



## *USIPeace Briefing*

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# Dollars and Diplomacy: Foreign Aid and the Palestinian Question

By **Scott Lasensky** and **Robert Grace**

*The worsening crisis in Arab-Israeli relations has brought into sharp focus the question of how foreign aid can be used as an instrument of peacemaking. The fighting in Gaza and Lebanon is creating pressure for major new international relief and reconstruction assistance. But can foreign aid help the parties return to a political process? Or will international economic assistance reinforce the status quo ante? Over the coming months, the United States Institute of Peace will examine the use and effectiveness of foreign aid in the Middle East. As part of this effort, a recent seminar was held on aid dependency and the future of international assistance to Palestinians. Upcoming programs will examine international reconstruction assistance to Lebanon, and Arab, European and American aid initiatives for Palestinians and Israel.*

For more than thirty years, the United States has relied on foreign aid as a principal diplomatic tool in the quest for Arab-Israeli peace. During this period, the U.S. has disbursed tens of billions of dollars to implement Arab-Israeli peace accords, to build public support in the region, and to facilitate ongoing negotiations. By the early 1990s, other donors joined the U.S. in a multilateral process to underwrite Arab-Israeli peace. But since the collapse of Israeli-Palestinian negotiations more than five years ago, the linkage between foreign aid and political progress has become increasingly strained.

International aid flows to the Palestinians came to a quick halt with Hamas' victory in the January 2006 legislative elections and the party's subsequent refusal to meet conditions laid down by the Quartet.<sup>1</sup> For its part, Israel is withholding \$50 million to \$70 million a month in Palestinian revenues. Given the Palestinian economy's heavy reliance on international aid and on trade with and through Israel, the result of these sanctions is an economic crisis of growing and unprecedented severity. The World Bank's dim economic forecast last spring – which predicted a 40 percent loss in GDP by year's end, accompanied by a rise in unemployment to 45 percent and in poverty levels to 70 percent – now appears optimistic, particularly in Gaza, where fighting has raged for months.

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<sup>1</sup> Earlier this year, the "Quartet" (the United States, the EU, Russia, and the UN) demanded that the Hamas government (a) recognize Israel's right to exist; (b) forswear violence; and (c) accept previous Israeli-Palestinian agreements.

## Lessons Learned

During the Oslo years, donors learned some harsh lessons. The Oslo process marked the first great experiment in the Israeli-Palestinian context with large-scale aid, making Palestinians the largest per capita recipients of international development assistance in the world. Initially designed to fuel Palestinian economic growth and to build public support for negotiations with Israel, the aid program was quickly redesigned to provide life support for a Palestinian economy in decline and a negotiating process that was constantly under attack.<sup>2</sup> A rash of Hamas bombings in the mid-1990s resulted in the first systematic Israeli “closure” policies – restrictions on Palestinian movement in the territories. The donor community’s reaction to these closures was to preserve jobs and to give Palestinians a lifeline as they faced economic instability. At the time, the Palestinian Authority (PA) was seen as critical to the continuation of the peace process and essential for employment in the West Bank and Gaza. Donors operated on the theory that rising Palestinian unemployment eroded support for the peace process and damaged Israeli security.

After several years of economic downturns, the situation for Palestinians began to improve. Rising employment followed a steady rise in international aid. From 1998 to 2000 Palestinians enjoyed 90% employment, as close to full employment as one can reasonably expect in such a setting. Palestinians were finally enjoying some of the economic fruits of peace. But Oslo soon collapsed and large-scale violence erupted in late 2000. Despite good intentions, it was apparent that donor efforts had few lasting positive impacts. Corruption in the PA was rife and often overlooked by international donors. In some cases, as with the so-called “monopoly accounts,” corruption was encouraged by Israel. In retrospect, more donor conditionality was needed. Continued Israeli settlement activity damaged Palestinian security and faith in the negotiations, just as Palestinian violence threatened Israeli security and trust. Designed as an instrument to facilitate ongoing peace negotiations, foreign aid was suddenly expected to compensate for serious pitfalls in the process.

With the outbreak of the second Intifada, aid to Palestinians was reengineered to address growing humanitarian concerns, and also to prevent the collapse of the PA, thus preserving a potential negotiating partner for Israel. Faced with a 40 percent loss in Palestinian personal incomes in the first two years of the Intifada, the donor community responded with a two-fold approach. First, consistent with the thrust of assistance during the Oslo years, they sought to strengthen and preserve existing governmental structures to ensure that the PA did not fall apart. This was done through direct budget support (from Arab states and the E.U., but without American aid). Second, donors sought to sustain the general welfare of the Palestinian population through stepped-up health, food, and other welfare programs on the ground. Giving lie to the idea of donor fatigue, international disbursements in this period doubled to \$1 billion per year. Stricter conditionality on

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<sup>2</sup> See Rex Brynen, *A Very Political Economy: Peacebuilding and Foreign Aid in the West Bank and Gaza* (Washington, DC: USIP Press Books, 2000), and Scott Lasensky, “Chequebook Diplomacy: The US, the Oslo Process and the Role of Foreign Aid,” in Keating et al, eds., *Aid, Diplomacy and Facts on the Ground: The Case of Palestine* (London: Chatham House, 2005).

governance led to notable improvements in areas like public finance, but the overall picture was of increasing aid and diminishing prospects for peace.

The donor approach was reactive. Increased pledges and donations risked becoming a substitute for meaningful diplomatic intervention. When opportunities did arise, as with the death of Yasser Arafat, the election of Abu Mazen and Israeli “disengagement” from Gaza, increased economic assistance was not used in concert with effective political and diplomatic strategies, thus becoming simply another feature in an increasingly unattractive status quo.

### **Uncertain Outcomes**

Born of a desire to pressure Hamas to recognize Israel, renounce violence, and consent to the terms of previous Israeli-Palestinian agreements, the Quartet’s strategy of aid sanctions may produce side effects even less desirable than the status quo. Three such possible outcomes were outlined by the World Bank in a policy paper addressed to the donors in early May of this year<sup>3</sup>:

**The sudden onset of humanitarian crisis.** Humanitarian crises, the Bank noted, are defined by both suffering and perception; in other words, public perception can precipitate and exacerbate a crisis. Moreover, humanitarian crises tend to happen all at once, without warning, and the suddenness of their onset can overwhelm already insufficient food stocks and mechanisms of distribution. Given that the PA is by far the largest employer of Palestinians – more than one third of Palestinians depend on PA salaries – the cutoff of Israeli revenue transfers and the international aid sanctions have obvious and potentially devastating consequences for the population as a whole. Suffering could be especially acute in Gaza, where PA employees constitute 40 percent of the working population and earn twice as much as private-sector employees.

**A collapse of governance.** As with any structure of government, should the PA break down it will be extraordinarily difficult to put back together. For example, should the PA education infrastructure disintegrate, Palestinian students (the vast majority of whom are enrolled in PA schools) will scatter in all directions— including to Hamas-dominated *madrasas*. Reincorporating students, teachers, and administrators into a public school system will be no small task. More generally, the PA was designed as an agent to provide services to Palestinians. Should it collapse, a huge vacuum could emerge, and the ensuing instability would persist even if the aid spigot was turned back on.

**A breakdown in the security services.** Nonpayment of salaries is likely to lead to the attrition of government workers, including security personnel. More ominous, perhaps, is the prospect of the mutation of the security apparatus: an unpredictable realignment of security personnel around new centers of political power. These cells could turn into sources of new violence against both Israelis

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<sup>3</sup> “The Impending Palestinian Fiscal Crisis, Potential Remedies,” May 7, 2006, World Bank, Washington, DC.

and Palestinians. There are signs that this has already begun to occur in Gaza and parts of the West Bank.

### **Aid Sanctions and Hamas**

The Quartet's policy of aid sanctions has contributed to the weakening of the Hamas-led government. But it is not yet clear that the Quartet's strategy is having the intended effect with respect to Hamas' image in the eyes of Palestinian society. Indeed, rather than decreasing the party's popularity, the suffering caused by the crippled economy appears to be engendering public solidarity with Hamas and strengthening its base of support. Hamas does not appear to be any closer to the negotiating table than it was before aid sanctions were put in place.

If, alternatively, the Quartet's strategy is meant to drive Hamas out of the government entirely, then it is still too early to judge the impact of aid sanctions. However, should Hamas be driven from the government due to outside intervention, it would most likely erode the legitimacy of the PA and consequently strengthen Hamas' well-developed network of social and religious institutions. (There is even talk among Palestinians of dissolving the PA.) Furthermore, much has been made of the role of corruption in Fatah's downfall and in damaging Palestinian public support for the PA and negotiations with Israel. Ultimately, it was the Palestinian electorate who addressed corruption by ousting the incumbents. Quartet efforts to discredit Hamas need to be considered with this recent past in mind.

### **The Role of Israel**

The relationship between the international donor community and the Palestinians is unique in that a third party (Israel) is always involved in aid considerations. Donors should view Israel as a legitimate and needed participant in the process, not simply as an impediment. Israel has genuine and pressing security concerns, given its long history of vulnerability to attacks by its neighbors. Furthermore, Israelis and Palestinians have had mutually beneficial trade arrangements in the past, when the security situation has allowed. Greater understanding and closer cooperation with Israel can be more productive than the traditional polemics and recriminations when it comes to finding solutions to questions of aid delivery, economic development, and Palestinian access and movement. There is growing support within the Israeli national security establishment for improving cooperation with the international community, particularly in terms of delivering aid. This trend was in evidence during the extensive World Bank-Israel dialogue in 2004-2005. Deeper understandings could be reached through more dialogue.

But Israel is often of two minds when it comes to the Palestinian economy. Some members of the national security establishment acknowledge the correlation between radicalization and restrictions on access and movement. They view Palestinian economic stability as an imperative, and express a willingness to relax Israeli control as much as security will allow. But others believe that the economy can be used punitively, as an instrument of coercion. International aid is necessary, according to this view, so that

Israel itself will not have to shoulder the financial burden, but can still exercise exclusive control over access and movement.

In times of crisis, the traditional Israeli security perspective takes over and the impulse is to exercise as much control as possible, regardless of the price. Short-term security considerations present the temptation to tighten the grip on the Palestinian economy, but longer-term security imperatives suggest that Israel's security is inextricably tied to Palestinian economic growth. Moreover, Israel's posture toward the Palestinian economy is not unrelated to the settlement question. The intensification and formalization of the closure system offered all too many opportunities for Israel to expand settlements and preserve privileged access to them.

### **Potential Solutions**

There can be no resolution of the current political impasse without an end to the Palestinian fiscal crisis. Resuming Israeli revenue transfers is a necessary part of any solution, since the continuous flow of tax and customs revenue is a *sine qua non* of PA fiscal stability. But restarting these transfers will not be sufficient. Increased foreign assistance is essential to get the Palestinian economy to a level of stability sufficient to generate growth. This may also require an increased international presence, perhaps at trade crossing points (such as Karni in Gaza). Only when the fiscal situation is stabilized can the groundwork be laid for a full economic recovery, since the prospect of a robust and sustainable Palestinian economy depends on (largely foreign) investment—and investment depends on fiscal stability.

Still, all the foreign aid in the world will have little impact if the parties cannot agree on a way to end violence and renew the political process. Foreign aid can be a powerful and effective instrument to facilitate peacemaking and sustain peace settlements. But it is a limited tool, especially when aimed at trying to end an active conflict.

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