



Palestine Economic Policy Research Institute

Enhancing The Capacity of the Palestinian Economy

Requirements for Developing Palestinian-Arab Economic Relations

Omar Abdel-Razeq

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- ♦ Bridging the gap between research output and the policy and decision-making process through applied socio-economic research to assist in the formulation of rational policies and appropriate legislation.
- ♦ Identifying developmental challenges and priorities and enhancing applied research.
- ♦ Providing technical support to PNA bodies (executive and legislative), the private sector, and NGOs to enable them to function more effectively and enhance good governance.
- ♦ Promoting the participation of civil society institutions in socio-economic policy formulation and decision-making.
- ♦ Broadening public debate on socio-economic issues and ensuring oversight of public performance.
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Summary

This study aims to provide a practical framework for the development of Palestinian-Arab economic relations that will benefit all the relevant parties. It is hoped that this will assist in achieving the strategy of:

1. Enhancing the ability of the Palestinian economy to support resistance to Israeli policies;
2. Reducing Palestinian economic dependence on the Israeli economy and rectifying the distortions that have plagued the Palestinian economy as a result of this dependency;
3. Developing Palestinian-Arab economic relations.

If these goals were to be achieved, it would mark an important step towards sustainable Palestinian development and strengthening Palestinian ability to counter Israeli policies and measures. The Palestinian economy would return to its origins rooted in the region, the Arab economies. This step needs to take place irrespective of calculations of material gains or losses that may result from the redistribution effects of integration since the integration of the Palestinian economy into the greater Arab economy is primarily based on national considerations.

It is assumed that the Arabs and Palestinians are convinced of the importance and necessity of developing economic relations between them to achieve required integration. The study also assumes that Arab support for the Palestinians aims to strengthen the Palestinian economy (through development aid) and reduce the persistent problem of unemployment resulting from the Israeli policy of siege. Another assumption is that Israeli-Palestinian economic relations will continue to suffer as a result of Israeli hostilities, whether current conditions prevail or whether the situation reverts to pre-Intifada days. This third assumption means that Israel will continue to implement policies that deprive the Palestinian economy of the spread effects of the special economic arrangement with the Israeli economy.

Different stages of time are discussed in the study. There is the present stage in which the prevailing conditions, particularly the Israeli siege and aggressive acts against the Palestinians and their economy, continue. It is assumed that the main Palestinian goal at this stage is survival and economic and political perseverance. The second stage assumes the redeployment of Israeli troops to the positions they occupied prior to

September 2000. It is assumed that multi-purpose negotiations between Palestinians and Israelis will be conducted at this stage, as was the case prior to the Intifada. We also assume that the negotiations will oscillate between Israeli stubbornness and Palestinian hopes of American pressure on Israel to concede to some Palestinian rights. Palestinian economic strategy at this stage would be assumed to concentrate on correcting distortions in the Palestinian economy by strengthening the Palestinian economy and developing Palestinian-Arab economic relations. This second stage should last until the establishment of an independent Palestinian state.

This study complements two other studies conducted simultaneously at MAS - one discussing ways and means of enhancing the Palestinian economy and the second on economic relations with the Israeli economy.

This study consists of an introduction and two further sections. The first section provides a theoretical background to economic integration and how it relates to the Palestinian economy. The second section deals with different aspects of Palestinian-Arab economic relations and how they might be developed. The study uses the results of a number of research papers conducted at MAS dealing with various aspects of the Palestinian economy within a major research project conducted for this purpose.

The study points out that literature on integration has concentrated on traditional forms and their static gains and losses. Although this might be suitable for integration between developed economies, it is not appropriate for a relationship between a large, developed economy and a weak, undeveloped one as in the relationship between the Palestinian and Israeli economies. Traditional analysis of integration has concentrated on the positive effects, referred to as 'trade creation', and the negative ones, named 'trade diversion'. Analysis of integration between developed and undeveloped economies adds the 'spread' and 'polarization' effects. The first consists of the transfer of technology and know-how from the developed to the undeveloped economy, promoting growth and thus raising income levels. However, the polarization effects consist of the transfer of factors of production (labor and capital) from the undeveloped to the developed economy because of higher wages and higher investment returns. This causes the deterioration of productive sectors in the undeveloped economy (industry and agriculture) in favor of service sectors, especially wholesale and retail sales, due to the increase in imports by the undeveloped economy from the developed one.

In addition to the economic aspects of integration, direct and indirect political and social incentives and goals usually influence decisions relating to integration between nations and economies.

The Palestinian case is a special one since the Palestinian economy requires integration for both economic growth and sustainable comprehensive development. The Palestinian economy is very small (in all respects); in addition to the small population (about 3 million in the West Bank and Gaza Strip), it suffers from low levels of capital and technology. Another distinction of the Palestinian economy is the fact that its resources (human and natural) are under Israeli occupation. Israeli policies imposed on Palestinian foreign trade since 1967 have diverted trade to the Israeli economy at higher prices. Despite the increase in Palestinian per capita income, Israeli policies resulted in an increase in Palestinian imports from or via the Israeli economy, undermining the role of Palestinian industry and agriculture in employment and income generation. Israel has succeeded in minimizing Palestinian gains from the spread effects and maximizing Israeli gains (Palestinian losses in the form of distortions and in Israeli exploiting Palestinian resources) from the polarization effects.

As the Madrid (and later the Oslo) process started, the Israeli and official Arab media marketed the “New Middle East” as an economic paradise to persuade the people of the region (specially the Palestinians and Jordanians) that the new political relations would result in economic prosperity. This was to occur through the spread effects, combined with Arab capital, bringing about significant development in the Palestinian and other Arab economies. Most of the analysts, and politicians who promoted that scenario ignored the polarization effects, in addition to their assumption that Israel would cease its measures against the Palestinian economy once the political settlement was signed. These assumptions lead to the conclusion of the Oslo political agreements (with its multiple names: Oslo 1 and 2, Cairo, Taba, etc.) and the Paris Economic Protocol with all its faults and problems. During the interim period, the erroneous nature of these assumptions about the economic effects of the agreements and the misconceptions of Israeli behavior and strategy were exposed. Israel did not alter its strategy towards the Palestinians and their economy. It continued the policy of siege and measures aimed to deprive the Palestinian economy of its resources and whatever benefits might result from the spread effects. This appears to have made Palestinian officials and analysts change the way they view future economic relations with the Israeli economy, moving towards reducing relations with Israel and enhancing Palestinian-Arab economic relations.

The high degree of similarity between the Palestinian and the Arab economies is an encouraging factor despite the short-term competitive structural changes that will take place. The Palestinian economy, it is now agreed, badly needs structural changes in order to develop and to rectify the distortions caused by its long dependence on the Israeli economy. The similarity in import structures points to the possibilities of success in import substitution projects due to the increased market size. The study shows that Arab markets are able to absorb most Palestinian exports. Similarities in export structure provide investment opportunities in marketing, promotion, and research into common international markets.

Poor achievements in Arab economic integration have been blamed on the lack of political will or administrative follow-up, in addition to neglecting production specialization in favor of facilitating trade. These should not be used as excuses for not integrating the Palestinian economy with those of the Arab world. The Palestinian economy has a choice between integration with the Arab world or continuing the distorted relationship with the Israeli economy. Special conditions granted to the Palestinian economy by its Arab partners would allow the integration process to bypass the traditional and political obstacles that have delayed Arab economic integration. In addition, the Palestinian economy has assets that would benefit the Arab partners, including a relatively high per-capita income, a tendency towards a large amount of imports relative to GDP, and the need for investment for reconstruction and to achieve social and economic developmental goals.

Claims that switching Palestinian economic relations from the Israeli economy to the Arab world will result in the loss of spread effects, especially those relating to the transfer of technology and skilled workers, can be responded to by four points. First, what is being suggested here is a reduction of relations with Israel and not their cessation, which is not possible in the foreseeable future. As a result, the Palestinian economy will continue to receive some of the spread effects as long as this process is not hindered by Israel. Second, the entire world has been moving towards trade liberalization and freedom and, therefore, the Palestinian economy can obtain technology from other international sources. Third, the problem of the Palestinian economy has been the structural distortions caused by dependence on the Israeli economy and not the lack of technological knowledge. Finally, integration with the Arab economies, which are open to the world in some degree or another, will not hinder Palestinian (or Arab) ability to import the technology they need. On the contrary, it might enhance their ability through the reduction of costs due to bulk imports.

Fears regarding the future of Palestinian industries or agricultural products exposed to competition from cheaper Arab partners can be mitigated by realizing that the Palestinian economy now has an opportunity to integrate gradually and to obtain exceptions for some products. Moreover, integration with the Arab world will enable the Palestinian economy to obtain raw materials at lower cost, thereby reducing the extent of the problem. In the long run, integration should reduce structural distortions and lower costs. Some support and compensation schemes can be adopted to help reduce the adjustment costs of the industries affected.

The study presents various areas in which the Palestinians might be assisted during the current stage. Assistance is required for employment schemes and also for the production of goods, services, and capital goods (economic and social) that meet some of the urgent needs of the Palestinian people. Attention should be paid to the goals of the next stage and an independent Palestinian state in order to achieve as much harmony as possible between current and future stages. At the same time, it is crucial for relief programs to continue to save the most needy Palestinians from starvation. However, these programs should concentrate on using locally produced products rather than imported goods.

Areas currently requiring assistance include:

1. Reconstructing what has been destroyed under Israeli occupation, including infrastructure, private and public buildings, farms and agricultural lands, factories, and craft works.
2. Maintaining the emergency relief program for the most needy of the population and helping others through alternative programs.
3. Repairing public utilities that provide essential basic services, including electricity, water, and phone networks.
4. Purchasing primary (traditional) Palestinian agricultural products, including olive oil, citrus fruits, grapes, and some vegetables.
5. Implementing housing projects that will assist in the employment of Palestinians, many of whom lost their jobs in the Israeli construction sector.
6. Providing funding to finance industrial projects that would employ workers who have lost their jobs as a result of recent Israeli hostilities. This could be successful if the resulting products were marketed in Arab markets in accordance with the resolutions of the 2001 Amman Summit.
7. Supporting social services, including health and education, to ensure they meet the requirements of Palestinian society.

The study reviews the major aspects of Palestinian-Arab economic relations, including the legal and institutional framework, the movement of goods and services, labor relations, investment opportunities, and infrastructure.

The Legal and Institutional Framework

Other studies have reviewed economic and trade agreements between the Palestinian economy and those of the Arab world and the possibilities of the Palestinian economy joining the Greater Arab Free Trade Area. The agreement between the PNA and the Jordanian government was used as representative of all Arab-Palestinian agreements since they all have a great deal in common. The agreement was then tested against a model of seven general criteria and five special criteria.

The general criteria included principles and features found in most international trade and economic integration agreements. These include market access, most favored nation treatment, national treatment, exchange of information and transparent regulations, good faith in interpreting the articles of the agreements, the principle of reciprocity, and the rules of exceptions. The special criteria included features relevant to Palestinian economic and political goals at present, including enhancing Palestinian sovereignty, the diversification of trade partners and reduction of trade with Israel, job creation, encouraging exports and investment, obtaining recognition of the existing distorted development status, and the relevance of the agreement to public revenues. The evaluation results were disappointing in that no special treatment was granted to the Palestinian economy, not even equivalent to that given to Israel in its agreement with Jordan.

This study recommends that Palestinian-Arab economic agreements be improved by the following four means:

1. **Recognition of the Distortions in Palestinian Development**
It is crucial for Palestinians to convince their Arab partners of the distortions plaguing the Palestinian economy due to its long-term dependence on the Israeli economy. The Israeli occupation did everything possible to sever the Palestinian economy from the Arab world and tied it to its labor market and foreign trade domain. As a direct result, a large portion of Palestinian public revenues is generated via economic ties with Israel, much of it collected by the Israeli authorities and therefore providing Israel with an additional lever with

which to apply pressure for achieve political concessions. The study offers three suggestions to overcome the problem of convincing Arab partners of the Palestinian situation:

- ✧ Emphasis must be placed on the important goal of strengthening Palestinian ability to withstand Israeli ambitions. The Palestinians should stress that the Arab world has national and religious responsibilities that form a reasonable basis for continued support for the Palestinians. However, this support should be allocated on the basis of a strategic Palestinian plan that facilitates the integration of the Palestinian economy with those of Arab economies.
- ✧ An agreement supporting the Palestinians should be made between the Palestinian economy and the Arab world. The basis of this agreement should be free trade for goods and services, the free movement of capital, national treatment of investments by both parties, and controlled access for Palestinian workers to the markets of the oil-producing countries in a manner that does not jeopardize the political goal of maintaining a presence on Palestinian land.
- ✧ The establishment of a special fund to support the implementation of the aforementioned agreement. Despite the considerable opportunities for Palestinian-Arab trade and for all parties to benefit, some obstacles will hinder the integration process. Since the political, social, and economic interests of the Palestinians and Arabs are in harmony, a mechanism must be made available to resolve any obstacles. Potential obstacles include competition of goods and services in the other party's markets and losses incurred by some industries and groups due to competition from the new goods and services. The proposed fund should provide resources to resolve any obstacles, compensate for losses, and support the restructuring of the Palestinian economy.

2. Applying Recognized General Principles

Any Palestinian-Arab agreement(s) should include all general principles like those of most favored nation, and national treatment of goods, services, capital, investments and Palestinian workers (controlled movement). The Palestinian economy would therefore become an intrinsic region of the Arab economy.

3. Exceptions and Privileges

The Palestinian economy should be granted the exceptions and privileges necessary to allow it to overcome its distortions within a

reasonable period of time. It appears that the best alternative is to grant the Palestinian economy some privileges, including support programs for Palestinian export-production processes (specially agricultural products) in order to enhance competitiveness in Israeli, Arab, and other international markets. This is in addition to the exceptions that are usually granted, including allowing a period of protection because the Palestinians will be unable to apply such protection to their economic ties with the Israeli economy.

4. Influencing Arab-Israeli Agreements

Some Arab countries (Egypt and Jordan) have signed political and economic agreements with Israel while other countries have some form of economic cooperation or protocol without a political agreement (Qatar, Tunisia, Morocco, Oman). Some of these agreements have serious effects on the Palestinian economy and its relations with Arab economies yet these Arab countries maintain the agreements nevertheless. The Palestinians should maintain a high level of cooperation with these countries to ensure that their relations with Israel do not harm Palestinian economic interests.

The Greater Arab Free Trade Area (GAFTA)

This study summarizes the main findings of an earlier study conducted at MAS (Suleiman, 2002) relating to the possibilities of the Palestinian economy joining GAFTA and reviewing the related obligations and privileges. The main results of that study are as follows:

Palestine will be granted special status in recognition of the distorted nature of Palestinian development. This classification enables Palestine to obtain a number of privileges and specific exemptions from obligations. Palestinian options can be summarized into three alternatives: not joining GAFTA, joining now despite current conditions, or joining once an independent state has been established. Suleiman suggests that Palestine should join now to obtain the benefits while delaying the application of obligations until independence. Suleiman suggests that the interim period ended in 2000, when the negotiations on the final status issues started, thus Palestinian-Arab relations should not be hostage to limitations of the Paris Protocol. Moreover, the PNA can and should abide by all the obligations. If there should be a waiver, it should not be tied to independence but to a limited number of years (5–10). Finally, this study suggests that Palestine be granted privileges rather than exemptions because the situation does not allow for the traditional protection usually granted under the exemptions.

The PNA should prepare a detailed plan of the special treatment required by the Palestinian economy for presentation to GAFTA.

Trade Relations

Many factors contributed to the performance of Palestinian international trade, which has been increasing steadily both prior to and following the Paris Protocol. Israeli political, economic, and security measures were the most important factors determining the size of Palestinian international trade and its geographical distribution. The Paris Protocol reiterated the Palestinian-Israeli economic relations prevailing at the time. In addition, PNA trade activities and trade and fiscal policies played an important role in the performance of Palestinian trade. The structure of the Palestinian economy and its dependence on that of Israel following 1967, provided a strong incentive for the relationship to continue, especially business ties and common investments, and this hampered the expansion of relations with the Arab world. Of course, the obstacles facing intra-Arab trade, including a high level of protection and political problems, apply to Palestinian-Arab trade, especially as the Arabs stopped giving Palestinian goods special treatment following the establishment of the PNA and lifted the Arab boycott of Israel.

Some studies have estimated the potential trade between the Palestinian economy and Arab economies, pointing to the possible commodity groups that could be traded. Despite the static nature of these studies and their assumption that structures would remain the same after commencing free trade with the Arab economies, they highlight the huge opportunities for Palestinian-Arab trade. They estimated the size of Palestinian commodity trade with three Arab markets (Jordan, Egypt, and the Gulf), comprising about 50% of the overall Arab economy, at about US \$2400 million. Of this, about US \$720 million would be Palestinian commodity exports and about US \$1680 million Palestinian commodity imports, comprising about 61% of overall Palestinian commodity imports and about 117% of overall Palestinian commodity exports (compared to 1999). In addition, the studies pointed out that Palestinian service trade with the Arab economies would develop along with commodity trade. In the meantime, (in normal situations) Palestinian service trade is estimated at \$740 million, with the Palestinians importing about 80% of it, mainly from Israel and Jordan. In addition, the Palestinian economy imports large quantities of electrical power and related equipment. There is no doubt that huge public and private investment is required to achieve greater trade volumes by Palestinian production and the supporting trade services. This is an

excellent opportunity for Arab capital to invest in the Palestinian economy. The studies pointed out that structural changes would be needed soon after the opening-up of trade between the Palestinian and Arab economies.

Labor Relations

The Palestinian economy suffers from chronic labor market problems as it is unable to absorb the Palestinian labor force and is dependent on the Israeli labor market. The structure of the Palestinian economy has developed in a way that deepens dependence on Israel. Studies of the Palestinian labor market that assume that the present economic structure will continue show that the labor market is able to absorb only 62% of the annual increase in the Palestinian labor force.

Thus, the creation of jobs has been the major challenge for the PNA in the economic sphere. That has been particularly clear during the last thirty months of continuous Israeli siege and hostilities. It is now apparent that there is an urgent need to eliminate or reduce Palestinian dependence on the Israeli labor market, which has been used by Israel as a tool to apply pressure on the Palestinians. The overall relationship of Israeli occupation requires that alternatives be implemented that support Palestinian capabilities and strengthen Palestinian resistance to Israeli policies.

Nevertheless, and due to the living conditions in the Palestinian Territories, the researcher and Palestinian policy makers are forced to look for available alternatives even if they run counter to some of the current goals. Therefore, Arab states need to support the employment of Palestinians in their markets through a controlled strategy that does not allow mass emigration from the Palestinian Territories. The Gulf countries comprise the only viable choice.

It is well known that the Gulf countries have been applying policies encouraging the employment of nationals to jobs. Their efforts have been less than successful due to the shortage of some major skills and the reluctance of nationals to accept 'dirty' jobs, plus the fact that nationals are more costly to the private sector than foreigners. Palestinians have a good chance to benefit from job opportunities in the Gulf due to their high qualifications and relatively high productivity. However, unemployed Palestinians might not fit the requirements of the vacancies available and may also be unable to compete, cost-wise, with labor from East Asian countries. This is why government support for Palestinian workers is required for a limited period of time.

Investment

The Palestinian investment environment has undergone several important developments in legal structure, the establishment of public institutions, development of infrastructure, and growth in public investment. Yet, the economic siege imposed by the Israelis has made it difficult, if not impossible, for the Palestinian economy to benefit from those developments, particularly since the start of the Al-Aqsa Intifada. Not all the problems facing investment are the result of policies implemented under the Israeli occupation. Some are due to internal Palestinian factors, including a weak judiciary, lack of respect for court decisions, and lack of law enforcement. These factors may have been more important in discouraging local investment and the failure to attract foreign investment.

Many studies have proposed various measures to be taken by the PNA to improve the investment environment in order to encourage local investment and attract foreign funds. These measures include reform of the 'new' law to encourage investment to make it more suitable for the Palestinian economy, especially as regards the size of capital eligible for exemptions and tying exemptions to performance. Other economic-related laws need to be introduced to enhance the legal setting for economic development. In addition, the judiciary needs to win greater respect by enforcing laws justly and equally on all groups and eliminating financial and administrative corruption, believed to be widespread at all levels of government. Also, plans must be put forward to market investment opportunities in the Palestinian economy and privatize PNA trade activities.

The Palestinian economy provides promising investment opportunities for the future including:

- ✧ Mining and extraction industries such as stone and Dead Sea minerals.
- ✧ Import substitution industries. Integration with the Arab economies and the high degree of similarity between Palestinian and Arab imports will help to solve the problem of a small market and encourage an import substitution strategy for both economies.
- ✧ Information technology, especially related to programming.
- ✧ Production of early crops including grapes, melons, flowers, medical plants, fruits and almonds. The special weather conditions of the Ghore region of the West Bank should be utilized to enhance the Palestinian agricultural sector and its exports.
- ✧ The construction sector provides huge investment opportunities at all stages.

- ✧ The diversion of some Palestinian trade from Israel to the Arab world will create investment opportunities in services related to trade facilitation and transport, storage activities, and others. The similarity of Palestinian and Arab commodity exports and imports provides opportunities for investment in joint ventures for common importing and exporting and researching overseas markets.
- ✧ The existing low level and quality of social services provide for investment opportunities in the Palestinian education and health sectors.
- ✧ Economic infrastructures also provide investment opportunities in the form of joint ventures to free the Palestinian economy from some of the worst ties with the Israeli economy. At present, the Palestinians import all their needs for electric power, most of their drinking water, and the services of Israeli air and sea ports. Integration with the Arab world and the opening of borders between them should free the Palestinian economy from such dependence.