2 State formation under the PNA

Potential outcomes and their viability

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The establishment of the Palestinian National Authority (PNA) in 1994 set up the institutions that it was hoped would grow into and form the core of a future Palestinian state. Its brief period of 'normal' operation over 1994–2000 provides valuable evidence about the nature of state-society relationships in Palestine, and the obstacles state formation is likely to face in the future. While the supporters and detractors of the PNA each want to focus on a partial picture of its successes and failures, the evidence suggests a more complex story of intense contestation, harsh external constraints and some unexpected strengths and weaknesses. This more complex picture provides valuable insights for identifying the governance issues most relevant for the future.

As we have seen in Chapter 1 by Khan, a number of different types of rents and rent-management capacities were in evidence in the Palestinian economy during this period. Here we want to investigate the incentives, pressures and constraints pushing the consolidation of these different rents and rent-management capacities. Some of these rents were clearly damaging for the viability of the emerging state, but others enhanced its potential viability. Some were imposed by external conditions; others were created and supported by the autonomous actions of the Palestinian Authority. Many of the rents and capacities of the PNA were consistent with those of a client state. But at the same time, we observed some rents and rent-management capacities consistent with characteristics of a predatory state, a fragmented clientelist state and a developmental state.

This chapter investigates the likelihood of some of these rents and rent-management capacities becoming more dominant over time and playing a determining role in future developments. It is difficult to measure precisely the relative magnitude of different types of rents, let alone track the development of rents, rent-management capacities and rent-seeking over time. We therefore follow a different approach. We examine the *theoretical conditions* that would favour the consolidation of each of a number of distinctive combinations of rents and rent-management capacities and we compare these theoretical conditions with observations of actual conditions in Palestine over this period. We also look at how these conditions were changing over time to assess the prospects of different state characteristics becoming stronger over time. The conditions we focus on include first *external conditions* (in particular the strategies and policies of the Israeli state), which clearly have played a significant role in determining rent-creation and rent-management in the specific context we are looking at. Second, we look at the *institutional structure and capacity* of the Palestinian quasi-state. These could directly explain the presence or absence of specific rent-management capacities. Third, we look at the distribution of power within Palestinian society, and in particular the *organization of civil society*, since this too can help explain the types of rents that were being created and the ways in which they were managed. Finally, we look at the *capacities and organization of the capitalist class* in Palestine to explain the rent-seeking strategies of emerging capitalists and state leaders.

We find that the actual conditions in Palestine *partially* supported the further consolidation of each of the incipient state characteristics that we identified in embryonic form. The eventual outcome was not a foregone conclusion, which is itself an important (and reassuring) conclusion for future policy. The rest of this chapter is organized as follows. First we identify the theoretical conjunction of factors that would be most conducive for the emergence of each of our four state types. We then look at the available evidence to see the extent to which the development of each of these state types was actually supported by conditions observed in the Palestinian territories over this period. Finally, we draw some conclusions for the future of state construction strategies in the Palestinian territories.

Rents, rent-seeking and types of states

Table 2.1 summarizes some of the conditions that, in theory, would facilitate the development and consolidation of the characteristics associated with each of our four state types. These conditions are, in turn, broadly grouped under four headings: the external context, state capacity, the organization of civil society, and the organization and capacity of the capitalist class. Variations in each of these conditions could, in theory, promote the development of particular rents and rent-management capacities and thereby strengthen the characteristics of a specific type of state. Moreover, changes in these conditions over time could strengthen or weaken tendencies for particular state types to consolidate. These are not necessarily the only conditions that determine why some types of rents and rent-management capacities may come to dominate others, but they cover some of the most important conditions identified in the theoretical and comparative historical literature (see Khan, Chapter 1). Our main task is then to compare these theoretical conditions with the reality on the ground to examine the extent to which the actual conditions in Palestine supported specific rents, and more importantly, to identify the trends supporting the development of rents and rent-management capacities in particular directions. The conditions we discuss should not

Table 2.1: State types and their supporting conditions

	Potential state types			
	Client	*Predatory*	*Fragmented clientelist*	*Developmental*
Dominant rents defining each state	Rents critical for state survival controlled by external power(s) and released subject to compliance	Damaging monopoly rents, direct extortions	Monopolies and transfers captured by powerful factions who can veto attempts to reallocate them	Rents for political stabilization and conditional subsidies for capitalists, both subject to performance
Theoretical conditions supporting the consolidation of each state				
i) The external context	External power is militarily and economically dominant	External conditions prevent growth making predation attractive for leadership	External powers can provide significant transfer rents in the form of aid	External powers allow developmental strategies or are unable to prevent it
ii) State capacity	Weak capacity to fight external powers but strong internal policing capacity	Weak institutional capacity to push growth, but strong coercive capacities	Weak state capacity to control competing clientelist factions	State with strong capacity to allocate and manage conditional rents to accelerate investment and maintain stability
iii) Organization of 'civil society'	Social groups opposed to client-state strategy too weak to challenge it	Social groups too weak to stop predation	Clientelist factions are fragmented but well organized: can veto attempts to reallocate rents	Political factions either too weak to veto rent-reallocations or centrally organized and act in concert with state to support developmental rents
iv) Organization and capacity of the capitalist class	Some capitalists may benefit from *integration* and support it but *containment* will be resisted and requires weak capitalists	Capitalists too backward to be dynamic growth partners of the state and too weak to stop predation	Capitalists are inefficient and prefer to capture rents by allying with factions	Capitalists relatively well developed but cannot form independent social alliances to protect inefficient rents

be interpreted as *invariable*, such that the direction of state development is *pre-determined*. On the contrary, political leadership, internal political mobilization, and external assistance can make a significant difference in changing these conditions and make different outcomes possible. But for intervention to target the right issues, the critical conditions determining state viability need to be identified and understood.

In the case of the *client state*, its viable consolidation depends in the first place on external conditions. There must, of course, be an external power that has both the intention of dominating policy-making in the client state, and also the ability to do so, in terms of being able to control the allocation of significant rents necessary for the latter's survival. But the broader economic strategy of the dominant power is also critical for determining the political viability of its client-state strategy. An *integrationist* strategy that allows economic growth to improve in the client state is obviously more viable from the perspective of the client compared to a strategy of *asymmetric containment* that seeks to achieve leverage by maintaining the economic vulnerability of the client and uncertainty about further penalties in case of non-compliance. The containment strategy is politically less viable, and requires a high degree of internal repression in the client-state for its implementation (Chapter 1 by Khan). Second, in terms of the state's institutional capacity, the client state by definition cannot have the military capacity to stand up to external efforts to dominate it, but it must have sufficient policing capacity to deal with internal opposition. These two conditions are to some extent interdependent. An integrationist strategy can survive with less policing capacity, but an asymmetric containment strategy is likely to require significant internal policing. Ultimately, if the economic vulnerability inflicted by asymmetric containment is very severe, no amount of internal policing is likely to be sufficient for maintaining the viability of the client state.

Third, social groups and classes opposed to the client strategy must be sufficiently weak and disorganized for the state leadership to be able to pursue any variant of a client-state strategy. Finally, as for internal capitalists, with *asymmetric containment*, the client state would be unlikely to get support from any of its own capitalists and would require either an absent or very weak capitalist class. However, an *integrationist* client state *could* get support from sections of capitalists who did not produce goods that were directly competing with the products of the dominant economy. These capitalists, typically at the lower end of the technology ladder, may benefit from greater access to markets in the more advanced economy and possibly from cheaper inputs as well. More advanced capitalists producing products similar to the ones produced in the dominant economy are likely to seek state assistance to improve their technological capacity, and are therefore likely to oppose even an integrationist strategy since in many cases this is likely to destroy them or prevent their growth.

Many of the conditions that supported the consolidation of a client state could be observed in Palestine over the period we are looking at. Israel would clearly only proceed with even its limited steps towards Palestinian state formation on the basis of maintaining significant leverage over the Palestinian quasi-state. Not surprisingly, the PNA's institutional capacity was biased towards policing, as one would expect. The internal social fragmentation of Palestinian civil society supported client-state strategies by preventing the development of broad-based or concerted opposition to the territorial boundaries, state powers and degree of sovereignty accepted by the PNA. The role of the capitalist class was more complex and reflected the ambiguous Israeli economic strategies towards the Palestinian territories. To the extent that integration was on the agenda, some Palestinian capitalists were happy to support a client state, hoping to gain from trading and investment opportunities. Others, particularly the expatriate capitalists, were less keen as they saw potential obstacles in the path of more advanced Palestinian capitalists like themselves. But in fact the emerging Israeli policy towards the Palestinian state veered towards asymmetric containment rather than integration. This fact alone made the client state politically and economically unviable in Palestine. As a result, relationships between the PNA and Israel remained fraught and indeed became worse over time. By the time of the Second *Intifada*, far from remaining a client, the PNA came out against Israel with its limited military forces.

Predatory state characteristics begin to emerge when public officials seize or extract resources by creating predominantly *damaging* rents that impoverish society. The conditions that might create a predatory state are interesting because creating damaging rents is not rational for state leaders who face no constraints. Rational leaders usually do better by creating and maintaining growth-enhancing rents and rights, since these allow them to extract an even greater amount from society over time. Resource extraction in the form of rent-sharing by state leaders in a context of rapid economic growth would by definition not be predatory and could even be consistent with a developmental state (see Khan, Chapter 1). Special conditions are required to induce strictly predatory strategies, as summarized in Table 2.1. First, external conditions might be so adverse that the state had no hope of implementing growth-promoting strategies. If this happened, the best strategy for state leaders would be to extract as much and as fast as possible, since their hold on power would be unlikely to last very long. The creation of damaging predatory rents may then allow rapid resource extraction at the price of accelerating the decline of the economy. Second, the absence of institutional capacity to create growth-enhancing rents would also enhance predatory tendencies. The complete absence of a competent economic bureaucracy that can manage growth-enhancing rents for investors may induce state leaders to create damaging rents to extract resources since in any case they are not capable of creating growth-enhancing rents. Third, predation can only take place if the internal organization of society *allows* predatory strategies on the part of the state. Social factions, typically led by members of the 'middle classes' in developing countries, have to be weak enough to be unable to resist predatory state strategies. And finally, the capitalist class has to be under-developed and lack significant developmental capacity. The absence of a skilled entrepreneurial class would make predation more likely. The absence of potential capitalist capacity means that predation does not result in any lost opportunities for the state, since growth is unlikely anyway.

Some of these conditions held in Palestine over our period. External constraints in particular were severe, and growth possibilities were limited by the asymmetric containment that Israel sought to impose. The developmental capacities of the state were also limited, though as we shall see, key decision-makers *were* able to direct rents to promote growth. Civil society was weak and fragmented, again supporting predatory behaviour, aided by institutional constraints on democracy. But on the other hand, a relatively developed capitalist class existed, particularly in the form of expatriate capital, creating incentives for the leadership to play a longer term developmental game. The relative autonomy of the state paradoxically also aided these developmental attempts, as we shall see later. Thus the conditions supporting predatory tendencies within the PNA were at best contradictory.

Fragmented clientelist state characteristics develop when the central state loses the ability to police the allocation of rents. The predominant rents are now redistributive transfers to powerful factions who can *dictate* the allocation of rents and *veto* their re-allocation (Khan 2000 and Chapter 1 in this volume). As a result, even if the state leadership wants to remove unproductive rents, or to redirect rents to more productive groups, it finds that it cannot do so. After a while, most rent allocations in fragmented clientelist states turn out to be damaging rents that benefit unproductive groups. Here, external factors are less important, but the availability of foreign aid can make things worse by providing a large pool of resources for redistribution which competing factions can fight over. Like the predatory state, a fragmented clientelist state also lacks the institutional capacity to implement growth-enhancing strategies. But the most significant condition promoting a fragmented clientelist state is a strong but fragmented civil society in the form of parties or factions often led by political entrepreneurs from the 'intermediate' or middle classes. In the extreme case, these groups and factions can effectively protect their rents despite the wishes of the executive. In the Palestinian context, external conditions and weak state capacity could have supported moves towards a fragmented clientelist state, but civil society was paradoxically *too* fragmented, and *powerful* factions of the type observed in fragmented clientelist states did not emerge. We find virtually no examples of cases where powerful factions overturned or vetoed executive decisions about rent-creation, allocation or rent-management.

Finally, *developmental state* characteristics are strengthened in proportion to the state's ability to allocate and manage rents to maintain political stability while enabling a capitalist class to develop and acquire technological capacity. For this to happen, external conditions have to be such that developmental interventions are either encouraged, or at least, not thwarted. Ultimately, this requires not only full sovereignty but also conducive international economic conditions and accommodating trading partners. Second, developmental strategies also require a minimal institutional capacity on the part of the state to identify and support growth-enhancing sectors and activities, and manage rent-allocation so that inefficient groups are not able to capture rents. Third, and most important, internal political conditions have to allow the state to manage rents to promote growth. In particular, the state has to have the capacity to *withdraw* rents if the recipient proves to be incompetent or the firm or sector proves to have been badly chosen in the first place. Subsidy withdrawal requires that recipients of rents are not able to buy or construct coalitions that can resist the state if rent-withdrawal becomes necessary. This in turn requires either very weak social factions so that clientelism cannot be used to protect inefficient rents, or a strong but centralized or 'corporatist' organization of social interests such that agreement can be reached centrally on the optimal allocation of rents. The worst outcome is an intermediate degree of fragmentation that allows fragmented clientelist coalitions to veto rent re-allocations (Khan 2000 and Chapter 1 in this volume). Finally, the developmental state requires as its partner an emerging capitalist class that has the capacity and experience to respond to incentives to attract investment and generate growth. Our conditions deliberately give less importance to the intentions and quality of the state's leadership even though this is clearly also important. Nevertheless, if the conditions identified above are fulfilled, it is very likely that the state leadership will over time behave in a developmental way out of self-interest, as developmental strategies will then deliver the greatest benefits for the leadership.

In terms of our conditions, external conditions were clearly adverse for constructing a developmental state in Palestine. Israeli control over the Palestinian economy and public finances was severely detrimental to any autonomous Palestinian economic development. On the other hand, the ensuing asymmetric containment created a growing perception within the PNA leadership that economic development was essential for its own survival. Paradoxically, the centralization of power meant that the PNA had *some* state capacity to allocate rents in ways that could promote a capitalist transformation. At the same time, the extreme fragmentation of Palestinian civil society, whilst damaging for democracy, meant that fragmented clientelist pressures from powerful factions for rent allocation were minimal. The construction of centralized and corporatist political organizations to resolve conflicts between factions did not therefore prove to be necessary. Finally, and most importantly, the existence of an advanced capitalist group in the form of expatriate capitalists provided the PNA with credible developmental partners. In the next four sections we discuss in turn, external conditions, state capacities, the organization of civil society and the organization and development of the capitalist sector in Palestine. This is then used to evaluate the likelihood of critical characteristics of each of our state types consolidating and eventually dominating in the Palestinian context.

The external context

The external context has been more important in the Palestinian context than in virtually any other emerging state in the developing world. To appreciate this we have to remind ourselves that many of the critical features of the impact of Israel on the Palestinian economy and society began long before Oslo. The 1967 occupation, and before that the setting up of the state of Israel in 1948 in historic Palestine had an enormous impact on what at each stage was left of Palestinian economy and society. From the outset, the Israeli state was not just a normal colonial state but also one that justified its colonialism and expansion by divine right and the historical injustices suffered by Jews in Europe. This made the dispossessions, the seizures of land and the building of settlements much more difficult to fight on the Palestinian side and explains some of the desperation and fragmentation observed in Palestinian society. In this section we will look at the factors that most directly impacted on the operation of the PNA, and are likely to affect the future prospects of a Palestinian state.

Colonial impediments to Palestinian development

The history of Israeli occupation and the impact this had on the class and social organization of Palestinian society is well known. The establishment of the state of Israel in 1948 in historic Palestine resulted in the expulsion of more than 700,000 Palestinians from what became Israel and many of them settled in refugee camps in the West Bank and Gaza Strip. The economy of these territories was thus dominated by the refugee economy from 1948 onwards. The occupation of the West Bank and Gaza Strip in 1967 further undermined the power base of the traditional landed and commercial capitalist classes (Kimmeling and Migdal 1994), and at the same time, it erected insurmountable obstacles for further indigenous economic development and the emergence of an industrial capitalist class. As an occupational force, Israel imposed political, economic and administrative restrictions, including the use of military orders that adversely affected Palestinian economic activity in WBG. These included the confiscation of prime Palestinian land for settlement building that aimed to change the ethnic character of the WBG using Jewish immigration to populate these areas. Colonial settlements were built on the best agricultural areas with easy access to water and wells. For Palestinians, on the other hand, there was strict rationing of water use and restrictions on construction activities. Israel introduced total control over financial institutions and the import and export trade. New taxation was imposed on the Palestinians that, in the fashion of other colonial occupations, was ostensibly imposed to pay for the costs of administration.

These interventions added up to a set of restrictions, seizures and extractions which limited autonomous Palestinian economic activity and made it practically impossible for a 'national' bourgeoisie to emerge in the WBG (Abed 1988; Aruri 1989).

The fragmentation of Palestinian society

Apart from preventing the development of a Palestinian capitalist class, Israeli rule seriously fragmented Palestinian society, and the middle classes in particular (Heiberg and Øvensen 1993; Kimmerling and Migdal 1994). Unlike the British colonial power in Asia and Africa which ruled through the incorporation of large parts of the indigenous middle classes as administrators and allies, the Israeli colonial occupation was much more like the Japanese one in East Asia, where all key administrative positions were controlled by the occupying military power and the indigenous population was controlled largely by military means.[1] Israel could follow such a strategy because of overwhelming military might and because it was primarily interested in the occupation and acquisition of land without a clear policy for the administration or otherwise of the Palestinian people. This has been frankly acknowledged by historians on the Israeli side such as Shlaim (2000) and Pappé (1999).

The Palestinian territories prior to the Oslo Accords were directly administered by Israel with a limited and low-level role for Palestinians in the 'Civil Administration'. The latter was a deliberately misleading term for the pre-Oslo administration that was headed by an Israeli colonel, subject to the Israeli Ministry of Defence, and under the direct command of an Israeli general (Halper 2001). At its height the Israeli Civil Administration employed around 20,000 Palestinians, mostly at the delivery end of the health and education sectors. There was no need to involve middle-class Palestinians at higher levels of the administration. Nor did the Palestinian middle class have the political power to demand incorporation as was typical in many British colonies before independence. Israel had the military power and international support from major powers to clamp down on any organized expression of Palestinian nationalism, for instance by outlawing the PLO and all its factions. It activated British mandate emergency laws on a protracted basis to 'administratively detain' (imprison without trial) several tens of thousands of Palestinians, expel many thousands of activists from the WBG, and demolish hundreds of Palestinian houses to punish the families of those actively opposed to the occupation. Under such a military and coercive administration, the political and organizational development of a Palestinian middle class was necessarily very limited. The Palestinian middle class was also effectively excluded from employment in Israel. Instead, until the first Iraq War, the oil economies of the region were the main employers of Palestinian professionals from the WBG.

Selective and detrimental integration into the Israeli economy

As a colonial power and the dominant economic power of the region, Israel's economic strategy towards the occupied territories critically affected the latter's pattern of development. Since 1967, Israel was primarily interested in appropriating resources through land confiscation, appropriation of water resources, and settlement building. It was also to a lesser extent interested in the exploitation of cheap unskilled labour (people who commuted to Israel on a daily basis to minimize social security claims), and the creation of a captive market for Israeli goods. All of these Israeli objectives were potentially detrimental for long-term Palestinian development. Nevertheless, the pre-Oslo colonial policies of the Israeli state did have some limited *integrationist* elements. In particular, employment in the Israeli labour market, even though restricted to unskilled workers, did yield short-term relief to the Palestinian economy. At a time when Israeli agriculture and industry were protected from competitive Palestinian products, Israel opened its market to Palestinian unskilled and semi-skilled labour. As a result, some 40 per cent of the WBG labour force was employed in Israel (comprising some 10 per cent of the Israeli labour force) till the early 1990s.[2] Labour was the major WBG export (to Israel and to other countries) till the first Iraq war. At the same time, the WBG became the second biggest export market for Israeli goods, second only to the USA. Even though the Palestinians were selling cheap labour to buy Israeli products that were relatively expensive at world market prices, Palestinians working in Israel were better off than those employed in the WBG where wages were even lower. The higher wages received by Palestinian workers in Israel, relative to wages paid in the WBG, and even relative to many middle-class occupations, had a levelling effect on differentials between middle- and working-class incomes in these areas. This reflected itself in patterns of consumption, particularly the ownership of durable goods. But even to enjoy this unequal exchange, the occupied territories were administered entirely through taxation raised from the Palestinian population, and moreover, they were prevented from following autonomous developmental strategies.[3]

While Israel was clearly interested in political domination and occupation, even this pattern of occupation could, in theory, have resulted in sustained improvements in Palestinian living standards *if* over time the pattern of economic exchanges had become less restrictive against the Palestinians. If Israel had allowed integration to deepen, we would have expected to see a sustained increase in the percentage of the Palestinian labour force employed in Israel. In particular, there should have been a loosening of the implicit ban on the employment of professional and middle-class Palestinians in Israel. In addition, there would have been a reduction of protection such that industries located in the occupied territories could grow by enjoying access to Israeli markets and capital. If all this had happened, the Palestinian economy *might* have developed more rapidly even if the development was unequal and led by Israeli rather than Palestinian capitalists. However, before Oslo, the employment of unskilled workers remained the dominant aspect of Palestinian 'integration' with the Israeli economy. There is little evidence that integration was moving in the direction of greater employment of skilled Palestinians in Israel or of faster industrialization in the occupied territories.

Post-Oslo tightening of Palestinian labour mobility

In principle, the signing of the Oslo Agreements could have allowed Israel to move forward on economic integration now that the question of the political status of the occupied territories was on the way to being resolved. Instead, one of the most damaging aspects of Israel's response to the signing of the Oslo Accords was that it saw an opportunity to formalize aspects of asymmetric containment that had already been built up since the early 1990s and indeed to extend these controls. Its implicit strategy towards the Palestinian economy thus changed from one of reluctant and partial *integration* to one that developed rapidly into *asymmetric containment* (see Chapter 1 by Khan, and Chapter 3 by Zagha and Zomlot). While the PNA gained *limited* control over *some* territories within the WBG, Israel made permanent and formal its newly developed capacities to control the movements of Palestinian goods and people through a complex network of checkpoints and began to extend these systems. These could be used to stop not only movements between the Palestinian territories and Israel, but also movements between the Palestinian enclaves themselves. The extension of 'border controls' was a dramatic break with the pre-Oslo period and imposed *new* restrictions and hardships. It also increased the uncertainty of Palestinian employment within Israel and in the occupied territories because these 'borders' could be sealed on a day-to-day basis (Zagha and Zomlot, Chapter 3).

WBG employment in Israel declined from its peak of around 40 per cent of total WBG employment in the pre-Oslo period to a low of around 14 per cent in 1996. Given that Israel also wanted to ensure security compliance on the Palestinian side over this period, developing its ability to block movements of labour and goods selectively and at short notice was consistent with a strategy of ensuring compliance through the threat of sanctions. The new controls over labour movements were one of the pillars of *asymmetric containment*. The labour front caused particular hardships on the Palestinian side because the Israeli restrictions coincided with the imposition of restrictions on the entry of Palestinian labour to the oil-producing Gulf states in the aftermath of the first Iraq war of 1991. An immediate impact was that Palestinian employment in Israel fell at a time when labour shortages in Israel were met by importing non-Jewish labour from Eastern Europe and the Far East. Thus the asymmetric containment strategy had costs for Israel too, but the cost to the two economies was itself asymmetric.

Once the physical apparatus for controlling labour movements had been fully established, restrictions on Palestinian employment in Israel began to be relaxed from 1998 up to September 2000. At the end of 1999, the number of Palestinians working in Israel or its settlements had crept back up to 139.1 thousand or 22.4 per cent of total WBG employment (MAS 2000: xii). In the second quarter of 2000 the number grew further to 143.4 thousand but as a percentage of total WBG employment, the figure was unchanged at 22.3 per cent (PCBS 2000a).

Thus, far from the post-Oslo economy offering Palestinians any improvement on the employment front, Israel's new ability to impose border controls on a territory that was effectively occupied, encircled and heavily dependent on Israeli labour markets increased Israel's economic control over the WBG without any greater economic integration. The main effect of *asymmetric containment* was a much greater economic *vulnerability* of Palestinian employment and trade. The growth of Palestinian employment in Israel in the late 1990s back towards its earlier levels did not reduce Palestinian vulnerability because by now labour was streaming in and out of heavily armed checkpoints on a daily basis to go to work. This explains the paradox that Palestinian frustration was growing before the Second *Intifada* while employment in Israel was returning to earlier levels. The essential aspect of asymmetric containment was that the new security and checkpoint apparatus could stop the movement of labour and goods within the WBG on a daily basis and without advance notice (for its impact on the Palestinian economy see UNSCO 2000). The efficacy of the containment system was proved when the Second *Intifada* began. Palestinian employment in Israel was immediately and drastically curtailed. The movement of Palestinians *within* the WBG also came to an almost total stop.

Israeli controls over Palestinian land and resources

Since Israel initially saw the Occupied Territories as an integral part of its territories, control over land and resources was one of the main aims of the Israeli occupation of 1967. As a result, there were a plethora of controls over Palestinian access to the natural resources of the WBG. Palestinian claims on natural resources were controlled and restricted, with a wide range of restrictions covering everything from digging wells to fishing. One of the problems with Israel's strategy of phased withdrawal from areas in the WBG was that it intended to retain control over almost all the strategic resources of these areas for an indefinite period *after* it had theoretically withdrawn. In particular, Israeli settlements sat atop all the critical aquifers of the West Bank. This prevented any substantial expansion of Palestinian agriculture or of water-dependent industry during the Oslo period or beyond, until the status of water and of the settlements had been decided. Even the mineral resources of the Dead Sea remained under Israeli control. Thus, the PNA as a quasi-state had no access to its 'own' natural resources. Indeed, even under the 'final' offer that was available to Arafat at Camp David, Israel would retain control over critical areas such as the Jewish settlement city of Ariel and its surrounding areas that sits on top of the major aquifer in the West Bank (Halper 2001). The implication was that the future Palestinian 'state' would remain dependent on enclaves belonging to a foreign country for access to water under its own territory.

Israeli controls over PNA revenues and trade

The Oslo Accords and the Paris Economic Protocol gave Israel a significant degree of control over the fiscal revenues available to the Palestinian quasi-state. In addition, since for 'security reasons' Israel remained in control of all borders with the outside world, the foreign trade of the Palestinian territories remained entirely with or through Israel, giving Israel control over the movement of all goods into and out of the Palestinian territories. More critically, as the Palestinian territories remained in a customs union with Israel, the latter collected the duties on Palestinian imports from the outside world, with an agreement in the Paris Economic Protocol to pass these on to the PNA. Following the setting up of the PNA, the WBG continued to import 90 per cent of its total imports from Israel or through its ports, and it exported 95 per cent of its total exports to or through Israel. Even the small amount of trade that the Palestinian economy could conduct directly with third countries such as Jordan could be stopped at short notice as Israel controlled those borders as well. The Palestinian economy remained totally dependent on Israel for its electricity, international communications, fuel, almost all its cement and more than 40 per cent of its water, which had to be purchased from Israeli companies even though they were appropriating the water from the underground aquifers of the WB (PCBS 2000c: 18).[4]

For all these reasons, the PNA had a low internal income-tax base. It was dependent, to a large extent, on aid from the donor community, on agreed transfers from Israel of customs duties collected on goods imported from abroad by Palestinian companies, on remittances by Israel of taxes collected from Palestinians working in Israel with work permits, and remittances by Israel of VAT collected on goods exported to Palestinian areas. Direct income tax formed a meagre 7.6 per cent of total PNA revenue in 1999, compared to tax clearance from Israel, which contributed 63 per cent in the same year (PA 2000; in Chapter 3 of this volume Zagha and Zomlot provide more details on taxation). Apart from delays and disputes in the calculation of these tax remittances, the ability to delay or even stop these transfers gave Israel significant leverage over the PNA. This capacity too was fully demonstrated when the Second *Intifada* erupted in 2000: Israel immediately held back all funds due to the PNA as a way of exerting political pressure. In the same way, but with somewhat different objectives, international donors have used aid as a tool to encourage the PNA to stick to the 'peace process', and to keep the PNA operational for this purpose.

Effects of external controls: Petty corruption, monopolies and special accounts

The external control that Israel insisted on under Oslo defined the higher-level governance architecture that in turn defined lower-level options available to the PNA. Clearly, our evaluation of rent-management and governance practices has to take into account the alternatives allowed under these arrangements.

Petty corruption

It is widely recognized that many types of petty corruption and monopoly rents followed directly from the system of control established by the external power. The most obvious and immediate effect of the mechanisms of controlling movements of goods and labour was to create a complex mosaic of territories and 'gates' within the Palestinian territories. With the signing of the Oslo Agreements, some areas in the WBG came under the jurisdiction of the PNA, some under joint Israeli and Palestinian jurisdiction but many remained entirely under Israeli control. Moving from place to place even *within* the WBG now became much more tortuous, time-consuming and often dangerous for Palestinians than it had been before Oslo. The system of gates and gatekeepers inevitably created its own associated system of petty corruption by gatekeepers. There were reports of small-scale extortion by Palestinian security officials, the victims often being small traders, shop-keepers and others. These opportunities for petty extortion thus followed directly from this system of control.

Trading monopolies

The Palestinian trading monopolies had significant economic effects, but here too, their economic and political implications cannot be understood without taking into account the context of external controls dictated by security-first considerations. Israeli control over Palestinian borders meant that the PNA lacked any fiscal ability to determine border prices and its trade and tax revenues were almost entirely controlled by Israel as part of the design of the Oslo architecture. Almost the only power of the Palestinian 'state' was its ability to restrict the movements of goods *within* the territories exclusively under its control. This power turned out to be quite useful because Israel itself was far from a free market, and many key commodities like fuel and cement were sold in Israel at prices well above world market prices by cartels or monopolies. The Palestinian ability to obstruct sales by Israeli monopolies or cartels in Palestine eventually led to agreements that effectively shared these monopoly rents. The 'solution' was the creation of Palestinian trading monopolies that imported fuel and cement from Israeli monopolies at lower than Israeli retail prices and sold them on at Israeli retail prices or even higher. These arrangements allowed the Palestinian monopolies to make easy margins in these trades, and it allowed Israeli monopolies to maintain high prices within the custom union as a whole (see also Chapter 5 by Nasr). Israeli acquiescence was undoubtedly assisted by the calculation that this was a way of maintaining Israeli monopolies since even limited direct Palestinian imports may have made Israeli monopoly prices unsustainable within the customs union. But perhaps more important for the Israelis was the consideration that this arrangement created yet another PNA rent that Israel could turn on and off as a way of retaining influence and leverage over its leadership. From the Palestinian perspective, the monopoly arrangement offered lucrative rents for the PNA and associated individuals. Moreover, while the Paris Protocol did allow limited imports of commodities like cement and fuel from non-Israeli sources, as long as Israel policed the external borders of Palestine, it could delay and obstruct imports of vital commodities by Palestinians even for the limited quantities allowed under the terms of the Protocol. In this context, the absence of Palestinian trading monopolies would very likely not have meant lower prices for Palestinian consumers, but it would have meant that the Palestinian quasi-state would have lost substantial revenues.

These arrangements collapsed following the Israeli re-occupation of Palestinian administered areas post-2000 and the collapse of almost all Palestinian institutions. From a 'good governance' perspective, the reforms accepted by the PNA between 2000 and 2003, at a time when it was under an Israeli blockade and its institutions were collapsing could still be construed as progress. Indeed the International Monetary Fund (IMF) was very positive about the reforms under which the Palestinian leadership agreed to reduce the monopoly rents of their trading companies and to prepare them for privatization (IMF 2003: 102). The measures adopted included imposing price controls on cement sales in the Gaza, allowing Jordanian companies to sell cement directly to Palestinian importers, and giving a commitment to prepare these companies for privatization. The IMF recognized that this would *considerably reduce* the revenues of the Authority, but was pleased that privatization was now on the agenda. Our analysis makes us less sanguine. Palestinian trading monopolies were clearly responsible for higher prices for Palestinian consumers compared to world prices and were responsible for a number of irregularities. In the normal course of events, this would be highly undesirable. The question remains though, whether, after the dust settles, Israel will be willing to withdraw from its control over Palestinian borders with the outside world that allows it to block imports of vital commodities at short notice on grounds of security. Imports of cheaper fuel and cement also threaten Israeli monopolies because some leakage of these commodities to Israel is inevitable. This too might induce Israel to use its powers to preserve the commercial interests of Israeli companies. Over time, it is very likely that Israel will use its border controls to persuade Palestinian companies to import from Israelis rather than risk seizures of their imports at the border. As a result, prices for Palestinian consumers might not come down significantly. The only achievement may eventually be a loss of monopoly rents to Israel and a future Authority that is even less financially viable. In other words, unless the client-state architecture is dismantled, these governance reforms may *reduce* the viability of the state apparatus that replaces the PNA and increase the rent-extraction by Israeli companies from Palestinian territories. There is no indication that Israel is willing to dismantle this control apparatus. As for the privatization of Palestinian assets, preparing for this now is almost surreal before violence and uncertainty can be ended by *first* creating a viable Palestinian state. We will return to this issue a little later.

Special accounts

At least as widely discussed have been the so-called special or secret accounts of the leadership that enabled some public funds to be allocated by the executive outside the budget. These accounts clearly violate good governance criteria of transparency and accountability, and are clearly not desirable in the long term in any state. What is perhaps less widely recognized is that these accounts were not secret at all and Israel and the external powers colluded in allowing the Palestinian leadership to exercise non-transparent control over part of its tax revenues. Israel even paid some Palestinian tax revenues into these 'secret' accounts. For instance, petroleum excise duties collected by Israel and due to the PNA were paid into an Israeli bank account controlled by Arafat and his financial advisor Muhammad Rashid (IMF 2003: 88). Some revenues from government trading monopolies that operated with the collusion of Israeli monopolies in fuel and cement also went into these unaudited accounts. Finally, some of the money in these accounts was possibly from sources such as kickbacks that could not be audited.

Israeli denunciations of the Palestinian leadership's secret accounts only began when it was clear that the PNA executive was not sufficiently dependent on Israel to use these secret funds only in ways approved by Israel. Its earlier collusion in these arrangements and its later criticism of Palestinian 'governance' can be explained if we remember the big picture of what the Oslo arrangements were all about. Both sides took a gamble from their own perspective (see Chapter 1 by Khan for a discussion of the client-state strategy). The Israeli gamble was that the PNA would emerge not just as a client state but also one that accepted asymmetric containment. The PNA leadership was willing to accept aspects of a client state but gambled that it could then further Palestinian economic and political aspirations and achieve a viable and dynamic state. Given the aspirations of both sides and the overall structure of external control, handing over part of Palestinian tax revenues directly to the PNA leadership was a rational component of Israel's 'client-state' strategy. It increased the ability of the PNA to carry out the necessary political stabilization, and to prioritize security expenditures in ways that might be difficult if revenues went through the Ministry of Finance and were subject to public scrutiny (see also Chapter 1 by Khan). From the perspective of the PNA, these resources enhanced its room for manoeuvre in emergencies. It was only when it turned out that the Palestinian leadership was not willing to accept a client state on the terms offered, and may indeed have been using these resources to attempt to break out of asymmetric containment, that Israel and its allies pointed out the 'governance failure' associated with unaudited accounts. Since Arafat's objections to the state being offered were well-known by then, it was convenient from a number of perspectives to attribute all failures to the venality of the PNA leadership.

Effects of asymmetric containment

We have argued that asymmetric containment was not a necessary outcome of Oslo but reflected additional strategic decisions within Israel (see also the discussion in Chapter 1 by Khan). The asymmetric containment strategy had critical implications for governance and rent-creation in the PNA. On the one hand, it created strong Palestinian incentives for pushing development since a viable client state was not on offer. In this context, the hidden accounts and the profits of PNA enterprises assisted the PNA *to hold out against Israeli pressure exerted through asymmetric containment*. On the other hand, in the longer run, containment also meant that even the PNA's second-best developmental options faced serious constraints, and this created growing antagonisms between Israel and its putative client state. In fact, the PNA eventually became the target of Israeli attacks during the Second *Intifada* that began in 2000. We will examine the developmental interventions of the PNA in a later section. Here we examine the implications of asymmetric containment for executive discretion and the special accounts.

We have seen that the unaudited special accounts under the control of the PNA president were to some extent necessitated by the inconsistent aspirations of Israelis and Palestinians that the Oslo architecture attempted to resolve. But the Palestinian executive also had incentives to expand the scope of these funds given its perception that it needed financial flexibility in a context of growing containment. The fiscal dependence of the PNA on Israel created strong *incentives* to extend its 'unofficial' sources of income given the highly vulnerable sources of 'official' income. Of course, a predatory executive could also use these arguments to justify its refusal to open accounts to public scrutiny. The existence of unaudited contingency funds inevitably led to some misallocation and misappropriation.[5] Even if secret accounts did not lead to misappropriation on a scale that would lead us to describe the state as predominantly predatory, this does not mean that resources were always allocated efficiently from the perspective of

Palestinian development. Nevertheless, the Palestinian Authority facing asymmetric containment had strong incentives to manage these funds efficiently to sustain its freedom of manoeuvre.

The PNA leadership consistently argued that it needed to have these contingency funds if aid from the donor community, or customs and VAT clearance from Israel were withheld or cut. Contingency funds would be necessary to maintain, at least for a time, the PNA bureaucracy and the patron-client networks necessary for the stability of the regime. Reserve funds would also be needed to reactivate the PLO should the peace process or the PNA completely collapse. Events following the collapse of the Camp David talks suggest that these contingencies were not necessarily far-fetched. The combination of political vulnerability and the centralization of power can explain why attempts to bring unaudited reserve funds under the scrutiny of the legislative (in the form of the Palestinian Legislative Council (PLC)) had limited success before the collapse of 2000.[6] Reformers often did not understand that if they were unable to change fundamentally the external constraints, reforms that implicitly reduced the flexibility of the leadership could worsen its already vulnerable position.

After the collapse of PNA institutions under the Israeli re-occupation that began in 2000, there were gradual moves towards greater transparency in the PNA's budget. These moves accelerated during 2002–03, when the economic and political situation in Palestine began to deteriorate rapidly. By 2003, when the Palestinian population was encircled in hundreds of pockets by the Israeli army, external pressure was able to achieve a degree of openness and transparency in the PNA's budget that was so impressive that the IMF described it as 'quite exceptional in the Southern Mediterranean region' (IMF 2003: 99). While the reforms look good on paper, they can be interpreted in two different ways. Either the economic and political crisis made the leadership recognize that it had to concede to reforms that would actually improve its own political viability and the economic prospects of the Palestinians, or the situation had become so hopeless that the leadership conceded to reforms that would make future progress along a security-first route even more difficult to achieve. Since budgetary transparency has implications for a wide range of activities, both possibilities are likely to be true depending on which activities we look at, but the second possibility has serious consequences for any effective re-starting of Palestinian state formation with the security-first conditions that Israel is bound to insist on. This leads us to ask why Israel has been keen to support governance improvements in the PNA post-2000. It may be hoping that with greater transparency, the fiscal flexibility of the Palestinian Authority will be significantly reduced. If *at the same time*, revenue remains dependent on Israeli transfers, *and* budgetary priorities continue to be set by security-first concerns, this would further increase the bargaining power of Israel vis-à-vis the Palestinian Authority. A future Authority may eventually accept that it had no option but to accept asymmetric containment and opt to survive by keeping its vulnerable fiscal revenues coming through by spending these in transparent and pre-determined ways. Unfortunately, this calculation ignores the expectations and mobilization of Palestinian society, which is not likely to accept the spending priorities (and even more so the actions) required to achieve security for Israel while the Palestinians live in asymmetric containment, regardless of the options available to its leaders. A more likely outcome is that even limited progress towards a two-state outcome under the security-first (or client state) route will be ruled out since no Palestinian leadership is likely to survive under these pressures.

A summary of the implications of the external context

Clearly, of all our state types, external conditions were most conducive for the consolidation of a client state. In fact, the higher level architecture of Israel–PNA relationships under Oslo had been deliberately constructed to enable the consolidation of a client state. But Israel's insistence on having both a Palestinian client state *and* an asymmetric containment strategy must be judged to have been unsustainable given Palestinian aspirations and the degree of mobilization of Palestinian society. Such a client state could only survive using excessive internal repression, and it only remained minimally viable because the executive used unconventional methods like monopolies, special accounts and (as we shall see later) centralized executive powers to sustain its viability. Even these could not prevent frequent outbreaks of violence given slow progress towards credible statehood. It would clearly be misleading to attribute violence and poor economic performance in the Palestinian territories to executive centralization or the corruption associated with unaudited accounts and trading monopolies if the latter were to some extent *responses* to the externally imposed governance architecture. The experience of the first phase of state formation suggests that only an *integrationist* client state *may* have been viable in Palestine. If economic integration was not acceptable, for whatever reason, it follows that a client-state strategy of any type is likely to be unviable in the future.

External conditions also had implications for a number of our other state types. The historical impact of the arrival of Zionism in Palestine weakened indigenous capitalist development, and to that extent made a developmental state less likely. Asymmetric containment was also directly contrary to any developmental strategies on the part of the Palestinian Authority. But paradoxically, the pressure of asymmetric containment on the executive could only increase its commitment to autonomous developmental strategies. The migration of many Palestinians to other countries had created an expatriate Palestinian capitalist class that enhanced the possibility of developmental strategies, and we will return to this later. On the other hand, the imposition of asymmetric containment could also have strengthened tendencies towards predation since it made developmental outcomes vulnerable, and ultimately dependent on an eventual dismantling of the client-state apparatus.

State capacity under the PNA

State capacity in our framework refers to the institutional capacity of a state to create and maintain different types of rents. Since each of our state types is defined by the predominance of particular rents, each requires specific state capacities to create and manage these rents. A *client* state has to be able to effectively police the domestic population and maintain social order, as well as to distribute the rents controlled by the external power to stabilize vital domestic constituencies. With *asymmetric containment*, its policing capacity would have to be much greater to deal with much more serious internal opposition. However, even with moderately well-organized internal opposition, no amount of policing capacity may be sufficient to make a client state based on asymmetric containment politically viable for too long. *Predatory state* characteristics are likely to develop if the state has a repressive apparatus that can deal with social opposition while enabling the extraction of resources from society. How extensive these policing capacities have to be, once again, depend on the strength of internal opposition to predation. *Fragmented clientelist state* characteristics are likely to develop when the state lacks the capacity to police internal factions and instead maintains a precarious political stability *primarily* by allocating rents to shifting coalitions of factions. Both fragmented-clientelist and predatory states are likely to be characterized by poor quality bureaucrats and/or bureaucratic structures that are unable to allocate or manage rents for development.

The institutional capacities required for strengthening *developmental state* characteristics are more demanding. The political-administrative structure has to be able to create and manage developmental rents and to withdraw or destroy value-reducing rents. This requires a state leadership, and eventually a bureaucracy with the appropriate skills, incentives and powers to monitor rent-allocation and performance. The more backward the economy, paradoxically the easier it is to identify the investments that need to be attracted and the technologies that have to be learned. A developmental state also requires a political leadership with the incentive to push development and the capacity to enforce these decisions. The political and institutional structures that have proved adequate for these tasks have, however, differed greatly from case to case, as an examination of the high growth economies in Asia shows. Developmental states have sometimes been authoritarian, as in the case of South Korea or Taiwan in the 1960s and 1970s, and sometimes moderately democratic, as in the case of Malaysia in the 1980s and 1990s. Predatory or fragmented clientelist states have also sometimes been democratic and sometimes authoritarian. In other words, neither democracy nor authoritarianism is necessary or sufficient as an institutional guarantee for a developmental state (see Chapter 1 by Khan). But all successful developmental states have had the institutional and political capacity to allocate rents to enhance growth and maintain political stability. In the remainder of this section we discuss the ways in which the *institutional structure* of the

PNA may have helped or hindered the creation and management of the rents appropriate for each of our four state-types.

The primacy of policing and the centralization of authority

At first sight, many of the institutional capacities of the PNA appear to be most appropriate for a client or a predatory state. This is not surprising since the initial focus of externally assisted institutional capacity-building in the PNA was in the areas of policing, surveillance, and the maintenance of internal order. The PNA had to prove its 'capacity' in these areas in order to make progress towards statehood. This meant essentially proving that it was able and willing to use repression on a sufficient scale to satisfy Israel that it could transfer to it the job of policing the Palestinians in the occupied territories. A number of competing security forces were set up within the PNA structure, each answerable directly to the President. A multiplicity of security forces would not make sense in a normal state but in the limbo status in which the PNA found itself, this institutional structure was not accidental.

Arafat's administration had to prove its ability to carry out a highly unpopular repression of its own people at a time when almost no progress towards Palestinian statehood could be demonstrated. The President therefore needed an enormously powerful security apparatus, and yet to ensure that the security chief did not become the most powerful person, particularly given that every other aspect of the state was extremely under-developed or absent. The mechanism through which the executive retained its power in such a context was through the device of setting up a number of competing security agencies, each of whose chiefs was dependent on the president for their position. The Palestinian Police Force alone employed more than 30,000 persons, giving a police-to-population ratio of 1 to 75, one of the highest in the world (Pederson and Hooper 1998: 5). The fact that there were a number of other parallel security forces effectively doubled this number. According to a reliable source, personnel employed across these security forces amounted to 50 to 60 thousand, with an annual salary budget of $200 to 250 million.[7]

A consequence of this extensive policing apparatus was that it further strengthened the executive in the form of Arafat. But under the Oslo architecture the Palestinians had to prove their ability to police opposition to the Israeli occupation *before* the occupation ended. It is unlikely that greater democratic control over the security apparatus would have delivered better results, given that most Palestinians were against the security-first route to statehood. In any case, it is important to remind ourselves that Arafat was the democratically elected president of the PNA and enjoyed enormous legitimacy. The general election of January 1996 was largely free and democratic (Rubin 1999: 49–51). Although the Islamists and some small left-wing secular PLO factions boycotted these elections, over 80 per cent of the electorate participated in the general and presidential elections that gave Arafat an overwhelming majority, and permitted his faction (Fateh) to dominate the legislative council (Hilal 1998a).

The popular support for Arafat was based on a gamble by the leadership, the precariousness of which was not always appreciated outside Palestinian society. It was premised on Arafat's system being able to deliver both independence and economic prosperity to a large enough number of Palestinians rapidly enough to undermine support for the Islamist opposition. Israeli economic policies towards Palestine that we described earlier, in particular the random closures, the continuation of settlement activity, the delays in implementation and finally the insistence at Camp David on further territorial concessions, however small, seriously upset this calculation. A poll conducted five months after the Second *Intifada* began showed a dramatic rise in popular support for Hamas in the Gaza Strip, equalling for the first time the support enjoyed by Fateh.[8] The hardening of popular opinion against the security-first Oslo route means that it may be even more difficult to combine democratic control over the executive with a security-first route to statehood in the future.

The president of the PNA was not only directly in control of all the security services but also of all ministries and public bodies. As the elected president of the PNA, Arafat combined this position with that of chairman of the Executive Committee of the PLO to construct a loosely defined institution called the 'Palestinian leadership'. This institution included all strategic posts: ministers, Executive Committee members, the speaker of the Palestine National Council, the speaker of the Palestinian Legislative Council, the heads of the main security agencies, and Arafat's main advisors (including his economic adviser who managed much of the PNA's investments). Directly or indirectly, most of these individuals owed their positions to Arafat personally.[9] This 'leadership' did not include representatives of the business community, the opposition, or popular organizations. The private sector was very weak, as were popular organizations, while the Islamic opposition opted to keep itself out of all PNA and PLO institutions.

A large number of security forces could potentially have resulted in the development of forms of localized warlordism that would have been consistent with fragmented clientelism. But the conditions at this time were such that no second-tier security chief could survive without Arafat's support, and as a result, localized warlordism did not emerge. Rather, the multiplicity of security agencies was a manifestation of, and indeed further reinforced, the centralization of authority. The central control over the coercive apparatus in turn meant that other aspects of institutional power were also effectively centralized. The effects of this centralization were not necessarily negative. Under some conditions, the centralization of power *can* support developmental states. If centralization allows the executive to resolve factional conflicts and override interests opposed to necessary restructurings of economy and society, it can accelerate social transformations (Amsden 1989; Wade 1990; Okuno-Fujiwara 1997 show how this happened in East

Asia). However, for centralization to have developmental effects, the state must have both the incentive to push development as well as the capacity to overcome the opposition of powerful coalitions which may oppose specific developmental strategies. We examine these later, but first we look at a number of other factors that contributed to the centralization of power.

Multiple legal systems and weak separation of powers

A number of additional features of the Palestinian situation helped the PNA leadership to further centralize its power. One was the operation within the Palestinian territories of multiple legal systems. The West Bank operated under laws inherited from the period of Jordanian rule and the Gaza Strip under laws inherited from the Egyptian Administration. There were also Emergency Laws from the British Mandate period that continued under the Israeli occupation. The plurality of legal systems and the potential for conflicts and confusion made it necessary for the President of the PNA to adopt prerogatives to make and interpret the day-to-day rules of governance. This in turn made it almost impossible to separate powers within the quasi-state. Arafat was able to use security courts to rule not only on matters of security but also on criminal and civil cases, and indeed on matters related to taxation. In addition, Arafat remained the chair of the Executive Committee of the PLO, which maintained its own revolutionary courts. Thus while the executive undoubtedly used this situation to strengthen its own position, it is also true that given the confused system of property rights and legal systems, not to speak of the limited jurisdiction of the Palestinian legislature to rule on these issues under the Oslo Agreements, a centralized executive was functionally necessary.

The separation of powers was also complicated by the fact that the president of the PNA had also been the leader of the largest political organization (Fateh) that in turn had dominated the PLO since the late 1960s. By virtue of this, and of being the main force behind the Oslo Accords, Fateh came to command the executive and legislative branches of the quasi-state, and to control its mass media. Hence, the president could rely on both PNA structures (particularly the security services) and on Fateh, as alternative power bases. This enabled him not only to undermine the PLC as an elected legislative body, but also to undermine the PNA's leading executive institutions (such as the ministerial council) as well as bodies of the PLO (its Executive Committee, the PLO Central Council, and the Palestine National Council). The uncertainties in the situation and the confused legal framework under which the PNA was set up allowed Arafat to activate PLO institutions only on those occasions where they served a specific political purpose.

This highly centralized power structure permitted the apex to marginalize the PLC (helped by its large Fateh majority), and to foil attempts to institute a political system with a clear separation of powers that would limit and check the President's authority. Thus, the President could easily delay the promulgation of the Basic Law passed by the PLC that aimed to institutionalize the separation of powers and limit the powers of the executive. While some centralization of power was functionally necessary for the reasons described earlier, it is also clear that Arafat's personal political pre-eminence and strong Palestinian support for national unity against the occupying power helped to further this centralization. But equally, to attribute the centralization entirely to Arafat's political machinations would be wrong. Any effective leader under a security-first route to statehood and with the economic and political restrictions enshrined in the Oslo architecture would have to achieve significant executive centralization to operate at all.

Developmental rent-management capacities

Not surprisingly, while some aspects of the PNA's political and institutional structure were potentially damaging for economic activity and for the general investment climate, others were unexpectedly conducive for development given the otherwise adverse political conditions. On the one hand, the multiplicity of legal systems, the absence of a clear rule of law based on judicial independence, and the ability of the executive to over-ride bureaucratic decisions were institutional conditions at variance with what investors in more advanced economies are used to. In particular, the concentration of power in the hands of the executive could potentially have been used in a predatory way to extract resources from investors and others. Undoubtedly some investors stayed away because of these dangers. In addition, some economic activity was no doubt adversely affected by the arbitrary actions of the executive.

The developmental capacity of the state was also limited by the very constrained powers of the quasi-state to which we have already referred. But despite the fact that the quasi-state lacked many of the normal powers of a state, it did have powers to allocate and rescind licences and contracts, and the power to enhance returns for investors in particular sectors. It could do so by allowing the creation of monopolies, or by allowing some investors to set prices through the exercise of state sanctioned market power in the internal market. Each of these state capacities potentially gave the state the ability to create rents that could make investment in particular sectors attractive. The quasi-state could also use its discretionary power to make sure that utility bills and taxation demands could be informally renegotiated to ensure that profitability in key enterprises or sectors was maintained. Last but not least, the PNA did enjoy a sufficient centralization power to be able to protect major enterprises from possible decentralized extortion demands of local 'mafias'. There is evidence that the PNA leadership used all these rent-creation and rent-protection possibilities to attract investments and to ensure that investment was directed towards sectors such as tourism and communications infrastructure that it believed would most contribute to future prosperity.

This invites us to probe deeper into the incentives of the leadership. A number of factors specific to the Palestinian context may have helped to create incentives for developmental interventions by the quasi-state. First, the conflict with Israel provided strong incentives for the executive to strengthen the national economy, in the same way that conflicts with neighbours provided incentives in South Korea, Taiwan, and other emerging Asian economies. In Palestine these incentives soon became much stronger when it became clear that there would be a long interim period with no clear end point during which Israel would continue to have control over critical aspects of Palestinian fiscal capacity, trade and borders as part of its containment policy.

A second factor that helped was the centralization of power within the PNA that enabled the executive to intervene in the allocation of resources and contracts in ways that ensured that economic performance was maintained. It allowed the executive to exercise control over lower-level bureaucrats and functionaries such that state decisions could actually be implemented. This in itself was an achievement given the problems of implementation faced by most developing countries with fully fledged states. In Palestine, appointments to all leading positions in the bureaucracy as well as the political structure (directors, general directors, deputy ministers and ministers) required the written approval of Arafat, as the head of the PNA. He could equally remove them with a single letter. As a result, the Palestinian quasi-state apparatus could rapidly implement decisions of the executive. The executive could also, as a result, rapidly correct mistakes once discovered.

Third, the blurred boundaries between the state and the political leadership paradoxically created incentives for the political leadership to take an interest in the profitability and viability of key enterprises. The grey boundary between the political leadership and the state meant that the political leadership effectively controlled state assets and benefited from their income that often remained outside the budget and directly enhanced the financial flexibility of the leadership. As part of its attempt to maintain and enhance its own economic viability, the political leadership began to acquire and own shares in new enterprises, and even to invest in shares of foreign companies. While these attempts by the executive could be characterized as predatory, they are also reminiscent of the Kuomintang's acquisition of shares in key Taiwanese public sector industries in the early years of Taiwan's development, which created strong incentives for the political leadership to make sure that economic growth was not impeded by an inefficient and loss-making public sector (Wade 1990). If the profits of the ruling group come from share ownership in key 'public sector' enterprises, it is unlikely that these enterprises will remain inefficient for long if the executive has the power to enforce its decisions and is reliant on a long-term flow of income from these assets. In Taiwan, the presence of external threats and the absence of powerful internal coalitions that could potentially block the leadership created a combination of incentives and capacities that ensured that leadership stakes in public sector enterprises did not lead to short-term asset stripping but to a longer-term concern with enhancing economic viability. Although economic and political circumstances in Taiwan in the 1950s were very different, a similar combination of external threats and an absence of powerful internal coalitions that could contest the decisions of the executive also obtained in Palestine. It is not entirely surprising that Palestinian public sector enterprises were relatively profitable. In 1999, for instance, the rate of return achieved in the PNA's public sector holdings was 22.4 per cent of their asset value (IMF 2003: 89).

The PNA's shares in enterprises were managed through the Palestinian Commercial Services Company (PCSC), a holding company chaired by President Arafat's chief financial adviser (Khalid Salam, also known as Mohammad Rashid). The PNA's Ministry of Finance was not sure whether it should treat the PCSC as a private or as a public company since its registration did not specify its legal status. This confusion continued until in June 2000 the PNA formally acknowledged that the PCSC investments were public investments, and it also signalled its intention to eventually privatize all public enterprises. At that time, the PCSC had shares in 33 private firms or subsidiaries. These companies ranged from the Jericho Casino to the Palestine Telecommunication Company or Paltel. The percentage of shares owned ranged from 100 per cent (for two companies including the Cement Company), which were therefore by definition totally public sector, to 5 per cent in a number of companies that were effectively public–private partnerships. The PNA put the total market value of its shares at $292 million at the end of 1999. In addition, the PNA declared ownership of land and other property valued at another $10 million, and other funds (not specified in the report) valued at $42 million (PA 2000: end table).

By May 2000, the IMF and the World Bank succeeded in putting pressure on the PNA to agree to restructure these public investments through privatization (PA 2000). The President agreed to set up a Palestinian Investment Fund (the PIF) to which all holdings of the PNA were to be transferred. All income from these assets would henceforth be paid into the central fiscal budget through a treasury account, and these assets were to be privatized as soon as practicable. But there was little progress in implementing these changes until well after Israeli attacks decimated the institutions of the PNA during the Second *Intifada* and made the prospect of statehood at best a very distant aspiration. It was under these conditions that the PIF was finally set up in October 2002 under the Ministry of Finance and managed by Arafat's financial advisor, Mohammad Rashid. In January 2003, PNA assets were estimated at $633 million, and included 67 enterprises and some liquid assets. This was almost double the $345 million valuation of PCSC assets in 1999, suggesting that the earlier coverage had been incomplete (IMF 2003: 101).

While these changes met with the approval of the World Bank and the IMF, the expected results of these reforms are likely to prove more complex than the good governance approach suggests. The PNA conceded to the implementation of these changes at a time when the limited state-like characteristics of the PNA had disappeared, its institutions had been destroyed, the President was besieged in his compound and the Palestinian territories were effectively under Israeli occupation once again. In contrast, when the PNA *was* operating as a quasi-state, its holdings of 'public' assets through the PCSC created incentives for effective management in a context of considerable uncertainty, and generated incomes that helped sustain the quasi-state's viability. The leadership relied on the income from these key assets, *and* it was politically secure enough within its own constituency to be able to take a long-term view. These two factors ensured that the leadership had strong incentives to manage these assets effectively and moderated any potentially predatory tendencies within the state as far as the assets of these critical firms was concerned. This might explain why Palestinian public sector investments, unlike those in many other developing countries, achieved very high rates of return. These arrangements were far from ideal. A transparent and accountable use of revenues would normally be highly desirable. But in the specific context of Palestinian state formation, our earlier discussion of the contrary implications of budgetary transparency is again relevant.

Moreover, if the external conditions remained, and income from public assets was paid into a budget whose security priorities were set by a foreign power, the managers of these assets may have significantly diluted incentives for their effective management. While the necessity of constructing a viable economy in Palestine is widely recognized, the conventional wisdom about how capitalism is to be constructed in contexts like Palestine is very unrealistic. The reason why the IMF and the World Bank were excited about the creation of the PIF is that they saw it as the first step towards privatization, which they assume will help to create a viable capitalism. But privatization is an almost surreal expectation in contemporary Palestine given the realities on the ground, the absence of potential investors inside the territories, and the absence of any state structures that might assure overseas Palestinian investors to invest in territories encircled, occupied and disputed by a hostile power. In most developing countries, the problem is that a ready-made capitalist class that has the capacity to run enterprises does not already exist, nor do ready-made state structures that can regulate a capitalist economy. In Palestine, the state itself does not exist. In such contexts, developmental states have to be constructed with the requisite rent-creation and rent-management capacities before it makes sense even to start planning for privatization (see Chapter 1 by Khan).

A summary of the implications of institutional capacities

The institutional structure of the PNA thus had a number of features relevant for our discussion. The centralization of power was the key characteristic of the PNA, and this could potentially support all of our state types except for *fragmented clientelism*, which requires a central state apparatus that is too weak to overcome the demands of powerful redistributive coalitions. Institutional capacity was particularly appropriate for the consolidation of a *client state*, and indeed many aspects of centralization were design features of the state apparatus that was set up as part of the Oslo Agreements. However, while the PNA may have been sufficiently centralized to maintain order under an integrationist Israeli strategy, it probably lacked sufficient repressive capacities, and certainly the will to exercise the capacities it did have, to support an Israeli strategy of asymmetric containment. Given the latter strategy, the centralization of power within the PNA could have had two quite different outcomes. It could have led in the direction of supporting *predatory state* characteristics if the executive gave up all hope of a long-term future and decided to make as much as it could in the short-run. Or it could have led in the direction of enhancing *developmental state* characteristics if the executive tried to break out of the impasse by creating more economic space for itself. While we will look at some instances of predation later, we also find a number of instances of developmental interventions by the PNA, which in turn are explicable in terms of the incentives, constraints and capacities discussed in this section.

Civil society organizations

States do not intervene or create rents in a vacuum but often do so in response to either demands coming from society, or in the face of social opposition. To explain the types of rent-creation and rent-management a state is engaged in we need to look at the social history of a society, and in particular, the distribution of organizational and bargaining power between different classes and groups. Looking at civil society organizations is one way of examining this distribution of power. The development of *client-state* or *predatory state* characteristics would require weak and highly fragmented social organizations that could not resist the rent-creation or extortion imposed by the state. On the other hand, *fragmented clientelist* state characteristics can only emerge if there are a large number of well-organized social factions that are strong relative to the state. The strengthening of *developmental state* characteristics is more complex. A developmental state can operate with very fragmented social organizations, as in the North East Asian countries. Social fragmentation can allow a strong state to push through painful structural changes rapidly. But developmental states can also operate with centrally organized 'corporatist' social organizations. These allow the state to rapidly reach agreements about rent-allocation to maximize growth, and subsequently to enforce these decisions. Variants of corporatist developmental states existed in Malaysia in the 1980s and in post-war Scandinavian countries.

Fragmented middle classes

We have already seen how Israeli colonial rule resulted in a weak and fragmented Palestinian middle class. In developing countries, the 'middle class' consists of intermediate classes who are neither working class/poor peasant on the one hand, nor owners of significant land, capital or other productive assets on the other. Unlike advanced countries, where the middle class consists largely of professionals, in developing countries they consist predominantly of petty traders, the petty bourgeoisie, the educated unemployed, rich peasants, as well as some professional white-collar workers. The organization of these intermediate classes is critical for understanding civil society in developing countries since they play a disproportionately important political role in these societies. Their organizational power and their degree of fragmentation can determine and set limits on the types of rents and interventions developing country states can create. Palestine was historically one of the more advanced regions in the Arab world in terms of education and therefore in the strength of its intermediate classes. In addition, the 1970s and 1980s saw the establishment of a number of new universities in the WBG. However, since the 1950s there has also been a strong trend of emigration out of the WBG, particularly among the professional middle class.

Following the establishment of the PNA in 1994, a huge increase in university education took place. The number of university students increased from 29,380 (16,042 males, and 13,338 females) in 1994/95, to 66,050 (35,696 males, and 30,354 females) in 1999/2000. In community colleges, student numbers showed a smaller increase over the same period from 4,110 to 5,157 (MAS 2001: Table 4.15). According to the Palestinian population census of 1997, some 5.4 per cent of the population of the WBG aged over 15 had a university education (MAS 2001: Table 1.4). A further factor that accelerated the growth of the Palestinian middle class in the post-Oslo period was the return of the cadres of most PLO political parties after the 1994 Accords were signed. The 1997 population census shows that by then some 10.5 per cent of the population of the WBG (267,355 persons) were returnees, or persons whose usual place of residence had been outside Palestine. Around 24.1 per cent of the returnees returned between the first Iraq war of 1991 and 1994 and another 48.5 per cent returned after the establishment of the PNA in 1994. Since Israel had always employed only unskilled and semi-skilled Palestinians, middle-class Palestinians had had to find employment elsewhere, primarily in the Gulf states. But following the war of 1991, Palestinians in Kuwait were forced to leave, returning to Jordan or the WBG. Data shows that returnees in general had higher levels of education than non-returnees. Of those aged 10 or over, 14 per cent of returnees had a university education, compared to 4.5 per cent of non-returnees. Returnees were also predominantly of working age with 68.8 per cent between the ages of 15 and 65, compared to 49.4 per cent in the case of non-returnees (Maliki 2000: 53–62).

But the steady growth in numbers of the Palestinian middle class in the 1990s did not result in a proportionate growth in their political power and influence. Despite many obvious differences in the historical context, the arrival of the PLO in the occupied WBG in 1994 can *in some respects* be compared to the arrival of the Kuomintang administrative and military apparatus in Taiwan from mainland China in 1949. In both cases, the incoming state apparatus was much better organized than the domestic population and consequently enjoyed a high degree of relative autonomy in policy-making and resource allocation. In both, the new state had powerful incentives to develop the domestic economy. In both, the boundaries between state and party, and between party and leader were blurred, arguably creating incentives for the top leadership to manage critical assets effectively. In both, there was access to foreign technology and a willingness to use it. But there were differences too, particularly in the international context, and in the degree of internal turmoil. The PNA was not a proper state, and large parts of its territories continued under foreign occupation, with the additional imposition of a containment strategy. Moreover, its development came to a (temporary?) end in 2000, leaving very few years of experience on which to base international comparisons. In addition, in the Palestinian case, while the middle class was relatively disorganized, it was nevertheless more politicized than in the typical East Asian country. As a result, the leadership faced greater criticisms for actions that appeared to be driven by the executive compared to East Asian states doing similar things at an equivalent stage of their development. Nevertheless, the comparison with East Asia is useful for suggesting that despite its size and politicization, the fragmentation of the Palestinian middle class allowed the executive to act for a time in ways that were closer to the experience of East Asian countries than the typical developing country with well-organized client factions.

Two features characterized the Palestinian middle classes in the WBG in the period under study: fragmentation, and a very low level of organization, despite a high degree of politicization in terms of ideology and aspirations. If fragmentation had been combined with a high degree of independent organizational and political power, this could have led to fragmented clientelism. But fragmentation combined with very weak organizational power of factions allowed a strong executive-led state to consolidate. The Palestinian intermediate classes were fragmented by geography (the territorial division of the occupied territories into the West Bank, the Gaza Strip and East Jerusalem, and beyond that into a large number of 'cantons' separated by Israeli controlled territories and gatekeepers). They were also fragmented by sector of activity (PNA, NGOs, private sector or political parties), by ideology (PNA, the secular opposition, the Islamist opposition, or independent) and by membership of different types of organizations (bureaucratic, traditional and modern). It had remained organizationally weak because of the occupation and repression by Israel that resulted in the exclusion of the middle classes from politics and administration. After 1994, it found in addition that it faced a relatively well-organized and to some extent imported state apparatus in the form of the PNA. Individuals and factions within the middle classes did achieve privileged access to resources based on *wasta* (mediation) and *mehsubia* (patronage)*;* that is, through the use of political, personal, family or regional connections and relationships.[10] But because of their organizational weakness, these mechanisms allowed the middle class to be easily incorporated into the state formation strategies of the executive.

Middle class growth under the PNA

The establishment of the PNA resulted in a rapid growth in the relative share of middle class employment in the WBG. In 1999, some 22.5 per cent of all employed persons in the WBG were classified as legislators, senior officials and managers, professionals, technocrats, and clerks, and a similar percentage (22.7 per cent) were in crafts and related occupations (PCBS 2000b: Table 26). Almost all of those in the first category were middle class. A smaller percentage of the second category (consisting of skilled artisans and craftsmen) could also be classified as middle class. Compared to these figures, in 1992, Israeli data for the same job classification in the WBG (but excluding East Jerusalem) indicated only 11 per cent of all employed persons were in occupations of the first category (administrators, professionals, technocrats, and clerks). Thus, the share of this category in total employment virtually doubled soon after the PNA's creation. In absolute numbers, the number of employees in this category increased more than threefold between 1992 and 1999, excluding East Jerusalem.[11] In contrast, the percentage reported in the second category (skilled artisans and craftsmen) declined in 1999 compared to the 1992 figure of 29.4 per cent (ICBS 1993: Table 27.20).

Some individuals in other categories should also be classified as middle class. In 1999 employers formed 5.5 per cent of all economically active persons, and the self-employed another 18.7 per cent (PCBS 2000b: Table 25). A large percentage of 'employers' ran very small enterprises (employing less than five persons with very little capital and simple technology). These petty-bourgeois employers should be classified as middle class. Similarly, many of the self-employed were craftsmen working, like most employers, in the small-scale informal sector of the economy and they too would be middle class in a developing country context. A small percentage of the self-employed were also professionals (architects, engineers, doctors, etc.), who were clearly middle class. The share of middle-class employment when all these individuals are added to the first category (administrators, professionals, technocrats, and clerks) would thus very likely be between 30 to 40 per cent of total employment.

Two main motors drove the rapid growth of middle-class jobs after the setting up of the PNA. The first was the political imperative of the emerging state to increase public employment as a way of distributing rents to maintain political stability. The second, which we will discuss later, was a related process of NGO growth, driven largely by external funding and externally distributed rents, and this too was partly motivated by a donor commitment to maintain political stability. The political imperative within the PNA was responsible for government employment reaching 17.9 per cent of total employment by the last quarter of 1999 (the rate in the Gaza Strip being double that of the West Bank). In comparison, 59.4 per cent of employment was in the private and NGO sectors, and 22.7 per cent in Israel and Israeli settlements (MAS 2000: Table 3.2).[12] The PNA had to absorb PLO cadres into the state apparatus, absorb Palestinians previously employed by the Israeli Civil Administration, and reward cadres of the ruling party. The regime, as we explained earlier, required a large security force and it needed to co-opt the more influential traditional families. In other words, public employment creation was not driven solely or even largely by the needs of administrative efficiency or economic rationality. It was also and perhaps largely driven by the rationality of state-building and regime maintenance. Hence factors such as the containment of opposition and discontent, and the need to enlarge the regime's political base across regional, kinship, and other parochial or traditional solidarities were critically important.[13]

The Israeli imposed Civil Administration of the WBG had employed some 20,000 Palestinians at the time it was taken over by the PNA. Six years later the number on the payroll of the PNA in its various institutions and agencies (including education, health, and security forces) had reached 120 thousand. Public employment in high positions (minister, deputy minister, director or head of one of the state agencies) carried valuable privileges (including, in most cases, a VIP card, the free use of a car and telephone, and rent-free housing). It also provided a level of income that would not, in most cases, be otherwise attainable by persons of similar qualifications elsewhere in the local economy. Thus public office was turned into a reward for political and/or personal loyalty, and thus a powerful mechanism through which the regime distributed rents to maintain political stability.

The number of ministers or officials with ministerial rank grew from 14 in May 1994 (when the PNA was established) to 23 in 1996 (after the general and presidential elections), to 33 (some without portfolios) by August 1998. In addition to the ministries, there were also some 75 public bodies linked directly to Arafat or his office, including a public monitoring unit set up and accountable only to the president.[14] The increase in the number of ministries and security agencies seemed to be aimed at the enlargement of the circle of the PNA's clientele, to include, among others, critics from the PLC and representatives of political parties who wished to be in the government. On the other hand, loud critics holding sensitive positions (such as chairs of PLC committees), were pressurized, out-manoeuvred or replaced by more amenable members. Positions of deputy ministers, general directors, and heads of agencies (civilian and military) and public institutions were predominantly awarded to Fateh cadres (Hilal 2002). Other political parties were offered a quota of positions as political favours, not as entitlements.

The interesting question for the state formation process is whether the allocation of rents to different middle-class individuals and groups was determined from below by the relative power of competing organizations, or decided from above in ways which furthered the objectives of the executive. This judgement is important to distinguish between what we have called a *fragmented clientelist* state captured by factions who can dictate the creation of jobs and rents, and a *developmental* or a *client* state where the allocation of rents is centrally determined by the economic and political objectives of the state leadership. In the Palestinian case, the evidence suggests that political rent allocation was a mechanism through which the president of the PNA consolidated the centralization of power by accommodating middle-class individuals and groups on terms determined by the state and on condition that they supported state policies. This would be consistent with characteristics of a client or developmental state rather than a fragmented clientelist one.

This helps to explain the paradox that despite the growth in the size and employment share of the middle class, its political influence *declined* with the establishment of the PNA. The middle class was aware of this, and indeed there was a broad-based middle-class disenchantment with the PNA. A much higher percentage of those with university education were found in opinion surveys to be critical of the PNA than those with little or no education. A higher percentage of the educated young also expressed a readiness to emigrate permanently.[15] This is particularly significant since substantial economic opportunities were emerging for the middle classes. The main beneficiaries of the PNA rent-allocation strategy through public sector job creation was the strategic strata of the middle class who secured managerial positions in the middle and upper echelons of the public administration in return for their support for the state formation process. But wider sections of the middle class also benefited in a number of ways. The subsidized expansion of higher education mainly benefited the middle class. Significant autonomy was also granted to NGOs (see p. 98), allowing job creation for new sections of the middle class based on foreign inflows. Popular organizations and professional associations also offered positions of privilege, contests for which took place on the basis of political affiliation. Political parties too provided positions of privilege, as well as getting direct rent-redistributions from the executive.

All this was in addition to the educated middle class being the main beneficiary, apart from the capitalists, of the expansion of the private sector. The growth of the financial sector provided the most striking area of middle-class employment growth in the private sector. By 1999, there were some 22 banks, Palestinian, Arab and international, with some 115 branches, nearly all of which opened after the establishment of the PNA in 1994.[16] A stock exchange was established in 1997, and by the summer of 2000 some 25 companies were listed. The number of insurance companies increased from

1 in 1994 to 8 in 2000. There was an even more significant increase in the number of hotels, restaurants, and travel agencies. The apparent paradox of the political disenchantment of the middle class in a context of growing economic opportunities suggests that the PNA leadership had effectively limited the autonomous powers of the middle class and made their economic opportunities conditional on their political quiescence.

The struggle for liberation and political centralization

As with other national liberation struggles, the Palestinian struggle had from the beginning recognized the importance of maintaining political discipline. As part of a system of political consolidation, the PLO had since the early 1970s operated a system of distributing funds to its affiliated parties in a centralized way. The political rents available to the PLO decreased sharply following the first Iraq War early in 1991 that in turn led to a sharp reduction in the regular transfers of rent to PLO factions. Later in that year, Fateh, the leading faction of the PLO, supported by some smaller factions, agreed to join the Madrid peace conference and two years later the Oslo Accords were signed. The result was dissension within the PLO, with a number of political factions rejecting the Oslo Accords and freezing their membership in the PLO Executive Committee. This led Arafat, as the chairman of the Executive Committee and later head of the PNA, to be more selective in his use of rent-allocation as a political tool. As the flow of funds to the PNA increased after Oslo, the allocation of funds to political groups became a tool of incorporation, not within the PLO framework, as was the case previously, but now within the framework of the PNA. The president of the PNA effectively became the authority determining who would get these allocations, and their size and frequency. Although most of the PLO political parties had their own financial resources, the political rent-allocation allowed the president of the PNA to exercise considerable leverage in maintaining political stability.

Rent allocation to political parties was not confined to cash handouts. It included other forms of rent (offices, cars, VIP cards, appointments of party cadres to the public administration, and so on). All this operated as an integration mechanism for the stabilization of the PNA regime. Opposition political parties recognized the new power centred in the PNA, and accepted, more or less, that they had to work within the ceilings set by the regime. Islamist factions, never having been part of the PLO, were never part of the PLO rent-distribution system. They emerged outside it, maintained their organizational, political and financial autonomy from the PLO, and relied on other sources of funding (both local and external) for their organizations and activities. This does not mean that attempts were not made to incorporate them. But when they failed, the President of the PNA relied on repressive measures, such as the imprisonment of their leaders and cadres and the closure of Islamic charitable institutions.[17]

Other civil society formations, such as mass organizations, professional associations and trade unions posed even less of a problem for the regime. They had lost much of their social base and mobilizing capabilities earlier in the 1990s after the erosion of the popular character of the First *Intifada* (1987–92). PLO factions had created the main body of these civil society formations as civic associations with the aim of organizing opposition to the Israeli occupation, while providing services to needy sectors of the population. Following the Oslo Accords, and the removal of restrictions on political parties in Palestinian-controlled areas, these associations lost their original function as arms of political parties. Many transformed themselves into professional NGOs, while others (such as trade union federations, women's federations, youth associations and so on) lost much of their constituency, and with that, their political credibility (Hilal 1998b). The main factor behind their demise was their inability to create a new organizational and programmatic role in the emerging political field. Most retained their headquarters and branch offices but depended on external financial resources. In the absence of an organized constituency, many popular organizations became *de facto* NGOs and collapsed into venues for personal rent-seeking based on access to external institutional and political donors. Most professional associations (lawyers, doctors, engineers, teachers, and others) were better organized than popular organizations, and unlike NGOs, had a well-defined and stable constituency. However, the ruling party, Fateh, dominated most of these associations, though it often had to engage in vigorous competition with the Islamists. Hence, most professional associations tended to avoid voicing open criticisms of the PNA.

The anomalous role of NGOs

Apart from the PNA's job creation, the second major process that contributed to the enlargement of middle-class employment was the proliferation of non-governmental organizations or NGOs throughout the late 1980s and 1990s. In Palestine, NGOs in the form of human rights advocacy groups, 'developmental' and service-oriented organizations and so on, were often the descendants of organizations formed by left-wing political factions that later succeeded in detaching themselves from their mother organizations. But they did so at a cost. Their 'professionalization' and the attendant transformation of organizational structures and agendas were necessitated by the requirements of international donors. This meant two things: dependency on short-term foreign funding, and delinking from political parties that lost them their organized constituencies. In addition they had to face occasional PNA attempts to limit their operational autonomy.[18]

The PNA did in the end change the very restrictive legislation originally proposed to govern NGOs, and approved legislation that left the NGOs with a tangible degree of autonomy. It even erected a ministry to deal with NGOs, aiming no doubt, to integrate them into the state framework. But the success of NGOs in keeping their autonomous space should not be entirely attributed to their own strength. They worked closely as a lobby with the PLC, many of whose members were sympathetic to the cause of NGOs, and a few PLC members were directly involved in these organizations. They also received direct and indirect support from the World Bank and international donors, who assured the PNA that the funds going to the NGOs were not coming from resources earmarked for the PNA.[19] The fact that the NGOs acted as providers of jobs and services to the poor in a situation characterized by high rates of unemployment and poverty was also relevant for persuading the PNA leadership not to encroach too much on their space.

However the NGOs' autonomy remained precarious. Most NGOs ran small-scale organizations, with short-term budgets and a small and unstable number of beneficiaries. At the same time, they provided their middle-class leaders with status, income and privileges unattainable in alternative opportunities, in other words, access to a range of rents.[20] Access to these rents kept them independent of the PNA, but highly dependent on fickle foreign donors.[21] Most NGOs were not interested in confronting the PNA, as it was rarely in their interest to antagonize the executive. In sum, NGOs in Palestine, as elsewhere in much of the developing world, did not necessarily provide an alternative *organizational* structure through which the middle and other classes could effectively constrain executive authority. Given the fact that the Palestinian middle class was fragmented and organizationally weak, the NGOs, if anything, contributed to the continuation of these features. By enabling many entrepreneurial and organizationally skilful middle-class individuals to acquire leadership roles in small well-funded organizations, the NGO structure contributed to the quiescence and incorporation of the middle class, while contributing to some service delivery functions. In the context of considerable social tensions and uncertainty in the Palestinian territories, the NGO sector may have positively contributed to social stability by providing rents to socially conscious middle-class individuals and opportunities to deliver socially desirable services.

The working class benefited the least from the regime emerging under the PNA. On the one hand, the PNA was committed to basic education and health for all. The ministry of social affairs provided assistance to very poor families, the United Nations Relief and Works Agency (UNRWA) continued to assist the extremely poor in refugee camps, and local NGOs, such as *Zakat* committees, together with international NGOs attended to marginal groups. Nevertheless, such services did not compensate for the highly precarious labour market that the working class and other marginal social groups faced since the Oslo Accords. The fragmentation of the working class, geographically and into different labour markets, did not help its bargaining power. This was compounded by weak labour organizations and the fragile and dependent Palestinian economy. Moreover, it was the working class that was the hardest hit in terms of unemployment and poverty rates by Israel's asymmetric containment strategy, and this capacity to debilitate became fully visible in the aftermath of the Second *Intifada*.

A summary of the implications of social organization

Our review of different aspects of middle-class organization shows how the fragmentation and disorganization of the middle class allowed the PNA to organize their incorporation on terms determined by the executive. Even in the NGO sector, the apparently autonomous activities of these organizations arguably contributed to the PNA being able to maintain its centralized hold on power. While such a distribution of power between the executive and those who could potentially constrain it could support *predatory* or *client-state* characteristics, in the context of the Oslo interim period, it also allowed the executive to allocate and manage some rents in a *developmental* way. The quasi-state could allocate rents and resources without powerful factions being able to determine the terms of these allocations. The least likely outcome given the organization of Palestinian civil society organizations was the development of *fragmented-clientelist* state characteristics, which require the presence of a number of competing parties and factions with significant bargaining power relative to the executive powers of the state.

The indigenous and expatriate Palestinian capitalists

The degree of development of the capitalist class clearly has important implications for the rent and intervention strategies of any state. The more developed the capitalist class, the more likely it is that the state will follow *developmental* strategies of the East Asian type. If the capitalist class has the capacity to acquire and use technology, conditional rent allocation to this class to accelerate growth can provide high economic and political returns for the state leadership. The Palestinian paradox was that its capitalist class was dualistic, with an indigenous capitalist class that was under-developed because of decades of Israeli occupation. On the other hand, expatriate Palestinian capitalists were more developed than capitalists in many other developing countries with equivalent per capita incomes. This dualism resulted in an implicit PNA strategy of trying to accelerate economic development by prioritizing the needs of the expatriate bourgeoisie while ignoring for the time being the demands of smaller and less advanced indigenous capitalists. This resulted in a bias in state support for capital-intensive investments in the tourism and communications sectors and a relative neglect of artisan manufacturing, agriculture, and petty businesses. While this strategy had costs, particularly in terms of the distribution of benefits, it was not necessarily entirely flawed if the priority was to accelerate economic growth. If rapid progress towards statehood had been achieved, the PNA's economic priorities in developing the tourism sector may well have provided significant returns for the Palestinian economy.

Indigenous Palestinian capitalists in the WBG were historically weak and under-developed because they had to operate under an external rule that imposed multiple restrictions on their development (Diwan and Shaban 1999). It lacked serious capital and it lacked political legitimacy since it had played a marginal role in the national liberation movement. On the other hand, the expatriate Palestinian capitalists, located in the oil-rich Gulf states, North America and Europe had significant blocks of capital. They were also eager to invest in Palestine for a combination of nationalistic and profit-seeking motives. But they too had tenuous relations with the national movement, and when they appeared in the WBG after the establishment of the PNA, they were clearly junior partners of the state leadership. The PNA granted expatriate capital privileged access to Palestinian markets and to major projects, and set contracts and conditions to ensure that these critical investors earned sufficient rents to compensate them for the precariousness of their investments. In return, the PNA too got a share of the rents, through share ownerships and kickbacks. It also benefited politically from the badly needed investments and job opportunities that enhanced its state-building project. As we saw in Table 1.1 (Khan p. 15), economic growth was relatively high during the period 1994–2000, the share of industry was maintained at around 20 per cent of GDP, implying equivalently high growth rates in the industrial sector. These high rates of private investment were particularly impressive given the uncertainty of the final status negotiations.

The interests of the indigenous and expatriate capitalists were different, and so were the roles they played in the PNA's development strategy. Indigenous capitalists were generally owners of small or *very* small enterprises, typically relying on cheap labour and simple technology. Many employed only two or three workers in artisanal enterprises or repair shops. They were likely to benefit somewhat from greater integration with Israel, which may have lowered the prices of some of their inputs and allowed some of them to seek higher prices for some of their products in Israel. Even if the PNA had wanted to construct a free market to help these small capitalists and informal sector traders, the externally imposed restrictions on movements of goods and labour, the territorial fragmentation of Palestine and the trade and fiscal restrictions imposed by the Paris Economic Protocol meant that this was not an attainable policy goal. At the same time, agricultural growth was constrained by Israeli control of Palestinian water sources, and to a lesser extent by trade restrictions that prevented Palestinian exports of agricultural commodities that could threaten Israeli producers (see Chapter 3 by Zagha and Zomlot). In this context, the PNA strategy of relying on big expatriate capitalists to drive economic growth through capital-intensive investments in service and manufacturing sectors could be defended as a promising economic strategy given the alternatives. This strategy had a number of other benefits since highly visible projects like hotels and telecommunication networks added to the prestige of the PNA, and it was easier to share rents with a few large capitalists than many small ones.

It is not surprising that there was a growing conflict of interests between smaller (mostly indigenous) capitalists and bigger (mostly expatriate) capitalists. Smaller capitalists were more likely to put pressure on the PNA for consultation and participation in policy-making, and to demand more transparent free-market policies. In contrast, expatriate Palestinian capitalists *were* capable of making concentrated long-term investments in higher technology sectors, and the PNA clearly saw them as significant agents of change. The PNA's economic policies show that the leadership was willing to create rents to attract investments from this group, even if it entailed raising prices for some critical goods and services that would hurt consumers and smaller producers in the short-run. Attracting large investments in a context of significant political uncertainty and weak state powers to protect domestic capitalists against the competition and restrictions coming from Israel required the provision of a variety of rents to these big investors. While the PNA's institutional structure left a lot to be desired in terms of transparency and accountability, it did respond to these requirements with a rent-allocation strategy that attracted a significant amount of expatriate capital in an otherwise hostile environment.

Rents to attract investments by large expatriate capitalists

Before the Oslo Accords, Palestinian expatriate capital had shown little interest in investment in the occupied territories, given their occupied status. This changed with the Oslo agreements. Expatriate investors were not only interested, they realized that in the long-run, profits would be even greater if they could have a say in the construction of the regulatory structure, the structure of taxes, and general economic policy-making. Thus, immediately following the Oslo Agreements, a number of large expatriate capitalists offered Arafat a partnership in which they would come up with significant investments in return for involvement in policy-making from the outset. Arafat turned down the offer, apparently fearful that the expatriate capitalists would be able to play a disproportionate role in determining the structure and policies of the new state before its authority had consolidated. Arguably, allowing a small group of investors to play a prominent role in influencing regulatory structures and policies at an early phase of state formation may not have been desirable given that these investors would very likely have tried to influence the design of institutions in ways that favoured them.

It was only after the PNA had achieved a degree of entrenchment following the general elections of 1996, and Arafat had secured substantial funding from the international donor community,[22] that he contemplated developing the partnership with expatriate capital. The latter was represented by figures such as Masri, al-A'qad, Khuri, Sabagh and Shuman. By then Arafat had both the resources and the institutional capacity to allocate rents independently and to determine overall policy. Consequently, he could hope to use the expatriate capitalists to further what he believed was the national interest, rather than letting them define what the national interest was. On the one hand, the leadership clearly recognized that rents would have to be created for expatriates to encourage them to invest. Investors repeatedly identified political uncertainties as the major disincentive for investment (see for instance, Diwan and Shaban 1999). On the other hand, executive centralization ensured that these rents could not be captured by capitalists unconditionally, in other words regardless of their performance. Moreover, by then the PNA had also acquired a capacity to create other types of rents necessary for its political survival, in particular, as we have seen, to accommodate and incorporate the middle classes.

Given the very limited powers of the PNA quasi-state, the rents that it could offer potential investors were not always conventional ones. It had no control over exchange rate or interest rate policy. As Chapter 6 by Fjeldstad and Zagha shows, it also lacked an adequate fiscal base to offer any significant direct or indirect subsidies. Thus rents were allocated through such mechanisms as allowing the creation of monopolies but implicitly demanding investment and performance in exchange. Expatriate investors were granted monopoly status in some activities (such as Paltel in telecommunications, and in a number of other companies held through Padico, the Palestine Development and Investment Company). Some of these companies were natural monopolies; others were not (see Nasr, Chapter 5). In each case, monopoly rents were not taxed away by the state but could be retained provided the investment was sustained and performance was acceptable. The PNA was also ready in its tax code to grant additional tax exemptions to investors for different periods depending on the capital invested and the labour employed. This further enhanced the rents of selected larger companies dominated by expatriate capital. In addition, informal mechanisms were also reported for enhancing the rents of vital companies, such as arrangements to defer utility or tax bills, often in exchange for kickbacks, but sometimes simply in response to special pleading.

If these rents were allocated regardless of performance and without any possibility of withdrawal and re-allocation, it is unlikely that they would have had any desirable effect, whatever the intentions of the parties. The incentive to act opportunistically would be irresistible once a rent had been captured. Here, the centralization of power gave the executive some leverage to make sure that the allocation of rents did have the desired effect of attracting investments and were not just free gifts for 'cronies'. The granting of the telecommunications licence, and its subsequent re-negotiation provides an example of how this rent-allocation system was beginning to work. Shortly after Oslo, Arafat granted an American registered company (Integrated Technology Incorporated) the sole right to operate telecommunications in the WBG for 25 years, the deal being subject to American law. A person associated by marriage with Arafat headed the company. Once the deal became public knowledge, a lobby was formed by a group of expatriate capitalists to persuade Arafat to rescind the deal on the grounds that the company was unknown and inexperienced and was likely to prove incompetent or inefficient. These expatriate capitalists agreed to cover the cost of annulling the licence (reported to have been many millions of dollars) in an out-of-court settlement. Arafat eventually granted the licence to a Palestinian company formed by expatriate capital, Paltel, in which the PNA became a shareholder. Paltel went on to become the most profitable company established under the PNA and modernized in a very short time the communication system in the WBG. State-led rent-management of this type is not surprising in a centralized regime that can take a long-term view. If a single decision-maker is comparing different options, allocations that are more efficient are likely to emerge because the leadership can easily see that the more efficient can credibly offer a higher payoff over time than the less efficient. Since Arafat and the PNA understood that their political survival would ultimately depend on economic performance, they had no reason to favour clan over economics.

Local capitalists, petty corruption and primitive accumulation

As we have seen, local capital in the Palestinian territories was dominated by very small-scale family capital, with at best a small number of medium-sized capitalists engaged in commerce, real estate and manufacturing. The privileged access to rents granted to large expatriate capital inevitably left indigenous small and medium capitalists disaffected. Most local capitalists also found that they could exercise little influence to change these economic policies. This was particularly galling because they looked at expatriate capital as having been absent while they had faced the restrictions and hardships of the Israeli occupation. And now the expatriates had apparently turned up to reap profits and privileges, arguably with no serious concern for political rights or democratic change. At the same time, expatriate capital looked upon local capital as technically backward and lacking knowledge and experience of operating in the modern world. To add to their difficulties, small capitalists most directly experienced the predatory aspects of the state apparatus, particularly at the local level. Since the leadership did not see small capitalists as critical growth leaders, and since their capital was not mobile, some amount of local extortion by tax collectors and security forces appeared to be sanctioned or at least overlooked by the centre.

These instances of petty extortion and corruption have to be clearly distinguished from much bigger processes of politically driven accumulation that we have previously described as ‘primitive accumulation’ (Khan, Chapter 1). Primitive accumulation describes a process involving high political and bureaucratic officials who use political power to help their own accumulation or to help proto-capitalists associated with them. Political power can be used to capture or acquire significant assets that are in the public domain, to be more or less rapidly converted into private assets. This too occurred in Palestine, as in other countries in the early stages of capitalist development. The small-scale indigenous capitalists were occasionally beneficiaries of these processes, but they were very often at the receiving end of asset transfers and politically driven accumulation that disadvantaged them. Much of the criticism and opposition to processes of primitive accumulation came once again from small capitalists and traders who were most vocal about this type of high-level corruption in which PNA officials were involved. To judge the effects of Palestinian primitive accumulation, we have to remember that primitive accumulation takes place in both dynamic and collapsing developing countries. In the former, primitive accumulation in the early stages of capitalist development takes place because a class of productive capitalists does not already exist. The collapse of pre-capitalist production enables a new emerging class to use its political power to consolidate resources and to become, over time, the new productive capitalist class. In the failed states, the capture of assets does not lead to production, but only to hoarding, conspicuous consumption and the export of assets to foreign banks.

Primitive accumulation can only lead to the development of productive capitalist enterprises if a number of conditions are met. Primitive accumulators must have the confidence to engage in long-term investments. This in turn requires that investors believe that the state has a long-term perspective and will not act in a predatory way, and that the state has the power to prevent or limit lower-level predation by its own staff. This does not mean that the state leadership will not want to tax (legally or otherwise) some of the profits of the new class. But investors must be assured that the tax will not be so big as to make their investment no longer worthwhile. The new capitalists are even more likely to remain productive if they believe that the state executive is relying on their profitability, and has the power to deprive them of their assets if poor management threatens leadership goals. It is not surprising that in countries with weak states, primitive accumulation often leads to assets leaving the country. In contrast, with strong states as in East Asian countries, primitive accumulation can lead to high rates of productive investment. Primitive accumulation in Palestine showed *some* evidence of proceeding to the establishment of viable capitalist enterprises, certainly more so than in many other comparable developing countries. A number of factors may have contributed to this: the presence of latent entrepreneurial skills, economic nationalism, and the perception that a centralized executive would not allow egregious violations that harmed the economy.

Amundsen and Ezbidi (Chapter 4) provide several examples of primitive accumulation in the Palestinian context. First, they describe how a Nablus security chief who did not have personal collateral used his political connections to get a bank loan to set up a chicken farm. In many if not most developing countries, a security chief getting a bank loan by using political connections would have set up a fictitious chicken farm at best, and the loan would be transferred to consumption or to a foreign bank, with no intention of repayment. But in Palestine, the outcome in this case was the construction of a real chicken farm that actually produced chickens for a profit. The chief made quite a lot of money, but he did so by producing chickens. Political capital in the first instance was converted into productive economic capital. They also cite other examples of primitive accumulation leading to the construction of hotels and other service sector infrastructure by politically connected individuals close to the leadership. In most of these cases, these were profitable enterprises. While Amundsen and Ezbidi are right to be critical of these processes and to point out that they could easily cause much damage, we argue that we need to compare Palestinian state performance in managing primitive accumulation with other developing countries at similar levels of development. In this *comparative* perspective, Palestinian primitive accumulation appears to have been at least partly *developmental*. The fact that so many primitive accumulators did in fact invest productively strongly suggests that while the exercise of political power for accumulation was tolerated, there were sufficient incentives for production, and disincentives for unproductive consumption. Examples of unproductive primitive accumulation are less frequently observed in Palestine. Along a spectrum of developing countries with countries like Nigeria at one end, where primitive accumulation is largely unproductive, and rapid developers like China at the other end, where primitive accumulation has been highly productive, Palestine would probably be somewhere in the middle, and possibly towards the China end of the scale. Given the very limited sovereignty enjoyed by the PNA, and therefore its very limited capacities to discipline primitive accumulation, this is a significant observation. If some amount of primitive accumulation has to happen when a pre-capitalist society is transformed into a capitalist one, the state capacities that the PNA displayed could be strengthened and institutionalized to accelerate this transition and achieve a structure of viable capitalist property rights that could then be stabilized. The PNA revealed some capacity for ensuring that primitive accumulation was consistent with a productive capitalist transformation, and feasible strategies of reform should seek to strengthen, develop and regulate these capacities in the future.

Not surprisingly, the capitalists who neither benefited from monopoly rents nor from primitive accumulation were most critical of the PNA's system of governance. These were largely the smaller and medium-sized local capitalists who felt that they were excluded from the system being constructed by the PNA. They participated instead in political activity to make the PNA more accountable and responsive to their needs. This took the form of establishing business associations and erecting coordinating structures, such as the Palestine Trade Centre or Paltrade, with the aim of voicing joint interests and demands. Small and medium capitalists were more concerned with establishing a level playing field, promoting a free market, and improving the rule of law and the quality of governance. But the vast majority of local capitalists were very small capitalists who did not even have the minimum economic resources to take part in this organizational activity. So in fact, the local capitalists leading the demands for greater accountability were of middling size and above. At the end of May 2000 Paltrade organized a national dialogue conference between the private and public sectors that came out with joint policy recommendations on issues of concern for local capitalists.[23] In December 2000, an overarching coordinating body was created that included the main sectors of indigenous capital: the Federation of Chambers of Commerce, the Federation of Chambers of Industry, Paltrade, business associations, and the Palestine Information Technology Association (Pita). In its programmatic statement, Paltrade went on to call on Arab states to take steps to support the private sector through loans, the easing of customs procedures, opening their markets to Palestinian goods and labour, and facilitating the use of Egyptian and Jordanian ports for Palestinian trade.[24] Representatives of local industry frequently and strongly demanded a transparent partnership between the private sector and the PNA in formulating a strategy supportive of local industry.[25]

Thus the political activity of small and medium capital, led mainly by the latter, was primarily concerned with getting rid of the damaging impact of market restrictions and rents. The rents being created by the PNA for big expatriate capitalists and trading monopolies (see Nasr, Chapter 5) were examples of these rents. But it has to be remembered that the most significant market distortions were caused by the restrictions on the movements of goods and labour that Israel insisted on, and by the restrictions on Palestinian fiscal, monetary and trade policies allowed under the Oslo and Paris Agreements. While domestic capital quite naturally aimed its criticisms against the PNA in the first instance, many of the rents being created by the PNA, such as the monopoly rents of the trading monopolies, were themselves responses to market distortions that were exogenously imposed. Regardless of the motivations of the PNA leadership in creating these rents, getting rid of them in this specific context would not necessarily improve the conditions even of small capitalists. Other rents, such as rents to attract investments and technologies, or those associated with primitive accumulation, are observed in almost all developing countries, and we have argued (Khan, Chapter 1) that the historical evidence suggests that development is accelerated if they are properly managed rather than if attempts are made to try to abolish them.

Partly, at least, the campaign for free markets and good governance was also driven by the global dominance of a particular version of market economics, and of the good governance agenda. These demands were strongly promoted by international donors, the World Bank and the International Monetary Fund. The absence of a significant public sector in the WBG and the fact that expatriate capitalists lacked local political voice meant that major public expressions of economic goals for society came from the local, relatively small-scale, private sector. It was also aided by the fact that the PNA itself adopted free-market doctrines without necessarily practising them, and publicly at least, acknowledged the need to limit its own role to a regulatory one.

Thus there were conflicts between the economic model desired by the local capitalists, and the rent-allocation model being used by the PNA executive to attract big blocks of expatriate capital to push development. But the conflict was often more apparent than real. Quite apart from the possibility that capitalists always find arguments to justify their own rents and to criticize the rents going to others, in the Palestinian context, significant moves towards a freer market were unattainable given the control exercised by Israel over movements of labour and goods. An immediate improvement in state accountability in the direction of an advanced economy with enforceable contracts and a sound judiciary was also unattainable, if only because of the disputes with Israel over land and resources, and the necessary centralization of power in a context of political conflict and uncertainty. As a result, much of the indigenous bourgeoisie's interaction with the PNA remained at the level of communicating aspirations. These aspirations were not alien to the top political elite, who also had an interest in the eventual emergence of a widely based and viable private sector. In the long run, they too wanted opportunities to convert some of their financial wealth into productive capital, and a more widely based capitalism would undoubtedly increase the revenues of the regime. Nevertheless, attracting big blocks of capital and expatriate expertise remained a major plank of the executive's medium-term economic strategy throughout the interim period. As we have already seen, it was only after the serious reverses of 2000 that the PNA began to dismantle some of the rent-creating mechanisms it had constructed, and we have argued that this was not necessarily a positive outcome for a future round of state formation under a client-state architecture, particularly if asymmetric containment is likely to continue.

A summary of the implications of the structure and organization of Palestinian capitalists

To conclude, the relative development of the Palestinian bourgeoisie and particularly of expatriate capital presented opportunities for the PNA that were significantly different from those available to most other Arab countries. In the 'state capitalist' strategies historically observed in Egypt, Algeria, Iraq and Syria, the public sector had to be the driver of accumulation and economic management (Perthes 1995). To some extent, this could be explained by the absence in those countries of big enough blocks of private capital (relative to the size of the economy) that could drive accumulation. The PNA, in contrast, had access to relatively large blocks of private capital which it could control politically and which could rapidly bring in expertise and developmental capacity. This created strong incentives to push growth through a partnership with the private sector since the leadership could get significant benefits from such a strategy. It also created incentives to dampen predatory activities and an opportunity to resist the asymmetric containment imposed by Israel. Elements of the state-led strategy in Palestine thus had developmental characteristics reminiscent of East Asian states where the state harnessed the private sector as a partner and provided it with the incentives and resources to play a dynamic role.

Conditional rent allocation to some of the big expatriate capitalists combined with sustained pressures for greater competition from indigenous capital created an environment that may potentially have been very conducive for growth and social transformation if the inhospitable environment in terms of external conflicts could have been improved. Such an assessment does not downplay the very real observations of shortcomings in regulatory structures, of low level extortions, of some allocations of rents that were clearly inefficient, and so on. It simply points out that *some* of the underlying conditions supported a number of developmental state characteristics that could have assisted in accelerating a capitalist transformation in the Palestinian territories. Policy could have been directed to develop and consolidate these embryonic state capacities. Had progress along these lines been achieved, it would subsequently also have been feasible to strengthen the rule of law, deepen democracy and counter corruption, while institutionalizing and legalizing the rent-seeking associated with necessary rents (Khan, Chapter 1).

Governance under the PNA and prospects for the future

Our examination of the internal and external conditions underpinning different types of rents and rent-management in Palestine shows that these conditions supported in different ways and to different extents a number of different state characteristics. The eventual outcome was therefore to a large extent an open one, and depended critically on the way in which internal developments and external pressures strengthened or changed these determining conditions. Israel appears to have supported the Oslo route as long as it believed that it could create a client state in Palestine. We have argued that there were a number of internal conditions in Palestine that were conducive for the emergence of an integrationist client state, one that could generate an acceptably rapid developmental transformation and thereby make an impact on Palestinian economic and political aspirations. But there was no support in Palestine for a client state based on asymmetric containment. However, for reasons that we have discussed in Khan (this volume), Israel was only prepared to offer a client state based on asymmetric containment.

These inconsistent aspirations fatally undermined the Oslo project, and this experience has critically important implications for the ongoing state-formation process in Palestine. The containment itself created conditions for the strengthening of predatory state characteristics within Palestinian institutions,

Table 2.2: Palestinian conditions and their implications for the consolidation of different state characteristics

Actual conditions in Palestine	*External conditions*	*State capacity*	*Organization of civil society*	*Organization and capacity of capitalists*
	(Israeli control of critical rents, Israeli strategy of asymmetric containment, substantial donor aid)	(Strong policing capacities, centralization, capacity to discipline bureaucrats, blurred division between state and ruling party)	(Fragmented middle class, weak secular opposition, repression of Islamists)	(Low-technology local capitalists, higher technology expatriate capitalists, both politically weak)
State characteristics	*Implications of actual conditions for the consolidation of different state characteristics*			
Client-state characteristics	The PNA accepted a limited client status but *asymmetric containment* made the client state **economically and politically unviable**	The PNA's extensive policing capacity **supported** the consolidation of a client state	Weak and fragmented opposition **supported** the consolidation of a client state	Lower technology capitalists **could potentially support** an *integrationist* client state, but no capitalists supported *asymmetric containment*
Predatory state characteristics	External conditions thwarting development created **incentives** for predatory state behaviour	Arbitrary state powers **supported** predation, but high enforcement capacity **restrained** predation as state could promote and gain from development	Weak and fragmented opposition **supported** the emergence of predatory characteristics	Expatriate capitalists with mobile capital **inhibited predation in strategic areas** but immobile, local capitalists were **exposed to predation in non-strategic areas**

Fragmented clientelist state characteristics	Easy aid availability **supported** emergence of fragmented clientelist state	Effective repressive capacities meant state paralysis due to demands of competing factions was **very unlikely**	Weak factions unable to challenge state rent allocations: made the consolidation of fragmented clientelism **very unlikely**	Inefficient capitalists **could support** fragmented clientelism by buying factional support to protect inefficient rents, but factions were weak
Developmental state characteristics	Adverse external conditions created **strong incentives** for developmental interventions, but *asymmetric containment* **limited** developmental possibilities	State capacity to withdraw conditional rents from investors and political factions **supported** strong developmental rent-management capacities, but limited by weak bureaucratic structures	Weak social factions unable to protect inefficient rents: **supported** developmental rent-management	Advanced capitalists were developmental partners of state, small capitalists felt excluded: in general capitalists **supported** state strategies but **with internal conflicts**

and to a lesser extent enhanced the possibility of a fragmented clientelist state emerging. Most important, though, was the growing recognition amongst the Palestinian leadership that the Israeli version of the client state was not going to be viable, and this must have created strong incentives for progress in the direction of developing embryonic developmental state characteristics. Table 2.2 summarizes our assessment of the conditions underlying the early state formation attempts in Palestine and helps to explain the impasse reached at Camp David in 2000 and the significant challenges facing the construction of a viable Palestinian state in the future.

The security-first route that Israel has always insisted on meant that if Palestinian state formation had to proceed at all, it would have to be achieved through the construction of a client state during an interim period and perhaps beyond. This was the implicit but critical condition under which Israel agreed to enter the Oslo peace process, and remains implicit in the 'road map' that the USA subsequently attempted to impose on the two parties following the second Iraq war. Israel's logic was that it had to maintain significant leverage over policy-making in the emerging Palestinian state to ensure that the new state gave *Israeli* security the priority Israel demanded. However reasonable such an aspiration may have been from an Israeli perspective, the attempt to construct a client state had significant implications for the viability of the Palestinian state-formation process. We have argued that the client-state strategy became unviable because despite pronouncements to the contrary by Israeli policy-makers, Israel failed to maintain, let alone deepen, its economic integration with the Palestinian economy. Instead, Israel sought to maintain control over Palestinian policy-making through a strategy of asymmetric containment. The adverse implications of this strategy for Palestinian economic and political development meant that in the end, no amount of force could ensure the acceptance by Palestinians of the strategy we have described as *asymmetric containment*.

At the same time, partly in response to the constraints created by Israel's asymmetric containment strategy, and partly driven by its own autonomous nationalism, the PNA also pushed developmental interventions using the limited political and economic powers that it enjoyed. The availability of expatriate Palestinian capital created incentives and opportunities for the leadership to try and exploit the possibility of breaking out of its containment through development. A number of internal conditions supported these moves, including, paradoxically, the centralization of power and the fragmentation of opposition groups in Palestinian society. But these moves remained patchy given that they were obstructed by the client-state architecture set up by Oslo and Paris, and given the absence of any international engagement in enhancing these critical developmental capacities of the PNA. We also noted some internal and external conditions that supported the possibility of state consolidation in the direction of predation and fragmented clientelism. Once again, the centralization of executive power created by Oslo, and the historical fragmentation of potentially powerful internal factions in Palestine *limited* moves towards these negative outcomes.

Table 2.2 summarizes the key points of our analysis. Our focus on the political necessity of many rents and of the dynamic economic effects of others, points to the importance of governance structures that can effectively and efficiently manage rents. This sharply distinguishes our approach from the good governance agenda. The emerging consensus that the PNA was failing *because* of its non-adherence to the good-governance criteria is very misleading since the good-governance framework is underpinned by the unrealistic assumption that a rent-free economy is a precondition for economic and political viability. Only if a rent-free economy was essential for development would good governance reforms that attempt to create a rent-free economy actually result in a more viable state being constructed (Khan, Chapter 1). While our reading of economic history leads us to reject this analysis, it may still be true that corruption or the weakness of democracy did have a role in damaging Palestinian state formation by allowing the establishment of damaging rents. We discussed this possibility by looking at the damaging rents underlying a client state, a predatory state, and a fragmented clientelist state and the conditions that would assist each of these to become dominant. Our analysis of Palestinian conditions suggests that there were indeed a number of conditions promoting damaging rents and the associated rent-seeking and corruption associated with them. Our analytical framework suggests that the most promising way to target the damaging rents associated with these types of corruption is to address the conditions that resulted in their creation and maintenance, rather than by pushing general good governance reforms. Not only are general good-governance reforms unlikely to be successfully implemented in developing countries, they would at best have very limited effects for improving economic and political viability.

Our discussion also shows that an analysis of observed governance failures must be informed by an assessment of the *hierarchy* of institutional and political factors causing these failures. By hierarchy we mean that some conditions and factors were more inflexible than others and their prior definition determined the operation of lower level institutions and governance arrangements. Figure 2.1 summarizes the critical components of the causal hierarchy that our analysis identifies. The most important institutional characteristic that could not be changed by the PNA was the architecture of Oslo set up as a result of Israel's insistence that the route to Palestinian statehood would be subject to Israeli security being satisfactory to a degree judged adequate by Israel. The insistence on the prioritization of security and the retention of controls over the emerging Palestine state so that it delivered this security has not changed post-Oslo and is driving the subsequent 'road-map' to Palestinian statehood.

The result of Israel's security-first requirement under Oslo was the 'client state', with its critical characteristics of externally controlled rents

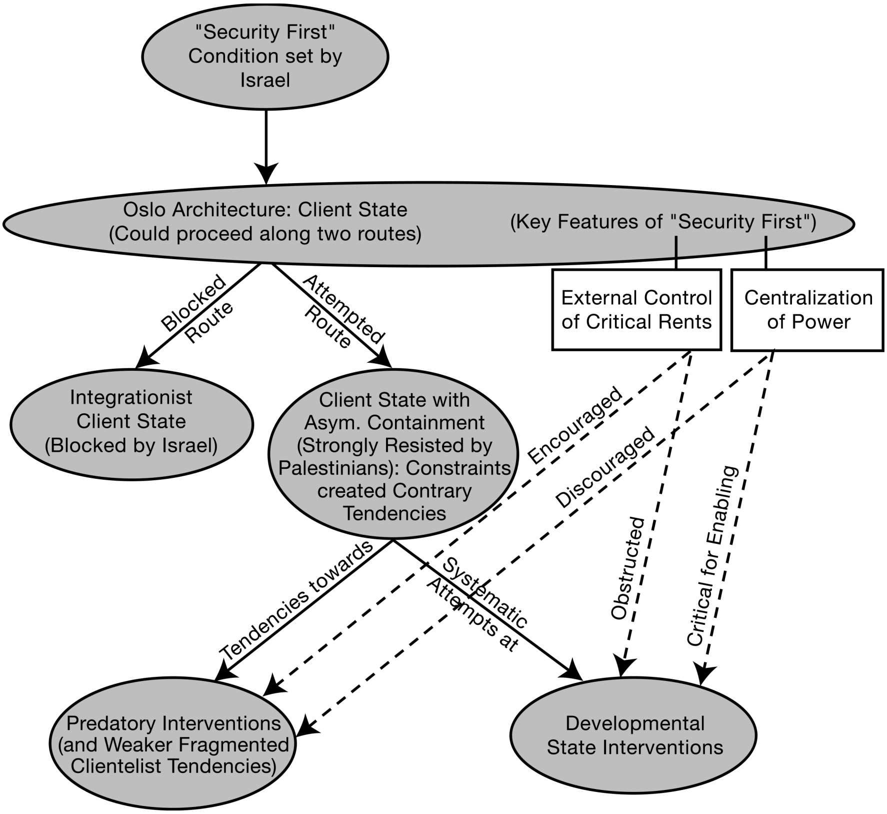

Figure 2.1 The hierarchy of determinants of Palestinian state characteristics

and executive centralization. But even within this externally determined architecture, further progress was additionally constrained by the fact that Israel's internal considerations took it down the non-viable route of *asymmetric containment* rather than the *relatively* more viable route of *integration*. It is in this context that we have to assess the lower level governance characteristics observed in the PNA. Figure 2.1 shows that the effective blocking of development in the asymmetrically contained client state created the incentives and opportunities both for the development of some predatory and fragmented clientelist characteristics, as well as the emergence of some developmental characteristics.

A number of lessons from the 1994–2000 period are thus likely to be of critical importance for the future. First, any observer of the PNA would have found plenty of instances of maladministration and predatory behaviour at different levels of the administration, particularly at lower levels. Figure 2.1 suggests that it would be very difficult to attack these problems if we focus simply on governance within the Palestinian territories, leaving out of the analysis the higher-level architecture that created strong incentives for predation and limited developmental interventions. This does not mean that some improvements in service-delivery and administration within the Palestinian territories are not possible, but we would argue that significant improvements are unlikely as long as the higher-level constraints are not tackled.

Second, our analysis suggests that given the hierarchy of determinants shown in Figure 2.1, an uncritical application of good-governance reforms can in some instances make matters worse. Suppose the client-state apparatus and asymmetric containment remains. In this context, an attack on the rent-creating capacities of the PNA in the name of good governance can reduce its capacity to intervene developmentally and reduce its financial viability. If so, the consequences could be serious. Such reforms may strengthen predatory characteristics or the emergence of fragmented clientelism. One can, for instance, imagine scenarios where a future leadership could fragment and cynical local leaders resort to predation or aid handouts to survive. Israel may hope that if good governance reforms destroy the rent-creating capacities of the PNA, this may force the leadership to accept a client state with asymmetric containment as a better option than full disintegration. This may well be an exaggerated hope. The PNA is more likely to simply collapse, and with it the prospects of a two-state solution. It is far less likely that even if its leadership eventually capitulates and signs an agreement amounting to an acceptance of a client state with asymmetric containment that this can actually by implemented or even sold to the Palestinian public.

On a positive note, our analysis also points out there are powerful conditions within Palestinian society that could support capacity building in the direction of some variant of a viable developmental state. If an integrationist client state is not on the agenda, the only other route to a viable state is to abandon the client-state route altogether, and to immediately construct a sovereign Palestinian state. This is unlikely to happen, given Israel's historic insistence on security first, and particularly given the possibility that the client state is not just required for Israel's security but also to protect the settlements and perhaps to deal with other aspects of Israel's 'Palestinian problem' (Khan, Chapter 1). But for the historical record, it is important to establish that even the Palestinian quasi-state labouring under a client-state apparatus and asymmetric containment was still able to display significant developmental characteristics. With sovereignty, these rent-creation and rent-management characteristics could have been rapidly developed and institutionalized in a state with substantial capacities for organizing a rapid transformation of Palestinian economy and society. If a sovereign Palestinian state does not emerge, it will not be because the Palestinians lacked the ability to construct a viable state with significant transformation capacities.

Notes

1 See Kohli (1994) for a comparison of Japanese and British colonial strategies. Kohli points out that the extreme social fragmentation which the Japanese brought about in East Asia may paradoxically have helped the subsequent consolidation of developmental states in East Asia. This is interesting for understanding the significance of the relative autonomy which Arafat's PNA enjoyed.
2 In some sectors such as construction, Palestinians formed more than 40 per cent of the Israeli labour force, but only 15 per cent in agriculture and insignificant in industry (annual Statistical Abstract of Israel for the 1970s and 1980s).
3 The Israeli budget for the occupied territories often ran a surplus, amounting to $17 million in 1992. Palestinians contributed direct and indirect taxes, and deductions for 'social security' (Diwan and Shaban 1999: 10).
4 Israel allocates some 80 per cent of the water from aquifers lying under the West Bank for its own use and sells some 31,184.3 thousand cubic metres to Palestinians.
5 See the reports of the Palestinian General Audit Department.
6 The chairman of the budget committee of the PLC was pressurized to resign because he insisted on presenting to the PLC a report highlighting irregularities in the PNA budget for 1999. The report revealed a missing sum of $126 million, apart from revenues of public investments that did not enter the treasury. The missing sums were deposited in bank accounts abroad for which various people had signing authority subject to the President's approval (Shu'abi 2000: 88–97).
7 Personal communication by an informed contact.
8 Berzeit University, Development Studies Programme, (survey No. 3), February 2001.
9 Although the speakers of the Palestine National Council (PNC) and the PLC were not appointed by Arafat, as the leader of Fateh, he had to agree to such appointments. Non-Fateh Executive Committee members of the PLO were appointed by factions in the PLO as their representatives. Independent members of the Executive Committee of the PLO had to be approved by Arafat.
10 *Wasta* can be used legally, to bypass bureaucracy (e.g. in acquiring a passport or accessing medical treatment), or semi-legally or illegally (but not always immorally) to gain an advantage over others in the competition for jobs or contracts. *Wasta* and *mehsubia* clearly favour intermediate social groups and classes. They should be differentiated from *rashwa* (bribe) which is considered illegal and immoral.
11 In 1992, the number of those employed in professional, technocratic, administrative and clerical type of occupation (excluding Arab Jerusalem) was 35,180 individuals, while the number in mid 2000 totalled (with Arab Jerusalem) some 144,675 individuals. According to the population, housing, and establishment census carried out at the end of 1997, the population of Arab Jerusalem totalled 210,209, and the total population of the WBG totalled 2,895,683 (1,873,476 in the WB, and 1,022,207 in GS). That is, the population of Arab Jerusalem (annexed unilaterally in 1967) formed 7.25 per cent of the total population of the WGS (ICBS 1993: Table 27.20; PCBS 2000b: Table 26; PCBS 1998; PCBS 2000d).
12 In 1999, employment in the local economy of the WBG was: agriculture 14.7 per cent; manufacturing and quarrying: 16.4 per cent; construction: 12 per cent; commerce, hotels, and restaurants: 17.6 per cent; transportation, storage and communication: 6.3 per cent; services and other activities: 33 per cent (MAS 2000: Table 4.2). At the same time, 57 per cent of Palestinians working in Israel and its settlements were employed in construction.

13 One result of this networking is the marginalization of institutions, including the cabinet. It made the president's office the centre of power, and those running the office more powerful than any minister (Shu'abi 2000: 88–97).

14 Ibid, p. 91.

15 In a public opinion poll carried out in February 2001 by the Development Studies Programme at Beirzeit University (survey No. 3), those interviewed with higher education (BA +) had much less confidence in Palestinian negotiators than illiterates, and a much higher support for changing the government than illiterates.

16 Before the Israeli occupation of the WBG in June 1967, there were 11 banks with 31 branches. All were closed by Israeli military orders, and replaced with 5 Israeli banks with 31 branches. Israeli banks limited their roles to commercial transactions between Israel and the occupied territories with no role in development lending. Before the PNA was established, two non-Israeli banks were allowed to operate in WBG under strict Israeli supervision (Gaza Bank in the Gaza strip, and the Cairo-Amman bank in the WB) with eight branches (Karim and Dhahir 1996; MAS 2000.)

17 On 25 September 1997, Palestinian security forces closed down about 20 offices and branches of Islamic charitable institutions suspected of being run by Hamas. In 1998 another 15 NGOs affiliated with Islamic groups were shut down.

18 Arafat was highly distrustful of NGOs, and till 1999 allowed his Ministry of Interior a free hand to control the NGOs, mainly because he saw them as diverting rents from the PNA. Early in 1999, Arafat spokespersons waged a campaign against the NGOs accusing a number of them of corruption and lack of transparency, and their heads of self-aggrandizement and using service delivery for political ends.

19 The World Bank, for the first time in its history, established in 1997 a project to support NGOs directly (the Palestinian NGO Project) without going though government channels, financed by a $10 million grant. The aim was to use NGOs as delivery mechanisms, to improve the institutional capacity of Palestinian NGOs, and to strengthen the relationship between the PNA and Palestinian NGOs.

20 According to MOPIC (1998), total governmental disbursements to NGOs for 1994–98 amounted to US $213 million, which was 79 per cent of the total (US$268), the remainder being from non-governmental sources.

21 By the early 1990s Palestinian NGOs were receiving between $140 and $240 million each year from outside sources. By 1994 (as a result of the Second Gulf War and the Oslo Accords), this assistance dropped to about $90 million, and further to around $60 million in 1995 and 1996 (World Bank 1997: 1–2).

22 Disbursements from the international donor community to the Palestinian areas between 1994 and the end of 1998 amounted to an annual average of half a billion dollars (MOPIC 1999).

23 The main recommendations were to affirm the free market model and the importance of external trade; but also to urge the PNA to oppose obstacles emanating from Israel that affected trade (*The Paltrader*, vol. V, nos. 2 and 3, May/June 2000).

24 See the interview of the director of Paltrade in the Gaza Strip, published in the daily *al-Ayyam* (Ramallah), 1 April 2001, p. 11.

25 For instance, by the president of the Federation of the Chambers of Industry in a press conference attended by the Minister of Economy and Trade, and representatives of the private sector, see *al-Ayyam*, 8 April 2001, p. 11.

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