs followed by international aids as the third important source of PNA budget. The non-tax revenue is considered the next major source of PNA after tax

revenues. However, the PNA did not issue governmental bonds, nor does it have a national currency, which forbids obtaining revenues from seigniorage. The PNA does not own land or property from which to gain revenues, as it controls only 2% of the West Bank.

Table 1.6 - Revenues of PNA budget 1995- 2005

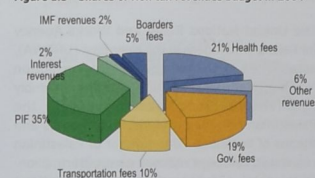
	Rank
VAT	1
Customs	2
International Aids	3
Exercises including fuel fees	4
Non- tax revenues (service fees)	5
Profit of PIF & other public firms	6
Income Tax	7
Loans	8
Selling of Assets	Limited
Issuing of bonds	No
Revenues of Land sand properties	No
Revenue from Seigniorage	No

4.2 Non - tax revenues

The non-tax revenues represent from 12% to 16% of the total revenues of the Palestinian budget, with an average of 13%, (an average value of 100 million dollars annually), leaving the tax revenue share from 84% to 89% (IMF, 2003a, and Sabri, 2000). However, the share of the non- tax revenues have increased in the last three years due to including the profit from the Palestinian Investment fund to the PNA budget. The non-tax revenue produced about 177 million dollars in the 2004 year.

The non-tax revenues include revenues, which are paid by the beneficiaries of public services such as fees collected from health insurance beneficiaries, health and educational fees and other registration fees paid by beneficiaries required to certify their transactions such as court, vehicle and property fees. The health insurance and other fees formed about 21% of the total revenues in the PNA budget for 2004, followed by transportation, vehicle and borders fees as shown in (Figure 1.5). However, due to the second Intifada and the occupier's measures that blocked all roads between cities and villages, the government reduced various vehicle fees by 50%.

Figure 1.5 - Shares of Non tax revenues budget in 2004



4.3 Palestinian Investment Fund

Palestine Investment Fund (PIF) was established by decree of the President of the PNA in 2000. It is an independent legal entity which aims to include all public firms and investments owned by the PNA. The fund is suppose to be run by a board of directors chaired by the Ministry of Finance and other officials of the PNA as well as by Palestinian businessmen from the private sector. The total investments for the fund reached about 773 million dollars and were distributed to about 79 firms and projects in 2004. Some of these projects are owned completely or partially by the PIF. The PIF reported a profit of about 40 million dollars during 2003 as stated in the annual year end report of 2003 (PIF, 2004).

The increasing role of the public sector in the PIF received many objections from both local and international bodies expressing concern about the transparency of fund operations and the government competing with the private sector especially in the area of trading activities. Accordingly, the PIF stated a strategy published in its annual report of 2003, which decided that the fund shall not compete with the private sector in Palestine where the private sector has traditionally taken an active role and that the state will gradually withdraw from existing projects relevant to the concept of privatization and according to a timely business plan (PIF, 2004).

Other criticism regarding the PIF related to the fact that more than 70% of its assets which are supposed to be invested within Palestine to enhance the Palestinian economy are located outside Palestine. In addition the headquarters of the fund is located outside Palestine, an

issue that is not justified. Moreover, there is criticism about the transparency of investment decisions conducted by the fund. For example, the process of selling 35% of the Palestine Cellular Communication Company raised many questions in the Palestinian Legislative Council. The investment decision was conducted by a sub-committee of four members of the fund, but without the relevant by-laws which state the mechanism by which such trading in the assets of the fund should occur.

5. Consolidated Public Budget

5.1 Introduction

As indicated earlier, the PNA government is not the only authority which offers public services to the Palestinian residents. The UNRWA is responsible for offering services to the Palestinian refugees living in the West Bank and Gaza Strip camps, the NGOs play a significant role in some of the public services such as higher education and health services, and the international aids help finance capital and infrastructure projects. Accordingly, there is a need to look to these sectors as complimentary to the PNA budget because eventually it will be the function of the PNA government to offer all needed public services. However, the share of the PNA is the primary share for consolidated public services, followed by international aids, UNRWA, and NGOs respectively as shown in (Figure 1.6), which illustrates the parties shares of financing public services during the period from 1994 to 2004. This shows that the government's share of the budget is about 60% of the total allocations for public services. Accordingly, the PNA should be ready to carryout the expected new obligation in case of the final political settlement, which may eliminate or reduce the role played by other parties. The share among the four parties varies from one service to another. For example, the share of ANRWA in the educational system reached 21%, the NGOs 18% as compared to 46% of the PNA budget, while the beneficiaries paid about 15% as shown in (Figure 1.7) (World Bank, 1999a and 1999c).

In addition, in some sectors, even the share of the PNA budget is much less, such as in

Figure 1.6 - Consolidated Budget for Groups Services between Public 1994 to 2004

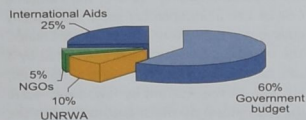


Figure 1.7 - Shares of Parties in Palestinian Education System

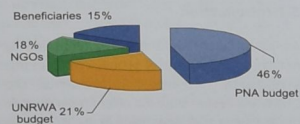
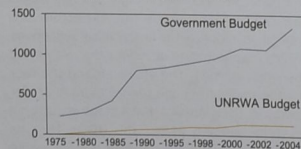


Table 1.7 - UNRWA budget in PNA

Year	Million \$
1972	18
1980	52
1988	84
1990-1991	195
1996-1997	208
2000-2001	272
2002-2003	294
2004-2005	321

Sources: UNRWA, 2004a UNRWA 1995-2002, Sabri, 1994

Figure 1.8 - The Trend of Government and UNRWA budget in PNA (1975-2004) in Millions \$

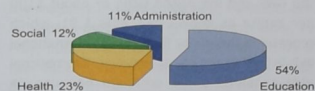


higher education expenditures. Finally, there is a need to explore in brief, the other three parties who participate in public service in Palestine.

5.2 UNRWA Budget

The United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), established in December 1947 by resolution No. 302, was issued by the UN general assembly to offer public and relief services to the Palestinian refugees who lost their homes and means of livelihood. The number of Palestinian registered refugees reached about four million. Of this total, 179,851 refugees live in the West Bank and 468,000 refugees are living in the Gaza Strip either in or outside camps. There are 20 refugee camps in the West Bank and 8 refugee camps in the Gaza (UNRWA Figures, 2004b). The total expenditures budget of UNRWA in Palestine increased from \$ 18 million in 1972, to \$ 120 million in 1989 and 321 million dollars for the years 2004-2005 as shown in (Table 1.7). The UNRWA hires about twelve thousand employees in Palestine. The share of the Gaza Strip is higher than that of the West Bank as expressed by allocated budget and number of employees. However, the size of UNRWA budget is small compared to the total PNA budget as shown in (Figure 1.8), but is not the case regarding social and educational services. The UNRWA offers public services in three major areas: relief services which include rations, shelters, special hardship assistants, and other social welfare programs; education services which include education in schools, vocational and technical training, and university scholarships and third, health services which include preventive and curative medical care, nursing, supplementary feeding, environmental sanitation and medical education. Education is the main public service offered by UNRWA and consists of more than half of the total expenditures, followed by health services as presented in (Figure 1.9). However, early years of UNRWA activities show that the majority of budget expenditures use to be allocated for relief services, while it concentrated in the last decade on education and health which formed more than two-thirds of the total UNRWA budget. The allocated budget for education was about 200 million dollars and for health was about 62 million dollars for the years 2004-2005 (UNRWA, 2004b). This means that the Palestinian central government if it holds the responsibility for the Palestinian refugees living in West Bank and Gaza Strip camps, needs to increase its budget by about 40% for social services.

Figure 1.9 - UNRWA Budget Expenditures (1988 - 2005)



5.3 The Non Profit Organizations

The NGOs that work in Palestine aim to provide general or specific services for the public with either free or subsidized prices. Accordingly, it is included in the definition of financing public services. The NGOs work under the laws that govern them and this sector is considered the oldest sector working within the Palestinian economy, as it was organized and regulated starting from the Ottoman Empire, and functioned during the British Mandate and Jordanian eras. However, the role of NGOs has increased since the seventies in order to cover the services which were not offered by the occupier, especially in the areas of higher education and health institutions. In addition, and after the initiation of the PNA, the number and activities of the NGOs increased significantly, creating the need for the issuance of a new law, issued in 2000, to organize and control their operations. Today, the number of the NGOs is about 976 firms that hire around 8393 employees, with compensation costs of nearly \$52 million, and with an added value of about \$ 230 million. (PCBS, 2000). The annual budget of the NGOs is between \$120 and \$150 million.

The major services offered by the Palestinian NGOs are higher education, kindergartens, hospital services, social and environment issues, and sport activities. Other NGOs work to promote civil society aspects including human rights, democracy, and women's issues. The educational and health NGOs offer services based on unsubsidized prices, while social NGOs offer services on a free basis.

The share of NGOs in public services as compared to total consolidated public services are presented in (Table 1.8). It shows for example,

Table 1.8 - Public services offered by the Palestinian NGOs

Sector	Activity	%
Education	Universities	90%
	Kindergartens	80%
Health	Hospitals	30%
	Health centers - clinics	40%
Social Work	Hardship families	30%
	Handicapped groups	90%
Research - training	Training	50%
	Research	40%
Human rights	Democracy	100%
	Women	80%

Source: (Sabri, 2003)

that the NGOs share in higher education reached about 90%. Although most of the funding for Palestinian higher education institutions comes from NGO funds, the NGOs receive partial funding from the PNA government. The share of NGOs in other services such as health and training services are from between 30% and 50%, while other services such as the civil society activities, and other social activities are offered exclusively by the NGOs. The major problem for the NGO sector in serving the general public is the lack of a permanent, sustainable fund to continue their work. Most of these NGOs receive grants or donations periodically and not on a regular basis hindering their ability to function appropriately. In addition, some of these NGOs face managerial problems, lack of legality regarding the relationship between general members of the NGO and its management, as well as lack of transparency regarding financial aspects, especially as organized in the last few years. The majority of these NGOs, which are supposed to manage on a voluntary basis are associated with individual founders rather than national institutions.

5.4 International Aids

The idea to offer international aids to rebuild the infrastructure of the new emerging Palestinian state started with the so-called Peace process in 1993. The annual international aid ranged from between \$ 650 million to 250 million yearly during the last eleven years. The total international aids funding offered to Palestine amounted to 4127 million dollars

during the period from 1993 up to the end of 2004, with an average annual amount of 375 million dollars. The major donors included the EC, USAID, the World Bank, the UK, and Saudi Arabia respectively. Of the total, the UNRWA, which received about 1674 million dollars to finance its operational budget ranked number one in the beneficiary category, followed by infrastructure projects, institutional buildings, water and sanitation, energy, education and health respectively (MOPIC, 2002 and PMA-MP, 2004).

The international aids are paid either directly through the PNA budget, or through one of its ministries, through the PECARD Institute, the official reconstruction public organization, through UNDP or the World Bank offices in Jerusalem for supervision and implementation, through UNRWA, or through the Palestinian NGOs. Recently, a special committee in the Ministry of Finance was established to coordinate the suggested needed projects with the donors. In the budget of 2003, half of the international aids were allocated to support the Palestinian government budget, while the other half was allocated to support development projects. Other international aids were allocated for emergency and welfare assistance, especially during the second Intifada (PNA-MP, 2004; and PMA, 2004). Parts of the international aids, as stated above, created three main funds which were established and run by the World Bank during the last ten years. The idea to establish such funds was because the PNA is not a member in either the IMF or the World Bank, and thus is not eligible to apply for financing from these institutions. Consequently, the Bank Board of Governors approved a grant of 50 million dollars to be transferred to a special fund. It became known as TFGWB, and aims to finance emergency and rehabilitation projects. The total balance of the fund reached about 415 million dollars in 2003. The other two funds, TAFE and the Holst fund and active between 1993 and 2001, were terminated (World Bank, 2003b and 2003 d). The major allocation of international funds were to the sectors for infrastructure, water and sanitation, institution building, education, transportation,

health, and other sectors.

Finally, the international aids represent 8% of the GNP and 9% of the GDP, or about \$100 per capita as shown in (Table 1.9), which represents the major features of international aids in the last ten years. However, international aids received some criticism because a substantial of the committed aids were never delivered. For example, only 44% of the total commitments were actually disbursed (Khadr, 1999). In addition, the aids are tied to the so-called peace process, and thus represents a measured pressure on the PNA to accept undermining political settlements. In addition, a substantial part of the allocated funds is in accordance with the agenda of granted parties. For example, the allocated fund for the so-called human rights and democracy sector was about 130 million dollars during the last ten years, which is more than that allocated to the humanitarian aids for the same period.

Table 1.9 - Features of International aids offered to the Palestinians

Total Value 1993- 2004	4127 million \$
% of GDP	9%
% of GNP	8%
Per capita	100 \$
Major participants	EC, US AID, World Bank, UK, Saudi Arabia, Germany, Norway
Channels	PNA, UNRWA, NGOs, UNDP, World Bank, PECARD
Sectors	Budget support, infrastructure, roads, and institutional buildings

Source: (Sabri, 2003)

6. Local Governments

6.1 Introduction

The importance of the role of local governments comes from the offering of needed services to residents living in their respective local communities. The offered services include the creation of and maintaining of roads, planning and control of buildings, supply of water and electricity, health services, environmental protection and others. As presented in section two the related laws applied by the PNA qualify the local communities to impose taxes. Their

councils are supposed to be elected by the residents of the communities, but up to now, the majority of local councils in Palestine are appointed by the PNA government. Only, in May, 2005, was the first partial election for a few local councils conducted. The local government sector includes 14 major municipalities, 94 small municipalities, 51 village councils, and 277 local committees (PNA, Ministry of local government, 2000). The local councils are working independently from the central government, but they are under its direct supervision through the Ministry of Local Government. The supervision extended to approval of the budget, controlling the implementation, and reviewing plans.

6.2 Budget of Local governments

The annual allocated budget of the local government in Palestine is still limited. At about five million dollars in 1967, it reached only 90 million in 1993. Since the establishment of the PNA, the total local government budgets value increased significantly, reaching about 300 million dollars in 2005, as shown in (Table 1.10). It is clear that the share of local government budgets in the GDP is still very small. The size of local government budget in the West Bank is three times more than it is in the Gaza Strip, due to the fact that the majority of residents in Gaza Strip are located in refugee camps which are under UNRWA responsibility. In addition, 80% of the local government budget belongs to few major cities such as Hebron, Nablus and Gaza city.

The major income of local government budget comes from taxes, fees on building, water revenues, electricity revenues, rent from owned properties, and other special fees in addition to the allocated funds from the central government which represent a share of taxes imposed on petroleum products. The collected local taxes and fees are supposed to be the first source of revenues, and it has been estimated to be only about 22% of local government revenues during the period of 1995 to 2004.

Table 1.10 - Local governments budget in Million \$ from 1968 to 2005

Year	Million \$
1968	5
1980	53
1993	90
1996	170
1998	188
2004	280
2005	300

Source: collected by authors

In addition, the majority of local councils received extra-ordinary revenues from foreign firms or through the program of international aids. For example, the World Bank and the EC supported a project called the Emergency Municipal Services Rehabilitation Project with 60 million dollars allocated mainly for construction of roads inside cities and villages, the rehabilitation of networks for electricity and water projects and maintenance of public buildings. The project was implemented during the years 2003 and 2004, and aimed to serve as an emergency program for rehabilitation of local council's facilities as well as helping to create jobs during the years of the Intifada. All implemented subprojects were supposed to include a 50% allocation as payroll for employees. The major expenditure items include education and health, environment, roads, planning and mapping of local community areas, and the operation of the water and electricity projects. A special tax, known as the educational tax, is allocated mainly to build and maintain schools within the community. In general, the majority of the annual local budget is allocated for operational purposes, while outside aids are allocated to capital projects. In addition, the local government councils hire about 8000 employees including engineers, accountants, and technicians. The main weakness in the performance of the local governments is its failing to collect the imposed taxes. For example, the ratio of local taxes to household expenditures is about 0.5% compared to 2.5% in cities in developed countries (World Bank, 1999b). In addition, there is a problem with the collection of the subsidized prices for the water and electricity services offered by the majority of the local councils.

7. External Debt

7.1 Introduction

When the PNA was established in 1994, it began with an external debt of 17 million dollars. This debt has increased gradually and was up to 378 million dollars in 2000, with an average number of new loans amounting to 50 million dollars yearly. However, with the onset of the second Intifada, the annual needed loans jumped significantly, and the accumulated external debt reached 827 million dollars in the year 2001. Today, the total external debt is about one billion as presented in (Table 1.11). To manage this accumulated external debt there is a need to establish a special fund. Up to now, the cost of external financing is at a minimum because the average period of the loans is about 20 years, with a medium lead period of eight years. Accordingly, the cost to finance external debt is still limited. The total amount of installments amounted to \$14 million and the cost of interest was \$ 4 million for the year 2005 (PNA, 2005a).

Table 1.11 - Accumulated External debt of the PNA

Year	Million \$
1994	17
1995	44
1996	82
1997	149
1998	224
1999	294
2000	378
2001	827
2002	950
2003	987
2004	1010

Source: PNA, 2005a

7.2 External Credit Issues

If we examine the conditions of the external debt of the PNA, we find that the major creditors are Arab states participating through what is known as Al-Qods (Jerusalem) fund, and which make up about 38% of the external debt. The second main creditor is the World Bank, which constitutes about 24% of the total debt, followed by the European Investment bank with 12%,

the government of Spain at 9%, and another ten funds and governments forming the remaining 17%. The interest rates for the external debt of the PNA range from zero to the labor rate plus 2%, the administration fees between 0% and 2.5%, the commission fees between 0% and 0.5%. Lending time is from between 7 to 15 years with an average of 8 years. Finally, the due dates for loans are from between 6 to 30 years with an average of 20 years. (Table 1.12) summarizes these major characteristics of the external debt of the PNA as it was at the end of 2004.

Table 1.12 - Major Characteristics of PNA External Debt

Characteristics	Values and %
Accumulated Debt	1010 Million \$
Debt to GDP	20%
Interest rate	0% to LIBOR +2
Administration fees	0% to 2.5%
Commission	0% to 0.5%
Lending period	Average 8 years
Loan period	Average 20 years
Due Loans for 2005	14 Million \$
Due Interest for 2005	4 million \$

Source: Compiled by the authors based on the PNA, 2005a

The accumulated external debt reached about 20% of the GDP in 2004. However, there is a proposed law related to the public debt that is under debate in the PLC, but not yet approved, which may organize some aspects of the external public debt. The proposed law sets a limit of 40% of the GDP as a maximum for accumulated credit (PLC, 2004, Proposed law of public debt). There are three major aspects to consider regarding the issue of external debt:

First, the legal issue: in the last ten years, the initiation of, the contracting for and the management of the loans were neither systematic nor legal. For example, contracting a loan should be conducted under the supervision of the Palestinian Monetary Authority as stated by its law, Article 35. In addition, the basic Palestinian laws in Article 83 states that the external loans process should be formalized by a low issuance rate and upon agreement by the Palestinian Legislation Council. The issuance of loans conducted up until 2004 were without coordination with the

PMA or the approval of the PLC (PLC, 2003).

Second, the management aspect: there is a need to consider setting up an exemplary, exclusive department to follow the issue of debt management. Several debt market crises occurred in past decades necessitating the need for responsible management of government debt. This would enable the government to meet its payment obligations at the lowest possible cost over a medium to long term period, and enable it to be consistent with due date time periods while maintaining a minimum degree of risk (IMF, 2003 b).

Third, there is a need to consider loans as debts to be repaid rather than possible grants.

8. Financial Reforms

8.1 Introduction

Due to the manner in which the PNA was established, there were numerous organizational aspects to consider regarding many public financial issues. However, due to local as well as international demands, various reforms were implemented in the last two years, while others are still in process. The World Bank played a critical role in implementing some of the reforms since producing its report entitled "Strengthening Public Sector Management" (The World Bank, 1999b) and ending with the last two reports entitled "Country Financial Accountability Assessment" (The World Bank, 2004a June) and the Proposed Public Management Reform Trust Fund reports (The World Bank, 2004b; and 2005). The UNCTAD secretary was also involved in the financial process reform through the implementation of the project capacities in debt monitoring and financial analysis known as DMFAS (UNCTAD, 2004). In addition to that, there are various recommendations issued by PLC and various governmental committees, which were also incorporated into the Palestinian fiscal and public financial system.

8.2 Major implemented reforms

Based on the above activities and reports,

examining official documents released by the Ministry of Finance, and reviewing notes included in the PNA law of budgets during the last three years, the following areas for reforms may be detected. These areas cover aspects of controlling revenues, expenditures, PNA treasury, external debt, internal and external control, financial system, and budget mechanism, the pension system and the publishing of financial information. However, some of these reforms may be still in the process of development or in the initial phases of implementation, while others have already been incorporated and implemented. Examples of such reforms are:

On the revenue side: A unified treasury account which provides a single pool of funds for all PNA transactions has been established. All public revenues have been deposited into that account and incorporated into the government budget. There has been the establishment of the PIF (Palestine Investment Fund) which includes the management of all business activities and assets owned by the PNA. Revenues of the PIF have been transferred to the PNA government budget as well as revenues collected from petroleum fees and cigarettes fees.

On the expenditure side: For the first time the budget law included information about public sector employment and the approved number of new posts for each ministry and governmental institution, unifying all payrolls of PNA employees under the Ministry of Finance including security employees, who are now paid directly through their bank accounts. A control has been imposed on the number of new posts created for each ministry or institution, as well as a significant reduction in the 2005 allocated budget for the office of the President.

On external debt side: The budget of 2005 included the majority of information related to the external debt provisions, including a list and conditions of loans.

On the internal control and audit side: In order to organize the task of independent

control authority, a new law, of the financial and managerial control was published in the Palestine Gazette in February 2005 (PNA, 2005d). This new law, No. 14 of 2004, reports the conclusion of how budget is implemented to the PLC.

On the organizational side: Incorporation of the majority of independent government institutes to the related government ministries.

9. Conclusion and Recommendations

9.1 Performance of PNA fiscal policy

The function of the fiscal policy of a government ranges from raising the need revenues to finance the public services, to achieving economic development and stability. It also includes the stabilization of the pricing system and redistribution of income to serve the social objectives of the society. To examine the performance of the PNA fiscal policy, the following notes that include positive as well as negative aspects are noted:

First: Job recruitment: Besides the emergency programs attached to the PNA budget which absorb an average of about 13,000 employees yearly, the number of recruited employees for the public sector increased by more than three times since the PNA emerged, the result of the job creation projects implemented during the last few years. By the end of 2004, the number of recruited employees reached about 133,000 constituting 22% of the total labour force working in Palestine. Moreover, as shown in (Table 1.13), there are about thirty thousand jobs included in the UNRWA, local governments and within the NGOs, raising the total number of public services employees to about 176,000 employees, which form about 31% of the total workers in Palestine 2005. However, this ratio is lessened when considering all workers who work inside and outside Palestine as well as the number of unemployed workers.

The annual increase of public employees are estimated to be one third of the total number of employees who enter the labor force annually. Some believe that this policy is

acceptable considering the political situation in the PNA territories, with the existence of the occupier's controls including the siege of major cities and the blockade of all roads between the various Palestinian districts. Others believe there is a need to change such policy and reduce the number of public employees or at least freeze it at this level, because this policy creates a burden on the tiny retirement system of the PNA, and creates an inefficient and crowded working environment. However, the 2005 budget includes the creation of 3000 new jobs in the education and health sectors.

Table 1.13 - Total public employees at of end 2004

Public Sectors	Employees
PNA budget	133,000
Emergency projects	13,000
Local governments	8,000
NGOs	10,000
UNRWA	12,000
Workers in Public services	176,000
Total of workers in Palestine	560,000
Ratio of Public workers	31%

Source: Compiled by the authors

Second: Poverty alleviation and social responsibility: The PNA has a commitment to provide free of charge and compulsory education up to the tenth grade, and full medical insurance to children up to three years of age. In addition, it offers a subsidized health insurance program in voluntarily basic, subsidizes higher education, finances colleges of education, offers limited annual income to families of those imprisoned by the occupier, plus the thousands of families of martyrs Palestinians and families suffering hardship (Sabri, 2002). In addition, it runs various projects for job creation efforts and emergencies. In the 2005 budget, a special fund of 250 million dollars And named the Social Net fund was allocated to address the needs of low-income groups. The fair commitment of the PNA budget towards social and human deployment of Palestinians is expressed by the fact that about 40% of the total PNA budget expenditures is allocated for social development including health, education, and social welfare. This commitment is reflected in the human development index in Palestine. For example, the literacy rate for both male

and female is about 92.4%, the life expectancy age at birth is about 72.4 years, and the entry rate for secondary education and basic school is 74% (HDR, 2004). These rates are relatively high when compared with rates that belong to countries with the same level of income.

Third: Connection to economic planning: There is no connection between the annual government budget and the economic plans prepared by other government authorities, such as that just published in May, 2005 by the Ministry of Planning, which is known as the Medium Term Development Plan for 2005 to 2007 (PNA, MP, 2005). The plan stated four objectives including social protection, investment in human capital, investment in good governance, and the creation of an environment for private sector growth. However, there is no stated mechanism by Ministry of Finance to accomplish such stated objectives through the annual government budget of PNA.

Fourth: Inflation rate: The annual inflation rate in Palestine ranged from between 1.2% to 14% during the last eleven years. The lowest years for inflation rates were in 2001 and 2002, which, due to the second Intifada, recorded the worst economic deterioration (PMA, 2005). The level of inflation in the PNA economy is considered acceptable and under control. However, it should be noted that if the PNA has its own national currency, considering the experience of other developing countries, the level of inflation might be higher than it is now.

Fifth: The role of PNA in other aspects of fiscal policy is so limited it is unclear if it even has a role. For example, with more than 90% of tax revenues coming from indirect taxes, the reallocation function such as redistribution of income is not considered in the PNA fiscal policy. In the absence of a national currency, coordination by PNA with the PMA concerning monetary policy does not exist. (Table 1.14) presents a summary of the major features of PNA fiscal policy performance.

Table 1.14 - Performance of PNA fiscal policy

Objectives of fiscal policy	Performance
Job recruitment	Over used
Poverty alleviation	Yes
Distribution of resources	Weak
Redistribution of income	No
Attached to general economic plan	No
Social responsibility	Moderate
Attachment to monetary policy	No
Cooperation with Palestinian Monetary Authority	Weak
Inflation rate	Moderate

9.2 Recommendations for policy makers

Based on the above presentation, four groups of recommendations are presented to reform the fiscal policy of the PNA.

The first group concerns tax policies and management, the second is related to the PNA retirement system, the third group is concerned with public funds owned by the PNA, and the fourth group focuses on the initiation, planning, organization, implementation, and reporting of the PNA budget, as shown in (Table 1.15).

First: Recommendations for tax policy: There is a need to reinforce the concept of democracy in the Palestinian State through the adoption of a well-balanced tax policy characterized by suitability, simplicity and certainty. The generally accepted international accounting standards published by the International Accounting Standard Board (IASB) can be used as a basis for preparing financial statements for public and private corporations and acceptance by PNA departments of taxes. Issuance of a Palestinian customs law: up to now, there is no Palestinian customs law. A draft for that law was initiated by the department of VAT and customs, but it was never submitted to the PLC. Adoption of the legal laws and regulations for levying indirect taxes especially the VAT, and the employment of various rates along with discriminating basic ranges from 0% to 20% is recommended. Additionally, each group of commodities should have different rates that observe the social and economic dimensions.

Table 1.15- Summary of recommendations regarding PNA fiscal policy

Taxation	To restructure tax departments. To reorganize and legalize indirect taxes. To issue a Palestinian customs law. To unify local taxes imposed on local councils. To consider social aspects in application of VAT. To clarify a base of income tax.
Retirement systems	To incorporate all employees in a unified system. To implement law of retirement issued in 2005.
Public funds	To transfer the headquarters of PIF to Palestine. To transfer the PIF investments to Palestine. To include other public funds in the PNA budget. To publish financial statements of all public funds.
Budgeting	To offer final statements of annual budgets. To comply with budget organizing law. To issue budget laws before the beginning of the fiscal year. To adopt GFS system to produce the needed data. To apply proper measures of internal control. To apply the relevant measures of output. To have a proper management of public debt. To issue the law of public debt. To unify business transactions into one currency.

Other recommendations: To unify all types of indirect taxes such as purchases tax, VAT, supplementary rates, production charges, and duties into one unified tax using various rates for different goods and services; To unify all local taxes and license fees into one tax with discrimination based on different commercial and residential categories considering type and quality of building, land and the size of business enterprise and to be applicable to both municipal and rural councils but with different rates.

Second: Recommendations for retirement system: One of the most complicated issues is the retirement system in PNA. There are three retirement systems including the law No. 8 of 1962 system known as the 10% system, and

the law No. 34 of 1959 system known as the 2% system, and the pension law No. 16 of 2004 system designated for security employees (PNA, 2005c). The first system has an independent fund and pays for retired employees from its own special account. It is not known whether or not the fund will fulfill the requirements of retired employees in the coming five years. The other two systems obtain the retirement payments from the regular annual current budget. In addition, there are five groups of employees who have different status, such as the employees in the West Bank, who followed the 2% system up to the year 2000, the Gaza employees who follow the 10% system and the new employees appointed in both the West Bank and Gaza since 2000 who follow the 10% systems. Employees attached to the PLO and transferred to PNA system and the security employees were included in the PNA budget. In May, 2005 a new retirement law was issued (PLC, 2005e) to include all civil and securities employees of age 45 or less under a unified retirement system, but it continued to have various types of accounts to accommodate the various groups of employees of the above 45 years category and other various systems of retirement. However, this law needs a mechanism for implementation. Accordingly, this issue is one of the most difficult issues facing PNA budget policy development and needs to be addressed as soon as possible.

Third: Recommendations for Public funds: There are four public funds owned by the PNA, including the PIF, the retirement fund, the insurance accidents fund, and the emergency employment fund. In addition, the PLO has shares in the capital of five development Arab and Islamic funds, including Islamic Development Fund, Arab Fund for Economic and Social Development, Arab Monetary Fund, ABEDA, and IAIGC (Sabri, 1997). For the PNA funds, the mechanism of trading their assets should be clear and transparent under supervision of special committees of PLC. For the last three funds, and up to 2005, there was no financial information available regarding their assets or their operations. Accordingly, there is a need to publish the financial

statements annually, and to incorporate the statements of such funds into the annual budget as stated by the law of organizing budget No. 8 of 1998, article No. 21. Headquarters of the PIF fund should be located in Palestine, and the holding investments should be switched to projects in Palestine rather than remain abroad.

Fourth: Budgeting: The following recommendations are related to preparing, approving, publishing, implementing, controlling, and reporting of the PNA government budget.

- The budget project should comply with the laws of budget organization and be presented in October of each year and published in the legal official Palestinian Gazette at the designated due time.

- To use innovative techniques for program and project classifications and to incorporate the concept and use of profit, cost and responsibility centers into the final statements of budgeting guidelines.

- To insure that the allocated social budget is utilized with efficiency for the relevant beneficiaries.

- To unify the financial and accounting systems of the Palestinian governmental sector and to attach an implementation process for PNA budget expenditures and revenues. Until now, the accounting cycle for the government's budget process and operations are not completed. In addition, many of the ministries use different accounting systems, including the Ministry of Finance, which has different systems for VAT and income taxes and other revenues and expenditures systems. Accordingly, there is a need to adopt a unified financial accounting system as well as to study the possibility of adopting the GFS system produced by the IMF, which may lead to overall improvement in the performance of and in the financial position of government operations (IMF, 2001).

- To offer the final budget statements to the PLC annually as stated by the related laws. The last final statement offered to the PNA

budget was in 1997 (Sabri, 2001) while the subsequent years have had no final budget statements.

- To prepare the financial and cash status and treasury balance of PNA and to attach these statements to the PNA annual budget according to Law No. 7 of 1998 of organizing budget.

- To have a proper mechanism to manage the external debt of the PNA, and to issue the new proposed law of public debt, which is now under debate in the PLC.

- To unify business transactions of the PNA budget into one currency in the preparation, implementation and reporting processes.

- Annual evaluation should accompany the budget implementation process, in order to measure the performance of the public services and to indicate the differences between the actual and budgeted data.

- To use more control measures to monitor the performance of government including an internal auditing system as stated in Article 63 of the law of organizing budget of 1998.

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Chapter II

Financial Policy Issues

1. Introduction

1.1 Historical background

Financial institutions and markets function as providers of financial services for the process of buying money or financial services for certain situations, and then selling the money or financial services in another situation. The institutions that provide such services are called intermediary institutions. The first intermediary institutions were the informal network of moneychangers which later grew into the commercial banking system of today. Other forms of financial institutions are insurance companies and financial markets which have emerged mainly during the past two centuries. In Palestine, the financial sector "which used to consist only of financial institutions" emerged at the beginning of the past century, and developed into a mature sector during the British mandate.

For example, the financial sector in Palestine included 5 foreign banks, 20 local banks and 83 credit cooperatives which held about 82 million pounds (LP) in 1945. Out of total deposits, 64% were held by foreign banks, 27% by local banks, and 9% by credit cooperatives. On the other hand, total credit advances amounted to 25 million LP with the industry sector enjoying 22% of total credit advances, 18% for agriculture, and 28% going to the commercial sector. The major Arab banks were the Arab Bank and the Arab National Bank which held 7 million as deposits in 1945 (AACI, 1991). After the 1948 "Great Catastrophe" (NAKBA), and the partitioning off of Palestine, the financial sector changed. Up until 1967, there were only two Egyptian banks, a few Jordanian banks working in either the West Bank or Gaza, and a Palestinian bank established in Gaza in 1960. The Arab Bank which was the major bank in Palestine moved its headquarters to Amman. In 1967, in the aftermath of the Israeli occupation, there were six banks which included 23 branches operating

in the West Bank and nine branches operating in East Jerusalem (MAS., 1995). At that time, the occupying authority closed all the commercial banks and their branches, along with other financial institutions such as the Agricultural Credit Corporation, and the Industrial Development Bank, both in the West Bank and Gaza. Their accounts were frozen, documents removed and cash transferred to the Central Bank of Israel as deposit accounts in the bank's name (UNICTAD, 1989).

The Jordanian banking law was cancelled, and the authority of the Central Bank of Jordan was replaced with an Israeli authority by military order Number 45, which established the Israeli currency as the legal tender in the West Bank. In addition, Israeli banks were allowed to operate in the Palestinian market both in the West Bank and Gaza by military order No.255 thus replacing Arab banks by Israeli ones. In 1981, the Bank of Palestine won a case in the Israeli courts that permitted it to re-open and commence its operations in Gaza Strip; some Jordanian banks were allowed to re-open their branches in 1986 (MAS, 1995).

However, banking operations offered the minimum level of activities and the other financial institutions barely existed except one insurance firm working mainly to cover automobile accidents. Finally, the evolution of financial sector in Palestine came after 1994, with the reopening of several Arab and foreign banks which had been operational before 1967, the establishment of new Palestinian banks, insurance firms, microfinance institutions and programs, the foundation of the Palestinian Monetary Authority (PMA), and the establishment of the Palestinian stock exchange in 1997.

1.2 The Palestinian financial sector

In spite of the generally unstable political and economic situation that exists in Palestine, during the last ten years the financial sector has witnessed a positive increase in the

development of financial systems. This increase includes both the formal and informal financing systems. However, the increase was more obvious in the formal financing system represented mainly by the banking system (commercial banks, Islamic banks, and specialized banks) resulting in securing the confidence of Palestinian people- a confidence reflected in the significant increase in total deposits by residents. In addition to that, it is worth mentioning that the financial sector was the least impaired sector by measures imposed by the occupier as compared to other sectors including agriculture and industry, which suffered extremely as a result of these measures during the period of 2001 and 2002. Today the financial sector in Palestine may be grouped in three financial institutions categories and one financial market category as presented in (Table 2.1).

Table 2.1 - Summary of Palestinian Financial Sector as in February 2005

Financial Sector	Numbers
First Financial Institutions	
1. Banks Sector	
Palestinian Monetary Authority	A government firm
Arab Banks	11 banks, with 72 branches
Palestinian banks	10 banks with 62 branches
Foreign banks	1 bank with 1 branch
2. Insurance Sector	
Insurance Control Authority	A government firm
Insurance Accidents Fund	A government firm
Palestinian general Insurance firms	5 Public corporations
Arab and foreign general & life insurance firms	3 Public corporations
Guarantee loan Insurance firm	1 private corporation
Insurance offices and agencies	120
3. Other financial Institutions	
Microfinance Institutions	UNRWA and 9 NGOs
Money Changers	20 corps. & 250 sole firms
Specialized Institutions	4 corporations
Second Financial Markets	
Stock Exchange	1 (25 listed corporations)
Broker companies	6 private corporations

Source: Compiled by the Authors

The first group is associated with the banking system, which includes 22 Arab, foreign, and Palestinian banks with 135 branches (PMA, 2005). The majority of these banks are

Jordanian, which were in operation before 1967. The banking sector in Palestine includes Islamic banks, commercial banks and investments banks. However, considering the capital value, the deposits and granted loans value, the commercial banks have more than 90% of the banking activities. Besides the banks operating in Palestine, there is an independent government authority that supervises and controls this sector known as the Palestinian Monetary Authority.

The second group is the insurance sector, which includes nine insurance corporations that deal with general insurance activities such as accidents, health, and life insurance, and loan guarantee insurance. Included in this sector is an insurance government authority and an accidents fund run by the government.

The other financial institutions form the third group of the financial sector operating in Palestine. This sector deals with moneychangers and microfinance firms. It includes 9 institutions dealing in micro finance activities and 270 corporate and individual moneychangers. The last sector is the financial market sector, which consists of only one stock exchange located in Nablus city. Participating in the stock exchange are 6 private corporations operating as registered brokers and located in the cities of Nablus and Ramallah. Minimum capital for brokerage firms is set at one million dollars. The financial settlement of the Palestinian stock exchange transactions are conducted through Arab banks for transactions by residents and through HSBC bank for foreign transactions.

The total headcount in the financial sector amounted to about 4500 employees with annual salaries totalling 62 million dollars bringing the total output of the financial sector to about 184 million dollars, with an added value of 147 million dollars in 2003 (PCBS, 2004).

The following sections will present the current situation of the above segments of the financial sector, including the major issues facing such activities, the policies adopted to regulate such segments as well as their role in financing the Palestinian private sector.

1.3 Features of Palestinian Financial Sector

Various features shape the existing Palestinian financial sector:

First, the unstable political situation, which has prevailed since September 2000 when the second Palestinian Intifada broke out, resulted in a decrease in the GNI by 38% when compared to 1999 figures, and in a reduction in the real per capita income by 46%. After 27 months of Intifada losses were at 5.2 billion (World Bank, 2003). However, there is some indication that the economic situation has been slowly improving over the last two years.

Secondly, the lack of a national currency resulted in the use of three different currencies for varying purposes such as exchange transactions, savings and wealth measurement. Such a situation of multi-currency circulation reduces the efficiency of the Palestinian economy and denies revenue benefits gained from the associated use of a national currency. Moreover it lead to non-utilization of the exchange rate strategy as a macro economic policy, and thus was subject to the limitations that occur with the fluctuations in the exchange rates of multi currencies (UNCTAD 1998). The issue of currency in the Palestinian financial sector is discussed in the next section.

Thirdly, the amount and value of incoming remittances to the Palestinian economy as compared to other developing economies. The number and value of incoming remittances has increased in the last few years due mainly to the corresponding increase in external aids provided to support the Palestinian budget. For example, the value of incoming remittances reached about three billion dollars as compared to 1.75 billion dollars in outgoing remittances which were allocated mainly to finance import activities. This lead to a cash flow surplus of 1297 million dollars in 2004 as presented in Table 2.2.

Among the other sources that have contributed to the positive net cash flow from remittances are the transfer of Palestinians working outside Palestine as well as the transfer of funds to

Table 2.2 - Net Cash Flow of Remittances from & to Palestine in US Million \$

	2003	2004
Incoming Remittances	1,835	3,047
Outgoing Remittances	1,514	1,750
Net Cash Flow	312	1,297

Source: PMA, 2005

finance activities of UNRWA and other foreign NGOs operating in Palestine (Sabri, 2000). Estimated revenues are about 585 million dollars. Finally, the Palestinian economy in general and the private sector in particular is still facing many obstacles, among which are the inability to control its borders, the economic siege, and the problems related to the lack of financing for the renewal of assets.

2. The Currency issue

Under the League of Nations mandate, the British Civil Administration in Palestine established the Palestinian currency board in 1927 to provide and control the supply of currency to Palestine. The Palestinian pound was thus introduced in 1927, and remained in circulation until 1948. However, following the partitioning off of Palestine and the creation of the state of Israel in 1948, the stocks of the Palestinian currency board were transferred in-part to Amman and to Haifa under Israeli Jurisdiction. By 1950, the Jordan Currency Board was established and the Jordanian dinar was declared as the legal tender throughout the Hashemite Kingdom of Jordan, including the West bank. In Gaza, the Palestinian pound was redeemed and replaced by the Egyptian pound and the Palestinian Currency Board was liquidated, (UNCTD, 1989). Between 1948 and 1967, the Jordanian dinar and the Egyptian pound were the currencies in use in the West Bank and Gaza Strip respectively.

Up until now, the PNA has not had its own national currency. Instead, it has a co-existing system with three currencies: the Jordanian dinar, NIS, and the US dollar. However, the exact share of each of the three currencies in the Palestinian economy is unknown. The World

Bank estimated the value of the Jordanian dinar currency to be up to the equivalent of 809 million dollars and 977 million dollars circulated in NIS (World Bank, 1994). The problem of determining the share among each of the three currencies circulated in the Palestinian economy is complicated. Each of the three currencies has different functions and is associated with different businesses. For example, the majority of deposits in banks operating in Palestine are in dollars or JD, and may be in Euro as well, while a very small share is in NIS. The majority of loans are in US\$ or JD, while the majority of overdraft loans are in NIS.

In addition, the Palestinian budget is prepared in both dollar and NIS. The payment system for daily transactions is different based on types of goods and assets. For example, trading in land and durable goods occurs in JD or the dollar, while trading in glossary and consumables occurs in NIS. (Table 2.3) summarizes the payment system in the Palestinian economy and the share of each of the three currencies in business transactions and savings.

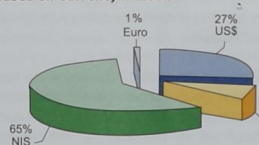
Table 2.3 - Summary of Currency Status in the Palestinian Economy

	US\$	JD	NIS
Loans	High	Low	
Overdrafts	High	Low	High
Deposits	High	Moderate	Low
Checks transactions	Moderate	Moderate	High
Government budget	Low		High
Payments for exchange land	High	High	No
Daily transactions	Low	Low	High
Financial stock exchange	Moderate	High	

The circulation of the three currencies throughout the banking system is also different from the circulation of cash transactions. This is because the majority of the import trade activities must pass through Israel. For example, the share value of checks offered to PMA for clearance represented 65% of the total value of the checking system during the year 2004, followed by the US\$, the JD and the Euro as presented in figure 2.1 (PMA, 2005a).

The absence of a national currency status leads

Figure 2.1 - Checks presented for PMAClearing based on Currency in 2004



to various problems and has negative consequences on the Palestinian economy for the following reasons:

First: The inability of preparing a fiscal government budget in a national currency. The budget is prepared in both the dollar, and the Israeli shekel and the exchange rate is averaged between the two currencies. This average fluctuates by high percentages, sometimes at 30% at the time of budget preparation thereby hindering the formation of quarterly or semi-annual reports that are beneficial for follow up efforts and control as well as obstructing the preparation of balance sheet reports.

Second: Using multi-currencies in calculating and paying expenses. In some cases an expense is calculated using one currency and paid in another currency.

Third: The instability of the exchange rate between the three different currencies used in the West bank and Gaza Strip. This creates a burden on how to determine the corresponding revenues and/or expenses in any of the currencies (Sabri, 1999b).

Fourth: The absence of a national Palestinian currency forbids the PNA to benefit from the Seigniorage. The prevailing agreement between the occupying authority and the Palestinian Authority stated that a Palestinian National currency could not be issued without the prior approval of the occupier, and no independent seigniorage can be generated for the Palestinian treasury as stated in Article Eleven- Item B of the Economic Protocol (IPA, 1995). In addition, there is no agreement about assigning a share of the seigniorage collected by the occupier to the Palestinian treasury under the present

currency union agreement. A study by the World Bank estimated that a fair formula for sharing seigniorage on NIS might contribute from between 3% to 5% of GDP annually to the Palestinian Authority revenues (World Bank, 1999).

Fifth: the absence of a national currency renders monetary policy ineffective in a fixed exchange rate regime. The existence of more than one currency standard has the potential of increasing the costs associated with fluctuations in exchange rates typical of a flexible exchange rate regime (Naqib, 1999).

Sixth: A dual currency situation tends to reduce the ability of commercial banks to perform transforming debt maturities because of the problem of currency mismatching inherent in portfolios. In addition, the Palestinian economy is vulnerable to financial fluctuations and disturbances originating in Jordan, Israel, or the USA. A Jordanian monetary disturbance is transmitted to the Palestinian economy by affecting capital accounts, where an Israeli monetary disturbance greatly affects current Palestinian accounts (Hamed, 2000).

To deal with the situation created by the non-existence of a national currency and in order to determine the best method, conditions and timing for the issuance of a Palestinian national currency, various alternatives were examined, debated and discussed thoughtfully during the last ten years. A summary of this debate indicates that three delivery instruments may be possible alternatives to address the problem. First: a national currency issued by a central bank and using either a fixed or flexible foreign exchange regime, with a partial foreign reserve. The second alternative is to issue the national currency through a currency board with full foreign reserves.

The idea to issue Palestinian currency through the currency board received intensive debate. Some researchers believe this choice may be relevant on a short-term basis but not appropriate for the long term (Naqib, 1999). Others found that it would stand a great chance for success if introduced through currency board management and followed up with reforms in fiscal policy and bank supervision (IMF, 2001).

The third alternative for the formation of a Palestinian currency is to issue an account unit currency as an interim process before moving to real currency issues by the central bank, which solves some of the present problems especially those related to the fiscal issues in the Palestinian economy (Sabri, 1999b).

3. Banks

3.1 Introduction

The banking sector includes commercial banks, Islamic banks and investments banks and offers different banking services including the granting of loans and other available credit facilities, acceptance of customer deposits, processing of checks and the transfer of funds for other services. The investment banks include three banks with a very small capital of 30 million dollars with a very limited share in the credit system and only one advantage which is the offering of medium and long term loans. The Islamic banks which are newly established in Palestinian have a small share of activities including some value in deposits and a small share in investment funds.

The commercial banks are the main section for banking business conducted in Palestine and include Palestinian, Arab and foreign banks. They operate under national public corporations for the Palestinian banks and under foreign corporations for the foreign and Arab banks. They operate under supervision of the Palestinian Monetary Authority as well as supervision of the other central banks as in the case of the Arab and foreign banks. In the past the banks in Palestine operated under the guidelines of Jordanian laws. But in 2002 adopted a new bank law No. 2 of 2002. This new law addresses aspects of control and measurement activities, management practices and financial aspects. It sets requirements for the establishment of new banks (PA, Official Gazette, 2002).

The size of bank operations in Palestine has grown significantly in the last decade as expressed by owner equity and total assets. For example, the owner equity of the banks operating in Palestine increased from 137

million dollars in 1996 to 307 million dollars at the end of 2004.

At the same time, total assets of all banks in Palestine increased from 2201 million dollars in 1996 to 5114 million dollars at the end of 2004, as presented in (Table 2.4) (PNA, 2005). (Table 2.4) illustrates the consolidated balance sheet of banks operating in Palestine and shows that all asset items witnessed an increase of about 100% or more during the last nine years.

Table 2.4 - Consolidated Balance Sheet of banks working in Palestine in US Million \$

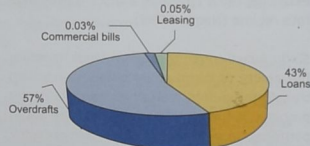
Items	End of 2004	End of 1996
Assets (Cash) with PMA	542	177
Assets (Cash) with other banks in Palestine	203	53
Foreign Assets	2619	1393
Credit for residents	1384	424
Profile Investments	122	46
Other Assets	244	108
Total Assets/Liabilities	5,114	2,201
Deposits of PMA	147	100
Deposits of banks operating in Palestine	201	60
Deposits of residents	3870	1708
Foreign liabilities	133	105
Other liabilities	456	91
Owner equities	307	137

Source, PMA, 2005

The major activity of banks is the granting of loans and other credit facilities such as overdraft services, the discounting of commercial bills and the financing of imports as shown in (Figure 2.2). The size of facilities advances increased in the last three years, but was less than forecasted. The total credit granted to private sector activities increased from \$114.4 in 1996 to about 1328 million dollars in 2005. In spite of the significant increase in credit advances during the last nine years, it is considered low when compared to the value of deposits held by the banks. The ratio granted facilities to total deposits is still around 38% compared to 63% in banks operating in Arab states (UAER, 2004). In addition, the majority of granted credit, which represents 57% of the total granted credit, is for overdrafts to cover commercial trading activities. While the share of loans forms just about 43% of the total

granted credit. In addition this share merely relates to short term loans of one year or less, while the share of medium loans are immaterial. The other two types of credit services offered by banks operating in Palestine are for leasing financing and discounting of commercial bills, but both have a very small share and represent less than 1% of the total credit.

Figure 2.2- Distribution of credit granted by banks operates in Palestine: February, 2005

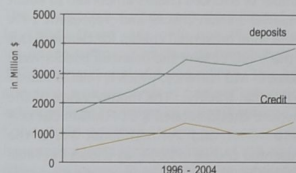


Source: PMA, 2005

The total amount of deposits has increased from \$ 1711 million in 1996 to \$ 3976 million in February 2005 representing the equivalent of 90% of the Palestinian GDP. This is a positive development and, with the exception of Lebanon is more deposit activity than that of most of the Arab states... It is also higher than the average ratio of deposits to GDP among all Arab states which was about 62% in 2003 (IMF, 2003). This level of collected deposits may be much higher if we look at the trend of deposits during the last ten years, as shown in (Figure 2.3). It indicated that the deposit trends witnessed a slow down in the years of 2001 and 2002, which were the most affected by the Intifada. Of the total deposits, there were about \$ 3391 million that belonged to residents, which is an increase of approximately 132% from that level of 1996, which was about \$ 1500 million. Total deposit distribution occurs over three types of accounts: Current accounts, saving accounts and time deposits accounts. According to 2004 figures, the share of each type was \$1161 million, \$750 million and \$1480 million respectively. As for the geographical distribution of deposits, about 79% of the deposits are located in the West Bank, while only 21% of the deposits are located in the Gaza Strip. Out of the grand total for deposits, 60% of deposits are in dollars, 23% in JD, 4% in NIS, and 13% in other currencies especially

in euro (PMA, 2005a; PMA, 2004).

Figure 2.3 - Trends of Banking Deposits and Credit in Palestine 1996-2004



Clearing activities have witnessed a positive improvement in checks cleared and transferred. The total number of checks presented for clearing has increased from 12% in 2003. The value of checks has also increased to a total value of \$ 3950 million thus representing a 26% increase in 2004. Finally, it may be concluded that the banking system is doing well on the deposit side, but is still, with the exception of overdraft facilities, at a level of average regarding all types of credit activity. In addition, the banks in Palestine still put the majority of their assets in banks outside of Palestine. (Table 2.5) shows the major features of the Palestinian banking system.

3.2 Banking indicators and performance

The general indicators and performance of the Palestinian banks have some positive as well as negative aspects as presented in (Table 2.6) For example, due to the PMA's clearly announced requirements for banks operating in Palestine to maintain a reserve of not less than 10% for commercial banks and 12% for other banks including investment and Islamic Banks, the banks operating in Palestine have been able to handle anticipated or unanticipated high-risk situations that might have otherwise touched its deposits.

While other measures related to credit- deposit ratios are still less than they should be, we may conclude that banks should play a more effective role in the financing of the private sector. The share of private sector in loans is 77% as compared to 33% for public sector and government. Another negative aspect is the high share of investments located outside Palestine, which is still around two-thirds of

Table 2.5 - Major features of Palestinian banking sector as in 2004

Major features	Percentage
1. High deposit rate to GDP (4 billions)	90% *
2. Low granted credit compared to deposits value	38%**
3. Main Investments are located outside Palestine	57%
4. low leasing financing	0.03%
4. The majority of credit is overdrafts service	55%
5. Ratio of allowance for bad loans to total credit	11%
6. Two leading banks hold the majority of deposits	55%
8. high margin between deposit and credit interest rates	7%
9. Total assets in billions \$	5.0
10. Total granted credit in billion \$	1.5
12. Deposits of residents in billions \$	3.9
11. Total Deposits in billions \$	4.2

* Compared to 61% in Banks in Arab States
** Compared to 63% in Banks in Arab States

Compiled by the authors based on (PMA, 2005a and 2004a; Sabri 2003a; UAER, 2004)

Table 2.6 - Performance measures of banks operating in Palestine - 2003

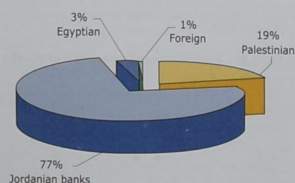
Indicators	Percentage
Credit for private sector/deposits.	25%
Credit /customers deposits.	30%
Loans provided for private sector/total loans.	77%
External investment/customers deposits.	68%
External investment/total deposits.	62%
Capital Adequacy : commercial banks	10%
Capital Adequacy: Islamic and Investment banks	12%
Total allowance to total Assets	5%

Source: PMA annual report, 2004a

total deposits. However, this situation is justified by the political situation. These investments are deposited in foreign banks, with low interest rates thus leading to the decrease of the "operations profits" of the majority of banks operating in Palestine. However, the performance variance between individual banks is notable. Generally speaking, there are two leading banks which hold the majority of the deposits, while the other 20 banks hold less than 50%. This is also applicable to credit facilities and other banking services. In addition, the performance of National banks fell behind that of Jordanian banks operating in Palestine and this is clearly reflected in the customers' deposits share in each category.

As demonstrated in (Figure 2.4), the national banks hold only 19% of total deposits and Jordanian banks hold 77%. This low deposit share affected the profitability of the majority of the Palestinian banks including the Islamic banks. Finally, we conclude that the Arab Bank is recording the highest performance level as expressed by deposits, loans, and quality of services including internet services offered to customers. This also applied to the reported profits for the 22 banks operating in Palestine. In the year 2003, more than one third of the banks reported losses mainly due to the high ratio of bad loans provisions. However, the overall result of 2004 improved and more banks reported profits.

Figure 2.4 - Deposits based on nationality of banks as March, 2005



3.3 Major issues in banking sector

There are some issues attached to the banking system in Palestine, which need to be treated carefully. For example, the issue of bounced checks, the high percentage of bad loans, the high margin between interest paid on deposits and interest earned on credit facilities, the low ratio of medium to long-term financing (more than one year), and the low ratio of lease financing. In the following paragraphs, we will elaborate on the first two issues, while other issues will be discussed in the sections to follow.

The phenomenon of bounced checks has existed in the payment system in Palestine for a long period of time and in the three currencies. It increased significantly when the second Intifada started, especially in the year 2000. Although the problem decreased during the last two years, it is still higher than it should be for a healthy banking system. For

example, bounced checks totaled 14% of total checks presented for clearing in 2003 as compared to 20% in the year 2002. The total number of bounced checks amounted to about a quarter million checks and represent 14% of the total presented checks for clearing. Out of the total, 90% of the bounced checks were issued in NIS currency, which is relates mainly to internal trading. The money value of the bounced checks totaled \$ 314 million out of \$ 3950 million and formed about 8% of the presented checks in 2004, as shown in (Table 2.7). In spite of the various reported reasons for not cashing the checks, an insufficient balance is the main reason.

Table 2.7 - Bounced checks in Palestinian Banking System during 2004

	Number	Value in M \$
Checks presented to clearing	1,805,412	3950
Bounced Checks	254,640	314
Ratio	14%	8%

Source: PMA, 2005

The second issue is the increasing ratio of bad loans. The allowance of uncollected loans in banks operating in Palestine increased from \$ 40 million in 1999 to \$ 144 million in 2003, which constitutes about 13% of the total granted credit and 2.6% of the total liabilities of the consolidated balance sheets of all banks operating in Palestine (PMA, 2005a; PMA, 2004b). This issue is the main obstacle facing the banking sector in Palestine. It negatively affects the bank investment policy as banks are now committing almost two-thirds of customers deposits to outside Palestine, thus adversely affecting bottom line profits. For example, as shown in the respected financial statements of the banks (Sabri, 2003a), the deducted allowance for bad loans reached more than the accomplished profit among four banks, and increased the losses significantly for another six banks and was about 50% or more in an additional six banks. The banks affected most by the issue of bad loans were the national banks, which contributed to, along with other causes, their reported losses during the last few years.

4. Insurance Sector

4.1 Introduction

The insurance activities were very limited up to 1994. There was only one Palestinian insurance company which was established in 1975 with a capital of \$ one million. This one company was involved in general insurance activities with reinsurance support secured in London. In addition, there were about 50 insurance agents located in most of the major cities. The insurance activities were conducted under the Jordan Insurance Law of 1965. The main activity of insurance was for compulsory automobile insurance that accounts for nearly 80% of the insurance premium (UNICATD, 1995). However, since 1994, the insurance sector witnessed significant development in Palestine, but is still considered less important than the banking sector in Palestine. Considering value added and number of employees, it forms only about 15% of the financial sector consisting of about nine insurance companies, including three foreign companies with a capital of 32 million dollars with 120 offices and insurance agents located in different Palestinian cities and villages. In addition, there is a new company with 5 million dollars in capital which has recently been established to deal with the insuring of granted loans. The most popular type of general insurance is still automobile accident insurance (which is compulsory), followed by health insurance and labor accidents. Out of the total, 74% of the value of insurance premiums comes from car accident insurance, 5% from health insurance, 4% from fire insurance, 6% from maritime insurance, 5% from life insurance and 6% from other types of insurances. Among the above types of insurance, based on the financial statements of the Palestinian insurance companies, the maritime insurance is considered the most profitable insurance activity. The second group is related to life insurance which provides protection against financial loss to a family that may occur as a result of the death of the family spouse/breadwinner. The life insurance activity is still pre-mature and the national insurance companies do not engage in providing this service with the exception of one company (Sabri, 2003a and Sabri, 2003b).

The third group offers insurance to cover the loans granted in the housing sector, but this activity is very new and presently immaterial. Due to the importance of automobile accidents insurance, the Palestinian Authority has established a special fund regarding road accidents. The special fund is organized by decree No. 95 which was issued in 1995 (PNA, Palestinian gazette, 1995). This special fund is based on collecting a small percent from all automobile accident policies. Resulting funds yield about 4 million dollars annually and are designated to compensate the victims of road accidents.

To evaluate the performance of the Palestinian insurance sector, various features are pointed out:

First: There is a gradual progress in insurance activities as expressed in the establishment of many new insurance companies since 1994. The share of value added by insurance activities is only about 21 million dollars as compared to the 124 million dollars in the banking sector. It employs around 845 people as compared to 4518 individuals working in the financial sector. (Table 2.8) summarizes the size of the Palestinian insurance sector.

Second: Life insurance activity is limited yielding around 4 million dollars in 2004 (PCBS 2004).

Third: The total capital of the majority of insurance corporations is \$ 32 million. In spite of the stated minimum required capital for insurance companies to conduct business, we find that some of the insurance companies do not meet these requirements, especially the foreign ones).

Fourth: Insurance activities still operate under different laws in the West Bank and in Gaza. The Palestinian insurance law is still under debate in the legislation council (PNA, proposed insurance law of 2005). The insurance activities are conducted now under the supervision of a government body of insurance control. The newly adopted law, No. 13 of 2004, transferred authority to a new proposed governmental body known as the Authority of Capital Market, but which has yet to emerge in an official capacity.

Table 2.8 - Size of the Palestinian insurance sector

Indicators	In \$ million
Capital	32
Revenues of general insurance	57
Revenues of life insurance	4
Insurance claims- cost	27
Re- insurance claims- cost	6
Output	31
Intermediate consumption	10
Gross value added	21
Compensation of employees	7
Imposed taxes	2
Insurance of cars	75% of total volume

Source: (PCBS, 2004a, Sabri, 2003a Sabri, 2003b)

4.2 Major issues of insurance

There are major issues facing the Palestinian insurance sector including:

First: Re-insurance: The insurance corporations operating in Palestine are supposed to reinsure issued policies through international reinsurance corporations especially for certain types of insurance and based on the value of the insurance premiums and total compensation. This practice allows for the insurer and reinsurer to share in compensation pay-outs for cases involving costly insurance accidents. However, there is not enough supervision overseeing this practice regarding the details of agreements, the class of the reinsurance company, and the percentage of the reinsured amount.

Second: The second issue is the commitment of insurance companies towards their clients regarding paying compensation. Due to the weakness of the legal system in Palestine, insurance companies may not meet their contractual commitments as they should. Subsequently, a substantial number of insurance claims end up in the courts. The PNA decided to obtain deposits from insurance companies and deposit the funds in the account of the Ministry of Finance. However, such deposits may not be adequate to enforce the payout of due compensations by the insurance corporations.

Third: The legal and supervision framework: The new Market Securities law requires that insurance firms operate under a supervisory body and classifies insurance activities in the category of financial markets. This law has not been implemented yet and accordingly, there is a legal vacuum.

The last issue is the minimum level of capital required from insurance companies working in Palestine, which is set at a low amount of five million dollars. Moreover, the foreign insurance companies doing business in Palestine did not meet the stated minimum level of capital. Accordingly, there is a need to increase the minimum requirements for both national and foreign insurance companies and to monitor the compliance of those companies to insure that the minimum required level of capital is maintained.

5. Other Financial Institutions

The last part of the Palestinian financial sector, known as the informal financing system, includes moneychangers, microfinance institutions and special financing programs.

5.1 Moneychangers

Before the advent of the PMA, and extending a long period of time, the moneychangers used to be a primary source of funding for the Palestinian financial sector. The moneychangers performed different tasks such as buying and selling of currencies, making money transfers, cashing checks, trading in local stocks and granting small loans. While not permitted to operate in Gaza, the moneychangers played a critical role in the West Bank between 1967 and 1994 during the absence of a formalized banking system. A study conducted in the early nineties found that 31% of moneychangers accepted deposits, 12% granted loans and 12% traded in local corporate shares (Jaber, 1993). In March 2005, there were about 20 private corporations and 246 sole business firms working as money changers and with a prescribed capital of 15 million dollars while the actual working capital may have increased by more than 150 million. The moneychangers are supposed to work exclusively in money and checks exchanges

(Sabri, 2003b). Their annual profit was estimated to be about 10 million dollars in 2003 (PCBS, 2004). The functions of deposits, credit, and trading in shares are not permitted under the new regulations.

The Palestinian National Authority issued a decree in 1997 to organize the profession of moneychangers and amended it in 2000 (PNA, Order No. 4 of 2000). The decree organized the profession in three categories based on legal entity and value of prescribed capital. It listed the permitted trading activities, which include currency exchange, traveler and personal check cashing and making transfers on behalf of customers. As stated in Article 12 of the decree (PNA, Order No. 4, 2000), it prohibited the receipt of deposits and the granting of loans. However, in spite of the above order this sector is still considered as one of the major microfinancing instruments which may be used by customers who are unsatisfied with the regular, more formal requirements. However, the idea of whether or not the moneychangers should play a role in microfinance is a controversial issue. Many support the informal financing system and believe that it creates positive competition with the formal system by forcing them to reduce the cost of financing services, and thus creating a balance with the formal system (Steel, et al, 1997; Chaudhuri and Gupta, 1996 and Bose, 1998).

5.2 Not for profit organizations

There are about nine voluntary local and foreign institutions that provide microfinance loans. Such institutions can be categorized under the "informal financing" category, with part of the loans directed to special sectors, women, and investors in rural areas. The value of microfinance loans ranges between \$ 300 and \$10,000. The interest rate ranges from between 6% and 24% in the case of loans of less than 1000 dollars. About three of the NGOs are specialized exclusively for women, some for farmers, or housing, while other NGOs are working for loans in general for small businesses and specialized programs (Sabri 2003a). The credit portfolio of the NGOs working in Palestine was about \$ 32 million in 2000 (UN, 2001). However, it is unknown to what extent such

programs, which are mainly directed to the self-employed micro-enterprises are successful, and thus there might be a need for re-evaluation. For example, one the NGOs that direct its loans to women has a total outstanding loan portfolio of \$ 1.4 million with a reported loan- loss rate of 8%, and operational self efficiency of 81% (Manalo, 2003). Other measures can be used to evaluate this sector of financing, such as outreach of loans, operational efficiency, and asset quality and loans loss (Rock et al., 1997).

5.3 Special programs and institutions

The United Nations of Palestinian Refugees Agency (UNRWA) started offering microfinance credit to refugees in 1993. Such programs aim to offer short-term working capital loans to micro-enterprises and long-term loans to small-scale businesses. The total disbursements value of this UNRWA project was about 76 million dollars. It includes 65,000 in loans, with an average of 1170 dollars per loan. The estimated operational sustainability for the loans was about 87% (UNRWA, 2004).

In addition, there are special programs being executed by different commercial banks funded by foreign institutions which specialized in medium term loans. Such programs include the French grant, IFC, and the German program. The average period for the loan granted by the German program was three years with an eight year extension possibility. The French Grants provide grants that reach 35% of the loan with a condition of buying the needed equipment from France. The IFC of the World Bank working in Palestine, granted loans of up to 30 million dollars in 2001, and it may extend its loans up to \$ 75 million (World Bank update, 2001). Finally, the Palestine company for real estate mortgages, which was established in 1997, is financing the buying houses for low-income customers, however its working capital is limited to about 20 million dollars.

6. Role of Central bank (PMA)

6.1 Introduction

The establishment of the PMA aims to conduct

the majority of the functions of the central bank. It started in January 1994 based on an economic agreement which is part of the Oslo peace agreement signed in 1993. In 1997, law No. 2 of 1997 was issued to regulate the work of the Palestinian Monetary Authority (PMA, Official Gazette, 1998). The aim of the PMA as stated in the law is to manage the government's gold and foreign currency reserves, to regulate the quantity and cost of credit system and to maintain an efficient and developed banking system through the organization of banking activities, to issue and cancel licenses of banks, to control and supervise them, in addition to exercising the privilege of issuing the national currency when it is possible or when the PNA decides. The PMA has been working for about ten years, during which its total assets have increased from 205 million dollars in 1996 to 569 million in 2004, as presented in (Table 2.9). The majority of the liabilities of the PMA come from regulatory reserves and deposits collected from local banks to meet control measures.

With the absence of a national currency, the PMA has little to do regarding currency exchange rates or stating interest rates using other possible monetary measures. In addition, until now, the PMA does not hold any government assets, funds, or accounts... Accordingly, the remaining functions of PMA are concentrated on conducting the clearance of checks, as well as the monitoring and controlling of the operation of Palestinian, Arab, and foreign banks working in Palestine, as well as organizing moneychangers' profession to pursue their work more officially. The PMA works independently and follows the office of the president of the PNA. However, there exists some coordination with the Ministry of Finance on monetary and fiscal policies as the deputy of finance minister is a member of the PMA board of directors.

6.2 Performance of the PMA

Concerning the control of banks operations in Palestine, the PMA has not officially adopted the Basel regulations yet. However, the law of banks of 2002, the law of Monetary Authority of 1997 and the various adopted regulations and orders control most of banking operations

Table 2.9 - Assets and Liabilities of the PMA in US million\$ between 1996 and 2004

Items	1996	2004
Balance with Banks in Palestine	117	140
Local Investments	0	18
Foreign Assets	87	401
Fixed Assets	1	1
Other Assets	0	1
Governmental loans	0	8
Total Assets - Liabilities	205	569
Deposits for banks and financial institutions	194	530
Allowances	1	0
Capital and reserves	10	37
Other Liabilities	0	2

Source, PMA, 2005

including activity, risk, capital adequacy, and liquidity of banking services as presented in (Table 2.10). The table shows that various measures have been set up to control types and limits of major activities of the banking system in order to assure minimum risk as well as to serve the Palestinian economy; this includes activities and investments outside Palestine, investments in fixed assets, securities, and the granting loans. However, the two most important measures are related to the imposition of the minimum ratio on the credit granted in Palestine and the maximum level of investments outside Palestine. In addition, there is a list of activities that are not permitted to be performed, besides a list of activities, which are permitted only upon the approval of PMA such as investment in options, granting of loans to non-residents, and investment in foreign securities.

For liquidity measures, the PMA is monitoring the banks' liquidity through two measures to keep a minimum level of liquidity, which is 25% and a minimum balance of cash at 4% of current liabilities. For risk measures, various maximum levels were stated regarding credit granted to one customer (assets concentration), ownership in a capital company, and trading in foreign currencies. In addition, detailed regulations are stated to organize the allowances for bad loans. Finally, for adequacy of capital, there is a minimum ratio of the adjusted ownership to weighted risk assets, a minimum amount of paid capital, and an annual 10%

Table 2.10 - Measures used by PMA to control the operations of Banks in Palestine

Aspects	Measures	Ratios
Activity measures		
Ownership of fixed assets	Fixed assets to total assets	25%
Ownership in securities	Securities to total assets	25%
Investments outside Palestine	Total investments to deposits	65% maximum
Granting loans and credit	Credit to deposits	40% minimum
Unpermitted activities	Stated by law of Banks, article 16	
Permitted upon permission	Trading in options Granting loans to non-residents Investment in foreign securities	
Adequacy of Capital		
Adequacy	Adjusted ownership to weighted risk assets	10% to 12%
Minimum capital requirements	Paid capital	5 to 20 US\$ million
Regulatory reserves	Up to 100% of paid capital	10% of profit
Liquidity		
Liquidity ratio	Current assets to deposits	25%
Cash ratio	Cash to deposits	4%
Risk		
Ownership in a capital company	Value share to capital	10% maximum
Credit granted to one customer	Value to capital	10% - 15% maximum
Trading in foreign currencies	Short or access in foreign currency positions to owner equity	5%
Allowance for bad loans	Due loan values based on due date of loan (180 to 360 days)	20% to 100%
Cash to be deposit in the PMA as minimum legal reserves	Based on deposits and credits	6% to 15%

Sources: Compiled by the authors based on: PMA law, Banks law of 2000, and various Circulars Issued by the PMA (1995-2004).

deduction of profit to be added to legal reserves up to 100% of the paid capital. The last measure applies to all corporations by the law of companies.

However, the compliance by the banking sector regarding the PMA stated ratios and measures have not materialized completely, especially regarding some Arab banks. For example, the credit to deposits ratio which is supposed to be about 40% reached only 18% for Jordanian banks, and 19% in the foreign banks operating in Palestine and only Palestinian and Egyptian banks granted loans above the minimum requirements (PMA, 2005b). In addition, the most important control measurement is the owner equity to total deposits ratio which has not yet been declared, however in an attempt to guarantee a safe defensive system as a step to implement such measures, the PMA has forced branches of foreign banks that have deposits of more than \$30 million to increase the capital to \$20 million. In addition, there is no stated limit for the collected fees and

charges that banks take from its customers in return for various services, which has totaled in some banks to 185 types of fees (PMA, 2004). The PMA issued an order to list 58 types of fees, without stating any limits for the charges, and the only stipulation made was on the types of fees, but not on the price or commissions (PMA, order No. 33, March 2004). Accordingly, there is a need to issue fee levels rather than to just list them. Finally, the PMA does not interfere in the interest rates and leaves it up to the banks and to the market; this situation resulted in a big interest spread which is the difference between rates paid on deposits and those collected on credits. For example, on average the deposit interest rate was 1% for the dollar, while it reached 8% on loans. Accordingly, the PMA has to intervene in one way or another on behalf of the Palestinian businesses and customers.

7. Financing of Private Sector

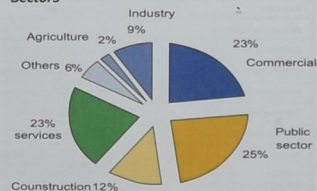
7.1 Introduction

The role of the Palestinian financial sector in financing the private sector has various deficiencies. First, the problem concerning credit: It is estimated that the share of medium and long term credit granted by banks operating in Palestine is about 8 %, while about 92 % are either in the form of overdrafts, short term loans (up to one year), and the discounting of commercial bills. This ratio is true when we consider even the investment banks and the IFC program, which have a small share of medium-term credit. The second disadvantage relates to the types of sector attractiveness to the financial system. The credit system prefers to deal with the commercial and service sectors, rather than to deal with the agricultural, housing or industrial sectors. This is due to the risk factor and logistic considerations. The last three sectors are the most important sectors capable of improving the general economy, and they are in need of real medium and long-term credit schemes. For example, the three sectors of agriculture, industry and housing have only a 23% share of the total credit granted by the banking system as compared to 46% of the total credit granted to the commercial sector as shown in (Figure 2.5) (PMF, 2005a). However, the lack of credit financing offered by banks to these major sectors is not related to the profitability of these sectors or to the ROI- interest rate, but rather to the fact that banks are more comfortable when dealing with short term loans and overdraft credits rather than examining medium and long-term loans even if such investments are more profitable. Various studies reported high returns on investments for the industrial sector (Sabri, 1998a and 1998a). ROI for the housing sector is also high, and some studies reported 21% for the renting of housing projects, and 18% for the selling of housing projects (Sabri, 1998b, Sabri, 2003b). The third disadvantage is that the role and the value of the formal financing sector is still low when compared to other sources of funds as presented in the next section.

7.2 Financing of private sector

Measuring the performance of the Palestinian financial sector and assessing its role in financing the private sector, we might conclude

Figure 2.5 - Types of granted Credit based on Sectors



that it is still in the early formation stages with a limited role. "The internal sources of financing" are considered to be the primary source for financing most of the sectors, including the paid-in capital, the gained capital, including the compulsory and optional reserves, and retained earnings, or what is known as the owner-equity, as shown in (Table 2.11). Studies have shown that the internal sources of funding range on average between 80% of total assets and this range can be applied to most economic sectors (Sabri, 2003a). The credit offered by suppliers (accounts payable) is the second source of funds for most of the commercial, industrial, and agricultural institutions. The role of other sources including the formal, non-formal and microfinance systems is confined to the remaining 10%. However, regarding the share value of the credit system, these sources vary. The commercial Arab banks are the main source for the credit system, followed by Palestinian commercial banks, investments and Islamic banks respectively. The NGOs and moneychangers form the least important source for the financing of the private sector as presented by the value of credit. The other issue is the need for a medium and long-term credit system. In a study that sought the opinions of Palestinian businessmen and managers of corporations and as presented in (Figure 2.6) the majority of respondents preferred the term of the loans to be three years and more, while only small share of businessmen needed loans of one year or less.

7.3 Gender issue in financing system

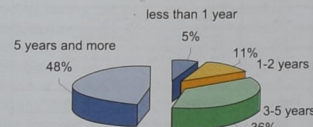
Women in Palestine are relatively well educated in comparison to women in other less developed

Table 2.11 - Sources of financing Palestinian private Sector

Sources of funds	Rank
First: The paid capital	1
Credit from suppliers (Accounts and notes payable)	2
Third : Sources of formal funds	
Arab commercial banks	3
Palestinian commercial banks	4
Investments and specialized banks	5
Palestinian Islamic banks	6
Foreign commercial banks and special programs	7
Foreign NGOs lending organizations	8
UNRWA programs	9
Local NGOs lending organizations	10
Fourth: Informal financing and money exchangers	11

Source: Sabri, 2003a

Figure 2.6 - Loan periods as preferred by the Private Sector in Palestine



countries and occupy a respected status in the business community when compared to the position of women in most other Arab states. This is expressed by the literacy rate and level of education among women, by the work opportunities and advanced levels of professions available to women in Palestine. For example, the literacy rate of Palestinian women in 2003 was about 87% as compared to 96% among men during the same period. Palestinian women work in the advanced professions sharing about 20% on average in the positions of dentists, journalists, lawyers, chemists, and civil engineers (PCBS, 2004b). The Palestinian women who share in the work force is nearly 25% of the total labor force working in agriculture, industry, the service sector, and public services. Women form nearly 30% of the industrial sector task force, a percentage that is considered to be the highest among other sectors. As for the service sector, women are also active, mainly in education, public

managerial positions, secretarial positions, hospitals and health services and telecommunications (UAER, 2004).

Considering the number of women sharing in the Palestinian financing system, we find that it's less than it should be even when taking into account the special programs for women. However, this is expected if we consider the number of women in advanced professions, or their participation in self-employed business, which is about 17% of the total businesses in Palestine (PCBS, 2004b). For example, the ratio of loans for women granted by microfinance programs conducted by UNRWA was about 31% (UNRWA, 2004). The share of loans granted to women by official banking system is estimated to be about 12% of the total loans, according to different bank sources.

8. Palestinian Securities Exchange

8.1 Introduction

The Palestine Securities Exchange (PSE) was incorporated as a private shareholding company in early 1995, owned by PADICO, 80% and SAMED, 20%. On February 1997, the PSE conducted its first trading session. By the end of 2004, the number of listed companies increased to 26 corporations (PSE, 2005). The listed corporations choose voluntarily to have their stocks traded inside the market, otherwise the trading of shares for the rest of Palestinian corporations are traded outside the market through transactions approved by the board of directors of the respected corporations as stated by the existing corporate law of 1965. They are all Palestinian firms, with the exception of one firm, which is a holding firm registered in Liberia, as presented in (Table 2.12). The listed firms form one third of total public corporations, which may be qualified to trade in the Palestinian financial market. According to the listing requirements in the Palestine Securities Exchange, companies should have at least fifty percent (50%) of the subscribed capital paid up, with a minimum capital of US \$750,000. The minimum number of outstanding common shares must exceed 100,000 shares, the company must have at least 100 shareholders, and at least twenty-five percent

(25%) of the common stock must be offered to the public (PSE, 2005).

The Palestinian stock exchange trades only with secondary markets, at one level. There is no primary market. Set up by the corporations law of 1964, the initial offering must occur under the supervision of one of the banks located in Palestine. There is no over-the-counter market in Palestine. For non-listed firms, seller and buyer agree directly and present the deal to the respected corporation for registration. The trading in the Palestinian stock exchange is conducted only over common shares with a stated par value and as a registered share not a bearer share. In addition, neither corporate nor government bonds are dealt with in the Palestinian market. The present law of companies permits and regulates the issuing bonds by public corporations, but this initiative was never used by any Palestinian corporations.

(Table 2.13) summarizes major features of the Palestinian stock exchange. The market index of the PSE which is called Al-Quds Index was established in 1997, based on ten listed firms with a weighted average of the firms' capital. It was established based on a 100 point scale and later moved up to 139 points at the end of 1997, and went up 278 points in 2004, which was the highest price index point reached during the last eight years.

However, later and at first quarter of 2005, it jumped to 690 points. The trading sessions were held five days per week from 10 to 12 am and the number of working days ranged from 66 days to 230 days annually. The price change during one session is allowed to move up and down with a limit. Regarding brokerage activities, the Palestinian securities exchange regulations state that the members wanting to trade in the market should be private corporations with at least a paid capital of no less than one million dollars and work exclusively in securities (PSE, 2005a). In addition, and due to an absence of national securities laws and regulations, the exchange is charged with enforcing its rules and regulations, covering the listing requirements, trading, settlements and clearing. A board of

Table 2.12 - Listed Firms in PSE in 2005 in Million

Capital	Company Name
JD	I: Firms paid capital in JD
0.7	Arab Concrete Products Co. Ltd.
6.9	The Arab Hotels Company
0.9	Arab Insurance Establishment
1.5	Arab Company for Paint Products
9.4	Arab Investors Company
0.9	Arab Real Estate Establishment Co.
10	Palestine Poultry Company.
10	Birzeit Pharmaceuticals
10	Arab Care Medical Services
1.2	Grand Park Hotel & Resorts
7	Jerusalem Cigarette Co.
1	Jerusalem Pharmaceutical Co.
5	Palestine Plastic Industrial Company.
3.9	National Insurance Co.
67.5	Palestine Telecommunication Co.
11.9	Palestine International Bank
15	Palestine Investment Co.
4.5	Arab Palestinian Shopping Centers
15	The Palestine Real Estate Investment
3	Vegetable Oil Company Ltd.
Capital \$	II: Firms with Paid Capital in Dollars
6	Ahliea Insurance Group Co.
172	PADICO
60	Palestine Electric Co.
20	Palestine Investment Bank
20	AlQuds Bank
21	Arab Islamic Bank

Source: Sabri, 2003a

eight directors representing the exchange itself, investors and securities firms governs the operation of the exchange. The number of traded sessions was limited during the first years of operation, which started with 66 sessions in 1997, and extended to 244 sessions in 2004. The number of traded shares ranged from between 10 million in 1997 to 100 million shares in 2004. The traded value of the market ranged from between \$25 million in 1997 to 200 million dollars in 2004; with an average annual trading value of 100 million dollars. The market capitalization ranged from between 500 million and 1100 million during the eight years of operations (PSE, 2005b). (Figure 2.5) based on the database of the stock exchange

Table 2.13 - Summary of Palestinian Stock exchange features as existed at the End of 2004

	Major features
Listed companies	26 out of 75 corporations
Paid Capital	\$63 million \$
Market Capitalization	1,069 million \$
Annual trading Volume	201 million \$
Annual volume	104 million shares
Annual traded equity	Stated par value Registered common share, One vote-share,
Market	One level of secondary market
Government bonds	Not Existed
Corporate Bonds	Not Existed
Primary market	Not traded
Money market	Not traded
Mutual funds	Not Existed
Future and options	Not Existed

(PSE, 2005b) indicates the trends of stock trading during the eight years of Palestinian stock exchange operations from 1997 to 2005. However, during the first quarter of 2005, the Palestinian stock market witnessed a dazzling period of trading regarding volume of trade and the extreme upward movement of stock price indexes. The price index jumped about 150% in just four months. The value of trade during the four months reached 623 million which is equivalent to the traded value over the past six years of operation for the market. Market capitalization increased from 1100 million to 2687 million dollars during this 4 month period.

8.2 Major issues in Palestinian stock market

The stock market in Palestine has passed the initial stage of development but is still far from being considered a success story. As a matter of fact, it is still considered to be in the high risk zone. This conclusion may be justified by the following facts and causes:

First: Conflict of interest and insider trading: The PSE works under self developed rules issued by the owner of the private corporation which owns the market. There is no independent control authority, no code of ethics regarding stock trading, nor are there any regulations

Figure 2.7 - Performance of Palestinian stock exchange



to control the trading activities, or to prevent insider information. The extraordinary size of trading that occurred during February - April 2005 was due to information leaked by insiders about the expected decision of how the shares would be split and information about the cash dividends of PALTEL, all leading to extreme enthusiasm for stock market trading. In addition, some members of the Palestinian exchange market are board members in the listed firms, while other board members work in brokerage corporations. Moreover, there are members who joined the board of the exchange, the board of the listed firms, and the board of listed firms from the same market as was being traded.

Second: Fundamentals facts. The fundamentals data of the listed corporations and of the major Palestinian economy indicators do not justify the dramatic increase in the stock price index of more than 100% during the four month period. For example, in the last five years only 8 corporations of the listed firms distributed profits from 5% to 25% of the share par value. In addition, during the period from 2000 to 2002 only two to four firms distributed profits as shown in (Table 2.14).

Third: The Index issue: The ten listed firms which form the PSE price index are changeable based on their traded volume, and thus include only the most traded listed firms, and exclude the least traded firms. This may create misleading information about the activity of the markets and movement of the prices as long as firms with less volume are excluded. Because the index is not fixed in a specific firm, it should include all the 26 listed firms, and thus determine the index by the average weighted volume.

Table 2.14 - Number of the listed firms distributed profit during 1999-2003

Year	Out of 26	Dividends %
1999	8	5% to 15% of par value
2000	4	5%-15%
2001	2	15% -25%
2002	4	7% -15%
2003	7	5% -15%

Source: PSE, 2004

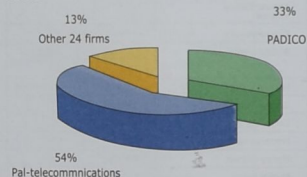
Fourth: The Legal framework: The moment the PNA authorized operations in a stock market exchange in 1997, it should have amended the related laws as well as issued additional needed laws and regulations. Only after eight years of PSE operations, the PLC approved two laws which are the Law of Capital Markets No. 13 of 2004 (PNA 2005 a) and The Palestinian Law of Securities 2.12 of 2004, (PNA, 2005b) which are supposed to organize the capital markets among other financial activities. However, law 2.13 of 2004 stated that the supervision of operation for the PSE should be under the Authority of Capital markets, which has not yet been formulated. Accordingly, the present PSE is neither operating under an adequate legal framework nor being supervised by an independent body.

Fifth: The ownership of the PSE: The PNA granted exclusive rights for trading stock to a private corporation owned by a foreign firm which owned 80% and a private corporation which owned 20%. The granting of this privilege is illegal and this should be changed. The changing of legal entities on the stock exchange would reflect on various aspects including profit targets and working conditions.

Finally, the size of trading in PSE comes mainly from to two listed firms. The first is the Pal-telecommunications company. The traded value of this firm formed about 54% of the total trading from 1997 to 2005, while the trading of the other firm's stock (PADICO) formed 33% for the same period as shown in (Figure 2.8). Both firms constituted 87% of the trading since the market was established and has continued up until now. This also applies to the cause of

the huge increase in the price index. The unusual size of trading is due to the fact that PALTEL was granted exclusive rights from the Palestinian National Authority government for ground communications and the PNE failed to

Figure 2.8 - Share of the two main firms in PSE from 1997 to May 2005 as expressed in trade value



impose relevant controls to accomplish a fair service price as outlined in Article 2.8 of the License agreement issued in November, 1996 (PNA, 1996). The second firm is an foreign firm established outside Palestine and which owns 29% of the first firm, thus allowing it to move with the same latitude and flexibility as the first one.

9. Summary and Recommendations

9.1 Summary

The role of the financial sector including financial institutions and financial markets in developing the Palestine economy is still limited. It is true that there are major advancements in the system that have occurred in the last ten years since the advent of the PNA. For example, the newly established and reopened banks reached up to 22 banks with 135 branches, holding about 4 billion dollars as deposits, with credit portfolios of about 1.3 billion dollars. The financial system has also witnessed the establishment of nine insurance companies with annual revenues of 62 million dollars. The microfinance programs continue to operate reaching the point of a \$30 million credit portfolio and an evolving stock market including 26 listed corporations with an average annual trading of \$ 100 million dollars. However, these positive trends are not reflected as positively

in the private sector or in the Palestinian economy in general. This is due mainly to the instability of the political situation, the permanent destructive measures imposed by the occupier, the weakness of the legal and court systems that exist in Palestine and the absence of relevant collateral instruments. Finally, other financing alternatives are not utilized in the Palestinian economy. An example of this is the non-use of bonds by the industrial and housing business corporations to finance medium and long-term projects. Another example is the failure to attract direct foreign investment or to attract cash inflow channeled through the primary stock market rather than through the secondary market and the failure to establish pension funds using resources available through the Arab development funds. Considering the above findings, the following sections represent the concluded recommendations, which are put forth for consideration by the policy makers of the Palestinian Authority.

9.2 Recommendations for policy makers

First: Regarding collateral and the grantee of loans issue: In order to encourage external investments as well as to encourage banks to direct their investments to the local market, there is a need to provide insurance coverage on investments and export credits to cover the political and commercial risks from nationalization, war, currency inconvertibility, civil disturbances, and cancellation of the import license. Examples of such firms are the Inter-Arab Investment Guarantee Corporation, in which Palestine is one of the owners (Sabri, 1997a), and the Multilateral Investment Guarantee Agency of the World Bank known as MIGA, which indicated a willingness to operate in Palestine. In addition, the PNA is called upon to upgrade the condition of lands and houses and improve registration laws for incorporation into the main collateral system, which would remove many of the obstacles for the granting of medium and short-term loans.

Second: To encourage banks to invest in both primary and secondary markets in Palestine the PMA should include investments in local

corporations as a part of the minimum requirements of credit to deposit ratio.

Third: Change the present legal entity of the PSE to either a non-profit organization owned by insiders known as stakeholders and include all listed firms and brokerage firms, or change to a public corporation with outside owners only or with a combination of insiders and outsiders and after a public offering or change to an independent government body.

Fourth: Legal framework recommendations: The proposed law of companies and law of insurance should be issued. The laws of securities should be revised and incorporated into the law of companies and law of insurance. The Authority of Capital markets should be established in order to fully exercise its' purposes as stated by law And finally, there is an urgent need to improve the judicial and court system, which is a fundamental requirement for a solid financial system.

Fifth: Expand the Palestinian stock exchange functions to improve the performance of the market for developing the Palestinian economy. Presently, the Palestinian stock exchange is no more than a place to trade the shares of few corporations. To develop the Palestinian stock exchange, the following recommendations should be implemented: convert the owner company to a cooperative institution that is owned by all stakeholders, including the primary market, issue code of trading ethical guidelines, and control insider trading abuses.

Sixth: Adopt the concept of cross- listing of companies in other stock markets. This may offer investors an opportunity to diversify their investments, by investing in different markets, and increase financial and economic ties within the Mediterranean and Arab regions (Sabri, 2002), offering opportunities for foreign firms to be traded in the PSE, and Palestinian firms to be traded in Arab and European stock exchanges. However, consideration of this cross-listing concept requires a vigorous and thorough review of existing laws and financial reporting requirements for Palestinian corporations.

Seventh: There is a need to include the primary market in the Palestinian stock market, and to consider the possibility of using international public offerings for newly established Palestinian corporations. However, any adoption of such measures must be incorporated into the Law of Companies, which is currently under debate.

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Chapter III Trade Issues

1. Introduction

The West Bank and Gaza Strip (Palestine), as is the case with most developing countries, is a net importer of food and manufactured products thus faces serious difficulties in their balance of payments. Consequently, the expected impact of the increases in world prices on the welfare of the population and on the balance of payment will be severe for Palestine. However, Palestine will benefit from the total liberalization of trade in raw materials and inputs. Thus, liberalizing the input markets from restrictions imposed by Israel will allow Palestinian producers and exporters to improve the competitiveness of the manufactured and farming sectors in the domestic market as well as in the international markets. In fact, importing inputs and raw materials from cheaper origins other than Israel will eventually reduce costs. Therefore, more jobs will be created and the value added for agriculture and industry will improve. In fact it has been significantly requested in the bilateral negotiations held between the Palestinian National Authority (PNA), Israel and Jordan. The three bilateral economic agreements signed between Israel, Jordan and the PNA include several non-tariff barriers (NTBs), which restrict the flow of Palestinian agricultural and manufactured products into their countries (El-Jafari, 1997a, 1997b; 2000).

It is believed that the Palestinian economy will benefit from trade liberalization with the application of the World Trade Organization (WTO) agreement. Palestine is not a member of the WTO, but it will be affected by the agreement regardless of whether it is signed or not. In fact, the WTO agreement will create a global market for agricultural and manufactured products, which will allow for the free movement of goods between the various countries in the region and abroad.

The bilateral trade relationships between Jordan, Israel and Palestine will be subject to trade liberalization in order to comply with the WTO agreement. While Israel and Jordan are currently WTO members, Palestine indirectly deals with the WTO. Eliminating the NTBs and reducing financial support granted to producers and exporters are the major requirements of any country to comply with WTO reforms, and liberalizing Palestinian trade from the NTBs imposed on Palestine by Israel is of primary interest to the PNA. Yet, Palestine is not currently realizing the benefits of the EU-Med partnership agreement due to the restrictions imposed on the agricultural trade (imports and exports) of all inputs and exports.

Furthermore, the PNA does not grant any financial support to local producers and exporters which, if it did, would make it easier to join the WTO. Providing adequate marketing, technical and health services to meet international standards import and export activities are major requirements for the PNA to be a member of the WTO. Therefore, eliminating all NTBs imposed by Israel will eventually lead to a situation where all requirements of the WTO, in terms of establishing all necessary trade services, will be met.

As trade continues to be liberalized in Palestine, the domestic markets will be less isolated from international and regional prices. In regards to exports, prices of commodities produced and exported from Palestine will stabilize and increase, rather than fluctuate and decrease. In particular, stabilization in outputs price and income would enhance production. Consequently, demand for production factors (major as well as non-major) will increase, particularly to produce labor-intensive commodities.

Farming and manufacturing in Palestine are

undergoing major structural improvements. Shifts to commercial production and vertical integration are increasing. Although they are importable sectors, several trade policies such as import substitution strategy (ISS) have been adopted to decrease the dependency of the Palestinian economy on Israel. It has been substantiated that there is a significant expansion in production of poultry products, dairy products and red meats. Applying ISS policy has decreased the level of unemployment by creating jobs for skilled and unskilled laborers alike. It is expected that an Arab Free Trade Agreement (AFTA) will facilitate the establishment of a more expansive Arabian market, which would have the potential to absorb the traditional products such as olive products, citrus and vegetables. For example Palestine and Jordan would both benefit from controlling their production and be in a position to improve their sanitation and quality control standards.

Experience with direct exports to Western Europe has not been, on the most part, encouraging. This is due to poor quality controls, inappropriate packaging and the high cost of delivery in the absence of national sea or airports. In addition, the prospects for direct exports of standard Palestinian products (citrus, tomatoes, eggplant and cucumbers) to Europe do not appear promising due to strong competition from southern Mediterranean countries. Greater attention is given to non-traditional, high quality products. Among the candidates are crops and flowers, medicinal herbs, asparagus, celery, onion seed, cantaloupe, avocado and dates. A start in this direction is already apparent in the flower production enterprises of Gaza. Furthermore, development of this potential is contingent upon the study of the European market and trade practices, through the adoption of correct production technology and the provision of adequate support services (World Bank 2004a,b, El-Jafari, 2004).

During, 1997-2000, annual growth rate of exports to Eastern Europe tended to increase rapidly. However, since 2001, it has come to a standstill following the major political upheavals in this region. With better marketing

and quality control, and a serious export-promotion drive, East European countries could again become important importers of Palestinian agricultural, chemical and pharmaceutical products. Conversely, East European countries have the potential to export cheap inputs and raw materials such as cement, iron, fertilizers and feed stuffs which would expand Palestinian agricultural production (El-Jafari, 2005).

2. Trade and Investment Indicators

Palestinian merchandise and service trade and investments showed an increasing trend between the years 1994-2000, but have since deteriorated badly. In this regard, this chapter analyzes the determinants of the performance and function of Palestinian foreign trade and investment between the years 1995-2004. In 1995, the PNA replaced the Israeli Civil Administration in administering economic activities in Palestine. According to the economic protocol signed in 1994 between the Government of Israel (GOI) and the Palestinian Liberation Organization (PLO), the PNA runs the economies of Palestine based on trade and economic arrangements reached in that protocol. However, by the fourth quarter of the year 2000 several economic measures and impediments had been imposed by the Israeli occupation authorities to suppress the Al-Aqsa Intifada. The impact of those measures has been increasing and accumulating over time. As a result, the Palestinian economy is totally contained by Israel.

Moreover, the dependency of the Palestinian economy on Israel has increased in terms of:

- Proportions of Palestinian exports to Israeli market: total exports increased from 90% in 1999 up to 96% in the year 2003.
- Proportions of Palestinian direct imports from Israel: total imports rose from 70% in 1999-2000 to 80% in 2003.
- The trade deficit has widened overtime, due to the percentages of reductions in exports which have been greater than those in imports.

In this chapter, trends in Palestinian merchandise and service exports and imports and trade balance are reviewed. Next, commodity and geographical distribution are discussed followed by investment indicators (PCBS, Palestinian Foreign Trade Statistics, various issues).

2.1 Main indicators of merchandise and service trade

In this section, trends of merchandise and service exports and imports are presented. First, the merchandise trade will be covered, followed by a discussion of the service trade.

2.1.1 Merchandise trade

During 1995-1999, Palestinian merchandise exports increased from 339.5 million in 1996 to \$ 615 million in 1999, an increase of 81% with an annual growth rate of 5.2%. In the following year, 2000, the level of merchandise exports went down to \$ 590 million, a decrease of 4% compared to its level in the year 1999. Concurrently, the significance of merchandise exports to gross domestic product declined sharply from 25% in 1990 to 10% in the year 2000. During the period 2001-2004, data provided by the Palestinian Central Bureau of Statistics (PCBS) indicated that merchandise exports have tended to decrease from year to year. In the year 2002, the level of merchandise exports reached \$ 288 million. They approximated 46% and 48% of their levels in 1999 and 2000, respectively. It is anticipated that merchandise exports will recover in the years 2003 and 2004. Projected data available from PCBS on merchandise exports indicate that they will grow by 5% during those years compared to their level in 2002 indicating that the adjustment process has taken place (World Bank 2004 a, b, MAS Economic Monitor).

During 1996-2002, merchandise imports reached a peak of \$ 2629 million in the year 1999. While experiencing an increase overtime between the years 1996-1999, at an annual growth rate of 5.8%, merchandise imports tended to decrease by 10% annually during 1999-2003. Based on empirical studies conducted on Palestinian trade, imports have a high association with gross

national disposable income (GNDI). While real GNDI averaged \$ 5108 million between 1996-1999 it went down to \$4285 million, a decrease of 16%. In addition, the depreciation of the Israeli currency with respect to the U.S dollar and the Euro has resulted in the Palestinians cutting their direct imports from both Europe and the United States (PCBS, Palestinian Foreign Trade Statistics, various issues, 1996-2004).

2.1.2 Service trade

While the local production of the services sector contributed up to 50% of the gross domestic product during 1995 - 2003, its contribution of total exports and imports was approximately 10%. However, when remittances are included, trade of services account for 30% of the total trade. An analysis of the structure of Palestinian exports in services reveals that they are limited to a few services such as transportation, travel and tourism, and the export of labor, especially to Israel. On the other hand, service imports include a wide range of services comprising transportation, travel, insurance, education, medical services, communications including telecommunications, cultural materials and information technology (IT) (El-Jafari and Al-Ardah, 2001; 2002). Exports of service (excluding labor exports), reached a peak of \$154 million in the year 2000, two times greater than the 1995 level. In the past four years, 2001-2004, exports of services went down sharply and by 2002 they averaged \$60 million, approximately 40% of the level in 2000. However, the rapid contraction in the exports of services has resulted directly from the decline in merchandise trade.

2.2 Structural distribution of Palestinian trade

This section covers commodity and service distribution of exports and imports. The analysis will be limited to the years 1996-2002, where reliable data published by PCBS is available for that period.

2.2.1 Structural and geographical distribution of the Palestinian export merchandise

Exports of manufactured products ranged

between 38% - 43% of total merchandise exports for Palestine during 1996-2002. Mostly, exports of manufactured products are classified as labor intensive products and raw materials, such as textiles, shoes, furniture, and marble and stones products. Next in importance are manufactured articles, accounting for from 15%-20% of total merchandise exports. They include certain designs of men and women's clothing, instruments, appliances, works of art, and printed matters.

On the other hand, exports of food products decreased sharply in 2001 and 2002 compared to their level in the years 1999 and 2000. However, the importance of other sets of exported commodities remained constant, such as beverages and tobacco, crude materials, mineral fuels, animal and vegetable oil, chemical and related products, and machinery and transport equipment as presented in (Table 3.1).

2.2.2 Distribution of the Palestinian merchandise imports

The significance of Palestinian imports of food products, fuels, machineries and transport equipments showed a constant trend over the period 1996-2003. They made up approximately 80% of total merchandise imports as shown in (Table 3.2). In contrast, proportion of imports of beverages and tobacco, crude materials, animal and vegetable oil and manufactured articles remains insignificant. (Table 3.3) indicates that Palestinian imports classified as final products are allocated for final consumption. Examples include food and live animals, manufactured products, animal and vegetable oil, and beverages and tobacco. Such imports make up an estimated 75% of total imports.

Data available from National Accounts published by PCBS reveal that imports of final goods

Table 3.1 - Commodity Distribution of Merchandise Exports between 1996-2002

	Section	Year						
		1996	1997	1998	1999	2000	2001	2002
0-	Food and live animals	14.38	15.046	15.65	16.35	21.1	11.73	11.22
1-	Beverages and tobacco	4.5	5.2	6.5	3.9	3.38	4.6	5.66
2-	Crude materials	6.86	4.53	4.4	3.6	3.91	4.43	5.96
3-	Mineral fuels, lubricants and related materials	2.43	1.62	1.8	1.33	0.91	0.74	1.03
4-	Animal and vegetable oils, fats	2.56	2.1	1.4	1.11	1.43	1.99	2.37
5-	Chemical and related products	6.97	5.96	6.24	8.12	7.41	9.5	8.4
6-	Manufactured goods	40.66	43.052	42	40.63	38.22	41.5	39.43
7-	Machinery and equipments	5.98	5.7	5.5	5.57	5.97	5.8	4.99
8-	Miscellaneous manufactured articles	15.32	15	16.3	19.21	17.61	14.5	20.69
9-	Unclassified commodities	0.25	1.4	0.27	0.11	0.05	0.17	-----
	Total \$ million	339.45	380.42	394.84	372.15	400.86	290.35	240.07

Source : Palestinian Foreign Trade Statistics, Various issues

Table 3.2 - The Distribution of Palestinian Exports by Destination in %

	Importing Countries of Palestinian Goods	Year						
		1996	1997	1998	1999	2000	2001	2002
0-	Jordan	5.58%	4.9%	3.03%	8.3%		5%	6.2%
1-	Israel	93.8	93.7	96.5	96.7	92.3	94	90
2-	Arab Countries in Africa	0.03	0.02	0.01	0.02	0.04	0.03	0.05
3-	U S and Canada	2.43					0.04	0.08
4-	E U	0	0	0.4	0.4	0.42	0.83	3.7
5-	Other Countries						0.1	
	Total \$ million	339.5	382.4	394.9	372.2	400.9	290.35	240.8

Source : Palestinian Foreign Trade Statistics, various issues

Table 3.3 - Commodity Distribution Merchandise Imports between 1996-2002

STTC-3	Section	Year						
		1996	1997	1998	1999	2000	2001	2002
0-	Food and live animals	20.9	22.2	18.82	23.6	18.12	20.1	-----
1-	Beverages and tobacco	5.33	3.3	4.1	3.11	4.27	4.77	5
2-	Crude materials inedible except fuels	3.37	3.5	2.83	2.52	2.61	2.06	2.34
3-	Mineral fuels, lubricants and related materials	19.1	15.2	17.26	14.79	19.12	18.6	23.8
4-	Animal and vegetable oils,	1.13	1.1	0.82	0.66	0.75	0.78	1.02
5-	Chemical and related products	7.84	7.81	7.98	6.6	9.7	8.04	9.21
6-	Manufactured goods	22.95	26.7	23.9	20.65	21.91	24.5	19.23
7-	Machinery and transport equipment	12.5	12.66	16.3	18.05	14.8	12.2	11.9
8-	Miscellaneous manufactured articles	6.6	6.95	7.4	9.6	8.3	8.9	5.9
9-	Commodities unclassified	0.24	0.63	0.6	0.31	0.38	0.05	-----
	Total \$ million	2016.3	2164.0	2375	2629.0	2382.8	2033.7	1515.6

Source : Palestinian Foreign Trade Statistics, various issues

account for 60% of the total private consumption expenditures. In fact, budget and trade deficits in Palestine are readily reflected in the savings investment gap, where aggregate demand exceeds aggregate supply. Shortages in domestic production are supplied by imports from abroad. The structure of Palestinian imports ensures the weaknesses of the national economy by increasing its dependency on Israel as presented in (Table 3.4) Since the 1970s Israel's economic policies designed towards Palestine aimed to generate income from abroad. As a result, merchandise exports and demand for labor in local production were substituted by exporting labor to Israel. Consequently, several industries, mainly labor intensive technology such as food products and the shoe industries, were closed. It has been estimated that around 1/4 of merchandise and service productions had been substituted by imports from Israel. In other words, 50% of merchandise imports from Israel can be replaced by local production.

In this regard, applying import substitution strategy requires necessary and sufficient conditions. While necessary conditions mainly concern fiscal policies designed to promote investments in local industries and agriculture, sufficient conditions relate to 1) competitive goods at lower prices and high quality, and 2) adopting new technology and granting access to the regional and international markets. However, in small open economies ISS is applied for a short term as a primary phase, to move toward export promotion policies.

The Palestinian merchandise trade indicates that the competitiveness of local production and exports has deteriorated by means of:

- Decreased productivity in both the agricultural and industrial sectors
- Growth rates in exports which have been declining over time
- Market shares of Palestinian exports in the

Table 3.4- Geographical Distribution of the Palestinian Merchandise Imports

	Exporting Countries of Palestinian Territories	Year						
		1996	1997	1998	1999	2000	2001	2002
0 -	Jordan	1.32	2.4	2.4	2.02	0.93	1.2	1.36
1 -	Israel	86.4	83.3	77.2	61.6	70.4	62.15	75.9
2 -	Turkey	0.44	1.4	2.1	2.4	3.27	3.3	3.79
3 -	China	0.53	0.72	1.43	1.42	3	2.57	2.72
4 -	Japan	0.19	0.27	0.29	0.43	1.26	2	1.4
5 -	Egypt	0.94	1.3	1.1	0.43	0.43	0.66	0.55
6 -	U.S and Canada	1.2	1.01	1.43	1.6	3.15	2.89	2.06
7 -	EU + EFTA	8.5	8.97	9.8	13.5	11.82	20.62	4.83
8 -	East Europe	0.4	0.6	0.5	0.79	1.2	1.5	1.44
	Total \$ million	2016	2238	2375	3007	2383	2031	1515

Source : Palestinian Foreign Trade Statistics, various issues

export market which tend to decline from one year to another, while the proportion of merchandise imports to private consumption expenditures have increased over time from 50% in 1999 to almost 60% in 2002 (MAS, Economic Monitor, various issues, 1992-2004).

2.2.3 Distribution of Palestinian service trade

Reliable and accurate data are only available on the Palestinian service trade with Israel as shown in (Table 3.5). On the other hand, the Palestinian service trade with Jordan is in one direction only. Palestinian service imports from Israel are mainly transportation, telecommunication and businesses services (85%), while transportation, higher education and medical services are the main services imported from Jordan. During 1995-2002, service imports from Jordan of total service imports ranged from 70% in 1995, to 58% in 2002. During the years 2001 and 2002, when heavy restrictions were imposed by Israel on

travel and labor mobility, Palestine service imports from Israel decreased in those years by 30%, 14%, respectively, compared to their level in the year 2000 as shown in (Table 3.6).

Official data on service imports from Jordan are not available, but are estimated based on Palestinians traveling abroad to and via Jordan. In addition, the number of Palestinians seeking higher education at academic institutions and demanding medical services at hospitals and clinics in Jordan is considerable. The service trade deficit went up during the period of 1995 to 1998, increasing from \$464 million in 1995 to a peak of \$559 million in 1998, but then declined. In 2002 it reached \$ 173 million resulting in a decrease of 70% from its 1998 level. However, this decline is attributed to the reductions in service imports which were relatively greater than those in service exports. While service exports decreased by 40% during 1999-2002, service imports fell by 60% as shown in (Table 3.6).

Table 3.5- Structural Distribution of Service Exports and Import, 2000-2002

	Item	Exports (100%)			Imports (100%)		
		2000	2001	2002	2000	2001	2002
0 -	Transportation	6.1	5.8	4.3	39.0	40.03	38.4
1 -	Travel	2.0	1.9	3.6	0.21	0.23	0.26
2 -	Tel communication	0.5	0.77	2.1	29.4	26	27.25
3 -	Construction	21.5	30.8	31.3	2.1	0.8	3.1
4 -	Insurance	3.0	2.5	2.8	0.05	0.01	0.13
5 -	Financial	00	00	000	5.5	5.5	7.5
6 -	Computer and information	1.0	0.89	0.73	6.2	3.1	2.4
7 -	Business services	6.2	5.1	8.8	16.0	20.03	18.56
8 -	Maintenance and repairing good	60.0	52.6	46	1.54	4.3	2.1
	Total \$ million	129.1	84.77	66.32	186.1	130.2	160.0

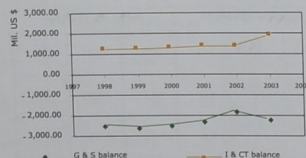
Source : Palestinian Foreign Trade Statistics, various issues

Table 3.6- Geographical Distribution of Service Trade

Year	Exports	Imports			Service Trade Account
		Jordan	Israel	Total	
1995	63	370 (10)	157 (30)	527 (100)	- 464
1996	74	425 ()	168 (28)	593 (100)	- 519
1997	84	378 (60)	254 (40)	632 (100)	- 548
1998	11.1	413 (62)	257 (38)	670 (100)	- 559
1999	130	315 (62)	273 (38)	588 (100)	- 458
2000	129.1	265 (59)	186.1 (41)	451 (100)	321.9
2001	84.77	185 (59)	130 (41)	310 (100)	-225.23
2002	66.32	140 (58)	160 (42)	240 (100)	-173.62

Source : Palestinian Foreign Trade Statistics, various issues

Figure 3.1- The balance on goods and services and income (I) and current transfers (CT)



Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

2.3 Structure of the Current Account

Current account (CA) statistics reveal the heavy dependence of Palestinian trade on the Israeli market; a result well orchestrated by the Israeli occupation. The Israeli security concerns have kept a tight grip on border crossings with the neighboring Arab countries, and now Israel is in the process of building the separation wall. The impact of this policy has been a large increase in transaction costs. The increase in transportation costs reduces the competitiveness of Palestinian products and reduces both exports and to a lesser extent imports. It is found that the closure policy has been most tightly implemented for labor

movements followed by exports and then imports in that order⁽¹⁾. Although the goods and services balances are both in a deficit, the trade in goods deficit was less than double the service deficit since 2000 on; prior to that it reached as high as 57 folds. This implies that the impact of the Al-Aqsa Intifada has been much worse on the service balance than it has been on the goods balance. Between 2000 and 2003 the service balance worsened by five fold while the goods balance improved by 35%. The service balance was primarily influenced by a sharp decrease in travel and transportation services which were a result of the deterioration of the peace process.

The current trade deficit was partly offset by the improvement in current transfers. While it averaged US \$ 2.2 billion over the period 1996 – 2002, it reached US \$ 1.45 billion in 2002. The balance on goods has also contributed to the improvement in the trade account due to the reduction in gross national disposable income (GNDI). During 2001 and 2002, GNDI dropped by 30% compared to its level in the year 2000 (World Bank 2003; 2004a). In fact, the decline in workers remittances contributed to a larger decline in imports of goods compared to exports leading to an improvement in the merchandise in trade as shown in (Table 3.7) balance.

Figure 3.2 below shows the magnitude of the change in workers remittances from Israel. The Palestinian economy has suffered from the twin deficit phenomenon due to the peculiar interaction of trade and budget deficit in Palestine. The bulk of budget revenues are collected on imports destined to Palestine by Israel, which is then remitted to the Palestinians⁽²⁾. This encouraged the dependence on imports as a source of revenues. Although government procurement by law should give priority to domestic production, it was not implemented thus leading to more imports. This appears to worsen the trade deficit, which in turn lowers the budget deficit contrary to what the theory predicts⁽³⁾. However, the above statistics reveal limited domestic productive capacity, dependence, and a high foreign trade to GDP ratio by international standards.

Table 3.7 Palestinian Trade Balance, in current US \$ million**

Year	Merchandise			Service			Trade Balance
	Exports	Imports	Balance	Exports	Imports	Balance	
1996	339.5	2016.0	-1676.5	74.0	593.0	-519.0	-2195.5
1997	382.4	2238.0	-1855.6	84.0	632.0	-548.0	-2403.6
1998	394.8	2375.0	-1980.2	111.0	670.0	-559.0	-2539.2
1999	372.2	3007.0	-2634.8	130.0	588.0	-458.0	-3092.8
2000	400.9	2383.0	-1982.1	129.1	451.0	-321.9	-2304.0
2001	290.4	2031.0	-1740.6	84.9	310.0	-225.1	-1965.7
2002	240.1	1515.0	-1274.9	66.3	240.0	-173.7	-1448.6

** Source Palestine Central Bureau of Statistics, Foreign Trade Statistics

2.4 Foreign Direct Investment

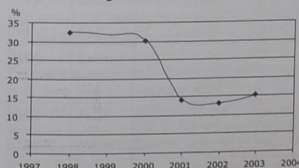
Global Foreign Direct Investment (FDI) has experienced negative growth over the last three years⁽⁴⁾. The current state of international politics may have contributed to this decline. Developing countries (particularly in Asia and North Africa) did better on average than the developed countries. For the United States alone, FDI inflow regressed by over 50% (World Investment Report 2004). In turn, FDI composition has been changing in favor of services in all regions. Palestine is poised to receive a larger FDI due to its central location, civil society, international empathy, and large network of wealthy and experienced Palestinian and a lack of political settlement have prevented expatriates (Stiglitz, 1999). Political unrest be central to the reversed FDI. The absence of a Palestinian currency has contributed to the inability to influence interest rates. As a result, FDI inflows have averaged 9.7% of

gross fixed capital formation for the period 1985–95, while outflows average for the same period was 10.3% as presented in (Table 3.8). The effect of the Al-Aqsa Intifada on FDI has been more drastic for Palestine than for Israel; inflows declined by 30% between 2000 and 2001 for Israel and 68% for Palestine. With the exclusion of 1999, net FDI inflow was positive for all countries in the region except for Palestine.

The Palestinian National Authority (PNA) alone can do little to change the status quo; Israel's lack of a serious commitment towards moving the peace process forward has resulted in considerable drawbacks. The literature (Jaumotte, 2004) on FDI points to several factors affecting its flows: the market size of Regional Trade Agreements is positively correlated to FDI owing to the degree of protection it offers and economies of scale. Palestine is bound by a customs union with Israel and a few FTA's with Jordan, Egypt and the EU for a selected number of goods. The proximity of Palestinian wages to wages in Israel, coupled with a small population also poses another threat to FDI in Palestine. There are two other factors that may play in favor of the Palestinian economy: the stability of financial institutions and an educated labor force.

The PNA launched its first reform initiative in 2000. Daoud (2003) reviewed the Palestinian reform experience; although there have been major advances in the control and processing

Figure 3.2. The ratio of workers remittances from Israel to goods and services balance



Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

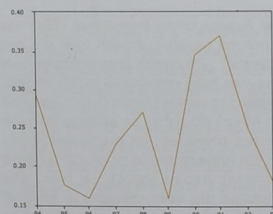
of the MOF operations, serious drawbacks still exist. Among those is the activation of an independent judicial system to protect property and individual rights. As a long-term strategy, the PNA has maintained that the public sector is complementary to rather than a substitute for the private sector. Daoud (2002) provides a review of the laws that have passed since 1996 and analyzes their private sector development needs. In practice, public sector employment was growing out of control before it was brought under check by MOF reforms (El-Jafari, et al., 2003). Another privatization indicator is the public to total investment ratio; it averages 24% over the period 1994 – 2003.

This ratio is lower up to 1999; the following decline is a reflection of the decline in both public and private investment. Private sector investment was fueled to a large extent by Palestine Telecommunication Company (PALTEL) and Palestine Development and Investment Company (PADICO) whose total assets reached U.S. \$ 243⁽⁵⁾ million at the end of 2004. Electricity and communications are provided privately; water is a regulated public monopoly. Although a relatively large share of Palestinian consumption of water and electricity is still imported from Israel (10% of total imports), Israel's policy in this regard continues to have control over the provision of key

services, while the Palestinians act as distribution agents.

Finally, the PNA has created some investments; Naqib (1997) points out that despite its declaration of commitment to privatization, the PNA has drifted toward establishing public owned monopolies. Makhool (2002) lists all PNA investments; the figures show that the PNA has investments in 35 establishments (with a capital of US \$ 291.7 mil.), the PNA's share of those investments was an average of 41%, although in two instances (cement and real estate) the PNA had 100% of the invested capital.

Figure 3.3- Public to total investment ratio



Source: UNCTAD data base (Integrated Framework Model)

Table 3.8-FDI flows for selected countries (Mil. US \$)

Country	85 - 95*		1999		2000		2001	
	Inflow	Outflow	Inflow	Outflow	Inflow	Outflow	Inflow	Outflow
Palestine	11	12	189	169	62	213	20	380
Jordan	14	-9	158	5	787	5	100	9
Turkey	529	24	783	645	982	870	3266	497
Egypt	924	24	1065	38	1235	51	510	12
Lebanon	10	6	250	5	298	125	249	92
Syria	83		263		270		110	
Israel	356	311	3111	967	5011	3465	3549	630
Developing economies	50773	21620	231880	75488	252459	98929	219721	59861
World	181704	203620	1086750	1092279	1387953	1186838	817574	721501

* (Annual average) Source : UNCTAD, WIR 2004

3. Trade Policy

Since 1967, Israel utilized trade with Palestine as a measure to restructure the Palestinian economy towards one dependent on Israel in order to serve its own economic interests. Israel's economic and security strategy focused on containment of the Palestinian economy. The adoption and adaptation of that strategy concentrated on what was produced and traded and in which markets trade was conducted. In fact, Israel practiced its strategy to distort the performance of the Palestinian economy through: 1.) imposing significant constraints on production, and 2.) imposing tariff and non-tariff trade barriers. Thus, under the PIEP, Israeli tariffs will serve as common external tariffs for both; it did, however, allow Palestinians to form FTA's with Jordan and Egypt (however insignificant⁽⁶⁾). Panagariya and Diwan (1997) argued that on purely economic grounds, the Palestinians are better off with a customs union as it allows free access of Palestinian products to the Israeli market and can benefit in the long run from Israeli advances in technology. This recommendation was conditioned by the freedom of movement of goods and services.

It turned out that in the last three years, average number of closure days/year was 200 days. In light of this information, a continuation of the customs union is not the best policy option for the Palestinian National Authority. This conclusion was echoed by Astrup and Dessus (2001) and more recently by Daoud, El-Khafif, and Makhoul (2005) where nondiscriminatory trade regime policy scenarios were superior. Unlike initial expectations, economic and trade indicators over the past ten years (1994-2004) show that very limited changes have taken place in the Palestinian economy. It has continued with the same characteristics as those continued between the year 1968-1994. During 1995-2000 the Palestinian economy's dependence on Israel has been strengthened and intensified, particularly through foreign trade and labor mobility. Palestine also remains dependent on value added tax (VAT) collected by Israel to finance the public budget. The sectors that link the Palestinian economy with Israel are outlined below:

- **Foreign trade:** Palestinian merchandise exports to Israel remain greater than 90% of total Palestine exports during the past four decades. On the other hand, Palestine direct imports from Israel account for more than 75% of total Palestinian imports. Furthermore, indirect imports through Israel originate from countries which have signed bilateral economic and trade agreements with Israel. The imports amount to 20% of total Palestinian imports. Therefore, it is not surprising to discover that Palestinians continue to import from countries that have economic relations with Israel. On the other hand, Palestine imports approximately less than 5% of total Palestinian imports from countries that have signed bilateral economic agreements with the PNA. Palestinian businessmen prefer to import from countries considered major exporters to Israel. They do so to avoid impediments and restrictions imposed on imports that do not meet Israel's measures of standards and quality (PCBS, Palestinian Foreign Trade Statistics, various issues, 1006-2004).

- **Labor mobility:** Absorbing an oversupply of Palestinian labor in the Israeli economic sectors over the past four decades is one indicator which pointed out the low capacity of the Palestinian economy.

Palestinian exports appear to be significantly affected by the relative real exchange rates of the Israeli currency. Merchandise exports to Israel were found to be less responsive to relative real exchange rate. These results, which were derived from a detailed quantitative method, suggest that an increase in the relative real exchange rates of one percent is likely to increase Palestinian exports to Israel by 0.33 percent. The Jordanian currency has depreciated several times since 1988, thus resulting in Palestinian growers and exporters preferring to supply their productions in the local and Israeli markets (El-Jafari, 2000; El-Jafari and Al-Ardah, 2002c).

On the other hand, the Israeli agricultural and industrial sectors entered an era of low growth recession rates, particularly since the mid 1990s. The increase in the level of output was due to a shift to a more market-oriented

production and adverse government policy. There was a reduction in credit, an increase in interest rates and a reduction in government policy programs which have seen a market reduction in the level of support offered to the agricultural and industrial sectors. In addition to subsidies, government supports are provided in the following ways:

- *Support farm and manufactured products directed to the domestic markets:* The Israeli government generally intervenes in regulating markets to achieve the following objectives: (1) reducing fluctuation in prices and seasonal supplies; (2) ensuring that prices are sufficiently stable to be profitable to both individual producers and the national economy.
- *Participation in an insurance fund for national disasters:* In this regard, involvement is in line with government policy to support the expansion of an insurance scheme to cover the principle branches and to reduce risks faced by the individual producer.
- *Encouragement and support of agricultural and manufactured exports:* The direct support of agricultural and industrial exports is manifested through participation in a fund established to promote exports, to carry out market research and surveys, and to encourage the development of new products. The fund is also intended to guarantee minimum prices for exports and to reduce the uncertainty associated with the exporting process.

However, these forms of support programs are not provided to producers in Palestine. Government policy toward agricultural and industrial sectors is designed to protect Israeli production. Recently, the level of subsidies has been markedly reduced. Despite this, the existence of indirect subsidies and government support schemes still create a situation of competition for Palestinian producers (El-Jafari, 2000). The possibility of establishing a similar system of subsidies in Palestine is practical, although it would be expensive to implement. In conclusion, while the Israeli producer enjoys both direct and indirect subsidies, Palestine receives little protection and, as such, faces unfair competition from Israel.

4. Non -Tariff Trade Barriers (NTBs)

Uncommon NTBs imposed by Israel to restrict the flow of Palestinian trade have increased and accumulated over time. Several NTBs were imposed such as political, marketing and trade constraints. The following discussion focuses on the main obstacles that impede the flow of trade between Palestine and their trading partners.

4.1 Transportation

Transportation of agricultural and manufactured products suffers from the conditions of the road networks that slow the movement of goods inside Palestine. In addition, transportation of these products is still subject to imposed measures such as the use of the so-called green trucks, the lack of refrigerated trucks and the inadequate facilities, which heavily affect the quality of perishable agricultural products. In cases when Israeli licensed trucks transport products, security procedures are faster at the checkpoints and consequently, the exporter bears more costs of licensing and insurance greater than their counterparts in Israel.

Transportation of animal products is not an exception, with only a few refrigerated trucks available in the WB to transport meat from slaughterhouses to butchers. Such transportation facilities are important since many slaughterhouses do not provide their own refrigerated truck services.

Palestinian traders access foreign markets via Israeli ports of entry and exit. As a result, Palestinian products receive discriminatory treatment, despite the Paris Protocol that affirms the principle of equal treatment for both Palestinian and Israeli goods. Checks and lengthy delays are very costly, particularly for perishable goods.

Livestock products that are to be exported are shipped in certain suitable vehicles that are secured with the seal of the official veterinary services. But the aforementioned restrictions imply that Palestinians must develop suitable means of transportation to reach the Israeli export markets. However, obstacles imposed

by Israeli security authorities over the past three decades have prevented Palestinians from developing appropriate transport vehicles to move agricultural and manufactured products. Furthermore, since March 1995 Palestinian exporters are not permitted to use local transportation vehicles to market products in Israel. Instead, they are required to rent Israeli transportation means at the security checkpoints in order to reach the Israeli markets. These measures have increased transportation costs to Palestinian agricultural markets, and have caused huge losses to the transportation sector in Palestine (World Bank, 2004b).

Transportation costs tend to increase over time due to the following measures and practices imposed mainly by Israel.

- *Back - to - back:* This procedure implies that unloading and loading of goods is time consuming on one hand and it leads to cause damages to merchandise trade flows. Therefore, back - to - back is an inefficient and expensive process. The Israelis justify it in terms of their security requirements.
- *Convoys trucks:* The convoy procedure is one of the impediments that allow 10-15 trucks to transport goods. Convoys are scheduled randomly, according to security considerations, which can leave trucks waiting for days. This, therefore, adds additional costs.
- *Standards:* Israeli standards are a type of non-tariff barrier. Any imports to Palestine through Israeli ports or airports are inspected to see whether they meet Israeli standards. However, delays on imports waiting for inspection can add additional costs.
- *Monopolistic practices:* Many basic commodities have been imported by few monopolists who determine market prices. In fact, monopolistic practices have led to market distortions, collusion and corruption. Imports of sugar, wheat flour, vegetable oil, frozen meats, live animals, wood, steel and cement are major goods imported by only a few monopolists. In addition, monopolists who

import have been engaged in smuggling and dumping leaving little room for competition to prevail in the Palestinian markets. It is evident that monopoly, smuggling and dumping usually distort the cost structure of production and transportation and consequently discourages investment.

4.2 Inadequate services of wholesale markets, cold storage and packaging

There are 12 wholesale markets in the West Bank and 2 major ones operating in the Gaza Strip. These municipal markets deal with fresh products (fruits and vegetables). Vegetables and fruits marketed in wholesale markets are sold through auctions held in the early morning or evening. Wholesalers play a substantial role in the local market. They carry out a series of tasks such as conducting sales through auctions, supplying inputs, production needs and packing materials to farmers, and offer transportation facilities (Aburajab-Tamimi, 1999). Support infrastructures (such as cold storage) are lacking in the Palestinian wholesale markets although these markets play an important role in the distribution chain of fresh fruits and vegetables. In fact, 75 percent of all sales of Palestinian fruits and vegetables are exchanged through wholesale markets. Particularly, at municipal markets the products can be either sold directly to wholesalers (40 percent) or to commission agents that are intermediaries to wholesalers (35 percent). Moreover, fresh vegetables and fruits are sold directly to retailers in a percentage that is estimated to be 5 percent while 20 percent of the production is directly exported (Aburajab-Tamimi, 1999).

The inadequate services of cold storage and storing capacities in wholesale markets have a limited role in adjusting production, extending the marketing period and reducing exports as well as local price fluctuations (El-Jafari, 1994). Fresh-cut flowers and strawberries produced in the GS are harvested, graded and packed in containers or carton boxes at the farm. Requirements on post-harvesting and packing are provided by the Israeli export company at the beginning of the export season. Quality controls are mostly conducted by the Israeli

export company, which trades the products to foreign markets. In the Israeli packinghouses, strawberries are checked for chemical residues, diseases, color, size and shape. If strawberries are rejected for color, size or shape only, they are sold in the local market or destroyed (Willems, 1997).

4.3 Additional constraints imposed on Palestinian trade during the transitional period

Israeli trade regulations governing Palestinian trade since 1995 are based on the Palestinian-Israeli Economic Protocol (PIEP). The PIEP includes direct marketing constraints, restrictions on input imports, regulations related to the dairy sub-sector and restrictions on water and land utilization. These additional constraints include:

- Inadequate direct export facilities;
- Uncompetitive and weak agro-processing industry;
- Unstable prices in the domestic markets;
- Long marketing channels (marketing margins are high);
- Frequent surpluses;
- Inadequate services of pre-cooling, grading, export packaging, cold storage and trucks.

Agriculture Article No. VIII in the Palestinian Israeli Economic Protocol primarily concentrates on veterinary services and plant protection. One important implication of this article is the necessity upgrading veterinary services in Palestine in order to reach their counterpart levels in Israel, and to facilitate flows of Palestinian agricultural products to Israel. However, veterinary services and plant protection in Palestine are still below the standard levels. As the importing and exporting of livestock products will be subject to Israeli regulations, it has been proposed that improving the performance of the veterinary services would be helped by increasing the public expenditures in this field. Until now, only Israel, particularly on imports from the GS, has

practiced veterinary restrictions and plant protection. On the other hand, checking imports from Israel on the Palestinian side has not routinely taken place. These violations of the agreements from the Israeli side have hurt Palestinian producers, as well as consumers (El-Jafari, 1997a).

Health and plant restrictions and veterinary service regulations will continue to impose the flow of Palestinian exports to the Israeli markets. Joint sub-committees from the Palestinian and Israeli sides has been established to update information and review issues, policies and procedures related to health, veterinary and plant restrictions. These regulations indicate that the Israeli authorities will continue having the right, indirectly, to allow Palestinian agricultural produce to enter its markets.

4.4 Restrictions on imported inputs

Animal feedstuffs, fertilizers, iron and cement are the main controlled inputs imported from Israel. In fact, local production of these inputs covers less than 20 percent of the total domestic demand. Under the PIEP, importing fertilizers and animal feedstuffs from abroad have been highly restricted by the Israeli authorities. For example, imports of fertilizers from Jordan and Egypt were allowed to up to six thousand tons annually. The Palestinian-Israeli joint committee, through negotiations, determines the imports in the case of animal feedstuffs. According to PIEP, due to security measures which in turn increase transportation costs, Palestine imports of cement from Jordan were below the quota allowed. Therefore, importing from or through Israel has become more preferable than to trade directly with Arab countries via Jordan or/and Egypt. Thus, the joint committee has been rigorously criticized. It is viewed as a creation of Israel in order to intervene directly in formulating Palestinian economic and trade policies as well as allowing Israeli agricultural and trading interests to monopolize the Palestine markets.

Prices of inputs and raw materials in Jordan and Egypt are much lower than those in Israel and in the local markets. In fact, importing those commodities from Jordan and Egypt

would not only develop direct trade with them, but would divert trade from Israel. Accordingly, this would greatly improve the competitiveness of the Palestinian production in the regional export markets. It is anticipated that utilizing imported inputs would expand productivity as well as total production. Consequently, merchandise exports would have more access to Israel as well as other external markets.

4.5 Regulations related to the dairy sub-sector

Under the PIEP, Palestinians and Israelis have agreed to establish a sub-committee of experts in the dairy sub-sector to exchange information and to discuss and coordinate their production to protect the interests of both sides. In principle, each side will produce according to its domestic consumption. The implication is that the policy will be adjusted, if only indirectly, to effectively protect Israeli interests. Because of this, Palestine will not be allowed to become net exporters or even small net importers of dairy products. Rather, indirect restrictions on importing animal feedstuffs and limited grazing areas ensure that the dairy industry in Palestine will remain limited and dairy products will continue to be an importable sector (El-Jafari, 2004).

4.6 Restriction on water and land utilization

Of all the problems that affect the Palestinian agricultural and industrial sectors, water is the most complex issue. Water pumping and utilization in Palestine has long been subject to Israeli restrictions and regulations. The overall picture for Palestine is dominated by competition between Israelis and Palestinians for water supplies. The Israeli water policy is considered aggressive and has influenced Palestinian agricultural production. Despite the close relationship between water issues and agricultural production as well as the industrial sector, the agricultural agreement was reached separately and independently of the land and water questions. The water supply in Palestine continues to be exogenously determined by the Israeli authorities and the land question has been deferred to final status negotiations.

Moreover, meeting the demand for water utilized in irrigation is still not an area under discussion in Palestinian agricultural policy (El-Jafari 1997a).

4.7 Constraints affecting trade with the rest of the world

The Israeli import policy applies to Palestinian imports, with the sole exception of goods listed in lists A1, A2 and B of the PIEP. Imports of inputs originating from countries such as Jordan and Egypt have been restricted to quotas in lists A1 and A2. This has provoked a major dependency on Israeli supplies, which are more expensive than Egyptian and Jordanian products. Obstacles to imports of raw materials from countries other than Israel have influenced the Palestinian economy. The limited resources to develop merchandise production in Palestine have favored Israeli exports over Palestine, thus strengthening the competitive position of Israeli producers.

However, Palestinian exports (particularly agricultural products) are subject to Israeli practices such as security measures, checks and inspections that slow and sometimes impede the free movement of agricultural goods outside Palestine. A major consequence of these discriminatory practices is that Palestinian exports reach their final destination countries late or damaged, thus affecting both the reliability and reputation of the Palestinian producers in the foreign markets (UNCTAD, 1998; World Bank, 2004b). Examples of such practices are outlined below:

- At Ben Gurion International Airport, Palestinian goods are stored at least 24 hours awaiting the first and the second security checks. However, Palestinian fresh-cut flowers and strawberries indirectly exported through an Israeli export company do not require passing the second security check at Ben Gurion Airport.
- Palestinian goods must be loaded on the ship 48 to 72 hours before departure time, while Israeli products can be loaded up to 12 hours before departure.

- Palestinian products are not allowed on passenger flights.

- Security checks are sometimes carried out with inappropriate instruments that damage the products.

4.8 Financial services

The performance and functions of banks, insurance companies and the securities exchange in Palestine suffer from a number of barriers which hinder them from building up the national economy. The following obstacles have a negative impact on the performance of banks by increasing their risks:

- Lack of political and economic stability due to Israeli occupation policies and practices;

- The absence of a national currency impels the banks to invest abroad, thus allowing the surplus of foreign currencies to circulate in Palestine. Consequently, the interest rate and exchange rate levels in Palestine are determined based on the economic forces of the neighboring markets, principally Israel and Jordan.

Despite the sharp increases in the banking institutions in Palestine since 1995, financing the activities of most export-import companies originate from informal sources such as self-financing and relatives. Long-term credit remains constrained. However, several flexible measures and steps have been suggested to stimulate access to formal credit markets. Yet, the largest challenge is to create a competitive financial system (banking and insurance). While banks in Palestine offer financial services similar to those provided by banks located in the regional countries, credit facilities remain very low. Proportion of credits to deposits ranged from between 21.6% to 23.6% during 1996-2003. On the other hand, overdraft credit facilities in U.S currencies account for 70% of the total credit, when utilized to finance import transactions from abroad.

Although Palestine is not a member of the WTO, barriers to trade in financial services have never existed. According to PIEP,

domestic, Arab (Jordanian and Egyptian) and foreign suppliers of financial services have been treated indifferently. Therefore, most Jordanian and Egyptian banks operating in Palestine before 1967 promptly returned in 1995. In contrast, the Israeli banks which have operated in the Palestine since 1968 closed their activities by 1994 (El-Jafari, et al., 2003).

4.9 Imports infrastructures

Israel has been considered the main producer and supplier of electricity, telecommunication and water to Palestine since 1967. Several restrictions were imposed from year to year to monopolize the Palestinian markets. Over the past four decades, Israel built its production capacity of public utilities to jointly meet the local demand in both Israel and the Palestine.

In particular, the Israeli strategy has been to maintain control over the land, water and public utilities (electricity, telecommunication) in Palestine. Consequently, manufactured and agricultural production in Palestine has become subject to Israeli constraints. In addition, prices and volume of imports of public utilities have been determined based on the demand and supply forces and government regulations in Israel. It was, therefore, not surprising to find the prices of public utilities in Palestine relatively greater than their counterpart in Israel. The cost of public utilities used in the industrial and agricultural sectors has deteriorated the competitiveness of the Palestinian production in the local market as well as in the export markets. It is noticeably evident that without granting input subsidies to Palestinian producers, Israel will continue controlling and directing the Palestine economies through the monopolization of the supply of public utilities. In comparison, Israel's RCA figures for the year 2000 is less than one for all major groups except manufacturing, where the value is 1.25.

In general, land, electricity, water and telecommunication prices in Palestine are significantly higher than those in neighboring countries. The cost of serviced land in Palestine is up to three times the cost in Egypt, 5 times the cost in Jordan and 10 times more than the

cost in Israel, the availability of land in Palestine is very scarce and therefore very expensive. Similarly, the price of electricity and water in the Gaza Strip is almost three times as that found in Israel (World Bank, 2002). It is obvious that service trade liberalization will enable the Palestinians to substitute imports of electricity, water, and telecommunication by local production. In the short-run, the PNA will have joint ventures with Jordan and Egypt to produce infrastructure average costs lower than prices paid for imports of these same services from Israel. In turn, barriers imposed by Israel on what is produced and traded in Palestine should be lifted.

In the disengagement plan outlining the Israeli withdrawal from the Gaza Strip in 2005, Israel shows its interest in continuing to supply the Gaza Strip with electricity, water, gas, and fuel under the existing arrangements. In fact, the PNA has already concluded several agreements and arrangements with Israel concerning water, electricity and electromagnetic areas (telecommunication) (El-Jafari, 2004).

4.10 Telecommunication services

In 1997, the Palestinian Telecommunication Company (PALTEL) replaced the Israel Telephone Company (Bezeq) in supplying services in Palestine. Since then a complicated but unique system was created between the two companies. In fact, PALTEL has been authorized to run the telecommunication network in Palestine through the Israeli networks. Accordingly, the cost associated with services provided by PALTEL is perceived to be too high when compared to similar services in Israel and Jordan. In fact, Israel imposes tariffs on Palestinian exports and imports of tele services even though the PALTEL network is totally linked with Israel. Internal and external telecommunications in Palestine remain dependent on Israel, where PALTEL rents areas for sending and receiving calls and other tele - services.

This implies that the gap between the value of exports and imports will increase. While imposing tariffs on tele - exports will decrease the net of exports revenues, tariffs imposed

on tele-imports will increase net imports. As a result, service trade deficits have increased over time. Israel has justified the link of its tele-network with that of Palestine due to security reasons. However, economic reasons cannot be ignored. Israel monopolizes over 50% of the market shares of cellular services in Palestine. Although illegal, Israeli cellular companies have access in Palestine, and thus do not pay taxes to the PNA for the use of Palestinian air space. In the past years 2001-2004, Israel has prevented PALTEL from enhancing its capacity by imposing restrictions on importing needed equipment (El-Jafari and Aradeh, 2001).

5. International Competitiveness

In this section, indicators of the competitiveness of the Palestinian economy are discussed. They are largely linked to Israeli fiscal and monetary policies, and price and wage levels.

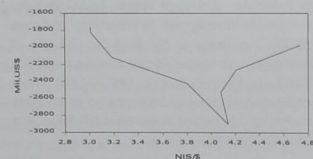
5.1 Terms of trade evolution and exchange rate regime:

The Palestinian economy has three main currencies in circulation: the US dollar (US\$), the Jordanian Dinar (JD) and the New Israeli Shekel (NIS). The US dollar's share of deposits fluctuates around 65% while the JD's is between 15% - 20% and the NIS is at 13% - 15%. The JD is fixed to the US \$ at 0.71JD/\$; on the other hand Israel's choice of exchange rate regime has evolved over time from a fixed rate to a horizontal band, to an upward widening band and finally a free float⁽⁷⁾. This development has accompanied Israel's trade liberalization from the mid-1990s on. Although the NIS continued to depreciate throughout the 1994-2002 period, the current account continued to deteriorate up to 1999 after which the Intifada effect has reversed its direction mainly due to a larger reduction in imports.

The Palestinian terms of trade measured by the export price index/import price index⁽⁸⁾ remained at parity for most of this period. The exception was in 2001 when import prices increased and export prices decreased causing a positive TOT shock. The reduction in the trade deficit began in 1999 prior to the change

in TOT. This may have accelerated the reduction in imports in 2002. Over the period depicted in (Figure 5), the simple correlation coefficient is -0.056 which is low, indicating a weak linear association between the two variables.

Figure 3.4- Trade balance and the exchange rate during 1994-2002

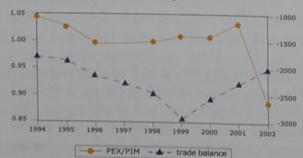


Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

5.2 Sectoral relative labor costs and the determinants of comparative advantage

Investigation of labor cost per dollar of value added shows that there has been a large increase in labor productivity, notably the manufacture of tobacco products. The value added/\$ in tobacco manufacture has increased from 7.4 in 1994 to \$43.8 and \$ 19 in 1999 and 2001 respectively. The reverse can be said about manufacture of medical equipment where the average was roughly \$12 in 95 - 97, and went down to \$ 1.9 in 2001. Table 9 shows labor cost per dollar for double digit ISIC in Palestinian industries. It has been noticed (Makhool and Atyani, 2004) that the weaker competitiveness of Palestinian industries is related to lower productivity of Palestinian labor rather than lower wages. Aggregation to a single digit ISIC shows the development of labor productivity over the 1994 -2001 period.

Figure 3.5- Terms of trade (left scale) and the trade balance (right scale)



Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

The highest productivity is in retail, wholesale, restaurants and the sale and repair of motor vehicles (ISIC 50-52), starting at nearly \$10 and dropping by roughly 50%. On the other hand, labor's performance is at its worst in education and health and social work; a \$1 in labor cost results in \$1.5 in value added on average (ISIC 80, 85) which accounts for the fact that the bulk of value added in those services is mostly labor costs. A noticeable expansion can be seen in transport, communication and travel services (ISIC 60, 63, 64); labor productivity grew by 40% between 1994 and 2001 (see Table 3.9).

A large part of this improvement came about because of the large increase in value added in post and telecommunications which grew by 600% between the two periods. Palestine Telecommunication Company along with Jawwal (the mobile service) has expanded their capacity and were able to increase their value added significantly. Electric supply, and collection and distribution of water have experienced the highest variance in labor productivity (ISIC 40, 41). Given that wages are higher in Palestine compared to Arab neighbors (namely Jordan and Egypt), relative productivity per \$1 labor cost is greater than 1 for most activities except tobacco manufacturing where the ratio is less than 1 for most countries⁽⁹⁾. This indicates that special attention ought to be given to this category in which Palestine has a competitive advantage.

5.3 Revealed Comparative Advantage

The Revealed Comparative Advantage (RCA) figure is calculated to show which products the country has as either a comparative advantage or disadvantage. It is calculated by taking the ratio of good i exports to total exports in a country relative to the world's ratio. If the ratio exceeds one, then the country has a revealed comparative advantage for the good in question. (Figure 3.7) below shows that Palestine is at a comparative disadvantage in the fuel category only, where exports were US \$ 8.3 million in 1997 and declined to US \$ 2.5 million in 2002. Obviously, Palestinian food items take a larger share of exports compared to the rest of the world. Palestine resembles trends in other

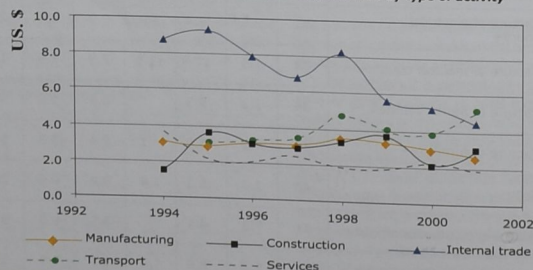
Table 3.9- Value added per \$1 spent on wages for two digit ISIC activities in Palestine*

Economic Activity	ISIC	1994	1996	1997	1999	2000	2001
Other mining and quarrying	14	3.8	2.3	3.3	3.5	2.3	2.4
Manufacture of food and beverage	15	2.9	3.1	4.4	4.1	5.5	3.8
Manufacture of tobacco products	16	7.4	9.3	7.5	43.9		19.1
Manufacture of textiles	17	3.1	4.8	4.0	4.4	2.4	0.4
Manufacture of wearing apparel	18	2.2	2.1	2.1	1.6	1.6	1.7
Tanning of leather, and bags	19	2.6	3.7	2.3	2.0	3.5	2.1
Wood and its products	20	5.0	2.9	5.2	3.6	6.0	3.1
Papers and its products	21	3.9	3.7	3.7	4.2	2.0	3.2
Publishing, printing and reproduction+	22	2.9	3.5	1.6	2.4	2.0	2.9
Chemicals and its production	24	2.0	3.1	3.3	3.1	2.6	1.6
Manufacture of rubber and plastic	25	2.4	4.6	4.0	9.0	3.9	3.6
Manufacture of non-metallic products	26	2.9	3.6	2.9	3.2	2.3	2.3
Manufacture of basic metals	27	3.2	2.3	3.2	4.1	2.9	2.8
Manufacture of metal products	28	5.0	3.0	5.5	3.6	3.3	3.7
Manufacture of machinery and equipment+	29	4.0	6.1	3.6	4.1	2.5	2.3
Manufacture of electrical machinery+	31	2.5	2.4	1.9	2.9	4.4	2.4
Manufacture of medical equipment	33	1.5	12.8	11.9	2.3	2.6	1.9
Manufacture of motor vehicles,	34	3.3	5.3		3.8	1.8	5.4
Manufacture of furniture+	36	4.1	3.8	4.1	2.4	3.3	1.9
Electricity	40	2.3	5.3	3.4	8.4	9.6	2.9
Collection and distribution of water	41	7.3	4.1		3.5	6.5	5.3
Sale and repair of motor vehicles	50	9.7	8.9	4.8	5.1	5.9	5.0

Whole sale and commission trade	51	7.8	5.7	6.2	5.3	5.5	3.8
Retail trade, repair of personal goods	52	9.4	9.7	8.7	6.2	4.9	4.7
Hotels and restaurants	55	4.0	3.9	3.4	2.5	3.3	3.9
Land transport	60		3.0	2.0	2.2	2.3	2.0
Support and auxiliary transport	63		4.0	3.9	4.0	4.1	2.8
Post and telecommunications	64		3.5	4.4	4.9	4.2	5.8
Real estate activities	70	25.0	3.3	1.5	4.7	6.2	4.1
Renting machinery without operator	71	7.8	3.3	2.7	4.5	3.0	4.8
Computer and related activities+	72	1.4	3.7	1.5	2.0	1.7	2.2
Other business activities	74	4.3	3.7	3.4	2.0	2.6	1.6
Education	80	1.4	1.2	2.0	1.3	1.5	1.4
Health and social work	85	3.3	1.8	1.8	1.8	1.6	1.9
membership organizations	91	2.3	1.5	1.0	0.8	0.8	1.2
Recreational, culture and sporting	92	2.4	1.8	2.1	1.5	1.6	1.9
Other service activities	93	11.8	3.7	3.7	3.2	3.8	6.4

Source: PCBS (2004) Economic Survey Series- 2003; unpublished data

Figure 3.6- The ratio of value added to employee compensation by type of activity



Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

developing countries in that its comparative advantage is in food items and agricultural raw materials.

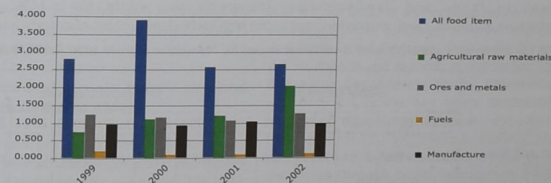
5.4 Export diversification

Export diversification is desirable to reduce the risk in terms of trade shocks. If a country is heavily dependent on a few export groups, negative changes in the relative price of those goods can adversely affect export revenues. The benefits of export diversification include job creation, learning through trade, and benefits from additional new products. The Export Diversification Index (EDI) and Concentration Index (CI) for Palestine were calculated based on 3-digit SITC using PCBS unpublished data as shown in (Table 3.10).

The diversification index for Palestine is higher than other competitor countries, with the exception of Egypt, implying less diversified exports in the year 2000. For the remaining

years, Palestinian exports seem to be the least diversified. The CI on the other hand reveals that Egypt and Israel's exports are more concentrated than that of the Palestine. For the years 2000 – 2002 Palestinians exported 189, 183, and 181 commodities, respectively, reflecting less diversification. The intra-industry trade index (Grubel-Lloyd index) measures the proportion of trade within industries. Using 3-digit SITC trade data, it was found that the value for the index is 73%, 76%, and 75% for 2000-2002. The figures are higher than expected given that most of Palestinian trade is with Israel, a country that is very different in its relative endowments. Closer inspection of imports reveals that roughly 11% of Palestinian imports are petroleum oils and oils obtained from bituminous minerals (other than crude), and 5%-6% are electric current. In comparison, the bulk of exports are found in flat-rolled products of alloy steel (21%), optical instruments and apparatus, n.e.s. (6%), and printed matter (5%).

Figure3.7- Revealed comparative advantage by major commodity groups



Source: PCBS (2005) unpublished data and UNCTAD Handbook of statistics 2004

Table 3.10- Export DI and CI for selected countries*

Country	2000			2001			2002		
	N	DI	CI	N	DI	CI	N	DI	CI
Israel	195	0.569	0.300				199	0.583	0.327
Egypt		0.820	0.450		0.680	0.290	175	0.704	0.251
Jordan	141	0.652	0.156		0.670	0.190	176	0.645	0.159
Turkey	122	0.581	0.093		0.550	0.090	222	0.562	0.094
Palestine ^o	153	0.743	0.187	119	0.744	0.200	113	0.745	0.205

* Source: UNCTAD Handbook of Statistics (2002 & 2004).
^o Authors calculations based on 3- digit SITC (unpublished PCBS data)
 N is the number of export commodities valued over \$100,000

5.5 International demand evolutions

It is expected that world trade will increase alongside the gradual elimination of trade barriers under the WTO. Under normal circumstances, this may provide opportunities for a small developing economy. The Palestinian economy, however, is still limited by its customs union with Israel⁽¹²⁾ and a complete borders control by Israel. This reduces the potential of trade opportunities by artificially raising transactions cost. On the other hand, the Palestinian government as well as the private sector lacks the institutions, experience, and infrastructure necessary to facilitate trade. Using 1996 as the base period, the Global Demand (GD)⁽¹¹⁾ indicator as presented in (Table 3.11). It shows that GD has hindered export growth for food and beverages; whereas for the products in group 5 and 7 (animal etc. and manufactured etc.) the share was either zero or undefined. On the other hand, the Competitiveness Index (CI)⁽¹²⁾ shows that Palestine experienced shrinking market shares for all exports in the years 2001 and 2002, whereas in foods and live animals, manufactured goods, and miscellaneous

manufactured articles all experienced positive market share growth between 1998 and 2000.

5.6 Technological content of Palestinian exports

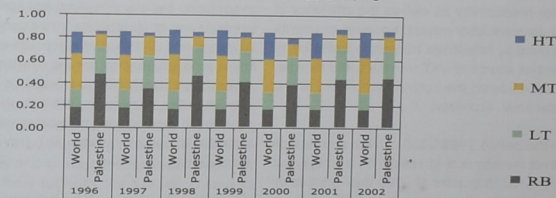
The literature points to the importance of financial services and facilitating access to trade information and tax breaks to be equally important factors to export growth as demand factors. But it is certainly true that the high technological content of exports has witnessed higher than average growth in its share of world trade⁽¹³⁾. Using United Nations Industrial Development Organization's (UNIDO) classification based on 3-digit SITC, Palestinian exports are divided into 4 categories: resource based exports (RB), low technology exports (LT), medium technology exports (MT), and high technology exports (HT). The shares are presented in figure 3.8.

The figure shows that resource based exports have maintained an average approximately 40% of total exports in Palestine; in comparison, the world's share is only 15% to 16%. Also the high technology content of exports has the

Machinery and transport equipment.	856	1175	1882	3837	2757	4280	1166	1343	2562	2151	7756	13524
Miscellaneous manufactured articles	1420	1590	3437	6490	6409	9363	30377	9616	15160	9638	4336	13670
Commodities and transactions, n.e.s. in SITC Rev.3	55	147	98	12	61	104	1781	373	389	820	279	252

Source: Author's calculations based on UNCTAD Handbook of Statistics online and PCBS unpublished data
* bold and italicized figures are negative.

Figure 3.8- Annual growth rates of exports by technology groupings



Source: Palestinian Central Bureau of Statistics/Palestine Monetary Authority, Balance of Payment Statistics, 2003

lowest share, though gradually improving. By contrast, RB exports have the lowest share in world exports followed by HT.

5.7 Price and income elastic ties and exposure to foreign shocks

Income and price elasticity of exports and imports are calculated using UNCTAD's data base on the Palestinian economy. The data covers the period 1972 – 2002 and the variables are measured in 1997 prices. The specification of those equations is along the lines of Daoud and Elkafif, (2005)⁽¹⁴⁾. Exports and imports equations show income and price elasticity are both inelastic. As expected, they are insignificant⁽¹⁵⁾ as prices in Palestine follow closely those prevailing in Israel. The more serious shocks are those associated with closure days, while closures affect imports positively; its effect on exports is negative (Table 3.9). El-Jafari and Al-Ardah (2002) obtained numbers that are similar qualitatively. Since both export and import elasticity are small in the short run, devaluation will have a negative impact on the current account. Long run price elasticity estimates continue to be very inflexible (.044

and .01) for imports and exports respectively. Income elasticity estimates however improve drastically in the long run; they are 1.02 and 0.4 for imports and exports, in that order. The degree of dependency of the Palestinian economy on Israel has been increasing overtime. Palestinian merchandise exports to Israel exceeded 90% of the total exports; and almost 80% of Palestinian imports have been channeled through Israel, particularly since 1995. The majority of Palestinian imports from abroad (approximately 70%) originate from countries which have trade relations with Israel. In fact, Palestinian exporters and importers prefer to trade with the international markets under the Israeli umbrella to avoid Israeli impediments and restrictions. Therefore, it is not surprising to discover that benefits attained from the bilateral agreements signed by the Palestinian National Authority (PNA) with other Arab as well as foreign countries are still not observed and remain limited.

During the period 1996-2002, the Palestinian trade deficit reached a peak of \$3093 million in 1999. By 2000, the trade deficit was \$1448 million, a 50% decline from the 1999 level. This reduction in trade deficit can be attributed

Table 3.11- Changes in global demand and market shares for Palestinian exports 1996 -2002 (\$ 000)*

SITC GROUP	Global Demand						Competitiveness					
	1997	1998	1999	2000	2001	2002	1997	1998	1999	2000	2001	2002
Food and live animals	226	1181	2504	3919	1520	979	24523	17642	18317	44045	11629	21349
Beverages and tobacco	674	1426	2724	2823	3334	2787	3006	10185	102	611	952	1739
Crude materials, inedible except fuels	162	1381	1504	86	228	1332	9443	4101	8080	8122	10146	9023
Mineral fuels, lubricants and related materials	1569	376	703	3742	3140	2899	2399	657	3051	9168	9758	9245
Animal and vegetable oils, fats and waxes							7334	4557	4593	1184	981	3070
Chemicals and related products, n.e.s.	426	585	960	1759	1852	3292	11264	343	4635	1756	1659	12886
Manufactured goods classified chiefly by material							74843	27836	14662	5548	22332	54642

to many factors. However, the sharp decrease in the Gross National Disposable Income (GNDI) is a primary cause behind the continuous reduction in merchandise and service imports. On the other hand, merchandise exports went down by 30% in the course of 1999-2002. A decline in the trade deficit therefore does not indicate an improvement in the performance of the Palestinian economy. Wages in Palestine depend positively on wages in Israel (relatively higher). Therefore, changes in the wage level have not materialized due to improvements in labor productivity as well as the efficiency in the domestic labor market. However, payments received by Palestinian workers in Israel, being a major source of VAT revenues and income, are considered the central component of the Palestinian economy.

In the period 1995-2000 private and foreign direct investments increased on average, but in the fourth quarter of 2000 they went down sharply. However, more than 80% of these investments were allocated to the housing and construction sectors. On the other hand, investments in Palestine continue to be highly associated with imports. In fact, investments in the housing and construction sectors have increased imports of raw materials and intermediate products; such imports are predominately from Israel. Therefore, the multiple effects of investments are reflected in the Israeli Gross Domestic Product (GDP) and employment. NTBs have gained prominence over tariffs in controlling and directing the performance of the Palestinian economy.

During the past four decades the economic and trade indicators illustrate that very limited changes have taken place in the Palestinian economy. During 1997-2000 the Palestinian economy's dependence on Israel has strengthened and intensified, particularly through foreign trade, labor mobility and VATs collected by Israel to finance the public budget.

6. Summary and Recommendations

6.1 Summary

The competitiveness of Palestinian trade can be summarized by the following features:

- The weaker competitiveness of Palestinian industries is related to lower labor productivity and higher wages which are determined based on the wage level in Israel. In this regard, although Palestine has a comparative advantage in producing and exporting food and agricultural products and other labor intensive goods such as shoes and clothes, the competitiveness of these products tend to decline overtime. The competitiveness indicators (such as annual growth rates of exports, market shares of Palestinian products in the local markets, as well as in export revenues) have been deteriorating.
- The diversification index for Palestine reveals that Palestinian exports seem to be less diversified than those of neighboring export markets such Jordan, Egypt and Israel.
- Palestinian exports are characterized with a high degree of resource based and low technology contents compared to the share in regional and world exports.
- Uncompetitive and weak agro-processing industries have led to increase imports of food and agricultural products to increase overtime. Despite the reduction in GNDI imports of those products showed an increasing trend during 2000-2003. In contrast, exports of farm and food products tended to decline during that period.
- Unstable prices in the domestic markets, in particular, showed variations for products produced locally. On the other hand, prices for imported products have been increased overtime (imported inflation).

6.2 Recommendations

The PNA should focus on removing the NTBs imposed by Israel on the Palestinian economy.

It is considered a necessary condition to liberalize the Palestinian trade in order to be engaged in regional and international markets. The reliance of Palestinian trade on a single market, in both exporting and importing, has led to a concentrated production in certain sectors and activities that fall within the interests of Israel. Therefore, the diversification of production and exports that match the demand in the neighboring countries could reduce Israel's monopoly over the Palestinian market.

On the Palestinian side, a number of measures can be taken to develop the performance of Palestinian trade. Despite the bilateral agreements signed between the PNA and neighboring and foreign countries, the benefits from those agreements to expand trade with new partners are still limited. Much still remains to be done by the PNA to reduce administrative burdens and transaction costs. In addition, institutional facilities are needed to expand trade policies in order to promote exports on one hand and to rationalize imports on the other. Furthermore, the current relationship between trade and domestic and foreign private investments needs to be modified and put on the right course. It is obvious that trade liberalization will attract the private sector to invest in diversified products for potential export markets. However, more effort should be made by both the private and public sectors to establish joint institutions necessary to create adequate and efficient marketing facilities and infrastructures.

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Notes

- 1) Daoud, El-Khaffif and Makhool (2005) found that the closure days coefficient was largest on labor movements, then exports and finally imports.
- 2) Abdel-Razeq et al. (2001) report the figure to be above 50% while El-Jafari, Zagha, and Al-Ardah (2002) report the figure to have reached 70% in 1995.
- 3) For a complete discussion on the interplay between budget and CA deficits see El-Jafari and Al-Ardah (2002).
- 4) UNCTAD, World Investment Report 2004 figures are -41.1, -17, -17.6 percent for the years 2001, 2002, and 2003 respectively.
- 5) Auditors reports are available at <http://www.padico.com/>
- 6) See El-Jafari, Zagha and Al-Ardah 2002 for detailed discussion of trade policy and options.
- 7) See David Klien's lecture for a seminar of the Euro-system and Mediterranean Central Banks, Naples, 14-15 January, 2004
- 8) The export price index and import price index are taken from UNCTAD's data base in constant 97 prices.
- 9) See Makhool and Atyani, 2004 table 8 for a complete listing of countries at the two digit ISIC. Using the Palestine as a reference (productivity = 1), a relative productivity greater than 1 implies competitive disadvantage for Palestine.
- 10) This is despite Israel joining the WTO and freeing its trade; differences in imports between Palestine and Israel make the average tariff on the Israeli import basket lower than that on Palestine's.
- 11) $GD = \sum_{j=0}^J S_{JO} (X_{JT} - X_{JO})$ Where S_{JO} , and $(X_{JT} - X_{JO})$ are the share of Palestinian exports from world exports in 1996, and deviation of global exports from 1996 level respectively. The indices J and NJ represent the aggregation over 3 digit SITC into a single digit SITC.
- 12) $CI = (S_{JT} - S_{JO}) / MgT$ where $(S_{JT} - S_{JO})$ is the change in Palestinian global market share of exports and MgT is global imports for single digit SITC commodities.
- 13) Industrial Development Report (2004), UNIDO
- 14) The model was presented at EcoMod at the Free University of Brussels in June 2005
- 15) The Augmented Dickey Fuller test of a non-stationary null could not be rejected. The insignificance is mentioned here to ascertain that Palestinian trade with Israel is the dominant component and is denominated by the NIS.

Chapter IV Governance and Institutional Issues in Palestine⁽¹⁾

1. Introduction

The Palestinian Authority (PA) is an autonomous Palestinian government set up in order to implement the Israeli-Palestinian agreements following the Oslo⁽²⁾ Accords of 1993. Since its creation, the PA was understood to be a transitional body that would form the basis for a future Palestinian government. The PA has placed state building among its top priorities and made great strides in developing public institutions under conditions of limited sovereignty. In a context where final status issues remained unresolved and under conditions of restricted functional authority, the PA focused primarily on reform and strengthening of fiscal, administrative and public security institutions.

To that effect, the United Nations and the international community have committed to assist the PA in its efforts to build credible public institutions. From the beginning, Palestinian civil society groups demanded that this process takes place with a maximum amount of transparency and that it results in the creation of accountable public institutions. This demand was complemented by a series of obligations and benchmarks that the international donor community placed on the PA in light of its increased technical and financial assistance. This effort, aimed at laying the foundations and infrastructure of a Palestinian state, was to take place while negotiations continued between the Israelis and Palestinians, with the aim of eventually reaching a final status agreement. This agreement would end the conflict and result in the creation of a sovereign Palestinian state.

The PA created an institutional framework to deal with these issues. Various committees, including the National Reform Committee (NRC), were established at different times to push the agenda forward. The NRC in particular was an attempt to shield the reform process from

those in the PA who opposed the agenda⁽³⁾. The necessary institutionalization and empowerment of this committee remained illusive. While resources were devoted and cooperation with the donors was steady, questions regarding prioritization of institutional reform were raised by donors through the representative body of the Local Aid Coordination Committee (LACC). This is largely the result of three factors: 1) The insufficient profile and power given to those tasked within the ministries to oversee these issues; 2) The lack of clarity over division of labor between the ministries on the reform agenda; and 3) Lack of progress on judicial and legislative reforms that included anti-corruption efforts.

External actors and events continued to affect the pace of success and/or failure of the PA's institutional development. Israeli actions including the closure of cities and towns, checkpoints and increased building on settlements in Palestine as stated above, served to limit the functional authority of the PA. While debate over the implementation of reforms continued, placing them into practice was hampered by the constraints placed on PA officials and civil servants. The Task Force on Project Implementation (TFPI) conducted a number of successful negotiations that allowed for the issuing of permits and facilitation of internal movement of identified reformers within the PA as well as legislators, judges and lawyers. However, the issuing of permits was often delayed and eligible Palestinians often had difficulty accessing them⁽⁴⁾. This system was applied with some success during the 2005 general elections, when many obstacles on internal travel were reduced facilitating the election process⁽⁵⁾.

Despite limitations, the PA was able to achieve considerable progress in certain areas of institution building and government reform. The basic foundations for a state were created and the framework of a presidential system

with executive, legislative and judicial branches of government was codified in the drafting of a basic law – the precursor to a proposed constitution. This progress was largely achieved during the period from 1993 until the outbreak of the second Intifada in 2000. Reform and institution building continued in fits and starts. A prominent success was the renewal of the democratic process with internationally endorsed Presidential and Legislative elections held respectively in 2005 and 2006. There were also measurable advancements in fiscal reform, and in strengthening financial and economic institutions. However, legislative and judicial reform occurred at a slower pace. Lack of political will was cited by analysts as a reason for the slow pace of reform on politically sensitive issues like judicial and legislative reform⁽⁶⁾. Accusations of corruption spurred the PA to adopt a series of measures aimed at increasing transparency consistent with its obligations to the international community⁽⁷⁾.

Despite certain accomplishments, "further significant efforts"⁽⁸⁾ are required for the PA to adequately achieve its stated goals with regard to strengthening the rule of law in general; a sector that involves not only the delivery of core public services, but one that is also fundamental to the PA's legitimacy and credibility in an era of renewed democratization and amid widespread accusations of corruption⁽⁹⁾.

The most immediate obstacle to the institutional building and reform agendas are the unresolved conflict with Israel and Israel's continued military occupation of the West Bank and Gaza – the same areas understood by the PA to consist of their future state. As a result of this, the PA came to rule over a patchwork of disjointed population centers and was unable to enter into final status negotiations with Israel⁽¹⁰⁾. This restricted the functional authority of the PA to adequately deliver services to the Palestinian people to varying degrees since 1993. Also, a persistent factor in the success or failure of the reform agenda was the combination of external constraints to the PA's functional authority. The behavior of external actors, including the Government of Israel and the international community, directly affected the course of reform in key areas, such as security and the rule of law, and directly affected

the definition of reform priorities and agreed upon benchmarks and the PA's progress towards achieving them.

2. Political Context

Both Palestinian and international voices have always called for a transparent and accountable democratic process of state and institutional building in Palestine. In May 2002, US President Bush called for the democratic reform of PA institutions and regime change as necessary steps to achieving a vision of "two-states," Israel and Palestine⁽¹¹⁾. The PA President, Yasser Arafat, and the Palestinian Legislative Council (PLC), in response to international as well as substantial and persistent local Palestinian pressure, adopted a comprehensive plan to tackle the issues outlined by the international community – primarily the passing of legislation and empowerment of ministries – called the 100 day reform plan. The plan became the basis for donor support to the PA and the corresponding structure of the TFPR was established to monitor the PA's implementation of the plan's recommendations. TFPR, empowered by the Quartet to work alongside the existing donor structure, has since served as the mechanism by which the major donors would monitor, assist and communicate with the PA on the reform and institutional development agenda. Seven groups made up of different donors were tasked to monitor progress of reform in each of the following sectors: Local Government, Judiciary and Rule of Law, Legislature, Market Economy, Elections, Public Administration and Civil Service, and Financial Accountability.

On 9 July 2004, the International Court of Justice rendered an advisory opinion stating that the construction of the wall "constitutes breaches by Israel of several of its obligations under the applicable international humanitarian law and human rights instruments".

On 20 July 2004, the General Assembly adopted resolution ES-10/15, which acknowledged the Court's advisory opinion, demanded that Israel comply with its legal obligations and called on all Member States to comply as well. The resolution also requested the Secretary-General to establish

a register of barrier-related damages. of efforts on the Roadmap.

Israel continued its construction of the Barrier in the West Bank. By early 2006, approximately 243 km (36.3%) was completed and a further 166 km (24.8%) was under construction. Of the constructed Barrier, 37 km was made up of 9 m high concrete slabs (15.2%) and the remainder consisted of a combination of ditches, trenches, roads, razor wire, and electronic fences. Since the beginning of its construction, the Barrier has led to the requisition of approximately 3,500 hectares of West Bank land. The Barrier buffer zone in the northern West Bank covers approximately 6,290 hectares of West Bank land. If all of the Ma'ale Adumim and Ar'el/Emmanuel sections marked as "subject to the completion of further inter-ministerial examination" are included, then approximately 57,050 hectares or about 10.1% of West Bank and East Jerusalem land will lie between the Barrier and the Green Line.

The period 2005 to date saw major steps towards the completion of the Barrier around Jerusalem, severely disrupting movement of Palestinians between the West Bank and East Jerusalem which, as a key commercial hub, accounts for about 30 percent of the Palestinian economy. About one-quarter of East Jerusalem residents will be located to the east of the planned Barrier and will need to cross it to access services inside Jerusalem. Where the Barrier has been constructed, Palestinians face economic hardship due to restrictions of access to their crops and grazing areas.

In May 2005, the Quartet appointed a Special Envoy for Disengagement to coordinate with the parties and the international community to promote the economic feasibility of Gaza in the post withdrawal period. In June 2005, a United States Security Coordinator was appointed to promote internal security reform within the PA, and ensure security coordination between the parties during the withdrawal operation. In September 2005 Israel concluded its withdrawal of settlers and military personnel from the Gaza Strip and parts of the northern West Bank. The international community, led by the Quartet, expressed hope that the successful implementation of Israel's unilateral Disengagement plan might lead to a renewal

On 25 January 2006, the Hamas list, "Change and Reform", won a majority victory in the Palestinian Legislative Council elections. In its statement of 31 January, the Quartet congratulated the Palestinian people on an electoral process that was free, fair and secure, but stressed that a new Palestinian government should be committed to non-violence, recognition of Israel's right to exist, and acceptance of previous agreements and obligations, including the Roadmap. The Security Council subsequently took the same position. Anticipating the imminent formation of a new PA, several donors undertook to review their assistance programs and to examine alternative channels of funding. Citing a lack of movement by the new PA towards the Quartet's three principles, the United States and European Union announced a freeze on their assistance to the government, shortly after its swearing in on 27 March while stating their intention to maintain direct assistance to the Palestinian people.

Israel's disengagement from Gaza and parts of the northern West Bank presented a positive platform for potential improvements in PA governance. However, it did not mean the renewal of negotiations between the Israelis and Palestinians and thus offered no clear indication of when final status talks will take place. With Israel out of Gaza and a reduced presence in an area of the northern West Bank, however, there is an opportunity for the PA to focus on a number of reforms as outlined by their ministries and the international community's assistance mechanisms.

Important challenges remained in the period following the withdrawal: While internal closures within the Gaza Strip were lifted as a result of the Israeli departure, external closures remained in place and squarely in Israeli control. The Agreement on Movement and Access, reached on 15 November 2005, with the assistance of the US Secretary of State and the Quartet Special Envoy, was viewed as an important step towards the improvement of the Palestinian's freedom of movement and economic activity. The agreement included a provision on the opening

of the Rafah border crossing between Egypt and Gaza, implemented beginning 18 December 2005 with technical assistance from the European Union. Since then, the Rafah crossing point has remained operational with a daily average of 700 travelers⁽¹²⁾ using the crossing point. Other aspects of the Agreement, however, are yet to be implemented.

The situation at the end of 2005 did not yet fully suggest that a clear, linear transition towards stability and sustained development was at hand. Rather it highlighted the fact of a co-existence of ongoing emergency needs and emerging development opportunities, with the balance between the two very much contingent upon the status of political interaction between the parties, the course of which remained uncertain.

The fluidity of the situation made comprehensive planning and resource mobilization efforts exceedingly difficult, obliging aid planners in the PA, the UN and the donor community to rely on working assumptions and scenario frameworks that pointed in different directions. The proliferation of immediate and medium-term planning instruments, such as the Palestinian Recovery Plan, the Quartet's Rapid Assistance Program, in addition to at least three Palestinian reform plans published during 2005, testified to the prevailing climate of uncertainty. It also raised increasingly pointed questions about coherence, priority and sequencing among the many plans themselves, and about the ultimate ownership of the aid agenda.

Strategic planning difficulties, in turn, encouraged the ongoing practice of decentralized forms of aid programming through multiple, often unconnected investment channels, and frequently undertaken on the basis of narrow priority sets championed by specific constituencies of donors, implementers and recipients.

3. Towards a New Appreciation of the Governance Type

Based on the above, it seems obvious that there are major complexities that overshadow the issue of governance in Palestine, which

makes the construction of any type of governance in Palestine somehow unique. First, Palestine is not a sovereign state or a well-defined entity. The Oslo Accord for the Declaration of Principles is merely a set of arrangements tailored for an interim phase and for the newly established self-rule PA without addressing the main issues of the conflict; i.e., the right of return for the Palestinian refugees, the status of Jerusalem, control over land and natural resources (water is the most important), and the control of borders. Such self-rule PA could never convince its population of its "legitimacy" since a legitimate government needs to have the exclusive holding of power, sovereignty over land and people, and needs to be an outcome of a democratic process. Israel maintained its control over borders; maintained the final word on disputed issues; and, exercised its full power over trade (including the migrant Palestinian labor working in Israel), currency, water, and land. The Palestinian society (with its main political, economic, and social actors) was held captive to Israeli strategies and policies. In such situations, the task of maintaining sustained economic and social development becomes complicated and gives rise to the necessity to revise the whole peace process that led to the deteriorating status of the Palestinian life. Also, the strong Israeli influence was the main actor to blame as opposed to the weak PA. In other words, such facts would rule out the argument that lack of governance among PA's institutions may bear the bulk of responsibility for the deteriorating standards of living for Palestinians.

Second, the call for combating corruption in the PA was triggered by Israel's Prime Minister Sharon in the course of his war against the Intifada and the PA. Sharon was against the Oslo Accord and declared that he will never deal with Arafat and the PA. Sharon's call for reforms in the PA was perceived by the PA and the Palestinians as an attempt to escape meeting Israel's commitments with respect to embarking on final status negotiations with the Palestine Liberation Organization (PLO). The United States took the side of Israel in calling for reforms, while the Palestinians maintained the position of calling for an immediate start of the final status negotiations.

Reforms, transparency, accountability and the rule of law were meant to be identical to Israeli claims that there is no "good" Palestinian partner to negotiate with. Israel continued with its unilateral measures; expanding settlements, confiscating land and attempting to impose a final status solution that creates a Palestinian state on less than 40 percent of West Bank and Gaza Strip without land contiguity, and the build up of the Israeli wall of separation and bantustanization of Palestinian areas.

Third, the invasion of Iraq by the United States was declared as a starting point for reforms in the entire region. The United States policy in Iraq is very unpopular in the Arab region, including Palestine. The association of the destruction of Iraq with reforms and democracy under occupation was always perceived with cynicism by the Palestinian people. This poses a major obstacle in the face of governance for the same reason: An occupying force is asking the indigenous societies to be reformed and not to be corrupt! This was very unfortunate to the cause of governance.

Despite those complexities, the Palestinians decided to remain positive vis-à-vis the issue of governance as a homework that must be done regardless. The main actors in the Palestinian society, i.e., the legislature, the executive, and the judiciary, and the civil society (political parties, the private sector, non-governmental organizations, and the Media), have stated their strong commitment to good governance, including sound macroeconomic and financial management, participatory pro-poor policies, effective delivery of public services, and enforcement of contractual and property rights. There is a growing belief among leaders on all levels that political legitimacy and stability depend in part on a well-managed economy to achieve short and medium-term goals for poverty alleviation and then moving ahead from economic relief to economic development in the long-run. In an effort to achieve these goals, a dialogue and information-sharing among the public and private sectors, research and scientific communities, and civil society is taking place, yet efficiency in the management of this dialogue is still questionable.

Given that reform efforts are unlikely to succeed unless the political realities that underlie governance problems are taken into account, a broader view of governance needs to be adopted. In line with this, this chapter will cover the political environment in which the main actors of the Palestinian society are functioning.

Measuring governance involves many challenges. Indicators can be a useful guideline in measuring a country's progress over time. The main indicators we will employ in characterizing the Palestinian case will follow. First, political stability, which provides the businesses and investors with the assurance that their investment will not be subject to unreasonable risk of destruction or expropriation or of being vulnerable to uncalculated losses. Second, Regulatory Quality: whether the regulatory and legal environment is malleable, corrupt, or unpredictable. Third, The Rule of Law: in terms of whether the country has a well-established system of contract law, which allows for successful suits for collection of unpaid debts, seizure of collateral and technical breakdowns. Fourth, Government Effectiveness: the efficiency and efficacy of government institutions and policies. These indicators, together with other issues such as transparency, participation, and accountability, will be dealt with as well in the context of describing the nature of the interrelationship existing between the different actors and the consequences of their form of interaction on the economy and economic decisions.

4. Strengths and Weaknesses of the Working Process

4.1 Decision Making and Constitutional Procedures

Palestine's constitutional legacy starts with the colonial constitution of 1922, which was enacted by the British Mandate authorities. This constitution lasted and was still in effect in 1948 when the "establishment of the State of Israel" was declared on eighty percent of Mandated Palestine. Jordan and Egypt took control over the West Bank (including East Jerusalem) and the Gaza Strip, respectively.

In 1952, the Jordanian constitution that aimed at integrating the West Bank and East Jerusalem into the Hashemite Kingdom of Jordan was introduced. Meanwhile, Gaza was under Egyptian military control, and in 1955 witnessed the adoption of the Basic Law to act as a precursor to the full constitution of the Palestinian State that is yet to see the light. Palestinians remained stateless and constitution-less with the advent of the Israeli occupation in 1967, which put the Palestinian territory (the two areas) under military occupation; a situation that remains until now. Such diverse brushes with constitutional legacies between the West Bank and Gaza lasted until recently when the Basic Law and then the Draft Constitution of the PA were ratified.

The PLC adopted its first Draft Constitution (the Basic Law) that was enacted in 1997, and was ratified, in its third draft form, by the President only on May 29th, 2002. The Basic Law, called the "Constitution of the State of Palestine," as the interim constitution, was subject to several amendments in the process of its transformation into a state constitution. The constitution is expected to be finalized prior to the long awaited independence. The Palestinian state will eventually adopt a constitution not different from the current draft, possibly with small modifications reflecting social and international demands. The Palestinian constitution indicates that it will take precedence over all other laws in Palestine. In addition, the Constitution states that Palestine abides by the Charters of the United Nations and Arab League.

Palestine's system of government is a constitutional parliamentary representative democracy, with mixed attributes of both the parliamentary and the presidential systems. There is no effective separation or division of powers, and the lines are more than blurred. The Basic Law stipulates that Palestine shall be a republic and a democracy with a clear separation of powers, and shall have independent judiciary (PA, Basic Law, 2003, p. 4). Islam is the main source of legislation, and the rights of other monotheistic religions are protected by the Basic Law.

Palestine is a pluralistic society composed of

Muslims, Christians and Jews, and the constitution guarantees equality in rights and duties to all religious communities. The constitution reaffirms that Christianity and all other monotheistic religions are accorded sanctity and respect.

Palestine is a centralist state, with two disconnected territories; the West Bank (including East Jerusalem) and Gaza Strip. Palestine is comprised of sixteen districts (5 in Gaza Strip and 11 in the West Bank, East Jerusalem being one of them).

However, the absence of effective sovereignty and the presence of Israeli settlements and military occupation forces in Palestine preclude the possibility of enforcing the rule of law under the Palestinian constitution on all residents of the Palestinian territory (Nathan Brown, 2003, pp.20-24). In effect, The rule of law is absent and the Palestinian citizen has most of his rights denied by the Israeli military occupation.

4.2 The Actual Processes: Structures and Methodologies

4.2.1 State Structure

According to the Election Law of 1996 all Palestinian citizens aged 18 and above, who are formally registered in the electoral list, have the right to vote. In all the electoral regulations, the right to vote and stand for office is universal to all Palestinians regardless of religion, ethnicity or gender (Central Elections Commission, 2002).

The main bodies provided for in the constitution are: the president of the state and the parliament, called the Representative Council, which is the legislative branch. The constitution also enumerates the government as well as cabinet ministers as the executive branch, and finally the constitutional court and the Supreme Council representing the judiciary branch of the state.

The president of the state, the prime minister⁽¹³⁾, or one-third of the members of the Representative Council may request the procedure for amending the constitution.

4.2.2 Elections

The Palestinian latest legislative elections were carried out on January 25, 2006, in unprecedented success with respect to plurality, freedom of expression and rule of law. There were no significant violations that would undermine its reliability or legality. This is an obvious achievement for the Palestinian people and the PA, and all of the participating parties in this democratic process under almost impossible conditions of direct Israeli occupation of Palestine and the absence of a sovereign Palestinian state. The landslide victory of the Islamic Resistance Movement "Hamas" in winning 74 seats out of 132 of the Legislative Council⁽¹⁴⁾ in the second Palestinian legislative elections formed a major transition point in the development of the Palestinian political system. This is to be compared to 45 seats won by Fateh, the leading PLO faction, and a mere 9 seats representing all the rest of the political spectrum. Prior to the recent elections, Fateh held the majority of the seats in the parliament, as well as position of spokesman, thus giving the council its monochromatic character. The 1996 elections were also judged free and fair by international observers.

4.2.3 Political Environment

Both Fateh and Hamas, the two largest political parties, operate on multiple levels. But Fateh is still in control of the governmental bureaucracy and security forces, and it controls most of the available resources, especially money and jobs. On the other hand, it also continues to maintain a large mass movement structure, which is relatively separate from these ruling functions. Its student branch, its youth movement (shabiba), and its women's movement have large popular bases in the society and continue to recruit and organize throughout the country and among different social groups. In sum, although the status of Fateh has receded in favor of Hamas during the last elections, Fateh still dominates a huge part of the political and "civil" field.

As for Hamas, it has created a political party, it maintains an underground military wing, and has created a host of civil society organizations working in education, welfare, day-care, health,

and even human rights. More importantly, it has a strong youth movement, (well-represented at universities), it has recently created a women's movement and one of its charitable foundations maintains one of the largest universities in Gaza. Hamas now controls the vast majority of municipal councils, in addition to emerging as the clear winner of the last legislative elections.

The remaining nationalist parties (of the left) have lost substantial membership over the past five years and represent a very narrow social strata - although they continue to symbolize certain values of social justice to a wider (generally educated) sector of the society.

This great change in the structure of the Palestinian political system, which was dominated by the PLO throughout the last forty years, forms a milestone for several important transformations within the Palestinian political society and the complex network of Palestinian foreign relations. Palestinian traditional political parties found it necessary to embark on a large-scale process of review and analysis of the structural deficiencies in their function and mission.

4.2.4 Civil Society

The Palestinian experience during the first Intifada (1987-1993) testified to the exceptional density of decentralized civil society networks, their efficiency, pluralistic nature, and wide proliferation. The Palestinians developed a vibrant civil society during the Intifada, with over nine hundred popular and voluntary associations, human rights organizations, as well as powerful trade unions and women's movements. This struggle seemed to suggest that Palestine enjoyed the promise of developing a democratic system of good governance after independence.

Locally as well, the performance of the civil society in Palestine, and after the establishment of the PA in 1994, has been placed under new challenges. It has not managed to advance the critical demands of society and did not stand its ground against the authority that was encroaching on civil and political freedoms. As a consequence, decentralized social

networks, mainly of civil society and other grassroots organizations, have all but perished (in most cases) and in the wake of their demise, a new stratum of professionalized, donor friendly, and large development NGO's has emerged. In short, the political elite of the PLO and the local civil society realized the necessity of embarking on dialogue as the authority started its "state-building" phase. An outcome yet to be achieved is to promote

professionalism, train the military and bureaucratic staff to observe new codes of conduct and develop relevant skills among the PLO staff.

Media and NGOs: The estimated number of Palestinian NGOs totals approximately 1440 NGOs and CSOs (Civil Society Organizations). Table (4-1) A Distribution of "Civil Society" Organizations in the West Bank and Gaza. Strip⁽¹⁵⁾.

Table 4-1 "Civil Society" Organizations in the West Bank and Gaza Strip

Type	Approximate number
Charity and welfare organizations	450
Labor and professional unions	310
Service provision	189
Development institutions	201
Cultural centers	136
Research centers and institutions	52
Human and civil rights	33
Sport Clubs	58
Political parties	15
Total	1440

4.3 The Economic Structure and Supporting Political Environment

The economic system in Palestine is based on the principles of free market economy and the state is entrusted with the task of providing the regulatory framework and the protection of private property.

The state has five main roles in the economy. First, it has the right to collect taxes, to determine the national budget, and to manage the monetary and financial systems; second, it controls, uses, and manages state properties (mineral and natural resources, bodies of water, and so on); third, it promotes economic development, especially in agriculture, handicrafts, and industry; fourth, it protects the environment and oversees the management of natural resources; and finally, it protects

consumers from illegal, counterfeit, or expired goods that could affect their health. The state is obligated to protect citizens' rights to obtain a quality education for at least nine years, with free provision of both primary and secondary education. The state is also responsible for providing health services and support for the socially vulnerable, specifically disease prevention and medical treatment. In Palestine, both the Ministry of Education and the Ministry of Health, together with United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) – a major service delivery agency for the Palestinian refugee camps- and other NGOs are coping with these services.

The private sector in the West Bank and Gaza was traditionally dominated by small

enterprises. These tend to be companies working under subcontracting agreements with Israel or family businesses that often depend on unpaid family labor. The private sector witnessed huge jumps since 1994 as about 100 public shareholding companies were registered. Currently, there are twenty seven shareholding companies listed on the Palestine Securities Exchange (PSE). These initial companies span a wide range of sectors including pharmaceuticals, utilities, telecommunications, and financial services.

Palestinian agriculture remains very labor intensive. It utilizes few of the agro-technological advances that benefit Israeli agriculture. It serves as the employer of last resort, particularly during times of economic disruption.

Ministries reporting to the executive branch of government became large and influential under the Oslo Accords. They were highly politicized at the top levels, and employment within the ministries served as a principle source of regime patronage. A Palestinian judicial system that included both civil and criminal courts predated the Oslo Accords but had largely become irrelevant under Israel's occupation. Reviving a judicial branch of government was a major challenge during the 1990s and remains a key challenge today.

Challenges

In short, Palestine already has executive, legislative, and judicial branches of the government in place. The main challenge, therefore, is not to create new institutions but to reform, strengthen, and make existing institutions functional by taking existing realities into account. We find that there are three basic challenges to reforming the Palestinian governmental framework so that it can promote and sustain good governance: promoting the rule of law, empowering parliamentary democracy, and promoting meritocracy in the civil service.

Needless to say, the Israeli Occupation in Palestine remains to be the major key political actor, the likely outcome of which is political instability. Political stability is a major challenge

in Palestine. Economic markets abhor uncertain environments. Businesses and investors desire assurance that their investment will not be subject to unreasonable risk of destruction or expropriation or a risk that could lead to general repudiation of debts if a state of disorder prevails. An environment of insecurity and political instability means that these agents will be less likely to invest, and that economic development and growth will suffer as a result. This sentiment is consistent with attitudes expressed by Palestinian businessmen in the World Business Environments Survey in 2000: Seventy-seven percent of respondents considered "policy instability and uncertainty arising from political conditions in the WBG [West Bank and Gaza]" a moderate or major constraint on expanding business operations and growth (Sewell, 2001, pp. 3-6).

Also, the Israeli occupation undermines the role of NGOs among the Palestinian society. As Palestinian cities, towns, and refugee camps were internally closed and isolated from each other during the second Intifada (since 2000), and the society as a whole is put under distress, the immediate agenda of many NGOs was reduced to mere survival, and maybe alleviating some of the suffering of the local Palestinian communities. Most public and private institutions have been paralyzed by the Israeli military closure, and the performance of NGOs varied widely and significantly, roughly along the lines of whether they were grassroots-oriented or foreign-aid-dependent.

4.4 Evaluation of the Gap Between Good Policy and Good Political Process

The Palestinian capacity in planning and prioritization has improved during the period 1994-99 as the Ministry of Planning and International Cooperation (MOPIC) assumed the central role for these matters. Nevertheless, competition among PA institutions for donor assistance has also led some donors to rethink arrangements with PA ministries and municipalities. The tendency to reformulate priorities and "shop" for funding has only confused the PA's and civil society's priorities further. Donor support for competing institutions has worsened fragmentation, as in the human rights sector. This has been most problematic

in the case of institutions that lacked the political or organizational skills to lobby for funding, thus compounding their weakness.

Although there are efforts - such as the Palestine Economic Indicator - to quantify and measure the Palestinian national economy, it is not self evident that the Palestinian economy can be treated as a "national economy" after all. Israel controls and manipulates all resources, exit-entry points, the labor market, trade, and currency of the Palestinian territory, and most of the Israeli decisions serve Israeli and not Palestinian interests. Indeed, the economic outcome of the five year transitional period - which by September 2000 had extended to 7 years already - was desolate, witnessing a serious drop in per capita income (20%), a growth in poverty (from one fifth of the population in poverty to one third between the two periods), and unemployment (from 18 to 28% using what the World Bank refers to as conservative measures). The public sector of the PA was allowed to play a greater role during the interim period, although the aim of the donor countries was to eventually enable the private sector to become the engine of the economy. In particular, the public sector was given the mandate to "upgrade physical and social infrastructure" since the private sector is unlikely to be interested in investing in these for some time. As such, the rehabilitation of physical infrastructure and the continued provision of social services were to be undertaken by the PA until a time when the economy takes off.

5. Consequences on The Economy and Lessons

This section deals with defining of economic climate by emphasizing the extent to which institutional and policy problems place constraints on the performance of firms. The most significant key institutional and policy constraints in the Palestinian case are the functioning of the judiciary, corruption, the state of disorder, policy instability, imported inflation, the circulation of three foreign currencies, taxes and regulations, anti-competitive practices, finance, and infrastructure. In the first manner, five major governance indicators will be tested as an

outcome of the form of interaction existing between different actors. The indicators are: control of corruption; quality of institutions and policies; decision making process in terms of predictability; the existence of "state capture" practices; and, the functioning of the legal system. Afterwards, a description of the nature of the interrelationship between the different actors and the consequences of that form of interaction on the economy and economic decisions will follow. Finally, a presentation of the needed reforms will be constructed, highlighting the potential levers, and assessing agents subject to mobilization.

5.1 Governance Indicators

First: Control of corruption

Corruption is a symptom of fundamental institutional weaknesses and thrives where the state is unable to impose the rule of law over its bureaucracy or protect property and contractual rights. There is no wonder that surveys on how corrupt the PA is show a proportionate rise in people answering yes as the PA became weaker since the start of the Israeli large offensive on the PA institutions in 2000 (The RAND Palestinian State Study Team, 2005, p. 22). The relevant key characteristics and policies of the state are the extent of state intervention in the economy and the degree of discretionary power of bureaucrats linked to the President.

Corruption is often cited as the major institutional constraint on business. Conventionally, corruption is defined as the abuse of public office for a private gain. While this definition encompasses a wide range of practices, we will confine our work to those pertaining to grand corruption and patronage.

In Palestine, there are no cases of sale of parliamentary votes on laws to private interests. Also, there is no sale of court decisions in criminal or arbitration cases (except in the well-known story of the Palestine International Bank in which President Arafat intervened in favor of the Palestinian Monetary Authority against the bank. Later developments, however, have shown the independence of the judiciary

as the distinction court reversed the primary court's decision in favor of the bank despite the President's intervention).

Patronage, however, is a different story. It can be felt on a wide scale in the public sector ministries and institutions. The case of the Palestinian Monetary Authority was discussed many times in the PLC and should be looked at as an extreme case for patronage, and bribes are paid to public officials to avoid taxes and regulations. The good news is that the PLC succeeded in making a good case and recommended to the President to fire the Governor of the PMA in a vote of confidence session. The Governor was eventually fired and his file was transferred to the desk of the Attorney General.

Second: Institutions and policies

Related to institutions and policies, macro-dimensions are the efficiency and efficacy of government institutions and policies. There are serious cases indicating delay in delivering public services across a number of dimensions including central government, parliament, the judiciary, utilities and the police. The quality of public services, while may fairly be ranked between medium and good, yet a more desirable quality is attainable (Panorama 2005, pp. 2-5). The poor functioning of the judiciary is mainly a result of the inability to enforce compelling decisions. Police and security forces are accountable only to the executive branch of the government but not to the PLC.

Other public services need heavy investments in infrastructure, such as public healthcare, education, road construction, postal service, telephone service, and electricity and water services. The strong Israeli military presence and the fragmentation of the Palestinian economy ensued from Israeli closures and policies make reforming these sectors a complex dilemma.

Third Predictability

From the point of view of business, unpredictable changes in government policy or regulations increase risks in the business environment and produce large disincentives

for investment. One of the typical examples of unpredictable (non-prudent in fact) decisions was the decision taken by the ex-Governor of the PMA to change the check coding-system in 2002, which brought about serious fears of jeopardizing the entire banking clearing system. Banks and the Union of Chambers of Commerce exerted heavy pressure on President Arafat to nullify the decision in light of the rejection of Israeli banks and businessmen to accept checks drawn by Palestinian businessmen on their local banks. Once President Arafat realized the scandal, he nullified the Governor's decision immediately. The outcome of this incident was a growing faith that the PA must make sure that such incidents would never be repeated and should put the decision making process within its institutions on decent footings. To eliminate the unpredictability in the decision making process, it needs to be institutionalized, while the implementation of rules and regulations need to be placed under accountability and the task of appointment of state officials ought to be merit-based and transparent.

Forth: State Capture Practices (micro-dimensions)

In addition to state intervention in the economy, there is a case for influence over the state in Palestine, as firms engage in lobbying to exercise influence, particularly at the level of executives and ministries. This, in part, could be ensuing from an attempt by firms to mitigate the uncertainties caused by state policy making. The case of PSE testified this "state capture" (A form of grand corruption, which refers to private payments to public officials to influence legislation, rules, laws, or decrees) by parts of the corporate sector to shape the underlying rules of the game by "purchasing" decrees, legislation, and influence at the capital market. The Palestine Development and Investment Company (PADICO) - a listed company on the PSE - was allowed to be the PSE's major investor and was placed in charge of administering the securities market.

The PSE continues to be dominated by two listings, PADICO and PALTEL, which operate without much competition. PALTEL, although

a private company, enjoys an unregulated monopoly in the telecommunications market as neither the Palestinian Post and Telecoms nor the Finance Ministry have yet established a regulatory framework for the telecom sector. Both companies are largely owned by one Palestinian wealthy family. In fact, traders are still skeptical about the PSE being dependent on two listings, as long-term growth could be neither sustained nor called a genuine market. Breaking up monopolies of these firms would create more competition and, thus a more attractive investment environment. To be effective, this should be introduced in combination with a more complete legal and regulatory environment for business (Abusalqan, 2003, p7).

The creation of a Palestinian capital market, with a securities exchange as its center of activities, constitutes a necessary condition for the repatriation of long-term investment capital; a result on which the much talked about investment-lead hangs. Given the dispersal of the Palestinian people and the concentration of personal wealth abroad, the act of mobilizing and channeling savings to finance the productive agents in the economy becomes a similar challenge to that of attracting overseas direct investments. But because of the inability of Palestinian expatriates to actively manage or monitor their potential direct investments in Palestine (given the current situation), they would require a vehicle to facilitate a passive mode of investing. Traditionally, the one venue available for such form of investment was real estate. Approximately 85 percent of gross fixed capital formation in the West Bank and Gaza Strip went into construction. In the aftermath of the Oslo Accord, heavy investments in real estate caused land prices to spiral upward while equity investments remained below commensurate or achievable levels. An efficient, modern and well-regulated capital market offers expatriates a better vehicle for passive investing, i.e., the tradable security.

In line with this, the PLC has promulgated the Capital Market Authority (CMA) Law in October, 2002. However, the CMA is not yet established. The law shall govern the activities of the CMA and be responsible for the licensing, regulation, and supervision of all and any legal and natural

persons performing non-banking financial activities. The CMA shall be an independent and autonomous self-regulatory organization. It shall be a corporate body with full legal personality and shall enjoy full administrative and financial autonomy.

Fifth: The functioning of the legal system

The legal system in Palestine is essentially fair and impartial, honest and uncorrupt, and consistent and reliable. However, it suffers from two shortcomings. Firstly, the independence of the judiciary is not well-anchored, neither institutionally nor in real practice. A non-shari'a judiciary charged with applying secular civil and criminal law has existed in Palestine since the mid-19th century, although its modern variant dates back to the British Mandate. Reforms are required to empower the judiciary and are within the realm of the possible. Creating a strong and independent judicial branch that can check executive power will require empowering judges. Judges have been underpaid and disempowered by the PA (and under Israeli military rule as well). While a Judicial Council is supposed to oversee the judiciary, in practice those powers were usurped by the executive branch, often through fiat.

In 2002-2003, Arafat took steps to reverse the degradation of judicial independence, especially through the promulgation of the Law on Judicial Independence. This effort needs to be expanded by his successors. In structuring a Palestinian state, a firm commitment to the empowerment and independence of the judiciary is a necessary step toward the realization of the rule of law.

Secondly, the judiciary is inefficient, slow, and unable to enforce the law especially when it comes to violations of private property rights by the PA. An empowered judiciary (and concomitant enforcement of judicial decision) will also be a boon to private property rights in Palestine. The institution of private property is firmly rooted in Palestinian law, in both the West Bank and Gaza. Private property rights exist on paper and are zealously guarded by Palestinian citizens. However, respect for the rule of law concerning those property rights has not always been practiced by the PA. For

example, the PA's heavy-handed confiscation of private property to establish the Gaza airport remains a powerful symbol of distrust of the government in Gaza. The new government of Palestine must do better than the PA in protecting property rights.

5.2 Presentation of the Reforms Needed, the Potential Levers, and the Agents Subject to Mobilization

The reforms to be adopted must meet the basic needs of the Palestinian society. Our approach is constructed upon the characterization of both the present and inherited coordinates that remain in force and influence the Palestinian economy. A quick sketch to the major developments in the Palestinian economy underlie the challenges that the PA faces at present, i.e. underdeveloped economic sectors; a growing labor force, much of which is currently unemployed; poor physical infrastructure; high uncertainty induced by threats to security and political instability; constrained private sector; and, immature governing institutions.

To tackle the above-mentioned challenges, there is an urgent need to adopt and launch a reconstruction program that should be aimed at creating a legal and institutional framework in which each sector specializes in what it does best.

The public sector must specialize in producing public goods, including a support system for the private sector, and must adopt policies reducing inequality in the distribution of income between individuals, social groupings and regions (the West Bank vs. Gaza Strip, urban vs. rural, and towns and villages vs. refugee camps). It is vital to note that private wealth be built up independent of political power or position, and vice versa, otherwise rent-seeking will supplant productive activities (UNCTAD, 1996, p.88).

The PA must refrain from engagement in direct business activities or management and should confine its role to legislation, regulation, supervision and enforcement. The PA may present itself in the public utilities sector (electricity, energy, and telecommunications,

etc.) and other strategic areas (e.g. commodity procurement). In very few areas where a more active government role is desirable, (especially regarding certain physical infrastructure), its involvement should be in partnership and coordination with private sector actors as much as possible. The private sector may optimize its diverse professional and technical capacities to assume the leading role.

The PA needs to continue replacing laws that govern the economic life and business conduct in the Palestinian territories and gradually establish a unified system of laws and regulations in both regions (West Bank and Gaza Strip). Issues of concern for legal reforms include property rights; commercial transactions; operations of banks; bankruptcy and foreclosure; clear land zoning; legal framework of the transportation system; and, unlawful gains. The adoption of these laws is considered a major step towards completing measures needed to reform the business and administrative environment and will contribute to strengthening principles of rule of law, transparency, accountability, protecting public funds, and ending corruption.

The PA should do whatever possible to expand its access to capital. Significant capital would likely be made available to assist Palestine once it gains independence. Palestinians currently receive substantial financial assistance from other countries and organizations such as the World Bank. Other sources of capital include the Palestinian Diaspora and foreign direct investment through multinational corporations.

The World Bank notes that the lack of private-sector access to capital is in part the result of the absence of a supportive legal framework and regulatory institutions, as well as the uncertain political and economic environment. The West Bank and Gaza lack the legal framework and supporting institutions necessary to establish and enforce property rights. Regulatory institutions lack mechanisms such as auditing and accounting standards to assess and mitigate risk (World Bank, 1999c).

However, the continuation of the Israeli occupation places efforts to reform under severe

hardships and leaves little for Palestinians to do.

The deficiencies of the legal framework have caused banks to adopt strict lending requirements including high collateral and traditional forms of security, such as cash, personal guarantors, and real property with clearly held titles—a rarity in the West Bank and Gaza for political and historical reasons. Most business assets such as working capital, equipment, and vehicles, as well as immovable assets are unacceptable to banks as collateral because they tend to be unregistered and as such cannot be readily seized.

Also, the PA must give the capital market its utmost care and help it function in such a way so as to reach its objectives in the allocation of resources within the economy in a manner which maximizes overall economic utility. To enable the discovery of security's true economic value or the price which reflects all available information required to judge such a value, it must reinforce the confidence in the price discovery mechanism, which requires fair and open trading conditions and a degree of market transparency (Abusalqan, 2004, pp. 4-9).

To tackle the challenge of immature governing institutions, the PA needs to work with the doctrine that governing institutions determine the rules by which a country's economic activities take place. A strong system of governing institutions is needed to support business transactions. These institutions create enforceable property rights, provide businesses with transparent information on taxation and registration, and issue clearly defined rules and regulations. These elements help minimize uncertainty and limit political and economic corruption. By so doing, they help to encourage economic activity.

Poor governance hurt the poor through both economic and non-economic channels. First, they weaken the effectiveness of markets, and thus hold down economic growth, which affects the poor because growth in the overall economy tends to be accompanied by equivalent growth in the incomes of the poor. Second, growth and human development does not automatically trickle down the poor: the structures that create

poverty need to be addressed. Good governance for poverty reduction includes (i) creating accountability in the use of public funds to aid the poor, (ii) building national capacities for pro-poor policy formulation and implementation, (iii) improving private sector participation for better service delivery to the poor, and (iv) helping the poor to organize themselves.

Improving the Business Climate

Improving the transparency and accountability of governance in the Palestinian State would increase investor confidence and encourage flows of foreign capital to fund Palestinian economic development. Improving Palestinian governance involves a broad range of activities, some of which are only tangentially related to economic policy. However, among these policies, one is repeatedly cited: improving the Palestinian legal framework. Several studies note the need to strengthen the independence of the judiciary and to eliminate the arbitrary, harsh security courts. Other important measures include improving mechanisms for the resolution of commercial disputes and creating legal guarantees for the repatriation of profits and capital by foreign investors.

Low-cost, transparent procedures for registering and regulating businesses have had some remarkable successes in terms of economic development: Witness Hong Kong, Estonia, and Singapore. Such a step would signal to the international investor community that the Palestinian government seriously wishes to attract foreign investment and support the private sector.

Regardless of whether the Palestinian government simplifies all regulations or just selected, zones, regulations should have the following characteristics: They should be designed to help facilitate the movement of people to their jobs and the movement of goods between port facilities and industrial or agricultural centers. Business regulations should be simple and clear. Procedures for settling commercial disputes should be acceptable to the international financial community. Such rules would provide safeguards to foreign investors and address investor concerns about the rule of law and transparency.

Essential to achieving good governance in Palestine, authoritarian practices and corruption that characterized rule under the Palestinian Authority must not be repeated. If good governance is to be achieved in a Palestinian state, a number of issues must be addressed: the promotion of the rule of law, the empowerment of parliamentary democracy, and the promotion of meritocracy in the civil service.

Promoting the rule of law

There is no substitute for the rule of law as the cornerstone of good governance. Among other things, the rule of law enhances accountability in governance, bolsters trade and promotes economic growth, and provides citizens with the security to lead productive lives. Given the right political context, Palestine has the necessary attributes to sustain the rule of law. Its reasonably educated population; middle class sensibilities; and an increasingly distant history of civil courts, secular law, and a (relatively) independent judiciary make it feasible to create a society based on the rule of law. However, the growing political and social fragmentation in Palestine over the past four years will impede a transition to the rule of law. Two elements will be essential to the development of the rule of law in Palestine: empowering the judiciary and adopting a good constitution (RAND, 2005, p. 25).

Empowering the judiciary

Needless to say, it is vital to think that good governance in Palestine will be positively affected by the adoption of a liberal constitution as advocated by the professional legal establishment in Palestine. Also Parliamentary democracy will be enhanced by giving the legislature full budgetary authority; adopting a single district, proportional representation electoral system.

Empowering Parliamentary Democracy

The idea that a functioning democracy is essential to good governance has become orthodox. On paper, Palestine currently has a relatively democratic system—indeed, relatively free and fair elections were held in 2006.

However, three steps must be taken to enhance parliamentary democracy in the context of actual statehood: empowering the legislature, adopting a single-district proportional representation system, and strengthening the powers of the new Office of Prime Minister.

Promoting Meritocracy in the Civil Service

Good governance requires that those who make and implement policies be competent in their duties and transparent in their actions. Palestine has an abundance of highly trained and capable technocrats both inside the West Bank and Gaza and in the Diaspora. A number of these technocrats have been employed by the PA, although many more have been reluctant to serve in the PA's ministries.

Those who have served have often been ineffectual due to the overtly politicized and personalized decision-making process. By the end of 2002, 84 percent of Palestinians viewed the PA as corrupt, a number that had doubled in only six years. The corruption is grounded in the personalized nature of power and appointments, where rank in the hierarchy was trumped by ties to Arafat. A dramatic example of this was the departure of the Palestinian Minister of Agriculture, who resigned in protest because his deputy—a man close to Arafat—kept countermanding his orders without penalty.

A merit-based civil service in Palestine is essential for good governance. Creating such a service is not impossible; it has been done in many countries around the world. Indeed, Palestine does have a merit-based civil service on paper, but its full implementation has been blocked to date. A patronage-driven bureaucracy allows leaders to maintain power through the distribution of jobs and resources based on personal loyalty. Creating an atmosphere that ensures a certain level of autonomy for technocrats to carry out their duties relatively free of intrusive politicking is a necessary condition for good governance to materialize in Palestine.

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2- Secret negotiations held in Oslo between members of the PLO and of the Israeli government led to a mutual recognition in September 1993. The PLO and Israel then started a process of bilateral negotiations supposed to bring a definitive solution in the long-term to the Israeli-Palestinian conflict.

3- Independent Task Force on Strengthening Palestinian Public Institutions - Update April 2004, p.7.

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5- NDI statement on Palestinian elections, January 10, 2005.

6- Independent Task Force on Strengthening Palestinian Public Institutions, April 2004 Update, p.10.

7- Development of the Anti-Corruption Strategy of the Palestinian Authority, de Spellville and Associates, April, 2005 p.6.

8- Summary of Palestinian Reform Accomplishments, July 2005. Report issued by the Reform Coordination and Technical Support Unit of the Prime Minister's office.

9- Development of the Anti-Corruption Strategy of the Palestinian Authority, de Spellville and Associates, April, 2005.

10- The PLO is in charge of negotiations with Israel, not the PA. According to the Oslo timetable, final status negotiations were to have concluded in 1999.

11- Speech by US President Bush, June 24, 2002.

12- UNSCO

13- A prime minister's office was added in 2003 with an eye toward diminishing the power of the president and creating more of a parliamentary system rather than a presidential one. The system remains a hybrid one today.

14- in addition to 4 independent council members, who were supported by Hamas.

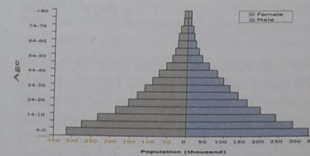
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Chapter V Labor and Human Resources Development

1. Introduction

The estimated number of Palestinians in the West Bank and Gaza Strip at the end of 2004 was 3.7 million persons. Of the total, 63% of them live in the West Bank and 37% in the Gaza Strip (MAS and PCBS 2005). Refugees constitute 42.6% of the total number, 29.4% of the West Bank's inhabitants and 65.5% of the Gaza Strip's. Palestinians living in the West Bank and Gaza Strip constitute 37.8% of the total number of Palestinians in the world (9.8 million). Palestinian society in the Palestinian territories is distinguished by its youthfulness. Its population pyramid has a broad base and a narrow peak. 46.1% of persons were less than 15 years of age in 2004, while only 3.1% were 65 years of age and above as shown in (figure 5.1) There is a clear difference between the West Bank and Gaza Strip with regard to population composition based on age. The percentage of persons who are less than 15 years of age is greater in the Gaza Strip than in the West Bank (49.2% and 44.3% respectively), while the percentage of older people (65 years and above) in the Gaza Strip is less than that in the West Bank (2.6% and 3.3% respectively).

Figure 5.1- Population Pyramid in West Bank and Gaza Strip Mid 2004 Estimates



Source: Palestine Central Bureau of Statistics, *Populations, in Palestinian Territories*, Ramallah, 2005.

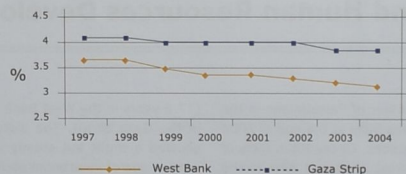
The age of half the Palestinians in the West Bank and Gaza Strip was 16.6 years or less

(17.6 years in the West Bank and 15.2 years in the Gaza Strip). The distribution of age showed a slight but steady increase in the median age of Palestinian society, rising from 16.4 to 16.6 years during the period 1997-2004. The continued youthful character of Palestinian society is due to significant natural growth rates. The average natural increase in the Palestinian territories is estimated at 3.4% (3.1% in the West Bank and 3.9% in the Gaza Strip) for 2004. PCBS estimated the average annual increase in the population of the Palestinian territories to be around 3.6% during the period 1997-2004.

The population growth tended to gradually decline in both the West Bank and Gaza Strip during the period 1997-2004. This is in conformity with the general trend of decline in the rates of total fertility (which declined from 6 children per woman of reproductive age in 1997 to 5.6 children per woman of reproductive age in 2003), and the decline in net immigration after 2000 (MAS and PCBS 2005). However, birth rates are still one of the highest in the world which will eventually lead to an increasing number of new entrants to the labor markets and exert more pressure on the labor market to create new jobs.

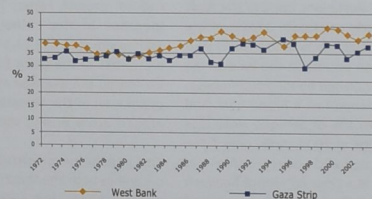
Data also revealed an increase in life expectancy. In 2004, life expectancy in the Palestinian territories was 71.4 years for males (71.6 years in the West Bank and 71.2 years in the Gaza Strip) and 72.9 years for females (73.3 years in the West Bank and 72.2 years in the Gaza Strip). The Palestinian National Authority is endeavoring to elaborate and implement population policies that take into consideration the particularities of the population problem in Palestinian society. It seeks to include this dimension in the development plans of various economic and

Figure 5.2- Average Population Growth in West Bank and Gaza Strip according to Region, 1997-2004



Source: PCBS, Population Estimates, 2005.

Figure 5.3- Labor Force Participation Rate in West Bank and Gaza Strip



Source: PCBS and Statistical Abstract of Israel.

social sectors. The aforementioned data reveal the importance of rapid elaboration of a clear national strategy in this regard, taking into consideration the continued long-term youthful character of Palestinian society and the satisfaction of Palestinian society's needs in the different areas.

2. Labor Force

The labor force participation rate (LFPR) in the Palestinian Territories increased slowly between 1972 and 2004. The LFPR rose from 39% at the end of 1995 to a maximum of approximately 43.5% by September 2000, and declined to 39.7% by the end of the first quarter of 2005. The LFPR in the West Bank and Gaza is relatively lower than that in Israel (54%) but higher than in Jordan (37.4%). The low LFPR might be partially justified by the high number of housewives (28% of the manpower), high number of students who constitute 20% of the manpower and the low participation rate of women in general. The rise in LFPR demonstrated improved confidence

in obtaining work in the formal labor market i.e., work opportunities in the Palestinian labor market generally improved during certain periods. This was in spite of obstacles imposed by the Israeli military occupation, at first strictly applied up to the end of 1997, but later relaxed until the end of September 2000 when the siege tightened. There were obvious fluctuations in Palestinian LFPR over time. In June 2002, the LFPR reached its lowest level when it dropped to 36.9%. The fluctuations appear much clearer in the Gaza Strip as presented in (Figure 5.3).

The West Bank was affected relatively less by the Israeli siege than was the Gaza Strip. The number of West Bank workers in Israel increased dramatically before 2000, particularly during periods when the siege was lax, but most of these workers were without a work permit. This was due to the nature of the borders between the West Bank and the Green Line, which are difficult for Israel to control in normal circumstances. The LFPR in the West Bank was higher than in the Gaza, mainly due

to the higher female LFPR in the West Bank (13.8% on average) as compared to 7.7% in the Gaza Strip.

The size of the Palestinian labor force increased steadily. At the end of 1995, the labor force totaled 551 thousand, rising to 858 thousand in the first quarter of 2005, representing an increase of 6.1% annually. This trend occurred in both the West Bank and in the Gaza Strip. The average monthly number of newcomers to the Palestinian labor market was about 3500 thus creating pressure on the labor market to provide new jobs. By the end of the first quarter of 2005, the West Bank accounted for 64% of the total Palestinian labor force. The Palestinian labor force is relatively well educated at the end of 2004, about 58% possessed more than 12 years of education. This ratio increases to 68% for the male labor force.

A considerable difference exists in the LFPR between males and females. The male LFPR reached 72% at the end of the first quarter of 2005 (74% in the West Bank and 68% in Gaza) where as the female LFPR reached 15% in the West Bank and 8.9% in Gaza for the same period (See figures 5.4 and 5.5). Since 1995, the female LFPR increased significantly, from its 1993 levels (6% in the West Bank and 2% in Gaza). Usually, with development, female participation rates increase but by 2005 it was 13% in Palestine as compared with 44% in Israel. The factors attributed to these figures are numerous. The weakness of domestic employment growth compared to labor force growth is one explanation. Shaban argues that the fall in female participation rates is attributed to the lack of appropriate, particularly public, employment which has limited women's chances of participating more actively in the labor force (Shaban 1993). However, some argue that employed women are unreported since many work in the informal sector or conceal their involvement in the labor force (Long and Mohanna 1990). The nature of the data collected also leads to a low reporting of women regarding their participation in the labor market. Data from the PCBS indicate higher female participation rates of 13.3% in

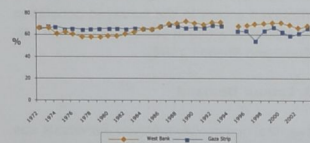
the West Bank and 9% in the Gaza Strip during May, 1996. This is due in part by improved access to the surveyed population as well as to a rise in public employment (Al-Qudsi and Shaban 1996).

3. Labour Demand

The total number of employed individuals was 586 thousand at the end of the first quarter of 2005. The private sector is the main employer accounting for about 70% of employees, followed by the public sector (20%) with the remaining (10%) employed in Israel (See figure 5.6). The relative importance of public employment is higher in Gaza (where 32% of the employed are public servants) compared to the West Bank (18% of the employed are public servants). The role of the Israeli market as an outlet for Palestinian workers has been shrinking in recent years and is expected to diminish even further since the announcement of Israeli policy that aims at closing the Israeli market completely to Palestinian workers by 2008. Sectoral employment fluctuates widely according to the severity of Israeli repressive measures, political and economic stability and the yearly fluctuations of the olives harvest that greatly affects agricultural employment. The service sector (including hotels, retail, transportation and storage) is the main economic activity in terms of employment. Its' share of employment was well above 50% in the Palestinian Territories. The sectoral distribution is relatively stable in recent years (See figures 5.7 and 5.8).

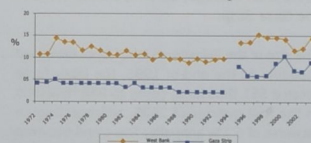
Since the 1967 occupation of the West Bank and Gaza Strip, Israel has been an important employment outlet and source of income for the Palestinians. The Israeli labor market absorbed nearly a third of the Palestine labor force from between 1975-1999. Since 1993, restrictions on Palestinian access to Israel have contributed to the rise in unemployment. The number of Palestinian workers reached its highest level of 145 thousand during the third quarter of 2000, then declined to 60 thousand during the first quarter of 2005. About 50% of Palestinians working in Israel

Figure 5.4- Male Labor Force Participation Rate in West Bank and Gaza Strip



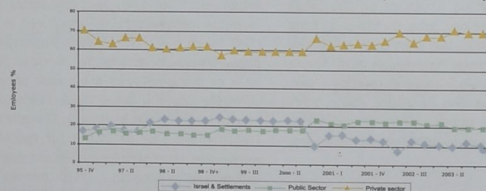
* Data is missing for 1994
Source: PCBS and Statistical Abstract of Israel.

Figure 5.5- Female Labor Force Participation Rate in West Bank and Gaza Strip



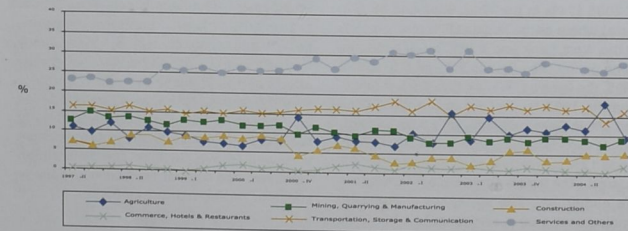
* Data is missing for 1994
Source: PCBS and Statistical Abstract of Israel.

Figure 5.6- Distribution of Employees from the West and Gaza by Bank the Employing Sector



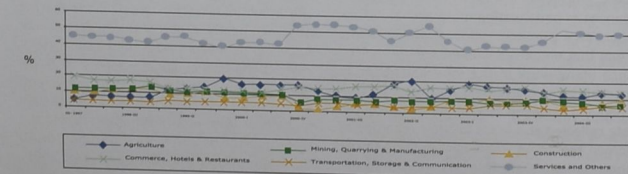
Source: based on PCBS Labor surveys

Figure 5.7- Quarterly Distribution of the Palestinians Employed in West Bank by Economic Activity



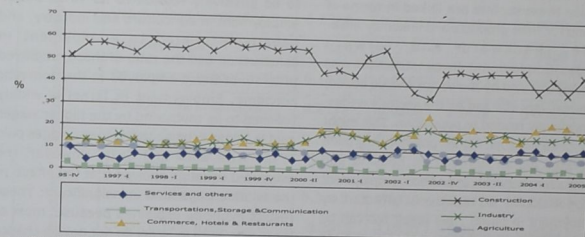
Source: Based on PCBS Labor surveys

Figure 5.8- Quarterly Distribution of the Palestinians Employed in Gaza by Economic Sector



Source: Based on PCBS Labor surveys

Figure 5.9- Quarterly Distribution of WBGS Workers Employed in Israel and Settlements by Sector (%)



Source: Based on PCBS Labor surveys

Figure 5.10- Female Percentage of total Employed



Source: Based on PCBS Labor surveys

work in the construction sector, followed by agriculture (See figure 5.9). In general, employment in the West Bank and Gaza is predominately male (84%) during the first quarter of 2005 as presented in figure 5.10. Wage employees formed about 61% of those employed, followed by 27% self-employed and being employers and unpaid family members making up the remaining 12%. The percentage of self-employed workers has increased since the third quarter 2000 because of rising unemployment forcing some people to start their own businesses. Their share increased from 18% to 26.8% by the end of the first quarter of 2005 (Table 5.1). The results of the determinants of employment of Palestinians both in Israel and in the domestic economy.

The results showed that employment in agriculture was positively affected by the sector's value added, where the elasticity of employment with respect to output was 0.19. This result is in line with the argument that

demands for labor is a derived demand from the demand for goods and services. The sector's wages negatively affected employment in agriculture as expected by the law of demand (the wage elasticity -0.13), and negatively affected by employment in industry (the elasticity -0.35). This could be justified on the basis that employment in agriculture booms when employment in other sectors slows down. Indeed agriculture acts as a shock absorber when its share in employment increases as other sectors' output declines. In addition, employment in agriculture is negatively affected by changes in the ratio of those employed in Israel in domestic employment. These result can be explained on similar grounds as were explained regarding the effects of industrial employment. Employment in services positively affected employment in agriculture as well.

As for industrial employment, the results showed a positive impact of the sector's value added, and showed a negative effect on the sector's wage and employment in construction

and services. This might be partially explained because these sectors are linked in terms of demand for their products and linked by intra-trade (backward and forward linkages). Employment in construction was positively affected by the sector's value added, and negatively affected by the sector's wages, and positively related to population. This might be justified because higher population growth generates higher demand on housing and infrastructure services. In addition, employment in construction is negatively affected by employment in Israel. This result too can be explained by the fact that most the Palestinians who work in Israel (about 44%) work in the construction sector and prefer to work in Israel (if they have the choice) due to the higher wages paid in comparison to wages paid domestically.

Employment in the services sector is found to be positively related to its value added employment in agriculture and industry, and negatively related to employment in construction and the ratio of those employed in Israel to those employed in the domestic economy. Employment in Israel is widely believed to be motivated by the higher wages paid in Israel relative to the lower wages paid in the West Bank and Gaza. However, the estimated equation showed that the effect of the relative wage level is insignificant. These results might be explained because most of those who work in Israel do not have a chance to work in the domestic Palestinian economy (push factors not pull factors), consequently they are forced to seek jobs in Israel. This conclusion is substantiated by the positive effects of the Palestinian labor supply growth

Table 5.1- Estimates of Sectoral Labor Demand*

Dependent Variable	Independent variables	Coefficient	Std. err	t-statistic	Pr.	R ²
Employment in Israel	Constant	5.8597	0.6147	9.5329	0.0000	0.877
	Palestinians wage in Israel	0.0402	0.0036	11.1591	0.0000	
	relative to average domestic wage	0.4690	0.0531	8.8329	0.0000	
	Labor supply					
	Closure days+	-0.0042	0.0002	-19.1421	0.0000	
	Government investment	-0.0646	0.0189	-3.4192	0.0007	
Employment in Agriculture	95,96 dummy+	-0.2746	0.0271	-10.1483	0.0000	0.855
	Constant	5.1046	0.7066	7.2239	0.0000	
	Value added in agriculture	0.1942	0.0361	5.3841	0.0000	
	Agriculture wage	-0.1297	0.0353	-3.6774	0.0003	
	Employment in industry	-0.3549	0.0953	-3.7252	0.0002	
	Employment in services	0.5386	0.0890	6.0553	0.0000	
	Change in employment in Israel to domestic employment ratio+	-1.1015	0.2407	-4.5753	0.0000	
	94-95 dummy+	0.2260	0.0289	7.8217	0.0000	
	Share of non-construction investment+	0.0616	0.0528	1.1665	0.2437	
	Lagged dep. Variable	0.1737	0.0608	2.8568	0.0044	

Employment in Industry	Constant	1.9985	0.1857	10.7622	0.0000	0.989
	Value added in industry	0.1368	0.0251	5.4453	0.0000	
	Industry wage	-0.0400			0.0000	
	Employment in construction	0.1838	0.0165	11.1237	0.0000	
	Employment in services	0.2177	0.0366	5.9429	0.0000	
	Lagged dep. Variable	0.3267	0.0369	42.6876	0.0000	
Employment in Construction	Constant	-7.6084	0.7657	-9.9367	0.0000	0.98
	Value added in construction	0.3951	0.0310	12.7624	0.0000	
	Construction wage	-0.2813	0.0530	-5.3095	0.0000	
	Population	1.0997	0.0687	16.0085	0.0000	
	Employment In Israel	-0.1364	0.0401	-3.3994	0.0007	
	Share of non-construction investment+	-0.3000	0.0536	-5.5943	0.0000	
	94,95,97,98 dummy+	0.4103	0.0154	26.6389	0.0000	
	Lagged dep. Variable	0.1806	0.0392	4.6093	0.0000	
Employment in Services	Constant	-0.0592	0.2103	-0.2814	0.7784	0.99
	Value added in services	0.3880	0.0162	23.8969	0.0000	
	Services wage	-0.0247	0.0162	-1.5216	0.1285	
	Employment in agriculture	0.2890	0.0151	19.0843	0.0000	
	Employment in industry	0.3886	0.0250	15.5384	0.0000	
	Employment in construction	-0.0619	0.0093	-6.6467	0.0000	
	Employment in Israel to domestic employment ratio+	-0.8097	0.0705	-11.4873	0.0000	
	Government employment	0.2464	0.0100	24.7196	0.0000	
	95 dummy+	0.1727	0.0128	13.4613	0.0000	

* All variables are in logs unless denoted by +

Source: Youssef S. Daboud, Mahmoud A.T. Elkhafifi and Basim Makhouf. Palestinian Economy, Policy Framework and Growth Prospects: A Modelling Perspective. A paper presented at the Middle East and North African Economies: Past Perspectives and Future Challenges conference organized by Econometric Modelling Network (EcoMed), at the Free University of Brussels on June 2-4, 2005.

which indicates that a higher labor supply increases the competition for the limited number of available jobs in the domestic economy causing individuals to seek jobs in Israel. Obviously, the higher number of closure days the less number of Palestinians there are who can reach their jobs in Israel. In addition, the higher investment on the part of government seems to attract more individuals

to seek jobs in the domestic economy instead of seeking jobs in Israel.

4. Unemployment⁽¹⁾

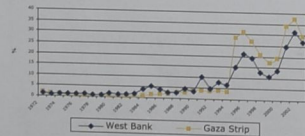
4.1 Unemployment Rate and Burden

The low absorption capacity of the Palestinian economy has caused a chronic unemployment

problem. However, the Palestinians recently realized the effects of this problem. Before the year 2000, Palestinians exported about 25% of the labor force to Israel, which absorbed about 145 thousand workers, and in addition exported labor to work in the Arab countries. These numbers diminished significantly after the two Gulf wars. Historically the unemployment rate was around 5% until 1993 then increased to 18% in 1995. This sharp increase was due mainly to the methodology used by the Israelis and the Palestinians in measuring unemployment.

The unemployment rate (according to the International Labor Organization's definition) in Palestine dropped significantly to 11% at the end of the third quarter of 2000 and jumped significantly due to the Israeli siege. The decline in unemployment was justified by three factors: the formation of the Palestinian National Authority that absorbed about 135 thousand employees, the real economic growth which reached around 9% up until 1999, and the labor exports to Israel which reached 145 thousand during the third quarter of 2000. Unemployment rates fluctuate sharply depending on the severity of the Israel repressive measures and the political and economic stability in the West Bank and Gaza as shown in (Figure 5.11).

Figure 5.11- Unemployment Rate in the West Bank and Gaza



Source: Based on PCBS and Israeli Statistical Abstract.

Historically, the unemployment rate in the Gaza Strip was higher than in the West Bank. The rate was 28% in the West Bank and 38% in Gaza at the end of the first quarter in 2005 (relaxed definition of unemployment). This might be explained by the greater severity of the Israeli siege on the Gaza Strip. In addition, the economic base in the Gaza Strip

is less developed and weaker in terms of employment absorption as compared to that of the West Bank. The burden of unemployment is not identical among the unemployed groups in terms of gender, education, age and location. Unemployment rate among females (20.2%) is lower than males (27.4%). This could be explained based on low female LFPR compared to males, and does not imply that the job opportunities for females are more than that to males; it is the other way around. In addition, unemployment rates decline with age. It was 48% for the age group 15-19 years and 17.5% for those aged 50 years or more. This is an expected result since most of the younger age individuals lack experience and are new to the labor market. Unemployment rates decline as the level of education increases. It reached 21.3% of those with thirteen years or more of education as compared to 31% for those with less than seven years of education.

Who are the unemployed? Available data from PCBS showed that the number of unemployed was 272 thousand. Of this, according to ILO standards, at the end of the first quarter of 2005, 64 thousand were discouraged workers. 62% of the unemployed live in the West Bank and the remaining live in Gaza, 87.5% of the unemployed are males (86% in the West Bank and 90% in Gaza). The largest portion of the unemployed are uneducated, 80.1% of them have less than thirteen years of education (high school or less). These results counter the widely held belief that the West Bank and Gaza suffer from unemployment of the educated. These results have serious implications for any policy that tries to remedy the problem of unemployment. Of prime concern is the possibility of exporting Palestinians workers to the Gulf countries, a solution that often is proposed to solve the unemployment problem in the Palestinian Territories.

However, the Gulf labor markets are saturated with unskilled laborers from East Asian Countries. Thus, most of the currently unemployed Palestinians have very limited competitive advantages compared to East Asian workers who generally accept a relatively low wage rate that might not be acceptable to Palestinians. Also, among the educated

unemployed, 83.1% are women. Employment of women in the Gulf countries is rare to non-existent, making it even harder to export women workers. Most of the unemployed are unskilled workers, 78% of them used to work in the construction and agriculture. Unemployment spreads more in urban areas compared to rural areas and refugee camps, 55% of the unemployed live in urban areas and 27% in rural areas and 18% in refugee camps. Forty-eight percent of unemployed workers are relatively young with limited work experience (60% in Gaza and 42% in the West Bank) which makes the exportation of this category of workers very difficult. As for the educated unemployed, the highest rate of unemployment was in the field of computer science (28.8%) during the second quarter of 2004, followed by the fields of science and engineering (21.2%).

4.2 Options to Deal with Unemployment

The Palestinian National Authority and the international community initiated many activities and projects to alleviate unemployment after 2000. The PNA has absorbed about 145 thousand workers in the public sector which reached a saturation level and evidence of disguised unemployment is apparent. In addition, the PNA has followed active labor market policies including the creation of a social safety net with a fund worth 240 million US\$ allocated in 2005. In addition, the PNA through the Ministry of Labor has activated the role of vocational training centers to provide needed training skills. Inactive labor market policies were also adopted by the PNA including tax and procedural incentives to private business, several favorable trade agreements were signed with the US, EU and many Arab Countries, as well as the issuance of a set of critical business laws such as tax, labor, investment promotion, etc. In addition, to encourage the participation of the private sector in development, the PNA privatized key sectors such as telecommunications and electricity. The donor countries and international agencies have contributed a large amount of money (about one billion US\$ a year since 2000) with efforts

to enable the Palestinian economy through the direct funding of humanitarian and development projects. Regardless of this effort, the size of the unemployment problem is beyond the capacity of the PNA to handle.

The private sector is the major pillar in any solution to the unemployment problem. However, the business environment is characterized by high risk and uncertainty, which makes the private sector reluctant in its production and investment decisions. Available evidence showed that the absorption capacity of the Palestine economy was 62% (85% in the West Bank and 52% in Gaza) in 1999, which means that only 62% of the new entrants to the labor market can be absorbed locally and the remaining will join unemployment or be exported (Makhood 2001). The most important sectors in terms of their absorption capacity are services (24.5% of the overall absorption capacity of the economy), construction (12.3%), transportation (5%), industry (4.8%), agriculture (3.8%) and retail sector (1.6%). Expectations are that the absorption capacity has deteriorated since 2000.

On average, the services sector remained the main source for new jobs before and after 2000. It provided 1476 new jobs monthly before 2000 and 1011 jobs after 2000⁽²⁾. The highest decline in the provision of new jobs was witnessed in agriculture where the job creation rate dropped by 94% (only 32 new jobs after 2000 compared to 573 before 2000), and construction (drop rate of 90%). Therefore, the private sector, to create jobs, needs many improvements in the business environment particularly in political and economic stability.

Other options include export of Palestinian workers to the Arab Gulf Countries, and indirect export of labor through exports of goods and services. Assuming that this option is politically accepted both by the PNA and the recipient countries, its expected role in alleviating unemployment is limited. This is due partially to the fact that most of these countries have their own severe unemployment problems and their markets are saturated with low wage

workers from East Asian countries. In addition, most of the unemployed Palestinians are uneducated, unskilled and women, all with limited export potentials. However, some highly skilled job vacancies are available in the Gulf countries mainly in the fields of telecommunications, IT, finance and management. Exporting workers with these type of skills might create shortages in the Palestinian economy. Therefore, the workers' export solution must be handled carefully to avoid political (migration) and economic consequences. As for the exports of goods and services, evidence showed that the price competitiveness of Palestinian products is relatively weak, compared to neighboring Arab countries (Makhool and Atyani 2004). Indeed, the PNA signed many preferential trade agreements, but benefits to Palestinian exporters were few. Several reasons are cited among which are weak competitiveness, non-tariff barriers, and lack of marketing research for potential export markets (Al-Jaffary and Lafi 2005).

5. Wages and their Determinants

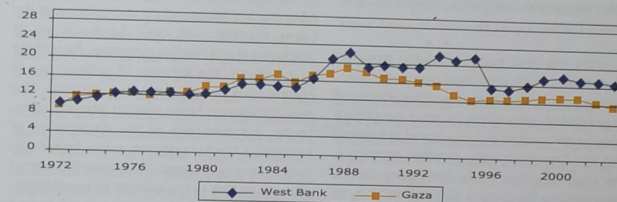
Wages represent the main income source of Palestinian households during the first quarter of 2005, where 29.8% of wages came from the private sector, followed by wages and salaries from public sector employment (20.2%) and from household projects (14.2%) (PCBS 2005). The average value of the nominal daily net wage of the employees in the West Bank decreased from 71.6 NIS in 4th quarter 2004 to 71.1 NIS in the first quarter 2005, compared with 70.3 NIS for the third quarter 2000.

The already nominal daily net wage of employees in the Gaza Strip increased from 59.4 NIS in the 4th quarter, 2004 to 59.8 NIS in the first quarter 2005, compared with 50.4 NIS in the 3rd quarter 2000. In addition, the average daily net wage for those working in Israel and the settlements decreased from 123.2 NIS in the 4th quarter 2004 to 121.8 NIS in the first quarter 2005, compared with 110.8 NIS in the third quarter 2000.

A large wage gap of 19% exists between the West Bank and the Gaza strip. The gap is expanding over time in real wages (See figure 5.12). A similar gap exists between those who work in the Palestinian Territories and Palestinians working in Israel. The gap was 71% relative to the West Bank and 103% relative to Gaza. Such differences in the wage gap between the West Bank and Gaza relative to Israel can be explained by the fact that the West Bank is relatively more open to the Israeli economy in terms of the movement of workers from the West Bank to Israel as compared to Gaza where the siege is strictly imposed. Also, the economic base in the West Bank is relatively more diversified and stronger than the economy of Gaza (PCBS, Labor Surveys, various issues). (Figures 5.13 and 5.14) show the real wage gap between the West Bank and Gaza has been narrowing over the last 10 years. In addition, wage data showed that a gender gap in wages exists in the Palestinian Territories. During 2003, wages paid to male workers were higher than those paid to female workers by 14%. Discrimination and/or productivity differences may account for this gap.

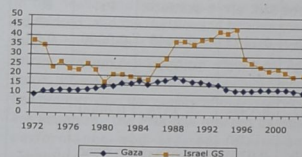
Wage gaps within the various sectors were also evident in the Palestinian Territories. The highest wages were registered in the electricity and water supply sector where the average yearly wage in 2001 was 11055 US\$, followed by transportation and communication (7953\$), with the lowest in hotels and restaurants (2823\$). However, these differences do not reflect productivity differences only. Wages were higher in the water supply sector by 290% and 104% as compared to the hotels and industrial sector respectively while productivity in the water sector was higher by 214% and 163% in the hotels and industrial sector. This is an indication that wages are more efficient in the hotels sector (efficiency is measured by wage productivity) (3.87%) followed by the industrial sector (2.14%) and the water supply sector (3.11)⁽¹⁾. Table 5.2 presents the main determinants of wages in the Palestinian economy by sector.

Figure 5.12- Average Real wage of Employees in the West Bank and in Gaza (US\$, Base year=1997)



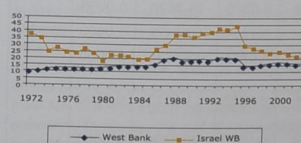
Source: Based on data from PCBS and the Statistical Abstract of Israel

Figure 5.13- Average Real wage of Employees in Gaza who Worked in Israel from Gaza (US\$, Base year=1997)



Source: Based on data from PCBS and the Statistical Abstract of Israel

Figure 5.14- Average Real wage of Employees in West Bank and who Worked in Israel from the West Bank (US\$, Base year=1997)



Source: Based on data from PCBS and the Statistical Abstract of Israel

It was found that wages in agriculture were positively affected by the level of wages paid to Palestinian who work Israel. This result is in line with the argument that the Israeli labor market has distorted wages in the Palestinian economy up to a point where higher wages are not reflected in higher productivity, which in turn hurts the competitiveness of the Palestinian economy at the aggregate and

sectoral level (Makhool and Atyani 2004). In addition, wages in agriculture were negatively affected by the unemployment rate which confirms the classical argument that markets react by lowering wages in response to unemployment.

Similarly, wages in industry are affected positively by the level of wages paid to Palestinians who worked in Israel, and negatively affected by the unemployment rate. The same conclusion can be drawn about the determinants of wages in the construction sector regarding the level of wages paid to Palestinians who work in Israel. In addition, it was found that productivity positively affected wages in construction. As for wages in the services sector they also were positively affected by labor productivity, wages paid to Palestinians who work in Israel, and government consumption and negatively affected by unemployment.

6. Labor Market Institutions

Labor markets are regulated by a set of laws; the labor law that regulates work in the private sector (including NGOs) and the civil servants law which regulates public sector employment. The labor law is widely criticized by the private sector because it overemphasizes the rights of employees relative to employers' rights. For example, female workers get 70 days paid maternity leave along with other rights. Employers argue that the law will increase their production costs and jeopardize their

competitiveness. Indeed some private businesses avoid employing females because of such rights.

Recently the PNA began applying the civil servant law, which presented many obstacles. For example, many who were either employed or promoted were done so on a subjective basis which resulted in some losses of financial and non-financial rights. Another obstacle is the need to secure the necessary funds, estimated to be around 200 million US\$, to cover additional rights granted to public servants under the provisions of the law.

Regarding labor market institutions, the PNA formed the Ministry of Labor in 1994 to handle labor market issues including regulation of the labor market and the formulation of employment and training strategies. Regardless of its efforts, the Ministry of Labor's role is considered weak and far behind the expectations of labor market stakeholders. Under the umbrella of the Federation of Palestinian Workers Unions, many Palestinian unions have been established covering almost all sectors. Due to the political circumstances, most (if not all) of these unions are involved in political activities at the expense of

performing basic duties for their members which are defending workers' rights and improving working conditions. Public sector wages are determined by the civil servant law scale that is based mainly on level of education, skills, and scarcity. Some of the public institutions have developed their own wage scale, which is another source of the obstacles facing the implementation of the civil servant law. Wages in the private sector are subject to market conditions (supply and demand), where most of the contracts are individually negotiated. The PNA does not interfere in wage setting in the private sector.

Public employment practices lack transparency. Most of the jobs (with few exceptions mainly in the health and education sectors) are not advertised, and the decisions to hire are made largely on the basis of personal connections, family relations, and political affiliations. As a result, the evidence of disguised unemployment, low productivity, low quality of public services are apparent. The PNA has realized its weak performance and started reform and rehabilitation measures to improve the performance of the public sector (Malhis 1998). Vocational training in the West Bank and Gaza is provided by 13 public centers along with private training centers, NGOs and the UNRWA. Vocational training suffers from many difficulties, including the absence of a national strategy that connects their training courses with labor market needs and lack of funds and other resources (Makhool, Al-Botmeh, and Atyani 2001). In addition, about 26 employment offices belong to the Ministry of Labor, whose main function is to match job seekers with job providers. In reality, the role of these offices is relatively minor. The Ministry has begun a program to computerize these offices, connect them, and encourage job seekers and providers to ask for their services.

The Ministry of Labor along with many donor countries and agencies implemented a set of temporary schemes to generate employment. Indeed the PNA has allocated 240 million US\$ for the Social Safety Fund, in an effort to alleviate unemployment and poverty. However, the effect of these employment generation

schemes were neither sustainable nor effective in alleviating the unemployment problem (World Bank 2000, Al-Botmeh 1996).

7. Child Labor

Child Labor exists in the West Bank and Gaza as in other developing countries. PCBS data showed that, at the end of March 2004, there were about 40 thousand children working in the Palestinian Territory, representing 3.1% of all children aged 5-17 years (3.8% in the West Bank, 1.9% in the Gaza Strip) (PCBS, Child Labour Survey, 2004). The majority of child laborers are ages 15-17 years (See figure 5.15). The share of child labor increased with age. The highest percentage of working children was in rural areas, 4.6% compared to 2.6% in urban and 1.8% in refugee camps. The highest percentage of working children was registered in the West Bank governorate of Jericho (13.2%), followed by the Salbit district (10.4%). In the Gaza Strip, the Gaza governorate registered the highest percentage (2.8%), followed by Rafah (2.2%), while the lowest percentage was registered in Deir al-Balah and Khanyunis governorates (1.0% each). Male children were more likely to work than female children (5.3% and 0.7% respectively). In addition, the majority of child laborers are among children under the age of 15 years (18,024 children), of whom 24.3% are not attending school (26.2% for males, 7.9% for females).

Most of the child laborers are involved in agricultural activities, with about 46% working in the agricultural sector (73.1% for females, 42.5% for males), 29% working in trade,

Figure 5.15- Distribution of Working Children by Age (5-17).

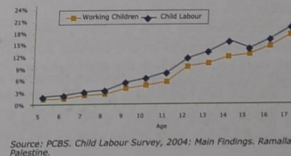


Table 5.2- Estimates of Wage Determinants

Dependent Variable	Independent variables	Coefficient	Std. err	t-statistic	Pr.	R ²
Wage in Agriculture	Constant	1.2728	0.1293	9.8446	0.0000	0.67
	Wage; Palestinian employment in Israel	0.4053	0.0370	10.9526	0.0000	
	Domestic unemployment rate+	-0.6937	0.1324	-5.2375	0.0000	
	AR(1)	0.5858	0.0365	16.0531	0.0000	
Wage in Industry	Constant	1.5750	0.1548	10.1774	0.0000	0.859
	Wage; Palestinian employment in Israel	0.3320	0.0395	8.4031	0.0000	
	Domestic unemployment rate+	-0.2292	0.0955	-2.4005	0.0166	
	AR(1)	0.8098	0.0330	24.5136	0.0000	
Wage in Construction	Constant	1.1981	0.1104	10.8479	0.0000	0.836
	Wage; Palestinian employment in Israel	0.3360	0.0241	13.9536	0.0000	
	Labor productivity in construction	0.0666	0.0059	11.2123	0.0000	
	AR(1)	0.7632	0.0373	20.4494	0.0000	
Wage in Services	Constant	-1.4791	0.8541	-1.7318	0.0837	0.686
	Unemployment rate+	-0.2220	0.1804	-1.2309	0.2187	
	Labor productivity in services	0.3034	0.0630	4.8179	0.0000	
	Government consumption	0.1272	0.0586	2.1693	0.0303	
	Wage; Palestinian employment in Israel	0.2006	0.0467	4.2956	0.0000	
	AR(1)	0.6928	0.0554	12.5002	0.0000	

* All variables are in logs unless denoted by +
Source: Daoud, Elkhaiir and Makhool 2005.

restaurants and hotels (30.8% for working males, 16.2% for working females), and 14% working in manufacturing. The percentage of working children in the construction sector reached 7% (6.2% in the West Bank and 8.0% in the Gaza Strip). About two thirds (67.4%) of working children work as unpaid family members (71.8% in the West Bank and 53.3% in the Gaza Strip), distributed as 87.8% of working females and 64.6% of males. At the same time, 28.1% work as wage employees for others (8.7% of working females and 30.7% of males). 98.0% of working children aged 5-9 years work as unpaid family members. Additionally, 37.6% of children not attending school, work as unpaid family members compared to 82.1% of those attending school.

As for the working conditions for children, half of the children who attend school work less than 15 hours per week (55.6%) and 29.7% work 15-34 hours per week, while more than two thirds of children not attending school work more than 34 hours per week (71.2%). The average number of work hours per week reached 25.6 hours (14.4 hours for the 5-9 age group, 33.8 weekly hours for the 15-17 age group). In the Gaza Strip children work more hours on average (28.2 hours per week as compared to 24.8 hours per week in the West Bank). The results showed that females work less hours on a weekly basis than do males or 16.6 hours for females compared to 26.8 hours for males. The majority of working children (87.0%) work during the day (before sunset) compared to 1.3% who work during the night, while 11.7% work during both. The survey indicated that 4.5% of children aged 5-9 years work during the day and night in the West Bank compared to 7.8% in the Gaza Strip. 10.5% of children aged 10-14 years in the West Bank work during the day and night, compared to 6.9% in the Gaza Strip. Also, children work in relatively risky conditions and data has shown that 7.6% of working children were prone to injury or chronic diseases during their work hours (7.5% in the West Bank and 8.3% in the Gaza Strip).

As for the work benefits, 9.3% of wage employee children receive paid holidays (7.6%

in them West Bank, 12.4% in the Gaza Strip), 15.0% receive paid sick leaves, 10.3% have health insurance and 16.3% of wage employee children receive frequent bonuses (12.2% in the West Bank, 23.6% in the Gaza Strip). In addition, 54.2% receive breaks during their workday (57.2% in the West Bank, 49.0% in the Gaza Strip). Seventy-one percent of children work due to economic need, 51.4% work to assist in a household project, 19.6% work to increase household income (75.2% in the West Bank, 56.6% in the Gaza Strip). Twenty-four percent of households stated that living standards would decline without the wages of the children, while 52.9% stated that the economic situation would not be affected.

8. Poverty and the Labor Markets

Poverty in the West Bank and Gaza is usually measured according to two poverty lines based on the actual spending patterns of Palestinian families. The first poverty line, termed "deep (absolute) poverty line," is calculated to reflect a budget for food, clothing and housing. The second line, termed "relative poverty line" adds other necessities including health care, education, transportation, personal care, and housekeeping supplies. The two lines are adjusted to reflect the different consumption needs of families based on their composition (household size and the number of children). Given the day-to-day developments in the Palestinian political situation, both consumption and income data were used to analyze poverty rates which showed a variation in the standards of living due to the variation of income, remittances, loans and social aids that households depend on.

The World Bank estimated the poverty rate to range from 38 to 51 percent in 2003 (World Bank 2004). The PCBS estimated the proportion of households below the poverty line ranging from between 61 and 72 percent. The latest available poverty data from the PCBS for 2004 shows a significant drop in the poverty level. However, poverty levels continued to be high, and the average income per family remained lower than it was before the Intifada. The absence of economic and political stability

continues to cast its shadow on Palestinian family consumption, their priorities and their adjustment mechanisms to conditions caused by Israeli repressive measures. The relative poverty line and the absolute poverty line for a six-member household in the Palestinian Territory in 2004 stood at US\$ 433 and US\$ 363 respectively (PCBS, January-December 2004). About 16.4% of the households in the Palestinian Territory, (about 2 of 10 households) were suffering from deep poverty in 2004, according to monthly expenditure, compared with 44.4 percent when monthly income was used. The rate of total dispersal of poverty among Palestinian households in the Palestinian Territory was 25.6 percent in 2004, when monthly consumption data was considered, and rose to 53.7 percent when monthly income data was considered.

However, poverty levels remain very high compared to what they were before 2000 when only 20% of Palestinian families lived under the poverty line in 1998. In addition, consumption data showed that 25.6 percent of households are below the poverty line even when including the value of the emergency assistance they consumed. When this emergency assistance is factored out, the poverty rates increased to 28.7 percent (assuming other factors remain unchanged in the absence of emergency assistance). On the other hand, the emergency assistance has served to reduce deep poverty rates from 19.4 percent to 16.4 percent (PCBS, January-December 2004). In addition, the data indicates that the leakage rate or those who receive emergency assistance but do not need it, is 47.9 percent. The under-coverage rate of needy households who do not receive emergency assistance is 47.2 percent; while 37.3 percent of total assistance went to the non-needy, which means that the total assistance value covers 81.1 % of the resources required to bring them up to poverty line.

Several factors are strongly related to poverty: the poor tend to have larger families and relatively low levels of education which strongly relates to unemployment and sporadic employment; refugees and those in femalehead

of household families are not significantly more likely to be poorer than others (World Bank 2004). In addition, the burden of poverty is relatively higher in Gaza, than in the West Bank. This finding is confirmed by the poverty gap measure as poverty increases consistently if one moves from the north to the south. There are significant differences in poverty within Gaza as well (PCBS, January-December 2004).

As for basic household needs, about 47.0 percent of households reported the need for food as their top priority, while 12.8 percent of households reported the need for money, and 12.3 percent of households expressed the need for education as their first priority, and 11.5 percent of households expressed the need for work as their first priority (PCBS, January-December 2004). Because of the economic hardship, Palestinian households took various coping measures depending on the monthly family income. Eighty-one percent of Palestinian families stated that they depended on the family's monthly income to carry on in 2004.

As a means to decrease family expenses, two thirds of families (67%) resorted to deferring payment of bills, 60% to decreasing spending on basic needs, nearly half (52%) borrowed from other members of the family, 27% sold their jewellery, 19% used their savings, 21% obtained help from family or friends, and 17% resorted to planting the land and breeding animals. A smaller percentage of Palestinian families obtained loans, directed one of its student members to work, or sold or mortgaged their land or house. Some sold their household furniture. Adjustment measures taken by Palestinian families indicated that their ability to continue depending on these mechanisms has been negatively affected. This will have immediate negative and long-term effects on quality of family consumption, resulting in the spending of savings, consumption of economic assets, and falling into debt. This is especially true of families classified as poor or weak.

In the same context, a large percentage of Palestinian families (15%) stated that they are in a difficult economic situation and do not know how to assure their basic needs for the

next twelve months. More than one quarter of Palestinian families (27%) stated that they can endure for less than four months. Only 22.2% of families stated that they are able to endure for more than 12 months. It is noted that the situation of families in the Gaza Strip is relatively better than for those in the West Bank. Nearly one third of families in the Gaza Strip (33%) stated that they are able to endure more than 12 months, while only 17% of families in the West Bank are able to do the same. That may be because a higher percentage of families in the Gaza Strip are employed in the public sector, which assures, at least for now, a stable income (PCBS, January-December 2004).

Due to these hardships, a large portion of the population live in poor conditions. About 69.8% of individuals (18 years old) were dissatisfied with their household living conditions in general, and 22.2% expected that their households' living condition will worsen during the next twelve months. 28.6% were not satisfied with the quantity of food consumed by the household members, compared with 37.5% who were satisfied with the quality of food consumed. Seventy-three point two percent were not satisfied with their current living conditions compared to last year, 35.5% of individuals were not satisfied about their ability to get a job, and 66.6% were not satisfied about the amount of salary earned by employed household members (PCBS, January-December 2004).

9. Impact of Israeli Measures on the Palestinian Labor Market

The Israeli restrictions on the mobility of individuals, goods, and services to and from within the West Bank and Gaza has resulted in a drastic decline in the performance of the labor market in terms of employment. About 145 thousand lost their jobs just six months after the Intifada. About 70% of the unemployed used to work in Israel, 34% of them from Gaza and the remaining from the West Bank (PCBS 2001). The unemployment rate jumped from about 10% during the third quarter of 2000 to about 31% in the first quarter of 2005. About 77% of those

unemployed reported that they lost their jobs due to their inability to pass the dangerous roads to reach their place of work. Another 51% reported that they lost their jobs because, when forced to use alternate routes, the length of time it took them to reach their place of employment was too long. Another 46% reported that they lost their jobs due to the high level of risk that existed in their place of employment.

The weight of the restrictive measures imposed on Palestinians by Israel varies among the working groups and economic activities. At the end of March 2001, wage employees had suffered the most, with 87% of them reporting loss of jobs as compared to 8% of those who were self employed. In addition, those employed by the construction sector suffered more than those employed in other sectors. For example, 59% of the unemployed, before the Israeli imposed restrictions, had held jobs in the construction sector. (36% in the West Bank, 44% in Gaza and 69% in Israel), 15% in the industrial sector, and 8% in the agriculture sector during the same period.

As for the distribution of employment by sector, the construction sector lost the most in terms of its employment share. It dropped from 22% during the third quarter of 2000 to about 13% at the end of the first quarter of 2005, while the share of the industrial sector dropped from 15% to 12% during the same period. The gain went mainly to the service sector whose share increased from 28% to 36% over the same period. In addition, major changes were witnessed in the structure of employment status. The share of self-employed increased from 18% to 27% over the same period, and the share of wage employees dropped from 68% to 61%. This is an indication of the difficulties of finding jobs in the West Bank and Gaza which is causing individuals to move toward self-employment activities.

In addition to the above changes, since the third quarter of 2000, Palestinians are working less hours and getting lower wages. The average work week dropped from 45 hours to 41.6 during the first quarter of 2005.

However, this decline is not an indication of improved economic conditions for workers, as the median daily wages has dropped from 70 NIS at the end of third quarter to 57.7 during the first quarter of 2005, and the average number of working days per month increased from 22.8 days to 23.6 during the same period. In addition, the economic dependency ratio increased in the Palestinian Territory from 4.8 in the third quarter, 2000 to 6.3 in the first quarter 2005 (the change rate is 31.3%). It increased in the West Bank from 4.3 to 5.6 (the change rate is 30.2%) and increased in the Gaza Strip from 5.9 to 8.2 (the change rate is 39.0%). The ratio in the West Bank reached 5.3 compared to 8.3 in the Gaza Strip in the fourth quarter, 2004. In addition, the percentage of employees whose monthly wages fell below the poverty line increased from 43.5% in the third quarter, 2000 to 58.8% in the first quarter 2005 (the change rate is 35.2%).

10. Labor Market Projections

A recent effort to develop a model for the Palestinian economy including the labor market was conducted by Palestine Economic Policy

Research Institute-MAS, UNCTAD and the ILO. The model was published by MAS and a modified version was presented at the EcoMOD conference in 2005 (Daoud, Elkhafif and Makhool 2005). A base line scenario that evaluated the impact of a number of proposed economic policies for Palestine against a benchmark forecast (baseline scenario) was conducted on the following basis: 1) movement towards some sort of a settlement between the PNA and Israel in 2005-06; 2) high level of international financial aid; 3) better mobility of goods similar to the 1994-2000 experience; 4) restriction on labor mobility is similar to the period 2000-2003 to reflect the Israeli permit policy; 5) trade and fiscal arrangements between the PNA and Israel and the rest of the world will return to those which prevailed between 1994 and September 2000. The results of this scenario showed that unemployment rates will decline from the present level of almost 28% to reach a bottom level of 15.4% in 2010, then climb up again to top almost 17% by the end of the forecasted period. Domestic employment will increase to 800 thousand in 2010. (Figure 5.16) presents the results of the baseline scenario.

Figure 5.16- Baseline forecast 2004-2015

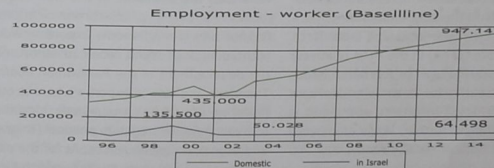
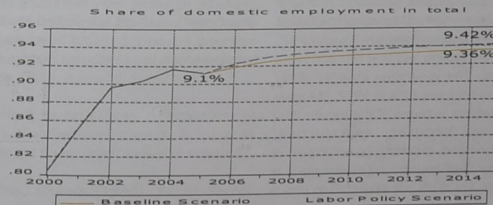


Figure 5.17- Labor policy scenario, 2004-2015



A labor policy scenario was estimated based on the assumption that PNA will tax the wages of Palestinians working in Israel to promote domestic employment through sectoral employment generation schemes and financed from the revenue of this tax. Specifically, the scenario assumes a 28% tax on wage earnings of those Palestinians employed in Israel in 2006, increasing it to 38% in 2012, bringing the net (after tax) wages earned by those employed in Israel close to the average domestic wage. Thus, 30%, 30% and 40% of the tax revenue will be allocated to generate sectoral domestic employment in agriculture, industrial and the services sectors, respectively. Construction employment is assumed to benefit indirectly from the increased employment in the other three sectors. (Figure 5.17) provides a snapshot of the impact of the labor scenario. The 2015 unemployment rate will drop from 17.4% in the base line to 10.7% in the labor scenario.

11. Summary and Recommendations

The Palestinian society in the Palestinian Territories (PT) has the distinguishment of being very youthful. 46.1% of the population were less than 15 years of age in 2004, which will eventually lead to an increasing number of new entrants to the labor market and more pressure to create new jobs. The labor force participation rate (LFPR) in the PT is relatively low but slowly increasing. The role of the Israeli market as an outlet for Palestinian workers has been shrinking in recent years and is expected to diminish further. Wage employees formed about 61% of those employed.

The burden of unemployment is not identical among the unemployed groups in terms of gender, education, age and location. The largest portion of the unemployed are uneducated, 80.1% of them having less than thirteen years of education. The absorption capacity of the Palestine economy was 62% in 1999. The most important sectors in terms of their absorption capacity are services, construction, transportation and industry. Direct export of labor to the Gulf countries (assuming it is politically accepted) is not expected to play a

major role in alleviating the unemployment problem. There were about 40 thousand working children in the PT at the end of March 2004, representing 3.1% of all children aged 5-17 years. Most of the child laborers are involved in agricultural activities, trade, restaurants and hotels. Two-thirds of working children work as unpaid family members. Unemployment is one of the main challenges facing the PNA.

The PNA and the international community initiated many activities and projects to alleviate unemployment after 2000. Regardless of this effort, the size of the unemployment problem is beyond the capacity of the PNA to handle. The private sector is the main pillar for alleviating unemployment. Therefore, much needs to be done to improve the business environment especially in the areas of political and economic stability, upgrading the efficiency and reforms of the public sector services, and in the legal system.

Other options to alleviate the unemployment problem include the exportation of Palestinian workers to the Arab Gulf countries, and the indirect export of labor through exportation of goods and services. Some highly skilled job vacancies are available in the Gulf countries mainly in the fields of telecommunications, IT, finance and management. Exporting workers with such skills could result in shortages in the development of the Palestinian economy. Therefore, the idea to export workers to outside Palestine should be carefully considered so as to avoid possible negative political (migration) and economic consequences. As for the exports of goods and services, much needs to be done to improve the competitiveness of Palestinian products, including more marketing research of potential e markets, elimination of non-tariff barriers, capacity building in packaging of services and human resource management.

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Notes

- 1) All unemployment figures mentioned in this section are based on the labor surveys conducted by PCBS unless otherwise as stated.
- 2) Compiled by the author based on the labor surveys published by PCBS.
- 3) Wage productivity is measured by dividing average productivity per paid employee by average wages per paid employee.

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