Iqtisadi
Middle East Economy

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Vol. 2, No. 5 July 2012

The Economic Viability of a Palestinian State[1]

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This article examines the economic viability of a Palestinian state and the conditions required for its future development. The Palestinian economy today reflects three lost decades in terms of growth and development. The economic situation seems particularly tough when compared with that of Arab economies, most of which achieved substantial progress during this period. Currently, Palestinian economic viability depends on large-scale foreign aid, which cannot be expected to last for long at the required volume.

Yet the Palestinian economy has considerable strengths. These strengths and advantages could allow Palestine to enjoy high and continual economic growth. This potential lies mostly in economic cooperation with Israel and a growth of exports, mostly to Arab markets. Comparing Palestine's economic development to Jordan's suggests that an export-oriented economic development strategy, in a new and stable relationship with Israel, could generate fast, sustainable growth in a Palestinian state.

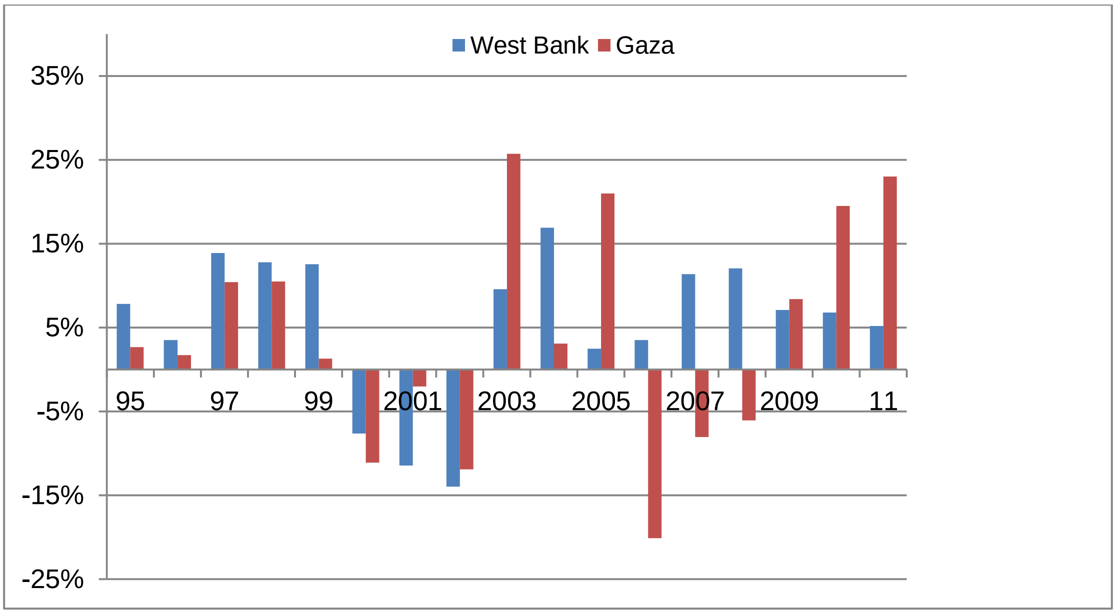
[1] This article is a summary of Yitzhak Gal's "The economic viability of a Palestinian state: insights and analysis in a long-term perspective," in Ephraim Lavie and Yitzhak Gal, eds., *Palestine–A State in Formation: Institutional, Economic and Planning Aspects* (forthcoming, the Moshe Dayan Center for Middle Eastern and African Studies and the Tami Steinmetz Center for Peace Research, Tel Aviv University).

The Palestinian economy's main features were consolidated during the first twenty years of direct Israeli rule, from 1967 until the eruption of the first Intifada in 1987, and to date remain largely unchanged. Economic growth was driven by an increase in personal consumption and investment in residential construction, based on incomes earned abroad. The development of industry and agriculture was very slow, and investments in economic infrastructure and production capabilities were low. This pattern of development steadily increased the economy's dependence on external resources.

With the eruption of the second Intifada in 2000, Israel restricted access and movement of people and goods in the Palestinian areas and into the Israeli market, which greatly damaged the Palestinian territories' economic functioning. The extent of Israeli security measures has since become the most influential factor on the Palestinian economy. As a result, the economy suffers from imbalance and an extreme dependence on external factors (mostly Israeli) and foreign aid. Economic development is characterized by large fluctuations in growth corresponding to the security measures imposed by Israel.

Chart 1 below illustrates this. The chart shows a high growth rate during a relatively peaceful period, 1997-1999; a steep decline in the first years of the Intifada, 2000-2002; and later improvement in 2003-2005. The data for 2006-2009 reflects the severe effect of the strict blockade on Gaza until the middle of 2010 and, at the same time, the positive effect of the alleviation of security restrictions in the West Bank. Alleviation of the blockade on Gaza in 2010 and 2011 had a similar effect on the Gazan economy.

Chart 1: Real Growth of Gross National Income in the West Bank and Gaza 1995-2011 (annual growth rates, %)



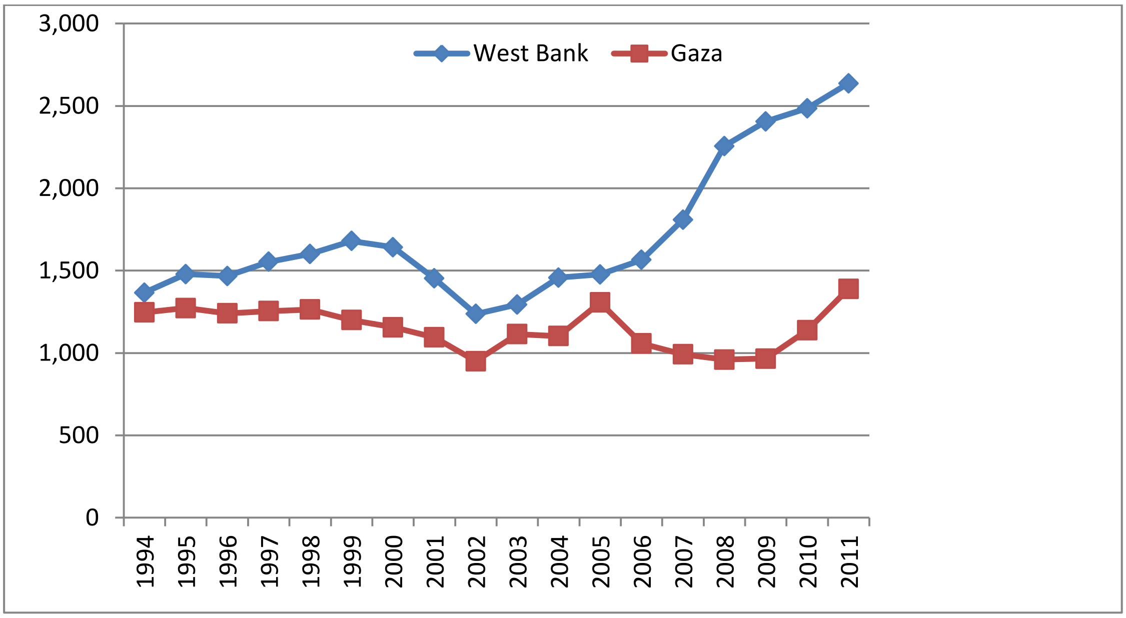
Source: PA, Palestinian Central Bureau of Statistics and IMF (2011 – preliminary assessment)

In the West Bank, improvement in security and easing of Israeli restrictions, along with the Palestinian Authority's (PA's) noticeable improvement in its functioning, enabled economic growth to pick up. Between 2005 and 2009, the West Bank's GDP grew by 43 percent; in real terms, GDP per capita also grew remarkably, albeit at a lesser rate of 26 percent (or by two thirds in current dollars, as can be seen in Chart 2). In the Gaza Strip, the strict Israeli blockade, directed against the Hamas regime, brought the local economy to an unprecedented low: a real decrease of 30 percent in the GDP and 40 percent in GDP per capita between 2005 and 2009.

The gap between the two regions in the level of GDP per capita, which in 2005 was only 13 percent in favor of the West Bank, grew to 150 percent in 2009 (Chart 2). The cumulative effect of the economic decline in the Gaza Strip following the harsh results of the first years of the Intifada brought the GDP per capita in Gaza to the level of less than $1,000 (in current dollars) in 2009. Such a low level of GDP per capita, along with other parameters, indicates an economic situation similar in many aspects to the situations in the world's most underdeveloped countries, such as Somalia. Then in the middle of 2010, a change emerged. The high growth rates in the West Bank showed the first signs of a slowdown. The one-time benefit of the easing of Israeli security restrictions started to wear off, while the basic weaknesses of the Palestinian economy became more and more apparent. In the Gaza Strip, on the other hand, the partial alleviation of the Israeli blockade in the middle of 2010 gave a boost to growth. In 2010, Gaza's GDP grew by more than 15 percent per capita, in real terms, and in 2011 grew another 20 percent. However, despite the growth in 2010-2011, GDP per capita in the Gaza Strip in 2011 was still lower, in real terms, than its level in 2005.[2]

Chart 2: GDP per capita in the West Bank and the Gaza Strip

1994-2011 ($, current prices)



Source: PA, Palestinian Central Bureau of Statistics and IMF (2011 – preliminary assessment).

The structural imbalance of the Palestinian economy is reflected in all economic parameters, especially in the huge deficit in the foreign trade account, as well as the deficit in the government's budget.

The deficit in the foreign trade account reflected very high imports (especially from Israel), compared with much lower exports (almost entirely to Israel). This developed

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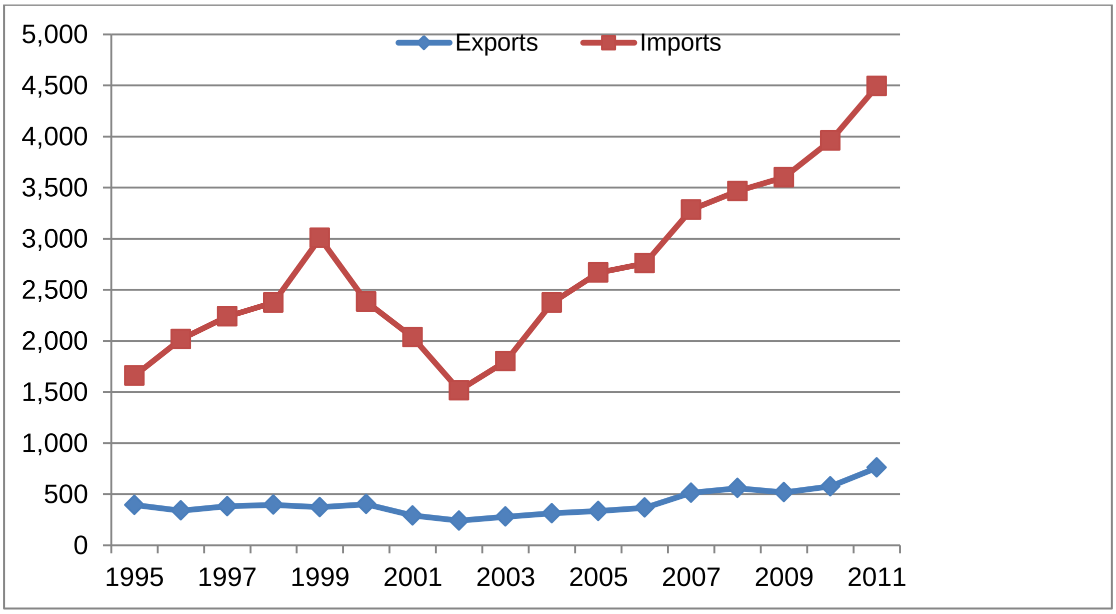
[2] In current prices. GDP per capita returned in 2011 to its nominal level from 2005 and even surpassed it a little; see Chart 2.

during the Israeli rule, but continued to grow during Palestinian self-government. The trade deficit grew from a little under $1 billion a year at the end of the Israeli rule to about $2.5 billion a year at the end of the 1990s, and was worth about 50–65 percent of the GDP. In 2011, the trade deficit was close to $4 billion, which is about 50 percent of Palestinian GDP.

The huge structural deficit in the foreign trade account is the result of the trade regime that was consolidated during Israeli rule and became permanent in the Paris Protocol, along with the security and other restrictions imposed by Israel. The Palestinian economy currently has no feasible option to develop large-scale exports. Exports to the Israeli market are held under a complicated system of limitations and barriers, and the barriers on exports to other markets are even more burdensome. As a result, Israel is the only significant export market of the Palestinian economy. During the past decade, Israel absorbed between 90 and 95 percent of Palestinian exports. In the last few years, a slight increase in exports has been noted, and the preliminary data for 2011 points to a significant growth. However, exports are still very small and growth in the last few years is dwarfed in comparison to the huge increase in imports, as can be seen in Chart 3.

Chart 3: PA Exports and Imports of Goods
1995-2010 ($, current prices)



Source: PA, Palestinian Central Bureau of Statistics and IMF (2011 data – preliminary assessment)

The inability to develop exports is one of the most difficult problems facing the economy. A small economy can only achieve stable, long-term economic growth through strong, continual increase in exports.

The steep rise in the trade deficit was funded by a parallel growth in foreign aid, which more than doubled between the first half of the 2000s and 2007–2009. The economy's deficits and the extreme dependence on Israel and foreign aid are reflected even more clearly in the PA's budget. Despite impressive progress made by the PA in tax collection, the indirect taxes collected for it by Israel amounted to 60 percent of its total tax revenues in 1999. Analysis of 2008–2009 budget data shows a similar share. The PA controlled only about 30 percent of its total budgetary resources, while Israel controlled about 50 percent, and international donors controlled about 20 percent.

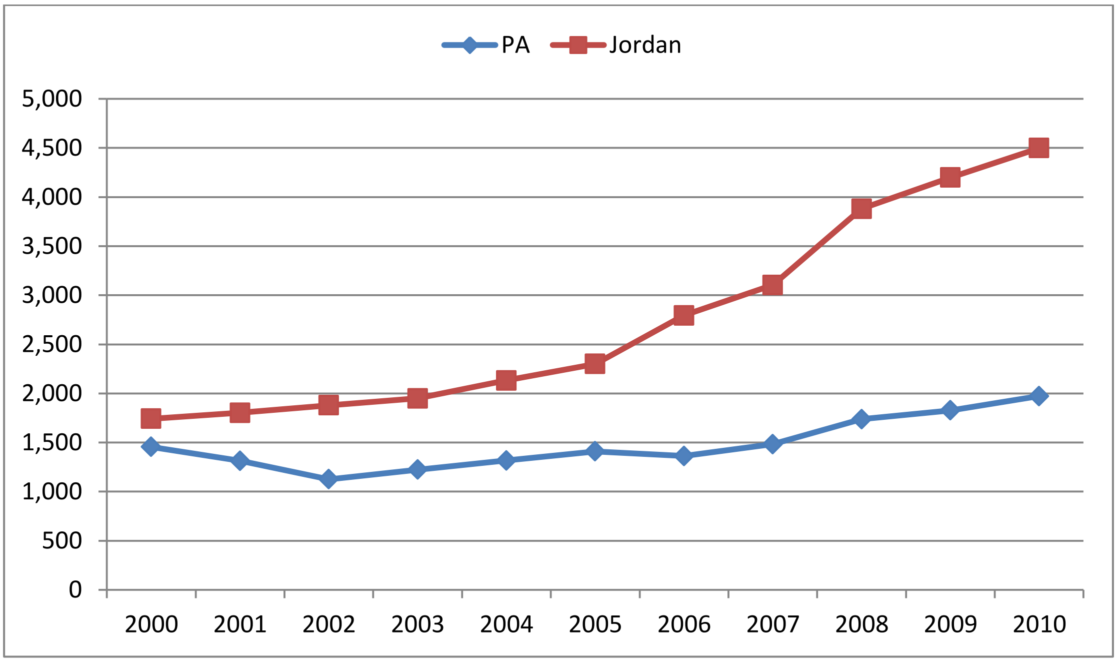
Because of the PA's economic dependence on tax revenues collected by Israel, its economic stability has been threatened again and again. With the eruption of the second Intifada at the end of 2000, Israel froze the transfer of tax funds to the PA for a prolonged period of time, a move that added another burden during the severe economic crisis of 2001-2002. Israel repeated this move in 2006, following Hamas's victory in the parliamentary elections and its establishment of a government in Gaza. A similar move was made in 2011 in retaliation for the Palestinian appeal for UN membership.

In long-term perspective, Palestinian GDP per capita in 2010 was 15 percent lower, in real terms, than in 1999.[3] The state of the economy is particularly weak when compared to other Arab economies that made significant economic progress during this period, especially in the last decade. Chart 4 shows Palestinian GDP per capita compared with that of Jordan over the last decade. Prior to the start of the second Intifada in 2000, Palestinian GDP per capita was about $1,500 (in current prices), very close to Jordanian GDP per capita, which was about $1,700. In the first years of the Intifada, Palestinian GDP per capita dropped to a low point of about $1,000 (in 2002), and only in 2007 returned to the nominal level of 2000. In 2011, following a very quick growth, Palestinian GDP per capita was slightly over $2,000.

[3] Calculated by the author out of the national accounting data of the PA from 1994-2010 (original data in dollars, in fixed prices).

Jordanian GDP per capita, on the other hand, grew faster and growth was more stable during the past decade; its level in 2010 was almost three times higher than that of 2000. The gap between it and Palestinian GDP per capita grew from about 15 percent in 2000 to about 125 percent in 2010.

Chart 4: GDP per capita in the PA and Jordan 2000-2010 ($, current prices)

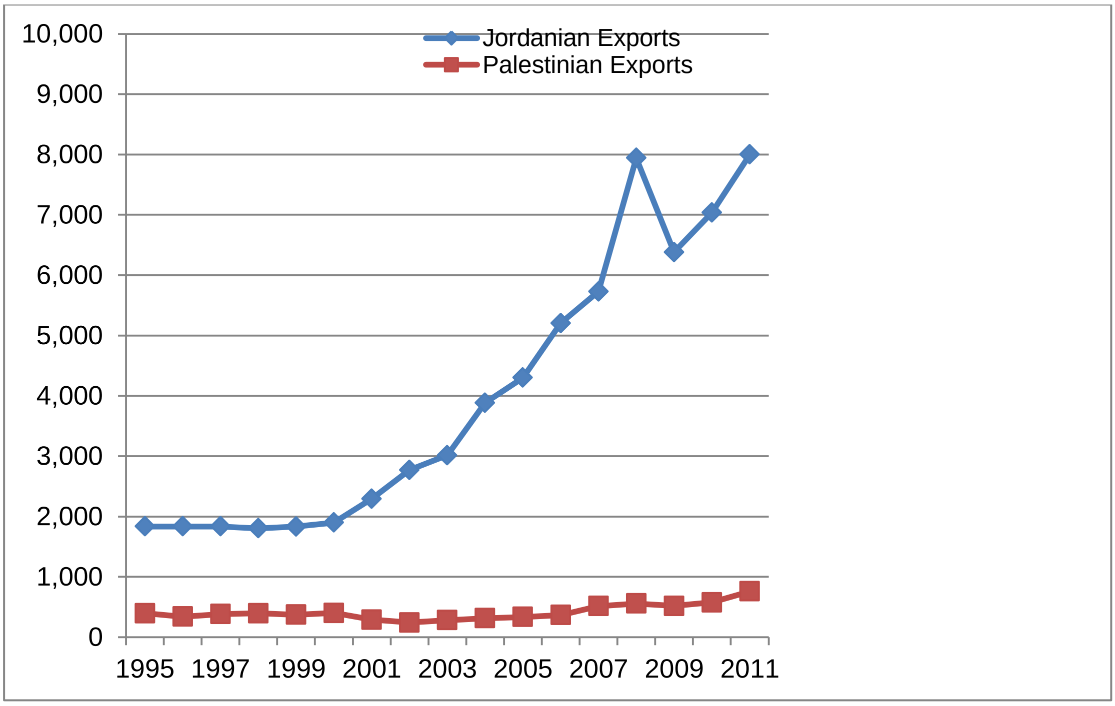


Source: PA, Palestinian Central Bureau of Statistics; Jordan – Central Bank

Jordan's continuous fast GDP growth was mainly due to robust export-oriented economic growth. The export of Jordanian goods grew fourfold in the past decade, from about $2 billion in 2000 to about $8 billion today. Palestinian exports, on the other hand, grew at a very low rate. This gap is illustrated in Chart 5. Overall, Jordan has tripled its revenues from the export of goods, services, and labor, from about $5 billion a year in 2000 to $15 billion in 2010–2011, while Palestinian overall exports of goods, services, and labor decreased significantly between 1999–2000 and 2011. In addition, foreign direct investments in Jordan grew almost fourfold, from an average of over half a billion dollars a year in the first half of the 2000s to an annual average of $2.5 billion in the second half of this decade, while foreign direct investments in the Palestinian economy fell dramatically.

Chart 5: Export of goods, the PA and Jordan

1995-2011 ($, current prices)



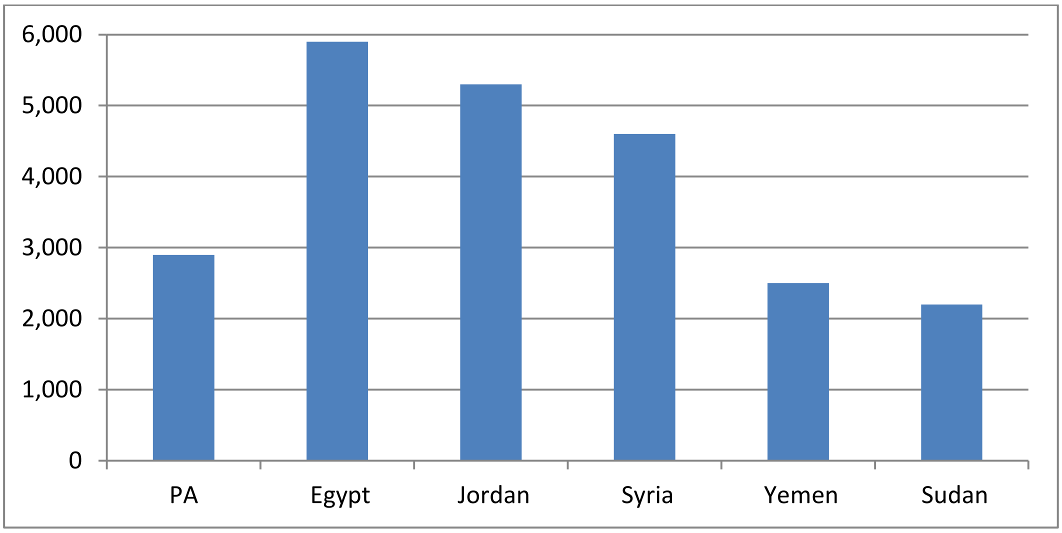
Source: PA, Palestinian Central Bureau of Statistics (2010 data – preliminary assessment, 2011 – predicted); Jordan – Central Bank

Chart 6 below compares Palestinian and Arab national income per capita.[4] In 2008, national income per capita in Egypt and Jordan was twice as high as that in the Palestinian territories. Even income per capita in Syria was higher than that of the PA by almost two thirds. Palestinian national income per capita in 2008 placed it at a slightly higher level than particularly poor Arab countries such as Yemen or Sudan.

[4] Comparison made in the Purchasing Power Parity (PPP) method, which calculates the level of product with the local level of prices.

Chart 6: Gross National Income per capita in the PA and several Arab economies

2008 ($, local purchasing power)



Source: *CIA World Fact Book*, GNI per capita, 2008

Along with the structural weaknesses described above, the Palestinian economy is struggling with a series of serious demographic, social, and economic challenges. The demographic challenge is the most serious one in the long term. The total fertility rate (the average number of live births a woman would have during her fertile period) of the Palestinian population declined steeply, from 6 births per woman in 1997 to 4.2 births per woman in 2010, but it is still one of the highest in the Arab world.[5] As a result, the Palestinian population is one of the youngest in the Arab world: 62 percent of PA residents are under the age of 24, and 41percent are under 14.

This young population needs education and health services, and as it matures, it demands adequate housing and decent job opportunities. The number of Palestinian youth reaching working age was 70-75,000 a year during the period 2000–2005. This number grew to almost 100,000 a year in 2010, and is expected to grow to 120,000 a year by 2020.

Another factor expected to increase the pressure on the labor market is the labor force participation rate (meaning the percent of workers, or job seekers, out of the entire working age population). The Palestinian labor force participation rate was traditionally low, mostly as a result of a very low participation rate among women,

[5] In comparison, the total fertility rate in Egypt in 2010 was only 3 births per woman.

but is expected to grow if the political and economic situation improves. Such an improvement will unleash the latent demand for job opportunities among youths who currently do not see any possibility of getting suitable work (especially women), or who despaired and quit the labor force. According to a quantitative analysis made by the author, in a state of economic and political stability, the growth in the participation rates (that is, the implementation of the latent demand for work among those who are not a part of the labor force today), along with continued growth in the number of new participants in the labor force, are expected to create an addition of about 8 percent a year to the labor force.

By these estimates, the PA must double the number of available jobs in the Palestinian economy from about 750,000 in 2010 to about 1.5 million in 2020 just to keep unemployment at its current rate, which is about 20-25 percent. The number of new jobs required to lower unemployment by 2020 to the rate prior to the Intifada (about 10 percent) is about a million, meaning about 100,000 new jobs each year during the next decade, compared to the 30,000 new jobs added on average to the Palestinian economy each year between 2003 and 2010.

Despite this, the Palestinian economy has strengths that would permit growth if a new political and economic relationship with Israel could be created. The most important of these strengths is an impressive economic and social resilience, manifested during the economic turbulence and the harsh conditions of the last decade. Along with that are its young and educated manpower and untapped production capacities. Additional strengths include the unique Palestinian advantage of immediate geographic proximity to the large, developed Israeli economy and the accessibility of the Arab markets, as well as the unusually large foreign aid the PA enjoys.

The Palestinian economy's extraordinary growth potential was repeatedly illustrated when the political situation improved, which led to easing of Israeli security barriers. Untapped production capabilities allowed the Palestinian economy to increase output immediately in response to the growth in demand as a result of these barriers' removal.

Being very small, the Palestinian territories can reach sustainable economic growth in the long term only through exports of goods and services (tourism, for example) and the export of "work services," i.e., Palestinian workers working outside of the

Palestinian economy in other markets that can absorb some of the Palestinian labor force. New relations with Israel are the key to the implementation of such an export-oriented economic development strategy. In addition, the Palestinian economy needs large and stable foreign aid that will support the process of economic rehabilitation and growth for at least another decade.

The comparison with Jordan's economic development helps to illustrate the Palestinian economy's growth potential in the case of a new relationship with Israel. Both economies are similar in the composition of their populations and in the basic structure of their economic resources. The most obvious difference between them is that Jordan has enjoyed independence and the ability to determine an export-oriented economic policy without any barriers and restrictions, while the Palestinian territories have lacked security, stability, free movement and access to export markets, as well as the ability to determine and run an independent economic policy.

A new relationship with Israel that removes these obstacles from the Palestinian economy could allow it to progress in a path similar to the one Jordan took in the last decade. Furthermore, the access and proximity of the Palestinian economy to the Israeli economy, Israeli technologies and international marketing platforms would give the Palestinian economy an advantage over Jordan's and allow it to progress even faster than Jordan did during the last decade. The economy's low starting point, combined with the momentum brought by a new trade regime with Israel, could allow the Palestinian economy to achieve quick, continuous growth in exports, and as a result, high, sustainable economic growth as well.

Yet even if the Palestinian economy will realize the most optimistic forecasts, and will achieve extremely high growth rates (around 10-11 percent a year on average for a whole decade), it will still be far from closing the gap, and will still be one of the poorest economies in the Arab world. The starting point of the Palestinian economy today is much lower than that of Jordan in 2000. The total Palestinian export of goods and services is minimal, less than $1 billion, and directed almost entirely to Israel, while transfers of funds from Palestinian workers abroad (not including Israel) are very limited.

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