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THE ECONOMIC AND SOCIAL EFFECTS OF FOREIGN AID IN PALESTINE

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CONTENTS

INTRODUCTION	5
LITERATURE REVIEW.....	6
DEFINITION	9
OVERVIEW OF THE PALESTINIAN ECONOMY.....	10
THE SOCIAL CONTEXT	11
THE ECONOMIC CONTEXT	12
AID TO PALESTINIANS: A BACKGROUND AND ANALYSIS OF MOTIVES	15
HISTORY AND DECLARED OBJECTIVES.....	16
BETWEEN WHAT SHOULD BE AND WHAT IS?	18
SOURCES AND USES OF FOREIGN AID.....	18
MEASURING ECONOMIC AND SOCIAL INFLUENCE OF FOREIGN AID	21
ECONOMIC INFLUENCE	21
SOCIAL INFLUENCE	25
INTERNATIONAL AID AND INTERNATIONAL SOLIDARITY	28
PALESTINIAN PERCEPTION OF ARAB SOLIDARITY	29
PALESTINIAN PERCEPTION OF INTERNATIONAL SOLIDARITY.....	29
CONCLUSION.....	31
BIBLIOGRAPHY	32

ACRONYMS

DAC	DEVELOPMENT ASSISTANCE COMMITTEE
EC	EUROPEAN COMMISSION
GDP	GROSS DOMESTIC PRODUCT
GS	GAZA STRIP
JD	JORDANIAN DINAR
MOP	MINISTRY OF PLANNING
NGO	NON-GOVERNMENTAL ORGANIZATIONS
NIS	NEW ISRAELI SHEKEL
OECD	ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT
ODA	OFFICIAL DEVELOPMENT ASSISTANCE
OPT	OCCUPIED PALESTINIAN TERRITORY
PCBS	PALESTINIAN CENTRAL BUREAU OF STATISTICS
PLC	PALESTINIAN LEGISLATIVE COUNCIL
PMA	PALESTINE MONETARY AUTHORITY
PNA	PALESTINIAN NATIONAL AUTHORITY
UNDP	UNITED NATIONS DEVELOPMENT PROGRAM
USD	UNITED STATES DOLLAR
WB	WEST BANK

THE ECONOMIC AND SOCIAL EFFECTS OF FOREIGN AID IN PALESTINE

ABSTRACT

This paper evaluates the economic and social affects of foreign aid in Palestine during the period of 1994 – 2009. The estimates of economic impacts have been obtained using the endogenous growth model, whereas the social effects have been gauged using qualitative and descriptive analysis. Results indicate that most of foreign aid is consumed and not invested, implying that the Palestinian National Authority can not depend on this aid to achieve sustainable economic growth. Moreover, a relatively high proportion of aid is given to Palestinians based on political considerations rather than for solidarity and development matters, which makes the Palestinians feel less affinity with the donors.

INTRODUCTION

As is the norm in economics, conflicting views arise when discussing the economic and social effects of foreign aid to developing countries, let alone its effectiveness. Thus any constructive and objective conclusion to such discussion must take into account the motives behind foreign aid.

Economists propose different rationales for why developed countries would extend a hand to the less developed. Martens (2005) sees it as a form of redistribution of wealth; a phenomenon stemming from a deeply embedded human inclination to aid one another, which surpasses immediate family to wider and more complex societies. Therefore, aid, according to Martens, is “a result of cognitive dissonance in the donor’s mind that the situation of the deprived does not correspond to his own perception of how the world should be”. Philosopher Peter Singer (1972) considers aid a moral obligation, on the premise that: *“If it is in our power to prevent something bad from happening, without thereby sacrificing anything of comparable moral importance, we ought, morally, to do it”*.

Opponents, in contrast, neutralize morality; scholars like Easterly (2003) and De Mesquita and Smith (2007) argue that donors provide aid to recipient countries in pursuit of their economic benefits, geopolitical interests, or both. Whether to gain allies, ensure access to recipients’ natural resources or mitigate political instability, such scholars believe that aid usually comes at a price (usually in the shape of policy concessions), which might, in turn, explain why aid might not go to the poorest countries.

One cannot truly determine the underlying purpose of foreign aid to a certain country without understanding the economic and geopolitical context of both the donor and the recipient, nor can one deem this aid as effective or ineffective without identifying the purposes it is supposed to serve. A closer look at the Palestinian case ties the timing,

volume, target and form of aid to political changes on the ground; it easily the responsiveness of aid to these changes, as we will discuss later on. Aid to Palestinians came in all forms and shapes: crisis relief, development projects, budget support, donations to grassroots organizations, loans and technical support; and all have served different purposes.

Regardless of the goals or forms of aid that Palestinians have received over the past two decades, however, this aid has been reflected significantly in the economic, social and political scene in Palestine. What we are trying to do here is to evaluate the effectiveness of aid in spurring economic growth, building strong and effective institutions, laying down the basis for economic development and paving the way to a Palestinian independent state.

Whether aid positively affects the Palestinian society, reduces poverty, leads to constructive cultural exchange or fosters solidarity between the people of both recipient and donor countries is also to be discussed in this paper.

LITERATURE REVIEW

The effect of aid on economic growth is usually the highlight of any discussion regarding the effects of foreign aid on under-developed countries. Yet other aspects such as its effects on governance, competitiveness, political independence, social composition, poverty and total welfare also attract the attention of many economists.

An array of literature argue in favor of positive effects of aid on growth; (Kosack and Tobin, 2006) hold that aid contributes powerfully to both economic growth and human development with a higher degree of democratic responsiveness in recipient countries, while (Burnside and Dollar, 2000) condition such positive relationship on the dominance of good economic policies. In their work, Burnside and Dollar examine the effect of good policies in recipient countries on both the effectiveness of aid and the amount of aid

donors are inclined to provide by constructing a policy index and incorporating it into their model. The result was that even though little evidence connected aid to growth, aid seems to have more influence in countries that adopt sound policies. The study also found that multilateral donors¹ prefer countries with good policies.

Neandis and Varvarigos (2005), on the other hand, were more concerned with the allocation of aid between productive and non-productive sectors and the effect of aid volatility on economic growth. The two researchers concluded that while directing aid to productive sectors has positive effects on growth, aid transfers to non-productive sectors adversely affects growth. In contrast, volatility of aid to productive sectors has damaging effects, while in non-productive sectors it enhances growth.

Not everyone applauds such findings, however. In an attempt to put Burnside and Dollar's work into a broader context, Easterly, Levine and Roodman (2003) conducted Burnside and Dollar's analysis more extensively, including more observations and using other equally plausible definitions of the variables used. No significant relationship between policies and aid effectiveness was found. Knack (2001) argues that higher levels of aid erode the quality of governance as measured by indices of bureaucratic quality, corruption and the rule of law.

Other scholars found little robust evidence of a relationship between aid inflows and growth, however. Whitaker (2006) argued that aid has an extremely modest effect and can be easily influenced by geopolitical factors to the extent that foreign aid might hinder economic growth. Rajan and Subramanian (2005) analyzed both cross-sectional and panel data yet found no evidence of a relationship between aid and growth; they also found no evidence that aid effects vary by soundness of policy, geographical location or type. Even though Rajan and Subramanian did not completely refute the

¹ A multilateral organization is an international organization whose membership is made up of member governments, who collectively govern the organization and are its primary source of funds. Examples of multilateral organizations are the World Bank and the United Nations. *Source: www.aidwatch.org.au*

existence of a relationship between the two, they argue that the existent aid apparatus must be changed for aid flows to be effective. In addition, further analysis must be done to understand the aspects that offset what ought to be the indisputable positive effects of aid.

In a following paper, the same scholars introduced an explanation for why no evidence exists of an effect of aid on long-term growth:

"We find that aid inflows have systematic adverse effects on a country's competitiveness, as reflected in the lower relative growth rate of labor intensive and exporting industries, as well as a lower growth rate of the manufacturing sector as a whole. We provide evidence suggesting that the channel for these effects is the real exchange rate overvaluation caused by aid inflows." Rajan and Subramanian, (2005)

But if aid harms the competitiveness of the recipients' exports, what alternatives can economists propose? Adam and O'Connell (2004) claim that trade preferences in the presence of learning-by-doing externalities in recipient-country's export production can increase the recipient's welfare. Others, stress the need for changes in developed countries protectionist policies. In an address in Uganda in 2002, Mark Malloch Brown, the head of the UNDP, criticized agricultural subsidies of developed countries:

"Every cow in Europe today is subsidised two dollars a day. That is twice as much as the per capita income of a half of Africa. It is the extraordinary distortion of global trade, where the West spends \$360 billion a year on protecting its agriculture with a network of subsidies and tariffs that costs developing countries about \$50 billion in potential lost agricultural exports.

Fifty billion dollars is the equivalent of today's level of development assistance. In short, there are huge distortions in the global political economy going way beyond

the modest levels of development assistance, which have to be tackled. The Millennium Development Goals are the vehicle for doing that."

Despite the enormous amount of literature discussing the impact of aid on growth, not enough attention was paid to its effect on poverty, as growth is considered the main driver in poverty alleviation. Le and Winters (2001) argue that poverty reduction cannot only be achieved by targeting economic growth, it requires an optimal allocation of aid among growth promotion, direct targeting of the poor and the provision of safety nets and direct transfers. In their case study, Le and Winters examined recent trends of aid in Vietnam across economic sectors, geographical regions and approach to poverty. The two researchers found imbalances between aid promoting economic growth and aid channeled directly for poverty alleviation. Such findings are an example of how inconsistencies in policies or aid programs can lead to mismanagement that can harm or at least not improve the welfare of aid recipients.

To summarize, no consensus is to be found among economists on the net effect of aid on growth, let alone relevant factors such as employment, poverty and overall welfare. Nonetheless, the above review serves two objectives. First, it provides insight on how aid works, and how factors in both recipient and donor countries can offset the positive impact of aid. Second, it sheds light on the aspects we should examine in this paper to evaluate the overall impact of aid to Palestinians. We start our analysis by defining what is 'aid' and what types are we to study, we then move to introducing an overview of the Palestinian economy.

DEFINITION

The term "Foreign aid", according to Whitaker (2006), may refer to a number of different activities, ranging from humanitarian support or crisis relief to military assistance and arms donations.

Burnside and Dollar (2000) define aid as the grant element of aid excluding the loan component of concessional loans, which are made at extremely low interest rates, a measure of aid that is called "Effective Development Assistance"

In this paper, we will examine the effect of Official Development Assistance (ODA) as defined by The Organization for Economic Cooperation and Development (OECD): grants and concessional loans net of repayment of previous aid loans – a measure that treats forgiveness of past loans as current aid.

OVERVIEW OF THE PALESTINIAN ECONOMY

Today's Palestinian economy is a product of a long and complex existential conflict. Yet history aside, the first time one was able to discuss a pseudo-autonomous Palestinian economy was after the signing of Oslo Accords in 1993, which replaced the direct and full Israeli authority over the two geographically separate regions (the West Bank (WB) and Gaza strip (GS)) with the Palestine National Authority (PNA). Palestinians were no longer under the civil rule of Israel. However, they were far from having space to grow, develop and move freely; restrictions on movement and trade were imposed, Israeli settlements continued to spread and expand within the Occupied Palestinian Territory (OPT), more land was confiscated, farms and trees were destroyed and houses were demolished systematically. The fight over resources continued, and this constrained entity was denied sovereignty; it had no specified borders, no control over crossings, no army or even a national currency.

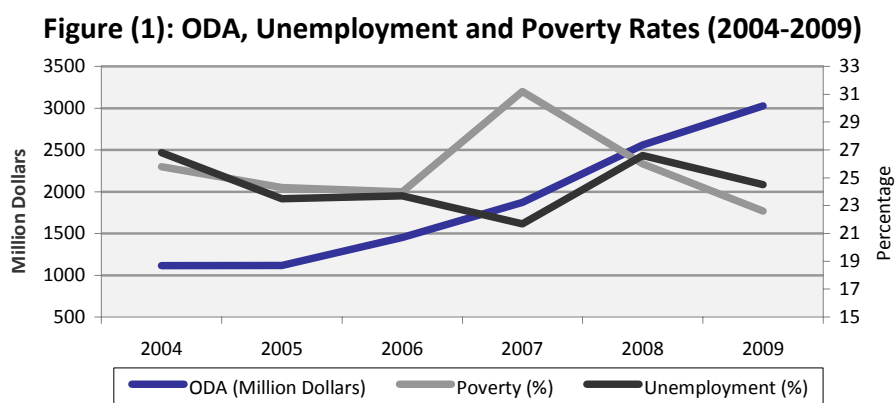
Eventually, an economy that is fraught with distortions and abnormalities came into existence. Despite several development attempts, today's Palestinian economy is best described as malformed. This small economy has been forced to grow dependent on: Israeli demand for goods and labor, international aid and remittances of Palestinian workers abroad. The absence of a national currency has deepened Palestinian dependence on others. Three different currencies circulate inside the Palestinian

Territory: the New Israeli Shekel (NIS), US Dollar (USD), and Jordanian Dinar (JD), leaving the economy subject to the monetary policies of issuing countries. Moreover, the unbroken cycle of military escalation has directed efforts from pursuing sustainable development and economic independence towards recovery from the considerable and repetitive damage.

THE SOCIAL CONTEXT

Numerous challenges have emerged from this constrained economic and political context. For the past 10 years, no less than a quarter of Palestinians were considered poor, and just as many were unemployed (this rate hit a staggering 40.1% among youth who received higher education in the age group 15-29 in early 2011). These indicators reached even higher rates in Gaza Strip (Palestinian Central Bureau of Statistics (PCBS), 2011).

For a Palestinian population of almost 4.17 millions in early 2011 (62% in WB and 38% in GS), growing at a rate of around 3%, such difficult economic conditions are even more pressing. Palestinians have an average family of 5.9 members, with almost 40% of the population under the age of 15 (PCBS, 2011).



However, the wide young base of the population has a promising side to it. This relatively young society enjoys literacy rates as high as 95% in 2010 (99.4 among age

group 15 – 24), with 50.4% of youth between the age of (18 - 22) enrolled in higher education in early 2011. Furthermore, around 41.1% of the population participate in the workforce, forming one valuable asset for Palestinians: human capital (PCBS, 2011).

THE ECONOMIC CONTEXT

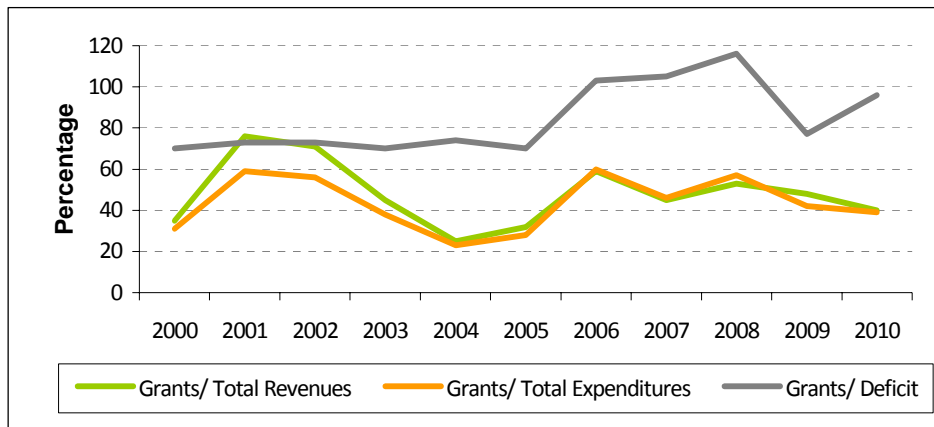
To this date, the Palestinian economy has failed to achieve self-sustained development. Growth has been extremely volatile and highly responsive to the political atmosphere. For instance, in 2001 and 2002 (the outbreak of the second Intifada) the economy shrank by 8.6% and 13.3% respectively. Recovery began afterwards at an average rate of 11.8% for the next three years (2003 – 2005) until legislative elections took place in 2006 and the Islamic Resistance Group (Hamas) won electoral majority; an economic siege followed. As a result, the economy suffered a 5% decrease in GDP. In the last four years (2007 – 2010), however, the relatively calm political atmosphere, and increased aid flows to the West Bank and Gaza Strip accelerated overall growth by an average of 7.3%. This growth was mostly attributed to significant increases in aid-funded government spending, which improved economic performance despite the worsened conditions in the Gaza Strip that remains under siege.

Overall prices of basic goods and services like water, electricity, telecommunications, transportations, and food are considerably high. Still, inflation rates over the last 10 years did not break from the ordinary. An average inflation rate of 3% has prevailed over that period, with the exception of two years: 2002, which witnessed the worst Israeli occupation and siege in the last decade, driving overall prices upwards by 5.7%, and 2008, with an inflation rate of 9.9% following the surge in global food and oil prices.

Today, both agriculture and manufacturing are in sharp decline due to high production costs, systematic land theft, vandalism of farms and production facilities and restrictions on movement of trade and labor. The manufacturing sector contribution to GDP went down from 22.1% in 1994 to 12.3% in 2010. Agriculture did not fare any better; its

contribution dropped from 13.2% to only 6.3% in 2010. On the other hand, non-productive sectors continued to grow to replace shrinking economic activities, amounting to almost 64% of total GDP² in 2010 (PCBS, 2011).

Figure (2): Contribution of Economic Activities to real GDP in 2010



Source: PCBS, 2011.

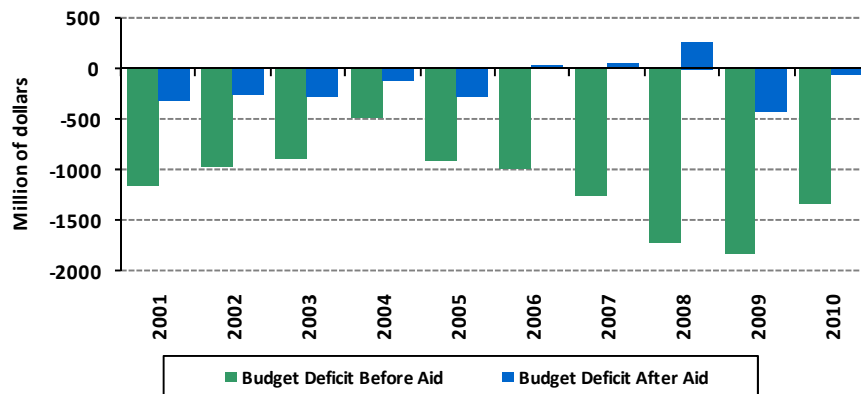
Economic closure and scarcity of resources has raised investment costs in Palestine significantly. The restricted high-risk investment environment has eventually driven out much of private investment. On the other hand, the public sector continues to grow. It employed, 178,800 Palestinians, or 24% of total employee workers in 2010, while government spending to GDP ratio amounted to 44% in 2010³ (PCBS, 2011).

The relatively high public spending is not the only problem; government revenue, although improving, still falls behind in meeting government expenditures, even at the short-term level. This prolonged gap caused an economic dependence on foreign grants and international aid, which still persists despite PNA efforts to reduce this dependence.

² This includes construction; wholesale and retail trade; transportation; storage and communications; financial intermediation; services; public administration and defense and households with employed persons.

³ Government spending to GDP ratio = Total Government Spending and Net Lending (Cash basis)/ Nominal GDP in 2010.

Figure (3): PNA Budget Deficit (2001 – 2010)



Source: The Palestinian Ministry of Finance, 2010.

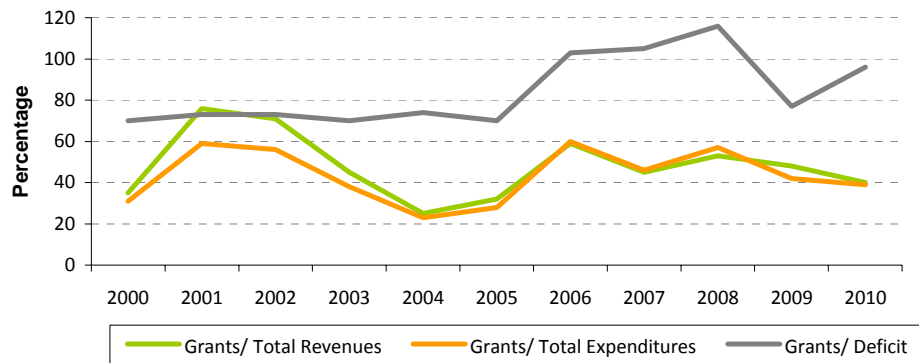
Budget deficit, as depicted in the above graph, has been considerably high over the past decade, and with the increase of government spending over the last 5 years, budget deficit seemed to grow further; in 2009, deficit hit its maximum level in a decade at almost 1.8 billion dollars.

Due to this growth in deficit, volatility of external funds, and diplomatic efforts to lay grounds for the future Palestinian state, the PNA has pursued several austerity measures, while simultaneously reforming the tax collection system, in an attempt to reduce deficit, and therefore, reduce dependency on international aid.

The figure below can help explain why aid dependency is such an issue for Palestinians. On average, aid has constituted around 48% of revenues, 43% of expenditures, and 84% of deficit financing over the last decade. These figures reflect the fragility of the PNA's financial position; with aid making almost half of its budget, any stop in aid flows will have disastrous repercussions on the PNA and the economy as whole. Palestinians experienced this first hand in 2006, after Hamas won the vast majority of the Palestinian Legislative Council (PLC). The economic siege imposed on the PNA lasted for around 18 months, making it unable to pay salaries for almost 160,000 government employees that year, who provide for almost one third of the Palestinian society. Consumption was

highly affected, and most of Palestinian NGOs lost their funding. All this practically paralyzed not only the PNA but also the entire economy.

Figure (4): Grants as a Percentage of Total Revenues, Expenditures and Deficit⁴



Source: Palestinian Ministry of Finance, 2011.

AID TO PALESTINIANS: A BACKGROUND AND ANALYSIS OF MOTIVES

Critics of international aid to developing countries often accuse it of being rather politically-driven than truly concerned with the welfare of recipients or with real sustainable development on the ground (Easterly (2003), Schraeder, Hook and Taylor (1998)). Others, such as Lumsdaine (1993) argue that even though political factors must be considered, the donor's "moral vision" is the main driving force behind foreign aid. Alesina and Dollar (2000) believe that the allocation of foreign aid is dictated as much by political and strategic considerations, as by the economic needs and policy performance of the recipients. To take either side or to tell the difference might be somewhat complicated in some cases.

An objective investigation of the motives behind foreign aid to Palestinians requires a comprehensive study of the history, declared objectives, composition and the

⁴ Total revenues = domestic revenues + grants – tax refunds

Total expenditures = current expenses + development expenses + net lending

Deficit = total revenues – total expenditure

responsiveness of this aid to geopolitical changes and the economic needs of Palestinians.

HISTORY AND DECLARED OBJECTIVES:

Until 1993, there was no Palestinian authority to directly administer the political, economic and social aspects of Palestinian life. A month after the declaration of principles, or what is now known as the Oslo Accords, a conference was convened in Washington for the international donor community to mobilize support for the newly established PNA and to garner all financial resources needed to make this agreement successful. Both donor countries and agencies pledged a total of \$2.4 billion in the form of loans, grants and technical support over a period of 5 years (Mark, 2005). The main purposes of this aid, as summarized by Awartani and Al-'Amad (2011), were:

1. Supporting the Israel-PLO peace process through financing sustainable economic development in the West Bank and Gaza Strip and implementing life-enhancing projects.
2. The creation of a new stabilized Mid-east system based on intermutual security and prosperity of the nations of the region, to later append this promising market to the global economy.
3. The elimination and containment of regional tension, violence and struggle, while pushing towards more liberalized markets and promoting democratic institutions and human rights protection.

Translating these goals into reality was easier said than done; only 50% of pledged aid was disbursed (Awartani and Al-'Amad, 2011), making it difficult for the development process to meet the outlined objectives in time. Moreover, the effectiveness of this aid was heavily impaired by Israeli on-ground policies and procedures that have been a constant obstacle to development.

Ever since, international aid, even though vital, has failed to lead the Palestinian economy to achieve sustainable development as revealed in our overview of today's economy. Israeli policies, especially during the second Intifada, had the lead role in interrupting the development process, as it led donors on numerous occasions to re-direct funds that were originally allocated for development purposes to contingent crisis-relief uses. Even in periods of relative calm, Israeli restrictions on movements of individuals and goods and control over resources have always managed to smother this economy enough to hinder real economic development (Shtayeh, 2011).

If the above is meant to prove anything, these are two: one, that donors face a rather difficult challenge, which is to eradicate, with money, the economic and social problems created by politics; and two, that they cannot, or at least, have fallen short of this challenge for the time being.

To achieve sustainable development in Palestine, donors need to first spot the deformities and abnormalities in the economy and to determine their causes, effects and context.

Deformities in the Palestinian economy are represented in the gradual erosion of the Palestinian productive sectors, specifically agriculture, while non-productive sectors continue to grow locally with low and internationally uncompetitive quality. The causes can be identified as Israeli closures; restrictions on movements of individuals and goods; barriers to trade and transfer of capital, labor and technology; continuous confiscation of land and intentional destruction of crops and production facilities, which all make products rather costly and uncompetitive and discourage investments in productive sectors. The effects can be summarized in one simple result: ***making self-sufficiency even harder and furthering Palestinian dependency on aid.***

All the above must be put into context; the Palestinian economy is originally an agricultural economy that benefits from fertile soil, geographical diversity and moderate Mediterranean climate. The quality of human capital makes it easier to transfer technology to Palestinian productive sectors. Solutions might vary, but the obvious one is as suggested above: adding political pressure on Israel to ease restriction and cease its systematic exhaustion of resources, while simultaneously providing extensive financial and technical support to Palestinian productive sectors.

BETWEEN WHAT SHOULD BE AND WHAT IS?

A question arises at this point: are there attempts by donors to provide such support? To answer, one needs to study two things: the current reality on the ground and past trends in allocation of aid.

The reality is rather obvious, settlement expansion (confiscation of lands) continues, so does the destruction of farms and crops for thousands of Palestinian farmers. Barriers to trade still hold, raising the prices of both imported raw materials and exported finished goods, making prices uncompetitive. Moreover, Gaza Strip is still under siege since 2006, and the business climate is still considered hazardous which discourages investment.

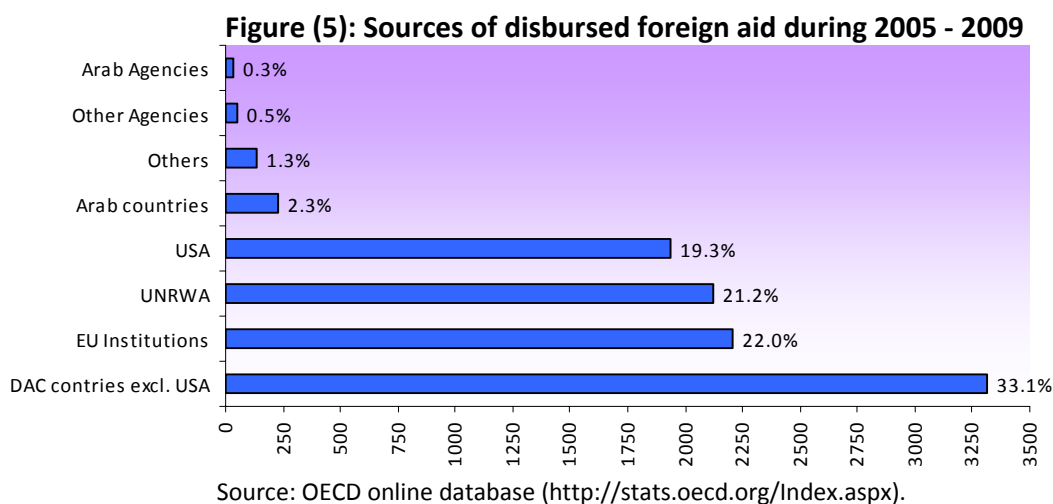
Even if we are to assume that Israeli policies would have limited effects on the development process, or at best can be neutralized, one cannot ignore that the volume and composition of aid determines to a great extent what this economy would grow into. Therefore, we must first depict the sources and uses of aid to Palestinians before we can evaluate its ability to satisfy Palestinian development needs.

SOURCES AND USES OF FOREIGN AID

Issues regarding data reliability, availability, consistency, and variations among different sources represent the main impediments to robust analysis of the effects of aid. Hence,

the uses and sources of aid to Palestinians have been analyzed for the period 2005 – 2009, where data show most reliability and consistency⁵. The Palestinian Ministry of Planning (MOP) indicates that Palestinians received about \$10.48 billion of foreign aid during this period, whereas OECD data estimates an amount of about \$10 billion. Therefore, based on data availability and details, we will use MOP data for purposes of sectoral distribution of aid and analysis of uses. On the other hand, we will use OECD data to analyze sources of aid.

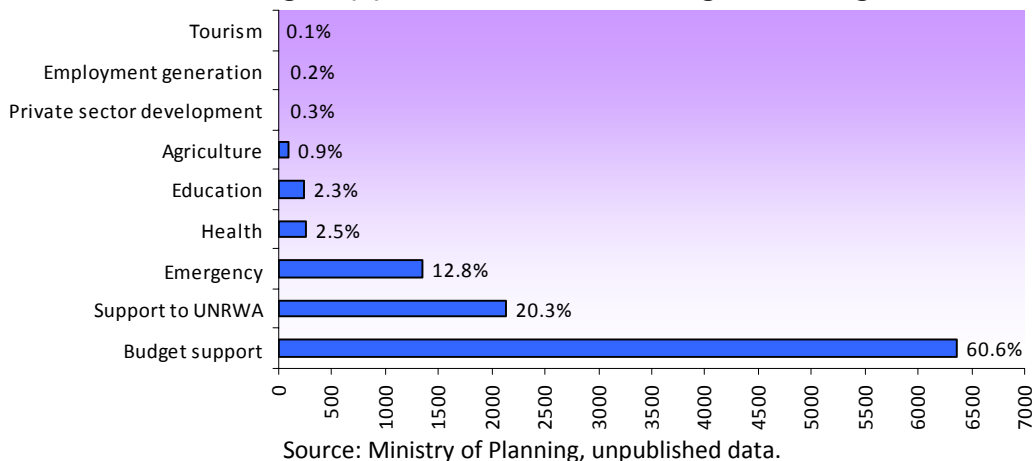
The Palestinian government and civil organizations received a total of foreign aid of about \$10 billions during the period of 2005 – 2009 from various donors. Of those donors, the Development Assistance Committee (DAC) countries (excluding USA) participated with almost one third of total funds during the period of analysis, or \$3.3 billion. European Institutions (EU) and UNRWA contributed about \$2.2 billions (22.0%) and \$2.1 billions (21.2%) of foreign aid, respectively. The USA , on the other hand, appears to be a key donor to Palestinians, as it solely provided about 19.3% of total foreign aid during 2005 – 2009. As for Arab countries, participation did not exceed 2.3% during the same period, providing an amount of \$231 million. Finally, other agencies, including Arab agencies, contributed almost 0.8% of foreign aid, figure 5.



⁵ MOP provides data for the period of 2005 – 2009 because recording and collecting foreign aid data before this period was performed in an inaccurate way.

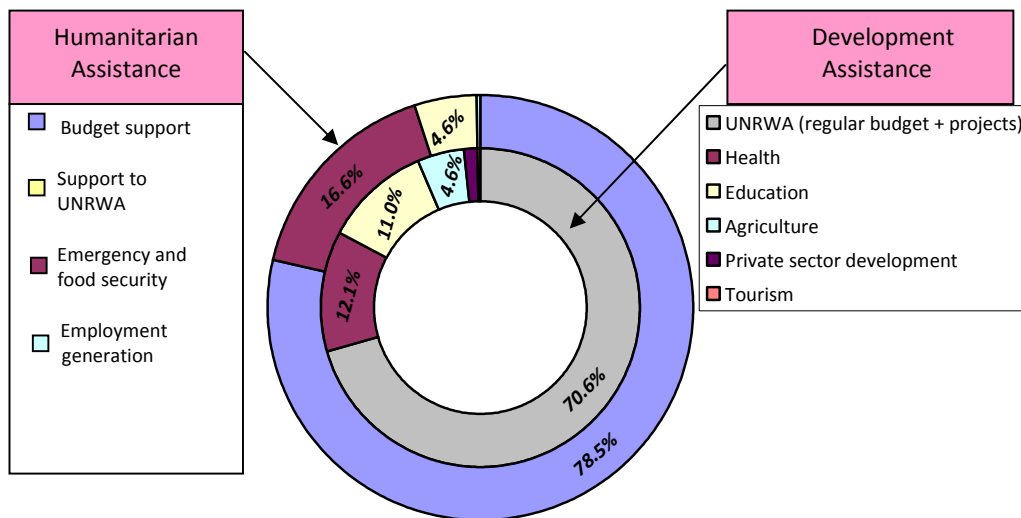
As for uses of foreign aid, data available indicate that most of aid during 2005 - 2009 was directed to budget support, as its share constitutes about 60.6% of foreign aid during the period of analysis. Support to UNRWA came second with almost 20.3% of foreign aid; while emergency and food security aid accounts for 12.8%. Aid directed to economic sectors is relatively little and even negligible. Health and education sectors received a relatively small percentage of aid, about 2.5% and 2.3%, respectively; Agriculture's share was even lower with about 0.9%, while tourism received about 0.1%. Private sector development and employment generation received about 0.3% and 0.2% of total foreign aid, respectively.

Figure (6): Uses of disbursed foreign aid during 2005 - 2009



The following chart is a graphical representation of the uses of disbursed foreign aid according to the type of assistance (i.e. Humanitarian and development assistance). Figure (7) shows that humanitarian assistance constitutes about 78.9% of foreign aid, compared to around 21.1% for development assistance. Moreover, of total development assistance, a relatively low percentage of foreign aid is allocated to productive economic activities. About 1.2% of development assistance is channeled for private sector development, while 4.6% and 0.4% are directed towards the agriculture and tourism sectors, respectively.

Figure (7): Disbursed foreign aid by category during 2005 - 2009



source: Ministry of Planning, unpublished data.

MEASURING ECONOMIC AND SOCIAL INFLUENCE OF FOREIGN AID

ECONOMIC INFLUENCE

Many economists raise the argument of the influence of foreign aid, where some argue that foreign aid has a positive influence on economic growth mentioning the advantages of this aid (Morrissey, 2001; Fayissa and El-kaissy 1999; and Papanek 1972). Others argue that aid has a negative influence on the real economy pointing out disadvantages of foreign aid (Duc 2006; Knack 2001; Easterly, Levine and Roodman 2003; Gong and Zou 2001). A third group of economists has linked the positive influence of aid to some political and economic conditions (Burnside and Dollar 1997; and Snyder 1993; Singh 1985). Therefore, the relation between foreign aid and economic growth is inconclusive.

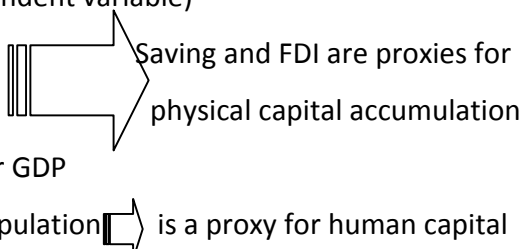
This paper tries to depict the type of relation between foreign aid and economic growth in Palestine i.e. it attempts to answer the following question: what is the relationship between foreign aid and economic growth in Palestine? We will answer this question

using an econometric "*endogenous growth*" model, in which we investigate the influence of foreign aid on economic growth⁶.

By doing so, we replicate Duc (2006), where he used the following model:

$$Y = f(S, FDI, ODA, ST, TR, POP)$$

Where

- Y Growth rate of GDP per capita (Dependent variable)
 - S Gross domestic savings over GDP
 - FDI Foreign Direct Investment over GDP
 - ODA Official Development Assistance over GDP
 - ST Number of Secondary Pupils over Population
 - TR Trade over GDP
 - POP Growth rate of population
- 

Data was compiled from two sources: Palestine Central Bureau of Statistics (PCBS), and OECD statistics. GDP per capita, saving, foreign direct investment, secondary pupils, trade, and population data were compiled from PCBS, while OECD is the source of official development Assistance data. Data is available for the period of 1994 – 2009; therefore, it is the period of interest.

Savings raises the capital stock, thus it's expected to have a positive influence on economic growth. In addition, FDI represents the channels through which technology is transferred from developed to developing countries, therefore, it is believed that FDI enhances economic growth. Investments in human capital are supposed to foster economic growth through generating new products and technological progress. High population growth rate entails economic and social problems, thus it has a negative

⁶ Fore more information about endogenous growth theory, please refer to Barro, 1991.

influence on economic growth. Finally, the influence of foreign aid remains ambiguous but likely to be positive in countries with good policies.

Ordinary Least Squared (OLS) technique is used to estimate the effect of the explanatory variables on the GDP per capita growth. Results presented in table (1) show a negative and insignificant relation between ODA and growth rate of GDP per capita, indicating that foreign aid to Palestinians is most likely consumed and not invested. This result coincides with Duc (2006), in which he shows that, in general, economic growth has a negative relation with foreign aid in developing countries. Moreover, results indicate that foreign aid is increased during periods of conflicts⁷, which implies that most foreign aid serves humanitarian purposes and is of short-term influence.

Table (1): OLS simple regression for the period 1996 – 2010

Variable	Coefficient	Standard Error
Constant	-1.18	3.206
Gross Domestic Saving/GDP	0.17	0.121
Foreign Direct Investment/GDP	1.66***	0.245
Official Development Assistance/GDP	-0.26	0.143
Trade (exports + imports)/GDP	-0.47**	0.180
Population Growth rate	0.25	0.649
Dummy (2008)	6.42	5.102
D01*ODA	0.22**	0.091
F-statistics	11.71	
Adjusted R-squared	83.3%	
Durban Watson	2.33	

*** and ** represents 1% and 5% level of significance, respectively.

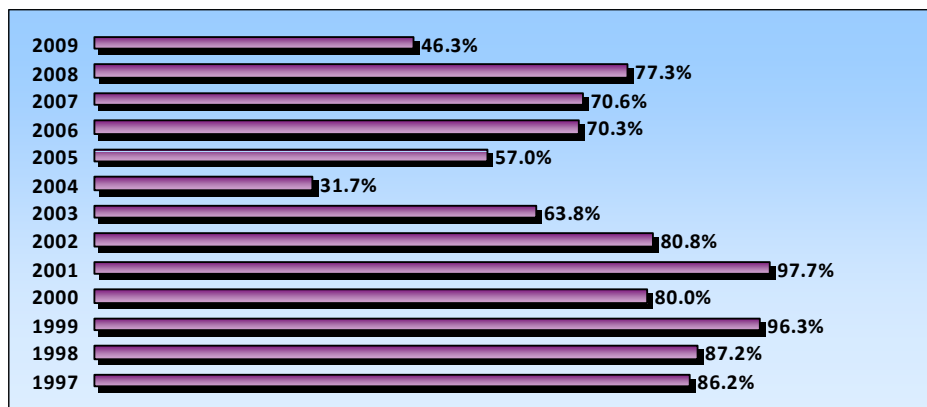
An analysis of the composition of aid might further explain results. Most of foreign aid given to Palestinians came in form of budget support, constituting about 72.7% of total foreign aid during 1997 – 2009, which implies that aid to Palestinians are consumed and not invested, therefore, it is not effective. This result is evident in budget support data

⁷ To this end an interaction between dummy variable D01 and foreign aid were created, where D01 equals 1 during the conflict periods (i.e. 1996, 2001 – 2004, and 2006 - 2007), and zero otherwise.

for the period 2007 - 2009, where aid designated for development expenditures did not exceed an average of 8% of total aid for budget support. Figure (8) below shows the share of budget support from foreign aid, where 2001 witnessed the highest share with 97.7%, while the lowest share was in 2004 with 31.7%. However, the high unemployment rate in Palestine is another indication of aid ineffectiveness. Despite substantial amounts of aid, unemployment amounted to about 24% of labor force in Palestine during 2000 – 2009⁸.

This is consistent with Burnside and Dollar (1997), who argued that foreign aid is effective only if it was invested, not consumed. On the other hand, Duc (2006) was more specific, arguing that foreign aid is more effective and viable if it is invested in the human capital rather than the physical capital of recipient countries.

Figure (8): Percentage of budget support to foreign aid 1997 - 2009



Source: MOP and ministry of finance data

Despite this result, foreign aid, still, has a significant role in poverty alleviation over the short-term, as discussed in the following section. However, aid inefficiency over the long-term requires Palestinian authorities to undertake a set of serious institutional, social, and economic reforms. Fighting corruption and reducing aid dependency are also vital to enhance the effectiveness of foreign aid. Moreover, donors might have to

⁸ According to geographical distribution, unemployment rates in the West Bank averaged about 20%, while in Gaza Strip it came close to about 33% during the period (2000 – 2009).

consider the specialty of the Palestinian society, its assessments and needs when aid is given. They need to support long term and strategic programs rather than short-term projects. Hence, foreign aid is effective when it supports reforms triggered by local government and meets Palestinian development needs, which is not the case in Palestine. Lastly and not least, an increase of international pressure on Israel to ease the trade and people movement is needed for enhancing the role of foreign aid.

SOCIAL INFLUENCE

In almost any development process, donors usually hope that the impact of aid will stretch beyond mere economic growth (i.e growth in real GDP). Development efforts usually aim at enhancing aid recipients' welfare through alleviating poverty, lowering unemployment and income inequality, providing improved social infrastructure and accumulating human capital among other things.

POVERTY

As with almost all economic variables, poverty levels reflect the impact of Israeli occupation practices and general political instability on Palestinian livelihood. In 2001, the World Bank issued a report '*Poverty in the West Bank and Gaza*' that covered the period 1996 - 1998. The World Bank reported almost a quarter of Palestinians living under national poverty lines⁹. The report also highlighted notable geographic disparities, as 17.5% of Palestinians in the West Bank were considered poor in 1996 compared to 46.1% of Palestinians in Gaza. Since then, donors have injected the Palestinian economy with millions of dollars for purposes of poverty alleviation, job creation, and crisis relief. By adopting various aid programs introduced mainly through the PNA, UNRWA and various NGOs, donors hoped to reduce the effect of the troubled political atmosphere on the poor. In this regard, statistics show some success in the short-term. In 2010, for example, direct cash or in-kind aid managed to reduce the poverty rate from 30.9% to

⁹ Poverty line in 1998 was set to NIS 1,460, or \$767.

25.7% (or by 17%). The table below depicts the effect of direct assistance on poverty for several chosen years.

Table (2): Poverty Rates in Palestine before and after assistance

Year	Poverty Rate Before Aid	Poverty Rate After Aid	Percentage Change
2003	40.4%	35.5%	12.1%
2005	34.2%	29.5%	13.7%
2006	35.7%	30.8%	13.7%
2010 ¹⁰	30.9%	25.7%	16.8%

Source: PCBS, 2011.

However, as donors expect development aid to achieve long-term welfare enhancement, a question arises to whether this aid, direct or indirect, has changed reality over the long term. Aid flows have proven to be crucial for alleviating poverty in the very short-term, and data shows that they may have achieved some success over the period 2003- 2010. However, even after 16 years of development efforts, almost a quarter of Palestinians remain poor.

HEALTH

In 1996 - 1997, the health sector's share of real GDP was around 3.3%, about 62% of Palestinians enjoyed health insurance, and 43 hospitals delivered health service to around 2.78 million people (a hospital for every 64,651 persons). In 2009, the number of hospitals reached 75, with a rate of 1 hospital to each 64,220 persons (PCBS, 2011).

Aid has played both a direct and indirect role in providing health insurance. By 2004, around 98.9% of Palestinians enjoyed health insurance. Direct funding of UNRWA and aid to the needy through the ministry of social affairs in 2004 has provided 35.2% of

¹⁰ PCBS, in cooperation with the World Bank, has adopted a new methodology for measuring Poverty, which reduced poverty estimates over the recent years. Data for 2010 is calculated according to the new methodology, which might create greater differences compared to previous years.

Palestinians with insurance, while supporting the PNA budget has helped the later to cover insurance costs for over 55.9% of Palestinians (PCBS, 2011).

Average contribution of health to GDP for the period 2005 – 2009 was 2.7%, while aid to the health sector projects constituted almost 2.5% of total ODA channeled through the Palestinian government during the same period. Donors have provided aid to this sector through Palestinian and international NGOs operating in Palestine as well. Unfortunately, though, accurate data regarding this issue is unavailable. However, UNRWA has also taken part in supporting this sector. In 2010, UNRWA had 61 primary health centers providing primary health care to about 1.68 million Palestinian refugees within the West Bank and Gaza Strip (UNRWA, 2011).

EDUCATION

Palestinians, as mentioned earlier, have relatively good levels of education, with a literacy rate as high as 95% in 2010, and around 50.4% of youth between the age of (18 - 22) enrolled in higher education. Donors have supported education over the past years through 4 main channels: the first is supporting PNA educational projects and budgetary expenses. In addition to supporting education-related budgetary expenses, donors have allocated almost 2.3% of financing to projects with the PNA to the education sector during the period 2005 – 2009. The second channel is through funding UNRWA. Today, UNRWA has 336 schools providing 265,800 students with primary and secondary education. The third and fourth channels are direct support to Palestinian private schools, universities and other educational institutions, and providing scholarships to Palestinian students. Data on aid for the last two categories is unavailable.

Although vital, aid to education remains insufficient. Keeping in mind our assumption, the education sector contributes to real GDP an average of 8.1%, while aid allocated to this sector is only 2.3% of total aid. Moreover, funding to UNRWA schools does not cover refugee needs. According to UNRWA, these schools lack proper infrastructure,

which is evident in the high average of students per class (50 student per class in 2010), and the need for some schools to use rented premises or even share buildings, reducing teaching time for Palestinian students.

INTERNATIONAL AID AND INTERNATIONAL SOLIDARITY

It was necessary to examine the effects of aid on the economic, political and social aspects of Palestinian life to be able to put Palestinian views of this aid into context. The peculiarities of the Palestinian struggle, the heated regional politics and the strategic importance of the region make it almost impossible for the development process not to tackle political issues. On this basis, Palestinians weigh international aid, donor interests, and development efforts rather differently.

When discussing aid and assessments of solidarity, we must consider two things; First, how Palestinians view their economic issue and in what broader context. Second, how Palestinians differentiate between Arab and non-Arab donors. According to Awartani and Al-'Amd (2011):

"The Palestinian development issue is a political one. The foundation for any solution lies in the concentration on this political aspect by adding pressures on Israel to adhere to concluded agreements and to grant Palestinians their legitimate rights. There is a pressing need for applying pressure on Israel, side by side with international aid, for the latter to be effective in achieving economic development instead of using aid as part of a political equation that weakens the Palestinian economy, exhausts its resources, and deepen its dependence on aid."

We stress the authors' (Awartani and Al-'Ahmd) conclusion because social and economic issues cannot be dealt with in isolation from the political situation on the ground. The very same issues aid and development efforts are trying to tackle like poverty, unemployment, poor economic performance and vulnerable Palestinian livelihood are usually caused directly or indirectly by Israeli policies and persisting occupation.

Moreover, the economy also suffers from restrictions on trade, movement, access to resources, and flow of capital in addition to discriminative policies against Palestinian productive sectors.

Political stability and economic freedom are the key to achieving sustainable development in Palestine, and without treating the root of the problem, Palestinians will remain vulnerable and dependent.

PALESTINIAN PERCEPTION OF ARAB SOLIDARITY

Palestinian ties to other Arab countries surpass geographical proximity to having a shared language, religion, culture, system of values and even a shared history. Despite geopolitical division, most Arabs, including Palestinians believe that they face similar economic conditions, deal with similar social issues and have common political challenges and interests. Therefore, Palestinian's evaluation of their strong ties to other Arab countries and their people is based on more than economic or political support, although these are vital.

Another aspect to take into account here is the religious and historical significance of Palestine to Arabs and non-Arab Muslims. Most of them believe that supporting Palestinians is not only a moral duty, but also a religious and patriotic one. Although Arab support is vital, Palestinian perception of Arab solidarity might not be notably affected by their views on the sufficiency of Arab political and financial support.

PALESTINIAN PERCEPTION OF INTERNATIONAL SOLIDARITY

Non-Arab donors might be viewed differently. Contrary to Arabs, the international community played different historical roles in the Palestinian-Israeli struggle. Western countries, especially US and Europe, have a significant economic and political influence on Israel being their main donors, trade partners and political allies. This influence enables western countries, in Palestinians' point of view, to exert pressure on Israel to

end its occupation and grant Palestinians their lawful rights and long-awaited independence. This might explain why development efforts that accept the political status quo and work within the current reality rather than attempting to change it might not be viewed favorably by Palestinians.

Another aspect to consider is conditional aid. Several donor conditions have been criticized by the Palestinian public, of which an example is the Anti-Terrorism Statement (ATS) that Palestinian organizations must sign before receiving US aid. ATS bears significance in the Palestinian case given the highly politicized nature of the society and the US labeling of some Palestinian political parties as terrorist organizations. International agencies operating in Palestine under such conditions are excluding politically-affiliated Palestinians who constitute a substantial part of the Palestinian people.

To better capture Palestinian definition of conditional aid, we also have to discuss some donors' insistence on tying aid flows to progress in the Palestinian-Israeli peace process. Achieving sustainable development requires consistent aid flows that change in response to economic needs not diplomatic ones. Examples of suspending aid flows, was the earlier mentioned economic siege on the PNA after Hamas won the legislative elections. US threat to suspend aid in response to the Palestinian UN bid in September 2011 is yet another example. Having inconsistent aid flows to finance the development process can at the very best slow its pace, if not harm it.

All the above would probably have a significant impact on how Palestinians view aid, its purposes and motives. The international community's choice of aid over political pressure on Israel, and the conditions in which aid is granted might not reflect positively on Palestinian perception of international solidarity.

CONCLUSION

It might be safe to conclude now that international aid, although vital in crisis relief, income creation and mitigating the negative effects of political unrest and economic distress, falls short of achieving sustainable development. Our analysis of aid allocation among sectors revealed that aid comes in most part for purposes of crisis relief and meeting short-term needs. Our statistical analysis emphasizes this result. Findings indicate that aid is mostly consumed and not invested, bearing no long-term significance. Sectoral allocation of aid also shows that most sectors still require more funding. Aid has not managed to decrease poverty or unemployment significantly over the long-run and the Palestinian economy remains aid dependent.

Despite this dependence, the PNA cannot rely on foreign aid to achieve sustainable economic growth. A relatively high proportion of foreign aid is given to Palestinians based on political interests rather than solidarity considerations. As a result, aid has been volatile and contingent enough to sustain little developmental value over the long run. These political motives along with the modest effect of aid on Palestinian welfare and development might make it harder for Palestinians to perceive aid as a form of solidarity from the people of donor countries.

Finally, given the limited local sources of funding on their hands, it might be reasonable for the Palestinian government and civil society organizations to try to use aid more efficiently, through improved sectoral allocation and disbursement mechanisms.

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