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מדינת ישראל

משרד הממשלה

משרד מוני

מט. ט. ט.

קצ"מ - (2)

מ - 6/98 - 11/97

תיק מס'

מחלקה אגב אשטא



שם תיק: לשכת היועץ המשפטי - הסדר קבע

מזוזה פנימי: גל-11-48355

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תאריך הדפסה: 23/01/2019

11

הנהגת מדיניות הממשלה והתקציב.

הנהגת מדיניות הממשלה והתקציב, הנהגת מדיניות הממשלה והתקציב, הנהגת מדיניות הממשלה והתקציב.

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1938
The first day of the year
is a day of hope and
of new beginnings.
It is a day when we
set our goals and
dreams for the year
ahead. It is a day
when we resolve to
be better people,
to live more
honestly and
kindly. It is a day
when we promise
ourselves to
work hard and
to be true to
ourselves. It is a
day when we
begin our journey
towards a
better future.
It is a day when
we say "goodbye"
to the old and
hello to the new.
It is a day when
we start over,
when we begin
again. It is a day
when we take
the first step
towards a
brighter tomorrow.
It is a day when
we are full of
hope and
optimism. It is
a day when we
believe in
ourselves and
in the future.
It is a day when
we are ready
to face whatever
comes our way.
It is a day when
we are full of
faith and
confidence. It is
a day when we
are ready to
take on the world.
It is a day when
we are full of
love and
compassion. It is
a day when we
are ready to
help others.
It is a day when
we are full of
joy and
happiness. It is
a day when we
are ready to
enjoy life.

In the year 1945 the first of the world's atomic bombs was used against Japan. The bomb was dropped on the city of Hiroshima. It was the first time that nuclear energy had been used for a destructive purpose.

The atomic bomb is a very powerful weapon. It is made of a substance called uranium. When the uranium is split, it releases a great deal of energy. This energy is used to create a very large explosion.

The atomic bomb is a very dangerous weapon. It can destroy a city in a few minutes. It can also cause a great deal of death and injury. It is a very powerful weapon.

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1971 - early spring, after the snow melted
to find a large amount of fish in the water
and many birds flying over.
The water was very clear and the fish were
very large and fat.
The birds were very noisy and
many of them were flying in
the air.

האדם האחרון: הוא, כפי שכתבתי, הוא האדם האחרון.
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הוא האדם האחרון. הוא האדם האחרון.

The first step is to identify the problem. This involves understanding the situation and the goals that need to be achieved. It is important to gather all relevant information and to consider the perspectives of all those involved.

Once the problem is identified, the next step is to generate possible solutions. This can be done through brainstorming, research, or consulting with others. It is important to think creatively and to consider a wide range of options.

After generating solutions, the next step is to evaluate them. This involves comparing the solutions against the goals and the constraints of the situation. It is important to consider the potential benefits and risks of each solution.

Once a solution has been selected, the next step is to implement it. This involves putting the solution into action and monitoring its progress. It is important to communicate the solution to all those involved and to ensure that everyone is clear about their roles and responsibilities.

Finally, the last step is to evaluate the results. This involves assessing the effectiveness of the solution and identifying any areas for improvement. It is important to learn from the experience and to use this knowledge to inform future decision-making.

In conclusion, the problem-solving process is a systematic and iterative one. It involves identifying the problem, generating solutions, evaluating them, implementing the chosen solution, and finally evaluating the results. By following these steps, it is possible to effectively solve a wide range of problems.

It is important to remember that problem-solving is not always a linear process. It may be necessary to return to earlier stages as more information is gathered or as new solutions are generated.

Overall, the key to successful problem-solving is to remain flexible and open-minded. It is important to be willing to try new approaches and to learn from both successes and failures.

By following these steps, you can increase your chances of finding an effective solution to any problem you face.

Remember, the goal is not just to solve the problem, but to find a solution that is sustainable and that meets the needs of all those involved.

With practice and a willingness to learn, you can become a more effective problem-solver and be better equipped to handle the challenges of the future.

Thank you for reading this article. I hope it has provided you with some useful insights and ideas for solving your own problems.

Best regards,

John Doe
Author of "The Art of Problem Solving"

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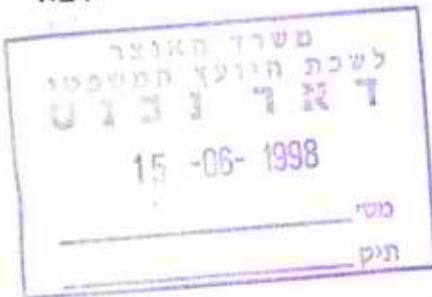
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ארכיון: אגף תיקונים
השירות המסחרי
מאג: אגף התוכנית-מסחר האזור

223.07 יוצא

1100 תיק:

מסמך: 3196943
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הודון: ישראל-רש"פ: קשרי גומלין כלכליים - מסמך עידכון.

ISRAELI-PALESTINIAN ECONOMIC RELATIONS - UPDATE
MAY 25, 1998

INTRODUCTION

RECENTLY, A SIGNIFICANT IMPROVEMENT HAS TAKEN PLACE IN THE PALESTINIAN ECONOMY. A NUMBER OF ECONOMIC INDICATORS SHOW THAT A MARKED IMPROVEMENT OCCURED IN THE PALESTINIAN AUTHORITY'S ECONOMIC CONDITION IN 1997 AS COMPARED TO 1996, AND THAT THIS IMPROVEMENT HAS CONTINUED INTO THE FIRST FOUR MONTHS OF 1998. THE ECONOMIC GROWTH MAY BE DUE, AMONG OTHER FACTORS, TO THE RELATIVE CALM WHICH PREVAILED DURING THIS PERIOD - WHICH SUPPORTS THE VIEW THAT AN ATMOSPHERE OF SECURITY AND POLITICAL STABILITY ENGENDERS A STRENGTHENING OF THE PALESTINIAN ECONOMY.

IT IS WORTHY TO NOTE IN THIS REGARD, THAT THIS YEAR, THERE HAVE BEEN NO SECURITY CLOSURES OF THE WEST BANK AND GAZA, AS COMPARED TO 63 DAYS OF CLOSURE IN 1997 AND 92 CLOSURE DAYS IN 1996. THIS POSITIVE GROWTH TREND IN EMPLOYMENT AND PRIVATE SECTOR ACTIVITY WAS DETAILED IN THE LATEST REPORT SUBMITTED BY THE SPECIAL UN COORDINATOR TO THE TERRITORIES (UNSCO) IN APRIL OF THIS YEAR. AMONG OTHER TRENDS, THE REPORT NOTED THAT IN 1997, A 14.4 PERCENT GROWTH OCCURED IN THE NUMBER OF PALESTINIAN EMPLOYEES WORKING IN ISRAEL, AS COMPARED WITH THE PREVIOUS YEAR. THE REPORT ALSO HIGHLIGHTS THE EXPANSION OF PRIVATE INVESTMENT, AS EVIDENCED IN THE GROWTH OF THE CONSTRUCTION SECTOR, THE RISE IN THE REGISTRATION OF NEW CORPORATIONS, AND THE INCREASE IN CREDIT EXTENDED TO PALESTINIAN BUSINESSES.

EMPLOYMENT WITHIN ISRAEL

INCOME FROM EMPLOYMENT WITHIN ISRAEL CONSTITUTES A VERY SIGNIFICANT ELEMENT IN THE OVERALL INCOME OF THE PALESTINIAN LABOR FORCE (30-40 PERCENT). A STEADY UPWARD TREND IN THE NUMBER OF WORKERS EMPLOYED BY ISRAELIS HAS EXISTED FOR SOME TIME NOW. WHILE THE AVERAGE NUMBER OF PALESTINIANS EMPLOYED BY ISRAELIS STOOD AT 39,000 IN 1996, THAT FIGURE INCREASED TO 47,000 IN 1997, AND TODAY STANDS AT ABOUT 55,000. OF THESE, ABOUT 13,000 ARE EMPLOYED BY ISRAELIS WITHIN THE WEST BANK AND GAZA SETTLEMENTS AND INDUSTRIAL ZONES.

IN ADDITION, TENS OF THOUSANDS OF WORKERS ARE EMPLOYED IN ISRAEL WITHOUT PERMITS, SO THE TOTAL PALESTINIAN WORKFORCE IN ISRAEL IS

352

ESTIMATED AT 100-110,000 INDIVIDUALS.

THE NUMBER OF WORKERS IN ISRAEL IN 1997 EXCEEDED THE PROJECTIONS MADE BY BOTH THE IMF AND THE PA FINANCE DEPARTMENT.

THE STEADY GROWTH IN THE PALESTINIAN WORKFORCE IS EVEN MORE SIGNIFICANT WHEN VIEW IN THE CONTEXT OF THE SLOWDOWN WHICH IS FELT IN THE ISRAELI ECONOMY AND THE RISE IN UNEMPLOYMENT AMONG ISRAELIS.

THE GROWTH IN THE NUMBER OF PALESTINIAN WORKERS MAY BE ATTRIBUTED TO A NUMBER OF STEPS TAKEN BY ISRAEL, SOME WITH THE COOPERATION OF THE PA:

- ABOLISHING THE QUOTAS FOR PALESTINIAN WORKERS. THE NUMBER OF EMPLOYEES IS NOW DETERMINED BY MARKET FORCES ALONE.
- LOWERING THE MINIMUM WORKER'S AGE LIMIT TO 23 - A MEASURE WHICH OPENS THE ISRAELI LABOR MARKET TO THOUSANDS OF ADDITIONAL PALESTINIAN WORKERS.
- ADOPTING A PROGRAM TO ALLOW PALESTINIAN WORKERS TO REMAIN OVERNIGHT IN ISRAEL, THUS ELIMINATING THE NEED FOR SEVERAL HOURS OF DAILY COMMUTING. TODAY, OVER 4,000 WORKERS ARE PARTICIPATING IN THIS PROGRAM.
- APPROVING A PROGRAM WHICH ALLOWS 30,000 PALESTINIAN WORKERS TO CONTINUE TO ENTER ISRAEL, EVEN DURING TIMES OF SECURITY CLOSURES.
- ORGANIZING EMPLOYMENT FAIRS IN THE CONSTRUCTION SECTOR, MEANT TO BRING PALESTINIAN WORKINGS INTO CONTACT WITH ISRAELI CONTRACTORS. OTHER PLACEMENT SERVICES ARE ALSO BEING CONSIDERED FOR THIS SECTOR.

THE ABOVE STEPS HAVE BROUGHT ABOUT A SIGNIFICANT IMPROVEMENT IN EMPLOYMENT, WHICH HAS BEEN RECONGNIZED BOTH BY FOREIGN REPRESENTATIVES AND BY PA OFFICIALS IN RECENT SESSIONS OF THE FORUM OF DONOR STATES.

PROMOTING PRIVATE SECTOR DEVELOPMENT

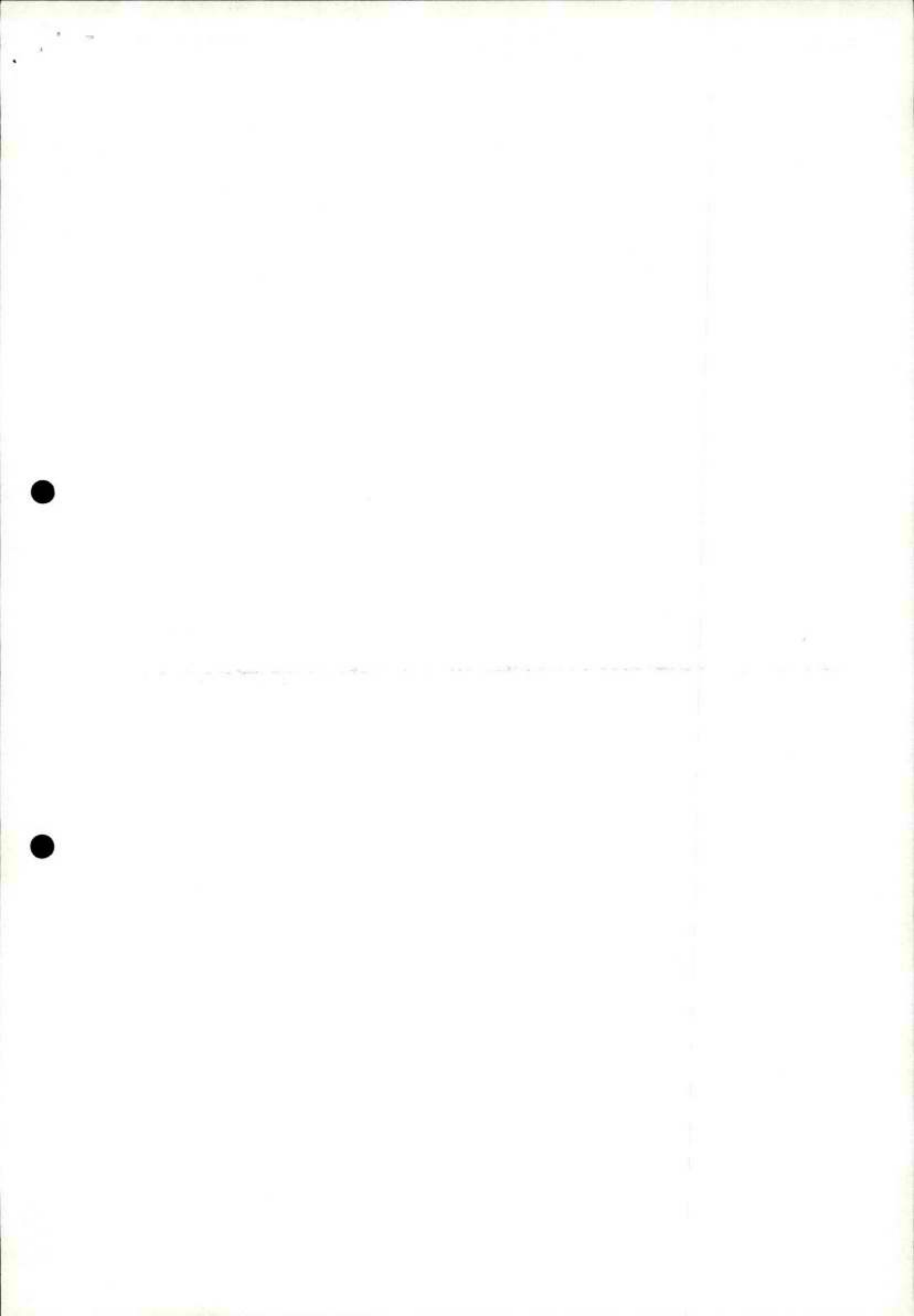
ISRAEL HAS TAKEN A NUMBER OF STEPS TO STRENGTHEN THE PALESTINIAN PRIVATE SECTOR, IN RECOGNITION OF THIS SECTOR'S CENTRAL ROLE IN THE FUTURE GROWTH OF THE PALESTINIAN ECONOMY AS A WHOLE.

COMMERCE AND MERCHANTS

THE NUMBER OF WEST BANK AND GAZA MERCHANTS GRANTED ISRAELI ENTRY PERMITS HAS BEEN EXPANDED TO 16,500, AS COMPARED WITH AN AVERAGE OF 6,374 PERMITS IN 1997 AND 3,420 IN 1996.

A COORDINATED EFFORT HAS BEEN UNDERTAKEN BY ISRAEL, TOGETHER WITH THE PA, TO EXPAND THE NUMBER OF PERMITS ALLOWING PALESTINIAN MERCHANTS TO ENTER ISRAEL WITH THEIR VEHICLES.

RECENTLY A NUMBER OF MEETINGS HAVE TAKEN PLACE BETWEEN ISRAEL AND PALESTINIAN BUSINESSMAN, IN ORDER TO FORGE A WORKING RELATIONSHIP BETWEEN THE TWO BUSINESS COMMUNITIES.



THE CONTINUING INCREASE IN THE SCOPE OF TRADE FINDS EXPRESSION IN THE NUMBER OF CROSSINGS OF TRUCKS, WHICH STANDS TODAY AT 15,500 TRUCKS A MONTH. (THERE ARE NO LIMITATIONS ON THE MOVEMENT OF TRUCKS AND THIS NUMBER REFLECTS RECORD ACTIVITY.) ALSO NOTABLE IS THE INCREASE, OF TENS OF PERCENTAGE POINTS, IN THE PALESTINIAN EXPORT OF VEGETABLES AND STRAWBERRIES IN THE 96/97 SEASON, AS COMPARED TO THE 95/96 SEASON.

THE KARNI INDUSTRIAL ZONE

ISRAEL CONTINUES TO PROMOTE THE KARNI INDUSTRIAL ZONE, WHICH IS PRESENTLY IN THE FINAL STAGES OF CONSTRUCTION. IN ADDITION TO A GOODS CHECKING STATION ON THE ISRAELI SIDE, WHOSE CONSTRUCTION IS NEARLY COMPLETED AND WHOSE MANAGEMENT WILL BE TRANSFERRED TO CIVILIANS, ISRAEL HAS RECENTLY ACTED TO CONNECT THE INFRASTRUCTURE (WATER LINES) OF THE INDUSTRIAL ZONE. IN ADDITION, INFORMATION ACTIVITIES WHICH AIM TO ENCOURAGE ISRAELI BUSINESSMEN TO INVEST IN THE KARNI INDUSTRIAL ZONE HAVE BEEN UNDERTAKEN.

TRANSFER OF FUNDS

THE ABOVE STEPS HAVE GENERATED A SIGNIFICANT RISE IN ECONOMIC ACTIVITY, WHICH CAN BE SEEN FROM THE SCOPE OF TRANSFER OF FUNDS TO THE PALESTINIAN AUTHORITY. IN 1997 ISRAEL TRANSFERRED SOME DOLLAR 540 MILLION TO THE PA (FOR IMPORT TAXES, VAT ADJUSTMENTS, FUEL TAXES, INCOME TAXES AND HEALTH TAXES), COMPARED TO DOLLAR 436 MILLION IN 1996, A INCREASE OF 24 PERCENT ! THESE FUNDS, IT SHOULD BE REMEMBERED, CONSTITUTE 63 PERCENT OF THE PALESTINIAN AUTHORITY'S BUDGET. IN THE FIRST THIRD OF 1998, THE FUNDS ISRAEL TRANSFERRED SOME DOLLAR 182 MILLION. THE TOTAL SUM TRANSFERRED SINCE 1994 IS DOLLAR 1.5 BILLION.

CONCLUSION

ISRAEL CONTINUES TO INVEST MUCH EFFORT IN IMPROVING THE STATE OF THE PALESTINIAN ECONOMY, RECOGNIZING THE FACT THAT THIS IS AN IMPORTANT ISRAEL AND PALESTINIAN INTEREST. STILL, IT IS CLEAR THAT PROGRESS IS DEPENDANT, FIRST AND FOREMOST, ON A STABLE SECURITY SITUATION AS WELL AS COOPERATION BY THE PALESTINIANS AND THE INTERNATIONAL COMMUNITY. IN THIS CONTEXT IT IS FITTING THAT ALL PARTIES ACT IN A MANNER THAT WILL ADVANCE COOPERATION BETWEEN ISRAELIS AND PALESTINIANS IN THE ECONOMIC SPHERE (THE PRINCIPLE THAT STANDS AT THE BASE OF THE PARIS PROTOCOL WHICH REGULATES THE ECONOMIC RELATIONS BETWEEN ISRAEL AND THE PALESTINIANS IN THE INTERIM PERIOD) AND NOT SACRIFICE IMPORTANT ECONOMIC INTERESTS TO POLITICAL CONSIDERATIONS.

מחלקת מידע - אגף תקשורת
25 במאי 1998

תפ: שהח, רהמ, שהבט, מונכל, ממונכל, תכוון, מצב
תפ: סמונכלים, מצפא, אירופה, מזאר, אמלט, אפסוק

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יוצא

אל: כל הוציגויות

דע: סמוכ"ל כלכלה
 אוטונומיה
 מתפ"ש - רע"נ כלכלה
 אוצר - אגף תקציבים

מאת: כלכלית ד'

הנדון: ישראל-רש"פ, קשרי גומלין כלכליים - מסמך עידכון

א. רקע

לנוכח השינויים והשיפורים שחלו בנושא זה מאז שיגרנו אליכם את מסמך הרקע הבסיסי (חוזם 2,1579 מה-1.2) ולאור העובדה שהנושא שוב עלה לאחרונה לכותרות בהקשר למסמכי נציבות האיחוד האירופי ואף תפס מקום מרכזי בתדריך שהעניק רוח"מ לשגרירים הזרים (22.5), ראינו לנכון לשגר אליכם מסמך עידכון

המרכז את ההתפתחויות העיקריות שחלו בתחום קשרי הגומלין בין ישראל והכלכלה הפלסטינית. מרבית הנתונים במסמך זה נימסרו לנו מתאום הפעולות שבשחים - רע"נ כלכלה, ועל כך נתונה תודתנו. מיסמך באנגלית יועבר בנפרד.

ב. כללי

1. בתקופה האחרונה חל שיפור במצבה של הכלכלה הפלסטינית. אינדיקטורים כלכליים רבים מצביעים על כך ששנת 1997 היתה טובה יותר משנת 1996 מבחינה כלכלית. עיון בתוצאות השליש הראשון של שנת 1998 מצביע על המשך ברור של מומת השיפור.

2. את השיפור בכלכלה ניתן לייחס בין היתר לשקט היחסי ששרר בתקופה זו, עדות לכך שאווירה בטחונית-פוליטית יציבה מהווה בסיס לפיתוחה של הכלכלה הפלסטינית. בהקשר זה ראוי לציין כי בשנת 1998 לא היו כלל סגרים (שהוסלו בעבר כתוצאה מפיגועים) לעומת 63 ימי סגר בשנת 1997 ו-92 ימי סגר בשנת 1996.

3. חשוב להדגיש כי המגמה החיובית בתחומי התעסוקה ופעילות הסקטור הפרטי, באה לידי ביטוי בדו"ח האחרון של המתאם המיוחד של האו"ם לשטחים (UNSCO), מאביב 1998. בין היתר נאמר בדו"ח זה כי בשנת 1997 היה גידול של 14.4 אחוז במספר הפועלים שהועסקו בישראל לעומת שנת 1996. הדו"ח מצביע גם על גידול בהקף ההשקעה הפרטית בשנת 1997 שהתבסא בגידול בפעילות בענף הבניה, רישום חברות חדשות ומתן אשראי במשק הפלסטיני.

ג. תעסוקה בישראל

1. כידוע מהוות ההכנסות מעבודה בישראל מרכיב חשוב ביותר מסך ההכנסות מעבודה של האוכלוסיה הפלסטינית (כ- אחוז 30-40).

2. קיימת מגמה רציפה של גידול במספר העובדים המועסקים בידי ישראלים. בעוד שבשנת 1996 עמד המספר הממוצע של מועסקים הפלסטינים על 39,000 הרי שבשנת 1997 הוא עמד על 47,000 ואילו כיום מועסקים בהיתר על ידי ישראלים

כ-55,000 פלסטינים. מתוכם מועסקים כ-13,000 בהתחלואות ובאזורי התעשייה באיו"ש וברצועת עזה.

בנוסף על כך מועסקים עוד עשרות אלפי פועלים ללא היתר כך שהמספר הכולל של העובדים מגיע כיום ל-110-100 אלף איש.

3. מספר הפועלים הממוצע שהועסק בישראל בשנת 1997 היה גבוה מזה שהופיע בהנחות העבודה של קרן המטבע ו"משרד האוצר" של הרש"פ.

4. את הגידול המתמיד במספר הפועלים המועסקים בישראל, הבולט עוד יותר על רקע ההאטה במשק הישראלי והעליה בשיעור האבטלה, ניתן לייחס למספר פעולות חשובות שנקטה ישראל, חלקן בשיתוף פעולה עם הרש"פ ובהן:

א. ביטול המיכסות לעובדים הפלסטינים. מספר המועסקים נקבע על פי דרישות השוק.

ב. הורדת גיל הרשאים לעבוד בישראל ל-23, צעד שעשוי לפתוח את שוק העבודה הישראלי בפני אלפי עובדים פוטנציאליים נוספים.

ג. ביצוע התכנית המאפשרת לפועלים לינוה בישראל ומונעת מהם את הצורך לנוע שעות ארוכות יום יום לישראל וממנה. כיום מנצלים אפשרות זאת כ-4000 פועלים.

ד. כזכור אושרה גם תוכנית שתאפשר ל-30,000 עובדים להיכנס לישראל גם בתקופות סגר.

ה. התקיימו ירידי תעסוקה בתחום הבנין, שמטרתם הפגשת מעסיקים ישראלים עם מבקשי עבודה פלסטינים. בענף מרכזי זה נבחנות גם תוכניות להפעלת שיטות השמה מתקדמות.

כאמור הביאו פעולות אלה לשיפור ניכר בתחום התעסוקה עובדה שזכתה להכרה גם ע"י נציגים זרים ודוברים פלסטינים בכירים, במפגשי המדינות התורמות שהתקיימו לאחרונה.

ד. קידום הסקסור הפרטי

ישראל נוקטת בפעולות רבות לקידום הסקסור הפרטי הפלסטיני מתוך הכרה בחשיבותו כמנוע הצמיחה העתידי של הכלכלה הפלסטינית.

מסחר וסוחרים

1. הוגדל מספר הסוחרים ואנשי עסקים מאיו"ש ומעזה המורשים להיכנס לישראל ל-16,500. זאת לעומת ממוצע של 6,374 אישורים בשנת 1997 ו-3,420 בשנת 1996.

2. נעשית פעילות, בשיתוף עם הרש"פ, להגדלה משמעותית של מספר האישורים שיאפשרו לאנשי עסקים מאיו"ש להיכנס לישראל עם רכבם.

3. לאחרונה התקיימו בעידודו מספר מפגשים בין אנשי עסקים ישראלים ופלסטינים במטרה ליצור קשרי עבודה בין שתי קהילות אנשי העסקים.

4. הגידול המתמיד בהקף המסחר בא לידי ביטוי גם בהקף מעבר המשאיות במעברים העומד כיום על כ-15,500 משאיות בחודש (אין הגבלות על תנועת המשאיות והמספר משקף שיא בפעילות). כמו כן ראוי לציין את הגידול, בשעור של עשרות אחוזים, בייצוא הפלסטיני של ירקות ותוחים בעונת 96-97 לעומת עונת 95-96.

אזור התעשייה קרני

ישראל ממשיכה לפעול לקידומו של אזור התעשייה קרני שבניתו נמצאת בשלבים מתקדמים ביותר. בנוסף למסוף ביזוק הסחורות שבניתו בצד הישראלי כמעט והושלמה ואשר ניהולו יעבור לידיים אזרחיות, פעלנו לאחרונה לחיבור תשתיות לאזור התעשייה (לזוגמא חיבור קווי מים) וכן נעשו פעולות הסברה שמטרתן לעודד אנשי עסקים ישראלים להשקיע בקרני.

העברות כספים

הפעולות הניזכרות לעיל הביאו לגידול משמעותי בפעילות הכלכלית, עליו ניתן
 ללמוד מהקף העברות הכספיים לפלסטינים. בשנת 1997 העבירה ישראל לפלסטינים
 סכום של כ-540 מיליון דולר (עבור מיסי יבוא, קיזוזי מע"מ, מיסי דלק, מס
 הכנסה ומס בריאות) לעומת 436 מיליון דולר ב-1996, עליה של 24 אחוז יש
 לזכור שהעברות כספיים אלה מהוות כ-63 אחוז מהתקציב הפלסטיני. בשליש
 הראשון של שנת 1998 הסתכמו ההעברות מישראל לרש"פ בכ-182 מיליון דולר
 ובסה"כ משנת 1994 בכ-1.5 מיליארד דולר.

ה. סיכום

ישראל ממשיכה להשקיע מאמצים רבים בשיפור מצב הכלכלה הפלסטינית מתוך הכרה
 שמדובר באינטרס ישראלי ופלסטיני חשוב. עם זאת ברור כי ההתקדמות תלויה
 בראש ובראשונה במצב בטחוני יציב ובשיתוף פעולה מטעם הפלסטינים והקהילה
 הבינ"ל. בהקשר זה ראוי שכל הגורמים יפעלו בצורה שתקדם שיתוף פעולה בין
 הישראלים לפלסטינים בתחום הכלכלי (העקרון העומד בבסיס "פרוטוקול פאריס",
 המסדיר את היחסים הכלכליים בין ישראל והפלסטינים בתקופת הביניים) ולא
 יקריבו אינטרסים כלכליים חשובים לסובת שיקולים פוליטיים זרים.

חיים זקסמן
 24 במאי 1998

תפ: שהח, רהמ, שהבט, מונכל, ממנכל, תכנון, מצב
 תפ: סמנכלים, מצפא, אירופה, מזאר, אמלט, אפסוק
 תפ: מצרים, ארבל, פרו, משפט, כלכלית, ממד, ירדן
 תפ: מקאב, אוסונומיה, רבצד, מגרב, מפרץ, ירושלים
 תפ: תקשורת, רם, אמן, ר' אגת, אאלדן/הדכא
 תפ: ארם/הדרכה, מתאסשסחים, עמית475, בינל/אוצר
 תפ: בדיקה

כלכלה

טבע רוכשת את Copley האמריקאית תמורת 220 מיליון דולר במזומן

מי האשם? הנגיד



יעקב פרינקל

מחיר יונקונס 23 שרי הממשלה כדי לאשר את מסגרת תקציב המדינה לשנת 2000. כמה שרים ירדו נגד יציבות בעד. אחרים יציבו נגד, אך יפולו הצדה כדי להיות בטוחים שלא הם יהיו אלה שיגרמו לאי-קבלת החלטה. המסמך שיציג יהיה האוצר לממשלה, נכתב על ידי חדר ד"ר. מנכ"ל האוצר, שאינו במקום, מוד המפקד שאינו במקום, למשל "אירועי בלאג 1000" או "דוח גבית לשרים" שמסמך לשרים העומדים במסגרת תקציב לשרים שהדיבת הגבוהה היא אם כל אותם בכירים היו בתפקידם. לפי המסמך, הדיבת היא זו ששלמה את הצמיחה וגרמה לאבטלה. היא זו שגרמה ליישק ולפגיעה בייצוא - כך שלא נשאר אלא להאשים את הנגיד בכל הערות החולות. קשה לגבש כמות גדולה יותר של אי-אמיתות הסעיות. אין שם אפילו מלה טובה אחת על מניית הדיבת. בכדי האוצר ולא נים שהאינפלציה הנמוכה היא תוצאה של הדיבת הגבוהה. הם לא מסבירים לשרים שתנאי המדינה לצמיחה יציבה לאורך זמן הוא השגת אינפלציה נמוכה. הם לא מתבים מה יעד האינפלציה ל-2000, והם אפילו לא מספרים לשרים שרווקא מאז תחילת '98 יעד היום, התרחק לל במשק פחות ריאלי מנכון של כ-8% - שהשגת יעד האינפלציה תהיה תמורה על למה לקלקל את מסע השיטה נגד הנגיד אותם כלכלנים באוצר חיים עדיין בעבר החוק, שהיה נשלט ע"י "קצוות פוליטיים". אך העקומה פסה מומן מהעולם. כיום מלמדים המוד צד שאפשר להשיג צמיחה לאורך זמן ע"י העלאת האינפלציה. זה עובד הפוך, למרות מה שכתוב המסמך. לאותם כלכלנים ולשר האר צד שפרק המדיניות המוניטרית נכתב לכבודו ראוי להוכיח מה הגורם למיתון במשק הגדולת הדיבתן בתקציב מ-1.75% מהתוצר ל-2.5%. הדיבת האטית מויל ל-1.5%. כתוצאה מכך גרל החוב הלאומי, כלומר עולה מחיר גיוס והפנימי החיצוני, כלומר עירוד המיתון. אפשר לצאת מהמיתון, אך זה תלוי במדיניות הממשלה. ראשית, יש לקדם את תהליך השלום כדי להקטין את האירואות במשק, וכך להגן דיל את הדיבת הפיסיית והחשקת. שנית, לבצע שינוי אמיתי ועמוק בסדר העדיפויות בתקציב - הרבה יותר לתשתיות הרבה פחות לחדר רים ולשטחים. זה לא קיים בתקציב, ושלישית, ביצוע רפורמות והפך שות בכל שטח המשק, את כל זה צריך לבצע שוטח. לא פרינקל, אבל מדוע להכות את חוד שלך, כאשר אפשר להכות את חזהו ערוד?

רווקא בשוק שהיה בשנה האחרת נה בעייתית ביותר עברה. טבע מוכרת בארה"ב בקצב שנתו של 500-450 מילון דולר, אך היא כמעט שלא צמחה בשוק זה ב-'98 ובמחצית הראשונה של '99. הרכישה הנכבדת של קופלי תאפשר לטבע להציג צמיחה משמעותית במכירות בארה"ב. החברה תשלם הרכישה תוך תר טבע עם יתרונות מומנים נמר מת יחסית, והדוביץ הערוד כי באמצעות הנפקת איגרות חוב, על מנת ליצור קופת מומנים זמינה של 200-250 מיליון דולר בתמורה.



אלי הורביץ

הערוד אמש כי בשנת 2000 תמנע הרכישה של קופלי ברוח למכנה של טבע ותגרע ממנו בנטף מחוקק הרכישה את טבע

בעלת המניות הגדולה של קופלי היא חברת הכסס (52%), שותפה של טבע לשיווק תרופת הקופק סון, שכבר הסכימה למכור לטבע את מניותיה בארה"ב. קופלי היא חברת תרופות גנריות המוכרת בעיקר בארה"ב והיקף מכירותיה ב-'98 - 133 מיליון דולר. הדוח הנקי של החברה ב-'98 היה 7 מיליון דולר. הולד הרעה משמעותית בתוצאה האולם במחצית הראשונה של '99 - פרמיה של 24% ביחס למחיר המניה של קופלי בבורסה. טבע תפרסם הצעת רכש לבעלי המניות של קופלי והשלמת הרכישה מתנחת בהיענות להצעה ובאישור הרשויות בארה"ב.

מבני תעשייה הרוויחה 18.8 מיליון שקל ממניות שרכשה

חברת מבני תעשייה שבשליטת אליעזר פישמן רכשה מניות בסכום של 130 מיליון שקל נטו ברבעון השני ב-'99. הרכישה מומנה באשראי בנקאי בסכום של 200 מיליון שקל. המשנה למנכ"ל מבני תעשייה, אבי אלימלך, אמר שהחברה רכשה בעיקר מניות מע"ף. מבני תעשייה הרוויחה על המניות שרכשה 18.8 מיליון שקל ברבעון השני ב-'99. הרווחים מניית רות ערך הביאו לגידול ברוח הנקי של החברה ל-24.7 מיליון שקל בממוח של 58 מיליון שקל ברבעון השני ב-'99, לעומת 18.7 מיליון שקל בממוח של 58 מיליון שקל ברבעון המקביל ב-'98.

טאוור סמיקונדקטורס וכלל תעשיות אלקטרוניקה במגעים לשלש פ"ע עם מוול ויטליק

חברת טאוור סמיקונדקטורס וכלל תעשיות אלקטרוניקה מנהלת, בנפדי, מגעים ראשונים עם הקונצרן הטייוואני מוול ויטליק, המועניין להקים בישראל מפעל שבנים בהיקף של 2.5 מיליארד דולר. נציגי שתי החברות יתפגשו עם שלושה בכירים מהקונצרן, שיגיעו בסוף השבוע לישראל. בין השאר יכתבו ראשי הקונצרן אפשרות שטאוור תשמש כנציגתם בישראל באמצעות השקעה משותפת בפרויקט. לחלופין יבנו אפשרות לרכוש את מניות משפת עופר בטאוור, ולשלב את המפעל הקיים בתוכנית החברה להקמת המפעל, ע"פ קריטריונים שהעביר הקונצרן הטייוואני, הם אוד תעשייה גליל תחתון (ליד צומת גולני), ציפודית, גזרת עילית, צבאים (ליד בית שאן), נתיבת חתף אשקלון. נציגי הקונצרן יסידו באזורים אלה במטרה לבנות האל-טה עד סוף אוגוסט.

מניית אינטרנט זהב צנחה ב-27% ביום המסחר השני לאחר הנפקתה

מניית אינטרנט זהב, שהחלה להיסחר ביום שישי בבר רשת הנאסד"ק בניו יורק, צנחה אמש, ביום המסחר השני שלה, ב-27% - למחיר של 8.75 דולר. אינטרנט זהב השלימה בסוף השבוע שעבר הנפקת ראשונה של מניית, שבמסגרתה גייסה 54 מיליון דולר לפי שווי חברה של 220 מיליון דולר. המניות נמסרו למשקיעים ב-12 דולר, וכיום שיש טגר, מנכ"ל החברה, קלה, אודי שבנתות המסחר כבר עלו ב-40%. אתמול היתה הנמטה שלילית החל מפתיות המסחר. מחיר המסחר המשיך לשמור על רמה גבוהה, ועמד על 13.5 מיליון מניות. בשוק הון בתל אביב העריכו כי מניית אינטרנט זהב היתה רושמת ירידה חדה כבר ביום המסחר הראשון שלה, אלמלא בנפץ זאת בנק ההשקעות ליהמן בראדרס, התמם הראשי בהנפקה. הערכה היא כי ליהמן רכש מאת אלפי מניות בשוק כדי לתמוך במניה, ואולם אתמול גם הוא לא היה יכול למנוע את הירידה.



ICQ חצה את קו 40 מיליון המנויים

חברת אמריקה און ליין, ספקית שירותי האינטרנט הגדולה בעולם, הדגיפה אתמול כי מספר המנויים של שירות ICQ שלה חצה את קו ה-40 מיליון. ICQ הוא שירות המסרים המיידיים באינטרנט, אותו רכשה AOL ממדיאבלים הישראלית לפני שנה וחודשים. תמורת 400 מיליון דולר, בעת הרכישה היו ל-ICQ 12 מיליון משתמשים, ומאז הגדילה את מספר לקוחותיה ב-230%.

יונתן נשיא

DD/MM/YY (שווי שוק, עמוד 7)

צדיק בינו במו"מ לרכישת אחזקות משפחת ליברמן בפז לפי שווי של 400 מיליון דולר

קול באקמת חדשה!

למכור את השליטה בה בעתיד מיליון דולר, ונתון היה להשיג עבודה מודר גבוה יותר אם יציע אותה למכירה הערכה גסה מעלה כי אם חברת רור אבגייה נרכשה לפי שווי של 102 מיליון דולר, שוויה של פו הוא 430 מיליון דולר לפחות. פעילים אחרים אבדו כי בינו ירכשו את פו כחברה להחזיק בה ולהשכיח - ואין לו כל כוונת

מספחת ליברמן כפון, מתוך הער- בה כי שווי החברה גבוה מ-400 מיליון דולר, ונתון היה להשיג עבודה מודר גבוה יותר אם יציע אותה למכירה הערכה גסה מעלה כי אם חברת רור אבגייה נרכשה לפי שווי של 102 מיליון דולר, שוויה של פו הוא 430 מיליון דולר לפחות. פעילים אחרים אבדו כי בינו ירכשו את פו כחברה להחזיק בה ולהשכיח - ואין לו כל כוונת

ליברמן מייצג כנ"מ עו"ד יזהר שר ורונצוויט. מספחת ליברמן קיבלה ב-'98 חלטה אסטרטגית למכור את אחזקותיה בנפ. מספחת ליברמן וליבנו הטכני הרדי לוכת סירוב ראשי נה, שלפיו ינתנו ליבנו 60 יום להחליט אם לרכוש את אחזקות ליברמן. ליברמן כפז לפי המחיר שנקבע בינה לבין הצד השלישי. פעילים במשק חלק העריכו אתמול, כי בינו ירכשו את מניות

מאת עמריה בוקן

יורד קבוצת פו, צדיק בינו, איש אתמול כי הוא מנהל מ"מ לרכישת אחזקות משפחת ליברמן (56%) בנפ. על פי מידע שהגיע ל"הארץ", הדיעה לפני כשבוע משפחת ליברמן וליבנו, כי היא מנהלת בנפ לרכישת אחזקותיה בנפ לצד שלישי, לפי שווי חברה של 400 מיליון דולר. את משפחת

אתה שותף ליצוא מוצר!

פיא יצוא פלוס

תחילת הפצת יחידות הקרן ב-12.8.99

מבצע רכשה ללא תוספה עד 30.9.99

פיא יצוא פלוס' היא קרן מנייתית המתמחה בחברות שלא פחות מ-40% מהכנסותיהם היו ממכירות ליצוא. הקרן גם משקיעה לפחות 3% מהשווי הנקי של נכסיה באופציות על חברות יצוא או באופציות על מע"ף.

ביהמ"ש אישר הגשת תביעה ייצוגית ב-800 מיליון שקל נגד בוק בינלאומי

מאת לאורה קפלן

שופט בית המשפט המחוזי בתל אביב, משה סלנג, החליט אתמול לאשר תביעה ייצוגית נכס ב-800 מיליון שקל נגד חברת בוק החברה הבת בוק בינלאומי, שהיו מנופול בשוק השיחות הבינלאומיות של לפתחתו לתחילת ביולי '97.

בוק כי המחירים שנקבעו בתק-נות על ידי השרים היו מחירים מחייבים, נרחבה "נראה לי כי יש סיכוי שהמבקשת תצליח להוכיח כי המחירים שקבעו השרים בתקנות היו מחירים מרביים, ולא מחייבים", כתב השופט. "מכל מקום, קיום תגום לב שבחב מנופוליסט שלא לקבע מחיר מופקע - היה מחייב על המבקשת לפעול להפחתתו".



משה סלנג

המדינה היא בעלת מניות בבוק ושותפה על פי חוק ברור חיה, ולפיכך נתנה מנבית הכספים. עלה זאת, מהחלטה ביהמ"ש העלה שהממנה על ההגבלים העסקיים הודיע לביהמ"ש כי ברשותו ראית כבודת משקל, שלפיה מחירים לא הודרו לפני פתיחת שוק

השופט כתב בהחלטתו: "הם" ענת המועלת נגד המשיבות סלולות האשמות תמורת של ניצול חתון המנופוליסטי לרעה. יש אינטרס ציבורי שאר שמת אלה יתבררו בבית המשפט".

לסענת קו מחשבה, המיוצג על ידי עורכי הדין אהרון פולק ורודן לוי, עם פתיחת שוק השיחות הבינלאומיות לתחרות יררו מחירי השיחות של בוק בינלאומי בכ-70%. בבקשה נכתב שהיחסי לתובעים, את המחירים בכ-70% ועדיין ליתבות מרווח סביר, מעדיה על פניה כי המחיר שקבעו ובנו בוק בינלאומי ובוק היה בלתי הוגן ובלתי סביר.

ניצול לרעה

שפוגע בתחרות. בנוסף נקבע בסעיף איסור לקביעת מחירים שיתפשו כבלתי הוגנים כלפי הצרכנים. הטענה העומדת במרכז התביעה היא שרק לאחר פתיחת שוק התקשרות הבינלאומית לתחרות, הודיעה בוק בינלאומי את תעריפי החיוג שלה ב-70% מנא, שהתעריף פים שבנתה החברה מיום הקמתה ועד הווה תעריפים מופקעים, שנקבעו באופן מרבי, תוך ניצול מעמדה כמכר נופול בשוק.

התביעה מתייחסת לתקופה של כשנה - בין מועד כניסת הסעיף המורכב לחוק ההגבלים העסקיים (10 במאי '96), לבין מועד פתיחת שוק התקשרות הבינלאומית לתחרות (8 ביולי '97). התביעה טוענת כי לקר חת שחינו לחול בתקופה זו, שילמו מחירים הגבוהים ב-80% מהמחירים ההגוינים לשירות, שנחשפו עם פתיחת השוק לתחרות.

אם אכן תתקבל התביעה, יהיה זכאי כל מי שחיג בתקופה האמורה להחזר בגין שחר תיו לחול. הנוסחה להישוב גובה החזר תיקבע ככל הנראה ע"י ביהמ"ש, ותבוסס על ההפרש בין תעריפי החיוג לפני פתיחת השוק לתוך רות, לתעריפים בתקופה שאוד ריה.

עקב הוכחה בתביעה כיצור גיה, והלקוחות הנפגעים לא גורשים להצטרף לתביעה, ויהיו זכאים לפיצוי באופן אוטומטי, אם היא תתקבל.

מס' 1 בקרנות נאמנות לאומיפא

תחילת הפצת יחידות הקרן ב-12.8.99

מבצע רכשה ללא תוספה עד 30.9.99

פיא יצוא פלוס' היא קרן מנייתית המתמחה בחברות שלא פחות מ-40% מהכנסותיהם היו ממכירות ליצוא. הקרן גם משקיעה לפחות 3% מהשווי הנקי של נכסיה באופציות על חברות יצוא או באופציות על מע"ף.

סוגיית מעמד הכלכלה הפלשתינית

האינטרס הישראלי: הפרדה כלכלית מהמשק הפלשתיני

קובע איגוד לשכות המסחר במסמך בעניין הסדר הקבע הכלכלי, "עדיף לישראל לבסס קשרים עם הסכם סחר חופשי ומדיניות מוניטרית נפרדת"

מאת אורה קרון
בסקטור הפרטי בישראל מתגבשת לראשונה תפיסה שעל פיה יש לקבוע גבול פיס בין ישראל לישראל ולתוכנית הכלכלית בין שני המשקיים במסגרת הסדר הקבע. לשכות המסחר באגוד ברך שניה בדיקה ראשונית העלתה כי קרב גורמים נוספים בסקטור הפרטי ובמנהל הממשלה מסתמנת תמיכה בנישה זו.

גישה זו שתרמה את מסמך הסדר הקבע הכלכלי שגובש לפני כחצי שנה ע"י צוות ישראל-פלשתיני ביחסי יוסי ביילין וזכאות ממשלת נורווגיה. המסמך נכתב ע"י צוות בראשות דוד ברזיס, מנכ"ל האגוד לשכות המסחר, ומגבש את ההגנה המבוססת על שיתוף פעולה כלכלי (הסכם פאריס), ר"ח מאזר אל קורד, יועץ הכלכלי להשקעות ופנינגס של י"ר והשותף הפלשתיני יאסר ערפאת.

על פי הצעת ברוטאל קורד, בין ישראל לרשות הפלשתינית יוכנו מודל כלכלי פתוח, המשלב איחוד מסך ואזור סחר חופשי. המסמך הוצג בפני גורמי סיוע בינלאומיים, מדינת הפעילות במזרח התיכון ומקבלי החלטות ישראלים ועבריים.

המסמך שגיבש איגוד לשכות המסחר חולק על עקרונות מסמך ברוטאל קורד. איגוד לשכות המסחר קובע כי האינטרס הלא-ישראלי הוא התנתקות מוצרי שוק הפלשתיני.

עקרונות הסדר הקבע הכלכלי שגיבש לשכות המסחר כוללים הפרדה ע"י גבול פיס, הפרדה רגולטורית בין המשקיים, גידול מדיניות סחר חופשי בין פלשתינית וצמחית על בסיס קשרי הסחר בין המשקיים על הסכם אזור סחר חופשי שיסדיר בהסכם הרחב את שיתוף המסך בצדדים, הקמת מנגנון פיקוח על הסחר וניהול מדיניות מוניטרית פלשתינית עצמאית.

מחברי המסמך של איגוד לשכות המסחר סבורים כי כותר צאה מהפרש הגדול בין המשקיים, ההפרשים הצפויים לישראל מצמצום הקשר הגובשי עם הרשות הפלשתינית יהיו ועדיים

הציבור משך 393 מיליון שקל מתוכניות החיסכון לטווח ארוך ביולי - פחות מאשר ביוני ובמאי

מאת מוטי במוק
כ-2.1 מיליארד שקל בכל '98 מתוכניות החיסכון הנכנסים, שרדו כחצי מיליארד שקל, עולה כי הציבור נטו בתוכניות החיסכון ב-184 מיליון שקל, לעומת 393 מיליון שקל ביוני ו-552 מיליון שקל במאי. וצבירה נטו שלילית של 568 מיליון שקל במאי.

בתוכניות החיסכון המדידת לים ובנק יהב, שרובו ע"י הארץ, צברה נטו שלילית של 245 מיליון שקל, לאורך 209-209 מיליון שקל. זאת לעומת 61 מיליון שקל, לעומת 553 מיליון שקל ביוני, ושל 735 מיליון שקל במאי. מתחילת '99 נמשכו מקופות הגמל ומקופות ההשקעות היובית - 850 מיליון שקל לעומת

צ"י מנהטן יבדוק עבור אל על את תוכנית ההצטיידות

מאת דודי בלומברגן
סיוחל על רכיבת מטוסי אייר בוס

תכנית אל על פנתה ל-Bank Chase Manhattan, אחד הבנקים הגדולים באר"צ, בבקשה למתן חוות דעת שניה על תקפת הפירמטה של תוכנית ההצטיידות של החברה. כמו כן התבקש הבנק לסייע בהבנת מסמכי הבקשה לרשויות האשראי בעקבות רכיבת מטוסי אל על. אל על מודר ברכישת מטוסי סיס מבוסר שבו מתורבת איירבוס ובואינג, שהיקפו 650-900 מיליון דולר.

הרשות האווירית הן בנק Exim באר"צ במידה שאל על תחליט על רכיבת מטוסי באוינג, או בנק Copas האירופי במידה

חבר הנהלת עיריית ירושלים למרדכי: לפתוח חניון קרתא בשבתות ובחגים

מאת מירי רייזל

חבר הנהלת עיריית ירושלים, יוסי סליג, המחזיק בחיקו התחרה את התשתיות בעירייה, פנה לתת אתמול במכתב לשר התחבורה, יצחק מורכי, בבקשה לפתוח את חניון קרתא בערב בשבתות וחגים, כדי לאפשר לאלפי המבקרים המגיעים לעיר העתיקה ליהנות משבתות חופשיות. לטענתו, מנהלי קרתא מרבים להיענות לבקשתו, ולכן הוא מבקש את התשתיות של קרתא משרד התחבורה בעניין.



פיקוח ארוך ארוך ארוך ארוך

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מסמך ברוטאל קורד - הסדר המשלב איחוד מסך ואזור סחר חופשי

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עיקר הסדר הקבע הכלכלי (EBS) הוצג בנובמבר '98 כסדר שהתקבל על הסכם דרדרי. המסמך נכתב ע"י צוות בינלאומי, מדינת הפעילות במזרח התיכון ומקבלי החלטות ישראלים ועבריים.

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צדיק בינו במו"מ

(סוף מעמוד 11)

צופה שהשוק יאפשר לו זאת בעתיד. בתחילת '99 ניהלה קבוצת לייבנדבינו מ"מ עם מיכאל דרדמן (חתנו של חר אריסון) וזמן בן יהודה, למכירת אחזקות הקבוצה (63% האחזקות קבוצת רנסנס (30% בפי. המ"מ, שנמדד שד זמן רב, נכשל בשל פערי המזון. בעוד שבינו עמד על שהשקעה תיערך לפי שווי תמורה של 400 מיליון דולר לפחות, הסיכמה קבוצת דרדמן ויהודה לשלם בעד המניות לפי שווי תמורה של 370 מיליון דולר.

פז הוא חברת הדלק הגדולה בישראל, ושולטת ישירות ובאמצעות חוד אספקה ב-220 תחנות בשרים האחרונות הגדולה החברה את פריסתה הארצית.

הפרדה כלכלית תואמת את ההפרדה הביטחונית שבה תומך ראש הממשלה

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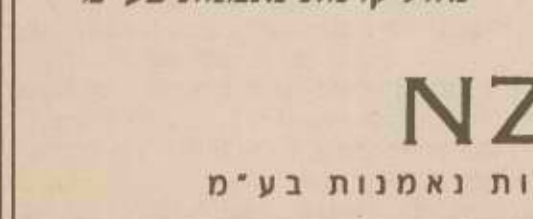
נשואה זנקס נהול קרנות נאמנות בע"מ

הודעה בענין חלוקת דיבידנד למחזיקי יחידות והגבלת המספר המירבי של היחידות המוצעות בקרן נאמנות "נשואה זנקס אג"ח מדינה"

נשואה זנקס נהול קרנות נאמנות בע"מ (להלן - "מנהל הקרן"), מנהל הקרן שבנדון, מודיע בזאת כדלהלן:
1. עפ"י החלטת דירקטוריון מנהל הקרן יחולק דיבידנד בסך 40 מיליון ש"ח, מרווחים צבורים הניתנים לחלוקה בקרן.
2. המועד הקובע לחלוקת דיבידנד הוא 22.8.99 (להלן: "היום הקובע"), ויום התשלום הוא 26.8.99 ("יום התשלום").
3. חלוקת דיבידנד תעשה למחזיקי היחידות באופן יחסי ליחידות המוחזקות בידיהם ביום הקובע, והתשלום יעשה באמצעות חברי הבורסה באמצעות מוחזקות היחידות, ביום התשלום.
4. החל מיום 9.8.99 ועד היום הקובע, יוגבל המספר המירבי של היחידות המוצעות בקרן באופן שמספר היחידות בקרן לא יעלה על 28,772,400 יחידות (להלן: "המספר המירבי").
5. המספר המירבי כאמור משקף שווי נכסי הקרן של כ- 450,000,000 ש"ח (בהתחשב במחירי הפדיון ביום 9.8.99).
6. במקרה בו במועד כלשהו, עד וכולל היום הקובע, יוגשו הצעות למספר יחידות העולה על המספר המירבי, יענה מנהל הקרן לבקשות שיוגשו באותו מועד בשעור אחיד באופן ששה"ח היחידות שיוקצו בקרן לא יעלה על המספר המירבי כאמור, וייתן על כך דיווח.

5. הקרן מינה קרן מסוייגת. לעניין הוראות המיסוי החלות על מחזיקי יחידות בקרן מסוייגת, ראה תשקיף הקרן מיום 1.7.99.
6. למועד הודעה זו מנהל הקרן גובה הוספה בשיעור 0.75% בגין רכישת יחידות בקרן.

בכבוד רב,
נשואה זנקס
נהול קרנות נאמנות בע"מ



נשואה זנקס ניהול קרנות נאמנות בע"מ

TOTAL P.01

משרד האוצר
 לשכת היועץ המשפטי
 לשכת הנשיא

23 -11- 1998

מס' _____
 תיק _____



**איגוד
 לשכות
 המסחר**

ה"פ: 98: 1833 ביניה ירוק
 פלישה תמימי

ארגון העסקים של ישראל

בית לשכת המסחר, רח' החשמלאים 84, ת"א 67132 • ת.ד. 20027 ת"א 61200
 סל' 03-5631010 • סקס' 5812614, 5819025, 02-5619027
 HTTP://WWW.CHAMBER.ORG.IL • E-MAIL: FEDCCI@ACTCOM.CO.IL

18 נובמבר, 1998
 סימוכין: 60494

58416

לכבוד
 מר נתן שרנסקי
 שר התמימי
 ירושלים

מנכ"ל
 כבוד השר,

הנדון: לקראת הסדר קבע כלכלי עם הישויות הפלסטינאיות

קשר המסחר בין הסקטור העסקי בישראל ליישויות הפלסטינאיות ענפים ותואמים את תפיסת העולם של איגוד לשכות המסחר בפרט, והסקטור העסקי בכלל. תפיסה הדוגלת בחופש הזדמנויות סחר חופשי ושיפור רמת החיים כגורם מרכזי בעצימות ובחורדות רמת האלימות.

בכל הסדר קבע כלכלי שינובש עם הרשות הפלסטינאית, אנו מבקשים להתבסס על התנחות הבאות:

- א. חופש תנועת סחורות ואנשים.
- ב. תחרות חופשית ומתן הזדמנויות שוות לאיש העסקים הישראלי ברשות ולחיפץ.
- ג. החזר מכסים, מיסים וחיטלים לסחורות המיועדות לרשות.
- ד. זהות תקנים ביבוא סחורות לרשות ולשראל. סחורות בסטנדרטים אחרים שיכנסו לרשות לא יורשו להגיע לישראל.
- ה. מנגנון אכיפה למניעת ניצול המצב הקיים להימנעות מתשלום ע"י אנשי עסקים משני הצדדים.
- ו. הימנעות הודית מצעדים חד-צדדיים שימנעו את הסחר התופשי ורמת הסחורות בין שני הצדדים.
- ז. עידוד מיזמים משותפים, שותפויות והשקעות ברשות, תוך ביטוח סיכונים ומערכת משפטית הולמת.

לסיכום: חשיבות השוק הפלסטינאי למגזר העסקי בישראל חורגת מהמספרים הנכבדים לשלל עצמם (כ- 3 מיליארד דולר בסחורות ושירותים), אלא בהזדמנות שכתות טובה, יציבות באזור והבטחת רמת חיים כסמל לשלום. בכדי ליצור תנאים אלו יש צורך בעידוד הסחר והסרת המגבלות.

איגוד לשכות המסחר, ואני אישית, נשמח לשתף איתך פעולה לקידום המטרות אשר כה חשובות לכולנו.

בכבוד רב / א' י' 98

דני גילרמן

IPCRI Roundtable Summary
Pursuing Economic Development and Growth

Notre Dame Center, Jerusalem

September 9, 1988

Speakers:

General Yaacov "Mandy" Or, Coordinator of Government Affairs in the Territories
Mohammad Rachid, Economic Adviser to Ra'ees Arafat

This roundtable meeting took place before the US direct intervention in the peace process during a time when there was almost a complete breakdown in communication between the Israeli government and the PA. General Or spoke first and emphasized the positive activities undertaken by his office to liberalize the movement of Palestinian workers and goods into Israel. He stressed the importance that the Government of Israel placed on Palestinian economic development. General Or presented a cautiously optimistic picture that if the security situation remained calm, the Government of Israel would continue with the process of allowing more and more Palestinian laborers to work in Israel and for Palestinian goods to flow freely through Israel. General Or also spoke about Israeli investments in infrastructure and in new technologies to allow for more rapid movement of people and goods.

Mohammed Rachid presented the Palestinian case that Israel has consistently blocked Palestinian economic growth and has held the Palestinian economy hostage of Israeli politics, often done in the name of "security". Mr. Rachid presented several cases and examples to demonstrate his point. Mr. Rachid stressed that the Palestinians were interested in economic cooperation with Israel, but on terms that involved reciprocity and mutuality and not unilateral Israeli decisions and actions.

The following are some of the issues raised during the roundtable:

The Gaza Industrial Estate.

There are clear differences in how the two sides view the Industrial zone. To the Palestinians, it is as a way of developing the Palestinian economy, employing more people, and attracting investors. To the Israelis, it is merely an alternative way of employing Palestinians. Mohamed Rachid mentioned that the current deadlock in negotiations over the Gaza Industrial Estate is caused by the fact that the deal the Israelis are offering is unacceptable to the Palestinians. It is not viable that movement from Gaza can be executed in Israeli trucks only. Palestinian assert that the packaging of goods must take place in the factories and not in the proposed Israeli packaging and transport zone on the Israeli side of the border. This will not encourage investors, it will cause potential damage to goods and will slow down the entire process. The Israelis promised to bring new technologies that the US agreed to fund, however, it appears that the new technologies will not be ready and working for another two years. Other solutions must be found for the "security" problems of the Industrial Estates.

General Economic Policy Issues

Trade with third countries is still very restricted by Israel, in particular with the two Arab countries that Israel has signed peace agreements with. According to the PA, Israel still owes the PA millions of dollars in purchase taxes, an issue that was not finalized within the Paris Protocol and has not been agreed upon since in the Joint Economics Committee.

Movement of Labor

According to Mohamed Rachid, the Palestinians agreed to many concessions in order to assure freedom of movement of goods and labor in the Paris Protocol. However, this promise was denied in the implementation of the agreement.

There was disagreement about how to interpret the statistics of Palestinian workers in Israel. General Or was impressed by a 10 percent increase in the number of employees from Gaza in Israel at a time where security considerations were important and unemployment was increasing in Israel. Mohamed Rachid claimed that the 10 percent increase was just a backdrop from the 80% decrease from previous periods. Whereas General Or said there was no closure last year, Mohamed Rachid calculated a 70% closure the same year by comparing both the number of workers and the hours per worker with the level before 1993.

According to General Or, the goal is to reach 100,000 to 120,000 Palestinian workers in Israel. General Or mentioned figures to demonstrate that the goal is not far from being accomplished: Legal workers from the West Bank and Gaza Strip constitute 50,000 to 60,000. In addition, there are an estimated 40,000 to 50,000 illegal workers.

Illegal Workers

Participants claimed that admitting figures for illegal workers refutes the argument about security and terrorism. General Or responded that since there is no effective fence around the West Bank, illegal workers are hard to restrain. The problem of illegal workers is twofold, they constitute a security risk, and they are denied their social rights. It should be the PA's responsibility to check both illegal and legal workers. They will have an incentive to do so, since they lose income tax by the high amount of illegal workers (General Or).

Physical Security or Economic Security?

Participants argued that the physical security of the Israeli people was an excuse to secure Israeli economic dominance. Under this security pretext the Palestinians are denied the most basic requirements for building an economy. For example, restricting on import of cows and milk: Since the cows will not join Hamas, it is not security issues that determines the policy. The issue is the competition with the Israeli Tnuva products.

Monopolization of the Palestinian Economy

Upon a comment from the audience about the monopolization of the Palestinian economy by the Authority, Mohamed Rachid stressed that there are only two official monopolies. There is a commitment to put an end to these under supervision of the World Bank and IFC.

Dependence or Independence?

Mohamed Rachid explained that there is no such thing as an independent economy. The Palestinian economy is highly dependent on its neighboring countries, especially Israel, which bears a high degree of responsibility for the current situation. The Palestinians, however, are determined to attain an independent economic policy, free of Israeli restriction and discrimination.

Future

General Or repeated that it is a process of trust building and things do not change overnight. He admitted that the number of trucks allowed exit or businessmen receiving permission are not sufficient but hopefully these numbers will increase as the relationship improves. It is not an Israeli unilateral decision making but a joint coordination between Israel and PA. However, sometimes this coordination is slow and difficult.

In General Or's view, a sound economic relationship is an integrated part of security. Therefore, there is an mutual interest to define the gaps and bridge them in cooperation.

IPCRI

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مركز اسرائيل/فلسطين للأبحاث و المعلومات
Israel/Palestine Center for Research and Information

Some Thoughts on the Creation of Employment in the Palestinian Territories

Transboundary Industrial Zones

January 1995

Gershon Baskin, Ph.D.

The following is part of a memorandum drafted and sent to Prime Minister Yitzhak Rabin ל"ר in January 1995. This memorandum led to the creation of a Ministerial Committee on Joint Industrial Zones.

1) Industrial Zones

The basis of this suggestion is that rather than bring the workers to the work, the work should be brought to the workers. There are many ways of conceptualizing this plan and of viewing its development. The following are several of the variables which much be considered:

a. Location

- i. On the Israeli side of the border
- ii. On the Palestinian side of the border
- ii. a transboundary zone

b. Ownership and management

- i. government
- ii. private sector
- ii. mixed private and public sector ownership and management

c. Make-up of Factories in the Zone

i. Israeli

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- ii. Palestinian
- iii. Foreign
- iv. foreign and local joint ventures
- v. Israeli-Palestinian joint ventures

d. Incentives and who provides them

- i. Israeli
- ii. Palestinian
- iii. The World Bank

The Ideal Scenario

The ideal scenario of the industrial zone would be as follows:

The zone will be a transboundary zone, located both in Israeli sovereign territory as well as in the Palestinian territory. The ownership and management of the zone would be private but the governments would provide the basic infrastructures. Incentives would be provided by both governments as well as the World Bank. The World Bank would provide loans and grants for the construction of the infrastructure of the zones as well as providing capital grants and low interest loans for factory relocation. The governments would declare the zone development areas class "A" with all of the incentives relevant in this classification. This includes tax holidays, grants and other incentives. Exporting from the zone would be encouraged both for the local markets and for foreign exports. The make up of factories would be a combination of all the options listed above (Israeli, Palestinian, foreign and combinations of joint ventures).

The Reality

The real situation is unlikely to develop according to the model illustrated above. The various options and variables should be examined in order to determine their possible implications.

Location

The easiest and probably the fastest way of creating such industrial zones would be for Israel to take a unilateral decision and simply develop areas on the border of the green line near densely populated Palestinian areas. These zones would be Israeli. Israel would develop them as she sees fit. There could be private sector involvement and probably would, if Israel could encourage private companies to invest in the development of these zones. The ideal situation for Israel would be to tender out the ownership and/or the management of these zones. Labor intensive industries would be encouraged by Israel to move to the zones and perhaps Israel could convince some of the donor countries to contribute funds towards the relocation of factories as they will provide labor mainly to Palestinians. Israel could also try and encourage foreign investments in the zone, however, it is highly unlikely that these investments will find their way there because foreign labor intensive industries will most likely still prefer to locate in regions with greater political stability.

The primary potential problem with the above model is that the means of employment will be solely in the hands of Israeli interests and the laborers will be mainly Palestinian. Management and ownership will be Israeli and Palestinians will provide cheap labor. This is

only a modified form of colonialism and would probably be successful only in the very short term. Eventually, it is likely that the industrial zone would turn into an arena of terrorism or sabotage which would drive industries out from the area. The Palestinian Authority would see little interest in squashing rejectionists of the Israeli "economic occupation" as there would be no Palestinian economic investment in the zones.

The Palestinians could unilaterally create industrial zones near the borders on their side. They could try to attract Israeli factories to set up shop there, but this is highly unlikely to succeed unless there is a significant improvement in the political stability and in the security situation. Most Israeli factories would prefer, at this point, to find more expensive replacement workers than to move their operations to the Palestinian sectors. The Palestinians could also try to attract foreign investment, but this too is unlikely to succeed.

The other option, then, would be for Israel and the PNA to combine efforts and create a transboundary industrial zone (or zones) which would be located physically on lands from both territories. The conditions for operation of the zones would have to be carefully negotiated.

Some of the issues to take into account are:

1. Ownership of the zones - public or private
2. Taxation and tax revenues
3. Private-Public sector involvement in the construction and management of the zones
4. Who are the owners of the factories (Israelis, Palestinians, others)
5. What industries can be located in the zones
6. Risk insurance and other forms of insurance
7. Banking regulations

1. The question of ownership of the zone is crucial to determine how the zone develops and how it is perceived. In any event, it would seem essential for any project of this kind to be based on parity between the sides. If the public sector is to be involved, there must be parallel arrangements for both authorities. If the zone would be owned and/or managed by the private sector involving Israeli and Palestinian interests, the same would apply. Parity should be sought in this question. Outside, third parties could be brought in as investors in the project and in fact, this would probably strengthen the likelihood of the success of such a project. This issue should not be underestimated in its importance.

2. The question of taxation and revenues is also very important. Industrial development is very important to provide a tax basis for the PNA. Likewise, Israel is not interested in reducing its own tax basis. Arrangements will have to be made in order to guarantee a regular and consistent flow of taxes. While tax incentives may be provided for companies choosing to relocate or to be established in the zones, the income taxes for workers, VAT and possibly municipal (property) taxes will have to be paid. Mechanisms for this must be established within the framework of the negotiations on the zones. There are many possibilities for arranging this, e.g.:

a. splitting all tax revenues equally between the two authorities

b. Income tax revenues from Palestinian workers to the PNA and income tax revenues from Israeli workers to the Israeli authorities. Special arrangements could be made if there are workers who are neither Israeli nor Palestinian.

c. Municipal (property) revenues could also be split or they could be funneled into a special fund for the purpose of creating additional zones or for the encouragement of the development of the zone itself.

3. Private-Public sector involvement in the construction and management of the zones.

As stated above, parity is a key question. The most likely scenario if this concept is to take hold is that the public sector authorities will be the owners of the industrial zones. If this is not the case, it can probably be assumed that the public authorities will, at least, be the owners of the land upon which the zone is constructed. It would be wise for the public authorities to tender out the development, construction and the management of the zone. In this case, a joint venture involving an Israeli and a Palestinian company, with the possibility of a third party, could create a holding company or a development-industrial company which would construct and manage the zone. Factories choosing to locate within the zone would have to purchase or lease space and facilities from the holding or development company and not from the public sector authorities. The holding company would be free to raise capital in capital markets. The holding company could purchase services freely from private sector companies and/or from public companies (this question would have to be resolved in the negotiations on the establishment of the zones between the Israeli and Palestinian authorities. The question of what company provides electricity, water, waste disposal services, etc. is a crucial element within the negotiations).

4. Who are the owners of the factories (Israelis, Palestinians, others)

The make-up of the factories within the zone is also crucial to the long-term success of this concept. Initially, it would probably most likely and feasible to encourage existing Israeli factories to simply re-locate within the zones. These would most likely be labor-intensive industries in food processing, textiles, etc. This should be encouraged through a range of possible incentives (see "Incentives"). However, there is a real danger in the possibility of the zones becoming mainly Israeli economic interests seeking low-wage Palestinian labor. This danger is already mentioned above.

The developers of this concept, must from the outset, encourage joint venture between Israeli and Palestinian companies which would receive incentives to locate within the zones. This is essential to the success of this zone in terms of insuring not only employment to the Palestinians, but sustainable economic development.

The developers in a later stage, once there is more political and economic stability, should actively seek out international investments which could be located within the zones. The more of an international character that will eventually develop to the zones, the greater the chances for long-term success and furthermore, long-term sustainable development.

5. What industries can be located in the zones

Eventually, the develops of the zones should provide preferences for industries which are mainly export oriented, however, initially, this should not be a matter for great concern. The first challenge must be to provide employment and the market for the goods produced should be of little concern. An issue of concern should be the environmental sustainability of the industries located within the zones. High environmental standards should be set from the outset and all factories should be made directly responsible for recycling and effective control of wastes. It is very important that the zone be clean and green. This will help to encourage future investments within the zones. These standards can only be set from the beginning. Pollution prevention is not only cheaper than pollution clean-up, it is also a wise policy to adopt to encourage additional investments in the future.

Security Within the Zone

The more of a joint nature that zone encompasses, the greater will be the security for all parties involved. Nonetheless, security is an issue which must be addressed both in negotiations and in the management of the zones. The normal security problems which exist for any factory anywhere (theft, vandalism, fire, etc) are only more complex and serious given the political situation in this region. Providing as near to absolute security is essential for this concept to succeed. The provision of security is costly and should probably not become the burden of the industries located within the zones. The expenditures for security will have to be covered by the public sector authorities (which may be able to get some support from international bodies to help off-set this costs).

Incentives

There are numerous incentives which could be provided in order to encourage private companies to locate within the zone. But, first, there are also potential incentives which could be provided to the authorities to encourage them to adopt this concept and to develop it. These are:

1. Greater economic stability in the Palestinian areas which would, in all likelihood, turn into greater political stability.
2. Potential capital grants and loans from donor countries
3. Creating a model of successful cooperative economic development which could be copied by others around the world
4. Increased foreign investment
5. Possibility of increased exports

In order to encourage companies to locate within the zone the following kind of incentives could be offered:

1. Tax holidays
2. Moving expenses
3. Capital grants and loans
4. Sharing of some marketing expenses
5. Providing a service of "match-making" in the potential creation of joint ventures

It would be wise to encourage international bodies such as the World Bank to provide some of these incentives. The easiest incentives for the World Bank to provide could be the relocation expenses and capital grants and loans for the development and expansion of new businesses (incentives could be linked to the number of jobs which would be created. The more jobs created the greater the incentives given).

Additional incentives or more substantive incentives should and could be provided for the encouragement of all kinds of joint ventures: Israeli-Palestinian, Israeli-foreign, Palestinian-foreign and any other possible combinations.

In September, 1995, IPCRI's Legal Staff prepared the following memorandum on legal issues regarding the Transboundary Industrial Estates

PALESTINIAN INDUSTRIAL ESTATES ON BORDER ZONES WILL REQUIRE THE GOVERNMENT OF ISRAEL TO DRAFT SPECIAL ISRAELI LEGISLATION

1. Preliminary Summary

These notes show that if the Government of Israel favors the establishment of the industrial estates on the border and wants them to succeed in attracting investment, Israel must pass far-reaching special legislation.

Special legislation is required, in brief, for three reasons: (1) to clarify for investors, particularly for Israelis and foreigners, precisely what are the commitments which Israel is undertaking in the context of the agreement with the Palestinians regarding the estates; (2) to clarify where the internal responsibilities created by the agreement fall within the Israeli governmental bureaucracy; (3) to harmonize the obligations undertaken by Israel in the context of the agreement with the Palestinians on the industrial estates with Israeli laws and international agreements (particularly the FTA's with the USA and the EU).

2. Clarification to Investors

Investors cannot reasonably be expected to invest in Gaza without some form of reliable guarantee that their operations will not suffer from non-individual treatment by Israel with respect to matters under Israeli control. This is most clearly manifest in the need of investors for uninterrupted access to their facilities for their workers, management, and suppliers, and for access out of the estates to Israeli ports or the airport. No investor will invest his capital in a situation where he could be closed down overnight because of security matters having nothing to do with his own operation. Some form of mechanism must be created which will either clearly guarantee that Israel cannot limit access without an individualized court action (e.g., create a corridor through the closure), or at least provide for prompt, adequate, and effective compensation for any losses due to non-individual restrictions on access (e.g., create government-sponsored non-commercial risk insurance for investments in the industrial estates).

In either of the above cases, however, the Israeli undertakings must be set forth in law, and not simply in policy statements or agreements signed with the Palestinians. Such policy statements or agreements do not have legal force. They can be changed or simply not implemented without creating any legal recourse on the part of a damaged investor who relied upon them. Furthermore, investors can be expected to calculate that a change in the Israeli government would be very likely to compromise the reliability of guarantees made by the present government, unless such guarantees are set forth in law. It is much harder to change a law than to change a policy, and a law is enforceable by the courts whereas a political agreement or policy is not.

3. Internal Responsibilities

Israel is undertaking various responsibilities with regard to infra-structure, such as power, water, telecommunications, and roads. The internal responsibilities of the various ministries and agencies within the Israeli government regarding these responsibilities must be clearly set forth in law. Otherwise, the agreement to cooperate could be killed in the bureaucracy. Furthermore, it is possible that some private interests within Israel will oppose one or another of the consequences of the arrangements for cooperation and may take legal action or lobby against it. A special law would protect the agreement signed by the government from stalling out due to these problems.

4. Harmony with Other Laws and Agreements

There are several areas where Israel's obligations regarding the industrial estates must be harmonized with Israeli law and international obligations. The most important area is in taxation. Israel does not have a double taxation treaty with the Palestinian Authority. This means that unless some special law is drafted to provide otherwise, the earnings of Israeli companies in the industrial estates will be taxed in Israel. Thus, the effect of the special tax holidays established in the industrial estates by the Palestinian Authority with World Bank assistance will be significantly undermined with regard to Israeli investors. This is particularly onerous since, even assuming no income tax will be paid to the Palestinian Authority by an Israeli investor in the industrial estates, the same Israeli investor will pay more taxes on his profits in the industrial estates than he would had he earned the same profits in Israel. This is because the tax incentives offered for investments in Israel under the Israeli Law for the Encouragement of Capital Investment will not apply to Israeli investments in the industrial estates unless some special law equalizes the incentive scheme. Finally, although Israeli law currently provides that no duties are levied on materials imported into Israel for direct reexport, it is not clear that this exemption from duties will apply to materials imported into Israel for export to the border industrial estates. A special law would clarify this point.

Other issues will crop up with respect to Israel's trade agreements with the USA and the EU. There are potential problems if untaxed goods enter the Israeli market from the industrial estates and could then find their way into trade with Europe or America. This potential problem could be corrected through special understandings with the US and the EU. The US and the EU should agree to treat certificates of origin from the industrial estates under the Israel-US and Israel-EU free trade agreements.

5. Conclusion

For the reasons described above, a special law is needed if the border industrial estates are to become a viable means of encouraging investment in the Palestinian territories and creating jobs for Palestinians. A law is needed to transform the purely political obligations undertaken by Israel in talks with the Palestinians and Israel into a legal commitment which investors can understand and rely upon. A law is also needed to set forth where responsibilities lie within the Israeli government, and to harmonize the commitments undertaken by Israel with other laws and international agreements.

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The Israeli-Palestinian Permanent Status
Economic Integration or Separation?

*Eli Sagi**

August 1999

המכללה האקדמית
של תל-אביב-יפו



בשיתוף פעולה אקדמי עם אוניברסיטת תל-אביב

The Israeli-Palestinian Permanent Status
Economic Integration or Separation?

*Eli Sagi**

August 1999

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1. Introduction

The formal establishment of an independent Palestinian state in the West Bank and the Gaza Strip is a coming political reality. The political, intellectual and economic discourse between Israelis and Palestinians is no longer about whether this should, or will, happen, nor even about when it is expected to take place. Rather, the debate focuses on what is the appropriate, or the expected, nature of the bilateral relations between the two adjacent independent states.¹ In this context the key question is that of separation versus integration, namely, should (or will) the two economies function like two regions within what is for practical purposes a single economy,² or should they rather relate to each other as two independent states separated by an (economic) border?

Both sides have crucial political and economic stakes in this question. The Palestinians' aim for the immediate future is to rapidly enhance and foster their national and political sovereignty and to improve the standards of living of their population. From the Israeli point of view, an agreement on permanent status with the Palestinians is a major step in the process of achieving an overall peaceful solution to the long lasting Israeli-Arab conflict. This may substantially improve and ensure Israel's national security on the one hand and provide the proper "environment", which is the necessary condition for its future economic prosperity, on the other hand. An improved "climate" is especially essential for smoothing the assimilation of Israel into today's integrated, global, world economy, which seems to be its main road to prosperity.³

From the Palestinian point of view, the alternative of economic separation seems to be positively correlated with national sovereignty. However, it is the contention of this paper that the existence of an economic border between Israel and Palestine, which is required under this option, imposes high costs on the Palestinian economy (while the costs are almost negligible from the Israeli perspective). On the other hand, the alternative of economic integration, with open borders, which allows (almost) free movement of labour, goods and services is crucial for ensuring rapid and stable Palestinian economic development. This, in our opinion, is an inevitable result of the huge difference in size of the two economies, their level of development and the fact that there is practically no distance between their economic centres.

The price that this alternative imposes in terms of national and political sovereignty, we believe, is "reasonable". In particular, some provisions can be made to allow the Palestinians more freedom of choice in economic policies even under open borders, in ways that can be acceptable from the Israeli point of view. A special joint project (the

¹ The economic controversy is reflected in many publications such as: Sagi et. al. (1992), Awartani (1993), Kleiman (1993), Mayshar (1994), Halevi & Kleiman (1995), Arnon et. al (1996, 1997).

² More specifically, by integration we mean, hereafter, that there exists no economic border between the two states so as to allow open (though not necessarily completely free) movement of goods, services, labour and capital. By separation we mean that a physical border, a fence, divides the economies and that cross border economic activity is regulated.

³ See, for example, Sagi (1999).

Economic Permanent Status (EPS) project)⁴ in which a group of Israeli and Palestinian professionals drafted a proposal for the permanent status economic agreement between the two sides suggests that both are aware of these arguments, and that such a compromise is possible.

In section 2 we present the trade-off between national sovereignty and economic prosperity, and briefly **survey** the Israeli-Palestinian experience. In section 3 we lay **out** the basic pro-integration arguments. Sections 4 and 5 expand the arguments by analysing the various major and minor dimensions of integration. Section 6 explains the implications of erecting and controlling a physical border between the states. The option of integration still leaves open many questions. A key one is the nature of the trade regime, and in particular which of the two alternatives - Customs Union or Free Trade Area - is the best in this case. This question is addressed in section 7, which briefly presents some elements from the compromise on this issue that was offered by the EPS project. While this paper is not based on quantitative analysis, some main indicators appear in the appendix. Given the difficulties in obtaining consistent, coherent and up-to-date data on the Palestinian economy since 1988, the figures presented should be regarded cautiously as rough indicators.

2. Sovereignty vs. Prosperity

The trade-off

The Palestinians, in pursuing national, political sovereignty and economic prosperity and growth face two uneasy questions. First, do these two goals go together? The conventional wisdom is they involve a trade-off, as more of the one may come at the price of less of the other. Second, is sovereignty equivalent to separation? Or, in other words, can there be prosperity without integration? Again, the conventional wisdom suggests that the two are correlated. The evolution of globalization, of international trading blocks and of economic unions in recent years has emphasized the existence of such tensions. These are clearly visible in the five decades long process that led to the formation of the EU, through which the member countries gradually relinquished elements of sovereignty, mainly in terms of their ability to operate an independent economic policy, trading them for the potential economic dividend.

The Israeli-Palestinian experience

The Israeli-Palestinian case, however, significantly differs from other examples (such as the European case) in that their mutual relationships were not the outcome of a voluntary agreement between equal parties. Rather, they were imposed unilaterally by one side on the other. Still, considering the circumstances under which the Palestinian economy has operated in the past 30 years and observing the history of its economic performance, one may conclude that the trade-off holds true in this case as well.

⁴ ECF, DATA-HCIF (1999)

This period may be divided into three main sub-periods: the first 20 years, from 1967 to 1987, during which the economy was under complete Israeli military rule; then, between 1988 and 1994, between the breakout of the Palestinian popular uprising (the Intifada) and the establishment of the Palestinian Authority, a period of great instability, during which economic activity was highly irregular; and finally, the last period, during which the economy has operated under the Palestinian Authority but has still not been completely free of direct Israeli rule.

A. 1967-1987

The first sub-period can be considered as a period of almost full integration between the Palestinian and the Israeli economies. That was the time of minimum sovereignty and maximum integration. Indeed, it was a forced integration rather than a voluntary one, between occupier and occupied rather than between equal partners. Nevertheless, this integration yielded extraordinarily rapid growth of Palestinian economic activity (GNP and GDP rose at average annual rates of 8.7% and 6.7% respectively) on average for a long period of 20 years.⁵ Standards of living, measured by per capita income, rose as fast as 6.4% annually, climbing from only 1/8 of the Israeli level at the turn of the 1970s to 1/4 by the mid-1980s. It may well be argued that the pattern of economic growth was far from optimal from the Palestinian point of view, as it was mainly channelled through the employment of Palestinians in the Israeli economy, while the development of the local economy was suppressed. This is true, but still the facts show a period of maximum integration, maximum growth and minimum sovereignty.

B. 1988-1994

The Intifada, which broke out in December 1987, brought to the Palestinians some immediate informal control over their lives. It was a major trigger of the Oslo process that led to the establishment of the Palestinian Autonomy. Thus, it may be regarded as a period when more sovereignty was gained. Economic activity was rather irregular and fluctuated sharply as a result of violence leading to strikes, boycotts, curfews and closures. On the other hand, the influx of Jews from the former Soviet Union to Israel spurred new demands for Palestinian labour in Israeli construction. Under those circumstances, though, the economic integration could not be utilized to its full capacity, and the economies grew to be rather more separated than before. This resulted, among other things, in a substantial decline in economic activity and wellbeing, exhibiting the trade-off once again.

C. 1995-1999

Since the Palestinian Authority was established, the relations between the two economies have been formally based on the Paris Protocol, which was agreed and signed by both sides. While this Protocol is a voluntary agreement, it is still an agreement between a strong sovereign state and an authority representing a much

⁵ As a matter of fact, growth slowed down considerably in the 1980s. Until then, during 1968-1979 GNP and GDP rose even faster, at annual averages of 11.6% and 9.0%, respectively.

smaller, much weaker people, still under the military occupation of the first party. The cause of Palestinian sovereignty has, however, been substantially enhanced during these past few years.

According to the Protocol the economies are supposed to remain practically integrated. However, the disastrous deterioration of the security situation, coupled with the very sensitive, complicated and volatile nature of Israeli domestic politics, resulted in severe closures that prevented proper implementation of the Protocol and effective integration. Consequently, the high hopes the Palestinians had from the new political status evaporated as the economic crisis of the early 1990s got even worse. GNP diminished at an annual average rate of 2.4% and in per capita terms by as much as 6.9%, to reach 25% below the level of 1994. This indeed is another very irregular period but it also suggests that more sovereignty, associated with lesser integration, is correlated with lower economic wellbeing.

3. Separation vs. Integration under Economic Permanent Status

Permanent Status perspective

At the present time, as the parties are about to commence negotiating their economic permanent status agreement, the dilemma surfaces once again, but it should, however, be looked at from a somewhat different perspective. This time, an economic agreement shall constitute a component of a comprehensive permanent status agreement between two independent states. Formally, the problem of Palestinian sovereignty will no longer exist. A comprehensive agreement is supposed to bring about a new era of neighbourly peaceful relationships between the former foes, which will resemble more those among Western states than those that have prevailed in the region until now.

Therefore, when addressing the issue of separation versus integration, one should take the permanent, long-term, perspective, presupposing that the two nations are at peace with each other. This means that there is no threat of Palestinian anti-Israeli terror activity, and thus Israel need not apply any special security measures. On the other hand, Palestinians are independent and sovereign and free from arbitrary unilateral retaliatory measures imposed by Israel.

Under these circumstances the question is which of the two regimes is the appropriate one? Which is the one that is expected to prevail? It is the view of this paper that the model should be, and probably will be, the integrative one, at the unavoidable cost of some loss of sovereignty (mainly for the Palestinians). The high cost of economic separation makes this alternative, in our opinion, a non-option for the Palestinians. The same holds true for Israel as well; but the importance of the issue for Israel is minor. Due to the substantial asymmetry between the two economies, the framework of their bilateral relations will hardly affect the performance and development of the much larger and far more developed Israeli economy.

The basic pro-integration arguments

The basic pro-integration argument is very simple: The case at hand involves two adjacent economies one of which, the Palestinian, is significantly smaller (about 3% - 4% in terms of GNP) and poorer (less than 15% in terms of income per capita) than its neighbour. Moreover, and very importantly, almost the entire Palestinian population lives within immediate proximity from the economic centres of the larger and richer neighbour (less than 50 km.). Under this state of affairs, unless very strong control measures are imposed, it will be very difficult to prevent market forces from taking their natural course, for the best interests of individual economic agents from both sides.

One of the counter arguments suggests that integration should be left for a later stage. "Separation first" is needed for sovereignty and independence to be well established, and the foundations of the local economy fostered so that integration will take place on more equal grounds between the partners. The long, gradual and careful unification process in Europe is offered as an example. In our opinion the Israeli-Palestinian case is quite different for three reasons:

- The European starting point was that of strict separation among independent states for which integration meant a significant change. Here the starting point is that of several decades of economic integration (forced, indeed, but still integration). Imposing separation now means a drastic change of the current economic structure, which may have a far reaching impact on the smaller, less developed and more vulnerable side of the link.
- The countries involved in the early stages of the European process were rather similar in terms of economic development and size (at least for the two principal players - Germany and France). The benefits expected from economic integration were not enormous and not even certain at the beginning. In the Israeli-Palestinian case, as already mentioned above, the drastic asymmetry between the two economies means that the two regimes (integration and separation) will yield substantially different economic results for the Palestinian economy.
- The European process started in a world of political and economic separation while negotiations on Israeli-Palestinian permanent status will take place in a world of globalization, major regional economic blocs, and high levels of external trade. In this world, economic separation seems like an unnatural movement against these global currents.

In our opinion, the "separation first" argument should be turned on its head. Given the current situation, Palestinians need "integration first". They can gradually separate themselves from the Israeli economy, if they find it an important national goal, but they can hardly bear the costs of cutting themselves off now, as implied by the idea of "separation first".

4. Major dimensions of integration

The contribution to the Palestinian economy of integration with the Israeli economy operates through several major channels:

Access to the Israeli Labour market

Since 1967, and despite all the disruptions and fluctuations, the Israeli economy has been the principal market for Palestinian labour. At its peak, about 1/3 of the labour force was employed in Israel, directly generating about 1/4 of the GNP, contributing indirectly to the GDP through the derived demand for local goods, magnified by the multiplier effect. Its share in total employment in the Israeli economy, on the other hand, never exceeded some 7%, emphasizing once again the gross asymmetry of the interdependence between the economies.

Indeed, the Palestinian dependence on the Israeli labour market is partly due to years of Israeli policy of deliberately obstructing and slowing the development of the local Palestinian economy. Under the opposite approach, such dependence could have been lessened at best, but not avoided. With an open border, the presence of the much larger and richer Israeli economy, allowing Palestinian guest labour to commute on a daily basis, would have been overwhelming.

Since the outbreak of the Intifada the flow of Palestinian labour into Israel has been subject to growing disturbances and fluctuations. This has been the principal cause for more than a decade of recession, deteriorating living standards and unusually high unemployment that the Palestinian economy has experienced. It took Israeli employers several years of frequent disruptions and irregularity in the flow of Palestinian employment to realize that some risk premium should be added to the direct costs of employing them. Consequently, by the mid-1990s, they turned to cheaper substitute sources of guest labour (mainly from Romania in the construction sector and from Thailand in agriculture).

Between 1992 and 1998 the estimated official number of guest workers in Israel increased by 60,000 (from 132,000 to 193,000) and the number of Palestinians among them declined by 60,000 (from 115,000 to 53,000).⁶ That means that Palestinians lost about 120,000 jobs as the result of the deterioration of stability and security. This number is equivalent to 21% of the Palestinian labour force in 1998 and 132% of the unemployment figure.⁷ During this period (1992-1998) local employment practically doubled (rising by 182,000, about 11% annually), which is impressively above the increase between 1968 and 1992 (only 70,000, a rate of just 1.7% per annum).

However, even this development could not have prevented the disturbing jump in unemployment by about 100,000, from 4.2% of the labour force in 1992 to 15.6% in

⁶ See Bank of Israel, annual report, 1998.

⁷ According to UN (1999) figures for 1998 labour data.

1998.⁸ Moreover, it is hard to expect local job opportunities to continue rising at this pace, since much of the increment in the past few years is due to the creation of the Palestinian public sector, a stage that is practically over. The expected large-scale financial support from donor countries and international institutions, which will be used mainly for infrastructure investments, will provide additional local jobs. However, these are rather capital intensive projects, and at any rate will allow only limited absorption of the increase in the local labour supply.

Bearing in mind that the Palestinian population is among the fastest growing in the world,⁹ the current situation may turn explosive. Thus, with the absence of much wider and smoother access to the Israeli labour market, local income per capita will remain low, if not declining, and unemployment will keep rising steeply, posing a real threat to political stability in Palestine which may well spill over into Israel.

In the coming years, with the growing sophistication of its own labour force, a further increase in the Israeli demand for foreign, unskilled or blue-collar, labour is expected. After a political solution is achieved, including the elimination of security problems, Palestinians should, and are likely to, regain their preferred status, over other foreigners for three main reasons:

- an economic reason - their familiarity with the Israeli environment, culture and especially language improves their productivity (in terms of output per-worker);
- a socio-political reason - they are daily commuters who return to their homes every evening. Thus much of the negative external effects of housing foreign workers, which place a burden on Israeli socio-economic infrastructure (e.g., health, education, law and order), are avoided.
- a regional political reason - as mentioned above, high and rising unemployment and deteriorating standards of living in Palestine pose a real threat to the peace process.

One may argue that by opening up such opportunities under the case of integration, the badly needed improvement of Palestinians' human capital will be discouraged and delayed. This need not be the case at all. Upgrading the existing Palestinian human capital is indeed critical to ensuring long-term sustainable growth. However, this is a long process, an investment that will take many years before its returns are noticeable at the aggregate macro level. For a good number of years this process will apply to a probably growing but still rather small segment of the population, leaving the many, a rapidly increasing number, with a need for regular employment.

The fact that the Israeli market allows Palestinian workers to commute on a daily basis is a crucial factor for them in preferring this alternative over seeking jobs in the Persian Gulf or in Europe. Also, the demand may not be sufficiently large. In the Gulf States, with the declining economic power of oil since the early 1980s, the demand for

⁸ Note that in effective terms, accounting for those underemployed due to border closures, the figure is substantially higher, as much as 22% according to the UN report.

⁹ The natural increase is about 3.5% (annual average). During 1989-1998, the returning of workers from the Gulf in the aftermath of the Gulf war and of PLO people from Tunis with the establishment of the Palestinian Authority raised the overall growth rate of the population to 5%.

guest labour cannot be expected to expand substantially. Moreover, in the aftermath of the Persian Gulf War Palestinians lost many their jobs in these countries, and returned to either the Palestinian territories or Jordan, and it is doubtful whether they can regain them. There is no experience yet with exporting Palestinian labour services to the EU, but it is unlikely that this will develop into a large-scale phenomenon.

Access to Israeli markets for goods and services

The obvious way of reducing the dependence on the Israeli labour market is, of course, by developing the local economy, i.e. by increasing the share of Palestinian GDP in its GNP. The productive capacity of the economy is expected to expand substantially under the permanent status, mainly, as a result of a high level of investment. First, the international community, through the donor countries and other world bodies (like the World Bank) have already pledged donations amounting to \$4.3 bn., of which \$3.6 bn. have been committed and \$2.5 bn. have been disbursed.¹⁰ Second, under the permanent status the business environment in the Palestinian economy will improve substantially, encouraging private sector investments.

In order to ensure efficient, steady utilization of the growth potential of the domestic economy, especially in today's integrated world economy, foreign trade should play an important role. In that respect, the Israeli markets for goods and services are crucial. Indeed, economic separation does not prevent trade between the neighbouring countries. However, the existence of a physical border that would prevent an open, relatively free, flow of goods and services, would definitely curtail the volume of Palestinian exports. Moreover, the Palestinians need access to external gateways and thus their exports to the Western world have to cross Israeli territory. The existence of a physical border increases transaction costs, making it more difficult to exercise the comparative advantages.

A. Source of Imports

In the past decades the Israeli markets were practically the only source for Palestinian imports. Again, this state of affairs was dictated to the Palestinians rather than being a result of voluntary engagement between sovereign economies or of the natural, normal, course of economic flows. Trading with the rest of the world was practically impossible for the Palestinians. Also, the obstacles imposed by the Israeli authorities on the development of domestic industries denied the Palestinians the ability to utilize their potential comparative advantage under the occupation. Yet even under a fully supportive government Israel would certainly remain the Palestinians' main trading partner for the same reasons mentioned above – the differences in size and level of development and the immediate geographical proximity of their markets.

The volume of Palestinian imports from Israel is outstandingly high – about \$1.5- \$2 bn., which is over half the Palestinian GNP. It is also a significant market for Israeli exports, in fact the second largest destination country for Israel (after the USA). This

¹⁰ UN and the World Bank (1999).

is somewhat misleading, though. To a certain extent it reflects indirect importation from other countries, since Palestinians were prevented from importing directly, and were obliged to channel their imports from the rest of the world via an Israeli dealer. Thus, the only value added to Israel stems from services associated with "transit" activity (e.g. dealer's profits). Another portion of this flow is of used durable goods, as Israelis sell to Palestinians their old appliances while replacing them with new (usually imported) ones. Some of the imports are directly tied to exports. An important activity of Palestinian manufacturing is that of sub-contracting jobs for Israeli firms.¹¹ In other words, unfinished goods are imported from Israel and then exported back containing some Palestinian value added. Another example of export related imports is expenditures made by Palestinians for their own immediate consumption while working in Israel (e.g., food, beverages and cigarettes).

Under the permanent status unrestricted competition with other sources will definitely reduce the Israeli share and probably gain the Palestinians better terms of trade. Nevertheless, it will still remain the principal source, mainly because of the proximity effect, which will make it difficult for others to compete.

B. Destination of Exports

Palestinian exports to Israel of goods and non-factor services have ranged between \$300 and \$500 mn. in the late 1990s.¹² This is about 80% of total Palestinian exports, but less than 1% only of Israeli imports of goods and non-factor services. Israeli markets have been practically the only destination for Palestinian exports. This characteristic, like others mentioned above, is to a certain extent the result of regulations and limitations that were arbitrarily imposed by Israel, usually under the excuse of security requirements.

Yet, even with no such trade barriers the picture would remain more or less the same, since the Israeli market is the most obvious destination for Palestinian exports. The immediate access to markets, customers, and dealers (in most cases a matter of minutes of driving distance) is a crucial factor. It is especially important for agricultural (fresh) produce and for sub-contracting activities. The other critical factor is the relatively large size of the Israeli economy, and the much higher average income level of its population. These attributes imply the existence of a relatively large (in Palestinian terms) market for goods and services aimed at the Israeli lower income classes, in which Palestinian industries have a comparative advantage.

Under the permanent status the existing obstacles will disappear, thus facilitating trade with the rest of the world, and reducing the effective transaction costs involved. However, the potential of such trade should not be exaggerated, at least for the interim period. Looking "eastward", at Arab markets, Palestinian products may find it hard to compete with local goods, produced at much cheaper labour costs, with no transportation costs involved, offered to a much poorer population than in Israel. The

¹¹ On sub-contracting see Sadan (1999).

¹² Around \$300 mn. according to Israeli sources (ICBS) and around \$500 mn. according to the PCBS and international agencies.

long-term prospects seem much better looking "westward", at industrial countries, mainly the EU. However, it may take a long time before Palestinian products qualify by European standards (mainly safety and public health requirements), and only then will a long and tough process of market penetration actually start. Until then, there is no real substitute for the Israeli market, and even in the long run it will probably retain a prominent status.

For Israel the issue is rather marginal, as suggested by the very low proportion of Palestinian goods and services in overall Israeli imports. Nevertheless, it enhances competition in the markets, thus serving the interests of the Israeli consumer. For the Israeli manufacturing sector, its Palestinian counterpart produces more complementary than substitute goods and in any case does not amount to more than 1%-2% (in terms of sales). The opposition on the Israeli side to open borders and integration is rather limited. It comes mainly from certain interest groups (such as agriculture, trade and commerce sectors). While these groups may have strong and loud lobbies their contribution to Israeli GDP is rather small.

Until now, Palestinian exports to Israel of (non-factor) services have been rather limited (Israelis buying services in Palestinian territory such as car repairs, dental treatment and shopping in stores and markets). After the breakout of the Intifada, Israelis stopped visiting the West Bank and Gaza Strip, and consequently that kind of trade in services practically disappeared. Under the permanent status there is no reason why those kinds of activities will not resume. However, the need to cross border stations, in case of separation, may prove to be an effective deterrent. An interesting example of a new type of export of services under the permanent status is the opening of Israeli public procurements to Palestinian suppliers. This is a very large "market" requiring a variety of services for government ministries (mainly defence, health and education), public agencies, government companies and municipalities. Being allowed to compete in this market will open a new and large market for the Palestinians, which will be a good substitute for direct employment in Israel. It will be much easier to exploit, obviously, under economic integration.

C. Sharing Infrastructure (economies of scale)

Lack of physical infrastructure is one of the most crucial bottlenecks for Palestinian economic development. To some extent this deficiency is another example of the neglect of the Israeli authorities, particularly with respect to utilities (e.g., distribution of electricity and water, sewage treatment and communication networks). But this is also a result of the presence of economies of scale (e.g. in power generation, roads, seaports and airports). On a purely economic basis, the Palestinian economy may not be large enough to justify the building of its own facilities. Using the existing Israeli installations, or expanding them in case of excess demand, is probably cheaper and more efficient for both economies, particularly for the Palestinians.

Under the permanent status the regular orderly usage of these services by Palestinians should not pose a problem. On the other hand, for Palestinians to establish a complete full-scale independent system of infrastructure would require investments of several

billions of dollars, an order of magnitude exceeding the level of current GNP. Indeed the costs may amount to something like the entire amounts of the donations pledged so far,¹³ and therefore it is doubtful whether the required funding could be secured in any case.

The dilemma of economic welfare versus sovereignty is best reflected in this issue. On the one hand, there are hardly any better examples or symbols of sovereignty. On the other hand, these symbols are expensive. Even if financial resources are mobilized the benefits from their alternative uses should be carefully compared, considering all other Palestinian needs and problems. In this respect, such an endeavour may prove too expensive. Moreover, these projects will take years to complete and until then the Palestinians will have little choice but to use the Israeli services anyway. Thus, they will be only be able to exercise and exhibit full sovereignty (through this channel) in a more distant future (perhaps more than a decade) when it will matter much less, on the assumption that the peace process holds.

The loss of sovereignty stemming from the common use of infrastructure, which is associated with economic integration, can be minimised by political means such as joint Israeli-Palestinian ownership of an installation, or separate ownership of different facilities of the same installation, or joint construction of future facilities when they are needed. While full-scale independent Palestinian projects are too expensive and unrealistic, the establishment of smaller scale medium-size ones, which are already in the making, is probably an unavoidable partial solution to the problem. They will provide tangible symbols of sovereignty at a bearable price. This, however, will be less than sufficient for the efficient operation of the local economy, which will have to keep relying to a large extent on the supply of these services by Israel. Needless to say, this flow of services will function much more smoothly and effectively under economic integration than under economic separation.

D. Coordination of Economic Policy

One of the most sensitive aspects of the conflict between integration and separation involves the issue of independence in economic policy. Along with the ability to fully control the border and reliance on one's own infrastructure, being able to design and implement independent economic policy is the clearest manifestation of sovereignty. The open border integrative alternative requires a compromise on this aspect, especially from the Palestinian side. In a number of key aspects, the policies of the two parties need to be coordinated if not harmonized. Given the gap in size and level of development between them, it is harder for the Palestinians, for whom such symbols matter much more at this point of time, to conduct an independent policy.

The key dimensions in which the dilemma is reflected are fiscal policy, external trade policy and the monetary regime. The difficulties arise especially with respect to indirect taxation (mainly sales taxes, VAT and customs duties). It is impossible to expect more than minor differences in rates imposed by the two sides, with open

¹³ See UN and the World Bank (1999)

borders. Given the immediate proximity of the populations and their business and commercial centres, people will shop where rates are lower. Israel will not tolerate lower Palestinian rates. Being the stronger side of this equation (inequality, to be more precise) Israel is more likely to apply retaliatory policy measures than to adjust its own rates downwards. On the other hand, if the Israeli rates are lower, the Palestinians will probably have little choice other than to realign theirs at the Israeli level.

Fiscal issues regarding direct taxation (mainly income tax) and other taxes and fees that are based on residence (e.g., car registration fees) do not pose a major problem. Economic integration, open borders and free movement of goods and services do not include freedom of residence (in the neighbouring state). Even if this will be possible, it is unlikely that income tax differentials will result in an influx of population from one state to the other.

However, this does not offer much comfort to the Palestinians for the near future. At present they lack an effective direct taxation system, and as is rather common for low-income countries, they will probably rely for a good number of years to come on the indirect tax system for their domestic source of public finance. On the other hand, Israel has undergone a process of reducing its indirect tax rates. In particular, it is in the advanced stage of a process of gradually eliminating its import tariffs, as implied by its free trade area agreements with the EU and the US. Since higher Palestinian indirect tax rates will probably drive consumers to buy in Israel they are effectively limited in choosing their system.

In conclusion, formally the problem of sovereignty is not critical. The Palestinians can choose their indirect tax rates without Israel being much affected. However, their choice, and thus their sovereignty, is rather limited, which will also cause difficulties in generating revenues for their public sector.

The monetary regime is another dimension where there will be a gap between the formal and practical levels of sovereignty and independence. There is no reason for Israel to object to the issuing of Palestinian currency. This will not exclude, even under separation and the existence of a border, the Israeli, and probably the Jordanian currency too, from serving as legal tender in Palestine. Thus, the Palestinians will have little control over the exchange rate of their currency, which will be determined by the financial markets and strongly affected by Israeli exchange rate policy. In the long run, this problem is likely to disappear, as Israel will probably join a currency block (most likely the Euro). The Palestinian monetary authorities will have limited control not only over exchange rates but over the quantity of money and interest rates as well. Those will practically become endogenous variables, determined mostly by the forces of the Israeli financial markets.

5. Secondary dimensions of integration

There are additional dimensions of economic integration which may contribute to productivity, efficiency in resource allocation and, thus, the growth potential of the Palestinian economy.

Access to markets in the industrial countries

Penetrating the markets in the industrial countries should be an important element of Palestinian long term development strategy. This will, among other things, reduce the dependence on Israel. However, as already mentioned, it is a long process, because of insufficient Palestinian technology, product quality and standards as well as lack of marketing channels. Israeli-Palestinian cooperation and joint ventures could prove very effective measures for this purpose in the near future, mainly by using the much more developed Israeli marketing channels.

In particular, Palestinian manufacturing could enjoy the special Israeli-EU and Israeli-US trade agreements, by applying favorable rules of accumulation to jointly produced goods so as to qualify under the rules of origin. This is not a necessary condition for the Palestinians to obtain a market share in the industrial countries but it could be an effective shortcut. Also, economic integration is not mandatory for this strategy, but it is far less natural and more difficult to carry out under economic separation.

Access to technology

A prominent binding constraint on the future economic development of the Palestinian economy is the technological level of its manufacturing sector. Like other aspects that were discussed above, the Israeli attitude towards the development of local industry and local human capital during the years of occupation bears much of the blame. Having an open economic border, business cooperation and joint ventures could play an important role in developing and reinforcing the level of technological know-how in the Palestinian economy. In particular, joint ventures may serve as a means of training and improving labour skills, thus upgrading the crucially important factor of Palestinian human capital.

Technological transfer can also be pursued by other means, mainly through activities of donor countries. But it will probably not be as effective as a joint venture between business and technical people who can interact on a daily and long-term basis. While open and unobstructed business interaction between the two economies (the integration option) is not a must for such a process to take place, it is obviously helpful for making it effective.

Utilization of business services (economies of scope and proximity)

Another aspect of economies of scale is the formation of business support centres. When a sufficiently large number of business organizations assemble close to each

other they can enjoy professional and technical services supplied by specialized firms rather than each of them employing their own experts. This allows better utilization of resources resulting in higher productivity of the economy.

The Palestinian business sector may be neither large enough nor sufficiently concentrated geographically to justify such centres. However, the possible location of almost any Palestinian business establishment is close enough to the nearest Israeli large business centre to enable it to use these services under economic integration. These services do not necessarily have to be provided by Israelis, since these centres can, and probably will, employ Palestinian professionals and technicians as well.

6. The Implications of Having a Border

Since the outbreak of the Intifada the Israeli army has faced serious difficulties in imposing effective closures on the Palestinian Territories and preventing the movement of people and merchandise. The economic incentives have pushed people on both sides to try to bypass the restrictions, infiltrate and smuggle, even if they have to risk their lives. Thus, a physical border between the states is mandatory in order to allow economic separation. Such a border already exists around the Gaza Strip but must be erected for the West Bank and both parts have to be maintained and controlled. However, having a border that strictly limits the freedom of movement between Israel and Palestine is against the very spirit of peace that is supposed to prevail under the permanent status agreement. It is also against the interests of economic agents on both sides and likely to slow down economic growth, as claimed in this paper. Advocates of economic separation may be willing to pay this price, but they have to consider two additional major problems to having a physical border: it could not be fully effective and it would be very expensive (especially from the Palestinian point of view).

The effectiveness of a border

The existing fence surrounding the Gaza Strip presents a relatively easy case of an effective border, but even in this case, it is far from being a hermetic seal. Constructing a fence along the border between Israel and the West Bank is much more complicated. It involves a long line, five times longer than that for the Gaza Strip, and one which will have to rise and fall over hills and waterbeds, **cut through** the middle of populated villages, and probably include enclaves of Israeli settlements. This would be not only more complicated technically but also much more difficult and expensive to operate, maintain and guard. It would be hard, even under this situation, to completely stop economic exchanges between Israelis and Palestinians. Moreover, under the permanent status two major loopholes will remain, through which economic activities will be able to bypass the fence: Israeli settlements that will remain in the West Bank and Gaza Strip, and the city of Jerusalem, which will most probably remain undivided. Both of these would allow interaction and movement between the two states that will be practically impossible to control.

The costs of erecting and controlling the border

Even if a fully effective fence is technically possible the costs of erecting a border are expected to be very high. Such a border, costing some \$16 mn. and stretching over 63 kilometers (at \$250,000 per km.), has already been built around the Gaza strip (for security purposes). Erecting a border between Israel and the West Bank would be a completely different story. Geography and topography make it much longer, at least 320 km., and far more expensive (since it would have to negotiate hills and waterbeds). The cost per km. is estimated to be at least twice the level of the Gaza Strip Fence, and may reach over \$150 mn.¹⁴ Apart from the initial expenditures for constructing a fence along the borderline, additional operational costs of maintaining and guarding it are needed, which, again, would be much more expensive in the case of the West Bank.

The question is, then, who would bear the costs of building it? From the Israeli purely economic aspect, as has been argued, while integration is preferred over separation, on a macroeconomic level it makes little difference which one of the two prevails. The main Israeli pro-border consideration is the question of security, which in the long-run, once peace exists in the region, should not be so important. In the short-run, on the other hand, it is not relevant anyway, since it will probably take a couple of years to complete. So even for Israelis advocating separation, the costs may prove too high for the limited expected benefits.

For Palestinians this is a symbol of sovereignty, for which they may be willing to pay. However, not only is this symbol against the direct economic interest of the Palestinians, as suggested by this paper, but building a border is, for them, a major project. It will require funds in the region of 4% of the existing level of GNP. Moreover, advocates of the separation alternative agree that in the long-run integration will probably take over (the "separation first" approach). So, Palestinians may find themselves financing an expensive project, which is against their economic interest, is not very effective in the short-run and is not really needed in the long-run. Given their resource constraints on the one hand, and the enormous expenditures needed to establish their independent state on the other, it is doubtful whether this project should receive priority.

7. The Trade Regime under Economic Permanent Status

The controversy over the appropriate pattern of economic relations between the two states has not yet been resolved. Somewhat strangely, it seems that Israeli and Palestinian officials are trading positions. The current mood of the new Israeli government, as expressed by Prime Minister Barak, leans towards economic separation (believing that reduced friction between the populations will improve Israel's internal security). A growing number of Palestinian politicians and officials, on the other hand, realize the adverse implications of separation and are willing to adopt a more pro-integration approach.

¹⁴ Based on estimates of Israeli official sources.

The EPS project

This new approach of the Palestinians was made clear in a special project where the principles of the economic permanent status were discussed. During the second half of 1998 a group of Israeli and Palestinian professionals (including the author of this paper) were engaged in an informal and unofficial think-tank, simulating the negotiations on an economic permanent status (EPS) agreement.¹⁵ The basic underlying assumption was that this (simulated) agreement constituted a component of a comprehensive Permanent Status Agreement between two states.

After half a year of intensive deliberations the teams signed a document, carefully written in legal language, which may be regarded as a draft for the final official agreement. The document attempts to address almost all the outstanding issues concerning the mutual economic relations between the sides, including the trade regime, fiscal policies, labour market and monetary systems. After being signed, the document was presented, using a presentation prepared jointly by the two teams, to policy makers and business communities in Israel and in the Palestinian Authority, and to the international community (e.g. the US and EU administrations and the World Bank).

The controversy between the two approaches - economic integration and separation - and the sensitive issue of sovereignty (mainly Palestinian) were inherent in the dialogue. The approach adopted by both teams eventually was that of "political separation and economic cooperation", in practice accepting the basic principle of economic integration as advocated in this paper. This is clearly declared in the preamble to the document, laying the "*Common Ground for Future Economic Relations*", stating that "*Israel and Palestine, recognizing the inherent dependence between the ... economies, viewing the ... free movement ... as a precondition for intensive cross-border economic activity, viewing such ... relations as conducive for prosperity and growth, and, therefore, for the consolidation of peace*".¹⁶

Free Trade Area vs. Custom Union

The tradeoff between sovereignty and prosperity was behind the scenes throughout the duration of the project, and is best reflected in the chapter on the trade regime. With the adoption of the principle of open borders and free movement between the economies, the sides still have to determine their trade regime. The choice is between two basic alternative trade agreements - a Free Trade Area (FTA) and a Customs Union (CU). Under a CU agreement, the external envelope of import duties is identical for both economies, while under an FTA each side has his own rates of import taxes. In both cases, no custom duties are imposed on goods produced in one

¹⁵ The Israeli team consisted mostly of ex-government officials (most of whom were official negotiators in drafting the Paris Protocol, the economic appendix to the interim agreement), led by a former director general of the ministry of finance. The Palestinian team included mostly acting senior officials in the Palestinian Authority, led by a senior economic adviser to Chairman of the Authority.

¹⁶ ECF, DATA-HCIF, p. 13

state and exported to the other. Thus, these goods are allowed to move freely between the states, as long as they comply with standards regulations, particularly environmental and public safety considerations.¹⁷

The two models differ with regards to the goods that are imported by one side from the rest of the world and are then moved to the other side. In the case of a CU there is no problem. Since the customs envelope is uniform, no extra charge need be imposed on such goods when they are traded between the two parties. Under an FTA, however, each case of cross-border transaction has to be examined so as to determine the origins of the good, calculate the tariff differential, collect the difference, and clear it with the other side. In this case the cross-border flow of goods has to be closely controlled and supervised, demanding some physical restrictions along the border as well as the establishment and operation of custom stations at designated crossing points.

The problem of choosing between these two models incorporates the fundamental dilemma between national sovereignty and economic welfare. The FTA model offers more sovereignty. Under this model the Palestinians are able to determine independently their own import policy, and in particular, the rate of tariffs. Also, they can practically control the borders, including the operation of customs houses, which are regarded as a symbol of sovereignty. Moreover, a CU model may impose a problem for their public financing. As argued above, the Palestinians will probably have to resort to indirect taxation, including on imports, as a principal means of public finance. Israel is in the later stages of eliminating its customs walls altogether. Thus, if Palestinians adopt the Israeli rates, they will effectively lose this important revenue source.

On the other hand, an FTA impedes the freedom of movement of goods and labour between the two economies, making it more difficult to utilize the economic potential of integration. Severe bottlenecks are expected to develop, slowing down economic traffic. This is a result of the significant (from the Palestinian point of view) daily volume of transactions, and in particular, of commuting workers, concentrated in a limited number of crossing points. Moreover, effective enforcement is not easy altogether, as argued above, and the creation of bypasses, loopholes, and smuggling activities will probably develop.

The EPS trade model

The EPS offers a compromise between the two models. It is an FTA in the sense that each side would be free to determine its own import policy (with a few exceptions) and establish stations at designated crossing points along the border. However, the sides would agree on coordinating most of their important and sensitive indirect tax rates. The rate of their VAT would be between 12% and 22% (5% above and below the current Israeli rate of 17%). Also, the purchase tax on an agreed upon list of 15-20 products, including, inter alia, durable goods, cigarettes, alcohol and petroleum

¹⁷ According to the EPS document, such regulations are not to be used as NTBs (non-tariff barriers).

products, would be identical. The sides would also agree that purchase taxes should not be unilaterally changed for a period of three years. As to the stations at border crossing points, their purpose would be limited, and they would not be supposed to operate like regular custom stations. Their role would be to implement domestic tax laws, import policies with regard to third parties, and market regulations. Also, they would gather documentation, but this would be for the sole purpose of establishing an administrative basis for bilateral revenue clearance. They would not be supposed to collect indirect taxes except in special cases, so as to allow traffic to be as smooth as possible.

In principle, the sides would employ a revenue clearance mechanism for transferring two types of taxes emanating from cross-border activities. One type is VAT and the second refers to goods imported from third parties, which are imported through transit and bonded areas (e.g., goods imported via Israel, unloaded in Israeli ports and transported to Palestine). Clearance of VAT revenue would be based on the actual presentation of special VAT invoices. As for import taxes, they would be collected either at the bonded warehouses, or at the importer's location or at a designated entry station that would serve as a customs house for that purpose. Thus, tax collection at the entry stations would be limited to collecting customs in certain cases of direct import in transit and to collecting the difference in rates of import taxes in all other cases (of imports from third parties).

This EPS model of the trade regime is a compromise between a CU and an FTA. The sides would be independent in determining their import policy, but still agree on close and restricting coordination. Entry (custom) stations might be established, but not for the purpose of collecting taxes. It is doubtful whether this rather arbitrary compromise is viable. Its implementation seems problematic and cumbersome. It is most likely to impede and slow cross-border activity on the one hand and contain loopholes that will undermine its effectiveness. In our opinion, the question of its viability is not so important, as "real life" economic powers will eventually determine the nature of the trade regime. The differences in indirect tax rates will narrow and the tax clearance mechanism will be improved over time and be sufficiently effective to preempt the function of the stations, allowing relatively smooth, free and open movement of goods, services and labour. In our view, integration between the economies under peace in the longer run permanent status is practically inevitable.

The Palestinian Economy - Main Indicators¹

% change, annual average

1995-98	1988-94	1968-87	Period
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A. National Aggregates

-2.4	5.2	8.7	GNP
-0.8	7.8	6.8	GDP
-6.9	0.7	6.4	GDP per capita

B. Labor Markets²

4.9	4.1	2.3	Population
15.1	2.2	3.9	Employment
8.1	5.5	0.6	Domestic employment
17	32	35	Employed in Israel as % of total Palestinian employment
2.5	4.1	5.8	as % of total Israeli employment
19	6.5	1.5	Rate of unemployment % of Palestinian Labor force

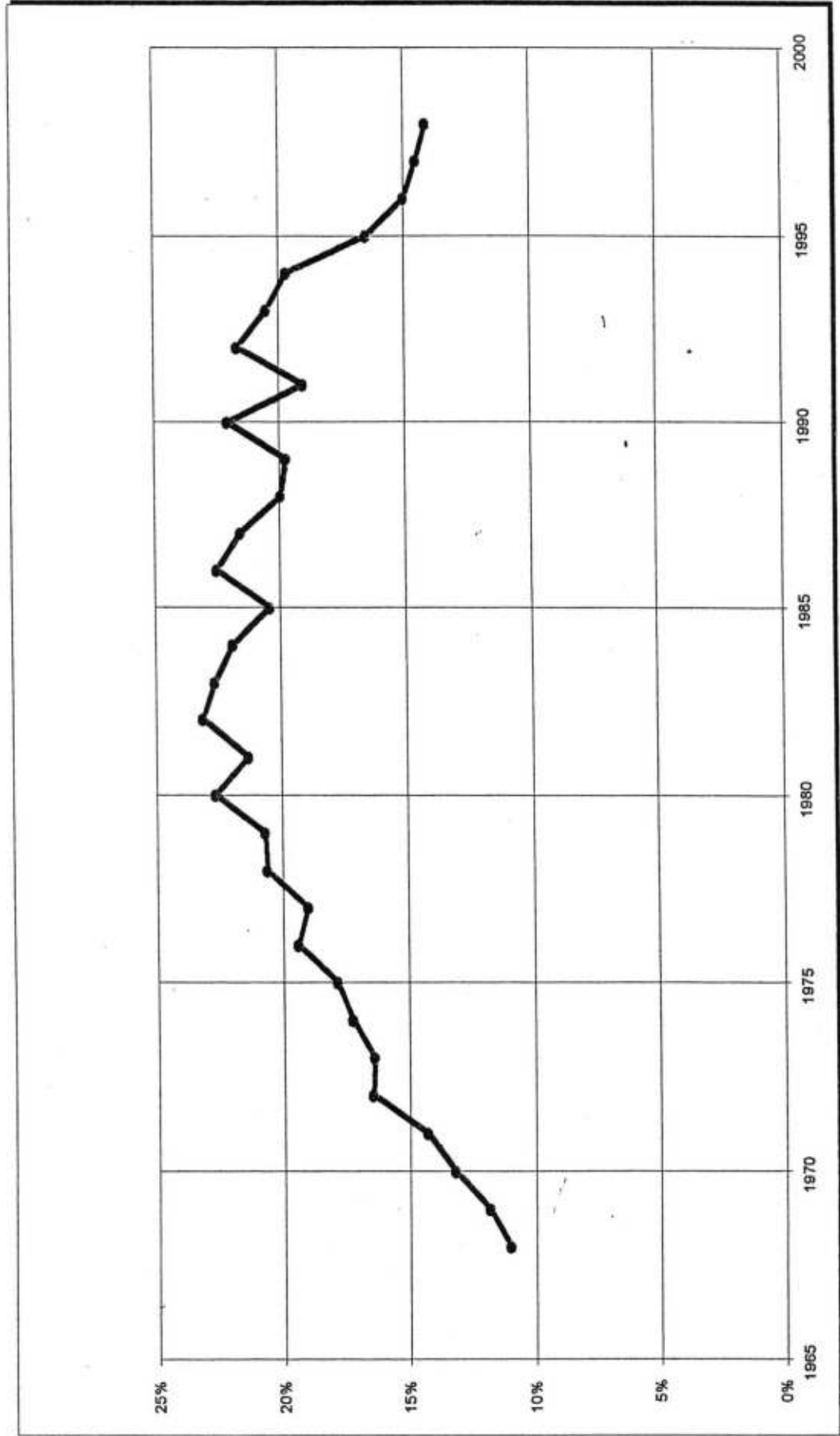
C. External Trade

14.5	-2.6	8.6	Imports of goods ³ real growth
N/A.	90	92	Imports from Israel as % of total Palestinian Imports ⁴
7.7	5.7	4.1	Imports from Israel as % of total Israeli exports ⁵
6.9	-6.7	7.0	Exports of Goods ³ real growth
N/A.	83	79	Exports of goods to Israel as % of total Palestinian exports ⁴
1.0	0.9	1.4	Exports of goods to Israel as % of Israeli exports ⁵

Sources: ICBS Yearbooks, BOI Annual Reports, PCBS, IMF, World Bank,
UNSCO

Palestinian Income per capita

% of Israel



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- ¹ Figures for the second and third periods are compiled and calculated from different sources, which are not always compatible with each other. Some of the figures for the third period are based on estimates and should be interpreted cautiously.
 - ² Under-employment in the 2nd and 3rd periods resulting from strikes, curfews and especially from closures, are considered here as employment. Thus, the shares of Israeli labor market, as well as the effective rate of unemployment, are understated.
 - ³ For the 2nd and 3rd periods – trade with Israel, according to BOI.
 - ⁴ In the last year of the period (1992 for the second period).
 - ⁵ Based on Israeli balance of payments data, according to BOI.

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DEVELOPING THE OCCUPIED TERRITORIES

AN INVESTMENT IN PEACE

Volume I: Overview

**The World Bank
Washington, D.C.**

September 1993

I. Introduction

The Context

The economy of the Occupied Territories (OT) is currently in turmoil. Income levels have stagnated over the past decade; unemployment and underemployment are rising rapidly; public infrastructure and social services are grossly overstretched; and the fragile natural resource base is threatened with irreversible damage. Above all, the economy remains highly vulnerable to external developments, as shown vividly by the economic hardship being experienced in the aftermath of the recent border closure with Israel. The resulting sense of despair and dependency, juxtaposed against high expectations derived from exposure to Israeli living standards within the OT and in Israel, is clearly a major impediment to achieving peace and stability in the region. While Israelis and Palestinians disagree, and disagree often passionately, on many issues concerning the future of the OT, they agree on one issue: the urgent need for stimulating economic development in the OT. Building upon this shared objective, this study aims to assess prospects for sustainable development in the OT, as well as outline a priority agenda of policy reforms, institutional development and investments needed to promote such growth.

It is worth highlighting two limitations of this study right at the outset. First, a number of key issues bearing upon the future development of the OT (e.g., the allocation of land and water resources, the disposition of Israeli settlements in the OT, the future status of expatriate Palestinians, the territorial issues surrounding Jerusalem and, most importantly, the nature of the proposed "self-governing" arrangements for the OT) are the subject of ongoing bilateral negotiations between the Israelis and the Palestinians. The resolution of these issues is likely to be based primarily on political and security considerations. As the Bank mission to the OT was a *technical mission*, with neither the mandate nor the expertise to deal with political or security aspects, this study does not take any position on issues that are on the agenda for bilateral negotiations. The focus instead is on policies, institutions and investments—where optimal choices are largely invariant to the eventual political arrangements that may emerge from the bilateral

negotiations. Thus, for example, while analysing, where appropriate, the economic links between East Jerusalem and the West Bank and Gaza, the report avoids making any judgements regarding the future status of East Jerusalem.

Second, the study has had to cope with very serious *data gaps and inconsistencies*. Much of the data on the OT are, directly or indirectly, from official Israeli sources. There are, however, serious gaps in the OT data base. A population census has not been carried out in the OT for more than 25 years. As a result, most of the demographic and labor force data are based on extrapolations and on sample surveys, the reliability of which are undermined by problems of non-response, especially since the onset of the *Intifada* (popular uprising) in 1987. Data on East Jerusalem and on Israeli settlements in the OT, both of which are treated as part of Israel by the official Israeli sources, are mostly unavailable. Data available on trade between the OT and Israel and on the profitability and competitiveness of the agricultural, industrial and service enterprises are also very limited. Data on the OT from Palestinian and Israeli nonofficial sources are sparse and selective. Also, Palestinian data, when they exist, are often based on *ad hoc* surveys that do not lend themselves easily to cross-sectional or longitudinal comparisons. In many instances, data differ between sources, and, even when the same source is used, there are gaps and apparent inconsistencies. Given these data problems, the report uses estimates that appear most plausible in light of the mission's field observations. In cases where the data differences among various sources are particularly sharp (e.g., population, unemployment and social indicators), the report attempts, where possible, to examine the reasons for these differences and to indicate the implications of alternative estimates for the results of the analysis.

In view of the limitations on the mission mandate, the data difficulties and the time and resource constraints, this study can only be considered a beginning. The analysis in the study, especially for the longer term, is necessarily incomplete; as, and when, progress is made in the bilateral negotiations, the study will need to be updated and expanded to take account of the agreements reached. Also, notwith-

Box 1.1 The Issue of Jerusalem

The city of Jerusalem has occupied a central place in the history of three great religions—Judaism, Christianity and Islam. It has also played a major role in shaping the economic, social and political lives of the Middle East Region for over three thousand years. Therefore, an important aspect of the current conflict in the Region centers on the control of Jerusalem.

The 1948 war led to partition of Jerusalem into the Eastern and Western parts. At the end of the 1967 War, East Jerusalem was occupied by Israeli forces. Following the occupation, the Jerusalem city limits were expanded by Israel to include some surrounding areas from the West Bank. The expanded city was annexed by Israel on July 30, 1980. Arab residents of Jerusalem have been given the option of obtaining Israeli citizenship although very few have chosen to do so. Israel views Jerusalem as its historic capital and maintains that Jerusalem must never again be a divided city.

Actions taken by Israel were considered invalid by the United Nations, which called upon Israel to refrain from taking any action that would alter the status of Jerusalem. Although the international community has not recognized the Israeli annexation of East Jerusalem, Israel continues to exercise authority over the area and considers it an integral part of Israel and not subject to further negotiations. The Palestinians insist that East Jerusalem is part of the West Bank as per the pre-1967 borders and that Israel should withdraw from all areas occupied during the 1967 war as per the United Nations resolutions.

There are important economic links between the West Bank and Gaza Strip and Jerusalem. Decisions concerning Jerusalem would, therefore, have important implications for future economic prospects and priorities for the OT. The following are among the most important of these links:

- The tourist potential of the West Bank is critically dependent on the ancient religious sites of Jerusalem.
- Major north-south transportation links in the West Bank pass through Jerusalem.
- The only tertiary care hospital and some of the best secondary care hospitals available to the West Bank population are located in East Jerusalem.
- East Jerusalem houses much of the Palestinian financial services, marketing facilities, and social and cultural infrastructure.
- Qalandia airport, a potential outlet for linking the West Bank with regional airports, is within annexed Jerusalem.
- Parts of East Jerusalem are an integral part of the power network covering the area from Ramallah to Bethlehem.

Considering that the question of Jerusalem is essentially a political matter, this report should not be construed as taking any position on this issue. Therefore, while analyzing the links where appropriate, this report has endeavored to avoid making any recommendations that might imply prejudging the status of Jerusalem.

standing the care exercised in locating and interpreting the data from various sources, the empirical underpinnings of this study leave something to be desired, and, therefore, the conclusions of the study should be treated only as indicative of broad trends and priorities. Further, in-depth studies and project feasibility work will be required before the findings of this report could be used to make operational decisions.

A Synopsis

The report is in six volumes; this synthesis volume is complemented by five other volumes detailing the analysis and recommendations of the five teams dealing, respectively, with macroeconomic issues, private sector development, agriculture, infrastructure and human resources. A brief synopsis of the six volumes follows.

- **Volume I** provides a summary *overview* of the key findings and recommendations of the

study. After commenting selectively on the current socioeconomic situation in the OT and its evolution over time, it discusses prospects for sustainable development in the future and outlines the priority agenda of policies and programs needed to promote such development.

- **Volume II** explores the strategic choices at the *macro* level that will be faced by the OT in the future and their implications for economic relations between the OT and the rest of the region. The study looks at the current economic situation and its evolution over the past 25 years. The study then examines several policy choices for the future affecting the structure of development in the OT. Finally, it outlines some illustrative scenarios for the future, focussing on the consequences of current developments in the region.
- **Volume III** reviews the performance of the *private sector* (including, in particular, the industry and tourism sectors) in the OT. It assesses the environment in which the private sector oper-

Box 1.2 Population Data on the Occupied Territories

The only comprehensive data set on the population of the OT is from the Israeli Central Bureau of Statistics (CBS). According to the CBS, the population of the West Bank (excluding East Jerusalem) totalled 1.0 million at the end of 1991 and that of Gaza, 0.68 million, for a combined total of 1.68 million. The estimates are based on a census conducted in September 1967 and updated annually by adding reported births, subtracting estimated deaths and adjusting for the number of net migrants.

Several attempts to verify the population figures, mostly by Palestinian but also by some Israeli researchers, have concluded that the CBS figures underestimate the population of the West Bank and the Gaza Strip by anywhere from 10 to 15 percent. One possible reason advanced for the underestimation is that the base figure from the 1967 census might be flawed; the census, conducted only three months after the occupation, was conducted under a military curfew using Israeli enumerators. Another possible reason cited for the underestimation is that both births and infant deaths are underreported. While the CBS corrects for the under-

reporting of infant deaths, it does not carry out a similar correction for the underreporting of births.

The CBS argues that the 1967 Census achieved exceptionally high coverage because the curfew that was in force confined people to their homes. It further argues that the registration of births since 1967 is likely to be very nearly complete because birth registration is required to exercise one's rights and to obtain social benefits. Accordingly, the CBS believes that the official data represents the best estimate of the OT population.

To the extent that the CBS figures may underestimate the size of the population, the per capita economic and social indicators for the OT derived from the CBS estimates would need to be interpreted with care. The possible error in the population size would also have a bearing on the social and physical infrastructural needs for the future. The continuing controversy on this issue underlines the urgent need for improving the statistical data base for the OT. In particular, organizing a new population census should be accorded high priority by the authorities.

ates and makes recommendations for accelerating private sector development in the future.

- **Volume IV** reviews the evolution and structure of the *agricultural* sector in the OT; analyzes its current characteristics; assesses OT competitiveness in the immediate and longer term; outlines the main policy options and their implications; and provides a preliminary assessment of sectoral financial and technical assistance (TA) needs.
- **Volume V** assesses the current situation in the *infrastructure* sectors (electricity, water supply and sanitation, transport, housing and solid waste services) in the OT; identifies the major

issues confronting these sectors; and outlines priorities for TA and investment needs. As local authorities are major institutions in the delivery of public services in these sectors, the study also includes a review of their current situation and makes recommendations for improving the functioning of municipalities.

- **Volume VI** reviews the current status as regards *human resource* development; analyzes options for enhancing individual welfare and labor productivity in the OT; and outlines investment and TA priorities for strengthening existing programs and for laying the foundation for later reforms.

II. Past Developments and Current Constraints

At the risk of some oversimplification, the economic performance of the OT over the past 25 years can be characterized as *rapid growth, but with serious imbalances*. Specifically, while the current per capita income levels in the OT are about thrice the level that prevailed in the early years of the occupation, this growth has been highly uneven over time and has been accompanied by the emergence of major distortions in labor markets, in sectoral production structure, in the structure of trade and in the balance between public and private consumption.

Overall Economic Trends

The economy of the OT grew rapidly between 1968 and 1980 (average annual increase of 7% and 9 percent in real per capita GDP and GNP, respectively), triggered by a number of factors, including the rapid integration with Israel and the regional economic boom. In the early years of the occupation, there was a sharp expansion in the employment of unskilled Palestinian labor in Israel and a rise in incomes, which in turn spurred domestic economic activity, especially in the construction sector. Earnings of Palestinian workers in Israel rose from negligible levels in 1968 to almost one quarter of GNP in 1975. The increased monetization of the economy following the occupation could have also contributed to the reported growth in the early years.

The rapid growth in the economy of the OT continued even after economic growth in Israel slowed in the mid-1970s following the first oil crisis, as skilled Palestinians from the OT increasingly found employment in the Gulf. As oil prices increased, so did the remittances of Palestinian workers and transfers from oil-rich Arab countries, offsetting weaker opportunities in oil-dependent Israel. Since unskilled labor played a central role in the growth, the poor shared in this growth, and as a result, in all likelihood, there was a significant reduction in poverty in this period. Household conditions also improved substantially, with a several-fold rise in the possession of consumer durables and significant increases in access to municipal water and electricity connections. Life expectancy increased by a decade, and there was significant progress in reducing infant

mortality. School enrollments also rose during this time. These advances mirrored substantial improvements in income levels and in living conditions all through the region during the 1970s.

Growth started slowing down with the end of the regional boom in the early 1980s, and decline set in after 1987. Between 1980/81 and 1986/87, real GNP per capita increased by 12 percent, and the real GDP per capita increased by only 5 percent. Export growth also stagnated during that period. The situation was exacerbated after 1987 with the *Intifada*, which caused disruptions in economic relations with Israel. Periodic OT closures and strikes adversely affected employment and trading activity. Exports fell sharply after 1987 and never fully recovered. In 1991, merchandise exports were estimated at US\$248 million, compared with US\$395 million in 1987. The impact of these adverse shocks was further amplified by a tightening up of the regulatory regime bearing on private sector activities, including restrictions on the movement of goods and people, prolonged delays in the granting of business licenses and permits and stringent tax administration measures. A subordination of OT economic interests to those of Israel may have also played a role in this respect. As a result, the per capita income levels hardly increased during the 1980s—a major turnaround from the exceptionally rapid growth of the 1970s.

The OT was effectively closed for several weeks in 1991 during the Gulf war, causing large income losses. There was also a large decline in the number of hours worked; in 1991, the number of hours worked in Israel was about 75 percent of the 1987 level. In the aftermath of the Gulf war, many Palestinians also lost employment in the Gulf countries, leading to a significant decline in remittances from abroad; in turn, the reduced purchasing power adversely affected domestic economic activities. There was a substantial rebound of economic activity in 1992, fueled partly by expectations of peace, and partly due to relaxation of some of the regulatory constraints. However, a sharp downturn is expected in 1993 mainly as a result of the (partial) closure of Israel to the OT economy in March.

With income levels stagnating or declining in many parts of the world, the 1980s were indeed a

Box 2.1 Occupied Territories—Key Socioeconomic Indicators

	1970	1980	1987	1991
Population (000)	980	1,181	1,434	1,682
GNP per capita (1991 US\$)	780	1,700	1,880	1,715
GDP per capita (1991 US\$)	670	1,310	1,280	1,275
Wage income from Israel (% of GNP)	12	24	28	24
Share of industry (% of GDP)	5	7	9	8
Exports (% of GNP)	22	23	15	9
Imports (% of GNP)	47	46	43	40
Employment (000s) in OT	160	141	169	190
Employment (000s) in Israel	21	75	109	97
Primary enrollment (000s)	179	259	295	321
Secondary enrollment (000s)	26	53	56	70
Hospital beds (per 1,000 pop.)	—	1.9	1.6	1.4
Birth rate (per 1,000 pop.)	42	48	48	51
Daily per capita calorie consumption	2,300	2,650	2,750	2,800
Life expectancy (years)	56	61	65	66
Infant mortality (per 1,000 live births)	95	65	50	42
Households with electricity (%)	30	66	75	85
Households with safe water (%)	15	47	67	90
Households with refrigerators (%)	11	57	71	85
Households with washing machines (%)	—	23	38	61
Households with automobiles (%)	2	—	—	16

Sources: Statistical Abstracts of Israel, Central Bureau of Statistics, various issues. Mission estimates.

difficult period for the world economy as a whole. Clearly, some of the economic difficulties experienced in the OT during the 1980s were simply a manifestation of the general malaise that affected the world economy and the economy of the Middle East region in particular. They also reflect, however, serious structural problems in the OT economy, which have emerged over time and which, if left unattended, will seriously handicap the future economic prospects of the OT.

Structural Imbalances and Distortions

The structural imbalances of the OT economy are manifested in several areas: (i) heavy dependence on outside sources of employment for the OT labor force; (ii) an unusually low degree of industrialization; (iii) a trade structure heavily dominated by trading links with Israel and with a large trade deficit; and (iv) inadequacies in the provision of public infrastructure and services.

Labor Markets

In the aftermath of the 1967 war, some 300,000 Palestinians migrated out, mostly to Jordan. Significant

emigration also continued afterwards (at an average rate of 1 percent per annum). Nevertheless, the Palestinian labor force in the OT more than doubled over the past quarter century. In contrast, the domestic employment opportunities grew by less than 25 percent. Instead, Palestinian employment grew mostly in two areas: unskilled work in Israel and higher-skill services throughout the world, but particularly in the Gulf countries. Prior to the 1967 war, the West Bank and Gaza had no economic relations with Israel. That changed rapidly after the occupation, and the number of Palestinians working in Israel rose to 75,000 in 1980 and to 109,000 by 1987; these workers accounted for 35 percent of the employed population in the West Bank and 45 percent in Gaza. This source of growth accounted for essentially the entire growth in the labor force until the *Intifada*. Employment was overwhelmingly in unskilled and semi-skilled work; construction employed the most workers; and wages were around the Israeli minimum wage. Only 2 percent of the Palestinians working in Israel were engaged in professional, technical and clerical occupations.

The pattern of employment of Palestinians in the Gulf states was quite different. The highest demand in the Gulf states was for skilled Palestinian labor;

Box 2.2 Income Levels in the Occupied Territories—A Comparative Perspective

On the basis of the official statistics, the OT had a GNP per capita of US\$1,715 in 1991. This GNP is similar to that of Tunisia (US\$1,500) and Turkey (US\$1,780) and substantially ahead of Jordan (US\$1,050), Morocco (US\$1,030) and Egypt (US\$610). However, this probably overstates the relative position of the OT, possibly by a substantial margin, for two reasons. First, some adjustment would be necessary to the extent that official estimates of the population may be underestimated. More important in quantitative terms, comparisons at official exchange rates often fail to reflect relative incomes in terms of real purchasing power because of differences in the prices of goods and services across countries. In general, the poorer the country, the cheaper the average price level is since non-tradeable factors of production are paid less (e.g., wages and land rents are lower) and, consequently, the non-traded goods are cheaper. The International Comparisons Project attempts to adjust for this by directly comparing the prices of goods in different countries. In terms of "international" purchasing power (using prices in the United

States as a base), the GNP per capita for Morocco is estimated at US\$3,300; for Tunisia it is US\$4,700; for Turkey, US\$4,800; and for Egypt, US\$3,600. There is no direct data for Jordan, though on the basis of adjustments made in other countries, its GNP per capita would also be expected to be increased by three to four times. The OT, for which there is also no direct information, will be affected by the high degree of openness to Israeli prices: the ICP estimate for Israel's GNP per capita in "international" purchasing power terms is only 10 percent more than the figure at official exchange rates. The adjustment for the OT will be higher than this since wages and land rents are lower than in Israel, but it is probable that it will be substantially less than that for the other lower-middle income economies in the region. Accordingly, the OT income levels could well be below those in Jordan, Morocco and Tunisia and not above them, as the estimates at official exchange rates indicate. In the absence of firm statistical underpinning, this conclusion remains, of course, highly conjectural.

and the wages earned there were substantially higher than those in the West Bank and Gaza. It is estimated that about 40,000 Palestinians from the OT went to work in the Gulf states during the 1973–1982 period. With the decline in oil prices and the regional recession, demand dropped considerably after 1982, and there was probably very little net outflow of labor to the Gulf during the rest of the decade. This is reflected in the relative price of skilled labor in the OT over time: the premium to a university education appears to have vanished by the end of the 1980s.

Direct contribution to GNP from wage income from abroad, mainly in Israel, rose from negligible levels at the start of the occupation to about US\$350 million in 1980 and to about US\$675 million in 1987, before stabilizing around that level in nominal terms. Although reliable data are lacking, remittances from long-term Palestinian workers in Gulf countries, and elsewhere, have also constituted an important source of disposable income. Adding the indirect economic stimulus provided by this large resource infusion, it is clear that external labor markets have played an important role in the economic growth of the OT over the past 25 years.

The future prospects for these labor markets, however, do not look promising; most Gulf demand for Palestinian labor has dried up in the wake of the Gulf war. The deteriorating security situation, and the increasing restrictions on the movement of people since the onset of the *Intifada* in 1987, are threatening the continuing access to the Israeli labor market. The

Israeli labor demand would have fallen sharply in any case after the current construction boom fades in Israel. Prospects in nontraditional labor markets in Europe and other Arab countries also do not appear good. Meanwhile, given the rapid population growth of the past, and the unusually low current labor force participation rate (especially for women), the labor force is set to double before 2010, even without considering the return of any Palestinian expatriates to the OT in the wake of a peace agreement.

Production Structure

Related to the heavy dependence on outside employment is the lack of dynamism in domestic economic activities in the OT, particularly in the industrial and service sectors. At less than 8 percent of the GDP, the share of industrial production in the OT is much below that in other economies with similar income levels. Mauritius, for example, like the OT, is a small, open economy with a significant agriculture sector and about the same income level; the share of industry in GNP in Mauritius is, however, three times as high as in the OT. The tourism sector, potentially a flagship industry in the OT, has also remained stunted with stagnation, or even actual decline, in supporting infrastructure such as hotels, travel agencies and tourist guides.

Small, underdeveloped enterprises dominate the production and service sectors. While individual and

firm-level entrepreneurial initiative and innovation are abundantly evident in the OT, this has not resulted in strong sectoral performance. Instead, the economy remains predominantly based on small cottage industries and sole proprietorships. In the industrial sector, only 5 percent of enterprises employ more than 20 persons, with almost two thirds employing fewer than 4 staff. The normal consolidation and rationalization of the industrial sector has not occurred, impeding the realization of economies of scale. The combination of the small size of the enterprises, the undeveloped state of marketing services and the lack of infrastructure and distribution systems constrains producers to sell directly to customers within a small geographical area (often a single town or village). This decreases competition, severely impedes the efficiency of factor utilization and militates against integrated markets. The lack of clear zoning regulations and public land use policy have acted to distort urban/industrial land prices, becoming a barrier to industrial expansion. Finally, business support services and institutions, both public and private, have yet to develop to a stage where they can cater to the needs of a dynamic private sector. These include, *inter alia*, information services to promote the diffusion of technology and the more efficient functioning of markets; training facilities for skill upgrading; and accounting and auditing services to meet the needs of larger business operations.

Investment by the private sector in productive assets has remained extremely low. While total gross fixed capital formation (GFCF) averaged a robust 27 percent of GDP during the period 1968 to 1991, construction (mainly in housing) accounted for more than 80 percent of GFCF. Investment in industry has often not even kept pace with the depreciation of

capital stock. The low investment level reflects a combination of factors, including political uncertainty, tenuous property rights, entry barriers, a restrictive regulatory and taxation environment and the lack of a supportive financial system. Formal financial intermediation remains at an exceptionally low level. There is no institutional capacity for mobilizing and allocating medium- to long-term funds. Private sector investments are, therefore, limited to individual savings and internal cash generation. A perceived lack of effective recourse against arbitrary actions by the OT administration has also discouraged entrepreneurial activity. Following the relaxation of some of the regulatory and administrative impediments over the past couple of years, there have been some signs of increased investment activity in recent months. However, lacking a fundamental change in perceptions about the business environment which appears possible only in the context of a peace agreement, the private sector response to these reform measures is likely to remain half-hearted and fragile.

The growth potential of the agricultural sector, rather modest in any case, has remained constrained by a stagnating or shrinking land and water resource base and by asymmetric trade relations with Israel which limits OT agricultural exports to Israel, where they are generally quite competitive. Renewable groundwater resources in the West Bank and Gaza, shared between Israel and the OT, are now fully exploited. However, annual use by the Palestinians has remained capped at the pre-1967 level. Current restrictions on access to water, including administrative limitations on surface water harvesting and the high costs of water caused by difficulties in renewing inefficient and worn-out wells, have meant the stag-

Box 2.3 Differences between the West Bank and Gaza

As many of the structural problems and strategic choices affecting the West Bank and Gaza are quite similar, to avoid repetition and unnecessary detail, much of the discussion in this report treats the two territories together. There are, however, notable differences that must be kept in mind:

- The population density in Gaza (1,870 persons per sq km) is almost 10 times that of the West Bank.
- GNP per capita in Gaza amounted to US\$1,230 in 1991, compared to US\$2,000 in the West Bank.
- Investment per capita in Gaza is less than half of that in the West Bank, and the physical infrastructure is much worse in Gaza than in the West Bank.

- The water demand/supply balance is much more precarious in Gaza than in the West Bank.
- Refugees make up over two thirds of the population of Gaza, compared to about 40 percent for the West Bank.
- Dependence on the Israeli market for employment is significantly higher for Gaza than for the West Bank; about 39 percent of the Gaza labor force in 1991 was employed in Israel, compared with 31 percent for the West Bank.

The report attempts to address, as much as possible, the problems arising from the differences between the West Bank and Gaza, especially in relation to investment needs.

nation of the irrigated area under Palestinian cultivation. In selected areas, notably in parts of Gaza, increasing salinity levels caused by excessive extraction have virtually halted agricultural production. Loss of access to traditional grazing lands in the West Bank, due to security considerations and the increase in nature reserves, has affected animal husbandry operations, forcing pastoralists to keep their flocks in confined areas. Security-related restrictions (recently relaxed) affecting the fishing areas in which Gaza fishermen were allowed to operate limited fish production to a fraction of the pre-1967 levels.

Trade

The two most striking developments in OT trade during the past 25 years are: a major redirection of trade towards Israel and the emergence of a large trade deficit. From no trading relations before the occupation, Israel has become practically the sole trading partner of the OT. The share of Jordan in total OT trade declined drastically over this period: exports to Jordan as a share of total OT exports declined from 45 percent in 1968 to 15 percent in 1991. Exports to Jordan are constrained by regulatory and security restrictions imposed by Israel, as well as by require-

ments regarding proof of origin and seasonal quotas on agricultural products imposed by Jordan, especially since the mid-1980s. However, Jordan does not impose any customs duties on goods imported from the OT. Furthermore, as a result of the security restrictions imposed by Israel, the OT can import virtually nothing from Jordan, even though in a number of cases (agricultural inputs, construction materials and households durables) Jordanian products could be highly competitive in the OT.

The Arab boycott of Israel as it relates to the OT, as well as various impediments to trade with the rest of the world, have also acted to distort the overall pattern of trade. A preliminary analysis of trading patterns based on the size of the economies, the geographical proximity and cultural similarities suggests that, in the absence of the above restrictions, Israel's share in OT trade would have been much lower; and Egypt, Jordan and the Gulf and OECD countries would have been significant trading partners. The disproportionate dependence on Israel for trading relations is in part linked to relatively better treatment received by the OT industry when subcontracting for Israeli firms, rather than directly exporting to non-Israeli markets. On the import side, the heavy dependence on Israel sometimes leads to inef-

Box 2.4 Occupied Territories—Selected Comparative Data (1991)

	<i>Occupied territories</i>	<i>Middle East and North Africa^a</i>	<i>Jordan</i>
GNP per capita (US\$)	1,715	1,940	1,050
GDP per capita (US\$)	1,275	...	1,130
Gross enrollment ratios			
Primary (% school age pop.)	102	97	94
Secondary (% school age pop.)	80	60	65
Pupil-teacher ratio (primary schools)	30	26	17
Repeater rate: primary (% of total enrollment)	7 ^b	11	5
Illiteracy (% of pop. age 15+)	40	45	20
Persons per physician	847	1,668	767
Persons per hospital bed	658	635	519
Age dependency ratio ^c	1.08	0.87	0.92
Total fertility rate (births per woman)	7.3	5.3	5.3
Infant mortality (per 1,000 live births)	42	60	29
Life expectancy (years)	66	64	69
Households with safe water (%)	90	83	96
Urban water supply (liters per capita)	60	...	137
Households with electricity (%)	85	...	98
Electricity consumption (kwh/capita)	680	...	1,130
Telephone subscribers (per '000 pop.)	22	...	67

^a Includes 18 countries extending from Algeria to Iran.

^b Data for UNRWA schools only.

^c Defined as the ratio of dependent pop. (under 15 and over 64) to the working age pop. (15-64).

ficient sourcing of inputs for the OT enterprises, undermining their overall competitiveness.

The above trade patterns were accompanied by a sizeable OT trade deficit, which reached US\$675 million in 1987, or 28 percent of GNP. The trade deficit was mainly with Israel while the OT enjoyed a trade surplus with Jordan. Although the trade deficit has been largely offset by incomes of Palestinian laborers in Israel, the resulting dependence on a single market makes the OT economy highly vulnerable to shocks, especially because labor flows are subject to political developments in the region. A collapse in labor income from Israel, as happened recently, would lead to a sharp decline in imports and have a depressive effect on domestic economic activity.

Public Infrastructure and Services

In contrast to impressive gains in private incomes and consumption, the provision of public services and physical infrastructure in the OT is highly inadequate. Although the coverage of services, particularly in the major urban areas, is fairly high, the quality of services often leaves much to be desired. The average urban water supply, for example, is only about 60 liters per capita per day (compared to 115 for Tunisia, 137 for Jordan and 230 for Egypt); a consequence of limited access to water resources and inadequate investment. Water actually consumed is much less due to deficient distribution systems with high losses (40–60 percent) in most municipalities. The inadequate supplies force many water departments to rotate water supplies to parts of their networks. The intermittent supply leads to the contamination of water from the intrusion of polluted water into the networks.

Due to supply constraints and network deficiencies, current electricity consumption of about 680 kwh/capita/year is also low compared to Egypt (1,055) and Jordan (1,055). Some 138 Palestinian villages have no electricity supply or only a part-time supply from isolated diesels. Suppressed peak demand is estimated at 30–50 percent. Load shedding and power interruptions are a frequent occurrence. Regulatory constraints on network expansion and on supplies from the Israeli system have forced many industrial users to resort to expensive captive supplies. Distribution losses are high at 20 percent, reflecting the need for major rehabilitation and upgrading. Because of these problems, and due to inadequate consumer tariffs and overdue accounts, all electric utilities in the OT are in poor financial condition.

Solid waste collection and disposal is grossly inadequate, raising serious health and environmental concerns. There are no modern sanitary landfills in

the OT. Refuse, if and when collected, is simply dumped outside municipal boundaries and often burned to reduce volume, leading to air pollution. Most of the municipalities do not have a satisfactory wastewater collection or treatment system. Generally, wastewater is discharged into seasonal streams or *wadis*. Where wastewater treatment plants exist, they appear to be poorly designed and operated. The poor management of wastewater is contributing to the contamination of groundwater, particularly in Gaza.

While the length of road networks per capita is typical of a country with similar per capita GDP, the physical condition of the roads serving the Palestinian population has deteriorated to the point where, without immediate rehabilitation, past investments may be completely lost. Most of the network needs to be improved through pavement strengthening. Many sections of the system need to be upgraded through improved vertical and horizontal alignments. The condition of the urban networks is also very poor. Roads in all municipalities lack adequate markings, lighting and the capacity to serve the needs of the population. The inadequate road network, especially rural roads, has served to increase the cost of transporting goods to markets dramatically, particularly for perishable agricultural products.

The ratio of telephone subscribers to total population in the West Bank and Gaza is about 1:46, as compared to 1:15 in Jordan and 1:34 in Egypt. There is a large suppressed demand with the backlog for new connections in the West Bank alone exceeding 12,500, or about one third the number of lines currently in use. Of 400 villages in the West Bank, only 80 had telephone service as of end-1991. Of these, most had usually only one connection, and it was frequently out of service. The lack of adequate telecommunications capabilities has had a particularly deleterious impact on the service industry, a sector heavily dependent on good telecommunications.

Educational facilities are also in poor condition. Many school buildings require major repairs. Libraries and laboratories are generally inadequate, as are supplies of textbooks and materials. The curricula require modernization, and the qualifications of educational personnel in almost all positions need to be upgraded through pre-service and in-service training. Vocational schools are seriously underfunded and have inadequate facilities and obsolete equipment. Universities are too small to be able to provide the facilities required for advanced study, particularly in the physical sciences. The fragmentation of the educational system—the Egyptian system is used in Gaza and the Jordanian system in the West Bank—is an added handicap. The frequent school closings

Box 2.5 Israeli Settlements in the West Bank and Gaza

Israeli settlement of the West Bank and Gaza, while beginning immediately after the 1967 war, intensified during the 1980s. According to unofficial Israeli sources, in 1992 there were about 136 settlements in the West Bank with 130,000 inhabitants and 17 settlements in Gaza with a population of 4,000 to 5,000.

Israelis argue that land for settlements has been acquired through legal means; Ottoman, British mandate, Jordanian and Israeli legislation have been used to obtain former state land, land left by Palestinian refugees and land where Palestinian occupants have been unable to prove their title. Palestinians have the right to appeal acquisition of land by the Israeli authorities through the Israeli legal system, but few cases have been successful. Palestinians point out that such settlements are prohibited under international law and are, therefore, illegal. The UN has taken the position that Israeli settlements in the OT have no legal validity and should be dismantled.

In order to attract settlers, the Israeli Government used to offer a number of incentives including: direct housing subsidies; land at discounted prices; mortgages at reduced rates; free hookups to utilities and municipal services; and higher schooling subsidies than in Israel. Israeli budgetary allocations for building settlements are not clear, but several sources report that they have been very large—perhaps as much as US\$20 billion over the past 25 years.

Infrastructure for the settlements is fully integrated into the Israeli national systems. Water, telecommunications and electricity grids function as integral parts of the Israeli systems and are operated by the national Israeli agencies. Transport systems built during the past 25 years have also been designed primarily to meet the needs of settlements, linking them to metropolitan areas in Israel.

For all infrastructure systems, there is an obvious difference in quality between facilities for the Israelis and the Palestinians—the former having been financed from the Israeli budget and the latter being funded by the CA. In contrast to the generally inadequate and poorly maintained infrastructure for the Palestinian population, there is well-designed and well-maintained infrastructure catering to the needs of the Israeli settlements. For example, the electric service to Israeli settlements, supplied by dedicated supply lines, is markedly superior, with annual per capita consumption more than double that of the Palestinian population. Similarly, most residences and businesses in Israeli settlements enjoy individual telephone connections, and the waiting period for new connections is one of weeks rather than of months or years, as in the case of Palestinians. Integrating the two systems into a rational, single system should offer significant cost savings and overall improvements in service standards.

since the beginning of the *Intifada* have reportedly led to an increase in dropout rates, a breakdown in discipline and a deterioration in student achievement. Widespread violence has also produced an alarming growth in the population that is physically or mentally disabled.

The health infrastructure is less in need of repair. However, the OT devote a relatively large share of their output (7 percent of GNP) to the health sector and do not obtain the health impact that should be expected from this expenditure. Several reasons for the poor performance are apparent. First, most health care resources are being used to provide costly, high technology, hospital-based care for the benefit of the relatively well to do. Second, very small, inefficient hospitals have been allowed to proliferate (over two thirds of all hospitals have fewer than 100 beds). Third, highly specialized procedures are being carried out by units that are too small either to exploit economies of scale or to provide physicians and staff with enough practice to maintain skills. Finally, too little attention is being given to reaching out to underserved groups, especially women.

The inadequacies in the provision of public services have to be seen in light of OT public finances. Expenditures by the Civil Administration (CA) and

the municipalities (including the public utilities) have been confined to the revenues collected by them: i.e., taxes, fees and utility tariffs. Public sector capital expenditures amounted to about 3.5 percent of GDP over the 1970–90 period, which is significantly below the average for developing countries. In Jordan, for example, the central government capital expenditure/GDP ratio has averaged about 9 percent in recent years. Three reasons seem to account for the “underinvestment” in infrastructure in the OT. First, the CA and the local bodies have inadequate resources because the tax effort is relatively low and because not all the taxes paid by the residents of the OT accrue to the budgets of the CA or the municipalities. The foregone revenues mainly relate to tariffs on trade with and through Israel. The shortfall between the revenues collected by the CA and the amount of taxes that are actually paid by the Palestinians leads to an element of “fiscal compression” and an underfinancing of public sector investment needs. Other agencies, both official and private, have tried to fill the gap left by inadequate availability of resources to the CA. Foremost amongst these is UNRWA which provides basic services to almost half the OT population at an annual cost of about US\$100 million. Jordan has been the other major contributor

until the 1988 "disengagement", providing some US\$750 million of assistance during 1967-1988, mostly as salaries and remuneration for the West Bank civil servants. OECD donors, UNDP and NGOs have also provided significant resources. Nevertheless, the overall availability remains much below the need.

Second, neither the CA nor the utilities borrow to finance investment expenditure, while such financing is a common feature in many of the developing countries. Public utilities have been forced to finance most investments from current revenues after part of the revenue has been siphoned off to cover non-fee-earning municipal services.

Lastly, the poor state of physical infrastructure and the inadequacies of the services provided reflect the lack of coherence in sectoral policies and programs. This incoherence is due to the lack of mechanisms and institutions for policy and program development responsive to the preferences and priorities of the population to be served. The fragmentation of institutional responsibilities for program implementation and operation contributes to diffused accountabilities, indifferent service standards and, sometimes, duplication of effort. The programs of the CA, for example, are poorly coordinated with those of UNRWA or with those of the numerous NGOs operating in the OT.

To sum up, the economy of the OT grew very rapidly in the 1970s. Growth slowed down considerably in the 1980s but was still not out of line with

performance in the rest of the region. This relatively respectable growth has been accompanied, however, by a skewed pattern of development and a serious underprovision of public services. High dependence on sources of employment that are now drying up combined with limited internal opportunities is perhaps the most serious structural problem facing the OT. Providing productive employment to the new entrants, as well as to those who may no longer be able to find employment outside the OT, will be among the most important challenges facing the OT in coming years. Stimulating growth in the productive sectors and services, particularly the latter, will be essential for coping with this challenge. As the OT economy tries to reduce its future dependence on labor flows to Israel, it also needs to improve its trade position by promoting exports, developing efficient import substitution and diversifying its trading relations. Significant improvements in public infrastructure and services are needed not only to improve living conditions directly, but also to support private business activities and to avoid environmental degradation. Past distortions and a series of adverse shocks, especially in areas critical to past sources of growth, are leading to economic stagnation, putting at risk the past gains in living standards. This, in turn, threatens the prospects for lasting peace in the region. Addressing these weaknesses is, therefore, essential for the future peace and prosperity in the region.

III. Prospects and a Strategy for the Future

Future Prospects

Although the OT suffer from serious structural problems and imbalances and have a very limited natural resource base, they also have substantial assets:

- First, the OT are blessed with a high quality human resource base. The Palestinians have the largest proportion of their population completing higher education of any Arab group (18 college graduates per thousand population). Despite significant outmigration, there is no shortage of either entrepreneurial talent or professional skills. The private sector in the OT is highly resourceful with a demonstrated ability to operate under rather challenging conditions. The removal of regulatory constraints and the establishment of supporting institutions and infrastructure should, therefore, help generate a significant supply response.
- Second, given the right climate, there could be significant private capital flows to the OT from the large and relatively prosperous expatriate Palestinian community in the Arab world and elsewhere. Many of the successful businessmen in the Arab world are of Palestinian origin. Surveys conducted in the early 1980s indicated that about one half of the Palestinians working in the Gulf states held what were classified as "professional and technical" jobs, the highest ranking category in terms of pay scale. Prior to the Gulf crisis, annual remittances from Palestinians working abroad (other than in Israel) exceeded US\$300 million, about a third of which came from Kuwait. It is estimated that currently there are some 200,000 Palestinian workers and businessmen living in the Gulf states and the OECD countries. Given the strong community ties among the Palestinians, it is likely that, in the wake of a peace agreement, a good fraction of these businessmen and professionals would wish to strengthen their links with the OT through increased remittances, as well as direct investment in productive ventures. In addition, Palestinian financial resources abroad could be tapped to support public sector investment through, for example, subscription to a Palestinian bond scheme.
- Third, because of their unique religious and cultural heritage, the OT have the potential for developing into an important tourism centre. The tourism industry was the mainstay of the economy of the West Bank before 1967, but it has suffered serious setbacks since then because of the unsettled political and security situation. With peace and the normalization of relations in the region, tourism and related industries can become a major source of foreign exchange earnings for the OT economy, especially if cooperative arrangements can be developed with neighboring countries to promote tourism on a regional basis. The geographic location of the OT, and the fact that the Palestinians now have experience in trading with both the Israeli and Arab economies, should also make the OT important transit points for future trade within the region.
- Fourth, unlike most other developing economies, the OT do not have to deal with the burden of crushing external debt. Public finances are also close to balance, and there is neither a bloated bureaucracy nor any loss-making public enterprise. Free from these legacies, public policy can, therefore, focus on structural reform. It also means that the OT economy can sustain a certain amount of external borrowing, especially for upgrading essential public infrastructure. Sound macroeconomic conditions can, however, be swiftly lost by imprudent policies, especially in the public sector.
- Finally, given the strategic location of the area and the problems that the OT have experienced, there are good prospects for attracting international official assistance to help overcome infrastructural bottlenecks and deficiencies.

A prerequisite for transforming the above potential into sustainable development for the future is the resolution of the long-standing political, security and governance issues affecting the region. That should release for socioeconomic development major resources, both financial and human, now being spent

to cope with the actual or perceived administrative obstacles, security threats and inequities. More importantly, by removing the strategic uncertainty and the perception of risk, the political settlement should unleash the financial and entrepreneurial resources of the private sector, both domestic and expatriate, for long-term investments in the OT. Lastly, access to external markets in the Arab world, likely to be normalized only with progress in the peace process, would provide additional impetus to development.

Elements of A Strategy for Economic Development

Political settlement and peace is a necessary, but not a sufficient, condition for economic development in the OT. Much will also depend upon the *quality of economic management* in the post-peace period and the strategic choices made in managing the OT economy. Choices on two issues will be particularly critical: the balance between the *roles of the public and the private sectors* in the OT; and the nature of OT economic links to the rest of the world, particularly neighboring countries.

Because of the existing economic imbalances and the unmet social needs, the public sector would clearly have an important role to play in economic development, particularly during the transition period. The upgrading of physical and social infrastructure, a key priority for improving living standards of the population and for stimulating private sector development, would have to be undertaken mostly by the public sector as private sector interest in financing such investments is likely to be limited, at least for some time. Even where private sector initiative may be forthcoming (e.g., in some segments of health services), a sound sectoral policy framework to safeguard the interests of both the providers and users of such services needs to be established. An even more crucial function for the public sector would be to provide a supportive business environment within which the private sector could flourish while, at the same time, protecting public interests in areas such as health, safety and the environment. There will be a need for a substantial strengthening of public action in many areas, including macroeconomic management, tax administration, the regulatory framework and the supervision of the banking system. In addition, this would mean relaxing some of the supply-side constraints (e.g., increasing the availability of land for new industries and businesses through an overhaul of the municipal zoning laws) currently affecting private sector performance. Providing an affordable social "safety net" through targeted programs would be another important function for the public sector.

While recognizing these imperatives, it is essential that the public sector role be not overstretched. In particular, any involvement by the public sector in directly productive ventures or interference in the marketplace by propping up unviable private sector activities (e.g., through price controls and by limiting competition) would retard economic development and, therefore, should be resisted. International experience indicates that differentiated patterns of protection, activist industrial policy or public channelling of money into unviable enterprises via the financial system too frequently lead to economic disaster. Economies that have prospered in the past have relied primarily on the private sector, working in undistorted markets, as the primary engine of economic growth. Relying on the private sector would be particularly prudent in the OT because, first, as noted above, the private sector in the OT is dynamic and capable; and, second, public sector resources, financial as well as administrative, are likely to be very scarce, at least for some time to come.

Regarding links to the outside world, in economic terms, the option of turning inwards would clearly be very costly for a small economy such as that of the West Bank and Gaza. It would mean major efficiency losses and a sharp decline in living standards. The opening up of external markets to exports from the OT is important if the economy is to achieve sustainable development. However, the external economic relations would need to be shifted from almost complete dependence on Israel, as at present, to interdependence with a range of economies, including Israel.

Given the close economic relations with Israel that have evolved over the past 25 years, the economies of the OT and Israel are bound to be inextricably interwoven for the foreseeable future. While a major reorientation in trade—to the region and to the rest of the world—should occur over the medium term, any sharp cut in trade in goods to Israel could have large short-run costs, because of Israel's predominance as a trading partner. This implies the desirability of mutually beneficial arrangements between Israeli and OT authorities regarding the flow of goods, services, financial resources, labor and visitors in the post-peace period. Even if the loss of substantial labor access to Israel is permanent, it would make sense for the West Bank and Gaza to not only maintain, but expand trade access to the Israeli market. The key issue in the Israeli market is agriculture. The opening of the Israeli market to agricultural products from the West Bank and Gaza, where they are highly competitive, would have a significant positive impact on OT agriculture by both increasing production and eliminating rents from illegal trade. Israeli consumers would also benefit significantly from easier access to OT produce.

Equally important, for export diversification by product and by destination, trade links to Israel should be complemented by increased access to both the traditional Arab markets and to nontraditional markets in Europe and North America. As noted earlier, the various restrictions on trade with and via Jordan have significantly reduced trade with the Arab countries. The removal of these restrictions should lead to increased production and exports, particularly of manufactured goods, as well as the importation of certain inputs—such as fertilizers and construction materials—at significantly reduced prices. An important issue for OECD markets concerns how far the OT can participate in the current free trade agreements which Israel has with the EC and the US. (The EC agreement is already applicable to the OT).

From the perspective of the West Bank and Gaza, a strategy that attempted to open up opportunities elsewhere, especially with Jordan, Egypt and the Gulf countries while maintaining open trade relations with Israel, would make sense. A possible approach to consider would be a free trade area with Israel, linked with a significant opening of trade to Jordan and Egypt. This would differ from the present (partial) customs union in allowing the OT to have different tariffs from Israel for trade with rest of the world. It would maintain open trading relations with Israel, but would potentially avoid protectionist aspects of Israel's trade regime that may not be suited to the economic structure of the OT. The opening of trade to Jordan, Egypt and the rest of the Arab world would allow the OT to diversify its export base, thus reducing its vulnerability to external shocks. However, while a free trade area, perhaps involving Jordan, is attractive in principle, there may be problems in practice linked to the establishment of customs borders and the "leakiness" of such borders. Equitable distribution of gains from free trade among the various partners may also require some transitional arrangements to enable the infant OT enterprises to compete on an equal footing. Another possibility to consider would be to recast the current asymmetric trading arrangements into a full-fledged customs union with Israel. That would have the advantage of administrative simplicity, however, careful attention would need to be paid in that case to putting in place mechanisms for opening up trading possibilities with Jordan, Egypt and other Arab countries.

Promoting regional infrastructural networks in electricity, transport, telecommunication, petroleum and gas pipelines and water would offer other opportunities for strengthening interdependence and benefitting from complementarities and economies of scale, which may not be available to the OT in the absence of such cooperation. Because of the poor endowment of natural resources, the landlocked lo-

cation of the West Bank and the small size of the economy, many infrastructure services in the OT are likely to be lower cost if regional solutions are adopted. Regional power interconnection would be of high priority to the OT because of the lower cost sources of supply in Israel, Egypt and, perhaps, Jordan and the improved reliability of supply to all participating parties. Similar economies of scale and the utilization of existing capacity are possible with highways and ports. Since water resources are common to both the OT and Israel, an attractive long-term solution would be the joint management of the shared resource.

Choices concerning the respective roles of the public and private sectors would be entirely up to the decision-makers in the OT, however, the choices concerning economic links would necessarily involve other parties and would depend upon negotiations between the OT, Israel, Jordan and other regional and non-regional parties. The international community and particularly the OT's neighbors could make an important contribution to economic growth in the OT by providing improved market access to OT exports and by supporting economically viable regional infrastructural investments.

Other strategic choices, dependent upon the outcome of the ongoing bilateral negotiations, concern the feasibility and desirability of an independent macroeconomic policy for the OT, including a separate currency. *Prima facie*, there are a number of reasons why an independent policy would make sense: it would allow the OT to deal better with real and nominal shocks, gain seignorage revenues and facilitate financial intermediation through financial sector development. Preliminary analysis suggests, however, that:

- In some areas, the pursuit of an independent macroeconomic policy is likely to be fruitless, e.g., attempts to have independent interest rates, given the degree of capital mobility in the region.
- In a second set of areas (e.g., managing "excessive" capital inflows, borrowing at home and abroad and supervising/providing liquidity to banks), independent policy is desirable but does not necessarily require a separate currency.
- Seignorage is traditionally important in the region but is unlikely to be so for the OT because of the likely initial low level of credibility of a new currency and the high capital mobility.
- Finally, there are areas for which a domestic currency is necessary, e.g., avoiding imported nominal shocks from other members of a currency union and facilitating real wage declines.

The above must be seen in the context of credibility, something that is hard to earn but that can be

obtained by being in a currency union(s) with a disciplined core or by establishing a track record of prudent macroeconomic, and especially, fiscal management. The OT do not have such a history, and new institutions of macroeconomic management are likely to be both fragile and under pressure. If a domestic currency is chosen, it might be desirable to start with a relatively restricted version, as in a Currency Board, that could gradually evolve to a fully fledged currency once discipline, and the associated demand for the currency, was well established. Decisions concerning an independent OT currency may have significant repercussions for both Israel and Jordan, particularly the latter since the JD currently in circulation in the OT may be a significant fraction of the total money supply in Jordan. Accordingly, retiring the Israeli and Jordanian currencies from the OT, may have to be done in a phased manner in consultation with the Israeli and the Jordanian authorities. The international community may also have a role to play in that respect.

Some Scenarios for the Future

Forecasting the pattern of growth is a highly uncertain business. However, assuming sound economic management, it would be reasonable to expect a relative expansion of domestic over external employment. Over time, a substantial diversification in economic relations would also be probable, with greater interdependence among economies in the region and an expansion in trading relations outside the region, notably with Europe. As regards the likely changes in the production structure of the economy, undoubtedly there is some room for expansion in agricultural and industrial production, once the present constraints on private sector development are removed, including access to outside markets. However, this point should not be overemphasized. Diminishing water resources throughout the region will constrain the development of the agricultural sector, with future growth limited to high-value export crops catering to niche markets. Given the paucity of industrial raw materials and the small market size, heavy industry is unlikely to be a major contributor to future growth. Instead, skill-based, light- and medium-sized industries would appear to be more promising. Above all, the economy of the West Bank and Gaza is likely to remain mainly a service-oriented economy with an important contribution made by the tourism sector.

A range of scenarios was developed to explore the potential trajectory of the economy in the future. These are illustrative only since little is known about either future conditions or economic responses. A critical factor in the scenarios is the overall "policy," encompassing a range of likely influences on future

development. "Good policy" would include, *inter alia*, a peace agreement that resolves strategic uncertainty sufficiently to provide the basis for private capital inflows and investment in productive activities; a relaxation of supply-side constraints, including deregulation and improvements in the supply of economic infrastructure and industrial land; trade arrangements that allow substantial trade expansion (in the region and elsewhere); a strong public finance framework with substantially expanded revenues (including taxes now accruing to the Israeli treasury); a major strengthening of the administrative and policy-formulating capability of the emerging, interim self-governing authority; and a strengthening of the human resource base both by stepped-up training programs and by access to entrepreneurial and professional skills of the Palestinians living abroad.

Preliminary analysis suggests that, assuming a "good policy," a growth rate in excess of 3 percent in per capita incomes is sustainable, with a total rise in incomes on the order of 40 percent in a decade, provided the phaseout from the Israeli labor market is managed in a "smooth" fashion and provided there are adequate external public and private capital inflows (about \$2,500 million during the five-year transition period).³ In case there is a "sharp" reduction in employment in Israel—for example, if employment does not rise above the 45,000 prevailing in June 1993—the short-run situation is likely to be much worse, with potentially large rises in unemployment and falls in wages and incomes. That would require short-run action, in terms of additional external inflows (a total of about US\$350 million over the five-year period) and poverty-related spending by the public sector to moderate welfare declines. However, with "good policies," the income levels would recover to the pre-cutoff period after about three years, and the economy could then again be on a steady growth path, with GNP per capita exceeding US\$2,300 after 10 years (compared to US\$1,715 in 1991).

By contrast, if policies are not sound, the outlook would appear to be grim. There could easily be declines in income per capita—on the order of 20 percent in a decade—even with a "smooth" labor decline. The outlook would be worse, especially in the short run, in case of a "sharp" reduction. Such growth scenarios would undoubtedly be associated with rising poverty, worsening social conditions and, potentially, rising violence. "Poor policy" could be offset by official capital inflows, but only for a while, since private capital is unlikely to flow in while the political uncertainties remain unresolved, and policy conditions are not perceived to be investor friendly.

An attempt has also been made to estimate the public sector financing requirements assuming "good policy". The analysis also assumes that:

- The new self-governing entity would reach agreement with Israel on a mechanism to ensure that the budget of the new entity receives all the taxes paid by the OT residents.
- The UNRWA operations would continue to function alongside the new entity during a five-year transition period.
- Of the public sector investment needs identified in Chapter V for the medium-term, 85 percent would, in fact, be implemented in that period.
- The revenue effort would be enhanced by 2 percentage points of GNP in the first five years, rising from 18 percent in the base year to 20 percent in year five as tax administration capabilities are improved and as cost recovery mechanisms are put in place.
- The current expenditures would also rise by about 2.5 percentage points of GNP in the five years, from 16.5 percent to 19 percent to support the gradual expansion and improvement in service and maintenance levels.

Under these assumptions, the external financing requirements of the public sector (including UNRWA) in nominal terms for the five-year transition period would be about US\$1,500 million under the "smooth" scenario and US\$1,750 million if the labor reduction is "sharp." The latter scenario would, furthermore, require some front-loading of the external assistance. It should be noted that external donors, including UNRWA, currently spend about US\$175 million annually in the OT. Thus, external aid flows would have to be roughly doubled from present levels to meet the financing needs of the public sector. As regards external private inflows, the requirements would be about US\$200–250 million per annum. With about 200,000 Palestinian workers in the Gulf states and the OECD countries, the implied remittances per worker would be about US\$1,000 annually, a very plausible amount.

The above discussion raises the issue of the terms on which the external aid to the OT would be extended during the transitional period. Currently, all official aid to the OT—whether through UNRWA or from other sources—is in the form of grants, as the aid is mostly of a humanitarian nature, and there is no legal entity to lend to. In view of the large uncertainties involved at this stage, the study has not analyzed the external borrowing capacity of the OT in the transitional period and beyond. As the OT does not currently have any external debt, there is clearly some scope for borrowing in the period ahead. Care should be taken, however, not to overburden the economy and strain future growth, nor to use funds for unproductive purposes. Given the likely fragility of the public sector revenues and of exports during

the transition period, it would be prudent if the external assistance to the OT over the medium term included some element of concessionality. Tentatively, it is estimated that if UNRWA financing was to continue in the form of grants and if there was a 20 percent grant element in the remaining external flows to the public sector, the debt services burden would remain manageable over the medium to long term.

The above scenarios should be treated as indicative. However, they do help illustrate the main implication of much of the analysis in these volumes: the OT have the potential to recover from both the loss in past sources of growth and from distortions in the pattern of development, and to become a viable, growing economy, provided that the policy and structural conditions are right. In the absence of a sound domestic policy, continuing strategic uncertainty and inadequate donor support, the OT could enter instead into a period of sustained decline in incomes, employment and welfare. Also, the initial recession caused by the "sharp" reduction in employment in Israel could generate internal social instability and rising violence, deterring private foreign investors. The faltering private investment could further accentuate social tensions leading to a vicious cycle of low growth, low revenues and inadequate public spending.

It should also be remembered that the OT economy has a number of limitations which leave policy makers with little room for maneuver. The limited natural resource base, the high degree of vulnerability to external shocks, and the fragility of the political situation following years of conflict, make the management of the transitional period a very delicate and difficult undertaking. Policy slippages could impose a heavy toll on an already fragile economy; a careful stewardship of the economy would, therefore, be necessary—a task which would be greatly facilitated by internal consensus among the Palestinians on a vision for the future OT economy.

To sum up, the OT economy appears capable of generating sustainable economic growth provided there is peace and stability in the region and provided the economy is soundly managed with a mix of prudent macroeconomic policies, expanded public services, support for private sector expansion and an expansion of trade to the region and the rest of the world. Significant external capital flows will be needed during the take-off period—partly to help overcome the existing deficiencies in public infrastructure and services and partly to augment the production base for private sector activities. It should be noted, however, that there are many downside risks which if not guarded against could easily trap the OT economy into a low level equilibrium.

IV. Policy and Institutional Imperatives

There are seven key institutional and policy areas where adjustments are needed in order to create a climate conducive to sustainable economic and social development: (i) the legal and regulatory framework; (ii) the management of public finances; (iii) the management of public infrastructure; (iv) financial sector development; (v) the management of natural resources; (vi) the provision of social services; and (vii) local government and public administration. These are considered below.

Legal and Regulatory Framework

As noted earlier, future economic growth and development in the OT is critically dependent upon the performance of the private sector. Unleashing this potential requires the creation of a legal and regulatory environment that supports private sector initiative. The legal system should provide a set of rules that govern property rights, their exchange and the settlement of disputes. More importantly, the rules should be perceived as transparent, stable and enforceable, through mechanisms that are seen to be fair and efficient. Despite some improvements in the recent past, there remains a widespread perception among OT entrepreneurs that the current business environment is ambiguous, complex and unpredictable. Trust in the ability of the legal system to provide an expeditious and effective appeals process also remains low. Particularly constraining to entrepreneurial activities are perceived barriers to entry, restrictions on the conduct of import and export activities, restrictions on the movement of people and goods and the perceived insecurity of property rights. These perceptions make investments in long-term fixed assets risky and unattractive, especially in high technology areas with a high probability of rapid obsolescence.

Progress in the current peace negotiations and agreements on self-governing arrangements should make possible a thorough review and overhaul of the existing legal and regulatory framework to provide the private sector with a sounder legal basis for commercial transactions. Some of the priority areas for review and revision include the commercial code, joint-stock company law, bankruptcy law, collateral

law, municipal zoning laws, business licenses, export/import licenses and regulations concerning the movement of people and goods. A strengthening of the appeals process would be another priority. The implementation of a supportive legal and regulatory framework requires credible institutions, the development of which is as much of a priority as the restructuring of current laws and regulations.

Management of Public Finances

International experience suggests that establishing a sound system of public finances in the West Bank and Gaza will be necessary in creating an environment conducive to private sector development and in attracting external assistance. Establishing such a system will mean ensuring that adequate revenues are collected/received by future authorities in the West Bank and Gaza and that the resources, including those that might be obtained from external sources, are managed properly.

On the revenue side, five key issues need to be addressed:

- *The Legitimacy of the Tax System.* Currently, there is a widespread perception among the Palestinian population that the existing system of taxation lacks transparency and due process and is administered in an arbitrary fashion. These negative perceptions materially reinforce tendencies for tax evasion and noncompliance, which exist, at least latently, in all societies. To a large extent, the negative perceptions are directly related to the current military occupation; and the emergence of a self-governing authority as part of the peace settlement should help change the situation significantly. That would, however, in no way obviate the need for creating an efficient tax administration system that is perceived to be fair by the population. The current tax administration system would need to be completely overhauled, including the establishment of transparent rules and enforcement mechanisms for tax assessments; the rationalization of advance payments of income taxes; and the introduction of a credible and efficient institu-

tional mechanism for the settlement of tax disputes. The role of accounting and auditing professionals would also need to be clarified in this context.

- *Fiscal Transfers Between Israel and the OT.* Under the current tax and trade arrangements between Israel and the OT, some OT taxes (primarily, the value-added tax (VAT) and other taxes on net OT imports from Israel and custom duties on imports through Israel) are accruing to the Israeli treasury. Given the absence of customs borders between the OT and Israel, the "origin principle" of indirect taxation is applied with respect to trade between the two, whereby taxes are collected where the goods are produced rather than consumed. Since the OT have a large trade deficit with Israel, there is a net revenue loss to the OT. Conversely, Israel also incurs expenditures in the territories from its own budget that are of benefit to the Palestinians (e.g., the subsidization of essential food items; Palestinian use of subsidized infrastructure and services in Israel). The Israeli and the OT authorities would need to agree on methodologies for estimating such transfers, as well as to devise suitable mechanisms for offsetting payments. Several alternative solutions appear feasible but would need to be considered in the context of the overall future economic relations between Israel and the OT. In any event, what is important is that all the revenues and expenditures and their financing are stated explicitly in the budget for the new OT entity.
- *The Appropriateness of the Domestic Tax Effort.* Despite perceptions of high tax rates among many Palestinians, the economy of the OT does not appear to be highly taxed. Even when all taxes paid by Palestinians are counted (including those currently accruing to the Israeli treasury), the tax effort is about 22 percent of GDP, compared with 27 percent in Jordan and 39 percent in Israel. In view of the need to strengthen public administration and expand public services, mobilization of additional domestic resources would be essential. It is true that the effective personal income tax rates are currently higher in the OT than in either Israel or Jordan. However, the tax effort in relation to the GDP is lower for several reasons, including the exemption of agricultural income from the tax net and possibly a high incidence of tax evasion. The question of the tax effort, therefore, will have to be examined in relation to the ability of the emerging entity to expand the tax base to protect its overall fiscal position, as well as its ability to harmonize tax policies with neighbor-

ing countries. This brings to the fore the importance of providing a very strong system of tax administration that can help widen the tax base and improve tax collection.

- *Cost Recovery.* An important aspect of domestic resource mobilization mentioned above concerns the establishment of mechanisms for cost recovery for the expanded public sector operations. User fees would be an important instrument to help cover the operations and maintenance costs and the debt servicing associated with new public sector investments in the transport, communications and solid waste disposal areas. Similarly, it would be important for the electric and water utilities that are being recommended to operate as commercially oriented autonomous entities, i.e., to charge tariffs that would make their operations financially viable without the need for any budgetary support.
- *Management of External Assistance.* To get the maximum benefit from the international assistance that might become available in the wake of a peace agreement, an efficient mechanism for directing and coordinating this assistance will be needed, balancing, in particular, donor interests and preferences with the developmental priorities of the OT. A careful monitoring of external borrowing will also be necessary to avoid any debt service problems in the future.

On the expenditure side, the key issues to be addressed are:

- *The Balance Between Current and Capital Expenditures.* A significant increase in the investment program during the transitional period would necessitate a commensurate increase in current expenditures on operations and maintenance to ensure that the capital stock would be adequately maintained. The budgeting process and the estimation of the financing requirements should, therefore, take into account the need for such expenditures. Experience suggests that this is often an overlooked item, with undesirable consequences.
- *The Sustainability of Expenditures.* As has been noted earlier, the direct role of the public sector should be mainly to provide basic infrastructural and social services, including a limited and well-targeted safety net for the poorest segments of the population. Care should be taken not to enlarge the bureaucracy of the public sector unduly, and the public sector must not act as the residual employer. The post-peace period could see large pressures for expanded

public spending, both in areas that are well justified (roads) and some that are not (excessive civil service growth). The likely temporary easing of financing constraints following a peace agreement could mask imprudent spending and borrowing policies for some years. Strong, conservative control will, therefore, be important for avoiding unsustainable level of expenditures, which would be difficult to reverse in the future.

Management of Public Infrastructure

Well-functioning public utilities will be essential to plan, implement and operate infrastructural investments on the scale needed in the OT. An early priority for the emerging self-governing entity in the OT would be to decide on how the ownership of utilities is to be structured and how the regulatory and policy-making roles are to be organized. The legal framework for these arrangements will also need to be established, taking into account the special circumstances involved.

To provide a sound basis for autonomy, accountability and efficiency, it is recommended that commercially oriented utility companies be established. Municipal governments should disengage from the direct role of provider of water and electricity, to the indirect role of owner. Since the legal framework covering the transitional period is not yet clear, the simplest legal basis for the new, reconstituted utilities would be the prevailing companies law, with the shares held in the public sector. This would not only provide a framework for enterprise autonomy and commercial orientation, but would also facilitate partial or total privatization in the future. It is also recommended that: (a) the roles of policy-making, ownership and regulation be separated among different institutions; and (b) the ownership (shareholdings) be spread as widely as possible among different municipalities, pension funds and other public or private agencies. The new entity should also try to define the regulatory system for the public utilities. Some of the key issues that need to be addressed are: (a) one multisectoral regulatory agency *vis-à-vis* several sector specific regulatory bodies; and (b) the basis for utility price setting.

Financial Sector Development

The present legal and regulatory framework, a patchwork of Jordanian, Egyptian, Palestinian mandate and Israeli legislation, is not conducive to the expansion of existing financial institutions or the establishment of new ones. This framework needs to be replaced with transparent, coherent legislation cov-

ering the West Bank and Gaza that: (i) sets clear criteria for licensing banks, insurance companies and other regulated financial intermediaries and establishes uniform standards as to capital requirements, liquidity and solvency; and (ii) establishes a new regulatory framework, consistent with international standards, for the supervision of financial intermediaries.

Within the above context, several steps are needed to strengthen the process of financial intermediation. First, entry barriers should be eliminated and existing banks in Gaza and the West Bank should be allowed to expand in either region to facilitate the economic integration of the two territories. Second, mechanisms should be devised to enhance or supplement the collateral of local investors by tapping the value of unmortgaged real estate. Third, the multiplicity of inefficient, small-scale, subsidized credit programs with unsustainable recovery rates need to be reformed and moved towards regular financial operations at market interest rates. Lastly, given the need for strengthening medium and long-term financial intermediation, establishment of an investment bank, preferably with foreign participation should be encouraged. Considering the strong financial and skill base of the Palestinians in the OT and abroad, every effort should be made to keep the ownership and management of such an institution entirely in the private sector. However, in case this is not feasible, as a last resort, some limited equity participation by the public sector may also be considered for the initial years.

Management of Natural Resources

While the question of access to natural resources ultimately depends on the outcome of the political negotiations, there are some measures that can be taken to ensure conservation and a better utilization of natural resources. Of special importance is the preparation of an environmental action plan underpinned by a comprehensive framework for environmentally sustainable development in the post-peace period. Other areas for priority attention include:

- Establishing, initially, a coordinating mechanism and, later, a management agency to oversee the development of the region's water resources in cooperation with the other riparians. Sharing data on the region's land and water resources would be a good beginning.
- Relaxing regulations governing the rehabilitation of irrigation wells.
- Addressing the severe quality problems of the municipal water supply in Gaza.
- Relaxing constraints in the use of grazing lands.

- Relaxing constraints on the harvesting of marine fisheries resources.
- Reforming the regulatory framework (land use planning, building standards, minimum lot sizes, the taxation of vacant land, rent controls, etc.) regarding the use and development of urban lands.
- Providing adequate infrastructure to, first, encourage the use of vacant urban land and, second, to extend municipal boundaries to provide adequate, affordable, serviced land for residential and commercial purposes.
- Establishing adequate arrangements for the collection and disposal of solid waste to prevent ground water pollution and an unhealthy and unsightly urban environment.
- Establishing institutions and a regulatory framework for the protection of antiquities and cultural property.

Provision of Social Services

The broad outlines of a sound social policy for the OT are clear. Basic health services should be made more accessible and hospital services and high technology health care should be deemphasized. Education and training should be strengthened in areas, such as curriculum development and teacher training, to enable the system to improve the quality of instruction and, thus, to improve the productivity and employability of Palestinian labor. The social security systems now operated by the CA, Israeli employers and UNRWA should be harmonized and unified; the system of private transfers should be supported through the development of appropriate financial institutions.

Present inefficiencies in the health sector are rooted in the fragmentation of responsibility, not only for the delivery of health care, but also for the management of subsidies to the sector from the government budget and external donors. A responsible body must be created to develop a sound health policy and to coordinate activities in the sector. Policies should, at the same time, seek to interrupt the link between refugee or employment status and entitlement to subsidized health care; instead, such care should be targeted to the needy. In assembling a set of policies, issues of health care finance, service standards, investment in technology and quality assurance should be addressed.

An extensive education planning process should be initiated to consider the goals, possibilities and resources for a unified education system for the Gaza Strip and West Bank. Planners, administrators and curriculum experts should be given training in carrying out these tasks. A revised curriculum should

be developed that can be adopted on both the West Bank and the Gaza Strip. It should not only give attention to the modernization of content and teaching methods, but should also link curricula to broad economic, social and cultural objectives. As the development of curricula is time-consuming and costly, in the short term, consideration should be given to adapting materials from other countries, especially in the sciences and mathematics. Personnel exchanges across institutions could prove useful in this endeavor.

Resources to support a comprehensive social welfare program are unlikely to become available to the OT entity within the foreseeable future. Nonetheless, in time, the OT authorities would be called upon to replace the benefits provided to the very needy by UNRWA and the CA. The targeting of the programs would, therefore, be essential. The OT would have to develop a basic program of social protections and ensure that this program received broad political endorsement. The program should provide for the handicapped, elderly, orphaned and widowed, but it should not seek to replace reliance on private transfers and personal savings. The OT should also encourage the development of private institutions that supply financial services, including health and life insurance companies and pension schemes.

Local Government and Public Administration

The policy and program agenda that the OT will face in the coming years would constitute a big challenge to any public sector apparatus. The OT administration, emerging in a period of transition with little experience in self-government, will be especially challenged. Institutional strengthening would, therefore, be critical both at the local level and at the territory-wide level.

Local governments in the OT are generally weak and ineffective. The legal environment in which they operate is complex, overregulated and nontransparent. Moreover, local public finances are largely controlled by the CA; local governments have little authority over taxes and fees and, as a result, are unable to finance recurrent expenditures adequately. Allocations of funds for capital investments, mostly financed with transfers from the CA, are also non-transparent. Improving the effectiveness of local governments would require, *inter alia*:

- The introduction of a rational legal foundation that clearly assigns an appropriate degree of local discretion over issues of local interest.
- The provision of greater local autonomy over user charges and local taxes.

Table 4.1 Phasing of Institutional and Policy Reforms

<i>Area of reform</i>	<i>Short-term</i>	<i>Medium-term</i>
Regulatory and legal framework	<ul style="list-style-type: none"> • Publish all regulations in Arabic • Review all commercial laws with a view to harmonize and modernize • Relax licensing requirements for foreign trade and for business • Simplify procedures for trade with Jordan 	<ul style="list-style-type: none"> • Develop market-friendly commercial laws • Ease restrictions on movement of goods and people
Fiscal system	<ul style="list-style-type: none"> • Relax advance income tax requirements • Reform income tax reporting and compliance provisions • Reform tax assessment practices 	<ul style="list-style-type: none"> • Develop a budgetary framework • Agree on mechanisms for fiscal transfers with Israel • Establish mechanism for management of external assistance • Design new taxation structure and develop tax administration capability • Establish cost-recovery mechanisms for public services
Public utilities	<ul style="list-style-type: none"> • Study issues concerning ownership and regulation of utilities • Initiate training programs for utilities 	<ul style="list-style-type: none"> • Establish financially autonomous, commercially-oriented utilities
Financial sector	<ul style="list-style-type: none"> • Eliminate barriers to entry and expansion • Establish payment clearing system 	<ul style="list-style-type: none"> • Create an enabling legal framework for financial system • Establish a single regulatory authority • Encourage establishment of an investment bank
Natural resources	<ul style="list-style-type: none"> • Relax regulations governing rehab of irrigation wells • Study alternative to address drinking water quality problems in Gaza • Relax constraints to grazing lands use • Develop environment action plan • Share data on natural resources 	<ul style="list-style-type: none"> • Establish agency to coordinate and oversee water resource development • Reform regulatory framework for development of urban lands • Establish mechanisms for protection of antiquities and cultural property • Establish an environment management organization
Social services	<ul style="list-style-type: none"> • Articulate sectoral policy framework • Launch socioeconomic studies 	<ul style="list-style-type: none"> • Adopt coherent policies for social sectors • Create health sector coordinating body • Start preparation for a census • Modernize educational curriculum
Local government and Public Administration	<ul style="list-style-type: none"> • Review laws and regulations affecting local government operations • Launch studies on trade, monetary, and fiscal issues • Initiate training programs 	<ul style="list-style-type: none"> • Revise legal framework governing local governments • Provide greater financial autonomy to local governments • Prepare strategies for regularizing UNRWA establishment over the longer term • Establish a development policy institute

- The introduction of more systematic and transparent criteria for the allocation of capital transfers.
- Technical assistance and staff training to promote institutional change and facilitate policy development relating to local government issues.

In addition to the strengthened role of the local government bodies, institutions would have to be developed to formulate, coordinate and implement policies at the territory-wide level. To develop these capabilities, the emerging self-governing authority needs a strong and efficient system of public administration responsive to the needs of the local popula-

tion. Suitable mechanisms would also have to be devised to ensure the accountability of the public administration. The 20,000 Palestinians currently employed by the CA could become the nucleus of the administrative structure for the emerging self-governing authority. However, the likely difficulties in molding the current CA establishment into an administrative structure suited to the needs of the self-governing authority should not be underestimated. For the longer term, integrating the UNRWA establishment into the normal administrative structure of the OT would be another major challenge.

Phasing the Policy and Institutional Agenda

The above agenda of institutional and policy reform is clearly extensive and complex, and some phasing

of the various reform measures would be necessary. A preliminary outline for such a phasing is shown in the Table 4.1 below. The definition of short and medium term is linked to the peace process, as explained in Chapter V. Basically, the short term covers the period up to end-1993, and the medium term covers the period 1994-98. It should be noted that the implementation of some of the actions for the short term is already underway. For example, business licensing procedures have been significantly liberalized recently, and impediments to exports to Jordan have been reduced. Tax changes to encourage investment in the OT have also been initiated. Areas open to Palestinian fishermen have been expanded. Some training and TA programs to strengthen institutional capabilities have also been initiated by several donors as part of the ongoing peace process.

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THE PALESTINIAN ECONOMY

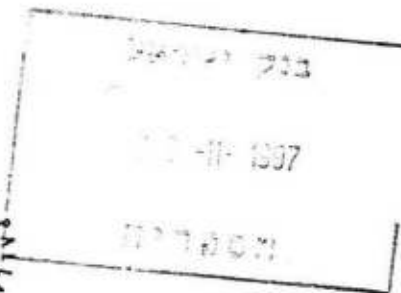
Between Imposed Integration and Voluntary Separation

BY

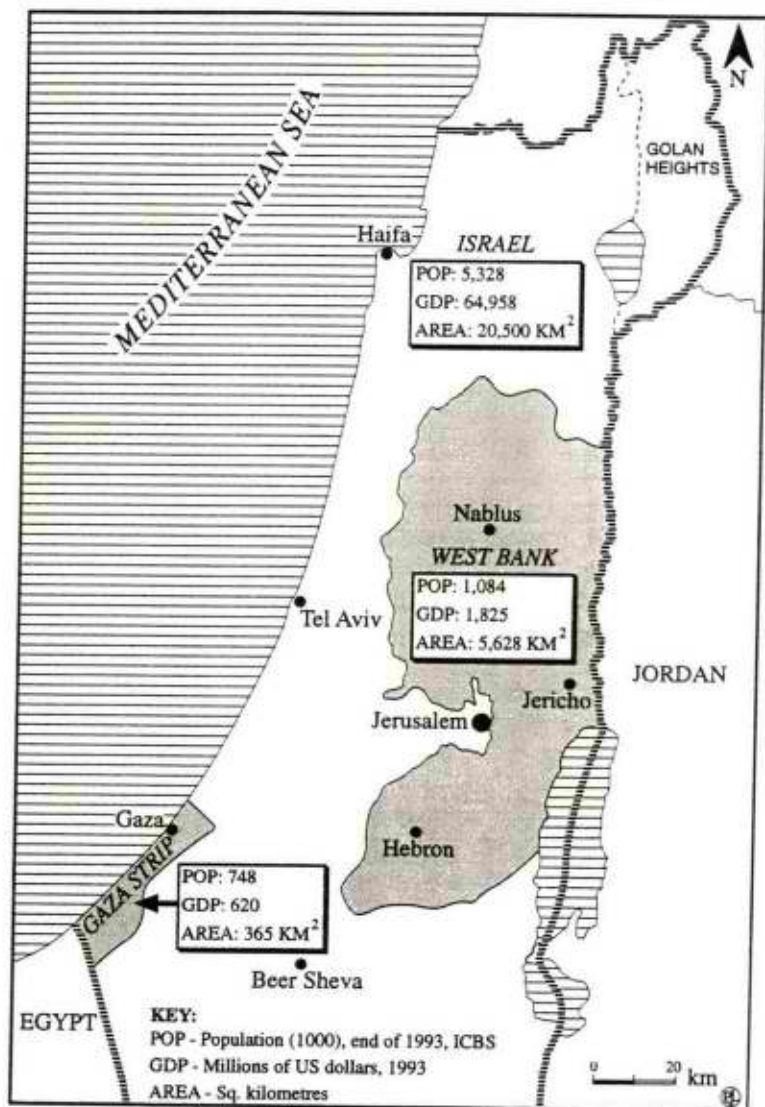
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CHAPTER ONE

INTRODUCTION

This book attempts to document and explain the development of the Palestinian economy in the three decades since Israel gained control over the West Bank and the Gaza Strip. Coverage is restricted to these territories, and excludes other areas in which Palestinians have lived since 1948. The method is an historical one, and uses the conventions of economists rather than those of sociologists or political scientists. We rely heavily on the available economic data, including national accounts for the West Bank and the Gaza Strip, data on population, the labor force, employment structure and unemployment, and data on the balance of payments of the two areas.

After researching the Palestinian economy for several years we are convinced that its links with the Israeli economy were the most important factor in determining the course of its economic development. The formation of these links, and the nature of the labor, goods and capital flows between the Palestinian and Israeli economies, were determined almost exclusively by Israel. Hence, Israeli considerations, not Palestinian ones, play a key role in our story.

The 1967 war is a natural starting point (see map). The West Bank was abruptly cut off from the eastern bank of the Jordan river, passing from the rule of the Hashemite Kingdom of Jordan to the control of Israel. The Gaza Strip and the Sinai Peninsula were severed from Egypt, and the Golan Heights—from Syria (the latter two areas will not be discussed in this volume). Israel's rule was enforced by the IDF (Israel Defence Force), which appointed military governors to handle all civilian affairs. Although Israel had had some experience with the complicated issue of controlling hostile civilian populations, it took some time for an effective governing authority to get underway. All economic decisions, which we believe were of utmost importance to the Palestinians, were made by the Israeli government. However, public discussion in Israel concerning these decisions was restricted.

The study of how public policy is formulated always suffers from many deficiencies, among them (and especially in the present case) the tendency of officials to maintain secrecy. The official records have

not yet been made public, but some evidence on the formulation of Israeli policy, especially concerning economic links with the Palestinian population, can be gleaned from the public parts of open debates as well as from memoirs.

It took three years for the economic links between Israel and the two Palestinian economies to take shape. Two closely related elements in these links—labor and trade—had begun to take form and led to what can be described as *imposed, impure, economic integration*. The interdependence of decisions regarding trade and labor was due to the fact that together they determined the welfare of the Palestinians. A decision to continue the total separation between both economies and Israel, as before the 1967 war, i.e., to leave both the border for labor and the border for goods closed, would have led to a deterioration of economic life and a sharp drop in the standard of living. Such a strategy was not acceptable either to the Israeli government or to the military, since it would have led to unrest and raised the cost of maintaining the status quo. Thus, either the border for labor or that for goods or both, had to be opened.

Immediately after the 1967 war Israeli economists assessed various alternatives. The most elaborate study was prepared by a team headed by Michael Bruno, which was part of a broader Committee on the Development of the Administered Territories—the Bachi Committee (1967). The team recommended implementing the (relatively) free movement of goods, but not of factors of production, and specifically not of labor.¹ The team calculated that, from an economic point of view, maintaining Israel's hold on the Palestinian territories, would not be too heavy a burden on the Israeli economy. The team also addressed the question of means to encourage emigration from the territories, especially from the Gaza area. It should be emphasized that the analysis was short-term, and depended on the "political future of the territories."

In the letter accompanying the Committee's report, dated September 13, 1967, and addressed to the then Israeli Prime Minister, Levi Eshkol, the Committee Chairman, Roberto Bachi, wrote:

The [team's] report is a systematic analysis leading to conclusions that the Committee considers as having implications of the utmost importance for the policy that should be implemented in relation to the administered

¹ The team submitted its report in September 1967. Its members included well-known Israeli economists such as Yoram Ben-Porath, Haim Ben-Shahar, Nadav Halevi, Giora Hanoch, Ezra Sadan, and Eitan Berglas.

territories... It seems to us that government agencies dealing with the problems... should receive the report... [our translation].

Though much of the report dealt with short-term calculations, especially the cost of holding on to the territories, it also included recommendations relevant to the long term structuring of relations between the Israeli and Palestinian economies. As mentioned above, the general approach favored free trade in goods and the prohibition of labor movements. This framework was adopted for the calculations prepared by the committee, and took the form of "working assumptions". However, in the last chapter of the Report, the team of economists assessed "Changes in the Assumptions" (Chapter H). The discussion in this chapter clearly reveals that the general assumptions adopted seemed appropriate under the conditions prevailing in the Israeli economy at the time (Israel was running unemployment rates in excess of 11% in 1966/7). However, the team was aware that economic conditions in Israel could change:

Concerning the near future, the prevention of work in Israel seems to be the preferred policy, based on the hypothesis that conditions in the labor market will continue to indicate a slack. However, under conditions of full employment and excess demand in the labor market, and when there are pressures on the wage rate, there is room for selective permissions to movements of Arab laborers. [Bruno Committee, 1967, p. H-2; our translation]

The team took a similar stand on capital movements: When the Israeli economy returns to full employment, it argued, free capital flows will become a reasonable policy. The adoption of such policies will lead to what economists describe as a "common market". According to the report:

Authorizing the free movement of labor and capital will lead to a complete integration of the administered territories into the Israeli economy. Even an economist who approves of this in the long run, on economic grounds—and these are not obvious—will admit that the economic considerations are secondary in this context. [Bruno Committee, 1967, p. H-3; our translation]

Thus, non-economic considerations, obviously the primary ones, were not discussed by the team and were left to the political policy makers, who, to the best of our knowledge, did not consult economic professionals again. Rather, the decision was taken to the Israeli political arena.

The next few years proved the committee right on the issue of labor movements; it was impossible to stop such movements, certainly when the Israeli economy went from recession to boom. However, the formulation of policy seemed to be driven more by the challenges of real-life situations than on the economic report of the team, as Professor Bachi had advised.

Evidence that the process was not based on economic theory but rather on a "problem-solving" process appears in a book written by the first Israeli military governor of the territories, General S. Gazit. In his book² Gazit documented the debate in the Israeli government towards the end of 1968, some 18 months after the war, a debate that culminated in the policy implemented since and remained in force until 1994.

Two opposing views of the links between the Israeli and Palestinian economies prevailed in the Israeli government. One, advocated by Defense Minister Moshe Dayan, argued for the free movement of both labor and goods. The other, presented by Finance Minister Pinhas Sapir, rejected the abolition of the labor border. Dayan stated his views in a speech in Beersheba in November 1968, where he favored integration of the two economies and explained that the Hebron-Beersheba area, on either side of the pre-1967 border, should become a single economic unit. Open deliberations in the Knesset (the Israeli Parliament) and in the government turned the debate into a public one.

The next round in the debate, several months later, raised the issue of employment in the territories versus work in Israel. The "Ministerial Committee for the Territories" had to set its priorities: to create employment opportunities in the territories themselves, encouraging the creation of new plants, by Israelis or Palestinians, versus opening the gates for work in Israel (Gazit, 1985, pp. 110-19, 147-150). Dayan, for pragmatic reasons, supported the second option; the majority, including the new Prime Minister, Golda Meir, favored the former. However, in spite of the majority view, no practical steps were taken to implement it:

Economic reality in the territories was stronger than all the decisions. Since no decision was made on investments in the territories, and Israeli entrepreneurs were excluded from the territories, no power could have prevented the growing phenomenon of work in Israel. At the time of

² See Gazit (1985). Gazit was the first Coordinator of Government Activities in the Territories.

the debate in the Ministerial Committee there were 15,000 workers from the territories in Israel, soon the number rose to 60,000 and maybe 70,000. [Gazit, 1985, p. 150; our translation.]

Thus, although the documentation of the process of decision making by Israel is far from complete, the facts are clear. Integration took place, and as we shall see below, was almost complete by 1972. It was, however, a peculiar form of integration. First, it was involuntary. Secondly, it was partial, in two respects: a protectionist policy biased in favor of Israeli agricultural goods, and restrictions on entrepreneurship within the territories.

One of the first decisions made by the military authorities in the Palestinian territories was to allow exports of agricultural produce to Jordan. This was made possible because Dayan had managed to keep the bridges over the Jordan river open, with the Jordanian government's consent (see Gazit, 1985). This policy, known as the "open bridges policy", created an outlet both for agricultural produce and for the movement of other goods and people. However, the excess supply of agricultural goods in the territories caused concern among Israeli farmers. As a consequence, the Israeli government provided these farmers with protectionist policies. For several years, restrictions in the form of trade barriers prevented Palestinian agriculture from competing in the Israeli market. These barriers were later replaced by a system of quotas on various crops. Thus, instead of barriers at the "green line" (the pre-1967 borders), protectionist policies were effective at the production level.

Protectionist policies were later also applied in other sectors. A well-known example dating from 1968, was a plastic sandals plant in Nablus. Although this plant was going to compete with an Israeli plant, the officer responsible for licensing imports approved a request to import the necessary machinery. However, the Committee of Directors General, which was responsible for implementing policy in the territories, banned marketing the Nablus sandals in Israel. The case was discussed several times in various government forums, where the "separationists" advocated more restrictions and the "integrationists" favored fewer restrictions.³ The case was finally decided in 1972,

³ In addition to Finance Minister, Pinhas Sapir, a known participant in the debate was Deputy Prime Minister, Yigal Alon, who demanded that every proposal to build a plant employing more than 20 persons, or with capital of more than (approximately) \$20,000, should be brought before a Committee of Directors General (see Gazit, 1985, p. 112).

when marketing quotas were lifted and measures restricting production capacity were introduced instead (Gazit, 1985, pp. 261–266). Gazit summarizes the policy and its consequences as follows:

Israeli policy in the administered territories created a peculiar combination of economic welfare and rising standards of living for individuals . . . combined with . . . no development within the territories themselves. . . . The Israeli authorities and the military government did almost nothing to develop the local economic infrastructure (apart from the modernization of local agriculture). . . . [*ibid.*, p. 266]

The military governors and the coordinators of government activities in the territories represented the sole authority in the West Bank and Gaza. They consulted with the local Palestinian leadership on minor issues, but policy was determined by Israel. The imposed nature of the arrangements and especially the form taken by the links between the two economies were decided in Israel. Thus, characterizing the economic arrangements as “imposed” (partial) integration, is borne out by the facts.

The Palestinian public sector was also controlled by Israel. Israeli officers were responsible for all facets of life, although lower-echelon Palestinian civil servants remained in office under Israeli supervision. Taxes were collected and expenditures made by the newly formed public sector, although some services, notably education and health, were run mainly by Palestinians. The financial sector had ground to a virtual halt: banks had been closed in 1967 and the political instability combined with unfavorable economic conditions contributed to an undeveloped financial system.

The peace process with Egypt (1977–79) also affected the West Bank and Gaza. Israel’s Prime Minister, Menahem Begin, proposed Palestinian autonomy, which included restricted self-rule, short of complete sovereignty, in the populated areas. Israel’s approach was rejected by both the PLO and the Egyptian government, resulting in the creation of a new authority in the territories: the Civilian Administration (this was, for all practical purposes, a change in name only, since the new body continued to function in the same way as the military governors).

In December 1987, over twenty years after Israel occupied the West Bank and the Gaza Strip, a major popular uprising erupted, known as the *intifada*, with important political and economic ramifications. Since then, the links between the Israeli and Palestinian economies,

briefly described above, were shattered and people on both sides set out on a serious search for alternatives. The search was mainly conducted in the political sphere, but the economic dimension also received some attention.

The PLO’s decision of November 1988, in Algiers, to accept a “two state” solution to the conflict, and other international and regional changes (such as the collapse of the USSR and the Gulf War) opened a “window of opportunity”. This resulted in the Madrid Conference (October 1991), and later, with the change of government in Israel, in the signing of the Declaration of Principles (DoP) in Oslo in September 1993. Those major political developments were reflected in the Palestinian economy and in its links with the Israeli economy. The DoP stipulated the schedule for the peace process: first, an interim agreement, then a permanent settlement of the Palestinian-Israeli conflict. As regards the economic arrangements, the most dramatic change was the mutual recognition that there were two legitimate parties to every economic decision affecting the Palestinian economy.

After several months of negotiations the Israeli government and the PLO reached a political and economic agreement concerning the implementation of the DoP, first in the Gaza Strip and the city of Jericho in the West Bank (see Map). The economic agreement, known as the Protocol,⁴ turned the *de facto* arrangements into agreed upon ones. Caution should be exercised in referring to the arrangements as being “voluntarily”, since some duress can exist even when two sides sign an agreement. However, the analysis of such an agreement, and the reasons why the parties accepted them, are totally different from the unilateral arrangements that had characterized the arrangements that were in place up to this point.

The *Protocol*, which preserved the customs union, monetary union, and the open borders policy on labor (see Chapters 3, 4 and 6 for a detailed analysis) was extended during the last months of 1995 from the Gaza Strip and Jericho to other cities and villages in the West Bank, which came under the jurisdiction of the Palestinian Authority. The elections to the Palestinian Council on January 20, 1996, created an elected authority which had a say in economic matters for the first

⁴ “Protocol on Economic Relations between the Government of the State of Israel and the PLO, representing the Palestinian people,” signed in Paris on April 29, 1994. It became part of the “Gaza-Jericho” agreement, signed in Cairo on May 5, 1994. See Appendix to this book.

time. However, the *Protocol's* basic approach to economic issues, and especially its position vis-à-vis the links between the Israeli and Palestinian economies, was not implemented. Since May 1994 a spate of violent attacks by Palestinians within Israel proper and the resultant public outcry led to a series of closures of the Gaza area and the West Bank, which turned the free movement of goods and labor into dead letter. Since several Israeli industries depended on Palestinian labor, it is not surprising that it took some time before these industries (especially construction and agriculture) adapted to the new circumstances. One of the factors that made it easier for them to adapt was the growing flood of foreign laborers to Israel: from 10,000 in February 1994, just before the signing of the *Protocol*, to around 200,000 two years later.

Thus, after almost thirty years of Israeli rule, the imposed integration is breaking up. What will take its place? This is a troubling question, which the negotiators of the permanent political and economic arrangements will have to answer. Since the timetable for these negotiations gives until May 1999 to conclude the talks, some answers will have to be found before then, and some modifications of the *Protocol* are obviously an urgent issue.

In our view, in order to answer this question one must analyze the effects of past political and institutional arrangements on the development of the Palestinian economy. Such an analysis is the major undertaking of this book. Our main thesis is that the peculiar integration of the labor markets, coupled with the low levels of productive investment in the Palestinian economy led to a distorted industrial structure in which manufacturing as well as other economic activities failed to develop sufficiently. The stagnation of the public sector, due to the political situation, further contributed to the distorted structure of the Palestinian economy.

There were several reasons for the underdevelopment of the manufacturing sector and other economic sectors where "tradables" are produced. They are listed below, not necessarily in order of importance:

- Insufficient investment in infrastructure, due partly to Israeli policy. Details are given in Chapter 5 on the public sector.
- Administrative hurdles set by the Israeli authorities hindered investment in exports to Israel and in imports substitutes, as discussed in Chapter 4 on trade.
- The lack of a banking system or other financial intermediaries that turn private saving into productive investment (see Chapter 6 on

the monetary and banking sector) contributed to the low levels of productive investment. Although saving rates in the Palestinian economy were high, they resulted mainly in investment in private housing.

- The peculiar form of integration of Palestinian labor into the Israeli labor market described in Chapter 3, resulted in an increase in real wages in the Palestinian economy. Consequently, Palestinian manufacturers had to earn more to cover this extra cost of labor relative to similar countries with low real wages.
- Ill defined property rights and a malfunctioning legal system, as well as political uncertainties, further discouraged investors.

Thus the unbalanced development of the Palestinian economy and its continued dependence on Israel was a result of the interaction of several complementary factors. However, the peculiar form of integration with Israel also had a bright side for the Palestinians. Chapter 2 reports the dramatic increase in standards of living, mainly during the first ten years of Israeli rule, but also later. On the other hand, while Chapter 7 stresses the small share of manufacturing in the Palestinian economy, it also documents the technical progress in agriculture and construction influenced by Israel (for example, drip irrigation systems and plastic hot-houses). Chapters 8 and 9, as well as sections in other chapters, are devoted to a discussion of alternatives for the future. Chapter 8 applies statistical models based on our data to evaluate alternative future scenarios which describe different levels of foreign aid and various economic arrangements with Israel. Surprisingly, we find that a reasonable rate of foreign aid would suffice to create jobs in the Palestinian economy which would be followed by a gradual disentanglement of labor markets without creating unemployment. However, these scenarios assume the continuation of past structures. The Epilogue discusses why past structures are changing and explain the disappointing economic performance since 1994.

Naturally, to restructure the Palestinian economy and to create more "normal" public sector, trade relations and local employment, will require time and many reforms. Part of this task is already underway as is evident from the recent growth of the public sector and the banking system. The formation and modernization of an infrastructure is also badly needed and will require foreign assistance.

The economic story told in this book raises a fascinating political question: Was the lack of development within the Palestinian economy the result of a deliberate, carefully thought-out Israeli policy? Some

authors (for example, Sara Roy (1995), reflecting Palestinian opinion, think it was. In our view this answer rests on an over-simplified story and needs more evidence than exists today. Although the facts are clear, and the "revealed preferences" of Israeli policy-makers tell a sad story, their intentions have not been proven. Only when the official public records of Israel are made available to researchers will we have a chance to answer this question satisfactorily.

Why is this issue such a complicated one? As explained in Chapters 3 and 4, and earlier in this introduction, the economic arrangements were initiated as a practical answer to the acute economic pressures of unemployment and surplus agricultural production. We do not know whether the meager investment in infrastructure in the Palestinian territories was part of a premeditated plan to keep them economically dependent on Israel. It may have been simply a convenient means for the Israeli authorities to cut down on the resources required for maintaining Israeli rule in the territories. Similarly, the policies concerning trade and investment were more a response to internal Israeli pressures than a calculated long-term policy.

We do know that Israel placed administrative obstacles in the way of Palestinian investment in local industry. The bureaucratic maze that was a consequence of the Israeli military orders and the Jordanian Law was another factor blocking local investment.

As to the permanent future arrangements, we believe that a "Filters Plan" can provide an answer. Such a plan, discussed in Chapter 4 and in the epilogue, will be feasible only if the parties agree on the demarcation of specific economic borders and agree on the arrangements along them. The agreement will have to specify what can and what cannot cross these borders, and stipulate the specific arrangements concerning the passage of goods and labor. The agreement should be such that under no circumstances will the borders be closed for more than brief periods. Border-crossing procedures should be sophisticated enough to enable satisfactory security checks. The alternative to such a plan is the complete separation of the Palestinian economy from Israel, with all the consequences this entails for the welfare and potential growth of the Palestinian economy.

The illusion of a possible leap from an imposed integration to a voluntary one has gradually evaporated. For both political and economic reasons, a permanent agreement will necessitate borders between the Israeli and Palestinian economies. In order to create conditions conducive to growth and welfare, the borders need to remain as open

as possible under all circumstances. This might seem inferior to a "no borders" solution, advocated by most international agencies and experts,⁵ but we believe that this is another example where the second best is a real solution. Those who believe that a common market, or complete economic integration, is a better solution, will have to wait for the political circumstances to change.

⁵ See World Bank (1993); the first and second Harvard Reports; Ben-Shahar Committee and the *Protocol* itself.

CHAPTER TWO

THE PALESTINIAN ECONOMY:
A MACROECONOMIC PROFILE1. *An International Comparison*

Since 1967 the Palestinian territories—the Gaza Strip and the West Bank—have become almost fully integrated “provinces” of the Israeli economy. While it is true that the integration was not entirely voluntary and includes a paradoxically clear segmentation of the various markets involved, significant symptoms of bona-fide integration are nonetheless evident: large volumes of merchandise flow from Israel to the Palestinian territories and a considerable stream of labor services flows in the opposite direction.¹

The separate and combined economies of the West Bank and the Gaza Strip represent very small economic entities compared with the Israeli economy, but we will refer to each of them separately because of the substantial differences between them in terms of economic structure and performance. The Palestinian territories' population in 1994 is estimated at 1.9 million,² as against 5.5 million in Israel. The economic gap between the economies is much wider: in 1989 GNP was \$1.8 billion in the West Bank, \$673 million in Gaza, and approximately \$42 billion in Israel (see Table 2.1), implying that the combined level of GNP in the Palestinian territories was approximately 6 percent of Israel's GNP in that year. We have no accurate figures on the Palestinian territories since 1993, but one may reasonably assume that the gap has increased since then, among other things because during the past five years economic growth in Israel has been rapid as a result of mass immigration from the former Soviet Union.

The combined GDPs in the Palestinian territories in 1989 amounted

¹ For a detailed description of economic developments see UNCTAD (1992); Sagi, Sheinin and Perlman (1992).

² The figures are from the Israeli Central Bureau of Statistics (ICBS); they are based on the only population census ever conducted in the Palestinian territories (in September 1967) and its updates. The reliability of these figures is questionable; Israel's Ministry of the Interior claims that 1.328 million inhabitants were registered in the West Bank at the same time. Talpaz and Freeman (1991) provide some explanation for this gap.

Table 2.1

Various Economic Indicators: International Comparison (1989) (current values)

	Popu- lation (mill.)	GNP per capita	GNP (mill. US\$)	GNP (mill. US\$)	GDP GNP	GNP per capita ICP*	Annual rate of change of GDP (1980-89) (percent)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
West Bank	0.91	1,933	1,799	1,230	0.70	2,249	1.6
Gaza Strip	0.60	1,122	673	434	0.64	1,325	3.1
Israel	4.50	9,330	41,985	46,030	1.10	11,940	3.2
Egypt	51.00	640	32,640	31,580	0.97	3,100	5.4
Syria	12.10	980	11,858	11,460	0.97	4,110	1.6
Jordan	3.20	1,240	3,968	3,330	0.84	4,530	0.8
Tunisia	8.00	1,260	10,080	8,920	0.88	3,979	3.4
Portugal	10.30	4,250	43,775	44,880	1.03	7,950	2.5
U.S.A.	248.80	20,910	5,202,408	5,156,440	0.99	21,360	3.3

* ICP—International Comparison of Products (see explanation in the text).

Sources:

West Bank and Gaza Strip: ICBS 1992.

Other countries: World Bank (1991, 1992).

to 5 percent of Israel's GDP.³ GNP per capita in 1989 was \$1,933 in the West Bank and \$1,122 in the Gaza Strip, compared with \$9,330 in Israel. These are simple measures of products converted into US dollars using the market exchange rate of the Israeli currency (NIS). Based on these figures, the West Bank has a GNP per capita that significantly exceeds that of Egypt, Syria, or Jordan. According to the World Bank's international ranking, these levels are considered high among low-to-middle-income countries. However, the economic literature on international comparisons of national product is critical of such simple comparisons, which do not account for purchasing power differences. One way of correcting such differences is by using an International Comparison of Products (ICP).⁴

³ The relative differences between GDPs is substantially larger, since GDP levels in the West Bank and the Gaza Strip are approximately 65-70 percent of these areas' GNP, while in Israel GDP is usually greater than GNP. In fact, in examining levels of real domestic economic activity, it is GDP levels that should be compared. Most of the difference between Palestinian GNP and GDP is due to net worker remittances from Israel. Thus, GNP does not clearly reflect economic activity at home, but rather a mixture of activity in the Palestinian territories and Israel.

⁴ See Summers and Heston (1991).

Table 2.1 makes such a correction for the Palestinian territories, assuming that the price levels in these territories were similar to those prevailing in Israel at the same time. When ICP-corrected exchange rates are used to compute GNP per capita, both the West Bank and the Gaza Strip fall below GNP per capita in Egypt, Syria, Jordan and other low-income countries. The figures indicate that although simple statistics show that average income levels in the Palestinian territories appear to be higher than in neighboring Arab countries, a more realistic measurement may not necessarily yield the same results.⁵ Indeed, economists disagree as to the relative levels of welfare and economic growth in the Palestinian territories as compared with other Arab countries such as Jordan,⁶ and the inconsistency of ICP with simple statistics does nothing to resolve this controversy. The truth probably lies somewhere between the simple GNP statistics and the ICP measures. In any case, there is little evidence that real income per capita in the Palestinian territories is significantly higher than in some of the neighboring countries.

Consumption per capita in the Palestinian territories, when measured in US dollars with no correction for purchasing power, is far higher than in neighboring Arab countries, and much lower than in Israel (see Table 2.2). Private consumption per capita in 1989 was \$1,477 in the West Bank, \$942 in the Gaza Strip, \$6,035 in Israel, \$495 in Egypt and \$811 in Jordan. There is a clear upward bias in the figures for Israel, the West Bank and the Gaza Strip. A specific ICP measure for consumption (which we do not have) would probably place the Palestinian territories lower than Jordan, Egypt, and probably Syria.

An interesting point is the relatively large share of GNP devoted to private consumption in the Palestinian territories—78 and 84 percent in the West Bank and the Gaza Strip, respectively. This is approximately the level in Egypt, and much higher than that of other Arab countries, Israel, or more developed economies. The high proportion of income (GNP) devoted to private consumption is characteristic of poor and underdeveloped countries. In Africa and some Asian and Latin American countries, this share is as high as 90–95 percent. In developed economies it ranges between 55 and 65 percent. This

⁵ The ICP method is not universally accepted and its results cannot be taken at face value.

⁶ See Hamed and Shaban (1993).

Table 2.2
Structure of Demand (1989)

	Private consumption			Investment		Government consumption			Total merchandise trade (mill. US\$)		Merchandise trade		
	Total (mill. US\$) (1)	Share of total in GDP (2)	Per capita (US\$) (3)	Total (mill. US\$) (4)	Share of total in GNP (5)	Per capita (US\$) (6)	Total (mill. US\$) (7)	Share of total in GDP (8)	Per capita (US\$) (9)	Exports (10)	Imports (11)	Exports/GDP (12)	Imports/GDP (13)
West Bank	1,339	0.78*	1,477	296	0.16*	328	123	0.07*	137	263	730	0.21	0.42
Gaza Strip	565	0.84*	942	132	0.19*	197	56	0.08*	95	42	342	0.10	0.51
Israel	27,158	0.59	6,035	7,365	0.16	1,637	13,349	0.29	2,966	10,735	13,101	0.23	0.28
Egypt	25,264	0.80	495	7,579	0.24	148	4,105	0.13	80	2,565	7,434	0.08	0.24
Syria	6,990	0.61	557	1,489	0.13	123	1,719	0.15	142	3,006	2,097	0.26	0.18
Jordan	2,597	0.65*	811	599	0.18	187	799	0.20*	249	926	2,119	0.27	0.54
Tunisia	5,708	0.64	713	2,051	0.23	256	1,516	0.17	190	2,932	4,366	0.33	0.49
Portugal	29,620	0.66	2,875	13,464	0.30	1,307	5,834	0.13	566	12,798	19,043	0.29	0.42
U.S.A.	3454,814	0.66	13,885	773,466	0.15	3,108	103,288	0.20	4,145	346,948	491,512	0.07	0.10

* Share in GNP.

Sources:

West Bank and Gaza Strip: ICBS 1992.

Other countries: World Bank (1991, 1992).

indicator is related not only to levels of national income, and possibly to its distribution, but also to the degree of government involvement, to taxation rates, and to the provision of public goods (health, education, etc.) by central or local governments. There is no doubt that the high ratio of GNP spent on private consumption in the Palestinian territories represents, among other things, a relatively low level of taxation and government spending. Indeed, as seen in Table 2.2, the government spent only 7–8 percent of GNP in 1989 on public consumption in the Palestinian territories, while in other Arab countries the proportion is 15–20 percent, and in Israel, in the same year, it was 29 percent.⁷ These higher levels of government spending are financed (at least in part) by higher levels of taxation, and hence disposable income as a share of GNP is obviously higher in the Palestinian territories than in other countries. In other words, a larger disposable income per dollar of GNP, combined with the need to privately purchase goods that are, under other circumstances, provided by the government, generates a relatively high level of private consumption.

The Palestinian territories also lack savings opportunities. Until recently, there was practically no banking system, and even at present, the financial sector is at best in its embryonic stage. Although the Palestinian territories can avail themselves of Israeli banking and financial facilities, and invest in the Israeli stock market, this option is not often realized owing to national reasons and mistrust. Table 2.2 presents investment levels and their ratio to GDP (or GNP): the proportion of GNP devoted to investment in the Palestinian territories is 16 and 19 percent for the West Bank and the Gaza Strip, respectively. These are fairly low figures compared with most other countries, but they are by no means unusual; they are higher than in Syria (13%), similar to Israel (16%), and slightly less than in Jordan (18%). In per capita terms, they are clearly higher than the figures for Egypt, Syria, Jordan, and even Tunisia.

These comparisons are somewhat misleading, because most (50–80 percent) of the investment in the Palestinian territories is in residential housing and not in productive capital, more than that in the

⁷ For the sake of accuracy, we should remember that public and government consumption in all countries except the Palestinian territories includes defense spending, which is not included in the statistics of total government expenditure in the Palestinian territories. Defense very often accounts for a large proportion of total government expenditure. In 1989, for example, it was 26 percent in Israel, 25 percent in Jordan, 14 percent in Egypt, and 40 percent in Syria.

Gaza Strip than in the West Bank. As mentioned above, until recently there were very few savings opportunities and practically no financial savings incentives in the Palestinian territories, so that most of the savings during the years of occupation were channeled to investments in residential construction and foreign currency, with only a small portion being converted into productive capacity.

The data on savings and investment can be explained in terms of supply and demand. There are several possible sources of funds for investment: private savings, government allocations, foreign investments and investment banking. Only the first source is relevant to the Palestinian territories. The demand for investment is generated by firms that invest in productive capital; by the public, that invests in housing; and by central and local governments that invest in infrastructure. In the Palestinian territories, the investment in productive capacity is very risky. The role of local government is limited, and most private investment is in residential construction. Since savings opportunities are so limited, investment in housing has become essentially the only financial outlet. These facts clearly affect the Palestinian territories' rate of economic growth, their output composition, their technology and their capital-labor ratios. The following section elaborates on the productivity issue.

The average annual rates of growth for the decade 1980–89 appear in Table 2.1. The West Bank had a 1.6 percent annual rate of GDP growth, while that of the Gaza Strip was 3.1 percent. The rate for the West Bank is on the low side, although not unusual for this period among both less developed and developed countries. In the Gaza Strip, the rate of growth is surprisingly high. One should remember that the period 1980–89 is not homogeneous. Since 1987, the Palestinian uprising, the *intifada*, has had an impact on the rates of growth which is not clear cut. Before the *intifada*, the annual rates of growth in the West Bank and the Gaza Strip were quite high. The uprising caused an abrupt fall in GDP in 1988, but in 1989 a recovery is evident and the Palestinian territories' GDP in 1989 is the same as that of 1987. In fact, there are clear signs that GDP growth in the Palestinian territories rose in 1990–94. Nevertheless, at the same time real GNP rose more slowly, or even decreased, due to the intermittent border closures and the resulting decline in Palestinian employment in Israel. In other words, it seems that the *intifada* had only a temporary adverse effect on the domestic level of economic activity. In the long run, the partial boycott of Israeli products in the Palestinian territories and the

availability of labor might have stimulated domestic output.

This brings us to the volume of international trade and the degree of openness. Table 2.2 shows the absolute volumes of merchandise exports and imports and their relative levels. According to these figures, the Palestinian territories seem to be neither among the most open nor least open economies. The exports/GDP and imports/GNP ratios are average compared with those of other countries. These figures do not tell the whole story. Most of the Palestinian territories' trade is with Israel: some 80–90 percent of all imports to the Palestinian territories originate in Israel, and similar ratios of their total exports are sold in Israel. Israel is thus by far the largest trading partner of the Palestinian territories (Jordan, in second place, lags behind). The Palestinian territories also represent an important trading partner for Israel, being the second-largest export market for Israeli products (after the United States). These facts support the claim that the Palestinian territories have been integrated into the Israeli economy. To this picture we must add the very large earnings in labor remittances from Israel to the Palestinian territories. These amounted to \$700–800 million until 1992, and since then fell to approximately \$500 million, due to the decrease of Palestinian workers employed in Israel. Indeed, as mentioned at the beginning of the chapter, this is an imposed integration, but it certainly represents the base line for any future economic developments in the area.

How do the Palestinian territories compare with other countries as regards the level of economic development? Answering this question is no easy task. Viewed in one way, income per capita in the Palestinian territories (disregarding ICP estimates), is characteristic of middle-income economies. In other respects it is below the group of less-developed countries. The share of agriculture in GDP is 24 percent in the West Bank and 16 percent in the Gaza Strip (see Table 2A.3). The West Bank ranks higher than any other country listed in Table 2.3, and probably higher than most countries in the World Bank's list of middle-income countries. This share, for both areas of the Palestinian territories, implies that they resemble low-income economies. This conclusion is reinforced when industry's share in GDP is considered: The figures for the West Bank and the Gaza Strip are 7 percent and 12 percent, respectively. These are extremely low levels of industrialization, probably lower than in most countries in the world.⁸

⁸ Cf. World Bank (1991), p. 208.

Table 2.3
The Structure of Output (% of GDP), 1989

	Agriculture	Industry
West Bank	24	7
Gaza Strip	16	12
Israel	3	25
Egypt	19	30
Syria	30	23
Jordan	7	28
Portugal	6	37
U.S.A.	2	29

Sources: ICBS (1996), World Bank (1991, 1992, 1996).

Another sign of low development is the heavy reliance of the economy on workers' remittances, which once accounted for approximately 30 percent of GNP and in 1994 went down to 14 percent. In proportional terms, it is probably the highest level in the world. Other countries also benefit from remittances of workers employed abroad, e.g., India, Pakistan, Egypt, Morocco, Turkey, Portugal and others. The phenomenon of a country benefiting from wages earned by their nationals working abroad is a sign of domestic unemployment and of labor-force characteristics that coincide with foreign requirements for workers (usually low wages and low skills). In some cases, a country's low level of domestic development is related to job opportunities abroad, as the availability of foreign jobs might cause domestic wages to rise as high as those attainable in the foreign country. If it is true that investments in general and foreign investments in particular, are attracted by low wages, because they generate high profits, then the option of finding work abroad, thereby raising the wage level at home, should deter investment and lead to a low level of development and employment. This may be the case for the Palestinian territories. While both foreign and domestic investments are naturally deterred by political uncertainty and by the Israeli occupation, it is also true that wages in the Palestinian territories were in the decade 1980–90 more or less equal to those earned by Palestinian workers in Israel,⁹ certainly a higher wage level than the one they could have earned in the Palestinian territories had they all been employed there. Under

⁹ Kleiman (1992a); see also Angrist (1994) and Table 3.4 below.

such conditions, the employment of Palestinian workers in Israel had a deleterious effect on investment in the Palestinian territories and on their economic development.

Since the signature of the interim agreement in Washington in September 1995, and the expected implementation of self-rule in most of the Palestinian territories, some of the political uncertainty has been reduced. Moreover, the placing of additional barriers to the employment of Palestinians in Israel has widened the gap between Israeli and domestically-earned wages in the Palestinian territories. These factors are likely to stimulate investment, employment, and domestic activity in the Palestinian territories. Indeed, the number of domestically employed workers in these territories rose by 29,000 in 1993 and by another 54,000 in 1994, after a decade (1980-90) in which domestic employment grew by at most 10,000 jobs annually.

The foregoing analysis points to the chronic under-development of the Palestinian economies. Other characteristics, not reviewed here, would probably be consistent with the general picture. Reference is mainly to infrastructure-related and standard-of-living indicators. For example, almost no electric power is generated in the Palestinian territories. It is true that electric power reaches almost every household (99 percent in urban areas and 65 percent in rural areas), but most of it is imported from Israel. Telephone services are very limited, health and education services do not come close to standards in developed countries, or even in most middle-income countries. Despite these symptoms of under-development, the use and ownership of some durable goods is almost as high as in developed countries: most households own cooking ranges, refrigerators, washing machines, radios, TVs and solar-powered water heaters. Furthermore, the daily calorie supply per capita is 2,900 Kcal in the West Bank and 2,600 Kcal in the Gaza Strip, equivalent to the levels in Japan, Singapore, and Saudi Arabia, and significantly higher than that of all low-income and many middle-income countries.

This international comparison can serve as a backdrop for a fundamental question that has not yet been resolved: What sort of economic relations will prevail between the Israeli and Palestinian economies after a final settlement is reached? At this stage we will not dwell on specific economic arrangements that should constitute part of a peace agreement. Rather we remain within the framework of an international comparison, observing that other cases can be cited, of neighboring countries, very different in economic size and structure,

coexisting in peace and practice economic cooperation. The most outstanding case is that of the United States and Mexico. Many of the economic ratios between Israel and the Palestinian economy are of the same order of magnitude as those between the U.S. and Mexico. Total GNP in Israel is approximately 18-20 times larger than that of the combined Palestinian territories; GNP per capita is six times greater in Israel than in the Palestinian territories. By way of comparison, the U.S. GNP is twenty-five times greater than that of Mexico. Other features in the U.S. and Mexico are also comparable with the relations between Israel and the Palestinian territories: Mexico suffers from low wages and excess supply of labor, and workers from Mexico attempt to work in the U.S.

In spite of the differences in size, income, and degree of development, these two economies and Canada signed the NAFTA (North American Free Trade Agreement) in the belief that cooperation and free trade would benefit both. We do not claim that free trade between Israel and the Palestinian economy is necessarily the best arrangement in the opening stages of a peace agreement, but it might be a longer-run goal. In view of the considerable differences between the two economies, it is not clear whether a free trade agreement will, indeed, enhance bilateral or international trade in the area; the example of the United States and Mexico relations merely demonstrates that common interests may be found among very different economies. The institutional arrangements made would probably contribute to the mitigation of these differences and reduce areas of friction and possible conflicts.

2. Economic Characteristics and Trends in the West Bank and the Gaza Strip

a. Economic growth

Since the Six Day War of 1967 and the occupation of the West Bank and the Gaza Strip by Israel, significant economic growth has taken place in the Palestinian territories. The average annual percent rates of GDP growth in 1968-90 were 5.4 for the Gaza Strip and 7.4 for the West Bank, compared with 4.5 percent in Israel. The "common knowledge" in analyses of the Palestinian economy suggests that the first years after the occupation (1967-73) were good for economic

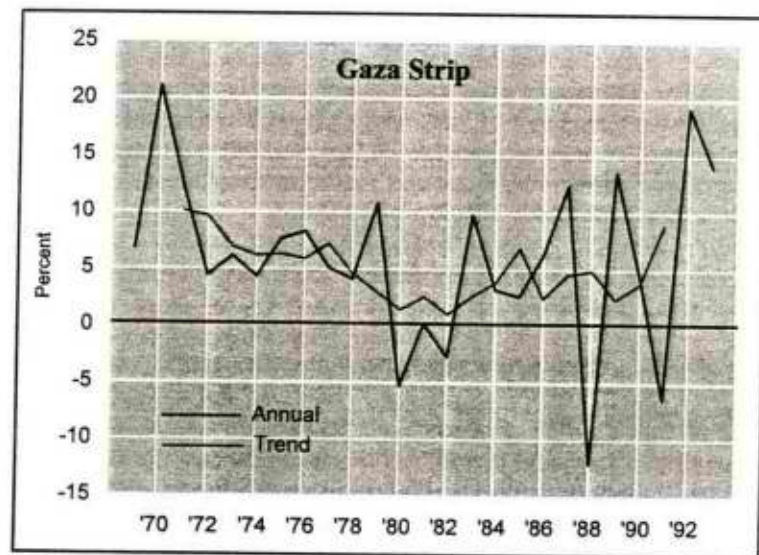
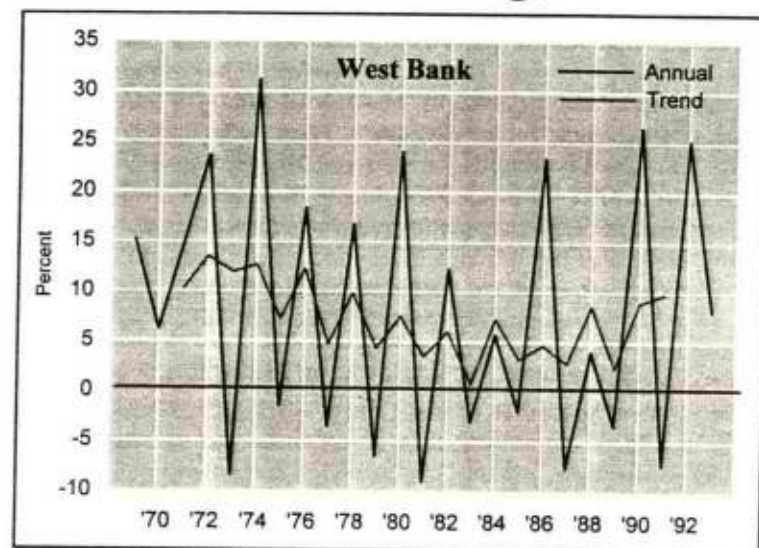


Figure 2.1. Annual GDP Growth (percent)

growth. The following years, according to these studies, showed significantly lower rates of growth of the Palestinian economies.¹⁰ The apparently unusual rates of growth during the first years of occupation were attributed to the integration of the Palestinian economy into the Israeli economy, to the removal of trade barriers, to the adoption of new technologies (especially in agriculture), and to the earning opportunities of Palestinian workers in the Israeli economy. As we will see later, growth rates in the 1970s were indeed higher than in the 1980s. There were better and worse periods; the data indicate that growth rates tended to fluctuate significantly, especially in the West Bank, where the results are related to the cyclical nature of olive yields which alternate every other year. Since olive crops and related industries (e.g., olive oil) represent 10–15 percent of GDP in the West Bank, in years with olive crops (even years) the registered economic growth is outstandingly high, often above 20 percent. In odd years, the percent GDP change in the West Bank is often negative, but that does not necessarily imply economic contraction (see Figure 2.1 and Table 2A.1 in the appendix). We will return to the issue of economic growth later in this chapter in the sub-section on productivity.

b. Consumption and investment

The years since 1968 have seen a clear rise in total and per capita levels of real consumption expenditure in both areas. From 1968 to 1990 real consumption per capita more than doubled (rising by approximately 130 percent); in the West Bank it rose from \$600 (at constant 1986 prices) to \$1,331, and in the Gaza Strip it rose from \$379 to \$875 (see Figure 2.2 and Table 2A.2). The relatively rapid growth of consumption was clearly related to the growth in GNP and disposable income. Note, too, the weights of consumption in GNP, which went down from close to (and above) 100 percent of GNP in the late 1960s to around 80 percent of GNP or less in the early 1990s (see Table 2A.2). As mentioned earlier, the very high proportion of GNP spent on private consumption is usually a characteristic feature of low-income and less-developed countries. The decreasing ratio in the Palestinian territories seems to indicate that their economic behavior is beginning to resemble the characteristic behavior of developed

¹⁰ See Lerner and Ben-Shahar (1975); the argument is summarized in Hamed and Shaban (1993).

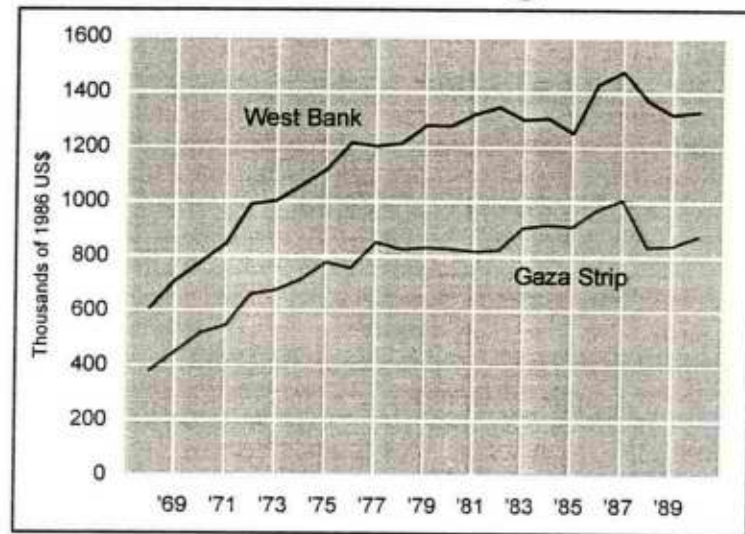


Figure 2.2. Consumption Per Capita

economies. However, this conclusion is not necessarily correct, as it could have been, had the amount of saved resources been transformed into productive investments and business capital. But this is not the case in the Palestinian economies: most investments are made in residential construction (see Figure 2.3 and Table 2A.3). The decrease of the GNP proportion devoted to private consumption therefore probably indicates, more than anything else, a change in the composition of consumption where relative spending on current consumption fell and that on housing rose. Indeed, while the share of consumption in GNP fell, investment in construction (mainly housing) rose from 2.3 percent in the West Bank and 4.6 percent in the Gaza Strip in 1968 to approximately 15 percent in both the West Bank and the Gaza Strip in 1986 and 1987. Investment in housing should be considered as the best reflection of savings in the Palestinian territories, since virtually no other financial savings opportunities existed.

The implication of these findings is that the level of savings, which rose in both proportional and absolute terms in the Palestinian territories since 1968, did not contribute much to the formation of productive capital and economic growth. Figure 2.4 and Table 2.4 present the development of capital-output and capital-labor ratios in

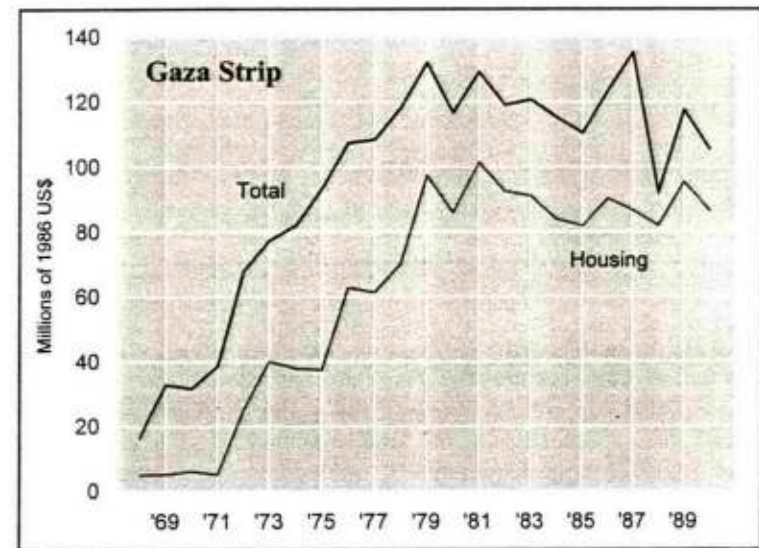
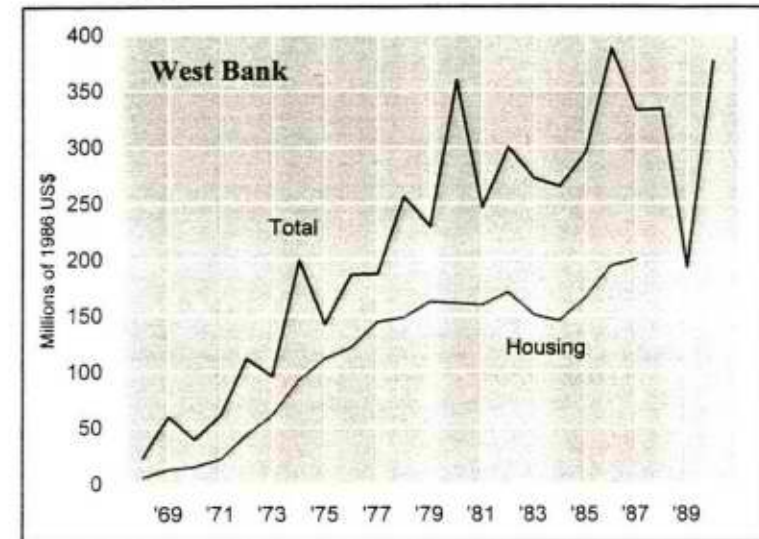


Figure 2.3. Total Investments and Investment in Housing

Table 2.4
Capital/GDP and Capital/Labor Ratios

	West Bank				Gaza Strip			
	Total capital over GDP (1)	Productive capital over GDP (2)	Total capital per worker ^a (3)	Productive capital per worker ^a (4)	Total capital over GDP (5)	Productive capital over GDP (6)	Total capital per worker ^a (7)	Productive capital per worker ^a (8)
1968	0.78	0.27	2.57	1.36	1.81	0.71	4.79	0.66
1969	0.86	0.34	2.61	1.45	1.80	0.68	4.55	0.79
1970	1.02	0.44	3.10	1.56	1.57	0.66	4.31	0.82
1971	1.08	0.49	3.72	2.16	1.51	0.64	4.60	0.96
1972	1.08	0.48	4.32	2.66	1.70	0.65	5.07	1.26
1973	1.41	0.57	5.09	2.95	1.89	0.66	5.58	1.40
1974	1.31	0.46	5.70	2.94	2.11	0.67	6.07	1.59
1975	1.58	0.49	7.17	3.21	2.32	0.68	7.16	1.88
1976	1.56	0.44	8.60	3.36	2.52	0.70	8.06	2.09
1977	1.89	0.48	10.16	3.54	2.76	0.73	9.16	2.37
1978	1.87	0.45	11.40	3.81	3.04	0.74	10.09	2.72
1979	2.31	0.53	13.02	4.31	3.08	0.77	11.64	3.11
1980	2.07	0.46	14.34	4.52	3.59	0.78	12.75	3.20
1981	2.48	0.51	15.77	4.64	3.96	0.80	13.67	3.29
1982	2.40	0.46	16.22	4.54	4.38	0.81	14.83	3.35
1983	2.68	0.50	17.15	4.78	4.25	0.81	15.24	3.49
1984	2.71	0.49	17.31	4.69	4.36	0.82	15.93	3.40
1985	2.97	0.52	18.97	4.87	4.46	0.82	16.01	3.28
1986	2.63	0.46	18.84	4.70	4.44	0.83	16.35	3.20
1987	3.10	0.54	19.14	5.15	4.17	0.83	16.15	3.22
1988	3.15	0.54	19.62	5.20	4.90	0.83	16.88	3.07
1989	3.41	0.58	20.72	5.54	4.48	0.83	17.55	2.64
1990	2.83	0.48	20.46	5.24	4.40	0.83	17.14	2.43

^a Thousands of U.S. Dollars of 1986.

the Palestinian economy. Both ratios increased steadily during the past two decades. For the West Bank, the capital-GDP ratios fluctuate as does GDP itself, due to the bi-annual olive crop. The average bi-annual values indicate that the total capital-GDP ratio in the West Bank rose from approximately 0.78 in 1968 to approximately 2.8 in 1990. The productive-capital/GDP ratio rose by slightly less than 21 percentage points. In the Gaza Strip, the capital-GDP ratios are higher than in the West Bank: in 1990 the total capital-GDP ratio was 4.4 and the productive-capital/GDP ratio was about 0.83. As in the West Bank, the total capital-GDP ratio rose significantly over the years.

The higher capital-output ratios in Gaza do not necessarily mean that

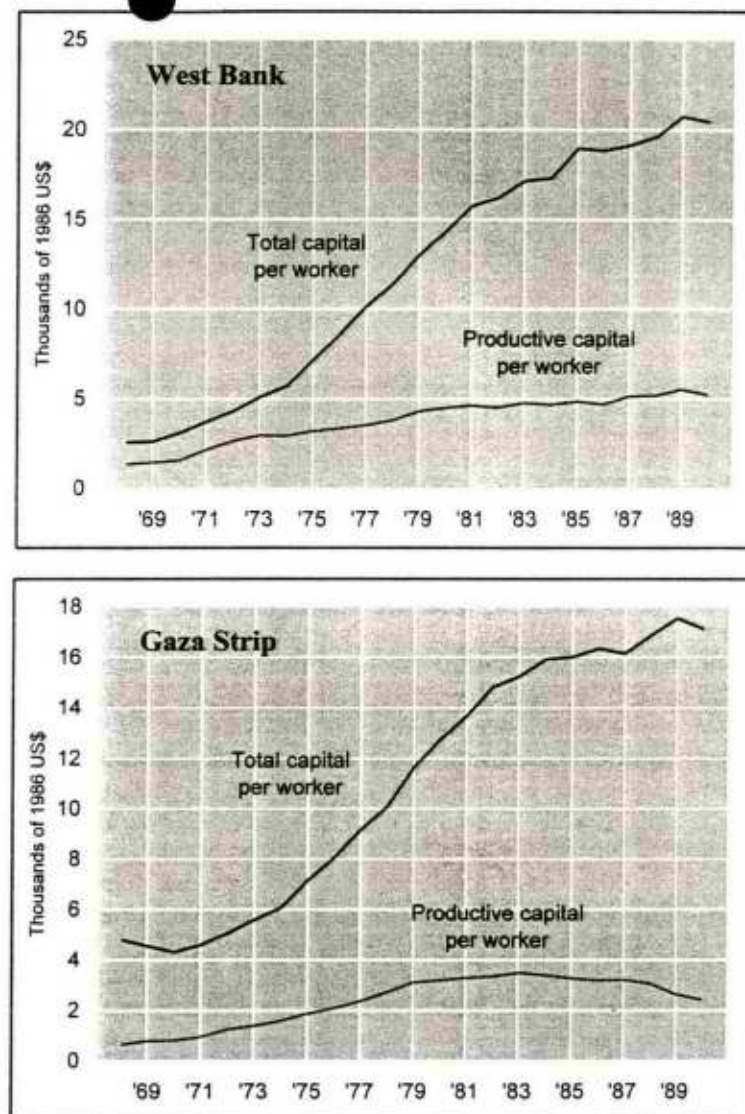


Figure 2.4. Capital/Labor Ratios

it is more capital-intensive or capital-abundant than the West Bank. To clarify this point, observe the capital-labor ratios in Table 2.4 and Figure 2.4: these ratios, especially for productive capital stock, are higher in the West Bank than in the Gaza Strip. In fact, the amount of productive capital per worker in the West Bank in 1990 (\$5,241) is more than double that of the Gaza Strip (\$2,428). At the same time, the difference between the two areas in total capital (including housing) per worker is far smaller, and can be explained by the larger proportion of savings and capital formation in the Gaza Strip that is devoted to housing. In other words, the productive business sector in the West Bank is significantly more capital-intensive than it is in the Gaza Strip. This might explain the higher levels of labor productivity observed in the West Bank, and will be analyzed later in the chapter. Figure 2.4 indicates that in spite of the significant increase in total capital-labor ratio in both territories, most of the change was in the housing component of the capital stock.

In any event, both the Gaza Strip and the West Bank suffer from very low levels of capital intensity. For the sake of comparison, in Israel in the early 1990s total capital per worker was estimated at \$100,000–120,000, and the productive capital-labor ratio was \$55,000–60,000. Thus, capital intensity in Israel is at least 10 times greater than it is in the West Bank and 20 times greater than in the Gaza Strip.

To complete this part of the macroeconomic picture, we look into the incremental capital output ratio (ICOR). Although the ICOR is a highly criticized indicator, it is still widely used in economic development studies, serving mainly as a policy-making indicator. The assumption is that the lower the ICOR, the more efficient is capital formation in generating output and stimulating economic growth. The ICOR is, indeed, a very simple estimate of the inverse value of the marginal product of capital. In 1985–90 the ICOR (excluding investment in housing) was 3.6 in Israel.¹¹ For any period since 1968, the same measure in the Palestinian territories was significantly lower, usually below 2 (see Figure 2.5). In the West Bank it was relatively high (2.5) in 1980–87, but has since fallen to less than 1. It was usually lower in the Gaza Strip than in the West Bank, and in 1987–90 it was negative because net capital accumulation was negative. Gross investment in productive capital was less than the depreciation.

¹¹ Diwan and Squire (1992). They show ICOR values for Israel (5.6), and other Arab countries. Their measure includes housing.

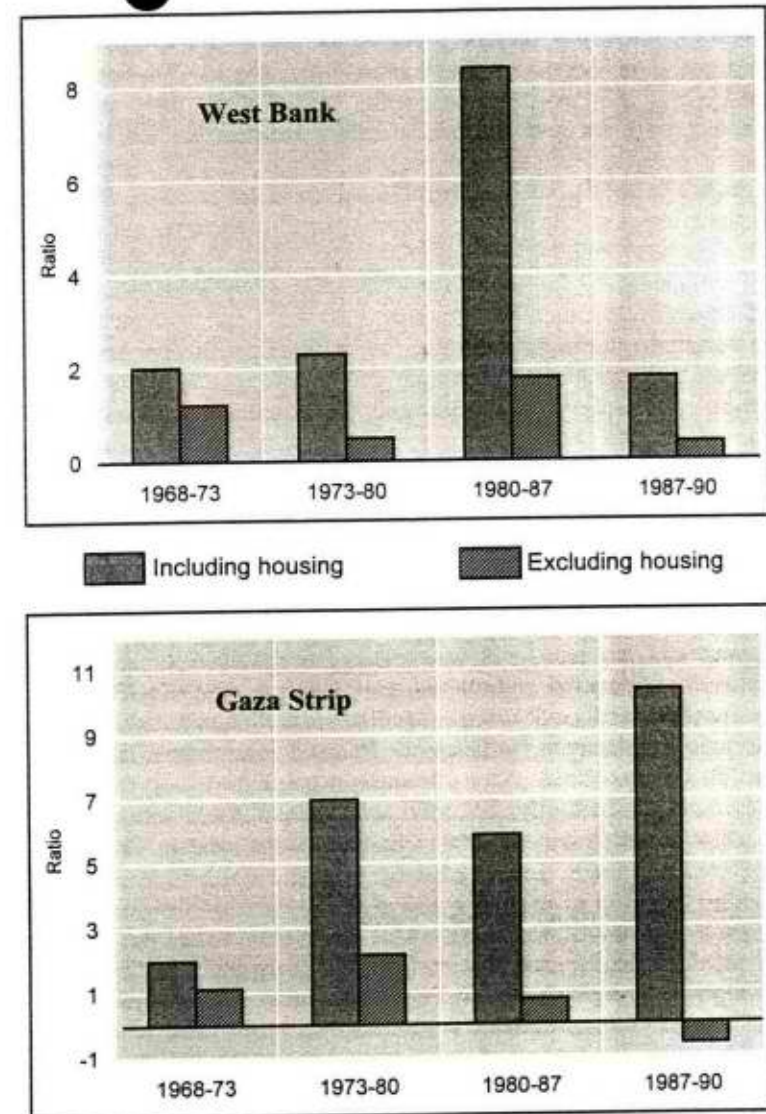


Figure 2.5. Incremental Capital-Output Ratios (ICOR)

These were the years of the *intifada*, when ICOR values were very low in the Palestinian territories due to the very low levels of investment and some negative rates of growth. Incidentally, investment in housing remained positive, and in the case of Gaza, they are even relatively high, in spite of (and possibly because of) the *intifada*. These figures indicate that the marginal productivity of capital may be higher in the Palestinian territories than in Israel. If so, it might be due to the dramatically lower capital-labor ratios in the West Bank and the Gaza Strip.

The implications for future prospects, especially if peace is achieved and normal economic relations prevail, is that capital might flow to the Palestinian territories both from Israel and from foreign countries. This would contribute to economic growth and to a reduction of the income gap between the Israeli and the Palestinian economies. In other words, the extremely low levels of ICOR in the Palestinian territories, especially in comparison with the levels in other Arab countries¹² would probably attract Arab, Israeli and foreign capital, provided that political stability and security prevail. Another requirement for the motivation of capital flows is the creation of a favorable economic climate by ensuring accessibility to home and foreign markets, by reducing barriers (economic and non-economic), by reducing bureaucratic red tape, and by creating mechanisms to encourage economic cooperation on both the micro and macro levels. The latter does not necessarily call for an immediate institution of a multinational free trade organization involving the Palestinian economy, Israel and possibly other countries. Such a framework might be a long-term goal, to be built up gradually. For more on potential trade arrangements in a peace setting see further on in this chapter and in Chapter 4.

c. Government expenditure and taxation

As noted earlier we saw that in 1989 the share of GNP devoted to government consumption in the Palestinian territories was significantly lower than in other countries. In absolute real terms, total government (including local government) consumption rose since 1968 in both the West Bank and the Gaza Strip (see Tables 2A.4). By 1990, the level had almost doubled in the Gaza Strip and almost tripled in the West

¹² Jordan (10.7), Syria (12.5), Tunisia (8.4) and Egypt (6.8) (see Diwan and Squire, 1992).

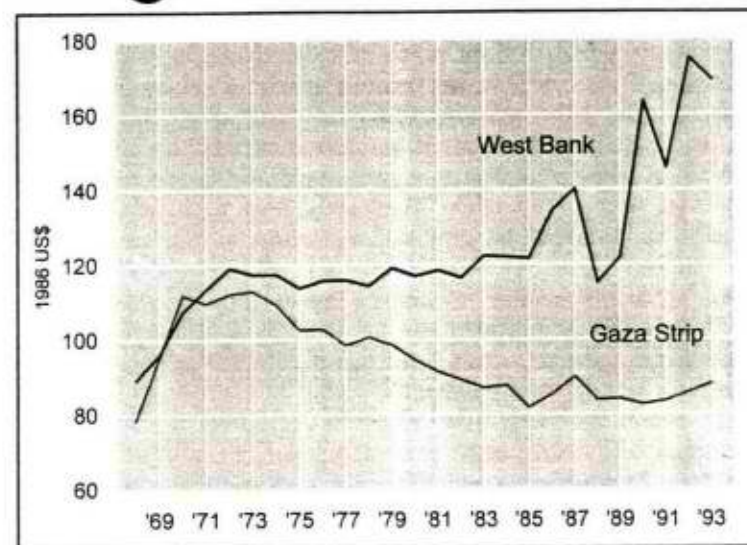


Figure 2.6. Government Consumption Per Capita

Bank. In both areas these cumulative rates of growth were less than the total growth of GNP in the same period: the share of GNP devoted to public consumption fell during the above period, from 15 percent to 8 percent in the West Bank and from 14 percent to 10 percent in the Gaza Strip. In per capita terms, spending on public consumption rose in the late 1960s and early 1970s to similar levels in the West Bank and the Gaza Strip (in both areas reaching \$110–115 per capita in constant 1986 prices in the early 1970s). While in the West Bank it stabilized at this level, later (in 1988) rising sharply, in the Gaza Strip since 1973 it started falling and continued to fall, bottoming at \$80–90 per capita in 1986–90 (see Figure 2.6). These figures represent a very low involvement of government in supplying or financing public goods by any standards. A significant amount of public goods, normally provided by governments, has to be purchased directly from the private sector by individual consumers. This is consistent with our earlier findings on the relatively high level of private consumption. Thus, the combination of the relatively high private consumption expenditure with the relatively (and absolutely) low public consumption outlays is a reflection of the trade-off between these two economic variables. This trade-off is accentuated in the Palestinian territories.

An important qualification should be pointed out here, concerning a characteristic feature of the supply of public goods in the Palestinian territories. The inadequate provision of public goods by local governments and by the central government, operated by the militarily-run Israeli Civil Administration, was complemented by an elaborate network of non-government, non-profit organizations in the fields of education, health and welfare. Their activities are funded by foreign transfers and local philanthropy, and are defined as "private consumption" although strictly speaking they should be attributed to the public sector. In fact, a number of non-government organizations (NGOs) are likely to be incorporated into the Palestinian Authority once the empowerment process is completed and the 1995 Washington interim agreement is fully implemented.

The picture described above might be considered laudable from a conservative economic point of view, but we cannot ignore the fact that there have been a series of market failures in the provision of public goods. They might have been caused by externalities in production and consumption, by differences between social and private optimum levels of various activities, and by other non-economic social and qualitative factors. Whatever the reason, the result of low government involvement is probably an inadequate level of supply, in both quantitative and qualitative terms, of services such as education, health, physical infrastructure, urban services, crime prevention and deterrence, welfare services, etc.

Another important feature of the fiscal system during Israel's rule over the Palestinian territories was the persistent existence of an effective "budget surplus," which has been mentioned in another context by Hamed and Shaban (1993). This surplus aroused considerable ill-will and might have been responsible for the charge that the Israeli government exploited the Palestinian territories. In general, a situation in which net government revenues significantly and persistently exceed government expenditures is considered undesirable by all economic schools of thought. It slows down economic growth by artificially reducing demand in the economy, and thus might have been one of the depressing factors in the Palestinian economy. The excess government revenue does not show up in the data on the direct fiscal activity of the Israeli government as represented by the Civil Administration in the Palestinian territories. On the contrary, a comparison of annual direct and indirect tax revenues in the Palestinian territories with annual government expenditure, including public consumption and investment,

reveals a relatively large government deficit (overspending). To illustrate, in 1986 total tax collection in the West Bank was \$93 million, while total government expenditure was \$152 million (public consumption alone was \$108 million). Obviously, more revenues were collected from Palestinians, but not from within the Palestinian territories. There are three channels through which such resources were drawn by the Israeli government:

- a. Inflation tax. This is the seigniorage implicitly collected by the Israeli government as the provider of currency that serves as legal tender in the Palestinian territories. Hamed and Shaban (1993) estimated the magnitude of this resource-transferring element. (See also Ch. 6). We ignore this phenomenon here since it does not deal with explicit taxation or with the fiscal network.
- b. Customs duties paid by residents of the Palestinian territories to the Israeli authorities. This component of tax collection relies on the fact that all imports to the Palestinian territories passed through Israel and were subject to Israeli tariffs on imports and to a value-added tax imposed on all transactions in the Israeli economy. Imports from abroad were a minor portion of total imports to the Palestinian territories. Most imports were (and still are) from Israel, and this component was subject only to the normal VAT.
- c. National insurance fees. A national insurance deduction was withheld from all legal Palestinian workers in Israel. It is not quite clear precisely what benefits go along with this deduction. The entire issue of national insurance and the accumulated funds of Palestinian workers is an important one, that requires clarification. Due to lack of information we have no choice but to ignore this issue here.

We therefore concentrate on a numerical illustration of the excess tax collection from residents of the Palestinian territories through the VAT and customs duty mechanisms. Table 2.5 shows findings on overtaxation for selected years 1986-90. The estimates of this extra tax burden in the Palestinian territories presented here are much lower than the estimates in Hamed and Shaban (1993), mainly because they ignore the surplus government expenditure over direct taxation in the Palestinian territories (they only quantified the value of forgone tariff revenue, and ignored the formal budget deficit). A chronic situation of government revenues exceeding expenditures could generate an extremely undesirable macroeconomic problem. Table 2.5 reveals that in the late 1980s excess government taxation in the Palestinian territories

Table 2.5
Tax Collection and Public Expenditures (millions of NIS, current prices)

	West Bank			Gaza Strip		
	1986	1987	1990	1986	1987	1990
(1) Public consumption and investment	232	316	425	93	178	192
(2) Direct and indirect tax collection	142	176	269	71	77	92
(3) VAT and custom duties on imports	207	212	267	139	131	150
(4) Total taxes, (2)+(3)	349	388	536	210	208	276
(5) Government surplus, (4)-(1)	117	72	111	117	30	84
(6) Surplus as % of GNP	5.0	2.6	2.6	13.0	2.5	5

amounted to 2.5–13.0 percent of Palestinian GNP. This is probably an understatement, because national insurance fees are not accounted for. This situation, which probably persisted for many years, undoubtedly had a dampening effect on the Palestinian economy for more than two decades. Had the excess taxation been recycled into the Palestinian economy, it would have raised the share of government consumption in GNP to levels closer to those of other economies. Moreover, it would have significantly contributed to economic growth and to domestic employment.

d. *International trade*

The Palestinian territories are highly open economies, an observation made earlier this chapter. The openness is mainly expressed as a high import-GNP ratio of 85 percent and more in the Gaza Strip and 60–65 percent in the West Bank (see Figure 2.7 and Table 2A.5). The export-GDP ratios, that are much lower in both territories, are still non-negligible. The problem with the international trade of the Palestinian economy is that by far its largest trading partner is Israel, both in exports and in imports. The Palestinian territories have been selling 80–85 percent of their exports to Israel and buying 80–90 percent of their imports in Israel for the past 28 years and this seems to remain the case since the implementation of the self-rule agreement and its

economic supplement—the 1994 Paris Agreement. These unusual trade relations were not the outcome of free trade since Israeli and Palestinian producers do not compete on an equal footing with foreign producers. Israeli producers enjoy a special preferred status in the Palestinian territories since their output is sold without restriction or surcharge, whereas Palestinian producers (especially farmers) face barriers to the sale of their products in Israeli markets. On the other hand, these goods, once they reach the Israeli market are not subject to any kind of tariff, and in this respect they do not compete with imports to Israel from abroad. The 1994 Paris Agreement establishes a free trade system. In fact, it is a partial customs union between Israel and the Palestinian territories. Nevertheless, merchandise flowing from the Palestinian territories to Israel, and possibly in the opposite direction as well, still suffers from disruptions generated by political problems, security issues, border closures and other barriers. Agricultural exports from the Palestinian territories to Israel are also subject to regulations that prevent them from flowing freely across the border.

A major problem with exports from the Palestinian territories in general, and with such exports to Israel in particular, is that their strongest comparative advantage is apparently in agricultural produce, which come under strict regulations in Israel and other markets. Industrial products may flow, but the supply of such goods is still very limited due to lack of development and growth in the Palestinian manufacturing sector. Therefore, one of the major questions concerning the future is: what kind of trade regime could be anticipated for the entire area, and especially for the Palestinian territories, Israel and Jordan.

The customs union agreed upon in the 1994 Paris Agreement is clearly an interim solution and several options are open for the final settlement of economic relations. The choices range between two extreme solutions: total separation or complete integration of the two economies. A view shared by most Israeli and some Palestinian economists is that when peace comes all the countries in the area—certainly Israel, the West Bank and the Gaza Strip, and possibly Jordan—should be part of some sort of integrated economic system. This view is certainly consistent with the ruling philosophy regarding international trade and economic efficiency. Moreover, it is not only popular and appealing from an international political point of view, it is also rational, in view of the fact that in many respects the Palestinian territories have already been integrated into the Israeli economy. However,

several reservations should be made to this simple and logical idea, on economic and political grounds (for more details see Chapter 4). Here we briefly state that the political opposition to the notion on the Palestinian side stems mainly from the desire to develop symbols of sovereignty. The freedom to determine a national, independent commercial policy should certainly be regarded as such a symbol. On the Israeli side, certain vested-interest groups, especially in the agricultural sector, might apply political pressure to prevent free trade with the Palestinian territories and Jordan. They have had some success in introducing trade barriers in the form of quotas on six products (poultry, eggs, melons, potatoes, cucumbers and tomatoes) in the 1994 Paris Agreement. The flow of labor from Palestinian areas to the Israeli labor market also generates antagonism. On the Israeli side it is mainly due to the security problems that it raises, and on the Palestinian side it stems from both nationalistic and long-term economic development grounds.

At this point, momentum seems to be developing in favor of a trilateral free trade area including the Palestinian, Jordanian and Israeli economies. This is a long-run goal that will at best be implemented over a period of fifteen to twenty years with asymmetric concessions, whereby Israel will lower trade barriers faster than the two other parties.

e. Supply-side characteristics

We now add a number of supply-related attributes to the demand-side characteristics described above, which are important in the context of economic growth, of the contribution of capital formation and labor growth to production possibilities, and of the evaluation of future competitiveness. Earlier in this chapter we looked into the development of capital stock, and capital-labor ratios in the Palestinian territories, comparing them to those of Israel. In this section we estimate some of the effects of changes in the various inputs (capital and labor) and measure the “unexplained” residual, usually referred to as Total Factor Productivity (TFP).

Table 2.6 shows average annual changes of capital and labor and their effects on GDP growth in the West Bank and the Gaza Strip. The West Bank's long-run average annual rate was growth of 7.16 percent, while the rate in the Gaza Strip averaged only 4.69 percent between 1970 and 1990. This period was not homogenous either in the West Bank or in the Gaza Strip: growth was faster in 1970–79,

Table 2.6
Total Factor Productivity (average annual percent changes)

	$\Delta K/K$	$S_K \Delta K/K$	$\Delta L/L$	$S_L \Delta L/L$	$\Delta GDP/GDP$	TFP
	(1)	(2)	(3)	(4)	(5)	(6)
a. West Bank						
1970-79	13.45	4.84	-0.77	-0.49	8.94	4.59
1979-87	7.97	2.87	2.62	1.68	4.77	0.22
1987-88	6.65	2.39	3.84	2.46	3.92	-0.93
1988-90	4.51	1.62	3.71	2.38	10.56	6.56
1970-90	9.97	3.59	1.25	0.80	7.16	2.77
b. Gaza Strip						
1970-79	15.16	3.94	-1.41	-1.05	7.22	4.33
1979-87	7.49	1.95	1.83	1.35	3.14	-0.16
1987-88	3.59	0.93	-1.11	-0.82	-12.06	-12.17
1988-90	3.61	0.94	6.60	4.89	8.91	3.09
1970-90	10.26	2.67	0.67	0.50	4.69	1.53

Legend: K	Capital stock including housing (from Table 2.4)
L	Labor input: number of employed workers
$\Delta K/K$	Average annual change of capital input
$\Delta L/L$	Average annual change of labor input
$\Delta GDP/GDP$	Average annual change of GDP (output)
S_L	Share of labor in GDP
S_K	Share of capital in GDP
$S_L (\Delta L/L)$	Contribution of labor input to GDP growth
$S_K (\Delta K/K)$	Contribution of capital input to GDP growth
TFP	Total Factor Productivity.

and then declined in the 1980s. In both territories, the most important factor in generating growth was capital accumulation: in the two decades between 1970 and 1990, 56 percent of growth in the Gaza Strip and 50 percent in the West Bank were generated by the growth of capital inputs. Growth of labor inputs contributed merely 10-11 percent of GDP growth in both territories, and TFP generated the rest (34-38 percent).

Changes were more dramatic during the first decade of the period under review. Annual rates of growth were 7.22 percent in the Gaza Strip and 8.94 percent in the West Bank. An interesting phenomenon is that this substantial growth was generated by capital accumulation and TFP, which is possibly a combination of improved productivity

and technological progress. During this period, changes in labor input were negative, and thus had a negative effect on GDP. The decrease in labor input in the 1970s was caused mainly by labor migration to Arab and other countries and to Israel. These labor input changes reduced GDP at an average annual rate of approximately one percent in the Gaza Strip and half of a percent in the West Bank.

The high TFP in the Palestinian territories is an important feature. It indicates the presence of forces beyond the mere quantitative growth of capital and labor, which contribute to economic growth. These forces are a combination of technological progress, the accumulation of human capital of all types, more efficient allocation of resources, and a higher rate of utilization of human, natural and artificial resources. It probably indicates the ability of the Palestinian economy to adopt new technologies and absorb innovations. The computed TFP rates are, in fact, higher than those of many developed countries, when measured over the same long periods of time. This is certainly true for the 1970s, when TFP was especially high. The combination of a decrease in labor inputs with a remarkably high rate of growth in the 1970s cannot be explained if we exclude significant exogenous productivity-improving factors. The unusually high of TFP rates observed in the 1970s are consistent with the view that the adoption of new technologies (mainly in agriculture), the removal of barriers, and the increase in labor productivity contributed to the Palestinian territories' economic growth.

We now turn to another aspect of macroeconomic productivity that is closely related to demographic conditions. As described earlier, the Palestinian territories and Israel differ considerably in terms of income per capita, which are caused by differences in output per worker and differences in the rate of participation in the labor force (LFPR). The second factor is especially important in the Palestinian territories: the LFPR in 1990 was 21 percent in the West Bank, 17 percent in the Gaza Strip, and 32 percent in Israel. We can define GNP (or GDP) per capita as the product of three ratios, as follows:

$$\text{GNP per capita} = \frac{\text{GNP}}{\text{Employment}} \cdot \frac{\text{Employment}}{\text{Labor force}} \cdot \frac{\text{Labor force}}{\text{Population}}$$

For a given level of labor productivity and unemployment, the higher the LFPR, the higher is income (GNP) per capita.

In the Palestinian territories, the LFPR is very low by any standard

for two reasons: (i) the very large proportion of young people in the total population (approximately half the population is under the age of 15), and (ii) the very low participation rate of women in the labor force, which is less than 10 percent in the Gaza Strip and less than 20 percent in the West Bank. The result is a very low GNP per capita for any given level of GNP per employed worker. Table 2.7 compares measures of GNP per capita and per worker in the Palestinian territories with measures of GDP per capita and per worker in Israel, for selected years (more complete details appear in Table 2A.6).¹³

The number of employed workers in the measure of GNP per worker in the West Bank and the Gaza Strip includes workers employed in Israel, so that this productivity measure is an average of labor productivity at home and in Israel. When comparing columns (3) and (6) in Table 2.7 panels (a) and (b), we see that the relative differences of income (GNP) per capita between the Palestinian territories and Israel decreased over time. In the West Bank, the decrease was more significant; income per capita there was 13 percent the Israel level in 1968, rising to 27 percent in 1990. In the Gaza Strip, income per capita rose from 9 percent of the Israel level in 1968, to 14 percent in 1990.

Productivity differences between the Palestinian territories and Israel were smaller, and here, too, the gap narrowed. In 1968, GNP per worker in the West Bank was 27 percent of GDP per worker in Israel and the ratio for the Gaza Strip was 21 percent. By 1990 these ratios had increased to 42 percent in the West Bank and 28 percent in the Gaza Strip. Column (7) of Table 2.7 shows the ratio of the employment rate in the labor force in Israel and in each of the Palestinian territories. This ratio could be interpreted as the difference in income per capita that would have prevailed between Israel and each of the Palestinian territories if GNP per worker in the latter had been equal to GDP per worker in Israel. In other words, column (7) shows the differences in income per capita attributable to demographic and cultural factors and assuming equal labor productivity. Note that for 1993 income per capita in Israel would still be 77 percent higher than in the West Bank and 113 percent higher than in the Gaza Strip even if labor productivity in all three economies were the same. The outcome of this analysis is that even when labor productivity (in the form of

¹³ This comparison uses GNP measures in the Palestinian territories, because it is a more correct indicator of income. In Israel, the difference between GNP and GDP is small, and thus we use the GDP indicator, the correct parameter for productivity purposes.

Table 2.7
Comparisons of Labor Productivity in Israel, the West Bank and Gaza
(US\$ of 1986)

	GNP per capita			GNP per employed person			Ratio (6)/(3)
	West Bank (1)	Israel* (2)	Ratio (1)/(2) (3)	West Bank (4)	Israel* (5)	Ratio (4)/(5) (6)	
a. The West Bank and Israel							
1968	551	4,373	0.13	3,630	13,472	0.27	2.14
1975	1,262	6,220	0.20	6,374	19,317	0.33	1.63
1980	1,735	6,430	0.27	9,195	19,875	0.46	1.71
1985	1,604	6,793	0.24	8,533	21,312	0.40	1.70
1990	2,019	7,424	0.27	9,816	23,189	0.42	1.56
1993	2,073	8,194	0.25	11,009	24,622	0.45	1.77
b. The Gaza Strip and Israel							
	Gaza Strip			Gaza Strip			
1968	375	4,373	0.09	2,853	13,472	0.21	2.47
1975	811	6,220	0.13	4,670	19,317	0.24	1.85
1980	1,038	6,430	0.16	5,781	19,875	0.29	1.80
1985	1,063	6,793	0.16	6,061	21,312	0.28	1.82
1990	1,066	7,424	0.14	6,428	23,189	0.28	1.93
1993	1,089	8,194	0.13	6,956	24,622	0.28	2.13
c. The Gaza Strip and the West Bank							
	Gaza Strip	West Bank		Gaza Strip	West Bank		
1968	375	551	0.68	2,853	3,630	0.79	1.15
1975	811	1,262	0.64	4,670	6,374	0.73	1.14
1980	1,038	1,735	0.60	5,781	9,195	0.63	1.05
1985	1,063	1,604	0.66	6,061	8,533	0.71	1.07
1990	1,066	2,019	0.53	6,428	9,816	0.65	1.24
1993	1,089	2,073	0.53	6,956	11,009	0.63	1.20

* For Israel, GDP is used instead of GNP.

GNP or GDP per worker) is equalized,¹⁴ there will still be a significant gap in income per capita caused by demographic factors. Such factors are usually much slower to vary, thus one can expect these differences

¹⁴ This is an operation that will require much investment in the Palestinian territories in order to bring capital-labor ratios closer.

to persist for some time. Table 2.7 (c) also compares the ratios in the West Bank and the Gaza Strip, showing that the West Bank is both more productive than the Gaza Strip and has a higher LFPR. Therefore, the relative productivity of the West Bank and its relative income per capita can be expected to improve more rapidly than in the Gaza Strip.

f. Other characteristics

To complete this review of the economic characteristics of the Palestinian territories, we should mention two more factors of major importance: the monetary-financial structure and the labor market. As both aspects are thoroughly analyzed in later chapters, we will mention them in passing.

Earlier in this chapter we referred to the Palestinian territories as having been "provinces" of the Israeli economy. The outstanding feature in this context is the absence of monetary independence: Palestinian territories had no monetary authorities or financial institutions, either in the form of commercial banks or with the powers of a central bank. Money supply was, and still is totally determined by the balance of payments, namely by a quasi "gold standard mechanism." Nevertheless, two important sets of variables, both very closely related to the monetary system, were (and still are) determined outside these economies, namely, interest rates and prices. These two factors were almost totally determined by the Israeli economy, and reflected economic trends and policies there. Therefore, money supply in the Palestinian territories was an endogenous variable that has not been directly manipulated since 1967. This may be considered an advantage by some economists, had the Palestinian territories been able to independently determine the levels of nominal variables (prices and interest rates). But since the price system was mostly determined by the Israeli economy, it was irresponsive to domestic trends, while the only component of this system to be partly determined at home related to non-tradable goods. Thus, the adjustment mechanism in the economy and convergence to equilibrium was realized through quantity (real) changes, not through price changes. This created a clear problem of instability in real variables on both the demand and supply sides, which may have slowed down economic activity as a whole.

Another factor operating in the same direction was the lack of a commercial banking system and a financial network operating to

transform household savings into productive capital, without which a modern economy cannot operate. In the short period since the establishment of the Palestinian Authority and its monetary agency, the Palestinian Monetary Authority (PMA), significant progress is evident. Ten banks started operating the West Bank and the Gaza Strip, with a number of branches. The total volume of deposits more than doubled in 1994 and the amount of outstanding credit more than tripled. According to the Paris Agreement, the New Israeli Sheqel (NIS) is one of the currencies circulating in the Palestinian territories, together with the Jordanian dinar and the US dollar. While the NIS is used mainly for small current transactions, the dollar and the dinar are used as a store of value, and as units of accounts (mainly the dollar) for large expenditures and real estate transactions.

In spite of these changes, the banking system still plays a minor role in financial intermediation, and most savings are still held outside the banking system. The PMA is by no means a central bank. Major issues that remain unresolved are:

- A decision on the nature of the currency to be used.
- The mechanism that will determine money supply and exchange rates.
- The establishment of a banking licensing and supervision system.
- The roles and powers of the PMA in determining monetary policy.

As regards the labor market in the Palestinian territories, where more than one-third of the labor force used to be employed outside the domestic economy, this economic phenomenon has been thoroughly analyzed in other studies,¹⁵ and is addressed at length in Chapter 3. There is no doubt that for twenty-eight years of occupation, the employment of Palestinian workers in Israel was an efficient and convenient solution for all parties concerned, at least in the short run. From the Israeli point of view, it provided relatively cheap labor with appropriate skills for the construction, agricultural and some service and manufacturing sectors. It kept production costs low, and enabled producers to remain flexible since they could avoid investment in more capital-intensive techniques. The latter is certainly true for the construction industry in Israel.

A rough, perhaps somewhat upward biased estimate, is that in 1991 Palestinian workers employed in Israel generated a net value added

¹⁵ See Kleiman (1992), Angrist (1994), and Farris *et al.* (1993).

of \$2.3 billion (at current prices) in the Israeli economy.¹⁶ This represented approximately 4 percent of Israeli GNP in that year. The Israeli government approved of employing Palestinian workers in Israel for several reasons: as mentioned above, such labor contributed to output, especially in some problematic sectors that rely on low wage labor. Moreover, this activity solved problems of employment and income generation in the Palestinian territories without requiring government involvement of any kind.

This type of employment was also convenient for the Palestinians. It certainly was an efficient way to earn an income. Palestinian workers earned wages that were initially higher than those in the Palestinian territories. In time, this labor opportunity raised wages in the Palestinian territories, as well, bringing them to a level equal to that of Palestinian wages in Israel. One of the socially desirable results was also a decrease in income inequality in the Palestinian territories. Another advantage, from the Palestinian point of view, was that worker remittances that were spent at home generated demand that eventually contributed to GDP growth. This was the case during the early years of occupation, 1968-73, when rates of economic growth in the Palestinian economy were especially high.

Since the implementation of the 1993 Washington Agreement, the employment of Palestinian workers in Israel has been steadily declining. In 1995 it was less than half the volume of the early 1990s. The major reason for this trend is the strict limitation imposed on the employment of Palestinian workers in Israel by the Israeli government. In addition, frequent border closures temporarily prevent workers crossing from the Palestinian territories to Israel. All these measures were enforced to prevent, or at least reduce, the growing terrorism of radical and fundamentalist Palestinians. As regards the future, it seems clear that the situation in which one-third or more of the Palestinian labor force works in Israel will not re-emerge. The future trend will probably be one of a gradual reduction of employment of Palestinian workers to a minimum.

The Palestinians face a dilemma. Short-run considerations suggest

¹⁶ This figure assumes that in each sector Palestinian workers contributed a portion of total value added equal to their employment share in that industry. According to this calculation, they generated \$3 billion of total GDP, taking home \$700 million in wages earned. The result is a net contribution to Israeli GNP of \$2.3 billion, or 4 percent of GNP. This figure may be above average, since in 1991 construction picked up due to mass immigration to Israel.

that the employment of Palestinians in Israel should continue, because it generates badly needed income, and solves unemployment problems. But it also raises wages in the Palestinian territories themselves, thus deterring investments and slowing down economic growth. Therefore, long-run considerations call for a gradual decrease of Palestinian employment in Israel. The long-run interests of both parties in this case probably coincide. We may therefore expect the peace era to generate a mechanism that produces a gradual phasing out of Palestinian labor activity in the Israeli economy.

3. Summary

This chapter presents a picture of two underdeveloped economies. It is true that when macroeconomic indicators such as GNP and consumption spending are compared with other countries, the Palestinian territories seem to be better off than the neighboring Arab countries. But a correction of the statistics shows that this is not necessarily so. These two economic systems exhibit a series of anomalies that require attention: a large portion of the labor force works outside the economy (in Israel), and a similar proportion of GNP is generated in the form of worker remittances. Such over-dependence on the Israeli economy is reinforced by extremely large import flows from Israel. Other unusual features are the very low levels of investment in productive capital, the very high levels of investment in housing, and the relatively low level of government consumption and supply of public goods.

The Palestinian economy still does not have an independent financial and monetary sector. Money supply is entirely determined by the state of the balance of payments, and is thus a totally endogenous variable. The price system is almost completely determined in the Israeli economy, so that it hardly reacts to changes of economic variables in the domestic economies. In the past the fiscal system reflected a chronic state of overtaxation that slowed down economic activity. Since the implementation of the 1995 Washington Agreement, serious problems of tax collection and public finance persist.

All the above characteristics produce an economy with low capital formation, low capital-labor ratios, and low labor productivity. However, prospects for economic growth are good, and the contribution of capital formation to productivity is expected to be significantly

higher than it is in Israel. Thus, once peace is achieved, the Palestinian economy will be a potentially attractive investment location. It has high marginal productivity of capital, skilled workers, and unutilized endowments of labor and human capital. Therefore, this economy stands a good chance of absorbing new technologies and growing rapidly. The findings presented in this chapter imply that there is considerable room for industrial cooperation between Israel and the Palestinian economy. Joint ventures could be financed by foreign capital and take advantage of the complementarity between Israel and the Palestinian economy in factor endowments.

The future issue of a formal free trade agreement is not yet clear. Against the economic arguments in favor of such an agreement, there is a series of economic, non-economic and political factors on both sides opposing the immediate implementation of such a regime. In the long run, it is certainly the optimal trade system that all countries of the region should aim for.

One other issue concerning the future is the type of fiscal policy that will emerge. There is no doubt that the past state of overtaxation has disappeared. It is likely, at least for the next few years, that the Palestinian Authority will have to bear a certain level of budget deficit to develop the supply of public goods but it need not be unusually large by the standards of developed and developing countries. This will cause government expenditure to rise steeply, but will also increase the productive capacity of the economy by improving the infrastructure. Therefore, one can expect significant economic growth that will also increase government revenues also.

CHAPTER TWO: APPENDIX

Table 2A.1
Aggregate Output Indicators, 1968-1993 (1986 US\$)

	West Bank					Gaza Strip				
	GNP		GDP		Total (\$ mill.)	GNP		GDP		Total (\$ mill.)
	Annual rate of change (2)	Per capita (\$ thous.) (3)	Total (\$ mill.) (4)	Annual rate of change (5)		Annual rate of change (7)	Per capita (\$ thous.) (8)	Annual rate of change (10)		
1968	318.4	0.551	308.2		134.9		0.375		134.9	
1969	392.1	23.2	355.2	15.2	150.8	11.7	0.418	6.8	144.2	6.8
1970	446.9	14.0	377.2	6.2	199.7	32.4	0.544	21.1	174.5	21.1
1971	552.0	23.5	432.9	14.8	228.1	14.3	0.609	12.2	195.8	12.2
1972	706.5	28.0	535.2	23.6	279.2	22.4	0.729	4.4	204.4	4.4
1973	643.8	-8.9	490.3	-8.4	306.7	9.9	0.778	6.1	216.9	6.1
1974	817.7	27.0	643.3	31.2	315.6	2.9	0.774	4.3	226.2	4.3
1975	848.4	3.8	633.6	-1.5	340.4	7.9	0.811	7.6	243.3	7.6
1976	969.8	14.3	750.0	18.4	368.0	8.1	0.853	8.3	263.6	8.3
1977	951.3	-1.9	723.5	-3.5	379.1	3.0	0.854	5.1	277.2	5.1
1978	1082.0	13.7	844.7	16.8	418.7	10.4	0.916	4.1	288.6	4.1
1979	1057.2	-2.3	789.5	-6.5	490.6	17.2	1.081	10.8	319.8	10.8
1980	1251.4	18.4	979.2	24.0	467.7	-4.7	1.038	-5.3	302.9	-5.3
1981	1183.6	-5.4	891.3	-9.0	490.9	5.0	1.060	0.2	303.6	0.2

for agricultural products can boost the growth of agriculture. The holy sites in Jerusalem and Bethlehem could attract millions of tourists when peace prevails. The central location of the West Bank between Jordan and Israel, with access to Saudi Arabia, Syria and Egypt, and their common culture, can motivate the development of trade relations.

Not so in the Gaza Strip. Resources and land are scarce, the infrastructure is primitive, and the population is large. The only possible avenue for development is in the manufacturing sector, but this would be impeded by the region's untrained labor force, the lack of services and industrial surrounding.

A long-run planner could consider several possible development paths pertinent to the current economic situation. A look at some other well-developed countries, whose geographical conditions resemble those of the Gaza Strip, reveals two notable cases: Singapore and Taiwan. In both these countries, manufacturing is the main economic sector, the population density is high, there is a shortage of natural resources and there are no large export markets in close proximity. However, Singapore and Taiwan differ from the Gaza Strip in at least three major respects: (i) The labor force is well trained, and there is an abundance of experts in engineering and the natural sciences; (ii) the infrastructure is highly developed, with an excellent system of transportation, communications, and other services; and (iii) the level of entrepreneurship there is high.

The above comparison was presented in order to argue that, on the one hand, while the Gaza Strip could adopt the industrial strategy of Singapore and Taiwan, the necessary changes in the structure of the labor force, infrastructure and entrepreneurship would require huge investments, a very long period of transition, and the steadfast dedication of all available resources to that goal. The industrialization process requires other pre-conditions as well. For example: supportive government policy, political and economic stability, and an appropriate legal system.

PROSPECTS FOR THE FUTURE: SIMULATION AND ANALYSIS OF ALTERNATIVE SCENARIOS

The general elections held in Israel in May 1996, brought a right-wing government to power, headed by Benjamin Netanyahu. While the political and economic views espoused by this government are quite different from those of the previous (left-wing) government, under Yitzhak Rabin and Shimon Peres, it has nonetheless acknowledged its commitment to the peace process between Israel and the Palestinians. In fact, the present government has formally decided to abide by and implement the Oslo Interim Agreement, in spite of its ideological reluctance and practical reservations.

The analytical work in this chapter was done before the 1996 elections, and was based on the assumption that the peace process would proceed as planned in the Oslo Agreement and aim at the formulation of a final settlement between Israel and the Palestinian Authority. We believe that in spite of the political events in Israel, the general nature of the agreement will remain the same as the one reached with and ratified by the previous government. Progress may be slower, but—from an economic point of view—it will follow similar lines.

The purpose of this chapter is to generate an analytical framework with which to forecast future macroeconomic trends in the Palestinian territories under alternative scenarios. The estimation of possible future effects of alternative economic agreements will hopefully make an important contribution to policy-making, by indicating the means required to achieve predefined economic goals. Such estimates can provide insights into the feasibility of alternative plans.

Economic forecasting is, of course, notoriously inaccurate, and the results, especially very long-run projections, should therefore be treated with a degree of skepticism. As in most economic forecasting, the analytical process in this chapter is based on simple econometric estimates; this always raises serious problems, which become especially acute in the context of the Palestinian economy. Nobel Prize Laureate Robert Lucas, in his critique of econometric models (Lucas,

1976) argues that in periods of major economic change the behavioral functions in an economy might undergo major alterations, causing coefficients in econometric equations to lose their relevance for future forecasting. This is an especially crucial problem when applying econometrics to the Palestinian economy, which has been in an abnormal state of occupation for 28 years. The Palestinian economy is now on the brink of a dramatic change and one may question the relevance of econometric equations estimated on past economic data to forecast future trends. We offer no answer to this question. However, as shown later in this chapter, our results are not unusual when compared with econometric work on other countries; if appropriate qualifications are applied, these results could be helpful in understanding the economic relationships and may also be used in policy-making to prevent the adoption of inferior solutions.

The model chosen here is as simple as possible. We avoid using sophisticated econometric techniques that might not be applicable to the Palestinian territories or to the available data, and that would not necessarily generate more reliable results. The framework is essentially based on an aggregate demand and supply approach. The demand side is directly derived from a simple Keynesian model of the real sector in the economy, ignoring monetary and price-determination mechanisms. This approach was chosen because (as described in Chapter 6) the Palestinian economy does not have an independent monetary and financial sector. Money supply is totally endogenous and determined by the balance of payments. Nominal variables such as the price system and interest rates are strongly tied in with the Israeli economy. Thus, we look at the real economic functions generating aggregate demand in the economy in their most elementary form.

The supply side in the simulation is represented by a simple Cobb-Douglas type aggregate production function. We elaborate later on the estimation method and the results. At this stage it suffices to state that an estimate of the supply and demand sides of the national economy is necessary for the formulation of a comprehensive analysis of existing and potential future trends and needs, which includes forecasting possible unemployment, investment requirements to achieve economic goals, and the trade flows that will have to be generated in order to create full employment conditions.

1. *Simulation of the Demand Side*

a. *The methodology*

The demand side simulation is presented in Tables 8.1–8.3. Table 8.1 displays the list of endogenous and exogenous variables. Note that government consumption and investment spending are defined as exogenous variables. Since, to the best of our knowledge, these two variables are not correlated with any other variable, this seems to be the most reasonable assumption. Factor income from foreign sources (FIA) consists mainly of Palestinian workers' remittances from Israel, and this variable is assumed to be exogenous, although it might be related to the level of activity and to the demand for labor services in the Palestinian territories. Since we were unable to find a satisfactory relationship between FIA and other endogenous variables, we define it as exogenous.

Table 8.2 presents the identities and estimated equations. Our approach is based entirely on estimating a set of behavioral equations (consumption, investment, etc.) and combining them into the basic identities of national accounts in order to obtain estimates of "demanded GDP" (or GNP) in the economy. The equations in the model are all linear, and were computed as ordinary least squares (OLS) estimates.¹

The demand side model in Table 8.2 is presented in general terms. It is based on a set of identities, of which identity 10 is probably the most important, since it identifies the demanded level of GDP in the economy. To build the estimates of the various variables in identity 10 (consumption, investment, government demand, etc.), a set of equations is estimated, one for each of the relevant demand-side variables. Nine equations are estimated: one for private consumption

¹ One might criticize the use of OLS estimates in an econometric model, since such models usually use simultaneous equation techniques. In our case, simultaneous equations were estimated using two-stage least squares measures, whose coefficients were not significantly different from the ones estimated with OLS, and their fit to actual figures was inferior to the ones shown here. Since our main interest is in forecasting, we chose the model that gave the better fit, namely the OLS estimates, and not the one that in theory provides more statistically correct coefficients. Intriligator (1978), Ch. 11, gives a long list of cases where OLS estimates should be considered as an appropriate and desired technique for the estimation of simultaneous equations, especially when the model is recursive (and our model has a strong recursive element). Moreover, the major purpose of the present study is forecasting, not testing, hypotheses. The two features justify the use of OLS instead of two-SLS or three-SLS estimates.

Table 8.1
List of Variables—The Demand Side

Endogenous variables		Exogenous variables	
GDP	Gross domestic products at market prices	FIA	Factor income from foreign sources
GNP	Gross national product	FPA	Payments to foreign factors
E	Aggregate demand	TFG	Government transfers to the private sector
C	Private consumption	UTF	Foreign transfers to the private sector
DIP	Private disposable income	IGOV	Government investments
TIND	Net indirect taxes	G	Government expenditures in the Palestinian economy
I	Gross fixed capital formation	DIPIS86	Disposable income in Israel
IINDUS	Investment in the business sector	RJDNIS	Real exchange rate of Jordanian Dinar in NIS
IHOUSE	Investment in residential buildings	AFF	Domestic product of the agricultural sector
ISTOCK	Investment in stock	T	Time
X	Exports	D	Dummy variable
XIS	Exports to Israel		
XOTH	Exports to other countries		
IM	Imports		
IMIS	Imports from Israel		
IMOTH	Imports from other countries		

spending, two for tax revenues, two for private investment, two for exports, and two for imports. A dynamic element is introduced in two of the equations (private consumption and investment in residential construction) by using a one-year-lagged dependent variable as an explanatory variable.

The model in Table 8.2 is estimated for variables denominated in US dollars at constant 1986 prices, for the West Bank and the Gaza

Table 8.2
Simulation Equations—Demand-Side Model

Functions

- $C_t = a_1 + b_{10} \text{DIP}_t + b_{11} C_{t-1}$ (consumption function)
- $\text{TD} = a_3 + b_{30} \text{GNP}$ (direct taxes)
- $\text{TIND} = a_2 + b_{20} \text{GDP}$ (indirect taxes)
- $\text{IINDUS} = a_4 + b_{40} \text{GNP}$ (investment in production)
- $\text{IHOUSE}_t = a_5 + b_{50} \text{DIP} + b_{51} \text{IHOUSE}_{t-1}$ (investment in housing)
- $\text{XIS} = a_6 + b_{60} \text{DIPIS86}$ (exports to Israel)
- $\text{XOTH} = a_7 + b_{70} \text{RJDNIS} + b_{71} \text{AFF}$ (exports to other countries)
- $\text{IMIS} = a_8 + b_{80} \text{GNP}$ (imports from Israel)
- $\text{IMOTH} = a_9 + b_{90} \text{GNP}$ (imports from other countries)

Identities

- $E = C + I + G + X - \text{IM}$ (aggregate demand)
- $\text{GNP} = \text{GDP} + \text{FIA} - \text{FPA}$ (gross national product)
- $\text{DIP} = \text{GDP} - \text{TIND} + \text{FIA} - \text{FPA} - \text{TD} + \text{TFG} + \text{UTF}$ (disposable income)
- $I = \text{IINDUS} + \text{IHOUSE} + \text{IGOV}$ (total investment)
- $X = \text{XIS} + \text{XOTH}$ (total exports)
- $\text{IM} = \text{IMIS} + \text{IMOTH}$ (total imports)

Table 8.3
The Estimated Demand-Side Model*

a. Gaza Strip

	R ²	D.W.
1. Consumption ^a $C_t = 0.6122 \text{Dip} + 0.2487 C_{t-1}$ (7.15) (2.23)	0.974	1.90
2. Exports to Israel ^b $\text{XIS} = + 0.00652 \text{Dipis86}$ (9.79)	0.82	1.71
3. Exports to other countries $\text{XOTH} = -60.98 + 10.81 \text{RJDNIS} + 0.858 \text{AFF} - 1.54 \times \text{TIME}$ (-2.63) (3.95) (4.50) (-5.58)	0.72	1.97
4. Imports from Israel ^b $\text{IMIS} = 189.53 + 0.378 \text{GNP}$ (2.73) (2.80)	0.81	2.00

Table 8.3 (cont.).

5. Imports from other countries IMOTH = 10.610 + 0.0519 GNP (2.57) (5.92)	0.66	1.85
6. Investment in the business sector ^{b, c} IINDUS = 0.039 GNP (5.51)	0.70	1.80
7. Investment in housing ^{a, c} IHOUSE = 0.046 DIP + 0.710 IHOUSE _{t-1} (2.577) (5.69)	0.90	2.16
8. Indirect taxes ^b TIND = +0.028 GDP (3.64)	0.81	1.69
9. Direct taxes ^{b, c} TD = 0.055 GNP (8.98)	0.88	2.30
<i>b. The West Bank</i>		
10. Consumption ^a C _t = 109.10 + 0.27 DIP + 0.58 C _{t-1} (3.90) (3.27) (4.96)	0.98	1.78
11. Exports to Israel ^f XIS = 0.00387 DIPIS86 + 0.20 AGIND (3.27) (2.82)	0.60	1.60
12. Exports to other countries XOTH = -61.44 + 24.56 RJDNIS + 0.12 AGIND (-3.85) (6.03) (3.11)	0.84	1.68
13. Imports from Israel IMIS = 78.21 + 0.38 GNP (2.17) (11.52)	0.89	1.78
14. Imports from other countries ^{b, c} IMOTH = 0.0556 GNP (11.30)	0.47	1.84
15. Investment in the business sector ^{b, c} IINDUS = 0.0526 GNP (9.50)	0.47	1.43
16. Investment in housing ^{a, c} IHOUSE _t = 0.078 Dip + 0.427 IHOUSE _{t-1} (4.08) (2.75)	0.92	1.70
17. Indirect taxes TIND = 14.88 + 0.023 GDP + 44.59 D8384 ^d (2.82) (3.78) (6.68)	0.78	1.48

Table 8.3 (cont.).

18. Direct taxes TD = -6.375 + 0.044 GNP (-1.49) (10.74)	0.86	1.60
19. Investment in inventories ^b ISTOCK = -107.475 + 0.539 AFF (-7.45) (8.79)	0.82	2.13

* Figures in parentheses are t-values.

^a LM tests for serial correlation show that no serial correlation exists at the 10% level of significance.

^b This equation is estimated using the Cochrane-Orcutt procedure.

^c The hypothesis that the constant is zero was accepted.

^d D8384, a dummy variable, equals 1 for 1983 and 1984.

Strip separately. The estimated equations appear in Table 8.3, and reveal several interesting points. First, all the coefficients have the expected signs. From an economic point of view, therefore, the Palestinian territories react as expected to economic change, despite the unusual political situation. Secondly, the consumption function for the Gaza Strip shows that the marginal propensity to consume is 0.59 in the short run, for transitory changes in disposable income, and 0.77 for permanent changes in disposable income. The corresponding numbers for the West Bank are 0.27 and 0.69. An increase in economic activity (GNP) stimulates productive investments slightly, but has a major positive effect on residential construction. Another interesting finding is the low coefficients in the tax equations, implying that the effective tax rates are very low by Western standards.

The validity of the model can be verified if we apply it to the past and test its fit to actual data. Technically, we estimate all the endogenous variables by introducing actual exogenous variables in the equations in Table 8.3.

The fit of this equation model to reality is shown graphically in the set of Figures 8.1-8.20. The general impression is that the model provides a satisfactory forecasting instrument for the demand side of the Palestinian economy. Nevertheless, there are several deviant cases. Two major causes are responsible for these deviations: one is the political climate, and the second is the availability of reliable statistical data.

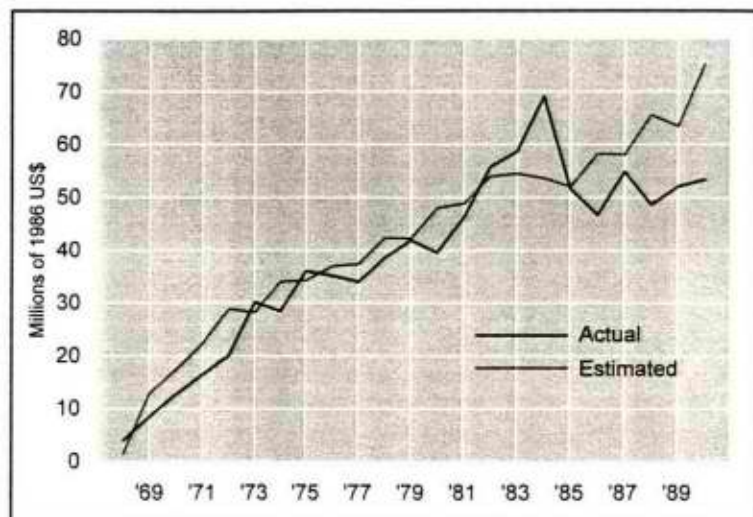


Figure 8.9. Direct Taxes: The West Bank

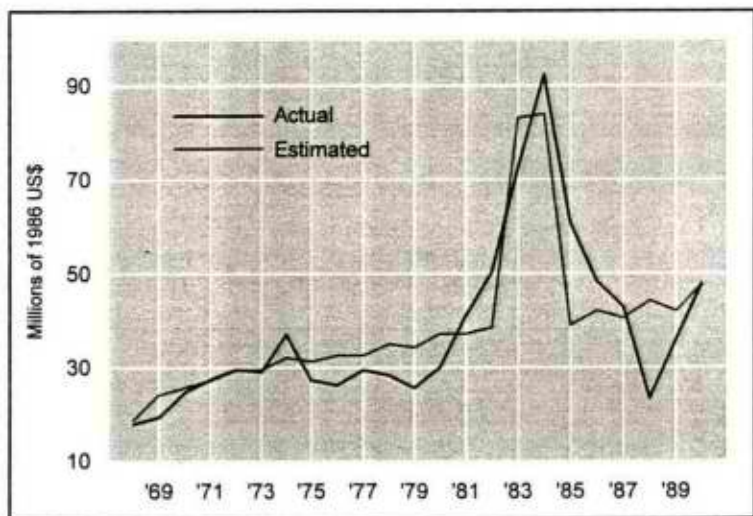


Figure 8.10. Net Indirect Taxes: The West Bank

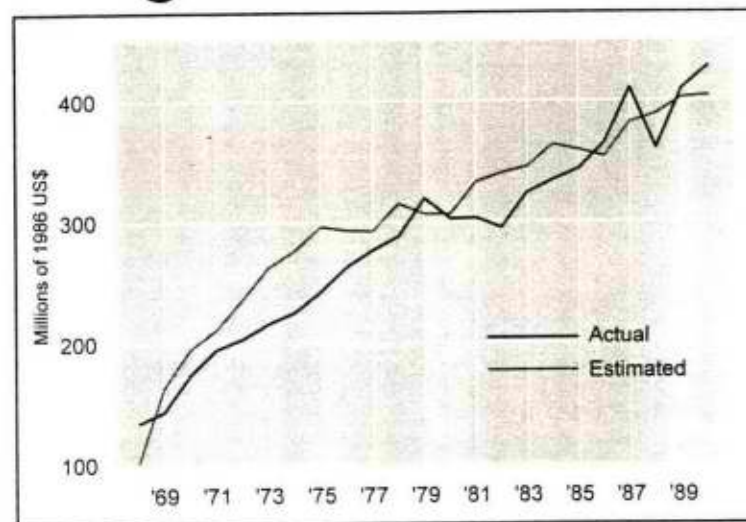


Figure 8.11. Gross Domestic Product: The Gaza Strip

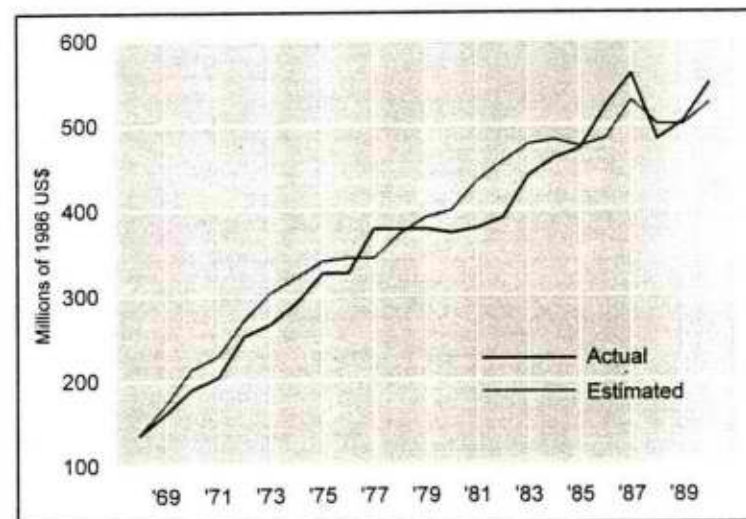


Figure 8.12. Private Consumption: The Gaza Strip

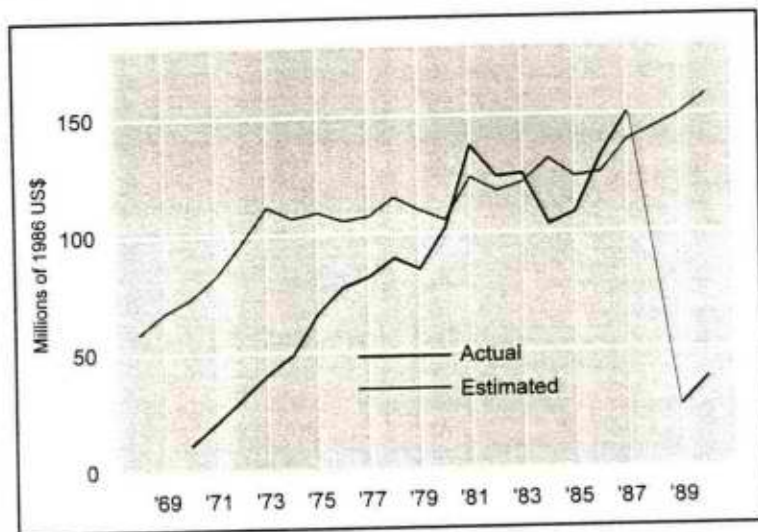


Figure 8.13. Exports to Israel: The Gaza Strip

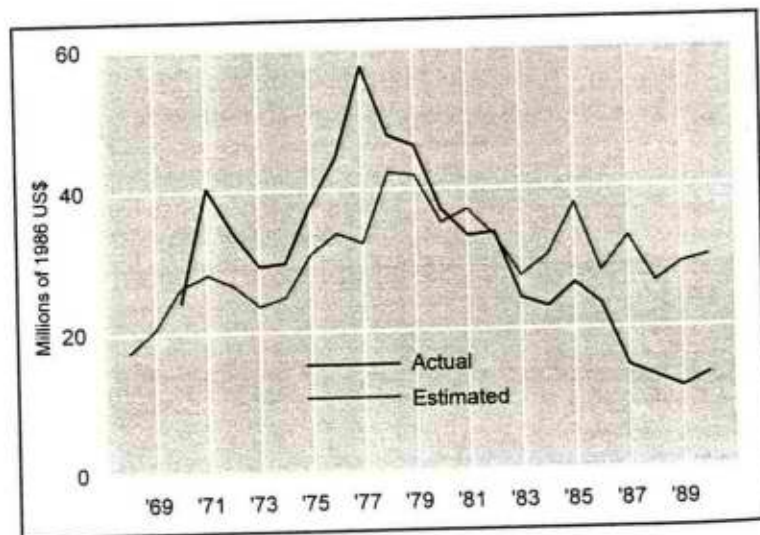


Figure 8.14. Exports to Other Countries: The Gaza Strip

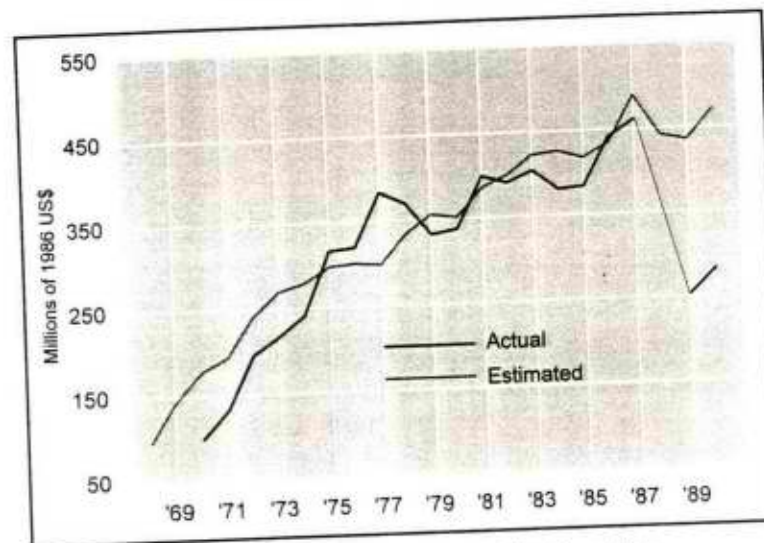


Figure 8.15. Imports from Israel: The Gaza Strip

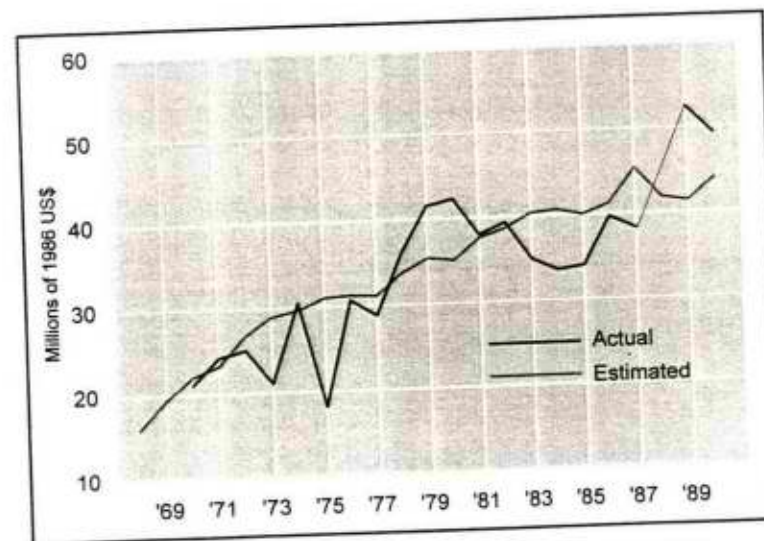


Figure 8.16. Imports from Other Countries: The Gaza Strip

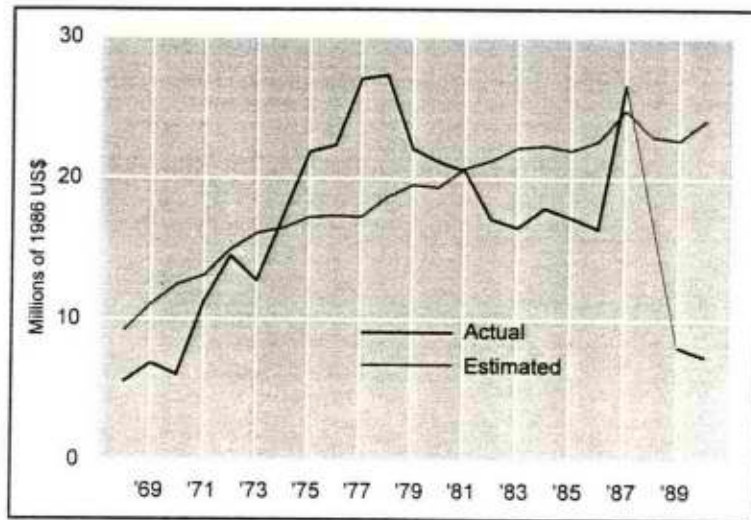


Figure 8.17. Investment in the Business Sector: The Gaza Strip

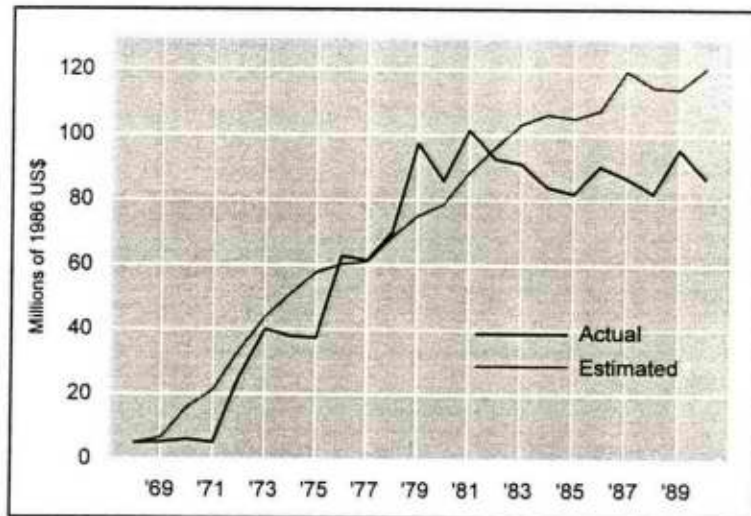


Figure 8.18. Investment in Residential Building: The Gaza Strip

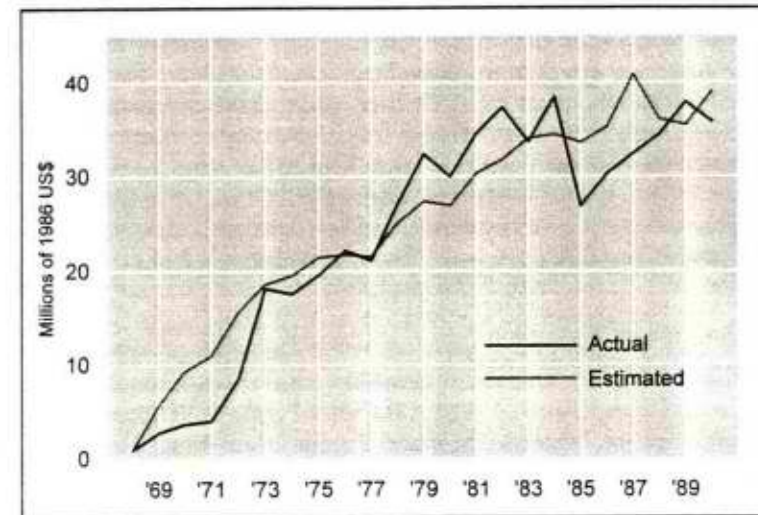


Figure 8.19. Direct Taxes: The Gaza Strip

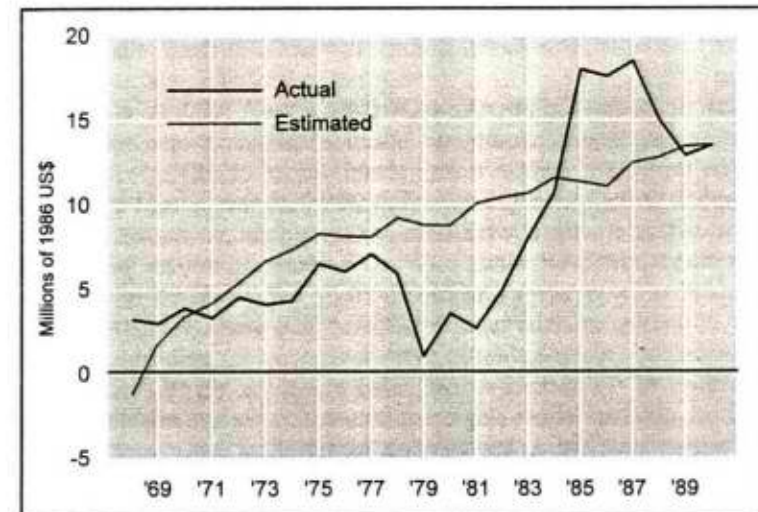


Figure 8.20. Net Indirect Taxes: The Gaza Strip

Generally speaking, the demand side simulation provides a better fit for the West Bank than it does for the Gaza Strip. The West Bank data may be better than the Gaza Strip data. Moreover, it is certainly possible that non-economic effects or shocks have a stronger impact in the Gaza Strip, leading to more widely fluctuating economic behavior, representing weaker economic logic. The Gaza Strip is therefore a more difficult system to simulate artificially. As we will see later, this is only true for the demand side, not for the supply side of the two economies in question.

b. Analysis of the results

The following brief discussion describes some of the most interesting results. A comparison of Figure 8.1 with Figure 8.11 illustrates the better fit of the demand-side model for the West Bank. The relative and absolute differences between estimated and actual values of demanded GDP (at market prices) are significantly smaller for the West Bank than for the Gaza Strip (the average error term is 5 percent for the West Bank and 8 percent for the Gaza Strip). The major component in demanded GDP in both economies is private consumption. Figures 8.2 and 8.12 show that the consumption estimates are more accurate and of better quality for the West Bank than for the Gaza Strip.

The estimates of demanded GDP for the West Bank do not capture the fluctuations generated by the bi-annual nature of olive tree yields, which are clearly visible in the actual values of GDP. Private consumption, though strongly related to GDP, exhibits a much smoother curve of actual values, with more moderate fluctuations; this is probably due to the determination of private consumption by permanent, rather than by transitory income.

A surprising result is related to the *intifada* years. Actual GDP and private consumption values in these years would *a priori* be expected fall short of the respective estimated values. In the West Bank we find the opposite result (Figures 8.1 and 8.2), and in the Gaza Strip there is no clear effect. The findings for the West Bank require explanation. The first factor contributing to this surprising result is dynamic: olive crops in 1986 were unusually high, raising GDP 23 percent above the level of the previous year. The result was a 17 percent rise in private consumption in 1986 year and another 7 percent in 1987.

This bumper crop represents a dynamic (long-run) effect on private consumption, which may have offset the possible negative effects of the *intifada* on this variable.

The second factor is probably directly related to the political and security conditions during the *intifada*. From 1988 onward, disposable income per given level of GDP rose; this was caused by a steep drop in tax collection in the West Bank (Figures 8.9 and 8.10). Indeed, actual direct and indirect taxes were substantially lower than in previous years and lower than their estimated values. It is not clear why this decrease in tax collection occurred. If difficulties in tax collection were aggravated by security problems or dissent, then the question is why did direct tax revenues in the Gaza Strip rise until 1989. We have no answer. The fact is that tax collection did fall in the West Bank during the *intifada* years, and private consumption did rise, raising GDP.

A third factor contributing to the upward GDP bias is a significant rise and upward bias of business capital formation at the same time (Figure 8.7). The investment functions for both the West Bank and the Gaza Strip are highly cyclical. The estimates do not capture the cycles, although an attempt was made to use accelerator models. Nevertheless, the actual investment data (Figures 8.7 and 8.17) support the hypothesis that investments do follow an accelerator or cyclical pattern in both Palestinian territories.

Exports from the West Bank to Israel are strongly related to Israel's disposable income level and to the West Bank's supply of exported goods, as represented by the sum of agricultural and industrial outputs (equation 11 in Table 8.3). West Bank exports to other countries are strongly affected by the exchange rate of the Jordanian dinar, and by outputs of exportable goods. Figure 8.4 shows the powerful effect of olive crops on West Bank exports.

Imports from Israel to the West Bank are closely related to local GNP (national income). Imports from other countries are also statistically significantly related to GNP in the West Bank. Nevertheless, as Figure 8.6 reveals, the actual values of this variable exhibit a cyclical pattern that is amazingly similar to the cycles of business investments (Figure 8.7). The implication is that most imports from countries other than Israel consist of capital goods, while most imports from Israel are consumer goods. For forecasting purposes, we leave the imports from "other countries" equation (equation 14) as is, and do not intro-

duce domestic business investment as an explanatory variable because we believe that in normal times imports from other countries will also include consumer goods.

The exports and imports equation generate a worse fit for the Gaza Strip than for the West Bank. Exports to Israel are clearly related to the level of disposable income in Israel, but they are apparently more strongly related to supply variables in the Gaza Strip. In other words, as in many small economies, Gaza Strip exports are determined mainly by domestic supplies of exportable goods, and less by foreign demand. Exports to other countries are affected by real exchange rates and by agricultural output. The fluctuations of the export variable are captured by the model, but there is a systematic bias of the estimates compared with the actual values, which the model does not solve.

Imports from Israel are strongly related to income (GNP) in the Gaza Strip. As in the West Bank, this relationship mostly represents consumer goods. Imports from other countries are also clearly related to income, but actual values fluctuate (Figure 8.16) and indicate a cyclical behavior. Unlike the West Bank case, the cycles here do not coincide with cycles of business capital formation, and consequently we may not infer that this component of total imports consists mainly of capital goods.

2. Simulation of the Supply Side

The supply side of the Palestinian economy is represented by two aggregate production functions relating the level of domestic output (GDP at factor prices) to the employed labor input, to capital input, and to the time variable. The research goal in estimating production functions is to develop the ability to estimate potential output. A comparison of the estimated demanded and actual outputs is the basis for assessing future unemployment levels. Such comparisons may also shed light on the effect of macroeconomic conditions on the volume of international trade and trade balances. Aggregate production functions in conjunction with the levels of capital formation are also a necessary instrument for estimating productivity in general, and labor productivity in particular.

We estimate Cobb-Douglas production functions involving constant returns to scale. The estimated production functions are of the following type:

$$Y = Ae^{gt} K^a L^{(1-a)}$$

where: Y denotes GDP at factor prices, t is a time variable, K and L denote capital stock (two options are used: capital stock with housing and capital stock without housing) and the number of employed workers, respectively. A is a technological coefficient, g is an average measure, over time, of total factor productivity (TFP), and a and $(1-a)$ are the shares of capital and labor in GDP, respectively. The production functions were estimated for both the West Bank and Gaza Strip.

Direct estimation of the production function was not possible because of a serious problem of multicollinearity. We therefore use an indirect method, based on statistical information on the shares of labor and capital in GDP from which we derive the following coefficients: A (the technological coefficient) and g (the rate of technical change). In some cases, dummy variables were used in order to capture qualitative factors such as the effect of the *intifada*. The estimated regression equation is:

$$\ln Y_t = \ln A + gt + a \ln K_t + (1-a) \ln L_t + b_1 D_1 + b_2 D_2$$

where a and $(1-a)$ are directly computed from the statistics as the capital and labor shares in GDP, respectively; and D_1 and D_2 are dummy variables. The results of this estimation procedure appear in Table 8.4.

A series of reliability tests were applied to the data that served in estimating the production functions in Table 8.4. We ran two tests, recommended in Intriligator (1978, Ch. 8):

- a. In the first test we estimated the equation:

$$Y/L = A(W/P)^{s/(1+\beta)}$$

where $s = 1/(1 + \beta)$ is the elasticity of substitution between capital and labor and W/P denotes real wages. In order to rely on the Cobb-Douglas form, the estimated elasticity of substitution s cannot be statistically significantly different from 1.

- b. In the second Cobb-Douglas test we regress a factor share, say $(1-a)$, against the capital-labor ratios, and expect to find no statistically significant relationship. In other words, when the statistically measured $(1-a)_t$ is regressed against $(K/L)_t$ as follows: $(1-a)_t = c + b(K/L)_t$, coefficient b has to be statistically insignificant.

Our data are consistent with these two Cobb-Douglas tests, and therefore the equations in Table 8.4 may be considered reliable.

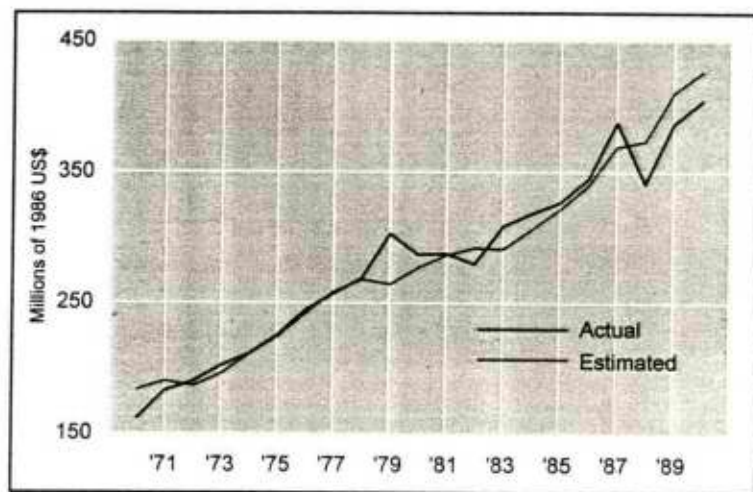


Figure 8.23. Production Function: The Gaza Strip

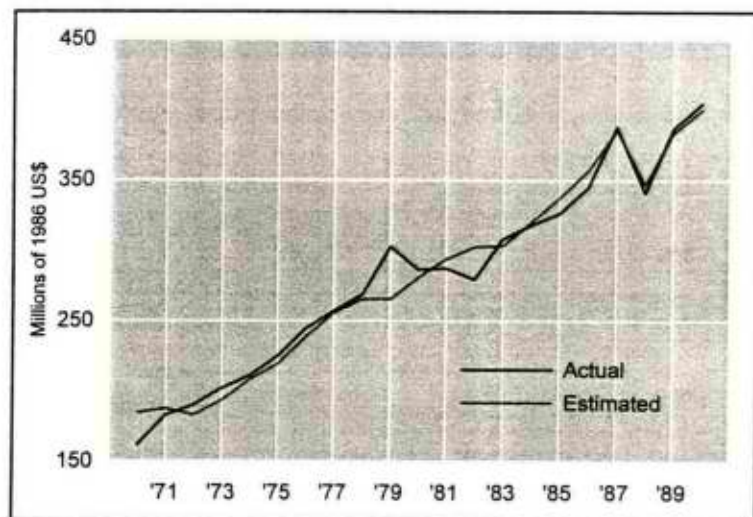


Figure 8.24. Production Function: The Gaza Strip
(with dummy variable for 87-90)

A comparison of the computed levels of GDP with the actual levels is graphically displayed in Figures 8.21 to 8.24, which show an excellent fit for the West Bank and even better fit for the Gaza Strip. The average error term for both regions is approximately 3 percent. The figures leave no doubt as to the accuracy and reliability of the estimated production functions.

The coefficients in Table 8.4 indicate that the West Bank has a higher share of capital and a lower share of labor in GDP than does the Gaza Strip. One interpretation of these coefficients is that the technologies used in the West Bank are more capital-intensive than those in the Gaza Strip. True, technology factor A is very similar in the West Bank and Gaza Strip production function equations; in fact, there is no statistically significant difference between the estimates of A. However, the West Bank has a consistently higher total factor productivity (TFP—the coefficient of the time variable), which may imply that the neutral technological change generated by the phenomena we define as TFP was stronger in the West Bank. The West Bank seems to have been more efficient in adopting new technologies and converting them into higher levels of output. In both territories, the *intifada* dummy variable generates a negative and significant coefficient. The numerical value of these coefficients indicates that the West Bank suffered a loss of 17–25 percent in total productivity and the Gaza Strip—12 percent (the lower figure for the West Bank, 17 percent, seems to be more realistic).

The coefficient of the olive crop dummy variable in all equations is approximately 10 percent, implying that the bi-annual olive crop generates an average GDP fluctuation of approximately 10 percent.

Table 8.4 provides a simulation instrument that can be used to estimate interesting parameters. For example, if the entire labor force in the West Bank were to be employed at home, and the capital stock remained constant, both average output per worker and the average wage rate would decrease by 14 percent (13 percent in the Gaza Strip). If only 50 percent of the workers employed in Israel were re-absorbed into the West Bank or the Gaza Strip, the decrease in output per worker would be approximately 8 percent in both Palestinian territories.

Another calculation relates to the level of capital stock that would be required in the Palestinian economy to absorb all the Palestinian workers employed in Israel, provided that output per worker remains constant: \$2.0 billion in the West Bank and \$1.2 billion in the Gaza

Strip (in 1986 prices). These figures are a first approximation of the sums required for simple development programs in the Palestinian territories. The calculations assume that the production functions remain the same; naturally, under normal conditions technological change and increased productivity would be possible.

3. Prospects and Scenario Analysis

The econometric simulation model is now used to estimate potential future trends, to identify possible macroeconomic features and problems, and for a quantitative assessment of future needs.

a. Baseline scenario—the demand side

We begin with the baseline scenario of the demand side, which provides estimates of various macroeconomic variables under existing conditions. The values of these projected variables are generated assuming that the exogenous variables will follow the same trends that existed in 1980–90. The endogenous variables are all computed within the equation system presented in Tables 8.2 and 8.3.

The outcome of this exercise is partly displayed in Table 8.5. The purpose of the selected projections shown in this table is to characterize the nature of macroeconomic trends in the Palestinian economy, assuming that the perceived present behavioral and technological equations remain unchanged and that existing economic conditions and trends will persist. This stylized profile will serve as the basis for comparison in assessing future policies, and will reveal some of the fundamental problems in these economies.

Table 8.5 shows a selection of anticipated future variables that are of special interest for 1990 (actual values), 1996 and 2000. The year 1996 was chosen in order to avoid the problems related to the bi-annual feature of olive crops on the West Bank (using an even-numbered year eliminates this problem).

a. *Economic growth and employment.* In the baseline scenario, economic growth based on the demand side is expected to be faster in the Gaza Strip than in the West Bank, largely because of the stronger sensitivity of exports in the Gaza Strip to increases in disposable income in Israel. In other words, Gaza Strip exports to Israel, which account for approximately 90 percent of total exports, are expected

Table 8.5
Estimated Values of Future Macroeconomic Variables: Demand Side
Estimates—Baseline Scenario (mill. 1986 US\$ unless otherwise stated)

	1990		2000	
	West Bank	Gaza Strip	West Bank	Gaza Strip
1. GDP	1,454.0	428.1	2,101.2	687.7
2. Average annual percent change, 1990–2000	—	—	3.8	4.9
3. GNP	1,890.6	667.8	2,745.3	1,035.5
4. Average annual percent change, 1990–2000	—	—	3.8	4.5
5. Direct government surplus (incl. govt. investment)	-5.83	-12.7	-142.2	-2.0
6. Percent of GNP	0.3	1.9	5.2	0.2
7. Total government surplus including VAT + import duties collected by Israel	41.1	31.1	74.2	106.3
8. Percent of GNP	2.2	4.7	2.7	10.3
9. Trade surplus	-576.0	-280.2	-829.9	-391.0
10. Net factor income	436.3	239.7	644.1	347.5
11. Unilateral transfers	49.4	65.4	37.5	84.9
12. Current account surplus (total)	-90.3	24.9	-148.2	41.4
13. Percent of GNP	-4.7	3.7	-5.3	3.0
14. Trade surplus with Israel (including remittances)	-120.9	-4.5	-152.1	-7.2
15. Domestically employed workers (thousands)	128.0	60.8	174.2	96.3
16. Labor force (thousands)	199.7	108.0	250.7	143.5
17. GNP per capita	2,019	1,065	2,258	1,188
18. Annual average percent change	—	—	1.1	1.0

to rise faster than West Bank exports, thus generating more rapid economic growth in the former region. Bear in mind that this result is based on an extrapolation of trends from 1980 to 1990.

In the case of the West Bank, GNP growth is expected to be similar to GDP growth, unlike the Gaza Strip where GDP is expected to grow faster than GNP. The anticipated annual rates of growth are around 4 percent, which would be considered fairly high in developed countries. However, in view of the development needs of the two territories and their production capacity, such rates of growth are very low, and quite inadequate for the Palestinian economy's needs.

As shown in lines 15 and 16 of Table 8.5, the employment generated by aggregate demand (GNP) is significantly lower than the respective labor forces in both territories. The employment figures are produced by combining the projected demanded GDPs (line 1) with implied future values of the capital stocks and the estimated aggregate production functions in Table 8.4. The future labor force is estimated by simply extrapolating from the trends in 1980-90. Line 15 indicates that when TFP and the projected growth of capital stock are accounted for, the demanded level of GDP in the West Bank in the year 2000 is expected to generate an employment level of approximately 174 thousand workers—far less than the projected labor force of 250 thousand. In the Gaza Strip, the number of domestically employed workers is expected to rise to 96.3 thousand, which will still be far below the projected size of the labor force (143.5 thousand). If Palestinian workers are not allowed to work in Israel, the baseline scenario predicts unemployment levels of 31 and 33 percent in the West Bank and Gaza Strip, respectively.

These figures, though they could be inaccurate and the projection might have a significant error term, highlight a serious problem: the Palestinian economy has in the past, and is expected to suffer in the future from chronic overcapacity, or deficiency of demand levels. In the past, most of the surplus labor force was employed by channeling Palestinian workers to Israel. If the present scenario materializes, the Palestinian economy will either suffer from chronic and rapidly increasing unemployment, or will come to depend permanently on Israeli and other foreign labor markets for employment (or both). The second possibility seems unlikely, because neither Israel nor the Palestinians desire it (see Diwan and Walton, 1994) on ideological, political, social, security, and purely economic grounds. Indeed, as shown in the next section, in the long run it would be beneficial (in terms of GNP and

productivity) for Palestinians working in Israel to switch to jobs in the West Bank and Gaza Strip, thereby increasing their GNP and correctly reallocating their labor force.

There is no doubt that the phenomenon discussed above is one of the fundamental problems of the Palestinian economy. Persistent deficient demand and high unemployment will have inimical social and political effects, will contribute to the creation of a stagnating economy, and will waste available resources. Success or failure in creating productive employment for these workers, and in bringing actual national output as close as possible to potential output, might make the difference between creating a modern and growing economy similar to newly-industrialized countries (NICs), or generating a third-world type economic system.

The demand policies that should be implemented are obviously those that stimulate aggregate demand. Such policies should be consistent with the effective constraints of the economy and should serve the long-term goal of economic growth and development. Recent literature in economic development suggests that a stable macroeconomic environment, undistorted foreign exchange markets, and openness to international trade are conducive to sustainable economic growth (Fischer, 1993; World Bank, 1991). Therefore, the policies designed to increase demand components (investment, government spending on public consumption and investment, and desirable exports) should seek to avoid high inflation, excessively large budget deficits, and massive intervention in the international trade and foreign currency sectors. We will return to some of these aspects below.

b. *Government deficits.* In the baseline scenario, direct budget deficits (including government investment) are expected to rise in the West Bank and fall steeply in the Gaza Strip. These opposite trends stem from the higher growth of projected tax revenues in the Gaza Strip, which will be generated by the faster growth of income there. Moreover, the growth of government spending (which is an exogenous variable in our model) is expected to be lower in the Gaza Strip: the budget deficit here is expected to virtually disappear by the year 2000. In the West Bank, on the other hand, it is projected to rise to 5 percent of GNP.

Lines 5 and 6 in Table 8.5 provide a partial picture of the fiscal conditions in the Palestinian economy. As shown in Chapter 2, effective tax collection by the Israeli government in the Palestinian territories before the implementation of the Oslo Agreement was much

higher than suggested by the official statistics. The difference can be attributed, among other things, to the VAT collected by the Israeli government on Palestinian imports from Israel and to customs duties levied by Israel on imports from abroad. When these taxes are added to government revenues, the apparent deficits appearing in the statistics of both the Gaza Strip and West Bank are transformed into substantial surpluses (lines 7 and 8 in Table 8.5). In the year 2000 these surpluses are expected to reach 2.7 percent and 10.3 percent of GNP in the West Bank and Gaza Strip, respectively.

The Paris Agreement (see *Protocol*, Articles V and VI) provides for a system of tax collection refunding between the Israeli government and the PLO. Custom duties collected by Israel on Palestinian imports passing through Israel and VAT revenues from Palestinian purchases of goods and services in Israel are to be refunded to the Palestinian Authority. A 75 percent refund of income taxes collected in Israel from Palestinian workers was also agreed upon. If these principles are implemented and preserved in the future, the tax revenues of the Palestinian Authority will exceed the projections of tax revenues based on Israeli direct tax collection in the Palestinian territories during the years of occupation (which was in any case rather limited, owing to enforcement problems). Therefore, the estimates that take into account indirect VAT and custom duties collected on imports from Israel and the rest of the world (lines 7 and 8) are probably more realistic as far as government revenues are concerned.

As for government spending, the estimates are clearly downward biased since they are based on Israeli government expenditure in the Palestinian territories, which was relatively low—8–9 percent of GNP in each territory.

The above findings are important because they demonstrate that if existing taxes are levied and collected, the government in the Palestinian economy will have substantial public resources at its disposal for spending on public consumption and investment, without necessarily creating a budget deficit (subject, of course, to the effective enforcement of tax laws by the Palestinian Authority). At any rate, an increase in public spending, using these or other resources, will contribute both to the generation of badly needed public goods (education, health, etc.), in addition to infrastructure. Furthermore, such a policy will certainly increase aggregate demand, thereby reducing the level of unemployment (or the level of employment abroad) and narrowing the gap between actual and potential GDP.

c. *The balance of external trade.* Lines 9–13 in Table 8.5 indicate that if existing trends continue, both the Gaza Strip and the West Bank will eventually have growing trade deficits. When income and unilateral transfers of foreign workers are accounted for, the West Bank will still face a current account deficit exceeding 5 percent of its GNP in the year 2000. The Gaza Strip, however, is expected to develop a rising current account surplus, reaching 3 percent of its GNP in the year 2000. In both cases these projections are downward biased, because large-scale private and public investment is expected in both the West Bank and Gaza Strip. The present levels of imports and exports are therefore probably not the appropriate basis for a simulation of future trends.

The investment projects, if and when they materialize, will certainly increase imports in the short run. In the longer run they will increase the supply of traded goods and improve international competitiveness, possibly increasing exports. In other words, both exports and imports are expected to follow different trajectories than the ones projected in the baseline scenario. An important result appears in line 14 and indicates that both Palestinian economies are expected to have trade deficits with Israel, over and above the size of workers' remittances.² The prospects in this context are troubling, especially if a free-trade agreement is envisaged between Israel and the Palestinian economy. The viability of such an agreement becomes doubtful when bilateral trade flows are seriously unbalanced, as such imbalance can tempt the Palestinian party to violate the agreement or abolish it altogether—a unilateral measure that is both economically undesirable and politically unhealthy.

The anticipated current account deficits imply that the Palestinian economy will first have to receive foreign credit or foreign aid, or both, in the foreseeable future in order to finance its current account deficit. The limits of this foreign exchange financing represent a foreign-currency constraint, which applies to investment, government expenditure and other employment-generating components of aggregate demand. One important way of stimulating domestic employment by enhancing demand without stretching the foreign-currency constraint

² Note, however, that future Palestinian trade relations, especially with Israel, need not necessarily follow present or recent past trends, although forecasts of uneven bilateral trade flows of similar magnitudes between Israel and the Palestinian economy have been made in other studies as well (Arnon and Weinblatt, 1994; and Halevi, 1994).

is by increasing exports. This solution calls for an outward-oriented growth strategy that emphasizes improving the international competitiveness of the economy.

b. The supply side—Baseline conditions and scenarios

We now turn to look at the projections emerging from the supply side equations (Table 8.4). Reference to the production functions was made in the previous section, when projected employment levels were compared with the respective labor forces in the two Palestinian economies. The importance of the supply side analysis is in providing insights into potential levels of economic activity, and in estimating the human and technological requirements for achieving a variety of economic goals (as shown in Luski and Weinblatt, 1994a, 1994b).

Projected levels of potential GNP and GDP and their growth rates under a variety of assumptions appear in Table 8.6. Line 1 in Parts a and b of the table represent the projected levels of potential GNP, GDP, and their per capita values in the West Bank and Gaza Strip, assuming that existing (1980–90) trends will continue. They are significantly higher than the projected rates of growth of demanded GDP, which implies that a significant portion of the Palestinian labor force will continue to be employed in Israel. The projected increase in the domestic labor force, capital stock, and productivity in this scenario generate average annual growth rates of potential GDP of 6.2 and 5.8 percent in the West Bank and Gaza Strip, respectively. The corresponding figures for potential GNP are 5.7 and 5.1. Recall that in the same period, the projected growth rates of demanded GDP (Table 8.5) were 3.8 and 4.9 percent, and demanded GNP—3.8 and 4.5 percent for the West Bank and Gaza Strip, respectively. Clearly, growth on the supply side significantly exceeds growth on the demand side, providing more evidence of what we believe is the fundamental economic problem of the Palestinian economy: a deficiency of demand. Existing levels of demand are inadequate to absorb potential levels of output. This conclusion is based on the minimalistic case, assuming that large-scale employment of Palestinian workers in Israel will continue. In the more realistic case—the repatriation of all or most Palestinian workers—the gap between potential and actual GNP will widen, and projected potential unemployment will be much greater (lines 2 and 3 in Parts a and b of Table 8.6).

Table 8.6
Potential GDP and GNP: Alternative Scenario Estimates

Year and Scenario:	GDP (mill. 1986 US\$)		GDP per capita (1986 US\$)		GNP (mill. 1986 US\$)		GNP per capita (1986 US\$)	
	Value	Annual % change	Value	Annual % change	Value	Annual % change	Value	Annual % change
<i>a. The West Bank</i>								
1990 (actual values)	1,454	—	1,553	—	1,890	—	2,017	—
2000								
1. Existing trend (1980–1990) (baseline scenario)	2,652	6.2	2,181	3.5	3,296	5.7	2,711	3.0
2. Repatriation of all workers from Israel	3,929	10.5	3,231	7.6	3,912	7.5	3,222	4.8
3. Repatriation of half the workers from Israel	3,325	8.6	2,735	5.8	3,642	6.8	2,995	4.0
<i>Assume \$1 billion additional investments</i>								
2000								
1.1 Baseline scenario	2,729	6.5	2,245	3.8	3,374	6.0	2,775	3.2
2.1 Repatriation of all workers from Israel	4,044	10.8	3,326	7.9	4,033	7.0	3,317	5.1
3.1 Repatriation of half the workers from Israel	3,433	9.0	2,815	6.1	3,739	7.1	3,075	4.3
<i>Assume \$2 billion additional investments</i>								
2000								
1.2 Baseline scenario	2,850	7.0	2,344	4.2	3,494	6.3	2,874	3.6
2.2 Repatriation of all workers from Israel	4,222	11.2	3,472	8.4	4,211	8.3	3,463	5.6
3.2 Repatriation of half the workers from Israel	3,574	9.4	2,939	6.6	3,889	7.5	3,199	4.7

Table 8.6 (cont.).

b. The Gaza Strip									
1990 (actual values)									
2000		428	683	—	667	—	1,065	—	
1. Existing trend (1980-1990) (baseline scenario)		755	867	5.8	1,103	5.2	1,266	1.7	
2. Repatriation of all workers from Israel		1,176	1,375	10.6	1,180	5.9	1,355	2.4	
3. Repatriation of half the workers from Israel		985	1,131	8.7	1,151	5.6	1,321	2.2	
Assume \$1 billion additional investments									
2000									
1.1 Baseline scenario		789	906	6.3	1,136	5.5	1,304	2.0	
2.1 Repatriation of all workers from Israel		1,251	1,436	11.3	1,234	6.3	1,417	2.9	
3.1 Repatriation of half the workers from Israel		1,090	1,182	9.8	1,194	6.0	1,371	2.6	
Assume \$2 billion additional investments									
2000									
1.2 Baseline scenario		833	956	6.9	1,179	5.9	1,354	2.4	
2.2 Repatriation of all workers from Israel		1,320	1,516	11.9	1,304	6.9	1,497	3.5	
3.2 Repatriation of half the workers from Israel		1,087	1,246	9.8	1,252	6.5	1,437	3.0	

A series of interesting inferences may be drawn from Table 8.6. A comparison of the projected rates of growth in the baseline scenario (line 1) with the case of all Palestinian workers in Israel returning home for employment (line 2) reveals that repatriation makes a dramatically positive contribution to increasing the growth rates in both territories for potential GDP and GNP. With respect to potential GDP, this is not surprising, since repatriation implies that domestic employment grows by almost one half. The finding regarding GNP is less trivial. The substantial increase in the rate of growth of this variable implies that the Palestinian economy would gain a great deal from the reallocation of workers from the Israeli labor market to domestic employment. Thus, the Israeli-employed Palestinian workers generate a higher net national income when employed at home than when employed in Israel. To illustrate, in the year 2000, West Bank GNP would "gain" \$620 million (in 1986 prices), approximately 20 percent of their projected potential GNP (in the baseline case), if all workers were to return home for work. The gain is smaller in the Gaza Strip—only \$77 million, or approximately 7 percent of their projected GNP. But it is important to qualify this optimistic picture, as at least two conditions have to be met for such potential growth to occur: (i) the occupational composition of the Israeli-employed Palestinian workers should suit the needs of increased production in the West Bank and the Gaza Strip, and (ii) demand will also have to increase in order to absorb the additional output.

The above discussion, facts, and estimates raise an interesting point about economic development in light of new growth theories. The extraordinarily rapid economic growth of East-Asian NICs has led many economists to believe that the outward-orientation of these economies created enormous productivity gains (see, e.g., Krueger, 1990), an argument challenged by Young (1993). While Young does not contest the fact that these economies are indeed outward-oriented, he claims that most economic growth in these countries should be attributed to the extraordinary rates of crude factor accumulation (including massive investment in and a sizable growth of the labor force through increased participation rates). In his view, these changes explain most of the rapid rise in output per capita in East-Asian NICs, while their TFP was not among the highest in the world.

The relevance of this discussion to our case is that participation rates in the West Bank and the Gaza Strip are extremely low (see Luski and Weinblatt, 1994a), being determined mainly by demography

(a large population of children) and culture (low women's participation). Both these factors are very slow to change. However, the Palestinian economy also has a very low rate of domestic participation due to large employment in Israel. The tens of thousands of Palestinian workers in Israel, if employed in their domestic economy with the appropriate amount of complementary capital accumulation, would generate high rates of output and output per capita growth, even without very high TFP rates. Evidence of the possibility of such trends appears in Table 8.6: the mere repatriation of workers would generate high GDP per capita growth rates of 7.6 and 7.2 percent, and GNP per capita growth rates of 4.8 and 2.4 in the West Bank and Gaza Strip, respectively (line 2). Adding to that a capital injection that would increase capital stock by \$1 billion (of 1986) in each of these economies would raise the growth rates even higher (line 2.1).³

These growth rates, if they materialize, would raise West Bank and the Gaza Strip to the top of the relevant country ranking. It would put the West Bank ahead of Taiwan, Malaysia and Korea, and the Gaza Strip would only be slightly below them.

Outward-oriented policies would certainly not hurt. Bear in mind that demanded output has grown alongside the growth of potential output, and at a similar rate, if unemployment is to be avoided. Therefore, the outward orientation of the economy, reflected by a rapid growth of exports, would certainly be consistent with the goal of achieving rapid and sustainable economic growth.

c. *Alternative scenarios*

In this section we try to estimate the effects of government development policies on the level of economic activity, government deficits, and trade deficits. The analysis proceeds in stepwise fashion: each step involves an additional simulated government measure whose macroeconomic impact is assessed.

One of the crucial problems facing the Palestinian economy and its governing authority is the development of a healthy public sector, including both government consumption and investment spending and their financing. The degree of government involvement in the economy, both in public consumption and in investment, is related to the con-

³ These projections are computed for a 10-year span and the estimated growth rates are therefore annual averages over ten years.

troversy over the relative efficiency or inefficiency of government versus the private sector. We do not address this controversy, but the fact is that in 1990 public consumption in the Palestinian economy was 7–8 percent of GNP, and public investment (infrastructure) amounted to 1–1.1 percent. Both levels are very low compared to most other economies in the world, especially to fast growing and developed economies. Therefore, it seems obvious that a major task of the Palestinian authority will be to establish an efficient public sector that will generate public consumption services such as education, health, internal security, municipal services, etc. Furthermore, it will have to initiate public investment in all fields of infrastructure in order to make up for an extended period of neglect.

Table 8.7 presents the macroeconomic effects of three cumulative measures: (i) An increase of public consumption to a reasonable level of 19 percent of GDP (scenario b), (ii) an increase of productive investment (assumed to be carried out by the government, but not necessarily so) to an annual level of \$400 million (of 1986) in each territory (scenario c) and (iii) levying indirect (value added) taxes at 16 percent of GDP (scenario d).

Increasing government expenditure to 19 percent of GDP, as assumed in scenario (b), will clearly stimulate output. Table 8.7 indicates that West Bank GDP in this case will be \$2.3 billion (of 1986) in the year 2000, 12 percent higher than in the baseline scenario. In the Gaza Strip, the growth of GDP due to a similar increase of government spending is 24 percent. The different rates of change in the two territories are explained by the higher national income multiplier in the Gaza Strip. Higher levels of output stimulate investment, thus generating a larger accumulation of capital stock than projected in the baseline scenario, and therefore potential GDP too is higher in this scenario than in the baseline case. In the West Bank, we see that the rise in government spending increases demanded GDP and brings it closer to potential GDP (without repatriation of Israeli-employed Palestinian workers), as shown in lines 10 and 11. In the Gaza Strip, the rise of demanded GDP raises this variable above the level of potential GDP. Therefore, we can expect that some of the Gaza Strip workers employed in Israel will return home as a result of such a change.

The rise of government investments to \$400 million per year, starting in 1995 in each territory, generates additional growth of demanded GDP. In the West Bank, it brings projected demanded GDP very close to its potential level (excluding West Bank workers in Israel). In other

Table 8.7
Scenario Analysis (mill. 1986 US\$)

Variable	West Bank		Gaza Strip	
	1990	2000	1990	2000
<i>a. Baseline scenario</i>				
1. GDP (demanded)	1,454	2,101	428	687
2. GNP (demanded)	1,890	2,745	667	1,035
3. Potential GDP ^a	—	2,652	—	755
4. Potential GNP	—	3,296	—	1,103
5. Capital stock	3,481	5,393	1,722	2,396
6. Govt. deficit (a) (incl. gov. investment)	58	142	12	2
7. Govt. deficit (b) (imputing VAT + customs)	-41	-74	-31	-106
8. Current account deficit (a)	90	148	-25	-41
9. Trade deficit with (b) Israel (incl. remittances)	120	152	-4	-7
<i>b. Government consumption = 19% of GDP</i>				
10. GDP (demanded)	—	2,358	—	853
11. Potential GDP ^a	—	2,758	—	770
12. GNP (demanded)	—	3,002	—	1,201
13. Capital stock	—	5,996	—	2,556
14. Govt. deficit (a) (incl. gov. investments)	—	326	—	80
15. Govt. deficit (b) (imputing VAT + customs)	—	91	—	-39
16. Current account deficit (a)	—	258	—	28
17. Trade deficit with Israel (b) (incl. remittances)	—	238	—	67
<i>c. Government investment = 400 m. \$, gov. consumption = 19% of GDP</i>				
18. GDP (demanded)	—	2,977	—	1,867
19. Potential GDP ^a	—	3,129	—	1,026
20. GNP (demanded)	—	3,621	—	2,214
21. Capital stock	—	8,031	—	4,834
22. Govt. deficit (a)	—	729	—	580
23. Govt. deficit (b)	—	450	—	389
24. Current account deficit (a)	—	531	—	445
25. Trade deficit with Israel (b)	—	485	—	432

Table 8.7 (c)

Variable	West Bank		Gaza Strip	
	1990	2000	1990	2000
<i>d. Indirect taxes = 0.16GDP, Govt. invest. = 400 m. \$, gov. consumption = 19% of GDP</i>				
26. GDP (demanded)	—	2,747	—	1,597
27. Potential GDP ^a	—	3,103	—	944
28. GNP (demanded)	—	3,391	—	1,944
29. Capital stock	—	7,920	—	4,744
30. Govt. deficit (a)	—	325	—	340
31. Govt. deficit (b)	—	60	—	168
32. Current account deficit (a)	—	430	—	334
33. Trade deficit with Israel (b)	—	397	—	335

^a This measure of potential GDP does not assume the repatriation of Palestinian workers in Israel, but merely the full employment of other workers. The growth over time is based on the extrapolation of the Palestinian labor force using the trends of the decade 1980-90.

words, an annual investment in productive capital of at least \$400 million during the decade of the 1990s would have created, by the year 2000, the additional jobs needed to provide employment to the growing domestic labor force. The goal of repatriating Israeli-employed Palestinian workers would require additional investments. In the Gaza Strip, which is a smaller economy, the annual investment of \$400 million, in addition to the 19 percent of GDP public consumption spending, is expected to generate a level of demanded GDP of \$1.8 million, which significantly exceeds potential GDP with or without the repatriation of Gaza Strip workers from Israel. Such levels of national expenditure would create serious inflationary demand pressure, unless unemployed West Bank workers or such workers employed in Israel choose to work in the Gaza Strip.

The above scenario (c) is highly unlikely because it assumes a very large increase in government expenditure for public consumption and investment, without assuming any significant change in government revenue. In reality, such large-scale activity would require levying taxes to partly finance the increased outlays. According to the Paris Agreement (see *Protocol*) the Palestinian Authority was to impose a VAT of 15-16 percent, which will probably be the major source of public funds. Therefore, in the simulation presented in Table 8.7, a

16 percent of GDP indirect tax is introduced in scenario (d) in addition to the increase in public consumption and investment. Since this case seems to be the most realistic of all four scenarios, it merits analysis in greater depth.

d. *The West Bank*

In the West Bank we see that the combination of assumed measures in scenario (d) will generate a demanded GDP of \$2.7 billion, which represents a 6 percent rate of annual growth. Potential GDP (without worker repatriation) would rise to \$3.1 billion in the year 2000. Thus, a gap of approximately 10 percent between aggregate demand and supply is projected, suggesting that some unemployment might be perpetuated under the conditions of this scenario. It also implies that free resources will exist and might be used to increase exports. When imputed revenues from VAT on imports from Israel and custom duties on other imports are excluded, while public investment spending is included in government expenditure, the direct government deficit comes to \$325 million, or almost 10 percent of GNP, and far too high by any standard, especially in an economy that hopes to accelerate economic growth. Nevertheless, since according to the Paris Agreement the Palestinian Authority will start collecting VAT and customs duties on imports and will be reimbursed for the indirect taxes collected by the Israeli government, estimate (b) of the government deficit seems to be more relevant. This estimate takes into account these (at present implicit) elements of public revenue. According to this estimate, the government deficit in the West Bank in the year 2000 will be only \$60 million, less than 2 percent of projected GNP, which is very reasonable for a rapidly growing economy. Thus, if the projections of this scenario are realized, serious fiscal pressure is not expected to develop in the West Bank.

This is not the case with the balance of payments. The simulation model indicates that the current account of the balance of payments by the year 2000 will have a deficit of \$430 million, or approximately 13 percent of GNP. This is a sizable deficit that implies future reliance of the West Bank on foreign aid or foreign credit. Even worse is the projected trade deficit with Israel, of almost \$400 million, after worker remittances are accounted for.

Some elaboration on this forecast, its implications, and possible setbacks, is needed. The simulation model in this scenario predicts total

levels of exports (excluding labor remittances) and imports in the year 2000 of approximately \$450 million and \$1.65 billion, respectively, or 13 and 48 percent of projected GNP, respectively. For imports this is a very high level, similar to or greater than the existing levels in most NICs. For exports, the ratio is high but not excessively so. The problem is that most West Bank trade will probably be with Israel, because the simulation model relies on existing conditions. The likelihood that the West Bank, or the Palestinian economy as a whole, will maintain such levels of imports from Israel in the future is probably small. Once the Palestinian economy is free to import directly from the rest of the world, at least some trade diversion will take place, and imports from Israel will be imported from other places. Thus, the trade deficit with Israel will probably be considerably less than \$400 million. Still, merely exchanging imports from Israel with imports from elsewhere does not solve or even alleviate the current account deficit problem. In fact, the opposite may be true. A deficit vis-à-vis Israel might be simpler to handle than a deficit vis-à-vis other countries. Nevertheless, the projected total deficit is probably also overstated. The export equation in the econometric model, like the rest of the model, is estimated using existing export trends. For the past 27 years these trends have been rather depressed due to the low level of investment in the Palestinian territories. It is likely that, following the abundant investments projected in this scenario, production will be more outward-oriented and the exports/GDP ratio will increase. If so, the total current account deficit will be smaller than projected, and the external position of the West Bank economy will be stronger than reflected by the model.

Generally speaking, an outward-oriented approach appears to be the most appropriate and promising strategy of development and growth. True, the economic literature includes arguments for and against this approach. Taylor (1991) opposes open trade and capital market strategies, but most economists (e.g., Romer, 1989; Grossman and Helpman, 1991a; Edwards, 1993; and many others) advocate trade liberalization and outward-oriented policies as an engine of economic growth. Trade liberalization reduces the anti-export bias of commercial policies and contributes to economic growth by improving economic efficiency, by introducing technological innovations, by enabling the exploitation of scale economies, and by supporting (on the demand side) the increase of labor-participation rates.

Therefore, based on theoretical considerations and on the experience of some Asian and Latin American countries, the West Bank will probably benefit from a liberalized approach to foreign trade. This is not consistent with the agreement to establish a customs union with Israel whereby, in effect, the Israeli trade policies will continue to be pursued in the West Bank as well. True, Israel itself is undergoing a (slow) process of liberalization, but it is not tailored to the goals or needs of the Palestinian economy. Neighboring Arab countries are also very far from trade liberalization (Jordan is liberalizing its foreign trade sector, but still suffers from serious distortions). Hence, the example given by other Arab countries is not favorable to trade liberalization and the likelihood of the Palestinian economy being different is small. Therefore, we may conclude that in spite of trade deficits, protective policies will persist and substantial foreign aid, in the form of grants and loans, will be needed in order to realize development projects.

e. The Gaza Strip

When we compare projected macroeconomic variables of the Gaza Strip with those of the West Bank in scenario (d) of Table 8.7, the most outstanding difference is in implied unemployment. Projected demanded GDP for the year 2000 in the Gaza Strip is \$1.6 billion, which represents an annual average 10 percent growth rate in terms of actual 1990 values. But this level of output will not be achieved unless most (90 percent) of Gaza Strip workers in Israel find employment at home. The projected level of demanded GDP exceeds projected potential GDP (without repatriation) by almost 70 percent. Theoretically, the assumed level of investment in this scenario might seem optimal to create the amount of jobs needed to eliminate the undesirable (for all sides) phenomenon of Palestinian workers in Israel. In practice, however, repatriation will involve a great deal of friction and structural obstacles because the occupational composition of these workers does not match the growth needs of the Gaza Strip. The figures in Table 8.7 indicate that the Gaza Strip economy might be too small to absorb an annual investment of \$400 million, which might exert inflationary pressures and throw the domestic labor market into disarray. The annual level of productive investment that could probably be absorbed in the next few years is about \$200 million.

The budget deficit generated according to scenario (d) in the year 2000 is \$340 million, if we ignore VAT and customs duties, at present collected by Israel (line 30). This is 17.5 percent of projected GNP, an unacceptable level of deficit. When VAT and customs duties are taken into account, the projected deficit is reduced to \$168 million, or 9 percent of GNP. This is still considered too high, but given that the Gaza Strip economy is projected to grow at 10 percent annually, it is probably tolerable. When both West Bank and Gaza Strip projected deficits and GNPs are combined, the deficit/GNP ratio is 4 percent. This is still a problem, but not an uncommon one in many developed and developing countries. Reducing projected government investment in the Gaza Strip to an annual \$200 million will virtually eliminate the projected budget deficit of type (b). In conclusion, a 16 percent VAT combined with direct taxation generating a revenue of 5-6 percent of national income, and government public spending amounting to 19 percent of GDP is, from a budgetary point of view, an attainable goal. Moreover, it will leave sufficient public funds available for public investment. This package of government involvement seems, on the whole, to be consistent with economic growth.

Regarding the balance of payments, Table 8.7 indicates a projected current account deficit in the Gaza Strip, in scenario (d) of \$334 million, or 17 percent of GNP. The trade deficit with Israel (after worker remittances) will be \$335 million. Again, as in the West Bank, these external deficits are not healthy. The Gaza Strip has a more acute problem than does the West Bank. Projected total imports amount to 56 percent of the Gaza Strip's projected GNP, and its dependence on the Israeli economy for both exports and imports, is greater than that of the West Bank.

These deficit estimates, too, are probably overstated. Total exports of the Gaza Strip in the year 2000 will probably exceed the projected \$250 million. Productive new investments will already be paying off, some of which output will be exported. The dependence on the Israeli market will probably also decrease. Investments of \$200 million (instead of \$400) will generate a current account deficit of approximately \$150 million or 10 percent of GNP.

4. Summary

The baseline scenario presented in this chapter indicates that if the economic and demographic trends of the 1980s continue in the West Bank and the Gaza Strip, annual growth rates will be around 4 percent. This average growth rate is obviously insufficient to meet the Palestinians' needs, goals, and expectations. The major problem will be employment. The growth rate of demand will fall far short of what is needed to create a sufficient number of jobs to provide employment for the rapidly growing labor force. This implies growing reliance on the Israeli economy for employment in the future, which all parties concerned deem undesirable.

The baseline scenario projections predict that if taxes are indeed imposed and collected, as planned by the Palestinian Authority, and if Israel transfers the amount of VAT, customs duties and income taxes collected from Palestinian workers, there should be no serious government deficit problem in the future. This is a somewhat surprising result, because at present, when no taxes are being collected by the Palestinian Authority, there is a feeling that the Palestinian economy will suffer from chronic budget deficits. This is not necessarily so; rather the reverse seems to be possible if a thorough implementation of accepted tax policies provides the Palestinian Authority with a relative abundance of resources for public consumption and investment.

Another very important problem to be solved is the expected current account deficit. The Palestinian economy will probably have such a deficit, especially in its bilateral relations with Israel, implying that it will need foreign aid for several years to come.

Potential output on the supply side is expected to grow faster than demanded output in the baseline scenario. This is another facet of the projected risk of unemployment mentioned above. Potential output (GNP) is expected to rise faster if and when Israeli-employed Palestinian workers seek employment at home. In other words, these workers are expected to contribute more to their GNP when working at home than when working in Israel. Thus, in addition to national, political and sociological incentives to repatriate these workers from Israel, there is a clear economic gain involved. In such a case annual GNP per capita growth rates in the West Bank and the Gaza Strip may well rise to the levels prevailing in the fastest growing economies—Taiwan, Malaysia and Korea. In order to sustain such growth rates, demanded output has to rise at similar rates, which depends on

exports significantly increasing. In other words, outward-oriented growth policy should be adopted, and they will probably have to entail trade liberalization in order to eliminate or prevent any anti-exports bias. Such a policy will not be easy to implement in the existing political, economic, and geographic environment of the Palestinian economy.

The more realistic scenario assumes public consumption of 19 percent of GDP, a 16 percent VAT over and above the existing level of direct taxation, and public investment of \$400 million in the West Bank and \$200 million in the Gaza Strip. This scenario seems to set out attainable goals.

GDP growth will be around 7–9 percent; budget deficits will be small, possibly negligible; and the combined current account deficit of the two territories will be in the vicinity of \$500 million (in 1986 terms). This is the amount that the Palestinian economy needs in foreign aid, as grants or loans, for several years, and it will amount to approximately 12–13 percent of the territories' combined GNP in the year 2000. This is a relatively high sum. If it is loaned to the Palestinian economy, it will generate a substantial foreign debt. Nevertheless, since the loans are small in absolute terms, they will be easier to obtain from international organizations and foreign governments. One of the important features of this scenario is that it incorporates a gradual repatriation of Palestinian workers from Israel to the West Bank and the Gaza Strip, so that a reduction in future potential unemployment and a stable macroeconomic environment may be anticipated. An outward-oriented development policy might contribute both to sustaining economic growth and to reducing the magnitude of the current account deficit.

Finally, a last reflection. Our forecast, which does not seem to be too far-fetched, gives rise to much optimism. It suggests that with relatively small amounts of foreign aid, which is certainly available, the Palestinian economy could move along a path of economic growth. If sustained in the long run, the Palestinian economy would probably come significantly closer to the standard of living in Israel and in the developed economies.

EPILOGUE: PAST DISTORTIONS, PRESENT REALITIES
AND NEW ARRANGEMENTS

The weaknesses and difficulties, as well as the strengths, which characterized the performance of the Palestinian economy since 1967 were described and analyzed in this book. The economic performance was largely the result of the peculiar interaction between two very different economies: the relatively modern Israeli economy and the more traditional Palestinian one. Israel shaped the links between the two economies and determined the economic policies, under the political realities of a military occupation. The combined effects of the links between the two economies and the economic policies implemented by the Israeli government resulted in the distorted structure of employment and trade described here.

An impressively large segment of the Palestinian labor force found employment in the Israeli economy, at higher wages than were possible at home. The remittances created increased aggregate demand in the Palestinian economy and resulted in rising standards of living. This rise in standards of living was not associated with a parallel increase in productive capacity within the Palestinian economy, which continued to depend on employment in Israel.

Several factors contributed to the continuation of this unbalanced development. One important reason is the structure of trade. With the exclusion of labor, the Palestinian economy imported from Israel more goods and services than it exported to it. Thus, the higher standards of living in the West Bank and Gaza were associated with a merchandise trade deficit while employment of Palestinians in Israel provided some of the funds necessary to cover the deficit in the balance of payments.

Was a different structure of trade possible? One can imagine another macroeconomic trajectory, along which the Palestinian economy could have exported more goods and services than it actually did and possibly also substituted imports from Israel with local production. In such a scenario, instead of the significant labor mobility between the two economies, one would have witnessed a greater flow of goods and

services and a smaller trade deficit. Thus, a more balanced structure was possible and, in fact, would have evolved naturally had economic forces alone shaped the links between the two economies and the development of the Palestinian economy. Such an outcome did not materialize for several reasons.

In order to exploit the comparative advantages of the Palestinian economy, its own productive base should have been expanded and reshaped by both the private and public sectors. Palestinian entrepreneurs did not expand the productive capacity of the West Bank and Gaza, and the public sector was not active in these spheres and was unable to assume this role. Two important barriers to the expansion of a productive base capable of producing tradable goods can be found in non-economic factors: Israeli policies and the high risk associated with political instability. Since 1967 and, it seems, up to 1991, Israel interfered with the creation of economic opportunities in the West Bank and Gaza that threatened Israeli interests. Licensing was required for each stage of business initiatives and were rarely granted. In addition, during many of the years covered here the degree of uncertainty concerning the future of the Palestinian territories prevented entrepreneurs from investing private funds in the Palestinian economy.

There are several additional possible explanations for the failure to expand the productive base of the Palestinian economy. Some observers raise purely economic reasons, such as the relatively high wages in the Palestinian economy, caused by the employment of Palestinian workers in Israel. This may have prevented the creation of the necessary conditions for the development of "infant industries". Other economic reasons were the inability to protect industries, due to the lack of trade policies and the lack of financial intermediation in the Palestinian economy that significantly affected the investment process. In spite of the relatively high saving rate, very few investments were directed to the expansion of productive activities; most savings were directed to housing investments. In addition to these economic factors, "administrative barriers" to trade and "political intervention" in the economic processes within the Palestinian economy played a major role in the process. The military government, and later on the civil administration, inadvertently or by design, discouraged Palestinian entrepreneurs from creating the productive capacity that could have changed the distorted industrial structure into a more balanced and productive one.

The protocol on economic relations that was part of the Oslo agreement raised the hope for a brighter economic future for the Palestinians. It gave the control of the public sector to the Palestinian Authority, and moreover, supplied it with international donor's funds, intended for the badly needed infra-structure. The establishment of the PMA (Palestinian Monetary Authority) facilitated the fast expansion of the banking system, serving as the needed intermediary between savers and investors. The agreement to continue open economic borders was intended to insure a smooth transition for Palestinian workers, serving as employment safety net. Because of the quasi-common market with Israel, some economic policies remained inaccessible to the newly created Palestinian public sector. Decisions on taxes and expenditures, subject to some restrictions specified in the economic agreements, were made by the Palestinian Authority, but internal debt, for example, had not been issued. Thus, fiscal policy, representing an important policy tool, was not used. The PMA is not allowed yet to perform all the functions of a central monetary authority, in particular the implementation of monetary policy.

It was expected that the changes will foster employment locally and reduce work in Israel. Indeed, the implementation of the Oslo agreements led to an impressive growth of economic activity in the Palestinian economy. The new institutional changes, combined with a substantial increase in population and a more favorable international environment, were probably the cause of the positive performance in 1994. The annual GDP growth rates in 1994 were 15 percent in the West Bank and 13 percent in the Gaza Area (the respective per capita rates were 8 percent and 5 percent).¹ The performance in 1995 was less impressive: GDP growth rates fell to 8 percent in the West Bank and 0 percent in the Gaza Area (the respective per capita rates were 0 and 7 percent). The major reason for the difficulties in 1995, which became even worse in 1996, was the deterioration in the links with the Israeli economy, especially the decline in the number of workers employed in Israel. Data on GNP, which also reflect the direct effect

¹ Since the deployment of the Palestinian Authority, data on the overall performance of the Palestinian economy became sparse and incomplete. The Palestinian Central Bureau of Statistics (PCBS) took over the roles fulfilled by the Israeli Central Bureau of Statistics (ICBS), and recently started publishing reports on the Palestinian economy. However, national accounts were not ready yet when this Epilogue was written. The data in this section were collected from various international agencies active in assessing economic conditions in the West Bank and Gaza as well as from the reports published by the PCBS.

of the remittances, tells the story: In 1994 GNP in the West Bank declined by 1 percent and in Gaza increased by 3 percent; in 1995 GNP in the West Bank declined by 5 percent and in Gaza it declined by 12 percent.² These numbers mean that in 1994 the increase in domestic production offset the loss of revenues from employment in Israel; in 1995 the revenues from employment in Israel declined further, but the meager local growth did not compensate for it.

A major factor in this disappointing performance is the closures policy, which Israel introduced after 1993 in response to terrorist activity. Palestinian laborers were often prevented from working in Israel unless they held a special permit. The number of such permits frequently changed in line with political developments. The decline in and volatility of access to the Israeli labor market had a direct effect on the level of Palestinian earnings and an indirect effect on the local economy, which suffered from a decline in demand and growing uncertainty.

In the spring of 1997, while this Epilogue was being prepared, the issue of integration versus separation was still an open question that had still not received the attention it deserved. Thirty years since Israel came to control the Palestinian economy in the West Bank and Gaza, and more than three years into the Oslo process, a viable economic development strategy has not yet been implemented. Such a strategy should have first laid down the major parameters of the economic regime, including the relations of the Palestinian economy with Israel and the rest of the world. As explained in the preceding chapters, the Paris Protocol did not change the basic economic relations between the Palestinian economy and the rest of the world, rather, it preserved the imposed integration of 1967–1994 with only few modifications. The hope in 1994 was that under the new political conditions, with the Palestinian Authority in place and a more encouraging Israeli approach to the Palestinian economy, as well as generous international support, new avenues would open that would dramatically change the course of development. The past three years have proved that this optimism was unfounded: The "one leap" from imposed to voluntary integration encountered serious obstacles, most of which originated in the political sphere.

Furthermore, during the past few years, while the peace process

² Due to the large population growth, per capita performance was even worse than these figures indicate.

brought Israelis and Palestinians to the negotiating table, economic links between the two economies paradoxically deteriorated. In the labor market, new divisions were introduced, and relatively fewer Palestinian workers were employed in Israel than in any period since the early 1970's. Moreover, the uncertainties caused by the volatility of employment in Israel contributed further to the poor performance of the Palestinian economy. Trade links became less free and unpredictable, both with respect to imports and to exports, and the actual costs associated with trade increased as a result of the fuzzy borders between Israel and the areas controlled by the Palestinian Authority. Thus, instead of a "no-economic-borders" scenario assumed in the Paris Protocol, the parties entered into a different phase where new forms of economic borders, and other barriers, interfered with labor and trade movements.

In the post-1994 period it became quite clear that Israel exercised control over several economic parameters that are typically at the discretion of economic entities with even less-than-full sovereignty. For example, the Palestinian Authority could not decide on trade links that conflicted with the rules of the customs union with Israel. Thus, the Authority was restricted in its search for new markets for its exports or new sources of cheaper imports. Furthermore, not even uninterrupted access to markets, particularly those of imported raw materials for production or exported finished goods, could be guaranteed. In other areas of economic policy, fiscal, monetary or other (such as the scope of the private and public sectors) no strategic decisions could be made. The economic situation in 1995-6 was such that the hopes for private-sector-led development had to be set aside by the international agencies involved in organizing aid to the Palestinian economy.

The vision of integration was suppressed by the reality of unplanned separation. The West Bank was separated from the Gaza area. Within the West Bank, various cities ("A areas" in the agreements' parlance) and villages ("B areas") experienced several periods of total cutoff, and long periods during which movement was severely curtailed by Israeli roadblocks in the territory still controlled by Israel ("C areas"). The division of the West Bank into three different types of sovereignty caused serious and unforeseen problems in the fields of infrastructure construction.

What are the alternatives? One must first distinguish between the short term and the longer run. In the next few years, before a permanent agreement is signed, some urgent modifications in the Paris

Protocol are necessary. The Palestinian economy should have better access to foreign markets and labor mobility should be less dependent on changing political occurrences.

In the long run, once permanent agreements are negotiated, the options open to the negotiators can be defined in terms of the permeability of the economic borders and the degree of independence in economic policy-making. Thus, the labor border can, in principle, be "open", (i.e., non-existent), "blocked" (i.e., totally closed), or, more realistically, shaped as an economic filter, where the parties to the agreements specify rules concerning labor movements. These rules will define the entry of Palestinian laborers into the Israeli economy and vice versa. The agreements will specify the terms for entering the other side's labor market, and will relate to both employers and employees rights and obligations. The lessons of the period that has elapsed since the 1994 Paris Economic "Protocol" was signed, point to the close link between each side's internal economic policies and the other side's macroeconomic environment. Thus, while the negotiators in 1994 assumed that more than one hundred thousand Palestinian workers would be employed in the Israeli economy, the closure policy and, what is even more important, the new Israeli policy regarding "foreign laborers", made this assumption unrealistic. Access to the Israeli labor market depends not only on the penetrability of the labor borders, but on the demand for Palestinian laborers within Israel. Is this an internal Israeli policy issue or a legitimate part of the negotiations?

Trade borders, too, can be "non-existent", "blocked", or serve as an economic filter that will let goods pass through according to rules agreed upon by the two partners. The 1994 agreements assumed, in principle, no trade borders between the Palestinian and Israeli economies, and a joint border between the combined areas of the two entities with respect to the rest of the world. The period since the signing of the agreements revealed that trade barriers were, in fact, created. The two sides interpreted the creation of these barriers quite differently. Israel attributed the barriers to security concerns, caused by the continuation of violent attacks within Israel; the Palestinians perceived the new barriers as a form of collective punishment. The assumption of the 1994 agreements, that "no-borders" would exist, caused many difficulties in monitoring movements of trade and labor, and resulted in more severe obstacles to the movement of trade and labor than under arrangements that would have negotiated the existence of

economic borders. Thus, paradoxically, a monitored border might have been more conducive to the free movement of goods than a theoretical "no borders" regime.

The lessons for a new development strategy that takes into account the political realities of the region are clear. The Palestinian economy cannot and should not rely on employment in Israel as the main solution to excess supply in the labor market, even if the borders issue is resolved satisfactorily. Emphasis should be on the creation of employment opportunities within the Palestinian economy. This might create short-term costs, but the long-run benefits seem to justify such a strategy. Hence, the creation of stable economic conditions and clearly defined legal and commercial environment, are top priority. The roles of the private and public sectors should become clear to potential participants in the development effort.

The trade regime should reflect and encourage this new strategy. Trade relations should be non-discriminatory, i.e., Israeli products should have equal access to the Palestinian economy and enjoy a "Most Favored Nation" status. At the same time, trade relations can be asymmetrical: Israel could and perhaps should provide the Palestinian economy with preferential treatment compared with other economies. This treatment will be similar to that granted to Israel by the EU in the past. It might seem costly to Israel in the short run, but it is beneficial in the long run.

The political process of achieving reconciliation might encounter difficulties. The fact of living together on the same tract of land forces both sides to reach arrangements that will address the other side's interests as well as its own. Economic cooperation in production and trade must create win-win arrangements that will be viable for both societies, which live so much closer to each other than is realized today.

APPENDIX

GAZA-JERICHO AGREEMENT

ANNEX IV

PROTOCOL ON ECONOMIC RELATIONS

between
the Government of the State of Israel
and
the P.L.O., representing the Palestinian people

Paris, April 29, 1994

PREAMBLE

The two parties view the economic domain as one of the cornerstone in their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace. Both parties shall cooperate in this field in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of mutual respect of each other's economic interests, reciprocity, equity and fairness.

This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities. The two parties recognize each other's economic ties with other markets and the need to create a better economic environment for their peoples and individuals.

Article I

FRAMEWORK AND SCOPE OF THIS PROTOCOL

1. This protocol establishes the contractual agreement that will govern the economic relations between the two sides and will cover the West Bank and the Gaza Strip during the interim period. The implementation will be according to the stages envisaged in the