

Economic options for a viable Palestinian state

A study for UNDP Jerusalem

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Executive Summary

Despite sustained economic growth in recent years the Palestinian economy appears to be on an unsustainable path. The sustainability of the economic growth is undermined by a negative trade balance that is composed of low domestic production, more imports than exports, and high dependence on external finances. The growth has hitherto been mainly fuelled by increasing aid inflows, which grew in response to the ever more chronic inability of Palestine to pay for its imports with own resources. In fact the economy shifted from a dependence on labour income of Palestinians working in Israel and in the Gulf countries to aid dependence once labour exports almost came to a halt in the 1990s. Unfortunately the tradable sector (i.e. the domestic production of goods and services to be sold in another location) has never played any major role in keeping the external balance of the economy in check due to its structural weakness. Instead, the non-tradable component of the Palestinian economy (i.e. services produced and consumed in one location which cannot be traded) has prevailed. This imbalance has been mainly linked to the restrictions imposed by the Israeli occupation. The Ministry of National Economy (MoNe) and the Applied Research Institute of Jerusalem (ARIJ) have recently estimated the economic costs of the occupation as equivalent to 85% of the entire Palestinian GDP in 2010.

Such a situation is hardly sustainable in the long-run. It is difficult to imagine that foreign aid may keep expanding in order to maintain a sustained pace of growth for the Palestinian economy. At the same time it is extremely difficult to imagine that the Palestinian economic sectors could drive the growth if the restrictions imposed by the Israeli occupation were not lifted.

In this context the study tries to identify possible sectoral options which may help ensure the economic viability of an independent and sovereign Palestine in the long run. These options would not make much sense if the Israeli occupation were to continue, as there can be no economic sustainability under the current regime of occupation. So in order to push towards an end of the occupation, the study also features short-term options to promote the sustenance of economic life in Palestine.

The identification of these sectoral options relies on an analysis of the geography and the endowment of the production factors of the occupied Palestinian territory (oPt). In addition, the study also looks at the economic specialisation of other successful small states with similar characteristics as the oPt to identify possible entry points. The oPt is a small country surrounded by larger economies. Israel dominates Palestinian external trade. Beyond this, the oPt under-trades with other countries in the Middle East and North Africa (MENA) region. Thus Palestinian factors' endowments should be evaluated in particular relatively to those of other MENA countries. Such factors include a very high population density, one of the highest in the world, coupled with a relatively skilled population – especially by regional standards – which has a low employment rate. This partly explains the low returns to schooling in the oPt, suggesting that a future sectoral specialisation will have to capitalise on these under-used human resources. Although not rich in natural resources, the oPt is endowed with some valuable resources, to which it has very limited access due to Israeli restrictions. These include in particular Dead Sea Minerals and Salts, Gaza offshore natural gas, water and gravel and stone. On the other hand, the oPt possesses plenty of natural and cultural amenities, although the access to many of these is also restricted by the Israeli occupation. Yet, despite the occupation, the oPt has achieved reasonably good governance, which may be an advantage for the development of more sophisticated sectors, although with very little political stability.

These characteristics suggest that the tradable sectors, which should be the backbone of the Palestinian economy, should ideally employ relatively little land and water and should be relatively intensive in skilled labour and/or amenities. We argue that labour export could not provide such specialisation any longer, as it did in the past, as the reliance of Israel on Palestinian labour has diminished substantially. An over-reliance on labour exports would also impair the competitiveness of the other tradable sectors while leaving the Palestinian economy dependent on Israel.

In any case, tradable services appear to be the sector most in line with the type of Palestinian factors' endowment. Services, such as tourism, ICT, real estate and business services tend to be intensive in relatively educated labour, while requiring comparatively low capital, energy and natural resources. Moreover services trade is less affected by transportation costs than the trade of goods and this could be important especially for the development of the sector in the short-run. Services' exports have also been the engine of growth in many of the more successful small states with similar factor endowments, including for example Singapore and Mauritius.

Palestinian services exports have expanded steadily since 2001, reflecting also the gradual reduction in civil and political unrest in the oPt, which has helped tourism to lead the growth of services exports. Given the unique religious, cultural and natural amenities of Palestine, tourism is likely to maintain a central role in Palestinian exports in the future. For example it is easy to envisage that once a Palestinian state gained sovereignty over its own territory and borders, it would be able to attract sizable flows of Muslim pilgrims along with increasing numbers of Christian pilgrims. Other services may hold some key potential for the sustainability of the economy as well. These may include real estate and related services, exploiting the potential boom in demand for housing in a sovereign state, especially second homes from the Palestinian Diaspora; ICT services, building on the pool of talent and the cost advantage of the oPt, but also on the expected growth in regional and worldwide demand in these services; business services, through increased temporary mobility of labour in the region, and education services, in line with the intention of Palestine to develop a knowledge based economy and exploiting the Palestinian culture of valuing human capital accumulation.

This does not deny the possible role of other tradable sectors, including e.g. high value added export oriented agriculture and natural resource based industries (once Palestinians regain access to these resources). In addition, stimulating energy production, particularly through renewable energy technology, is likely to be important for economic sustainability as it has the potential to greatly reduce imports. However the development of these sectors is less in line with the present characteristics of the Palestinian economy than services, especially as far as the availability of an idle relatively skilled labour force is concerned.

These specialisation options for the Palestinian economy carry some implications for policy both in the short- and in the long-run. We suggest a non exhaustive list of them and present suggestions for how to pursue some policy options. This includes inter alia short-term policies related to prioritising areas of negotiations with Israel more relevant to the specialisation envisaged, i.e. restrictions to the free mobility of persons, TLC related restrictions, limited Israeli access to Palestinian water resources, and building restrictions in Area C. Other examples of short-term policies in line with the specialisation proposed include piecemeal reform of the post-secondary education system to better tailor the curriculum to the needs of youth and employers, and legislative intervention to create incentives for clean energy production and to induce more competition into the TLC sector.

In the long run a considerable amount of funding would be needed, especially for infrastructure development such as TLC, electricity and physical connectivity, but also for the exploitation of natural resources. We argue that sizable financial resources may be available to feed the needed investments drawing on current Palestinian investments in Israel and the settlements (given limited investment possibilities in Palestinian projects), on the Palestinian Diaspora, and on the international community. In addition, the development of a knowledge-based economy necessary for trade in services calls for an overhaul of the entire education system in the long run, particularly the post-secondary one. Finally, the importance of Area C to the economic sustainability of Palestine suggests a two-pronged approach in terms of economic planning in Area C: first resisting attempts to de-populate the area by Israeli restrictions, e.g. by maintaining low-intensity economic activity; second, exploiting the existing structures in the long-run by using the existing infrastructure and connecting the areas currently under-served with the rest of the economy.

1. Introduction

As the Israeli occupation of the Palestinian territory enters its 45th year, the Palestinian economy shows some renewed signs of resilience. Economic growth has been robust in the last 5 years in the West Bank and even the economy of Gaza has expanded considerably and against all odds since 2010 and even more 2011. These are undoubtedly positive developments which provide some short-term relief to a population which has constantly been under pressure of difficult social, political and economic conditions. However scratching the surface of this apparently incipient economic resurgence unveils a much less hopeful economic story. This is a story of de-industrialisation and of increased dependence on foreign assistance due to the ever more chronic inability of Palestine to pay for its imports and resulting negative trade balance. It is ultimately a story of military occupation which would make it impossible for any economy to be viable on its own, let alone to thrive as the recent estimates by the Ministry of National Economy (MoNe) and the Applied Research Institute of Jerusalem (ARIJ) testify (MoNE-ARIJ, 2011). In fact the recent spurt in economic growth has been almost entirely fuelled by foreign aid inflows (World Bank, 2011a, UNCTAD, 2011).

This situation is hardly sustainable in the long-run. It is difficult to imagine that foreign aid may keep expanding in order to maintain a balanced pace of growth for the Palestinian economy. Moreover, even if aid kept growing at unexpected rates in the future, the increasing aid flows would only exacerbate the current aid dependence related problems of Palestine. At the same time it is impossible for the Palestinian economic sectors to drive the growth unless the restrictions imposed by the Israeli occupation are lifted.

The aim of this study is thus to identify possible options which may guarantee the economic viability of an independent and sovereign Palestine. One fundamental disclaimer needs to be highlighted at the outset. Unsurprisingly, the options discussed in the paper would not make much sense if the Israeli occupation were to continue. As already noted, there can be no economic sustainability under the current regime of occupation. No sector of the economy is immune to the pervasive impact of the occupation, whose restrictions directly or indirectly stifle the development of all economic activities in Palestine. Thus the whole study would lose much of its meaning if the Palestinian economy were to remain under occupation. A few of the options discussed in the study could have some implications for short-term policy-making and we do highlight *how* those could be implemented whenever possible; however most of them would not make sense without the complete lifting of the occupation, which the long-term options stipulate.

Given the unsustainability and the artificial current structure of the economy, a fairly radical restructuring would be needed in order for a sovereign and independent Palestinian economy to become viable. The study provides some suggestions towards this end. The driving question of this assessment is to what extent the various sectors may support the viable development of the Palestinian economy. To be sure, this is not the first study which tries to imagine how an independent and sovereign Palestinian economy could look like. Previous recent attempts to do so include for instance studies by the Rand Corporation (Rand, 2007) and by the Aix group (Arnon and Bamyra, 2007). While building on these precedents, this study tries to go beyond them by providing a more complete and specific discussion of possible sectoral specialisation options based on an evaluation of the comparative advantage

of the Palestinian territory as well as the international experience of countries with similar characteristics.

It is important to note that whenever trying to delineate the contours of a possible sectoral specialisation for any country, one needs to set the objective(s) to be achieved through it. In this case the objective pursued by the analysis is to guarantee the economic sustainability of an independent and sovereign Palestinian state with long term increases in income per capita. This objective is probably the most relevant one from an economic standpoint for it prioritises economic growth and poverty reduction while aiming for the Palestinian economy to be independent of foreign assistance. The recent wave of protests in the oPt against worsening economic conditions back this objective.

However this is not necessarily the only or even the most desirable objective for the Palestinian people and its policy-makers. For example, ensuring the country's food self-sufficiency could be an equally or even a more important aim to pursue from a Palestinian point of view. This would of course have different implications in terms of the economic specialisation pertinent to the relative importance of agriculture and the food producing sector in general. Another objective that Palestinians may consider could be to keep at a minimum the economic relationship with Israel. Again, this would have a number of different implications for economic specialisation as Palestine should seek other markets to source its imports and sell its exports to.

Beyond this, policy-makers may try to achieve more than one of such objectives through economic policies (as it is often the case), which would lead to a blending of different strategies to try to accommodate the different needs. This indicates that the different aspects that pertain to the identified objective(s) are comprehensive. This paper will thus concentrate exclusively on the objective of reaching economic sustainability to ensure growing per capita income levels. This choice allows keeping the exercise manageable while pursuing a relevant aim for the economic prospects and the economic welfare of the Palestinian people. It also allows complementing other types of economic analyses already undertaken on the future Palestinian economy that also target economic sustainability (e.g. Davoodi and von Allmen, 2001, Arnon and Bamyá, 2007).

As we study options for a hypothetical independent economy, all of the discussion is underpinned by a considerable amount of contingency. For this reason by no means this is a prescriptive exercise. It is rather meant to provide an informed basis to discuss about the direction the Palestinian economy could take and the related policy measures in some more structured way than it has been done so far. In that way it will not include any rigorous costs and benefits analysis but it would rather provide indicative suggestions on the possible benefits and costs as well as on how to pursue the short- and long-term options.

Also, the study does not touch upon the discussion on the borders of a future Palestinian state and assumes that these follow the pre-1967 armistice line. Therefore the state considered here will be composed of the West Bank and Gaza with East Jerusalem as its capital, and West Bank and Gaza will be connected by at least one road and/or train network under complete control of the Palestinian state.¹

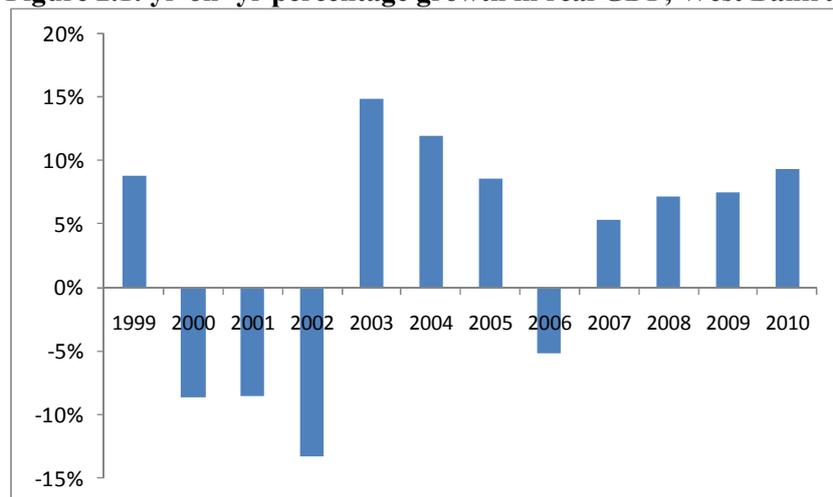
¹ Several authors have attempted to provide workable options for the composition of a Palestinian state (see e.g. Arnon and Bamyá, 2007).

The study is organised as follows: the next section briefly describes the recent economic history of Palestine which has led to the current economic structure; section three analyses the main features of the Palestinian economy, also in international perspective; section four discusses what type of economic specialisation other small states with similar characteristics have followed; section five assesses the various economic options against the background of the sustainability of an independent Palestine; on the basis of this identification, the paper then discusses some policy and infrastructure development priorities which would be needed to unleash the development of a viable economy. Whenever possible these priorities are divided into short (i.e. before the actual creation of a state) and long-term priorities. Section seven revises the arguments and concludes.

2. An economy under occupation

For the first time since the 1990s the Palestinian economy has grown for a period of five consecutive years between 2007 and 2011 (for which only preliminary estimations are available). Year on year growth in real GDP has reached almost 10% in 2010 (Figure 2.1). This apparent incipient economic resurgence however masks a different and much less promising economic story: one of de-industrialisation and of increased dependence on foreign assistance due to the ever more chronic inability of Palestine to pay for its imports.

Figure 2.1: yr-on- yr percentage growth in real GDP, West Bank and Gaza



Source: PCBS

2.1 From labour export to aid dependence

The basic contours of the recent Palestinian economic history describe a “quasi-economy” with one of the largest trade deficits in the world following the restrictions imposed by the Israeli occupation and the shrinking of its tradable sector as a whole.

After its occupation of the Palestinian territory in 1967, Israel discouraged Palestinian trade with the rest of the world through a series of measures including red tape and security barriers, lack of investments in improving Palestinian infrastructure (while infrastructure investments in Israel soared) and explicit hindrances to the development of the Palestinian agricultural sector (Aranki and Daoud, 2010). The latter include the confiscation of land for Israeli settlements, the takeover of the West Bank underground water supply and the pollution resulting from settlement sewerage.

These restrictions have made it very difficult for Palestinian firms, which were generally smaller and technologically backward vis-à-vis their Israeli counterparts, to compete with Israeli firms. The Israeli restrictions have been motivated by two main reasons. First, the desire of Israel to prevent any Palestinian competition with Israeli economic interests, which is summed up by Yitzhak Rabin, while holding the post of Israel’s defense minister in 1986: “there will be no development initiated by the Israeli Government, and no permits will be given for expanding agriculture or industry, which may compete with the State of Israel” (UNCTAD 1986).

Second, by restricting the development of the Palestinian domestic sectors, Israel has been able to use the Palestinian market as a reserve of cheap unskilled labour. Indeed, the labour market policies of Israel were much less restrictive than the other economic policies in the occupied Palestinian territory. Following the occupation, the Israeli government began issuing general permits, granting residents in the Palestinian territories unlimited access to Israel and East Jerusalem, as well as unrestrictive movement between the West Bank and the Gaza Strip. As show in Figure 2.2, prior to the outbreak of the Gulf War in 1991, Palestinian labor flows from the West Bank and Gaza to Israel grew steadily and reached a peak of 45% of the employed labour force in Gaza and 35% in the West Bank at the end of the 1990s (Aranki and Daoud, 2010).

The large labour flows to Israel, where salaries were much higher than in the Palestinian territory, pushed up also the reservation wage in the Palestinian territory (i.e. the wage under which Palestinians were not willing to be employed). This contributed to further weaken the Palestinian tradable sector, which had to rely on a more expensive workforce than the level of development of the economy would suggest (Astrup and Dessus, 2005).

Figure 2.2: Labour employed in Israel from the West Bank and Gaza (% employed in WB&G)



Source: Aranki and Daoud (2010)

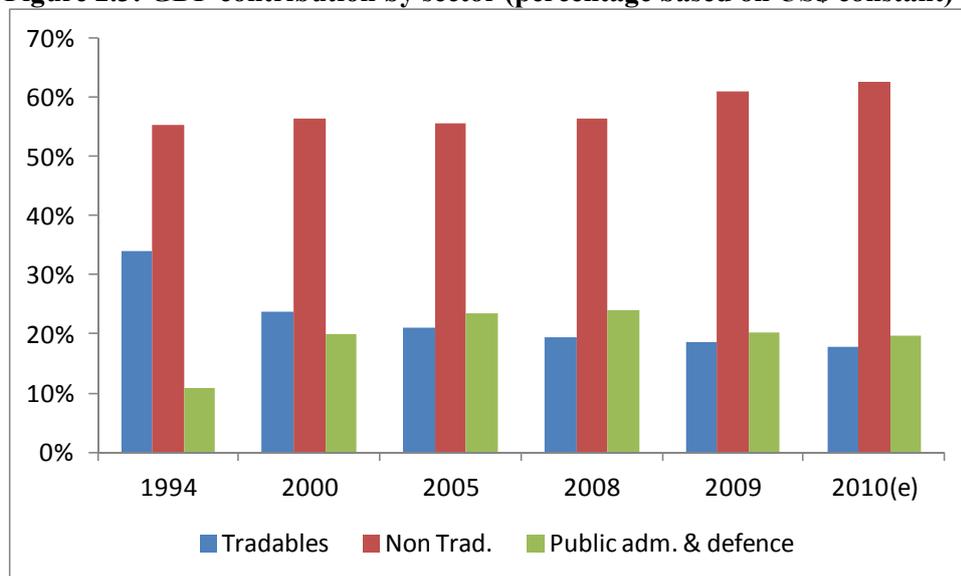
During the first period of the Israeli occupation this labour export was responsible for the vast majority of the external earnings of the Palestinian economy, which essentially kept the external balance of the Palestinian economy. The large trade deficit in goods (a by-product of the weak Palestinian tradable sector) was compensated by a large surplus in labour income from abroad. The labour flows to Israel were compounded by a substantial Palestinian emigration to the countries of the Persian Gulf, especially during the oil boom of the 1970s.

However, following the total curfew placed by Israel on the Palestinian territories during the Gulf War, Israel erected checkpoints along its borders and by 1993 the general permit system was replaced with an individual permit system, which made it more difficult for Palestinians to reach work in Israel. This resulted in a marked decline in Palestinian employment in Israel and the settlements between the end of the 1980s and the beginning of the 1990s. In addition, Palestinian workers suffered a further blow when Kuwait and other Persian Gulf states expelled them during and after the first Gulf War, as a response to support for Iraq by the Palestinian Liberation Organization (Adams et al., 2007).

The 1993 Oslo Accords brought about a limited amount of self-rule for the Palestinians. This included little economic control through the signing of the Paris Protocol in 1994, which instituted the Palestinian Authority (PA) and the customs union between Israel and the Palestinian territory. In the aftermath of the Oslo Accords, the public sector grew rapidly because of the establishment of the PA and other government institutions. This public sector growth accounted for most of the growth in Palestinian domestic employment since 1993 (Adams et al., 2007). As the Oslo Accords did not alter any of the major Israeli restrictions imposed on the Palestinian economy (some of which in fact intensified), they did not lead to any industrial or agricultural development in the Palestinian territory. These included restrictions on access to water, land, Dead Sea natural resources, mining and quarrying resources, on movement of goods. In addition Israel introduced restrictions on the movement of people within the Palestinian territories and border closures in early 1993 and more intensely in 1996 and 1997, which increased transaction costs for business and increased investor uncertainty. Even during the initial period of rapid growth following the signing of the Oslo Accords, increases in industrial and agricultural output were modest.

In the absence of the development of the Palestinian tradable sector, public sector growth effectively replaced labour export as the main driver of economic growth in the second half of the 1990s. The institution and expansion of the Palestinian public sector also led to a boost in construction activity, particularly infrastructure, as well as in non tradable service sectors. Indeed, the share of the public administration sector in GDP doubled between 1994 and 2000 at the expense of a constantly weakening tradable sector, whose share in GDP declined from 34% to 24% in the same period (Figure 2.3).

Figure 2.3: GDP contribution by sector (percentage based on US\$ constant)



Source: Author's elaboration on PCBS

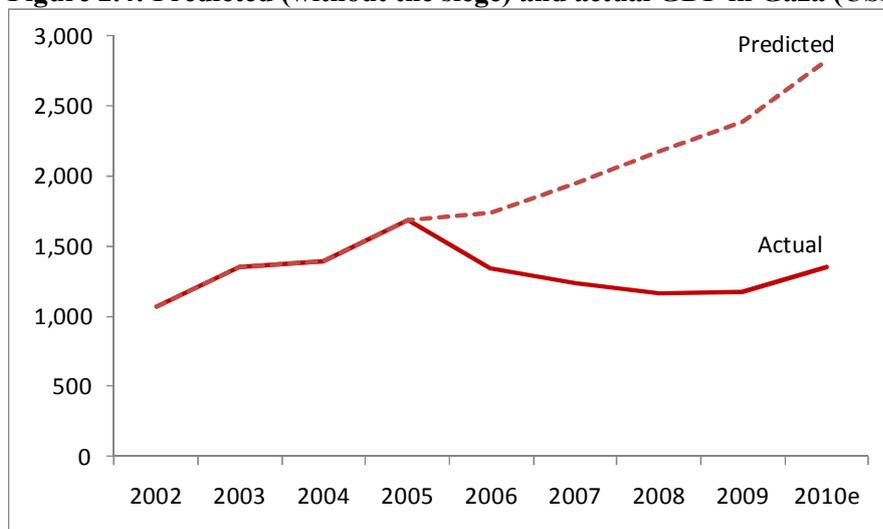
As the resources for the creation and expansion of the PA came chiefly from abroad, this period marked the beginning of the aid dependence for the Palestinian economy. Labour migration to Israel (and to the Gulf countries) had historically been the way in which the Palestinian economy financed its large trade deficit. In the 1990s foreign assistance started to play the role of labour export to guarantee Palestinian economic survival.

This period of economic growth was abruptly interrupted by the beginning of the second Intifada in September 2000. Israeli military action in the West Bank and Gaza along with

Israeli restrictions on Palestinian travel to Israel, between the West Bank and Gaza, and within the West Bank brought the Palestinian economy almost to a halt.² As a consequence real GDP collapsed and unemployment soared. At the end of 2002, it stood between 42 and 53% up from 10 percent in the third quarter of 2000, according to the Palestinian Bureau of Statistics. Estimated physical capital losses mainly from the Israeli destruction of Palestinian infrastructure (i.e., roads, water, sanitation power and communications systems, and public buildings) stood at \$728 million by the end of August 2002, equivalent to three to four years of public investment since the signing of the Oslo Accords (Adams et al., 2007).

As the violence of the second Intifada progressively declined, the Palestinian economy started to bounce back since 2003 (see Figure 2.1 above), again sustained by foreign assistance and by some return of Palestinian workers to Israel. The post-Palestinian election conflict along with the Israeli incursion into the West Bank disrupted the economic recovery, which eventually turned into another grave economic crisis in Gaza following the heightened restrictions and then the outright siege imposed by Israel in 2006-2007. On the basis of the predicted growth path of the economy (based on the post-2005 West Bank growth), MoNE and ARIJ (2011) estimated that in 2010 this siege costed over 100% of Gaza's GDP (see Figure 2.4). In contrast, the West Bank economy recovered quickly in 2007 with the transitional government led by Fayyad and expanded through substantial injections of foreign aid, which fed the growth of the PA and of the non tradable sector. The latter in particular (which includes also PA dominated sectors such as education and health) increased its share in GDP between 2005 and 2010, again at the expenses of the tradable sector, whose weight in the economy has become smaller than the public administration and defence (Figure 2.3).

Figure 2.4: Predicted (without the siege) and actual GDP in Gaza (USD mln constant)



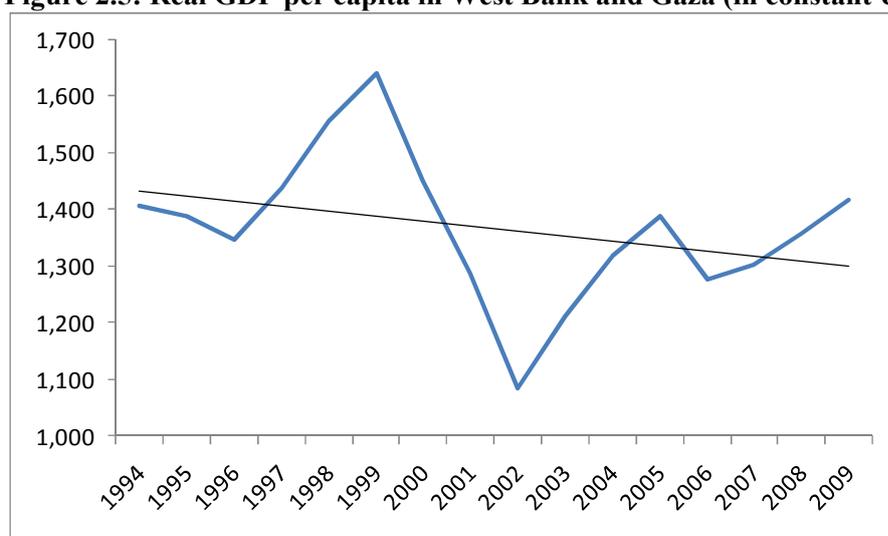
Source: MoNE and ARIJ (2011)

2.2 The structure of the Palestinian economy today

Despite the economic recovery of the last few years, the Palestinian population is poorer today than it was at the end of the 1990s, as Palestinian real GDP per capita is still well below its 1999 level (Figure 2.5).

² For example the flow of Palestinian workers to Israel decreased by over 90% between the third and fourth quarter of 2000 (Miaari et al., 2011).

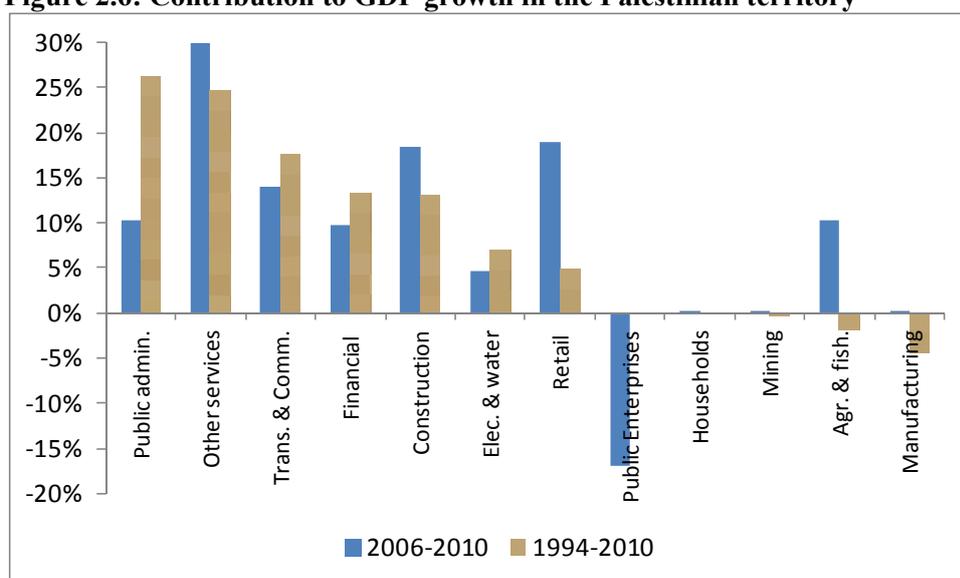
Figure 2.5: Real GDP per capita in West Bank and Gaza (in constant USD)



Source: PCBS

Importantly this decline has been accompanied by a structural transformation of the economy, highlighted in Figure 2.3 above: since the Oslo Accords the non tradable sectors have grown in importance along with the public sector while the tradable sectors have shrunk in relative (and in some instances even in absolute) terms. This is confirmed by the analysis of the contribution to GDP growth of the various sectors shown in Figure 2.6. Public administration and defence has been the largest contributor to the growth of the economy since 1994, accounting for over a quarter of the total GDP growth. Another quarter is composed by non tradable services such as real estate, education and health, while the rest is accounted for by other services, including transport and communications, financial, construction, utility supply and retail. On the other hand, tradable goods sectors – manufacturing, mining, agriculture and fishing - do not underlie any of the expansion of the Palestinian economy since 1994. In fact, manufacturing and agriculture contributed negatively to the growth, i.e. their absolute value declined over the period.

Figure 2.6: Contribution to GDP growth in the Palestinian territory

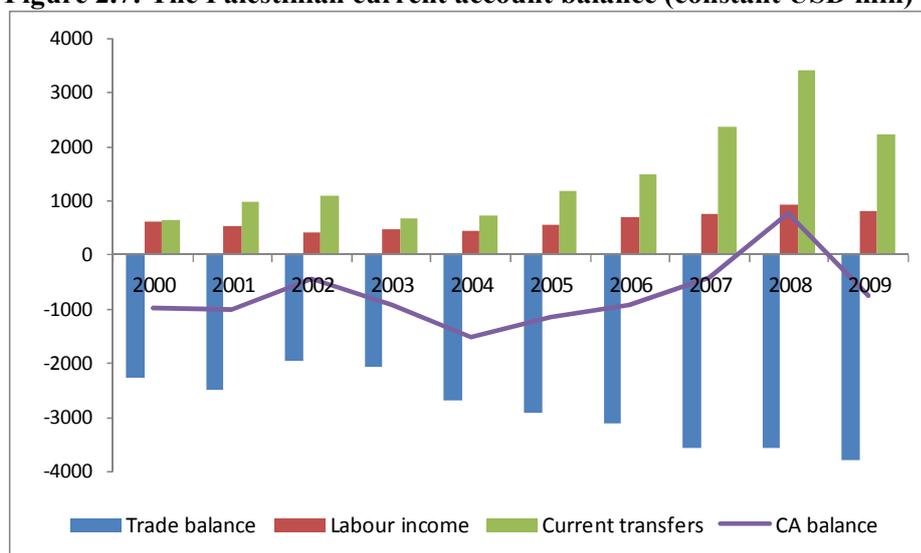


Source: PCBS

The latest period reveals a similar pattern. Services sectors, particularly real estate, business and education, contributed almost a third of total growth over 2006-2010, and construction and retail another 20% each. Public administration and defence contributed only 10%, but the dismissal of state owned enterprises has made the overall contribution of the public sector fairly small.³ Tradable goods sectors have again played a marginal role in the recent growth of the economy, with a 10% contribution explained entirely by the growth of agriculture. This confirms that the recent spurt of growth of the economy has been led almost entirely by non tradable services sectors.⁴ In fact we are not able to disentangle precisely tradable from non tradable services given the data available. To be sure some of this services growth has been also fuelled by some emerging tradable services sectors, notably ICT and tourism (e.g. hotels and restaurants doubled in value between 2006 and 2010). This is an important point to which we will return below, as such tradable sectors are likely to represent in our view a key element of the future sustainability of a sovereign Palestinian economy. However, the data suggests that these sectors are still a minor component of the services sectors in Palestine, most of which is composed of non tradable services.

The growth of these non tradable sectors in turn has been funded by external sources, as tradable sectors have not expanded significantly during the same period. In fact, the anaemic growth of the tradable sectors has contributed to the deepening of the already large Palestinian trade deficit. The latter almost doubled since 2003, reaching USD 3.8 billion in 2009 (Figure 2.7). With limited growth of labour income from abroad, the increasing trade deficit has been almost entirely compensated by the surge in foreign aid. Current transfers in the Balance of Payment (BoP), which are essentially foreign aid, increased four-fold between 2003-04 and 2008-09, almost single-handedly maintaining the current account in balance (figure 2.7).

Figure 2.7: The Palestinian current account balance (constant USD mln)



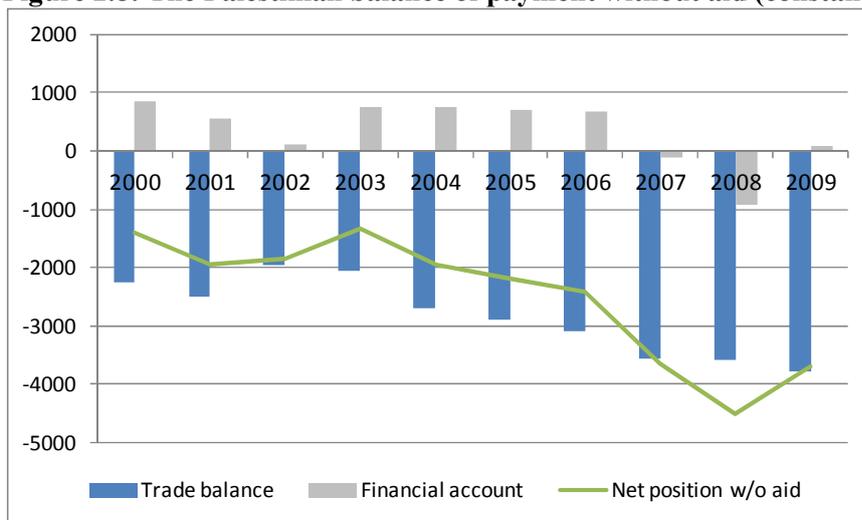
Source: PCBS (BoP)

³ The public sector also includes most of the health and education sectors, which have grown over the period.

⁴ Non tradables are those sectors which produce services for local consumption and cannot be traded, e.g. retail services, construction, restaurants and hotels, hairdressing, public sector services. The rest of the economy is composed of tradable services.

As figure 2.8 shows, without foreign aid, the net position of the Palestinian BoP would be consistently unsustainable, as the financial account, which records net international private capital flows, is typically very small. This is due to the fact that the Palestinian economy is not able to attract foreign private capital flows due to the uncertainty and the low expected returns connected mainly to the Israeli occupation (World Bank 2010). Therefore a balanced current account is necessary to maintain the external equilibrium of the economy. And in the absence of a sufficient labour income from abroad, foreign aid is the only way to achieve it. Funding this huge trade deficit is the main reason for the aid dependence of Palestine. Incidentally this makes the calls to reduce the aid dependency of the PA via fiscal discipline and higher revenues largely irrelevant to reducing overall Palestinian aid dependence.

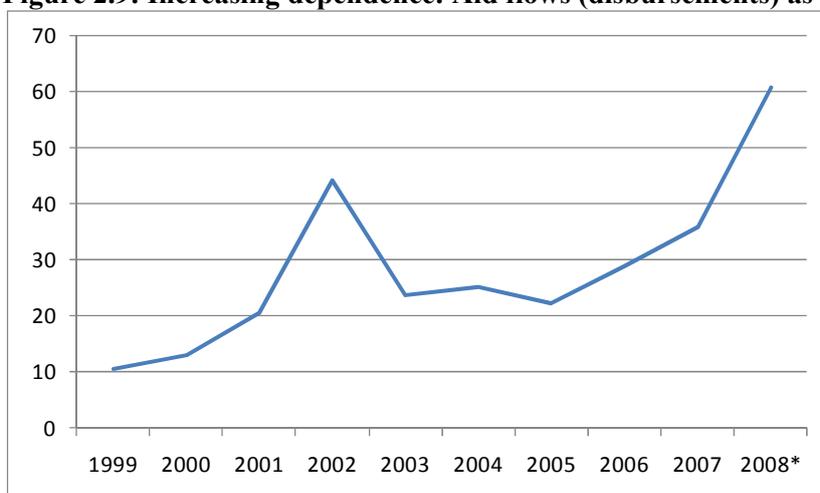
Figure 2.8: The Palestinian balance of payment without aid (constant USD mln)



Source: PCBS (BoP)

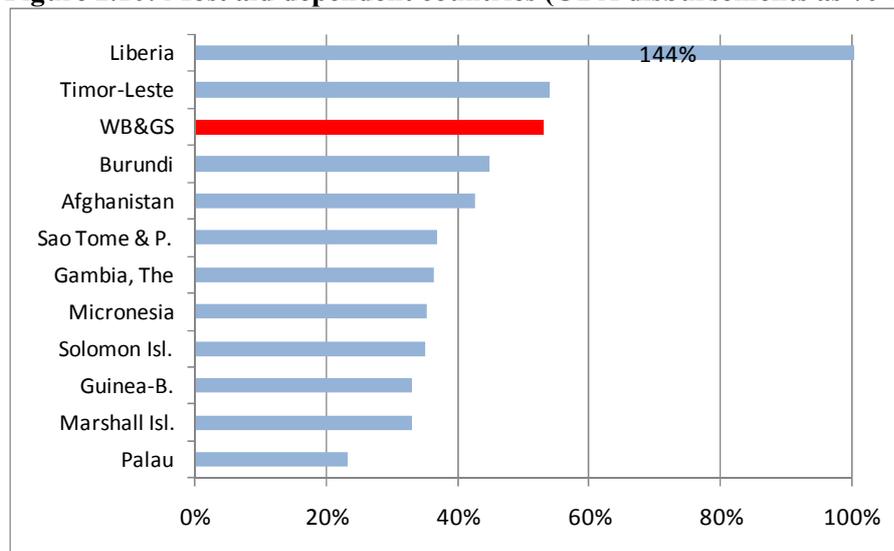
This dependence increased dramatically over the last decade with aid peaking at 62% of GNI in 2008 (Figure 2.9). Moreover external assistance in the form of budget support funded around 53% of the PA's budget in 2009, with a steep rise from the 20% funded in 2003. These figures make Palestine the third most aid dependent countries in the world (in 2008), preceded only by post-conflict countries Liberia and East Timor (Figure 2.10).

Figure 2.9: Increasing dependence: Aid flows (disbursements) as % of GNI



* Estimates. Source: DeVoir and Tartir (2009) and PCBS

Figure 2.10: Most aid dependent countries (ODA disbursements as % GDP in 2008)



Source: DeVoir and Tartir (2009) for West Bank and Gaza and OECD/DAC for other countries

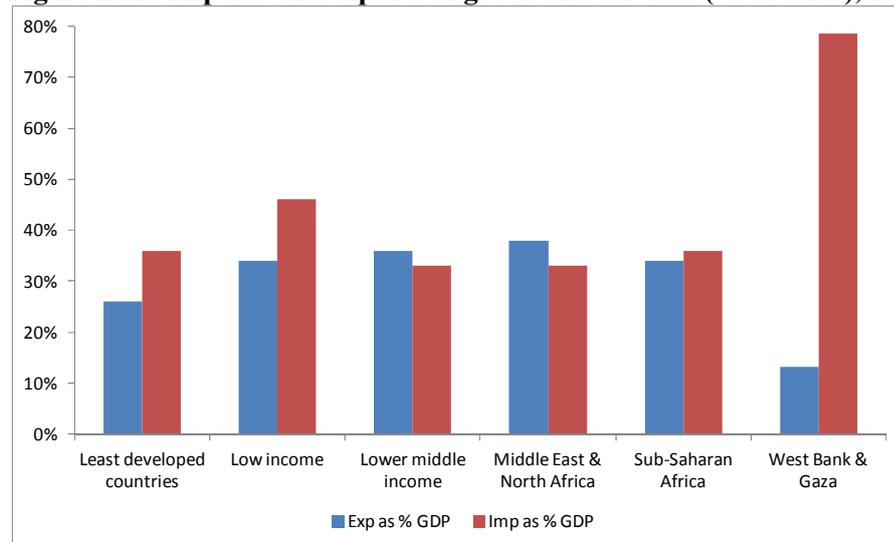
It is clear that depending on foreign aid is not a viable strategy for a sustainable Palestinian economy. First it is highly uncertain whether foreign countries will be willing to channel large amounts of aid to the Palestinian territory in the future, especially given the grim economic prospects of many of the main donors. But even if that were not the case, aid dependence is deeply problematic in itself as it may disrupt domestic political accountability and weaken the country's governance (Djankov et al., 2008) and it may further weaken the country's tradable sector (Rajan and Subramanian, 2011). Cali (2011) provides further suggestive evidence for these perverse effects in the oPt. In addition, the allocation of foreign aid to Palestine is problematic as it is constrained by politics. Far from tackling in any substantial way the root of the economic problems of the oPt, i.e. the Israeli occupation, foreign assistance has concentrated predominantly on short term emergency relief and increasingly on budget support to provide a lifeline to an otherwise bankrupt PA (Cali, 2011).

The question at this point is how to make the Palestinian economy viable and bringing the aid dependence to an end. To answer this question, it is worth analysing the origin of the Palestinian trade deficit in some more detail. Figure 2.11 confirms that this is due to the weakness of the Palestinian tradable sector. Palestinian exports of goods and services represent a much lower share of GDP while its imports constitute a much higher share than that of other developing countries, including those at earlier stages of development such as Least Developed Countries and sub-Saharan Africa. To be sure, the small size of the economy suggests that Palestine has a natural tendency to import a great deal of its consumption needs. Conversely, it should be able to export a relatively large share of its production given that the small domestic population should absorb only a small proportion of domestic production. The fact that this does not happen is a sign of the low international competitiveness of Palestinian firms.

There is no question that the ultimate cause of such low competitiveness is the restrictions imposed by the occupation regime. As mentioned above, these have played out to stifle any developments of the tradable sectors since the early stages of the occupation. The recent work by MoNE and ARIJ (2011) provides a systematic calculation of the costs of several of the

restrictions imposed by the Israeli occupation to the Palestinian economy. Although they have not been able to include all the costs, their estimation suggests that the Israeli occupation imposes huge costs to the Palestinian economy, equivalent to USD 6.9 billion in 2010, or 85% of the entire Palestinian GDP. These are composed of direct costs, e.g. due to restrictions which increase the costs of inputs, and indirect costs, e.g. due foregone revenues from not being able to exploit Palestinian resources. Moreover by impairing any normal development of the economy, the restrictions imposed by the Israeli occupation are also the root cause of the fiscal imbalance which plagues the operations of the PA.

Figure 2.11: Imports and exports of goods and services (% of GDP), 2007



Source: World Development Indicators and IMF (2010) for WB&G

From this discussion it emerges that the key for the Palestinian economy to be sustainable is a strong tradable sector. As highlighted above, the necessary condition for that (and thus for any sustainable economic development of the Palestinian economy) is the end of the Israeli occupation and the removal of all of the restrictions related to it. Without such removal no economic development plan – no matter how visionary and efficiently implemented - could turn Palestine into a sustainable economy. Having said that, the removal of the occupation alone is unlikely to be a sufficient condition for creating a strong tradable sector. This would need more than that. It would need the right policies and adequate soft and hard infrastructure, which is the end towards which this paper develops short- and long-term options.

A fair amount of discussion has taken place on the types of economic policies needed by a sovereign Palestinian economy, from trade policy (including the regime regulating trade with Israel, Palestine’s dominant trading partner) to monetary policy and economic legislation (e.g. Astrup and Dessus, 2005, Arnon and Bamyra, 2007; World Bank, 2010, 2011a). While much of this work is precious in helping future and to some extent current policy-making, it is largely devoid of any discussions on what the Palestinian economy could look like in terms of its production structure. However every policy discussions should ideally be linked to the possible specialisation of the economy, particularly in a case such as that of Palestine where an overall restructuring of the economy is likely necessary to ensure sustainability. In the remainder of the study, we seek to help fill this gap by identifying some possible options of economic specialisation for a viable Palestinian economy and on the basis of that draw some implications for economic and infrastructure policies.

3. Palestinian characteristics

While the oPt is currently a non tradable services based economy, its economic structure is not necessarily reflective of its factors' endowments and of its geography. As seen above, the restrictions imposed by the Israeli occupation, the partial integration within the Israeli economy and the dominant role of aid all have distorted the structure of the Palestinian economy. These distortions make any analyses based on revealed comparative advantage not entirely appropriate in identifying possible sectors of future specialisation for Palestine. Rather it is useful to analyse the main features of the economy, including its geography and factors' endowment, in order to better gauge what economic specialisation could potentially ensure its sustainability.

3.1 Geography

The oPt has a small size spanning around 6,000 square kilometres divided between the West Bank (5,655 Km²) and Gaza (360 Km²) and generally a rugged terrain except for a few fertile plains in the north of the West Bank and in Gaza. According to data from PCBS (2011b) about 1,200 Km² of the Palestinian territory is agricultural area although only around 1,000 Km² is actually cultivated, the majority of which as fruit trees, particularly olive trees. According to Ministry of Planning data most of the agricultural land is medium-value and only a handful of areas (around 28% of total agricultural land), mainly concentrated in the Jordan Valley and in the Jenin governorate, are considered as high value agricultural land. The non agricultural territory in the Palestinian territory is composed of desert, rugged hills or built-up area. Palestine enjoys a dry sunny climate, with an estimated 340 days of sun per year (both in West Bank and Gaza), which can be an important factor for some sectors, such as certain agricultural products, solar energy generation and tourism (see more on this below).

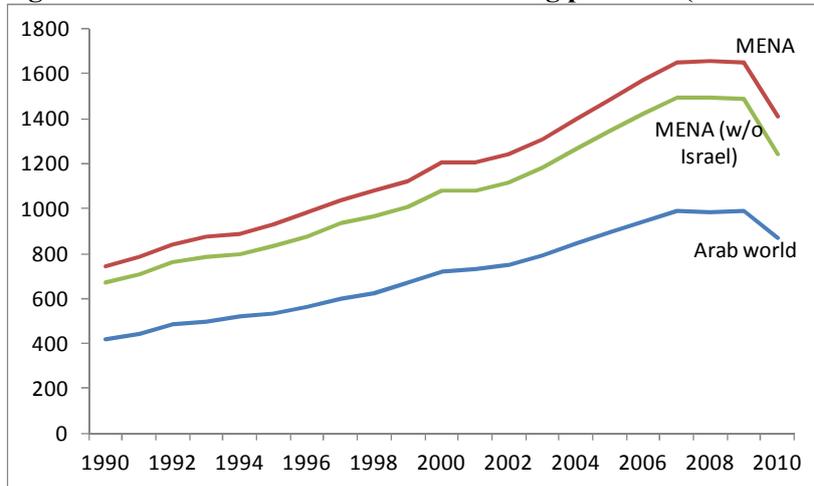
The location of the oPt makes it a natural gateway between North Africa and the Middle East, as well as between Israel and the Arab countries. It borders with Egypt, Syria, Jordan and Israel, and it is at arm's length to Lebanon, Syria and Saudi Arabia as well. Two bridges (Allenby and Damia) connect the West Bank to Jordan, and Gaza is the gate of access to Egypt. In a scenario of an independent Palestinian state with a proper road and/or rail connection between Gaza and the West Bank, it would be possible to travel between the border with Egypt and the Allenby bridge in just over an hour.⁵

This location delineates also Palestine's potential geographic trading pattern. Aside from intense trading with the much larger Israeli economy, distance, common language and culture should put the Palestinian state in a privileged position to exploit the growth in the economic potential of its regional neighbours. A straightforward way to illustrate this growth is to look at the evolution in the total size of the economy in the Middle East and North Africa (MENA) region (including Turkey). Figure 3.1 shows that the real GDP of the main potential trading partner of Palestine has more than doubled between 1990 and 2008, before falling somewhat due to the current global economic crisis. However the total size of the economies in MENA

⁵ This is based on the fact that greater Al Quds (East Jerusalem, Ramallah and Bethlehem) would be connected to the international airport in Rafah in less than one hour (Arnon and Bamyra, 2007).

is still remarkable, at around USD 1.4 trillion, less than 10% of which is made up by Israel. The Arab countries (a potentially closer reference group for Palestine) account for around half this figure and their growth has been similar to that of the region.

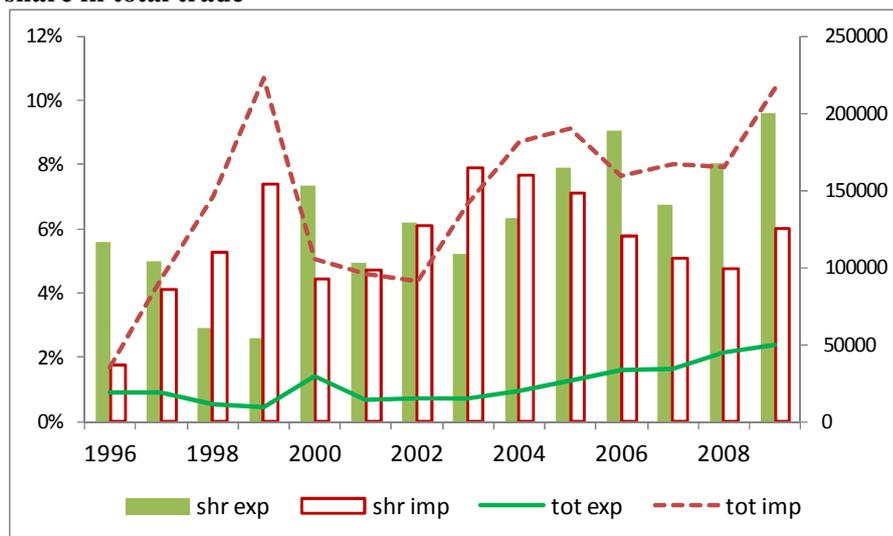
Figure 3.1: GDP of main Palestinian trading partners (constant mln USD)



Source: Author's elaboration on World Bank (2012)

In line with these trends, the share of the MENA region (excluding Israel) in Palestinian export has increased since 1996, from just below 6% to over 9% (Figure 3.2). On the other hand the share in imports has increased only slightly and has even decreased in the last decade. Despite the overall increase in the share of MENA in Palestinian trade, the region (excluding Israel) remains a relatively marginal trading partner for Palestine, and the Arab countries are an even smaller partner. That is because Israel dominates Palestinian trade, accounting for 87% of the exports and 72% of the imports in 2009.

Figure 3.2: The evolution of Palestinian trade with MENA region (w/o Israel), mln USD and share in total trade

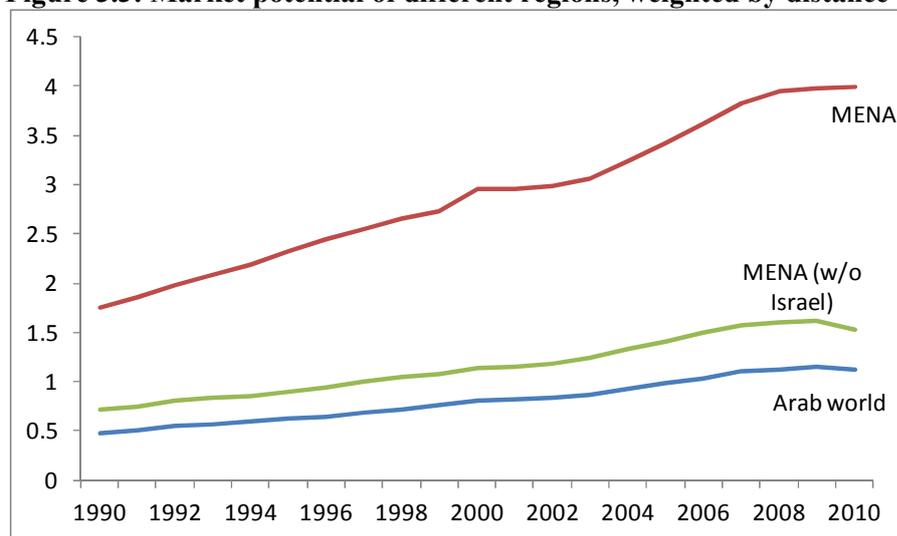


Source: Author's elaboration on PCBS (2011b)

Part of the reason for such dominance is that Israel is much closer to the West Bank and Gaza than any other countries. In order to take this distance factor into account we compute a measure of market potential for Palestine given by the sum of GDP of all Arab countries

weighted by the inverse of the distance of the country's capital city to the future capital Greater Al Quds.⁶ According to this measure, more than half of the market potential of the MENA region for the Palestinian economy is constituted by Israel (Figure 3.3). Moreover the Israeli part of the MENA market potential for Palestine has been growing faster in the last two decades than the part of the rest of the MENA region. That is due to the fact that the Israeli economy has grown faster than the average in MENA.

Figure 3.3: Market potential of different regions, weighted by distance



Source: Author's elaboration on World Bank (2012) and Mayer and Zugnago (2006)

But even when accounting for the distance factor, the regional economies other than Israel tend to under-trade with Palestine relative to what their market potential would suggest. Palestinian exports to Israel are nine times larger than those to the rest of the MENA region, and imports from Israel are twelve times larger. While Israel being the largest trading partner of Palestine is not at all surprising given its vicinity and size, its dominance in Palestinian trade reflects the restrictions imposed by the occupation on Palestinian trade with the rest of the world. One way to overcome such restrictions for Palestinian firms is to use Israeli traders for their international commerce. Thus, much of the Palestinian trade with Israel is actually indirect. A recent study by the Bank of Israel (2010) indicates that 58% of the Palestinian imports from Israel in 2008 were through trading companies (much of which was re-export). Firm-level evidence from World Bank (2007) and from the recent Fund for New Market Development (FNMD) programme confirm that if there was a different trade regime and if Israeli security measures were relaxed, trade with other countries would indeed increase.

In sum, the other trading partners and those in the MENA region in particular are likely to play a much more important role in Palestinian trade in the context of a sovereign Palestinian state. In order for such trade to be stimulated, physical connections to Jordan and Egypt would need to be strengthened, including through trade facilitation measures, and the

⁶ More formally (see Cali and te Velde, 2011) the index is computed as is computed as: $MP_{it} = \sum_{j=1}^N \frac{GDP_{jt}}{d_{pj}}$,

where GDP_{jt} is total GDP of country j at time t and d_{pj} is the distance in Km between Palestine and country j (measured as the great circle distance between the respective capital cities). Data on bilateral distances between capital cities to compute the market potential variable come from Mayer and Zignago (2006) at CEPII, who compute geodesic distances through the great circle formula while data for countries' GDP come from World Bank (2012).

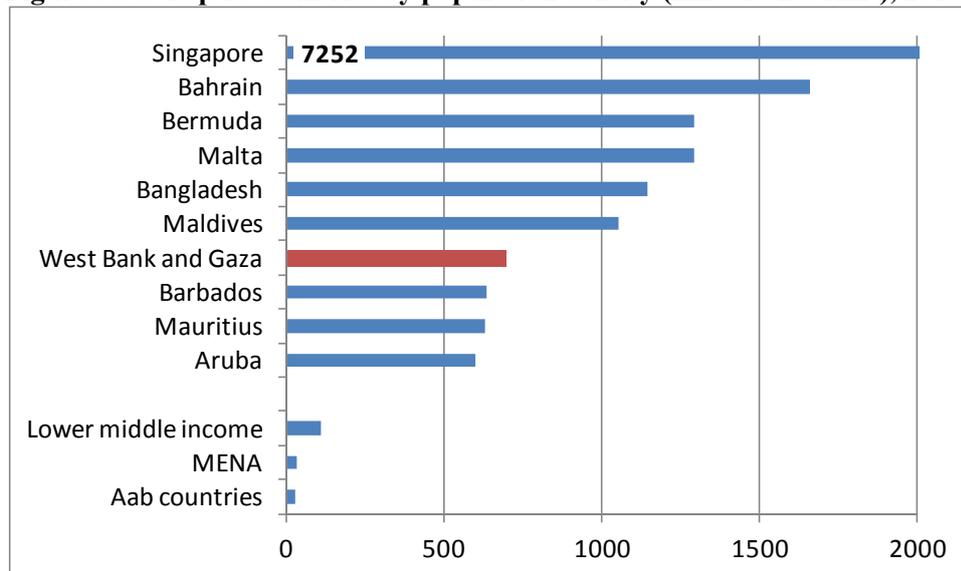
Palestinian economy would need to build on the comparative advantage vis-à-vis the other economies in the region.

3.2 Factors' endowment

High population density

One of the most salient features of the Palestinian territory is its high population density. According to PCBS (2011a) estimations, the total size of the population in the Palestinian territory was 4.17 million in mid 2011.⁷ Population density reached 693 persons/km² in the Palestinian territory in 2011 (with 456 persons /km² in West Bank and 4,353 persons/km² in the Gaza Strip). This figure makes Palestine one of the countries with the highest population density in the world (Figure 3.5a), way above the average for lower-middle income countries (the income category the oPt belongs to), the MENA region and Arab countries. Except for Bangladesh, the other countries topping the ranking are micro or city-states much smaller than Palestine.

Figure 3.5a: Top 10 countries by population density (inhabitants/Km²), 2010



Source: World Bank (2012)

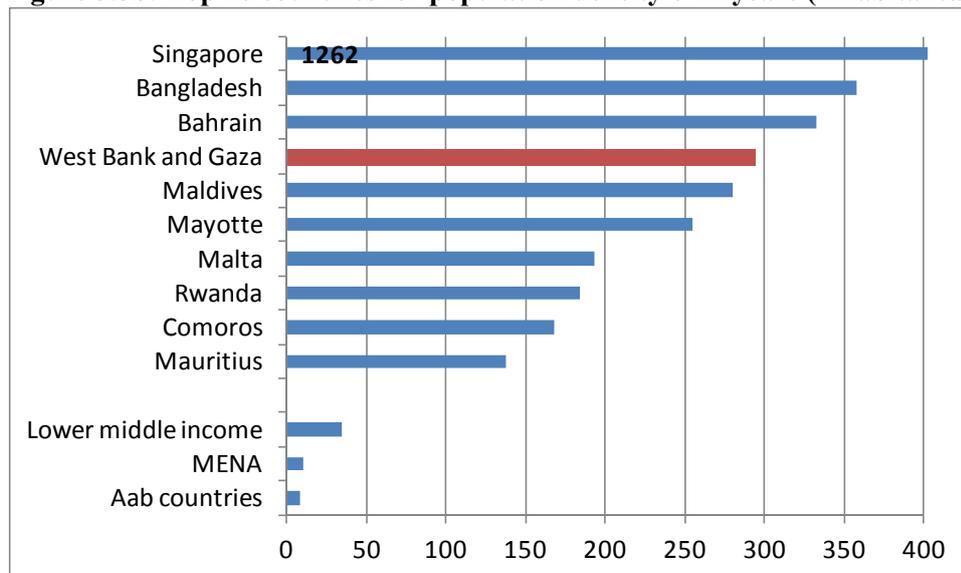
Given the high fertility rate, which reached 4.2 births per woman in 2010, and the high share of young population, population density in West Bank and Gaza is bound to increase.⁸ An indication of this is that the ranking of Palestine is even higher by the density of young people (i.e. below 15 years of age) – Figure 3.5b.

These figures indicate that Palestine currently has one of the lowest amounts of land available per capita in the world. And this dearth of available land per capita is bound to deteriorate further in the future. As we will see, this has clear implications first and foremost on the role of agriculture and other land intensive sectors in a future Palestinian state.

⁷ This is based on the results of the PCBS Population, Housing and Establishment census 2007.

⁸ PCBS (2011a) projects the population to increase 5.37 million in mid 2020 and 6.06 million in mid 2025.

Figure 3.5b: Top 10 countries for population density 0-14 years (inhabitants/Km²), 2010



Source: World Bank (2012)

Relatively skilled population

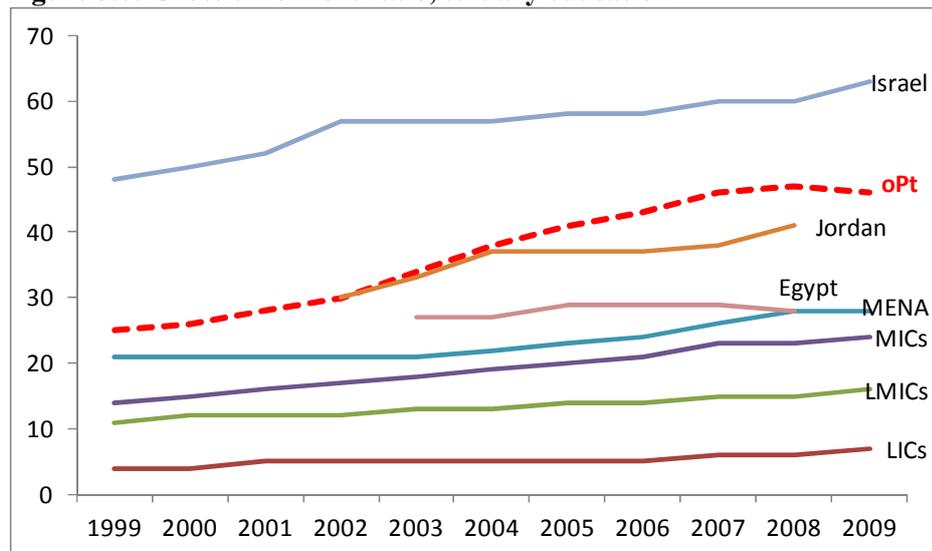
The high population density is accompanied by a relatively skilled profile of the population in the oPt. The adult literacy rate is amongst the highest in developing countries: at 95% it compares favourably with lower-middle income, middle income countries, as well as countries in the region such as Egypt and Jordan.⁹ The high literacy rate is compounded by a relatively high level of tertiary education by international standard. The gross tertiary enrolment rate in the oPt was 46% in 2009 with a sustained rise since 1999 and well above the average in the MENA region, as well as middle and lower middle-income countries (Figure 3.6).¹⁰ The rapid growth in tertiary education suggests a process of future convergence with the Israeli rate, which has been historically much higher than the Palestinian one.

These statistics do not attest by themselves the actual skills of the Palestinian population and in fact there are some causes of concern regarding the effective quality of the education as well as the preparedness of the graduates to the labour market. For example, West Bank and Gaza students perform relatively poorly in the international comparative student assessment Trends in International Mathematics and Science Study (TIMSS), which provides information about trends in performance among eighth graders. Such data suggest that there may need to be substantial improvements in the educational system. Nonetheless the general picture remains one of a country with a relatively high share of educated people, although with little employment opportunities.

⁹ Note that literacy data are not available for many countries in the MENA region.

¹⁰ The gross enrolment ratio is defined by the World Bank (2012) as the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown.

Figure 3.6: Gross enrolment ratio, tertiary education

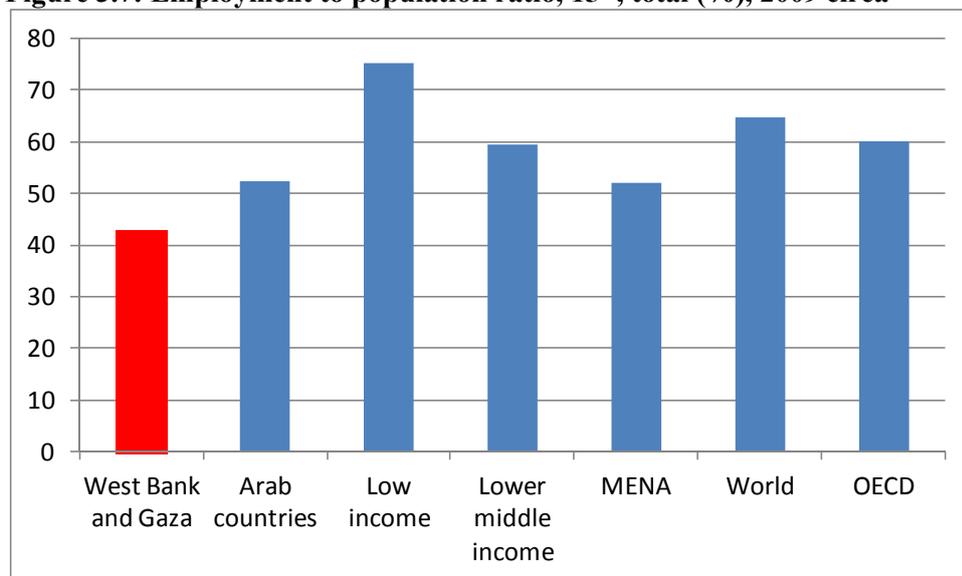


Source: World Bank (2012)

Low employment rate and low returns to schooling

The downside of this picture is that the educated people - just as the others in Palestine – find it difficult to find employment in Palestine. The employment to population ratio, an indicator of the extent to which the adult population is employed, is lower than the average in Arab countries, MENA region and lower-middle income countries (Figure 3.7).¹¹ Part of the reason for that may be a higher enrolment rate in tertiary education among young adult, but most of it is due to a high unemployment rate (24% in 2010) and to a low female labour participation rate (15% in 2010).¹²

Figure 3.7: Employment to population ratio, 15+, total (%), 2009 circa



Source: World Bank (2012)

¹¹ In fact this low ratio is mainly driven by Gaza, while the West Bank's ratio is closer to the average of Arab countries.

¹² Source for the data: PCBS Labour Force Survey.

Unemployment and under-employment are particularly severe among the relatively skilled labour force. As we have seen the constraints imposed by the occupation on the Palestinian economy tend to distort the economy towards non tradable activities. These tend to be intensive in relatively unskilled labour (such as retail trade, construction and basic public services), save those related with the international aid sector and few others. This lack of job opportunities for the educated labour force contributes to keeping the returns to schooling low. According to the analysis by Daoud (2011), the return to an extra year of education for wage employees is around 4.3% in the West Bank and Gaza, a considerably low figure by international standards. Two other factors contribute to the low returns to schooling in the oPt. First, the distribution of public employees' wages is compressed with a low wage differential between highly and lowly educated (Miaari, 2009). Second, Palestinian employment in Israel is concentrated in low-skilled occupations which can lower returns to schooling, as these jobs earn similar wages than those paid for skilled workers in the West Bank (World Bank, 2012b), and as employment may reduce the supply of unskilled workers within the West Bank.¹³

*Availability of natural resources (with restricted access)*¹⁴

Due also to its small territory Palestine lacks any major reserve of precious natural resources unlike many of its Middle-Eastern neighbours. One resource which is instead (potentially) available is water, at least to satisfy the population's needs (but not necessarily the agricultural needs, see below). However, Palestinians have had very limited access to the water resources within their territory in the pre-1967 border as Israel has taken control of most of them, including the water from the Jordan river and from the underground aquifers. There are three groundwater aquifers (basins) underlying the Palestinian territory: the Eastern aquifer, the Western Aquifer, and the North-western aquifer. These aquifers provide jointly around 679 million cubic meter (MCM)/year (Table 3.1). The Oslo Agreement allocated Palestinians 138.5 MCM of them, about one fifth of the estimated potential, while Israel was allocated the rest. This was supposed to be a temporary allocation to be revised within five years and to be settled along with the rest of the negotiations. In fact, on the basis of the location of the water basins as well as of their recharge areas, MoNE and ARIJ (2011) estimate that the water accruing to the Palestinians from these aquifers should be around 469 MCM/year.

The situation on the ground is however very different. Israel has an almost complete control of the aquifers in the West Bank from which it has been consistently over-extracting even vis-à-vis its generous allocation of water according to the Oslo Accords. This causes the depletion of the aquifers' reserves at the expenses of the Palestinians, who have been able to extract only 91.5 MCM from the West Bank aquifers in 2008 (PCBS, 2009), an amount much lower than that in 1999 and even as late as in 2007. Half of Palestinian wells have dried up over the last twenty years. The effects are particularly severe for the generally more vulnerable population groups living in Area C.

The Jordan River is an example of an even more inequitable allocation of water resources. Presently, Israel uses approximately 58.7% of the waters of the Jordan River; Jordan uses 23.4%; Syria 11% and Lebanon 0.3% (McHugh, 2009). Palestinians, in contrast, are allocated none. In a situation without occupation, clearly Palestine would have access to part of the

¹³ Ektes (2011) provides some empirical evidence in support of this by showing a negative association between returns to schooling and the number of permits across West Bank governorates.

¹⁴ This section draws extensively on MoNE and ARIJ (2011).

water from the river as one of the countries through which the river flows. As argued by Glover and Hunter (2010) the most equitable means of reallocating Jordan water would be on a per capita basis, so that each riparian would receive a share of water proportionate to its population size. Taking the 2008 population levels of Israel, the West Bank and Gaza, Glover and Hunter (2010) estimate that an equitable per capita distribution of Israel's current allocation of Jordan water would be 268 MCM for the Palestinians and 501 MCM for Israelis.

In addition to the water available in the West Bank, the Palestinians could also count on the renewable safe yield of the Aquifer in Gaza, which has been estimated to be 124 MCM/yr (Vengosh et al., 2004).¹⁵

Table 4.1: Allocation of water from the main groundwater aquifers in the oPt

Aquifer	Potential (MCM/year)	Palestinian allocation* (MCM)	Proposed Palestinian allocation*** (MCM)	Palestinian Abstraction 2008 (MCM)
Eastern	172	74.5**	172 (100% of 172)	
Northeastern	145	42	116 (80% of 145)	
Western	362	22	181 (50% of 362)	
Total/ year	679	138.5	469	91.50

* According to Article 40 (Oslo II Agreement, September 18, 1995).

** Including extra 20.5 MCM of "immediate needs" to be developed for Palestinian use from Eastern Aquifer.

*** The proposed allocation was considered according to the aquifer location and recharge area.

Source: MoNE and ARIJ (2011)

If access to water is hindered by the occupation, access to other natural resources available in the oPt is often completely prohibited. That is the case for the Dead Sea's salts and minerals as well as the Gaza offshore gas. The Dead Sea lies between the West Bank, Jordan and Israel but access to the Dead Sea is completely sealed off for Palestinians as far as economic activities are concerned. Israeli and Jordanian companies have been extracting large quantities of commercially valuable salts and minerals for many decades. For the Palestinian economy this restrictions represents a loss proportional to the potential economic value from the exploitation of these resources. In particular, three types of salts make up most of the Dead Sea economic resources: Potash (which is mainly used to produce agricultural fertilizer), Bromine (flame retardant, pesticide and some other minor applications such as gasoline additive, medical and veterinary) and Magnesium (industrial applications, such as de-icing roads and used in textile and cosmetics industries).

In 2000, a consortium led by British Gas discovered over 30 billion cubic meters of natural gas in two Palestinian offshore gas field. These are the Gaza Marine, which is the larger field and is located entirely in Palestinian territorial waters, containing an estimated 28 billion cubic meters of gas; and the Border Field, which is an extension of the Israeli Noa Field, partially located in Israeli territorial waters. The volume of gas in Border Field is estimated at around 3.5 billion cubic meters (Palestine Investment Fund, 2011). At 2010 prices, the value of the natural gas discovered in both fields is estimated at over USD 6.5 billion (PIF, 2011). However, Israeli restrictions have so far impeded the development of the project including the extraction, sale and use of the gas (MoNE and ARIJ, 2011).

¹⁵ However note that Gaza over-extracts from the Aquifer with a total extraction of around 160 MCM per year (PCBS, 2009b).

The West Bank territory is also rich in gravel and stone, and they represent the major current merchandise export of Palestine (along with marble). Most of the mines and quarries from which these materials are extracted are located in area C and are under direct Israeli control. Israel uses them to extract material mainly for the Israeli economy preventing Palestinian companies to carry out any such exploitation.

The next sections will touch upon the extent to which these natural resources may help an independent Palestinian state reach economic sustainability.

Abundance of natural and cultural amenities

The oPt enjoys a combination of religious, natural and historic amenities which are among the finest in the region. The sites in the “old city” of Jerusalem (which would be easily accessible from East Jerusalem even in the event of the “old city” coming under international control), Bethlehem, Jericho and the Baptism site on the Jordan River are only some of the main examples of religious sites dear to both Muslims and Christians located in the oPt. As noted by the World Bank (2010), area C offers a unique combination of health, leisure, sport/adventure, ecological, agro, and religious tourism destinations in a single area, including the Dead Sea, the Jordan River, and the Jordan Valley slopes. Such sites would be key for the proper development of the tourism industry in an independent Palestine. The restrictions imposed by Israel and the political instability have greatly limited tourism development in the oPt so far but as we argue below this may be a highly important sector for a future Palestinian state.

Reasonably good governance without political stability

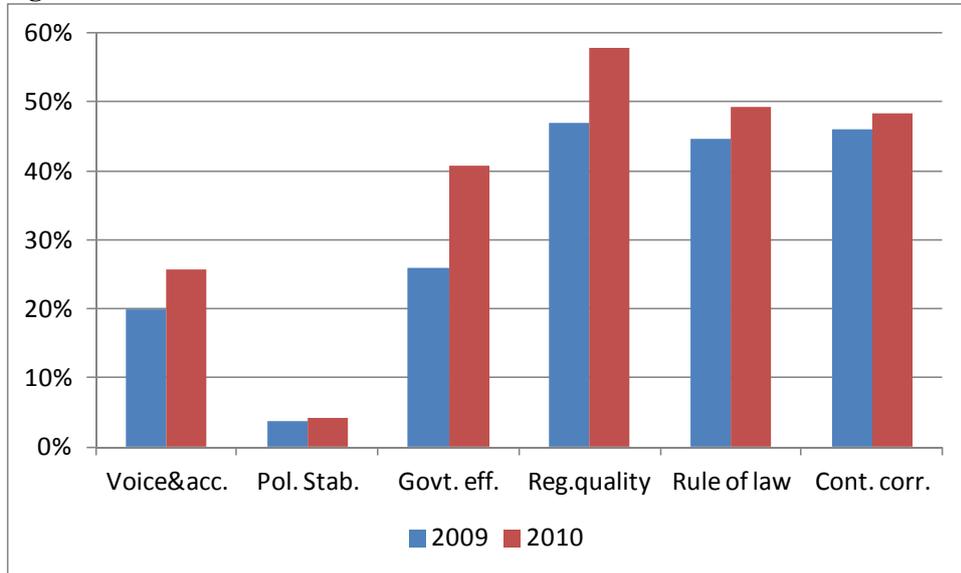
Although not exactly part of the factors’ endowment of a country, the extent to which a country is run transparently, effectively, efficiently and in a democratic way has an important impact on the viability of all sectors in the economy (Rodrik et al., 2004). Many of these characteristics are collectively defined as the country’s governance, which various institutions have been trying to measure in different ways. While the direction of causality is not clear, “good” governance and economic performance are positively related and high income countries systematically have better governance than low income countries. It is worth looking at these aspects in the case of a Palestinian state, as this is an important factor in explaining why developing countries are at a disadvantage to compete with high income countries in more sophisticated sectors.

We use here the World Bank Governance Indicators, which is probably the most recognised attempt to measure governance across countries. Figure 3.7 show the percentile group of the West Bank and Gaza (across all countries surveyed) in various dimensions of governance: the higher the percentage, the better the perceived relative performance.¹⁶ While the oPt is among the worst performers in terms of political stability and to some extent democratic strength, the performance of its government is considered to be around the world’s average (but with a slight improvement between 2009 and 2010). The negative performance in the first two dimensions is essentially explained by the occupation and its related instability. In light of this non conducive context, the reasonable quality of the government action, measured by

¹⁶ For example being in the 60th percentile indicates that there are 60% of countries which fare worse than the subject country in the specific dimension.

government effectiveness, regulatory quality, respect for the rule of law, and control of corruption, provides for some cautious optimism for the role of governance in helping the competitiveness of firms in a future Palestinian state.

Figure 3.7: Governance indicators in the West Bank and Gaza



Source: World Bank (2011b)

4. What have other small states done?

Before exploring the complex question of what type of sectors the Palestinian economy could possibly rely on as a sovereign country, it is useful to look at what path of specialisation other successful countries with similar factor endowments like the oPt have taken. In particular, the experience of small developing countries (both by population and size) may be indicative for Palestine.

There is close to an intellectual consensus that small developing countries have difficulties competing globally in manufacturing (Winters and Martins, 2005; Briguglio et al., 2006; Qureshi and te Velde, 2008). That is due to the small domestic market size, which implies that most of the firms in small states are small and medium enterprises with limited opportunities for reaping the benefits of economies of scale and investing in research and development. Hence, unit costs of production tend to be higher as compared to larger economies. Winters and Martins (2005) find that business costs, particularly transport and labour, are significantly higher in small states. They argue that small consignment size, poor infrastructure, lack of competition and weak institutions inflate the costs of trade, and create such strong economic disadvantages for these countries. For these reasons of impeded potential of manufacturing Briguglio et al. (2006) suggested that small states would need repositioning themselves in the global economy by way of creating a comparative advantage in knowledge-based and service industries such as tourism, finance, insurance, health, education, and information and communication technology services. In addition, for small countries with high levels of human capital, developing the services sector will help them exploit their comparative advantage based on skilled labour force.

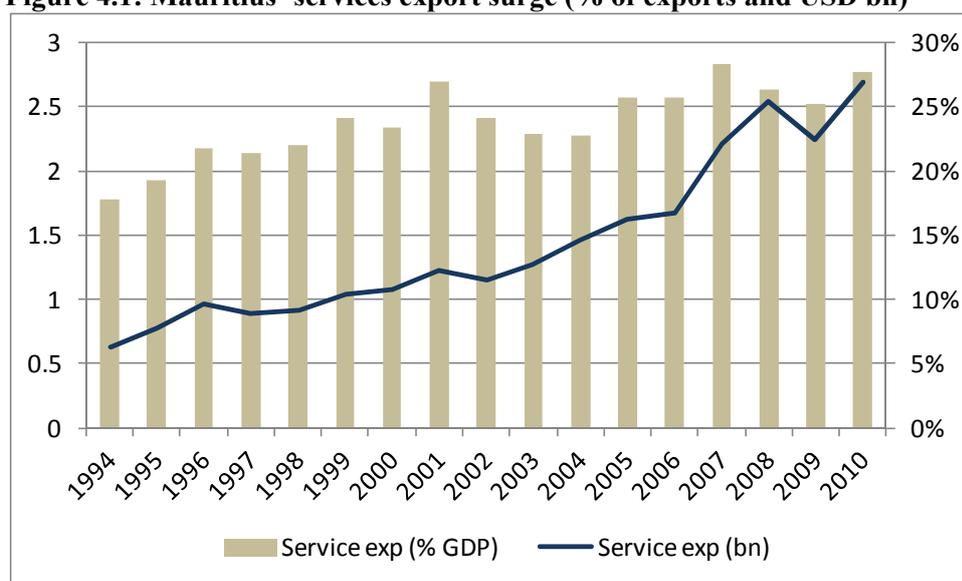
Qureshi and te Velde (2008) provide a review of this type of economic specialisation strategies that gave way to some successful developing and emerging small economies. Mauritius is a particularly interesting case for Palestine as it has a small population along with a very high population density similar to that of oPt (see Figure 3.5). In addition, like Palestine, the country is poorly endowed with natural resources, except for natural amenities and has a relatively skilled workforce. Faced with the prospect of deteriorating preferential access to the EU sugar and textile markets, which had been the backbone of the economy up to the 1990s, Mauritius sought to re-orient its economy towards tradable services sectors. It has diligently pursued the development of the services sector, and has added three services sectors – tourism, financial services and ICT – to the two traditional pillars of the economy, sugar and textiles. The rapid expansion of services has already absorbed (employment) losses stemming from agriculture and textiles that were previously dependent on trade preferences. This strategy has resulted in a surge in services exports which have expanded five-fold since 1994, and in 2010 were worth 27% of GDP, up from 17% in 1994 (Figure 4.1). This expansion has helped the country sustain high GDP growth rates since the 1990s and Mauritius has now reached the status of middle-income country.

While the bulk of services export is composed of tourism, other sectors including IT-enabled, financial and health services are also increasingly contributing to this surge in exports. For example, Mauritius has been able to find a niche in back office operations, such as call centre and business process outsourcing, in large part thanks to a relatively educated workforce able to communicate fluently in French and English. Also IT exports are starting to make a dent in Mauritius' economy and the country is now perceived relatively well as an offshore location in the global environment. This is documented in the AT Kearney Global Services Location Index, which ranks the top 50 countries according to their attractiveness as services offshore

locations (based on financial attractiveness, people skills and business environment). Mauritius entered the ranking in 2006 for the first time, attesting to the efforts made especially in terms of skills and business environment. The latest version of the Index (AT Kearney, 2011) includes Mauritius as the 36th preferred destination, ahead of countries such as Canada, Israel and Ireland.

Subramanian and Roy (2001) highlight the importance of efficient and well-functioning institutions in explaining the strong growth performance of Mauritius. It enjoys a clear comparative advantage over other South African countries in governance, including in terms of political stability, government effectiveness and rule of law indicators. The government has had an active role in the success story of Mauritius' services, as described in box 1.

Figure 4.1: Mauritius' services export surge (% of exports and USD bn)



Source: World Bank (2012)

Box 1: The role of the government in Mauritius' services success story

With the aim of creating the right type of human capital, the government facilitated the growth of tertiary education in the country by establishing a Tertiary Education Commission (TEC) with the aim of promoting and regulating post-secondary education in Mauritius. The TEC has put in place a new regulatory framework, the Strategic Framework 2007-2011, to develop an education sector of international standard in Mauritius and make it a regional and international knowledge hub and centre for learning.

In the tourism sector, the Ministry of Tourism, Leisure and External Communications devised the National Tourism Policy to ensure high quality tourism for visitors. A Mauritius Tourism Promotion Authority was also created in 1996 to promote Mauritius as a tourist destination in other countries, provide information to tourists, and cooperate with tourism agencies overseas. In addition, the Tourism Authority was set up under the Tourism Act 2004 which aims to formulate necessary policy and nationally integrated planning for the tourism industry, co-ordinate the activities of the various organisations concerned with the tourism industry, and supervise the operations of tourist enterprises.

In terms of information and communications, Mauritius has a fairly advanced broad-based information policy which is modelled around Singapore's ICT policy. The government intends to make ICT as the fifth pillar of the economy in addition to the sugar, textiles, financial services and tourism sectors. Mauritius has a Ministry of Information Technology and Telecommunications which

is responsible for devising the policy and administering programs to improve telecommunications services. It also has an Information and Communications Technologies Authority which is the regulator of the telecom sector and ensures the implementation and promotion of the government's policy objectives for the telecommunications sector. The government established a parastatal body, the National Computer Board (NCB), in 1988 to promote the development of ICT. The NCB manages the National IT Strategy Plan that has been devised to accelerate development of the IT sector in Mauritius.

The government has been supporting the growth of tradable services through active international trade and investment policies as well. Mauritius has been a member of the WTO since 1995 and has been an active member of both the South African Development Cooperation (SADC) and the Common Market for Eastern and Southern Africa (COMESA) Protocols to encourage regional trade as well as negotiate agreements with large partner countries such as the EU and the US. In the context of particular sectors, Mauritius has made specific commitments within the WTO General Agreement on Trade in Services (GATS) in the financial services sector (both in banking and insurance) but with certain restrictions. Mauritius has also made specific commitments in the telecommunications sector. It has not liberalised its fixed telecommunication network but has committed to a higher level of liberalisation in the sector. In addition, it has made commitments in the tourism sector with some limitations.

As for the investment barriers to trade Mauritius adopted legislation in 1993 to regulate and facilitate foreign investment in the country. In addition it has signed a number of bilateral FDI treaties with both developed and developing countries to promote foreign investment and double taxation treaties with to remove the double taxation of investments. Mauritius is a member of several international investment institutions and has ratified international agreements that regulate FDI such as Multilateral Investment Guarantee Agency, International Centre for Settlement of Investment Disputes, Convention on the Recognition and Enforcement for Foreign Arbitral Awards, and World Intellectual Property Rights Organization.

Source: Qureshi and te Velde (2008)

Other small countries have followed similar experiences with booming services trade, which has become the backbone of the economy, such as St. Lucia, Vanuatu and Barbados and Singapore. In particular the latter is an important success story for small states striving to build a strong services sector. The public sector created the right environment (a business friendly climate, export-oriented economic policy framework, improved regulatory and legal systems and state-led investments in strategic sectors) for the services sector to develop. The support framework has evolved gradually over time from one that stimulated manufacturing in 1960s to one that promoted a knowledge economy in the 1990s and beyond. Singapore has a competitive advantage over many large countries in terms of its excellent transport and ICT infrastructure and availability of skilled labour force.

The government had laid particular emphasis on promoting the education sector even further to make Singapore the regional hub for educational services. Having identified the objective of developing a strong tertiary education sector already in mid-eighties, the government has undertaken numerous initiatives to promote tertiary education in the country. Besides establishing three world class public universities, the Economic Development Board – the efficient government agency responsible for economic strategies – embarked upon an ambitious plan to attract renowned foreign academic institutions and bring in more specialised programs through tie-ups with local private educational institutions. The strengthening of the tertiary educational service sector has also helped reinforce other knowledge services sectors such as ICT and financial services.

5. What specialisation? Moving beyond traditional sectors

In order to reach economic sustainability and prolonged income growth, Palestine will have to follow a specialisation based on its comparative advantage and on the relative growth prospects of the sectors. Several key features of the oPt explored above, including a low land-labour ratio, the abundance of idle relatively skilled labour and of natural and cultural amenities and the scarcity of water, may indicate a possible pattern of specialisation. These characteristics suggest that the tradable sectors, which should be the backbone of the Palestinian economy, should ideally employ relatively little land and water and should be relatively intensive in skilled labour and/or amenities.

However the current pattern of trading does not reflect this type of factors' endowments. Other than being limited, Palestinian exports are also low value added. They are generally either natural resource intensive or labour intensive products that require low levels of processing and embody little technology. The largest export in 2008/09 was stone and marble (Table 5.1), which accounted for 17 percent of total exports and is mostly unprocessed stone. The following major exports similarly embody relatively low value added, such as metal scrap, articles for packing, bedding articles, furniture, cigarettes, footwear and olive oil. The only category among the largest exports with relatively higher level of sophistication was pharmaceuticals, but their total value was just USD 14 million in the period 2008/09.

Table 5.1: Main Palestinian exports (average 2008-09 in '000 USD)

Code	Value (2008-09)	Description
6802	91,960	Building stone and articles thereof; mosaic cubes and the like, of natural stone
7204	27,010	Ferrous waste and scrap; remelting scrap ingots of iron or steel
3923	20,658	Articles for the conveyance or packing of goods, of plastics;
9404	19,488	Mattress supports; articles of bedding and similar furnishing
9403	17,923	Other furniture and parts thereof
2402	16,023	Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
6401	14,393	Waterproof footwear with outer soles and uppers of rubber or of plastics
4415	14,030	Packing cases, boxes, crates, drums and similar packings, of wood
7604	11,320	Aluminium bars, rods and profiles
9401	10,648	Seats (other than those of heading 9402)
1509	9,535	Olive oil and its fractions, whether or not refined, but not chemically modified
7213	7,563	Bars and rods, hot-rolled, in irregularly wound coils, of iron or non-alloy steel
3003	7,415	Medicaments consisting of two or more constituents
3004	7,019	Medicaments consisting of mixed or unmixed products
1515	6,985	Other fixed vegetable fats and oils (including jojoba oil) and their fractions
3402	6,527	Organic surface-active agents (other than soap); surface-active preparations
7404	6,327	Copper waste and scrap
4818	6,148	Toilet paper and similar paper, cellulose wadding or webs of cellulose fibres
403	6,056	Buttermilk, curdled milk and cream, yogurt, kephir and other milk
6910	5,272	Ceramic sinks, wash basins, wash basin pedestals, baths, bidets, etc.
1704	5,263	Sugar confectionery (including white chocolate), not containing cocoa
4412	5,142	Plywood, veneered panels and similar laminated wood

Source: PCBS

So what type of pattern of specialisation could Palestine follow as an independent state in order to be more in line with its factors' endowments and with the experience of other similar successful countries? In the following we try to suggest some options by looking at the broad tradable sectors, i.e. labour exports, agriculture, industry and services. The discussion will delve somewhat within these macro-sectors at a level of detail equivalent to the 1-digit standard sectoral classification. That is the maximum sensible specification for a general discussion based on broad characteristics such as this one (Hausmann and Rodrik, 2003).

5.1 Labour exports

As mentioned above, the Palestinian external sector has mainly relied on labour exports especially to Israel for three decades. Could this type of exports become again the engine of the economy once Palestine becomes an independent state? After all, this would allow for a labour intensive specialisation, employing idle human resources and yielding earnings similar to those of skilled labour within the oPt. Against this, labour exports do provide some non negligible foreign exchange and most probably will continue to do so in the future considering the labour supply gap in Israel especially in certain profession. However it is not likely, nor is it in our view desirable, that such labour exports represent again the backbone of the economy as they used to for a number of reasons.

First, whatever the political settlement between Palestinians and Israelis, the reliance of Israel on Palestinian labour has been reduced over the past two decades (see Figure 2.2 above). New Israeli citizens (especially from Russia) and more recently waves of migrants from developing countries have by now replaced most of Palestinian labour in Israel and there is no sign hinting that this trend may be reversed. Incidentally this is also the case for the Gulf countries. This reduced dependence has also shrunk the importance of labour income in the Palestinian economy, which in 2009 was worth less than twelve percent of the GDP.

Second, and more importantly, it is doubtful whether a specialisation based on labour exports may be ideal for the long-term prospects of the economy. Such a specialisation would impair the competitiveness of the other tradable producing sectors, as income inflows from labour exports increase the real exchange (Astrup and Dessus, 2005). In addition, it would leave the Palestinian economy dependent on Israel, which would crucially undermine the economy's stability. Astrup and Dessus (2005) show that income losses incurred by the closure of the Israeli labour market to Palestinian workers could not be compensated by the export-enhancing depreciation of the real exchange rate after the Israeli closure.¹⁷ Moreover, due to the low skill content of the work offered in Israel to the Palestinian, the possibility of technology and know-how transfer through labour exports is limited. This export, at least in the foreseeable future, will remain limited to the relatively low skilled labour. One important negative implication of it is that this low skilled Israeli labour demand may reduce the Palestinians' incentives to accumulate human capital.

As in the case of merchandise trade, some Palestinian labour export to Israel is likely to continue, given the size, the vicinity and the excess labour demand in certain professions of the Israeli economy. While such exports may be useful to fill some excess labour supply in

¹⁷ Other negative effects of Israeli labour market closure on the Palestinian economy include a reduction in the Palestinian wage in the oPt, especially of unskilled labour (Mansour, 2010) and increase of violence (Miaari et al., 2011).

the oPt, especially in unskilled occupations, they are likely to (and shall) be relatively limited in scope. A possibly more interesting option would be that of exporting services via the temporary mobility of relatively skilled labour, a possibility which is explored in the section below on services.

5.2 Agriculture, animal farming and fishing

The very low land/labour ration and relative scarcity of water would caution against any economic specialisation based on agricultural and animal farming activity in the oPt. However there may be specific sub-sector as well as other considerations which may qualify this caution. We explore them in turn.

5.2.1 Agriculture and animal farming

Agriculture has historically played an important role in the Palestinian economy, providing source of income and employment to large shares of the population. However the last decades have seen a gradual loss of importance of agriculture, which in 2010 was estimated to contribute only seven percent of Palestinian GDP.¹⁸ The oPt is moving resources away from agriculture, but unlike in the case of most developing economies, this is mainly due to the restrictions placed on agriculture by the Israeli occupation rather than to the movement of resources towards higher value added sectors.

The chief restriction on agriculture development is currently access to water, as described in section 3 above. In their recent report, MoNE and ARIJ (2011) estimate that according to an equitable distribution of the water resources based on principles of geographic location, population and fairness, the total allocation of water to Palestine should be around 861 million cubic meters per year. If this level of water were available to the Palestinians, the Palestinian agricultural sector could drastically expand its production by way of greatly increasing the share of irrigated agricultural land, which is estimated to be as much as 15 times more productive than rain-fed land (MoNE and ARIJ, 2011). The added production resulting from the additional irrigated areas (net of the rain-fed production lost to the irrigated production) is estimated to be USD 1.44 billion, with a gross value added of USD 1.12 billion. Such an expansion of agriculture would also involve significant increases in employment opportunities within the sector.

However the possibility of expanding agriculture in the long-term would in practice face two important obstacles. First, the over-exploitation of water resources by Israel, particularly the Jordan River, is likely to reduce the possible amount of water available to Palestinians in the future whatever the eventual political settlement of the conflict might be. Second, and more importantly, the relatively rapid growth of Palestinian population along with its urbanisation will increase considerably the demand for water for domestic use. Expanding the Palestinian irrigation network will inevitably place even greater strain on already over-exploited water resources. This is especially the case if population growth continues at current rates and immigration accelerates (for example due to a number of refugees flowing into Palestine). In

¹⁸ This share comes from national accounts, which tend to under-estimate agricultural value added relative to other sources, such as the agricultural statistics (PCBS, 2009b).

that case it is actually possible that there will be less water available for the agricultural sector and not more (even without occupation).

As domestic demand increases, higher quantities of water will have to be reallocated to the municipal sector leaving less and less for the agricultural sector. As a consequence, priority should be given to sectors that are capable of generating a higher level of output per unit of water consumed (Glover and Hunter, 2010). This should involve prioritizing industrial water usage over agricultural water usage as both the industrial and the services sector generate far more output per unit of water than agriculture. Irrigated agriculture appears not to fit Palestinian comparative advantage according to other factors' endowment either, including the very low land/labour ratio, and the high level of educational attainment of the Palestinian labour force relatively to its neighbours.

Similar arguments apply to *animal farming* as well, whose production is even more intensive in land than agriculture. In fact the vast majority of the fodder used by the sector, the main input along with water and land, needs to be imported and the domestic production is subject to a high degree of variability over time. For these reasons animal farming is currently a relatively small sector in Palestine although it is important for the livelihoods of certain vulnerable sections of the population, such as the Bedouins.

These considerations may provide a warning also against eventual other objectives which policy-makers may want to achieve as agricultural specialisation, such as ensuring the country's self-sufficiency. In fact as noted by Glover and Hunter (2010), in the Middle East, sustainable food self-sufficiency is actually unachievable. Whilst Palestine is naturally less water scarce than many of its neighbours, a Palestinian state will not be able to escape this fact. Food security will almost invariably require some imports (Glover and Hunter, 2010). By importing foodstuffs, water-poor states such as the oPt can achieve a higher level of water efficiency. For example by importing four tonnes of wheat, a state effectively saves 12,000 MCM worth of fresh water. Therefore, even in order to achieve food security, the development of non agriculture tradable sectors would seem to be more effective than producing food through the expansion of agriculture. These sectors, especially those more in line with Palestinian comparative advantage, should be able to provide adequate foreign exchange to purchase sufficient food from international markets.

While these considerations suggest caution with respect to using resources to significantly expanding agriculture in the long-run, they must not be taken as an indication that agriculture should be disregarded. In fact, agriculture will continue to provide a source of income and employment to a relevant part of the population. Traditional cultivations such as olive, grape and citrus, which are mainly rain-fed, already provide to some extent valuable inputs for food processing industries, which may hold some interesting growth potential in the future as well.

In addition, the development of *high value added export oriented agriculture* on a small area in the Jordan Valley could be a valuable option as suggested by Gal et al. (2010). This possibility could be feasible given the high value productivity of flower and vegetable land areas in the Jordan Valley, the huge demand for quality vegetables and flowers especially in the Gulf Cooperation Council (GCC) markets, and the preferential access of Palestinian products to these markets. Gal et al. (2010) estimate that it would be possible to develop an export-oriented capital intensive high-value vegetable, flower, and herb industry valued at around US\$1 billion per year on around 50,000 dunum in the Jordan Valley. The authors reckon that even water availability may not be an obstacle as such a strong agricultural sector

would be able to finance the import of desalinated water it would need together with equally strong agro-industrial and food industry.

Importantly, as long as the Palestinian territory is occupied, agriculture also provides a fundamental tool for Palestinians for maintaining a presence and keeping activities on land often subject to Israeli attempts of confiscation to expand the occupation. Therefore in the short-run (or at least until the Israeli occupation is ongoing) it would be important to maintain agricultural activity on all the possible land in the West Bank.

5.2.2 Fishing

The fishing industry in the oPt has collapsed since the siege on Gaza. The current fishing limit of three nautical miles imposed by Israel restricts the fishing supply to such an extent that most fishing activities are not viable any longer. However, unlike the rest of the primary agricultural sector, the expansion of fishing activity is a potentially viable undertaking in the long-run for a number of reasons.

First, the access to twenty nautical miles typical of a sovereign country would guarantee a relatively large fishing supply. Second, the world demand for fish and related products is on the increase, including in Europe and in the Gulf countries, which may open potential markets for the Palestinian fishing sector. Third, the existing capital equipment of Gaza's fishermen is severely under-utilised which would allow a relatively easy expansion of catch without further investments. Tracking the demand patterns in the region, and the evolution of the fishing basin, it may even be sensible to plan for an actual expansion of the investments in the fishing industry in the future.

While the sector could provide for some increase in employment opportunities and income, given the relatively small stretch of coast (just over 40 Km), this is bound to remain a relatively marginal activity.

5.3 Industry

5.3.1 Natural resources based industries

According to the data in World Bank (2012), the share of natural resources rents in Palestinian GDP is zero against an average of 30% for the Arab countries, 26% for the MENA region, and nine percent for lower-middle income countries. As noted above, the oPt is not rich in valuable natural resources and thus it is not plausible to envisage such high shares as in the Arab countries and in MENA. However, removing the Israeli restrictions could unleash some of the economic potential of the natural resources available in the oPt, which may play some role in helping an independent Palestinian state reach economic sustainability.

First, the mining and quarrying industries, which already provide the largest merchandise export to Palestine in the form of marble and stone, could be further expanded once Palestinians gain access to most mines and quarries in Area C. These are currently under direct Israeli control and which Israel uses to extract construction material mainly for the Israeli economy preventing Palestinian companies to carry out any such exploitation. MoNE and ARIJ (2011) estimate that the potential value of production from these mines and

quarries under Israeli control is around USD 900 million per year, with a value added of USD 575 million, equivalent to 7.1% of Palestinian GDP in 2010. Considering the know-how accumulated by Palestinians in these industries, and the existing infrastructure to exploit these mines and quarries, an independent Palestinian state should be able to expand its stone, marble and gravel production using these so far inaccessible mines and quarries. Such increased production could be used to fuel both the possible expansion of the domestic construction sector as well as the international demand.

Other potential expansion of natural resource based industries in an independent Palestine could come from accessing Dead Sea Salt and Mineral resources. As mentioned above the Dead Sea is a vast (practically inexhaustible) and highly concentrated source of reserves of Potash, Bromine, Magnesium and Salt. According to Israeli Chemicals Ltd (ICL), an Israeli chemical multinational, the cost of production of Potash and Bromine from the Dead Sea is relatively lower than the cost faced by other producers in the world (ICL, 2011). A significant part of ICL operational advantages in the international markets derive from the characteristics of the Dead Sea, particularly its high concentration of minerals and the relatively low cost of their production compared - for example - with mining Potash from underground deposits or extracting Bromine from less concentrated sources. Moreover the hot and dry climate of the Dead Sea allows the storage of large quantities of Potash in open areas at particularly low cost. These appealing characteristics would make the development of chemical industries based on these resources potentially viable in a future Palestinian state.

Along with these resources, the Dead Sea is also rich in minerals which are used to produce skin care and other beauty products. The largest producer is Dead Sea Laboratories, with its Ahava brand exported throughout the world. Its products are all based on minerals extracted from the West Bank side of the Dead Sea. The annual revenues of the company are estimated in USD 150 million in 2009 (Lev-Ram, 2009) and represent a good indicator of the potential economic value of the mineral resources of the Palestinian Dead Sea for beauty and skin care applications.

Taking the recent production of Potash, Bromine, Magnesium and Salt by Israel, Jordan and Dead Sea Laboratories' revenues, MoNE and ARIJ (2011) estimate the potential value of natural resources in the Palestinian Dead Sea to be about USD 1.79 billion, with an estimated gross value added of USD 1.10 billion, about 14% of total Palestinian GDP.

Unlike the mining and quarrying industries, there is no experience in Palestine in developing these natural resources sectors. Therefore the country lacks specialised capital, infrastructure know-how, and commercial links necessary to develop such industries. While these are not impossible to build over a period of time, they would require some concerted public-private efforts, including relatively sizeable capital and research and development investments.¹⁹ It is worth adding that an independent Palestinian state could also rely on the capital of Palestinian investors which has been invested so far in Israel and the settlement mainly due to the lack of adequate opportunities in the oPt. According to a recent research by Smeirat (2011), such private capital is even larger than the private capital currently invested in the oPt and in the absence of the occupation much of it would be invested in Palestine. It could help raise substantially the capital-labour ratio in Palestinian industries thus increasing the productivity and the return to labour.

¹⁹ For example ICL invested around USD 64 million (employing 395 staff) in R&D activities in 2010 (ICL, 2011).

In addition, while such natural resource based industries (including also mining and quarrying) may provide valuable foreign exchange, their production tends to be capital intensive and thus may not be particularly suitable for absorbing much of the idle human resources available in Palestine.

5.3.2 Energy production

Electric current is one of the largest Palestinian imports. It was the second largest SITC two-digit import in 2008, worth USD 380 million.²⁰ Adding natural gas, which is used to produce energy mainly for heating, this figure becomes over USD 500 million, over 14% of Palestinian imports in 2008. While lacking fossil fuels and rivers, a Palestinian state could still use some of its natural resources, such as natural gas, solar and geothermal, in order to satisfy at least part of its own energy needs, potentially substituting much of the imported energy. An expanded energy domestic production could also improve the current electricity supply, which is often unreliable and represents one of the highest barriers to firms' development (World Bank, 2007).

There are at least three ways in which a Palestinian state could substantially scale up energy production. First, it could exploit its natural gas in the Gaza marine offshore field, whose development has so far been held back by Israel (PIF, 2011). Lifting such restrictions would allow the Palestinian Authority to run the existing Gaza power station with natural gas, which would make the electricity production in Gaza more efficient, reliable and cheap. This would also allow reducing substantially Gaza's current electricity and diesel imports from Israel while increasing the reliability of the electricity provision.

In addition, a situation free of Israeli restrictions would allow expanding electricity production also by developing a gas-fed power plant in the West Bank. The occupation has so far restricted the potential for electricity generation due to restrictions on the importation of spare parts, and technicians, as well as by not guaranteeing the import of gas needed to run the power plant. Generating electricity in Palestinian power plants with Palestinian natural Gas would be much cheaper than importing diesel from Israel. In fact, PIF plans to expand the existing power plant in Palestine and establish new ones to create the economic scale needed to make the new strategy work (PIF, 2011).

Finally, a Palestinian state could significantly expand its currently limited renewable energy production by exploiting resources such as the sun and geothermal energy. In fact solar energy has already been used in Palestine for several decades mainly to heat domestic water. In addition, a few small solar power generated systems are already being developed in the West Bank and Gaza, especially in those areas which are not connected to the electric grid. As these are concentrated in Area C, the development of such projects is usually made difficult by the Israeli restrictions. However, with the rapid fall of the cost of solar panel and the improvement in the technology, generating energy via solar power is an increasingly viable strategy in a place like Palestine, which enjoys around 340 days of sun per year. This should not be limited to those areas not connected to the grid. In addition, geothermal energy could also offer a useful alternative for domestic heating and cooling, which cause a substantial share of the energy consumed in Palestine. Geothermal technology essentially

²⁰ According to MoNE-ARIJ (2011) calculations Palestinian electricity imports are even higher at around USD 590 million in 2010.

exploits the difference in temperature between the earth (which is always constant) and the outside air (which varies throughout the year) in order to produce energy to heat and cool buildings.

Generating energy via gas-fed power plants requires substantial investments, and would most likely require the cooperation between the Palestinian public and private sectors. This may be a viable option probably in the longer-run once the Israeli restrictions have been lifted. Due to the smaller scale, renewable energy production appears to be more feasible in the shorter-run, but would require a stronger commitment on the side of the authorities especially in terms of legislation (see the next section). Other than reducing a substantial part of Palestinian imports, energy generation may also provide employment, especially as far as renewable energy production is concerned (which tends to be more labour intensive than production through gas-fed power plants).²¹ This type of employment would require a certain degree of skills, which is likely to be in line with the factor endowments of Palestine, although there is likely to be a need for further education investments to create specialised skills in the sector.

5.3.3 Manufacturing

As discussed above, the manufacturing sector has been progressively declining in importance in the Palestinian economy over the last two decades. Its share in value added has declined from 20% in 1994 to 15% in 1998 and 10% in 2010, and even its absolute value added has declined in real terms by almost 20% between 1994 and 2010.²² This decline has been accompanied by a corresponding decrease in the employment share of manufacturing, which has shrunk from 17% in 1998 to 11% in 2010.²³

This conspicuous decline is even more problematic when considering that the Palestinian manufacturing sector has never been large by international standards due to the Israeli restrictions (see section 2). The decline is however not surprising given that Palestinian costs, particularly wage rates, are too high to compete in labour intensive manufacturing (which in turn is a by-product of the partial integration with the Israeli labour market and the massive aid inflows). But its productivity is not high enough to move easily into higher value added manufactured products. An analysis by Makhool and Atyani (2004) on data from 2002 suggests that wage productivity in Palestinian manufacturing, i.e. the value added of a dollar unit of labour, was considerably lower than that in other countries in the region, including Egypt, Jordan and Turkey. This penalty for Palestinian manufacturing vis-à-vis other economies specializing in labour intensive manufacturing, including India, Turkey, Philippines and Vietnam is confirmed by a more recent analysis using PCBS data and World Bank Enterprise Survey data for 2009 (Table 5.2).²⁴

These figures suggest that the Palestinian economy will not be able to rely on producing low value added, labour intensive goods that have been a key feature of the small Palestinian

²¹ Such work may include for instance sale, designing, installation and maintenance of renewable energy systems.

²² Author's calculations based on PCBS' National Accounts (data for 2010 is preliminary).

²³ Author's calculations based on various rounds of PCBS' Labour Force Surveys. We exclude employed in Israel and the settlements from the calculations to better reflect the sectoral composition across the Palestinian sectors.

²⁴ The comparison is obtained by matching data in the World Bank's Enterprise Survey database and the PCBS' Economic survey. This is not exactly precise due to the slight differences in sectoral definitions and survey questions between the two sources of data.

manufacturing sector so far. Palestine is not going to be competitive vis-à-vis countries with large pools of unskilled cheap labour (unless it is willing to accept much lower wages and levels of welfare). The recent decline in the apparel and leather and tanning industries, which have not been able to withstand the increased competition from East Asia, confirms this.

Table 5.2: Value Added to Wages for Selected Countries

	India 2006	Turkey 2008	Philippines 2009	Viet Nam 2009	West Bank 2009	Gaza 2009
Manufacturing	7.1	10.2	7.6	5.0	4.2	2.8
Garments	6.0	17.6	3.6	3.0	2.2	6.0
Furniture	8.4	NA	4.4	4.0	3.8	2.8

Sources: Elaborations on PCBS Economic Survey and World Bank Enterprise Survey

On the other hand, medium and high value added manufacturing has always played a marginal role in Palestine's industry with the pharmaceutical sector being perhaps the most relevant exception. However even the latter has mainly competed in the market for generics without any R&D component and with relatively low value addition (DAI, 2007). Low investments in capital (both in soft and hard equipments) have limited the development of higher value added sectors in Palestine and while this low fixed capital formation may be reversed in the absence of the Israeli occupation, Palestine does not seem to have a clear comparative advantage in capital intensive manufacturing production.

Exceptions to this general pattern can and probably will occur in a Palestinian state once the Israeli restrictions will be lifted, perhaps building on a strong tradition of food processing and furniture industries. Some of these firms, especially in the food sectors are starting to penetrate higher value added niches, such as organic, fair trade and specialty food production. Moreover there is probably some scope for expanding import substitution production in some relatively low value added light manufacturing and agro-industrial products, which are currently imported in large quantities. However due to the arguments detailed above, the bulk of the Palestinian tradable sector is likely to be outside manufacturing industries.

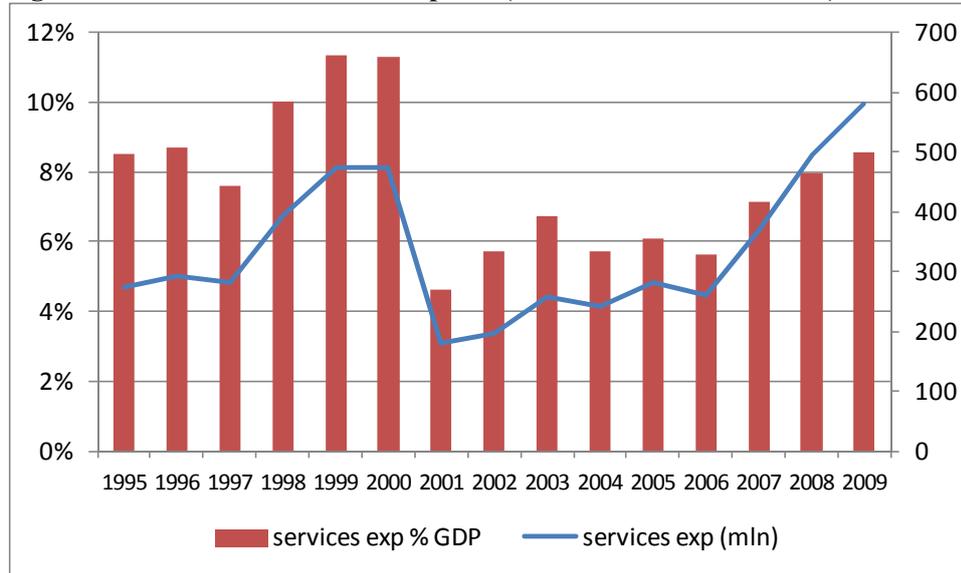
5.4 Tradable services

While the factors' endowment of the Palestinian economy is not particularly suitable for the development of agriculture and manufacturing, it seems to be more beneficial for tradable services, such as tourism, ICT, real estate and business services. Their production tends to be intensive in relatively educated labour, while requiring comparatively low capital, energy and natural resources. In addition services trade is less affected by transportation costs than goods' trade and this could be an important consideration in the short-run. Not surprisingly, services' exports have also been the engine of growth in many of the more successful small states with similar factor endowments.

Factors' endowment which is particularly suitable for the development of services along with the increasing tradability of services across borders due to technology improvements have helped Palestinian services export to grow substantially in the last decade (Figure 5.1). They reached almost USD 600 million in 2009, equivalent to over eight percent of GDP, against an

average of six percent in lower-middle income countries and 7.6% in MENA. This increase comes after a severe fall-back of services exports at the beginning of the first Intifada essentially due to the drop in the largest export category, tourism. After 2001 tourism has picked up again and has led the recovery of Palestinian services exports.

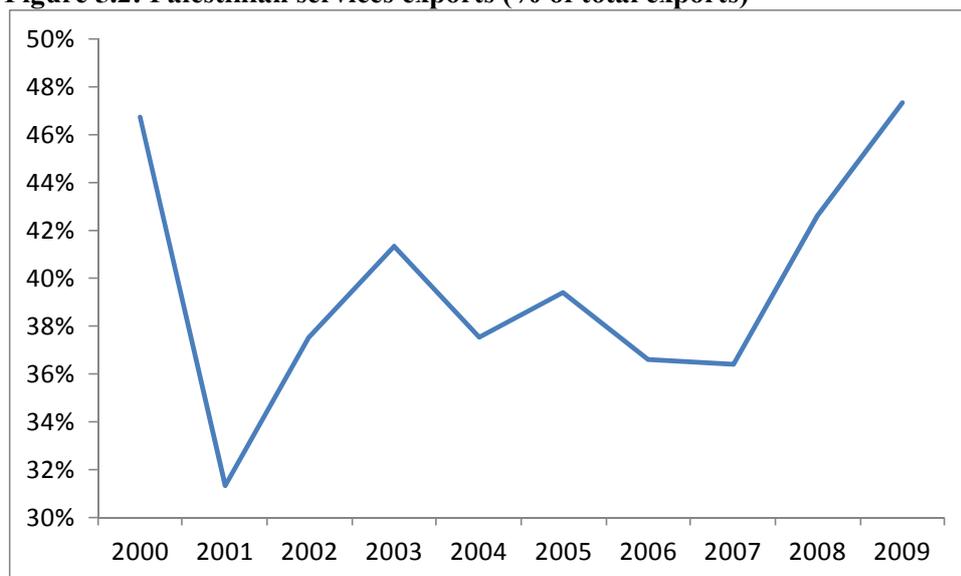
Figure 5.1: Palestinian services exports (USD mln. and % of GDP)



Source: Author's elaboration on PCBS data

After the drop in 2001 the growth of services exports has also been much faster than that of goods' exports and by 2009 services represented almost half of total Palestinian exports, a much higher share than most developing countries. This confirms that services production is better able than that of goods to withstand the restrictions imposed by the occupation regime and it is more in line with Palestinian factors' endowment, which tends to determine the production pattern in an open economy regime such as that of Palestine in the last decade.

Figure 5.2: Palestinian services exports (% of total exports)



Source: Author's elaboration on PCBS data

Notwithstanding the relatively good recent performance, Palestinian services exports with the exception of tourism are still in their infancy and they need to grow substantially before they can become one of the pillars of Palestinian economic sustainability. In addition, the level of sophistication in services exports should also be sufficient to support the relatively high cost structure in the oPt.

5.4.1 Tourism

Given the political instability and the severe movement and access restrictions imposed by Israel there has been relatively little tourism development in the oPt, but this situation is bound to change once the Palestinian state is formed and the stability resumes. To be sure there has already been a marked increment in exports of travel services (which is most closely related to exports tourism services) in recent years. These increased from USD 36 million in 2001 to USD 410 million in 2009. This massive rise is mainly explained by the improvements in the security environment in the West Bank since 2003, which have attracted an increasing number of foreign tourists, mainly Christian pilgrims.²⁵ Unfortunately, although there are no firm figures about it, vast numbers of pilgrims do not stay overnight in the West Bank when they visit religious sites there and in the case of the Nativity Church often their visit is not even associated with any expenditures in the West Bank.

It is easy to envisage that once a Palestinian state gained sovereignty over its own territory, borders and over Jerusalem, it would also be able to attract sizable flows of Muslim pilgrims aside from increasing numbers of Christian pilgrims. In addition, the abundance of health, leisure and sport/adventure amenities spread over a small territory would increase considerably the attractiveness of a country, which may well become one of the main centers of Middle Eastern tourism. For example the commercially successful experience of the Jordanian Dead Sea, right across the West Bank side, confirms the potential for a possible rapid development of tourism on the Palestinian side. On the basis of the tourism revenues on the Jordanian side of the Dead Sea, MoNE and ARIJ (2011) estimate that the potential revenues generated only by hotels in the Palestinian Dead Sea to exceed USD 200 million per year. Given these figures, the consolidated tourism industry in an independent Palestinian state is likely to be worth various billions of dollars in foreign exchange revenues and several tens of thousand direct and indirect jobs.²⁶ The sector would continue to be among the largest exporters around which a sizable portion of the Palestinian economic sustainability may be built.

The provision of tourism services is intensive in labour (mainly but not only relatively unskilled) and it could also take advantage of labour and capital by Palestinians in East Jerusalem, who could bring in their experience in the sector. Other than the private capital to establish hospitality structures, public infrastructure is needed to facilitate the connection of the West Bank with the rest of the region and of the world. This includes in particular an international airport and border crossing agreements with the neighbouring states.²⁷

²⁵ This is supported by the findings of a survey among tourists who have spent at least a night in the West Bank in 2009 (PCBS, 2009c): the most visited sites during the trip were all Christian sites, including the Nativity Church, the Church of the Holy Sepulchre, Old Jericho and the Church and Gardens of Gethsemane.

²⁶ The hotel and restaurant sector was employing around 10,000 workers in 2010 according to PCBS' labour force data.

²⁷ An important question for the future tourism sector in Palestine revolves around the status of Jerusalem, e.g. completely divided or connected city, including the Old City (see Arnon and Bamyra, 2007), but this goes beyond the scope of this study.

5.4.2 Real estate and related services

Not only would a sovereign and independent Palestinian state have the potential to attract a large amount of international tourists, but it would also be likely to attract Palestinians from the Diaspora into the new country. Some of them – including perhaps some returning refugees according to how the ‘refugee issue’ will be settled - would settle down in Palestine. Others may just want to establish a stronger connection with Palestine without moving their residence there but establishing a base through a second home. Some Palestinians from the Diaspora are already doing that even in the current conditions but the level of such investments is expected to increase dramatically once an independent Palestine arises. The result is expected to be a considerable amount of foreign exchange being channelled to fund the construction and the purchase of new houses. Such resources would essentially be fuelling real estate and construction services exports by Palestine, and may well play an important role to maintain the economic viability of the state. In addition, auxiliary services would be needed such as maintenance, repair and cleaning services.

Somewhat similarly to tourism, the provision of these types of real estate related services will require a variety of labour types, from relatively unskilled construction workers to medium-skilled estate agents, to highly educated professionals, such as engineers, designers and architects.

A rapid expansion of real estate services would require functioning land markets, flexible and competent labour markets, efficient municipal and regional administrations. There would be potentially major implications in terms of land titling, urban planning and infrastructure development, for which it would be worth starting to prepare sooner rather than later. In particular, land titling and urban planning are activities which would be valuable to invest in already at this stage as they appear to be possible bottlenecks to an orderly expansion of the Palestinian population (regardless of the rise in the demand for new housing).

On the other hand, whether the increased demand for the provision of such services will also pose strains on the tertiary education sector is something that is difficult to anticipate at this stage.

The experience of the largest housing development recently undertaken in the oPt, the Rawabi complex, may provide useful lessons on the challenges facing large residential housing expansion.

5.4.3 ICT services

Information and communications technology (ICT) is one of the fastest growing traded services worldwide. Technology advances as well as the rapid pace of diffusion of electronic equipment have fuelled this growth which has benefited a number of developing countries.

In particular offshoring services represent the bulk of ICT exports by developing countries. The last decade has seen a dramatic rise in the offshoring of services, virtually all concentrated in two broad categories: Information Technology (IT), and the Business Process Outsourcing (BPO). India has been the leading offshore destination during this period, but China and other large developing countries especially in Asia have also increased their exports dramatically. Such countries enjoy a mix of cost advantage due to low wages and

availability of skilled labour. Using these two criteria along with the quality business environment at Kearney (2011), large Asian countries are ranked as top destinations for offshoring activities in 2011. Interestingly the MENA region has become an increasingly attractive destination thanks to its proximity to Europe as well as vast pool of talent. As a matter of fact Egypt was the fourth best destination according to the ranking just before the beginning of the political unrest which swept the country.

In line with the rest of the region the oPt is starting also to be recognized as a possible IT offshoring destination with a number of IT companies being created and expanding through such services exports, especially in West Bank.²⁸ Frank Mueller, AXSOS AG CEO explaining the reason behind choosing Ramallah as their first branch in the Middle East declared: “There is a high education rate, wide international exposure, a large number of IT graduates, in addition to the oriental hospitality and friendliness in Palestine. This attracted us to invest in the market.” (Maan News, 2011). Although labour cost in Palestinian ICT is slightly higher than larger markets such as China and India, it is still much cheaper than Europe, North America and Israel while providing a comparable quality for standard outsourcing services.

The increase in IT offshoring activity has helped spur the recent growth of the Palestinian ICT sector. Employment in computer related sectors is estimated at almost 2,500 in 2010, a four-fold increase since 2001 (Figure 5.3). It is still a relatively minor sector, accounting for 0.3% of total employment but its share has increased six-fold in the last decade. While IT offshoring activities may hold most potential for employment growth in Palestinian ICT sector, their value added remains relatively modest. In addition much of the offshoring carried out by Palestinian firms is currently linked to Israeli companies (which in turn are often sub-contractors for other firms), which may be a problem to the extent that Palestine wanted to reduce dependence from Israel. Therefore some observers argue for the development of original IT services through in house research. This is more onerous than IT offshoring services as it entails relatively large research and development investments. The latter may not be easily funded especially given the current market conditions in the oPt. It is possible that eventually a combination of the two types of IT services exports may emerge in Palestine.

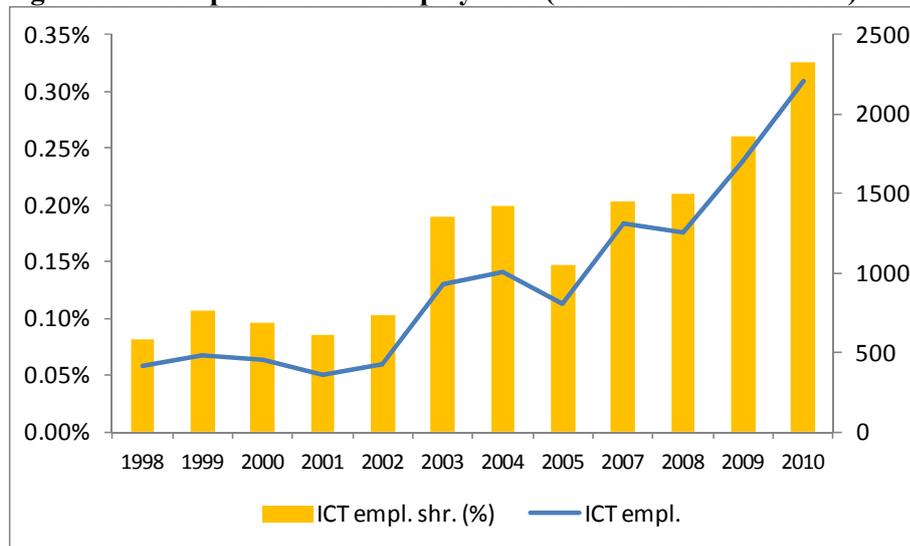
An analysis by NASSCOM-McKinsey (2006) indicates that the potential market for global offshoring exceeds US\$ 300 billion, with the global BPO industry expected to grow at even higher rates than the rest of the offshoring services. BPO growth is driven largely by traditional industries (e.g., retail banking) and cross-industry functions such as human resources and finance and accounting. These developments may be opening windows of opportunities for Palestine, which for example could leverage on its relative abundance of skilled labour (including a fairly good English knowledge) to develop for instance regional call centers and back office operations.

This has not happened yet due to two main issues: restrictions on visa for foreigners accessing the oPt, which prevents the easy entry of potential foreign investors, quality and costs of telecommunication services. Note that these two problems are also relevant for IT services exports although not to the same extent as for BPO. In addition a constraint which may become more biting as the industry grows is the availability of a sufficient quantity of IT related graduates with the right skills for the industry needs. An oft-quoted figure in

²⁸ However there are few such examples in Gaza as well.

conversations with IT experts is the 2,000 strong batch of IT related graduates every year. However questions remain as to the extent to which their skills are relevant to the labour market requirements.

Figure 5.3: Computer related employment (% in total and absolute)



Source: Author's elaboration on PCBS Labour Force Survey

5.4.4 Other possible services exports

Other tradable services sectors are relatively less developed in the oPt so far. However that does not necessarily indicate that they may not hold important potential in a future Palestinian state. Without any ambition of being exhaustive or even of picking those with more potential, we mention here a couple of examples of other tradable services sectors that may help the economic sustainability of the state: business services exports via temporary movement of people and educational services.

The relatively large idle skilled labour force in the oPt may provide a valuable opportunity to supply business services via temporary movement of skilled and semi-skilled labour. The opportunity may be feasible especially towards neighbouring countries, which are currently importing much of these services from other developing countries. Typically the provision of those services requires the movement of individual or teams of professionals for a limited period of time in the importing country. That is the case for example of teams of engineers and architects overseeing a construction project; or a doctor or a nurse spending regular stints in a foreign hospital to fill shortages of personnel on a rolling basis.

This type of service provision which in WTO language has come to be defined as “mode 4” trade in services, has been expanding rapidly over the years as the labour markets have started to respond more flexibly to skills mismatch across countries. Opportunities exist already in the provision of architectural, design, engineering, IT and health services on a temporary basis to various countries in the Middle East, especially in the Gulf, a sovereign Palestinian state may tap into especially once mobility restrictions imposed by the occupation have been lifted. This type of service exports would allow Palestine to use part of its educated labour force and would have the advantage of not generating any domestic loss of skills as it

is the case with permanent migration. Bilateral agreements with importing countries may eventually be useful to facilitate and regulate this type of services exports (Amin and Mattoo, 2007).

The mirror image of the services exports via “Mode 4” is the export of the services provided by Palestinian companies that customers from abroad come to experience upon their arrival in Palestine. This is a form of service sale that the oPt is already exporting, especially as far as retail services are concerned. These are exported mainly to the relatively large number of Palestinians citizens of Israel flocking into West Bank cities, especially in the north, to do shopping, repairing their cars, etc. Before the outbreak of the second Intifada such type of export also included other Israeli citizens, and it is likely to expand in case a political settlement is found. The positive feature of this type of export is that it is labour intensive. However, the value added is limited but it could be useful to support the employment of relatively unskilled and semi-skilled labourers.

Finally, to the extent that Palestine may want to develop a service based economy as a means of attaining economic sustainability, the role of educational services, especially post-secondary education, becomes crucial. This includes both university education as well as technical and vocational education and training (TVET). Other successful countries such as Singapore have managed to become large services exporters by investing greatly in this type of education, which in turn has allowed them to become important exporters of education services. Developing high quality tertiary education services could allow Palestine to become an educational centre at the regional level potentially attracting students from across the region as well as from the Diaspora. This however would require structural reforms in the Palestinian tertiary educational system, creating centres of excellence, attracting investments in education and high calibre academics to Palestinian universities. Whether this will be feasible even in a sovereign Palestine is matter of speculation, but the advantage for Palestine is that it could count on a relatively high tertiary enrolment rate and a generally widespread culture of valuing human capital accumulation.

6. Policy implications

The previous section has argued that considering its factors' endowment and the experience of successful states with similar characteristics, a possible viable Palestinian economy would be likely to rely on tradable services, and to some limited extent also on natural resource based industries (especially if enough capital can be mobilised). If Palestinian policy-makers want to develop a strong tradable services sector, they should explicitly make services trade a priority of the economy and then orient much of the economic policies around it. That has been the path that most of the successful small developing states have followed, as explained in section 3. Importantly that is not far from some of the Palestinian economic priorities set in the National Development Plan, i.e. the development of a knowledge-based economy.

Focus	Justification	Objective
<ul style="list-style-type: none"> On tradable rather than non-tradable services: tourism, ICT, real estate and business service 	<ul style="list-style-type: none"> Services production is more in line with Palestinian factors' endowment (well educated work force, low transportation costs, high value added) Better able than that of goods to withstand and circumvent the restrictions imposed by the occupation regime 	<ul style="list-style-type: none"> Improve current economic performance and socio-economic situation Promote economic sustainability and livelihood in Palestine

What kind of policy priorities could follow from this type of specialisation? We analyse this question in turn, by providing but some examples of possible policies that may help the specialisation pattern envisaged and identifying ways how to pursue them. This is

by no means an exhaustive list, let alone a policy formulation exercise, which would also require other complementary types of analysis. However it provides some useful examples of the kind of policy implications that could follow through from the identification of a possible broad economic specialisation pattern.

Given the unique challenges of the Israeli occupation for the Palestinian economy, these policy implications need to be distinguished between those policies which could be implementable in the short-term (i.e. even under the occupation regime) and those that are possible in the long-run only. Given the prominence of area C in the Palestinian territory and its special restrictions that it is subject to, we also briefly review the potential implications for Area C of such an economic specialisation.

6.1 Short-term

As argued above, the restrictions imposed by the Israeli occupation are the most relevant constraints to the development of the Palestinian economy. Challenging those restrictions should be a policy priority in the short-run. It is unlikely that such restrictions may be lifted all at once, and in fact there has so far been a very slow piecemeal approach to the lifting of restrictions by Israel. In this context there may be a case towards prioritising the lifting of certain restrictions on the basis of the sectors that policy-makers may want to promote.

Our analysis of possible specialisation pattern suggests prioritising restrictions particularly harmful for services trade. There are two types of such restrictions, i.e. *restrictions to the free mobility of persons*, especially entering the oPt (but in the case of Gaza also exiting), and

TLC related restrictions, in particular related to the release of frequencies and to the import and placement of TLC equipment.

Prioritize areas of negotiation to limit Israeli restrictions

What area	How to pursue negotiation
1. Restrictions to the free mobility of persons	<ul style="list-style-type: none"> - remove restrictions on visa for foreigners accessing the oPt, which prevents the easy entry of potential foreign investors, quality and telecommunication services - work to address visum issues through foreign embassies - employ ILO expertise to promote specify agreements that facilitate mobility
2. TLC related restrictions	<ul style="list-style-type: none"> - promote bilateral agreements with importing countries to facilitate and regulate services exports (temporary labor movement) - For Palestinian firms, use Israeli traders for international commerce
3. Limited Israeli access to Palestinian natural (water) resources	<ul style="list-style-type: none"> - Start with working to limit restrictions on marble and stone fields, then expand to other mines and quarries in Area C - Negotiate access to Dead Sea Salt and mineral resources - Allow exploitation of natural gas in the Gaza marine offshore field

The former type of restrictions hinders face-to-face interactions, which the development of much of trade in services often relies on. For example in the case of IT related trade, technicians need to be able to get into the country for reparation and maintenance almost in real time; perspective clients need face to face interactions before choosing a software supplier, a designer or engineering company; businesses need to visit the place where their perspective investment is going to be based, e.g. establishing a call centre or back-office operations; foreign instructors must be able to enter and exit the country to provide educational services. The difficulty and uncertainty about visa for foreigners (Paltrade, 2010a) complicate greatly these types of activities.

Tradable services, especially the more sophisticated ones, need to rely also on efficient and high quality TLC services in order to be competitive. These services are undermined by various restrictions imposed by the occupation regime, including the delay in releasing additional 2G spectrums, the refusal to release the WiMAX frequencies, the delay and confiscation of equipment, the restrictions to operate in Area C and to import the necessary equipment (Paltrade, 2010b). This has stifled the development of the TLC services and this may help explain why the oPt has today less fixed telephone, less mobile subscriptions and less secure internet server density than the MENA region and the Arab world (source: World Bank, 2012).

Economic activity within the oPt

What area	How to pursue it
1. Improve post-secondary education system to better tailor the curriculum to the needs of youth and employers	<ul style="list-style-type: none"> - structural reforms in the Palestinian tertiary educational system, creating centres of excellence, attracting investments in education and high caliber academics to Palestinian universities - more intense and systematic cooperation between universities and industry to shape the industries-relevant elements of degree programs as well as to provide students with work experience during their studies; for example through mapping of assets and needs and public-private partnership initiatives
2. Initiative incentives for clean energy production	<ul style="list-style-type: none"> - Promote legislation through exchange of best practices
3. Induce more competition into the TLC sector	<ul style="list-style-type: none"> -
4. Resource-management	<ul style="list-style-type: none"> - Prioritize available resources: industrial water usage over agricultural water usage as both the industrial and the services sector generate far more output per unit of water than agriculture

	<ul style="list-style-type: none"> - Promote high value added export-oriented agriculture - Develop legislation to facilitate renewable energy production
5. Food sector (as part of manufacturing)	<ul style="list-style-type: none"> - penetrate higher value added niches, such as organic, fair trade and specialty food production in line with factors' endowments - expand import substitution production in relatively low value added light manufacturing and agro-industrial products
6. Tourism	<ul style="list-style-type: none"> - improve infrastructure for Muslim and Christian pilgrims to stay - exploit abundance of health, leisure, and sport/adventure amenities
7. Real estate and construction services exports	<ul style="list-style-type: none"> - promote auxiliary services such as maintenance, repair, and cleaning, including a variety of labour types, from relatively unskilled estate agents to highly educated professionals, such as engineers, designers, architects. - Introduce functioning land markets, flexible and competent labour markets, efficient municipal and regional administrations, with a focus on land titling, urban planning and infrastructure development

Along with the Israeli restrictions, also the lack of progress on the domestic front has stifled the development of an efficient TLC sector in the oPt. In fact the Telecommunications Regulator Law was passed, which created a competition law and specialized regulatory agency for telecommunications sector, but the establishment of the actual institution was stalled. Even if this agency were established, in the absence of a broader regulation, competition would remain a challenge. The recent introduction of a new mobile company operator, Watanya, has spurred some competition in mobile telephone, but PalTel retains a de facto monopoly in the fixed landline and broadband (ADSL) services. This is reflected in relatively high prices for internet services along with a less than satisfactory bandwidth available to customers due to the lack of investments in the existing local land broadband infrastructure run by PalTel (Paltrade, 2010b).²⁹

Aside from the areas of negotiations which explicitly hinder the development of services, there are other important areas which generally stifle economic development in the oPt. In particular, the very *limited access to water resources*, the *movement restrictions within the West Bank* and the *building restrictions in Area C* are cases in point which could be prioritised in the negotiations in the short-run. As discussed above, access to water is highly problematic in the oPt mainly due to the unequal allocation of water in the West Bank. This has clear social but also economic implications. Not only is this the main constraint to agricultural development, but it is also a constraint on the expansion of practically any other economic activity. That is the case also for the restrictions on the movement of persons and vehicles within the West Bank imposed by Israel. Indeed according to IMF (2010) one of the main factors behind the recent growth of the West Bank economy has been the easing of these restrictions. However many of them are still in place hindering the movement of labour and goods and are estimated to cost the Palestinian economy close to USD 200 million per year (MoNE and ARIJ, 2011). Also, restrictions in Area C are highly problematic as this constitutes most part of the oPt and is currently the least built area in the occupied Palestinian territories, so it should also provide the physical area for any major expansion of economic activities in Palestine. Challenging such restrictions is likely to be more feasible through small-scale projects.

In addition, the analysis above points also to the need of developing skills which are relevant in particular to the production of tradable services, as this is intensive of relatively skilled labour. The oPt exhibits high levels of school attendance and literacy, but firm level evidence

²⁹ The lack of such investments is disputed by PalTel. While some hold the view that PalTel does not commit to new investments as the cost of infrastructure development is relatively high compared with the expected profits, PalTel contends that new investment in infrastructure is usually delayed and hindered by the Israeli restriction on Area C coupled with the delay and confiscation of imported equipment (Paltrade, 2010b).

suggests that a key constraint for firms – especially in the tradable services sector – is the mismatch between the graduates’ skills and the needs of the labour market as well as the level of competencies and experience of graduates.³⁰ For example, although the Palestinian tertiary education system produces around 2,000 IT related graduates per year, only some of them possess skills that make them actually employable in the IT sector. This calls for a piecemeal reform of the post-secondary education system in the short-run, particularly university education in order to better tailor the educational curriculum to the needs of youth and private employers. While we do not discuss the actual needed reforms here, a key element should include more intense and systematic cooperation between universities and industry to shape the industries-relevant elements of degree programs as well as to provide students with work experience during their studies. In the long-run a more radical restructuring of the entire tertiary education system may be envisaged (see below).

As mentioned, the development of renewable energy production could be an important way to reduce the dependence on energy imports. This development would need active legislative intervention by the government to create (tax based or otherwise) incentives for such clean energy production. In addition, in order to stimulate production the regulation should also permit and possibly incentivise (as in most OECD countries) the sale of electricity generated through renewable sources on to the grid.³¹

6.2 Long-term

Free of the occupation regime and with a contiguous territory comprising the West Bank, including East Jerusalem and Gaza, an independent Palestinian state could unleash the economic potential of its factors’ endowment. In order to take advantage of the opportunities arising from the economic specialisation envisaged above, the state should develop appropriate physical infrastructures and adequate skills to support a services based specialisation, and should implement an open trade regime intensifying its links with the Arab states.

It is beyond the scope of this paper to provide the details of such policies for an independent Palestinian state. Also, these have already been treated extensively elsewhere as noted above. Here we are more concerned about highlighting the types of policies relevant to the economic specialisation discussed above.

In the long run, appropriate TLC and electricity infrastructures will be key for the competitiveness of the tradable services sector. This would require a considerable amount of funding for infrastructure development, which however could be eventually covered by the increased production (and taxation). Also, physical connectivity with international markets will have to be guaranteed by adequate airport and road infrastructure. While the latter is already relatively well developed, large investments would be needed for the development of one (let alone two) international airport, which could be built on the site of the current airport in Gaza. Such investments may be feasibly covered through public-private partnership considering the large expected flow of persons (e.g. tourists, business people, Palestinian Diaspora) using this infrastructure.

³⁰ This is based on USAID (2010), on recent unpublished World Bank data as well as on our own interviews with Palestinian services firms.

³¹ For instance in the case of solar power other than creating the legal possibility to sell the solar energy to the system, this also requires to connect the solar panel powered system to the electric grid.

Large investments would be needed also for the exploitation of natural resources to which Palestinians have currently no access. These would be needed for the purchase of sector-specific capital as well as the development of public infrastructure such as roads and electricity. As the return of sector-specific capital investment would be mainly private, most of the investments in these sectors would most likely be private as well.

The large size of such economic investments call into question the extent to which the resources needed for the development of a viable Palestinian economy would be likely to materialise in the long-run. This is a complex question and we can only speculate about it. However some signs suggest that in fact a sizable amount of financial (as well as human) resources may be available to feed the investments needed. First, part of the large amount of Palestinian assets currently invested in Israel and the settlements is likely to flow back into a Palestinian state as expected returns to investments there improve. Smeirat (2011) estimates that between 2.5 and 7 billion USD is currently invested by Palestinians in Israel and the settlements. The main reasons why these resources are not invested in the oPt have to do with restrictions imposed by the occupation, e.g. constraints to imports, high electricity costs, lack of business network abroad. Once such restrictions are removed it is likely that at least part of these resources flow back to Palestine. Second, anecdotal evidence suggests that also Palestinians in the Diaspora possess resources that could be invested productively in the oPt should the restrictions of the occupation be lifted. Third, it is likely that the international community may keep providing and perhaps even step up its support to a new Palestinian state, as it would have an interest in helping ensure the economic viability of the state as a way to enhance the political stability of the region. Finally, a Palestinian state could provide opportunities to non Palestinian investors as well, particularly from the region.

The other key factor of production for the long-term competitiveness of the Palestinian economy would be appropriate skills, especially as much of the sustainability of the economy could hinge on the services sector. In the long run this calls for an overhaul of the entire education system, particularly the post-secondary one. As in the case of other successful small states, such as Singapore and Mauritius, the cornerstone of the development of a knowledge based economy would be a university system acting as the centre of innovation in close cooperation with industries. This would have to incentivise competition between university centers to attract both high quality researchers and students. It would need to reward quality research becoming a centre of excellence at the regional level. As in many successful developing countries, the post-secondary system should also develop effective TVET programs to feed industry needs for less skilled more technical types of human resources. Again, close involvement with the industry would be key to the success of such programmes, especially in areas such as curriculum content, training, and internship opportunities is needed, to ensure up-to-date curricula in line with industry requirements.

6.3 The role of area C

While the entire Palestinian territory would be involved in the structural change required for the development of a sustainable economy, a particularly important role would be granted to Area C. That is due to the fact that it contains most of the land of Palestine, around 57%, and the vast majority of the space for any urban or economic expansion, as it is the least built-up area in the oPt. Area C would provide the space to create new urban centres and expand existing ones, where much of the new tradable services activities should take place. It also holds economic potential in other sectors as well, including economically valuable resources in agriculture, tourism, manufacturing and mining and quarrying.

Area C is likely to play a central role in any spatial economic planning in Palestine because to develop services and other non goods in Area C will likely benefit the production of other goods and the rest of the economy as well (whether agriculture, industry or services), such as water, energy, telecommunication, transportation, etc. Most of major infrastructure projects including national roads, railways and airports; water and electricity networks are likely to be based in Area C. These should also allow for the “de-cantonisation” of the West Bank, i.e. the strengthening of the connection between the different areas in the West Bank so as to create a truly integrated market.

Area C

Action	How to pursue it
- maintain agricultural activity in all possible land to 1) resist attempts to de-populate the area from current Palestinian dwellers and 2) integrate market	- maintain low-intensity economic activity, including agriculture, energy production, mining and quarrying and small-scale productive activities in manufacturing and services - create new urban centers and expand existing ones - focus infrastructure projects, including national roads, railways and airports; water and electricity networks here

The importance of Area C to the economic sustainability of Palestine suggests a possible two-pronged approach vis-à-vis this area in terms of economic planning. On the one hand there is the need for the Palestinian to ‘holding on’ in spite of Israeli pervasive restrictions in Area C. This would involve trying to resist any attempts to de-populate the area from the current Palestinian dwellers, for example by maintaining low-intensity economic activity in Area C, including in agriculture, energy generation, mining and quarrying and small-scale productive activities in manufacturing and services. This is by no means an easy task and will not depend only on the will of Palestinian policy-makers, but the potential success of this strategy is likely to be higher, the higher the importance attached to it.

On the other hand, spatial economic planning would have to exploit the existing structure of Area C: concentrated urban areas – i.e. the settlements – connected by an efficient road network and supplied with public utility by a well developed infrastructure network along with little or no infrastructure development in the areas currently inhabited by Palestinians. The challenge for spatial planners would be to use the existing stock of infrastructure to take advantage of economic opportunities in various sectors and connect the areas currently underserved with the rest of the economy.

7. Conclusions

This study has proposed a few options for a possible specialisation of the Palestinian economy, with a view of ensuring its economic sustainability and raising income levels in the long-run. The time frame is intended to be one in which the foremost constraint to Palestinian economic development, i.e. the Israeli occupation, has been removed. This is the necessary (but not sufficient) condition for a viable Palestinian economy. To this end, the paper has also proposed some short-term policy options to promote existing economic opportunities.

The analysis of Palestinian geography and factors' endowments as well as of other small states with similar characteristics as the oPt suggests that tradable services are likely to be the cornerstone of the specialisation of an independent Palestinian economy. These sectors are most in line with Palestinian factors' endowments, rich in idle relatively skilled labour and religious, cultural and natural amenities. Aside from services, some natural resource based industries, high value added export oriented agriculture and energy production may help support a viable Palestinian economy.

We argue that these options for a possible sectoral specialisation may carry some implications for policy both in the short- and in the long-run. We have suggested a non exhaustive list, which includes examples of short- and long-term policies. The former include prioritising areas of negotiations with Israel more relevant to the specialisation envisaged, i.e. restrictions to the free mobility of persons, TLC related restrictions, limited access to water resources, and building restrictions in Area C. In addition, other short-term policies in line with the specialisation proposed include a piecemeal reform of the post-secondary education system to better tailor the curriculum to the needs of youth and private employers, legislative intervention to create incentives for clean energy production and to induce more competition into the TLC sector.

In the long run a considerable amount of funding would be needed, especially for infrastructure development such as TLC, electricity and physical connectivity but also for the exploitation of natural resources. Some signs suggest that a sizable amount of financial resources may be available to feed the needed investments drawing on current Palestinian investments in Israel and the settlements, on the Palestinian Diaspora, and on the international community. In addition the development of a knowledge-based economy necessary for trade in services calls for an overhaul of the entire education system long run, particularly the post-secondary one.

Finally, the importance of Area C to the economic sustainability of Palestine suggests a two-pronged approach in terms of economic planning: first resisting attempts to de-populate the area by Israeli restrictions, e.g. by maintaining low-intensity economic activity; second, exploiting the existing structures in the long-run by using the existing infrastructure and connecting the areas currently under-served with the rest of the economy.

Far from establishing a firm set of policy priorities, we view this study just as a possible contribution towards a needy discussion on the type of economy that Palestine would want to be in the long-run and what type of policy options may be most effective towards that end.

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