

Memo on State Building, Economic Development and Conflict Resolution: Insights from Palestinian state-building during the Oslo Period.

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Mushtaq H. Khan

The contemporary consensus on state-building in developing countries has built on a set of widely shared propositions that have come to be known as the 'good governance' reform strategy. There are general questions that I have raised elsewhere about the general applicability of the good governance approach for state reform strategies in developing countries (Khan 2004, 2006b, 2007). There are several common themes in this critique, which I build on in assessing state formation strategies in conflict and post-conflict situations, looking in particular at the experience of Palestinian state formation during the Oslo Period (Khan, et al. 2004).

The good governance agenda recognizes that states are critical for economic development and political stability and goes on to prescribe a set of state governance capabilities and functions based on a selective reading of New Institutional Economics and of political economy. If these governance capabilities and functions could be achieved, they would in theory ensure low transaction cost markets (and therefore economic efficiency that would in turn drive economic development) and political accountability to the majority, which would ensure political stability.

The key prescriptions of the good governance agenda are to develop state capabilities to ensure i) the protection of property rights to achieve minimal expropriation risk and stable expectations of investors, ii) institutional arrangements to reduce rent seeking and corruption, iii) political institutions to ensure political accountability and transparency.

These prescriptions are theoretically interconnected, drawing (selectively) on results of New Institutional Economics, New Political Economy and the neo-Weberian analyses of the state, particularly in Africa. Achieving accountability and transparency in political institutions is expected to reduce rent seeking and corruption, lower rent seeking and corruption is expected to stabilize property rights and thereby allow liberal market economies to perform more efficiently. Political accountability and the suppression of patron-client politics is expected to stabilize politics and result in the provision of efficient public goods, which in turn should help economic development.

The theory behind these propositions is plausible and the propositions are further supported by extensive cross-country regressions which tend to show that better scores on good governance indicators are correlated with better economic performance and lower poverty.

The argument against this reform agenda has a number of elements:

i) The good governance propositions are indeed widely supported. However, the coalition supporting it is mostly composed of those who support these objectives as *ends*, that is, goals that are desirable in themselves. But international agencies support

these goals as means to ends, based on a particular group of theories and evidence. There is no question about the desirability of these ends, but the theoretical adequacy and empirical verification of these objectives as the most important targets of policy is much more questionable.

ii) There are significant theoretical arguments, many of them consistent with New Institutional Economics, which show that many of these goals are unachievable to any significant extent in poor economies, certainly not to any extent that would make the economy sufficiently efficient for this to be the primary focus of governance reforms for economic development. In particular, stable property rights and a political process based on accountability that does not depend on patron-client networks assumes the existence of substantial fiscal resources to make these processes work. These are not available in any developing country.

iii) The empirical evidence is suspect because cross-country regressions are very inefficient in separating cause from effect. The cross-country results are to a large extent due to the fact that rich countries have better governance indicators, not because anyone has convincingly shown that rich countries became rich *because* they first introduced good governance and *then* achieved economic development.

iv) Case studies of developmental transitions in the last century (and indeed successful transitions that are going on right now) suggest that these successful transitions do not fit the good governance expectations.

v) This case study evidence suggests that some governance capabilities were very important for successful transitions, but these governance capabilities were very different from good governance expectations, and also differed from country to country depending on their initial political and economic structures and therefore the types of economic and political problems that were critical to resolve at the early stages of their transitions.

vi) At a general level, a number of observations can be made:

a) Political stability depends not on an abstract achievement of representation and accountability, but rather on how patron-client politics is organized. Patron-client politics is structural in poor countries. The difference between stable and less stable countries depends on whether their patron-client politics allows powerful constituencies to have an expectation of access to political power, sufficient to deter them from violence.

b) Rents and rent seeking are widespread not just in developing countries, but also in advanced countries, and economic and political stability depends on the details of the rents that the institutional structure protects and the incentives for managing these rents within that institutional structure. In developing countries, much of the rent seeking is difficult to legalize, resulting in a much greater share of corruption. For reform purposes, it is important to distinguish between different types of corruption and focus on removing the most damaging types.

c) Finally, the overall protection of property rights is generally not achieved till relatively high levels of development. In the meantime, economic development depends on institutional and political arrangements that allow the protection of critical property rights (both the rights of critical investors but also the rights of critical vulnerable groups).

vii) These insights can give a very different perspective for assessing the performance of institutional reform and governance in post-conflict and conflict situations. Palestine during the Oslo interim period shows the conflicting pressures that can be put on the recipients of aid and donor political support, to the extent that these expectations can have contrary effects on the sustainability of reform. These pressures not only contributed (we believe) to undermining the emerging Palestinian state formation process, but also took our eyes off the real political conflicts that were obstacles to peace-building in the Middle East.

viii) An alternative assessment of the Palestinian National Authority (PNA) operations suggests that it was reasonably effective in establishing political order and organizing economic development. It was arguably on the way to constructing a viable developing country state if political progress on conflict resolution with Israel had been successful.

i) Political stabilization through the patron-client networks of the PLO and Fatah was remarkably successful in maintaining internal political peace and support for the peace process. Peace is a relative term in a conflict situation, but while there were occasional acts of violence on both sides between 1994 and 2000 (including the assassination of the Israeli Prime Minister by an Israeli), violence on the Palestinian side at no point threatened the viability of the PNA or its commitment to achieving a two-state solution.

ii) The PNA's control of rents and the capacity to create rents for Palestinian investors led to an investment boom in the tourism sector in particular, but also in telecommunications. Rents compensated for the otherwise non-existent property rights for investors in a war zone *before* borders or sovereignty for the Palestinian state had been established. Economic growth was relatively high, as was evidence of real investment in hotels, tourism infrastructure and in communication infrastructure.

iii) The PNA experience underlines in an extreme form the difficulty of establishing stable property rights in developing countries, but particularly in disputed territories and in conflict situations. However, rent creation and rent management can paradoxically still attract investors looking to establish first mover positions in these contexts.

The peace process was aborted not because the governance structures of the nascent Palestinian state were inappropriate for economic development and political stability, but because the zero sum conflict between Palestinians and Israelis could not be mediated by international organizations in a way that could lead to a reasonably just resolution of this conflict. The failure to make progress did eventually undermine the Fatah leadership and result in their growing isolation and eventual defeat in Gaza, and this appeared to confirm the international assessment that the Palestinian leadership had lost the confidence of its people because of its poor governance record.

This assessment has had and will continue to have serious consequences for the peace process and for establishing a viable Palestinian state. The incoming Palestinian leadership under Mahmood Abbas carried out far-reaching governance reforms under international pressure, including making budgetary allocations completely transparent, getting rid of many of the rents that had characterized the previous regime and taking a public stand against corruption (without of course succeeding in any significant reduction of corruption). None of these reforms helped the Palestinian

Authority, and if anything contributed to the economic and political collapse of the Palestinian Authority, further helped by the blockade imposed on the Palestinians because they voted for the wrong side in the elections of 2006.

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