Select Committee on International Development Written Evidence

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BACKGROUND TO THIS SUBMISSION

In 1998 the Norwegian Foreign Ministry and NORAD commissioned a study to investigate the impact of governance failures, including corruption and the operation of Palestinian institutions on Palestinian state formation. This was in the context of Norwegian aid support to the Palestinian Authority and its sponsorship of the Oslo Process. Three people led the research team: myself, based at SOAS, Dr Inge Amundsen, a political scientist based at the Christen Michelsen Institute (CMI) located in Bergen, Norway, and Dr George Giacaman, a Palestinian sociologist based at Muwatin, a research institute based in Ramallah in Palestine. A further eight researchers were part of the team, from the CMI and SOAS, but mostly commissioned from Palestinian universities by Muwatin, in Palestine. The project became a wide-ranging investigation of the constraints facing state formation in Palestine and the team kept working until 2002. The report has taken the shape of a book that is being published by Routledge early next year.

SUMMARY

The Oslo Agreement intended to set up a Palestinian client state; the evidence suggests that both sides broadly accepted the limits of this state, even though neither would refer to it as a client state for obvious reasons. Israel's insistence on a client state was driven by its security concerns, but it could only be made effective either by creating incentives for compliance through economic integration or severe penalties for non-compliance through asymmetric controls over the Palestinian economy. Israel started with the former objective in its declarations but its actions very soon could only be described as consistent with the latter. We argue that this can in turn be explained by Israel's demographic concerns with economic integration. We argue that many of the governance failures of the Palestinian Authority can be explained in terms of the design features of the Oslo Agreement. Other apparent failures were paradoxically developmental interventions that successfully attracted overseas Palestinian

investors by offering them non-transparent benefits in a context of great uncertainty. A third category of governance failures reflected genuine failures of the Authority. Our analysis directs attention to features of Palestinian governance that need attention in the future, but also points to the importance of external donors having a clear idea of what a viable Palestinian state would require before they engage in conflict resolution. This was missing in Oslo, and is particularly important now that Israel seems to have adopted a "bantustanisation" strategy that is likely to create lasting problems for a two-state solution, and which is ironically not in Israel's interests either.

Framework of Analysis

The Palestinian Authority was not a state, and lacked many of the critical powers of a state. It did not have control over its borders, currency, fiscal or monetary policy, natural resources, or foreign policy, it did not determine citizenship, and much of its trade was with or through Israel and regulated tightly by the Paris Economic Protocol. On the other hand, it was somewhat more than a municipal government. It had policing and security powers over Palestinians, and most Palestinians recognised its exercise of lethal force over themselves as legitimate. Its leaders also had access to budgetary (and off-budget) resources, which were used for political accommodation and stabilisation within the Palestinian polity, and this gave it a state-like quality. And despite the absence of any formal powers to determine property rights, its leaders had the political legitimacy to sign economic "contracts" with overseas Palestinian investors with sufficient credibility to encourage many of them to invest in a context of great uncertainty. These characteristics meant that any analysis of governance would have to take into account the specific context in which Palestinian state formation was happening. In particular, *the Authority had a number of contradictory state characteristics in incipient form, and we wanted to identify the internal and external conditions that would encourage the further development of particular combinations of characteristics*.

A further complication for assessing performance is that the Palestinian economy was highly dependent on the Israeli one. Part of this was a natural dependence given the much greater degree of capitalist development in Israel and the availability of labour market opportunities there, but part of it was an engineered dependence, based on artificial controls over trade, investments, fiscal space, and of course, restrictions of movement *within* the Palestinian territories through settlements and checkpoints. As a result, the Palestinian economy was hugely dependent on the performance of the Israeli economy, and more importantly, it could be made to suffer if Israel took particular actions like limiting the flow of labour to Israel or cutting off parts of the Palestinian territories from each other.

The following table shows that as soon as Oslo was signed, the Gross Domestic Product (GDP) of the Palestinian territories collapsed, and this was largely because Israel imposed new "border controls" between Israel and the Palestinian territories, and within the Palestinian territories. The fall in Gross National Income (GNI), which includes labour remittances, was thus even more severe than the fall in GDP. This relationship between GNI and GDP is a persistent feature of the Palestinian economy and is an index of its dependence on labour flows to Israel. This can be seen in the first two rows of the table. In downturns, GNI falls more than GDP, and in upturns, it rises by more.

After the first two years of adjustment, GNI strongly recovered. This was because labour was once again allowed into Israel, but now in the context of a system of controls that could be used to stop movements at short notice. But what is more interesting is that growth of GDP shot up as well. Unfortunately, this round of the state-formation exercise abruptly ended in 2000. The figures for the succeeding period are being constantly revised downwards and are less trustworthy, but there is no question that the Palestinian economy has been destroyed during the second intifada. We can explain the growth spurt from 1996 to 1999, and in particular the strong GDP growth, in terms of the strong recovery in *private sector* investment, as shown in the third row of the table. Since the local Palestinian private sector consisted largely of small and low technology artisans and farmers, this private investment boom was driven by incoming investments of overseas Palestinians who began to invest in the tourism sector, in telecommunications and in related service sectors. Those who visited Ramallah or Bethlehem over this period could not have failed to notice the large number of quite decent hotels that were springing up almost overnight. This story, we believe, has not been adequately told or understood, and it provides a glimpse of what the Palestinian economy could have achieved under different external conditions.

Also interesting is the fact that aid as a share of GDP was on a persistent downward trend *throughout* this period. The main impact of this was on *public investment* that began to decline from 1997 onwards, as shown in the fourth row of our table. While this was undesirable given the weakness of public infrastructure and the political instability of the times, the growth figures also show that the Palestinian territories are not necessarily heavily aid dependent, and that considerable autonomous economic development is potentially possible if expatriate Palestinian capitalists can be harnessed to play a role in developing the Palestinian economy.

PALESTINIAN ECONOMIC TRENDS DURING THE OSLO PERIOD

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000 (p)*
Real GDP Growth	8.5	-2.4	-3.2	4.8	7.0	6.0	-1.5
Real GNI Growth	0.9	-4.3	-4.6	7.6	11.9	7.2	-4.9
Real Private Fixed Investment Growth	na	5.0	-5.0	5.0	11.3	19.0	-12.2
Real Public Fixed Investment Growth	na	10.0	15.0	20.0	-3.0	-13.0	-17.1

Aid as Proportion of GDP(%)	18.0	17.6	15.0	14.0	10.0	10.0	na
Unemployment Rate	14.8	18.2	23.8	20.6	13.2	11.8	14.1

We analysed the Palestinian Authority and its different, and sometimes contradictory governance characteristics in the context of its specific economic and political environment. Given the transitional nature of the Authority, we could only look for incipient characteristics whose further development might define different "types" of state, and we looked for the institutional, political and external conditions that sustained these characteristics and/or could lead to their change or further consolidation. Not surprisingly, we found elements of institutional and political characteristics that could potentially support very different types of states, defined in terms of their economic and political features. The further development of these features would depend on how political and institutional conditions developed. For convenience, we refer to these possibilities as a *client state*, a *predatory state*, a *fragmented clientelist state*, and a *developmental state*.

CLIENT STATE CHARACTERISTICS

Many of the characteristics of the Palestinian Authority could be described as characteristics of a client state (of Israel). This was reflected in the agreements the PLO signed at Oslo, in the Paris Protocol, and other treaties. These allowed Israel not only to restrict the defence capacities of the PA, but also to determine its international trade, ensure its fiscal dependence on taxes collected from Palestinians by Israel, control its international borders and internal checkpoints for an indefinite period, and so on. The political imperatives that forced the PLO to this route are well known, and follow from Israel's insistence on "security-first", namely that until Israel is assured of its security, it will insist on retaining sovereign powers within the Palestinian territories. This condition was understood and implicitly accepted by the Palestinian leadership and a considerable coalition of interests within the West Bank and Gaza that provided the constituency for Arafat's programme.

However, while the principle was widely accepted, compliance by a client state can be ensured through very different strategies, and we find that Israel's contradictory strategy after Oslo contributed to make progress unviable. This incoherence in Israeli strategies is likely to block progress under the new Road Map. We distinguish between two types of strategies that could ensure that a Palestinian client state remained compliant with the security interests of Israel. The first can be described as an *integrationist* strategy. This would involve a gradual but progressive opening up of capital and labour markets, such that the economic interests of the two states become convergent, and *incentives* were created that would prevent actions by the client state against the interests of the dominant power. This strategy was outlined by Peres in his book *The New Middle East* and some moves were made in this direction in the form of joint Israeli-Palestinian investments (for example, the Jericho casino, Israeli investments in some Palestinian companies, and some Israeli subcontracting to Palestinian companies in the Gaza strip). Potentially, economic integration may have allowed the Palestinian economy to grow sustainably, and would have been economically beneficial for the Israeli economy too. However, these moves rapidly came to an end, and in the critical area of labour mobility, the moves were in the opposite direction from the outset, with significantly increased restrictions from the signing of Oslo onwards. We find it difficult to explain these restrictions in terms of security concerns alone. Although there were sporadic acts of violence on both sides after Oslo, these were both expected and actually quite limited in the early years when there was widespread goodwill and optimism on both sides. Integration may have provided significant dividends in the long term. In our opinion, the unstated problem that drove the closure of the integrationist route is a political rather than a security problem. As the EU experience shows, *economic* integration leads (sooner or later) to gradually increasing *political* integration and this threatens to defeat the purpose of the two-state solution from the Israeli perspective. If the Palestinian population of the territories occupied in 1967 are added to the Israeli Palestinians who already have political rights in Israel, the Jewish-non Jewish balance is already 50-50, and is likely to become 40-60 in the next couple of decades. If this political obstacle is going to prevent any meaningful progress towards economic integration in the Middle East, this has critically important implications for external aid and donor policies.

The initial moves towards integration were not followed through, and instead there was a rapid shift to a strategy of *asymmetric containment*. In contrast to integration, here the goal is to enforce compliance by creating huge *penalties* for non-compliance. Amongst the mechanisms that were consistent with this strategy were new and intrusive restrictions on the movement of labour, retaining control over key roads and checkpoints *within* the territories, the control of international borders and the ability to delay imports and exports, retaining control of Palestinian fiscal revenues and determining the timing of their release, and so on. By the end of the period, although economic growth took off, led by new external drivers, the *vulnerability* of the Palestinian economy had *increased* as a result of institutional changes that gave Israel the power to shut off the Palestinian economy at short notice; an ability that was demonstrated rapidly when the second intifada began. In contrast to the integrationist strategy, a client state strategy based on asymmetric containment exposes the client to perpetual economic vulnerability, and is not likely to be politically acceptable to a people aiming to achieve greater sovereignty. It is important to recognise that key features of asymmetric containment were likely to continue under the "final offer" that Arafat rejected at Camp David. As a Palestinian negotiator put it: "In a prison, the prisoners control 95% of the space. It is the 5% they do not control that make it a prison".

It is important to recognise that many of the apparent governance failures of the Authority were a direct consequence of the design features of the Oslo constitution that *intended* to create a client state with a strong executive with limited accountability. All parties recognised in 1994 that pushing through a two-state solution against the strong opposition of some Palestinian minorities would require an emphasis on security apparatuses and a strong executive. Our assessment is that this was not necessarily a mistake, and in terms of what the Authority was supposed to achieve, its initial performance in security and development was not bad. However, the problem was that the *asymmetric containment* version of the client state was structurally unviable in the sense that imposing it on the Palestinian population eventually threatened to cost too much in terms of the suppression of a Palestinian opposition. Far from this being a ploy of Arafat, an objective analysis suggests that imposing a client state with asymmetric containment is likely to be politically impossible for any leadership of the future. This conclusion too is likely to be of interest to external donors and the hopes that are being pinned on an eventual change of the Arafat leadership. If anything, a post-Arafat leadership is likely to find adherence to *any* client state strategy much more difficult.

Once the economy is perceived to be unviable, this has implications for the strategies of political players and the political leadership. Even a well-intentioned political leadership would then be likely to descend into either a predatory mode, or to fragment into versions of fragmented clientelism, since it is not possible to seek power or wealth through economic development. Alternatively, depending on its opportunities, economic constraints can result in greater state efforts at pushing development. Characteristics of all these types of states could be found in embryonic form in the Palestinian Authority, and our project examined the conditions under which each of these combinations of characteristics are likely to be furthered.

PREDATORY STATE CHARACTERISTICS

A predatory state is one that extracts resources from its citizens to enrich state officials; but at such a rate that economic growth is lowered or even made negative. We typically find such states in contexts where economic growth is difficult to trigger anyway, for instance because of social resistance, the under-development of capitalists and the infrastructure they operate with. Many of the instances of petty corruption and extortion of bribes from businesses observed in the Palestinian Authority are consistent with a predatory state. However, while these issues needed to be addressed, the PA compares favourably with other developing countries. This is surprising given the uncertain context in which the Palestinian Authority operated, but it can be explained by the development options available to the executive. These options were not poor to the extent that predation became the more profitable option. Nationalism may also have helped, as it has in a number of East Asian countries. But most importantly, the availability and willingness of expatriate Palestinian capitalists to return to Palestine played a key role in determining better strategies for the political leadership.

Fragmented Clientelist Characteristics

Another variant of state failure is observed when competing (patron-client) factions within a developing country are strong but fragmented, and productive opportunities are limited. In this scenario, competing factions are likely to seek redistribution rather than policies to enhance growth. This is a very common scenario in developing countries, where the competing demands of powerful factions can serve to paralyse the state, and we describe this as fragmented clientelism. The large redistributive transfers made by the PA to maintain political stability had some characteristics of fragmented clientelism. The administrative structure, and the security apparatus in particular, probably employed more than a few people who had to be accommodated for reasons of political stabilisation. While these problems were real enough, the Palestinian Authority did not suffer from these redistributive demands to the same extent as many other developing countries. Not only was executive power sufficiently centralised to prevent redistributive demands going out of hand, Palestinian civil society was, paradoxically, too fragmented to allow the consolidation of factional parties along the lines of many developing countries that face severe constraints as a result of clientelism.

Developmental Characteristics

Most surprising was our finding that in response to asymmetric containment, the PA engaged in a number of interventions that in the Palestinian context amounted to developmental interventions. Here, we did not apply any textbook notion of the conditions that encourage investment, but rather we looked at the evidence of developmental states in East Asia that were successful in encouraging investment in climates that were otherwise adverse for investors. Historically, this has often involved necessarily non-transparent incentives for investors, granting them temporary monopolies, or otherwise augmenting profitability to encourage investment and risk-taking, while disciplining investors who did not perform. The Palestinian Authority had virtually no fiscal powers to give incentives to investors, but it did allow the setting up of monopolies that enhanced profits for critical investors, granted them tax breaks and other incentives such as delayed payments of utility bills. It also shared some of the profits of these enterprises, both legally, as the Authority owned shares in many of these enterprises, but also illegally, in the form of kickbacks that augmented the off-budget resources that were vital for regime survival in a context of fiscal control by Israel. Critically, it showed itself able to change the allocation of contracts if opportunities that were more productive emerged, since the institutional and political conditions meant that the executive had no interest in knowingly tolerating inefficiency. This system cannot be described briefly, but while it certainly had costs and disincentives, its net effect was to attract vital investments by overseas Palestinians in a context of tremendous uncertainty in an area whose final status was not clear, and where property rights were ultimately controlled by Israel. These interventions had the appearance of governance failures but they were important for explaining the reasonably good economic performance in the final years of Oslo, despite a tightening of asymmetric containment.

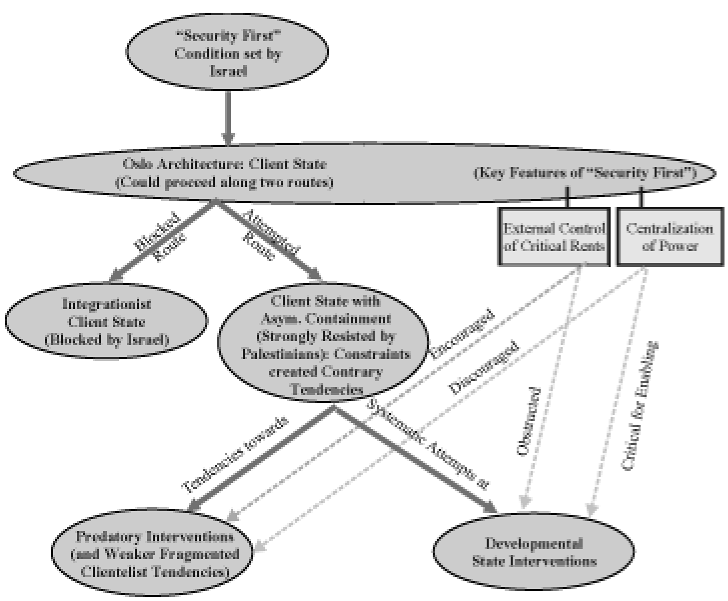
Thus, we differentiate between three different types of governance failures observed in the PA. First, there were apparent governance failures that were directly the result of the design of the Oslo Architecture. Examples of these include petty corruption at border posts, since an excessive number of checkpoints were constructed, excessive expenditure on security and security personnel, and executive centralisation. These were arguably necessary costs of trying to construct a client state. They did have negative economic effects, but these failures were not in the control of the PA. It may be very difficult to address these governance issues within the context of a client state strategy.

Secondly, there was clearly a range of internal failures of the PA. These included instances of petty corruption by security officials, extortion by officials, and a centralisation of decision-making beyond what was necessary in the circumstances. The leadership could have addressed the negative effects of these failures. If a client state strategy is to be pursued in the future, attention should be focused in these areas.

But finally, there were apparent governance failures that were associated with the Palestinian leadership's attempt to break out of its asymmetric containment by pursuing developmental strategies and enhancing its own economic flexibility. These strategies included maintaining secret funds, promoting Palestinian trading monopolies as counterparts of Israeli trading monopolies, granting special privileges to Palestinian expatriate investors, including temporary monopolies, and so on. These interventions paradoxically *enhanced* the viability of PA and allowed economic development in the territories that was faster than might otherwise have been the case. It follows that attempting to change *these* governance characteristics without addressing asymmetric containment and broader issues of accelerating development may actually be counter-productive. This too is an important conclusion for donors and aid strategies.

CONCLUSIONS

Oslo has been important for establishing that any external assistance for conflict resolution and economic development can only help if it comes with a clear picture of the "final status" that is to be achieved. Here final status has to be defined not only as territorial boundaries (which are critical for determining the political viability of any future Palestinian entity) but also its proposed economic sovereignty. The openness of Oslo with respect to a number of potential outcomes eventually led to its failure. The diagram below summarises some of the arguments we make about state characteristics and how they developed. The most important point to make in this brief submission is that the client state strategy (though it was not called that by any party for obvious reasons) was accepted by both sides in 1993 as the only viable way forward. But the Palestinian constituency behind Arafat would not accept asymmetric containment, and Israel would not proceed with economic integration. This raises a fundamental challenge for any road map of the future. There are unlikely to be conditions as favourable as in 1993-94 for attempting a client state based on economic integration, and we have provided a demographic explanation of why Israel rejected this route. Our analysis suggests that the only other possibility of constructing a two-state solution would be an immediate move towards a fully sovereign Palestinian state on international (1967) borders with no territorial exceptions. The problem of exceptions in the form of settlements and East Jerusalem is that a Palestinian constituency would not be found that was big enough to enable a viable state to be formed. If a "Green Line" Palestinian state could be formed, security for Israel would then have to be internationally guaranteed, rather than guaranteed by maintaining the Palestinian state in client status. Our analysis suggests that while the loss of employment opportunities in Israel would hurt, the presence of expatriate Palestinian capitalists means that even a state with PA governance characteristics could very soon become reasonably viable with full sovereignty and separation from Israel. If a Green Line state proves not to be possible, a demographic shift is likely to hit Israel within a couple of decades if not sooner, and rational Palestinians will begin to demand civil and voting rights instead of land. This strategy may have its own merits but was outside the remit of our project.



(*Source:* Khan, M H *et al* (eds) *State Formation in Palestine*. London: Routledge (*forthcoming*).

In the meantime, the post-intifada Palestinian economy has fragmented by design because of Israeli closures. In the interim, survival in Palestinian enclaves has come to depend on aid, remittances, income sharing and a return of the population to the land and to a more basic economy. This is clearly not a viable situation for too long, but Sharon's administration may hope that the Palestinian polity will also fragment and then it may be possible to separately administer Palestinian regions under regional political leaders. We describe this strategy as "bantustanization", and it may be that this will now continue for some time. It is, of course, not a permanent or viable solution, and its only effect will be to make the two-state solution even less likely. This is so because the land on which the Palestinian state can be constructed is steadily being lost, and the population balance is shifting to an extent that Palestinians have more to gain by demanding civil and voting rights instead of an unviable state. It may already be too late, but our analysis suggests that in any case donors have to be careful not to let Israel shift into a bantustanization strategy by uncritically allowing aid to be used to sustain unviable enclaves. Even if aid has to flow for humanitarian reasons, each tranche should be time-bound and its renewal should be an occasion for pressuring Israel to accept its responsibilities for the people living under its control. The analysis and case studies backing up this memorandum are due to be published as a book by Routledge as I have already indicated[253]. However, pending publication, I will be happy to provide the committee with further information if required.

October 2003

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