

Between Oslo and al-Aqsa

Taxation and state formation in Palestine 1994-2000

Odd-Helge Fjeldstad and Adel Zagha

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1 Introduction

The Palestinian state-formation process is at a dead end. Officially the process started with the signing of the first Oslo Agreement in Washington on 13 September 1993, followed by the famous handshake between the PLO leader Yassar Arafat, the late Israeli Prime Minister Yitzhak Rabin and Foreign Minister Shimon Peres. It ended – at least for the foreseeable future - by Prime Minister Ariel Sharon's visit to the Temple Mount, which ignited in late September 2000 a popular uprising known as the *al-Aqsa intifada* in the occupied territories and inside Israel.¹

The road from Oslo to al-Aqsa has certainly been a dramatic one, in terms of bloodshed, hopes and despair on both sides of the conflict. The Oslo Agreement was a declaration of principles which laid the foundation for a limited, interim Palestinian self-rule in those areas of Palestine occupied by Israel since 1967; the West Bank, including East Jerusalem, and the Gaza Strip.² This included approximately 20% of the Palestine that the United Nations decided to separate into two states in 1947 (Butenschøn, 1998:19).

The Oslo Agreement was not an agreement between equal partners, but an agreement between an occupying power and an occupied people. However, for Palestinians the new reality after Oslo involved the creation of a Palestinian National Authority (PNA) in 1994 with some jurisdiction over the Palestinians living in the West Bank and Gaza Strip (Giacaman, 1998:1). Moreover, the agreement included the establishment of an elected Palestinian Legislative Council (PLC) with executive and legislative authority constrained by the agreement.

Although the PNA operated over only a small part of the territory of the WBGS, it had a degree of sovereign legitimacy within the Palestinian territories. In the period 1994-2000, the PNA set up institutions which were intended gradually to form the core of a future Palestinian state (Hilal & Khan, 2002:1). The PNA established state institutions such as ministries and agencies, it had its own police force, a tax system was developed, and it received foreign aid from both multi- and bilateral donors. However, the second intifada and the Israeli re-occupation of major parts of the West Bank during spring 2002 have put further progress on hold.³

The turmoil that began in late September 2000 has caused a collapse of the Palestinian economy. Moreover, during the Israeli re-occupation in 2002 much of the PNA's

¹ The al-Aqsa Mosque, located at the Temple Mount, was built by the Caliph al-Walid (r. 705-715) of the Umayyad dynasty. It is one of the three most revered places of worship for Muslims, and a major religious and educational centre. Moreover, it is a showcase for Islamic architecture and design from Umayyad to Ottoman times.

² Actually, there were two Israeli-Palestinian agreements referred to as Oslo I (signed in September 1993) and Oslo II (signed in September 1995). See Butenschøn (1998) for an analysis of the Oslo Agreements placed in the context of Israeli and Palestinian political strategies. Giacaman & Lønning (1998) provide a critical assessment of the Oslo process from various perspectives.

³ After a series of suicide bombings, the Israeli army invaded and re-occupied Palestinian population centres on the West Bank. The military occupation lasted for 3-4 weeks (29 March to 21 April 2002).

administrative and physical infrastructure on the West Bank was destroyed.⁴ Real per capita gross national income (GNI) has fallen sharply since 1999 (Fischer et al., 2001).⁵ According to the United Nations, three-quarters of all production in the West Bank has come to a halt, and three-quarters of the workforce is temporarily or permanently unemployed. Few have cash and their savings are exhausted. Moreover, aside from the Israeli invasions, the 40% of the West Bank that the PNA once partially controlled is currently divided into eight zones, 120 checkpoints and 220 enclaves (*The Economist* 29 June 2002:27).

It is clear that no functioning, central Palestinian Authority, reformed or otherwise, can emerge in these circumstances. But although the events since autumn 2000 have put further progress on hold, the experiences of the PNA during the period 1994-2000 provide valuable evidence about the nature of state-society relationships in Palestine. Moreover, the experiences of state building from this period may provide important lessons about the economic, political and institutional constraints that a future Palestinian state might face.

We use the tax system as an entry point to analyse the state-formation process. The relevance of the tax system in this respect lies in fact that tax revenues are central to (i) building state capacity and service delivery; (ii) the shaping of state-society relations; and (iii) the sustainability of aid interventions. Furthermore, based on historical evidence from the West, the way a state tackles the issue of domestic revenue mobilisation significantly influences its potential for economic growth and democratic consolidation (Tilly, 1992).

This report analyses the evolution of the tax system in the Palestinian territories governed by the Palestinian National Authority during the period 1994-2000. In particular, it explores the political, institutional and economic forces that shaped the tax system. The tax system during this period reflects, we assume, the impacts of and changes in four main constraints when seeking to increase revenues: These constraints relate to (a) the socio-economic structures of Palestine; (b) the nature and capacity of the political and administrative institutions of government; (c) the PNA's bargaining position vis-à-vis various groups of citizens; and (d) the international context, here defined as the external actors and institutions that affect the PNA's economic policies. Of particular relevance are the Israeli-Palestinian linkages and foreign aid.

The study is organised as follows: The following section briefly describes the economic structure and tax system in Palestine in the period 1994-2000. In section 3 various theoretical approaches to analysing the constraints facing a state's revenue policies are

⁴ In Ramallah, for instance, Israeli soldiers, in a pattern so routine that it seemed to observers to be policy, invaded PNA ministries, removed land registries of maps, raided courts, broke into banks and stole money, and trashed non-governmental offices servicing health, human rights and commerce. In the Ministry of Finance in Ramallah the Israeli Defence Forces (IDF) confiscated and/or destroyed hard disks containing tax records, payroll schemes, financial records and accounts (LACC, 2002; PNEIJ, 2002). Similar confiscations and damages of hard disks and data files were reported from the Palestinian Central Bureau of Statistics. For detailed accounts of the damages caused by the IDF during the re-occupation, see *Press Release* of the 'Local aid co-ordination committee co-chairs' [LACC] (15 May 2002); and PNEIJ (2002).

⁵ The *International Monetary Fund* estimated real GNI per capita growth in 2000 to minus 8.3% (Fischer et al., 2001:Table 1).

discussed, including the role of domestic and external interest groups. In the main analysis in section 4 these constraints are analysed within the context of the post-Oslo accord. A concluding section summarises the main arguments and points to possible lessons for future developments of the taxing powers of a Palestinian state. Moreover, a detailed description of the Palestinian tax system is presented in the appendix.

2 Economic structure and the tax system

In the period 1994-2000 the PNA was a self-government that possessed administrative, legislative and political power over only parts of its territory. About a third of the area of the Gaza Strip (GS) and around 60% of the West Bank (WB) were controlled by Israel. However, the majority of the population of more than 3 million people came under the jurisdiction of the PNA, except from those living in East Jerusalem and some villages in the West Bank that were under Israeli security control. With a GDP per capita income of USD 1387 (in 1998), Palestine fell into the category of middle-income countries (PCBS, 1999).⁶ However, since the second *Intifada* started in September 2000, living conditions in WBGs deteriorated dramatically. Real GDP per capita has now reached its lowest level since 1980. By the end of year 2000, 35% of the population lived below the poverty line, a figure that was expected to rise to over 50% by the end of 2001.⁷ The official unemployment rate was 14.5% in 2000. But, when including workers discouraged from entering or remaining in the labour force the unemployment rate was estimated to almost 40% in the last quarter of 2000.

2.1 Economic policy and employment

The PNA implemented and maintained a liberal economic policy regime, emphasising incentives for investments and a stable macroeconomic environment. At the same time, the public sector expanded rapidly. Total public expenditures accounted for more than 27% of GDP in 1999, compared to 14.7% when the PNA was established (Fischer et al., 2001:256). This expansion was mainly due to an almost four-fold increase in public sector employees, including security forces (from 31,140 in 1994 to approximately 110,000 in mid-2000), and provision of social services to health care and education. The PNA used public office holding as a reward for political and personal loyalty, and as a mechanism of incorporation and stabilisation of the regime (Hilal & Khan, 2002; Amundsen & Ezbi, 2002). However, the growth-oriented policies during the period 1994-2000 did not yield results in the form of substantial private sector job creation, and thereby expanding the tax base. Moreover, the PNA's policy of using public sector employment as a tool of incorporation and stabilisation slowed down considerably by the end of the 1990s. Increasing criticisms of inefficient, overstaffed government departments also contributed to slow the expansion of the public sector.

The public sector was by far the largest employer in the areas controlled by the PNA. By end 1999, about 19% of all employed persons in the WBGs (approximately 110,000 people) were on the PNA's payroll (including education, health and security forces).⁸ Of those employed in the local economy on the West Bank and the Gaza Strip by end 1999 (PEPRI/MAS, 2000):

⁶ This average excludes East Jerusalem with a population of more than 210 000 (in 1997). The figure also hides substantial differences between the West Bank and the Gaza Strip.

⁷ See UNSCO (2001:29).

⁸ According to Nasr (2002), the public sector wage bill amounted to more than 12% of GDP in 1999.

- 33% were employed in services and other activities, including the public sector;
- 17.6% in commerce, hotels and restaurants;
- 16.7% in manufacturing and quarrying;
- 14.7% in agriculture;
- 12% in construction; and
- 6.3% in transportation, storage and communication.

Small, family-owned firms dominated the economy. According to UNSCO (1998), 76% of the firms in the WBG were sole ownerships, and almost 60% of the people working in these companies were owners and unpaid family members. Furthermore, in the industrial sector more than 90% of the companies had less than 10 employees (PCBS, 1999).

In the 1970s and 1980s the proportion of the Palestinian labour force employed in the Israeli economy exceeded 30% in the WB and even more in Gaza (Arnon & Weinblatt, 2001:298). After 1994, however, this proportion declined to only 14% (i.e., 75,000 people) in 1996. Thereafter, the number of Palestinian labourers working in Israel and its settlements increased to 130,000 in 1999 (i.e., 22.8% of the employed labour force). But because of the Israeli policy of closing the 'borders' a substantial share of the annual working days was lost. Israel's compulsive closure policy stopped in periods all movement of people and goods between Israel and the Palestinian regions, as well as between the West Bank, the Gaza Strip and East Jerusalem. According to UNSCO (2000), the number of 'effective closure days' (excluding weekends, Muslim and Jewish holidays) were 64 in 1994, 84 in 1995, 90 in 1996, 57 in 1997, 14 in 1998, and 7 in 1999. In 2000, the days of closure reached 62 days (see www.paltrade.org). Moreover, the closures opened the labour market in Israel to foreign labourers, notably from Romania and Thailand (Arnon & Weinblatt, 2001:299).

It is clear that that the WBG's economic performance was substantially hampered by the 'siege and closure' policies of Israel since the establishment of the PNA. The policy of closure was particularly damaging because it was often totally unpredictable (Kanafani, 2001:289). Closures were declared for different lengths of time and were imposed on various categories of workers, according to age, sex, marital status etc. (Arnon & Weinblatt, 2001:298). All existing permits were suspended as long as a closure was in effect. Consequently, political uncertainty was perceived to be the main obstacle for investments. For instance, in a survey of the business environment in WBGs, 77% of the respondents from the private business sector cited instability and uncertainty as the major constraints for their operations and expansion (Sewell, 2001). Moreover, in a survey of small and medium scale enterprises, 76.5% of the respondents in the WB and 84% in the GS said that political instability was a major problem for their businesses.⁹ Furthermore, three decades of Israeli occupation imposed huge constraints on the development of the domestic market by neglecting improvements of physical and administrative infrastructure, and restraining trade and access to financial resources (Nasr, 1994).

⁹ The last survey was carried out in 2001 as part of our study and covered 34 firms in the WB (Ramallah and Nablus) and 50 firms in Gaza.

2.2 Fiscal policy and revenue clearance with Israel

The ratio of fiscal revenue to GDP was estimated to 23.4% in 1999, which compares well with countries at a similar level of development (Fischer et al., 2001:272).¹⁰ Table 2.1 provides an overview of the composition of fiscal revenues in Palestine during the period 1995-1999. The major tax bases were personal and corporate income taxes (8.2% of total tax revenues in 1999), indirect taxes on domestic goods and services (47.7%) and taxes on international transactions (30.3%). Furthermore, various types of fees and charges were collected.¹¹ While VAT and other indirect taxes on domestic goods and services still accounted for almost half of total tax revenues, their share dropped substantially during the late 1990s. In 1995, they accounted for about 66% of total revenues. During the same period, revenues from customs duties and taxes on imported goods increased from about 6% of total revenues in 1995 to approximately 30% in 1999. Income tax revenues remained fairly stable between 8-9% of total fiscal revenues during the period 1996-99.

Table 2.1 Composition of major fiscal revenues in Palestine, 1995-2000 (in % of total fiscal revenues)

Revenue sources	1995	1996	1997	1998	1999	2000
Income taxes	11.6	8.3	8.6	9.0	8.2	8.3
Indirect taxes on domestic goods and services	66.0	61.2	54.6	51.0	47.7	n.a.
Indirect taxes on international transactions	6.2	16.0	20.0	26.7	30.3	n.a.
Property taxes	0.16	0.14	0.07	0.06	0.15	n.a.
Non-tax revenues (fees and charges)	15.8	14.3	16.7	13.3	13.6	n.a.

Sources: Palestinian National Authority (2000) and World Bank (2001).

The PNA's fiscal operations in the period 1994-2000 were to a large extent governed by the principles of the Paris Protocol (PP), signed in 1994. This *Protocol of Economic Relations between the Government of the State of Israel and the PLO, Representing the Palestinian People* limited the role of the PNA in designing its own fiscal and trade regimes.¹² In the area of tax administration, the PP provided a revenue clearance system, according to which Israel collected and transferred to the PNA taxes and

¹⁰ The figure is, however, higher than the average for Arab countries. In 1995, tax revenue as a percentage of GNP for Egypt was 26.3%, Yemen 13%, Morocco 23%, Syria 17.8%, Jordan 20.4%, Tunisia 21%, Lebanon 10.8%. All these countries had lower GDP figures than the PNA due to their dependence on migrant remittances (World Bank, 1997:258-259).

¹¹ Annex 1 provides a detailed account of the Palestinian tax system during the period 1994-2000, including the major central and local government tax bases and the revenue administration.

¹² The title of the Protocol indicates that it was drawn up between two equal partners, in spite of the fact that one contract partner was a state and the other an organisation (see Arnon & Weinblatt, 2001:295). Kanafani (2001) provides an insightful discussion of the strengths and weaknesses of the PP from both Israeli and Palestinian perspectives.

customs duties imposed on Palestinian imports from or via Israel, in addition to the income taxes from wages of Palestinians working in Israel. However, with respect to customs duties, the PNA could only reclaim import duties on goods that were directly imported by Palestinian companies via Israel. Products that initially were imported by Israeli companies and then re-exported to the Palestinian territories were, according to the Israeli interpretation of the Paris Protocol, not eligible for re-claiming of customs duty. Since a bulk of the imports to Palestine came via Israeli companies, 60% according to some estimates, this arrangement with Israel led to a substantial loss in customs revenues for the PNA (see section 4.4 for further details).

The share of fiscal revenues collected by Israel through the clearing system remained fairly stable in the period 1995-99, and accounted for around 63% of the PNA's fiscal revenues in 1999 (Fischer et al., 2001:267). However, for individual revenue bases some changes were observed during this period. For instance, in 1995 Israel collected 80.2% of indirect taxes on domestic goods and services, compared to 70.8% in 1999. The opposite trend was observed for indirect taxes on international transactions where Israel collected 72.1% in 1995, compared to 87.9% in 1999 (see Table 2.2).¹³

The figures above reflect the heavy dependence - and vulnerability - of the Palestinian economy on Israel with respect to foreign trade, employment and tax revenues. However, they also indicate that during the first years of operation, the unified invoice system seemed to function fairly well, and probably better than most other arrangements between the PNA and Israel. But it is clear that Israel's narrow interpretation of the clause of 'place of final destination' of imports led to substantial revenue losses. As noted above, goods imported to the WBGs via the Israeli market were not considered by Israel as being 'proper imports' and thus not eligible for reclaim of customs duties by the PNA. This reflects the imperfection of the bilateral contract as well as the asymmetry of power between Israel and the Palestinian authorities (see, for instance, Arnon & Weinblatt, 2001).

Table 2.2 Fiscal revenues collected by Israel through the clearance system, 1995-1999 (in % of total revenues from the specific revenue base)

Revenue sources	1995	1996	1997	1998	1999
Income taxes	10.1	7.2	9.1	13.5	8.4
Indirect taxes on domestic goods and services	80.2	75.6	72.8	70.2	70.8
Indirect taxes on international transactions	72.1	79.1	86.7	89.5	87.9
Non-tax revenues (fees and charges)	25.4	12.4	14.3	15.6	15.2

Sources: Palestinian National Authority (2000) and World Bank (2001).

¹³ These figures include income taxes, indirect taxes on domestic goods and services (VAT and excises), taxes on international transactions, and non-tax revenues. However, property taxes and local government taxes and charges are excluded.

2.3 Tax administration

In the areas controlled by the PNA, there were four central government agencies authorised to collect taxes: (1) The Customs Department collected customs on goods imported directly from Jordan and Egypt or through these countries; (2) The VAT and Excise Taxes Department collected VAT and purchasing tax on domestic goods and services; (3) The Income Tax Department collected personal income taxes through a withholding system, as well as corporate profit taxes from registered companies based on self-assessment albeit subject to negotiations with taxpayers in virtually all cases; and (4) The Fiscal Department collected and managed the property taxes. There were twelve offices for each of these departments in the main towns in the West Bank and Gaza Strip. The health, insurance, transportation fees, etc. were collected through different offices on an annual basis.

With respect to local government taxes, the taxing power of local authorities was limited. Fiscal decentralisation – including increased local tax autonomy – was discussed during the late 1990s, but the implementation of this policy moved very slowly. However, in January 2001, the responsibility for collecting property taxes was transferred from the Ministry of Finance to local authorities on the WB (see appendix). In addition, various forms of user charges were major revenue sources for local authorities. But, generally, the uncertain political situation and the PNA's well-founded fear for increased fractionalisation of the country, contributed to sustain the highly centralised taxing authority.

In the period 1995-2000, there were few and limited changes in the tax structure, except from simplifications of the rate structures and reduction of some rates. The most important changes were related to the granting of tax exemptions (see section 4.1 and 4.3). However, this is not surprising, since the Paris Protocol placed substantial restrictions on how and what revisions could be made. Thus, due to the compelling need to raise revenue quickly, the PNA focused on improving tax administration, including the revenue clearance system with Israel, rather than revising the existing tax structure. The increased domestic revenue generation during the period was, therefore, mainly due to administrative measures such as the implementation of a tax arrears settlement programme, improvements in enforcement provisions in the legislation, and a campaign for tax registration. Additional measures to improve the tax administration included the creation of a large taxpayer unit, a delinquent taxpayer unit, and the establishment of a tax court.¹⁴ These measures enabled the PNA to establish a potentially well functioning central government tax administration within a fairly short period of time.

Despite the progress made to improving the tax administration there were substantial weaknesses. Firstly, the tax base was eroded due to generous tax exemptions. In particular larger companies, foreign investors, professionals and the agricultural sector

¹⁴ No tax disputes seem to have been solved by bringing them to court. Disputes have been solved either by forwarding them to the Chairman of the PNA (President Arafat), or by negotiations and compromises between the taxpayers and tax officials.

were benefiting from exemptions. Secondly, current procedures facilitated tax evasion and corruption, including:¹⁵

- lack of consistent audit and enforcement procedures and techniques;
- a practice of 'negotiating' income tax assessments;
- insufficient resources allocated to the large taxpayers unit; and
- inadequate training of staff.

According to the Director of the Income Tax Department (ITD) of the West Bank, there were only 10 employees in this department in 2000. On average each of these income tax officers handled some 65 files in the West Bank.¹⁶ Tax assessments by the Palestinian Revenue Authority (PRA) found that in 90-95% of the cases incomes were underreported. But, in spite of the existence of a tax court only 2-3 cases were filed to the court per year. Most of the cases found a compromise through negotiations between the taxpayer or his representative and the income tax official (see section 4.1).

¹⁵ Personal interview with an international public finance expert who resided at the Ministry of Finance for a period while on an IMF mission (11 January 2001). The person preferred to be anonymous.

¹⁶ Only 650 private companies were registered and had files at the ITD in 2000. In addition, there were some 30 partnerships registered with files in the department. Public companies did not file. Registration procedures were based on the registration at the Ministry of Economy and Trade, which provided a license number accompanied with the internal by-laws and contract of establishment. Procedures for tax assessment were based on officially audited statements according to the companies and the tax code. The Director of the ITD was not able to provide corresponding data from Gaza.

3 Taxation and state-formation: Theoretical perspectives

What factors explain the evolution of the Palestinian tax system since the mid-1990s? In this section four analytical approaches are outlined, which may contribute to explain observed changes and the major constraints that a government face in its efforts to raise revenues from its citizens.

The structure of a country's economy may be important in determining both the level of taxation and the characteristics of the tax system (Tanzi, 2000). It is, for example, administratively easier and cheaper to tax major industrial activities than peasant agriculture. Thus, the economic structure ought to inform tax-policy making. Moreover, the economic structure has also considerable effects on tax administration and through this on state-society relations.¹⁷ Furthermore, structural changes in a country's economy are likely to change the constraints faced by government in its search for revenue. Literature on tax structure change maintains that economic development creates tax bases that can be exploited, and, thereby, raises the 'taxable' capacity of the country (Hinrichs, 1966; Musgrave, 1969). Thus, Tanzi (2000:224) argues that the 'increasing importance of taxes on personal income in many countries is closely related with the increase in the share of wages and salaries in national income as well as the expansion of incomes from interest, rent and dividends, as compared with incomes of independent contractors including farmers'.

Politics, on the other side, determine the formulation and implementation of tax politics (Brennan & Buchanan, 1980; Levi, 1988; and Steinmo, 1993).¹⁸ According to Steinmo (1993), differences in tax systems and tax burdens between countries are due to different political institutions, and not from differences in citizens' attitudes to service delivery or willingness to pay taxes.¹⁹ Domestic political institutions operate within and must be understood in the context of the broader social, economic and political setting in which they are embedded. Political institutions provide the context in which individuals, groups and classes interpret their self-interests and thereby define their policy preferences. Political institutions alter the distribution of power among participants, and the structure of the decision-making institutions strongly affects how interest groups, politicians and bureaucrats develop their policy preferences.

Following Steinmo (1993), individual interests concerning taxation are often confused and split (wanting better public services and, at the same time, lower taxes). Sometimes citizens also oppose outright what the government must do, for instance raising taxes to achieve macroeconomic balance. If citizens' opinions were unambiguous, the mechanisms by which these opinions are translated into public policy should have little

¹⁷ In a study of tax shares (tax to GDP ratios) in sub-Saharan Africa, Stotsky & WoldeMariam (1997) estimate a tax share for each country based on the structure of its economy. As expected, tax shares are negatively related to agriculture's proportion of the economy, and positively correlated with export share and per capita income.

¹⁸ Therkildsen (2001) provides an excellent critical review of this literature.

¹⁹ Steinmo (1993) analyses the development of the tax systems in Britain, Sweden and the USA within a historical institutional framework.

independent effect on policy outcomes. But when public guidance is unclear or subject to different interpretations, political institutions become important in shaping tax policy decisions. Such institutions also shape the trade-off between the autonomy of the ruling elite and its responsiveness to the public's ambiguous tax/spending preferences. Thus, Steinmo (1993) argues, it is institutions – rather than ideology – that are significant in shaping the tax systems.

While Steinmo emphasises political institutions, Levi (1988) adds the perspective of individual actors to her analysis of revenue generation and tax compliance.²⁰ Levi argues that it is important to maintain both an actor and an institutional perspective to account for the effects of institutional change. She assumes that actors who compose the polity are self-interested in the way that they calculate the costs and benefits of proposed actions and chooses the course of action most consistent with their preferences. Moreover, she assumes (p. 10) that rulers are predatory because they need state revenues to pursue their personal objectives of staying in power.

Levi's main proposition is that 'rulers maximise revenue to the state but not as they please' due to the various constraints: transaction costs in tax enforcement, the discount rate of rulers, and their relative bargaining power *vis-à-vis* agents and constituents (p. 10). These constraints determine the choice of revenue system, since rulers do not possess unlimited power, nor do constituents pay taxes voluntarily. Even with extensive power and effective monitoring of taxpayers, a ruler cannot achieve full compliance. Consequently, a ruler attempts to improve compliance at minimum costs, while taxpayers try to avoid and evade taxes (Levi, 1988:49). A 'balance' between these conflicting interests is achieved through bargaining between the ruler and various groups making up the polity. This results in a 'fiscal constitution' for a polity (Therkildsen, 2001:104).

Once a 'fiscal constitution' is negotiated, the contract between the rulers and constituents comes under pressure due to free-rider problems, imperfections in the specification of the contract, and changes in the relative bargaining power between rulers and constituencies. For instance, various interest groups may negotiate favourable deals for themselves, or people may find ways to evade taxes. Moreover, state functions may change in scope and character. Such factors will all influence people's perceptions of the costs and benefits of a given revenue system. Most taxpayers are of course unable to assess the exact value of what they receive in return from the government for taxes paid. However, it can be argued that the taxpayer has general impressions and attitudes concerning his own and others' terms of trade with the government (Fjeldstad, 2001). If this is the case, then it is reasonable to assume that a taxpayer's behaviour is affected by his satisfaction or lack of satisfaction with his terms of trade with the government. Thus, if the system of taxes is perceived to be unjust, tax resistance may, at least partly, be considered as an attempt by the taxpayer to adjust his terms of trade with the government. Reciprocity is therefore crucial.

The three approaches summarised above hold intrinsic values for analyses of tax policies in Palestine. The tax handle approach suggests that the structure of the

²⁰ Levi, working within the tradition of rational choice institutionalism, is inspired by Machiavelli and theories of collective action. She uses case-studies from republican Rome, medieval England and France, Britain in the 18th century, and Australia in the 20th century.

economy may be important in determining both the level and characteristics of the tax system. The historical institutional perspective of Steinmo (1993) proposes that changes in a country's revenue system may be connected with major historical changes, such as wars, or, as in the case of Palestine, the establishment of the PNA. Moreover, the historical perspective provides an important reminder of the need to analyse the evolutionary nature of the institutions setting tax policies, and that the preferences of interest groups and individual actors are partly formed by institutions (Rakner, 2001:132). Levi's perspective on the state (the ruler) as an institution with interests of its own may contribute to the understanding of politics in Palestine, as politics is characterised by strong executive powers (see Amundsen & Ezbidi, 2002). Furthermore, her emphasis on policy formulation as a bargain between different groups of actors may offer important insights into the study of institutional change in Palestine, as it suggests that power relates both to politics (majority position) and control of economic resources.

However, none of the analytical approaches discussed above have much to say about the international context. In Palestine, the Israeli occupation undoubtedly affected institutional development. Many of the institutional forms set up by Israel were transferred to the PNA directly. Moreover, the Oslo Accord and the Paris Protocol limited the PNA's room for manoeuvring its own policies (see section 2). Furthermore, foreign aid was an important revenue source for the PNA. Thus, an important question is whether the external dependency on aid contributes to reduce domestic efforts for revenue generation? Furthermore, does aid dependency undermine future sustainability of the public sector if or when aid declines? And how does dependency affect accountability relations between state and citizens?

Moore (1998) provides an innovative contribution to this debate by emphasising the international context as a factor determining a government's tax policy.²¹ According to Moore, successful state formation in Europe came about through two main processes.²² Firstly, through inter-state military competition, and, secondly, through an intra-state process of resource mobilisation for war that stimulated the creation of state-society linkages, markets, bureaucracies, tax systems, etc.. In this process, states lost despotic power (i.e., direct arbitrary control of subjects) but gained 'infrastructural' power (i.e., capacity to penetrate society, to extract resources from it and to co-operate with social classes to achieve collective goals). Consequently, there is considerable historical evidence to suggest that the emergence of a representative government and, more loosely, of reciprocity and mutual accountability between states and citizens is more likely when states face incentives to increase income through bargaining with citizens.

The process discussed above, however, did not take root everywhere. It was most pronounced where capital was mobile, i.e., in the form of financial and trading assets. Here the mutual advantages of co-operation between rulers and citizens were greatest (see Therkildsen, 2001:114). Co-operation protected owners of capital from arbitrary and exploitative tax enforcement. It also gave owners of capital direct and legitimate

²¹ This discussion builds on the review by Therkildsen (2001).

²² Moore builds here on Tilly (1992) who explores the evolution of European states. Tilly's main argument is that in Europe over the past two centuries taxation and disputes over the use of revenues stimulated the development of greater citizen rights and privileges, with democratic institutions enforcing accountability and greater transparency in expenditures.

influence over the military and diplomatic policies and operations. This was useful when competing with other trading nations. Rulers on the other hand could gain greater tax compliance from co-operation by retaining owners of mobile capital within their jurisdiction and by attracting capitalists from other states. But, such processes are not likely to operate when the state is fiscally *independent* of its population because its revenues are obtained from owners of fixed property, or from a few specific internal natural sources (e.g., oil and minerals), or from foreign aid.

Thus, Moore's key proposition is that the more a state 'earns' its income through the operation of a bureaucratic apparatus for tax collection, the more it needs to enter into reciprocal arrangements with citizens about provision of services and representation in exchange for tax contributions.²³ In other words, the greater the share of 'earned' incomes represents of total revenues, the more likely it is that state-society relations will be characterised by accountability, responsiveness and democracy. But, aid dependency may thwart these processes. A relevant question is therefore whether foreign aid, so substantial in relation to other income sources, made the PNA relatively dependent on external political and material support, and relatively independent of its own citizens on the WBSG?

²³ Moore (1998: 94) argues that the use of the concept 'earned' is a logical extension from the term 'rentier', since rentier is 'unearned' in the language of classical political economy.

4 The politics of tax policy in Palestine

The questions of concern in this section are: How is the socio-economic structure reflected in the politics and administration of taxation during the period 1994-2000? To what extent are the interests of particular groups reflected in the tax system? Had any interest group any significant impact on the tax system? To what degree did the nature and capacity of the administrative and political institutions in Palestine represent a constraint for the PNA to implementing tax policy? Moreover, to what extent was the influence of Israel reflected in the present tax system? And what impacts on tax policy had foreign aid since the establishment of the PNA? The theoretical frameworks discussed above may all offer some insights into these questions, and, together, they suggest that the PNA faced four major constraints in terms of revenue mobilisation.²⁴ These constraints are:

- The socio-economic structure;
- The nature and capacity of administrative and political institutions;
- The bargaining powers of interest groups; and
- The influence of external actors, i.e., the international context.

In the remaining part of this section, these four factors are discussed as potential constraints on the efforts of the PNA to raise revenues, and, thus, to explaining the observed tax policies and related rent-seeking activities.

4.1 The socio-economic structure

It can be argued that if a sector of the society controls major economic interests, the bargaining position of the government is challenged (Levi, 1988). Likewise, but inverting the argument, Moore (1998) questions the willingness of a government to abide by democratic rules if the same government controls major economic resources through state ownership and rents (see Rakner, 2001:137). In Palestine during the period 1994-2002, the economy was dominated by small, family-owned farms and enterprises, and peasant agriculture (see section 2.1 above). However, many of the larger private firms, including some monopolies, were owned – or managed – by high-ranking public officials (PLC, 1997; CPRS, 1998). Moreover, some of the larger companies were owned – fully or partially – by the PNA. These included, for instance, the Petroleum Public Commission, the Tobacco Commission, the Radio and Television Commission, and the Palestinian National Company for Economic Development (see Nasr, 2002).

To what extent is this ownership structure, i.e., control over resources, reflected in economic policy and the tax system? Following the Oslo Accord between the PLO and Israel, the PNA's principal challenges were to promote economic development and alleviate poverty. But, the PNA faced major constraints in pursuing these objectives: lack of control over borders, limited control over land, water and other natural resources, poor physical infrastructure, weak institutions, limited financial and human capital, and a high degree of political and economic uncertainty. In this setting, the

²⁴ This framework follows the analytical approach suggested by Rakner (2001).

PNA was faced with a choice between either a policy of drastic redistribution that might have resulted in the better-off pulling out and an uninviting climate for new foreign investments, or, alternatively, a policy of encouraging foreign and domestic investments and private enterprise at the expense of continued socio-economic inequality. The PNA chose the second line, assuming that market-oriented policies would further economic growth.

The PNA repeatedly called upon foreign investors and in particular the Palestinian Diaspora to invest in Palestine. Responding on this call, one group of Palestinian investors established the 'Palestinian Development and Investment Corporation Ltd.' (PADICO). This company established a number of subsidiaries in various sectors, including telecommunications, real estate, industrial estate, tourism, electronics, poultry, etc. (see Nasr, 2002). Another group of investors founded the 'Arab Palestinian Investment Corporation Ltd.' (APIC), which set up subsidiaries within medical services, car rental, cold storage, shopping centres, etc.. Furthermore, both foreign and local investors invested in the banking sector, which expanded from two banks in 1993 to 22 banks (and 120 branches) in 2000. Of these banks, 13 were owned wholly or partially by the Diaspora (PEPRI/MAS, 1997). In addition, some smaller foreign investors invested in real estate and the service sectors, which were perceived to be less risky than other sectors. Long-term investments in job-creating sectors, however, were limited due to the political instability.

The important role played by the international community in setting up the peace agreement with Israel and the financial assistance from donor countries, made the World Bank and the International Monetary Fund (IMF) very influential in pushing for an export oriented, private sector-led market economy (PNA, 1996). Thus, since 1994 the PNA implemented an economic policy that benefited large corporate interests and the manufacturing industry, which had close linkages to - and was partly owned by - the political and administrative elite. Moreover, the policy benefited foreign investors.

To some extent small-scale agriculture also benefited. Since most agricultural activities were located in either the B-designated areas where security was joint between the PNA and Israel or in the C-designated areas where security was totally under the Israeli control, both the PNA and foreign donors were reluctant to give aid to agricultural activities due to the uncertain political situation. The sector was partly compensated by various economic concessions, including tax exemptions. In the West Bank, but not in Gaza, all agricultural incomes were exempted from income tax. The differences between the West Bank and Gaza in this respect are partly historical. Under the Jordanian tax codes that were in force in the WB during the period of 1951-1967 and onwards until the establishment of the PNA, farmers and the agricultural sector were exempted from income taxes. In GS, however, the tax codes were influenced by the Egyptian codes, which did not exempt farmers from taxation. The PNA did not show willingness to substantially change these codes under the pretext that agricultural income in the WB was more subject to weather fluctuations since it depended heavily on olive production. But, the fact that farmers, peasants and village dwellers in general played an important role in the national movement in the WB, most likely also had impacts on the tax policy toward these groups.

4.2 Institutional constraints on revenue mobilisation

As emphasised by Rakner (2001), one obvious weakness of much of the current theoretical literature on revenue mobilisation is the implicit assumption that, once decided on, policies are implemented. Particularly in a developing country context, a major obstacle is the government's own capacity to carry out policies (Therkildsen, 2000). The institutional constraints on policy change were substantial in Palestine after Oslo. The extreme political uncertainty added to these institutional constraints. Thus, factors beyond the control of the PNA had significant impacts on both policy formulation and implementation. Much of the PNA's fiscal operations were governed by the Paris Protocol, which only gave the PNA a limited role in designing its own fiscal and trade regimes. Thus, with respect to tax policy, the best the PNA could do was to strengthen the domestic tax administration and to establish the revenue clearance system with Israel.

The PNA used public office holding as a reward for political and personal loyalty, and as a mechanism of stabilising the regime (see section 2.1). Particularly, the expansion of the security forces can be seen in the context of the PNA trying to strengthen its control over the population. However, a tax system is also potentially an instrument for political control based on information about citizens, and on a network of tax collectors (Moore, 1998). With little bureaucratic presence and limited information about what goes on at the grassroots level, a government leaves itself vulnerable to organised predators, such as private armies and religious fundamentalists. In such situations states may also rely more on patrimonial and personal linkages in running the government. These observations may contribute to explain why the PNA put so much effort into establishing the new tax administrations. It may also explain why several revenue administrations were set up, thereby not risking that one, strong central revenue authority would be in complete control of taxation.

It should, however, be acknowledged that setting up a large centralised revenue administration may take more effort and require higher institutional capacity than setting up several smaller ones, though the latter may have positive long-run effects on tax capacity. Moreover, the set-up of the tax administrations in the WBGs was heavily influenced by the IMF and the World Bank. For instance, several IMF-missions in the mid- and late 1990s resided with the Ministry of Finance offering technical assistance and policy advice on taxation and administration. In particular, the International Finance Institutions focused on building institutional capacity within the PNA emphasising 'transparency' in government operations.²⁵

The administrative structure that was established with several tax administrations put, however, severe burdens on senior officials within the Ministry of Finance. For instance, they had to intervene to settle disputes on tax assessment especially when influential taxpayers were involved: 'Give a discount or a tax exempt' was the approach to solve problems. The integrity of the tax officers was under heavy pressure due to social obligations and political interventions, which reduced the arm's length relations between taxpayers and enforcers.

²⁵ In April 2000, however, the PNA consolidated all tax revenue under the Ministry of Finance. According to Fischer et al. (2001:271), the PNA took this step to '...make its own financial operations more transparent...'

Furthermore, low wages in the public sector in general and in the tax administration in particular, left no option but to accept the employment of second or third rated graduates with limited skills in accounting. The best graduates usually were recruited to more attractive jobs in private accounting companies. Moreover, some of those who were recruited to the tax administration exploited their positions to supplement their own meagre salaries by extracting rents through the informal system of settling accounts. For instance, in a survey of small and medium sized firms, 41% of the respondents in the WB said that their own tax assessment differed from that of the revenue authority (PRA).²⁶ Businesspeople interviewed gave various reasons to explaining the differences in tax assessment, including 'the PRA officials do not trust the books', and 'some expenses are not recognised by the tax officers'. 35% of the respondents in the WB said the differences were solved through negotiation with the tax officers. Dishonest tax collectors were perceived to be a problem by 38% of the respondents in the WB and by 30% in Gaza.²⁷ According to an official interviewed in the Income Tax Department (ITD) in Ramallah, very few corrupt tax collectors were detected. However, those few who were caught were asked to resign to maintain their dignity instead of being brought to court.

4.3 Interest groups and the role of civil society

Within pluralist systems of rule, voluntary associations operating independently of state structures can be expected to play a major role in shaping and implementing tax policies. Thus, we would expect that the introduction of competitive electoral policies would bring new stakeholders into the debates over the politics of taxation. The establishment of the PNA does not support this expectation.

The PNA inaugurated a liberal 'constitution'. The general election in 1996, which was largely conducted in a free and democratic way, gave this emerging state system the necessary legitimacy (see Hilal & Khan, 2002). However, the executive controlled the security apparatus. Moreover, most of the members of the 'Palestinian leadership' (i.e., the Speaker of the PLC, the Speaker of the PNC, heads of the main security forces, ministers, executive committee members, etc.) owed their position to Arafat personally (Amundsen & Ezbidi, 2002). Furthermore, the political 'leadership' did not have representatives from the private business community or the opposition or civil organisations. These features led to a situation where the PNA managed to centralise power.

Linked to the increasing consolidation of political power within the PNA, no meaningful opposition was established as a political factor until the second Intifada. The 1996 election campaign produced a variety of political programmes by the different political organisations campaigning. But neither Fateh nor the opposition made any reference to taxation. Thus, it cannot be argued that the PNA faced any major challenges from its political opponents with respect to revenue policies.

²⁶ The survey was carried out in 2001 as part of this study (see section 2.1).

²⁷ Some respondents mentioned that certain tax collectors gave them a 'secret account number' where deposits could be made to settle a tax assessment differential. Others said that they had to pay in the form of a gift (usually electrical devices).

The increasing influence of the executive power in Palestine during the period 1994-2000 is partly explained by the weakness of interest groups. Opposition parties more or less accepted to work within the ceilings of the new regime (Hilal & Khan, 2002). Other civil society formations, such as professional associations and trade unions lost much of their social base and mobilising capabilities in the early 1990s after the erosion of the popular character of the first *Intifada*. The PLO factions created the main body of these civil society formations with an overarching aim of organising opposition to the Israeli occupation and of providing some services to poorer segments of the population. Thus, they posed no serious problem to the regime.²⁸

A number of civic associations transformed themselves into professional NGOs – in the form of human rights advocacy, ‘developmental’ and service-oriented organisations. But the NGOs autonomy remained questionable, partly because of their dependency on short-term external donor funding, and partly because they had no real organised power base and therefore little real bargaining power with the ‘government’. They had therefore very limited influence on economic policies. According to Hilal & Khan (2002), most NGOs retained an interest in colluding with the PNA, as it was in their interest not to ‘irritate’ it. One outcome of this ‘collusion’ was that NGOs were exempted from taxation, including VAT and taxes on imported goods and services.

Few of the economic interest groups in Palestine had the capacity, in respect of membership density, finances and organisational resources, to engage in an active dialogue with the regime on issues of taxation and, more generally, economic development. Fateh dominated most of the professional associations, including those of lawyers, doctors and engineers (see Hilal & Khan, 2002). These associations were better organised than popular organisations, and had, unlike NGOs, a well-defined and stable constituency. The relationship between professionals and Fateh may, thus, have hidden important channels of rent-seeking and channels of influence of government policies. Hence, many professionals stayed outside the tax net. For instance, the Income Tax Department (ITD) was tolerant towards them on the ground that ‘it was enough that they paid the VAT’.²⁹ This was due even though the tax authorities assumed that many professionals underreported their sales to evade taxes, and it was very difficult to check their true turnover. Thus, the lion’s share of personal income tax revenues was generated from wage employees where taxes were withheld at source.³⁰

In contrast to local capital that was dominated by small-scale family capital, expatriate capital was represented by larger businesses. Following the Oslo agreement, a number of large expatriate businesspeople offered ‘partnership’ with the PLO to developing Palestine economically. But according to Hilal & Khan (2002), Arafat was careful not to give political weight to expatriate capital. Instead he viewed these partnerships as a

²⁸ In 2000, several business associations joined forces with the aim of voicing their interests. In December 2000, an overarching co-ordinating body was established. This body included the main sectors of the indigenous capital, including the Federation of Chambers and Commerce, the Federation of Chambers of Industry, Paltrade, and Palestine Information Technology Association.

²⁹ Personal communications with staff at the ITD (June 21, 2001, Ramallah).

³⁰ To further illustrate this point, there were only 650 files of registered companies in the West Bank, and no company was registered in Gaza Strip. This implies that on average a company in the West Bank paid less than USD 18,000 in corporate taxes on an annual basis (see annex 1). This supports the argument that the Palestinian income tax during the period 1994-2000 was mainly imposed on individual wage earners and, to some extent, on smaller firms with limited opportunities for evading.

way of enhancing the rent-seeking activities of the PNA, e.g., by providing discretionary funds, and to some extent also as a tool for job creation. In return, the PNA granted expatriate capital monopoly status (see Nasr, 2002) and tax exemptions (see section 4.1 above and details in annex 1).

The PNA established ‘investor-friendly taxes’ with relatively low corporate taxes and absence of capital-gains taxes. The ‘Investment Promotion Law’, which was passed in 1995 and modified in 1998, aimed to provide incentives to local and foreign private entrepreneurs (Ministry of Economy and Trade, 1998:18-19).³¹ In 1997 and 1998, 144 projects applied for tax exemptions (74 in 1997 and 70 in 1998).³² The Palestinian Investment Promotion Agency (PIPA) approved 125 projects. Of these only 52 projects were implemented in 1997 and 1998, representing a total investment of USD 97.5 million (i.e. 28.4% of the projected investment). The remaining either existed before the Law or were not implemented. In 1998, 22 ‘existing’ projects benefited from the tax exemptions (almost one third of those approved in 1998) with a total value of more than USD 20 million.

Almost two third of the projects that were granted tax exemptions were classified as ‘industrial’ while the rest were in the service sector, including tourism and health. However, many projects classified as ‘industrial’, were actually hotels and private medical services. Moreover, most of these projects were large projects of which the capital investment exceeded one million USD. Due to fairly generous exemptions and tax holidays benefiting larger companies, some critics argued that the law was biased towards large firms, thus promoting monopolies and rents to politically influential groups. Moreover, it was argued that the ‘Investment Promotion Law’ ignored small-scale businesses that represented the majority of Palestinian enterprises.

This argument is also supported by survey-data. According to Sewell (2001), perceptions of the tax system and regulations differed between firms according to firm size. Almost 65% of the small firms (with fewer than 10 full-time employees) and 57% of the medium-size firms (with 10 to 50 full-time employees) in the sample considered taxes and regulations to be major or moderate constraints to business. In contrast, less than 35% of the larger firms gave this answer. With respect to taxation, 74% of small-size firms, 61% of medium-size firms and only 26% of large firms considered high taxes to be a moderate or major constraint to their businesses. Moreover, in contrast to smaller and medium sized firms, a majority of large firms (58%) said that they or their trade associations were frequently, mostly or always consulted about changes in regulation or policies.

The tax concessions given to larger investors, however, reflect the substantial bargaining power of owners of mobile capital vis-à-vis the PNA, in contrast to the bargaining powers of small-scale businesses whose major capital was in the form of

³¹ The *General Department of Investment* at the Ministry of Economy and Trade provided internal reports (in Arabic) on investment projects that benefited from the law. The information in this paragraph is based on the reports for 1997 (before the law was passed by the PLC) and 1998.

³² These projects represented total investments of USD 343 million. Fully domestically owned projects, represented about 57% of this capital, while pure foreign owned investments represented less than 5% of the capital. Joint-ventures between foreign and domestic investors, contributed with the remaining 38%.

fixed property (see Moore, 1998; and Tilly, 1992). But, given the extreme political instability in the Palestinian territories, and the fact that the PNA during this period was a 'government' that lacked many of the formal powers of a national government, these achievements of attracting large-scale investors were not trivial. Here the mutual co-operation between rulers and capitalists was highest. Thus, these activities indicate that the PNA managed to take a longer-term perspective for developing Palestine. Yet, the PNA faced substantial institutional constraints in terms of both extracting more revenues from the business sector and widening its tax base.

To summarise this discussion, neither the electoral processes nor organised interest groups exerted major pressures on the regime to review its tax policy. However, the educated middle class (professionals) and expatriate capitalists had close, informal ties with Fateh – the ruling party. Thus, to get things done, consultations were done on an *ad hoc* (one-to-one) basis. Moreover, widespread tax exemptions seem to be founded on the regime's concern for political support. Taxation is in general unpopular. Thus, a policy to widen the existing fairly narrow tax base to include sectors that were not paying taxes would most likely be a politically risky affair leading to increased unpopularity. Furthermore, it might also have led to a more active and co-ordinated business community that would develop into a politically strong interest group.

4.4 The influence of Israel and foreign donors on tax policies

The Paris 'Protocol of Economic Relations' limited the role of the PNA in designing its own fiscal and trade regimes (see section 2.2). Israel collected a major share of the PNA's tax revenues through the revenue clearance system, reflecting the heavy dependence of the Palestinian economy on Israel with respect to foreign trade, employment and tax revenues (see Table 4.1).

Some of the arrangements within the Paris Protocol were, however, highly unfavourable for the PNA.³³ For instance, the PNA could only reclaim import duties on goods that were directly imported by Palestinian companies via Israel. Products that initially were imported by Israeli companies and then re-exported to the Palestinian territories were, according to the Israeli interpretation of the Paris Protocol, not eligible for re-claiming of customs duty. Since the bulk of the imports to Palestine came via Israeli companies, this arrangement led to substantial losses in customs revenues for the PNA. Furthermore, many Palestinian merchants disguised the true final destination of their imported goods in order to avoid delays and complications by the Israeli customs, with the consequence that the PNA lost revenues from import duties. Another significant source of fiscal leakage was Israel's refusal to refund to the PNA the purchase taxes, excises and surcharges that were imposed on some locally produced Israeli products which were exported to the WBGs and consumed by the Palestinians. On cigarettes alone, approximately USD 25 million were lost.

There have been several attempts to estimate these lost revenues (Kanafani, 2001:286). According to Sahban & Jawhary (1995:xxxiii), the foregone revenue on indirect imports as a percentage of GDP was about 6% -7%. The PNA estimated the 'fiscal leakage' to USD 380 million annually (PNA, 1998).³⁴ Dumas (1999), however, concluded

³³ See Kanafani (2001:285-288) for details.

³⁴ In comparison, the total donor funding to the WBGs in 1998 were USD 553 million (see Table 4.1).

that the lost revenues amounted to USD 90-140 million in 1997, equivalent to 2.6-4.2% of the GDP of the WBGS. According to estimates made by the IMF resident mission in the WBGS, the annual loss in revenues through these unequal arrangements corresponded to 77% of the amount actually refunded in 1997.

**Table 4.1 Revenue clearance with Israel and foreign aid, 1994-1999 (in million USD).
Figures in brackets are in percentage of GNI**

	1994	1995	1996	1997	1998	1999	1994-9
Revenue clearance	25 (0.06)	266 (6.4)	420 (10.3)	496 (11.1)	542 (11.4)	626 (12.2)	2,375 (9.0)
Total foreign aid disbursements	612 (15.4)	547 (13.2)	647 (15.8)	654 (14.7)	553 (11.6)	609 (11.9)	3,622 (13.8)

Sources: Fischer et al., (2001:256, Table 1) and Arnon & Weinblatt (2001:299, Table 4).

It is clear that the way certain aspects of the Paris Protocol were designed and implemented led to continuous conflicts of interest between the contracting parties. It also raises the question of why Palestinian negotiators initially accepted such terms. It seems, however, clear that the Palestinian negotiators tried to acquire as many attributes of sovereignty as possible, while the Israelis wanted to postpone as many decisions as possible to the negotiations over the final status of the Palestinian territories (Arnon & Weinblatt, 2001:296). The Palestinians aspired to set their own priorities, without Israeli interference, including the formation of a new Palestinian trade policy. The Israeli negotiators, however, proposed to continue the existing *de facto* (partial) customs union, which did not require the creation of trade borders between the two economies. They succeeded to convince the Palestinians that a more protectionist policy would reduce the Palestinians' chances of building a prosperous economy. Clearly the Paris Protocol reflects the uneven balance of power between the two parties and the transitional nature of the agreements. While Israel was a well-established state with a large modern army, the PNA had limited autonomy and was making its first steps towards national sovereignty. As a result, the power sharing of the Paris Protocol itself gave significantly more power to Israel than to the PNA (Arnon & Weinblatt, 2001:301).

The dependency on Israel left the PNA extremely vulnerable and gave Israel a political weapon to exert pressure on the PNA. On several occasions during the 1997-2000 period, Israel withheld tax revenues collected (Nasr, 2002). This measure was *prima facie* a violation of the Paris Protocol, reflecting the imperfection of the bilateral contract whereby one side could violate the agreement without bearing noteworthy consequences (Arnon & Weinblatt, 2001:302). To reduce its vulnerability, the PNA, therefore, undertook various types of off-budget fiscal activities and established 'secret' accounts. Little information exists on the sources and scope of these off-budget accounts, and how these funds were used.³⁵ Thus, in recent years, there have been repeated accusations of non-transparency and manipulations of the secret accounts

³⁵ According to Fischer et al. (2001:258), a large part of this money went to finance investments in commercial operations through the Palestinian Commercial Services Company (PCSC). But it is still not known how much has been used on current expenditures.

controlled by the PNA. However, given the unstable political situation and the fact that Israel on several occasions stopped transferring tax revenues collected to the PNA, it seems both legitimate and rational that the PNA operated with such accounts as a buffer to meet urgent needs and commitments.

To what extent did the inflow of foreign aid to Palestine provide a disincentive for the PNA in terms of tax-collection effort? During the period 1994-2000, the PNA had significant, although declining, 'unearned' incomes in the form of foreign aid (Table 4.1). In view of their active involvement in the Middle East peace process, we may thus expect that international aid organisations would have a substantial influence in shaping the economic policies – including the tax policies - of the PNA. Moore's (1998) approach may offer important insights into the question whether pressures for accountability and transparency came from internal or external actors (see section 3).³⁶

Annual disbursements to the PNA – in the forms of loans and grants – averaged USD 600 million per year in the period 1994-99, corresponding to almost 14% of Gross National Income (GNI) per annum over the six years (see Table 4.1). Almost 90% of the aid in this period was provided in the form of grants. Moreover, more than half of the aid was for current spending, including job creation and technical assistance, and the rest was devoted to investments projects (Fischer et al., 2001:258). In 1999 foreign aid funded all Palestinian public investments, of about 5% of GDP (including investments undertaken by UNRWA). Still, the ratio of fiscal revenue to GDP was about 23% in 1999, compared to an aid to GDP ratio of around 10%. However, when excluding the revenues collected by Israel through the clearing system, the 'domestic' fiscal revenue to GDP ratio was approximately 9%. Furthermore, foreign aid amounted to almost USD 175 per capita, making the West Bank and Gaza one of the largest recipients of aid in the world on a per capita basis, together with Bosnia Herzegovina and Israel where non-military foreign assistance represented approximately USD 200 and USD 247 per capita, respectively (DAC, 1997). This level of assistance reflects the great importance that donors placed on supporting the Middle East peace process. Donor support for current expenditures declined, however, during the period in question. Overall, foreign aid in percent of GDP fell from 18% in 1994 to around 10% in 1999.

Based on the available data, it is, however, not possible to provide a clear answer to the question raised above on the possible impacts of foreign aid on domestic revenue generation. With respect to taxation, the scope for influencing the tax policy was also limited. Firstly, the PNA inherited a fairly developed tax system, including VAT, because of the Israeli occupation in 1967. Secondly, after 1994 the tax system, especially indirect taxes, was to a large extent regulated by the principles of the Paris Protocol.

But, there can be no doubt that donor assistance had a substantial effect on the Palestinian domestic economy in the period 1994 to 2000. Most immediately, the inflow of foreign aid stimulated local economic activity and contributed to household incomes. Moreover, until the Israeli demolition of the administrative and physical

³⁶ Brautigam & Botchwey (1999) argue that many 'aid dependent' governments seem currently to face more organised and effective pressures for accountability and transparency from the international community and donor agencies than from their own citizens and parliaments.

infrastructure on the West Bank in April 2002, aid also enhanced the productive potential of the economy by supporting investments that expanded the underlying economic productive capacity.

World Bank (2000:26-27) estimated that the production capacity of the Palestinian economy was 6-7% higher than it would have been without donor-financed investments. Thus, foreign aid contributed to offset parts of the cumulative negative effects of the Israeli policy of border closure and other restrictions against the Palestinian people. In particular, the initially high degree of budget support provided by donors helped the PNA to establish operations and avoid potentially destabilising fiscal deficits at a critical stage. However, recurrent budget support also facilitated an expansion of public sector employment that, in spite of immediate political support, led to overstaffing and probably undermined the administrative efficiency of the PNA.

On several occasions the donors criticised the PNA for lack of transparency in its financial operations, including the off-budget fiscal activities and weak technical decisions in its handling of public finances. But, the donors' focus was on keeping the peace process alive. Thus, generally, foreign donors' seemed to turn a blind eye to issues such as transparency and accountability in the PNA's fiscal affairs. Given the political instability and the contagious effects of the escalating violence in the area, this position may seem to have been justified. However, by making the PNA relatively dependent on external political and material support, and relatively independent of its own citizens on the WBGS, this approach may in a longer-term perspective have contributed to undermine the development of state-society relationships based on responsiveness and accountability. In this perspective, it may take long time to re-establish the credibility and trustworthiness of the PNA vis-à-vis its citizens.

To summarise the discussion in this section: The socio-economic structure, the nature of government institutions, the bargaining powers of interest groups, and international actors were treated as potential constraining factors on the efforts of the PNA to raise revenues, and, thus, to explaining the observed tax policies. First, and not very surprisingly, the socio-economic structure mattered. In particular, the fact that a large share of the population lived under the poverty line limited the tax base. Moreover, small-scale farming and small, family owned enterprises dominated the economy. The taxable capacity of these sectors is often limited and the administrative costs of enforcing taxes from these sectors are high. This partly explains why the most productive tax handles from a revenue perspective, were income taxes on public sector employees and taxes on international trade. Second, the administrative and political institutions in Palestine during the period in question were to a large extent controlled by the executive, and, thus, did not represent constraining factors on the government's tax policy. However, in a developing country context it must be acknowledged that the government's own capacity to carry out policies is a major obstacle for implementing policies. The gap between implementation and policies is often huge, and institutional change often a slow and incremental process. Third, various interest groups, particularly foreign based capital owners (the Palestinian Diaspora) and to some extent professionals constrained the PNA's revenue mobilisation efforts. The tax exemptions given to larger investors, reflect the substantial bargaining power of owners of mobile capital vis-à-vis the PNA, in contrast to the bargaining powers of small-scale enterprises whose major capital was in the form of fixed property. Finally, the

international context was a factor that substantially influenced the revenue-collection efforts. More than any other stakeholders, Israel represented a constraint on the PNA's tax policies and revenue collection. Moreover, the dependency on external assistance both for investments and to cover running expenses may have had impacts on the PNA's incentives to enter into reciprocal and accountable arrangements with citizens about provision of services and representation in return for tax contributions.

5 Concluding remarks

The state formation process in Palestine during the period 1994-2000, in contrast to the European experience, was not related to inter-state war but to insurgency against, or negotiation with, Israeli occupation. This conflict did not contribute to increased tax extracting capacity of the Palestinian National Authority (PNA) as wars did in the West. Although the conflict changed the relations between the new rulers and the ruled, relations of accountability between the PNA and citizens remained weak – perhaps because the government depended only partly on their citizens to mobilise revenues. The authority relied more on foreign aid and taxes on international trade.

Israel partly controlled and clearly dominated tax policies in the WBGS. The integration between the Palestinian and Israeli goods, labour and capital markets imposed severe constraints on the ability of the PNA to choose its own tax policy direction. Israel collected the bulk of taxes on traded goods on behalf of the PNA, and until the second Intifada a large share of income taxes came from Palestinians working in Israel. By withholding revenues collected on behalf of the PNA, Israel was able to exert substantial financial pressure on the PNA. This measure was a direct violation of the *Paris Protocol of Economic Relations*, reflecting the imperfections of the bilateral contract and the uneven balance of power between the two parties. Thus, Kanafani (2001:282) argues that the weaker Palestinian party was left with ‘a chronic sense of being ill-treated and of being impotent, while the other party was bound to fall into the trap of the arrogance of power’. Another problem of the *Paris Protocol* was its failure to take adequately into account the Palestinians’ aspirations for sovereignty (see Arnon & Weinblatt, 2001). Instead it maintained the heavy dependence of the Palestinian economy on Israel and its economic policies.

However, within its room of manoeuvre, the PNA maximised domestic revenues subject to the constraint of consolidating and maintaining power. In particular, the PNA was constrained by the bargaining powers of interest groups and international factors in its efforts to mobilise tax revenues. Thus, the PNA used the tax system as a means of enhancing rents from industries and sectors into which the leadership had economic interests, and, furthermore, to grant generous tax exemptions to potentially important stakeholders such as professionals and large expatriate capital. In contrast, few tax concessions were given to employees in the formal sector. Thus, the business interests of the minority of expatriate capitalists were more influential than trade unions and the emerging domestically based business associations.

During the first four years after its inauguration, the PNA was able to maintain the dualism of macroeconomic orthodoxy and provide generous tax incentives for important groups in the society, combined with fairly progressive social policies due to the revenue windfall from foreign aid and the monopolies. The PNA made also real progress, with generous external assistance, in establishing a functioning economic administration and in developing the physical and institutional infrastructure of the economy. This secured widespread internal legitimacy among the Palestinian population, which also was reflected in the 1996-election, and helped the PNA to centralise power.

But, a major problem for the PNA was that it did not manage to create confidence in its ability and capacity to deliver promised returns for taxes paid and foreign aid received. The deteriorating security situation in the late 1990s and declining social welfare raised citizens' perceptions of exploitation from an unequal contract with the government and promoted resistance. In this perspective, the PNA's trustworthiness was closely linked to citizens' perceptions of the capacity of the PNA to make credible commitments about the use of tax revenues and foreign aid, as well as its procedures for designing and implementing fiscal policy non-arbitrarily. Moreover, extensive and increasing corruption contributed to undermine popular confidence in the PNA as a trustworthy force in the struggle against the Israeli occupation. The al-Aqsa intifada further eroded the domestic financial sources of the PNA, both in the form of general tax revenues and incomes from the monopolies. Since Israel in October 2000 stopped transferring revenues collected on behalf of the PNA, the central state organs in Palestine became cash strapped. This led to long delays in payment of salaries to ministerial staff. Moreover, limited means were available for the funding of public services by the PNA, and maintenance of infrastructure came to a standstill.

Foreign aid did not manage to compensate for this revenue shortfall. Increasingly aid was bypassing the central government and went directly to local institutions and non-governmental and religious organisations. In particular, this was the case for aid and financial support originating from other Arab nations. This, coupled with escalating poverty and unemployment, and growing frustration among Palestinians for lack of progress in the relationship with Israel, have led to increasing support to opposition parties and the Islamists.

Until the second Intifada, no meaningful opposition to PLO had established itself as a political factor. However, since September 2000 Hamas has won increasing support among broader segments of the population. The Islamist movement's new strength and popularity is partly due to the social work that Hamas charities are carrying out. The Israeli policy of destabilising the PNA by withholding revenues has also contributed to strengthen the Islamists as an alternative to the PNA with respect to social welfare and service delivery, as well as a credible force in the struggle against the occupation. In Gaza, with more than 35% unemployment and where one in two families are impoverished, the extensive welfare projects of Hamas stand in stark contrast to the perceived inefficiency and corruption that plagued the PNA in the late 1990s. Thus, a secular in Gaza stated that 'the authority is rotten. Hamas is serious' (*The Economist*, December 1st-7th 2001, p. 41). These factors, combined with Israel's re-occupation of large parts of the West Bank towns in April 2002 and the following destruction of administrative and physical infrastructure, have eroded the centralised power of the PNA. The executive's personal position among Palestinians is also substantially weakened.

Within this scenario the ongoing intifada and Israel's re-occupation of the West Bank may lead to a further fractioning of Palestine. Such a development seems to be in line with the Sharon Government's policy: To establish competing 'bantustans' or districts in the Palestinian areas ruled by chiefs compliant to Israel. However, a more likely outcome of further erosion of the PNA is the establishment of non-compliant, uncompromising districts. Therefore, the establishment of a developmental Palestinian

state, with a strong central government body, is probably the only guaranty for a lasting peace. This also requires a more balanced structure of the economic relations between Israel and Palestine and, thus, substantial revisions of the *Protocol of Economic Relations*. Otherwise, Israel will continue to rely on its vast military force and substantial - but volatile - US economic and political support.

For the PNA, the challenge is to re-establish its legitimacy. This legitimacy is partly based on its ability to deal with issues such as financial mismanagement and corruption, and its capability to provide security and basic services to the population and to maintain physical infrastructure. In the short term, the re-construction and service provision will require substantial external assistance. In the longer term, however, sustainable development requires more reliance on domestic resources. Time will show whether a reformed PNA is able to challenge the factors constraining domestic revenue mobilisation and to enter into more reciprocal relationships with the citizens, or whether it will seek the relatively easy alternative and resort on continued foreign aid.

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Appendix: The tax system in Palestine

1 Introduction

This appendix describes the structure of the tax system in the Palestinian Authorities during the period 1995-2000. The presentation covers the major bases and rates, the legal basis for the tax system and the administrative apparatus responsible for enforcing the tax laws at both central and local levels. It is conventional to distinguish direct from indirect taxation. The Concise Oxford Dictionary of Current English defines an indirect tax as one 'paid by consumer in form of increased price for taxed goods'. The dictionary defines a direct tax as one 'levied on persons who bears the ultimate burden of tax, e.g. income tax, but not value added (tax)'. In a world in which the incidence of taxation is an issue of complexity, such definitions are difficult to sustain. In general, the distinction between direct and indirect taxes reflects at least three different aspects of tax structures:

- the choice between taxes on income and taxes on consumption;
- the choice between taxes on commodities and taxes on individuals; and
- the choice between a source of origin and a destination basis for taxation.

Without elaborating these distinctions any further, we will follow the categorisation of taxes used by the Palestinian Ministry of Finance when describing the tax system.

The appendix is organised as follows: Section 2 describes the structure of direct taxes, emphasising corporate and personal income taxes. The present structure of indirect taxes on domestic goods and services (VAT, excises, etc.) is presented in section 3. Taxes on international trade are discussed in section 4. In section 5, property taxes are presented, followed by a discussion of non-tax revenues in section 6. Finally, in section 7 the local government tax structure is briefly presented.

2 Income taxes on individuals and companies

Revenues from income taxes during the period 1995-2000 are summarised in Table 1. The relative share of income tax revenue of total revenue (excluding donations disbursed) declined from 11.6% in 1995 to 8.2% in 1999, and was estimated to be around 8.3% in the year 2000. Moreover, the bulk of these taxes (91.6% in 1999) were collected by the PNA. The fluctuations of income tax revenues were partly attributed to the fluctuations of income tax revenues from Palestinian workers in Israel, and partly to the general decline in business activity in the Palestinian territories caused by the political instability. The income tax revenue/GNP ratio was low, but not very different from the average for Middle East Arab countries.

Table 1: Income tax revenues of the PNA for the period 1995-2000 (in million USD)

	1995	1996	1997	1998	1999	2000
Domestic income tax revenue	44.4	52.8	65.7	68.2	74.9	n.a.
Income tax clearance with Israel	5	4.1	5.2	9.2	6.3	n.a.
<i>Total income tax revenue</i>	<i>49.4</i>	<i>56.9</i>	<i>70.9</i>	<i>77.4</i>	<i>81.2</i>	<i>80.2</i>
Income tax clearance with Israel in % of total income taxes	10.1	7.2	9.1	13.5	8.4	n.a.
Income tax revenues in % of total tax revenues*	11.6	8.3	8.6	9.0	8.2	8.3
Income tax revenues in % of GNP**	1.2	1.3	1.6	1.5	1.6	1.6

* Total revenue excludes grants, donations and loans.

** GNP-figures are from World Bank (2001). The use of these figures as a denominator is based on the argument that that taxes on incomes generated outside Palestine are included in total revenue. Some of the figures are translated from New Israeli Shekel into dollars using the exchange rate as published in World Bank (2000).

Sources: (1) Palestinian National Authority (2000) and World Bank (2001). Figures for 1995 are Ministry of Finance estimates.

2.1 The legal basis

The central government income tax structure in Palestine is founded in the Income Tax Act No. 250 of 1964 (i.e., the Jordanian law applicable in the West Bank Governorates) and the Income Tax Act No. 13 of 1947 (i.e., the law applicable to the Gaza Strip Governorates), and the agreements reached with Israel in this respect. These two acts have some major differences that are outlined in Table 2. Most of these differences, however, have been subject to unification of the tax codes in the two areas in the new Income Tax Act that was approved by the Palestinian Legislative Council in 2000, but not yet implemented due to the Israeli destruction of the PNA's infrastructure in April 2002. It should also be noted that the tax system in East Jerusalem is that of Israel.

Table 2: Differences between applicable income tax acts in the West Bank & Gaza Strip

No.	Subject	The Income Tax Act (No. 25) of 1964 applicable in the WB	The Income Tax Act (No. 13) of 1947 applicable in the GS
1	Income earned outside Palestine and transferred to Palestine	Non-taxable income	Taxable income only if the transferee stays in Palestine for more than six months during the tax year
2	Income from agricultural branches	Non-taxable income	Taxable income
3	Tax for ltd. Companies	38.5% of profit	37.5% of profit
4	Spouse income	Added to the other spouse's income	Considered independent of the other spouse's income
5	Life insurance, savings and individual premiums and instalments	5% of the value of premiums or instalments is tax credit for a maximum of 100 NIS* per annum	The value of premiums or instalments is deducted as expenses for a maximum of 1/6 of the taxable income, provided that the deducted amount does not exceed 150 NIS per annum

* NIS: New Israeli Shekel = 4 USD (per 2000).

Source: PNA (1997:8).

2.2 Personal income tax brackets

The Income Tax Act specify 8 tax brackets, with the tax rate increasing by 5% from one step to the next. It is under consideration to reduce the number of tax brackets to 4 and the maximum income tax rate to 20%. The Palestinian Legislative Council (PLC) has approved the new law in its second reading and it was to be discussed in its final reading to become effective in 2001. But, the second Intifada since late September 2000 has created a situation that makes it difficult for the PLC to convene and pass laws or amendments. Therefore, the new tax brackets and rates were made applicable per decree without waiting for the new law to be passed by the PLC.

Table 3: Palestinian personal income tax schedule (in effect since January 1995)

Annual Taxable Income (JD)*	Tax Rate (%)	Newly Approved Tax Brackets** (JD) (Under consideration)	Newly Approved Tax Rates** (%)
1-724	5	1-5000	5
725-1810	10	5001-10000	10
1811-2897	15	10001-20000	15
2898-5069	20	20001 +	20
5070-8690	30		
8691-14483	35		
14484-25345	40		
25346 and more	48		

Notes: * 1 USD = 0.71 JD (Jordanian Dinar). Based on this rate, income tax brackets were recalculated from the original table in the Income Tax Guide where figures are in NIS. We applied an exchange rate of 1JD = 5.8 NIS.

** These are the income tax brackets (in Jordanian Dinar) and rates that have been approved in the new tax law initially planned to become effective from 2001.

Source: PLC (2000)

2.3 Income tax deductions

Deductions are generous and will become even more generous when the new income tax law becomes effective. Table 4 lists the main deductions used to calculate the taxable income of individuals.

Table 4: Deductions from the individual income tax

No.	Existing Deductions	New deductions under consideration
1	JD 724 for residency	JD 1500
2	JD 435 for a non-working wife	JD 500
3	JD 145 for every child	JD 500
4	JD 217 for each dependent	JD 500
5	JD 724 for a university student	JD 2500
6	20% of the gross salary of an employee in the private and public sectors	35%
7	50% of the value of residential rent up to JD 1380	Without a percentage and is up to JD 1800

Note: Original amounts were in NIS and were changed into JD by using the exchange rate of 1JD = NIS5.8.

Source: PNA (1997:20).

The new deductions are stipulated in the proposed law. Deductions number 2, 3 and 4 are all unified in one category called (family allowance deduction). Expenses like medical expenses are deductible provided that they do not exceed the taxable income and official documents (receipts etc.) are presented.

The Income Tax Department in the Ministry of Finance distinguishes between four categories of tax collections:

- *Deductions at source*: These include deductions from wages and salaries and 5% of the value of any commercial transaction whose value is more than NIS 500 (equivalent to JD 87).
- *Individuals and companies*: Include persons and firms that pay taxes in instalments over the year.
- *Cars*: Include all taxpayers who own cars and use them for income generating activities. Taxes are not imposed on income earned, but as a lump sum of 2% of the book value of the car according to the type of car (i.e., taxis, trucks, buses, etc.).
- *Transfers*: Include income taxes paid by Palestinians working in Israel and Israeli settlements, and transferred by Israel.

2.4 Corporate income taxes

The tax base is corporate profits. The tax rates are 38.5% of net profits in the West Bank and 37.5% in the Gaza Strip (see Table 2).

The new rates that have been approved in the second reading of the proposed law by the PLC are:³⁷

- 10% for industrial companies, hotels and hospitals;
- 15% for private or public limited corporations; and
- 20% for banks, exchange bureaus, and financial intermediation companies.³⁸

³⁷ Law Proposal on Income Tax Law as approved in its first reading by the PLC in September 2000, Chapter 5, Article 16, p. 4.

2.5 Tax exemptions

Exemptions can be granted according to the Investment Encouragement Law (No. 1 from 1998).³⁹ The most important of these exemptions are:

- (1) Five years exemption for a project with a paid-up capital of more than USD 100000 and less than USD 1 million starting from the year of production. Such projects can also enjoy a lower corporate profit tax of 10% on net profit for 8 MORE years.
- (2) Five years exemption for a project with a paid-up capital of more than USD 1 million and up to USD 5 million starting from the year of production. Such projects can also enjoy a lower corporate profit tax of 10% on net profit for another 12 years.
- (3) Five years exemption for a project with a paid-up capital of more than USD 5 million starting from the year of production. Such projects can also enjoy a lower corporate profit tax of 10% on net profit for 16 more years.
- (4) The Board of the PHAEI may ask the Council of Ministers to grant certain projects additional exemptions depending on their nature and the needs and development priorities of the Palestinian economy. Such projects an also enjoy a lower profit tax of 10% on net profit for additional 20 years.

Exemptions can be extended for an additional period of no more than 5 years based on the recommendation of the PHAEI. In all cases this grace period can be extended to an additional period of two years if the local content exceeds 60% exclusive investments in land and buildings.

3 Taxes on domestic goods and services

These taxes include VAT, purchase tax and fuel tax. With respect to revenues, they are the most important taxes for the PNA (see Table 5). In addition, there is a production tax on the wholesale prices of domestically produced goods, but the revenues from this tax are insignificant. Value Added Tax (VAT) is the most important of these taxes with respect to revenue generation. VAT was introduced by Israel in the 1970s and is included in the Paris Protocol (PP). The general VAT-rate is 17%. However, exports, tourist services, fruit and vegetables are zero-rated. According to the Paris Protocol, the PNA can apply a rate of 15% on specific goods and services if it deems necessary, but has not used this option yet. VAT revenues on goods and services imported via or from Israel are collected by the Israeli revenue authority and transferred to the PNA upon the handing of the unified VAT vouchers.

Revenues from VAT and excises collected domestically and those collected through the clearance system with Israel are summarised in Table 5. Combined these taxes contributed with about 10% of GDP. Thus, these sources contribute substantially more to total tax revenues (47.7% in 1999) than income taxes (8.2%). They are also more important than revenues from taxes on international transactions (30.3% in 1999, see

³⁸ Value added tax (VAT) is also imposed on banks and financial companies at 17% on the total wage bill and on net profits of the financial institution. This is in accordance with the Israeli tradition to include financial services in the VAT system.

³⁹ Ministry of Economy and Trade (1998); Investment Encouragement Law, Article 23, pp. 18-19.

Table 7). In recent years, however, revenues from indirect taxes on domestic goods and services have steadily declined, from about 66% of total tax revenues in 1995, to less than 48% in 1999. Furthermore, the importance of the domestically collected indirect taxes has increased relatively to those collected through the clearance system with Israel. But, still by the end of 1999 more than 70% of these taxes were collected by Israel.

Table 5: VAT, excises and fuel tax for the period 1995-1999 (in million USD)

	1995	1996	1997	1998	1999
(1) Domestic VAT	55.8	66	74.6	80.3	89.9
(2) Domestic Excises	0	36.8	47.3	50.4	48.1
(3) Total VAT and excises collected by PNA (1+2)	55.8	102.8	121.9	130.7	138
(4) VAT through clearance	191.9	217.3	215.3	201.6	233.3
(5) Fuel excise through clearance	33.5	100.6	110.7	106.6	100.7
(6) Total VAT and excises through clearance with Israel (4+5)	225.4	317.9	326	308.2	334
(7) Total VAT, excises and fuel taxes (3+6)	281.2	420.7	447.9	438.9	472
Indirect taxes on domestic goods and services collected by clearance with Israel in % of total indirect taxes (ratio of 6/7)	80.2	75.6	72.8	70.2	70.8
Indirect taxes on domestic goods and services in % of total tax revenues (ratio of 7/total revenue of the PA)	66	61.2	54.6	51	47.7
Indirect taxes on domestic goods and services in % of GDP (ratio of 7/GDP)	7.8	11.3	11.3	10.4	10.9

Source: Palestinian National Authority (2000)

3.1 Value added tax

Collection of VAT depends on the classification of the business establishment according to turnover. The VAT Department has classified three kinds of establishments as follows:

- (1) Licensed establishments with sales of NIS 185 000 (almost USD 46 250) or more.
- (2) Small establishments with sales between NIS 42 000-185 000 (USD 10 500 - 46259).
- (3) Exempted establishments with sales below NIS 42 000 (USD 10 500).

Establishments with annual sales of more than NIS 365 000 (approximately USD 91 250) pay taxes every month, while those with sales below that figure pay taxes every two months. Financial institutions pay 17% on both salaries of employees and net profits. Firms whose annual sales are less than NIS 42,000 do not pay VAT. These revenues together with VAT on imported goods and services are collected by the VAT Department of the PNA. VAT on goods and services imported via Israel or from Israel are, however, collected by the Israeli revenue authorities and transferred to the PNA upon the handing of the unified VAT vouchers.

3.2 Purchase (excise) tax

The base of this tax is the wholesale prices of consumer goods and some types of raw materials and processed goods. The rates range from 5%-95%. Table 6 presents the rates on selected goods.

Table 6: Purchase tax rates for selected goods

Item	Purchase Tax Rate
<i>Cigarettes</i>	<i>51.5% + 37.5 NIS on each quantity of 1000</i>
<i>Alcohol</i>	<i>5%, 10%, or 20% according to alcohol content</i>
<i>Chemicals</i>	<i>5%-10%</i>
<i>Cars</i>	<i>95%</i>
<i>Electric Equipment</i>	<i>10%</i>
<i>Stones</i>	<i>10%</i>

Source: Ministry of Finance, Ramallah.

There are some exemptions of this tax, but these are conditional to certain products in the education, health, industry and agricultural sectors. They also apply to some companies covered by exemptions under the Investment Encouragement Law.

3.3 Fuel Tax

The tax base is the purchases of fuel products. There is a specific rate in NIS for 1000 litre updated every three months, according to the rise in consumer prices. Fuel tax shall, according to the tax law, be transferred to local governments. However, this is not the case in the PNA. Instead, the proceeds are transferred to a special account outside the control of the Ministry of Finance. This practice has been a matter of concern for the public, the International Monetary Fund (IMF), the World Bank and the donor community. Thus, the *Progress Report on the Economic Policy Framework*⁴⁰ stresses this issue and demands a stop to the diversion of excise revenues to accounts outside the control of the Ministry of Finance starting from January 1, 2000. However, by end 2000 only about two-thirds of almost USD 70 million for each of the years 1998 and 1999 had been refunded to the Ministry of Finance.

The rates of the fuel tax vary depending on the type of fuel. For example, the rates that were applicable from 1 January - 31 March 1996⁴¹, were NIS 1375 per 1000 litre of gasoline 91 octane, NIS 1450 per 1000 litre of gasoline 96 octane, NIS 82.44 per 1000 litre of diesel oil or of kerosene.

4 Taxes on international trade

Taxes on international trade are composed of customs duties and VAT and excises on imported goods. The PNA has some power for direct collection when imports are from or through Jordan or Egypt. However, trade with these countries is limited. Revenues from taxes on international transactions collected by the PNA are therefore very small

⁴⁰ The Palestinian National Authority Official Website: *Events, West Bank and Gaza: Economic Policy Framework*, Progress Report (May 31, 2000:5).

⁴¹ The rate for a more recent period was not available for this review.

(see Table 7). In 1999, almost 90% of the revenues from international trade were collected by Israel.

Table 7: Revenue from taxes on international trade (in million USD)

	1995	1996	1997	1998	1999
(1) Customs by the PNA	7.3	23	21.9	24.2	36.2
(2) Customs through the clearance system with Israel	18.9	87.1	142.7	205.3	263.3
(3) Total Customs	26.2	110.1	164.6	229.5	299.5
(4) Customs collected by Israel through the clearance system in % of total Customs (ratio of 2/3)	72.1	79.1	86.7	89.5	87.9
(5) Customs in % of total revenue (ratio of 3 to total revenue)	6.2	16	20	26.7	30.3
(6) Customs in % of GDP (ratio of 3 to GDP)	0.7	2.9	4.2	5.4	6.9

Source: Palestinian National Authority (2000).

Although the nominal value of customs collected by the PNA in 1999 has increased 5 times its 1995-level, its share of total tax revenues is limited. It has declined steadily from 28% in 1995 to about 12% in 1999 (see row (4) in Table 7). This is mainly due to the fact that trade with Egypt and Jordan has remained at a low level compared to trade with or through Israel which experienced a substantial increase till September 2000. Furthermore, total revenues from customs in percent of total tax revenue have increased rapidly from 6% in 1995 to more than 30% in 1999. The corresponding figures for the ratio of customs revenue to GDP are less than 1% for 1995 and about 7% for 1999. The trend of increasing customs revenues through the clearing system with Israel reflects that the economic dependency on Israel has increased during the period 1995-2000, despite efforts from the PNA to reverse the trend.

The rates on customs duties are levied on the c.i.f. value of imported goods and services. The general rates are about 50%, except for cars and transportation vehicles for which it is 95%. The PNA has the right to charge lower rates on two lists of goods as specified in the Paris Protocol (PP). In addition, comes the VAT rate of 17%. There is also a purchase tax, which is levied on the c.i.f. value of the imports plus customs plus TAMA. The rates of this tax vary from 5% to 240%.⁴² There are a few exemptions, and these are mainly to enterprises under the privilege of the Investment Encouragement Law.

5 Property Taxes

The base for property taxes in the West Bank (WB) and the Gaza Strip (GS) varies. Building and non-farm lands within municipalities in the WB are subject to property taxes of 17% of the net annual rental value of the property (defined as 80% of the total rental value), and 15% in the GS. Properties outside the municipalities are subject to property taxes of 10% of the annual rental value. Farmland is subject to a tax of 6

⁴² TAMA is a procedure of calculation that reflects domestic wholesale price as the basis for valuation. Israel has recently abolished this tax on many items, with negative impacts on revenues transferred from Israel to the PNA.

USD per donum in the WB and 15% of the annual rental value in the GS as long as the land is developed (i.e., planted with fruits and/or vegetables). However, for farmland the property tax rates may vary according to the crop.

Property taxes are collected by the central government. On the West Bank 90% of the revenues are transferred to the municipalities. In the Gaza Strip, however, all property tax collections are retained at the central level. Gaza municipalities therefore levy additional property-related taxes, such as Gaza City's housing/room tax. In January 2001, the Ministry of Finance decided to transfer the responsibility of the collection of property taxes to the local government bodies in response to their demands⁴³.

Revenues from property taxes are insignificant when compared to total tax revenues. In 1999, they contributed with only 0.15% of total tax revenues (see Table 8). But, the revenue figures do not reflect the fact that most Palestinians keep their wealth in the form of property. However, they do reflect both the regressivity of the tax system and the narrow tax base which the PNA rules over. Table 8 summarises the trend of this revenue source. The table shows that the contribution of the tax to total revenues has fluctuated very much in recent years. This may also explain why the Ministry of Finance supported the proposal of handing over the responsibility of this tax to local authorities.

Table 8: Property tax revenue of the PNA, 1995-1999

	1995	1996	1997	1998	1999
Property tax revenue (in million USD)	0.7	0.94	0.58	0.53	1.5
In % of total revenue	0.16	0.14	0.07	0.06	0.15

Source: Palestinian National Authority (2000)

6 Non-tax revenue

In addition to the various types of taxes the PNA collects fees and charges. These include transportation fees, car registration fees, health fees and insurances, and business fees. Some of these are directly collected by the relevant offices of the PNA, while others are transferred by Israel after they have been deducted from the wages of Palestinians working in Israel. The role of non-tax revenue clearance with Israel is, however, limited, and it fluctuates according to the number of Palestinian workers allowed at any time to work in Israel. Table 9 provides a summary of revenues generated from these fees and charges. In 1999, they contributed with more than 13% of total domestic revenues, equivalent to 3.1% of GDP.

⁴³ Al-Ayyam Newspaper, January 11, 2001, p. 5.

Table 9: Fees and charges collected by the PNA and through the revenue clearance system with Israel, 1995-1999 (in million USD)

	1995	1996	1997	1998	1999
(1) Local non-tax revenue	50.2	86.2	117.6	96.6	114
Transportation Fees	11.1	22.6	32.3	28.9	28.3
Heath Insurance	12.7	12.6	12.7	14.4	20.1
Heath Fees	11.9	9.4	10.1	10.2	9.2
Other local non-tax revenue *	14.6	34.6	62.5	43.1	56.5
(2) Non-tax revenue clearance	17.1	12.2	19.6	17.9	20.5
Health Fees	10	6.3	8.1	9.2	8.7
Other non-tax revenue	7.1	5.9	11.5	8.7	11.8
(3) Total non-tax revenue	67.3	98.4	137.2	114.5	134.5
(4) Ratio of (3) to total revenue	0.158	0.143	0.167	0.133	0.136
(5) Ratio of (3) to GDP	0.019	0.026	0.018	0.027	0.031

Note: * A major part of these 'other non-tax revenue' includes business fees and cars registration fees.

Source: Palestinian National Authority (2000)

7 The local government tax structure⁴⁴

A primary function of local authorities is to provide services, in particular water and electricity. User fees from water and electricity utilities are the major revenue sources for many municipalities. Revenue bases vary substantially between municipalities. In some local authorities, for instance, fees and charges do not match the costs of delivering the services. For instance, personnel involved in the World Bank's Municipalities Institutional Development Program (MIDP) have estimated that fees for municipal waste collection and disposal recover as little as one tenth of the actual costs incurred (World Bank, 1999).⁴⁵

Non-utility revenues of municipalities come from a variety of sources. The most important is a property tax on the net rental value of land and buildings and defined as 80% of the total rental value. The property tax rate is, as noted above, 17% in the West Bank and 10%-15% in the Gaza Strip. Collected by the Ministry of Finance, 90% of the revenue is returned to West Bank municipalities. In Gaza, all property tax collections are retained at the central level. However, Gaza municipalities levy additional property-related taxes, such as Gaza City's housing/room tax.

West Bank municipalities also levy a local education tax equivalent to 7% of the net rental base, i.e., the same base as the property tax. The net proceeds of the education levy are used to finance school construction, maintenance and textbooks. These are areas in which central funding falls short of local needs. A separate "school" committee administers the education tax. Thus, revenues and expenditures associated

⁴⁴ This section draws on the World Bank (1999:49-51).

⁴⁵ It has proved difficult to get data on the relative importance of municipal taxes, fees and charges in the various local authorities. The available data is not categorised in a way that permits such an analysis. Moreover, to our knowledge, disaggregated data on local government revenues is not available. This is a statistical gap that the Ministry of Finance or the PCBS ought to cover when rebuilding the statistical material on Palestine.

with the education tax do not appear in the municipal accounts. Because it is collected locally on the same base as the property tax, administration is also duplicated.

Moreover, the Ministry of Finance collects an occupation tax on businesses and professions in both the West Bank and Gaza strip, and remits 90% of the proceeds to municipalities, retaining 10% to defray collection costs. Rates vary by nature, size and location of the business. Furthermore, from 1998 onward, the central government is obliged under the 1997 Local Government Act to share revenues from the motor vehicle licenses and traffic fines with the municipalities of origin. As of August 1999, transfers for 1998 had only been made to some Gaza local authorities, although it was anticipated that all the local governments in Gaza would have received these transfers by September 1999. As of August 1999, transfers to the West Bank local governments were being delayed until an arrangement for dealing with municipal arrears to Israeli utilities had been reached.

About 75% of local government non-utility revenue comes from various charges, fees and profits from local enterprises, of which the most important source is building licenses. Because local revenues from property and occupation taxes are primarily controlled by the central government, and because there are few alternative revenue-raising options, some local governments have established commercial ventures.

Still, the lack of a major broad-based local tax and the heavy reliance upon a few own-revenue sources present a serious concern for the financing of local authorities. The mismatch between local revenues and expenditure requirements may suggest a need for revenue restructuring and greater autonomy in setting tax policy. However, experiences from other developing countries, suggest that increased local government autonomy with respect to taxation, needs cautious supervision from above to avoid double taxation and inconsistencies between policies implemented at the local level and the national government's development policies (Fjeldstad & Semboja, 2000). There are also ongoing initiatives to create regional self-financing water, wastewater and electricity utilities. While such facilities may relieve local governments of distributing these services, this might also imply that some local authorities lose their most important income bases. Thus, the PNA and the World Bank have discussed the need to introduce equalisation grants from the central level to finance local services across the West Bank and Gaza Strip. Given the current economic situation, it is, however, unrealistic that such a transfer system can be put in place without substantial external donor funding.

Summary

The state formation process in Palestine during the period 1994-2000, in contrast to the European experience, was not related to inter-state war but to insurgency against and negotiation with Israeli occupation. This conflict did not contribute to increased tax extracting capacity of the Palestinian National Authority (PNA) as wars did in the West. Although the conflict changed the relations between the new rulers and the ruled, relations of accountability between the PNA and citizens remained weak – perhaps because the government depended only partly on their citizens to mobilise revenues. The authority relied more on foreign aid and taxes on international trade instead.

The study argues that a major problem for the PNA was that it did not manage to create confidence in its ability and capacity to deliver promised returns for taxes paid and foreign aid received. The deteriorating security situation in the late 1990s and declining social welfare raised citizens' perceptions of exploitation from an unequal contract with the authority and promoted resistance. In this perspective, the PNA's trustworthiness was closely linked to citizens' perceptions of the capacity of the PNA to make credible commitments about the use of tax revenues and foreign aid, as well as its procedures for designing and implementing fiscal policy non-arbitrarily. Moreover, extensive and increasing corruption contributed to undermine popular confidence in the PNA as a credible force in the struggle against the Israeli occupation.

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