ECONOMIC RELATIONS BETWEEN PALESTINE AND ISRAEL DURING THE OCCUPATION ERA AND THE PERIOD OF LIMITED SELF-RULE.

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Working Paper 2015

Abstract

This paper intends to analyze the dynamics of the relationship between the Israeli economy and the Palestinian economy as they have evolved during both the occupation period and the past six years of limited self-rule. The analysis of the relationship is within the context of two opposing effects: a positive one that tends to help the Palestinian economy expand, develop and grow, and a negative one that tends to retard economic evolution and reinforce underdevelopment. The paper identifies the practices and policies of successive Israeli governments' as being responsible for incapacitating the normal operation of market forces and blocking the positive spread effects as well as bolstering the negative backwash effects. The changes brought about by the limited self-rule are examined and illustrations given as to how these changes have failed to alter the essential dynamics of Zionism, which therefore, could not arrest the cumulative movement of the backwash effects which continue to weaken the Palestinian economy. The paper also examines the prospects for future relations between the two economies based upon a more equitable economic environment.

Introduction

The establishment of Palestinian limited self-rule in parts of the West Bank and Gaza Strip, which has taken place in stages since May 1994, engendered high expectations of considerable improvement. Self-government was envisaged as setting free the country from the harsh conditions of the occupation, and creating a new environment conducive to the expansion of production and trade. Peace and stability would encourage domestic economic activities, attract foreign investment, and open the door to regional coordination and integration, with all the benefits of rationalizing economic activity. In addition, the international community's commitment to underwrite part of the cost of the Palestinian reconstruction program was looked upon as a great boost, as it promised to supply much needed capital and foreign exchange[1]. Five years of limited self-rule, however, have not brought about any of these expected improvements. Quite the contrary. The economic situation in the West Bank and Gaza has deteriorated steadily, and at some point during 1996-1997 it reached crisis proportions, featuring a sharp increase in unemployment, a drastic decline in trade, an unprecedented spread of poverty, and a general condition usually associated with economies under siege[2].

The Israeli government blames the Palestinian Authority (PA) for the deterioration of the economic situation. The failure of the PA to prevent Hamas from carrying out violent acts against Israel has led the Israeli government to close its borders to the Palestinian territories, causing the drastic decline in Palestinian employment, production and trade[3]. The PA, on the other hand, while condemning the acts of Hamas, points to the Israeli government's actions as the real culprit in creating an atmosphere of conflict and strife which is conducive to violence. These actions include the continued building of Jewish settlements on Arab lands, the reneging on many agreements signed with the PA, and a general tendency toward regarding self-rule as merely another form of control.

As is often the case, fierce polemics about responsibility and blame are arguments over symptoms rather than causes. They are indeed a smokescreen disguising the failure to address deep-rooted problems that provide the fertile ground for violence. The inability of limited self-rule to deliver on its promises during the five years of the interim period is due primarily to the fact that it was an outcome of flawed accords - Oslo I and II and the Paris Protocol[4]. The accord simply did not deal with the crux of the problem, which is the dispute over sovereignty, nor did it change the colonial-like relationship between the Israeli and Palestinian economies. Postponing the resolution of this core problem to a later date of final status negotiations has proved to be pernicious. At the political level, it has furnished the enemies of the accord, from both sides, with sufficient time to derail its implementation. At the economic level, despite some improvements in the policy environment brought about by establishing Palestinian national authority and dismantling some of the occupations' harmful structures, the increased activities related to Zionist ideology of confiscating Palestinian lands and building new Jewish settlements as well as expanding old ones, has created a poisonous atmosphere of strife. In addition, the mismatch between authority and responsibility created a multifarious uncertainty that stifled investment and growth. The relapse into the old habits of daily scuffles and clashes between Palestinians protesting Israeli settlements and land policies and the Israeli security forces, has suffocated the euphoric mood that greeted the signing of the peace accord. It brought deterioration in the relations between the two economies and prevented any serious movement toward reconstruction and development of the Palestinian economy.

[1] The US administration convened an international conference of 42 countries during October 1993, which promised 2.4 billion dollars to help the Palestinian reconstruction and development program (1994-1999).

[2] See Roy, S. (1998).

[3] The circle of violence took a very dangerous turn with the Hebron massacre in February 1994, when Jewish extremist murdered Muslims at prayer in the mosque. It was escalated by attacks by Hamas suicide bombers on civilians in Jerusalem and Tel Aviv which peaked during October 1994 and again in February and March 1996.

[4] The first agreement was signed on 13 September 1993, in Washington and is known as the Declaration of Principles (DOP). On 29 April 1994, in Paris, the two sides signed the "Protocol on Economic Relations between the Government of Israel and the PLO, representing the Palestinian People". This 60 page document "establishes the contractual agreement which will govern the economic relations between the two sides, and which will cover the West Bank and Gaza Strip during the interim-period". On 28 September 1995, the Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip, (known as Oslo II) was signed. The last agreement was signed on 23 October 1998, and is known as The Wye River Memorandum.

This paper sets out to analyze the dynamics of the relationship between the Israeli economy and the Palestinian economy as they have evolved during the occupation period and the past five years of limited self-rule. The aim is to reveal the various anomalies in those relations, whose removal is a prerequisite for any serious and genuine attempt at reviving the peace process and allowing the economic dimension to promote and support the peace efforts, rather than block or hinder them. Section I provides the theoretical framework within which the relationship between the two economies is analyzed. It focuses on the interconnections between a large, advanced economy and a small, poor neighbor, as formulated by Mydal (1937), Thirlwall (1994) and Krugman (1998). It identifies the positive consequences of any linkage between the two economies, which tends to help the small economy expand, develop and grow; these are called the spread effects. It also identifies negative repercussions that tend to work in the opposite direction and thus retard the evolution of the small economy, reinforcing its underdevelopment; these are called the backwash effects. The section identifies both effects in the Israeli-Palestinian context and concludes that had they been allowed to work within a free market context, the positive effects would have dominated during the last thirty years, contributing to a substantial economic development and growth of the Palestinian economy. In section II practices and policies of the successive Israeli governments - restrictions over the use of natural resources, a regulatory regime inhibiting business activities, and fiscal compression - are identified as responsible for incapacitating routine operation of the normal market forces, blocking the positive spread effects and bolstering the backwash effects as the dominant force in the relation. Section III examines the changes brought about by the limited self-rule of the last five years and illustrates how these changes have failed to alter the essential dynamics of Zionism, and thus could not arrest the cumulative movement of the backwash effects, which continue to weaken the Palestinian economy. Section IV presents some conclusions relating to the present situation of the Palestinian economy and the prospects for future relations with the Israeli economy based upon a more equitable foundation.

I. The Dynamic Relations between the Israeli Economy and the Palestinian Economy in the West Bank and Gaza Strip.

In 1967, Israel occupied the West Bank and Gaza Strip and integrated their markets into its own. The size of the Israeli economy at that time was around ten times that of the Palestinian economy, its product diversification was much greater and the manufacturing sector's share in GDP was more than four times larger. These differences in size and structure made the relations between the two economies, one between a large, advanced and rich economy and a small, underdeveloped and poor economy. Both theoretical analysis and empirical studies suggest that the dynamics of such a relationship always generate two opposing forces that disproportionately affect the smaller economy and shape its development. A favorable repercussion is an increased demand for the products of the small economy, a diffusion of technology and knowledge, as well as other spread-effects, resulting from the geographical proximity to a large market leading to subcontracting, joint ventures and coordination in tourism and other services. Unfavorable repercussions arise from the disappearance of many industries in the small economy, its confinement to producing low-skill goods, and the emigration of a sizable segment of its labor force to the neighboring economy, as well as to other countries. These effects are known in the literature as backwash-effects or polarization-effects arising from the capability of efficient, large-scale industries in the advanced economy to out-compete inefficient small-scale industries in the less advanced economy, and attract its labor and capital[5].

From the perspective of the small economy, therefore, the crucial question is the balance of the dynamic impacts. To what extent would they help its own development, and to what extent would they reinforce underdevelopment? Among the factors that determine the relative strength of these two trends is the degree of integration between the two sides, which can be easily appreciated by considering trade. A removal of tariff and other barriers to trade between the two countries would increase the exports of the small economy to its neighbor, as trade between them takes on a pattern based on comparative advantage. This level of exports, however, will not be sustained if the free trade between the two countries is accompanied by a common external tariff (as in a custom union), where the tariff

[5] For a good analysis of these effects see Krugman and Obstfeld (1994), Krugman (1998), and Thirlwall (1994).

is substantial and is set, as it most likely would be, with the objective of protecting the advanced economy's industries. Such protection would increase the price of intermediate and capital goods imported by the small economy, and thus raise its cost of production and compromising its comparative advantage. Further measures of integration between the two economies, such as allowing free movement of labor and capital, would significantly reduce the export of goods from the small to the large economy as the export of labor services would be substituted for the export of goods. In other words, free trade and free mobility of factors would gradually wipe out trade based on comparative advantage and confine it to trade based on absolute advantage, resulting in the small economy exporting low-skilled goods and importing high-skilled goods, thus "locking in" its poverty[6]. The small economy would be relegated to the status of a backward region in an otherwise advanced country, as is the case of southern Italy and central Appalachia in the United States. Had the integration between the two countries been allowed to proceed at a slower pace - free trade between the two sides first, without a common external tariff and free mobility of factors - producers in the small economy would have been able to expand production by taking advantage of scale economies, and enhancing a comparative advantage favorable to development. In short, a slow pace of integration would improve the comparative advantage of the small economy by tapping the spread-effects, whereas a hasty integration would destroy comparative advantage through the working of the polarization effects.

Immediately after occupation in 1967, Israel imposed on the West Bank and Gaza Strip a custom union trade arrangement that increased tariffs approximately fourfold[7]. Naturally, this drastic increase, along with the many non-tariff barriers applied by Israel, resulted in a huge trade diversion away from neighboring Arab countries and the rest of the world toward the Israeli market, raising the cost of capital and intermediary goods to Palestinian producers that effectively wiped out their competitive edge in foreign markets. Recent studies show, for instance, that the cost of garment production in the West Bank is larger than that of Jordan by a factor of 2.17. An important component in that difference is due to the fact that Palestinian producers pay double the price for their imported Turkish textiles, compared to the superior - quality East Asian materials imported by Jordanian producers. The Palestinians cannot import the Asian textiles because of the prohibitive tariff imposed by Israel to protect its own industry. Similarly, the cost of agricultural products, pharmaceuticals and shoes in Jordan is lower than in Palestine partly because of the differences in imported input prices[8].

Another reason for the high cost of Palestinian production in both agriculture and industry is the relatively high wage rate. It is estimated that wages of Palestinian workers are larger than those in Jordan by a factor of two-to-three in agriculture, a factor of two in the garment industry and a factor of 2.3 in the shoe industry[9]. These high wages are the result of distortions in the labor market created by the hiring of Palestinian commuters to work by the day in Israel; a practice which started with the occupation and steadily increased to account for almost a third of the Palestinian labor force in the 1990s[10]. Naturally, this trade arrangement has increased the cost of Palestinian production, causing Palestinian exporters to loose their comparative advantage in traditional neighboring markets. More importantly, economies of scale realized by the advanced Israeli manufacturers enabled them to undercut the small Palestinian firms producing for the domestic market, disrupting and replacing Palestinian artisan and small industry production.

A UN study in the-mid 1980s showed that 50 percent of Palestinian imports from Israel had been produced domestically prior to the occupation[11].

While these adverse polarization effects were at work, various positive spread effects were also introduced by the occupation. These included the new opportunities that opened up for employment in, and trade with, Israel and for some transfer of technology. The income earned by Palestinians working in Israel

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[6] The advanced economy is generally more productive in the majority of sectors. The small economy will be able to export to the large economy goods that have no absolute advantage in production provided it has smaller productivity disadvantages and its labor accepts wages lower than those prevailing in the large economy. Free mobility of labor would induce labor to move from the low-wage small economy's industries to the high-wage large economy's industries, gradually wiping-out the former and expanding the latter. In the long-run, no industry will survive in the small economy unless it enjoys an absolute advantage over its counterpart in the large economy, and that means a predominance of low-skilled industries.

[7] See German - Arab Chamber of Commerce (1995)

[8] For analysis of the cost of agricultural products see Awartani (1994), and for similar analysis related to garments, pharmaceuticals, and shoes see Makhool (1996).

[9] Ibid.

[10] See UNCTAD (1996).

[11] See UNDO (1984).

contributed to rapidly rising money income and, in turn, to increased demand and domestic economic activities. Palestinian agriculture benefited from a transfer of technology from the more advanced Israeli agriculture and this contributed to increased exports of some agriculture products to Israel. The cumulative impact of this expansion in economic activities helped increase income, saving and investment, especially investment in residential construction.

II. The Role of Zionism in Creating an Adverse Path of Dependence.

Had the economic relations between Israel and the Palestinian territory been confined entirely to the dynamic forces described above, the positive spread-effects would probably have dominated the adverse polarization effects by the end of the second decade of the occupation. The higher cost of living in Israel and the external diseconomies produced by congestion would have outweighed benefits of greater efficiency and given way to increased investments in the Palestinian economy. Increased economic activities in the Palestinian territories would then have gradually corrected the distortion in the labor market by reducing the number of Palestinians seeking daily work in Israel. The spread-effects would have certainly asserted themselves and generated a process whereby Palestinian income was created endogenously in the internal productive sectors, rather than exogenously. Instead, we see that the relation between the two economies has followed quite a different path. As is shown in Table 1, the Palestinian economy benefited significantly from its relationship with Israel in just the first decade, and then that relationship became harmful. In the first decade the Palestinian GDP per capita grew from nine percent of that of Israel to 15 percent, but then the ratio declined continuously and at the start of the limited self-rule was almost at the level of a quarter of century before. Thus, in the first decade of occupation the relations between the two economies went through a process of convergence; the poor economy grew at a rate faster than the rich economy. Afterwards, the process was reversed and became one of divergence; the rich economy growing at a faster rate. The reason for this reversal is that the economic relationship between the two economies was not confined to the working of the polarization and spread effects operating through the market. The Zionist policies practiced by Israel since the start of occupation, which increased in intensity and aggressiveness in the mid-1970s, has circumvented the forces in the market, bolstering the effects of polarization and diminishing the spread-effects.

These policies and practices include the following measures.

i. Restriction on the Use of Natural Resources.

Since the start of the occupation, the Palestinians in the West Bank and Gaza Strip have increasingly lost control over their land and their supply of water. The Israeli authorities used many different and complex measures and policies, all of which were designed to place under Israeli control the largest possible area of land, and the maximum amount of water. It is widely believed that by the time of establishing Palestinian limited self-rule Israel had confiscated 68 percent of the total land of the West Bank and 40 percent of that of Gaza Strip[12]. On the other hand, estimates indicate that Palestinians in the West Bank use only about 15 to 20 percent of the annually available water originating in the area. The rest is used by Israeli settlers and within Israel[13]. New Jewish settlements were built on part of the land taken from Palestinian use and control. The rest of the confiscated land was turned into closed military areas. By the end of 1991, the number of these settlements had reached at least 156 in the West Bank and 18 in Gaza Strip, with a population of 250,000[14]. These Israeli policies toward land, water and settlements have created an atmosphere of conflict, strife and uncertainty, which has had a profoundly negative impact on all economic activities. The direct adverse effect was felt most strongly in agriculture, where the area of irrigated land has declined by six percent, and where prices of land and water increased to a very high level[15]. This distortion of prices, combined with the refusal of the Israeli authority to allow the for normal expansion of municipal boundaries has also resulted in high building costs for new industrial plants, and thus acted as a strong barrier to industrial expansion.

ii. Restrictions on the Economic Activities of the Productive Sectors.

In addition to the removal of land and water from Palestinian control, the Israeli authorities have followed a general practice aimed at changing the structure and performance of the Palestinian economy. All economic activities were placed under the scrutiny of the Israeli military administration in the territories. Every

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[12] See UNCTAD (1993)

[13] See World Bank (1993) Vol. 4, p. 54

[14] The same source as (12).

[15] World Bank (1993) Vol. 4, p.20.

economic undertaking required its approval. Plans by Palestinian businessmen to start a new venture, or to expand an old one, were often frustrated by delays in granting the appropriate permit, or in outright denial. Permits were required for all activities related to the acquisition of land, the construction of buildings, the transformation of goods, and export and import activities.

The taxation of Palestinian business activity was equally detrimental. Palestinian firms have had to pay value-added tax (VAT) on all their imports of raw materials through Israel. The long delay in receiving the refunds of this tax caused these firms severe cash flow problems and capital shortages. This has resulted in an annual loss estimated to be eight to 12 percent of the value of their finished products[16].

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

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

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

[16] Ibid, Vol. 3, p. 16.

iii. Resource Transfer to Israel and the Neglect of the Public Sector.

The forced integration of the Palestinian economy into that of Israel was associated with a transfer of resources from the former to the latter. Three channels were involved. First, Palestinians paid VAT and custom duties on products imported from Israel. It is estimated that half of the taxes paid by Palestinians in the Occupied Territories accrued to the Israeli treasury in this way[17]. The second source is the income tax and social security contributions paid by Palestinians working in Israel. The third was the seigniorage revenue Israel received because its currency had been made legal tender in the Occupied Territories. The total of these resource transfers is large, and according to some estimates has reached, in any given year, from fifteen percent to a quarter of the Palestinian GNP[18]. This transfer has been dubbed the "occupation tax" by an Israeli observer[19], but it would be more appropriate to call it the "Zionist exaction". Given that Israel was not prepared to undertake public expenditures in the Occupied Territories beyond the tax revenues actually raised there (as opposed to those paid Palestinian consumers and workers but collected in Israel), all the public infrastructure in the West Bank and Gaza Strip is in a very poor state, and the level and quality of public services and utilities are far below that of neighboring countries[20]. The poor condition of the basic infrastructure and public services causes market fragmentation, and this inhibits specialization and the realization of economies of scale, which are essential for a small economy to be competitive.

The cumulative impact of the foregoing restrictions on resource use, business activities and domestic and international trade, has substantially weakened the traditional productive sectors of the Palestinian economy. This has caused a general reallocation of factors of production combined with the reorientation of the trade flows to the benefit of Israel. As a consequence a major structural transformation of the Palestinian economy has taken place. It has become an

[17] See Fischer et al (1994), p.120.

[18] See Hammed and Sha'ban (1993) and Leask and Weinblatt (1996).

[19] M. Benevenisti, the ex-deputy of the Mayor of Jerusalem. See Roy (1995), p.195.

[20] This Israeli behavior is quite consistent with past British and French colonial behavior in the Middle East. One of their major underlying economic principles was that "colonies should pay for themselves without recourse to special financial assistance from the metropolis". See Owen and Pamuk (1999), p.52.

economy characterized by two growing disequilibria: a resource gap and labor market imbalance, and a great and unhealthy dependence on external sources of income. It also features a sectoral disarticulation and an infrastructure gap.

The resource gap.

The Palestinian economy suffers from a chronic incapacity to generate more than two-thirds of its national income. Usually, the yearly total domestic absorption (domestic consumption and investment and government expenditures) is more than one-and-a-half times the economy's total production (GDP). Imports fill this gap, and assume a very important role in the economy. In the years preceding the establishment of limited self-rule, the import surplus (imports-exports) measured as a percentage of GDP, had reached 59 percent and had never been less than 43 percent (see Table 2). The financing of these huge imports was generated mainly from the income of Palestinians working in Israel, and the remittances of those working in the Gulf States. These factor incomes account for the wide disparity between GNP and GDP and is shown in the same table.

Another manifestation of the resource gap and the central role played by factor incomes is the investment-saving imbalance. Domestic savings in every year of the occupation was negative. Thanks to factor income, however, national saving was positive, and generated part of the funds needed for investment; the rest has been acquired from foreign savings.

The labor market imbalance.

The mirror-image of the resource gap is the imbalance in the labor market between the growing supply of labor, reflecting both a high natural rate of growth and the age structure of the population, and the limited capacity for employment due to hostile economic environment of the occupation. Between 1972 and 1987 the labor force increased by around 50 percent, while domestic employment increased by 27 percent in the West Bank, and 18 percent in the Gaza Strip. The difference was mainly absorbed by the Israeli market, in which employment of Palestinians from the West Bank increased by 80 percent and from Gaza strip by 163 percent, in the same period. Table 3 shows the main features of the labor market.

The sectoral distortion

While the resource gap and the labor market imbalance portray weaknesses of the Palestinian economy at the macro level, the sectoral distortion pertains to the underlying causes of this weakness at a micro level. Table4 presents the Palestinian sectoral shares in GDP, along with those of neighboring countries. The harmful structural transformation noted above is revealed by the fact that the share of agriculture in Palestine is the highest, and its share of industry is the lowest. It is striking that the Palestinian agricultural share is more than four times that of Jordan, while its share of industry is little more than half that of Jordan.

The infrastructural gap

Fiscal compression and under–investment, as well as neglect in the public sector, have made the Palestinian economy seriously deficient in most infrastructures and public services. Table 5 shows that the Palestinian economy is lagging in all infrastructure provision compared to its neighbors. Transportation and sanitation are in dire straits. Almost all the major roads in the West Bank and Gaza Strip were constructed before 1967, and have received minimal maintenance during the years of occupation. Sanitation is in a health threatening condition, as only 25 percent of households in the West Bank and Gaza Strip are connected to sewerage networks. Garbage collection is deficient and poses a major health hazard. One feature of Table 5 is especially noteworthy; at the regional level, Israel is ranked first, and the Palestinian territories last in infrastructural provision.

III. The Economics of Limited Self-rule during the Interim Period.

The gradual establishment of Palestinian limited self-rule in parts of the West Bank and Gaza Strip was the result of the implementation of several agreements between Israel and the PLO. As a consequence, there was a transfer of power over some economic affairs from the Israeli Civil Administration (CA) to the Palestinian Authority. This included the removal of direct restrictions on business activities. Palestinian firms can now function without the crippling effects of permits and licenses previously required by the CA. Notwithstanding the importance of this, however, it should be mentioned that some of the indirect restrictions remain. These restrictions include the treatment of indirect taxes, and the tariffs on consumer durables from neighboring Arab countries.

The asymmetric custom union regime, which characterized the economic relationship between Israel and the Occupied Territories, has changed in two directions under the limited self-rule. First, many elements in the asymmetry have been removed. In principle, Palestinian goods should receive the same treatment in Israel that Israeli goods receive in Palestine. Second, some elements of a Free Trade Area regime have been introduced. The PA should also have the freedom to choose its own tariff rates on three lists of goods. They list goods, which can be imported from or through Jordan and Egypt.

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

Under the limited self-rule some of the resource transfers to Israel have been eliminated. Seventy five percent of the income tax collected from Palestinians working in Israel, and 100 percent of the income tax collected from those working in Jewish settlements, will be reimbursed to the PA. Israel is also required to transfer to the PA all VAT on goods purchased in Israel by Palestinian firms. However, the resource transfer from the Palestinian economy to the Israeli economy has not been eliminated. Palestinian imports from the rest of the world, which must pass through Israel, still generate custom duties received by Israel and not transferred to the Palestinian Authority. This happens because Palestinian wholesalers and firms use Israeli traders to import from the rest of the world. A common practice of these traders is to include the Palestinian imports as part of imports destined to Israel (not the West Bank and Gaza Strip). Accordingly, customs paid by Palestinians on these imports accrue to Israel and are not transferred to the PA, as is the case of Palestinian imports from Israel destined to the West Bank and Gaza Strip. Obviously, there is no precise way of measuring the exact size of this forgone revenue, but recent studies have estimated it is around one-third of total tax revenue and around 3 percent of the Palestinian GDP[21]. It should be noted, also, that Israel still collects seigniorage revenue since its currency is still legal tender in the Palestinian areas.

The most important feature of the limited self-rule is related to sovereignty and natural resources. In the Declaration of Principles, it was agreed that there would be no change in sovereignty over land, water and settlements during the transitional period. These issues were left to be negotiated as part of the final settlement. Consequently, the restrictions imposed on the Palestinian use of land and water remain completely intact. The substantial restriction on the use of irrigation water in the West Bank, and the diversion of water from aquifers for use in Israel and its settlements, will continue to harm Palestinian agriculture and prevent any serious move to expand and diversify crops. As of June 1997, "Israel directly controlled 40 percent of the land of the Gaza Strip and 74 percent of the West Bank, the latter known as Area C. In Area C, Israel has full authority over zoning, building, and land registration. In those West Bank lands under both Palestinian and Israeli authority (Area B) - approximately 23 percent - the Israeli government maintains complete control over land registration procedures. It is only in Area A (approximately 3 percent) of the West Bank that Palestinians exercise full control over land disposition"[22]. It should be noted that the Israeli authorities retain full control over all borders, which implies control over the movement of labor and goods between the Palestinian territories and the outside world. Furthermore, the conditions under which the limited self-rule has been implemented have caused geographic segmentation with harmful economic effects. According to a World Bank report, the new situation "split up the West Bank and Gaza into a number of largely separate economic units with little

[21] See Naqib (1996).
[22] See Roy (1998).

economic interrelationship among them, breaking up an already small domestic market into even smaller ones"[23].

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

Yet, none of these aspects of Israeli control, profound as they are, is the most crippling aspect of the limited self-rule. The interim period received its severest blow with the continuation of building new Jewish settlements and expansion of existing ones[24]. The growth of settlement activities since the signing of the DOP in 1993 is an unambiguous indication that the peace process, as exemplified by the limited self-rule, did not address the root of the problem; the Zionization of the West Bank. Within just two years after the signing of the DOP, the following activities took place[25],

- confiscation of 55 thousands dunums of Palestinian land, (see Table 6)[26],
- 17,860 dunums bulldozed by settlers without being officially confiscated,
- direct expansion of existing settlements by 8,993 dunums,
- uprooting of 28,752 trees,
- chemical destruction (poisoning) of thousands of trees in the West Bank by settlers,
- use of 11,433 dunums for road construction to link settlements by by-passing Arab population centers.

[23] See Roy (1996).

[24] The Palestinian side maintains that confiscating land and building Jewish settlements violates the spirit, if not the letter, of the Oslo accord since it alters facts on the ground, so prejudicing the negotiation of final settlement.

[25] See PHRIC, (1995).

[26] 1 Dunum = 1/4 Acre.

All of these activities have increased in scope and intensity in the last two years, especially in Palestinian lands surrounding the city of Jerusalem. Indeed, immediately after signing the Wye accord in October 1998, foreign minister Ariel Sharon counseled the settlers to make haste by "grabbing hilltops" before land was turned over to the Palestinians. Israeli peace groups reported that 16 new settlements were established in the first five months after the Wye accord was signed at the White House[27].

It should come as no surprise, therefore, that the peace process did not eliminate the bases of conflict, strife and violence. Nor is it surprising that after five years of limited self-rule the economic condition is as bleak as it was under the occupation. In fact, the general well-being of the Palestinian people in the West Bank and Gaza Strip has undoubtedly deteriorated since the establishment of the limited self-rule. According to a survey conducted by the Palestinian Central Bureau of Statistics (PCBS), real per capita average expenditures in the 1995-1996 survey period was about 15 percent below its average for the years 1992-1993. This deterioration in the standard of living is also manifested by the growing gap between the Israeli and the Palestinian per capita income. Table 1 shows that after 30 years of imposed integration between the two economies, the gap between them has expanded, signifying a dominance of the polarization effects over the spread-effects. This adverse trend is also demonstrated in the performance of the Palestinian economy at the macro level, as exemplified in the continuance of the resource gap and the labor market imbalance, (see Table 2 and 3).

IV. Prospects for Future Israeli-Palestinian Economic Relations

Two major themes have emerged from the foregoing analysis. The first is related to the fact that Israeli activities over more than a quarter of a century of occupation have engendered a debilitating path of dependence in the Palestinian economy. The second is the fact that the last five years of limited self-rule have not been able to overcome that path and replace it by a qualitatively new growth-augmenting style of path, which would cement the road to a genuine peace.

Notwithstanding various and important improvements in the economic environment brought about by the establishment of limited self-rule, the essence

[27] See the New York Times, 3 March 1999.

of the relationship between the Israeli and the Palestinian economies is still as it was during the occupation. A relation between two dissimilar economies, whereby the large economy practices policies that keep the small economy weak and dependent. The dynamic of this relationship is best epitomized by the working of the labor market. Since the beginning of the occupation, opportunities open to Palestinians to work in Israel has been the most important single factor in the relations between the two economies. As Table 3 shows, in just a few years after the occupation, the problem of unemployment in the Palestinian economy was completely eliminated by allowing Palestinians to work in Israel. The Palestinians were hired as commuters to work by the day in Israel, mostly in construction and agriculture. These workers are largely laborers with few skills and live in refugee camps and rural areas[28]. The number of these workers increased steadily in the first decade of the occupation and contributed to a very rapid increase in Palestinian monetary income. However, this steady injection of financial resources was not channeled into productive investment in the Palestinian economy, due to various obstacles created by the Israeli regulations that stifled investment under occupation. More fundamentally, the export of labor to Israel, without the revenue being able to be used in productive investments, became the major instrument by which Israel maintained its dominance over the Palestinian economy. It impacts the economy in two ways that tend to reinforce each other. From the supply-side, the induced higher wage in the domestic economy - which does not arise from any increase in domestic productivity - results in a contraction of agricultural and industrial production, due to the increase in the cost of production, the decline in profitability and the loss of competitiveness in foreign markets. From the demand-side, the increase in income generated from earnings of workers in Israel increases the aggregate demand in the domestic economy without parallel increases in production. Thus, the increase in demand for traded goods is met by an increase in imports, and the increase in demand for non-tradable goods is met by an increase in prices. This “Dutch Disease” change in relative prices causes a contraction in the tradable goods sectors (agriculture and industry) and stimulates the production of non-tradable sectors (construction and services)[29].

[28] See Farsakh (1998).

[29] For a detailed analysis of the Dutch Disease phenomenon see Gordon and Neary (1982).

As a result of this dynamic, the export of labor to Israel, instead of being a vehicle to stimulate domestic economic activities, became a means of paying for imports from Israel. The Palestinian imports bill, of which 90 percent goes to Israel, amounts, on the average, to around 60 percent of GDP and more than 50 percent of private consumption[30]. To put it another way, the Palestinian economy became doubly dependent on the Israeli economy as a source of income and imports. The former amounts to almost 30 percent of GNP and the later to around 40 percent[31]. The vulnerability of the economy to such one-sided dependency has been exposed in the 1990s after Israel implemented its permits and closure policies[32]. Estimates of economic losses from the resulting interruption to labor and trade flows vary, but most indicate very large losses, reaching in 1996, 18.2 and 39.6 percent of GNP of the West Bank and Gaza Strip, respectively[33].

Obviously, relations between two neighboring countries, in which measures taken by one, can cause the other to lose overnight the income of one-third of its labor force, and interrupt 90 percent of its imports and 80 percent of its exports, is simply untenable. The disproportionality - in what might be called the costs of dissociation - renders the Palestinian-Israeli relationship unstable and must be corrected if more rapid economic growth is to develop. From the Palestinian side, this requires a complete eradication of all activities that skew the relationship in favor of Israel and its polarization effects. It also requires a new arrangement whereby there is no mismatching between responsibility and authority. Those who have the power to license businesses should also have authority over the crossing of borders and movements of goods, labor and capital.

A new environment free of conflict over sovereignty, and clear and well - defined authority over economic activities can take the Palestinian economy a long way toward a higher path of development and growth. Such a new and enabling environment would cement new economic relations between the two economies, which could exploit possibilities of complementarity and rationalization, and

[30] See UNCTAD(1998), Table 7, p. 108.

[31] Ibid.

[32] Since March 1993, Israel has intermittently closed various borders - between the West Bank and Gaza Strip, between the West Bank or Gaza Strip and Israel or the rest of the world, and between various cities and communities of the West Bank - for varying lengths of time.

[33] Diwan and Shaban (1999), p. 52.

acknowledge the need of the Palestinian economy to use reasonable measures to safeguard against dependence upon one major trading partner. The following sectors could furnish a fertile ground for more equitable and profitable relations in the future.

(1) Agriculture

Agriculture is an area that has almost all the ingredients for making it a testing ground in any new relationship. This is due to the fact that the rationalization of agricultural production between the two sides requires major changes in policies, as well as serious efforts at cooperation and coordination. The agricultural sector is very important to the Palestinian side in that it employs around one-quarter of the labor force, and contributes approximately one-third of GDP and exports. It uses highly labor-intensive methods of production and generally does not incorporate scientifically advanced methods of irrigation and fertilization. In contrast, Israeli agriculture is a very advanced, capital-intensive sector, but contributes no more than two percent to GDP and less (1.7 percent) to exports[34]. This being the case, trade based on comparative advantage will lead Israel to specialize in high value seedlings and prototypes, and to Palestine specializing in labor-intensive branches of fruits and vegetables. This would benefit both sides, and has previously been blocked by the protective policy of Israel. For decades, this policy has used a very complex subsidy system embracing all aspects of production and marketing, to the extent that Israeli farmers have been able to sell fruits and vegetables in the Palestinian territories, Europe and North America at prices far below their real costs[35]. Furthermore, the policy adversely impacts on Palestinian agriculture, in that cheap water offered to Israeli farmers is partly taken from Palestinian sources[36]. Thus, removing this huge distortion requires the gradual dismantling of the Israeli protective policy, and a fairer distribution of water. Both of these measures would create a more level playing field in agriculture, that would reduce prices, increase welfare and conserve water for both sides.

From the Palestinian perspective, the Israeli market is very important because of its size, geographical proximity and familiarity. Nonetheless, reviving the agricultural sector to successfully play its developmental role, requires also an expansion of Palestinian agricultural exports to Middle Eastern markets, as well as to Eastern and Western Europe markets. In this regard cooperation with Israel over the transfer of technology such as drip-irrigation, fertilization and filtration systems, as well as modern methods of storing, packaging, and marketing, could be beneficial to both sides.

(2) Industry

Israel has an overwhelming advantage in most industrial branches, so trade with the Palestinian territory will be in its favor for a long time. On the other hand, Israel is going through a structural change whereby workers are attracted to high-technology manufacturing establishments, reducing the supply of labor for traditional industry. Faced with higher wages, traditional industries have to look for supplies at lower wages so as to maintain their competitive edge in foreign markets. So far, Israeli firms have been able to adjust through sub-contracting with firms in the West Bank and Gaza. The arrangement involves neither a commitment of Israeli capital nor a transfer of technology. Israeli firms bring to Palestinian firms semi-finished Israeli goods and contract for processing according to certain specifications[37]. It is basically an indirect trade in labor services similar to the direct employment of Palestinian daily workers in Israel. In a new environment characterized by more openings to the rest of the world, it is highly unlikely that such arrangements would survive. Inflows of capital, along with competition, would gradually substitute foreign direct investment (FDI) and joint-ventures for sub-contracting. From the Palestinian perspective, Israeli-Palestinian joint-venture schemes are preferable to that of sub-contracting. In addition to reducing the risk arising from the involvement of Israeli capital, joint-ventures are superior to sub-contracting in that they reduce the degree of dependency on Israel.

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[34] The very low contribution of agriculture to GDP and exports reflects the rapid transformation of the Israeli economy towards high-tech activities, as well as a considerable reduction in government subsidies to agriculture in recent years.

[35] See, Lonergan S., and Brooks, D., Watershed: The Role of Fresh Water in the Israeli - Palestinian Conflict. International Development Research Centre, Ottawa, 1994, p. 79.

[36] See, UNCTAD, (1996).

[37] For more details concerning sub-contracting in the pre-1990 period, see: “Palestinian external trade under Israeli occupation”, (UNCTAD/RDP/SEU/1). A more recent treatment of the subject may be consulted in Mansour, A., and Destremau, B., Palestinian and Israel: Subcontracting in the Garment Industry, Ramallah, Palestine Economic Policy Research Institute (MAS), December 1997.

Put another way, joint-ventures distribute the dissociation costs more evenly. There are many areas where joint-ventures can be very beneficial to both sides in that factors of production from both could complement each other, and markets for products are accessible. These areas include:

(a) Textile and garments

This industry is very important in Israel, contributing around nine percent to total industrial manufacturing and some eight to nine percent of industrial exports. The Israeli fashion industry has secured some access to European and North American markets through a variety of licensing and other production arrangements with firms in those markets. However, the high and rising cost of labor in Israel is an obstacle to its acquiring a distinct competitive edge that would enable it to pursue a policy of aggressive penetration into those markets. A joint-venture arrangement with Palestinian firms would significantly reduce labor costs in addition to expanding exports to Arab and Muslim countries whose preferences are very similar to those of Palestinians. In return, Palestinian firms would gain from technological transfer and the learning of new skills.

(b) Agro-industry

The Palestinian agro-industry includes food processing, olive packing, tobacco and dairy plants. A joint-venture with Israeli firms that improves the technology in canning, drying and freezing of fruit and vegetables could go a long way toward allowing Palestine to develop an exporting industry. A demand for such products exists in Arab and Muslim countries, as well as in Arab and Muslim communities in Europe and America.

(c) Computer services

There are a few successful Palestinian firms in the West Bank producing Arabic software, including word processing, graphics and Arabic calligraphy. It is expected that those firms would be able to export their services to the neighboring Arab countries once trade is normalized in the region. Joint-ventures with Israeli firms could expand exports to include more sophisticated computer services, such as information systems and consultancy.

(d) Tourism

Perhaps the most promising area of cooperation between Palestine and Israel lies in the field of tourism. A peaceful environment would certainly increase significantly the number of tourists to each area. Accommodating that increase and expanding the industry to realize the full potential of the region’s religious and cultural attractions require serious efforts in coordination.

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Table 1: Comparison of GDP per Capita in Israel and the Palestinian Territories, (US $ at 1991 prices)

Year*	Israel	West Bank and Gaza Strip (2)	Ratio (2) / (1) / (3)
1968 -1969	6,043	601	0.09
1975 - 1976	8,163	1,026	0.13
1980 - 1981	8,613	1,252	0.15
1985 - 1986	9,051	1,264	0.14
1990 - 1991	0,912	1,320	0.13
1995 - 1996**	16,694	1,626	0.10
1997 - 1998	16,492	1,523	0.09

Notes: *Average of two years are taken to neutralize variations in the Palestinian GDP caused by the cyclicality of the olive crops; **GDP per capita for 1995-1998 are in current prices.
Source: Author calculations using *Statistical Abstract of Israel*, 1998; World Bank-*Developing the Occupied Territories* Vol. 2, Table. 1 p. 135; Palestinian Economic Policy Research Institute (MAS), *Economic Monitor*, Issue Number 6-April 2000.

Table 2: The Resource Gap (%)

	1968	1975	1980	1985	1990	1995	1998
Import Surplus (1)	34	59	45	56	39	37	42
Investment Surplus (2)	43	24	16	15	5	28	28
GDP / GNP	107	78	80	77	75	93	86

Notes: (1) Defined as (Imports - Exports) / GDP; (2) defined as (Investment - Saving) / GNP.
Source: Calculated by using Table.1 in *Developing the Occupied Territories*, Vol. 2, 1993 and a memo issued by the Palestinian National Authority. Ministry of Finance, October 1998.

Table 3:The Labor Force Imbalance (Thousands)

	1968	1975	1980	1985	1990	1995	1997
Labor Force	146.6	206.6	218.5	251.5	307.8	497.2	572.7
Number of Employed	128.0	264.7	215.7	242.1	297.0	402.9	444.9
Percentage of Employed in Israel (%)	0.0	32.4	34.8	36.8	36.4	16.1	16.1
Unemployment Rate (%)	13.1	0.9	1.3	3.6	3.7	18.2	22.1

Source: Leila Farsakh, *Palestinian Employment in Israel 1967-1997: A Review*, Palestinian Economic Policy Research Institute (MAS), August 1998. Tables 2 and 5.

Table 4: The Sectoral Disarticulation: Sectoral Share in GDP (%)

	Palestine	Jordan	Egypt	Israel
Agriculture	25	6	18	2
Industry	10	17	30	22
Construction	14	7	na	10
Services	48	37	52	65

Source: The figures for Palestine are calculated as an average of two years to smooth the olive cycle. They are taken from estimates of the UNCTAD Secretariat for the years 1992-1993. The rest of the figures are calculated for 1991 at current prices. World Bank, *Peace and the Jordanian Economy*, *1994*, Table 1.2, p. 10.

Table 5: The Infrastructure Gap (1992-1994)

Country	Pop (million)	Per Capita Income US$	Electric Supply KW/100 people	Electric Power System Loss %	Households with Sanitation %	Number of Phones Per 100 people	Meters of paved roads Per 100 people
Egypt	55.0	650	21.0	14.0	50	4.3	39
Jordan	3.9	1,120	25.0	19.0	100	7.0	170
WB & Gaza Strip	2.4	1,450	13.0	30.0	25	3.1	80
Lebanon	4.0	2,500	32.0	n.a.	n.a.	9.3	n.a.
Syria	13.0	2,800	30.0	n.a.	63	4.1	180
Israel	5.1	13,500	82.0	4.0	100	37.1	266
LMICs [1]	1,152.6	1,620	21.5	12.4	-	7.9	-

Notes: [1]Lower Middle Income countries.
Source: I. Diwan and R. Shaban, Development Under Adversity, Palestine Economic Policy Research Institute (MAS) and the World Bank (Forthcoming).

Table 6: Israeli Confiscation of Palestinian Land (1990 - 1997)

Year	Confiscated Land (Dunum) [1]
1990	227,335
1991	80,594
1992	14,669
1993	49,466
1994	5,119
1995	24,867
1996	6,000
1997	24,938

Notes: [1] 1 Dunum = 1/4 Acre.
Source: 1990-1995: Palestinian Human Rights Center PHRIC. 1996: Approximate numbers based on data provided by PHRIC. 1997: Annual Report of the Palestinian Society for the protection of Human Rights and the Environment: Jerusalem.