M A S

Palestine Economic Policy Research Institute (MAS)

Background Paper

Roundtable (1)

Economic Disengagement from Israel: Challenges and Feasibility

2019

The decisions of the PLO Central Council during its meeting last August, echoed by the Presidency and the Government, show that economic disengagement from Israel and building the Palestinian economy are now national priorities. Witnessing how Israel took advantage of the Paris Protocol to perpetuate its control over the Palestinian economy, Palestinian decision-makers and economic experts have realized that ending the Palestinian economic dependence on Israel must become a national quest. Israel had imposed its hegemony over the Palestinian economy well-before before the signing of the Oslo Accords, after which it continued the same by breaching the terms of its economic Annex (Paris Protocol on Economic Relations) and by showing disregard to the political terms (which were supposed to provide only a temporary framework for regulating relations during the interim period, as stipulated by the Oslo Accords). This has rendered the relationship with the Israeli economy unequal, creating a wholly dependent and distorted Palestinian economy, as shown by a number of studies, such as those by the Palestine Economic Policy Research Institute (MAS), the World Bank, the International Monetary Fund, and the United Nations Conference on Trade and Development (UNCTAD), and many others.

While some believe that disengagement can only be achieved by withdrawing from the Paris Protocol (i.e. seeking ways to annul or modify it or preventing further Israeli violations of its terms), others argue that a disengagement plan should first consider strengthening the Palestinian economy and its resilience, with or without the Paris Protocol. Only a strong economy enables the Palestinian leadership to better delineate the economic relationship with Israel, also after ending the occupation. Obviously, economic independence cannot be realized only through Israel's compliance with the provisions of the Protocol, nor by the benefits the Palestinian economy might gain from some of its terms. There are many important elements to consider when building the Palestinian economy, some of which can be harnessed now to reduce dependency. Some of these were addressed in MAS's Economic Conference in 2016 where possible interventions were proposed for strengthening the Palestinian economy. While some interventions were impossible either because of commitments to the Paris Protocol or because of the continued Israeli military occupation, many of the proposed interventions however were feasible - notwithstanding the difficulty to implement them- as they did not clash with the terms of the Paris Protocol.

This provides only an overview of the challenge ahead. The Paris Protocol remains one important obstacle that must be overcome to end economic dependence on Israel, but certainly it is not the only one. Even with better utilization of the possibly advantageous margins in the Protocol, coupled with Israel's compliance with all its provisions, the major obstacle to economic growth remains, namely the occupation. Below, we outline the economic distortions created by the Israeli occupation of the West Bank and Gaza Strip since it began in 1967. Then, we look at some gaps in the Paris Protocol. This will help in defining the main features of economic dependence.

Economic distortions Israel created after the 1967 occupation

Following occupation of the West Bank and Gaza Strip in 1967, the Israeli authorities forcibly rendered the Palestinian economy dependent on Israel. This was possible through a range of military policies and laws that allowed Israel to control Palestine's natural and human resources. In its efforts to perpetuate Palestinian economic dependence, Israel opened its labor market for Palestinians, which allowed it to achieve a dual goal: taking advantage of cheap labor and containing resistance against the occupation in the West Bank and Gaza. As of the early 1970s, the poor economic conditions in Palestine led around one-third of Palestinian labor force to seek employment in the high-wage labor market of Israel.[1]

The Israeli occupation authorities also tightened the grip on the Palestinian economy by making it very easy for Israeli goods to enter the markets in the West Bank and Gaza, which in the process has disintegrated the Palestinian economy from those of its Arab neighbors. Simultaneously, Israel made restrictions on Palestinian goods entering the Israeli market, allowing through only raw materials and traditional industries through subcontracting. A set of military ordinances were introduced to frustrate the development of a Palestinian national banking system (Diwan and Shaban 1999), which heavily distorted the Palestinian economy despite the high growth of GDP (in the West Bank and Gaza) in the

[1] National Accounts of Judea, Samaria and Gaza area 1968-1986. Israel Central Bureau of Statistics.

1970s and 1980s.[2] That growth was mainly due to labor remittances from the Israeli market, not a result of productive economic activities typically associated with accumulation of capital (Arnon and Weinblatt 2000; Dessus 2004).[3]

Economic implications of the Paris Protocol

The first Palestinian Intifada broke out in December 1987 against the Israeli occupation, demanding the establishment of an independent Palestinian state. In 1993, the PLO and the Israeli Government signed the Declaration of Principles, which came to be known as the Oslo Accords, which created the Palestinian National Authority (PNA). The Accords and the subsequent agreements (the Gaza-Jericho Agreement, the Interim Agreement and others) gave the PNA civil and security control over the Gaza Strip and about 18% of the West Bank (known as Area A) and administrative jurisdiction over Area B, while Israel retained full control over about 60% of the West Bank (Area C). The Gaza-Jericho Agreement and the Interim Agreement, along with the Protocol, came to govern economic relations between Israel and Palestine during the interim period. The Agreement considered the West Bank and the Gaza Strip as a single geographical unit, which means free movement of goods within the Palestinian territories and access to Israeli crossings as well as crossings with Arab countries.

The Agreement regulates many aspects of the economy, including:

- Import policies and direct and indirect taxes;
- The shipment of goods and PNA's control over commercial and passenger crossings;
- Clearance of import taxes and other levies between Israel and the PNA;
- Banks, financial and monetary issues and related policies;
- Palestinian workers in Israel, tax deductions and labor insurance issues;
- Transport of agricultural products and control of agricultural diseases and pests.

The preamble to the Protocol confirms that it lays the groundwork for strengthening the Palestinian economy and allows Palestine exercise its right to make decisions regarding its own economy based on its own development plan and priorities. However, the application of the Protocol has restricted the ability of the PNA to formulate independent economic policies in line with national priorities. Rather, it has perpetuated Palestinian subordination to the Israeli economy through stipulation of a customs union type relationship, which has rendered the subordination into a contractual agreement, which regulates taxation, leaves limited space for formulating economic policies in limited areas and for a limited number of goods under the so-called "A" and "B" lists. For example, the agreement obligated the PNA to apply the Israeli tariff rates as a minimum, while VAT must remain within 2 percentage points of Israel's VAT rate. Israeli authorities were also given the exclusive powers of inspecting goods and collecting tax revenues as Palestinian goods pass through Israeli crossings, thus making the PNA unable to monitor Palestinian markets or control fiscal leakages arising from direct and indirect importation (UNCTAD, 2014). [4] Furthermore, the Palestinian economy has become exposed to fluctuations resulting from changes in Israeli monetary policy and exchange rate of the Israeli currency. The Israeli side has also been authorized to collect and transfer clearance revenues to the PNA, which Israel has subsequently misused as a means of political extortion.

The Paris Protocol, according to many economists and observers, has other severe gaps too. First, it essentially depends on the good will of the parties. Second, it has not considered designation of an international reference body that can settle potential disputes (Shuaibi, 2013). As an alternative, the Protocol provided for the formation of the Palestinian-Israeli Joint Economic Committee (JEC) to monitor implementation and address its related problems. Third, the Protocol stipulated that Palestinian side must obtain approval by Israeli authorities in advance should they wish to modify the terms. It appears that the Palestinian side accepted the agreement as a concession under the assumption the

[2] Diwan. I and Shaban. R (1999) "Development Under Adversity: The Palestinian Economy in Transition". MAS and the World Bank, Washington D.C.

[3] Arnon. A and Weinblatt. J (2000) "Sovereignty and Economic Development: The Case of Israel and Palestine.Ben-GurionUniversity of the Negev, Israel. Photocopied.
Dessus. S (2004) "A Palestinian growth history, 1968-2000". Journal of Economic Perspectives, 19: 447-69.

[4] https://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1034

interim period would end after the planned five years, after which they could negotiate an agreement that essentially would allow the PNA to exercise sovereign economic and political control over the West Bank and Gaza Strip.

Since the outbreak of the second intifada in September 2000, the JEC and its subcommittees were suspended. This has paralyzed the Protocol, which however continued to and will likely continue to govern the economic relationship with Israel as long as chances for arriving at a just peace deal are virtually nonexistent. The Israeli occupation authorities have imposed full compliance on the part of the PNA, while Israel retains the right to violate some of its terms, the most important of which is its refusal to reinvigorate the JEC. In addition, Israel continues to violate the terms related to freedom of movement as it has separated the West Bank from the Gaza Strip, on which it has imposed a total economic blockade since 2007.

To summarise, Palestinian high hopes of achieving economic independence were turned into more dependence across the board, and this also includes the labor force (see Table 1 in the Appendix that lists Israeli violations of the Paris Protocol). According to the Palestinian Labor Force Survey 2017, 19% of the total labor force in the West Bank works in Israel, with remittances from Palestinians working there accounting for 35% of the wage bill for all West Bank wage earners. This is not a small figure, and it can be concluded that a potential decline in the number of workers in Israel will mean (at least in the short term) a rise in unemployment and a fall in aggregate demand for goods and services (the impact of the decline in remittances). A shock like this could cause a period similar to the first years of the second intifada, which would be disastrous and likely cause a recession.

No less important is foreign trade. Israel remains the main supplier of goods to the Palestinian market: 55% of the total imports recorded in 2017. Despite the decline in previous years[5] due to direct imports from other countries, Israel is still the major supplier of strategic goods such as fuel, electricity, water, cement and fodder, which constitute about 50% of all imports from Israel.[6] On the export side, Israel is the main destination for the Palestinian high value-added products such as stone, furniture, plastic and footwear. A third gap is the clearance regime that has exposed the PNA to Israel's unilateral decisions, who sometimes withhold clearance transfers on political and security grounds. Israel has on multiple occasions used clearance revenues to politically pressure the PNA.

The bulk of available literature has shown that the performance of the Palestinian economy has declined sharply in the last ten years, largely due to the inequitable Protocol. The economy has suffered structural imbalances that have led to an array of inter-economic distortions and weakened productive capacity (World Bank, IMF and UNCTAD). The most recent report by the International Monetary Fund– presented at MAS on December 11, 2018– has in its findings confirmed the existence of such distortions, specifically:

- Unprecedented unemployment rates, especially in the Gaza Strip;
- Widening budget deficit, increased public debt, decline in the financial capacity of the PNA and increased fiscal leakages resulting from Israel's violations of the Paris Protocol;
- Increased reliance on donor aid, which has seen declines, adversely affecting the government's spending and investment plans;
- Distorted business environment and reduced investment; and
- Projecting further distortions in the coming years, owing to the increasingly untenable situation in Gaza, which is stifling the overall economy.

A host of threats, such as the increased Israeli intransigence and the potential repercussions of the infamous "deal of the century" by the US – have increased calls for Palestinian disengagement from the Israeli economy by withdrawing from the Protocol and strengthening the national economy. During its meeting last August, the PLO Central Council issued several resolutions, one of which called for

[5] The figure does not cover unreported, smuggled imports.
[6] Imports from Israel, PCBS.

economic disengagement from Israel on the grounds that the interim phase had elapsed a long time ago (see Table 2 in the Appendix for further details on the main disengagement procedures proposed by the Central Council as well as interventions proposed at the MAS Economic Conference-2016 to counter the Israeli hegemony and violations of the signed agreements).

Building on facts– Palestinian economy's dependence on Israel, absence of Palestinian sovereignty over the crossings, and Israel's violation of the Paris Protocol– we raise a set of questions for discussion, hoping the answers give insights for the Palestinian decision-makers when deciding upon policy interventions for economic disengagement and strengthening the Palestinian economy:

- To what extent is disengagement from the Israeli economy currently possible? What is the expected timeframe for that?
- How does disengagement affect the Palestinian economy in light of the continued Israeli occupation, limited resources and weak capacity of the private and public sectors in creating jobs for the steadily growing population?
- What are the possible impediments to implementing the proposed interventions for disengagement and strengthening the Palestinian economy?
- What are some of the immediate, workable, and realistic economic interventions that can help in economic disintegration, especially in terms of imports, indirect tax policies and currency?
- How could Palestine’s membership in international organizations help stop Israel's violations of Palestinian economic rights?

Annex I: Israeli Violations of the Paris Protocol- Quick Reference

Article	Paragraph Number	Violations
Article II: The Joint Economic Committee	1, 2, 4	The JEC has been inactive since 2000, except for one brief, futile meeting in 2009.
Article III: Import Taxes and Import Policy	2, 3, 4, 16	The tariff lists A1, A2, and B were only reviewed once in late 1997 at a meeting of the JEC at the time and were never revised again.
	6	Israel has violated its duty to consult with and notify the Palestinians before making any changes to Israeli import policy or rates that affect Palestinians.
	8	No agreement was made on the rules of origin because the joint sub-committee never met as a result of the lack of desire by the Israeli side to change the status quo.
	12	Israel refuses to recognize Palestinian standard certificates and conformity marks and restricts the PA's right to set its own petroleum products policy.
	13	Israel closed Damia Bridge (Prince Muhammad Bridge) over the Jordan River between the West Bank and Jordan.
	14	• Israel continues to deny the PA full authority to implement its own import policy at the international border crossings in the West Bank and the Gaza Strip; • Israeli authorities have prevented any presence of Palestinian customs officials at the King Hussein Bridge; • Israel closed Rafah Crossing from 2007 to 2010.
		• Israel discriminates against Palestinian importers, causing delays and added costs to the Palestinians.
Article IV: Monetary and Financial Issues	10	• In 2007 and up until now, Israeli banks stopped providing banks in Gaza with NIS banknotes and imposed many restrictions on the transfer of money from the West Bank to Gaza; • The idleness of the JEC is one of the major constraints behind the inability to introduce a Palestinian currency.
	13	Israel rejected Palestinian membership in the Israeli clearing house after the Second Intifada.
	14, 15	Israel refused to convert excess NIS in the West Bank and Gaza into foreign currency through the BOI, and in 2011 the BOI only allowed the transfer of a specific amount of money ($120 million) each month.
Article V: Direct Taxation	2	Israel is not committed to transferring income tax from Israeli tax payers working in Area C.
	4	Israel has not transferred all taxes it has collected from Palestinian workers, mainly the levy equalization funds, national insurance contributions, and pension funds.
	5	Israel did not prevent double taxation and did not activate the discount system between the two sides in a comprehensive manner.
Article VI: Indirect Taxes and Import Policy	5	Israel froze the transfer of clearance revenues on many occasions. By doing this, Israel abused the agreed upon procedures in the PP, violated the principle of transfer, and used its asymmetric power as an occupier to enforce a punitive measure (or exert political pressure) over the occupied.
Article VII: Labor	1	Israel has arbitrarily restricted labor mobility between the OPT and Israel.
Article VIII: Agriculture		• Israel has introduced many restrictions on Palestinian agricultural exports and has hindered Palestinian agricultural products from entering the Israeli market, because of either security or technical reasons. In some cases, the Israeli authorities subject Palestinian agricultural products to severe

Article	Paragraph Number	Violations
		inspections and long waiting time on checkpoints before allowing them to enter the Israeli market. This has led to damages to many products before accessing the Israeli market. Israel violates 10 out of 17 paragraphs in this Article; • Israel applies different standards for plants and animals, animal products, and biological products from those adopted or recommended by relevant international organizations, resulting in trade barriers between the two parties and between Palestinians and the rest of the world with regards to agricultural products; • Israel has attempted to prevent Palestinian dairy and meat products from entering East Jerusalem, which forms part of both the OPT and the Israeli markets.
Article X: Tourism	2	The Israeli authorities continue to act in the archaeological and tourism sites in the West Bank. Israel also develops and markets these sites as Israeli because they fall in Area C. Some examples include: Herodion in Bethlehem, Good Samaritan in the Red Khan, and the Jordan River Baptismal site.
	4, 6	Israel prevents Palestinian tourist buses from entering Israeli areas.
	7	Israel does not recognize the licenses given to Palestinian tour guides, neither does it issue permits to all Palestinian tour guides to enter Israel.
Article XI: Insurance Issues	3, 4, 5, 6, 7, 10	The violations to this Article are mainly as a result of Israel's not recognizing of Palestinian laws and procedures, in addition to not fulfilling its responsibly as stated in the PP, especially in Area C.

Sources: Shuaibi (2013), PLO (2011) and notes from different Palestinian ministries concerning the PP.

Table 2: Policies and interventions proposed to support economic disengagement from Israel

- Full enforcement of the 2010 law regarding the ban on settlement goods- with those violating the law becoming subject to penalties, and a total ban on Palestinian entry to the settlements
- Undertaking a comprehensive review of the lists of goods and the quota system stipulated in the Paris Economic Agreement; the system was introduced in 1994 and is no longer relevant due to the changing demand for most of the listed goods
- Strengthening national products and encouraging new alternative industries through import substitution policy and channeling investment to these industries, as well as through tax incentives and prioritizing development in areas adjacent to the settlements
- Giving Israeli violations of the agreements tit for tat– this should be careful and take into account the actually available alternatives
- Clamping down on smuggling, especially in Area C, and reconsidering the pertinent existing loose laws to put teeth in them
- Expanding the tax base, improving tax collection, and modifying tax policies to be in line with the economic development trajectory
- Mobilizing international support to facilitate Palestinian foreign trade; cooperating with trade partners that can provide technical, administrative and logistical assistance which can enhance the Palestinian trade; reinvigorating the Palestinian Export Council; and implementing the government's export strategy
- Setting up a national fund for economic and technological development and providing it with the needed resources; and setting up another fund for public-private joint investments and granting incentives to developers within the fund
- Developing standards and quality control systems to enhance competition and win the confidence of the Palestinian consumer; this is coupled with a wise industrial policy that targets specific products, controls prices and protects fair competition
- Encouraging direct imports through tangible support and practical industrial and commercial policies in order to reduce indirect imports through Israeli companies, in which case the treasury loses its share of taxes and customs duties
- Gradually reducing dependence on the Israeli shekel through different methods including: 1. making the US dollar or the Jordanian dinar the currency of the general budget; 2. paying public servants' salaries in US dollar or the Jordanian dinar; and 3. turning to the digital currency (some countries are now considering adopting their own national crypto currency)
- Designing banking procedures and policies that help develop industrial and agricultural investment and limit excessive investment in land and real estate
- Ratifying the Central Bank Law
- Speeding up the implementation of regional and local development initiatives and draw development plans for different regions
- Restructuring the general budget as well as fiscal and lending policies to encourage investment in productive sectors, namely industry, agriculture and services
- Encouraging and supporting alternative energy sources, and building the infrastructure needed for buying electricity from Egypt and Jordan, making sure such efforts are coordinated with these two countries to ensure sustainable supply of petroleum
- Intensifying the campaign at home and abroad against the economy of the colonial settlements
- Re-energizing the economic agreements between the PA and other countries, especially the partnership agreement with the European Union and the neighborhood agreements, particularly the agreements with Egypt and Jordan; the Palestinian businesses need to know the benefits these agreements bring to the economy
- Proceeding immediately with constructing water desalination plants in the Gaza Strip