Observations

Disengagement: Can it Improve the Palestinian Economy?

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The geo-political environment in the Western world has been circumscribed in the past 50 years by a movement of supranationalism. For many, the idea of a nation-state has become *passé*, and the emergence of the European community since the late 1950s has had an important impact on international relations, adding to the consensus that it would be optimal to establish supranational structures. This mindset has also had a strong impact on economists' views on the Middle East. For the past decade, the common view among economists analyzing the Israeli–Palestinian conflict was that the best economic solution was to have interwoven economic relations between Israel and the Palestinian Authority (hereafter, PA).

Since the beginning of the al-Aqsa Intifada in late 2000 this line of thinking has faded. The Middle East is not yet ready to adopt solutions that suited Europe after World War II. What has been so fruitful for the development of Europe would not necessarily be beneficial for the Middle East.[1] Rather, it has become clear that following the disengagement process the economic relationships will have to be analyzed in a non-cooperative context.

While the Gaza disengagement has been welcomed by the PA, the building of a fence and the disengagement process taking place in the West Bank are vehemently opposed on political grounds. However, in the international arena, the Palestinians try to persuade the world that their opposition to the disengagement in the West Bank and the fence is mainly economic, since the fence will subject them to a life of misery, and it has been widely claimed that the poverty inflicted by the wall has been devastating for Palestinians.

The purpose of this paper is to analyze the effects of disengagement on the economic development of the PA. It will show that contrary to PA

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claims, disengagement could open up an opportunity to set in motion a process of economic development and growth. Since the disengagement process in the West Bank contains elements that are ambiguous and uncertain, from an economic point of view, it must incorporate two necessary conditions.[2]

The first is that goods, though not populations, should be permitted to move freely between the two regions separated by the security fence. The second is that within each region there should be free movement of goods and labour. These two conditions imply that, on the one hand, there is a border which blocks the free movement of labour and population, yet, on the other hand, checkpoints within the PA will be removed by the Israelis to allow free movement of goods and labour. This second condition—even if it might, for security reasons, lead to moving Israelis from the east side to the west side of the fence—is necessary from an economic point of view, as explained in the following sections.

THE PALESTINIAN ECONOMY

During the years of Israeli rule in the West Bank and Gaza post-1967 the areas enjoyed rapid growth, but this was stunted with the outbreak of the intifada in 2000. The chaos that ensued led to a reduction in Gross Domestic Product (GDP) of 20 percent and, with a 28 percent growth in the population over the past five years, income per capita is some 40 percent lower than in 1999, while poverty afflicts some 50 percent of the population.

Table 1 presents some of the main indicators relevant to an analysis of the conditions of the Palestinian economy today. A GDP per capita of US$700 places Gaza among the poorest regions in the world. One has to be aware that this massive reduction in GDP per capita is not due only to a reduction in production, but also to a huge increase in population. Like most developing countries, one of the main problems in the PA is the high fertility rate (a 6 percent increase per annum), which is manifested in 46 percent of the population being under 15 years of age. This means that each year some 70,000 young people enter the labour market, and 68,000 new pupils start school. The poverty rate in the PA increased from 20 percent in 1999 to 50 percent in 2004. However, despite these high rates, hunger is not apparent in the PA due to massive aid from the UN and other foreign donors.[3] The PA receives the highest sum of aid per capita; each Palestinian receives seven times more aid than a citizen of Niger receives (Niger being as poor as Gaza, if not poorer).

In order to analyze the necessary conditions for economic development and growth, it is important to compare the development of the PA relative to other countries, as shown in Table 2. The main differences between developed and non-developed countries that can be perceived in the data

TABLE 1
MAIN DATA ON THE PALESTINIAN ECONOMY

Statistic	1999	2002	2004
GDP per capita (U.S.$)	1,493	879	934
GDP ($m)	4,179	2,831	3,336
Population (000)	2,849	3,231	3,761
Poverty rate (%)	21	60	47
Workers in Israel	128,000	36,000	37,500
Remittances/GDP (%)	21	–	–
Unemployment (%)	10	30	27
Dependency ratio	WB 4.3	5.8	
Gaza	5.9	8.2	
Investments ($m)	1,450	150	
Population under 15 (%)		46	47
Foreign aid per capita ($)		315	300

Notes: 50 percent of the West Bank population and 86 percent in Gaza receive foreign aid after the Intifada.
Source: World Bank, 2003 and 2004.

presented are the rate of population growth as already stressed, the literacy rates, and the percentage of the labour force engaged in agriculture. The PA economy exhibits these features.

Table 2 shows that countries with high rates of population growth do not get out of the trap of under-development because they cannot afford high enough capital per capita, which is a *sine qua non* for initial economic development. Looking at Table 2, we find that the size of a country has no relationship to its growth and economic development; some very small countries are quite prosperous, such as Luxembourg and Belgium, while big countries like Angola and Egypt do not have sustainable economic development.

One should remember these facts when raising the subject of the size of a *viable state*. Looking at the data on the size of nation-states of the world, it becomes clear that the *size* of the PA in the West Bank and in Gaza is sustainable. However, while size is not important to the prosperity of a country, the *efficiency of its transportation network* is, meaning that the roads between cities *must remain open* so that inter-urban trade is possible.

The other element important to growth besides fertility rates is the level of literacy. Compared to other countries with similar GDP per capita, the level of literacy in the PA is not negligible. In the West Bank, the literacy rate among men is 95 percent, while in Gaza it is 90 percent. Relative to its GDP per capita, the PA has the highest literacy rate among developing countries. For instance, in Niger, the literacy rate is only 25 percent. The high level of human capital in the PA can permit rapid development as in

TABLE 2

VARIABLES RELATED TO ECONOMIC GROWTH: DEVELOPING AND DEVELOPED COUNTRIES (2003–2004)

	Size country (sq km 000)	Population (millions)	Change in pop. (%)	GDP per capita	population under 14 (%)	Unemploy-ment (%)	Fertility Rate	Literacy rate (men, %)	Agriculture as part of GDP (%)	Labour force in agriculture (%)
Developing countries										
Angola	1,246	10	1.9	1,700	44	50	6.3	56	8	85
Cameroon	475	16	2.0	1,700	42	30	4.6	84	46	70
Egypt	995	74	1.88	4,000	34	12	3.0	68	17	29
Haiti	27	7.5	1.67	1,400	42	–	4.9	54	30	66
Algeria	2,381	32	1.65	5,400	32	31	2.6	78	8	25
Niger	1,247	11.7	2.63	900	47	–	6.7	25	39	90
Developed countries										
Cyprus (Greek)	9	0.77	0.56	15,000	21	–	1.9	99	4.6	5
Israel	20	6.1	1.4	19,500	26	10.4	2.4	98	3	2.6
Belgium	30	10	0.14	29,200	17	–	1.6	98	2	2
Luxembourg	2	0.45	1.23	48,900	19	–	1.7	100	1	1
Netherlands	41.5	16.3	0.57	28,600	18	4.2	1.7	99	2.6	4
US	9,631	293	0.9	37,800	20.8	6.2	2.1	97	2	2.4
The PA										
West Bank	5.8	2.2	3.8	800	43.8	30	4.4	95	9	40
Gaza	0.4	1.4	4.4	600	49	50	6.0	90	9	–

Source: World Development Indicators Database and CIA, 2005.

South Korea or China; however, a high human capital level is a necessary but not a sufficient condition.

The third and main element affecting the path to economic growth is the size of a country's agriculture sector. This variable is endogenous, and is the best indicator as to whether an economy is developed. A high percentage of the population working in agriculture indicates that the sector is inefficient due to a lack of capital. A *sine qua non* condition for economic growth is the worker leaving agriculture for employment in other sectors. Moreover, the difference between the percentage of the agriculture sector in the economy and the percentage of workers in this sector is the best predictor for economic development. The case of Niger makes it clear: There, 90 percent of the population earns its livelihood from agriculture while the agriculture sector accounts for only 39 percent of GDP. In the West Bank, 40 percent of the population is engaged in agriculture, but it produces only 9 percent of GDP. The economy is consequently inefficient. One must remember that the Industrial Revolution began with the transition from agriculture to industry. Without an increase in productivity in the agriculture sector and the concurrent drift from the country toward the city, the Industrial Revolution would not have been possible.[4]

THE EFFECTS OF DISENGAGEMENT ON THE PA ECONOMY

Disengagement will affect the PA economy through two main channels: trade and factors affecting growth. Let us begin by defining the conditions necessary for a sustainable process of disengagement.

Economic Conditions for a sustainable Disengagement Process

The analysis of disengagement has been monopolized by political scientists who have tried to define the elements necessary for a sustainable status quo. However, it is necessary to define the essential *economic* conditions that will generate economic growth. Therefore, the two necessary economic elements of disengagement are:

- A real border in the form of fence, wall, or other barrier that clearly defines the two sides of the economic border.
- No 'internal fences' inside the PA, which means that when the disengagement process is concluded, there will be no checkpoints, so that workers and goods can flow freely within the West Bank.

These two conditions are vital to achieving the free movement of labour and goods inside the PA. It might be that the political consequences of these conditions are that there will be no Israelis living on the east side of the border, thereby eliminating the need for checkpoints. The main economic and political issue raised by the disengagement process is whether the borders should be opened to Palestinians for work in Israel. We will therefore analyze the effect of disengagement in two scenarios: the first, in which only goods may pass through the fence, and the second in which labour is also allowed to enter Israel.

Trade

The basic theorem of international trade claims that a situation in which *workers* move from a country with low wages to one with high wages is equivalent to a situation in which *goods* move freely between these two countries. In other words, 'movement of goods is equivalent to a movement in the factors of production'. The premise underlying this theorem is that when trade is allowed, then a country that is relatively abundant with unskilled labour will export goods whose production process is labour-intensive.[5] Consequently, wages will go up, just as if workers had worked abroad. We may then extrapolate from this international trade theorem that allowing *free trade* between Israel and the PA is equivalent to allowing the *movement of labour* from the PA to Israel, since the PA is abundant with unskilled workers and Israel is relatively abundant with capital and human capital.

For this international trade theorem to apply—which implies that allowing either workers and goods to enter Israel, or goods only, has the same effect—many assumptions have to exist. We will show that in a world with imperfect information and/or with externalities, these two options are not only *not* equivalent, but in the medium term allowing an influx of Palestinian workers into Israel is the wrong choice. Let us first analyze the scenario wherein workers are allowed to enter Israel.

The Entry of Workers into Israel

Allowing a Palestinian labour inflow into Israel implies a return to the pre-Intifada situation (assuming that terrorism has ceased and therefore an inflow of workers is allowed by Israel). The remittances from workers in Israel, which before the Intifada represented 20 percent of the GDP, will lead to an increase in output and real wages and to a fall in unemployment.

This appears to be good for the Palestinian economy in the immediate term; however, it has negative implications for the future. Sending workers abroad is not economically perspicacious. First, the best workers will be the first to be hired in Israel, which leads to lowered productivity in the PA. Second, the fact that workers can work abroad usually reduces the desire to invest in the domestic economy. The stock of capital being already low in the PA, the highest priority must be to grant incentives to the financial and business world to invest there. An outflow of PA workers signals that it is not profitable to invest in this country: If the inhabitants, who have the best knowledge of the economy of the region, prefer not to invest, then nobody else will either.

Sustainable development requires investment in infrastructure, which will not happen if the tendency of workers is to go abroad to work. No less important, sustainable development is a consequence of learning by doing, which is not possible when workers leave their country. An outflow of workers is a signal that there are no dynamics of development, and since development is also a self-fulfilling equilibrium through investment, working abroad is a bad option.

Outflows of Goods, But Not *Of Workers*

The other possible scenario is that disengagement will result in goods but not workers being permitted to enter Israel. Since the PA has an abundance of unskilled labour, it will export goods that are labour-intensive. During the first two years following disengagement, there will not be enough capital in the PA to enable full employment. Therefore, it is important that foreign donors, including the EU and the US, help with funds to cover the gap in capital. Yet over time, with an increase in exports, this aid will not only enable wages to rise, but will also reduce unemployment. Assuming that terror will have ceased, and as such there will be no IDF incursions into the area to destroy terror infrastructure, then the low relative wages in the PA will enhance incentives to invest, and a process of development will start.

While this process takes time, it is the only way to increase productivity and decrease employment in agriculture over time, which is the essential condition for development. The inflows in capital that will then occur, instead of the outflows of workers, will perhaps lead to the same ratio of capital to labour, yet over time these flows will enable the development of the industrial and services sectors, resulting in higher productivity. The process of learning by doing and building human and physical infrastructures are necessary prerequisites for an inflow of private capital.

In conclusion, despite the fact that in the short run either a movement of labour *or* of goods is equivalent; in the medium and long term, the difference will have an impact. A country that is leaning on an outflow of workers pays a price in the short run when this option is suddenly eliminated. But in the long run, halting the outflow of workers is the only way to enable development and growth.

Applying the theorem of international trade to the disengagement process, which is abhorred by the Palestinians for political reasons, will in fact incur many benefits from the economic point of view. But is disengagement alone a sufficient condition for development? In order to answer this question, one must turn to the theories of economic growth.

Economic Growth

Theories of economic growth focus on the elements necessary to the process of development. In the 1950s, the seminal work of Nobel Prize winning economist Robert Solow showed that in order to allow high output per capita and resultant economic growth, high investment rates and low fertility rates are essential.[6] Recently, new growth theories have changed the focus of economic development, emphasizing that it is not sufficient to emphasize investment and fertility rates, as it is more important to stress the elements that *lead* to high investment and low fertility, i.e., the country's institutions. Empirical work has shown that the system institutions that impede growth are, among others, corruption, a lack of property rights, and a bad judicial system.[7]

While there is no argument that high fertility rates impede growth, they are no longer seen as exogenous, but rather are affected by the trade-off that the family faces between quality and quantity of children, taking into account the whole economic structure (the term *quality vs. quantity of children* was coined by Nobel Prize winner Gary Becker).

The high fertility rate in the PA is due, on the one hand, to the specialization in agriculture, and on the other hand to dependence on foreign aid. On the first issue, many countries are caught in a non-development trap because the population works in agriculture, and since child labour is required in this sector, fertility rates are high. In other words, high fertility rates are related to an economy specializing in agriculture. It is not easy for countries where a high percentage of the labour force works in the agriculture sector to move to equilibrium with lower agriculture, lower fertility rates, and higher output in industry and services. However, output per capita will increase only when workers move out of agriculture and into either industry or services.

In the past few decades, countries such as South Korea and China that have succeeded in making this transition did so through government intervention. It might seem odd for neo-liberal economists to infer that government intervention is necessary. However, countries that did not initiate their own industrialization processes are trapped in a bad equilibrium of a high agriculture ratio and high fertility rates, and they have no incentives to change it. Policies that give incentives to a more rapid move out of agriculture are painful in the short run, but it is the only way for a country to develop in the long run. Moreover, the drift away from the rural sector endogenously also affects fertility rates. Consequently, if concomitantly with the building of the fence—by rendering agriculture less appealing—foreign countries invest in industrial clusters throughout the PA, then this could produce a 'shock' enabling the Palestinians to begin a growth process.

On the second issue, foreign aid to the PA is necessary today and will be necessary in the next decade, and while it must have some long-term aims of enhancing a path of self-sustainable growth, UN policy should not be counterproductive. Today foreign aid leaves families unaware of the trade-off between quality and quantity of children, since food is available.

Foreign aid should create the right incentives by making aid a function of fertility rates, that is, foreign aid per person should be negatively related to the size of the family.[8] If parents think that they can afford to have more children, the West should not have to pay for them, particularly as there is a consensus among economists that, 'After decades of controversy over the issue of population policy, there is a new international consensus among, and between, industrial and developing countries that individuals, countries, and the world at large would be better off if population were to grow more slowly'.[9]

A decrease in fertility, which goes hand in hand with a reduction of the agricultural sector, will lead to investment in human capital, and in turn to a process of growth. The shock of the disengagement process can therefore trigger the move to equilibrium with high growth. In addition, simultaneous to a reduction in the percentage of the population working in agriculture, the decrease in fertility will enable more investment in human capital. In this new equilibrium, we will see the economy climbing 'up the ladder' from agriculture to industry and services. In conclusion, neither opposition to the disengagement process nor that to the building of a fence has an economic rationale. However, the debate regarding the fence has been handled sloppily: the disagreement is actually about the *route* of the fence.

THE ROUTE OF THE FENCE

While there is no vigorous debate in Israel on the necessity of the fence, there are disagreements on its route. The fact that each month changes are made in the fence's route leads to a reduction in its credibility, not to speak of a rise in political friction. Despite the fact that it is obvious to all that the fence's route is a political choice, borders based on some rational decisions are more sustainable than those based solely on politics. A rational path in this case would be to arrive at the route as an optimal solution to an analytical question in performance analysis.

The route of the fence should be such that it minimizes the population of Israelis on its eastern side, and at the same time minimizes the Palestinian population on its western side. Inserting data on the topology, and demography of the region, one has to run an equation on the form: Min P_l s.t. $P_e < P_o$, and s.t. $L_l < L_o$; where P_l, P_e are respectively the size of the Palestinian population on the west side of the border, and the size of the Israeli population on the east side of the border; P_o is the maximum size of the Israeli population that could stay on the east side for political and security reasons; L_l is the size of land expropriated (or bought) from the Palestinians, and L_o is the maximum size of territory disenfranchised from the Palestinians that can be accepted by a court of law. While it is possible to add some more constraints to this maximization, the important outcome of this exercise is that the fence route ultimately chosen has the credibility of being rational, and will therefore be immune to international criticism.

CONCLUSIONS

The disengagement process that took place in Gaza caused a shock to Israeli society, with its long-term effects still unforeseen; yet its after-shock on Palestinian society is no less worthy of attention. The disengagement from Gaza is only the first step in a process that will also entail disengagement, in some form, from the West Bank. Focusing only on the economic side-effects, this paper has shown that the disengagement process and the security fence can have positive effects on the Palestinian economy. This positive conclusion may seem strange in light of the poor performance of the PA economy in recent years. But the disengagement process can play the role of a catalyst for the changes necessary to enable the PA to escape the underdevelopment trap. A good example of such a catalytic phenomenon, and a process of development that took place, are the Eastern European countries. The Romanian and Ukrainian economies were in chaos following the transition to democracy. Their GDP per capita was very low, and during the first half of the 1990s both countries lost more than 30 percent of their GDP. These countries are now growing by 6 percent per year. The transition process has taught us that exogenous shocks can have a positive permanent effect on countries. Hopefully, the disengagement process might have the same effects.

However, this positive conclusion is predicated on steps taken by both the PA and the Israeli government. On the one hand, the PA not only needs to implement its programme of governance reforms in order to create an environment more appealing to private investors, but it must also end internal political chaos. On the other hand, Israel must permit the free trade of goods in the most efficient way. There is a tendency to address the misery of the Palestinians by pointing fingers at Israel. But the extent to which the PA will be the author of its own future misfortune or success should be given adequate consideration.

This paper has stressed that free flows of goods are necessary for the development of the PA economy, but free movement of labour is not. There is no doubt that in the short term it is easier and better for the PA economy to let the Palestinians work in Israel. However, in the medium and longer term this is not the best solution. Rather, it is preferable to create employment in the West Bank and Gaza. The disengagement process should therefore also be applied to the flow of workers.

This proposal may seem strange, since most economic analysis in recent years has been monopolized by experts who have argued for the integration of the economies of Israel and the PA. This paper takes the opposite view, showing that for both Israel and the PA disengagement can be economically beneficial. For Israel, the gain will be a decrease in terrorism and a return to normal investment rates. From a purely economic standpoint, neither disengagement nor integration makes much difference to Israel, since its interaction with the PA is minimal. For the Palestinians, disengagement could be a jolt, which if exploited to make some institutional changes will enable the Palestinian economy to start developing.

At first glance, the arguments presented here could be perceived as provocative in a world where Palestinians try continuously, and with some success, to persuade the West of the horror of the disengagement and the wall. The World Bank has arrived at similar conclusions:

> It is true that access to the Israeli labour market would be a quick way to boost income [in the PA]. However, it would risk perpetuating a high level of economic dependence on Israel, hindering the emergence of a diversified development strategy with long-term growth potential.[10]

We cannot fool ourselves into thinking that, as in a fairy tale, a fence will be erected and economic growth will simply appear. As was discussed above, other elements are necessary for generating the dynamics of development, including changing the country's institutions, eliminating corruption, and allowing free trade. However, while disengagement *per se* is not enough, it could be a trigger for generating both institutional changes and a move out of agriculture, therefore, pushing the PA in the direction of development and growth.

NOTES

1. These conditions are met in post-disengagement Gaza, although free movement of goods outside Gaza requires further agreements between Israel, the PA and Egypt.
2. There are, however, some signs of malnutrition.
3. N. F. R. Crafts, *British Economic Growth during the Industrial Revolution*, Oxford, 1985.
4. See P. Krugman and M. Obstfeld, *International Economics*, New York, 2003.
5. See R. M. Solow, 'A Contribution to the Theory of Economic Growth', *Quarterly Journal of Economics*, Vol. 70 (1956), pp. 65–94.
6. P. Mauro, 'Corruption and Growth', *Quarterly Journal of Economics*, Vol. 110, No. 3 (1995), pp. 681–712.
7. It is surprising that in World Bank reports on the PA economy, the problem of population increase is not addressed.
8. R. Cassen, *Population Policy: A New Consensus*, Washington, 1994, p. 12.
9. World Bank, *Twenty-Seven Months—Intifada, Closures, and Palestinian Economic Crisis: An Assessment,* Washington, DC, 2003.
10. See Brezis, E. S. 'Economic Cooperation and conflict Resolution: Europe and the Middle East', *European Union Review,* (2003), pp. 7–38.