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Palestine Economic Policy Research Institute

Enhancing The Capacity of the Palestinian Economy

Palestinian-Israeli Economic Relations: Reality and Future Prospects

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Summary

The paper explores three themes related to economic relations between Israel and the Palestinian Territories. The first theme analyzes economic relations between the two parties prior to and following the peace process. The second examines the economic consequences of a unilateral separation imposed by Israel. The third explores the prospects for future relations reached through negotiations.

Chapter I: Economic Relations Prior to and Following the Peace Process

The first chapter emphasizes the need to identify an appropriate theoretical framework with which to analyze Palestinian-Israeli economic relations. There are two important features: the relationship between a wealthy, advanced economy and a poorer weak one and between a colonialist state committed to expansion and a third world people struggling for an independent state free from occupation.

Both theoretical analysis and empirical studies suggest that the dynamics of the first relationship always generate two opposing forces that disproportionately affect the smaller economy and shape its development. A favourable repercussion is an increased demand for the products of the small economy, a diffusion of technology and knowledge, as well as other spread effects resulting from the geographical proximity to a large market that leads to subcontracting, joint ventures, and coordination in tourism and other services. Unfavourable repercussions arise from the disappearance of many industries in the small economy, its confinement to producing low-skill goods, and the emigration of a sizeable segment of its labour force to the neighbouring economy, as well as to other countries. These effects are termed as backwash or polarization effects, arising from the capability of efficient, large-scale industries in the advanced economy to out-compete inefficient small-scale industries in the less advanced economy and attract its labour and capital.

From the perspective of the small economy, therefore, the crucial question is the balance of the dynamic impacts. To what extent would they help its development or reinforce underdevelopment?

Had economic relations between Israel and the Palestinian Territories been confined entirely to the dynamic forces described above, the positive

spread effects would probably have dominated the adverse polarization effects by the end of the second decade of occupation. The higher cost of living in Israel and the external diseconomies produced by congestion would have outweighed the benefits of greater efficiency and given way to increased investment in the Palestinian economy. Increased economic activities in the Palestinian Territories would then have gradually corrected the distortion in the labour market by reducing the number of Palestinians seeking daily work in Israel. The spread effects would have certainly asserted themselves and generated a process whereby Palestinian income was created endogenously in internal productive sectors rather than externally.

Instead, the relationship between the two economies has followed quite a different path. The Palestinian economy benefited significantly from its relationship with Israel in the first decade but the relationship became detrimental thereafter. In the first decade, Palestinian GDP per capita grew from nine per cent of that of Israel to fifteen per cent. However, the ratio then declined continuously and at the start of the limited self-rule was almost at the level of a quarter of century before. This is also evidenced from the increase in the resource gap in the Palestinian economy presented in the following:

1. The import surplus (imports-exports/GDP) increased from 34% in 1968 to 39% in 1990, and to 65% in 2000.
2. The investment surplus (investment-savings/GDP) was 43% in 1968 and declined to 5% in 1990, increasing again to 36% in 2000.
3. The ratio of GDP to GNP declined from 107% in 1968 to 75% in 1990 and was 87% in 2000. This points to the decline in Palestinian productive sectors and growing reliance on the Israeli economy, which employs approximately 25% of the Palestinian labour force. The reason for this reversal is that the economic relationship between the two economies was not confined to the working of the polarization and spread effects operating through the market. It was also subject to the colonial policies of Israel from the start of occupation, which increased in intensity and aggressiveness in the mid-1970s. These Zionist policies circumvented market forces, bolstering the effects of polarization and diminishing the spread effects.

These policies and practices include the following measures:

1. The Israeli authorities implemented many different and complex measures and policies to place the largest possible area of land and the maximum amount of water under Israeli control. By the time

Palestinian limited self-rule was established, it is believed that Israel had confiscated half of West Bank land and one third of Gaza Strip land. It controlled 75% of Palestinian water resources and 85% of their productive supply. There were 192 new Jewish settlements built on Palestinian land (28 in Jerusalem, 148 in the West Bank, and 18 in the Gaza Strip).

2. In addition to removing land and water from Palestinian control, the Israeli authorities followed a general practice aimed at changing the demographic structure. The Jewish population in East Jerusalem increased from zero in 1967 to more than 50% by 1993. Over the same period, the population of Jewish settlers in the West Bank reached 176,000.

3. Israeli policies have aimed to weaken the structure of the Palestinian economy. All economic activities were placed under the scrutiny of the Israeli military administration and every economic undertaking required its approval. Plans by Palestinian businessmen to start new ventures or expand existing ones were often frustrated by delays or refusal in granting the appropriate permit. Permits were required for all activities related to the acquisition of land, the construction of buildings, the transformation of goods, and export and import activities.

   While these measures distorted incentives and increased the risk to business activities, investment was further discouraged by the underdevelopment of effective financial intermediation in the Palestinian economy. This was reflected in the fact that all Arab banks were closed at the beginning of the occupation and only reopened on a very small scale in the mid-1980s.

   Another important restriction was related to technological change and modernization. The Israeli authorities did not permit Palestinian firms to import machines and tools incorporating up-to-date technology. Instead, they were compelled to buy second-hand machines from Israel.

   It should also be noted that the customs union arrangement imposed by Israel on the Territories, was, in effect, an asymmetric trade scheme. It allowed Israel's own heavily subsidized products free entry into Palestinian markets but prevented the entry of Palestinian products into the Israeli market, except on a selective and limited basis. This asymmetric trade relationship, combined with complex administrative procedures aimed at discouraging Palestinian exports internationally, made Palestinian trade completely dependent on Israel. The fact that 90 per cent of all Palestinian imports come from Israel presents one side of this forced dependency. The other side is shown in the fact that Palestinians pay for these imports partly by exporting labour services to Israel and partly by exporting goods manufactured under subcontracting arrangements with Israeli firms.

4. The forced integration of the Palestinian economy into that of Israel was associated with a transfer of resources from the former to the latter. Three channels were involved. First, Palestinians paid VAT and customs duties on products imported from Israel. It is estimated that half of the taxes paid by Palestinians in the Occupied Territories accrued to the Israeli Treasury via this route. The second source is the income tax and social security contributions paid by Palestinians working in Israel. The third was the seigniorage revenue Israel received as its currency was made legal tender in the Occupied Territories. These resource transfers total a large sum which, according to some estimates, has reached in any given year from 15 per cent to a quarter of Palestinian GNP. Given that Israel was not prepared to undertake public expenditures in the Occupied Territories beyond the tax revenues actually raised there (as opposed to those paid by Palestinian consumers and workers but collected in Israel), all public infrastructure in the West Bank and Gaza Strip has fallen into a very poor state and the level and quality of public services and utilities is far below that of neighbouring countries The poor condition of basic infrastructure and public services causes market fragmentation, inhibiting specialization and the realization of economies of scale that are essential for a small economy to be competitive.

   The cumulative impact of these restrictions on resource use, business activities, and domestic and international trade has substantially weakened the traditional productive sectors of the Palestinian economy. This has caused a general reallocation of factors of production, combined with the reorientation of trade flows, to the benefit of Israel. As a consequence, a major structural transformation of the Palestinian economy has taken place. It has become an economy characterized by two growing disequilibria: a resource gap and labour market imbalance, and a large and unhealthy dependence on external sources of income. It also features sectoral disarticulation and an infrastructure gap.

The gradual establishment of Palestinian limited self-rule in parts of the West Bank and Gaza Strip was the result of the implementation of several agreements between Israel and the PLO. There was a transfer of power over some economic affairs from the Israeli Civil Administration (CA) to the Palestinian Authority. This included the removal of direct restrictions on business activities: Palestinian firms could now function without the crippling effects of permits and licenses previously required by the CA. Notwithstanding the importance of this, some of the indirect restrictions remained, including the treatment of indirect taxes and tariffs on consumer durables from neighbouring Arab countries.

The asymmetrical customs union regime that characterized the economic relationship between Israel and the Occupied Territories changed in two directions under the limited self-rule. First, many elements in the asymmetry were removed. In principle, Palestinian goods should receive the same treatment in Israel that Israeli goods receive in Palestine. Second, some elements of a free trade area regime were introduced. The PA was given the freedom to choose its own tariff rates on three lists of goods, including goods imported from or through Jordan and Egypt.

While the monetary arrangements during the transitional period represent an improvement over those of the occupation, they are certainly not optimal. Arab banks reopened and new ones were established, monitored by the Palestinian Monetary Authority (PMA), which has some of the functions of a central bank but not the right to issue national currency. The Israeli currency (the shekel) and the Jordanian currency (the dinar) are used as legal tender. Thus, the monetary arrangements combine some of the worst aspects of two polar-type exchange rate regimes. The absence of a national currency renders monetary policy ineffective, as in a fixed exchange rate regime. On the other hand, the existence of a two-currency standard has the potential to increase those costs associated with fluctuations in exchange rates typical of a flexible exchange rate regime. In addition, a dual currency tends to reduce the ability of commercial banks to perform their function of transforming debt maturities because of the problem of currency mismatching inherent in portfolios. This discourages them from extending long-term loans, which are essential for investment and growth.

Under the limited self-rule, some of the resource transfers to Israel have been eliminated. Seventy five per cent of the income tax collected from Palestinians working in Israel and 100 per cent of the income tax collected from those working in Jewish settlements should be reimbursed to the PA.

Israel is also required to transfer to the PA all VAT on goods purchased in Israel by Palestinian firms. However, the resource transfer from the Palestinian economy to the Israeli economy has not been eliminated. Palestinian imports from the rest of the world, which must pass through Israel, still generate customs duties to Israel that are not transferred to the PA. This happens because Palestinian wholesalers and firms use Israeli traders to import from the outside world. A common practice of these traders is to include Palestinian imports as part of imports destined to Israel (not the West Bank and Gaza Strip). Accordingly, customs paid by Palestinians on these imports accrue to Israel and are not transferred to the PA, as is the case with Palestinian imports from Israel destined to the West Bank and Gaza Strip. Obviously, there is no precise way of measuring the exact size of this forgone revenue but recent studies have estimated it to be around one-third of total tax revenue and around three per cent of Palestinian GDP. It should also be noted that Israel still collects seigniorage revenue since its currency remains legal tender in Palestinian areas.

> *The most important feature of the limited self-rule is related to sovereignty and natural resources. In the Declaration of Principles (DoP) it was agreed that there would be no change in sovereignty over land, water, and settlements during the transitional period, these issues being left for negotiation as part of the final settlement. Consequently, the restrictions imposed on Palestinian use of land and water remain completely intact. The substantial restriction on the use of irrigation water in the West Bank and the diversion of water from aquifers for use in Israel and its settlements will continue to harm Palestinian agriculture and prevent serious attempts to expand and diversify crops.*

The Israeli authorities retain full control over all borders, which implies control over the movement of labour and goods between the Palestinian Territories and the outside world. Furthermore, the conditions under which the limited self-rule has been implemented have caused geographic segmentation with harmful economic effects. According to a World Bank report, the new situation:

> *'split up the West Bank and Gaza into a number of largely separate economic units with little economic interrelationship among them, breaking up an already small domestic market into even smaller ones'.*

Furthermore, the awkward arrangements of the limited-self rule have created a multidimensional uncertainty that is discouraging to both domestic and foreign investment. A prospective investor can obtain a license to start a business from the PA but bringing capital, goods, and people for that investment from outside needs the approval of the Israeli authorities. The investor has to operate without any knowledge of the future trade and monetary arrangements. How easy will it be to export to Arab countries, the European Union (EU), or the United States? Will there be a Palestinian currency and foreign exchange controls?

Yet, these aspects of Israeli control are not the most crippling of the limited self-rule. The most severe blow of the interim period has been the continued building of new Jewish settlements and the expansion of existing ones. The growth of settlement activities since the signing of the DoP in 1993 is an unambiguous indication that the peace process, as exemplified by the limited self-rule, did not address the root of the problem; the ongoing Israeli infringement of Palestinian sovereignty. According to Israeli sources, the number of Jewish settlements in the West Bank doubled during the period of limited self rule (1994 – 2000).

The steady deterioration of the Palestinian economic situation, the building of new Jewish settlements and the expansion of existing ones, together with the failure of the American-sponsored conference at Camp David to reach an agreement, combined to heighten the Palestinian sense of frustration, anger, and helplessness. On 28 September 2000, an Israeli provocation created the spark that inflamed the Palestinian popular uprising (*Al Aqsa Intifada*).

Since the beginning of the *Intifada*, Israel has imposed a total closure on the Palestinian Territories that has caused serious dislocation of the Palestinian economy with huge losses of income. Closures comprise two types. Under border closure, Palestinians are not allowed to enter Israel (including East Jerusalem) or travel to Jordan and Egypt, effectively isolating them from the rest of the world. Under internal closure, Palestinians are not allowed to move between urban centres within the West Bank or to and from the surrounding villages. The imposition of these two types of closure for long periods since October 2000 has turned the Palestinian Territories into small isolated islands surrounded by the Israeli army. It has also hampered the movement of goods and factors of production, causing losses to the Palestinian economy of between US $1.8-2.5 billion in the first eleven months according to UN estimates. Losses include declining incomes from Israel (accounting for around 20 per cent of total losses) as well as a decline in most domestic sectors. In addition, indirect losses involving the destruction of infrastructure are estimated at well over US $200 million for the first six months of the *Intifada*. Unemployment grew rapidly to 30-40 per cent in the West Bank and well over 50 per cent in the Gaza Strip. The spread of poverty has reached an alarming level. It is estimated that in August 2001, 60.8 per cent of households, or 2.03 million individuals, were living below the poverty line (US $2.10 per person per day). In the Gaza Strip the situation was more acute with 81.5 per cent of households reporting an income below the poverty line compared to 50.3 per cent of West Bank households.

The economic situation took a drastic turn for the worse in March-April 2002 when the Israeli army reoccupied most of the West Bank and imposed total curfew on the inhabitants of major cities.

Chapter II: Unilateral Separation by Israel

The second chapter examines the 'concept of separation' as evolved by the Israelis over the last three decades. The concept is vague and is not associated with any single political party or faction. The motivation for separation varies according to the period and the different proponents but includes security, economic, cultural, and religious considerations. Supporters and detractors are drawn from all political parties, from the extreme right to the extreme left. However, none of the programs for separation were adopted over a quarter of a century by any Israeli government as interest always faded once security conditions improved and relative calm set in. Also, settlers and some important elements of the Israeli right harbour the fear that separation may lead to the establishment of undesirable permanent borders. It should also be noted that, generally speaking, the concept was looked at as demographic rather than geographic in nature. The idea was to confine the Palestinians inside their territories and control their movement to and from Israel while at the same time maintaining the flow of Israeli goods to the Palestinian market and the flow of cheap Palestinian labour to Israel.

Following the *Al Aqsa Intifada*, separation has become the adopted policy of the Israeli government with the geographic dimension at its center. The Sharon government is currently using the separation concept as an instrument to implement the Likud plan for a final settlement with the Palestinians. It has already carried out the following:

1. In the Gaza Strip, the Israeli army has started the construction of a border fence and bypass roads around three settlements in the north. It is constructing a bridge to separate Israeli transport from that of Palestinians.
2. In the West Bank, construction of the 'Separation Wall' is continuing at a rapid pace. The wall should be 350-400 km and, rather than being built along the Green Line, it is erected inside Palestinian land and involves the annexation and confiscation of large areas of West Bank land. It also separates Palestinian farmers from their land and deprives them of water resources. At the same time, the construction of bypass roads to circumvent Palestinian towns and villages and link Israeli settlements to each other and to Israel proper has continued.
3. In Jerusalem, the Israeli government is continuing its policy of separating Jerusalem from the rest of the West Bank. It is constructing a ring road around the city that will connect Israeli settlements in the southern part of Jerusalem with those in the northern part, as well as connecting the Jerusalem settlements with the coastal area of Israel. The government is also planning to annex Rachel's Tomb to Jerusalem. This plan will swallow a huge chunk of Palestinian land and will present a terrible blow to Bethlehem's tourist industry.

The separation plan as implemented by the Sharon government serves the purpose of dividing the West Bank and Gaza Strip into isolated 'bantustans'. Its ultimate aim is to destroy Palestinian goals of national freedom and independence.

Chapter III: Prospects for Economic Relations with Israel reached via Negotiation

Negotiations with Israel are likely to deal initially with reaching an interim agreement on the withdrawal of the Israeli army from the Palestinian Territories and later to reach a final settlement to the conflict. Regarding the former, the following points demand a high priority:

1. Any future economic agreement should stand in its own right and should not be tied to security issues. This should include a guarantee of free movement of people and goods under any circumstances.
2. The agreement should have a well-defined, effective mechanism for its implementation.
3. The agreement should have a provision for a third party to act as arbitrator.

4. The agreement should specify the number of Palestinian workers allowed to work in Israel and assign the security issue related to this matter to the PNA.
5. The agreement should give the Palestinians full control over foreign investment in the Palestinian Territories and allow the PNA full control over economic relations between Palestine and the rest of the world.
6. The agreement should forbid Israel from dealing with individual Palestinians and confine its contacts to the appropriate ministries of the PNA.

Regarding the later negotiations, the following points are very important:

1. Full control by the Palestinian state over borders, airports, and seaports.
2. Removal of all settlers from the West Bank (including Jerusalem) and the Gaza Strip.
3. The present customs union arrangement between the two sides is detrimental to Palestinian interests. A non-discriminatory trade policy (NDTP) arrangement would serve Palestinian interests better, allowing for the diversification of trade and the gradual integration of the Palestinian economy into regional and world markets. It would also allow the Palestinian state to pursue an independent development plan.

It should be emphasized that any change to the existing economic conditions that favor Israel cannot be implemented simply by signing a new agreement altering institutional relations with Israel. Real change comes from certain achievements to expand the capacity of the Palestinian economy. In this regard, the following have high priorities:

1. The adoption of a comprehensive reconstruction and development program aimed at dismantling the negative economic legacy of the occupation.
2. The creation of a customs administration to operate border controls and facilitate trade.
3. The creation of institutions to help the private sector to successfully compete in neighbouring and world markets.
4. The development of a tax administration to pursue an independent tax policy in accordance with the stage of Palestinian development.
5. The strengthening of economic relations with neighbouring Arab countries.