

TOWARDS SUSTAINABLE PALESTINIAN DEVELOPMENT

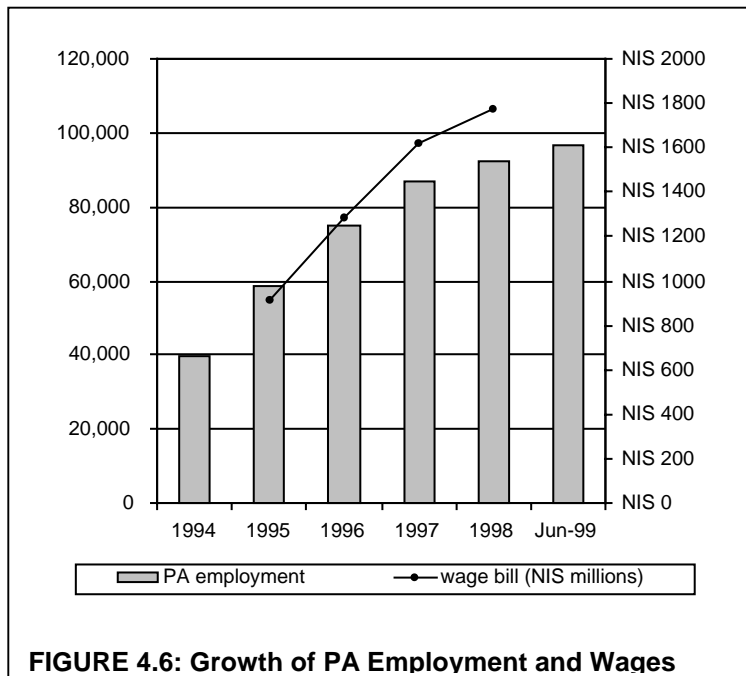
- 4.1. At the outset of the current program of assistance to the WBG in 1993-94, donor support was driven by two urgent priorities. The first of these imperatives was to support the establishment of the Palestinian Authority and to build—where none had existed before—the institutions necessary for self-government. The second imperative was to signal—to Palestinians, the region, and the world—the strong commitment of the international community to support progress towards peace in the Middle East. In this context, it was essential that Palestinians experience, as part of the fruits of the peace process, tangible improvements in their everyday lives. In both of these pressing tasks, issues of sustainability, while not irrelevant, were typically secondary to other considerations.
- 4.2. Whereas both the donor community and the PA always envisaged a shift from emergency and transitional assistance to longer-term public investments, this was delayed in 1995-96 by an extended need for budgetary support for the PA, as well the devastating effects of closure. Faced with economic decline and the growth of unemployment, donors devoted significant resources to quick-impact employment-generation programs. Within the PA, increased public sector hiring reflected political pressures to absorb returning PLO cadres, reintegrate ex-detainees and other local activists, and offset high unemployment in a rapidly growing labor force.
- 4.3. Today, both donors and the PA need to devote much greater attention to the long-term sustainability of public investments and Palestinian economic development. In particular, several factors loom on the short- and medium-term horizon which could pose a significant challenge to sustainability. These include a potential fiscal squeeze due to a growing public sector wage bill and other recurrent costs; demographic pressures; changes in the volume and composition of donor assistance; and a range of issues related to permanent status arrangements.

Fiscal Challenges

- 4.4. The fiscal challenges facing the PA are clear: potential revenue growth is limited, while recurrent costs have continued to grow. As the World Bank has previously argued, the PA currently faces periodic liquidity problems, and “risks facing a growing revenue gap in the coming years” (World Bank 1999g, 20).

4.5. As noted above in Section 2, the PA has made impressive strides in strengthening revenue collection, with actual receipts often exceeding projections. However, there remain only marginal potential gains in this area through increased efficiency. Any future growth in revenues will therefore be due either to (desirable) underlying economic growth or (undesirable) increases in the tax burden.

4.6. Donors have expressed mounting concern at the continued growth of the public sector—and hence of the public sector payroll. Between 1995 and 1998, these grew at an average annual rate of 25 percent and 16 percent per year respectively, compared to a general population growth rate of 4.5 percent per year during this same period (Figure 4.6). As a result, some 14 percent of the entire Palestinian labor force is presently employed in the public sector (16 percent if UNRWA is included), compared to 12 percent in



Egypt, 10 percent in Jordan (11 percent with UNRWA), and 10 percent in Tunisia. In 1998-99, 58 percent of the PA's of current expenditures were devoted to salary, well above the MENA average of 45 percent and over twice the world average (World Bank 1999g, 55-56). In the draft PA budget for the year 2000, this proportion is slated to grow further, to almost 60 percent.

4.7. It should be noted, moreover, that civil service salaries are generally low, and have eroded in real terms since the establishment of the PA. If public sector employees were to receive the pay increases proposed in the 1998 Civil Service Law, the wage share of the recurrent budget would increase further.

4.8. While the wage component of the PA's recurrent budget has received much critical attention from the donor community, it is important to recognize that there are a number of non-wage items which are also cause for concern. In many sectors, significant recurrent costs—for example, the printing of school textbooks—have been met by donors. As a consequence, the current budgets of line ministries often underestimate the actual costs of program operations. Similarly, the PA allocates relatively few resources for facility maintenance, especially in the case of new investments where some of these

costs are incorporated into project costs in the short run. In the education sector, for instance, the Ministry of Education has no allocated budget from the Ministry of Finance for maintaining school buildings, resulting in very limited resources for school maintenance—around NIS1 million per year—which is taken from a small fee paid directly by students.

- 4.9. The recurrent costs of donor investments can be substantial. A recent World Bank study (1998b) estimates that the investment priorities of the Ministry of Health could result in an additional US\$48 million in recurrent costs per year by 2002, or 30-35 percent of the Ministry's projected current expenditure. Similarly, donor capital investment in the education sector since 1993 has stimulated new non-wage recurrent costs for maintenance and supplies, quite apart from the need to hire and supervise new teachers. And the estimated cost to maintain *new* schools stood at over US\$1 million in 1999, or more than four times the actual maintenance expenditures for *all* PA schools.¹
- 4.10. At present, the issue of recurrent costs is addressed in several ways within the development planning process. At the level of projects, donors usually require assurance of the sustainability of the initiatives that they support. However, because this analysis is done on a project-by-project basis, it provides little real indication of the future sustainability of overall sectoral or ministry capital expenditures, nor does it address the aggregate impact of donor projects on the total PA budget. Therefore, donor projects that appear individually sustainable within a line ministry's budget may be unsupportable in total. Internally, most PA ministries do not look at the recurrent cost implications of their projects beyond the planning horizon of the project itself, and typically seek donor financing for these costs in any event. Ministry plans tend to focus on a relatively short time-frame of 2-3 years; moreover, most ministries are ill-equipped or inexperienced in assessing the long-term costs of new initiatives.
- 4.11. The Ministry of Finance currently requests that PA ministries supply estimates for their developmental budgets, but the sophistication of future budget planning varies widely across ministries. Moreover, this process does not necessarily link current development plans and future recurrent expenditures. PA officials admit that it may be several years before a streamlined system can be developed that fully anticipates the recurrent cost implications of investments on the overall budget.
- 4.12. In its present form, the Palestinian Development Plan does not provide a clear picture of the future costs associated with each project. However, MOPIC does require line ministries to provide recurrent cost projections for all projects submitted for inclusion in the PDP, and sustainability is one of the criteria used in the PDP screening process. Theoretically, excessive future costs could be grounds for excluding a project from the PDP, unless other means of sustaining those costs can be identified. In practice, however, this rarely occurs; only large projects with obvious recurrent cost implications have been questioned. Moreover, future cost projections from PA line ministries differ widely in terms of both quantity and quality. MOPIC is attempting to develop its own

methodologies for estimating future costs in an attempt to provide an additional check on line ministry estimates. These would identify typical cost ratios associated with different types of projects, based on past projects as well as comparative international experience. This process is still in the early stages, however, and has yet to be effectively integrated into the development planning process. The World Bank and other donors are providing assistance to MOPIC to help it develop these future cost projections. Similar assistance is also being provided to the Ministry of Education and the Ministry of Health.

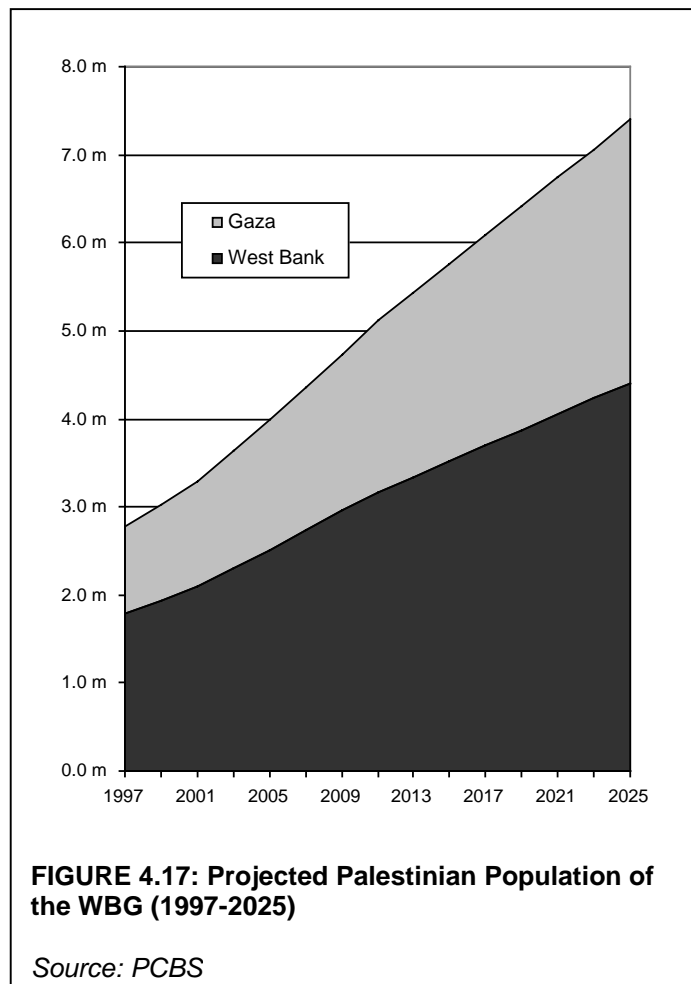
- 4.13. Too little attention is devoted to the potential contribution (or lack thereof) of local communities to sustain projects. This is particularly important in community development projects, interior road construction, small water and sanitation projects, and similar initiatives. This oversight (whether by major donors or the PA) tends to undermine other efforts to encourage local communities to shoulder the recurrent costs for community projects.
- 4.14. In the absence of sufficient attention to future maintenance and running costs, donors risk seeing their investments age prematurely or otherwise become unsustainable. Donors themselves must take some initiative to assure that their programs enhance the capacity of Palestinian institutions to carry on after project completion. However, the main efforts in this area must come from the Palestinian side in the context of an overall policy of sound budgetary management. To achieve better control over future recurrent costs, both the Ministry of Finance and MOPIC will need to ensure that budgetary and development planning processes include robust estimates of the future implications of planned development expenditures. Line ministries need to strengthen their ability to undertake such estimates—an area where there is scope for expanded donor assistance. Such efforts will only bear fruit, however, to the extent donors utilize the PDP as a framework for targeting and prioritizing investments. In the absence of discipline by donors and the PA, well-intentioned donor investments (and equally well-intentioned donor-financed capital investments by PA line ministries) could have the perverse long-term effect of saddling the PA with an increasingly unbearable level of recurrent costs, thereby undermining the collective sustainability of prior development initiatives.

Demographic Growth

- 4.15. In 1999, the total population of the WBG was estimated at over 3 million, with an annual rate of population growth of around 4 percent—one of the highest rates anywhere in the world (PCBS 1999). As a consequence, the WBG has a young population; in 1999, the median age in the WBG was estimated at 16.4 years. The dependency ratio—that is, the ratio of young (children aged 0 – 14 years) and elderly (adults aged 65 or older) to those potential labor force members aged 15-64—stood at the extraordinarily high level of 101.3, in sharp contrast to the average dependency ratio (1998) of 72.7 for the Middle East and North Africa region, and 58.8 for lower-middle income countries.

4.16. This rate of population growth compounds the fiscal challenges outlined above. It creates high demand for new jobs; according to one estimate, natural population growth in the WBG requires the creation of 30,000 jobs per year (Pedersen and Hooper 1998, 34). In the past, public sector employment has been used to mitigate unemployment, but in a way that is ultimately unsustainable in light of fiscal constraints. Rapid population growth also creates mounting demands on health, education, and other social services. In the case of education, annual outlays will have to increase by an estimated 64 percent in real terms between 1996 and 2010 simply to maintain current student/teacher and student/classroom ratios (Pedersen and Hooper 1998, 57). Other estimates suggest that the PA will need to construct more than 50 new schools *per year* over the next ten years to keep pace with the growth of gross enrollments (Berryman 1999, 163). And in the health sector, a 20 percent increase in annual budgets would be required every five years to maintain current levels of government health provision (Pedersen and Hooper 1998, 62).

4.17. These effects are even more dramatic when the potential repatriation of displaced persons, refugees or other members of the Palestinian diaspora is considered. The Palestinian Authority's current *National Policies for Physical Development* (MOPIC 1998b, 87) makes the planning assumption that some 700,000 persons might repatriate to the WBG by 2010, at a rate of 100,000 per year. Alternative calculations by the Palestinian Central Bureau of Statistics assume the repatriation of 500,000 Palestinians to the WBG by 2010. Adding this to the existing rate of population growth, PCBS calculates that the total population of the WBG will grow from 3 million in mid-1999 to 4.9 million by 2010, and subsequently to 7.4 million by 2025 (Figure 4.17).



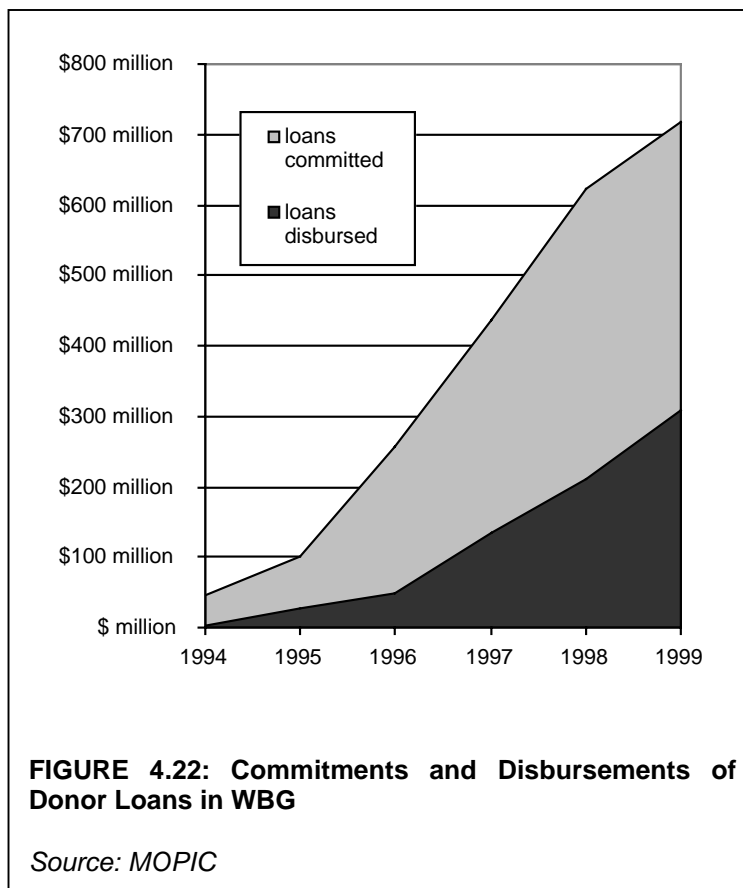
Shifts in Donor Assistance

- 4.18. As discussed in Section 2, there have been significant changes over time in both the volume and composition of donor assistance. In particular, recent years have witnessed a decline in the volume of donor assistance, and a shift to a higher reliance on loan-based assistance. These trends have important implications for the sustainability of development efforts in the WBG.
- 4.19. The high levels of aid to the WBG in the past have—as is evident throughout this report—had numerous positive effects. However, with these levels of aid comes the risk of creating a growing structural dependency on external resources. The comparative experience of other economies suggests that the distortions generated by large external resource flows reduce policy flexibility, consolidate unsustainable patterns of public expenditure, and lead to a number of other adverse consequences for future development. These problems are further compounded when the flow of external resources declines.
- 4.20. In the WBG, this potential dependency has largely been averted in the recurrent expenditure side of the budget. The PA has successfully made the transition from heavy reliance on budgetary support from donors to fiscal self-reliance. Despite periodic liquidity problems (largely arising from the failure to centralize all revenues and expenditures under Ministry of Finance control), PA revenues and recurrent expenditures are by-and-large balanced.
- 4.21. On the capital investment side, however, the problem emerges. The PA continues to rely almost exclusively on donor assistance, even for capital investments that cannot be funded indefinitely from external sources. According to the draft 2000 budget, total PA capital investment of all kinds is slated to remain below 3 percent of total expenditures. This level of investment is clearly inadequate to address the depreciation of existing capital assets, let alone the future demands generated by demographic pressures. School construction—an unavoidable necessity given the rapidly-growing population of the WBG—is a case in point. To date, it has been almost exclusively financed by donors, despite the allocation (but not disbursement) of some funds by the Ministry of Education. In brief, *the PA is presently unable to sustain the level of capital expenditure required to maintain the developmental status quo, let alone invest for the future.*
- 4.22. With respect to external debt, the PA has thus far avoided major obligations: some US\$309 million in donor loans had been disbursed in the WBG as of end-1999. Moreover, many of these are connected with private rather than public sector investments. However, a further US\$408 million in loans have been committed by donors but not yet disbursed (Figure 4.22). As noted in Section 2, there are indications that donors may rely to a greater extent on loans rather than grants in future aid packages.
- 4.23. At present, there is no centrally-compiled data available on the terms of current and potential loans and their proposed repayment schedules. The existing MOPIC donor matrix provides very limited data on loan-based assistance, and even this contains

inconsistencies.² Moreover, MOPIC reports the nominal value of loans rather than their effective grant component (which may be substantial for highly concessional lending, and very small in other cases). The matrices therefore tend to exaggerate the size of donor pledges and commitments—for example by equating a US\$1 million grant with a US\$1 million credit at commercial bank rates—and may also provide a distorted picture of the relative allocation of donor resources across sectors. It is impossible to compute—in the absence of definitive information on current and potential donor loans—the extent to which current MOPIC data suffers from this weakness. But previous comparative work by

the World Bank suggests that published figures for net Official Development Assistance overstate the effective value of ODA by around 25 percent in the Middle East and North Africa, and around 10 percent in regions such as sub-Saharan Africa where assistance typically has high grant and concessional components (Chang and Fernandez-Aria 1998, 38). For similar ratios in the WBG, this would imply that 1999 MOPIC data overstates the effective value of total donor pledges by between US\$420 and US\$930 million.

- 4.24. In order to address some of these shortcomings, the Ministry of Finance plans to establish a debt management unit equipped with a computerized debt management and financial analysis system provided through UNCTAD. This initiative is currently in proposal form, and under negotiation for financing. A public loans law will also be drafted.
- 4.25. More broadly, the Palestinian Authority needs to develop an overall system, in the context of its economic planning processes, for determining when and where loans will—and will *not*—be utilized to support the development effort. Although some criteria have been developed, there is not yet any central or common process for doing so. It is also essential for borrowing needs to be determined at a national rather than sectoral or line ministry level. In January 2000 the PA took steps in this direction. Specifically, it authorized the formation of a General Directorate for Loans, with a mandate to regularize



all public borrowing in accordance with both the Palestinian Development Plan and policies set by the newly-established Higher Council for Development. For their part, donors need to study carefully the current obligations and repayment capabilities of the PA before offering or providing additional loans, so as to reduce the risk that Palestinian external indebtedness reaches inappropriate levels in the future.

Permanent Status Arrangements and Palestinian Economic Development

4.26. The future sustainability of economic development in the WBG will be fundamentally affected by the outcome of permanent status arrangements between Israel and the Palestinians. The future political status of a Palestinian entity, the extent and nature of its physical borders, the nature of trade and tax regimes, mobility and access issues, the sharing of regional water supplies, and demographic changes related to the peace process will all have profound effects on the potential for, and character of, future growth. For both Palestinian economic policy-makers and donors alike, the current period poses the difficult challenge of preparing for an unknowable future.

4.27. Although the ultimate disposition of the various final status issues cannot be predicted *ex ante*, it is possible to identify a number of lessons from the recent economic history of the WBG which may be relevant to the design of future political arrangements.

- *The need to minimize constraints on the internal and external flow of labor and goods.* During the mid-1990s, mobility restrictions and periodic closure of the territories wrought substantial economic hardship on the WBG. Modest growth since 1997 has been possible, in large part, because of improved conditions for commerce and trade, and hence for private sector growth and investment.
- *The close interconnection between the Palestinian and Israeli economies.* The general reduction of Palestinian employment in Israel, coupled with acute interruptions due to closure, represented a major component of the economic decline of the WBG in the mid-1990s. The WBG also remains highly dependent on Israel for trade. While a variety of economic arrangements are possible, any sudden disconnection of the Israeli and Palestinian economies would have major negative repercussions for the latter. It would also nullify the various gains from building on the complementarities between the two. The success of the Gaza Industrial Estate in attracting local and external investment demonstrates the benefits of a cooperative approach.
- *The need to design an effective tax regime.* To the extent that the architecture of future Palestinian revenue collection may be shaped by permanent status arrangements, it is important to minimize the sorts of tax leakages that occur under the present system.
- *The need for donor assistance to support a difficult transition.* The adoption of permanent status arrangements may involve substantial new challenges for the PA as

- it adopts administrative functions and investment strategies to meet whatever constraints and opportunities are presented by a future agreement on permanent status. While the magnitude of these challenges may be smaller than those associated with the initial establishment of the PA in 1994, there will nevertheless remain substantial need for a generous and timely response from the international donor community.
- 4.28. Despite considerable uncertainty about final status outcomes, it is possible to anticipate how potential permanent status arrangements might shape future economic challenges. With respect to the refugee issue, for example, it is possible to identify (without prejudging political outcomes or prejudicing the inherent rights of refugees) a number of aspects that have profound implications for the international donor community.
- 4.29. The first is the challenge of *repatriation*. As noted earlier, the potential repatriation of Palestinians from the diaspora could have large demographic effects, and important implications for employment, prices, investment, social service provision, and the fiscal balance in the WBG. A second dimension of the refugee issue that will confront the PA and donors concerns the *current and future status of refugee camps in the WBG*. At present, some 27 refugee camps in the WBG host a refugee population numbering more than 578,000 persons (UNRWA 1999b). Leaving aside the highly political issue of the future status and location of refugees, these physical areas—characterized by dense housing, poor infrastructure, complex and ambiguous property rights, and acute social and economic needs—will nonetheless pose a continuing developmental challenge, both for Palestinian planners and the donor community (Razzaz 1997). The economic contours of the WBG—and hence the prospects for sustainable development—will also be shaped by any system of *refugee compensation* that might be agreed to by the parties.
- 4.30. A final—but critically important—component of any future resolution of the refugee issue concerns the *provision and sustainability of social services*. As noted in Section 2, UNRWA currently provides primary and secondary education services for more than 210,000 children in the WBG, representing over one-quarter of all students in the territories. It provides health services through a network of more than fifty clinics in the WBG, treating 3.5 million patients per year. UNRWA also operates 25 women’s program centers, 17 community rehabilitation centers, and 26 youth activity centers in the various refugee camps. Finally, it provides social assistance to more than 96,000 “special hardship cases”. To date, the recurrent cost of UNRWA activities in the WBG—budgeted at US\$165 million in 1999—has been entirely financed by the international donor community.³ In 1999, actual UNRWA expenditures in the WBG were equivalent to around one-seventh of total PA recurrent spending, and its staff was equivalent to around one-sixth of PA civil service employment. Following a mutually-acceptable resolution of the refugee issue, the possible assumption by the PA of UNRWA services in the WBG (representing 3 percent of Palestinian GDP) would have major fiscal and developmental implications (PRRN 2000).

- 4.31. The issues raised above describe just some of the implications of the refugee issue for the future direction and sustainability of development efforts in the Palestinian territories. Moreover, the refugee question represents just one of several permanent status issues having potentially profound political, social, and economic implications. As the parties continue their progress towards a comprehensive permanent status agreement, it is essential that the Palestinian Authority and the donor community prepare for the many serious developmental challenges that such an agreement will inevitably entail. In the case of the refugee issue, some of this work is already underway. MOPIC, PCBS, and the PLO Department of Refugee Affairs have begun preliminary work on planning for demographic changes. Canada, as gavel-holder of the Refugee Working Group of the multilateral peace process, has supported a range of relevant activities. Norway has undertaken database activities inside and outside the WBG that are likely to prove useful in preparing for any eventual agreement. The European Union and the UK have sponsored research on the economic dimensions of the refugee issue. Other donors have supported additional useful activities, including work by scholars, NGOs and other researchers on a range of related issues. Nevertheless, much remains to be done (PRRN 1997).

Conclusions

- 4.32. While the urgent character of donor assistance during the first few years of PA existence tended to overshadow issues of sustainable development, it is important that donors and the PA alike devote much more attention to medium- and longer term economic issues. Failure to do so raises risks that the WBG may develop an untenable degree of dependence on external resources, threatening the future of current development initiatives.
- 4.33. One of the most immediate challenges in this regard, as highlighted by this study and in previous work by the World Bank, is the need to establish solid fiscal footing for Palestinian public services and investments. Uncontrolled recurrent wage costs represent a real danger to fiscal stability, and various non-wage costs of development initiatives must also be addressed in a systematic and effective way. Although primary responsibility for doing so lies with the Palestinian Authority, donors could also do more. Greater donor attention to the sustainability of projects, more effective donor coordination, and especially greater donor compliance with Palestinian development planning procedures would facilitate the control of future costs.
- 4.34. Population growth in the WBG represents another pressing development challenge. The best response to increasing demands on public services and infrastructure arising demographic pressures is economic growth (and the enhanced fiscal revenues it brings), coupled with effective institutions and models of service delivery. In the absence of these, population growth will aggravate fiscal instability, creating a vicious cycle of rising tax burdens, service cut-backs, and declining economic performance and family

incomes. Here as elsewhere, effective public institutions and appropriate economic policies will prove critical—an aspect addressed in detail in Section 5.

- 4.35. Changes in patterns of donor assistance are likely to have a large impact on the sustainability of Palestinian development efforts. In particular, appropriate precautions are necessary to prepare for possible future changes in the level of assistance available, as well as the proportion of assistance provided through development loans.
- 4.36. Finally, it is impossible to address issues of sustainable development in the WBG without also addressing the profound and unavoidable impact of future permanent status. The shape of future agreements is, of course, unknowable at present. However—as the brief discussion of the refugee issue demonstrates—it is possible to identify how potential negotiated outcomes may affect social and economic conditions in the West Bank and Gaza, and to undertake some preliminary research and planning on this basis. Failure to do so now might substantially increase the potential uncertainties and costs of any future political transition.

NOTES: SECTION 4

¹ Based on information provided by the Ministry of Education. Necessary maintenance costs are estimated to be approximately 1 percent of capital expenditures.

² The February 2000 MOPIC donor matrices, for example, contain a US\$20 million discrepancy between the totals provided and the actual sum of the annual disbursements indicated in the body of the loan matrix.

³ UNRWA's budgeted expenditures represent the Agency's views of the level of resources necessary to maintain adequate services for refugees. In practice, donor contributions fall short of this. As a result, in 1998 the gap between budgeted and actual cash expenditures was US\$62 million (UNRWA 1999a).