



Editors: Paul Rivlin and Yitzhak Gal, Assistant Editors: Teresa Harings, Tal Fuchs

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The Palestinian UN Bid: Economy in Crisis

Yitzhak Gal

As the Palestinian Authority (PA) pushes for UN recognition of Palestine as a state, the Palestinian economy is sinking into crisis. The West Bank's economic recovery from the intifada, which was made possible by the partial easing of Israeli restrictions on Palestinian movement and increased foreign aid, has decelerated since mid-2010. In 2011, as a result of steep decline in international aid, the slowdown turned into a severe crisis.

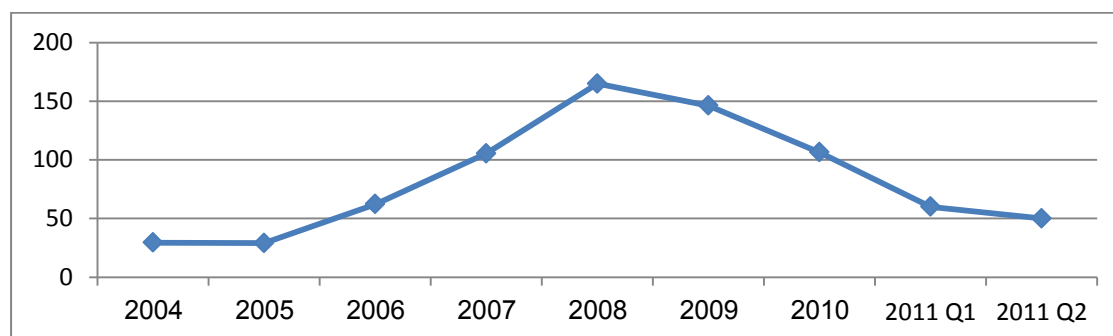
Since May 2011, the PA has not been able to pay the salaries of public-sector employees on time. Only in early August was it able to pay half of their June salaries. The PA is limited in taking additional loans to finance recurrent deficits because it is deeply in debt to local banks. Hence, at the end of August, in an attempt to pay the second half of June salaries before the Eid Al-Fitr holiday, the PA arranged short-term bank credit, while asking Israel for an early transfer of the next monthly payment of tax revenues collected for it by Israel. When the Israeli Ministry of Finance refused, the June salary payment was again partly delayed, and the PA's position with the banking system became even more difficult. Prime Minister Salam Fayyad described the situation as one of the worst financial crises the PA has ever faced.

State-paid employees, including security forces personnel, account for almost one quarter of Palestinian employment, and the PA's failure to pay salaries to the public sector has a major effect on the purchasing power of the Palestinian public. Growing resentment was heightened further as Palestinian households were unable to properly prepare for Eid Al-Fitr

and the new school year, and face uncertainty about their income over the coming months.

The West Bank's recent fast economic growth was driven mostly by generous international aid, which increased sharply in the post-Intifada years and financed public sector salaries, government services and a vast social security net. This trend changed in 2009 and aid steeply declined in 2010-2011. The average monthly amount of external aid received, for recurrent budget support and for development combined, fell by more than two thirds, from over \$150 million per month in 2008, to \$50 million per month in the second quarter of 2011.

External Support to the PA Budget, 2004 – 2011, Monthly Average
(aid for recurrent and development expenses, \$ million)



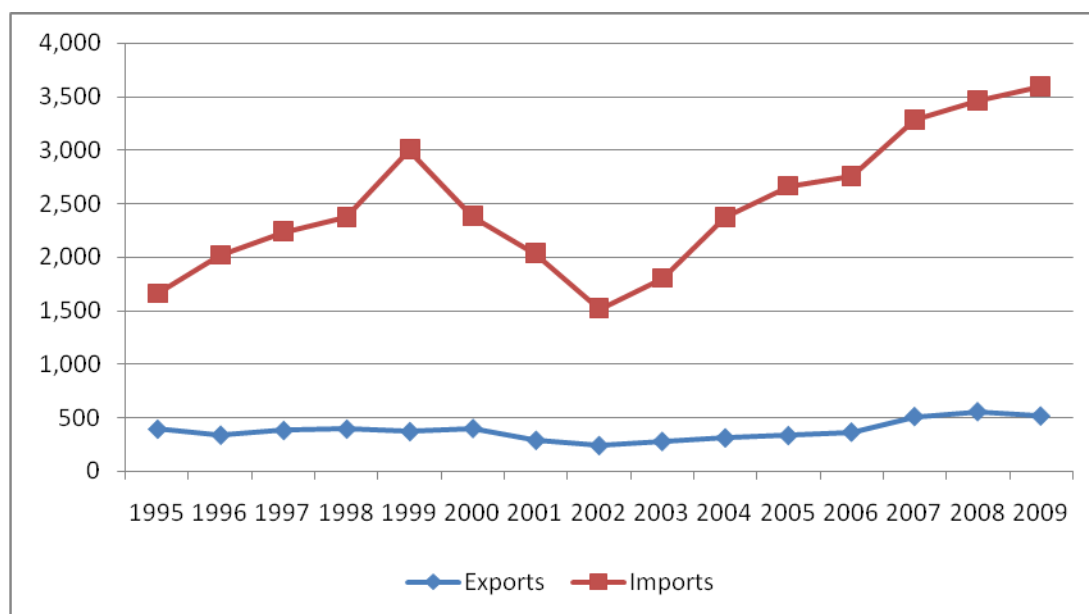
Source: IMF WB&G reports: April 2011, September 2008, March 2007; PA, Ministry of Finance, February 2011, June 2011

The speed and strength of the negative effects of the decline in external aid on the economy highlights the fragility and unsustainable nature of Palestinian economic growth. This fact has been repeatedly stressed by commentators. In April 2011, the IMF emphasized that recovery cannot be sustained without further easing of restrictions on movement and access. The World Bank warned that “growth does not appear sustainable. It reflects recovery from the very low base reached during the second intifada and is still mainly confined to the non-tradable sector and

primarily donor-driven.” The new Palestinian development plan for 2011 – 2013 notes that economic development under the present conditions cannot be sustained because “continued impediment of trade and investment would inhibit private sector growth, while public sector investment plans would continue to be stalled; ... and economic growth would falter... Budgetary revenues and external aid would be depressed. Rising unemployment and escalating poverty would necessitate increased expenditure on social transfers.”

These problems are made clear by looking at the components of the West Bank’s fast growth of recent years. Between 2005 and 2009, private consumption in the West Bank grew by 80 percent, government consumption grew by 136 percent, and investment in buildings (mainly for residential uses) increased by 120 percent. On the other hand, in 2008 and 2009, non-building investments, reflecting investment in the economy’s production capacity, were even lower than in 2005. The fast growth in consumption and in residential construction was reflected in a huge increase of imports, while that of exports was very modest. The gap between West Bank’s exports of goods and services and its imports rose between 2005 and 2009, from \$1.6 billion in 2005 to \$2.8 billion in 2009.

Palestinian Exports and Imports of Goods (\$ million, current prices)



Source: PCBS, Foreign Trade Statistics, 2009, published March 2011

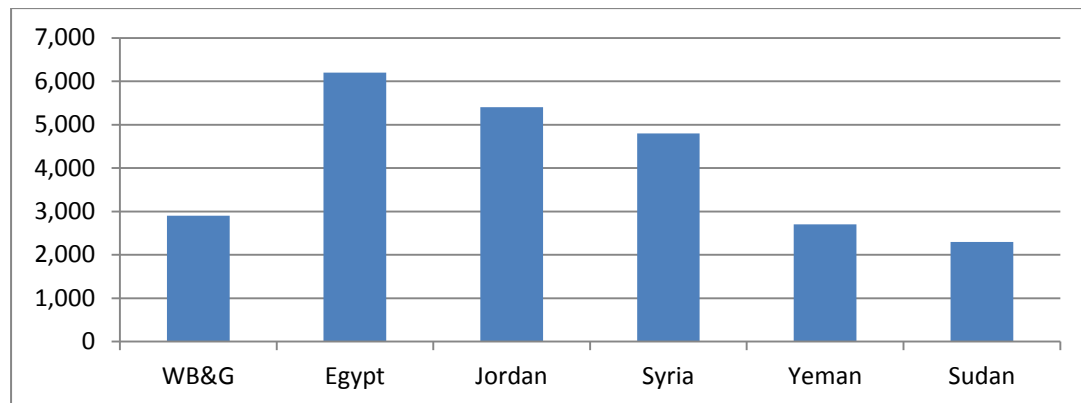
This pattern of growth mirrors the weaknesses and vulnerabilities, which have developed since 1967: extreme dependencies on Israel and external economic support; an under-developed economic infrastructure; a complex array of constraints related to the economic regime and restrictive trade arrangements with Israel; access and movement restrictions and other crippling physical constraints; as well as overwhelming demographic, labor-market and social pressures.

These problems are interwoven with the political stalemate and the recurrent eruptions of conflict with Israel, and influence all aspects of Palestinian economic and social life.

External trade patterns illuminate this. The present Israeli-Palestinian trade regime combines with other Israeli restrictions in gravely constraining Palestinian exports. As shown above, the PA has developed a huge structural trade deficit, which, in turn, has greatly increased Palestinian dependency on external Sources of income and aid.

Another remarkable example relates to purchasing power and standard of living. The economic integration with the Israeli market is reflected in price levels similar or close to Israeli ones, while Palestinian wages are much lower than in Israel. As a result, the real purchasing power of Palestinian households is much lower than the nominal level shown in national accounts and household income statistics. The impact of this linkage on price levels is dramatic. International comparisons show that Palestinian GDP per capita, when adjusted to local purchasing power, is far lower than that of neighboring Arab countries, and is only slightly higher than that of countries as poor as Sudan or Yemen.

West Bank & Gaza GDP per Capita, in Comparison to Selected Arab Countries (\$, adjusted to local purchasing power according to the PPP method, 2010 estimates)



Source: CIA World Fact Book; Country Comparison: GDP per capita, as per the Purchasing Power Parity (PPP) method.

Despite these weaknesses, the PA has greatly advanced in the process of state-institution building, based on the “bottom up” approach outlined by Prime Minister Fayyad. Since Fayyad’s program was launched, the PA has strengthened its institutions and performance in the fields of governance, economic management, infrastructure, fiscal responsibility, justice and rule of law institutions, and social services. Although these resulted from the commitment of the PA government under Prime Minister Fayyad, they were also based on strong donor backing.

Furthermore, as emphasized in the Palestinian development plan for 2011 – 2013, state-institution building must go hand in hand with long-term economic development, and cannot be sustained unless international aid continues at a generous level in coming years.

International aid to the PA is politically motivated, as the international community has regarded its economic aid as one of the pillars of the Israeli-Palestinian peace process. Considering the strong political nature of international aid to the PA, the impasse in the peace process has weakened donors' commitment, reflected in the reduction of aid since 2010. Bearing in mind the growing internal economic pressure on the main donors—the US and the EU—it is very likely that the sharp cut in the volume of aid in 2010 – 2011 will not be reversed unless the international community feels that the peace process has revived and there is a realistic chance of a political solution.

Declining external aid combined with the other weaknesses of the Palestinian economy put the economic and social stability of the PA at imminent risk. Economic and social risks would increase if the bid for UN recognition is followed by continuation of the political impasse, which might trigger stricter Israeli restrictions on movement and access, and delays in transfer of Palestinian tax revenues collected by Israel. This would deepen the economic crisis and would gravely weaken the PA. Social unrest may combine with political frustration to take angry young Palestinians to the streets, and further de-stabilize the position of the PA and Israeli-Palestinian relations.

The Politics and Economics of the Arab Spring

Paul Rivlin

The so-called Arab Spring has so far resulted in the fall of the rulers of Egypt, Libya, Tunisia and Yemen. The future for President Assad of Syria now looks very uncertain.

The reasons for the protests were different in each country, although all included the call for freedom. What unites these unprecedented protests is the electronic media that sections of the population in each country can access. Crucially, when Egyptians saw and heard about the fall of Ben Ali in Tunisia, they were galvanized by the idea that they could do the same. When they did, protests took hold in Syria where most people realized that the regime would be much more vicious in defending itself, and it was. Tribal and ethnic divisions played a role in the conflicts in Libya and Yemen, factors that were absent in Egypt (although Salafist violence against Copts preceded and followed the ousting of Mubarak) and Tunisia. They are not far from the surface in Syria where the Alawite-controlled army remains largely united behind Assad.

Behind the revolts in these five countries, and the pressures for change in Bahrain, Jordan and Morocco, are political and economic factors. While there was economic growth in Mubarak's Egypt and Ben Ali's Tunisia, it was accompanied by very unequal distributions of income, high poverty rates and massive corruption.

How did these rulers manage to control their societies for so long and accumulate so much wealth? One explanation is that for hundreds of years the state in the Middle East was strong and society was weak. This pattern prevailed into the twenty-first century: not only was society weak and the state strong, but the latter increased its power at the expense of

the former. In Egypt, Nasser, Sadat and Mubarak all acted against political parties that had their origins in Egypt's democratic (or relatively democratic) period from the 1930s to the 1950s. The military regimes tried to monopolize power in a way that left democratic forces very weak. This poses major problems as the first parliamentary elections of the post-Mubarak era approach. Still, Egypt and Tunisia do have traditions and the remnants of institutions (including some pluralism of thought and political parties) that may help them move closer to democracy in the future. These factors are significant and contrast with the US-led attempt to bring democracy to Iraq where ethnic divisions have determined the results of elections and attempts to develop a political culture of compromise have so far failed.

The Free Officers' regime that has ruled Egypt since 1952 and the Baath in Iraq and Syria all created economic systems that placed the state in the center. The private sector was emasculated in the 1950s and 1960s and has remained deeply dependent on the state ever since, despite years of partial economic liberalization. Not only the private sector, but the society as a whole, became dependent on the state.

Among the factors that have created tensions in recent years are demographic pressures, the role of rents, the effects of the inter-Arab system, the impact of colonialism and the reaction to it and finally the impact of economic policies implemented under the framework of the Washington Consensus that generated greater inequality.

Even though in recent years growth rates have slowed, the absolute size of the population in all Arab states has increased. In 1970, the Arab population was 122 million. By 2005 it had more than tripled to over 300 million; the UN forecast for 2015 is 395 million.

The population of working age has grown much faster: from 64 million in 1970 to 164 million in 2000 and a forecasted 240 million in 2015. The fact that the share of those of working age in the total population has increased from 52 percent in 1970 to 54 percent in 2000 (and a forecasted 62 percent in 2015) means that there are and will be more shoulders to carry the burden of looking after the young and old. But this assumes that there is work for them and that assumption is false. Unemployment has, in fact, increased and among the consequences have been poverty and income inequality. Demographic transition means more young people are coming onto the labor market but the economy is not growing fast enough to absorb them. This has major political implications and young people have played a significant role in the Arab Spring.

The weakness of the productive system – industry, agriculture and services – in the Arab world is closely related to the role of rents. There are several kinds of rents: the first is income from natural resources, primarily oil and gas. Another is foreign aid and a third emigrant remittances. These sources of income are largely not earned as a result of work in the economy. The most dramatic example is oil: a barrel of crude oil costs as little as \$5 to drill out of the ground in eastern Saudi Arabia and Iraq, but it sells for up to \$100. This means that 95 percent of the proceeds are rental.

All Arab countries have been involved in the rental economy, even those with little or no oil, because poor countries have sent labor to work in the oil states and have become reliant on the incomes that are sent home. Egypt, Jordan and some other states have relied on foreign aid, exploiting their geo-political position to extract benefits from the international system and from richer Arab states (or in the case of Syria, from Iran).

There are also longer-term factors at work. Islam began in part as a response to some of the inequalities that prevailed in the seventh century: Islamic inheritance laws were designed to spread wealth and prevent its accumulation in fewer and fewer hands. As men were allowed many wives, they often had many children. Islamic inheritance law protected them all. While Islam put ethical or social considerations first, the business empires of successful merchants never survived them. Their estates were divided and dispersed into small, commercial institutions that were incapable of mobilizing large quantities of productive resources and enduring over time. The region did not, of course, develop alone: it had to compete with its neighbors. Competition created gaps and these widened over time. In the year 1000, the share of the Middle East in world's gross domestic product (GDP) was 10 percent while Europe's was 9 percent. By 1700, the Middle East's share had fallen to just 2 percent while Europe's had risen to 22 percent. In 2005, the Arab states had 2.4 percent of world GDP, a very modest improvement.

In Europe, the corporation was created on the basis of Roman law, from which other business structures developed. By 1470, the house of the Medicis had representatives in eight European cities. In contrast, the Islamic world failed to innovate. Under Islamic law, businesses could be dissolved at the whim of a single partner. Islamic inheritance laws and the practice of polygamy meant that wealth was dispersed among numerous heirs.

As business became more complex, the West was much better placed to take advantage of economic opportunities. While business institutions in the Islamic world remained atomized, the West developed ever more resilient corporations with limited liability widely available in the mid-

19th century—as well as vital business systems such as modern systems of book-keeping and stock markets.

The weakness of the Islamic world's economy and political system and the existence of strategic assets—the region's location between Europe and Asia and, from the twentieth century, its oil—meant that it was exposed to foreign intervention. After independence, its response was in part to turn to the Soviet Union and then back to the West, constantly collecting strategic rents, acting as a proxy in superpower conflicts and suffering economically as a result. This helped breed complacency towards autocratic regimes as long as they preached anti-Westernism. The notion that change would benefit the West and Israel, rather than looking at issues through the prism of “what is good for us,” was commonly held.

For years the inter-Arab system has meant constant inter-family quarrels. There have also been wars with neighbors including Israel and Iran. These have had enormous costs for countries such as Egypt and Iraq. Civil wars in Lebanon and Sudan, conflicts in Morocco and Yemen, and now those in Libya and Syria have all caused or are causing economic damage. Why did Egypt get involved in the war in Yemen and then the Six Day War against Israel just as it needed all the resources it could muster in order to implement its five-year plans and industrialize? The simple answer is that the regime felt that politics was more important than economics for its survival.

From the late 19th century onwards, the Middle East created Western-style institutions in order to boost economic growth. It modernized its legal systems, enabling corporations to be formed and other changes. These steps helped, but they were introduced in an unhelpful environment: other institutions that were needed to support growth were

either weak or absent. The region lacked (and still lacks) a strong civil society and educational institutions that would supply the lawyers, administrators, technicians, engineers, scientists and others needed for economic development to take off. The legacy of Islam and its close association with the state has been to discourage critical thinking lest this be considered apostasy.

The Arab Spring, by concentrating on domestic issues, is a refreshing change, although as current events in Egypt suggest, it is far from clear that the new thinking will prevail. Even if it does, the Arab world has a long way to go if it is to catch up with more dynamic economies elsewhere.

For the previous issue of Iqtisadi, Press [here](#).