Taxation during state formation. Lessons from Palestine, 1994-2000*

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The article analyses factors constraining the capacity of the Palestinian National Authority (PNA) to raise domestic tax revenue during the period 1994-2000. The article shows that more than any other factor, Israel represented a constraint on the PNA's tax policies and revenue collection. Israel collected the bulk of taxes on traded goods on behalf of the PNA, and until 2000 a large share of income tax came from Palestinians working in Israel. By withholding revenue collected on behalf of the PNA, Israel was able to exert substantial financial pressure on the PNA. However, within its restricted room of manoeuvre, the PNA managed to raise significant domestic revenues subject to the constraint of consolidating and maintaining its power. The PNA also used the tax system as a means of enhancing rents from industries and sectors that the leadership believed were important for economic development, and to grant generous tax exemptions to politically important stakeholders.

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JEL classification: H20, H30, O19, O23, O53

1. Introduction

States need money. States under formation need a lot of money. But while the politics of revenue mobilisation is one of the most important policy concerns for any state, we know very little about it during processes of state formation. This is surprising given the fact that tax revenue is central to (i) building state capacity and service delivery; (ii) the shaping of state-society relations; and (iii) the sustainability of aid interventions (Levi, 1988; Steinmo, 1993; Moore, 1998). Furthermore, based on historical evidence from the West, the way a state tackles the issue of domestic revenue mobilisation significantly influences its potential for

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economic growth and democratic consolidation (Tilly, 1992). Hence, a key question is: What are the main factors constraining a regime's capacity to raise revenue during state formation?

The Palestinian experiences over the period 1994-2000 provide an opportunity to explore this question. Although the Palestinian National Authority (PNA) operated over only a small part of the territory of the West Bank and Gaza Strip (WBGS), it had a degree of sovereign legitimacy within the Palestinian territories in this period. The PNA set up institutions that were intended gradually to form the core of a future Palestinian state (Hilal and Khan, 2004). It established state institutions such as ministries and agencies, and a tax system was developed. Based on the institutional literature, we suggest that the PNA faced four main constraints to enhancing domestic revenue. These constraints emanated from: (i) the effectiveness of the tax administration; (ii) the nature and capacity of the political institutions; (iii) the PNA's bargaining position *vis-à-vis* various groups of citizens, including owners of capital; and (iv) the impacts of foreign aid on domestic revenue generation.

The article shows that more than any other factor, Israel represented a constraint on the PNA's tax policies and revenue collection. Israel collected the bulk of taxes on traded goods on behalf of the PNA, and until 2000 a large share of income taxes came from Palestinians working in Israel. By withholding revenue collected on behalf of the PNA, Israel was able to exert substantial financial pressure on the PNA. However, the article argues, within its restricted room of manoeuvre, the PNA managed to raise significant domestic revenues subject to the constraint of consolidating and maintaining its power. It also used the tax system as a means of enhancing rents from industries and sectors that the leadership believed were important for economic development, and to grant generous tax exemptions to politically important stakeholders such as professionals.

The Palestinian state-formation process is now at a standstill. 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.[1] It ended – at least for the

[1] The Oslo Agreement was a declaration of principles which laid the foundation for 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 (WBGS). This included approximately 20 per cent of the Palestine that the United Nations decided to separate into two states in 1947. 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

foreseeable future - with 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.[2] But, although the events since autumn 2000 have put further progress on hold, the experiences over the period 1994-2000 may provide important lessons about the economic, political and institutional constraints that a future Palestinian state will face with respect to revenue mobilisation.

The remaining part of the article is organised as follows: Section 2 briefly describes the macroeconomic policy and the tax system in Palestine over the period 1994-2000. In Section 3 various institutional approaches to analysing the constraints facing a state's revenue policies are discussed. Section 4 analyses factors constraining the PNAs' capacity to raise revenue. Finally, Section 5 concludes.

2. Macroeconomic policy and the tax system in Palestine

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 per cent 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 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 US$ 1387 (in 1998), Palestine fell into the category of middle-income countries (PCBS, 1999).[3] The official unemployment rate was 14.1 per cent in 2000 (DSP, 2002). But when workers discouraged from entering or remaining in the labour force are included the unemployment rate is estimated to be almost 40 per cent in the last quarter of 2000.

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analysis of the Oslo Agreements placed in the context of Israeli and Palestinian political strategies. Giacaman and Lønning (1998) provide a critical assessment of the Oslo process from various perspectives.

[2] 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.

[3] 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. Since the second *intifada* started in September 2000, living conditions in WBGS have deteriorated dramatically. Real GDP per capita has now reached its lowest level since 1980. By the end of the year 2000, 35 per cent of the population lived below the poverty line, a figure that rose to over 50 per cent by the end of 2001 (see UNSCO, 2001: 29).

The PNA implemented and maintained a liberal economic policy regime, emphasising incentives for investments and a stable macroeconomic environment. 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 PNA chose an investor-friendly policy with the aim of furthering economic growth. This policy was also encouraged by the international community and foreign donors. In particular, the World Bank and the International Monetary Fund (IMF) were influential in pushing for an export-oriented, private-sector-led market economy (PNA, 1996).

The private sector was dominated by small, family-owned farms and enterprises and peasant agriculture. Many of the larger private firms, including some monopolies, were owned or managed by high-ranking public officials (PLC, 1997; CPRS, 1998). Some of the larger companies were fully or partially owned 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 (Nasr, 2004). Private-sector job creation, however, was disappointing despite the growth-oriented policies adopted during the period 1994-2000. As a result the tax base did not expand significantly.

At the same time, the public sector expanded rapidly. Total public expenditures accounted for more than 27 per cent of GDP in 1999, compared to 14.7 per cent when the PNA was established (Fischer *et al*., 2001: 256). This expansion was mainly due to an almost fourfold increase in public sector employees, including security forces (from 31,140 in 1994 to approximately 110,000 in mid-2000), and an expansion of social services in health and education. This reflects that 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 and Khan, 2004). The growth in public sector employment had to slow down by the end of the 1990s, partly because of financial constraints, but also due to increasing criticisms of inefficient, overstaffed government departments. Nevertheless, by end-1999, about 19 per cent of all employed persons in the WBGS were on the PNA's payroll (including education, health and security forces).[4]

Fiscal policy and revenue clearance with Israel

The ratio of Palestinian fiscal revenue to GDP was estimated at 23.4 per cent in 1999, which compares well with countries at a similar level of development (Fischer *et al.*, 2001: 272).[5] Table 1 provides an overview of the composition of fiscal revenue in Palestine during the period 1995-1999. The major tax bases were personal and corporate income taxes (8.2 per cent of total tax revenue in 1999), indirect taxes on domestic goods and services (47.7 per cent) and taxes on international transactions (30.3 per cent). Furthermore, various types of fees and charges were collected. While Value Added Tax (VAT) and other indirect taxes on domestic goods and services still accounted for almost half of the total tax revenue, their share dropped substantially during the late 1990s. In 1995, they accounted for about 66 per cent of total revenue. During the same period, revenue from customs duties and taxes on imported goods increased from about 6 per cent of total revenue in 1995 to approximately 30 per cent in 1999. Income tax revenue remained fairly stable at around 8-9 per cent of total fiscal revenue during the period 1996-99.

TABLE 1 IN ABOUT HERE

[4] According to Nasr (2004), the public sector wage bill amounted to more than 12 per cent of GDP in 1999.

[5] 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 per cent, for Yemen 13 per cent, Morocco 23 per cent, Syria 17.8 per cent, Jordan 20.4 per cent, Tunisia 21 per cent, and Lebanon 10.8 per cent. All these countries had lower GDP figures than the PNA due to their dependence on migrant remittances (World Bank, 1997: 258-59).

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.[6] 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 customs duties imposed on Palestinian imports from or via Israel, in addition to the income taxes from wages of Palestinians working in Israel.

The share of fiscal revenue collected by Israel through the clearing system remained fairly stable in the period 1995-99, and accounted for around 63 per cent of the PNA's fiscal revenue 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 per cent of indirect taxes on domestic goods and services, compared to 70.8 per cent in 1999. The opposite trend was observed for indirect taxes on international transactions where Israel collected 72.1 per cent in 1995, compared to 87.9 per cent in 1999 (Table 2).[7]

These figures demonstrate the heavy dependence – and vulnerability – of the Palestinian economy on Israel with respect to revenue from foreign trade, employment and tax. 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 (see Section 4).

[6] The full title of the Paris 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 and Weinblatt, 2001: 295). Kanafani (2001) provides an insightful discussion of the strengths and weaknesses of the PP from both Israeli and Palestinian perspectives.

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

TABLE 2 IN ABOUT HERE

3. Institutional perspectives on constraints to revenue mobilisation

What factors explain the evolution of the Palestinian tax system over the period 1994-2000? Based on the institutional literature derived from Western historical experiences we suggest that the PNA faced four main constraints to enhancing domestic revenue.[8]

First, there is increasing evidence that the effectiveness of the tax system depends on the efficiency and integrity of the tax administration (Bird, 1992; Das-Gupta and Mookherjee, 1998). In many developing countries the low-revenue yield of taxation is attributed to the fact that the tax provisions are not properly enforced, either due to poor administrative capacity or due to corruption (Chand and Moene, 1999; Fjeldstad and Tungodden, 2003). No system of tax laws, however carefully conceived, is proof against collusion between the tax collectors and the taxpayers. Hence, an efficient tax administration consisting of competent people of high integrity is an important requirement for enhancing revenue and fully exploiting the tax potential of the country. It is reasonable to assume that this also applies to Palestine.

Second, political institutions matter (Brennan and Buchanan, 1980; Levi, 1988; Steinmo, 1993). According to Steinmo (1993), differences in tax systems and tax burdens between countries are due to differences in the way political institutions function, and involve factors such as the relations and degree of power-sharing between the executive and the parliament. Hence, in the Palestinian context we would expect the tax system to reflect to some extent the relative bargaining power of the executive *vis-à-vis* other domestic political institutions. It is also reasonable to assume that political and administrative agreements with other states affect domestic policy-making in the area of taxation. Political institutional constraints on taxation must therefore be understood in the context of the broader national and international

[8] In a study of the development of the Namibian tax system, Rakner (2001) applies a similar analytical framework. Therkildsen (2001) provides a critical review of this literature and its relevance for developing countries.

economic and political setting in which they are embedded. In Palestine we would expect the institutions governing the fiscal relations between Israel and the PNA to be important.

Thirdly, the bargaining power of various individuals and interest groups are likely to matter. Following the approach suggested by Levi (1988), rulers maximise revenue to the state but not as they please, due to the various constraints: transaction costs in tax enforcement, their own time preference, and their relative bargaining power *vis-à-vis* agents and constituents (*ibid*, p. 10). These constraints, she argues, determine the choice of revenue system, since rulers do not possess unlimited power, nor do constituents pay taxes voluntarily. But, 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. However, once 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. The mutual advantages of co-operation between rulers and citizens are greatest where capital is mobile, particularly in the form of financial and trading assets. Co-operation protects owners of capital from arbitrary and exploitative tax enforcement. Rulers on the other hand can gain greater tax compliance from co-operation by retaining owners of mobile capital within their jurisdiction and by attracting capitalists from other states. Hence, in the Palestinian context we would expect that various interest groups may negotiate favourable deals for themselves, or that people may find ways to evade taxes. In particular, we would expect to see that differences in the bargaining power of individual businesses, for instance related to their size and strategic importance for the PNA, are reflected in the tax system.

Fourth, the domestic tax system may be affected by the international system of financial transfers, in particular foreign aid. Some scholars argue that high levels of aid diminish a government's incentive to make full use of its domestic resources for revenue generation (Brautigam and Botchwey, 1999). Furthermore, according to Moore (1998) bargaining over the budget and over tax policy is one of the primary ways in which different state and societal goals are reconciled in a democracy. He argues that the more a state 'earns' its tax revenue from its domestic population 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 political representation.[9] But such processes are not likely to operate when the state is fiscally *independent* of its population because much of its revenue is 'unearned' – for instance, obtained from foreign aid (or natural resources such as oil and minerals). Hence, in the Palestinian context, a relevant question is whether foreign aid, so substantial in relation to other income sources, has provided a disincentive for domestic revenue mobilisation?

4. Constraints on tax policy in Palestine

In this section we explore the impacts of the four sets of constraining factors outlined above on the PNA's efforts to raise domestic revenue.

Tax administration

In the areas controlled by the PNA, there were four central government agencies authorised to collect taxes: (i) the Customs Department collected customs duties on goods imported directly from Jordan and Egypt or through these countries; (ii) the VAT and Excise Taxes Department collected VAT and purchase tax on domestic goods and services; (iii) 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; and (iv) the Fiscal Department collected and managed the property taxes. There were 12 offices for each of these departments in the main towns in the West Bank and Gaza Strip. Health, insurance, transportation and other charges were collected through different offices on an annual basis. With respect to local government taxes, the taxing power of local authorities was limited. Various forms of user charge were major revenue sources for local authorities during this period. Generally, the uncertain political situation and the PNA's well-founded fear of increased fractionalisation of the country contributed to sustaining the centralised taxing agencies and restraining fiscal decentralisation.

In the period 1995-2000, there were few and minor changes in the tax structure consisting of simplifications of the rate structures and reduction of some rates. The most important changes were related to the granting of tax exemptions. The limited number of changes is not surprising since the Paris Protocol placed substantial restrictions on how and what revisions

[9] The concept 'earned' is a logical extension of the term 'rentier', since the latter means 'unearned' in the language of classical political economy (Moore, 1998: 94).

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, including the creation of a large taxpayer unit, a delinquent taxpayer unit and a tax court.[10] These measures enabled the PNA to establish potentially well-functioning central government tax agencies within a fairly short period of time.

Despite the progress made to improve 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 benefited from exemptions. Secondly, some procedures facilitated tax evasion and corruption. These included:[11]

- the absence 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.

The administrative structure that was established, with several forms of tax administration, put 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 exemption’ was the approach often used 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. 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

[10] 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.
[11] Personal interview with an international public finance expert who was stationed for a period at the Ministry of Finance in Ramallah (Adel Zagha, January 2001). The person interviewed preferred to remain anonymous.

tax officers handled some 65 files in the West Bank.[12] Tax assessments by the Palestinian Revenue Authority (PRA) found that in 90-95 per cent of the cases incomes were underreported. But, despite the existence of a tax court only two or three cases were filed to the court each year. Most of the cases found a compromise through negotiations between the taxpayer or his/her representative and the income tax official.

Low wages in the public sector in general, and in the tax administration in particular, left no option but to accept the employment of less qualified graduates with limited skills in accounting. The best graduates were usually recruited to more attractive jobs in private accounting companies. 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 per cent of the respondents in the West Bank said that their own tax assessment differed from that of the revenue authority (PRA).[13] Businesspeople interviewed gave various reasons to explain the differences in tax assessment, including ‘the PRA officials do not trust the books’, and ‘some expenses are not recognised by the tax officers’. As many as 35 per cent of the respondents in the WB said the differences were solved through negotiations with tax officers. Dishonest tax collectors were perceived to be a problem by 38 per cent of the respondents in the WB and by 30 per cent in Gaza.[14] According to an official interviewed in the ITD in Ramallah, very few corrupt tax collectors were detected.[15] However, the few who were caught were asked to resign to maintain their dignity instead of being brought to court.

Political institutions

The institutional constraints on policy changes were substantial in Palestine after Oslo. Many of the PNA’s fiscal operations were governed by the Paris Protocol, which only gave the PNA

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[12] 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 register. Registration was with the Ministry of Economy and Trade, which provided a license number accompanied by relevant information about the internal by-laws and a contract of establishment. Procedures for tax assessment were based on officially audited statements according to the companies and the tax code. On request, the Director of the ITD was not able to provide corresponding data from Gaza (Adel Zagha, January 2001).

[13] The survey was carried out in 2001 as part of this study.

[14] 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).

[15] Personal interview (Adel al-Zagha, January 2001).

a limited role in designing its own fiscal and trade regimes (see Section 2). The Israeli interpretation of the terms of the Protocol also resulted in the loss of significant revenue for the PNA (Kanafani, 2000: 285-88). Israel collected a major share of the PNA's tax revenue through the revenue clearance system (Table 3). But, the PNA could only reclaim import duties on goods that were directly imported by Palestinian companies via Israel. Products initially imported by Israeli companies, and then re-exported to the Palestinian territories, were, according to the Israeli interpretation of the Paris Protocol, not 'proper imports' and, thus, 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 revenue 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 revenue from import duties. Another significant source of fiscal leakage was Israel's refusal to refund to the PNA the purchase tax, excise tax and surcharges that were imposed on some locally produced Israeli products exported to the WBGS and purchased by Palestinians. This reflects the imperfection of the bilateral contract as well as the asymmetry of power between Israel and the Palestinian authorities.

There have been several attempts to estimate the extent of this lost revenue. According to Sahban and Jawhary (1995: xxxiii), the revenue lost on imports coming through Israel corresponded to about 6-7 per cent of GDP. The PNA estimated the 'fiscal leakage' at US$ 380 million annually (PNA, 1998).[16] Dumas (1999), however, concluded that the lost revenue amounted to US$ 90-140 million in 1997, equivalent to between 2.6 per cent and 4.2 per cent of the GDP of the WBGS. According to estimates made by the IMF resident mission in the WBGS, the annual loss in revenue through these unequal arrangements corresponded to 77 per cent of the amount actually refunded in 1997.

TABLE 3 IN ABOUT HERE

[16] In comparison, total donor funding to the WBGS in 1998 was US$ 553 million (Table 3).

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 in the negotiations over the final status of the Palestinian territories (Arnon and 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, wanted to continue the existing *de facto* (partial) customs union, which did not require the creation of trade borders between the two economies. They succeeded in convincing the Palestinians that a more protectionist policy would reduce the Palestinians' chances of building a prosperous economy.

The dependency on Israel through the revenue clearance system 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 revenue collected, in *prima facie* violation of the Paris Protocol (Nasr, 2004). This also reflects the imperfection of the bilateral contract whereby one side could violate the agreement without bearing noteworthy consequences (Arnon and Weinblatt, 2001: 302). To reduce its vulnerability the PNA undertook various types of off-budget (and, by definition, unregulated) fiscal activities and established 'secret' accounts. Little information exists on the sources and scope of these off-budget accounts, or how these funds were used.[17] Nevertheless, there have been repeated accusations of non-transparency and manipulation of the secret accounts controlled by the PNA. But, given the unstable political situation and the fact that Israel on several occasions stopped transferring tax revenue to the PNA, it seems both legitimate and rational that the

[17] 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.

PNA operated by means of such accounts as a buffer against Israeli practice and in order to meet urgent needs and commitments.

Hence, factors beyond the control of the PNA had a significant impact on both tax policy formulation and implementation. Thus, with respect to tax policy, the best the PNA could do was to strengthen the domestic tax administration. In addition to enhancing revenue, this measure had a specific political dimension. A tax system is potentially an instrument for political control, based on information about citizens, and a network of tax collectors. With little bureaucratic presence and limited information about what goes on at the grassroot level, a government can be vulnerable to organised predators, such as private armies and religious fundamentalists. These factors may contribute to explaining why the PNA put so much effort into establishing the new forms of tax administration (see above). It may also explain why several tax-collecting institutions were set up: namely, to obviate the risk of failure on the part of one central revenue authority. But it is also likely that establishing a centralised system of revenue administration would have required more financial and administrative resources than setting up several smaller ones. Furthermore, the establishment of the tax administration system in the WBGS was heavily influenced by the IMF and the World Bank. IMF missions in the mid- and late 1990s resided with the Ministry of Finance, which offered technical assistance and policy advice on taxation and administration. The International Finance Institutions focused particularly on building institutional capacity within the PNA, emphasising 'transparency' in government operations.[18]

Civil society, interest groups and capital owners

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 anticipate that the introduction of competitive electoral policies in Palestine would bring new stakeholders into the debates over the politics of taxation. The experiences with the PNA during the period 1994-2000 do not support this expectation. The 1996 election campaign produced a variety of political programmes by the different political organisations involved. But neither Fateh nor the opposition made any reference to taxation. Hence, it

[18] 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…'.

cannot be argued that the PNA faced any major challenges from its political opponents with respect to revenue policies.

The general election in 1996, which was largely conducted in a free and democratic way, gave the emerging state system the legitimacy it required (Hilal and Khan, 2004). However, the executive controlled the security apparatus. In addition, most members of the 'Palestinian leadership' (the Speaker of the Palestinian Legislative Council, heads of the main security forces, ministers, executive committee members, among others) owed their position to Arafat personally (Amundsen and Ezbidi, 2004). Furthermore, the political 'leadership' had no representatives from the private business community, the opposition or civil organisations. These features led to a situation where the PNA managed to centralise power.

The increasing influence of the executive power in Palestine during the period 1994-2000 is partly explained by the weakness of various interest groups. Opposition parties more or less accepted to work within the constraints of the new regime (Hilal and Khan, 2004). 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 the overarching aim of organising opposition to the Israeli occupation and of providing services to poorer segments of the population. Hence, they posed no serious challenge to the regime.[19]

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 and Khan (2004), 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.

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[19] 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

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 (Hilal and Khan, 2004). These associations were better organised than popular organisations, and had, unlike NGOs, a well-defined and stable constituency. Hence, the relationship between professionals and Fateh allowed for some important channels of rent-seeking and political influence. For instance, many professionals stayed outside the tax net. The Income Tax Department (ITD) was tolerant towards them on the grounds that 'it was enough that they paid the VAT'.[20] This was so, even though the tax authorities assumed that many professionals underreported their income to evade taxes, and it was very difficult to check their true turnover. Thus, the lion's share of personal income tax revenue was generated from wage employees where taxes were withheld at source.[21]

From 1994 onwards, the PNA implemented an economic policy that benefited large corporate interests and the manufacturing industry, which had close linkages with the political and administrative elite or was owned by foreign investors. 'Investor-friendly taxes' were established; this meant relatively low corporate taxes and the absence of capital-gains taxes. The Investment Promotion Law, 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).[22] In 1997 and 1998, 144 projects applied for tax exemptions (74 in 1997 and 70 in 1998).[23] The Palestinian Investment Promotion Agency (PIPA) approved 125 projects. Of these only 52 were implemented in 1997 and 1998, representing a total investment of US$ 97.5 million (i.e. 28.4 per cent of the projected investment). The remaining projects either

capital, including the Federation of Chambers and Commerce, the Federation of Chambers of Industry, Paltrade, and Palestine Information Technology Association.

[20] Personal communications with staff at the ITD (Adel al-Zagha, June 2001, Ramallah).

[21] To illustrate this point further, there were only 650 files on registered companies in the West Bank, and no company was registered in the Gaza Strip. This implies that on average a company in the West Bank paid less than US$ 18,000 in corporate taxes on an annual basis. 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 evasion of tax.

[22] 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.

[23] These projects represented total investments of US$ 343 million. Fully domestically-owned projects represented about 57 per cent of this capital, while exclusively foreign-owned investments represented less than

existed before the law was passed or were not implemented. In 1998, 22 'existing' projects (almost one-third of those approved that year) benefited from the tax exemptions, with a total value of more than US$ 20 million.

Almost two-thirds 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. Most of these were large projects where capital investment exceeded US$ 1 million. 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.

The PNA repeatedly called upon foreign investors, and in particular the Palestinian diaspora, to invest in Palestine. Responding to this call, one group of Palestinian investors established the Palestinian Development and Investment Corporation (PADICO). This company established a number of subsidiaries in various sectors, including telecommunications, real estate, industrial estate, tourism, electronics and poultry (see Nasr, 2004). Another group of investors founded the Arab Palestinian Investment Corporation (APIC), which set up subsidiaries within medical services, car rental, cold storage, shopping centres, etc. Both foreign and local investors invested in the banking sector, which expanded from two banks in 1993 to 22 banks (with 120 branches) in 2000. Of these banks, 13 were wholly or partly owned by the diaspora (PEPRI/MAS, 1997). In addition, some smaller foreign investors invested in the real-estate and 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.

In contrast to local capital that was dominated by small-scale family capital, expatriate capital was represented by larger businesses. A number of large expatriate businesspeople were offered a 'partnership' with the PLO to develop Palestine economically. But according to Hilal and Khan (2004), Arafat was careful not to give political weight to expatriate capital. Instead, he viewed these partnerships as a way of enhancing the rent-seeking activities of the

5 per cent of the capital. Joint ventures between foreign and domestic investors contributed the remaining 38 per cent.

PNA: for instance, by providing discretionary funds and to some extent also as a tool for job creation. In return, the PNA granted expatriate capital selective monopoly status (see Nasr, 2004) and tax exemptions.

This is also supported by survey data. According to Sewell (2001), perceptions of the tax system and regulations differed between firms according to the size of the firm. Almost 65 per cent of the small firms (with fewer than 10 full-time employees) and 57 per cent of the medium-size firms (with 10-50 full-time employees) in the sample considered taxes and regulations to be major or moderate constraints to business. In contrast, less than 35 per cent of the larger firms gave this answer. With respect to taxation, 74 per cent of small firms, 61 per cent of medium-size firms and only 26 per cent of large firms considered high taxes to be a moderate or major constraint to their businesses. Moreover, in contrast to smaller and medium-size firms, a majority of large firms (58 per cent) 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 reflect the substantial bargaining power of owners of mobile capital *vis-à-vis* the PNA, in contrast to the bargaining power of small-scale businesses whose major capital was in the form of fixed property. 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. It is here that the mutual co-operation between the PNA and capitalists was highest. Thus, these activities indicate that the PNA managed to take a longer-term perspective on the development of Palestine. Yet, the PNA faced substantial institutional constraints in terms of both extracting more revenue from the business sector and widening its tax base.

To some extent, small-scale agriculture also benefited from tax exemptions. Since most agricultural activities were located in either the B-designated areas where the PNA and Israel had joint responsibility for security, or in the C-designated areas where security was totally under 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 1951-1967, and onwards until the establishment of the PNA, farmers and the agricultural sector were exempted from income taxes. In the GS, however, the tax codes were influenced by the historically Egyptian codes, which did not exempt farmers from taxation. The PNA showed no willingness to change these codes substantially, and used the pretext that agricultural income in the WB was more subject than elsewhere 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 adopted towards these groups.

Foreign aid

To what extent did the inflow of foreign aid to Palestine provide a disincentive for the PNA in terms of its tax-collection efforts? During the period 1994-2000, the PNA had significant, although declining, 'unearned' incomes in the form of foreign aid (Table 3). In view of their active involvement in the Middle East peace process, we would expect that international aid organisations substantially influenced the shaping of the PNA's economic policies – including tax policies.

Annual disbursements to the PNA – in the form of loans and grants – averaged US$ 600 million per year in the period 1994-99, corresponding to almost 14 per cent of Gross National Income (GNI) per annum over the six years (Table 3). Almost 90 per cent 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 per cent of GDP (including investments undertaken by the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA). Still, the ratio of fiscal revenue to GDP was about 23 per cent in 1999, compared to an aid-to-GDP ratio of around 10 per cent. However, when the revenue collected by Israel through the clearing system is excluded, the ratio of 'domestic' fiscal revenue to GDP was approximately 9 per cent. Foreign aid amounted to almost US$ 175 per capita, making the West Bank and

Gaza one of the largest recipients of aid in the world on a per capita basis.[24] Donor support for current expenditures declined, however, over the period from 18 per cent of GDP in 1994 to around 10 per cent in 1999.

Based on the available data, it is not possible to provide a clear answer to the question of whether the inflow of foreign aid impacted on domestic revenue generation – and if so, how. The scope for influencing the tax policy was limited, too. 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 in relation to 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 from 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 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.[25]

The World Bank (2000: 26-27) estimated that the production capacity of the Palestinian economy was 6-7 per cent 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 led to overstaffing and probably undermined the administrative efficiency of the PNA.

On several occasions, donors criticised the PNA for lack of transparency in its financial operations, including its off-budget fiscal activities and weak technical decisions in its handling of public finances. But their focus was on keeping the peace process alive. Hence, foreign donors' seemed to a large extent to turn a blind eye to issues such as transparency and

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[24] In comparison, non-military foreign assistance to Israel represented approximately US$ 247 per capita (DAC, 1997).

[25] 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 over three weeks (29 March to 21 April 2002). For detailed

accountability in the PNA's fiscal affairs. Given the political instability and the contagious effects of 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, the approach taken by donors, if it had been continued, might have contributed over time to undermining the development of fiscal rectitude and accountability in the PNA.

5. Concluding remarks

While acknowledging the obvious weaknesses of an essentially exploratory study we have argued in this article that over the period 1994-2000 the PNA faced three main constraints to enhancing tax revenue. First, and not very surprisingly, the quality of the tax administration system was crucial. Institutional capacity was weak and had to be built up from scratch. Within a fairly short period of time, the PNA managed to establish relatively well-functioning central government tax agencies. But despite the progress made in improving the tax administration substantial weaknesses remained. Most important was the erosion of the tax base due to generous tax exemptions. Moreover, some administrative procedures facilitated tax evasion and corruption. Second, and more important than any other factor, Israel represented a constraint on the PNA's tax policies and revenue collection. The dependency on Israel through the revenue clearance system left the PNA extremely vulnerable and gave Israel a political weapon to exert pressure on the PNA. On several occasions Israel withheld tax revenue collected, in violation of the Paris Protocol. Third, various interest groups – in particular foreign-based capital owners, 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. But they were also consistent with the PNA's economic policy, emphasising investment incentives to large corporate interests in order to further rapid economic growth. It is uncertain, however, whether the dependency on foreign assistance both for investments and to cover running expenses had direct impacts on the regime's tax policies and incentives to raise domestic revenue.

accounts of the damage caused by the IDF during the re-occupation, see the press release of the 'Local aid co-ordination committee co-chairs' [LACC] (15 May 2002); and PNEIJ (2002).

To conclude, within its restricted room of manoeuvre, the PNA managed to raise significant domestic revenues subject to the constraint of consolidating and maintaining its power. It also used the tax system as a means of enhancing rents from industries and sectors that the leadership believed were important for economic development, and to grant generous tax exemptions to politically important stakeholders such as professionals. In contrast, few tax concessions were given to employees in the formal sector. The business interests of the minority of expatriate capitalists were more influential than trade unions and the emerging domestically based business associations. At the same time, the PNA also made 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 was also reflected in the 1996 election and helped the PNA to centralise power.

The *al-Aqsa intifada* marks the end of the first phase of state formation in Palestine. Revenue in the form of general taxes and income tax from monopolies dried up with the escalation of the conflict. From October 2000, Israel stopped transferring revenue collected on behalf of the PNA and the central state organs in Palestine became strapped for cash. This led to long delays in the payment of salaries to ministerial staff, and the maintenance of infrastructure also came to a standstill. Foreign aid did not manage to compensate for this revenue shortfall. Increasingly, aid bypassed the central government and went directly to local institutions and non-governmental and religious organisations. This was particularly the case with aid and financial support originating from other Arab nations. This situation, coupled with escalating poverty and unemployment, and growing frustration among Palestinians about lack of progress in the relationship with Israel, led to increasing support for opposition parties and the Islamists. But although the events since autumn 2000 have put further progress on hold, the experiences over the period 1994-2000 is likely to provide important lessons about the constraints that a future Palestinian state will face with respect to revenue mobilisation.

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TABLES

Table 1 ***Composition of major fiscal revenues in Palestine, 1995-2000 (as % 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).

Table 2 ***Palestinian 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).

Table 3 ***The PNA's revenues cleared by Israel and foreign aid, 1994-1999 (million USD, the figures in brackets are in percentage of GNI)***

	1994	***1995***	***1996***	***1997***	***1998***	***1999***	***1994-9***
Revenue cleared by Israel	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 and Weinblatt (2001:299, Table 4).