Reshaping Palestinian economic policy discourse: putting the development horse before the governance cart

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REVIEW ESSAY

RESHAPING PALESTINIAN ECONOMIC POLICY DISCOURSE: PUTTING THE DEVELOPMENT HORSE BEFORE THE GOVERNANCE CART

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State Formation in Palestine: Viability and Governance during a Social Transformation, edited by Mushtaq Husain Khan, with George Giacaman and Inge Amundsen. London: RoutledgeCurzon, 2004. x + 238 pages. Index to p. 249. $19.99 paper.

Ever since the first internationally sponsored effort in May 2000 to rehabilitate the economic governance record of the Palestinian Authority (PA), issues of corruption, transparency, and reform have become inextricably intertwined with the political debate of the day. At that time, PA President Yasir Arafat, with support from the International Monetary Fund (IMF), established the Higher Council for Development (HCD) to oversee PA efforts to enhance governance and strengthen public finances. The strategic role envisaged for the HCD, which included three ministers, was to help reorient PA economic policies and to bring Palestinian public policy more into line with global standards. The HCD met only a few times and was not transformed into a financial reform instrument, though the issues with which it was mandated to deal became the central planks of Ministry of Finance reform over the subsequent years. These included consolidating disparate public revenue accounts; curtailing current public expenditures; fully disclosing PA commercial operations and investments; designing a privatization strategy for PA holdings; and elaborating PA policy on public debt.

Hundred-day, annual, and triennial plans have since been drawn up, international conferences and seminars convened, and countless teams of international experts dispatched to Palestine to address the Palestinian record in this newly critical area of economic performance. And as the possibility of progress on the vital Palestinian issues of occupation, refugees, sovereignty, and Jerusalem grew more distant after 2000, so have the pressures on the PA for some/any movement forward in the vast area of Palestinian internal "reform" intensified. Tellingly, a Google Internet search for "Palestinian reform" in mid-March 2005

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revealed 1.4 million Web pages relevant to the subject and 7,000 news items over a typical ten-day period.

REFORMING THE PALESTINIAN AUTHORITY

Today, all parties (except perhaps the PA) consider that intractable issues such as statehood cannot be addressed until the PA has undertaken wide-ranging reforms. For many years, PA officials under Arafat would bristle at suggestions of corruption in their midst or at best would point to other developing (and developed) countries and national liberation movements as evidence that nobody is perfect. They also could credibly argue that problems of ministerial mismanagement, lack of financial accountability, corruption, and patronage had first been uncovered and investigated by PA institutions (e.g., PA Comptroller General report of 1997, Palestinian Legislative Council report of 1998). But since the short-lived government of Mahmud Abbas in 2002, and even more so under the post-Arafat regime, PA financial accounts and functions, ministerial structures, policy roles, draft legislation, and development plans have all been subject to extraordinary scrutiny by donors and the international community and their watchdog institutions.

While some PA officials continue to remonstrate that reform remains first and foremost a Palestinian affair, the PA has signed on to a host of essentially new governance commitments proposed by donors at the March 2005 London Meeting on Strengthening the Palestinian Authority. Most of the London commitments had already appeared in previous PA Reform Plan documents. However, the prioritization, emphasis, and direction of PA "reform" today entail growing hands-on international funding and support, administered through a host of donor coordination fora and channels and joint working groups with PA counterparts.

Prior to the year 2000, the international community was careful not to rock the PA governance boat too hard so as not to compromise the much-trumpeted "economic dividends of peace" widely seen as central to the success of the Oslo process. Thus, while some international agencies and task forces have over the years addressed the overall challenges facing the PA in the area of building governance institutions and the rule of law (e.g., the Rocard Commission report of 1999), only a few of these investigations openly tackled the most widely cited forms of "corruption" (monopolies, undeclared public revenues, irrational or wasteful public expenditures, graft, extortion, and patronage) except in the most careful and diplomatic terms. As has been well documented elsewhere, donors moved slowly in making their concerns known to the PA, mainly working through back channels and discrete pressure rather than through objective, transparent, and constructive debate and dialogue. Indeed, until 2000 most donors expressly refrained from attaching any political or other explicit conditions to their aid to the PA, despite a good knowledge of the state of PA governance and financial control.

Since the end of the peace talks, however, creeping donor micromanagement of PA finances and programs was prompted initially by the need to account to legislatures and to respond to claims of donor funds being diverted by the PA to finance Arafat's security apparatus. These fears were proven largely unfounded by international inquiries and independent reports, most notably the investigations by the European Commission and Parliament between 2003 and 2005, as well as a 2003 IMF report, which documented PA off-budget finances and concluded that donor funds had not been diverted for illegitimate purposes. Soon, however, with the increasing fragility of the PA and its deficit finances since 2004, the attention of donors and international institutions began to turn to the nuts and bolts of PA finances, civil service performance, and the degree of its commitment to market transparency and liberalism.

Certainly, the use of traditional "conditionality" by donors and international lending institutions has not been feasible in the Palestinian case both for political/moral and legal reasons (i.e., the situation of occupation and the fact that the PA/Palestine is not a recognized state). By 2005, however, the degree of international involvement in Palestinian economic and public sector management had reached a level and intimacy that, in all but name, amounted to an international financial trusteeship for the envisioned State of Palestine. Through a variety of trust funds, oversight and auditing mechanisms, built-in budget controls, and technical assistance projects, donors and international institutions are well placed to monitor the operation of PA public finances down to the last shekel. This total financial transparency has without doubt encouraged continued donor support for the PA budget in a climate of uncertainty and is proudly exhibited by the PA and IMF as a model for developing countries. But it also implies that international aid for Palestine is less and less "demand-driven" by the Palestinian beneficiary's national strategies and increasingly "supply-driven" by donor agendas.

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THE PALESTINIAN ECONOMY AND THE QUEST FOR A STATE

The Palestinian economy, as most international observers agree, continues to feature deep-seated structural imbalances and distortions, both within the economy itself and in its external sector (trade, labor, and finance). These persist owing to occupation, separation from neighboring states, internal fragmentation, war, institutional attrition, and the uncertainty of implementation of the two-state solution envisioned in UN Security Council resolution 1397 and the road map. In the absence of deliberate and comprehensive policy attention to these pending challenges, the Palestinian economy is effectively being transformed into one of subsistence. While the decline since 2000 stabilized after 2003, this has so far been, at best, a rebound from, and adjustment to, a very depressed economy that has lost at least one fifth of its economic base over the last four years. The PA (and its international supporters) has recently begun to emphasize that any political process or moves toward alleviating those constraints and blockages should go parallel with an economic development strategy. Yet even in the absence of political progress, the Palestinian economy has demonstrated resilience and successfully employed coping strategies, which should provide the guiding elements of conflict and postconflict development endeavors by the PA and the international community.

The crisis of recent years has highlighted the vulnerability of the economy, which even before the onset of the al-Aqsa intifada lacked an internal engine of growth and was highly dependent on donor assistance and employment in Israel for generating growth. Aggregate economic indicators continue to depict an adverse environment and dim prospects for trade, investment, employment, or social welfare. The dark cloud's silver lining, if there is one, is that against all odds, Palestinian society has come together in unprecedented social cohesiveness. For example, it managed in 2003 to employ domestically more workers than in 1999, including some 77,000 workers of the 130,000 no longer employed in Israel. Although this shift was involuntary, and at lower wages and productivity, it shows that in the face of harsh conditions the Palestinian economy has been able to adjust and to increase employment, thereby redistributing whatever income it was able to accrue under economic siege.

The publication of *State Formation in Palestine* could not have come at a better moment to stimulate a more open and frank debate on an issue that has become increasingly contentious in PA-donor relations. For the first time, a scholarly and thoroughly researched analysis has been published on the realities, facts, and figures of Palestinian economic management since 1994, as well as its interactions with the external environment and obligations created by the Oslo accords. The findings of this research project, undertaken by an impressive team of international and Palestinian economists and social scientists and hosted by the Palestinian NGO Muwatin, are accessible not only to specialists but also, notwithstanding its rigorous conceptual framework, a wider audience interested in Palestinian affairs.

Development activists, practitioners, and policy-makers can all benefit from the volume's serious economic analysis and methodology, thanks to the skillful editing of and contributions by Mushtaq Khan, senior lecturer at the School of Oriental and African Studies and a leading development economist. And more general readers, including both sympathizers and detractors of the PA, can learn from the presentations in this volume to be more prudent in offering sweeping generalizations about the Palestinian leadership's mixed institutional and policy performance, commonly lumped together under the broad and simplistic theme of "corruption." Through reference to a body of literature already well established by Khan and other studies of Asian development experiences, this collaborative volume, which is based on intensive field research, allows for a better understanding of phenomena known in the discipline as the seeking and generation of nonproductive economic "rents." A straightforward non-academic source defines rent seeking as "the inclination of everyone who is alive and breathing to get as much as they can for themselves. This stems from the idea of economic rent, which is a payment over above the opportunity cost. People are said to be rent seeking when they try to get higher wages, more profit, or any other payment over above the minimum they would be willing to accept."*

As the reader will discover, not only are some of the usually cited forms of "corruption" widely practiced in developing (not to mention developed) countries, but these have also, under certain conditions, led to lasting development and state-formation gains for many of the countries that engage in such practices. With reference to the experiences of countries such as South Korea, Taiwan, Malaysia, Thailand, and China, Khan shows in this volume (and elsewhere) that "the evidence of historical transition thus shows that the sequence of reforms that led these countries to successful capitalist development contradicts" the conventional wisdom and orthodoxy in this field (p. 26). And when this line of inquiry is pursued in the specific Palestinian case, the interrelation between national/political and economic policy-making processes is seen to have a powerful effect on the incidence and impact of rent generation and rent seeking in Palestine. In the Palestinian situation, it is clear that while corruption may be a serious ethical problem, its existence and role cannot be separated from unique state-formation and capitalist accumulation processes under particularly difficult conditions. For reform to be meaningful and beneficial to the "reformee," the practices to be reformed should be understood and dealt with in their wider context. An open-minded reading of this book can provide a new angle from which to evaluate PA performance so far and to design the best possible development policies and practices in the coming phase of Palestinian state formation.

The first chapter of the book sets out the conceptual and historical framework for the research as a whole, while the second chapter looks at potential outcomes of the state formation process and their viability in light of that framework. The policy and regulatory environment for Israeli-Palestinian economic relations since Oslo is covered by a third chapter, followed by a review of the PA political institutional experience and its relevance for state formation in chapter 4. The last three chapters examine the main components of the PA's finances: monopolies, taxation, and donor assistance.

The book sets out with two main objectives, which are pursued consistently in the careful synthesis of the contributions by its eleven coauthors. Its first, over-arching purpose is to revisit, indeed redefine, the 1994–2000 PA institutional development experience and the economic management challenges it

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* As defined by AmosWEB (www.amosweb.com). A more academic definition by Alan Deardorff (http://www-personal.umich.edu/~alandear/glossary/) of *economic rent* is "the premium that the owner of a resource receives over and above its opportunity cost," while *rent seeking* is defined as "the using up of real resources in an effort to secure the rights to economic rents that arise from government policies" and by extension, *rent generation* is the active provision and management of rents, usually by governments.

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spawned. The authors understand this as a process of state formation under adverse conditions, starting with the "asymmetric relation" with Israel enshrined in the Oslo accords and compounded by the post-2000 devastation wrought by four years of war and uncertainty. This asymmetry threatens the nascent state's diverse means of survival, beginning with those in the financial sphere. This approach implies that instead of identifying a series of "corrupt" rent-generation and rent-seeking processes as generic sources of economic inefficiencies and distortions in need of reform, these processes must be analyzed in relation to the overriding imperatives of Palestinian national aspirations, state formation, and socioeconomic development objectives. The question then arises as to the policy space available to the Palestinian leadership in pursuing its national agenda in a hostile environment—i.e., to what extent it can exercise the "independent Palestinian decision" to which Arafat often referred and which was actually synonymous with much of his lifelong Palestinian national strategy.

The second, and equally important and innovative, objective of this volume is to demonstrate, through well-referenced, balanced, and transparent research, just how sophisticated and pluralistic Palestinian state formation and economic management processes have been over the past ten years. The crude but prevalent characterization of the scale and purposes of the legendary "Arafat financial empire," which was put into realistic perspective by a February 2005 *Financial Times* investigative article, appears even less plausible in the light of the complex and effective PA rent-management system depicted by Khan and his co-contributors. After reviewing the system and assessing it in an economic development light, this book recasts what casual observers see as a corrupt and unchecked regime of patronage to sustain political domination, as a thoroughly rational and carefully managed component of a deliberate state formation process.

In pursuing this second objective, the authors are actually tackling the conventional wisdom established by mainstream neoliberal economists over the past two decades in the context of the "Washington consensus" on "sound" economic and development policies, still upheld largely intact by the Bretton Woods Institutions (the World Bank and the International Monetary Fund). A deft economist like Khan is on familiar territory in this respect, and the book's calm and reasonable analysis, coupled with the appropriate moral rejection of corruption in general, makes for a strong case that both donor institutions and Palestinian economic policy makers should address with the same transparency and realism. It is also a valuable empirical and methodological addition to the growing literature on rent management worldwide.

GOOD GOVERNANCE AND POSSIBLE STATE FORMATION OUTCOMES

Khan's lead chapter introduces the reader to prevailing economic theory regarding rent management through his review of the "good governance" agenda, which is rooted in neoclassical economics (contemporary mainstream economic thought) and liberal politics and the related "neopatrimonial" model from modern political science. Both conceptual frameworks relate democracy, anticorruption policies, free-market economics, and ensuing prosperity in a sort of virtuous cycle.

According to "good governance" development policy, a competitive market economy is efficient to the extent that it precludes or eliminates "imperfections" such as the generation of rents, or "politically-generated income, which would not exist without some specific rights, subsidies, or transfers that were artificially maintained through a political process" (p. 19). The existence/generation of economic rents within the discretion of the state, and the seeking of rents by interest groups willing to expend resources to capture those rents, are mutually reinforcing. In the neopatrimonial analysis, the personalization of power is a result of the absence of democratic, accountable government: "the state is the 'property' of the leader who rules with the help of his clients" (p. 23). Corruption is systemic and the economy features "politically driven accumulation by the leader and his clients," which debilitates the economy.

Khan's chapter recalls that rents can be *generated* in the form of monopoly rights granted over certain import commodities, subsidies, redistributive income transfers, and unnecessary public sector job creation. At the same time, rents are often *sought* either legally (such as expenditures on lobbying or contributions to political parties) or illegally (bribes to public officials by individuals or firms, illegal funding of parties, and other illegal influence-seeking modes). There is also a grey area of quasi-legal rent seeking, which often entails gaining privileged access to the state and its resources.

For good governance gurus, the impact of rent seeking can only be negative and unproductive, and should thus be prevented (or eliminated) through a package of reforms. In their generic "one-size-fits-all" format, these reforms include privatization of state commercial or productive holdings, elimination of state-enforced or protected monopolies, public finance transparency, and minimal state intervention in market operations, among other prescriptions. According to the orthodoxy, these are most effective when pursued in parallel with democratic and accountable government that prevents minority groups from seeking—and thus encouraging the generation of—rents and upholds the virtuous cycle.

While Khan maintains that "corruption is illegal rent-seeking," he also clarifies that "much rent seeking consists of legal activities that aim to influence public officials for the benefit of rent-seekers" (p. 20). For this volume, it is as important to investigate the evidence and determinants of rent generation and rent management in the Palestinian context as it is to place these processes in the appropriate state-formation conceptual framework. Khan is well aware that rent seeking and rent generation can lead to the formation of *client, predatory*, or *fragmented clientelist* states and political systems, but he also demonstrates the no less significant historical experiences leading to other results—notably the so-called *developmental* state. These four types of states are distinguished from each other in terms of the prevalence of rents in their economy as well as how each manages rents and toward what ends. Thus, while a *client* state usually features a deeply entrenched relationship with an external (state or non-state) actor, the *predatory* state has systemized corrupt rent generation and rent seeking to an extent that debilitates development prospects. As for the *fragmented clientelist* state, this type compensates for limited budgetary resources by allocating resources to critical economic agents within patron-client networks.

By contrast, in the case of the *developmental* state, Khan shows how economic rents can be generated, managed, and eventually phased out as part of a strategic state formation process underpinned by a national development agenda. In this state type, rents are managed to maintain political stability, and their transfer to capitalists is conditional upon performance. Rent seeking entails mainly lobbying by emerging capitalists to obtain specific types of rents: income transfers, redistributive rents, or temporary monopoly rents. In the historical experience cited by Khan, moderate or high economic growth often ensues in such states. In the least developed state type, the *client* state, on the other hand, transfers from external sources are critical for state survival and are handed down to internal factions through a client state intermediary. Resources are used and managed (often *mis*managed) through illegal channels by public officials to maintain security and political control. Economic outcomes can range from moderate growth, if an *economic integration* strategy is pursued with the patron state(s), to vulnerable, uncertain growth in cases where the patron state relates to its client in the context of a strategy that the authors term *asymmetric containment*.

Khan's introductory chapter as well as the following chapter, which he wrote with sociologist Jamil Hilal, present the volume's central findings on the interrelationship between Palestinian state formation under the PA and rent management, focusing on the specificities of the Palestinian self-government arrangements established by the Oslo accords. Their analysis finds "moderate evidence" in the Palestinian experience of practices prevalent in the *predatory* and *fragmented clientelist* models, in the form of some extortion and economically damaging monopolies, and factional resource allocation, respectively.

A central tenet of the book's analysis is that the Oslo economic accords, and in particular the manner in which they were implemented within the prevailing balance of economic and political/security power between the two sides, were viewed (and used) by Israel as the instrument of an overriding economic containment policy. In fact, the book evaluates the economic record of the 1994–2000 interim period as having been primarily determined by Israel's political/security needs which entailed a gradual disengagement from the economic integration strategy underpinning the Oslo regime. Though this research precedes the Israeli Gaza disengagement plan of 2004, events since then have only confirmed that the New Middle East touted by Shimon Peres at the height of the peace process in the 1990s is a long-forgotten vision (mirage?) of cooperation that has been reduced today to barriers, checkpoints, no-go zones, and closures. While major economic links remain, especially in trade and finance,

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few common interests are perceived by either of the sides and cooperation in labor, investment, and other Oslo-period joint ventures is almost nonexistent.

The containment policy is thoroughly discussed in this context in the third chapter by economists Adel Zagha and Husam Zumlot. The authors explain the policy in detail through reference to the terms of the Paris Protocol on Economic Relations that govern their trade and financial relations until today, and its implementation by Israel (and the PA). This policy, along with "extensive evidence" of *client* state rents (undeclared resources spent on security control, management of rent allocation for political stabilization purposes) leads Khan to consider this state type especially relevant to the Palestinian experience. And the Palestinian evidence of rent-management practices that may be considered as predatory indicates that the state formation process has yet to stabilize in one clear direction. But he and the other authors generally see these rents as inevitable outcomes of the asymmetric balance of political and sovereign powers between Israel and Palestine. This asymmetry should be addressed if corrupt rent management is to be usefully and effectively tackled.

DEVELOPMENTAL RENT GENERATION AND PALESTINIAN STATE FORMATION

One of the significant findings drawn throughout this volume is the extent to which some of the PA rent-generation processes were *developmental* in intent and practice, notwithstanding limited state capacity in regulating those rents. The authors are very careful not to mistake predatory or other types of rents for what might be construed as developmental rents. "Nevertheless, although this is not widely recognized, there were elements in the rent allocation organized by the PA that were consistent with a nascent developmental state" (p. 55). The most notable of these developmental rents was their use to attract Palestinian expatriate capitalists with funds and experience (Arafat, again, often referred to his search for "Palestine's Rothschild") and to correct allocations of rents to the most economically efficient entrepreneurs. Perhaps the most notable examples of these are some of the private import monopolies granted by the PA and public sector involvement in commercial activities, though the book is careful not to overstate the efficiency of their application in the PA experience so far.

The fascinating fifth chapter by distinguished Birzeit University Professor Mohamed Nasr on PA monopolies provides a short explanation of the economic costs of what are generally considered to be inefficiencies in resource allocation that result from monopolistic practices. The chapter is certainly the most careful and thoroughly referenced study of this subject to appear anywhere and makes clear the different roles and functions of private and public monopolies, both of which had some damaging economic effects that Nasr does not minimize. However, Nasr's lasting contribution is in showing how "some monopolies might have played a positive role in promoting private sector investments . . . especially in infrastructure and services," as well as the critical off-budget financing provided by certain public import monopolies that "were rational responses on the part of the PA in a context where its trade and fiscal opportunities were serious constrained by the Paris Protocol" (p. 188).

The other chapters in the book are no less revealing. Chapter 4, by political scientists Inge Amundsen and Basem Zbedi, provides a relevant institutional vantage point from which to round out the Palestinian state-formation story, with clear evidence that the PA demonstrated "relatively positive prospects for becoming a developmental entity" and "strong political will to embark on a developmental economic course, which was its only option" (pp. 162–63). In this article, as in others, the authors are careful with their new findings and do not ignore other indications that the PA had traits congruent with the clientelist state model (presidentialist and patrimonial logics). But the emphasis here and throughout the book on the positive aspects of the PA institutional record (the cup seen as half full) deserve no less attention than the countless references elsewhere that stress the Palestinian governance cup as being, at best, half empty.

Another chapter by economists Odd Fjeldstad and Adel Zagha competently addresses the complex and critical Palestinian tax and fiscal administration, which was one of the main channels for maintaining and manipulating the client-state relation between the PA and Israel (through import and other tax clearance arrangements and mechanisms as well as donor funding channels). The chapter also highlights the PA's functional and institutional achievements in managing this sector, at least until 2000: "the PA was able to maintain macroeconomic orthodoxy while providing generous tax incentives for important groups in society as well as fairly progressive social policies paid for with the revenue windfall from foreign aid and the monopolies" (p. 209). And the concluding chapter on donor assistance, rent seeking, and elite formation by sociologist Sari Hanafi, with Linda Tabar, is daring in exploring the intricate balance of interests and resource transfers between donors, the PA, and civil society. The short, but groundbreaking, section on the role of Palestinian "monopolistic mega-NGOs," rent seeking in the NGO sector, and the "emergence of NGO leaders as a new globalized elite" (pp. 233–36) rounds out the volume's contribution to a much deeper and more objective understanding of the overall Palestinian development experience since 1994.

This exhaustive volume is not, however, solely concerned with setting the historical record straight, which it does admirably. It is also intended to pave the way for establishing benchmarks for *developmental rent generation* that could contribute to state viability in the future. This is a task of vital importance to Palestinian policy makers, both in terms of preparing for the next phase of state formation and in being better equipped to address conditionality questions that will almost certainly arise as they enter into more intensive negotiations with donors and the Bretton Woods Institutions. Already, aid is being gently and loosely tied to progress in "performance indicators" in political, administrative, legal, and security reform, as the London meeting demonstrated. It would appear to be only a matter of time before that is extended to include

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macroeconomic, fiscal, and trade policy. This book should set off alarm bells, and it can only be hoped that the PA is listening.

In Khan's meticulous logic, rent-management reform is not enough to assure the viability of the future state, and indeed on its own could undermine that viability, as the concluding paragraph of his introductory chapter states clearly:

> If capitalist development and the deepening of political institutions take place in parallel, the emerging capitalist system can become politically entrenched through democracy.... But since the Palestinian economy during our period could hardly be described as having achieved the necessary conditions for viable economic development in the long term, focusing on the secondary reforms necessary for politically entrenching a dynamic capitalist economy would not necessarily ensure viability in this context. These reform priorities can be especially misleading if they take attention away from the fundamental constraints that prevented the construction of a viable Palestinian state. Indeed... some of the apparent governance failures of the PA were in fact rent-management strategies that attempted to enhance the economic and political viability of the state in the context of containment. If reform removed these capacities without addressing the problems they were responding to, the emergence of a viable state may become less likely. (pp. 59–60)

This book is by no means the last word in a debate that has increasingly important implications for future Palestinian state viability. Nor should it be taken as a sophisticated fig leaf for crooked or dubious rent-management practices by the PA today or in the future. Nevertheless, amidst the plethora of international studies and reports and continuing strong media interest in the open book of Palestinian public finances, this new alternative approach merits the serious attention of researchers, policy-makers, and international institutions and greater exposition to Palestinian public opinion.