

Economic Support for Peace: The Role of the Donor Community

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In-Depth Reports

We have all heard the statement that foreign policy is economic policy, and vice versa. This may seem like a cliché when one talks about the need for a global trade regime in the post-Cold War world, or U.S. bilateral relations with Mexico. But even in a region where politics continue to be the central challenge facing the international community, it is an important truth. In fact, when one looks closely at the dynamics of the overall situation and the prospects for the future in the Middle East, nowhere is the link between economic and foreign policy more relevant.

History teaches that countries with rapidly growing economies are more likely to maintain political stability and less likely to become involved in conflicts, either at home or abroad. Of course economic prosperity does not eliminate political struggle and tension, nor should it be a substitute for democratic ideals. But it does foster peaceful and evolutionary resolution of differences and attainment of national consensus. Prosperity expands life choices. Individuals have more hope for the future -- and are less likely to fight for violent change -- when they live in societies with economies that are creating jobs.

This is why the reconstruction of the Palestinian economy is so profoundly important. Without economic growth in Gaza and the West Bank, it will be extraordinarily difficult to continue to advance political reconciliation.

A Profile of the Challenge The West Bank and Gaza are home to almost 2 million people with a per capita income of roughly \$1,500. That is broadly comparable to the per capita income of countries like Turkey, Algeria, Thailand, and the Ukraine. The total gross national product (GNP) of the Palestinian economy is nearly \$3 billion, or about 5 percent of the Israeli GNP. It is equivalent in size, as MIT economist Stanley Fischer likes to point out, to the economy of Newton, Massachusetts.

The Palestinian economy is neither large nor typical. Unlike many others, its GNP and gross domestic product (GDP) are significantly different. GNP is about one-third higher than GDP because of Palestinians who earn their incomes through migrant labor in Israel and the Gulf. Agriculture accounts for more than 20 percent of GDP and more than half of exports. And industry makes up less than 10 percent of GDP. Average industrial production for countries of comparable income size is in the range of 30-37 percent. Sixty percent of the industrial firms in the area employ less than four workers. In other words, there is great potential for industrial growth.

Social indicators are also important factors in assessing what needs to be done and how difficult it will be. While statistics on unemployment and underemployment vary significantly, they all indicate that insufficient job opportunities are a major problem. Population growth is high -- about 4 percent in the West Bank and 5 percent in Gaza. Roughly half of the population is under 15-years-old. Infant mortality in 1991 was forty-two per 1,000 live births. Electricity consumption and telephone subscriptions are well below those of neighboring Jordan and Egypt.

Growing a Palestinian Economy Developing the Palestinian economy will require capital, technical resources, and confidence-building. But there are more basic considerations that must also guide this process. While conditions

and characteristics vary from country to country, there are certain principles that carry economies through the development process.

First, the private sector is and must be the engine of growth for any economy. This is an area where the Palestinian people have an advantage, since they are widely known for their entrepreneurial energy and drive. This potential must be facilitated at all levels -- particularly at the smallest scale, where individuals who have not been inclined or able to contribute to the economy during the occupation now have the incentive to become productive economic actors. The prevalence of cottage industries in the West Bank and Gaza adds weight to this argument.

Second, the innovative hand of the market cannot operate without the strong skeleton of the government. Governments must have the capacity to assess and collect taxes. They must have the authority and means to enforce the law. They need to establish a regulatory system that protects citizens without putting counterproductive constraints on economic activity. The Palestinian authority must establish policies and operations that allow citizens and the business community to be confident about their ability to pursue their interests. This includes both a sound and stable macroeconomic policy and a market-based approach to all aspects of economic management.

Of course, these broad principles must be applied with the special circumstances of the Palestinian economy in mind. The Paris and Cairo agreements defined how the new Palestinian economy would interact with the Israeli economy, and in so doing set some parameters for how the private sector can operate and how the government must do its job.

The economic protocol between Israel and the PLO calls for an expansion of trade for the West Bank and Gaza. It allows the Palestinians to import from neighboring Arab countries in quantities to meet their demand, and -- it is important to note -- it provides for unlimited exports from Gaza and the West Bank. The Palestinian authority will need to focus on expanding the opportunities for exports. Free trade agreements within the region should be a priority, and trading relationships with the United States and the European Community should be nurtured.

The business community needs financial services as it seeks to expand its activity. Banking activities, which have been strictly limited up to this time, will be supervised according to the international principles of the Basel Committee. Facilitating the development of this sector while wisely regulating it will be a major challenge. And there are specific guidelines for assessing and collecting tax revenues and distributing them appropriately between the Israeli government and the Palestinian authority.

In this context, there are several clear indications about how growth and governance can and should proceed. The private sector will have increased opportunities to fill needs within the region, particularly infrastructure, and the potential for exports will be greatly increased. The agricultural and industrial sectors are the most likely sources of dynamism. The relatively small role of the industrial sector to date can be at least partially attributed to conditions that discouraged investment -- high political risk, lack of financial intermediaries, and legal problems of property and land ownership. While improved production methods and marketing can increase agricultural output and profitability, agriculture will still be limited by the region's scarce water supplies.

Palestinian Development Strategy and International Support The success of reconstruction and economic development will be determined by the efforts of the Palestinians themselves, and this is where the focus should be. But foreign assistance and advice will profoundly affect this process. We want to contribute to success in Gaza and the West Bank, without driving the process from outside or complicating it with our commentary.

It is clear that the Palestinian economy is in a position to benefit to a larger extent from foreign assistance than other developing economies. During the October 1993 conference here in Washington to support peace in the Middle East, the donor community pledged \$2.1 billion -- including \$500 million from the United States -- over the next five years for the development of Gaza and the West Bank. This amounts to \$200 per person annually for the next five years,

and makes the ratio of assistance pledged to Palestinian GNP quite high -- about 13 percent -- compared to 2 percent of GNP that Europe received under the Marshall Plan, and about 10 percent for those African and other countries that are currently considered to be relatively high aid recipients.

The challenge is clearly not to find enough resources, but to use the resources that have been found well. During the October conference, we also established an ad hoc liaison committee, with the World Bank as the secretariat, to coordinate international donor assistance to the Palestinians and avoid duplication. The Bank has also assisted the Palestinians in developing an investment plan and economic strategy that includes the following priorities:

- Start-up costs. The Palestinians have a number of clear and immediate needs as they seek to start their operations in a range of areas. It is vital that they be equipped to move as efficiently as possible. A number of donors are helping in this area. This is not a traditional way of approaching development. Donors prefer to target money to specific projects. Excessive expansion of the government sector has traditionally been a problem in a number of developing countries, but in this case, more government is actually needed. And donors have responded by pledging \$120 million toward these needs. The Johann Jurgen Holst Peace Fund coordinated by the Bank is a part of this effort.
- Infrastructure. In order for the Palestinian economy to function smoothly and expand, the basic physical infrastructure must be in place. Infrastructure and public services are inadequate in all areas -- water, electricity, transportation, and communications. Financing projects in this area is a focus of both donors and the private sector. And infrastructure projects will be an important stimulant of economic activity and job creation as well. There is a Special Emergency Rehabilitation Project totaling \$128 million for water, sewage, road and power rehabilitation. \$98 million of this is co-financing from other donors.
- Housing. Action here will be one of the strong contributors to a positive outlook on the part of the Palestinian people. It is important both to meet immediate needs and to develop a viable long-term approach. This is an area in which the U.S. Agency for International Development has been particularly active: a \$25.5 million project is underway to build new homes and renovate existing ones.
- Institution building. Building administrative capacity is a critical element of each and every project, as well as in overall international support for the Palestinian effort. The World Bank is administering a \$30 million technical assistance program to help the Palestinians develop policies that will help the economy grow and sustain itself.

A critical element of success in the Palestinian economy will be the creation of an institution to receive assistance, coordinate its distribution, and work with the international community on development strategy. Transparency and accountability in this process, as in any such institution, will be critical if overall Palestinian governance is to earn the confidence of both donors and citizens.

The Palestinians are establishing a structure to fill this role known as the Palestinian Economic Council for Development and Reconstruction (PECDAR), which will be the voice of Palestinian development priorities and the agent for interaction with the donor community. The council will make policy decisions and develop future institutions to make and implement policies on financial, trade, labor, health, and education issues, among others.

Looking Forward Having spent eight months in the difficult process of implementing the declaration of principles, we have made progress. We now have a chance to move forward. The potential and the opportunity are all there. The question is whether we can seize it.

Faisal Husseini is fond of comparing the signing of the Declaration of Principles to the birth of a child. While some were expecting a stronger newborn, I want to point out that the nurturing and maturing of this child is much more important than its birth weight. The Palestinian leadership has the task of insuring that the interim self-government

will mature and that the Palestinians have the support of the international community in assisting them in the process.

I became a father around the time of the Madrid peace conference in September 1991. Becoming a parent is infinitely more difficult than I ever anticipated. All my prior experience did not fully prepare me for the extreme pleasure and trials that come with a child -- or, in my case, twins.

I anticipate that it will be the same for the Palestinian Authority. There will be up and downs as the economy and its institutions mature in normal fits and starts. The decisions of the Palestinian authority will determine the general form and direction of the economy. As economic growth takes hold, the economy will undoubtedly experience some adolescent challenges. But with perseverance and appropriate international support, the Palestinians can look forward to a robust and diverse economy that will support their efforts to achieve a secure, stable, and prosperous home.

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