1 Evaluating the emerging Palestinian state

‘Good governance’ versus ‘transformation potential’

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In assessing the governance capacities and areas of weakness of the Palestinian state, we have to remember that we are evaluating a developing-country state that potentially shared all the challenges of economic development faced by other developing country states. But moreover, the ‘quasi-state’ that was set up in 1994 to administer parts of the occupied Palestinian territories lacked most of the powers of a conventional developing country state. Apart from lacking control over borders or possessing contiguous territory, the PNA also lacked an adequate fiscal base and was dependent on tax remittances of customs and income taxes collected by Israel from Palestinians. Its trade relationships with the outside world were dependent on Israel with which it remained in a customs union. Its economic survival therefore depended on transfers from Israel of taxes collected from Palestinians and on aid from donors. The movements of goods and people to the outside world and even within its own territories had to go through multiple Israeli controlled checkpoints that could be opened or closed depending on the satisfactory performance of the PNA from the Israeli perspective of delivering security (see Chapter 3 by Zagha and Zomlot, pp. 000–00). On the Palestinian side, Oslo and the subsequent accords were premised on a huge gamble by the PLO, and later by the PNA. Their leadership hoped that rapid progress could be achieved, based on these agreements, to lead to a sovereign Palestinian state on the entire occupied WBG (*including* East Jerusalem), that a just solution to the question of Palestinian refugees would be found, and that there would be rapid economic progress under Palestinian sovereignty. Only then would it be able to undercut support for rejectionist political positions within the Palestinian community and guarantee its own political survival.

State formation under these conditions required a high degree of executive centralization. This was widely recognized and built into the governance architecture created for the PNA under the Oslo Agreements. Much of the observed maladministration and some of the evidence of corruption flowed directly from the construction of this architecture. It is important to remember that this architecture was essential for the ‘security-first’ route that Israel insisted on, and nothing else was on offer to the Palestinians in their attempt to construct a two-state solution. Nevertheless, the Palestinian president operating this centralized system enjoyed widespread legitimacy within the WBG Palestinian constituency. This offered a unique historical opportunity to make painful decisions provided clear achievements towards rapid statehood could be demonstrated to the Palestinian public. But in fact, progress on this route came to a grinding halt with the outbreak of the Second *Intifada* following the breakdown of final status negotiations at Camp David in July 2000. As the *Intifada* advanced and Israeli military and political reactions intensified, the project that motivated the establishment of the PNA became increasingly vulnerable. Inevitably, the *Intifada* and Israeli reactions to it will lead to a fundamental re-thinking of strategies on both sides, and what may have been possible in the Oslo phase may not be possible later on. In any case, the causes behind this dramatic reversal have to be properly understood, even if only to identify more accurately the hurdles on the way.

Table 1.1 gives a picture of the economic performance of the Palestinian territories during this period. Clearly, the period in question was very short and the data has a margin of error. But it is good enough to indicate the broad outlines of economic performance. Compared to other middle-income developing countries, economic growth in the Palestinian territories was remarkably high before the blockade that was imposed on the economy after the beginning of the Second *Intifada* in 2000. These high growth rates, and the high investment rates sustaining them, are particularly remarkable given the great uncertainty about the future of the territories. Immediately after the creation of the PNA in 1994, growth rates were low, partly because of administrative disruptions but largely because Israel immediately set about establishing internal borders and checkpoints to control Palestinian population movements and the transit of goods. However, by 1997 real gross domestic product (GDP) growth became strongly positive. By this time, the PNA had established much of its administrative apparatus. Moreover, by then Israel had also set up its checkpoints and internal borders, and it began to allow more Palestinian labour movements, but now with the possibility of shutting off entire Palestinian areas not only from Israel but also from each other at very short notice. Private investments in the Palestinian territories also picked up sharply after 1997, indicating that the PNA had acquired the capacity and credibility to induce expatriate Palestinians to begin investing in the territories. The share of industry, broadly defined, remained constant at around 20 per cent of GDP over 1994–2000. Given the rapid growth of GDP during this period, this indicates that growth rates for industry were just as high.

Throughout this period, the Palestinian territories remained heavily aid dependent, with 18 per cent of GDP coming from aid in 1994. However, as GDP grew, the share of aid declined sharply to around 10 per cent of GDP by the end of the period, and this possibly explains the decline in *public* investment over this period, which was heavily financed by aid.[1] In 1999, the

Table 1.1: The economy of the Palestinian territories 1994 –2002

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001 (est)*	*2002 (est)*
Real GDP growth rate	8.5	6.1	2.5	12.2	11.8	8.9	-5.4	-15.0	-14.5
Real GNI growth rate	0.9	8.5	0.8	12.4	16.3	8.4	-6.8	-16.2	-16.4
Share of industry in GDP (%)	21.8	21.7	19.8	19.9	20.0	19.1	20.7	na	na
Share of private fixed investment in GDP (%)	26.5	21.8	26.3	25.3	26.4	31.7	25.0	20.1	16.6
Share of public fixed investment in GDP (%)	6.6	9.5	6.6	6.5	6.4	7.0	5.4	6.1	3.5
Aid as proportion of GDP (%)	18	17.6	15	14	10	11	12	na	na
Unemployment rate	14.8	18.2	23.8	20.3	14.4	11.8	14.1	25.5	31.1

The difference between gross domestic product (GDP) and gross national income (GNI) is that the latter includes the income of Palestinians working in other countries, in particular, Israel. Industry includes mining, manufacturing, electricity, water and public enterprises. Figures not available are reported as 'na'.

Source: IMF (2003): 20-25 (for recent estimates of disbursed aid), Tables 2.1, 2.2, 24; Valdivieso et al. (2001): Table 1.1, World Bank (2000, 2001).

per capita GDP (at current prices) for WBG (excluding East Jerusalem) was estimated at $1,641 ($1,851 for the West Bank excluding East Jerusalem and $1,339 for the Gaza Strip).[2] Clearly there were serious economic problems but Palestine was potentially not the typical basket-case economy that often emerges out of long-running conflict situations. In particular, the evidence on *private* investment and GDP growth, once the administration had stabilized, are not unimpressive for a high-conflict zone. Service-delivery by the authority in key areas of health and education had its critics and suffered from resource scarcities, but performance was comparable to or better than in countries at similar levels of development (as assessed by a task force commissioned by the US Council on Foreign Relations 1999: 5). All of these achievements, however limited, came to an abrupt halt in 2000. The Israeli control over the borders of non-contiguous Palestinian enclaves and many of their inner roads explains the massive and immediate impact of Israeli closure measures following the Second *Intifada*. The subsequent years mark a clear break with the previous period. The administrative structure of the PNA was seriously degraded, with direct attacks on its physical infrastructure. Not surprisingly, the private investments that had buoyed the economy also collapsed as the territories were closed off.

Even when the economy was rapidly growing in the late 1990s, there were many observations of internal maladministration, petty and not-so-petty corruption, and very slow progress in the deepening of democracy. Questions began to be asked about the institutional and governance reforms that had to be addressed if the PNA was to achieve better economic performance and greater political viability. The good governance approach is one of a number of approaches that try to answer this question by comparing developing country states with an abstract model of a liberal democratic state as it is supposed to work in an advanced capitalist economy. The observed differences between actual governance and theoretical good governance are used to *explain* backwardness or poor economic performance in the developing country. While the *good governance model* is based on neo-liberal political and economic theory, its conclusions and criticisms have gained wide currency because these appear to be supported by other analytical methodologies as well. The neo-patrimonial model, based on extensions of Weberian sociology, reaches similar policy conclusions about the importance of democracy and corruption. Both approaches provide a ready-made critique of what went wrong in the PNA. Since evidence of corruption, monopolies, centralized power, and slow progress towards democratization could be readily found within the PNA, the good governance and neo-patrimonial models suggest that these factors played an important role in impeding Palestinian progress towards viable statehood.

There are two fundamental problems with the good governance and related neo-patrimonial approaches. First, at a general level, the causality implied in these models, running from anti-corruption, democracy and liberalization to economic prosperity, is contrary to a significant body of historical evidence (Khan 2004, 2002b). The theory and evidence underpinning the good governance model and our alternative framework for assessing the role of the state during processes of *social transformation* are discussed in the next two sections. The social transformation framework suggests that there can be no disagreement about the desirability of democracy or a corruption-free society as *goals*, there is considerable doubt about whether policy to push either agenda as a *means* of accelerating development is likely to be effective in the typical developmental context. It is not even clear that these reforms can be implemented at all in the absence of transformation being accelerated through appropriate policies.

A second problem with any attempt to apply the good governance frameworks in the Palestinian context is that the PNA was a unique type of quasi-state that lacked almost all the powers and territorial sovereignty of a normal state. The expectation that it should achieve democracy and good governance *before* it had achieved statehood is even more implausible as a demand. Moreover, even the limited powers that it had under the Oslo Agreements included deliberately designed anti-democratic features and structures that created incentives for corruption. These characteristics were the result of the peculiar economic and security concerns of Israel that the Oslo framework was trying to operate within. It is important to remember that the Oslo Agreements allowed Israel to maintain its settlements and extend controls over the movement of goods and people *within* the Palestinian territories and between the territories and Israel without giving the PNA almost any of the powers of a sovereign state. The PNA did not control a contiguous territory, it had almost no fiscal autonomy, and it did not control its own borders, including internal borders between enclaves. These arrangements made executive centralization and corruption not just possible but almost *inevitable* if the 'state' was to operate at all, and in the early years, Israel and the external sponsors of the peace process participated heavily in setting up these structures. As Joseph Saba, the former head of the World Bank's West Bank and Gaza division put it: 'You set up gates, and you set up gatekeepers on each side of the gate, and history tells us that gatekeepers charge tolls' (Lagerquist 2003: 26). Palestinian traders had to set up elaborate systems of influence and often of bribery involving Israeli customs and other officials simply to be able to trade on a day-to-day basis. Similarly, Oslo quite deliberately set up strong executive and security institutions in the PNA to push through a peace process that was likely to face strong, often violent, internal dissent within the Palestinian territories. This too is not surprising when we recognize the enormous historic compromise the Palestinians were asked to make by giving up all claims on 78 per cent of historic Palestine in exchange for an uncertain promise to get an unknown fraction of the remainder. And during this interim period, there were no promises about the eventual status of Jerusalem, of refugees, or the degree of sovereignty that was eventually going to be achieved.

An application of abstract good governance criteria to judge the emerging Palestinian state is therefore doubly misleading and can give a seriously distorted impression of what went wrong on the way to statehood. In contrast to the good governance and neo-patrimonial approaches, the social transformation perspective argues that confusing means with ends is dangerous, particularly in conflict situations and in situations like that in Palestine where the 'state' faced powerful externally determined institutional, political and economic constraints. In these contexts, it is important to focus instead on identifying and developing the state capacities that are required to achieve a rapid transformation of society in the direction of greater economic and political viability. A naïve good governance or neo-patrimonial approach may be misleading or worse. They may be misleading if they lead policy-makers to believe that attempts to tackle in a general way problems of corruption and democracy would have yielded, or will yield in the future, the economic and political results that are desired. But they may be worse if intentionally or otherwise they write off a state-building exercise that may actually have worked, and which failed for reasons that international policy-makers have no desire or ability to address.

The first section of this chapter discusses the thinking behind the good governance agenda with its roots in neoclassical economics and liberal politics, and the related neo-patrimonial model, which reaches similar policy conclusions from a neo-Weberian perspective. In the second section, we examine an alternative framework for looking at the role of the state during processes of social transformation. This approach focuses on the importance of different types of 'rents'. It argues that while some rents are damaging, others are critical for accelerating development and maintaining political stability. In this alternative approach, the importance of analysing corruption and rent-seeking is to identify critical areas where state capacity has to be improved with the aim of accelerating a viable and developmental social transformation. In the third section, we discuss the Palestinian evidence on rents and rent-seeking in the context of our framework and identify the major types of rents and rent-seeking that were in evidence over this period. In the fourth section, we argue that these rents were consistent with a number of different incipient state capacities and characteristics. Since the viability of the Palestinian quasi-state was initially subject to Israeli control through fiscal, trade and other mechanisms, we describe these rent-management arrangements as a client state. We then argue that within this client state, a number of contrary state characteristics and capacities were observable in incipient form. These included some predatory characteristics, some characteristics of a fragmented clientelist state, and some developmental characteristics. In the final section, we discuss the methodology that we will use in the rest of the book for analysing the likelihood of these different outcomes materializing, and the conditions under which this might happen.

The liberal state as a benchmark for reform

To arrive at an appropriate theoretical framework for assessing the Palestinian quasi-state, we will first critically examine the appropriateness of the good governance framework applied to developing countries, and in particular to Palestine. In this section, we examine in turn the good governance framework and the related neo-patrimonial framework, before discussing our alternative framework in the next section.

The good governance framework

The good governance agenda emerged out of a confluence of neoclassical free-market economics and the 'new' political economy. It established a set of plausible and apparently policy-relevant interconnections between democracy, anti-corruption policies and the establishment of a free-market economy from which prosperity is supposed to follow. These relationships are summarized in Figure 1.1. The first and most critical claim in the good governance model comes from neoclassical economics that argues that the achievement of economic prosperity requires a competitive market economy, defined by free entry and exit. This is shown in step (i) of the good governance argument in Figure 1.1. The underlying logic is that if the market is competitive, only those who can satisfy consumer demand at the lowest cost can survive, and this ensures that welfare is maximized. To maintain competition, the role of the state is only to protect property rights, maintain free-markets, and provide a small number of essential public goods that cannot be efficiently provided by the private sector. The way to check whether a state is maintaining competitive markets is to see if it allows any 'rents' to exist in the economy. *Individuals or firms earn rents if they can earn a higher return in a specific activity than they could in their next-best opportunity*. In liberal economic theory, excess incomes would never exist in the absence of some political intervention in the market. So, a commonsensical definition of a rent is that it is a politically generated income, which would not exist without some specific rights, subsidies or transfers that were artificially maintained through a political process. Monopoly profits, subsidies, transfers, unnecessary job creation in the public sector are all examples of rent-creation. Conversely, the theory says that the absence of rents means that the market is fully competitive and this ensures the maximization of prosperity and therefore of social welfare (see Khan 2000a for a detailed analysis of rents).

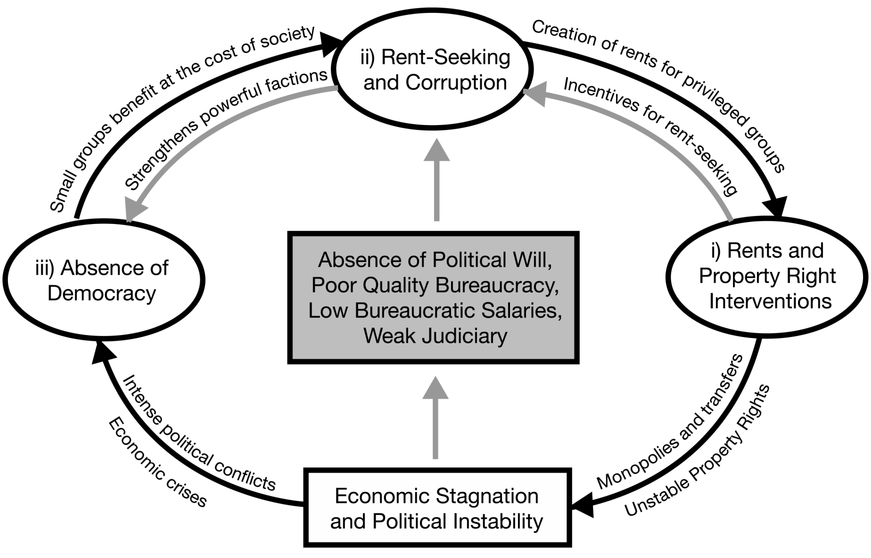

Figure 1.1 State failure in the good governance framework

A wide variety of state interventions can create these damaging types of rents. For instance, states can give monopoly rights to favoured companies to import particular products. They can prevent competition over the award of public construction contracts, thereby creating monopoly rents for favoured contractors. They can subsidize inefficient industries, creating rents for them through transfers. They can create artificial jobs for favoured groups; another case of transfer rents. In the simplest case, the state can transfer resources legally or illegally to unproductive groups, creating rents for these recipients. In each of these cases of damaging rents, the state-created rent lowers economic efficiency as measured by a lower net output for society as a whole. Moreover, to create these rents, states have to create new property rights, disrupt existing property rights or transfer property rights. Disrupting property rights further lowers incentives to invest in that society. *The first principle of the good governance agenda is therefore that states should protect rent-free competitive markets, and by extension, stable property rights*.

The second step in the good governance model is to explain why, if rents are so damaging for the economy, states persistently create them. The explanation provided is that individuals who want to benefit from rents drive the rent-creation. They spend resources to 'influence' or 'capture' the state and this activity creates rents. *Rent-seeking is the expenditure of resources to influence or capture the state in order to acquire or retain rents*. This is step (ii) in Figure 1.1. While rent-seeking creates rents, rent-seeking is in turn more likely if rents already exist and more can be created. As a result, there is a two-way relationship between (i) and (ii): rents and rent-seeking reinforce each other. Corruption is illegal rent-seeking, where the rent-seeker breaks the law by bribing a public official to get a benefit that is by definition a rent. But much rent-seeking consists of legal activities that aim to influence public officials for the benefit of the rent-seeker.

Legal rent-seeking includes expenditures on lobbying, legal contributions to political parties, the time spent on these activities, and so on. These are clearly an important part of any legitimate political process, but in economic terms, legal rent-seeking has the same costs as any other type of rent-seeking. *Illegal rent-seeking* includes corruption of different types. Corruption is an illegal exchange between a public official and an individual or firm, where in exchange for a bribe, a public official provides a benefit not otherwise available to the briber (by definition a rent). Corruption includes the bribing of public officials, illegal funding of parties and political movements, and other illegal forms of influencing activity. The bribe is the rent-seeking expenditure, which if successful, 'buys' rents of different types. Outright expropriation or extortion can also be classified as a variant of illegal rent-seeking. Here a public official threatens to create illegal rents for himself or a client (extortion is essentially an illegal transfer) and to achieve or stop this, the official and/or the affected individuals spend resources on rent-seeking. The official spends resources to achieve coercive power to capture the illegal rent while affected individuals spend resources to restrict this power or to bribe the official to take less.

Finally, there is a grey area of *quasi-legal rent-seeking*, which may not be formally illegal, but which is not legally sanctioned either. Examples of this type of rent-seeking in developing countries include the use of traditional and personalized sources of power and influence. These often work through *patron–client networks* that give well-connected individuals privileged access to the state and to its resources. To maintain their power to influence the state and capture rents, patrons spend resources to maintain their networks. This includes providing resources for clients in times of need, finding them jobs, and so on. The cost of doing this is the rent-seeking cost for the patron, and this allows the patron to maintain his political power based on his clients, and use this to bargain with the state for more rents. Although there are clear *economic* similarities, there are clearly *moral* and *political* differences between legal and illegal rent-seeking, since unchecked corruption can over time destroy the legitimacy of a state. But even these differences are ones of degree, since legal rent-seeking can also be immoral in its privileging of some groups, and too much of it can easily damage the political legitimacy of the state.

In the good governance framework, the effects of all types of rent-seeking are *always* negative because rent-seeking has a two-fold negative effect summarized in Figure 1.2. First, rent-seeking expenditures (whether legal, lobbying type expenditures or illegal corruption and bribery) are always a social cost because these are unproductive expenditures. This is shown in the arrow marked A in Figure 1.2. Second, in return for these

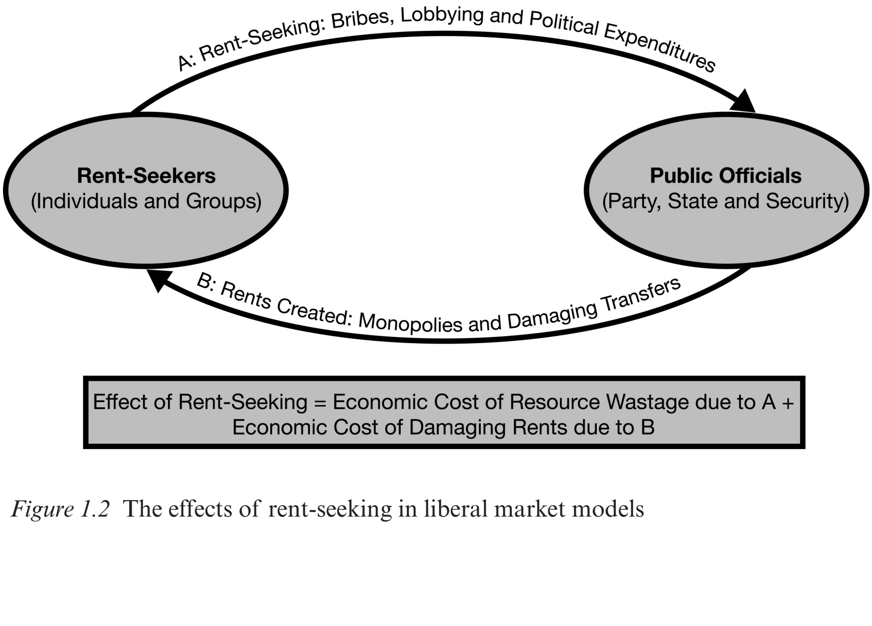

Figure 1.2 The effects of rent-seeking in liberal market models

expenditures, the state creates rents for rent-seekers, shown by the arrow marked B in Figure 1.2. These rents have *additional* negative effects on the economy because rents are also damaging for the economy, according to liberal market economics. Thus, because both sides of the exchange in Figure 1.2, A and B, are negative for society, A + B adds up to a significant negative effect (or cost). This is the outcome of *all* rent-seeking, which includes corruption, lobbying and other forms. This analysis of rent-seeking was developed in a series of articles beginning with Krueger (1974), Posner (1975), Buchanan, Tollison and Tullock (1980) and Colander (1984). The subsequent literature on corruption was heavily influenced by this analysis. For a critical survey of the literature on corruption, see Andvig *et al*. (2000) and Bardhan (1997). A key policy position follows. *The second principle of the liberal state is that all types of rent-seeking have to be prevented*. In particular, the illegal and semi-legal types of rent-seeking, namely corruption and clientelism, are the most pernicious, since they are difficult to detect, and they corrode confidence in modern institutions and in the state.

The third and final element of the good governance model is to explain why rent-seeking with its negative effects continues to persist. The answer provided is that although rents impoverish society, they obviously enrich the few who are the beneficiaries. Hence, for rent-seeking to continue, the majority must be unable to stop the damage caused to them by powerful minorities. This is step (iii) in the good governance model shown in Figure 1.1. The absence of democracy allows small groups to monopolize access to the state and engage in rent-seeking. Rent-seeking in turn consolidates the power of privileged groups, further undermining democracy. Once again, the relationship between (ii) and (iii) runs both ways. *Thus, the third principle of good governance is that democracy and accountability must be promoted to ensure that minorities are not able to further their interests at the expense of the majority*. The claim that the absence of democracy allows minorities to seek rents was developed by the 'new institutional economics', in particular by North (1990) and Olson (1997, 2000).

The interlocking relationships suggested by the good governance model imply that societies can be locked into either a good or a bad political–economic equilibrium. In a 'bad' equilibrium, the absence of democracy supports substantial rent-seeking, which in turn allows the creation of lots of damaging rents and the economic and political crisis that follows ensures that democracy never develops. In a good equilibrium, democracy ensures that rent-seeking and corruption are low, as a result there are few rents, markets are competitive and economic prosperity and political stability follow, which in turn ensures that democracy remains stable. An important consequence of the good governance analysis is therefore that improvements in economic and political performance can only be achieved if *parallel* moves are made on all of these fronts. Economic liberalization, effective measures against corruption and rent-seeking, moves to deepen democracy and civil society participation, each have to be *simultaneously* pushed to break out of the equilibrium of poor performance.

The neo-patrimonial analysis

One reason why the good governance framework has received wide support across academic and policy circles is that its conclusions are broadly supported by a number of other approaches assessing the performance of developing country states. In particular, the *neo-patrimonial* analysis of corruption and clientelism in developing countries identifies very similar problems and policy responses. Eisenstadt (1973) and Médard (various works, summarized in 2002) developed this analysis, based on their work in African countries. The neo-patrimonial analysis identifies a number of characteristics that differentiate African states from advanced European ones, and on this basis, it attempts to provide an explanation of poor economic and political performance in Africa.

The main lines of argument in the neo-patrimonial model are summarized in Figure 1.3. The key characteristic of the neo-patrimonial state is the personalization of power. This in turn is a product of the absence of democracy and of political accountability. The state is the 'property' of the leader who rules with the help of his clients. This has a number of important political effects. One result is that formal rules (laws) are less important than informal rules based on the use of power. Second, the leader and his clients operating through patron–client networks dominate politics. Third, corruption is systemic, operating at all levels of the state since there is no check on the venality of the supreme power. The effects of this arbitrary and unchecked power are that the economy is characterized by politically driven accumulation by the leader and his clients and the economy is, as a result, totally debilitated. Médard's analysis distinguishes between different countries in Africa and points out many subtle differences between them, but overall they are all variants of a neo-patrimonial type of state that is the

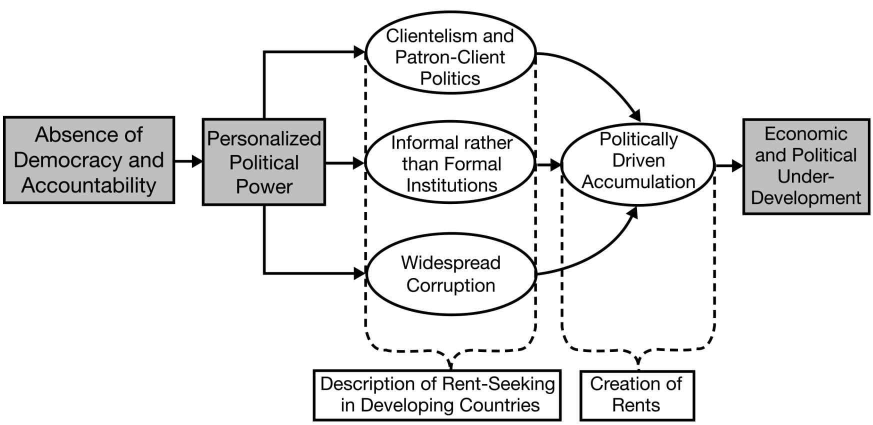

Figure 1.3 The neo-patrimonial model

antithesis of a modern bureaucratic state. In particular, the political interventions of the neo-patrimonial state in the economy, and its interventions in property rights through systemic corruption and outright expropriation lead to economic backwardness.

Although its analytical roots are different from the neo-liberal model discussed earlier, there are striking underlying similarities in the way the role of markets and states is understood. As Figure 1.3 also shows, the neo-patrimonial model's emphasis on clientelism and corruption describes nothing other than the dominant forms of rent-seeking in a developing country context. This is identified as a problem because what follows is politically driven accumulation that disrupts the logic of the market. Disrupting the 'market' by politically driven interventions that create special benefits for some groups is, by definition, the creation of rents. Thus, the underlying economic analysis of the neo-patrimonial and good governance models is surprisingly similar. So are the policy conclusions. Both agree that development requires a separation of the state from the economy. Neo-patrimonial theorists like Médard do not believe this can be achieved through liberalization in the first place, since liberalization on its own can squeeze the state and make it even more predatory. This is similar to the position taken by many neo-liberal good governance theorists who argue that without political reform, liberalization cannot be implemented. And as with the latter, the neo-patrimonial model argues that the separation of state from society is to be achieved through the promotion of democracy, accountability and pluralism. These will assist in checking the state's ability to act arbitrarily, implicitly inhibiting its ability to create rents.

In this sense, the implicit analytical links in the neo-patrimonial analysis are quite consistent with the causal links derived from rent-seeking theories that inform the good governance analysis summarized in Figure 1.1. There is an even more fundamental similarity in the *sequencing* of reforms. They both identify as a policy goal the need to *first* establish a modern state with a formal set of rules governing it. This state has to have an impersonal and non-corrupt professional bureaucracy that does not politically interfere in the market, and it has to have checks and balances limiting executive power through an effective democracy. Once all this is in place, a (rent-free) competitive market economy will follow and will lead to economic and political progress. Unfortunately, no evidence is provided from recent history to show that this sequence of reforms has ever worked to accelerate a developmental transition. Before we discuss the relevance of these approaches for assessing the Palestinian quasi-state, we need to consider the adequacy of the good governance framework and the related neo-patrimonial framework in comparative historical terms.

The role of the state in transformation processes

The *good governance* model and the related *neo-patrimonial* model are not only superficially plausible, the correlation they suggest between variables such as democracy and a corruption-free society on the one hand and economic development on the other is highly desirable from a humanist or progressive perspective. Unfortunately, the historical evidence suggests a more complex reality. While a correlation between these variables can indeed be found in the historical data, the *causality* between the variables is much more problematic. The statistical correlation that is observed in cross-country regressions shows that countries with lower corruption and greater democracy do indeed have greater wealth and higher growth rates (for instance, Hall and Jones 1999; Kauffman, Kraay and Zoido-Lobatón 1999; Johnson, Kaufman and Zoido-Lobatón 1998; Clague *et al.* 1997; World Bank 1997; Knack and Keefer 1997, 1995; Barro 1996; Mauro 1995). But these correlations do not establish *causality* (Khan 2004). Developing countries are by definition poor and most have low growth rates. Most of them also have relatively high corruption and weak democracies, or authoritarian regimes. On the other hand, most advanced countries have the reverse characteristics. It is not surprising that when we correlate these variables, we find that rich countries are less corrupt and more democratic. But are rich countries rich *because* they first instituted democracy and reduced corruption or do they have viable democracies and low corruption *because* they first became rich and are now already developed? Examining *sequence* is the only way to test for causation: did advanced countries *first* achieve democracy

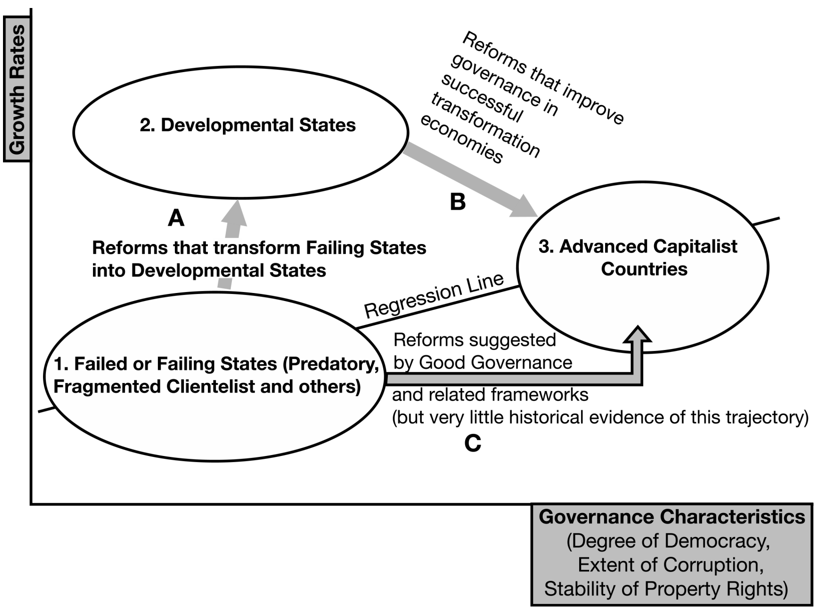

Figure 1.4 Good governance, state capacities and the capitalist transformation

and the reduction of corruption and *then* become rich or is it the other way around? The historical evidence, as opposed to correlation analysis, suggests that the deepening of democracy and the lowering of corruption were long historical processes that made serious progress in the early capitalist countries well after their industrial revolutions.

Most developing countries are located in group 1 in Figure 1.4, with poor governance characteristics and low growth rates. These failed or failing states can in turn be classified in various ways: predatory, fragmented clientelist and so on. In contrast, advanced countries are mostly in group 3, with good governance characteristics and somewhat higher growth rates. Countries in group 1 obviously want to reach group 3 but how do they get there? The correlation summarized in the regression line suggests that the appropriate policy is to follow the good governance prescription and improve the governance characteristics identified in these models; this will enable a country to go from group 1 to group 3. These are the reforms shown by arrow C in Figure 1.4. The problem is that we have no historical evidence of any country achieving a transition to advanced country status by following the reforms suggested. The recent examples that we have of countries moving from group 1 to group 3 are the transitions to capitalism in a small number of developing countries over the last 50 years. These include countries like South Korea, Taiwan, Malaysia, Thailand and now China, which are at different stages of a transition from group 1 to group 3. But in terms of the sequencing of 'good governance' characteristics, they seem to be following the arrows marked A and B rather than the arrow marked C. If developing countries have any lessons to learn, clearly they have to look carefully at these recent cases of successful transition and not primarily at countries that became capitalist centuries ago and are already very rich. The evidence of historical transitions thus shows that the sequence of reforms that led these countries to successful capitalist development contradicts both the good governance and neo-patrimonial policy prescriptions (for a discussion of some of the evidence see Khan 2004, 2002b; Woo-Cumings 1999; Aoki, Kim and Okuno-Fujiwara 1997; Wade 1990; Amsden 1989).

During their high-growth transition periods, these developmental countries were located in the region marked group 2. They scored badly in terms of democracy, corruption, stability of property rights and other 'good governance' characteristics. Contrary to the neo-patrimonial analysis, they also suffered from a confusion of formal and informal rules. Political power was highly centralized and could be used to override formal rules, they had regimes that relied on variants of clientelism and patron–client networks for maintaining regime stability, and all of them extensively used political power for accelerating accumulation by emerging capitalist groups. Clearly, these countries are the ones that are most relevant for understanding the *sequence* involved in successful development. Some of the more advanced of these successful developing countries subsequently made slow but sustainable progress in reducing corruption and deepening democracy, the trajectory shown by arrow B in Figure 1.4.

This history suggests that the most important task for developing countries is to identify the reforms shown in arrow A, which could transform failing states into developmental ones. This involves developing the capacities of states to push developmental changes in their society, a process we have described as the capitalist transformation. Success has depended on identifying and then sustaining and strengthening these developmental characteristics of states. The important point is that historically, developing these transformation capacities has *not* necessarily involved a *prior* reduction of corruption, clientelism, patron–client networks, the centralization of power, the instability of property rights or any of the features identified in the good governance and neo-patrimonial models. Nevertheless, it *has* involved wide-ranging changes in institutions, policies and politics that enhanced specific state capacities to push developmental changes, manage necessary rents and destroy damaging rents. Indirectly, this had the effect of changing the *types* of corruption, clientelism and rent-seeking that were prevalent even if the aggregate amount did not immediately go down significantly. We argue that the critical role of the state in development can be better understood by distinguishing between different types of rents and rent-seeking (including differences in the types of corruption and patron–client networks), and this enables us to distinguish successful transformations from the others.

There are, of course, high-growth cases like Indonesia where the state failed to deepen democracy and reduce corruption fast enough and as a result suffered a precipitous collapse of legitimacy during an economic crisis. Clearly while sustained economic development is *necessary* for the sustainable deepening of democracy and the achievement of lower corruption, it is not *sufficient*. The trajectory shown in arrow B is by no means automatic and does require institutional and political attention, but these are only likely to be viable if the conditions for viable growth have already been achieved. This sequence and prioritization is markedly different from that proposed by the good governance and neo-patrimonial models, where the reform priorities are shown by the arrow marked C in Figure 1.4. Here, the sequence is to *first* achieve the good governance characteristics of a liberal-democratic state, and then the expectation is that higher growth will be realized. But to repeat, there is no evidence that such a strategy has worked in the past (Khan 2004).

Even cross-country correlations, for all their shortcomings, show that the relationships between good governance characteristics and economic performance are quite complex. For instance, it is *not* the case that democracy is always associated with lower corruption even when we pool advanced and developing countries. The effect of democracy on lower corruption is found in some studies to be very weak and if it operates at all, it does so with a time lag of *several decades*. This suggests that the main determinant of lower corruption may be economic development, since only countries that grow reasonably fast can sustain democracy over decades (Treisman 2000). Burkhart and Lewis-Beck (1994) also find that rises in per capita incomes *precede* the emergence of democracy and not the other way round, suggesting that economic development may be a precondition for democracy, rather than democracy being a precondition for economic development.

Let us be clear though about what this historical evidence is telling us. It is *not* saying that we should not be worried about corruption or democracy. Instead it is saying that to attack these problems we have to ensure that the conditions for rapid development are achieved. This requires targeting damaging rents and rent-seeking that can have extremely negative effects on growth. On the other hand, it requires an *enhancement* of state capacities to create and manage necessary rents, both for political stabilization and for accelerating the emergence of capitalists and regulating their incentives. It follows that the rent-free market is not a very useful benchmark for judging the efficiency of a transformation economy. The challenge for policy-makers is to be able to identify damaging monopolies, transfers to unproductive groups and other damaging rents, with their associated rent-seeking and corruption, and to tackle the causes of these rents vigorously. On the other hand, if the capacity of the state to create and manage the rents necessary for political stabilization or the rents necessary for accelerating the capitalist transformation are removed, far from more rapid development, we may instead see a collapse. In the case of a conflict economy, where rents may also be used as a mechanism through which one country or group attempts to exert influence over another, there is an added and critical dimension of the problem that affects our assessment of the efficiency or otherwise of other rents.

We will argue that when we look at the redistributive rents, monopolies and other transfers that the PNA was involved in creating and managing, we observe a complex picture. Some of these rents were indeed damaging and if their scope increased over time, the future Palestinian state would be doomed to remain in group 1 in Figure 1.4, with other poorly performing developing country states. However, we will argue that many rents managed by the PNA were dynamic rents that gave the emerging Palestinian economy *some* of the characteristics of group 2 countries. Given the very limited formal powers of the quasi-state, the adverse external constraints, and the context of extreme uncertainty about the future, these developmental characteristics of the PNA were quite remarkable. But given the high growth-rates achieved in Palestine under the PNA, shown in Table 1.1, it should not be surprising to discover that the PNA had some developmental rent-management capacities. If a Palestinian transition to a group 3 country is to be accelerated, these incipient powers and capacities of the fledgling quasi-state would need to be developed in the future. Before we look at some of the specific features of the Palestinian quasi-state, we will identify some of the general issues that transformation states have had to address.

Property rights and rents

The foundation of the good governance model, shown in point (i) in Figure 1.1, is that a rent-free economy with stable property rights is the most efficient market structure for development. This is a fundamental proposition of liberal economic theory, but it has significant shortcomings when applied to developing countries. Economic development is not just a process of making 'the market' work better. Development historically has involved the emergence and growth of a *capitalist* sector. Even in the most volatile and vulnerable contexts, the creation of a viable capitalist sector is usually a critical requirement for achieving economic, and therefore political viability. Far from requiring the stability of property rights and the absence of rents, development is a period of momentous changes in the structure of property rights. It involves the emergence of new classes through processes that involve the creation and management of substantial rents as well as disruptions of pre-capitalist property rights. Far from state withdrawal from the market being a necessary condition for a successful capitalist transition, the historical evidence suggests that it is necessary for the state to intervene to accelerate the emergence of capitalists and assist and discipline them in the acquisition of technological capacity. By definition, this requires state support for 'politically driven accumulation', contrary to the neo-patrimonial model (Figure 1.3). The relevant state capacity in these contexts is its ability to carry out the appropriate social transformations, its ability to allocate rents to emerging capitalists, discipline them if they do not perform, and to use rents to maintain social stability at acceptable levels (Amsden 1989; Wade 1990; Aoki, Kim and Okuno-Fujiwara 1997; Woo-Cumings 1999; Khan 2004).

Before a capitalist economy has become dominant, the accumulation that drives the emergence of capitalism has usually required state assistance to transfer resources to the emerging capitalist sector from non-capitalist sectors and activities. These types of accumulation classically have been referred to as *primitive accumulation*. Primitive accumulation is common when pre-capitalist production systems have become unviable but a viable capitalism has not yet emerged. Stabilizing the pre-existing but economically unviable pre-capitalist rights is not possible, nor is capitalism likely to emerge rapidly through the operation of a market in such a context. Examples of non-market transfers of rights that have played a critical role in the transition to capitalism have included compulsory land reform (in South Korea, Taiwan and China) and transfers of assets to emerging capitalists through state-owned or controlled banking systems (South Korea, Malaysia, and many other developing countries). They have included state-supported seizures of natural resources, and in particular of land, by emerging capitalists (in Thailand in the 1980s, during the English Enclosures of the seventeenth to nineteenth centuries, and during the westward expansion of the United States of America into Indian territories till well into the nineteenth century). They have also included more subtle mechanisms such as exchange rate controls that have been used to transfer resources from peasant agriculture to emerging industrial capitalists (in most developing countries). This is not an exhaustive list, but it reminds us that state actions during rapid transformations typically have not been to *stabilize* pre-existing allocations of resources, but more often to directly or indirectly change that allocation, if necessary by radically disrupting prior property rights systems (Khan 2002b). It also tells us that politically driven accumulation and the rent-seeking associated with it is unavoidable during this period of development.

Yet, it is also clear that in many cases the result of such interventions in property rights has only been destructive. Unstable property rights have often been associated with predation and plunder. Unfortunately, this is the more usual story in the typical developing country where state officials and their clients capture resources, subsidies and credit to enrich themselves, and they do not go on to become productive capitalists. Nevertheless, the difference between dynamic and collapsing developing countries is *not* that in the dynamic countries property rights were stable, and politically driven accumulation did not occur. Rather the difference was a subtler one. In the dynamic group, the transformation of property rights rapidly took these societies in the direction of viable and dynamic capitalist economies. Ensuring this required different combinations of conditions, but most often, it required a state that could discipline primitive accumulation and ensure that those who were enriching themselves remained productive. Over a period, this resulted in growth and development that in turn allowed a deepening of democracy and the achievement of greater accountability. The problem in most non-dynamic developing countries is that property rights are transferred to unproductive classes and groups who do not graduate to become productive capitalists for a variety of reasons, including the failure of the state to adequately assist or discipline them. In these more typical cases, economic and political development is stifled. But it would be wrong to argue that development would be faster if these countries could stabilize property rights and prevent their states from intervening. There is no example in history where stabilizing pre-capitalist rights accelerated the transition to capitalism.

The good governance and neo-patrimonial frameworks are also wrong to argue that successful development requires the absence of rents. In fact, economic theory recognizes that many rents are essential for the efficient operation of a market economy (Stiglitz 1996; Aoki, Kim and Okuno-Fujiwara 1997). The problem is that ‘good’ rents can very easily become ‘bad’ rents and effective *rent-management capacities* of the state are critical for success. For instance, redistributive rents are essential for achieving political stabilization, even though they can have disincentive effects on those who are taxed. Properly managed, the benefits of stabilization can more than compensate for these costs. However, in other cases redistributive rents can impose costs that are greater than the benefit of the political stability that is achieved: and in the worst cases, redistribution can even result in *lower* political stability! Similarly, 'developmental' rents for capitalists can create incentives for the generation of information, and for risk-taking and innovation (Khan 2000a). For instance, patent laws, competition laws, and taxes and subsidies can create rents for innovators and risk-takers in ways that improve economic performance. But here too, mismanaging these rents can do more harm than good. Rents for risk-takers that last too long simply convert them into monopolists. The aim of rent-regulation is to create incentives, say for innovation, but also to ensure that these rents do not last for so long that they become monopoly rents. In advanced countries, there are sophisticated institutions such as competition regulators and courts that exercise judgement in eliminating wasteful monopoly rents while protecting rents that create incentives for national innovation and risk-taking.

In developing countries, the need for making considered judgements about the social value of different rents is even greater, but the capacity for making such judgements is much less developed. Ironically, the economic models of free-market economics have prevented international agencies from providing support to developing countries to develop these critical rent-management capacities. Rents are important in all developing countries to encourage emerging capitalists and assist them to acquire entrepreneurial and technological skills, but they are particularly important in conflict societies like Palestine where capitalists would not otherwise be sufficiently attracted (Aoki, Kim and Okuno-Fujiwara 1997; Khan 2000a). Of course, many other rents, like monopoly rents, are indeed harmful, and states must have the capacity to identify and remove them. Thus, economic theory tells us that different types of rents can be beneficial or damaging for society. But even the potentially beneficial rents have to be managed and regulated if they are to have a beneficial effect.

In advanced countries, the redistribution of income that is required for political stabilization is usually organized in a transparent way through the budget. States in developing countries also have to maintain social and political stability, but the absence of sufficient budgetary resources often means that political stabilization works through the allocation of resources to critical clients within patron–client networks. By definition, the resources for such targeted redistribution necessary for stabilization does not come from the budget. Clientelism is thus a way of achieving political stability in a context of resource scarcity. The distribution of rents to clients through patron–client networks can take a variety of forms, ranging from job creation in public enterprises to outright subsidies. If the same degree of political stability had to be achieved through general fiscal transfers, broader categories of recipients would have to be identified that included the politically critical individuals and factions as a subset. Clearly, much greater fiscal resources would be required to achieve this.

The historical evidence from developing countries suggests that clientelism is only likely to end when states have the fiscal resources to maintain political stability through general transfers, in other words, when a substantial degree of economic development has already been achieved. Not surprisingly, and in contrast to the claims of the neo-patrimonial model, we find variants of patron–client networks in *all* developing countries, including the high-growth ones, before they eventually make a transition to political management through transparent fiscal redistributions. The difference between dynamic developing country states and the others is not that the former did not engage in clientelism while the latter did. Rather, in the dynamic countries, states possessed the ability to discipline and control their clients to ensure that a rapid capitalist transformation took place. In non-developmental states, the clients of the state are unproductive, just as the neo-patrimonial model argues, and the state lacks the capacity and eventually the inclination to do anything about it. Thus in contrast to point (i) in the good governance model in Figure 1.1, *the transformation approach recognizes that property right interventions are necessarily widespread in all developing countries; in addition some types of rents are critical for growth and political viability while others are indeed damaging*.

Rent-seeking and corruption

If we move to point (ii) of the good governance model outlined in Figure 1.1, rent-seeking theory *is* correct in its claim that if rents exist, so will rent-seeking. Individuals and groups will spend resources to capture or retain rents. If many types of rents are essential for the social transformation, we should expect a considerable amount of rent-seeking to be characteristic of this period. Indeed this is what we observe in every developing country without exception. Since rents in some countries can be mostly damaging and in other countries mostly growth-enhancing, rent-seeking can be associated with both growth and stagnation. This overturns the link made in step (ii) of the good governance logic in Figure 1.1 that suggests that rent-seeking and corruption are always associated with poor economic outcomes. The neo-patrimonial model in Figure 1.3 also associates systemic corruption with poor performance, and this model too is challenged by our observation that extensive rents and political interventions are necessary in *all* developing countries. In fact, even advanced countries have massive rent-seeking as part of the institutional structure of their democracies. The only difference between advanced and developing countries is that in the former a bigger part of overall rent-seeking is legal, having become institutionalized in the form of many different forms of lobbying, political contributions to parties, legal costs, entertainment accounts and so on. In contrast, in developing countries, a bigger share of rent-seeking takes the form of corruption or expenditures on patron–client networks. Part of this difference is due to

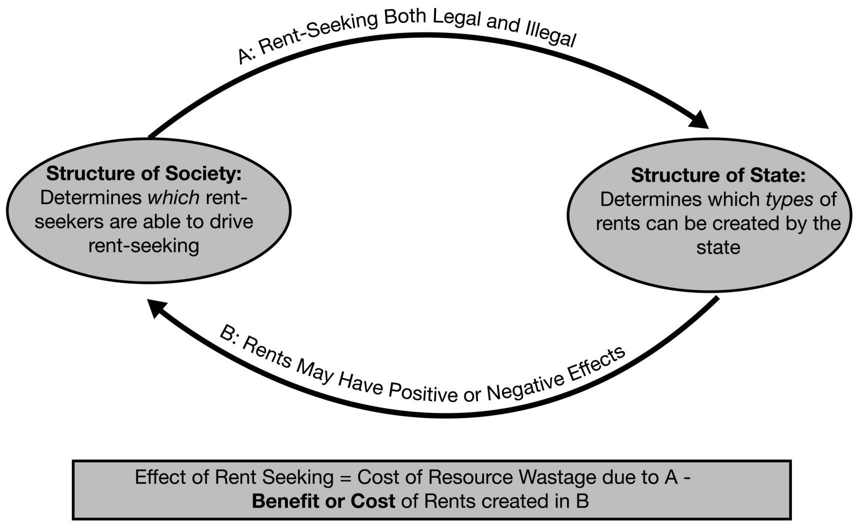

Figure 1.5 Rent-seeking in the real world

an inadequate institutionalization of rent-seeking, which is difficult to achieve before a reasonably stable economic structure has emerged.

The most important point that follows from our analysis is that the *types* of rents that are being created through processes of rent-seeking and corruption are critically important. This is the main difference between countries, not the presence or absence of rent-seeking, since the latter is widespread in *every* society. This is shown in Figure 1.5, which can be contrasted with the liberal market perspective summarized in Figure 1.2. While rent-seeking and corruption always have a cost, they may be associated with rents that are critical for growth and social transformation. In these cases, the overall effect of A + B in Figure 1.5 can be positive even in the presence of significant costs due to rent-seeking and corruption. In contrast to the good governance proposition that all corruption and rent-seeking have to be attacked, in point (ii) in Figure 1.1, the policy conclusions of the transformation approach are more complex. *Given the impossibility of ruling out all rents, the task for policy must be to prevent the creation of damaging rents, and the types of corruption associated with these, while enhancing the state's capacity to create and manage developmental rents. There will inevitably be rent-seeking associated with developmental rents, and here policy should seek to legalize and regulate this rent-seeking*. This approach directs our attention to the factors determining the *types* of rents that are demanded and created in different societies rather than the impossible 'good governance' task of trying to create a rent-free market economy.

The neo-liberal policy conclusion that ending corruption at any cost is a *precondition* for progress is based on the assumption that a no-rent economy is both possible and desirable in a developing economy. In contrast, the social transformation perspective suggests that the fight against corruption has to distinguish between the corruption associated with damaging rents and the corruption associated with essential rents. In the former case, anti-corruption can aim to get rid of both the corruption and the rents associated with it. But in the latter case, anti-corruption strategies have to be very careful to target only the corruption, while *strengthening* the capacity of the state to create and manage these rents. A simplistic anti-corruption strategy that damaged the capacity of the state to create and manage developmental rents could do more harm than good. The long-term goal for these rents would be to legalize and regulate the associated rent-seeking, rather than get rid of the rents.

Democracy and rent-seeking

Finally, step (iii) in the good governance model in Figure 1.1 claims that democracy limits the rent-creating interventions of the state, and the absence of democracy is also the key driver of the neo-patrimonial model in Figure 1.3. This argument too is theoretically and empirically weak. Democracy is supposed to be desirable *because* it makes politically driven interventions in the economy (in other words rent-creation) more difficult. But we have already seen that some rent-creation and politically driven accumulation may be both necessary and desirable during the transformation period and beyond. Moreover, if democracy reduced corruption, developing country democracies like India would have less corruption than non-democratic developing countries. The evidence does not even support this conclusion (see Treisman 2000). And if democracy reduced rent-seeking in general, we would expect advanced countries with mature democracies to suffer the least from rent-seeking. But in fact, advanced country democracies suffer from massive, though mostly legal rent-seeking, in the form of lobbying, contributions to political parties, expenditures on consultancies and so on. In advanced countries, popular majorities do not succeed in preventing rent-seeking by minority interests in agriculture, or the oil and arms industries, for example. The obvious explanation is that in democracies, minorities find it easier to organize compared to majorities particularly when the minorities are smaller and richer than the majority. In fact, it is widely recognized that stable democracies suffer from very extensive rent-seeking driven by well-organized vested-interest groups (for instance, Olson 1982).

Far from democracy being a bastion against rent-seeking, it would be more accurate to describe democracy as a form of *institutionalized rent-seeking*, where rules are defined for different groups to seek rents through the political process. The historical evidence is that democracy becomes truly viable when productive and growth-enhancing groups become big enough and organized enough to use democracy to protect and promote their interests (Moore 1991; Rueschemeyer, Stephens and Stephens 1992). Meaningful democracy also requires substantial fiscal resources such that legitimate demands for redistribution can be met legally through fiscal redistributions (Khan 2002a). These conditions too are unlikely to be met before substantial development has already occurred. Without them, democracy is likely either to remain vulnerable, as it is in most developing countries, or to break down entirely if unproductive groups are large, powerful or organized enough to democratically capture political power.

In advanced capitalist countries, we find that the rents created through the democratic process are usually not totally debilitating for a number of reasons. One reason is that when capitalism has become the dominant sector in the economy, long-term growth in the incomes and welfare of all classes and groups, including those who are not capitalists, depends on the growth of the capitalist sector. Hurting the capitalist sector impacts rapidly on virtually everyone and this prevents other groups creating rents that hurt the capitalist sector too much. Since the well-being of the state also depends on the health of the capitalist sector, advanced country states have regulatory structures that can discriminate between acceptable and damaging rents. Thus, instead of democracy *preventing* rent-seeking in advanced capitalist countries, we find a large amount of rent-seeking that is nevertheless (on the whole) consistent with dominant capitalist interests and economic growth (Khan 2002a).

In contrast, the link between democracy and development is more problematic in developing countries. Developing countries, whether or not they have democracy, are not, by definition, dominated by capitalism. Rent-creation that damages capitalist growth has a negligible effect on most people because the capitalist sector is itself negligible. By definition, the politically powerful groups and factions driving politics in developing countries are not yet dominated by capitalists. As a result, democracy in developing countries does not provide any institutional guarantee that rents that may damage the emergence of capitalism will not be created, but neither does authoritarianism. In general, the outcome of the political process, whether democratic or authoritarian, is much more open in developing countries in terms of the types of rents that are created. The outcome can sometimes be a predominance of productive rents but often it can be a predominance of damaging rents and destructive property right interventions. The implication is that democracy cannot be an instrumental variable in developing countries despite the claim in point (iii) of the good governance approach in Figure 1.1 or the neo-patrimonial model of Figure 1.3. *In the social transformation approach, democracy is supported as an end in itself; the viability of democracy depends on getting other institutional and political conditions right so that the rents created through the democratic process are value-enhancing and the state has the institutional and political capacity to manage these rents.*

Characterizing the emerging Palestinian state

In this section, we will review what the evidence tells us about the dominant types of rents and rent-seeking in Palestine under the PNA. This in turn will help us to say something about the transformation capacities of the state. Over the period we are looking at, we find that there is no clear dominance of some types of rents over others. This is obviously because an identifiable type of Palestinian state hardly existed. Instead, a number of quite different types of rents and rent-seeking could be observed in *emergent* form in the Palestinian quasi-state, and under different circumstances, each of a number of different constellations of rents and rent-seeking *may* have consolidated to become the dominant ones. To help our analysis, we identify four 'types' of state that could have consolidated in Palestine, each defined by the combination of a particular constellation of rents. These state types are purely descriptive and are defined by the predominance of certain types of rents. Our focus is also restricted to Palestinian territories over this period, and these state types are not necessarily relevant for other cases. We begin by reviewing the types of rents and rent-seeking that were observed in Palestine over this period, and the political processes with which they were associated.

Rents in the Palestinian context

Many rents in the Palestinian context were directly the result of the specific arrangements set up by the Oslo Agreements. But other rent-management problems were more like those faced by all developing country states. Some rents were intrinsic to the promotion of capitalists and the attraction of new technologies and investments. As in other developing countries, these rents could play a dynamic role, but under quite likely conditions, they could also become very damaging and reduce growth. And finally, some redistributive rents were critical for political stabilization and were recognized as such by external donors. These rents too, have in some contexts played a useful role in stabilizing the polity, and at other times have gone out of control and caused a lot of damage. Looking at some of these rents helps to identify the critical issues of rent-management in the Palestinian context and the conditions assisting or blocking a potentially successful transformation in Palestine.

Monopolies

There are a number of reasons why we would expect to have seen some degree of monopolistic market power in the Palestinian economy. First, economies of scale can make many firms "natural monopolies" in a small economy like that of Palestine. The most efficient way of producing often involves companies that are so big relative to the economy that one or two can dominate the market. These firms are then able to raise prices and earn monopoly profits. Services like telecommunications, or utilities like electricity and water (if the Palestinian economy were allowed to develop its own utility supplies) are very likely to be natural monopolies in a small economy. But large firms in these sectors may still be the most efficient alternative provided an efficient regulatory structure ensures that profits are not excessive and the most efficient managers are selected. For regulation to be effective, regulators would have to have the capacity to assess performance, as well as have the political power to impose penalties if managers proved to be inefficient. Thus, enhancing efficiency does not always dictate the destruction of natural monopolies, but always requires their effective regulation.

A second factor that made monopolies quite likely in the Palestinian economy was the nature of the trade and import conditions imposed by Israel under the aegis of Oslo. These conditions ensured that virtually all imports into the Palestinian territories had to take place through Israel (the monopolies are discussed further in Chapter 2 by Hilal and Khan, and Chapter 5 by Nasr). Israel's control of borders allowed it to protect its own domestic monopolies in critical commodities like cement and petroleum. For instance, in the case of cement, the Nesher Company of Israel was an effective cement monopoly in the greater Israeli market that included the Palestinian territories. The Oslo Agreements and the Paris Economic Protocol allowed the Palestinians to import limited quantities of specified commodities from non-Israeli sources, but in practice, these imports could be obstructed by Israeli customs and security checks. If Israeli border guards decided to open every bag of cement to hunt for weapons, the imports allowed to the Palestinians from outside Israel could be disrupted at any time. On the other hand, importing cement from Israel meant allowing an Israeli monopoly to extract rents from Palestinian consumers.

While the PNA could not bypass Israel's control of its borders, it did have the power to prevent access by Israeli companies to Palestinian markets. The outcome that eventually emerged was a Palestinian cement monopoly that bought cement at world prices from Nesher and sold it on to Palestinians at or even slightly above the Israeli price. This arrangement allowed the Israeli monopoly to retain monopoly pricing within the Israeli customs union while the PNA could earn margins that contributed to its own survival given the very limited tax revenues it could collect from other sources (Lagerquist 2003). Given these circumstances, how should we evaluate the implications of the trading monopolies set up by the PNA? On the one hand, they probably did *not* make matters much worse for Palestinian consumers given that Israeli monopolies existed anyway, and attempts to import from third countries would very probably be impeded by Israel. On the other hand, the Palestinian trading monopolies allowed the Palestinian Authority to capture some of the rents that would otherwise have passed to Israel. Assessing the social efficiency of these monopolies thus requires an explicit consideration of the trade and fiscal agreements that the PNA had to sign with Israel as part of the Oslo Agreements (Chapter 2 by Hilal and Khan).

A third issue with respect to the role of monopolies in Palestine is related to the problem of attracting investment into a conflict zone. The rights of investors in Palestine were uncertain given that the end game in terms of the eventual Palestinian state was itself hardly clear. Much more than the infant industry struggling to learn new technologies in the typical developing country, investors in a conflict zone like Palestine require temporary rents to induce them to invest anything at all. The PNA's problem was that it did not have the resources to offer any direct inducements to new investors, particularly expatriate Palestinian investors who were taking big risks to invest in the emerging state. We will see in the chapters in this volume by Hilal and Khan, and by Nasr, that one of the ways in which the PNA attracted new investors was to offer them temporary monopolies, or at least substantial market power in key sectors like telecommunications by limiting entry in favour of critical investors.

Was this a socially damaging strategy? The answer depends on an assessment of the viable alternatives. On the one hand, market power in these sectors did mean higher prices for consumers. Indeed that was the intent, thereby giving investors sufficient rents to attract them to Palestine. On the other hand, the economy collectively benefited from investments and technologies that might otherwise not have been attracted at all. Far from being a simple story, this evidence suggests that there were contradictory forces at work within the Palestinian state, with at least some conditions supporting rent-allocation in ways that maintained economic dynamism and political stabilization. Expatriate investors were attracted, and at least in some cases, the more efficient were systematically preferred. Thus while some monopolistic arrangements were clearly restrictive practices in the classic textbook sense, a number of apparently monopolistic arrangements may not have been as damaging as they appear at first sight. Indeed, in creating and managing these monopolies, the PNA displayed some nascent developmental capacities, and an intelligent policy of engagement would have sought to strengthen these nascent state capacities.

Redistributive (transfer) rents

Redistribution is a necessary part of social stabilization in every society. In the conflict situation in which the PNA found itself, it is not surprising that *substantial* redistributive rents were politically necessary to stabilize the polity by accommodating critical constituencies. But more than 60 per cent of the PNA's revenues depended on taxes collected in the first instance by Israel from Palestinians and then transferred to the PNA, and aid accounted for around 10 per cent of GDP over this period (Chapter 6 by Fjeldstad and Zagha). This excessive fiscal vulnerability of the PNA gave considerable potential leverage to those responsible for clearing the transfers required for its day-to-day survival. The symbiotic interest of both the Israeli and the Palestinian side in being able to allocate these rents in ways that furthered their interests resulted in some unexpected 'institutional' arrangements. For instance, the Israeli government paid part of the official tax remittances owed to the PNA into accounts outside the Palestinian Ministry of Finance that were directly controlled by Arafat and his financial advisor, Muhammad Rashid (Lagerquist 2003; IMF 2003: 88).

Since Israel colluded for many years in these arrangements, until after the beginning of the Second *Intifada*, we can conclude that these arrangements were initially advantageous for both sides. On the one hand, the situation allowed Israel to withhold transfers at will without having to formally justify this, thereby maximizing its leverage over Arafat and the PNA. At the same time, Arafat's executive maximized its freedom of allocation over these resources and was able to use them for political stabilization in ways that might be difficult in a fully accountable system. While the existence of these accounts was well known from the outset, Israel only began to mobilize international concern with Arafat's special accounts when it became clear during the Second *Intifada* that Arafat had refused to construct the type of client state that was on offer from Israel (Hilal and Khan discuss the special accounts at greater length in Chapter 2).

The executive in turn used a large part of its vulnerable fiscal resources to create jobs to stabilize the polity. The explosion of employment in the public sector and in the security agencies followed from these political concerns. This kind of job creation effectively creates redistributive rents for critical constituencies. The challenge is to evaluate how damaging these redistributive rents were, by examining their cost in terms of economic inefficiency as against the political stabilization they achieved. If the economic inefficiency of these transfers is to be outweighed by the benefits of political stabilization, the state has to be able to control effectively the type and allocation of these redistributive rents. If powerful clients can force the creation of a growing number of damaging redistributive rents, economic inefficiency can rapidly escalate and the political stability that is purchased can be illusory (Khan 2000b). In our investigation of the Palestinian context, (Chapter 2 by Hilal and Khan) we find that individual Palestinian factions were not strong enough to veto the executive's allocation of redistributive rents. In other words, even though as in every developing country much redistribution was necessary for stability, in the Palestinian case the executive retained the ability to determine the type and allocation of these redistributive rents. This makes the Palestinian case potentially different from some of the more serious cases of state failure in developing countries.

A second redistributive imperative in developing countries is the need to make resources available to emerging capitalists to accelerate the emergence of capitalism from essentially pre-capitalist societies. Accelerating the development of the productive sector often involves giving tax breaks, subsidies, subsidized credit or other inducements to emerging capitalists as part of a strategy of promoting capitalism. The pay-off from such a strategy depends on the state's regulatory framework and whether it can ensure that these privileged individuals deliver growth. In the Palestinian case, the very limited state powers under the Oslo Agreements meant that the resources available for direct redistribution to emerging capitalists were extremely limited. There were some tax breaks for investors that are examined in Chapter 6 on taxation by Fjeldstad and Zagha. But the most important incentive for potential investors came from the creation of effective partial monopolies in the way discussed earlier, and examined here in the chapters by Hilal and Khan (pp. 000–00) and Nasr (pp. 000–00).

Finally, some of the redistribution that happened could only be described as predatory. This consisted of forced transfers from small traders and merchants to security officials, customs and tax officials and others, in ways familiar to most developing countries. Examples of such predatory behaviour were, however, less widespread in Palestine than in equivalent developing countries elsewhere in the world. But to the extent that these processes were going on, they were clearly very damaging. It is important to point out that we are not suggesting that the Palestinian Authority necessarily created any of these rents as the outcome of a deliberate plan or careful foresight. Indeed that is rarely the case in any country. On the contrary, we argue that a number of structural, political, institutional and external factors have to be taken into account to explain the specific patterns of rent-creation. In promoting the capacity of the state to manage developmental rents and limit damaging rents, these factors need to become targets of policy.

Corruption and rent-seeking in Palestine

The theory of rent-seeking suggests that each of the important types of rents observed in the Palestinian context might be associated with a specific process of rent-seeking or corruption. Beginning with the most damaging types of rents and rent-seeking, there was undoubtedly evidence in Palestine of rent-seeking associated with straightforward predatory *extortion*. Extortion in Palestine was mostly a low-level activity by officials managing a highly restrictive network of security. The rent-seeking expenditures associated with these predatory activities were resources spent by officials to get into positions that allowed them to extort, and expenditures by citizens to evade extortion. Fischer, Said and Valdivieso (2001: 73) estimate that for trade with the outside world, Israeli security restrictions directly resulted in Palestinian businesses facing costs that were 30 to 45 per cent higher than those faced by equivalent Israeli companies. Israeli customs and security officials thus had the power to financially destroy Palestinian traders by delaying their goods at borders. This gave them not only powers of occasional extortion but also ultimately the power to ensure that Palestinian traders would cooperate with Israeli economic and political interests. Thus, it was often cheaper for Palestinians to engage in corruption to bypass Israeli restrictions, or to pay Israelis to import or release goods through security points and thereby earn easy margins. Similar security checks and checkpoints had to be maintained on the Palestinian side, though the restrictions were relatively less onerous. Nevertheless, similar exactions on the Palestinian side inevitably happened. Most journalistic reports refer to relatively small though systematic exactions by Palestinian officials at borders and crossings, or tolls collected by security personnel. There is no clear evidence that the Palestinian security forces operating within the Palestinian territories were significantly more corrupt or extractive than the Israeli military government that preceded them, and no evidence that Palestinian security forces carried out outright looting as Israeli troops did in Palestinian areas during Operation Defensive Shield in 2002 (Lagerquist 2003).

Since the Israelis were an occupying force and could therefore get away with high levels of looting and extortion, it would be more relevant to compare extortion by Palestinian security forces with the experience of internal extortion in other developing countries. While such judgements inevitably have to be impressionistic rather than quantitative, the Palestinian territories suffered relatively little from extreme forms of extortion, for instance by warlords linked to crime. Nevertheless, since any restrictions that generate this type of extortion and corruption are themselves damaging for the economy, there can be no disagreement that the removal or reduction of these extractions is highly desirable. But clearly a significant reduction in this type of extortion would be contingent on restructuring the system of checkpoints and gatekeepers, and extortion is unlikely to be significantly reduced by reforming the Palestinian security forces alone.

The much bigger transfers associated with political stabilization created their own structures of rent-seeking and influence-buying. These rent-seeking activities included, most importantly, the PNA's investments in security to assure external powers to release PNA resources on time, and the establishment of personalized networks between Palestinian officials and critically placed individuals in the Israeli administration to negotiate and facilitate the transfers. While it is easy to understand the functional necessity for these special accounts given the external constraints, there was obviously the possibility of misuse and misappropriation by rent-seekers with access to the executive. Indeed, we might expect that since the PNA had resources that were going to be used for political stabilization, there would have been some, maybe even substantial amounts of rent-seeking by political factions seeking to get a share of these rents. All of these types of rent-seeking were the result of the systemic presence of rents that were available to the executive for political stabilization as part of the design of the Oslo architecture and the necessity of at least some of these expenditures during a period of contested state formation. Thus, it is *not* the case that rent-seeking or corruption was *driving* the creation of these rents in any simple sense. On the contrary, the rent-seeking and corruption associated with these rents were the *result* of specific rents that were created and managed as a necessary part of the Oslo Agreements.

Nevertheless, these rent-seeking expenditures, for instance in maintaining patron–client networks, had a clear social cost. But the net effect of the rents distributed by the PNA for political stabilization was not necessarily negative. Much of these redistributive rents were used for job creation in the security services. The direct effect of many of these rents was very likely negative because sectors such as security were not high priority in terms of social needs, and they allowed the employment of individuals who were not best qualified for specific service-delivery sectors. Nevertheless, to the extent that this employment-generation achieved political stability, it had a positive economic effect in the form of faster development, greater investments and so on, compared to the alternative of social disruption by disaffected groups. The net effect of such stabilization rents may be positive or negative depending on the allocation and management of such rents, and the net positive effect may be big enough to also outweigh the rent-seeking costs in terms of the costs of maintaining patron–client networks, corruption, and so on. These judgements are difficult to quantify precisely, but before 2000, a significant degree of political stabilization *was* achieved by the PNA through these mechanisms, and this did create a context for considerable external investments despite the overall context of uncertainty and conflict with Israel.

Finally, we have seen that a number of rents have historically been critical for *economic* development, and the PNA was involved in the creation and management of some of these developmental rents. With these rents too, there is bound to be some associated rent-seeking and even corruption. However, if (as in the East Asian countries) a developmental state can allocate these rents efficiently, then even though corruption is always undesirable, some amount of corruption can co-exist with rapid development. As the economy becomes more developed and a capitalist class entrenches, some of this corruption is rapidly converted into legal influence-buying in the form of lobbying and political contributions, and the more damaging aspects of this corruption can be outlawed. The real problem emerges when a state lacks the capacity to create growth-enhancing rents. In these cases, states end up supporting inefficient industries and growth-reducing transfers. The corruption that is associated with *these* rents effectively allows inefficient capitalists to buy themselves protection, or maintain their damaging monopoly profits or subsidies, and the overall effect can be massively negative (Khan 1996a, b). Thus while the focus on corruption is important, its significance is to enable us to identify the causes preventing states from playing a dynamic transformation role. A state with high transformation capacities could perform well with some degree of corruption, but it would obviously perform even better if corruption could be reduced. But a state that lacks transformation capacities would not necessarily perform much better if it got rid of all corruption. Most seriously, if a badly constructed reform aiming to reduce corruption and increase accountability damaged the limited capacities of such a state to create and manage developmental rents, the results could paradoxically be very negative. In the chapter by Hilal and Khan, we will consider whether some of the post-2000 governance reforms that were pushed through in the PNA under external pressure may have had just such damaging effects.

Democracy in Palestine

Quite apart from the general problems of deepening democracy in developing countries, Palestine and the PNA faced some special problems over this period. This is because the PNA was clearly *not* set up through the Oslo Agreements primarily to deliver democracy to Palestinians. Its primary objective was to negotiate the territorial and constitutional limits of a Palestinian quasi-state in the context of an extreme asymmetry of power and resources vis-à-vis Israel. To get anything at all, it had to demonstrate its ability to deliver security to Israel on terms determined by the latter. In turn, this meant that from the beginning, there were serious conflicts between the immediate democratic rights of the Palestinian opponents of this particular 'peace process' and the imperative of maintaining security. The implications were well understood and widely reported from the outset by human rights organizations.

A particular problem for the operation of democracy in the Authority was that it had to allocate Israeli controlled fiscal resources to achieve political stabilization and security. For these redistributive rents to be allocated transparently, we have to ask if it might have been possible to institutionalize and legalize the transfers necessary for political stabilization in the Palestinian context. Transparent and democratic regulation of these rents in such a context would be highly desirable but would not be simple. The public regulation of these transfers would require the prior existence of a majority in Palestine that agreed about the aims that were to be achieved through political stabilization. For instance, it would have to agree that it was proper and necessary for these transfers to be ultimately controlled by Israel during the interim period and perhaps beyond, with Israel retaining the fiscal and political capacity to halt these transfers if Israeli aims were not being achieved. It would then have to agree to monitor the use of these funds controlled by Israel to maintain Palestinian political stability to achieve Israeli aims of security without knowing in advance the nature of the Palestinian state that Israel would eventually allow. A constituency with such a sympathetic understanding of the security concerns of the occupying power is unlikely to have been broadly enough based in Palestine to have allowed a democratic government to be constructed that could openly carry out the necessary regulation of these political transfers. Moreover, as we have argued earlier, the possibility of open democratic transfers assumes that fiscal resources are sufficient to satisfy enough demands legitimately to maintain stability. It is unlikely that Palestinian fiscal capacity, even with a full transfer of tax-collecting powers to the PNA, would have been sufficient to achieve stability through generalized transfers given the widespread economic deprivation and political dissatisfaction with the terms of the two-state solution. This fiscal constraint is an important imperative driving patron–client politics in developing countries. By definition, patron–client politics involves secret transfers to critical groups rather than open transfers to all deserving groups. These considerations warn us not to be overly optimistic that democratization of control over tax revenues would be sufficient to achieve the allocation of resources required in conflict and transformation contexts.

If it was not the *intention* of the Oslo Agreements to immediately create a liberal-democratic state in Palestine, it makes little sense to criticize the PNA leadership for not delivering a satisfactory democracy before the 'peace process' had delivered a state. In addition, even in a more typical developing country where a sovereign state already exists, it is not clear that a democratic state can be entrenched without addressing the problem of how to create a viable and dynamic economy. If we reject the simplistic good governance or neo-patrimonial models, rapid democratization would not *in itself* have addressed the problem of social and economic transformation, without which the conditions for sustaining democracy and making it viable would not have been attained.

Clearly, progress in democratization under the PNA was too slow. But how is progress to be accelerated? Here there is room for genuine disagreements about the extent to which the pace of democratization was held back by a lack of 'democratic will' on the part of the Palestinian leadership, as opposed to structural constraints, in particular the institutional and economic arrangements underpinning the peace process. In Chapter 2 by Hilal and Khan, we argue that economic development and political stabilization were primarily constrained by the nature of the institutions set up by the Olso agreements and by the external strategies and constraints imposed by Israel. In turn, this made progress in democratization very difficult to sustain. Given these internal and external constraints, far from the concentration of executive power being dysfunctional, centralization arguably maintained the viability of the PNA, by allowing the executive to create rents and transfers that stabilized the economy and polity in very difficult circumstances. It is likely that a weaker executive would have led to an earlier collapse of the PNA due to its inability to maintain even limited stability and security.

In the aftermath of the Second *Intifada*, the US-sponsored Road Map demanded a decentralization of power within the Palestinian Authority and the creation of checks and balances on the powers of the executive as a precondition of further progress. It is not clear why checking the executive will necessarily deliver democracy that is more meaningful for the

Palestinian people. Moreover, it is far from clear that a weaker executive will be able to manage rent-allocation for economic and political stabilization even to the extent of the previous administration. While the Palestinian public was dissatisfied with the degree of democracy that it enjoyed, and progress towards statehood was indeed stalled, it does not follow that the weakness of democracy was the *cause* of the stalled peace process. Correlation does not establish causation. Democracy in Palestine, as elsewhere in the developing world, is an end in itself. Democracy of any particular type does not *necessarily* play a functional role in terms of promoting the viability of transformation economies or reaching territorial compromises with a colonial power. Rather, democracy needs to be entrenched by ensuring rapid economic growth and the construction of a viable polity. Over the longer term, the democratic aspirations of the Palestinian people were more likely to have been furthered by strengthening the capacity of the Palestinian quasi-state to manage developmental strategies in the context of a viable state. Indeed a full-blooded Palestinian democracy may have made the 'security-first' route to statehood much more difficult if not impossible. Since this was self-evident to Israel in 1994, one can question why Israel and its external allies have put so much emphasis on the 'democratization' of the PNA after 2000. It is possible that Israel began to believe that a divided and weak Palestinian leadership would be easier to negotiate with. But if the Palestinian executive were actually to be weakened, this would be a Pyrrhic victory for the Israelis. A Palestinian leadership that was weak enough to accept impossible Israeli terms is likely to be too weak to impose any such 'solution' on its unwilling population.

Four routes of state formation

The rents observed in the Palestinian economy suggest that the effects and implications of externally controlled rents dominated the operation of the quasi-state. We described such a state as a client state. At the same time, other rents observed in the Palestinian context suggested a number of different state characteristics that existed in incipient form in the PNA. Some of the observed rents were compatible with aspects of a predatory state, others with a fragmented clientelist state, and others with a developmental state. If the client state was an interim rather than a permanent phenomenon, the PNA could have progressed along one of these possible routes, depending on which rents and rent-management capacities became more dominant over time. Table 1.2 lists the rents and rent-management features that are consistent with each of these state types, and summarizes the evidence discussed so far.

In the rest of this section, we discuss the client state and its two variants – the integrationist and asymmetric containment client states. Since these variants have very different implications for Palestinian state viability, and therefore for internal governance improvements, we discuss the viability of

Table 1.2: Rents, rent-seeking and state characteristics in the Palestinian context

	Client state	*Predatory state characteristics*	*Fragmented clientelist state characteristics*	*Developmental state characteristics*
Rents defining each type of state	Transfers to the PNA conditional on political compliance for downward transfer to internal factions	Economically damaging monopolies; Extortion by PNA officials	Monopolies and transfers for faction leaders *who can veto* rent-reallocations	Transfers to capitalists *conditional* on performance; Clientelist transfers to maintain stability
Associated forms of rent-seeking	Resources spent by officials to maintain security control; Corruption by officials managing rent-allocation for political stabilization	Corruption/ lobbying to get monopolies; Expenditures by state to maintain its coercive apparatus	Extensive expenditures on maintaining factions; Kickbacks to state leaders from factional leaders	Lobbying by emerging capitalists and kickbacks to state leaders; Expenditures by state to maintain centralized power
Expected economic outcomes	Moderate growth with *integration stategy*; Poor/vulnerable growth with *asymmetric containment*	Poor economic growth	Poor to moderate economic growth	Moderate to very high economic growth
Evidence in Palestinian context	Extensive evidence of client-state rents and of an Israeli attempt to achieve *asymmetric containment* in Palestine	Moderate evidence of predatory rents but some monopoly creation could have alternative explanations	Moderate evidence of factional allocation but weak evidence that faction leaders could veto rent-allocations	Moderate evidence of developmental rents but limited state capacity in regulating rents

these state types at length. We also discuss Israel's possible strategic calculations in wanting a client state, and eventually a particular variant of a client state in Palestine. These strategic concerns are important for assessing the feasibility of the state formation process as a whole. We then discuss the incipient predatory, fragmented clientelist and developmental characteristics of the quasi-state, and the significance of these observations.

Client-state characteristics

As we have already observed, the rents transferred by external powers to ensure political compliance by the PNA played an important role in the security-first route to Palestinian statehood. If these externally controlled rents had institutionalized into a long-term arrangement for determining the economic and social policy of the Palestinian state, this would amount to a consolidation of a Palestinian *client state*. The client-state outcome is specific to the Palestinian state-formation experience, and the conditions underpinning it flow from the peculiar security concerns of Israel. Since Israel believed that it was unlikely that a sovereign Palestinian state would put the security of Israel at the top of its agenda, it insisted on controlling a range of rents that were critical for the survival of the emerging Palestinian state. The Oslo Agreements institutionalized the dependence of the PNA on rent flows controlled by Israel and the donors during the interim period (see Chapter 3 by Zagha and Zomlot as well as Chapter 2 by Hilal and Khan). Many of the Palestinian critics of the PNA identified the way in which Israel sought to control rents that were critical for the Palestinian economy, and the way in which the PNA appeared to acquiesce to this control, as evidence of an operating or emerging client state. In the eyes of these critics, the donor community contributed to the construction of a client state by also making aid to the PNA conditional on Palestinian participation in a peace process that gave priority to Israel's security requirements. Although neither side would describe these arrangements as a 'client state', we will use this term to describe the external rent-control aspects of the Oslo Agreement. The facts of externally controlled transfers and other mechanisms of control are not in dispute (see Chapter 3 by Zagha and Zomlot, and Chapter 6 by Fjeldstad and Zagha). The question is only about the effects of this dependence, and whether these were transitional or permanent characteristics of the emerging state.

Transfers from an outside power can only ensure compliance by a client in conjunction with other policies. Compliance can in theory be induced by two quite different strategies. At one extreme, transfers could be linked to the implementation of policies that achieved the goals of the dominant power but which were greatly *beneficial* for the client as well. Some constituencies in the client state may resist these policies in the short run, and conditional rent-transfers from the dominant power could assist the implementation of mutually beneficial policies by creating immediate *incentives* for compliance. Once these policies were in place, external control of rents would no longer be necessary because co-existence would be mutually beneficial and there would be endogenous incentives for compliance on both sides. At the other extreme, if the goals of the dominant power could not be achieved through policies that benefited the client, transfers combined with policies that maintained the vulnerability of the client could ensure compliance. If the economy of the client were vulnerable, the threat to withdraw transfers and to otherwise damage the economy of the client would threaten regime survival and would therefore ensure compliance. In principle, each of these polar strategies could ensure that the external control of transfers and other control powers would have the effect of ensuring compliance, but with very different consequences for the client. The economic and political implications of a client state consolidating in Palestine would therefore depend critically on where Israeli strategies were located along this spectrum.

The best client-state scenario (from the Palestinian perspective) would clearly be one where Israel attempted to ensure compliance through policies that over time created endogenous *incentives* for compliance. The most obvious policy of this type in the Israel–Palestine context would be an Israeli push for the full integration of the two economies. Such an *integrationist strategy* would involve a rapid, or at least a steady increase in investment and capital flows from Israel into the Palestinian territories and an equivalent reduction of restrictions on the movements of labour of all skill categories in the other direction. From a Palestinian perspective, while integration is not necessarily the *best* strategy for ensuring the rapid development of the Palestinian economy, it is a reasonably attractive one. It is not the best because integration may slow down the development of a Palestinian national capitalism. Nevertheless, the Palestinian economy would clearly benefit from freer access to the labour and capital markets of the more advanced Israeli economy. It would allow accelerated capitalist development in the Palestinian territories, but one that would be dominated by Israeli capitalists for a very considerable time. Moreover, given the long history of conflict, economic development alone may not have satisfied Palestinian demands for justice and redress. Occasional acts of violence on both sides could be expected. Nevertheless, as integration deepened, a Palestinian client state would have neither the interest nor the ability to challenge Israeli interests, and eventually control of its fiscal resources would no longer be necessary. Thus while the long-term success of an integrationist strategy was not guaranteed, it had a good chance of success. But a minimum precondition for its success was that the Palestinian quasi-state should be able to offer rapid economic development for broad sections of its population, and to demonstrate to its people that prosperity depended on compliance with the security priorities of Israel. An *integrationist client-state strategy* might have satisfied these conditions.

Although some Israeli policy statements suggested that the Israeli strategy was indeed one of constructing an integrationist client state (see for instance, Peres 1993), in fact moves towards economic integration were at best halting. We argue (Chapter 2 by Hilal and Khan, and Chapter 3 by Zagha and Zomlot) that contrary to expectations, Israel rapidly strengthened the mechanisms of control that existed before Oslo, and introduced new mechanisms of control deep inside the Palestinian territories that significantly increased the vulnerability of the Palestinian economy. The failure to deepen integration and indeed its reversal in many respects cannot be explained by security threats because the reversal began at the very outset, at a time when there was widespread support for the Oslo route on both sides. However, it is possible to make sense of Israel's retreat from this route if we remember that along with security, Israel had another fundamental objective, and that was to maintain its identity as a Zionist state. As the European Union (EU) model shows, in the long run the political separation of closely integrated economies makes less and less sense. It may have been the fear that ever closer economic integration may in a distant future lead to political integration that ruled out strong support for an integrationist strategy in Israel (see DellaPergola 2001 for an analysis of the demographic data and its implications for the viability of Israel).

If the integrationist approach failed to make progress for this or for any other reason, leverage over a Palestinian client state would have to be maintained by other means. The worst scenario of a client state from a Palestinian perspective would be one where Israel did not allow economic integration, but attempted to create an economic context where the suspension of transfers would amount to a severe *penalty* for non-compliance. Instead of integration, an Israeli capacity to periodically close down movements of labour and goods in large parts of the Palestinian economy would also ensure that Israeli control over PNA rent transfers would provide significant leverage over the client state. But to do this without also hurting the Israeli economy, integration would have to be highly selective to maximize the asymmetric impact of closures. We describe this as a strategy of *asymmetric containment*. By ensuring that the Palestinian economy could be hurt in an asymmetric way by Israeli decisions, the Israeli state ensured that the Palestinian economy remained in a state of sustained vulnerability. A suspension of transfers would then greatly magnify Israel's economic and political influence. Arguably, compliance would follow. Indeed, following this strategy, if the Palestinian economy were to become more self-sufficient, the threat of rent-withdrawal would work less well for ensuring compliance.

Many aspects of Israeli policy during this period are consistent with a strategy of *asymmetric containment*. Even before the Oslo Agreements, only unskilled Palestinians could find employment in Israel, and they could be excluded at short notice without significant cost to the Israeli economy. This did not change after Oslo, contrary to the requirements of deepening economic integration. On the contrary, the Palestinian labour market became much *more* vulnerable. Israel rapidly institutionalized what began as a temporary system of checkpoints and prohibited areas. This allowed it to disrupt movements of goods and people *within* the Palestinian territories, and potentially to isolate Palestinians within particular villages and towns. In addition to formalizing and deepening existing methods of control, Israel established extensive controls over Palestinian trade and diplomatic relationships with the outside world as part of the Oslo Agreements. This made Palestinian consumers and producers much more vulnerable than if they had been purchasing imported products directly from Israelis, as they had been before Oslo.

The effects of this system of control assisted in the 'de-development' of the Palestinian economy (Roy 2001). Our notion of asymmetric containment suggests that de-development may have been to some extent an *intended* consequence of Israeli policies. Palestinian economic vulnerability ensured that control over critical Palestinian rents gave Israel greater leverage to ensure compliance in security and other issues. To make matters worse for the Palestinians, it would be much more difficult to guarantee Israeli security with asymmetric containment since Palestinians would now face much greater hardships. Compared to an integrationist client state, a client state that accepted containment would have to use much greater repression on its own people. In our assessment (Hilal and Khan, Zagha and Zomlot, this volume), Israeli strategies on the ground were closer to the *asymmetric containment* end of possible compliance strategies. There were some investments in Palestinian territories by Israelis over this period (for instance in the Jericho casino and in some indirect shareholdings), but significantly, there was no loosening of restrictions on labour movements. In fact, controls over labour movements became *much more* restrictive during this period, as did controls over movements of goods. The degree of restriction has to be measured not just by looking at the aggregate movements of labour and goods, but by looking at the system of control that allowed Israel to stop movements on a daily basis *inside* the Palestinian territories, as well as to and from the outside world.

While the Palestinian leadership clearly accepted some version of a client state as the only deal on offer in the interim period, for their own survival they refused to accept a client state based on asymmetric containment as a long-term possibility. However, it soon became apparent that this was the only client state that was on offer in the interim period and beyond, creating profound obstacles for the Oslo road-map. Many of the conflicts between the Palestinian leadership and the Israelis during the Oslo period, and particularly towards the end of this period, reveal a growing tension between Israeli attempts to enforce a system of compliance based on asymmetric containment and Palestinian attempts to break out by following independent developmental strategies.

Israeli objectives and the feasibility of its client-state strategy

A number of deeper questions are raised by these observations. It is easy to explain why Israel wanted and still wants a two-state solution. The demographic balance has already shifted to the point that a Zionist state in historic Palestine (that is 1948 Israel and the occupied territories) is no longer viable. But why did Israel want to have a client state in the occupied territories that would now become the truncated state of Palestine? And why did it then impose asymmetric containment on it? These are fundamental questions with enormous implications for the future viability of a Palestinian state. After all, Israel could simply have withdrawn to the internationally recognized 1967 borders and allowed full sovereignty to the new state. We can only reflect on a number of possible answers to these questions since fully satisfactory answers would require a separate project on Israeli political economy. The simplest but least plausible possibility is that Israel felt threatened by a fully sovereign Palestinian state if it simply withdrew to its 1948 borders, and it therefore needed to have security guarantees by retaining controls over the foreign and defence policies of the new state. This may appear to be plausible but it is actually extremely unlikely that Israel had anything to fear militarily from the fledgling Palestinian state.

A more plausible possibility is that powerful groups in Israel would not give up the large number of settlements (with roughly a quarter of a million settlers) in the Palestinian territories that they saw as Jewish territories by divine right. If so, full separation would not be feasible and Israeli security would now definitely require a client Palestinian state. Palestinians would have to accept a number of non-contiguous territories as a 'state' and they would have to accept a permanent Israeli presence in strategic and economically valuable locations within their 'state', such as settlements sitting atop all the critical water sources. In such a context, Palestinian security cooperation would be required on an ongoing basis to protect the settlements (Judt 2003). This is plausible, but if the survival of Zionism behind 1948 borders only required action against the settlers, we would have expected to see greater efforts, at least by Labour, to prepare the grounds for removing them. But instead of any concerted attempts to withdraw settlements, *both* Labour and Likud built *new* settlements and expanded existing ones after the signing of the Oslo Agreements. So, if the impossibility of withdrawing settlements drove Israel to a client-state strategy, it was not because the establishment that signed the Oslo Agreements discovered that it could not get rid of the settlers, but rather it appeared that it did not even intend to remove them.

This suggests a third possibility that the problem facing the Israeli state may have been even more intractable than that of removing the settlers. The actions of both Labour and Likud suggest that a broad swathe of the Israeli political class did not see the creation of a sovereign Palestinian state as a solution to the 'Palestinian problem'. A possible explanation of such an attitude could be that the Israeli political class could see that even after the creation of a Palestinian state, a significant Palestinian minority would remain in Israel with Israeli citizenship. This Israeli Palestinian minority was already around 20 per cent of the Israeli population at the time of the Oslo Agreements, and its faster growth was expected to steadily increase this per centage in the decades ahead. There was also the issue of the refugees. Many of them were unlikely to give up their historic struggle to gain the right of return, irrespective of any agreements signed by their leaders. This can explain why the Israeli political class may have felt that Israel as a Zionist state would always have to live with a 'Palestinian problem', and the exercise of power over the Palestinians was going to be a permanent part of Israel's survival strategy as it had always been in the past (see for instance, Shlaim

2000). If so, it would make perfect sense to concede at best a client Palestinian state that may in the future assist in the ongoing management of the bigger problem.

If a client state for the Palestinians made sense for Israel, why did it also want to impose asymmetric containment on this state? The answer to this would depend on why we think Israel wanted a client state in the first place. If the client-state strategy had been driven primarily by security fears, and the need to have some degree of influence over security expenditures and security arrangements in the Palestinian state, a client state with integration would be eminently feasible. Indeed, the relatively low level of violence in the period immediately following Oslo suggests that security cooperation between the two sides was initially quite good. Moreover, remarkable optimism and calm on both sides characterized the immediate post-Oslo period. Clearly, the problem was not the policing capacity or even the determination of the quasi-state to deliver security. If integration could rapidly increase the incentives to comply, why was the integrationist strategy not more forcefully pursued, and why did asymmetric containment increasingly become the dominant strategy? To find a plausible explanation we have to remember that Israel was not just concerned about security, but security *and* demography. If the possibility of sharing sovereignty with a non-Jewish majority in any form and at any time, even in the distant future, is ruled out, so is economic integration, since the latter is likely to lead in the end to some forms of political integration. Thus even if the initial concern was purely one of security (whether security within 1948 borders or security for the intractable settlers as well) demographic concerns would still rule out an integrationist strategy. If the initial concern was one of security *and* keeping all options open regarding a much bigger demographic challenge that included Palestinians within Israel and the refugees, then integration was even more forcefully ruled out, even though a client state would still be desperately required. While a number of factors were clearly jointly at play, this complex set of options may help to explain why Israel wanted to achieve both a client state *and* one that was based on asymmetric containment.

What was amazing about the historical opportunity that was opened up by Oslo was that on the Palestinian side, the Palestinian leadership accepted the necessity of at least a temporary form of ‘client’ status for the emerging Palestinian state (defined as external control over critical rents and decisions). It was clear to the Palestinian leadership that at best what was on offer as the outcome of the Oslo Agreements was not only a territorial compromise from the perspective of historic Palestine, but also an acceptance of an Israeli veto over many important decisions of their ‘state’, which would therefore be less than sovereign. For instance, it was clear that any future Palestinian state would have limited military and foreign policy freedoms compared to other states and cooperation with Israel on security was not going to be optional at least in the immediate future. By signing the Oslo Agreements, Arafat and his leadership implicitly accepted these limits. Perhaps surprisingly, there was initially strong internal support for a compromise along these lines within the WBG Palestinians, and this provided Arafat with his political constituency.

Nevertheless, within these limits, Arafat and his constituency had some clearly defined minimum requirements. Some of these requirements are well known and were articulated during the Camp David talks on the final settlement. On the issue of territory, it was clear that after relinquishing the 78 per cent of Palestine on which Israel had been established in 1948, the Palestinian state would have to include all of the territory occupied in 1967 (including East Jerusalem), with minor border adjustments on the basis of exchanging territory where necessary. On the issue of the refugees, the PNA knew that no solution would work if Israel did not admit that ethnic cleansing took place in 1948. It followed that Israel had to recognize in some form the right of return that is enshrined in international law, but with flexibility in its implementation. What is critical is that while Arafat demanded 'true independence and full sovereignty: the right to control our own airspace, water resources, and borders; to develop our economy; to have normal commercial relations with our neighbours, and to travel freely'[3], these demands were not articulated to include military and foreign policy independence, or to exclude security cooperation. In other words, the PNA deferred to Israeli security concerns in ways that *de facto* amounted to reduced sovereignty during the interim period and beyond.

The compromise that Arafat and his constituency were willing to make was to accept a state that had all the trappings of sovereignty but which allowed Israel to have a say in all matters that could be related to security. Such a state clearly would not have full sovereignty in all respects. *But this compromise on sovereignty could only remain politically viable if the emerging state could provide the PNA's internal constituency with substantial new economic opportunities*. The rents that Israel and the donors controlled could have assisted in attaining these economic and political objectives provided Israeli policies allowed rapidly expanding economic opportunities for all sections of the Palestinian people, including skilled professionals, Palestinian capitalists as well as unskilled workers. In theory, an integrationist strategy may have allowed this. However, as the strategy of asymmetric containment became clearer, the aspirations of both sides became increasingly inconsistent. The PNA's political viability was directly affected because its leadership had to generate growth through special privileges for expatriate investors that alienated important sections of its own population, and at the same time, the degree of 'policing' required to maintain a client state with asymmetric containment proved to be ever increasing in its required severity. These considerations have enormous significance for Palestinian state formation strategies of the future. If an integrationist client state is not possible for the Israelis, and an asymmetric containment state for the Palestinians, then a client state is effectively ruled out. The question then becomes whether Israel can ever concede a fully sovereign Palestinian state on 1967 borders even though this does not solve its bigger 'Palestinian problem', and may even shrink a number of options in dealing with other aspects of the 'problem'. If not, the Oslo experience tells us that the two-state solution is not likely to proceed much further.

Predatory state characteristics

We have seen that there was evidence of some amount of extortion by PNA officials and of many damaging monopoly rents. For instance, the monopoly rents created by setting up trading monopolies, or the alleged extraction of tax resources into secret accounts controlled by the leadership could easily have become predatory rents. There was also evidence of lower-level extortion by PNA security staff from small businesses and others. Rents are predatory if leaders extract resources from society, and the extraction leaves society worse off than it would otherwise have been. The latter qualification is important because in our definition predation is not determined by the legality of the resource extraction but its economic effects. Resource extraction by the state happens in all states. In developed countries most of the resource extraction is legal in the form of taxes, but in developing countries, a greater part comes from grey activities or is illegal. To judge whether rent extraction in any context is predatory, we focus on the damage done to society, compared to viable alternatives where these rents could be avoided or allocated in a better way. When we look at many of the apparently predatory PNA rents from this perspective, only the examples of direct extortions from businesses are unequivocally predatory rents. Some of the Palestinian trading monopolies could have been beneficial for the Palestinian economy compared to the alternative of not having them, given the specific context of Israeli monopolies and Israeli control over external borders. Similarly, some of the kickbacks going into secret or special accounts may have been necessitated by the imperative of maintaining security and flexibility in a context of fiscal control by the colonial power. At the same time, some of these resources could easily be misappropriated and used to enrich the leadership at the expense of society *given what could be achieved under these constraints*. The judgement of when rents in a difficult transformation and conflict context become predatory is therefore a difficult one, and one over which there can be genuine disagreement.

Fragmented clientelist state characteristics

Redistributive transfers, as well as the creation of monopolies for powerful faction leaders would also be consistent with aspects of an emerging *fragmented clientelist state*, but only if we can also find evidence that the recipient factions had the power to *veto* attempts at rent re-allocation by the state. The qualification is important since *all* states have to create some redistributive rents to maintain political stability. The PNA too was clearly distributing rent to critical client factions during this period. For instance, there was a rapid growth in employment in the state sector as thousands of individuals were absorbed into administrative jobs, particularly in the various security services. When public sector jobs are created without any proportionate service delivery purpose, these jobs primarily deliver rents to those who are employed. Was this simply political stabilization or was there evidence that powerful Palestinian factions had sufficient power to demand rent allocations of a type and extent that they themselves determined? In our next chapter by Hilal and Khan, we examine these possibilities and find very little evidence over this period that client factions could veto rent-re-allocations in Palestine.

Developmental state characteristics

Some of the rents created by the Palestinian state had potentially positive effects for economic development and political stabilization. The conditions and capacities required for a developmental state need to be carefully identified because the range of rents such a state creates can be *superficially* similar to those created by predatory or fragmented clientelist states. For instance, a developmental state could create temporary monopoly rents, but in this case, it would be to attract investment and encourage risk-taking, and these rents would be managed to achieve these goals. A developmental state could also create transfers and redistributive rents to accelerate the emergence of capitalists and to maintain political stability, but these transfers would be managed so that their efficiency costs were controlled, and the net effect was an acceleration of developmental transformations.

To test if rent-management in the Palestinian context displayed any *developmental state* characteristics, we should look for evidence of rent allocations that maintained political stability and provided *conditional* support to emerging capitalists. A developmental state would have to have a much greater degree of sovereignty than was allowed to the PNA under the Oslo Agreements. Nevertheless, although this is not widely recognized, there were elements in the rent-allocation organized by the PNA that were consistent with a nascent developmental state. The scale was inevitably small given the powerful external constraints facing the state, and the short time period before the first normal period of development ended in 2000. But there is evidence that the PNA used rents to attract expatriate Palestinian capitalists who had substantial investment funds and entrepreneurial experience. Many *did* invest in Palestine under the PNA despite the extreme uncertainty regarding the future of the Palestinian state formation experiment. The PNA also displayed some ability to correct mistakes in the allocation of rents, re-allocating rents to those who might be more efficient (and who could therefore offer bigger benefits to the PNA over time). The ability to override factional interests and to correct misallocations of rents despite factional opposition is a characteristic of developmental states that distinguishes them from fragmented clientelist ones, and enables them to ensure that rents remain growth-promoting.

Since the rents and rent-management capacities underpinning all of our incipient 'state types' could be found to some extent in the Palestinian territories under the PNA, our task is the more difficult one of identifying the conditions under which each may have become more dominant. State failure in our approach is explained not by the absence of conditions recognized as good governance characteristics. Rather it is explained by the weakness of conditions under which a developmental state with transformation capacities could have emerged, capable of dealing with the problems of transformation in the Palestinian context. Conversely, conditions that strengthened the possibility of one of the less dynamic types of state consolidating, in particular a predatory, fragmented clientelist or a client state based on asymmetric containment would result in a decline in state viability and possibly signal impending state failure.

A methodology for assessing state performance

The *types* of rents a state supports and its rent-management capacities depend in turn on underlying institutional, political and other conditions. The institutional structure of states is clearly important since this can directly determine its rent-management capacities. The political context is also critical, in particular because the distribution of power between groups and classes can determine which groups are likely to succeed in getting the rents that favour them. Other variables that are likely to play a role in determining the dominant types of rents include external conditions, particularly in small states and states in conflict where rents may be controlled by external powers. Initial conditions are also important, of which the most important for our purposes is the prior degree of development of capitalism. This may determine the types of rents that are feasible since some rents, such as rents to accelerate technology acquisition, require a minimum level of prior capitalist development. Figure 1.6 shows the four key sets of conditions that we will look at in explaining the prevalence of different types of rents and rent-management capacities.

First, the prior degree of development of capitalism and the organizational strength of capitalists are important variables determining rent-outcomes. The relative power of different factions of capitalists and their power relative to other social groups can determine the types of rents that are created and how effectively the state can discipline and manage these rents. Second, and related to this is the distribution of organizational power in the broader society. The relative power of different groups and classes can explain their ability to demand rents of different types. A third

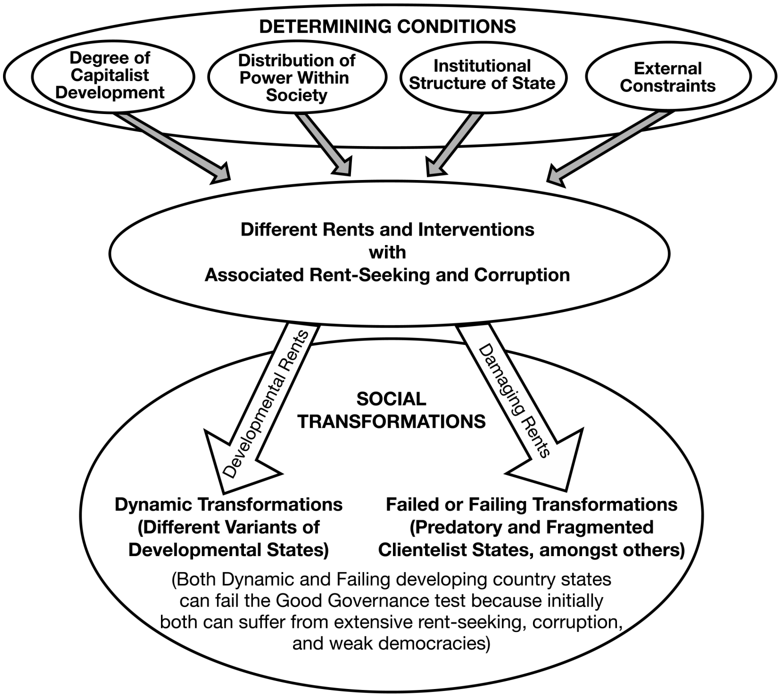

Figure 1.6 Conditions determining rents and rent-seeking in social transformation

determinant of types of rents is the institutional structure of the state, and this refers to both economic and political institutions. But instead of presuming that democratic, decentralized or any other institutional structure results in better rent-management capacities, our approach is to establish the effects of a particular institutional structure, *given the overall context defined by other conditions*. Thus, it is quite possible for democratic institutions, for instance, to sometimes support value-enhancing rents, and at other times to support value-reducing rents. Similarly, the effect of the centralization of decision-making has to be examined in a specific context. At a general level, all we can say is that the centralization of some critical state powers is important for the functioning of any state. In particular the ability of the central executive to coordinate the activities of different state agencies is critical if developmental rents are to be created as opposed to redistributive rents that only benefit particular groups. The leadership in a coordinated state is less likely to benefit from damaging redistribution, because while some constituents gain, others lose out, and the support base for the state is not necessarily increased. In contrast, an institutionally fragmented state is more likely to support damaging redistributive rents because each agency can hope to benefit from redistribution to *its* constituents, without caring for the loss of other constituents unconnected to it (Okuno-Fujiwara 1997; Shleifer and Vishny 1993). Effective institutional centralization in turn requires a corresponding distribution of political power that supports it since the implementation of state decisions requires both institutional and political capacities (Khan 1995). Finally, external conditions also have to be taken seriously, particularly in the case of small countries and in conflict situations. Indeed, in the Palestinian case, external conditions were of paramount importance.

Each of these sets of conditions clearly keeps changing over time. Moreover, growth or stagnation can itself feed back to change these conditions, for instance by weakening or strengthening particular classes or by allowing state capacity in particular areas to be improved, or constraining it to collapse further. These feedbacks can in turn result in vicious or virtuous

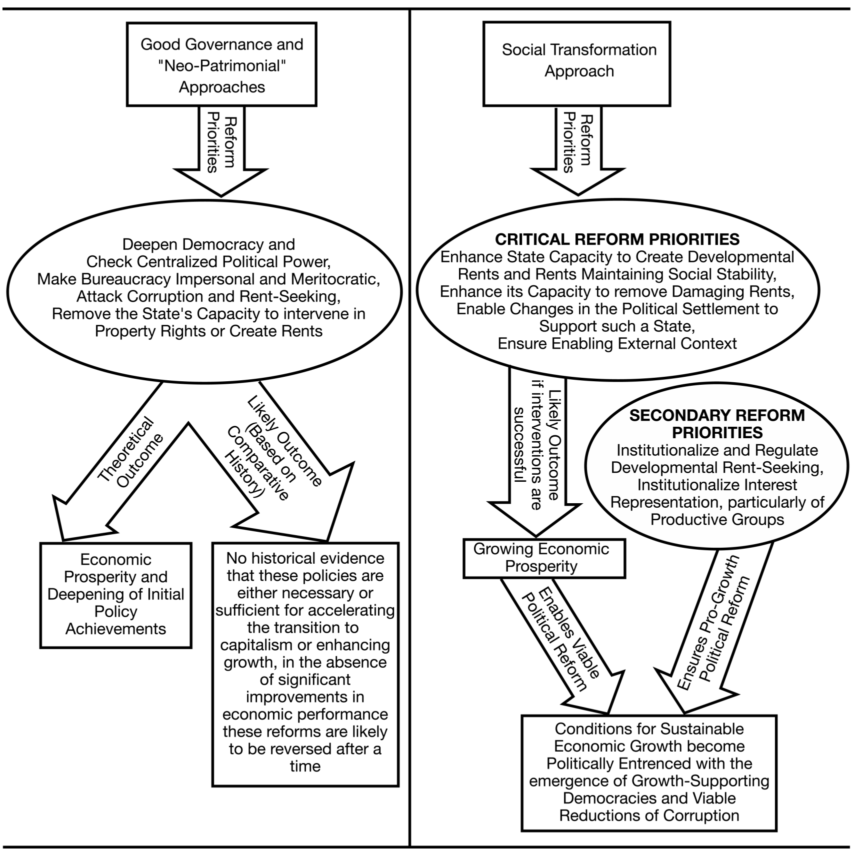

Figure 1.7 Policy sequencing in the good governance, neo-patrimonial and social transformation approaches

cycles involving state capacity and economic performance. We can now summarize the main differences in the policy implications of the good governance or neo-patrimonial approaches on the one hand, and our historical approach on the other that aims to identify critical state capacities in a comparative context. The left-hand column of Figure 1.7 shows the well-known reform priorities of the good governance and neo-patrimonial models, and the right-hand column contrasts these with our analysis based on a comparative analysis of social transformation. The good governance and neo-patrimonial approaches claim that democratization, anti-corruption strategies and liberalization are *preconditions* for development because achieving them will ensure that economic growth takes off and political viability is achieved. The economic growth that is supposed to follow then ensures that these initial reforms are sustained and deepened. In contrast, we argue that comparative history does not provide much evidence that developing countries became advanced capitalist countries by following such strategies. Theory and evidence are at best weak and equivocal on the necessity or sufficiency of these policies for accelerating growth. In the Palestinian context, an uncritical application of good governance or neo-patrimonial models can be doubly problematic in that it can divert the frustration with the slow progress and relatively poor performance of state formation to problems that while real, were not primarily responsible for the results.

The right-hand column in Figure 1.7 shows in contrast the policy implications of the social transformation approach described in this chapter. Here the primary policy emphasis is to achieve the institutional, political and external conditions that assist the creation and effective management of developmental rents, including the rents necessary for maintaining political stability; while reducing the rents that are damaging for growth and rapid social transformation. If these necessary conditions for viable development can be put in place, the next tier of policy priorities would be to try and legalize the types of rent-seeking that support growth-enhancing rents so that the corruption associated with these rents can be reduced, or replaced with legal forms of rent-seeking. The historical evidence suggests that satisfactory reductions in corruption are only likely to be achieved once a broad-based capitalist class has developed that is no longer dependent on primitive accumulation and can legitimately bargain over the allocation of growth-enhancing rents. The growing prosperity of the economy in turn allows sustainable extensions of democracy since more and more of the rents required for political stabilization can be converted into formal fiscal transfers.

If capitalist development and the deepening of political institutions take place in parallel, the emerging capitalist system can become politically entrenched through democracy. On the other hand, a failure of these second tier reforms can mean that even high-growth emerging economies can face a political crisis at some point. But since the Palestinian economy during our period could hardly be described as having achieved the necessary conditions for viable economic development in the long term, focusing on the secondary reforms necessary for politically entrenching a dynamic capitalist economy would not necessarily ensure viability in this context. These reform priorities can be particularly misleading if they take attention away from the fundamental constraints that prevented the construction of a viable Palestinian state. Indeed, we have suggested that some of the apparent governance failures of the PNA were in fact rent-management strategies that attempted to enhance the economic and political viability of the state in a context of containment. If reform removed these capacities without addressing the problems they were responding to, the emergence of a viable state may become *less* likely. In the next chapter by Hilal and Khan, we use the methodology developed in this chapter to explore these possibilities.

Notes

1 Consolidated figures for aid flows to the Palestinian territories have not yet been collated. Figures here are estimates based on a number of sources, World Bank (2000) and (2001) and IMF (2003: 20–5).
2 PCBS, Press Release of Palestinian National Accounts for 1999, Ramallah, 2000.
3 See for example, the article by Yasser Arafat, 'The Palestinian Vision of Peace', *New York Times*, 3 February 2002.

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