

TIGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER Working Paper Series

No. 8

Israeli-Palestinian Economic Relations: Past Experience and Future Prospects

Ephraim Kleiman

Warsaw, June 2001

Patinkin Emeritus Professor of Economics, Department of Economics, The Hebrew University of Jerusalem, Mt.
Scopus, Jerusalem, Israel. e-mail: Ephraim.Kleiman@huji.ac.il

Ephraim Kleiman

Israeli-Palestinian Economic Relations: Past experience and Future prospects¹

Summary

The paper briefly surveys and analyzes the economic relationship between the Palestinian territories of the West Bank and Gaza Strip (WBGs) and Israel, since their occupation by Israel in 1967 until today, and points out the directions in which it may be expected to develop in the future. The proximity and size of the Israeli labour and goods markets provided the Palestinian economy with opportunities for rapid economic growth, which were expected to be exploited to the full following the establishment of the Palestinian National Authority (PNA). However, the deterioration of the security situation at about the same time severely restricted economic flows, bringing about a worsening in the economic situation in the WBGs. By establishing an effective border, especially around the Gaza Strip, this change in circumstances effectively prevented the implementation of the *quasi* customs union envisaged in 1994. It is against this background that the development of future Israeli-Palestinian economic relationships is evaluated. There is a pronounced tendency of both sides towards increased economic separation, motivated on the Palestinian side by political considerations and on the Israeli side by real and perceived security ones.

¹ I am indebted to participants in a seminar on the *Peace Process in the Middle East* at the Instituto de Estudos Avançados of Sao Paulo University, for helpful comments on an earlier version of this paper.

1. Introduction and background

The recent state of the Palestinian-Israeli conflict has unavoidably relegated the question of the long-term economic relationships between them to an, at best, position of secondary interest. Yet ultimately the two parties will have to find ways to coexist with each other and will have to decide on arrangements that will regulate their economic relationships. Preferably, this will be done by agreement. But even a decision to separate itself unilaterally from the other party implies economic arrangements of one sort or another, affecting both sides.

To provide some background for the discussion in this paper, it may be worthwhile to remind the reader that area that presently contains Israel and the Palestinian territories was until the first world war part of the Ottoman (Turkish) empire, and was under British administration between 1917 and 1948. Following the establishment of the State of Israel, part of the eastern, mountainous part of British Palestine became incorporated in the Hashemite Kingdom of Jordan, and came to be known as the West Bank (of that state). A narrow coastal strip in the Southern part, named after its main city of Gaza, came to be administered by (but never incorporated in) Egypt. Both areas came under Israeli rule in the wake of the Six Days' War. The so-called Oslo agreement of 1993 led to the establishment of a Palestinian National Authority (PNA) in the West Bank and the Gaza Strip (WBGS), which were expected to evolve into an independent state. In the summer of 2000, however, negotiations between the PNA and Israel broke down, leading shortly afterwards to an outbreak of limited armed clashes between them.

All three areas are very small by international standards, occupying altogether an area of 27,000 square kilometers (equivalent to less than one-tenth of the area of Poland), of which Israel, in its pre-1967 borders, accounts for 77 per cent. On the latest count, the population of Israel amounts to 6 millions, that of the WBGS to 3 million. Population growth has been rapid, in Israel because of immigration, in the Palestinian territories because of both immigration (since the establishment of the PNA in 1994) and of natural increase, the rate of

which is among the highest in the world.² The Palestinian GNP was expected to reach slightly over US \$ 6 billion in the year 2000, as against Israel's GNP of nearly US \$ 100 billion.³

In this paper we shall first survey the effects on the Palestinian economy of its forced integration with the Israeli one, and of their gradual separation in the second half of the last decade. A number of possible alternative arrangements for the future relationship between these economies will then be considered. It will be suggested that although it is not in the economic interest of either of the parties involved, these economies might be expected to drift further apart in the coming years.

Because of the inevitable lag in the collection and processing of statistical data, and in the hope that the present state of affairs in the region is not going to persist, the economic situation referred to in the paper is the one that held before October 2000.

2. A brief history

When the West Bank and the Gaza Strip were taken over by Israel in 1967, both were relatively small, poor, labour intensive economies. They were also suffering from chronic unemployment, both overt and disguised, aggravated further by the sudden severance of their ties with, respectively, Jordan and Egypt, and these countries' military defeat. Compared to them, Israel was a large, technologically much more advanced and relatively capital intensive economy, on the verge of an economic boom. Under the pressures that these circumstances generated, the initial idea of keeping the Palestinian territories economically separate from Israel was soon abandoned. For most practical purposes, the West Bank and Gaza found themselves joined in an economic union with Israel. Although this union was imposed on them from above and was far from equitable, its results followed the textbook case of economic integration almost to the letter.

These results were what economic theory leads us to expect, when a small, poor, labour endowed economy is brought into contact with a relatively big, rich, labour scarce one. Given

² Throughout this paper, all data on the WBGS, i.e., Palestinian, economy are exclusive of the Israeli settlements established there since 1967. They, as well as the mainly Palestinian populated, formerly Jordanian ruled east part of Jerusalem, are included in the statistics for Israel.

³ For the expected Palestinian GNP, see U.N., Office of the United Nations Special Co-ordinator [to the Palestinian territories], *The Impact on the Palestinian Economy of Confrontations..., 1 October 2000- 31 January 2001*", Gaza City, March 2001.

virtually free access to the Israel labour market, workers from the Palestinian territories were quick to take advantage of it, shifting from subsistence earnings in the traditional sector there, or even from dire unemployment, to the relatively much higher wages offered them in Israel. By 1987 employment in Israel came to account for over one-third of all gainfully employed residents of the Palestinian territories, their gross earnings accounting for nearly one-quarter of the Gross National Product of the West Bank, and as much as two-fifths of that of Gaza.⁴

Because of the disparity in labour force size between Israel and the Territories, these 'guest workers' never amounted to more than about 7 per cent of total employment in Israel (though they came to constitute the majority of all wage earners in construction and a significant share in agriculture). Consequently, their absorption could take place, as it actually did, without any discernible fall in Israeli wages, and without arousing any opposition towards it among Israeli labour.

Although Palestinians working in Israel were employed in highly volatile industries, construction in particular, this volatility was not fully transmitted to the economies of the West Bank and of Gaza.⁵ This was due to the fact that the residents of the West Bank, at least, had practically free access to labour markets to the east of them. While the Arab/Persian Gulf markets provided an outlet mainly for educated labour, nearby Jordan provided one for artisans and even construction workers. Thus, until the Gulf War, the Palestinians straddled two separate, unrelated labour markets.⁶

A potential alternative to large-scale employment of Palestinian workers in Israel, at least insofar as manufacturing was concerned, could have taken the form of Israeli capital moving into the WBGS — bringing the machines to the workers, rather than the workers to the machinery. That this did not happen was due, first and foremost, to uncertainty regarding the political future of these territories as well as to the security situation there, which also deterred foreign investors. Furthermore, once the initial adjustment of labour allocation

⁴ See, for example, Israel Central Bureau of Statistics (ICBS) "National Accounts of Judea, Samaria and the Gaza Area, 1968-1993, *Publication No. 1012* (Jerusalem, 1996), Table 24 and Tables 9 and 16, respectively. These figures overstate somewhat the importance of earnings from work in Israel for the Palestinian economy, for they refer to receipts from gross wages, while taxes and other obligatory payments withheld at source are regarded under national accounting conventions as imports of government and other services from Israel.

⁵ The considerable volatility observed in the GDP of the West Bank (and, because of that also in the combined one of the Palestinian territories) is due to the biennial cyclicity of the olive crop that dominates West Bank agriculture.

⁶ See Shaban, R., "Palestinian Labour Mobility" *International Labour Review*, 1993, 134:5-6, 655-72; also E. Kleiman, "The Flow of Labour Services from the West Bank and Gaza to Israel", Hebrew University Department of Economics, *Working Paper No. 260*, July 1992.

between the Israeli and the domestic market took place, the wages of Palestinian workers in similar occupations became practically equalised as between Israel and the Palestinian territories, removing thereby the incentive for shifting operations to the latter.

The forced economic union with Israel also opened up what constituted, by the standards of the WBGs, a huge market at their doorstep, which could more than compensate the Palestinians for the loss of their traditional ones in Jordan and the rest of the Arab world. However, Israel's highly protective farm policy prevented it from allowing free access to its markets to what was to remain for a long time the main export potential of these territories — farm produce. In fact, Israel used its rule there to restrict the cultivation and, even more so, the export to Israel of many agricultural products. At the same time, through the "open bridges" policy, Israel tried to find a vent for this produce outside the country, to the east of the Jordan River.

While exports of manufactures were not similarly hampered, Israel's general policy was to prevent the setting up in the WBGs of industrial plants that could compete with Israeli ones in their domestic market. Though never officially admitted, this policy seems to have been often extended, in practice, to protect also the share of Israeli firms in the Palestinians' own markets.

That the economies of these territories nevertheless grew quite impressively despite these (and similarly motivated, Jordanian imposed) handicaps, demonstrates the tremendous impact on them of their economic integration with Israel. Being the much smaller partner, the Palestinian economy could be expected to gain much more, certainly in relative terms, than Israel even from the partial access to Israel's market. As can be seen from Table 1, the rate of economic growth in the WBGs did, in fact, for a long time greatly outpace that in Israel.

Table 1
Growth of Per Capita Product, 1969-1992
(per cent per annum)

	GNP			GDP		
	West Bank and Gaza	Israel	Diffe- rence	West Bank and Gaza	Israel	Diffe- rence
1969-72	19.9	7.9	12.0	11.2	7.6	3.6
1973-76	5.4	0.7	5.7	5.6	1.0	4.6
1977-80	4.5	0.9	3.6	4.6	1.0	3.6
1981-84	0	0.6	-0.6	-1.7	0.8	-2.5
1985-88	0.9	2.4	-1.3	0.3	2.4	-2.1
1989-92	4.9	1.6	2.3	6.2	1.2	5.4
1969-92	5.7	2.4	3.3	4.2	2.8	1.4
<i>1992/1969</i>	<i>3.8</i>	<i>1.8</i>		<i>2.7</i>	<i>1.9</i>	

Sources: World Bank, *An Investment in Peace*, Vol. 2, Statistical Appendix Table 1; and Israel Central Bureau of Statistics (ICBS), *Statistical Abstract of Israel*, 1992, Table 6.1

Once the integration process had, more or less, run its course, growth slowed down. Altogether, however, Palestinian per capita GNP nearly quadrupled between 1969 and 1992, while in Israel it hardly doubled.⁷ Despite this rapid growth, the economies of the West Bank and Gaza remained very small compared with the Israeli one. Even before the setbacks of the popular Palestinian uprising, the *intifada*, that broke out in late 1987, the combined GDP of both these territories amounted to only one-twentieth that of Israel.⁸

⁷ The growth in *domestic* product, i.e., exclusive of the wages earned in Israel, was somewhat slower. But even so it nearly trebled between 1969 and 1992. For a discussion of the effects of the forced integration with Israel see, e.g., my paper on "Some Basic Problems of the Economic Relationships between Israel and the West Bank and Gaza" in S. Fischer, D. Rodrik and E. Tuma, *The Economy of Middle East Peace* (Cambridge, MA: MIT Press, 1993), 305-333; and the World Bank, *Developing the Occupied Territories: An Investing in Peace* (Washington, D.C.: The World Bank, September 1993), Part II.

⁸ U.S. \$ 1,580 millions in a biennial average for 1986-87, as compared to U.S.\$ 31,390 for Israel. ICBS, *op. cit.*, Table 1 and *Statistical Abstract of Israel No. 47*, Tables 6.1 and 9.12.

Although it lies outside the scope of this paper, mention should be made here of a little discussed and even hardly mentioned outcome of the forced integration with the Israeli economy. Employment opportunities in Israel wrought a great change in Palestinian social class relationships. In a society that lacked an urban proletariat, those who went to work in Israel came mainly from the traditional farming sector and, especially in the case of Gaza, the refugee camps. Receiving ready money wages, they were now freed from their erstwhile dependence on their landowners or on the local merchant or moneylender. It was not by chance that the first *intifada* proclamation, that turned what was until then sporadic demonstration into a popular uprising, was composed by two electricians – a situation unthinkable in the ‘notables’ dominated society of two decades earlier.⁹

3. In the aftermath of Oslo

The “interim agreement” between Israel and the PLO, establishing the Palestinian National Authority (PNA), also specified the economic arrangements between the areas under the latter’s jurisdiction and Israel. Under the economic protocol signed in Paris in April 1994, the conditions of the economic union between the Palestinian territories and Israel were to become more equitable: The Protocol removed, or phased out, all economic restrictions on exports to Israel; and with the transfer of all governmental authority there to the PNA, Israel was no longer to be able to obstruct the establishment of Palestinian manufacturing plants that would compete with Israeli ones. Arrangements were also laid out for the transfer to the PNA of taxes paid by the Palestinians to the Israeli exchequer.

The only, but also most important sphere where the Protocol retrogressed was that pertaining to labour flows. Following a spate of knifing attacks on individual Israeli civilians, the Israeli government refused to undertake any obligation to restore the virtually complete freedom of entry into Israel, which the Palestinians enjoyed until the Gulf War, if not even until February 1993. But it was hoped on both sides, that with the removal of all restrictions on Palestinian exports to Israel and on Palestinian industrialization, exports of the product of Palestinian labour would more than compensate for any possible losses in the direct exports of labour services.¹⁰

⁹ See Yaari, E., and Z. Schiff, *Intifada: The Palestinian Uprising* (New York: Simon and Schuster, 1990), p. 106 ff.

As is well known, this did not happen. The year 1994 brought with it not only the establishment of the PNA and the Israeli withdrawal from the Gaza Strip, but also a series of suicide bombings instigated by Islamic fundamentalists. These called forth stringent Israeli security measures that severely restricted the movement of people, vehicles and goods from the WBGS into and through Israel. Under the stranglehold of these restrictions the Paris Protocol became a dead letter (or, as one Palestinian commentator put it, was hijacked by security considerations.) The only exception was the tax clearance mechanism which, despite certain complaints on both sides, has been operating successfully and, for most of the time quite smoothly, tax transfers from Israel financing over 60% of the PNA's budget.¹¹

These developments had a very adverse effect on the Palestinian economy, resulting in a severe economic depression there in the immediate years following the establishment of the PNA. The decline in terrorist activities against civilians in Israel since then resulted in a gradual easing of security restrictions, especially in the case of the West Bank.¹² Together with measures taken by both sides to facilitate the movement of goods under the remaining restrictive conditions, this brought about a revival in Palestinian economic activity, with per capita GDP in 1998 registering some increase after declining in the three preceding years.¹³ But it is unfortunately clear that we will not witness in the near future a return to the virtually completely free movement of people, goods and the vehicles that transport them, that characterized the first two and a half decades of Israel's rule in the West Bank and Gaza.

More important than their immediate effects might be the impact of these developments on Israeli-Palestinian relationships in the long run. Here they accelerated the uncoupling the two economies that has already been going on since the outbreak of the *intifada* some years earlier –

¹⁰ For a description and analysis of the Paris Protocol as it was envisaged at the time of its signature, see Kleiman, E., "The Economic Provisions of the Agreement between Israel and the PLO", *Israel Law Review*, 28 (1994), 347-373; and El-Musa, S., and M. El-Jafari, "Power and Trade: the Israeli Palestinian Economic Protocol", *Journal of Palestine Studies*, 24 (1995), 20-31. For an evaluation of its actual operation, see, European Commission, *Evaluating the Paris Protocol* (Brussels: EC, July 1999).

¹¹ See Alonso-Gamo, P. *et. al.*, *West Bank and Gaza Strip: Economic Development in the Five Years Since Oslo* (Washington, DC, International Monetary Fund, 1999), Tables 3.1 and 3.2.

¹² In fact, the number of Palestinians employed in Israel in 1999 was close to that in 1992, the highest ever recorded. See Palestinian Central Bureau of Statistics (PCBS), "Labor Force Surveys, 2nd Quarter 1999 (www.pcbs.org/labor). But they constitute a much lower share of both the Palestinian and the Israeli labour markets and originate mainly from the West Bank, rather than from the more easily sealed off Gaza Strip. Furthermore, the implications of working illegally are now much more serious than they were before 1993.

¹³ See, Alonso-Gamo, P. *et. al.*, *op. cit.*, Table 2.1, and UNSCO, *Report on the Palestinian Economy*, (Gaza, Autumn 1999). Unfortunately, as of the time of writing, the deterioration in Israeli-Palestinian security situation has resulted in a severe regression in economic conditions in the WBGS.

a process perhaps best described as unscrambling the omelette. This expressed itself in adjustments made on both sides that were, however, much easier for Israel. Its most obvious immediate manifestation was the substitution of the formerly daily commuting Palestinian labour by guest workers from overseas, recruited in Romania, Turkey, Thailand and even China; and the diversion by Israeli firms of outsourcing and sub-contracting orders from Gaza to more hospitable milieus, such as Jordan.

But what have also changed were attitudes. Throughout the whole peace process the Palestinians have been hankering after attributes and symbols of the sovereignty which have been so far denied to them. Not surprisingly, given the historical circumstances, they also wished to distance themselves as much as possible from Israel. But now there has been added to it a very strong wish for economic separation as well. In particular, there is talk of the need to be able to protect Palestinian infant industries from Israeli competition; of being in a position to obtain concessions for Palestinian exports through bilateral protocol trade agreements, which are still common in the trade of Arab countries; and of being less dependent on Israel for fiscal revenue or, alternatively, of substituting the present invoice-based tax clearance mechanism with a macro-economic formula based on statistics collected at border checkpoints. At the same time, however, the Palestinians would like to maintain or, rather, to regain, free access to the Israeli labour market, and least in the short and intermediate runs. They also want to continue having free access to the Israeli goods' markets.

On the Israeli side here have been all the time, ever since the time of the Oslo agreement, voices calling for the establishment of an economic border between Israel and the WBGs. In the past, these demands mainly came from the same vested interests that tried to restrict Palestinian competition in the pre-Oslo years. But now the pressures for economic separation also stem from political and administrative policy motives. Having had no normal land borders at all before the 1979 peace treaty with Egypt and, for most practical purposes, almost until now, Israel was free to ignore all that was going on in the neighbouring countries, insofar as its own domestic economic policies were concerned. As a result, it developed a certain insularity and is not used to having close economic neighbours. The prospect of tax competition taking just below the windows of the Finance Ministry, or of tax-free luxuries being purchasable half an

hour's drive from the homes of most Israelis, is often regarded as virtually doing away with Israel's ability to conduct its own economic policy.

To this there should be added various complaints, justified or not, off tax cheating by Palestinians, possibly even with semi-official connivance, difficulties in debt collection enforcement and, last, but far from least, real and perceived security considerations. In particular, the popular perception of a large scale presence of Palestinian workers in Israel as constituting a threat to people's individual safety, combined with the discovery by employers of supply sources of workers willing to work for wages much lower than those of the Palestinians, is the source of considerable opposition to the free entry of Palestinians into Israel. Finally, there is the political wish not to be held responsible, both domestically and internationally, for what is or will be going on under the PNA or in a future Palestinian State, either in the economic or in the civil liberties spheres.

At the same time, however, most Israelis realize that cut off completely from Israel the Palestinians will be reduced to third world levels. Although their actions might sometimes suggest the opposite, Israeli decision-makers are well aware that the resultant destabilization of Palestinian society is something Israel should avoid for its own interests. Hungry neighbours make bad neighbours.

4. From separation to integration and back

The tremendous impact on the small Palestinian economy of first the removal of most obstacles to the free flow of goods and services and then of their reintroduction, is summarized in Table 2. It can be seen there that in the roughly first two decades under consideration, the size of the Palestinian population relative to that of Israel remained practically constant. Nevertheless, the ratio of the domestic products rose during this period, the Palestinian GNP rising from slightly less than one-thirtieth to one-fourteenth the Israeli one. The convergence process to be expected under the circumstances described earlier can be observed to have been actually taking place during this period, with GNP per capita more than doubling between 1968 and 1986.

Table 2

The Size of the Palestinian Economy Relative to Israel^a
selected years

(per cent)

	<u>1968</u>	<u>1986</u>	<u>1998</u>
Population	33.9	31.7	44.5
Labour force	15.8	17.8	25.4
Gross Domestic Product	3.3	5.3	3.6
Gross National Product	3.5	7.2	4.3
GNP per capita	10.2	22.8	9.7
GNP per person employed	24.8	37.9	23.0

^a At current prices. Data for 1998 still subject to revision.

Source: Israel Central Bureau of Statistics (ICBS), *Statistical Abstract*, 1977, 1988 and 2000, and Alonso-Gamo, P. *et. al.*, *West Bank and Gaza Strip: Economic Development in the Five Years Since Oslo* (Washington, DC, International Monetary Fund, 1999), Tables 3.1 and 3.2.

Most of the last two decades summarized in Table 2 were characterized by recurrent outbreaks of violence and of their repression by stringent security arrangements imposed by Israel. Although unaccompanied by any substantial formal change in the economic arrangements, such developments could not but result in the unhitching of the two economies. As can be seen in Table 2, practically all the gains made by the Palestinians in the earlier period were lost in the later one. The convergence process was reversed in this period, both income per capita and product per person employed in the WBGS lagging behind Israel's, reverting by 1998, in relative terms, to below their 1968 level.

5. Borders or no borders?

Because of the great differences in both size and economic development between the WBGS and Israel, the future economic relationship between them is of crucial importance to the Palestinians, but of only a marginal one to Israel. Consequently, the Palestinian should, and most probably will, be able to choose the relationship they deem most advantageous to them, provided its external aspects do not seriously endanger Israel's interests. It has to be remembered, in this

context, that the main interests of the two pertain to different aspects of this relationship. Although recent Palestinian statements have stressed the fiscal aspect, in the form of the tax revenue sharing mechanism, the main Palestinian interest lies ultimately in the unobstructed, free access to Israel's labour and merchandise markets. Israel's main interest, on the other hand, is in preventing the Palestinian economy from becoming a conduit for the circumvention and, ultimately undermining of its fiscal regime. Thus, it is the choice of their trade regime *vis á vis* Israel that matters most to the Palestinians, and the choice of the corresponding fiscal one that matters most to Israel.

Looking at it in this way, the basic difference is between trade regimes that require an economic border between Israel and the WBGs and those that do not. In the absence of a border, differences in the rates at which imports are taxed will result in trade being diverted through the tax jurisdiction where the rates are lower, with a corresponding loss to the exchequer of the high rate jurisdiction. They will also vitiate any industrial, social or environmental policy these rates were intended to serve. The same is true, to a considerable extent, of domestic indirect taxes, such as excises or VAT. The existence, in general, of considerable price differentials among different retail venues within one and the same locality suggests that some leeway could be allowed in this case for the Palestinian and Israeli rates of both customs and domestic indirect taxation to differ from one another. But the scope for such differential is very small, and indirect taxes would have to be, if not actually made uniform then, at least, very closely harmonized.

Such a regime, however, raises the already referred to question, of the decision process by which these tax rates will be determined. The common presumption is that, in view of their much lower income level, the Palestinian would prefer to adopt much lower customs and indirect tax rates. In fact, however, the opposite may be true. Low-income economies find it very difficult to finance themselves by direct taxes, such as personal and corporate income taxation. Thus, if at all, the Palestinians would most probably opt for an average level of indirect taxation exceeding the Israeli one. But their desired structure of these taxes might be different, raising tax diversion problems for both sides in the border-less case.

Absence of borders also requires some mechanism for the sharing or clearance of tax revenues. Even with a deep-sea harbour operating in Gaza, much of the Palestinians' import trade will continue to reach them through Israeli sea- and airports. And as long as large numbers of Palestinians continue to be employed in Israel, the merchandise trade between them will

continue to be unbalanced, WBGS imports from Israel greatly exceeding their exports to it.¹⁴ This imbalance has a fiscal aspect, as it means that the customs duties on goods imported *via* Israel and the indirect taxes on Israeli sales to Palestinians, which accrue to the Israeli exchequer, greatly exceed the revenue accruing to the Palestinian exchequer from indirect taxes on Palestinian sales to Israelis. Hence the need for some clearance or sharing mechanism, in the absence of which the Palestinians will, in effect, be subsidizing Israel.

These problems are considerably mitigated, even if not completely eliminated, by the presence of an economic border. In principle, such a border allows both side complete freedom of action in determining its rates of indirect taxation, both on imports and on domestic goods. Given the minute distances between the Israeli and the Palestinian markets this, however, is not quite true in the present case. Coupled with the length and convoluted line of any future border, this geographic proximity offers almost unlimited scope for smuggling, which it would be extremely difficult and costly to prevent. Both sides would then find it advisable to harmonize their taxes rates to a considerable extent, either by agreement and co-ordination, or simply by unilateral responses to changes in each other's tax schedules.

A customs border would also make it possible to dispense with all or most of the need for tax revenue clearance or sharing. Sales from Israel to the WBGS could be then treated as all other exports, and exempted from all Israeli indirect taxation, with any Palestinian taxes on them collected at the border; and similarly for Palestinian sales to Israel. The present tax clearance mechanism would then be retained only for customs duties on Palestinian imports from the rest of the world transported *via* Israel. Alternatively, they could then be transported in sealed containers, dispensing altogether with all need for any tax sharing or clearance arrangements.

On the other hand, it has to be kept in mind that a border raises a further hurdle that trade has to overcome, in the form of time lost at checkpoints and the preparatory paperwork associated with moving goods across them. It also invites pressures by various interest groups for the imposition of protective or retaliatory tariffs and facilitates the establishment of non-tariff-barriers, such as insistence on industrial standards requirements.

The foregoing discussion should make it clear that, from the purely economic standpoint, the border or non-border alternative involves a trade-off. The no-border situation is more

¹⁴ Strictly speaking, of course, income from work in Israel could reflect itself in an import surplus with the rest of the world, rather than with Israel. In view of the close geographic proximity, however, such a result seems unrealistic.

conducive to trade, but severely restricts at least one of the partners' freedom to determine its own customs and indirect tax policies. The border situation removes this restriction although, as has been argued here, it does not do so completely. It is, however, less favourable to trade. The smaller an economy, the more it depends on trade for its welfare. In particular, the growth of the Palestinian economy will not keep with the growth of its population, unless it is able to greatly expand its exports.

It should be pointed out in this context, that the bilateral protocol trade agreements with other Arab countries, which the existence of an economic border with Israel could make possible for the Palestinians, cannot be expected to compensate for the corresponding loss of markets in Israel. Israel alone imported on the average in 1996-1998 to the amount of US\$ 30 billion, as against US\$ 37 billion for all the Arab countries bordering on Israel (and, practically, therefore, also on the WBGS) taken together, of which Egypt accounted for one-half. Furthermore, not only are the distances to these markets greater than to Israeli ones, but generally speaking theirs are competing, rather than complementary economies, insofar as the WBGS are concerned. To illustrate, imports from other Middle East countries amounted to no more than 3 per cent of Egypt's total imports.¹⁵

Trade with the Palestinians is of relatively little consequence to the Israeli economy as a whole.¹⁶ If it does matter to Israel it is because of the political implications of Palestinian economic prosperity. On the other hand, however, Israel's fiscal system, with its high dependence on VAT receipts, is very vulnerable to Palestinian indirect tax policy and, perhaps even more so, to the manner in which this policy is being implemented in practice.¹⁷ Ultimately, the question of economic borders will, most probably, be decided on non-economic grounds – political considerations being paramount to the Palestinians, security ones to Israel.

¹⁵ See I.M.F., *Directions of Trade Statistics Yearbook 1997 and 1999* (Washington, 1997 and 1999, respectively).

¹⁶ The often heard argument, that the WBGS constitute Israel's second largest export market after the U.S.A, ignores the fact that a large proportion of this trade represents what in effect is only transit trade. Because of the relatively small size of the Palestinian market, imports destined to it often brought in as parts of larger consignments, addressed to Israeli importers and resold by them later to Palestinian merchants. Perhaps even more importantly, a considerable share of imports from Israel consists of goods, e.g., sugar or rice, that are only repacked there – i.e., with a very small Israeli value added component. This does not, of course, mean, that some individual Israeli firms would not be badly hit by a reduction in their sales to the Palestinian market, as would be some Israeli importers, especially those presently holding exclusive dealerships that also cover the WBGS.

¹⁷ VAT accounted for between one quarter and one-third of all of Israel's tax revenues in the 1990s. See Israel, Directorate of State Revenues, *Annual Report No. 48* (Jerusalem 1999).

6. A Free Trade Area Agreement (FTA)

The existence of economic borders need not preclude relatively free Palestinian access to the Israeli market, provided their economic relationship is governed by a free trade area agreement. Under such an agreement goods produced in the Palestinian economy would be admitted duty free to Israel, and *vice versa*. For the rest, each of these two economies could have its own customs tariff and its own, reciprocal or not, trade arrangements with the rest of the world.

A FTA would thus make it possible for each side to reach its own trade agreements with third parties. In particular, it would enable the Palestinians to offer concessions to other Arab states on a bilateral basis, in exchange for easier access for Palestinian exports to their markets.

By allowing free entry to goods produced in the other economy, a FTA agreement would minimize the scope that a border provides for economic protectionism. Paradoxically enough, however, it would also impose an extra cost on such exports, as it requires proof of their complying with the “rules of origin”, that make the goods in question eligible for exemption from customs. The very high Palestinian imports to GDP ratio, characteristic of all such small economies, will also make it difficult for much of their exports to fulfill the domestic value added requirement to qualify for exemption under a FTA.

7. Hybrid solutions

As we have seen earlier, there is, on both sides, a conflict if not of interests then of aims: to separate and at the same time not to deny the Palestinians (or, from the Palestinian point of view, not to give up) the relatively easy access to Israeli markets. Can this circle be squared? In principle – yes. The economic arrangements of the interim agreement amounted to a customs union with some, partly token partly real exclusions from the common customs “envelope”. These exclusions constitute what is known in the economic literature as a “positive” list, of cases that are exempt from the common tariff and in which each of the parties to the customs union is allowed a free hand to fix its own import policy. The resultant trade regime may be regarded as an incomplete, *quasi* customs union.

The alternative, less close association is that of a free trade area agreement (FTA) described above. Unlike a customs union (CU), a pure FTA would require a physical economic border, at

which the origin of goods – domestic or imported - can be checked to determine whether they qualify for free entry into the other economy, and import duties collected where appropriate. Such a border, with its unavoidable delays etc., would, of course, constitute an impediment to trade, as compared to the free movement under a CU.¹⁸

But in symmetry with a *quasi* CU, there could also be a *quasi* FTA. This would take the form of “negative” lists, i.e., of lists of goods imported from the rest of the world which would be *excluded* from the discretion to fix its own tariff, which each party enjoys under a pure FTA. With enough “quasis” on both sides, *quasi*ⁿ FTA= *quasi*ⁿ CU. Furthermore, not all goods require a tangible, physical border for each country to be able to enforce its own import policy. Where registration of ownership is required, as in the case of motor vehicles, crossing the economic border can be established and taxes, if any, collected, without resorting to the evidence of checks at some physical border line. If the two parties could agree to widely rely on such notional borders, the damage due to partial separation would be minimized.

A *quasi* FTA, especially if “quasi-ed” enough not to add the costs of economic checks to whatever security checks that will characterize the future borders, will also help not to complicate further the issue of Jerusalem. This is a city in which both sides wish to maintain some standing, yet which neither wishes to see physically divided. Any less integrative relationship would require a physical border, thereby greatly adding to the already great complexity of devising a satisfactory solution to this question.

Such a pseudo FTA could also make possible the participation of Jordan. That country is far from ready yet, both economically and politically, for a customs union with Israel or even for an exclusive FTA arrangement with it. Nor are the Palestinians ready, at this stage, for a customs union with Jordan. A tripartite arrangement, not necessarily with the same degree of “quasi-ness” in each pair of participants, could ease Jordan’s adherence to what could become the nucleus of a regional trade area.

8. Drifting apart?

¹⁸ It should be pointed out that such impediments would come in addition to the obstacles already posed by Israel’s requirement that all goods coming in from the WBGS undergo strict security checks.

There is, however, a serious danger that the *quasi* FTA suggested here might turn out to be unstable. The success of such an arrangement depends on its observance by both parties and the ease with which it can accommodate changes in exogenous conditions, unexpected situations, etc. The present attitudes of both sides do not bode well in these respects.

The Palestinians regard themselves in their relations with Israel both as the wronged party and as the underdog. Consequently, they feel they have the moral right to exploit any crack in their agreements with Israel if this will serve their interests or, as they themselves would put it, redress the power imbalance. Israel, on the other hand, continues to be very suspicious of the Palestinians' acquiescence of its existence. Because of this, as well as of it being, as has already been mentioned, unused to having passable land borders and, in the final account, merely because of it wielding the power, Israel may be expected to over-react to any Palestinian infringement of the agreed arrangements.

Besides all this there also looms the real problem of how should decisions on changes or on interpretations of any economic agreement be made, given the great disparity in the economic size of the two contracting parties. This disparity, as well as the history of Israeli-Palestinian relationships, rules out consensual decision making. On the other hand, giving either side veto rights inescapably invites stalemates; while the right to demand compensation for decisions a party deems injurious to its interests invites blackmail. There remains, of course, arbitration. But throughout its existence, Israel has shunned letting third parties have the last word in its disputes with its neighbours.¹⁹ It would certainly avoid it in the present case, where the inferior position of the Palestinians could be expected to make an outside arbiter tend to decide in their favour. At the margin, arbitration by international organizations to which both sides belong, such as the ILO or the WTO, might be possible on specific, probably minor issues. But it is highly doubtful whether it would be acceptable in the case of major ones, such as, say, the harmonization of indirect tax rates.

Thus, between the real problems and the inherent tendencies of the two sides, a *quasi* FTA agreement may turn out to be unstable. Not only will it be difficult to negotiate in the first instance, but it will also be subjected to continuous demands for revisions and unilateral changes

¹⁹ The only exception was the dispute over the demarcation of the Israeli-Egyptian border line in the Red Sea resort of Taba (in which Israel lost).

in its interpretation, through which it will be gradually eroded. We will be witnessing then the further and further drifting apart of the Israeli and the Palestinian economies.

It would be a great pity if this, indeed, were to happen. If present globalization trends and the communications' revolution of the last few years persist, Israel will have soon to adjust itself to a situation in which a state's economic sovereignty has become much curtailed by world market forces and where economic frontiers are difficult to maintain. What it now regards as problematic in relatively open economic arrangements with the Palestinians may then no longer be seen as such.

But by then it might be too late. The progressive separation from Israel can be expected to direct the Palestinian economy away from openness in general and towards Israel in particular. The resultant trade protectionism will, in its turn, engender the rise of groups with a vested interest in its continued to be upheld. As the smaller and the poorer in natural resources the economy, the more dependent it is on trade with the outside, pervasive trade protection can be highly detrimental to Palestinian economic growth. And as Israel's own experience demonstrates, once protectionism and all that it entails have been established, they can be very difficult, and take a very long time, to dismantle.

Recent developments in the region suggest that this is, indeed, the turn events are taking. With the deterioration in the security situation, the notion of unilateral, physical separation from the Palestinians has been gaining in popularity in Israel. Political considerations militate currently against the erection of the concomitant physical border. But the plans for it already exist and its construction could start any day now, if political circumstances change or if the security situation continues to deteriorate. Although officials have in the past spoken of a "friendly" or "breathing" border, signs are multiplying that, as suggested earlier in this paper, once established a physical border will soon also become an economic one.