Medium-Term Economic Prospects: Could the Future Be Brighter?

Introduction

The poor overall performance of the Palestinian economy in the last five years raises the question of whether the outlook for the medium term can be expected to be any brighter.[1] It is clear that some of the conditions necessary for achieving a better performance are already present. The population is young and well educated. Furthermore, there have been important improvements in both the physical and the institutional infrastructure, including the establishment of key policy institutions and some progress in legal and regulatory reform. The capacity to effectively implement public investment projects—in the public sector as well as in the private (subcontractor) sector—has improved considerably, and in the future a larger share of foreign aid should go to investment rather than consumption. Thus, there are objective elements for a better outcome than in the last five years. At the same time, major obstacles will have to be removed for the economy to be able to reach its potential, including those that restrict the flow of goods, people, and capital within the West Bank and Gaza, and that limit trade with the rest of the world. Another key obstacle relates to the institutional capacity. While progress has been made in setting up policy institutions, much remains to be done (including adoption and effective implementation of laws and regulations) in order for the institutional framework to be truly supportive of economic growth. This chapter discusses the challenges posed by the demographic dynamics over the medium term, the implications of maintaining a real GDP growth rate around the level recorded in 1998 and the investment requirements to sustain that growth performance. The chapter also reviews the factors that could help enhance medium-term growth prospects.

The Challenge from Demographic Trends

The demographic situation presents a formidable challenge for the West Bank and Gaza. The natural population growth, at just below 4 percent a year, is among the highest in the world. Furthermore, almost half the population is below 15 years of age and a large share is expected to enter working age in the next few years. As a result, the labor force is expected to grow by as much as 5–6 percent a year over the medium term, and this growth rate could be even higher if the relatively low labor force participation rate of about 40 percent should increase because of, say, higher participation of women or immigration.

The main challenge for the Palestinian economy in the medium term is to absorb this labor inflow into productive employment in the private sector at reasonable wages, while progressively reducing the unemployment rate. The unemployment rate at the end of 1998 was almost 13 percent, about twice the level recorded five years earlier. Although the unemployment rate declined markedly in 1997 and 1998, this was largely the result of an unsustainable expansion in public employment and a recovery of

[1]This chapter draws on material in a paper by Fischer and others (forthcoming).

employment in Israel and the settlements. The scope for further growth in public sector employment is extremely limited; this sector has already overextended itself, and a key policy element for the medium term will be to halt the growth in public employment and the wage bill. While some additional employment growth may take place in Israel and the settlements, it is clear that most employment creation will have to take place in the private sector in the West Bank and Gaza. On this basis, employment in the private sector would have to grow by about 7–8 percent a year just to avoid a rise in unemployment, compared with an estimated annual job growth of less than 2 percent in 1994–98, and around 4 percent in 1997–98.

The absorption of a swelling labor force could be, in principle, a positive growth factor, provided labor markets are flexible and the climate for investment is good. In other economies that have gone through similar population phases, the growing labor force has been absorbed into higher levels of productivity without a rise in unemployment, and the increase in labor force to the total population provided an important, albeit transitory, growth effect by increasing labor input per capita, private saving, and investment.[2] Such a positive outcome is not inevitable, however. In the West Bank and Gaza, the environment for private investment is generally poor, and it is possible that the large inflow to the labor market will lead to higher unemployment and a compression in real wages, at least in the short run.

An Illustrative Medium-Term Scenario

For illustration, a medium-term scenario has been prepared on the assumption that conditions in general would not be very different from those that prevailed in 1998. The scenario also assumes that the PA would pursue a prudent fiscal policy and gradually build up a surplus on the fiscal current account to finance part of the capital budget through own resources. The bulk of donor financing for investment is assumed to continue to be in the form of grants, and the level of foreign aid in dollars is assumed to be in line with commitments made at the donor conference in Washington, D.C. in December 1998. It is also assumed that the number of Palestinians working in Israel and the settlements would remain around the level observed in the fourth quarter of 1998. Public sector employment growth would be limited to 3,000 positions in 1999 and to 2,000 thereafter, and would be almost entirely concentrated in the health and education sectors.

The scenario should not be seen as a projection, but rather as an attempt to illustrate implications for the medium term if economic conditions do not change significantly from those in 1998. It is one out of many possible paths for the Palestinian economy.

The Scenario

The decline in private gross fixed investment (excluding inventories) is assumed to have bottomed out in 1998, and investment would grow by 3–4 percent in real terms over the medium term. Although a large share of private investment would continue to be in the form of housing construction, which does not add to the productive capital stock, there would be some growth in nonconstruction investment as well. At the same time, public investment would rise gradually in percent of GDP. Donor-financed public investment would increase in dollar terms but decline somewhat when expressed as a percent of GDP, although this would be more than compensated for by public investment financed from the PA's own resources because of the assumption that the surplus on the fiscal current account would increase gradually to 1.5 percent of GDP in 2003 (Table 8.1).[3]

On this basis, and even assuming a gradual, modest decline in the capital/output ratio over the medium term and modest positive growth in total factor productivity (TFP), the accumulation of productive capital would not be sufficient to support real GDP growth of more than 4–5 percent over the medium term, about the same as in 1998. The decline in the capital/output ratio and the growth in TFP would stem from the improvement in the environment for business due to legal and regulatory reforms and the continued stable political environment, as measured by few incidences of closures.

[2]See, for example, Bloom and Freeman (1986). Also, in east Asia, a similar rise in the share of the working age population is estimated to have contributed about 1.5–1.9 percentage points to annual per capita income growth in 1965–90 (Bloom and Williamson, 1997).

[3]In line with the projection presented by the PA at the Consultative Group meeting in Frankfurt in early 1999 (Palestinian Authority, 1999).

TABLE 8.1
Illustrative Medium-Term Scenario

	1998	1999	2000	2001	2002	2003
			(Annual percentage changes)			
Real GDP	4.1	4.0	4.3	4.4	4.5	4.5
Real GDP per capita	0.2	0.2	0.5	0.6	0.7	0.6
Employment[1]	6.2	4.0	3.7	3.8	3.7	3.6
Inflation[2]	9.7	3.1	4.0	4.0	4.0	4.0
			(In percent of GDP)			
Gross domestic savings[3]	–30.9	–29.9	–28.9	–27.9	–26.8	–25.8
Private	–26.7	–26.3	–25.7	–25.2	–24.7	–24.3
Public	–4.2	–3.7	–3.2	–2.7	–2.1	–1.5
Of which: central government	–0.1	0.2	0.4	0.7	1.1	1.5
Gross fixed investment[4]	21.5	21.2	21.1	21.2	21.3	21.3
Private[4]	14.0	14.0	14.0	14.0	14.1	14.1
Public	6.1	6.3	6.5	6.8	7.0	7.2
Foreign financed	6.1	6.1	6.1	6.1	5.9	5.7
Financed with own resources	. . .	0.2	0.4	0.7	1.1	1.5
Change in inventories	1.3	0.8	0.6	0.4	0.2	0.0
Exports of goods and services	20	20	20	21	21	21
Imports of goods and services	72	71	70	70	69	68
Net factor income	20	20	19	18	17	16
Current account balance	–33	–31	–31	–31	–31	–31
Memorandum items:						
Total factor productivity[5]	–3.0	0.1	0.4	0.3	0.3	0.2
Unemployment rate[6]	14.5	15.0	17.1	19.1	21.1	23.1
Donor aid disbursements[7]	549	494	492	508	520	532

Source: IMF staff estimates and projections.
[1]Includes employment in Israel and the settlements with and without permits.
[2]Change in consumer price index. End of period.
[3]Equals gross national savings less net factor income and net transfers from abroad.
[4]Includes net errors and omissions from the national accounts.
[5]Contribution to real GDP growth.
[6]In percent of labor force.
[7]In millions of U.S. dollars. Disbursements through the development plan, including to the PA, NGOs, and UNRWA.

Under this scenario, real GDP per capita would improve modestly, but in 2003 it would still be about 10 percent below its 1993 level. Furthermore, this pace of investment and growth would not be enough to absorb all of the inflow to the labor force, and unemployment would rise over the medium term to above 20 percent in 2003 from roughly 15 percent in 1998, despite a moderate decline in the capital/labor ratio, which in turn would be associated with a compression of real wages.

Exports of goods and services would grow faster than real GDP, reflecting in part the decline in real wages and some growth in tourism earnings. Imports of goods and services would grow with an income elasticity of less than one, also partly because of the decline in real wages. Net factor income and net transfers would decline in percent of GDP because of the assumption of no growth in employment in Israel, and the expected continued decline in donor finance for technical assistance and transitional support (current grants) in favor of investment. On that basis, the external current account deficit would remain virtually unchanged.

Factors for Higher Medium-Term Growth

The above medium-term scenario illustrates that, if conditions for business in general were to remain as in 1998—the year with the best economic performance since 1994—living standards in the West Bank and Gaza would not improve substantially; indeed, donor assistance would re-

main crucial to prevent an erosion in living standards. This raises the question of what can be done to spur faster capital accumulation in the private sector and to promote faster changes in production systems in order to foster growth in labor productivity and induce an increase in labor demand. In fact, annual output growth would have to be at least three percentage points higher than in the baseline scenario for the economy to absorb the rapidly growing labor force and to achieve a significant reduction in unemployment.

Recent empirical growth literature emphasizes the importance of foreign trade and variables that policymakers typically can influence, or directly control, rather than a country's physical resource endowment.[4] The following section discusses three factors that are considered important for long-run growth and that are relevant to the Palestinian economy: openness, institutional framework, and macroeconomic policy. The discussion focuses on factors that are important mainly for the long-run output path; in the short run, output might be most influenced by shocks to the economy, for instance in the form of closures.[5]

Openness

It is virtually impossible for a small economy like that of the West Bank and Gaza to develop without free trade.[6] The channels through which free trade contributes to raising a small economy's income include the exploitation of economies of scale and comparative advantages; the exposure to competition and international prices, which in turn ensures more efficient resource allocation; and the incorporation of new technologies and know-how. The Palestinian economy is not only suffering from restricted access to trade with the rest of the world, but also from the lack of free movement of goods and people between the West Bank and the Gaza Strip. The positive dynamic forces that free external trade can set in motion apply also to trade and factor mobility within the economy.

Internal Integration

For the Palestinian economy to develop and prosper, the trend toward less internal integration—even continued disintegration—must be reversed. This would require an easing of the controls and of the permit system that were introduced in 1993.[7] Closer integration of the Gaza Strip and the West Bank would allow better use of scale economies and would help limit duplication of business and government functions in the two regions. Greater integration would also facilitate economic adjustment in response to shocks to, say, the terms of trade. In this connection, free passage between the West Bank and the Gaza Strip would greatly improve the situation.

Free Trade with the Rest of the World

The West Bank and Gaza is in a de facto customs union with Israel, except for the lists of goods included in the Interim Agreement, which allows the PA some limited independent trade policy.[8] The customs union has given Palestinian exporters important access to the Israeli market that has been beneficial to the manufacturing sector in particular. At this stage, it is not known what type of arrangement will govern trade between Israel and the West Bank and Gaza in the future. It is clear, however, that in order to reap the benefits of free trade, the PA should seek a nondiscriminatory trade regime with very low tariffs and with as open an access as possible to the Israeli market, which is the largest economy in the region and the one offering the greatest scope for trade expansion for the West Bank and Gaza. Also, the PA could greatly improve the climate for trade by reversing its policy of granting import monopoly rights, breaking up existing monopolies, and imposing sole agency requirements for certain imports. Equally important, trade with countries other than Israel is also hampered by the lack of infrastructure, most notably a seaport, which was mentioned in the Interim Agreement. Without a seaport, the West Bank and Gaza is effectively a landlocked economy.[9]

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[4]See, for example, Barro (1991), Barro and Sala-i-Martin (1995), Hall and Jones (1999), and Sachs and Warner (1997). A common finding is that countries with large resource endowments tend to grow more slowly than those without natural resources.

[5]The effects from closures were discussed in Chapter 2.

[6]Sachs and Warner (1997) list openness to trade as the most important factor in explaining differences in growth rates across countries.

[7]Access between these two areas was basically free until the Gulf War, but with the Economic Protocol, they were almost completely separated.

[8]Lists A1, A2, and B. See Barnett and others (1998) for an extensive discussion of the trade regime in the West Bank and Gaza.

[9]It has been estimated that in Africa countries with access to the sea grow faster than landlocked economies by more than half a percentage point a year (Sachs and Warner, 1997).

Institutional Framework and Governance

The Palestinian Authority can help support economic growth and development by strengthening the institutional framework. A good institutional framework—including well-functioning policy institutions and an independent and market-oriented legal and regulatory framework that effectively protects property rights—is crucial for long-term growth because it improves incentives to the private sector to undertake long-term investments.[10] A recent study of 127 countries shows a close and powerful association between output per worker (productivity) and social infrastructure, comprising institutions and government policies that affect the economic environment within which individuals accumulate skills and firms accumulate capital and produce output (Hall and Jones, 1999).[11] Despite recent progress, much remains to be done before the institutional framework in the West Bank and Gaza is truly supportive of private sector development. The PA is now creating the needed institutional structure, and is thus in the process of laying the foundation for the future path of the Palestinian economy. In so doing, it should design institutions carefully because, once established, they are difficult and costly to reform (North, 1991).

The PA must make its own operations more effective and transparent, and ensure that policy institutions are as insulated as possible from political pressures. The rapid expansion of the public sector and the PA's increased involvement in the economy, including its monopoly companies, may undermine the development of an economy in which the private sector is able to flourish and lead the growth process. The PA must also improve its financial operations and make them more transparent by bringing all revenues under the control of the Ministry of Finance and all expenditure into the budget. Perceptions of excessive red tape, inadequate transparency, and weak financial management in the PA deter investors and donors, undermine confidence in policymaking, and reduce the effectiveness of policies. If these issues are not dealt with promptly and convincingly, they will contribute to continued sluggish private investment.

There is a need to establish a transparent and independent legal and regulatory system that effectively protects property rights. This in turn requires judicial institutions that can act independently to ensure a fair and nondiscriminatory implementation of laws and regulations. The authorities are aware of the need to undertake reform in these areas and are working on a broad array of laws, including those governing industrial estates, securities, banking, competition, intellectual property, and the stock exchange. It is vital that these laws be formulated and implemented in a way that ensures a fair and level playing field for all in the economy, protects property rights, and promotes competition. The authorities are also working to modernize the entire dispute settlement system, to strengthen the legal institutions by training more judges and other court personnel, and to make information on laws and regulations more easily accessible.

Macroeconomic Policy

An important condition for sustainable long-term growth is a stable macroeconomic environment, in particular a sound fiscal policy.[12] Studies of other regions have found that the relationship between government saving and growth is positive and significant because of its tendency to raise national saving and investment.[13] Furthermore, stable macroeconomic conditions are important for the effectiveness of public investment, a consideration of particular relevance to the West Bank and Gaza given the size of the planned public investments. A recent study of investment projects in 61 countries found that in countries with poor macroeconomic policies the

[10]For a general discussion of the importance of institutions to economic development, see North (1991) and Bates (1996), and for estimates of their importance to growth in other countries, see Barro (1991), Barro and Sala-i-Martin (1995), Hall and Jones (1999), and Knack and Keefer (1995).

[11]An illustration of the importance of institutional framework is seen in the commuting of Palestinians to Israel. In 1998, according to the PCBS, Palestinian workers in Israel and the settlements earned an average net wage almost twice as high as that in the West Bank and Gaza, even after controlling for sectoral differences. There are many explanations for this, including a significantly higher level of capital/labor ratio in Israel. But the difference is also a result of the phenomenon that the Palestinian worker becomes more productive in Israel; in other words, a worker can earn a higher wage because his or her human capital is employed in a higher productivity setting.

[12]For a discussion of macroeconomic factors and growth, see Fischer (1993). For the effect of inflation on growth, see, for example, Ghosh and Phillips (1998).

[13]See, for example, Barro and Sala-i-Martin (1995), Fischer (1993) and Sachs and Warner (1997). Fischer estimated that an improvement of 1 percent of GDP on the budget balance raises annual output growth by about a quarter of a percent.

productivity of all types of investment projects tended to worsen (Isham and Kaufmann, 1999).

Fiscal policy has a key role to play in overcoming the challenges faced by the Palestinian economy, and, starting already in 1999, the PA would be well advised to begin building up surpluses on the recurrent budget (increase government saving) by containing the level of current expenditure, while allowing for growth in spending on education, health, and social assistance. A surplus on the recurrent budget will be necessary for the PA to finance part of public investment from its own resources and to build up a buffer for the large implicit liabilities that have accumulated in the pension systems (see the Annex) and the eventual increased social expenditures relating to services now provided by UNRWA and NGOs. The PA should be concerned with reducing its dependency on foreign aid and begin moving toward a situation that is financially sustainable over the medium term. Donor financing—even under the most optimistic circumstances—is not going to cover all the required investment in infrastructure in the West Bank and Gaza over the coming years.

Conclusion

The absorption of the expected large inflow to the labor market presents a formidable challenge to the Palestinian economy over the next few years. On the assumption that the number of Palestinians working in Israel and the settlements remains at the levels that prevailed in late 1998, and that public sector employment growth is limited, the local private sector in the West Bank and Gaza would have to grow much faster and create considerably more jobs than it has in the past five years just to prevent a rise in unemployment or a severe drop in real wages. Even stronger investment would be needed to achieve a further decline in unemployment over the medium term. This chapter illustrated that it may be possible to sustain the economic growth performance of 1998, the fastest real GDP growth rate since 1994, over the medium term, mainly in the context of a modest increase in investment. This would not, however, allow the private sector to absorb the expected inflow to the labor market, and unemployment would rise even with some reduction in real wages. To achieve a faster rate of growth in the private sector and to avoid a rise in unemployment, private investment would need to grow much faster, and this would require a significant improvement in the business environment in the West Bank and Gaza. To this end, the restrictions to trade and internal integration would have to be eased significantly, and an institutional framework that improves the environment for private investment and business activity would have to be established. The issue of governance in connection with the PA's operations would also have to be addressed promptly. Macroeconomic policy, especially fiscal policy, has a crucial role to play in achieving higher growth through contributing to higher domestic saving and investment. In this vein, it would be crucial to halt the excessive growth in the public sector wage bill.