

*A World Bank
Publication*

OVERVIEW

I

*An Investment
in Peace*



DEVELOPING
THE OCCUPIED
TERRITORIES

12360 Vol.1
Sept. 1993



DEVELOPING THE OCCUPIED TERRITORIES

AN INVESTMENT IN PEACE

Volume I: Overview

**The World Bank
Washington, D.C.**

September 1993

Copyright © 1993
The International Bank for Reconstruction
and Development/THE WORLD BANK
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

All rights reserved
Manufactured in the United States of America
First printing September 1993
Third printing October 1994

The six-volume series, *Developing the Occupied Territories: An Investment in Peace*, is published to communicate the results of the Bank's work to the development community with the least possible delay. The typescript of this paper therefore has not been prepared in accordance with the procedures appropriate to formal printed texts, and the World Bank accepts no responsibility for errors. Some sources cited in this paper may be informal documents that are not readily available.

This paper has been prepared by staff of the World Bank and should not be attributed in any manner to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence of their use. The boundaries, colors, denominations, and other information shown on any map in this volume do not imply on the part of the World Bank Group any judgment on the legal status of any territory or the endorsement or acceptance of such boundaries.

The material in this publication is copyrighted. Requests for permission to reproduce portions of it should be sent to the Office of the Publisher at the address shown in the copyright notice above. The World Bank encourages dissemination of its work and will normally give permission promptly and, when the reproduction is for noncommercial purposes, without asking a fee. Permission to copy portions for classroom use is granted through the Copyright Clearance Center, Suite 910, 222 Rosewood Drive, Danvers, Massachusetts 01923, U.S.A.

The complete backlist of publications from the World Bank is shown in the annual *Index of Publications*, which contains an alphabetical title list (with full ordering information) and indexes of subjects, authors, and countries and regions. The latest edition is available free of charge from the Distribution Unit, Office of the Publisher, The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A., or from Publications, The World Bank, 66, avenue d'Iéna, 75116 Paris, France.

ISBN 0-8213-2688-0
ISBN 0-8213-2694-5 (6-vol. set)

Contents

| | |
|--|-----------|
| Foreword | v |
| Currency Equivalents and Glossary of Abbreviations | vi |
| Preface | vii |
| The Occupied Territories—A Brief Profile | viii |
| I. Introduction | 1 |
| The Context | 1 |
| A Synopsis | 2 |
| II. Past Developments and Current Constraints | 4 |
| Overall Economic Trends | 4 |
| Structural Imbalances and Distortions | 5 |
| Labor Markets | 5 |
| Production Structure | 6 |
| Trade | 8 |
| Public Infrastructure and Services | 9 |
| III. Prospects and a Strategy for the Future | 12 |
| Future Prospects | 12 |
| Elements of A Strategy for Economic Development | 13 |
| Some Scenarios for the Future | 15 |
| IV. Policy and Institutional Imperatives | 17 |
| Legal and Regulatory Framework | 17 |
| Management of Public Finances | 17 |
| Management of Public Infrastructure | 19 |
| Financial Sector Development | 19 |
| Management of Natural Resources | 19 |
| Provision of Social Services | 20 |
| Local Government and Public Administration | 20 |
| Phasing the Policy and Institutional Agenda | 22 |
| V. Investment and Technical Assistance Needs | 23 |
| Investment Needs | 24 |
| Technical Assistance Needs | 24 |
| Next Steps | 25 |

Notes 26

Boxes

- 1.1 The Issue of Jerusalem 2
- 1.2 Population Data on the Occupied Territories 3
- 2.1 Occupied Territories—Key Socioeconomic Indicators 5
- 2.2 Income Levels in the Occupied Territories —A Comparative Perspective 6
- 2.3 Differences between the West Bank and Gaza 7
- 2.4 Occupied Territories—Selected Comparative Data (1991) 8
- 2.5 Israeli Settlements in the West Bank and Gaza 10

Tables

- 4.1 Phasing of Institutional and Policy Reforms 21
- 5.1 Public Sector Investment Needs in the OT 24
- 5.2 Technical Assistance Needs in the OT 25

Map IBRD 24884R

Foreword

The whole world welcomed the historic accord signed by Israel and the Palestinian Liberation Organization on September 13, 1993. Peace, at last, now promises to provide the foundation for sustainable development in the Middle East.

As this report indicates, the World Bank has been working for some time to help prepare the analysis, and an action plan, that can begin to address the difficult challenges that face the region, particularly in the Gaza Strip and West Bank. The Occupied Territories are rich in human resources, but they need to build the infrastructure and the institutions

of a modern economy to provide employment and raise living standards.

It will not be an easy task. Many uncertainties remain. Hard work, perseverance, and a truly joint effort by the international community are the keys to long-term success.

The World Bank stands ready—with our experience, advice and financial resources—to work with all our partners to ensure that the potential created by peace will be fulfilled.

Lewis T. Preston

Currency Equivalents (As of January 1, 1993)

Currency units in use = New Israeli Sheqalim (NIS) and Jordanian Dinar (JD)

NIS 1.00 = US\$0.361

US\$1.00 = NIS 2.764

JD 1.00 = US\$1.453

US\$1.00 = JD 0.688

Fiscal Year

(January 1 to December 31)

Glossary of Abbreviations

| | |
|--------------|---|
| CA | Civil Administration |
| EC | The European Community |
| GDP | Gross Domestic Product |
| GFCF | Gross Fixed Capital Formation |
| GNP | Gross National Product |
| JD | Jordanian Dinar |
| NGO | Non-Governmental Organization |
| NIS | New Israeli Sheqalim |
| OECD | Organization for Economic Cooperation and Development |
| OT | Occupied Territories (West Bank and Gaza Strip) |
| UNRWA | United Nations Relief and Works Agency |
| VAT | Value Added Tax |
| WHO | World Health Organization |

Preface

At the request of the sponsors and organizers of the Middle East Peace Talks, the World Bank has been supporting the work of the Multilateral Working Group on Economic Development by providing analyses of the key economic issues and developmental challenges facing the Middle East region. At its second meeting in Paris in October 1992, the Working Group requested the Bank to expand its contribution to include, *inter alia*, an assessment of the development needs and prospects of the economies of the West Bank and the Gaza Strip (commonly referred to as the Occupied Territories). In response to this request, a Bank mission visited the Occupied Territories during the period January 21–February 24, 1993. The mission comprised five teams focusing on the following areas: Agriculture, Human Resources, Infrastructure, Macroeconomics and Private Sector Development. Each team was in the field for about two weeks. The mission was led by Prem Garg who, together with Samir El-Khoury, stayed in the field throughout to provide continuity and guidance to the five teams. The staffing of the five teams was as follows:

Macroeconomics:

Michael Walton (Team Leader)
Samir El-Khoury (Fiscal Analyst)
Ishac Diwan (Macroeconomist)

Private Sector Development:

Albert Martinez (Team Leader)
Robert Mertz (Financial Sector Specialist)
Joseph Saba (Legal Specialist)
Dileep Hurry¹ (Regulatory Environment
and Tourism Specialist)

Agriculture:

Gert van Santen (Team Leader)
Ulrich Kuffner (Water Resource Engineer)
Merle Jensen¹ (Horticulture Specialist)

Infrastructure:

Alastair McKechnie (Team Leader)
Ulrich Kuffner (Water Resource Engineer)
Lawrence Hannah (Urban Specialist)
Nail Cengiz Yucel (Transport Sector Specialist)
Ted Moore¹ (Power Engineer)

Human Resources:

Fredrick Golladay (Team Leader)
Maureen Field¹ (Education Specialist)
Radwan Ali Shaban¹ (Human Resource Economist)

Mission members travelled extensively in the West Bank and Gaza, visiting municipalities, farms, businesses, industries, academic institutions, refugee camps and NGO-run facilities. Mission members also travelled in Israel, as needed, and paid several visits to Amman. The representatives of the key bilateral and multilateral donors in Jerusalem, Tel Aviv and Amman responsible for the Occupied Territories were kept briefed about the work of the mission. Close contact was also maintained with the field staff of UN agencies.

The Bank mission was received warmly by all sides, who took keen interest in the work of the mission and provided superb logistical and counterpart support for the field work. The main counterparts on the Israeli side were the Bank of Israel and the Civil Administration in charge of the Occupied Territories. On the Palestinian side, the main counterparts were the Technical Committees of the Palestinian Team to the Peace Conference, consisting mainly of Palestinians who are members of the bilateral or multilateral peace teams. The Ministry of Planning was the main contact on the Jordanian side. The Bank would like to thank all concerned parties, especially the Israeli, Jordanian and Palestinian hosts, for the excellent support and cooperation that the Bank mission received for this field work.

This report is based on the findings of the above mission. Besides the mission members, the following also contributed significantly to the preparation of the report: Ahmed El-Hamri (Macroeconomic Database), Rita Hilton (Local Government and Solid Waste), Suhail J.S. Jme'An (Infrastructure), Srish Kumar (Agriculture), Anat Levy (Labor Markets), Raed Safadi (Trade), Maurice Schiff (Trade Policy) and Marc Stephens (Macroeconomic Analysis). Jo Bischoff helped with the editing of the report, and the secretarial assistance was provided by N. Perez, F. Willie, B. Williams, D. Judkins, T. North, I. Sevilla, C. Parsons, N. Cherbaka and B. Lundquist.

At various stages of its work, the mission benefited greatly from comments and advice from many Bank staff, including Shawki Barghouti, Sue Berryman, Vinay Bhargava, Yousef Choucair, Gershon Feder, David Ferreira, Mike Garn, John Hayward, Magdi Iskander, Sarshan Khan, Odin Knudsen, Pierre Landel-Mills, Ira Lieberman, Slobodan Mitric, Herbert Morais, Ngozi Okonjo-Iweala, Toni Pellegrini, Klaus Schmidt-Hebbel, K. Sheorey, Vinod Thomas, William Tyler, and Arvil van Adams and Chris Ward. The mission would also like to thank Caio Koch-Weser, Ram Chopra,

Harinder Kohli, Anil Sood, Lyn Squire and Abdallah Bouhabib for their guidance, advice and encouragement.

An earlier draft of this report was discussed with the Israeli, Jordanian and Palestinian authorities by a Bank mission to the region during July 12–26, 1993. Where appropriate, the report has been revised to incorporate the comments received by the mission during the July discussions.

Funding for this work was provided as grants by the European Community, Sweden and the US; their financial support is gratefully acknowledged.

The Occupied Territories—A Brief Profile

The Occupied Territories (OT) consist of the West Bank and the Gaza Strip. Together with what are now Israel and Jordan, the OT were among the areas ruled by the Ottoman Empire prior to 1917. Towards the end of World War I, Britain gained control of Palestine, and in 1922, the areas were entrusted to Britain by a mandate of the League of Nations.

Escalating strife and unsuccessful British attempts to mediate between Jewish and Palestinian nationalisms caused Britain to return its mandate to the UN in 1947. The UN suggested Palestinian and Jewish independence on a partition basis. The Palestinians and Arabs rejected the suggestion, and the State of Israel was proclaimed in 1948. In the aftermath of the ensuing military conflict, the Gaza Strip came under Egyptian control, and the West Bank became part of Jordan. During the 1967 Arab-Israeli war, the West Bank and Gaza were occupied by Israel. Since then, Israel has administered the areas as the occupying power, except that Eastern Jerusalem has been formally annexed by Israel and is considered part of Israel by the Israeli authorities. Israel's annexation of East Jerusalem has not been recognized by the United Nations.

The West Bank and Gaza have a combined area of about 6,000 sq kms; a 1991 population of about 1.7 million; a GNP of about US\$2.9 billion; and a GNP per capita of US\$1,715. The population of East Jerusalem is about 300,000, including about 150,000 Jews settled there since 1967. In addition, there are about 135,000 Israeli settlers residing in some 150 settlements that have been built in the OT over the past 25 years.

It is estimated that currently about 3.5 million Palestinians live outside of the OT. Some have maintained residency rights in the OT and are, in principle, free to return, while the return of others will be subject to negotiation between Israel and the Palestinians. How many Palestinians might actually return would also depend upon their perceptions of future economic opportunities in the OT.

The economy of the OT is mainly service-oriented with agriculture accounting for about 30 percent of GDP

in 1991, industry about 8 percent, construction about 12 percent and services the remaining 50 percent. Private sector activity dominates the economy of the OT, accounting for about 85 percent of GDP. A striking feature of the OT economy is its heavy dependence on the Israeli economy. Until the recent border closure with Israel, about one third of the OT labor force worked in Israel (mostly on a daily commute basis), and earnings from these workers accounted for more than one quarter of the GNP of the OT. Over 90 percent of the OT trade is also with Israel. Remittances from Palestinians working in the Gulf countries have been another important component of the disposable OT income.

All powers of government concerning the OT are currently vested in the two Area Commanders (one each for the West Bank and Gaza) appointed by the Israeli authorities. The Civil Administration (CA), working on behalf of the Area Commanders, is responsible for administering all economic matters including, *inter alia*, granting licenses and permits, regulating trade, collecting taxes, organizing public infrastructure and services and supervising the operations of local governments. Currently, the CA has about 22,000 employees, of which approximately 95 percent are Palestinians. Most policy-making and senior administrative positions in the CA are, however, staffed by Israelis.

Local-level governments in the OT consist of 29 municipalities and 96 village councils. In addition, there are 27 refugee camps run by the United Nations Relief and Works Agency (UNRWA). Generally, local governments are responsible for operating power, water, solid waste and local road services within their jurisdictions; the CA, on the other hand, has direct responsibility for delivering education, health and inter-city road services. The provision of services in the refugee camps is mostly the responsibility of UNRWA.

Except in the case of three municipalities (Bethlehem, Tulkarm and Bir Zeit) where mayors elected in 1976 are still in place, all local government bodies are run by Israeli-appointed officials.

I. Introduction

The Context

The economy of the Occupied Territories (OT) is currently in turmoil. Income levels have stagnated over the past decade; unemployment and underemployment are rising rapidly; public infrastructure and social services are grossly overstretched; and the fragile natural resource base is threatened with irreversible damage. Above all, the economy remains highly vulnerable to external developments, as shown vividly by the economic hardship being experienced in the aftermath of the recent border closure with Israel. The resulting sense of despair and dependency, juxtaposed against high expectations derived from exposure to Israeli living standards within the OT and in Israel, is clearly a major impediment to achieving peace and stability in the region. While Israelis and Palestinians disagree, and disagree often passionately, on many issues concerning the future of the OT, they agree on one issue: the urgent need for stimulating economic development in the OT. Building upon this shared objective, this study aims to assess prospects for sustainable development in the OT, as well as outline a priority agenda of policy reforms, institutional development and investments needed to promote such growth.

It is worth highlighting two limitations of this study right at the outset. First, a number of key issues bearing upon the future development of the OT (e.g., the allocation of land and water resources, the disposition of Israeli settlements in the OT, the future status of expatriate Palestinians, the territorial issues surrounding Jerusalem and, most importantly, the nature of the proposed "self-governing" arrangements for the OT) are the subject of ongoing bilateral negotiations between the Israelis and the Palestinians. The resolution of these issues is likely to be based primarily on political and security considerations. As the Bank mission to the OT was a *technical mission*, with neither the mandate nor the expertise to deal with political or security aspects, this study does not take any position on issues that are on the agenda for bilateral negotiations. The focus instead is on policies, institutions and investments—where optimal choices are largely invariant to the eventual political arrangements that may emerge from the bilateral

negotiations. Thus, for example, while analysing, where appropriate, the economic links between East Jerusalem and the West Bank and Gaza, the report avoids making any judgements regarding the future status of East Jerusalem.

Second, the study has had to cope with very serious *data gaps and inconsistencies*. Much of the data on the OT are, directly or indirectly, from official Israeli sources. There are, however, serious gaps in the OT data base. A population census has not been carried out in the OT for more than 25 years. As a result, most of the demographic and labor force data are based on extrapolations and on sample surveys, the reliability of which are undermined by problems of non-response, especially since the onset of the *Intifada* (popular uprising) in 1987. Data on East Jerusalem and on Israeli settlements in the OT, both of which are treated as part of Israel by the official Israeli sources, are mostly unavailable. Data available on trade between the OT and Israel and on the profitability and competitiveness of the agricultural, industrial and service enterprises are also very limited. Data on the OT from Palestinian and Israeli nonofficial sources are sparse and selective. Also, Palestinian data, when they exist, are often based on *ad hoc* surveys that do not lend themselves easily to cross-sectional or longitudinal comparisons. In many instances, data differ between sources, and, even when the same source is used, there are gaps and apparent inconsistencies. Given these data problems, the report uses estimates that appear most plausible in light of the mission's field observations. In cases where the data differences among various sources are particularly sharp (e.g., population, unemployment and social indicators), the report attempts, where possible, to examine the reasons for these differences and to indicate the implications of alternative estimates for the results of the analysis.

In view of the limitations on the mission mandate, the data difficulties and the time and resource constraints, this study can only be considered a beginning. The analysis in the study, especially for the longer term, is necessarily incomplete; as, and when, progress is made in the bilateral negotiations, the study will need to be updated and expanded to take account of the agreements reached. Also, notwith-

Box 1.1 The Issue of Jerusalem

The city of Jerusalem has occupied a central place in the history of three great religions—Judaism, Christianity and Islam. It has also played a major role in shaping the economic, social and political lives of the Middle East Region for over three thousand years. Therefore, an important aspect of the current conflict in the Region centers on the control of Jerusalem.

The 1948 war led to partition of Jerusalem into the Eastern and Western parts. At the end of the 1967 War, East Jerusalem was occupied by Israeli forces. Following the occupation, the Jerusalem city limits were expanded by Israel to include some surrounding areas from the West Bank. The expanded city was annexed by Israel on July 30, 1980. Arab residents of Jerusalem have been given the option of obtaining Israeli citizenship although very few have chosen to do so. Israel views Jerusalem as its historic capital and maintains that Jerusalem must never again be a divided city.

Actions taken by Israel were considered invalid by the United Nations, which called upon Israel to refrain from taking any action that would alter the status of Jerusalem. Although the international community has not recognized the Israeli annexation of East Jerusalem, Israel continues to exercise authority over the area and considers it an integral part of Israel and not subject to further negotiations. The Palestinians insist that East Jerusalem is part of the West Bank as per the pre-1967 borders and that Israel should withdraw from all areas occupied during the 1967 war as per the United Nations resolutions.

There are important economic links between the West Bank and Gaza Strip and Jerusalem. Decisions concerning Jerusalem would, therefore, have important implications for future economic prospects and priorities for the OT. The following are among the most important of these links:

- The tourist potential of the West Bank is critically dependent on the ancient religious sites of Jerusalem.
- Major north-south transportation links in the West Bank pass through Jerusalem.
- The only tertiary care hospital and some of the best secondary care hospitals available to the West Bank population are located in East Jerusalem.
- East Jerusalem houses much of the Palestinian financial services, marketing facilities, and social and cultural infrastructure.
- Qalandia airport, a potential outlet for linking the West Bank with regional airports, is within annexed Jerusalem.
- Parts of East Jerusalem are an integral part of the power network covering the area from Ramallah to Bethlehem.

Considering that the question of Jerusalem is essentially a political matter, this report should not be construed as taking any position on this issue. Therefore, while analyzing the links where appropriate, this report has endeavored to avoid making any recommendations that might imply prejudging the status of Jerusalem.

standing the care exercised in locating and interpreting the data from various sources, the empirical underpinnings of this study leave something to be desired, and, therefore, the conclusions of the study should be treated only as indicative of broad trends and priorities. Further, in-depth studies and project feasibility work will be required before the findings of this report could be used to make operational decisions.

A Synopsis

The report is in six volumes; this synthesis volume is complemented by five other volumes detailing the analysis and recommendations of the five teams dealing, respectively, with macroeconomic issues, private sector development, agriculture, infrastructure and human resources. A brief synopsis of the six volumes follows.

- **Volume I** provides a summary *overview* of the key findings and recommendations of the

study. After commenting selectively on the current socioeconomic situation in the OT and its evolution over time, it discusses prospects for sustainable development in the future and outlines the priority agenda of policies and programs needed to promote such development.

- **Volume II** explores the strategic choices at the *macro* level that will be faced by the OT in the future and their implications for economic relations between the OT and the rest of the region. The study looks at the current economic situation and its evolution over the past 25 years. The study then examines several policy choices for the future affecting the structure of development in the OT. Finally, it outlines some illustrative scenarios for the future, focussing on the consequences of current developments in the region.
- **Volume III** reviews the performance of the *private sector* (including, in particular, the industry and tourism sectors) in the OT. It assesses the environment in which the private sector oper-

Box 1.2 Population Data on the Occupied Territories

The only comprehensive data set on the population of the OT is from the Israeli Central Bureau of Statistics (CBS). According to the CBS, the population of the West Bank (excluding East Jerusalem) totalled 1.0 million at the end of 1991 and that of Gaza, 0.68 million, for a combined total of 1.68 million. The estimates are based on a census conducted in September 1967 and updated annually by adding reported births, subtracting estimated deaths and adjusting for the number of net migrants.

Several attempts to verify the population figures, mostly by Palestinian but also by some Israeli researchers, have concluded that the CBS figures underestimate the population of the West Bank and the Gaza Strip by anywhere from 10 to 15 percent. One possible reason advanced for the underestimation is that the base figure from the 1967 census might be flawed; the census, conducted only three months after the occupation, was conducted under a military curfew using Israeli enumerators. Another possible reason cited for the underestimation is that both births and infant deaths are underreported. While the CBS corrects for the under-

reporting of infant deaths, it does not carry out a similar correction for the underreporting of births.

The CBS argues that the 1967 Census achieved exceptionally high coverage because the curfew that was in force confined people to their homes. It further argues that the registration of births since 1967 is likely to be very nearly complete because birth registration is required to exercise one's rights and to obtain social benefits. Accordingly, the CBS believes that the official data represents the best estimate of the OT population.

To the extent that the CBS figures may underestimate the size of the population, the per capita economic and social indicators for the OT derived from the CBS estimates would need to be interpreted with care. The possible error in the population size would also have a bearing on the social and physical infrastructural needs for the future. The continuing controversy on this issue underlines the urgent need for improving the statistical data base for the OT. In particular, organizing a new population census should be accorded high priority by the authorities.

ates and makes recommendations for accelerating private sector development in the future.

- **Volume IV** reviews the evolution and structure of the *agricultural* sector in the OT; analyzes its current characteristics; assesses OT competitiveness in the immediate and longer term; outlines the main policy options and their implications; and provides a preliminary assessment of sectoral financial and technical assistance (TA) needs.
- **Volume V** assesses the current situation in the *infrastructure* sectors (electricity, water supply and sanitation, transport, housing and solid waste services) in the OT; identifies the major

issues confronting these sectors; and outlines priorities for TA and investment needs. As local authorities are major institutions in the delivery of public services in these sectors, the study also includes a review of their current situation and makes recommendations for improving the functioning of municipalities.

- **Volume VI** reviews the current status as regards *human resource* development; analyzes options for enhancing individual welfare and labor productivity in the OT; and outlines investment and TA priorities for strengthening existing programs and for laying the foundation for later reforms.

II. Past Developments and Current Constraints

At the risk of some oversimplification, the economic performance of the OT over the past 25 years can be characterized as *rapid growth, but with serious imbalances*. Specifically, while the current per capita income levels in the OT are about thrice the level that prevailed in the early years of the occupation, this growth has been highly uneven over time and has been accompanied by the emergence of major distortions in labor markets, in sectoral production structure, in the structure of trade and in the balance between public and private consumption.

Overall Economic Trends

The economy of the OT grew rapidly between 1968 and 1980 (average annual increase of 7% and 9 percent in real per capita GDP and GNP, respectively), triggered by a number of factors, including the rapid integration with Israel and the regional economic boom. In the early years of the occupation, there was a sharp expansion in the employment of unskilled Palestinian labor in Israel and a rise in incomes, which in turn spurred domestic economic activity, especially in the construction sector. Earnings of Palestinian workers in Israel rose from negligible levels in 1968 to almost one quarter of GNP in 1975. The increased monetization of the economy following the occupation could have also contributed to the reported growth in the early years.

The rapid growth in the economy of the OT continued even after economic growth in Israel slowed in the mid-1970s following the first oil crisis, as skilled Palestinians from the OT increasingly found employment in the Gulf. As oil prices increased, so did the remittances of Palestinian workers and transfers from oil-rich Arab countries, offsetting weaker opportunities in oil-dependent Israel. Since unskilled labor played a central role in the growth, the poor shared in this growth, and as a result, in all likelihood, there was a significant reduction in poverty in this period. Household conditions also improved substantially, with a several-fold rise in the possession of consumer durables and significant increases in access to municipal water and electricity connections. Life expectancy increased by a decade, and there was significant progress in reducing infant

mortality. School enrollments also rose during this time. These advances mirrored substantial improvements in income levels and in living conditions all through the region during the 1970s.

Growth started slowing down with the end of the regional boom in the early 1980s, and decline set in after 1987. Between 1980/81 and 1986/87, real GNP per capita increased by 12 percent, and the real GDP per capita increased by only 5 percent. Export growth also stagnated during that period. The situation was exacerbated after 1987 with the *Intifada*, which caused disruptions in economic relations with Israel. Periodic OT closures and strikes adversely affected employment and trading activity. Exports fell sharply after 1987 and never fully recovered. In 1991, merchandise exports were estimated at US\$248 million, compared with US\$395 million in 1987. The impact of these adverse shocks was further amplified by a tightening up of the regulatory regime bearing on private sector activities, including restrictions on the movement of goods and people, prolonged delays in the granting of business licenses and permits and stringent tax administration measures. A subordination of OT economic interests to those of Israel may have also played a role in this respect. As a result, the per capita income levels hardly increased during the 1980s²—a major turnaround from the exceptionally rapid growth of the 1970s.

The OT was effectively closed for several weeks in 1991 during the Gulf war, causing large income losses. There was also a large decline in the number of hours worked; in 1991, the number of hours worked in Israel was about 75 percent of the 1987 level. In the aftermath of the Gulf war, many Palestinians also lost employment in the Gulf countries, leading to a significant decline in remittances from abroad; in turn, the reduced purchasing power adversely affected domestic economic activities. There was a substantial rebound of economic activity in 1992, fueled partly by expectations of peace, and partly due to relaxation of some of the regulatory constraints. However, a sharp downturn is expected in 1993 mainly as a result of the (partial) closure of Israel to the OT economy in March.

With income levels stagnating or declining in many parts of the world, the 1980s were indeed a

Box 2.1 Occupied Territories—Key Socioeconomic Indicators

| | 1970 | 1980 | 1987 | 1991 |
|--|-------|-------|-------|-------|
| Population (000) | 980 | 1,181 | 1,434 | 1,682 |
| GNP per capita (1991 US\$) | 780 | 1,700 | 1,880 | 1,715 |
| GDP per capita (1991 US\$) | 670 | 1,310 | 1,280 | 1,275 |
| Wage income from Israel (% of GNP) | 12 | 24 | 28 | 24 |
| Share of industry (% of GDP) | 5 | 7 | 9 | 8 |
| Exports (% of GNP) | 22 | 23 | 15 | 9 |
| Imports (% of GNP) | 47 | 46 | 43 | 40 |
| Employment (000s) in OT | 160 | 141 | 169 | 190 |
| Employment (000s) in Israel | 21 | 75 | 109 | 97 |
| Primary enrollment (000s) | 179 | 259 | 295 | 321 |
| Secondary enrollment (000s) | 26 | 53 | 56 | 70 |
| Hospital beds (per 1,000 pop.) | — | 1.9 | 1.6 | 1.4 |
| Birth rate (per 1,000 pop.) | 42 | 48 | 48 | 51 |
| Daily per capita calorie consumption | 2,300 | 2,650 | 2,750 | 2,800 |
| Life expectancy (years) | 56 | 61 | 65 | 66 |
| Infant mortality (per 1,000 live births) | 95 | 65 | 50 | 42 |
| Households with electricity (%) | 30 | 66 | 75 | 85 |
| Households with safe water (%) | 15 | 47 | 67 | 90 |
| Households with refrigerators (%) | 11 | 57 | 71 | 85 |
| Households with washing machines (%) | — | 23 | 38 | 61 |
| Households with automobiles (%) | 2 | — | — | 16 |

Sources: Statistical Abstracts of Israel, Central Bureau of Statistics, various issues. Mission estimates.

difficult period for the world economy as a whole. Clearly, some of the economic difficulties experienced in the OT during the 1980s were simply a manifestation of the general malaise that affected the world economy and the economy of the Middle East region in particular. They also reflect, however, serious structural problems in the OT economy, which have emerged over time and which, if left unattended, will seriously handicap the future economic prospects of the OT.

Structural Imbalances and Distortions

The structural imbalances of the OT economy are manifested in several areas: (i) heavy dependence on outside sources of employment for the OT labor force; (ii) an unusually low degree of industrialization; (iii) a trade structure heavily dominated by trading links with Israel and with a large trade deficit; and (iv) inadequacies in the provision of public infrastructure and services.

Labor Markets

In the aftermath of the 1967 war, some 300,000 Palestinians migrated out, mostly to Jordan. Significant

emigration also continued afterwards (at an average rate of 1 percent per annum). Nevertheless, the Palestinian labor force in the OT more than doubled over the past quarter century. In contrast, the domestic employment opportunities grew by less than 25 percent. Instead, Palestinian employment grew mostly in two areas: unskilled work in Israel and higher-skill services throughout the world, but particularly in the Gulf countries. Prior to the 1967 war, the West Bank and Gaza had no economic relations with Israel. That changed rapidly after the occupation, and the number of Palestinians working in Israel rose to 75,000 in 1980 and to 109,000 by 1987; these workers accounted for 35 percent of the employed population in the West Bank and 45 percent in Gaza. This source of growth accounted for essentially the entire growth in the labor force until the *Intifada*. Employment was overwhelmingly in unskilled and semi-skilled work; construction employed the most workers; and wages were around the Israeli minimum wage. Only 2 percent of the Palestinians working in Israel were engaged in professional, technical and clerical occupations.

The pattern of employment of Palestinians in the Gulf states was quite different. The highest demand in the Gulf states was for skilled Palestinian labor;

Box 2.2 Income Levels in the Occupied Territories—A Comparative Perspective

On the basis of the official statistics, the OT had a GNP per capita of US\$1,715 in 1991. This GNP is similar to that of Tunisia (US\$1,500) and Turkey (US\$1,780) and substantially ahead of Jordan (US\$1,050), Morocco (US\$1,030) and Egypt (US\$610). However, this probably overstates the relative position of the OT, possibly by a substantial margin, for two reasons. First, some adjustment would be necessary to the extent that official estimates of the population may be underestimated. More important in quantitative terms, comparisons at official exchange rates often fail to reflect relative incomes in terms of real purchasing power because of differences in the prices of goods and services across countries. In general, the poorer the country, the cheaper the average price level is since non-tradeable factors of production are paid less (e.g., wages and land rents are lower) and, consequently, the non-traded goods are cheaper. The International Comparisons Project attempts to adjust for this by directly comparing the prices of goods in different countries. In terms of "international" purchasing power (using prices in the United

States as a base), the GNP per capita for Morocco is estimated at US\$3,300; for Tunisia it is US\$4,700; for Turkey, US\$4,800; and for Egypt, US\$3,600. There is no direct data for Jordan, though on the basis of adjustments made in other countries, its GNP per capita would also be expected to be increased by three to four times. The OT, for which there is also no direct information, will be affected by the high degree of openness to Israeli prices: the ICP estimate for Israel's GNP per capita in "international" purchasing power terms is only 10 percent more than the figure at official exchange rates. The adjustment for the OT will be higher than this since wages and land rents are lower than in Israel, but it is probable that it will be substantially less than that for the other lower-middle income economies in the region. Accordingly, the OT income levels could well be below those in Jordan, Morocco and Tunisia and not above them, as the estimates at official exchange rates indicate. In the absence of firm statistical underpinning, this conclusion remains, of course, highly conjectural.

and the wages earned there were substantially higher than those in the West Bank and Gaza. It is estimated that about 40,000 Palestinians from the OT went to work in the Gulf states during the 1973–1982 period. With the decline in oil prices and the regional recession, demand dropped considerably after 1982, and there was probably very little net outflow of labor to the Gulf during the rest of the decade. This is reflected in the relative price of skilled labor in the OT over time: the premium to a university education appears to have vanished by the end of the 1980s.

Direct contribution to GNP from wage income from abroad, mainly in Israel, rose from negligible levels at the start of the occupation to about US\$350 million in 1980 and to about US\$675 million in 1987, before stabilizing around that level in nominal terms. Although reliable data are lacking, remittances from long-term Palestinian workers in Gulf countries, and elsewhere, have also constituted an important source of disposable income. Adding the indirect economic stimulus provided by this large resource infusion, it is clear that external labor markets have played an important role in the economic growth of the OT over the past 25 years.

The future prospects for these labor markets, however, do not look promising; most Gulf demand for Palestinian labor has dried up in the wake of the Gulf war. The deteriorating security situation, and the increasing restrictions on the movement of people since the onset of the *Intifada* in 1987, are threatening the continuing access to the Israeli labor market. The

Israeli labor demand would have fallen sharply in any case after the current construction boom fades in Israel. Prospects in nontraditional labor markets in Europe and other Arab countries also do not appear good. Meanwhile, given the rapid population growth of the past, and the unusually low current labor force participation rate (especially for women), the labor force is set to double before 2010, even without considering the return of any Palestinian expatriates to the OT in the wake of a peace agreement.

Production Structure

Related to the heavy dependence on outside employment is the lack of dynamism in domestic economic activities in the OT, particularly in the industrial and service sectors. At less than 8 percent of the GDP, the share of industrial production in the OT is much below that in other economies with similar income levels. Mauritius, for example, like the OT, is a small, open economy with a significant agriculture sector and about the same income level; the share of industry in GNP in Mauritius is, however, three times as high as in the OT. The tourism sector, potentially a flagship industry in the OT, has also remained stunted with stagnation, or even actual decline, in supporting infrastructure such as hotels, travel agencies and tourist guides.

Small, underdeveloped enterprises dominate the production and service sectors. While individual and

firm-level entrepreneurial initiative and innovation are abundantly evident in the OT, this has not resulted in strong sectoral performance. Instead, the economy remains predominantly based on small cottage industries and sole proprietorships. In the industrial sector, only 5 percent of enterprises employ more than 20 persons, with almost two thirds employing fewer than 4 staff. The normal consolidation and rationalization of the industrial sector has not occurred, impeding the realization of economies of scale. The combination of the small size of the enterprises, the undeveloped state of marketing services and the lack of infrastructure and distribution systems constrains producers to sell directly to customers within a small geographical area (often a single town or village). This decreases competition, severely impedes the efficiency of factor utilization and militates against integrated markets. The lack of clear zoning regulations and public land use policy have acted to distort urban/industrial land prices, becoming a barrier to industrial expansion. Finally, business support services and institutions, both public and private, have yet to develop to a stage where they can cater to the needs of a dynamic private sector. These include, *inter alia*, information services to promote the diffusion of technology and the more efficient functioning of markets; training facilities for skill upgrading; and accounting and auditing services to meet the needs of larger business operations.

Investment by the private sector in productive assets has remained extremely low. While total gross fixed capital formation (GFCF) averaged a robust 27 percent of GDP during the period 1968 to 1991, construction (mainly in housing) accounted for more than 80 percent of GFCF. Investment in industry has often not even kept pace with the depreciation of

capital stock. The low investment level reflects a combination of factors, including political uncertainty, tenuous property rights, entry barriers, a restrictive regulatory and taxation environment and the lack of a supportive financial system. Formal financial intermediation remains at an exceptionally low level. There is no institutional capacity for mobilizing and allocating medium- to long-term funds. Private sector investments are, therefore, limited to individual savings and internal cash generation. A perceived lack of effective recourse against arbitrary actions by the OT administration has also discouraged entrepreneurial activity. Following the relaxation of some of the regulatory and administrative impediments over the past couple of years, there have been some signs of increased investment activity in recent months. However, lacking a fundamental change in perceptions about the business environment which appears possible only in the context of a peace agreement, the private sector response to these reform measures is likely to remain half-hearted and fragile.

The growth potential of the agricultural sector, rather modest in any case, has remained constrained by a stagnating or shrinking land and water resource base and by asymmetric trade relations with Israel which limits OT agricultural exports to Israel, where they are generally quite competitive. Renewable groundwater resources in the West Bank and Gaza, shared between Israel and the OT, are now fully exploited. However, annual use by the Palestinians has remained capped at the pre-1967 level. Current restrictions on access to water, including administrative limitations on surface water harvesting and the high costs of water caused by difficulties in renewing inefficient and worn-out wells, have meant the stag-

Box 2.3 Differences between the West Bank and Gaza

As many of the structural problems and strategic choices affecting the West Bank and Gaza are quite similar, to avoid repetition and unnecessary detail, much of the discussion in this report treats the two territories together. There are, however, notable differences that must be kept in mind:

- The population density in Gaza (1,870 persons per sq km) is almost 10 times that of the West Bank.
- GNP per capita in Gaza amounted to US\$1,230 in 1991, compared to US\$2,000 in the West Bank.
- Investment per capita in Gaza is less than half of that in the West Bank, and the physical infrastructure is much worse in Gaza than in the West Bank.

- The water demand/supply balance is much more precarious in Gaza than in the West Bank.
- Refugees make up over two thirds of the population of Gaza, compared to about 40 percent for the West Bank.
- Dependence on the Israeli market for employment is significantly higher for Gaza than for the West Bank; about 39 percent of the Gaza labor force in 1991 was employed in Israel, compared with 31 percent for the West Bank.

The report attempts to address, as much as possible, the problems arising from the differences between the West Bank and Gaza, especially in relation to investment needs.

nation of the irrigated area under Palestinian cultivation. In selected areas, notably in parts of Gaza, increasing salinity levels caused by excessive extraction have virtually halted agricultural production. Loss of access to traditional grazing lands in the West Bank, due to security considerations and the increase in nature reserves, has affected animal husbandry operations, forcing pastoralists to keep their flocks in confined areas. Security-related restrictions (recently relaxed) affecting the fishing areas in which Gaza fishermen were allowed to operate limited fish production to a fraction of the pre-1967 levels.

Trade

The two most striking developments in OT trade during the past 25 years are: a major redirection of trade towards Israel and the emergence of a large trade deficit. From no trading relations before the occupation, Israel has become practically the sole trading partner of the OT. The share of Jordan in total OT trade declined drastically over this period: exports to Jordan as a share of total OT exports declined from 45 percent in 1968 to 15 percent in 1991. Exports to Jordan are constrained by regulatory and security restrictions imposed by Israel, as well as by require-

ments regarding proof of origin and seasonal quotas on agricultural products imposed by Jordan, especially since the mid-1980s. However, Jordan does not impose any customs duties on goods imported from the OT. Furthermore, as a result of the security restrictions imposed by Israel, the OT can import virtually nothing from Jordan, even though in a number of cases (agricultural inputs, construction materials and households durables) Jordanian products could be highly competitive in the OT.

The Arab boycott of Israel as it relates to the OT, as well as various impediments to trade with the rest of the world, have also acted to distort the overall pattern of trade. A preliminary analysis of trading patterns based on the size of the economies, the geographical proximity and cultural similarities suggests that, in the absence of the above restrictions, Israel's share in OT trade would have been much lower; and Egypt, Jordan and the Gulf and OECD countries would have been significant trading partners. The disproportionate dependence on Israel for trading relations is in part linked to relatively better treatment received by the OT industry when subcontracting for Israeli firms, rather than directly exporting to non-Israeli markets. On the import side, the heavy dependence on Israel sometimes leads to inef-

Box 2.4 Occupied Territories—Selected Comparative Data (1991)

| | <i>Occupied territories</i> | <i>Middle East and North Africa^a</i> | <i>Jordan</i> |
|--|-----------------------------|---|---------------|
| GNP per capita (US\$) | 1,715 | 1,940 | 1,050 |
| GDP per capita (US\$) | 1,275 | ... | 1,130 |
| Gross enrollment ratios | | | |
| Primary (% school age pop.) | 102 | 97 | 94 |
| Secondary (% school age pop.) | 80 | 60 | 65 |
| Pupil-teacher ratio (primary schools) | 30 | 26 | 17 |
| Repeater rate: primary (% of total enrollment) | 7 ^b | 11 | 5 |
| Illiteracy (% of pop. age 15+) | 40 | 45 | 20 |
| Persons per physician | 847 | 1,668 | 767 |
| Persons per hospital bed | 658 | 635 | 519 |
| Age dependency ratio ^c | 1.08 | 0.87 | 0.92 |
| Total fertility rate (births per woman) | 7.3 | 5.3 | 5.3 |
| Infant mortality (per 1,000 live births) | 42 | 60 | 29 |
| Life expectancy (years) | 66 | 64 | 69 |
| Households with safe water (%) | 90 | 83 | 96 |
| Urban water supply (liters per capita) | 60 | ... | 137 |
| Households with electricity (%) | 85 | ... | 98 |
| Electricity consumption (kwh/capita) | 680 | ... | 1,130 |
| Telephone subscribers (per '000 pop.) | 22 | ... | 67 |

^a Includes 18 countries extending from Algeria to Iran.

^b Data for UNRWA schools only.

^c Defined as the ratio of dependent pop. (under 15 and over 64) to the working age pop. (15–64).

efficient sourcing of inputs for the OT enterprises, undermining their overall competitiveness.

The above trade patterns were accompanied by a sizeable OT trade deficit, which reached US\$675 million in 1987, or 28 percent of GNP. The trade deficit was mainly with Israel while the OT enjoyed a trade surplus with Jordan. Although the trade deficit has been largely offset by incomes of Palestinian laborers in Israel, the resulting dependence on a single market makes the OT economy highly vulnerable to shocks, especially because labor flows are subject to political developments in the region. A collapse in labor income from Israel, as happened recently, would lead to a sharp decline in imports and have a depressive effect on domestic economic activity.

Public Infrastructure and Services

In contrast to impressive gains in private incomes and consumption, the provision of public services and physical infrastructure in the OT is highly inadequate. Although the coverage of services, particularly in the major urban areas, is fairly high, the quality of services often leaves much to be desired. The average urban water supply, for example, is only about 60 liters per capita per day (compared to 115 for Tunisia, 137 for Jordan and 230 for Egypt); a consequence of limited access to water resources and inadequate investment. Water actually consumed is much less due to deficient distribution systems with high losses (40–60 percent) in most municipalities. The inadequate supplies force many water departments to rotate water supplies to parts of their networks. The intermittent supply leads to the contamination of water from the intrusion of polluted water into the networks.

Due to supply constraints and network deficiencies, current electricity consumption of about 680 kwh/capita/year is also low compared to Egypt (815) and Jordan (1,055). Some 138 Palestinian villages have no electricity supply or only a part-time supply from isolated diesels. Suppressed peak demand is estimated at 30–50 percent. Load shedding and power interruptions are a frequent occurrence. Regulatory constraints on network expansion and on supplies from the Israeli system have forced many industrial users to resort to expensive captive supplies. Distribution losses are high at 20 percent, reflecting the need for major rehabilitation and upgrading. Because of these problems, and due to inadequate consumer tariffs and overdue accounts, all electric utilities in the OT are in poor financial condition.

Solid waste collection and disposal is grossly inadequate, raising serious health and environmental concerns. There are no modern sanitary landfills in

the OT. Refuse, if and when collected, is simply dumped outside municipal boundaries and often burned to reduce volume, leading to air pollution. Most of the municipalities do not have a satisfactory wastewater collection or treatment system. Generally, wastewater is discharged into seasonal streams or *wadis*. Where wastewater treatment plants exist, they appear to be poorly designed and operated. The poor management of wastewater is contributing to the contamination of groundwater, particularly in Gaza.

While the length of road networks per capita is typical of a country with similar per capita GDP, the physical condition of the roads serving the Palestinian population has deteriorated to the point where, without immediate rehabilitation, past investments may be completely lost. Most of the network needs to be improved through pavement strengthening. Many sections of the system need to be upgraded through improved vertical and horizontal alignments. The condition of the urban networks is also very poor. Roads in all municipalities lack adequate markings, lighting and the capacity to serve the needs of the population. The inadequate road network, especially rural roads, has served to increase the cost of transporting goods to markets dramatically, particularly for perishable agricultural products.

The ratio of telephone subscribers to total population in the West Bank and Gaza is about 1:46, as compared to 1:15 in Jordan and 1:34 in Egypt. There is a large suppressed demand with the backlog for new connections in the West Bank alone exceeding 12,500, or about one third the number of lines currently in use. Of 400 villages in the West Bank, only 80 had telephone service as of end-1991. Of these, most had usually only one connection, and it was frequently out of service. The lack of adequate telecommunications capabilities has had a particularly deleterious impact on the service industry, a sector heavily dependent on good telecommunications.

Educational facilities are also in poor condition. Many school buildings require major repairs. Libraries and laboratories are generally inadequate, as are supplies of textbooks and materials. The curricula require modernization, and the qualifications of educational personnel in almost all positions need to be upgraded through pre-service and in-service training. Vocational schools are seriously underfunded and have inadequate facilities and obsolete equipment. Universities are too small to be able to provide the facilities required for advanced study, particularly in the physical sciences. The fragmentation of the educational system—the Egyptian system is used in Gaza and the Jordanian system in the West Bank—is an added handicap. The frequent school closings

Box 2.5 Israeli Settlements in the West Bank and Gaza

Israeli settlement of the West Bank and Gaza, while beginning immediately after the 1967 war, intensified during the 1980s. According to unofficial Israeli sources, in 1992 there were about 136 settlements in the West Bank with 130,000 inhabitants and 17 settlements in Gaza with a population of 4,000 to 5,000.

Israelis argue that land for settlements has been acquired through legal means; Ottoman, British mandate, Jordanian and Israeli legislation have been used to obtain former state land, land left by Palestinian refugees and land where Palestinian occupants have been unable to prove their title. Palestinians have the right to appeal acquisition of land by the Israeli authorities through the Israeli legal system, but few cases have been successful. Palestinians point out that such settlements are prohibited under international law and are, therefore, illegal. The UN has taken the position that Israeli settlements in the OT have no legal validity and should be dismantled.

In order to attract settlers, the Israeli Government used to offer a number of incentives including: direct housing subsidies; land at discounted prices; mortgages at reduced rates; free hookups to utilities and municipal services; and higher schooling subsidies than in Israel. Israeli budgetary allocations for building settlements are not clear, but several sources report that they have been very large—perhaps as much as US\$20 billion over the past 25 years.

Infrastructure for the settlements is fully integrated into the Israeli national systems. Water, telecommunications and electricity grids function as integral parts of the Israeli systems and are operated by the national Israeli agencies. Transport systems built during the past 25 years have also been designed primarily to meet the needs of settlements, linking them to metropolitan areas in Israel.

For all infrastructure systems, there is an obvious difference in quality between facilities for the Israelis and the Palestinians—the former having been financed from the Israeli budget and the latter being funded by the CA. In contrast to the generally inadequate and poorly maintained infrastructure for the Palestinian population, there is well-designed and well-maintained infrastructure catering to the needs of the Israeli settlements. For example, the electric service to Israeli settlements, supplied by dedicated supply lines, is markedly superior, with annual per capita consumption more than double that of the Palestinian population. Similarly, most residences and businesses in Israeli settlements enjoy individual telephone connections, and the waiting period for new connections is one of weeks rather than of months or years, as in the case of Palestinians. Integrating the two systems into a rational, single system should offer significant cost savings and overall improvements in service standards.

since the beginning of the *Intifada* have reportedly led to an increase in dropout rates, a breakdown in discipline and a deterioration in student achievement. Widespread violence has also produced an alarming growth in the population that is physically or mentally disabled.

The health infrastructure is less in need of repair. However, the OT devote a relatively large share of their output (7 percent of GNP) to the health sector and do not obtain the health impact that should be expected from this expenditure. Several reasons for the poor performance are apparent. First, most health care resources are being used to provide costly, high technology, hospital-based care for the benefit of the relatively well to do. Second, very small, inefficient hospitals have been allowed to proliferate (over two thirds of all hospitals have fewer than 100 beds). Third, highly specialized procedures are being carried out by units that are too small either to exploit economies of scale or to provide physicians and staff with enough practice to maintain skills. Finally, too little attention is being given to reaching out to underserved groups, especially women.

The inadequacies in the provision of public services have to be seen in light of OT public finances. Expenditures by the Civil Administration (CA) and

the municipalities (including the public utilities) have been confined to the revenues collected by them: i.e., taxes, fees and utility tariffs. Public sector capital expenditures amounted to about 3.5 percent of GDP over the 1970–90 period, which is significantly below the average for developing countries. In Jordan, for example, the central government capital expenditure/GDP ratio has averaged about 9 percent in recent years. Three reasons seem to account for the “underinvestment” in infrastructure in the OT. First, the CA and the local bodies have inadequate resources because the tax effort is relatively low and because not all the taxes paid by the residents of the OT accrue to the budgets of the CA or the municipalities. The foregone revenues mainly relate to tariffs on trade with and through Israel. The shortfall between the revenues collected by the CA and the amount of taxes that are actually paid by the Palestinians leads to an element of “fiscal compression” and an underfinancing of public sector investment needs. Other agencies, both official and private, have tried to fill the gap left by inadequate availability of resources to the CA. Foremost amongst these is UNRWA which provides basic services to almost half the OT population at an annual cost of about US\$100 million. Jordan has been the other major contributor

until the 1988 "disengagement", providing some US\$750 million of assistance during 1967-1988, mostly as salaries and remuneration for the West Bank civil servants. OECD donors, UNDP and NGOs have also provided significant resources. Nevertheless, the overall availability remains much below the need.

Second, neither the CA nor the utilities borrow to finance investment expenditure, while such financing is a common feature in many of the developing countries. Public utilities have been forced to finance most investments from current revenues after part of the revenue has been siphoned off to cover non-fee-earning municipal services.

Lastly, the poor state of physical infrastructure and the inadequacies of the services provided reflect the lack of coherence in sectoral policies and programs. This incoherence is due to the lack of mechanisms and institutions for policy and program development responsive to the preferences and priorities of the population to be served. The fragmentation of institutional responsibilities for program implementation and operation contributes to diffused accountabilities, indifferent service standards and, sometimes, duplication of effort. The programs of the CA, for example, are poorly coordinated with those of UNRWA or with those of the numerous NGOs operating in the OT.

To sum up, the economy of the OT grew very rapidly in the 1970s. Growth slowed down considerably in the 1980s but was still not out of line with

performance in the rest of the region. This relatively respectable growth has been accompanied, however, by a skewed pattern of development and a serious underprovision of public services. High dependence on sources of employment that are now drying up combined with limited internal opportunities is perhaps the most serious structural problem facing the OT. Providing productive employment to the new entrants, as well as to those who may no longer be able to find employment outside the OT, will be among the most important challenges facing the OT in coming years. Stimulating growth in the productive sectors and services, particularly the latter, will be essential for coping with this challenge. As the OT economy tries to reduce its future dependence on labor flows to Israel, it also needs to improve its trade position by promoting exports, developing efficient import substitution and diversifying its trading relations. Significant improvements in public infrastructure and services are needed not only to improve living conditions directly, but also to support private business activities and to avoid environmental degradation. Past distortions and a series of adverse shocks, especially in areas critical to past sources of growth, are leading to economic stagnation, putting at risk the past gains in living standards. This, in turn, threatens the prospects for lasting peace in the region. Addressing these weaknesses is, therefore, essential for the future peace and prosperity in the region.

III. Prospects and a Strategy for the Future

Future Prospects

Although the OT suffer from serious structural problems and imbalances and have a very limited natural resource base, they also have substantial assets:

- First, the OT are blessed with a high quality human resource base. The Palestinians have the largest proportion of their population completing higher education of any Arab group (18 college graduates per thousand population). Despite significant outmigration, there is no shortage of either entrepreneurial talent or professional skills. The private sector in the OT is highly resourceful with a demonstrated ability to operate under rather challenging conditions. The removal of regulatory constraints and the establishment of supporting institutions and infrastructure should, therefore, help generate a significant supply response.
- Second, given the right climate, there could be significant private capital flows to the OT from the large and relatively prosperous expatriate Palestinian community in the Arab world and elsewhere. Many of the successful businessmen in the Arab world are of Palestinian origin. Surveys conducted in the early 1980s indicated that about one half of the Palestinians working in the Gulf states held what were classified as "professional and technical" jobs, the highest ranking category in terms of pay scale. Prior to the Gulf crisis, annual remittances from Palestinians working abroad (other than in Israel) exceeded US\$300 million, about a third of which came from Kuwait. It is estimated that currently there are some 200,000 Palestinian workers and businessmen living in the Gulf states and the OECD countries. Given the strong community ties among the Palestinians, it is likely that, in the wake of a peace agreement, a good fraction of these businessmen and professionals would wish to strengthen their links with the OT through increased remittances, as well as direct investment in productive ventures. In addition, Palestinian financial resources abroad could be tapped to support public sector investment

through, for example, subscription to a Palestinian bond scheme.

- Third, because of their unique religious and cultural heritage, the OT have the potential for developing into an important tourism centre. The tourism industry was the mainstay of the economy of the West Bank before 1967, but it has suffered serious setbacks since then because of the unsettled political and security situation. With peace and the normalization of relations in the region, tourism and related industries can become a major source of foreign exchange earnings for the OT economy, especially if cooperative arrangements can be developed with neighboring countries to promote tourism on a regional basis. The geographic location of the OT, and the fact that the Palestinians now have experience in trading with both the Israeli and Arab economies, should also make the OT important transit points for future trade within the region.
- Fourth, unlike most other developing economies, the OT do not have to deal with the burden of crushing external debt. Public finances are also close to balance, and there is neither a bloated bureaucracy nor any loss-making public enterprise. Free from these legacies, public policy can, therefore, focus on structural reform. It also means that the OT economy can sustain a certain amount of external borrowing, especially for upgrading essential public infrastructure. Sound macroeconomic conditions can, however, be swiftly lost by imprudent policies, especially in the public sector.
- Finally, given the strategic location of the area and the problems that the OT have experienced, there are good prospects for attracting international official assistance to help overcome infrastructural bottlenecks and deficiencies.

A prerequisite for transforming the above potential into sustainable development for the future is the resolution of the long-standing political, security and governance issues affecting the region. That should release for socioeconomic development major resources, both financial and human, now being spent

to cope with the actual or perceived administrative obstacles, security threats and inequities. More importantly, by removing the strategic uncertainty and the perception of risk, the political settlement should unleash the financial and entrepreneurial resources of the private sector, both domestic and expatriate, for long-term investments in the OT. Lastly, access to external markets in the Arab world, likely to be normalized only with progress in the peace process, would provide additional impetus to development.

Elements of A Strategy for Economic Development

Political settlement and peace is a necessary, but not a sufficient, condition for economic development in the OT. Much will also depend upon the *quality of economic management* in the post-peace period and the strategic choices made in managing the OT economy. Choices on two issues will be particularly critical: the balance between the *roles of the public and the private sectors* in the OT; and the nature of OT economic links to the rest of the world, particularly neighboring countries.

Because of the existing economic imbalances and the unmet social needs, the public sector would clearly have an important role to play in economic development, particularly during the transition period. The upgrading of physical and social infrastructure, a key priority for improving living standards of the population and for stimulating private sector development, would have to be undertaken mostly by the public sector as private sector interest in financing such investments is likely to be limited, at least for some time. Even where private sector initiative may be forthcoming (e.g., in some segments of health services), a sound sectoral policy framework to safeguard the interests of both the providers and users of such services needs to be established. An even more crucial function for the public sector would be to provide a supportive business environment within which the private sector could flourish while, at the same time, protecting public interests in areas such as health, safety and the environment. There will be a need for a substantial strengthening of public action in many areas, including macroeconomic management, tax administration, the regulatory framework and the supervision of the banking system. In addition, this would mean relaxing some of the supply-side constraints (e.g., increasing the availability of land for new industries and businesses through an overhaul of the municipal zoning laws) currently affecting private sector performance. Providing an affordable social "safety net" through targeted programs would be another important function for the public sector.

While recognizing these imperatives, it is essential that the public sector role be not overstretched. In particular, any involvement by the public sector in directly productive ventures or interference in the marketplace by propping up unviable private sector activities (e.g., through price controls and by limiting competition) would retard economic development and, therefore, should be resisted. International experience indicates that differentiated patterns of protection, activist industrial policy or public channelling of money into unviable enterprises via the financial system too frequently lead to economic disaster. Economies that have prospered in the past have relied primarily on the private sector, working in undistorted markets, as the primary engine of economic growth. Relying on the private sector would be particularly prudent in the OT because, first, as noted above, the private sector in the OT is dynamic and capable; and, second, public sector resources, financial as well as administrative, are likely to be very scarce, at least for some time to come.

Regarding links to the outside world, in economic terms, the option of turning inwards would clearly be very costly for a small economy such as that of the West Bank and Gaza. It would mean major efficiency losses and a sharp decline in living standards. The opening up of external markets to exports from the OT is important if the economy is to achieve sustainable development. However, the external economic relations would need to be shifted from almost complete dependence on Israel, as at present, to interdependence with a range of economies, including Israel.

Given the close economic relations with Israel that have evolved over the past 25 years, the economies of the OT and Israel are bound to be inextricably interwoven for the foreseeable future. While a major reorientation in trade—to the region and to the rest of the world—should occur over the medium term, any sharp cut in trade in goods to Israel could have large short-run costs, because of Israel's predominance as a trading partner. This implies the desirability of mutually beneficial arrangements between Israeli and OT authorities regarding the flow of goods, services, financial resources, labor and visitors in the post-peace period. Even if the loss of substantial labor access to Israel is permanent, it would make sense for the West Bank and Gaza to not only maintain, but expand trade access to the Israeli market. The key issue in the Israeli market is agriculture. The opening of the Israeli market to agricultural products from the West Bank and Gaza, where they are highly competitive, would have a significant positive impact on OT agriculture by both increasing production and eliminating rents from illegal trade. Israeli consumers would also benefit significantly from easier access to OT produce.

Equally important, for export diversification by product and by destination, trade links to Israel should be complemented by increased access to both the traditional Arab markets and to nontraditional markets in Europe and North America. As noted earlier, the various restrictions on trade with and via Jordan have significantly reduced trade with the Arab countries. The removal of these restrictions should lead to increased production and exports, particularly of manufactured goods, as well as the importation of certain inputs—such as fertilizers and construction materials—at significantly reduced prices. An important issue for OECD markets concerns how far the OT can participate in the current free trade agreements which Israel has with the EC and the US. (The EC agreement is already applicable to the OT).

From the perspective of the West Bank and Gaza, a strategy that attempted to open up opportunities elsewhere, especially with Jordan, Egypt and the Gulf countries while maintaining open trade relations with Israel, would make sense. A possible approach to consider would be a free trade area with Israel, linked with a significant opening of trade to Jordan and Egypt. This would differ from the present (partial) customs union in allowing the OT to have different tariffs from Israel for trade with rest of the world. It would maintain open trading relations with Israel, but would potentially avoid protectionist aspects of Israel's trade regime that may not be suited to the economic structure of the OT. The opening of trade to Jordan, Egypt and the rest of the Arab world would allow the OT to diversify its export base, thus reducing its vulnerability to external shocks. However, while a free trade area, perhaps involving Jordan, is attractive in principle, there may be problems in practice linked to the establishment of customs borders and the "leakiness" of such borders. Equitable distribution of gains from free trade among the various partners may also require some transitional arrangements to enable the infant OT enterprises to compete on an equal footing. Another possibility to consider would be to recast the current asymmetric trading arrangements into a full-fledged customs union with Israel. That would have the advantage of administrative simplicity, however, careful attention would need to be paid in that case to putting in place mechanisms for opening up trading possibilities with Jordan, Egypt and other Arab countries.

Promoting regional infrastructural networks in electricity, transport, telecommunication, petroleum and gas pipelines and water would offer other opportunities for strengthening interdependence and benefitting from complementarities and economies of scale, which may not be available to the OT in the absence of such cooperation. Because of the poor endowment of natural resources, the landlocked lo-

cation of the West Bank and the small size of the economy, many infrastructure services in the OT are likely to be lower cost if regional solutions are adopted. Regional power interconnection would be of high priority to the OT because of the lower cost sources of supply in Israel, Egypt and, perhaps, Jordan and the improved reliability of supply to all participating parties. Similar economies of scale and the utilization of existing capacity are possible with highways and ports. Since water resources are common to both the OT and Israel, an attractive long-term solution would be the joint management of the shared resource.

Choices concerning the respective roles of the public and private sectors would be entirely up to the decision-makers in the OT, however, the choices concerning economic links would necessarily involve other parties and would depend upon negotiations between the OT, Israel, Jordan and other regional and non-regional parties. The international community and particularly the OT's neighbors could make an important contribution to economic growth in the OT by providing improved market access to OT exports and by supporting economically viable regional infrastructural investments.

Other strategic choices, dependent upon the outcome of the ongoing bilateral negotiations, concern the feasibility and desirability of an independent macroeconomic policy for the OT, including a separate currency. *Prima facie*, there are a number of reasons why an independent policy would make sense: it would allow the OT to deal better with real and nominal shocks, gain seignorage revenues and facilitate financial intermediation through financial sector development. Preliminary analysis suggests, however, that:

- In some areas, the pursuit of an independent macroeconomic policy is likely to be fruitless, e.g., attempts to have independent interest rates, given the degree of capital mobility in the region.
- In a second set of areas (e.g., managing "excessive" capital inflows, borrowing at home and abroad and supervising/providing liquidity to banks), independent policy is desirable but does not necessarily require a separate currency.
- Seignorage is traditionally important in the region but is unlikely to be so for the OT because of the likely initial low level of credibility of a new currency and the high capital mobility.
- Finally, there are areas for which a domestic currency is necessary, e.g., avoiding imported nominal shocks from other members of a currency union and facilitating real wage declines.

The above must be seen in the context of credibility, something that is hard to earn but that can be

obtained by being in a currency union(s) with a disciplined core or by establishing a track record of prudent macroeconomic, and especially, fiscal management. The OT do not have such a history, and new institutions of macroeconomic management are likely to be both fragile and under pressure. If a domestic currency is chosen, it might be desirable to start with a relatively restricted version, as in a Currency Board, that could gradually evolve to a fully fledged currency once discipline, and the associated demand for the currency, was well established. Decisions concerning an independent OT currency may have significant repercussions for both Israel and Jordan, particularly the latter since the JD currently in circulation in the OT may be a significant fraction of the total money supply in Jordan. Accordingly, retiring the Israeli and Jordanian currencies from the OT, may have to be done in a phased manner in consultation with the Israeli and the Jordanian authorities. The international community may also have a role to play in that respect.

Some Scenarios for the Future

Forecasting the pattern of growth is a highly uncertain business. However, assuming sound economic management, it would be reasonable to expect a relative expansion of domestic over external employment. Over time, a substantial diversification in economic relations would also be probable, with greater interdependence among economies in the region and an expansion in trading relations outside the region, notably with Europe. As regards the likely changes in the production structure of the economy, undoubtedly there is some room for expansion in agricultural and industrial production, once the present constraints on private sector development are removed, including access to outside markets. However, this point should not be overemphasized. Diminishing water resources throughout the region will constrain the development of the agricultural sector, with future growth limited to high-value export crops catering to niche markets. Given the paucity of industrial raw materials and the small market size, heavy industry is unlikely to be a major contributor to future growth. Instead, skill-based, light- and medium-sized industries would appear to be more promising. Above all, the economy of the West Bank and Gaza is likely to remain mainly a service-oriented economy with an important contribution made by the tourism sector.

A range of scenarios was developed to explore the potential trajectory of the economy in the future. These are illustrative only since little is known about either future conditions or economic responses. A critical factor in the scenarios is the overall "policy," encompassing a range of likely influences on future

development. "Good policy" would include, *inter alia*, a peace agreement that resolves strategic uncertainty sufficiently to provide the basis for private capital inflows and investment in productive activities; a relaxation of supply-side constraints, including deregulation and improvements in the supply of economic infrastructure and industrial land; trade arrangements that allow substantial trade expansion (in the region and elsewhere); a strong public finance framework with substantially expanded revenues (including taxes now accruing to the Israeli treasury); a major strengthening of the administrative and policy-formulating capability of the emerging, interim self-governing authority; and a strengthening of the human resource base both by stepped-up training programs and by access to entrepreneurial and professional skills of the Palestinians living abroad.

Preliminary analysis suggests that, assuming a "good policy," a growth rate in excess of 3 percent in per capita incomes is sustainable, with a total rise in incomes on the order of 40 percent in a decade, provided the phaseout from the Israeli labor market is managed in a "smooth" fashion and provided there are adequate external public and private capital inflows (about \$2,500 million during the five-year transition period).³ In case there is a "sharp" reduction in employment in Israel—for example, if employment does not rise above the 45,000 prevailing in June 1993—the short-run situation is likely to be much worse, with potentially large rises in unemployment and falls in wages and incomes. That would require short-run action, in terms of additional external inflows (a total of about US\$350 million over the five-year period) and poverty-related spending by the public sector to moderate welfare declines. However, with "good policies," the income levels would recover to the pre-cutoff period after about three years, and the economy could then again be on a steady growth path, with GNP per capita exceeding US\$2,300 after 10 years (compared to US\$1,715 in 1991).

By contrast, if policies are not sound, the outlook would appear to be grim. There could easily be declines in income per capita—on the order of 20 percent in a decade—even with a "smooth" labor decline. The outlook would be worse, especially in the short run, in case of a "sharp" reduction. Such growth scenarios would undoubtedly be associated with rising poverty, worsening social conditions and, potentially, rising violence. "Poor policy" could be offset by official capital inflows, but only for a while, since private capital is unlikely to flow in while the political uncertainties remain unresolved, and policy conditions are not perceived to be investor friendly.

An attempt has also been made to estimate the public sector financing requirements assuming "good policy". The analysis also assumes that:

- The new self-governing entity would reach agreement with Israel on a mechanism to ensure that the budget of the new entity receives all the taxes paid by the OT residents.
- The UNRWA operations would continue to function alongside the new entity during a five-year transition period.
- Of the public sector investment needs identified in Chapter V for the medium-term, 85 percent would, in fact, be implemented in that period.
- The revenue effort would be enhanced by 2 percentage points of GNP in the first five years, rising from 18 percent in the base year to 20 percent in year five as tax administration capabilities are improved and as cost recovery mechanisms are put in place.
- The current expenditures would also rise by about 2.5 percentage points of GNP in the five years, from 16.5 percent to 19 percent to support the gradual expansion and improvement in service and maintenance levels.

Under these assumptions, the external financing requirements of the public sector (including UNRWA) in nominal terms for the five-year transition period would be about US\$1,500 million under the “smooth” scenario and US\$1,750 million if the labor reduction is “sharp.” The latter scenario would, furthermore, require some front-loading of the external assistance. It should be noted that external donors, including UNRWA, currently spend about US\$175 million annually in the OT. Thus, external aid flows would have to be roughly doubled from present levels to meet the financing needs of the public sector. As regards external private inflows, the requirements would be about US\$200–250 million per annum. With about 200,000 Palestinian workers in the Gulf states and the OECD countries, the implied remittances per worker would be about US\$1,000 annually, a very plausible amount.

The above discussion raises the issue of the terms on which the external aid to the OT would be extended during the transitional period. Currently, all official aid to the OT—whether through UNRWA or from other sources—is in the form of grants, as the aid is mostly of a humanitarian nature, and there is no legal entity to lend to. In view of the large uncertainties involved at this stage, the study has not analyzed the external borrowing capacity of the OT in the transitional period and beyond. As the OT does not currently have any external debt, there is clearly some scope for borrowing in the period ahead. Care should be taken, however, not to overburden the economy and strain future growth, nor to use funds for unproductive purposes. Given the likely fragility of the public sector revenues and of exports during

the transition period, it would be prudent if the external assistance to the OT over the medium term included some element of concessionality. Tentatively, it is estimated that if UNRWA financing was to continue in the form of grants and if there was a 20 percent grant element in the remaining external flows to the public sector, the debt services burden would remain manageable over the medium to long term.

The above scenarios should be treated as indicative. However, they do help illustrate the main implication of much of the analysis in these volumes: the OT have the potential to recover from both the loss in past sources of growth and from distortions in the pattern of development, and to become a viable, growing economy, provided that the policy and structural conditions are right. In the absence of a sound domestic policy, continuing strategic uncertainty and inadequate donor support, the OT could enter instead into a period of sustained decline in incomes, employment and welfare. Also, the initial recession caused by the “sharp” reduction in employment in Israel could generate internal social instability and rising violence, deterring private foreign investors. The faltering private investment could further accentuate social tensions leading to a vicious cycle of low growth, low revenues and inadequate public spending.

It should also be remembered that the OT economy has a number of limitations which leave policy makers with little room for maneuver. The limited natural resource base, the high degree of vulnerability to external shocks, and the fragility of the political situation following years of conflict, make the management of the transitional period a very delicate and difficult undertaking. Policy slippages could impose a heavy toll on an already fragile economy; a careful stewardship of the economy would, therefore, be necessary—a task which would be greatly facilitated by internal consensus among the Palestinians on a vision for the future OT economy.

To sum up, the OT economy appears capable of generating sustainable economic growth provided there is peace and stability in the region and provided the economy is soundly managed with a mix of prudent macroeconomic policies, expanded public services, support for private sector expansion and an expansion of trade to the region and the rest of the world. Significant external capital flows will be needed during the take-off period—partly to help overcome the existing deficiencies in public infrastructure and services and partly to augment the production base for private sector activities. It should be noted, however, that there are many downside risks which if not guarded against could easily trap the OT economy into a low level equilibrium.

IV. Policy and Institutional Imperatives

There are seven key institutional and policy areas where adjustments are needed in order to create a climate conducive to sustainable economic and social development: (i) the legal and regulatory framework; (ii) the management of public finances; (iii) the management of public infrastructure; (iv) financial sector development; (v) the management of natural resources; (vi) the provision of social services; and (vii) local government and public administration. These are considered below.

Legal and Regulatory Framework

As noted earlier, future economic growth and development in the OT is critically dependent upon the performance of the private sector. Unleashing this potential requires the creation of a legal and regulatory environment that supports private sector initiative. The legal system should provide a set of rules that govern property rights, their exchange and the settlement of disputes. More importantly, the rules should be perceived as transparent, stable and enforceable, through mechanisms that are seen to be fair and efficient. Despite some improvements in the recent past, there remains a widespread perception among OT entrepreneurs that the current business environment is ambiguous, complex and unpredictable. Trust in the ability of the legal system to provide an expeditious and effective appeals process also remains low. Particularly constraining to entrepreneurial activities are perceived barriers to entry, restrictions on the conduct of import and export activities, restrictions on the movement of people and goods and the perceived insecurity of property rights. These perceptions make investments in long-term fixed assets risky and unattractive, especially in high technology areas with a high probability of rapid obsolescence.

Progress in the current peace negotiations and agreements on self-governing arrangements should make possible a thorough review and overhaul of the existing legal and regulatory framework to provide the private sector with a sounder legal basis for commercial transactions. Some of the priority areas for review and revision include the commercial code, joint-stock company law, bankruptcy law, collateral

law, municipal zoning laws, business licenses, export/import licenses and regulations concerning the movement of people and goods. A strengthening of the appeals process would be another priority. The implementation of a supportive legal and regulatory framework requires credible institutions, the development of which is as much of a priority as the restructuring of current laws and regulations.

Management of Public Finances

International experience suggests that establishing a sound system of public finances in the West Bank and Gaza will be necessary in creating an environment conducive to private sector development and in attracting external assistance. Establishing such a system will mean ensuring that adequate revenues are collected/received by future authorities in the West Bank and Gaza and that the resources, including those that might be obtained from external sources, are managed properly.

On the revenue side, five key issues need to be addressed:

- *The Legitimacy of the Tax System.* Currently, there is a widespread perception among the Palestinian population that the existing system of taxation lacks transparency and due process and is administered in an arbitrary fashion. These negative perceptions materially reinforce tendencies for tax evasion and noncompliance, which exist, at least latently, in all societies. To a large extent, the negative perceptions are directly related to the current military occupation; and the emergence of a self-governing authority as part of the peace settlement should help change the situation significantly. That would, however, in no way obviate the need for creating an efficient tax administration system that is perceived to be fair by the population. The current tax administration system would need to be completely overhauled, including the establishment of transparent rules and enforcement mechanisms for tax assessments; the rationalization of advance payments of income taxes; and the introduction of a credible and efficient institu-

tional mechanism for the settlement of tax disputes. The role of accounting and auditing professionals would also need to be clarified in this context.

- *Fiscal Transfers Between Israel and the OT.* Under the current tax and trade arrangements between Israel and the OT, some OT taxes (primarily, the value-added tax (VAT) and other taxes on net OT imports from Israel and custom duties on imports through Israel) are accruing to the Israeli treasury. Given the absence of customs borders between the OT and Israel, the "origin principle" of indirect taxation is applied with respect to trade between the two, whereby taxes are collected where the goods are produced rather than consumed. Since the OT have a large trade deficit with Israel, there is a net revenue loss to the OT. Conversely, Israel also incurs expenditures in the territories from its own budget that are of benefit to the Palestinians (e.g., the subsidization of essential food items; Palestinian use of subsidized infrastructure and services in Israel). The Israeli and the OT authorities would need to agree on methodologies for estimating such transfers, as well as to devise suitable mechanisms for offsetting payments. Several alternative solutions appear feasible but would need to be considered in the context of the overall future economic relations between Israel and the OT. In any event, what is important is that all the revenues and expenditures and their financing are stated explicitly in the budget for the new OT entity.
- *The Appropriateness of the Domestic Tax Effort.* Despite perceptions of high tax rates among many Palestinians, the economy of the OT does not appear to be highly taxed. Even when all taxes paid by Palestinians are counted (including those currently accruing to the Israeli treasury), the tax effort is about 22 percent of GDP, compared with 27 percent in Jordan and 39 percent in Israel. In view of the need to strengthen public administration and expand public services, mobilization of additional domestic resources would be essential. It is true that the effective personal income tax rates are currently higher in the OT than in either Israel or Jordan. However, the tax effort in relation to the GDP is lower for several reasons, including the exemption of agricultural income from the tax net and possibly a high incidence of tax evasion. The question of the tax effort, therefore, will have to be examined in relation to the ability of the emerging entity to expand the tax base to protect its overall fiscal position, as well as its ability to harmonize tax policies with neighbor-

ing countries. This brings to the fore the importance of providing a very strong system of tax administration that can help widen the tax base and improve tax collection.

- *Cost Recovery.* An important aspect of domestic resource mobilization mentioned above concerns the establishment of mechanisms for cost recovery for the expanded public sector operations. User fees would be an important instrument to help cover the operations and maintenance costs and the debt servicing associated with new public sector investments in the transport, communications and solid waste disposal areas. Similarly, it would be important for the electric and water utilities that are being recommended to operate as commercially oriented autonomous entities, i.e., to charge tariffs that would make their operations financially viable without the need for any budgetary support.
- *Management of External Assistance.* To get the maximum benefit from the international assistance that might become available in the wake of a peace agreement, an efficient mechanism for directing and coordinating this assistance will be needed, balancing, in particular, donor interests and preferences with the developmental priorities of the OT. A careful monitoring of external borrowing will also be necessary to avoid any debt service problems in the future.

On the expenditure side, the key issues to be addressed are:

- *The Balance Between Current and Capital Expenditures.* A significant increase in the investment program during the transitional period would necessitate a commensurate increase in current expenditures on operations and maintenance to ensure that the capital stock would be adequately maintained. The budgeting process and the estimation of the financing requirements should, therefore, take into account the need for such expenditures. Experience suggests that this is often an overlooked item, with undesirable consequences.
- *The Sustainability of Expenditures.* As has been noted earlier, the direct role of the public sector should be mainly to provide basic infrastructural and social services, including a limited and well-targeted safety net for the poorest segments of the population. Care should be taken not to enlarge the bureaucracy of the public sector unduly, and the public sector must not act as the residual employer. The post-peace period could see large pressures for expanded

public spending, both in areas that are well justified (roads) and some that are not (excessive civil service growth). The likely temporary easing of financing constraints following a peace agreement could mask imprudent spending and borrowing policies for some years. Strong, conservative control will, therefore, be important for avoiding unsustainable level of expenditures, which would be difficult to reverse in the future.

Management of Public Infrastructure

Well-functioning public utilities will be essential to plan, implement and operate infrastructural investments on the scale needed in the OT. An early priority for the emerging self-governing entity in the OT would be to decide on how the ownership of utilities is to be structured and how the regulatory and policy-making roles are to be organized. The legal framework for these arrangements will also need to be established, taking into account the special circumstances involved.

To provide a sound basis for autonomy, accountability and efficiency, it is recommended that commercially oriented utility companies be established. Municipal governments should disengage from the direct role of provider of water and electricity, to the indirect role of owner. Since the legal framework covering the transitional period is not yet clear, the simplest legal basis for the new, reconstituted utilities would be the prevailing companies law, with the shares held in the public sector. This would not only provide a framework for enterprise autonomy and commercial orientation, but would also facilitate partial or total privatization in the future. It is also recommended that: (a) the roles of policy-making, ownership and regulation be separated among different institutions; and (b) the ownership (shareholdings) be spread as widely as possible among different municipalities, pension funds and other public or private agencies. The new entity should also try to define the regulatory system for the public utilities. Some of the key issues that need to be addressed are: (a) one multisectoral regulatory agency *vis-à-vis* several sector specific regulatory bodies; and (b) the basis for utility price setting.

Financial Sector Development

The present legal and regulatory framework, a patchwork of Jordanian, Egyptian, Palestinian mandate and Israeli legislation, is not conducive to the expansion of existing financial institutions or the establishment of new ones. This framework needs to be replaced with transparent, coherent legislation cov-

ering the West Bank and Gaza that: (i) sets clear criteria for licensing banks, insurance companies and other regulated financial intermediaries and establishes uniform standards as to capital requirements, liquidity and solvency; and (ii) establishes a new regulatory framework, consistent with international standards, for the supervision of financial intermediaries.

Within the above context, several steps are needed to strengthen the process of financial intermediation. First, entry barriers should be eliminated and existing banks in Gaza and the West Bank should be allowed to expand in either region to facilitate the economic integration of the two territories. Second, mechanisms should be devised to enhance or supplement the collateral of local investors by tapping the value of unmortgaged real estate. Third, the multiplicity of inefficient, small-scale, subsidized credit programs with unsustainable recovery rates need to be reformed and moved towards regular financial operations at market interest rates. Lastly, given the need for strengthening medium and long-term financial intermediation, establishment of an investment bank, preferably with foreign participation should be encouraged. Considering the strong financial and skill base of the Palestinians in the OT and abroad, every effort should be made to keep the ownership and management of such an institution entirely in the private sector. However, in case this is not feasible, as a last resort, some limited equity participation by the public sector may also be considered for the initial years.

Management of Natural Resources

While the question of access to natural resources ultimately depends on the outcome of the political negotiations, there are some measures that can be taken to ensure conservation and a better utilization of natural resources. Of special importance is the preparation of an environmental action plan underpinned by a comprehensive framework for environmentally sustainable development in the post-peace period. Other areas for priority attention include:

- Establishing, initially, a coordinating mechanism and, later, a management agency to oversee the development of the region's water resources in cooperation with the other riparians. Sharing data on the region's land and water resources would be a good beginning.
- Relaxing regulations governing the rehabilitation of irrigation wells.
- Addressing the severe quality problems of the municipal water supply in Gaza.
- Relaxing constraints in the use of grazing lands.

- Relaxing constraints on the harvesting of marine fisheries resources.
- Reforming the regulatory framework (land use planning, building standards, minimum lot sizes, the taxation of vacant land, rent controls, etc.) regarding the use and development of urban lands.
- Providing adequate infrastructure to, first, encourage the use of vacant urban land and, second, to extend municipal boundaries to provide adequate, affordable, serviced land for residential and commercial purposes.
- Establishing adequate arrangements for the collection and disposal of solid waste to prevent ground water pollution and an unhealthy and unsightly urban environment.
- Establishing institutions and a regulatory framework for the protection of antiquities and cultural property.

Provision of Social Services

The broad outlines of a sound social policy for the OT are clear. Basic health services should be made more accessible and hospital services and high technology health care should be deemphasized. Education and training should be strengthened in areas, such as curriculum development and teacher training, to enable the system to improve the quality of instruction and, thus, to improve the productivity and employability of Palestinian labor. The social security systems now operated by the CA, Israeli employers and UNRWA should be harmonized and unified; the system of private transfers should be supported through the development of appropriate financial institutions.

Present inefficiencies in the health sector are rooted in the fragmentation of responsibility, not only for the delivery of health care, but also for the management of subsidies to the sector from the government budget and external donors. A responsible body must be created to develop a sound health policy and to coordinate activities in the sector. Policies should, at the same time, seek to interrupt the link between refugee or employment status and entitlement to subsidized health care; instead, such care should be targeted to the needy. In assembling a set of policies, issues of health care finance, service standards, investment in technology and quality assurance should be addressed.

An extensive education planning process should be initiated to consider the goals, possibilities and resources for a unified education system for the Gaza Strip and West Bank. Planners, administrators and curriculum experts should be given training in carrying out these tasks. A revised curriculum should

be developed that can be adopted on both the West Bank and the Gaza Strip. It should not only give attention to the modernization of content and teaching methods, but should also link curricula to broad economic, social and cultural objectives. As the development of curricula is time-consuming and costly, in the short term, consideration should be given to adapting materials from other countries, especially in the sciences and mathematics. Personnel exchanges across institutions could prove useful in this endeavor.

Resources to support a comprehensive social welfare program are unlikely to become available to the OT entity within the foreseeable future. Nonetheless, in time, the OT authorities would be called upon to replace the benefits provided to the very needy by UNRWA and the CA. The targeting of the programs would, therefore, be essential. The OT would have to develop a basic program of social protections and ensure that this program received broad political endorsement. The program should provide for the handicapped, elderly, orphaned and widowed, but it should not seek to replace reliance on private transfers and personal savings. The OT should also encourage the development of private institutions that supply financial services, including health and life insurance companies and pension schemes.

Local Government and Public Administration

The policy and program agenda that the OT will face in the coming years would constitute a big challenge to any public sector apparatus. The OT administration, emerging in a period of transition with little experience in self-government, will be especially challenged. Institutional strengthening would, therefore, be critical both at the local level and at the territory-wide level.

Local governments in the OT are generally weak and ineffective. The legal environment in which they operate is complex, overregulated and nontransparent. Moreover, local public finances are largely controlled by the CA; local governments have little authority over taxes and fees and, as a result, are unable to finance recurrent expenditures adequately. Allocations of funds for capital investments, mostly financed with transfers from the CA, are also nontransparent. Improving the effectiveness of local governments would require, *inter alia*:

- The introduction of a rational legal foundation that clearly assigns an appropriate degree of local discretion over issues of local interest.
- The provision of greater local autonomy over user charges and local taxes.

Table 4.1 Phasing of Institutional and Policy Reforms

| <i>Area of reform</i> | <i>Short-term</i> | <i>Medium-term</i> |
|--|---|---|
| Regulatory and legal framework | <ul style="list-style-type: none"> • Publish all regulations in Arabic • Review all commercial laws with a view to harmonize and modernize • Relax licensing requirements for foreign trade and for business • Simplify procedures for trade with Jordan | <ul style="list-style-type: none"> • Develop market-friendly commercial laws • Ease restrictions on movement of goods and people |
| Fiscal system | <ul style="list-style-type: none"> • Relax advance income tax requirements • Reform income tax reporting and compliance provisions • Reform tax assessment practices | <ul style="list-style-type: none"> • Develop a budgetary framework • Agree on mechanisms for fiscal transfers with Israel • Establish mechanism for management of external assistance • Design new taxation structure and develop tax administration capability • Establish cost-recovery mechanisms for public services |
| Public utilities | <ul style="list-style-type: none"> • Study issues concerning ownership and regulation of utilities • Initiate training programs for utilities | <ul style="list-style-type: none"> • Establish financially autonomous, commercially-oriented utilities |
| Financial sector | <ul style="list-style-type: none"> • Eliminate barriers to entry and expansion • Establish payment clearing system | <ul style="list-style-type: none"> • Create an enabling legal framework for financial system • Establish a single regulatory authority • Encourage establishment of an investment bank |
| Natural resources | <ul style="list-style-type: none"> • Relax regulations governing rehab of irrigation wells • Study alternative to address drinking water quality problems in Gaza • Relax constraints to grazing lands use • Develop environment action plan • Share data on natural resources | <ul style="list-style-type: none"> • Establish agency to coordinate and oversee water resource development • Reform regulatory framework for development of urban lands • Establish mechanisms for protection of antiquities and cultural property • Establish an environment management organization |
| Social services | <ul style="list-style-type: none"> • Articulate sectoral policy framework • Launch socioeconomic studies | <ul style="list-style-type: none"> • Adopt coherent policies for social sectors • Create health sector coordinating body • Start preparation for a census • Modernize educational curriculum |
| Local government and Public Administration | <ul style="list-style-type: none"> • Review laws and regulations affecting local government operations • Launch studies on trade, monetary, and fiscal issues • Initiate training programs | <ul style="list-style-type: none"> • Revise legal framework governing local governments • Provide greater financial autonomy to local governments • Prepare strategies for regularizing UNRWA establishment over the longer term • Establish a development policy institute |

- The introduction of more systematic and transparent criteria for the allocation of capital transfers.
- Technical assistance and staff training to promote institutional change and facilitate policy development relating to local government issues.

In addition to the strengthened role of the local government bodies, institutions would have to be developed to formulate, coordinate and implement policies at the territory-wide level. To develop these capabilities, the emerging self-governing authority needs a strong and efficient system of public administration responsive to the needs of the local popula-

tion. Suitable mechanisms would also have to be devised to ensure the accountability of the public administration. The 20,000 Palestinians currently employed by the CA could become the nucleus of the administrative structure for the emerging self-governing authority. However, the likely difficulties in molding the current CA establishment into an administrative structure suited to the needs of the self-governing authority should not be underestimated. For the longer term, integrating the UNRWA establishment into the normal administrative structure of the OT would be another major challenge.

Phasing the Policy and Institutional Agenda

The above agenda of institutional and policy reform is clearly extensive and complex, and some phasing

of the various reform measures would be necessary. A preliminary outline for such a phasing is shown in the Table 4.1 below. The definition of short and medium term is linked to the peace process, as explained in Chapter V. Basically, the short term covers the period up to end-1993, and the medium term covers the period 1994-98. It should be noted that the implementation of some of the actions for the short term is already underway. For example, business licensing procedures have been significantly liberalized recently, and impediments to exports to Jordan have been reduced. Tax changes to encourage investment in the OT have also been initiated. Areas open to Palestinian fishermen have been expanded. Some training and TA programs to strengthen institutional capabilities have also been initiated by several donors as part of the ongoing peace process.

V. Investment and Technical Assistance Needs

A critical element of the strategy for achieving sustained economic and social development in the OT is the major upgrading of physical and social infrastructural services. This is a function to be undertaken mainly by the public sector and is important not only for improving the quality of life in the OT, but also for providing an enabling environment that supports the growth of a dynamic private sector. Since private sector investment will be the result of decisions by many individual entrepreneurs, using primarily private capital flows, the focus here is only on public sector investments. Thus, private sector investment needs in areas such as agriculture, industry, tourism and housing are not included in the following estimates. Investments in telecommunications and petroleum and gas pipelines are also expected to be through the private sector and, hence, not considered here.

In assessing the future investment and TA needs of the OT, three main phases have been distinguished linked to the likely time frame of the ongoing peace negotiations: Phase I, the *short term*, extends to the time when an agreement is reached in the bilateral peace talks on interim self-government arrangements. Phase II, the *medium term*, covers the period from the end of Phase I until the time when final political arrangements regarding the OT are in place. Phase III, the *long-term*, refers to the post-peace period, following agreement on the final political arrangements. The duration of these phases will depend upon progress in the peace talks. However, for the purposes of this report, it is assumed that the short term will not extend beyond end-1993 and that the medium term will last for a period of five years thereafter.

The analysis of investment and TA needs is based on the assumption that there would be no large population movements in the periods under consideration. The investment requirements would be larger to the extent that the Palestinians living abroad are allowed to return and choose to do so. The requirements indicated below may need to be modified in the future after agreement is reached between the concerned parties on this issue.

The following framework forms the basis for the prioritizing and phasing of various investment and TA programs being considered for the OT:

- Public sector investments should support rather than preempt private initiative. Accordingly, only those investments where the private sector is unlikely to be interested for sometime to come would be undertaken by the public sector. Even then, where possible, the investments should be designed in a manner so as to facilitate privatization at a later date.
- Because of the relatively short time-horizon for Phase I, it is unlikely that significant new external assistance for financing investments in the OT would be available during this phase, and, hence, no investments have been proposed for this period. It should be noted that some of the rehabilitation works in water supply, sewerage, education, transport and electricity could be taken up without additional technical studies. Accordingly, the implementation of such investments could be launched as soon as the financing is mobilized.
- It would not be feasible during the medium term to implement investments whose design and viability depend upon agreement on the eventual political arrangements; accordingly, such investments are considered for implementation only in Phase III.
- The investment program for the medium term would also need to recognize the limited institutional capacity, especially during the early years. In some cases, therefore, even investments that do not depend upon resolution of political uncertainty might need to be spread over a longer period, thus spilling into Phase III.
- All feasibility studies and project preparation work for investments during the first 2–3 years of the “self-governing” arrangements are taken up in the short-term while those concerning the rest are included for financing in the medium-term.

- To lay the foundation for sustainable development, TA and training to support institution-building, manpower development, improvements in the OT database and analytical work to sharpen policy choices facing the OT should be launched as early as possible.

Investment Needs

Based on the above framework, the public sector investments (in constant 1993 prices) are estimated at US\$1,350 million for the medium term and US\$1,600 million for the long term (Table 5.1). The focus during the medium term will be on the rehabilitation and upgrading of the local level public infrastructure and services in water supply, sewerage, solid waste, road transport, electricity, education and health. In addition, some support would be needed for strengthening agricultural support services and for improving natural resource management through erosion control measures and forestry development. The tentative priorities for the long term include, besides the completion of the rehabilitation works started in Phase II, power generation facilities (preferably as part of a regional power grid), selective capacity expansion in the main road network, capacity expansion in health and education systems, the design of a modern education curriculum, the strengthening of university education and the improvement/construction of airport facilities.

Table 5.1 Public Sector Investment Needs in the OT¹
(US\$ million, constant 1993 prices)

| Item | Medium-term ² (1994–98) | Long-term (1999–2003) |
|---------------------------------|---------------------------------------|--------------------------|
| Water | | |
| Water and wastewater | 280 | 200 |
| Transport | 330 | 500 |
| Power | 350 | 600 |
| Solid wastes | 100 | |
| Education | 190 | 160 |
| Health | 60 | 90 |
| Agric. supp. services | 20 | 10 |
| Natural resources management | 20 | 40 |
| Total | 1,350 | 1,600 |

1. Figures shown are for commitments during the indicated period. Actual disbursements may lag commitments by up to three years.

2. About US\$70M of these investments could be launched as soon as financing is available.

The above investment estimates are, in most cases, based on very limited data. Systematic assessments of the current conditions of the existing infrastructure or their rehabilitation needs are generally unavailable. Accurate unit cost data is also lacking in most cases, and the available figures often require adjustments to reflect experience in neighboring countries. Finally, very few of the proposed investments have been subjected to rigorous financial and economic viability tests. Accordingly, the estimates here are merely indicative of the broad investment priorities and the likely investment magnitudes. The picture is particularly cloudy in this respect for long-term investments where the usual data limitations are further compounded by design uncertainties related to the outcome of the ongoing bilateral negotiations.

Preliminary analysis indicates that the investments proposed for the medium term should directly generate about 70,000 man-years of employment in construction works, i.e., the equivalent of about 14,000 full time jobs for the 5-year period of Phase II. Considering that many of the Palestinians employed in Israel have been construction workers, the implementation of the proposed program should, thus, help reduce significantly the adverse effects of the shrinking employment opportunities in Israel.

Technical Assistance Needs

To ensure that the scarce aid resources make the greatest possible contribution to improved living standards in the area, detailed project feasibility studies are needed in most cases. In addition, technical assistance and training are needed to foster institutional development and enhance implementation capacity. The cost of the preparatory studies, technical assistance and training proposed for launching in the short term is estimated at US\$35 million. A further US\$50 million of TA would be needed over the medium term (Table 5.2). Much of the second phase TA could perhaps be "piggybacked" to investment operations resulting from the TA proposed for the short term.

Slightly over half of the TA would be for project preparation and feasibility studies, done in sufficient detail so that the resulting projects and programs would be ready for appraisals by the donor community. The rest would be used for institutional development activities including, *inter alia*, the following:

- Studies and training to strengthen local governments and public administration in the OT.
- Studies on trade, monetary and fiscal choices facing the OT in the medium-term.

- Studies to decide on the future organizational structure of the electric and water utilities in the OT.
- Training programs for the Palestinian staff in the electric, water, highways and sanitary sectors.
- The review and revision of the legal and regulatory environment affecting private sector activities.
- Studies to modernize and strengthen the financial sector.
- Studies to help develop housing sector policies and institutions.
- The development of an action plan and building capacity for environmental management.
- Socioeconomic surveys and the preparation for a population census.
- The strengthening of the agriculture database.

Next Steps

To have a shelf of priority projects ready for implementation as soon as adequate progress is made in the bilateral negotiations, and to strengthen institutional capacity, it is important that the preparatory studies and institutional development activities be initiated without delay. Provided there is a broad agreement among the concerned parties on the analysis and findings of this report, the next step would be for the donor community to mobilize funds to the tune of US\$35 million to help launch the TA activities proposed for the short term.

Because of the relatively large size of the proposed TA program and the lack of experience in the OT in managing such programs, careful attention would need to be paid to the implementation arrangements. For the TA to be relevant and useful, clearly the Palestinians would need to have a major decision-making role in the design and administration. Equally important, the success of the TA program, for the short term, would require significant support from the CA; the implementation arrangements would, therefore, also need to be developed in close cooperation with the CA. Ensuring accountability in

Table 5.2 Technical Assistance Needs in the OT¹
(US\$ million, constant 1993 prices)

| <i>Item</i> | <i>Short-term²</i> (to end-1993) | <i>Medium-term³</i> (to end-1993) |
|--|--|---|
| Water and wastewater | 8.0 (6.5) | 10.0 (8.5) |
| Transport | 6.0 (4.5) | 12.0 (8.5) |
| Power | 7.0 (3.0) | 7.0 (5.0) |
| Solid wastes | 1.5 (1.0) | |
| Education | 4.0 (3.5) | 1.5 (1.5) |
| Health | 1.0 (1.0) | 1.0 (1.0) |
| Agriculture | 1.5 (0.5) | 2.5 (0.5) |
| Local government and public administration | 1.0 | 3.0 |
| Housing | 0.5 | 2.0 |
| Monetary, fiscal and trade issues | 0.5 | 0.5 |
| Inst. framework for public utilities | 1.0 | 1.5 |
| Env. action plan and management | 0.5 | 5.0 |
| Socioeconomic studies and surveys | 2.0 | 2.5 |
| Business support services | 0.5 | 1.5 |
| Total | 35.0 (20.0) | 50.0 (25.0) |

1. Figures shown are for commitments during the indicated period. Actual disbursements may lag commitments by up to two years.

2. Some of this TA may have been initiated recently with support from bilateral and multilateral donors.

3. Figures in parenthesis are the respective TA amounts required for project feasibility studies and project preparation work.

the use of TA funds would be another important consideration in designing the implementation arrangements.

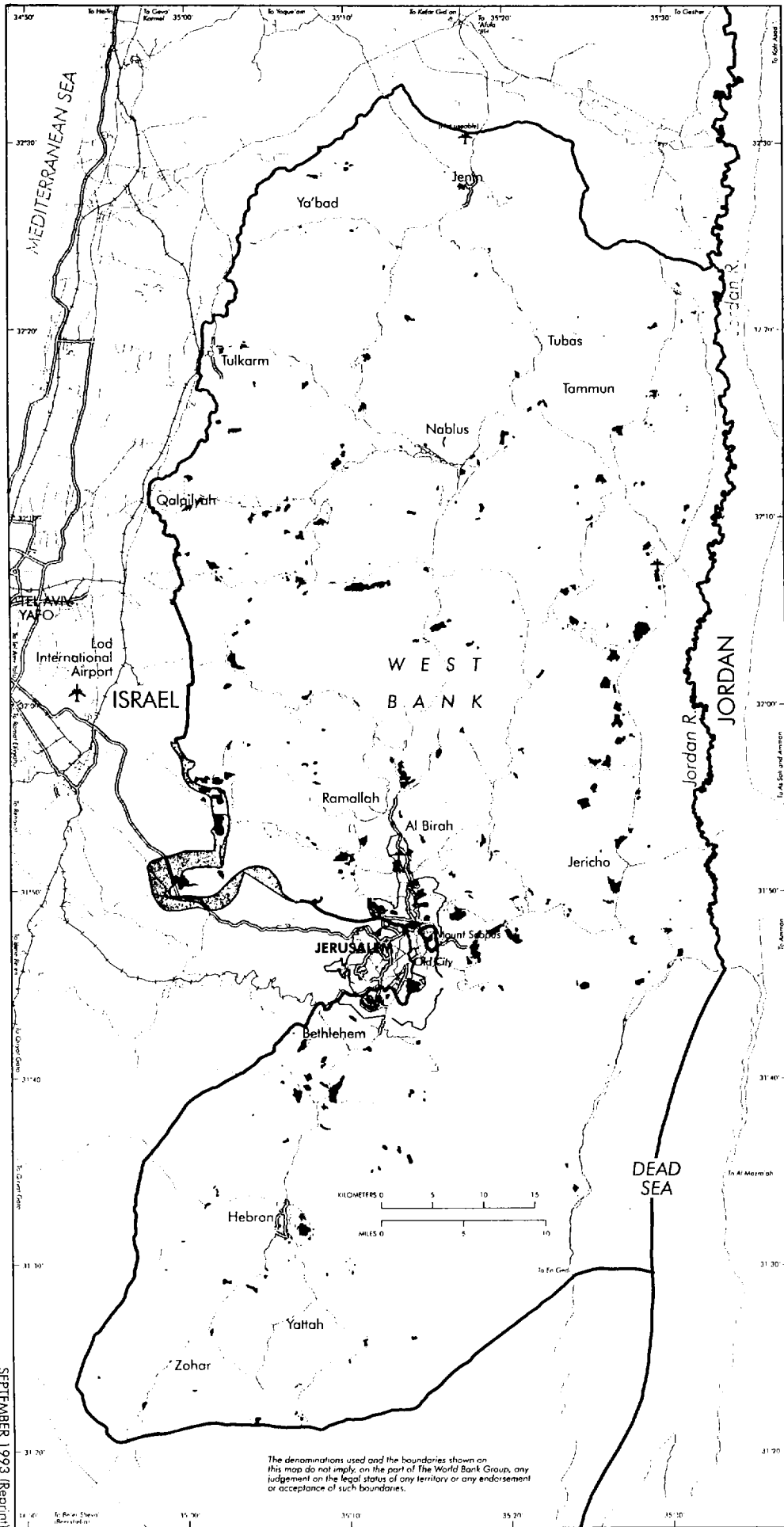
Notes

1. Bank consultant.

2. Even this was only possible due to an unusually high growth reported in the OT agriculture sector following the *Intifada*, apparently stimulated by Palestinian resistance to consuming imported produce. Per capita non-agriculture GDP declined by 12 percent between 1987 and 1991.

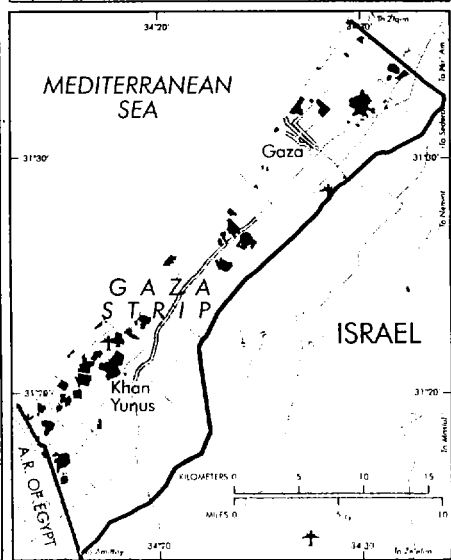
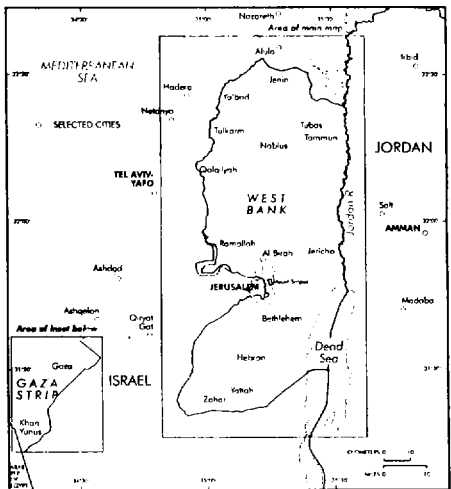
3. To the extent there is any net immigration into the OT following a peace agreement, the need for external inflows would be higher and depend, in part, on the asset base of the returnees.

4. The external inflows stipulated in these scenarios do not include labor income earnings in Israel, which are assumed to decline over time in both scenarios—but from a much lower level in the “sharp” reduction scenario.



OCCUPIED TERRITORIES WEST BANK AND GAZA STRIP

- ✚ AIRPORTS / AIRFIELDS
- ══ MAJOR HIGHWAYS
- TWO OR MORE LANES, HARD SURFACED ROADS
- ⚡ RAILROADS
- BUILT-UP AREAS
- ▲ UNRWA REFUGEE CAMPS
- ▲ ISRAELI SETTLEMENTS
- ARMISTICE DEMARCATION LINES, 1949
- NO-MAN'S LAND AREAS, ARMISTICE DEMARCATION LINE, 1949
- JERUSALEM CITY LIMIT, UNILATERALLY EXPANDED BY ISRAEL JUNE 1967; THEN ANNEXED JULY 30 1980
- INTERNATIONAL BOUNDARIES



The denominations used and the boundaries shown on this map do not imply, on the part of The World Bank Group, any judgement on the legal status of any territory or any endorsement or acceptance of such boundaries.

The World Bank

Headquarters

1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

Telephone: (202) 477-1234

Facsimile: (202) 477-6391

Telex: WUI 64145 WORLDBANK

RCA 248423 WORLD BK

Cable Address: INTBAFRAD
WASHINGTONDC

European Office

66, avenue d'Iéna
75116 Paris, France

Telephone: (1) 40.69.30.00

Facsimile: (1) 40.69.30.66

Telex: 640651

Tokyo Office

Kokusai Building
1-1 Marunouchi 3-chome
Chiyoda-ku, Tokyo 100, Japan

Telephone: (3) 3214-5001

Facsimile: (3) 3214-3657

Telex: 26838



12688 DEV 100
0-8213-2688-0
DEV OCC TER V1 OVERVIEW



400000009667

\$6.95

Cover design by Walton Rosenquist

ISBN 0-8213-2688-0
ISBN 0-8213-2694-5 (6-vol. set)