



The Aix Group

# Economic Dimensions of an Agreement between Israel and Palestine:

Summaries of Recent Studies and Lessons Learnt

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Summaries of Past Studies

## THE "BIG PICTURE"

On the Political and Economic Alternatives Facing Israelis and Palestinians

# THE BIG PICTURE

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## On the Political and Economic Alternatives Facing Israelis and Palestinians

Based on several versions of the “Big Picture” produced since 2009

A historic compromise along the lines described in this document offers a realistic solution to the Palestinian-Israeli conflict, but this vision is not carved in stone and will eventually have to yield to the reality of conditions on the ground. The Aix Group is aware that continued rejectionists’ efforts on the one hand and pre-emption on the other hand will eventually undermine the two- state solution on which our efforts are based. Therefore, any reasonable solution would require a timeline in which changes on the ground are declared null and void, by a binding mutual agreement.

The Aix Group believes that the economic analysis presented in its works, under suitable political circumstances, lays the foundation for optimistic future developments for both Israel and Palestine. The related concepts of open borders, cooperation between two sovereign states and interdependencies, combined with conditions of stability and wide political support for the new arrangements on both sides, could lead us out of this dark period and into a better future.

A feasible agreement on two states will have to address the difficult trio of borders, Jerusalem and refugees. It will also have to deal with the question of “pre-emption” and the long-term impact of creating “facts on the ground”. A positive conclusion that addresses the minimum and necessary requirements of the two sides will most probably look like the following:

- The borders between the two states will be drawn so that they will have continuity; the land will be divided 77 percent to 23 percent based on the 1967 borders, allowing for agreed-upon and limited swaps of land along the “Green Line”; arrangements satisfying contiguity between Gaza and the West Bank will guarantee the free flow of people and goods within both Israel and Palestine so that travel between Gaza and the West Bank will not entail crossing a border.
- Jerusalem will be the capital of both Israel and Palestine. Two options for Jerusalem’s borders can be considered:

- a. An “open” Jerusalem, necessitating the creation of borders around Jerusalem, or the part of the city that remains “open”.
- b. A border that will bisect Jerusalem.

- A just and fair solution to the 1948 refugee problem will address both the individual claims and the collective considerations of the two sides and provide a way to reconcile the two. It is the goal that the Palestinian refugees will be able to choose a permanent place of residency, and that the implementation of these decisions will be agreed to by, and subject to the sovereignty of, all the countries that will be affected, including Palestine and Israel.

Programs for the refugees will address resettlement/repatriation, or what we sometimes describe as relocation, as well as rehabilitation. A substantial compensation scheme for the refugees will be agreed upon. The process will end the status of refugeehood and turn all refugees into citizens, with the agreement and cooperation of the refugees themselves.

We suggest that the economic aspect of the new agreement include several key principles. First, it is imperative to agree that the sovereign authority of each party, within internationally recognized borders, includes the right to conduct internal and external economic affairs, including the operation and administration of that party’s economic borders, autonomously but in cooperation with one another. Second, economic relations shall be guided by the concepts of cooperation in both trade and labor, as well as in infrastructure, R & D, etc. Thus the parties can establish the rules and arrangements which will regulate the trade in goods and services, and the flows of labor and investment.

The Aix Group efforts were not academic in the abstract meaning of the word. They did not abstract from the current situation and do not reflect a visionary’s detached exercise. We present very realistic and practical alternatives that rely on our ability to understand that there is more than one point of view. The area between the Jordan River and the Mediterranean Sea contains two peoples who deserve better: They both deserve independence, security and prosperity. The economic dimension may be secondary to the political one, but economic performance is not secondary. If the economic agreements fail to provide the necessary conditions for real development, the political agreement will also fail.

There is a real fear that time is running out for a two state arrangement. If this idea is not accepted and implemented relatively soon, the two sides will have to consider an alternative political economy. The “One State” alternative, while proposed and defended until recently by a minority among both sides, is currently gaining ground due to the very conditions that undermine the possibility of territorial compromise. The Aix Group is convinced that if bold steps are not taken in the direction of rapid implementation of a territorial solution, then an alternative vision of one state for both people, on the basis of common citizenship and equality before the law, will increasingly be

placed on the agenda. Such an agenda will require detailed new thinking about many of the elements of this document; but if the vision of “Two States” crumbles, it will become the only alternative to the current conditions of continued occupation.

## 1. Introduction

Since the beginning of 2011 a political storm has engulfed the region; clearly one has to remain very modest trying to understand such dramatic events in real time. But we would like to share with you our attempts to understand the new phenomena and the implications for “our” conflict. Rereading the “Big Picture” text, prepared before the current political transformation, we find that there are good reasons to believe that our main conclusions still hold. Although some political parties are quick to presume that this is the time to “wait and see” and reassess, we tend to conclude that they are wrong and, in fact, this may be the best time for a breakthrough. The reasons for our tentative, yet more optimistic, conclusion are as follows:

- The strength of the status quo before 2011 was partially based on the Israeli-Egyptian (separate) peace agreement. Although the 1978/9 agreement mentioned the Palestinian question and a framework for negotiations was drawn, the issue had actually been postponed. Not until Oslo in 1993 was there any serious attempt to address the Israeli-Palestinian conflict, and even then the process addressed only interim aspects. The failure to reach a permanent agreement which would address the most fundamental and difficult issues that we discuss below, was acceptable to the “old regimes” in the region probably more than it will be tolerated by the “new” ones. Thus, the cost of no agreement was deemed to be higher after 2011.
- The new regimes represent, we think, both the interests of those who would like to see more prosperous economies as well as the search for a more moral polity. Of course, corruption was feeding the protest; but on top of the non-democratic characteristics of the “old regime,” the desire to experience growth and distributive justice were strong forces in the revolt. However, one should not ignore the strong feelings of the majority concerning the weakness of the “old regimes” to change the status quo vis a vis Israel. In particular, solidarity with the Palestinians is a very strong sentiment in the new regimes. Their desire for change would most probably lead away from accepting the “balance” of the last 30 years.
- The call for democracy, and the general support it received around the world, makes the Israeli-Palestinian case a unique outlier: No one can defend the current status quo on the basis of democratic principles. The pressure to address the Israeli-Palestinian conflict will continue growing.

In 2003, the Aix Group agreed on a basic concept which remains central in our discussions to this day. We came to the conclusion that one of the errors committed and followed by the two sides since 1993, when the Oslo process started, had been to base the peace process on “gradualism”.

Gradualism takes the form of an incremental approach, moving one step at a time with no agreement on, or even discussion of, the end result. The right way forward, in our opinion, was to adopt what we have called a “**reverse engineering**” approach (see the “Economic Road Map”, 2004). In “reverse engineering”, the sides first agree on where they want to go, i.e. on the contours of a permanent agreement, and then decide how to reach that end.

The second understanding we reached is that of the utmost importance of symmetry in the solution to the Israeli-Palestinian conflict and in the future economic relations between the two sides. This symmetry is already implicit in the generally accepted solution to the conflict, namely “two states for two peoples”, but the current situation is one of sharp asymmetry between the two sides, between occupied and occupier, between one side that has long since gained independence and one side that still yearns for it. We need to strive to reach greater symmetry between the two sides in order to reach a situation where two independent states live side by side, engaged in many different ways, but with neither state exercising control over the other. We are fully aware of the large economic, military, and political gaps between the two peoples, and we know that no peace agreement will eliminate these gaps overnight. However, formal symmetry in such an agreement is crucial to its success. If the much stronger side tries to dictate conditions to the other side, an agreement might not be reached or, even if reached, might not survive.

As a consequence of its basic positions - reverse engineering, the need to address all issues and the strong need for symmetry - the Aix Group’s approach is in direct conflict with the gradualism that has characterized the political process since 1993, as well as with unilateralism and with the many attempts to pre-empt the “Two State” solution. Moreover, as a result of its many discussions the Group rejected the view that economic development could pave the way to a political process or be a substitute for such a process. Both reality over more than forty years and a strong set of arguments prove the futility of this approach. In our Economic Road Map (2004) and in additional documents, we agreed upon and defined the basic requirements needed for the permanent existence of two viable states, Palestine and Israel.

The calls to substitute a permanent political and economic agreement with “economic measures only” that will supposedly produce prosperity were raised by Israeli policy makers immediately after the 1967 war. Moshe Dayan, the Israeli Defense Minister, was the better known among them, but from time to time others repeat this argument. However, in order to bring about a real path of development to a viable Palestinian economy and make the convergence of the standards of living between the two economies a real possibility, some basic requirements are needed. Among those requirements are: the need for stable and predicted macro environment; continuous exchanges of goods and factors of production between the economies; coordination of the financial and monetary spheres, etc. These requirements, analyzed in our Economic Road Map, cannot be addressed unless – and until - the sides reach an end to the political conflict. Hence, the calls for “economics first” measures are at best naïve, and at worst are hiding the desire to avoid the difficult political compromise that is necessary in order

to achieve the change to which we aspire.

Concerning the permanent economic agreement, we base our analysis of future relations between the Palestinian and Israeli economies on the concept of economic sovereignty, implemented in two independent states with separate geographies, independent policies, full control over their territories and borders, and cooperation between them. This is in full accordance with the principle of symmetry. We believe that Palestinian and Israeli interests would be best served by a Free Trade Area (FTA) arrangement that enables each customs authority to be a partner to the other side without losing its basic independence. Israeli and Palestinian border control agencies could also manage borders and border crossings to ensure the enforcement of the agreed-upon trade regime between the two sides. Special attention was paid in our discussions to the need to ensure Palestinian labor flow into Israel. An agreement on such labor flows is vital to the future well-being of the Palestinians and for a smooth implementation of the peace agreement.

The failure so far to agree to and successfully implement the “Two State” formula is due in part to the fact that since 1993, the sides have avoided serious discussion of the permanent stage; then at Camp David in 2000, they failed to reach an agreement. But whereas many concluded after the failure at Camp David that it is altogether impossible to reach an agreement, we concluded that it is impossible to give up on reaching one. Thus we thought, and still think, that in spite of the painful failure in 2000 and the painful consequences of that failure, the two sides should resume meaningful negotiations that will lead to a permanent resolution to the conflict.

We believe that the ongoing power imbalance between the two sides is partially responsible for the long delay in resuming meaningful negotiations. An example of the consequences of this imbalance is the recent failure to achieve a permanent agreement in 2008, in the Annapolis process. A permanent agreement will be possible and stable only if it is based on symmetry between the two sides in important dimensions concerning sovereignty, despite the asymmetry in power they face currently. Therefore, in order to reach such an agreement, the current imbalance in power must be addressed. Both the international community and regional players will need to play an important role in achieving a balance of power and in bridging the gaps between the sides. We outline below the necessary first steps to be taken, based on the reverse engineering concept and with respect to the power imbalance between the two sides that has contributed to the failure to achieve a breakthrough. The road to peace can be taken only if it is accompanied by a continuous effort to treat both sides more symmetrically. This is the abiding essence of the “Two State” solution.

## **2. Between “One” and “Two”**

The Israeli-Palestinian conflict is not a purely territorial war, as some have argued (especially since 1967). It is not only a conflict about the future of the West Bank and Gaza or merely the result of disagreements about human or political rights. It is a conflict between two peoples over one land.

Any imagined agreement between the two sides can be conceptualized in terms of two possible schemes: a) a “Two State” scheme, i.e. the division of the land into two states and two sovereign economic entities; or b) a “One State” scheme, i.e. the establishment of a single political and economic entity. Of course, if no agreement is achieved, the current status quo, i.e. the continued occupation and conflict, will prevail with all the negative consequences. Since 1967 Israeli policy has repudiated both the “Two State” and the “One State” solutions. It has changed the character and formulations from time to time, as have the Palestinian positions. Sadly, the two peoples are deeply divided within themselves as to the “One” vs. “Two” State schemes, and some on both sides reject both options. We will review below these two basic possibilities for an agreement and ask how any future permanent agreement can address the core “trio” of issues -- borders, Jerusalem, and the 1948 refugees -- as well as other key issues like independence, security and prosperity.

The assumption that the Aix Group made and that we continue to hold is that the conflict is one where there are two peoples with legitimate claims. Some think that it was not always so; that in the past, the conflict had one side that was “right” and hence legitimate, and another that was “wrong” and illegitimate. We will not address those views concerning the past here. However, when we say that today the two sides both have “legitimate claims”, we have to define those claims carefully. Moreover, if we seek consistency and symmetry, and we do, we have to convince the reader that those claims, which are both individual and collective in nature and which seem to some to be contradictory, can be addressed in a compromise between the two sides -- in an agreement that both sides can accept as a resolution to the conflict. That is, we will argue that the conflict can be resolved in a compromise that will address what each side sees as its minimal necessary claims and which a clear majority on each side will support.

In reality, there are critical asymmetries between the two sides to the conflict: Israel is an independent state and the Palestinians do not have independence; Israel is the occupying power and the Palestinians are the occupied. There are also clear differences in the current strength of each side, including both military capabilities and economic development. Yet the resolution to the conflict that we discuss is based on symmetry between the two sides.

The preliminary assumption that today there are two legitimate sides with legitimate claims is negated by some Israelis and Palestinians (as well as by others). There are Israelis who deny the collective and individual rights of Palestinians. There are Palestinians who deny the collective and individual rights of Israelis. These two camps both reject a permanent, final, political agreement with the other side. Usually they reject such an agreement because they deny the legitimacy of the other side’s claims; hence they are commonly known as rejectionists, rejecting an end to the conflict via a political compromise. We will add below a few observations concerning the strong rejectionist camps on both sides that deny the legitimate rights and even the right to the existence of the other side, and how they have influenced the failures to achieve an agreement over the years. Their role may help to explain why gradualism and “economics first” failed as policies.

The two frameworks for a compromise, the “One State” and “Two State,” are both feasible

in principle in our case and in similar conflicts where two legitimate sides fight over one territory. However, we argue that the two alternatives are very different in reality: the “Two State” solution is capable of answering the legitimate claims of the two sides and hence is **realistic**; the “One State” solution leaves some legitimate claims unanswered and is **not**, in our view, a **realistic** alternative. We often hear that the “Two State” solution is wishful thinking and no longer a practical alternative. We disagree and would like to argue that sometimes the inconceivable and imaginary becomes conceivable and real. This always was and continues to be the optimist’s line. We are optimists. It **can** happen under certain circumstances.

### 3. The Political Models

Palestinians’ and Israelis’ disagreements are over core issues such as self determination, sovereignty, independence, collective identity, future prosperity and security, but also about individual rights and claims to land, property and justice. In a conflict where two legitimate sides fight over sovereignty -- over the ability to control their own lives democratically through their representatives -- they can, in principle, agree on one of two schemes:

- One State
- Two States

We will discuss both of them from a political perspective and, briefly, from an economic perspective, which is less common but vitally important.

What is a political “One State” agreement when two legitimate sides fight over land and other issues?

- It is an agreement to run the polity in the contested land so that the territory will not be divided geographically and so that a power sharing arrangement is agreed to. Politically, the sides should find mechanisms that will guarantee the individual rights of all and also a plan that will address the collective aspirations of the two sides, including independence, security and prosperity. The agreement would have to address the present balance of power but also possible changes in the balance of power. Specific internal issues such as economic policy, civilian affairs, education, health, and security (internally and toward the outside world) should all be addressed. Clearly there will be no internal borders, hence also no economic borders, and there will be an agreed upon, unified economic policy.

What is a political “Two State” agreement when two legitimate sides fight over land and other issues?

- It is an agreement to run the polity in the contested land so that the territory will be divided geographically and a power sharing arrangement is agreed to. In principle each side is responsible for the implementation of its sovereignty in its area of control.

Again, politically the sides should find mechanisms that will guarantee the individual rights of all and also a plan that will address the collective rights of the two sides. They will have to address the present balance of power but also possible changes in the balance of power. Specific internal policy issues such as economics, civilian affairs, education, health, and security (internally and toward the outside world) should all be addressed. But in this case some of the decisions can be separated and put in the hands of the two sides.

One has to remember that we have some experience concerning the possible economic regime for the future, although no experience with an agreed-upon permanent economic regime. After the 1967 war, Israel unilaterally imposed an economic regime based on the integration model, “one state – one economy”. It did so without taking into account the Palestinian interests. In 1994, following and as part of the Oslo process and the recognition that there are two sides to the conflict, the imposed regime was modified a little and received the official approval of the government of Israel and the PLO. The economic agreement signed in May 1994, known as the Paris Protocol, assumed no internal borders, Israeli control over the external borders (the “customs envelope”) and Israeli monopoly over trade policy. This agreement reflects to a large degree the basic asymmetry between the two sides, which was one of the reasons for its failure.

The economic consequences of Oslo were very disappointing. The conflict continued and the economy was another of its victims. By the beginning of the current century many economists -- Israeli, Palestinian and those from the international community -- had adopted a very different approach from that of Oslo and the Paris Protocol. They reconsidered the arguments for and against integration and came to the conclusion that from an economic point of view there are good reasons to support two economic sovereigns, two sets of trade policies, and joint regulations concerning labor flows between Palestine and Israel. The work of the Aix Group was part of this change. The main reason for it was the realization that integration exacerbates the control of the strong side over the weak. Relations are never purely economic; they involve much politics. A lack of borders creates a situation wherein the strong side increases its control by mustering its political, military and economic superiority to create conditions that strengthen itself and weaken the other side. The fact that the policy of integration was implemented in the Oslo process as an interim solution was used as a justification to maintain and even increase the basic asymmetry between the two sides. This is one of the reasons why the Aix Group came to the conclusion that the right way forward is to adopt a “reverse engineering” approach.

#### **4. Paving the Path to a “Two State” Agreement**

The issues which need to be addressed in the final agreement are all well known and have been addressed by many already, including by the Aix Group. Below is an analysis of how these issues are related to the current situation, and how they should be treated in the short-to-medium term in order

to avoid pre-emption and to ensure the adoption of reverse engineering toward a final agreement.

Negotiations in and of themselves are not an end but simply a means for reaching the required compromise for both sides. Hence, the peace process should not be perceived as an end in itself, but rather as a process that will eventually lead to a peace agreement which is embraced by each side. Since 2000, negotiations have been running in a closed circle, with little achieved by way of potential agreement, due to the fact that not all parties agree on what the outcome or end result will be; no reverse engineering is being done. At the outset, a framework agreement which sets out the parameters for a comprehensive agreement should be reached in order to guarantee that negotiations are guided in body and spirit by the end results.

In this context one has to understand that the current settlement enterprise is not only illegal but harmful, as it pre-empts the capacity of having a real Palestinian state that has well defined territory and contiguity. The settlements tend to intersect the West Bank, and prevent sovereignty and control that is necessary for the creation of infrastructure such as electric grids, water and transportation and telecommunications networks, as well as housing and the natural expansion of Palestinian cities and residential areas.

## **5. On Some Weaknesses in the “One State” Solution**

Let us explain briefly why at this stage a “One State” agreement cannot, in our view, address the legitimate claims of the two sides.

- In a “One State” agreement there are no satisfactory answers to Jewish Israeli claims for self-determination and independence.
- The question of collective Jewish rights becomes more severe in a “One State” framework with a resolution of the refugees’ problem. The conflict between the return of the refugees to Israel and the Jewish Israeli desire to maintain a collective identity, self-determination and sovereignty (even in an Israeli state that has a Palestinian national minority where the majority are Jews) is clearly the focus of many of the disagreements. Thus, no common ground exists today for a “One State” agreement that can receive the support of a majority of Israelis.
- There are no satisfactory answers concerning security, particularly in the face of a strong rejectionist presence, and there are no satisfactory answers to the economic questions. “One State” leaves security in the hands of one sovereign while there are those who do not recognize the existence and rights of the two sides. This cannot be considered an answer to the legitimate claim of most Jews in Israel to an agreement that will provide for their safe existence and the safeguarding of their collective rights.
- Legitimate Palestinian claims for self determination, including independence and control over various aspects of life, cannot be answered in a “One State” framework; certainly not in the near future when the Palestinians are a minority.

- As long as a very strong minority, maybe even a majority, on the two sides of the conflict (or even just on one side), rejects the “One State” arrangement, violence will likely continue. There will be constant conflict for the foreseeable future between the two populations within the one state, as well as conflict about power positions and the allocation of resources. The risk is that the political environment will be unsustainable, which may even lead to a civil war.

The coexistence within one state of two peoples in which one has greater financial means and more economic development than the other, will induce strong asymmetry in political power between the two communities. This will further amplify the economic gaps between them, mainly through control over lands. As a result, the “One State” solution would undoubtedly lead to further tensions and animosity between the two peoples and will not constitute a solution at all.

## 6. Why has the “Two States” solution failed so far?

There are several arguments raised against the idea that two states are possible and desirable, arguing that this model is not -- or is no longer -- an answer:

- Reality is Irreversible. This argument claims that it is impossible to change the geographic-demographic reality that we described above and reach a two state agreement that is practical and viable. But in our view reality **is** reversible, depending on the political power on each side. There is nothing on the ground that contradicts the ability to reach an agreement on partition.
- The Israeli side will not agree to the contours of the two states described above. More specifically, the Israeli side will reject the borders, the agreement in Jerusalem and maybe even the agreement on the refugees. But this argument is faced with a number of counter arguments. First, whatever Israeli support for the “Two States” solution may be, Israeli support for the “One State” solution is much smaller. Second, Israeli support for the “Two States” solution, despite the territorial cost, is quite significant. Support in Israel for pulling out unilaterally from 90 percent of the West Bank was overwhelming just a few years ago. This signals that Israeli attachment to the West Bank is not the real obstacle. The Israeli public seems to be more ready for a compromise even on Jerusalem if the deal is perceived as a serious one in which the other side would stick to and accept as a closure to the conflict, and if the international community, including the U.S., supported it.

If we do not accept these standard arguments against the “Two State” solution, we are left with the question of why it has failed so far. We have two basic answers to this question. One is related to symmetry and the other is related to cooperation between rejectionists on both sides.

We have already mentioned that there is significant economic, military, and political asymmetry between the two sides, mainly with respect to international support. This tempted the Israeli negotiators to seek an agreement that would reflect this asymmetry to some extent. Thus the Israeli negotiators tried to assert long-term Israeli control over the Jordan Valley, which is of critical importance to the

Palestinians in their desire to control the external borders and as a main agricultural area. Israeli negotiators also tried to maintain elements of control over Palestinian movements between the West Bank and Gaza, despite the impingement on Palestinian sovereignty. There are many more examples of Israeli attempts to reinforce the existing asymmetry.

The other explanation for the failure to achieve an agreement so far is tacit collaboration between rejectionists. The conflict is between two groups but the developments are determined by (at least) four: between two camps who reject a compromise and two who are ready to accept it. We think that the supporters of “One State” have no real answer to the fact that there are indeed four camps in the region, and two of them reject the collective rights of the other side. This is part of our explanation for the collapse of Oslo.

Taking into account the historical aspects that brought the conflict to where it is today, we believe that the “Two State” solution, while deeply problematic, is more practical than the “One State” solution and has better political chances for success. The “One State” solution cannot address the fact that there are now, always have been, and will continue to be those who deny the other side’s claims. Thus, there is no way to agree on a consistent one-state framework that will guarantee security to the two sides.

An agreement must not be vulnerable to political changes, and must provide answers to the basic fear that the other side will change its view or elect a rejectionist faction. Thus, a call for a “Two State” solution with relatively open borders between the states is the only realistic alternative.

The next question is whether such a solution addresses basic legitimate rights. The most difficult issue is the refugees’ demand to return to the specific locations inhabited by their ancestors. If the refugees will agree to return to their homeland but not to their original villages, and if the Israelis will accept the rights of the other side and agree to a full withdrawal, we will be able to test the above arguments. It calls for a major change in Israel. It calls for a major change in Palestine. It will enable two sovereign political entities to coexist. As a result of an agreement, a clear understanding will be established as to who “belongs” to each entity as far as citizenship, residency and property rights are concerned.

Time is running out for a “Two State” arrangement. If this idea is not accepted and implemented relatively soon, the two sides will have to consider an alternative political economy, and the “One State” alternative, on the basis of common citizenship and equality before the law, will increasingly be placed on the agenda. Such an agenda will require detailed new thinking about many of the elements discussed today; but if the vision of “Two State” crumbles, it will become the only alternative to the current conditions of continued occupation.

The passage of time makes the resumption of meaningful negotiations even more difficult, since two serious problems challenge an agreement: one is that of a strong opposition and terror campaign against a political “Two State” agreement, based on the negation of the existence and rights of Israel and the Jewish collective; the second is that of “pre-emption”, i.e. a process of creating facts on the ground through sustained settlement expansion. These processes, combined with the physical transformation of land in the occupied Palestinian territory, create conditions which undermine and supersede an agreement based on meaningful sovereignty for both sides.

## 7. Summary and Conclusion

A feasible agreement for two states will have to address the difficult trio of **borders, Jerusalem and refugees**. It will also have to deal with the question of “pre-emption” and the long-term impact of creating “facts on the ground”. A positive conclusion that addresses the minimum and necessary requirements of the two sides will most probably align with the following:

- The borders between the two states will be drawn so that the two states will have continuity; the land will be divided 77 percent to 23 percent based on the 1967 borders, allowing for agreed upon and limited swaps of land along the “Green Line”; arrangements satisfying contiguity between Gaza and the West Bank will guarantee the free flow of people and goods within both Israel and Palestine so that travel between Gaza and the West Bank will not entail crossing a border.
- Jerusalem will be the capital of both Israel and Palestine. Two options for Jerusalem’s borders can be thought of:
  - a. An “open” Jerusalem, necessitating the creation of borders around Jerusalem, or the part of the city that remains “open”.
  - b. A border that will bisect Jerusalem.

A just and fair solution to the 1948 refugee problem will address both the individual claims and the collective considerations of the two sides and provide a way to reconcile the two. It is the goal that the Palestinian refugees will be able to choose a permanent place of residency, and that the implementation of these decisions will be agreed to by, and subject to the sovereignty of, all the countries that will be affected, including Palestine and Israel.

Programs for the refugees will address resettlement/repatriation, or what we sometimes describe as relocation, as well as rehabilitation. A substantial compensation scheme for the refugees will be agreed upon. The process will end the status of refugeehood and turn all refugees into citizens, with the agreement and cooperation of the refugees themselves.

If the two peoples want self-determination, normalcy and prosperity, they should head toward this historic compromise. By supporting such a “package” as the outline of an agreement, the international community can also contribute to the beginning of a new path in our troubled region.

We suggest that the economic aspect of the new agreement should include several key principles. First, it is imperative to agree that the sovereign authority of each party, within internationally recognized borders, includes the right to conduct internal and external economic affairs, including the operation and administration of that party’s economic borders, autonomously but in cooperation with one another. Hence, the parties must reciprocally recognize each other as independent customs territories and make this recognition the foundation for their economic and trade relations. Second, economic relations shall be guided by the concepts of cooperation in both trade and labor, as well as in infrastructure, R & D, etc. Thus the parties can establish the rules and arrangements which will regulate the trade in goods and services, and the flows of labor and investment.

The current widespread pessimism seems to choke off any initiative that dares to think about a permanent arrangement and which presents an alternative to the continuation of the existing conflict. We should not surrender to the pessimists and should not accept their verdict of more years of death and suffering. Time is running out for a “Two State” arrangement. The Aix Group believes that the economic analysis in the ERM and in the papers presented here lay the groundwork for optimistic future developments for both Israel and Palestine. The related concepts of open borders, cooperation between two sovereign states and interdependencies, combined with conditions of stability and wide political support for the new arrangements on both sides, could lead us out of this dark period and into a better future.

Summaries of Past Studies

ECONOMIC FRAMEWORK FOR A "TWO STATE"  
PERMANENT AGREEMENT

# ECONOMIC FRAMEWORK FOR A “TWO STATE” PERMANENT AGREEMENT

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The Aix Group’s first publication, in 2004, addressed the economics of a “Two State” permanent agreement. The Group analyzed the agreement in the context of the political discussions at that time which focused on the Road Map for Peace. The Road Map (December 20, 2002 version) had very little treatment of economic issues. Its three phases are defined principally in political terms:

- Phase I involved ending terror and violence, normalizing Palestinian life, comprehensive security reform, Israeli military withdrawals to the pre-Intifada positions of September 2000, cessation of settlement activity and free Palestinian elections.
- Phase II aimed at the establishment of a Palestinian state with attributes of sovereignty, provisional borders and a new constitution.
- Phase III assumed the conclusion of a permanent status agreement and the creation of a sovereign Palestinian state.

In the year 2004, the Aix Group published a paper entitled “The Economic Road Map (ERM)” which assessed future policy options in specific economic areas. The paper focused on the final status agreements and the creation of a sovereign Palestinian State (Phase III of the ERM). The Group chose to focus on the permanent status since it believes that the economic content of the previous phases of the ERM dealing with security and the foundations for statehood can only be determined correctly if a clear vision of final status arrangements exists first. We called this approach “reverse engineering” and have continued to follow this non-gradual strategy since.

In accordance with the ERM, the paper assumes the emergence of a “Two State” solution embodying Palestinian economic sovereignty, unambiguous borders and the conduct of economic relations in a spirit of cooperation and mutuality. The group’s economic vision of permanent status is based on economic arrangements that will seek a convergence of Palestinian living standards with those of Israel and promote independence in economic policy-making while acknowledging economic interdependency.

The ERM assessed and recommended future policies in trade, labor, fiscal, monetary policies and investment.

## 1. Trade

When it comes to the choice of a trade regime, there are a number of options, the main ones being a Customs Union, a Free Trade Area (FTA) and a Most Favored Nation (MFN) regime.

The FTA between a Palestinian state and Israel is likely to be feasible and efficient, as well as to offer advantageous development opportunities. A bilateral free trade agreement would provide the Palestinian state open access to the Israeli market, which will continue to be a key trading partner. At the same time, it will allow the Palestinian state to diversify its trade relations and implement development policies conducive to economic growth and prosperity. A FTA model will be most efficient if it is accompanied by a friendly system of Rules of Origin which would minimize negative impacts on trade.

The FTA regime recommended by the Group requires cooperation between the parties in the following areas:

- First, the FTA regime should allow for a degree of asymmetry – whereby for a temporary period Palestine can implement certain trade restrictions on imports from Israel on a MFN basis. The purpose of this would be to stimulate Palestinian economic growth and domestic employment, as was the case with the 1975 agreement between Israel and the EEC.
- Second, the Israeli and Palestinian governments would need to discuss and agree upon:
  - Rules of Origin
  - Standards
  - Cooperation in export promotion
- Third, the guiding principles for trade relations should be those enshrined in the World Trade Organization (WTO) agreements, including the dispute settlement mechanisms which are applicable between members.
- Fourth, supervising the implementation of the agreement should be entrusted to a Joint Israeli–Palestinian Economic Committee, which should be empowered to recommend revisions to the agreement where appropriate and mutually agreeable.

## 2. Human Capital and Labor Mobility

The group recommends the establishment of designated passages across which labor flows will be unencumbered, but subject to regulation through taxes and/or permits.

The regulation of labor flows will need to address both sides' macroeconomic interests as well as their security needs. Some of these policy measures should start in Phase I such as:

- designated passages to regulate and supervise labor flows;

- creating a Uniformity in Working Conditions agreement to include common rates of income, other labor taxes, and identical regulations;
- de-monopolization of the labor market through granting work permits to individual workers and allowing permit holders to seek jobs in Israel freely;
- favoring Palestinian workers: A surcharge should be imposed on non-Palestinian workers on account of the negative externalities resulting from their presence in Israel.

### **3. Fiscal Policy**

Under a FTA, each country would run an independent international customs policy, but would not impose duties on goods originating in Israel/the Palestinian state (with certain exceptions as defined under the agreement).

To minimize smuggling, indirect tax policy needs to be closely coordinated, and VAT and other indirect tax rates (excises, purchase taxes) should only diverge marginally, if at all.

Double taxation should be avoided since this would discourage cross-border economic activity. Accordingly, there is a case for applying lower income tax rates to Palestinian workers in Israel as compared to those applicable to Israelis or other foreign workers. Alternatively, Israel should continue to remit to the Palestinian state a large portion of the income tax it levies on Palestinians working in Israel, as well as any social security deductions.

Once Phase III is achieved, it is vital that Palestinian tax administrative capacity be built-up so as to avoid revenue losses that the Palestinian budget can ill afford. Capacity building programs of this kind are often given low priority; the cost of neglect in this case would be immense for the Palestinian state as well as Israel, and the stability of both tax systems would be threatened.

The Group recommends that Israel and the Palestinian state would need to share information, hold regular consultations and coordinate indirect taxation policies in order to avoid smuggling, enhance efficiency in collection, avoid double taxation on incomes and minimize fiscal leakage.

### **4. Monetary Policy**

The Aix Group recommends that the restrictions embedded in the Paris Protocol preventing the Palestinian Monetary Authority from issuing Palestinian currency be lifted in Phase II (whether or not the Palestinian Authority (PA) then decides to create a new currency). At present, the Palestinian Authority does not receive revenue from issuing and circulating a currency, and this raises the possibility of the PA sharing the revenue derived from the issuance of Israeli Shekels while the current currency system continues.

In order to facilitate bilateral trade and investment, payments and transfers for current or capital transactions should be kept free of restrictions (as is the case today). Correspondent relations between banks on both sides should also be facilitated, especially insofar as check clearing and

reciprocal arrangements for letters of credit and letters of guarantee are concerned.

A sovereign Palestinian state can decide either to use one or several foreign currencies as legal tenders, or to introduce its own currency. In the latter case, the state also needs to decide what exchange rate regime to adopt, whether it is a fully flexible exchange rate, an adjustable peg (linked to a foreign currency or a basket of foreign currencies), or a currency board. As long as the current currency regime continues, several foreign currencies will continue to circulate and be used, including the New Israeli Shekel (NIS).

The new Palestinian state could choose to implement monetary and exchange rate policies fully independently, but coordination with Israel is obviously advisable in view of the interdependence of the two economies. In addition, the two central banks should consult over the supervision of branches and subsidiaries operating within each other's jurisdiction (the supervision of such branches and subsidiaries would have to be conducted in accordance with the international prudential rules defined by the "Basle Accord"). Another area of coordination should be the payment system and the existence of clearing houses.

## 5. Investment

The Group recommends that both countries accord one another's investors and investments national treatment - with some exemptions in cases that bear upon special national interests. The future economic agreement should permit full repatriation of revenues and income, should preclude the possibility of double taxation and should address expropriation and regulatory matters pertaining to facts and disputes created after its entry into force. Donors can contribute to cross-border investment by establishing funds that can be used to build equity positions in Palestinian firms and to create joint ventures with Palestinian partners, as well as by continuing to offer risk insurance and guarantees to investors.

There is undoubtedly potential for greater Palestinian trade in services with Israel, Arab countries and the rest of the world. Growth in this area is best approached through incentives for Israeli investors to take equity positions and enter into joint ventures with Palestinian partners. This will require the elimination of discriminatory treatment, consistent with the obligations of the WTO Agreement on Trade-Related Investment Measures (TRIMs).

Industrial estates may also offer opportunities for investment. These estates could be located along the border with Israel or within the Palestinian state; to attract Israeli investors, they would need to offer a rock-solid security environment.

### *Areas of Cooperation and Joint Institutions*

The introduction of these new economic arrangements will require intensive bilateral cooperation. This would be facilitated in particular by the establishment of a Joint Israeli-Palestinian Economic Committee, as well as by regular dialogue at experts' level to exchange views on all areas of economic

policy. The establishment of an Israeli-Palestinian Development Fund should also be considered; this institution could play a major role in encouraging a variety of joint activities, such as industrial estates, business ventures for domestic and external markets, tourism projects and joint public/private infrastructure initiatives.

### ***Transition***

The transitional period requires, above all, a vigorous effort to stimulate Palestinian economic recovery. This can only be done by restoring movement and predictability in transactions. Three basic ingredients are required to achieve this:

- unencumbered flow of goods across borders and within the West Bank and Gaza;
- unencumbered flow of persons within the Palestinian Territories, coupled with the flow of workers to Israel which regains some stability and predictability;
- The continued uninterrupted flow of fiscal transfers from Israel to the Palestinian Authority.

The meaning and operation of a Palestinian state with provisional borders, as envisaged under Phase II, needs thorough exploration since it will serve as the precursor to full economic independence. Phase II arrangements must realistically be based on a “Paris Plus” formula – that is, the full implementation of the modified Paris Protocol.

Phase II arrangements should include measures that ensure territorial viability, i.e. the creation of internal contiguity and the inception of economic control over external borders. Steps should be taken to denote emerging sovereignty, including the right to issue currency and the granting of observer status in the IMF, the UN, the World Bank and the WTO. Attention should also be given to the development of institutions that will reinforce cooperation and resolve disputes.

## Summaries of Past Studies

# AIX GROUP'S THOUGHTS ON A RESOLUTION TO THE PALESTINIAN REFUGEES WITHIN A TWO STATE AGREEMENT

# AIX GROUP'S THOUGHTS ON RESOLUTION TO THE PALESTINIAN REFUGEES WITHIN A TWO STATE AGREEMENT

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Based on Aix Group's papers (2007, 2010)

## **Abstract**

There will be no permanent peace agreement between Israel and a future Palestine without an agreement on a resolution for the Palestinian refugees that will start the process of becoming citizens. Today, the 1948 Palestinian refugees and their descendants are estimated to number more than five million, depending on the definition used, and they constitute the world's oldest and largest refugee population. It is clear that any agreement concerning the refugees will have many dimensions, including legal status, place of residence and financial compensation, all of which have significant economic dimensions.

The Aix Group analyzed an agreement that will be based on two foundations:

(1) Choices made by the individual refugees themselves and (2) An agreement between the representatives of the two peoples. The Aix Group suggested a mechanism that makes the outcome of the two foundations compatible; i.e. the implementation of the principles described below concerning the two foundations -- the individuals' choices and the political agreements signed by the representatives of the two sides -- will be consistent.

The overall process will be implemented and supervised by the International Agency for the Palestinian Refugees (IAPR), an international administration discussed in detail below. The IAPR will prepare a comprehensive list of all refugees and collect written statements from refugees regarding their claims and preferences. The Aix Group estimated in 2007 that the magnitude of the various financial costs of an agreed-upon resolution for the refugees lies between US\$55 billion and US\$85 billion over the period of implementation.

## **A Preliminary Note**

Over the course of several years, from 2005 to 2010, the Aix Refugees Working Team exchanged ideas on various aspects of a possible permanent resolution for the Palestinian refugees, within an overall Two State solution. As in the other parts of the Aix Group's work, we had to imagine a political solution which seemed to some observers, and sometimes also to some in the Group, as a

very remote possibility. Still, despite all the reservations that we have, we assume throughout the work that an agreement acceptable to the two peoples will be reached. Only in that context do our detailed discussions make sense. Thus, we would like the readers of the paper to assess the arguments below while imagining that an agreement on all issues except for that of the refugees has been reached.

This summary presents the major points in our discussions. However, not every sentence necessarily reflects the views of all the participants. As much as possible, the emphasis in the summary is on a professional, forward-looking economic perspective, and less on the legal, historical and philosophical dimensions that are so important to our subject.

## 1. Introduction

The Israeli – Palestinian conflict is about two contradictory sets of claims that refer to both geographic territory and human rights: On the one hand, many Israelis claim that they have exclusive rights for sovereignty over the land between the Jordan River and the Mediterranean Sea, and they deny that Israel has deprived the Palestinians, in particular the refugees, of their rights; on the other hand, many Palestinians claim that they have exclusive rights to that same land and that Israel has denied the Palestinians, and in particular the refugees, their basic rights since 1948. These contradictory claims, though they do not cover all the differences between the two sides, are at the core of the Palestinian-Israeli conflict and are defining the two sides' narratives. The strength and impact of these narratives are changing in direct proportion to the distance from meaningful negotiations that may lead to the resolution of the above claims and to a peace agreement. In many ways, the above narratives' strengths today are a clear sign of the difficulties we face and indicate how far away we are at present from a political compromise.

Over the last ten years, the Aix Group outlined what its members believe to be a reasonable and practical compromise that is forward looking. The compromise avoids the two conflicting narratives and attempts to present a political alternative to the continued confrontation that even those who argue in the name of "their" narrative can live with. The compromise is defined through two dimensions: one dimension is the **territory** - known as Palestine to the Palestinians and Eretz-Israel to the Israelis - and the second, concerns the **Palestinian refugees' rights**. On both dimensions the compromise that we (and many others) have discussed in detail answers the legitimate claims and minimum necessary core demands of the two peoples with regards to both territory and the rights of the refugees.

The **territorial compromise** assumes two sovereigns with symmetrical features (control over their borders, having a capital in Jerusalem, equal authority over internal and external policy, etc.); i.e. "[real and full] Two States". The territory between the Jordan River and the Mediterranean Sea will be divided on the basis of the 1967 borders with agreed and minimal "swaps". Jerusalem will be the capital of the two states. If there are asymmetries, on military arrangements for example, these should be balanced and agreed upon.

The **refugee question** will be solved in a way that will address both sides' legitimate claims and concerns and will provide an acceptable and desired common ground. The refugee issue did not receive proper attention in many public discussions, and will be the focus of our discussion here. We believe that there will be no "end of conflict" unless both the sovereignty and refugee questions are answered satisfactorily and since the failure of gradualism is beyond doubt after all these years, it is time to fully respond to both issues.

## 2. The Principles for a Resolution

The Aix Group outlined in 2007 and 2010 (and has since continued to work on it) a possible compromise on the refugee issue along the following lines:

- The refugees will make "choices" concerning their preferred future residential location; they will choose between the five possibilities mentioned in Clinton's December 2000 parameters (see below). We propose that during the process of "choice" the refugees will rank-order their preferences.
- The representatives of the two sides will negotiate a comprehensive framework "agreement" addressing all the aspects related to the refugee question (as well as the other permanent status issues). This will include a matrix scheme for relocation where the agreed maximum and/or minimum numbers of people at each location after completing the implementation process will be specified.
- The IAPR will be responsible for implementing the comprehensive plan and will also address any possible inconsistencies between the outcome of the above "choices" and the framework "agreement", thus ensuring that the agreed matrix scheme numbers and the refugees' stated preferences will be consistent.
- In addition, the IAPR - working with the authorities of the two sides, the regional countries involved in the refugee issue, other regional countries and the international community - will be responsible for implementing all the aspects involved in resolving the refugee issue. The following four aspects will be under its authority:
  - **Relocation**, including absorption, employment opportunities, housing, legal aspects, etc.
  - **Rehabilitation**, including infrastructure renewal, employment, legal aspects etc.
  - Resolving **1948 Lost Properties** claims.
  - Addressing **Refugehood** claims.
- The IAPR efforts will be coordinated with the relevant regional countries that are linked to any solution for the 1948 refugees. In particular, the outcomes of implementing the above dual process ("choices" and bi-lateral "agreement") in Jordan, Syria, Lebanon and other Arab states will address those aspects of the 1948 Palestinian refugees that were not addressed by the dual, bi-lateral process. These will include both backward-looking and forward-looking elements concerning past costs and claims and possible negative impacts of the implemented

solution on labor, housing and infrastructure in the various guest-countries as a result of the implementation.

The role of the IAPR is of the utmost importance since it will be responsible for implementing an agreed-upon mechanism to ensure that the final decisions satisfy the wishes of the refugees as much as possible. It is also their responsibility to ensure that the final decisions are in line with the overall agreements to be signed between the representatives of the two sides and with the relevant host countries and other relevant countries. The IAPR will also supervise the various arrangements, mechanisms and programs that will address the following four critical topics:

- Resettlement/Repatriation, or what we sometimes describe as relocation programs
- Rehabilitation programs
- Claims concerning properties
- Compensation for Refugehood

In its 2007 paper, the Aix Refugees Working Team estimated the costs of relocation and the costs of rehabilitation (i.e. expenses covering those programs intended for refugees who choose not to change residency). The paper suggested the following:

- In order to implement comprehensive resettlement programs, the IAPR will need funds in the order of US\$8 to US\$19 billion over a period of ten years, depending on the number of refugees who choose to relocate.
- In order to implement rehabilitation programs, the IAPR will need funds in the order of US\$10 to US\$14 billion, depending on the number of refugees who decide not to relocate and on whether they currently reside in or outside camps.

The question of settling claims concerning lost properties, and the financial dimensions of such a question, are very complicated. Under international law, and similar to other reparation programs created to respond to other situations, reparations can take many forms. The Aix Group has explored the options of restitution and compensation. These, among others, are appropriate forms of reparations for Palestinian refugees. The Group introduced a concept of “full and fair compensation” to be determined objectively by a board of experts associated with the IAPR that will administer the lost properties claims process. Restitution will be considered only in those cases where “full and fair compensation” has not been offered and where the properties exist in a form that can make restitution practical and equitable.

The funds needed for “full and fair” compensation for the expected property claims are not clear; in the studies we roughly estimated them to be between US\$15 and US\$30 billion. The wide range reflects conceptual as well as data gaps.

We recommend the establishment of a fund that will finance compensation for refugehood not related to property claims or to the above programs.

- All registered refugees will receive uniform sums. Each refugee will receive a sum when he\ she registers with the IAPR at the start of the process and an additional sum when the decisions concerning the individuals are completed. This fund will require approximately US\$22 billion.
- The main responsibility for compensation of refugee property taken over in 1948 and 1967 will lie with the State of Israel. If the State of Israel fails to come up with adequate compensation then the rule restitution will prevail. Similarly the future state of Palestine will be responsible for compensation/restitution of Jews who lost their property in the West Bank.

A long term resolution of the Palestinian refugee issue should be based on all relevant UN resolutions, including GA Res. 194, while recognizing that a literal application of this Resolution is no longer possible given the substantial changes on the ground. As in the Clinton parameters, the parties would agree that the measures recommended in the paper implement Res. 194. The Aix Group considers that the refugees' right of return to their homeland, even in a modified and limited sense, together with the other measures discussed in this paper, should be an essential component of closure to this issue.

*The magnitude of the financial dimensions of an agreed-upon resolution for the refugees is quite significant; we estimated it in 2007 as between **US\$55 billion and US\$85 billion** over the period of implementation. The financial estimates are explained in the 2007 paper; one has to remember that resettling/relocating/rehabilitating around 4.5 million people and settling 60 year-old claims on many lost properties is an enormous task.*

### **3. The Essential Facts**

During the war immediately following the UN's partition decision in 1947-1949, around 750,000 Palestinians fled or were forcibly expelled from their homes, in addition to 240,000 more Palestinian refugees who fled their homes during the Six Day War of June, 1967. In the papers we analyzed only the 1948 refugees.

In 2006, nearly one third of the registered refugees – about 1.3 million people – lived in 59 recognized UNRWA refugee camps in Jordan, Lebanon, Syria, the West Bank and Gaza; a significant number also lived in informal settlements near camps. Additional numbers of refugees live in non-UNRWA territories, mainly in Egypt and Iraq. Table 1 presents figures of the locations of the Palestinian refugees as of 2006, published by UNRWA, which were used in our estimates. We quote UNRWA's figures, which are the most updated available, although they are considered by some to underestimate the real numbers and by others to exaggerate the number of refugees in certain locations. The main reasons for the various estimates are the lack of coverage of unregistered refugees, missing data on refugees outside the camps and outside UNRWA's coverage and missing information about people who have moved. However, for our purposes the data presented in Table 1 is a good approximation of the demographic scope of the refugee situation.

**Table 1: Palestinian Refugees<sup>1</sup> - Figures as of September 2006<sup>2</sup>**

UNRWA Fields of Operations	Registered Refugees	By Location %	Official Camps	Registered Refugees in Camps		
				Families	Individuals	Percent In Country
Jordan	1,835,704	42%	10	61,063	316,549	17%
Lebanon	405,425	9%	12	49,836	214,093	53%
Syria	434,896	10%	10	25,740	116,253	27%
West Bank	705,207	16%	19	38,954	185,121	26%
Gaza Strip	993,818	23%	8	92,322	474,130	48%
<b>Total</b>	<b>4,375,050</b>	<b>100%</b>	<b>59</b>	<b>267,915</b>	<b>1,306,191</b>	<b>30%</b>

One should recall the fact that refugees constitute about one-half of all Palestinians, as can be seen in Table 2.

**Table 2: Palestinian Population 2007/8<sup>3</sup>**

	Total Palestinians	Registered Refugees	No. of Camps	Registered Refugees in Camps
West Bank	2,281,714	754,263	19	191,408
Gaza	1,416,543	1,059,584	8	492,299
Jordan	2,867,000	1,930,703	10 (+3 unofficial)	335,307
Syria, Lebanon and other Arab countries	1,632,000	416,608	12	220,809
Foreign Countries	580,000	456,983	---	123,646
Israel	1,200,000	---	10 (+ 3 unofficial)	---
<b>Total</b>	<b>9,977,257</b>	<b>4,618,141</b>	<b>59 (+ 6 unofficial)</b>	<b>1,363,469</b>
<b>Total in Diaspora*</b>	<b>5,079,000</b>	<b>2,804,294</b>	<b>32 (+ 6)</b>	<b>679,762</b>

\* Outside of historic Palestine, i.e. the total number excluding those living in the West Bank, Gaza and Israel.

1 We used UNRWA data based on their definitions: «Under UNRWA's operational definition, Palestine refugees are persons whose normal place of residence was Palestine between June 1946 and May 1948, who lost both their homes and means of livelihood as a result of the 1948 Arab-Israeli conflict. UNRWA's services are available to all those living in its area of operations who meet this definition, who are registered with the Agency and who need assistance. UNRWA's definition of a refugee also covers the descendants of persons who became refugees in 1948.»  
See <http://www.un.org/unrwa/english.html>.

2 <http://www.un.org/unrwa/publications/index.html>

3 Refugees' figures are from UNRWA's June 2008 records; total Palestinians from PCBS end 2007 [http://www.pcbs.gov.ps/Portals/\\_PCBS/Downloads/book1526.pdf](http://www.pcbs.gov.ps/Portals/_PCBS/Downloads/book1526.pdf)  
[http://www.pcbs.gov.ps/Portals/\\_pcbs/PressRelease/gaza\\_census\\_e.pdf](http://www.pcbs.gov.ps/Portals/_pcbs/PressRelease/gaza_census_e.pdf) | [http://www.pcbs.gov.ps/Portals/\\_PCBS/Downloads/book1530.pdf](http://www.pcbs.gov.ps/Portals/_PCBS/Downloads/book1530.pdf)  
Palestinians in Israel end 2007: <http://www.cbs.gov.il/reader/>

#### 4. Individual choices, the agreements and some possible relocation matrixes

The Aix Group has examined the economic dimensions of possible solutions for the refugees. The economic components generally stem from two different processes that will follow any agreement on them:

1. Resettlement/repatriation (sometimes referred to below as relocation) and rehabilitation;
2. Financial arrangements concerning reparations for losses and suffering and for covering the costs of relocation.

It is assumed that these two processes will be pursued parallel to one another through a comprehensive mechanism designed especially for implementing a permanent status agreement on refugees. The process will be supervised and managed, as we proposed above, by the IAPR.

##### *Relocation and Rehabilitation*

There are over 4.5 million Palestinian refugees,<sup>4</sup> the majority of whom reside outside of historic Palestine. To both ensure that the relocation decision is made voluntarily and to meet political and practical exigencies, the Palestinian refugees should be presented with options for electing a place of permanent domicile through which they can normalize their status, gain citizenship and begin the process of rebuilding stable, prosperous lives. It is worth noting that this study does not relate to displaced persons after the 1967 war; it is assumed that those displaced in 1967 who were not refugees of 1948 will have the right to return to their homes following the establishment of a Palestinian state.

##### **These options include:**

- The Palestinian state (borders on the basis of pre-1967 borders);
- An agreed-upon and limited land swap, added to the territory of the Palestinian state;
- Israel;
- The present host countries;
- Other countries.

The IAPR will prepare a comprehensive list of all refugees. It will collect written statements from each refugee concerning his or her past and present conditions and preference regarding future residency. The process of implementing the agreements and achieving a practical solution will be based on choices made by the refugees, who will assess their own best interests and choose between alternative locations for residency, as outlined in the Clinton parameters. As explained above, this choice will be made individually, in a well-organized process supervised by the IAPR and according

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<sup>4</sup> See discussion in Abu Libdeh (2007). In this study we use UNRWA figures for September, 2006. The figures can be debated, of course, both those concerning specific locations and the totals. They serve us as a point of reference; revision of the figures will change the results.

to an agreed-upon time frame, and each refugee will choose more than one alternative and rank them according to his or her preferences. The goal of this process is to ensure that the final decisions will satisfy the refugees as much as possible and will be in line with both the agreements to be signed between the representatives of the two sides and with the relevant host countries and other countries.

These decisions will have to take into account not only the final destinations but also the timetable for relocation and rehabilitation. Obviously not all the refugees will be able to be processed at once and priorities will have to be assessed, taking into account each refugee's wishes, the urgency of his or her situation (based on his or her present conditions), the economic situation at each location and the time needed to prepare the new locations for absorption. The refugees who have claims concerning lost properties will file their preliminary statements at this stage.

The relocation, repatriation, and rehabilitation processes will be a major logistical undertaking, requiring significant institutional resources. For instance, institutional arrangements will need to be set up in order to disseminate information about the options available to the refugees and to register their choices. Responsibility for this process will rest with the IAPR and with domestic ministries and organizations that will have to support and facilitate the movement and/or integration of the refugees.

### ***Targeted Programs***

Targeted programs will have to be put in place to help the refugees' transition to their new lives. These programs, in the West Bank, Gaza, Swap WB, Swap Gaza etc. (see Tables 3 & 4), should include housing, employment and infrastructure programs as well as educational and health services. Regional administrations will be created by the IAPR to deal with the various aspects of implementation of resettlement/relocation/rehabilitation:

- *Housing and infrastructure*: Improved and/or new housing will have to be provided to refugees to replace their temporary, inadequate shelters and/or to house relocating refugees.
- *Education and health services*: Creating or improving education and health services for the new as well as the existing population will be an important part of the project.
- *Direct rehabilitation assistance*: In addition to the generalized measures listed above, directed assistance may be provided through stipends to refugee families for the early period of resettlement, until they adjust to their new lives (a practice that Israel uses with new Jewish immigrants). Other forms of direct rehabilitation assistance may be identified depending on particular return/resettlement needs.

These components carry costs that should be factored into an assessment of the economic dimension of a solution. While it is obvious that the components might vary from one state to another according to need, this difference would mainly be in the cost of a certain component and to what degree it is needed.

In addition, the provision of services and rehabilitation assistance should be integrated with the overall macro-economy and management policies of the receiving state. The integration and rehabilitation of refugees should be part of the overall development goals, particularly in the case of the future Palestinian state. The economic component of refugee resettlement should be integrated with national Palestinian development goals. Third countries will share responsibility for these costs by either absorbing refugees directly or providing financial assistance to receiving states, including the Arab host states. The financial aspects will be managed by the IAPR.

### *Macroeconomic Implications*

The macroeconomic implications will heavily depend on the nature of the agreements, as well as on the reaction of the population that is affected by them. Thus, the socio-economic characteristics of the refugees, their current places of residency, their level of integration in the various countries, and of course the size of the populations, should be discussed. The number of persons who would become eligible for IAPR assistance under the various scenarios was disputed for many years, but it seems that we are now approaching a consensus on the figures.

Thus, the agreement and the refugees' decisions will result in changes in places of residency. We present below four relocation scenarios, some more acceptable to one side, some more acceptable to the other, and some unacceptable to both. We use these scenarios in order to clarify the challenges that the implementation of a possible agreement presents and to argue that the scenarios are feasible. The results of the four scenarios, presented in terms of the total numbers of refugees in each location, are presented in Table 3.

**Table 3: Number of Refugees at Each Location under the Four Scenarios**

(in thousands, rounded figures)

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
In:				
<b>Jordan</b>	<b>1101</b>	<b>1101</b>	<b>1469</b>	<b>1101</b>
<b>West Bank</b>	<b>1904</b>	<b>1729</b>	<b>1094</b>	<b>1330</b>
<b>Gaza</b>	<b>497</b>	<b>497</b>	<b>596</b>	<b>596</b>
<b>Syria</b>	<b>87</b>	<b>87</b>	<b>174</b>	<b>174</b>
<b>Lebanon</b>	<b>0</b>	<b>0</b>	<b>81</b>	<b>81</b>
<b>Swap WB</b>	<b>325</b>	<b>325</b>	<b>325</b>	<b>325</b>
<b>Swap G</b>	<b>199</b>	<b>199</b>	<b>199</b>	<b>199</b>
<b>Israel</b>	<b>44</b>	<b>219</b>	<b>219</b>	<b>350</b>
<b>R o W</b>	<b>219</b>	<b>219</b>	<b>219</b>	<b>219</b>

The scenarios reflect a summation of the many decisions of the refugees and represent “net” outcomes; thus, for example, in Scenario 1 the refugee population in the West Bank (1,904,000) includes those who decided to stay and rehabilitate and those who opted to come to the West Bank from other locations, minus those who left for other places. Among the options for the refugees, we include what we called “Swap West Bank” and “Swap Gaza”, two areas where new specific development projects are planned. Thus, the number of refugees in the West Bank does not include those who opted to settle in the new construction projects in the “Swap WB” areas.

### ***Refugees' Lost Properties Claims***

The issue of compensation for lost properties is very complex, even if we focus only on the economic aspect and ignore the political, emotional and legal aspects. First, there is a wide range of estimates for the original scope of the properties. Second, there are several methods for calculating the current value of past properties, and each of these methods leads to a different result. Finally, there are questions regarding the micro level, or how the compensation would be distributed to the original owners and their descendants. This section briefly summarizes the research and analysis that has been done so far. It also adds details regarding the estimates of the value of movable properties, and expands the description of the technical part of the estimates.

### ***Estimations of Past Value of Lost Properties***

Surveying the results of different studies will help to reach rough estimates of the aggregate financial compensation for lost properties. Since 1948, several studies have attempted to document, evaluate and measure the size and the values of the lost properties. In the brief survey below, we rely on the comprehensive studies of Fischbach (2003, 2006). Fischbach estimates that the potential sum of compensation varies widely among the parties which have estimated the value of the property (the UN estimates, Israeli estimates and Arab estimates). The divergence between the estimates results from: 1) different conceptual definitions of land (should the definition include only privately-owned property which is registered, or also land held collectively without being registered?); and 2) different assigned values (should the value be based on market factors or taxation assessment, and a difference of opinion about when Israel became liable for the compensation - immediately after the refugees left or only after the Israeli authority took control?).

## **5. The IAPR and the Implementation of Resolution**

The IAPR will be responsible for identifying and compensating each of the refugees' households, subject to the household's acceptance of the authority of the IAPR and of its mechanism of relocation. It is important to note that the value of compensation will not be dependent on the location preferences, or final location, of the refugees.

The IAPR will prepare a comprehensive list of all refugees and collect written statements from each refugee concerning his or her past and present conditions and his/her preference regarding future residency. The process of implementing the agreements and achieving a practical solution will be based on choices made by the refugees; their choice will be made individually, in a well-organized process supervised by the IAPR and according to an agreed-upon timeframe. The goal of this process is that the final decisions will satisfy the refugees as much as possible and will be in line with the agreements to be signed between the representatives of the two sides and with the relevant host countries and other countries. These decisions will have to take into account not only the final destinations but also the timetable for relocation and rehabilitation. Obviously not all the refugees will be processed at once and priorities will have to be assessed, taking into account each refugee's wishes, the urgency of his or her situation (based on his or her present conditions), the economic situation at each location and the time needed to prepare the new locations for absorption.

These components carry costs that should be factored into an assessment of the economic dimension of a solution. While it is obvious that the components might vary from one state to another according to need, this difference would mainly be in the cost of a certain component and to what degree it is needed.

In addition, the provision of services and rehabilitation assistance should be integrated with the overall macro-economy and the management policies of the receiving state. The integration and rehabilitation of refugees should be part of the overall development goals of the state, particularly in the case of the future Palestinian state. The financial aspects will be managed by the IAPR.

The Aix Group proposed the following stages for the creation of the IAPR and the implementation of its program:

Stage I: Drafting of a bilateral agreement on the principles for resolution between Israel and a future Palestine.

Stage II: Establishment of the IAPR in line with the bilateral agreement and under the coordination of the international community.

Stage III: Establishment by the IAPR of its program and structure.

Stage IV: Implementation of the program by the IAPR.

*Structure:*

The IAPR structure will be created in an international conference on refugees in which the Palestine Liberation Organization/Palestinian Authority (PLO/PA) and Israel will be constituent parties. The structures and functions of IAPR will take international precedents into account (e.g. Kosovo, Bosnia, Namibia, and South Africa). The IAPR will have direct representation among Palestinian refugee communities in the Arab host countries, in PA areas, and in the remaining diaspora countries.

The IAPR will include all the main parties involved in the solution, primarily the refugees themselves and the absorbing countries. The IAPR will be constructed from representatives of the following bodies/countries:

- The UN

- The G8
- The World Bank
- The Palestinian representatives from the PLO/PA
- The host countries
- The absorbing countries, i.e. Palestine (in the West Bank, Swap West Bank, Swap Gaza), Israel, and other countries who will participate in the process; Canada will be the leader of the multilateral refugees' discussions

*Mission:*

The mission of the IAPR is to bring an end to the period of Palestinian refugehood by agreeing on a long term solution. The solution will be based on the Clinton parameters and on the scenarios that were presented in the Aix phase III paper.

*Role:*

The IAPR will be responsible for implementing an agreed-upon mechanism to ensure that the final decisions satisfy the wishes of the refugees as much as possible and are in line with the overall agreements to be signed between the representatives of the two sides, and also with the relevant host countries and other countries. The IAPR will also supervise the various arrangements, mechanisms and programs that will be implemented.

The three main functions of the IAPR are:

- Assigning each refugee a permanent “target country”, either his or her current location or another country.
- Assigning each refugee an amount of money for his or her individual compensation.
- Assigning each “target country” the amount of money that is needed for the relocation and rehabilitation process.

In order to fulfill these functions, the IAPR will have to develop and operate a mechanism that will achieve a solution, considering both the individual will of the refugees and the different interests of the relevant countries, all under a fixed budget.

The huge number of refugees, the complexity of their situation, and the inability of the two direct parties – Israel and the PLO/PA – to solve the problem on their own, requires the involvement of other countries and international organizations in both the practical aspects (e.g. financing and providing permanent places of residence) and the organizational aspects (e.g. the institutions/bodies that will manage the various processes of collecting information, registering claims and requests, checking and assessing them, and deciding on and distributing the different benefits).

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<sup>1</sup> There are no refugees by UNRWA definition in Israel. The issues covered in this paper do not address Palestinians in Israel. The figure is calculated from the ICBS, and includes Arabs in Israel excluding those in Jerusalem.



Summaries of Past Studies

THE ECONOMIC ISSUES OF A FINAL STATUS  
AGREEMENT IN JERUSALEM

# THE ECONOMIC ISSUES OF A FINAL STATUS AGREEMENT IN JERUSALEM

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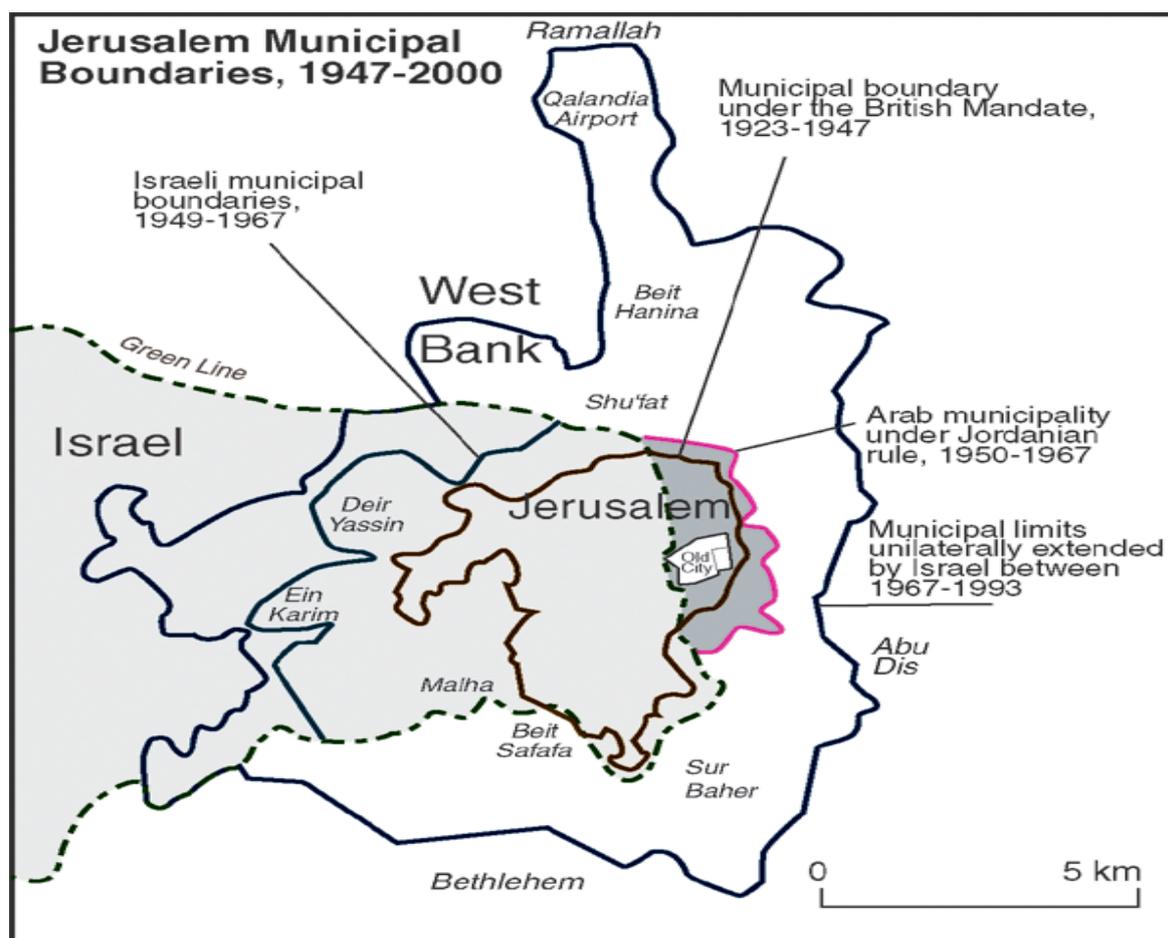
## 1. Introduction

This document discusses the economic aspects of a future final status agreement between Israel and Palestine on the issue of Jerusalem. Its main goal is to offer ideas for the economic agreements and arrangements that should accompany such an agreement. It also studies how economic considerations might affect reaching and sustaining a political agreement on Jerusalem.

We bear in mind that an economic agreement will be part of a broader Israeli-Palestinian final status agreement, which will be very difficult to reach. Since we are so far away from an agreement, it is hard to imagine how it will look. The difficulties in forecasting an agreement are even greater in Jerusalem, where the current positions of the two sides are much farther apart than on most other issues of the conflict, and so the shape of a future agreement is even more uncertain. Thus, in some cases our recommendations for economic arrangements do not address a single solution, but rather a range of possible solutions.

## 2. Background

Jerusalem has national-historical significance to both Israelis and Palestinians. It was the capital of the country in most historical periods. After the British Mandate, in the years 1948 – 1967, the city was divided between West Jerusalem in Israel and East Jerusalem, controlled by the kingdom of Jordan. The dividing line was called the “Green Line.” Immediately after the 1967 War the Israeli government decided to annex East Jerusalem. This annexation added East Jerusalem, an area of 6.5 sq. km, and a larger area of 70 sq. km, which included 28 villages close to the city. The annexed territory became part of the greater municipal Jerusalem. The Palestinians in the annexed areas became residents of Israel, but not citizens.



After the annexation in 1967, Israel began massive construction in the annexed area of both neighborhoods for Israelis and of infrastructure. In 1982, the Israeli Knesset passed special legislation that further formalized the annexation of East Jerusalem by defining Jerusalem as a unified city within the Israeli municipal borders. These borders created a line between East Jerusalem and the West Bank and thus began to separate the Palestinians in the two areas. Palestinian residents of East Jerusalem differed from residents of the West Bank by identification, by participation in Social Security programs, and by ability to enter Israel and work. The separation increased over time. Access restrictions on entry of West Bankers to Jerusalem intensified during and following the Second Intifada (2000-2005). The separation became almost hermetic with the building of the wall which separates East Jerusalem from the West Bank, and served to reduce mobility between the north and south of the West Bank as well. Further intensifying the separation of East Jerusalem from the West Bank is the on-going expansion of Ma'aleh Adumim, a settlement east of Jerusalem founded in 1975, and its many satellite settlements. This expansion threatens to effectively close the eastern gate of Jerusalem, and sever the West Bank in two.

We next turn to a brief description of the economic situation of Palestinians in East Jerusalem. In 2005 the total population of Palestinians in East Jerusalem was 251,000, which comprised 33 percent of the total population of Jerusalem. This has been a rather young population, as 42 percent were younger than 15 years old, and only 3.3 percent were older than 65. It is also an economically

poor population relative to Israelis in Jerusalem, but not relative to the rest of the Palestinians. The Palestinian poverty line is at US\$2 a day per person, and according to this, the poverty rate in East Jerusalem was 3.6 percent in 2003. The Israeli poverty line, however, is relative and according to it, the poverty rate among Palestinians in East Jerusalem was 42 percent in 1999. It has worsened since then. Another indication for poverty in East Jerusalem is the low level of property tax paid to the municipality, which is only 11 percent of the municipality revenues. Palestinians in East Jerusalem are also heavily discriminated against in the municipality budgets and they receive only 12 percent of the expenditures. With a population of one-third of the city, and a population that is poorer and with a higher share of children, this number is indeed staggering.

The participation in the labor market in East Jerusalem is quite low. In 2005 the participation rate was 37.2 percent overall, reflecting 66 percent of men and 8.2 percent of women. The unemployment rate reached 20 percent. Half of the workers from East Jerusalem work in West Jerusalem and in the rest of Israel and they work mainly in the service industry. The main economic sectors in Palestinian East Jerusalem are construction, tourism, transportation, small to medium size manufacturing, retail and commerce. The main service sector in East Jerusalem is tourism, but it suffers strong fluctuations in demand in times of violence and political unrest, much more than tourism in West Jerusalem. Firms in East Jerusalem are small, and 85 percent of the firms have fewer than five workers each.

### **3. Potential Outlines of the Final Status Agreement**

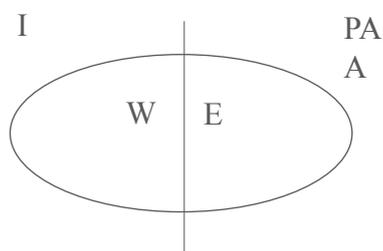
Any attempt to describe economic arrangements of the final status agreement must make some assumptions on the possible political characteristics of the final status agreement itself. We next present our working assumptions, which reflect the basic requirements of any future final status agreement:

1. There will be two states, Israel and Palestine, living side by side, with an agreed border between them.
2. Jerusalem will be divided, with East Jerusalem as the capital of Palestine under Palestinian sovereignty, and West Jerusalem as the capital of Israel under Israeli sovereignty.
3. The agreement will determine the precise location of the border between the two cities. In general, the Aix Group assumes that the border between the two states will be based on the June 4th, 1967 “Green Line” with small and equitable exchanges of territory. Since many of these modifications will be in Jerusalem, they will be substantial relative to the city.
4. Whether divided physically or not, the two cities will have separate municipalities.
5. Access to the holy places in both cities should be free for all.
6. The implementation of the agreement after it is signed will take between one year in some issues to five years on others, all specified in the agreement.

We next classify the many possible regimes in Jerusalem into three main types:

### A Physically Divided City

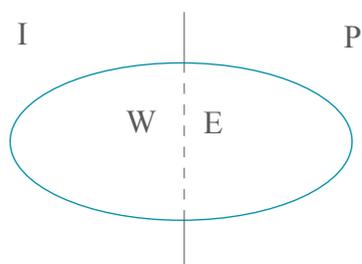
In this regime the two cities are divided by a physical barrier. Passage between the two cities is possible only through a few controlled gates.



Physically Divided city

### An Open City

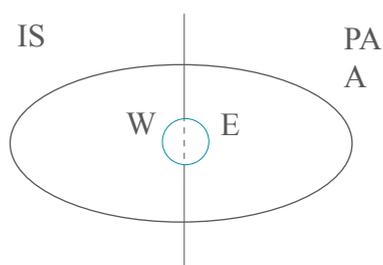
In this case, there is free movement of people and goods between the two cities, but then Jerusalem must be separated physically both from the rest of Israel and from the rest of Palestine, to avoid smuggling and trade violations through the city.



Open city

### Semi-Open City

The third case is a combination of the two above cases. A smaller area in the city is open, for example the Old City, while the rest of the two cities are divided physically.



Semi-Open city

In order to analyze the different regimes, we need to consider the possibilities with respect to the location of the political border since the two are strongly related. There are three main possible locations of the border:

1. The political border between the two cities goes along the 1967 lines, which involves the evacuation of most Jerusalem settlements/neighborhoods from East Jerusalem. In this case, the “open city” scenario becomes quite impossible, since such a massive evacuation will create a huge hostility between the two peoples in the city. Hence, this case fits the “physically divided” city option best.
2. The second case is that the border will reflect the current main divide between Jews and Arabs, as proposed by the Clinton parameters (2000). This case raises serious problems of continuity within the Palestinian city and with the rest of Palestine and also for some Jewish neighborhoods. For this case,

all the above regimes are possible, but the “open city” becomes preferable, as it solves mobility issues. 3. The third case is between the above two cases. The border will leave some Jerusalem settlements/neighborhoods in Israel, but will also include the evacuation of some to enable greater “contiguity” in the Palestinian city. Examples for such evacuated settlements/neighborhoods can be Atarot, Har Homa, Neve Yaacov, or Pisgat Zeev. Using the above reasoning, we conclude: the larger the evacuated area, the less possible is the “open city” regime.

From this discussion we reach the following conclusion: The future decision on the regime in Jerusalem will be significantly affected by the location of the future political border in Jerusalem. The closer the border is to the 1967 line, the stronger the “physically divided city” option becomes. If, however, the border is close to the current divide between Jews and Arabs, then the option of an “open city” rises. It is also important to note that there are some economic considerations with respect to the choice of regime in Jerusalem. One consideration is the current income gap between the two parts of the city. An “open city” regime might continue the specialization in low-skill services in East Jerusalem and it might also hamper economic development.

#### **4. Institutions for Economic Negotiations**

The issues related to Jerusalem require special arrangements in many areas, both political and economic. We suggest that in conjunction with the political negotiations, there will be a special negotiation mechanism for the economic arrangements in Jerusalem that will consist of:

- Jerusalem Economic Negotiation Teams (JENT): Special negotiating teams will decide on the economic-specific aspects of the agreement on Jerusalem. The teams will begin their work after the signing of the political agreement, or even earlier if possible, and end it before the full implementation of the agreement.
- Jerusalem Economic Arbitration (JEA): In the event that the JENTs will not be able to reach an agreement, the matter will be brought to an agreed arbitrator, the JEA.

#### **5. Trade Arrangements**

The general regime of international trade recommended by the Aix Group for Israel and Palestine is a Free Trade Area. This means bilateral free trade between Israel and Palestine, while each country sets its own independent trade policies with third countries.

We next examine whether Jerusalem should have the same trade regime. We begin with the following immediate conclusions:

1. If the city is “physically divided,” the trade regime in the city can and should be the same as between Israel and Palestine elsewhere.
2. If the city is “open,” it must keep a uniform set of tariffs and taxes, including with respect to goods from third countries. This follows from the free transport of goods in the city.
3. As a result, an “open city” in Jerusalem must be a special trade zone for goods from third countries relative the rest of the two states, with lower or equal rates. This imposes restrictions on transportation

between West Jerusalem and Israel and between East Jerusalem and Palestine, at least for commercial vehicles.

4. In the “semi-open city option,” the open area is relatively small and trade should not create problems if it can be restricted only to goods like food, textiles and tourism.

These conclusions help us to analyze the interaction between the city regime and the trade regime. Once independent, Palestine might decide to impose higher tariffs and taxes on various goods, reflecting both the need to finance its expenses and the protection of local infant industries. Israel, however, has relatively low tariffs and purchase taxes. Such discrepancies in tariffs and taxes between Israel and Palestine might lead to massive smuggling through Jerusalem, which could be quite costly for both sides. We estimate that the costs of smuggling to Israeli public finance will not exceed 1 percent of GDP. While this figure is not very high, it is not negligible and is around 3 percent from the total tax revenues. It is hard to draw conclusions to losses of income to the Palestinian government, but we can say that these losses could be much higher, since income from purchase tax and tariffs will be larger relative to income in Palestine. There would be additional non-pecuniary costs, both social and moral, to making Jerusalem a main channel for smuggling between the two states. These potential costs of the trade arrangements in Jerusalem, imposed by the “open city” regime, should be taken into consideration when the future regime of the city is discussed in the political negotiations as they make the “open city” option less attractive.

## 6. Labor Arrangements

Generally, the Aix Group recommends that labor flows between Palestine and Israel will be free, subject to regulation through taxes and/or permits. We adopt this idea for Jerusalem as well, with one addition. First, unlike trade in goods, labor arrangements do not depend much on the possible regime in the city. The main reason is that while trade in goods is anonymous, labor contracts hold for well-known parties. Hence, it is possible to allow labor flows across a physical border, and it is possible to regulate labor flows even if the city is open. Hence, labor arrangements in Jerusalem can be similar to the general labor arrangements between the two states. One difference arises from the fact that Palestinians from East Jerusalem have been working for Israeli employers for many years. We therefore suggest that there should be an additional provision for Jerusalem, that Palestinians from East Jerusalem who have been working in Israel prior to the agreement will be able to keep their jobs until retirement, or at least for ten more years.

## 7. Infrastructure

The division of infrastructure between the two cities requires special attention for two issues. The first is that infrastructure projects have significant network externalities. The second is that infrastructures are much more developed on the Israeli side than on the Palestinian side. For example, West Jerusalem and the settlements/neighborhoods have 680 km of roads and streets, while East Jerusalem has only

87 km. West Jerusalem has 650 km of sewage, while East Jerusalem has only 76 km.

Our recommendations on dividing the infrastructure between the two cities are:

1. The infrastructure networks should remain intact on impact. Citizens of one city who use services of the network of the other city or state will continue to use them for a transitional period of 10 or 15 years, as agreed by both sides.
2. During the transitional period, citizens of each side will pay their own state's providers for the infrastructure services, and the provider will settle accounts with the other side's provider. For example, an Israeli neighborhood that gets electricity from the Jerusalem Electric Company will pay the Israel Electric Company, which will settle accounts with the Jerusalem Electric Company. The Jerusalem Economic Negotiating Teams (JENTs) will agree on the rates.
3. During the transition period, each municipality will build its own infrastructure, so that by the end of this period they can separate the networks.
4. It is also possible for the two sides to continue to share infrastructure beyond the transition period mentioned above if both sides wish it.

## **8. Costs of Setting a Border**

Since 1967 Israel has built 12 settlements/neighborhoods in East Jerusalem. Around 200,000 Israelis live in East Talpiot, Gilo, Givah Tsarfatit (French Hill), Giv'at Ha-Matos, Har Homa, the Jewish Quarter of the Old City, Ma'alot Dafna (East), Neve Ya'acov, Pisgat Ze'ev, Ramot Allon, Ramat Shlomo and Ramat Eshkol. To this we should add Atarot, which is mainly an industrial and commercial center. While Israel views them as legitimate neighborhoods that should remain in Israel, the Palestinians view them as illegal settlements that should be evacuated. Still, it seems that any future agreement on Jerusalem might leave some settlements/neighborhoods under Israel's sovereignty, within the framework of a land swap, but might also include the evacuation of some to enable more contiguity and future development space for East Jerusalem.

Hence, our working assumption is that a future agreement on Jerusalem will determine which settlements/neighborhoods will become part of Israel and which will be evacuated. Here we deal only with the economics of such an agreement. While we cannot foresee the exact location of the future border, we can foresee two types of economic-geographical issues that such a border will create. One is how to conduct an evacuation of a settlement/neighborhood, if it remains in Palestinian territory. The second is how to build and finance infrastructure adjustment for contiguity, like tunnels, bridges, or circumventing roads. Even if the source of many finances will be the international community or donor countries, we discuss the payments as bilateral, to clarify responsibilities and mechanisms.

We first describe how to transfer settlements/neighborhoods to the jurisdiction of Palestine. The JENT will negotiate and reach a specific economic agreement over each such settlement/neighborhood, which will follow these guidelines:

1. Structures in the East Jerusalem neighborhoods are mainly apartment buildings suitable for Jerusalem Palestinians. Hence, we strongly recommend to sell them to Palestine and not destroy them. Such destruction would be extremely inefficient.

2. Palestine will create an administrative body that will handle the allocation and distribution of these assets, with a priority to returning lands to their original owners. This administrative body will cooperate with the JENT.
3. The JENT will decide the payment by Palestine for the assets, tangible and intangible, that will be left by Israel in an evacuated Jerusalem neighborhood/settlement.
4. The JENT will negotiate an additional agreement on the past use of land of all Jerusalem settlements/neighborhoods from 1967 to the time of the agreement. This should be payment for the use of land only. It should include even settlements that remain under Israeli control.
5. The Palestinians will describe, in the most detailed way possible, their plans concerning such evacuated neighborhoods/settlements to contribute to good will on both sides.

Dividing the city also requires building infrastructure to enable mobility between Jerusalem neighborhoods, above, below, or around neighborhoods of the other city. We divide the issue into two, construction and finance:

1. The JENT should agree on all construction plans. The side that uses the construction should be the initiator and main decision maker, but the other side should be part of the agreement as well, to minimize harm at construction and at operation.
2. The finance of such projects should be borne by Israel, since the construction of these Jerusalem settlements/neighborhoods has created the need for such investments. To avoid a problem of agency, where Palestine decides on construction for which Israel pays, the JENT should decide on the costs of the projects.

## 9. Social Security

All Palestinians who currently have Israeli residency status are compulsorily insured by the National Insurance Institute (NII). According to the 1999 income surveys of the Inter-Commercial Business System (ICBS), East Jerusalem Palestinians received substantial amounts of their net income from the NII, 19 percent of their net income, compared with only 9 percent for residents of West Jerusalem. The Palestinians in East Jerusalem also participate in the Israeli Public Health system by paying the health tax to the NII, which entitles them to receive health services from the Israeli HMOs and hospitals.

We have four basic recommendations in this area:

1. East Jerusalem Palestinians who have contributed to the NII in the past will continue to receive the benefits they have already earned by their contributions, until death.
2. The Jerusalem Economic Arbitrator (JEA) will establish a body that will monitor these payments and will ensure that the rights of the recipients are fully respected.
3. After the agreement, East Jerusalem Palestinians will pay the Palestinian Social Security Institution and will accumulate separate benefits from then on.
4. To smooth the transition of health insurance from the Israeli to the Palestinian providers, we suggest that during a transition period (5 years) East Jerusalem Palestinians will be able to continue to pay health tax to Israel and receive health services from Israel.

## 10. The Current Situation and the Final Status

Finally, we would like to highlight an economic reason why settlement building and other “facts on the ground” make it harder to reach an Israeli-Palestinian agreement, because such activity has an adverse effect on economic development. We strongly believe that economic development in Palestine is crucial to reaching an agreement and sustaining it. People who live in a developing economy and who work hard on improving their standards of living are less willing to indulge in fighting, hatred and hostility. The main barriers to economic development in the Jerusalem region are the separation wall, the expansion of settlements and the light rail. The separation wall closes East Jerusalem from the large Palestinian area and puts obstacles between the north and south parts of the West Bank. The expansion of the settlements east of Jerusalem, especially between Jerusalem and Maale Adumim, further blocks passage between the two parts of the West Bank. This hurts not only the current economic status of Palestinians, but it also reduces their ability to begin large-scale development projects for the future. The light rail also contributes to the expansion of settlements east of Jerusalem by better connecting them to the center of the city. This significantly supports the expansion of these settlements.

## 11. Summary

This paper outlines possible economic arrangements that would accompany a final status agreement. We show that economic arrangements for a final status agreement in Jerusalem are possible. Despite the difficulty of reaching such an agreement, it is possible to describe various economic arrangements for almost all possible scenarios. We think that our proposals are feasible, simple and realistic, once an agreement is reached.

The agreement is feasible, but costly, mainly due to the costs of setting the border, evacuating neighborhoods/settlements and building infrastructure. This is a result of the vast Israeli settlement activity in East Jerusalem and around it. These costs are increasing over time as a result of ongoing settlement activity. One conclusion of this analysis is that imposing a settlement freeze in the West Bank in general and in East Jerusalem specifically is required both politically and economically.

This construction activity also creates obstacles to Palestinian economic development. The physical blocking of Palestinian mobility reduces chances for Palestinian economic re-integration, derails developments of networks, reduces returns to scale, and prevents construction of large-scale development projects. This effect is significant because Jerusalem has always been the social, economic and political center of Palestinian society.

This report ends with a mixed message. Peace in Jerusalem is possible, but time is running out. There is a need to begin negotiations soon, but more importantly there is a need to stop the building of settlements immediately, as it derails Palestinian economic development, hurts trust between the two sides, and sends a negative signal on the willingness to reach a lasting agreement.

Summaries of Past Studies

THE TERRITORIAL LINK BETWEEN GAZA  
AND THE WEST BANK

# THE TERRITORIAL LINK BETWEEN GAZA AND THE WEST BANK

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## 1. Introduction

The Palestinian Territory has been separated geographically since 1949, when Jordan gained control over the West Bank and Egypt over the Gaza Strip. Prior to that, both areas were ruled by the British (from WWI to 1948). Following the Israeli occupation of the Territory in the 1967 War, from 1967-91 Palestinians enjoyed fairly free mobility between the two regions. But since 1991 mobility restrictions increased, and since the disengagement from Gaza in 2005 and later developments, the two regions have been completely cut off from one another. The lack of mobility and transport between the West Bank and Gaza causes human and economic hardship, and it also violates the 1993 Oslo Agreement that recognizes the West Bank and Gaza as a single territorial unit.

In this article, we focus mainly on the Territorial Link between the West Bank and Gaza as part of the final status agreement. It is important to stress that as long as a direct Territorial Link is not built, it is impossible to set a safe passage, namely a fully normalized interim transit system between the West Bank and Gaza that utilizes existing Israeli roads. Our main conclusion in this study is that building the Territorial Link should start immediately. The reason for that is that its building might take a very long period, up to ten years. Furthermore, both sides agree in principle that the location of the Link will be determined by Israel, since both sides share the same interest, namely that the Link should be as short as possible. Hence, the fact that the Territorial Link is not yet in construction casts a shadow on the declared willingness of Israel to promote an agreement with the Palestinians.

## 2. Political, Legal, Security and Socio-Economic Aspects of the Link

### *Legal Aspects of the Territorial Link*

The Oslo agreement states that the final peace agreement between Israel and Palestine should include building a Territorial Link between the West Bank and Gaza which will pass within the territory of Israel. We assume in this paper that the legal status of the future Territorial Link should be based on Israeli sovereignty and Palestinian jurisdiction. Note that such a split between sovereignty and jurisdiction is the general principle, but such an arrangement requires careful attention to a number of important details:

- a. Deciding on physical barriers that separate a Territorial Link under Palestinian jurisdiction from Israeli infrastructure and population.

- b. Does the source of funding for the Territorial Link, be it international, Palestinian or Israeli, hold legal significance?
- c. Does the identity of the operator of the Territorial Link, whether international or Palestinian, affect legal considerations?
- d. Under what circumstances does the principle of servitude apply: by lease or by evident practice of long-term use of the Territorial Link?

### ***Security and Safety Aspects Regarding the Link***

From the Palestinian point of view, the Territorial Link must be secure from any possible disruption of traffic by Israel. From the Israeli point of view, a Link built on Israeli land that crosses Israel from east to west raises concerns as well. We believe that the best way to deal with the security concerns of both sides is by constructing a solid system of isolation using fences and a military presence both inside the Territorial Link (Palestinian) and outside of it (Israeli). We strongly believe that any Link, regardless of type, will have to be well-guarded until relations become more peaceful.

### ***Socio-Economic Benefits of the Link***

- **Key Socio-Economic Benefits of a Direct Link**

The current impediments imposed by Israel on the movement of goods and people between the West Bank and Gaza can teach us how important it is to establish the Territorial Link, as they show how vulnerable the Palestinian economy is to barriers to mobility. For example, currently Israeli regulations require Palestinians to completely unload their cargo and reload it onto Israeli trucks at each border crossing when passing through Israeli territory. It adds significant transaction costs to Palestinian commerce by the order of 50%-100%. Our paper on Palestinian development has shown that these increased transaction costs lead to significant reductions in output and productivity. The barriers to mobility cause not only economic hardship, but also cause human and social suffering, by cutting families and friends apart.

The Link will not only have a strong effect on output and productivity, but also on the structure of production and on specialization. Today, exports to Israel account for about 90% of Palestinian exports, while only 6% of Palestinian exports reach neighboring Arab countries, and only 4% reach the EU. Expansion of trade, as well as tilting the trade balance away from Israel, could reduce dependence on Israel and lessen vulnerability to political and security shocks. Also, Gaza could become the principal provider of perishable products such as vegetables and fish, requiring fast transit to the West Bank, thus eliminating the need for Israeli products. Increased trade ultimately generates more employment opportunities and raises wages.

- **Short-Term Benefits of Establishing the Link**

The construction of the Link itself will generate new Palestinian employment opportunities. Estimates place the total number of jobs involved to be in the hundreds over a 5 year

construction period. Moreover, if this project were contracted in full or even in part to the domestic private sector, an additional benefit would be the development of private Palestinian construction firms. Mixed foreign and domestic management of construction could facilitate the transfer of project management skills and construction technologies, augmenting the domestic construction industry.

- **Increased Palestinian Trade in the Regional Perspective<sup>1</sup>**

As the PA is a member of the Arab Free Trade Area, and has free trade agreements with both the EU and the USA, it could capitalize greatly on improving its trade abilities. As a member of this community, the PA enjoys free access to this trade bloc and this potential trade capacity should be fully realized.

Arab market-oriented export growth would actually open a potentially large indirect export channel for Israel. Also, under a stable Israeli-Palestinian political arrangement, these markets will open to the direct export of joint Israeli-Palestinian products as well. Furthermore, the Territorial Link, together with the roads in the West Bank and Gaza could also be a Territorial Link between the Middle East and North Africa. Such a Link between the two parts of the Arab world can contribute significantly to Arab trade, which would greatly benefit the Palestinians.<sup>2</sup>

### **3. An Engineering Analysis of Possible Territorial Links**

#### *Underlying Assumptions of Analysis and Planning Principles*

The assumptions for the engineering analysis are as follows:

1. Operating the connection will be possible only after achieving a political agreement between Israel and the Palestinian state.
2. A central Palestinian entity will govern both the West Bank and Gaza.
3. In the framework of the agreement, procedures regarding control and use of the Link will be settled, including among others: the issue of sovereignty and civil powers; the system of laws and regulations; the right of free movement, interference procedures, and criminal and traffic law enforcement; the handling of casualties, security incidents, and hazardous materials leaks; procedures for the passage of goods and for transferring firearms, weapons, and troops; and procedures for infrastructure establishment and maintenance.
4. The Territorial Link will be established as a separate road system between the West Bank and Gaza and will not allow connection to Israel.

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<sup>1</sup> In the paper of the Territorial Link, the authors explain how the cut flower industry is an example for the potential growth of the Palestinian Trade. (Aix Group 2010), pages 156-157.

<sup>2</sup> See chapter on Trade in the Aix Group book on the API.

5. The Territorial Link will allow a continuous flow of goods and passengers according to Palestinian demand, and will also handle the transit of goods and passengers between Egypt and the Arab East.
6. The Territorial Link will not interfere with Israeli territorial contiguity and will not disrupt the traffic system within Israel.
7. Planning will include an infrastructure corridor for transportation, railway, electricity, water, natural gas, etc.
8. The approval of the route will require a statutory process within Israel.
9. Donor countries and international institutions will fund the planning, establishment, and operation of the passage.

These assumptions lead to the following planning principles:

1. There will be only one Link from the West Bank to Gaza assigned for Palestinian traffic.
2. The passage will be part of the Palestinian state transportation system between different areas of the country and between Palestine and neighboring countries.
3. The Link route will adhere to civil planning principles, such as safety, security, environmental concerns and protected areas, land use, future plans, existing and planned infrastructure, and other considerations.
4. The passage through Israel will be as short as possible.
5. The infrastructure will be flexible enough to endure various political and security scenarios.

### *Alternative Means of Transportation and Construction Methods*

- **Alternative Means of Transportation:**

1. Highway: It saves waiting and loading/unloading time. The separate passage of each vehicle allows continuous movement. On the other hand, autonomous vehicular traffic does not allow for the control of each vehicle. In addition, infrastructure is required to prevent the flow of vehicles and passengers from the main route to the surrounding areas.
2. Train: A train is characterized by one route of journey, with no option of changing directions or routes. It allows the transit of a large number of passengers and cargo. The railway is easy to control and monitor. The disadvantage of a train is the high cost of infrastructure, and high costs of operation (passage from vehicles to train and back). Lack of current trains in the Palestinian territory make this idea very problematic.
3. Monorail: This rapid transit system is based on a single rail track that employs powerful electromagnets. The idea has been tested in many places in the world and found to be less

effective for commercial use. Today monorail systems are mainly used on limited routes at tourist sites and airports. The advantages of the monorail system are very high speed and the lack of air pollution. The main disadvantage of the system is the limited weight the system can bear. To that we can add all of the disadvantages of a train above.

- **Alternative Construction Methods<sup>3</sup>:**

These are the four suggested methods of construction of a road: surface, underground, bridge or submerged highway. Each of these construction methods has pros and cons.

1. Surface: This is the conventional method for roads and railways. It is the least costly to construct.
2. Underground: A tunnel has a number of great disadvantages: construction and maintenance are very costly, and it takes a long time to build. The tunnel has an advantage from an Israeli security perspective as it is difficult for people traveling in it to get out, but a tunnel has a security disadvantage for Palestinians, since it is very sensitive to bombings.
3. Bridge: The advantage of a bridge is that it is ecological and also provides for the security of Israel. The disadvantage is that it has very limited options for future development and it also damages the landscape.
4. Submerged Highway: This concept was developed by engineer Giora Shilony with the intention of hiding the transportation system from the ground. The disadvantages of this method are the damage to ecological systems, the high cost of construction and the need to supply surface emergency traffic connections.

- **Conclusions from Analysis of Transportation Methods:**

1. The monorail will not answer the Palestinian need for the massive transfer of goods and cargo, and thus is not being considered.
2. The use of a train alone requires much loading/unloading, parking lots and transportation terminals on both sides and is therefore too costly. We therefore recommend integrating rail into the infrastructure corridor but as a secondary means of transportation.
3. The tunnel and bridge alternatives were found to be expensive and to hamper future expansion of development of the Link. Their contribution to security is marginal and can be replaced by other means. In addition to that, a 50 km long tunnel could lead to serious safety issues and require above ground bypass roads.
4. **The best alternative, according to our analysis, is a surface road, combined with a railroad throughout.**

For the planning of the Territorial Link, unique characteristics should be added: physical

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<sup>3</sup> For more details check (Aix Group 2010) page 164, Table 1: Comparison of Transport Systems and Construction Methods.

isolation, different heights when meeting existing and planned roads, emergency entrance and exit ramps, and a central command and control system. In specific places where required due to the abovementioned conditions, or where friction with Israeli needs might occur, a bridge or tunnel bypass of limited length may be implemented.

### ***Possible Connection Points of the Territorial Link***

- **Possible Connection Points in Gaza<sup>4</sup>**

1. Erez: Located in northern Gaza, with convenient access from the Palestinian side, Erez is a busy crossing for pedestrians and goods.
2. Karni: It is in northeast Gaza and it has a large terminal for transferring goods between Israel and Gaza. Its advantage is easy access to Gaza City and nearby open areas for future development.
3. Kerem Shalom: It is located in southwest Gaza and serves as a main transit terminal between Gaza, Egypt, and Israel. Its advantage is the possible connection to Egypt, but its disadvantage is in its relative distance from Gaza City and the West Bank.

- **Possible Connection Points in the West Bank<sup>5</sup>**

1. Tarkumiya: It is located in the eastern part of the Hebron district in the southern West Bank. Its advantage is proximity to Gaza and that it has the only good road in the area that leads to it in the steep topography of the Hebron Mountains.
2. El Majed: It is located southwest of the Hebron district, between Shekef and Shomria, at the closest point to Gaza. Its advantage is minimal passage through Israeli territory and relative isolation from other functions. Its disadvantage is the need to build a new road to connect it to the central Mountain Road. A significant advantage of the site is the possibility to continue the railroad into the West Bank at a reasonable slope.
3. Kramim Crossings: It is located south of the Hebron district and serves as a major crossing point from the southern West Bank to Beer Sheva and the Negev in Israel. Its advantage is its connection to the Mountain Road, while its disadvantages are in its proximity to the Israeli villages of Meitar and Kramim, its proximity to one of the passages between Palestine and Israel, and in its greater distance to Gaza.
4. Latroon (Beit Sira): It is located west of the Ramallah district. Its main advantages are in access to the northern and central West Bank, as well as its distance from the passage to Israel. The main disadvantage is the length of the route required within Israel.

In our research we reached a conclusion not to determine the exact location of the route. The

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<sup>4</sup> Check Appendix 1 for a detailed map.

<sup>5</sup> Check Appendix 2 for a detailed map.

main reason for that is that we think that the decision on the location of the road should be left to Israel. First, because the road passes through its area. Second, because the Palestinians and the Israelis have the same interests with respect to the road, as both prefer it to be as short as possible: The Israelis for reasons of limited sovereignty and security, and the Palestinians for reasons of having as short a travel time as possible.

#### **4. Security Considerations**

The main security threats to Israel are attacks from the Link and the use of the Link for transferring troops, weapons and arms inside Palestinian territory. The main Palestinian security threats are attacks on the Link's infrastructure and passengers. The main ways to cope with these security threats is to envelop the Territorial Link with sufficient physical barriers and to add to them significant patrolling. Adding to these measures various ways of electronic monitoring of the Link and its surrounding areas can help to significantly reduce risks to both sides. To these measures we should also add coordination and focused intelligence cooperation, and operational coordination between the two states and the relevant authorities.

#### **5. Estimated Engineering and Construction Costs**

Based on the Trans-Israel Highway experience and the National Roads Company experience, the basic price for such routes is US\$8 million per km. To this price, one should add the cost of expropriations, planning, administration and supervision, unpredictable expenses (20 percent), and VAT (17 percent). For the submerged highway section, an addition of about 20 percent for water carriers should be taken into consideration. Expanding existing roads, which requires more agricultural paths and interchanges could add 10 percent. To that we should also add the cost of building the two crossing areas with the facilities for security checks and the building of fences along the Link. Hence, the total costs of the Link will probably surpass US\$1 billion.

As for the cost of railways, a price is about US\$6 million per km. This price includes double railways and infrastructure, routing means, supporting walls, expropriation, planning, administration and supervision, and VAT. It does not include the construction of stations and a maintenance depot, infrastructure for an electrical train or the train itself.

#### **6. Final Conclusions and Recommendations for Further Procedures**

- A. From financial and engineering considerations, it is recommended that the monorail, tunnel, and bridge options be abandoned, and to focus on an above ground transportation system that will include a road and a railway.
- B. It is recommended to immediately promote a statutory planning process, supported by

an early engineering plan to determine and ensure the route, including examination of the route.

- C. Since the plan requires an Israeli government resolution, a draft resolution should be prepared, accompanied by suitable planning and political background.
- D. It is recommended to promote a collaborative planning effort with professional Palestinian representatives and the donor countries' organization as soon as possible.
- E. The long preliminary processes and duration of construction require an early beginning of the project in order to enjoy its benefits as soon as a permanent agreement between the parties is realized.
- F. We believe that rather than waiting for the signing of a final status agreement, now is the time to begin constructing a Territorial Link as it is integral to a future "Two State" solution, and its construction time will be very long, between seven to ten years.



Summaries of Past Studies

THE PARIS PROTOCOL TWENTY YEARS AFTER OSLO:  
Reassessment and Possible Modifications

# THE PARIS PROTOCOL TWENTY YEARS AFTER OSLO: REASSESSMENT AND POSSIBLE MODIFICATIONS

(written in 2014)

## 1. Introduction

The Paris Protocol (PP) was the agreement that shaped the economic regime in the Palestinian economy after Oslo had been signed in 1994. The PP was supposed to sustain prosperous economic development, an essential ingredient for the success of the peace process. Thus, the PP was devised with the intention of creating the required conditions for such positive performance.

### *Historical Background*

The Palestinian economy is functioning under exceptional circumstances. Following the 1967 war, Israel determined that the Green Line would no longer exist as a full-fledged economic border. A process of “imposed integration” began, where the trade and labor borders between the two very uneven economies tended to disappear. The new arrangement yielded obvious results: The more advanced economy attracted cheap labor from the less developed one. Palestinian employment in the Israeli economy helped to solve some short-term issues, such as high levels of unemployment and low incomes, but it also contributed to the greater dependency of the Palestinian economy.

In early 1990s, and after the First Intifada, Israelis and Palestinians negotiated directly for the first time. In 1993, they reached an interim agreement (Oslo Agreement) that was intended to be valid for five years and was meant to address the economic and political dimensions of the conflict. After six months of negotiations, a new economic agreement (PP) was concluded between Israel and the PLO, with the preamble clearly describing two parties with legitimate interests and equal claims to economic policymaking. However, the Israeli settlements in the occupied territories created significant obstacles to economic development, among other things, through the use of natural resources (water, the Dead Sea, land, stone, etc.).

## 2. Macroeconomic Imbalances under the Paris Protocol Regime

### *The Trade Imbalance*

One of the primary promises of the Paris Protocol was to grant the newly formed Palestinian National Authority (PNA) policy space in the realm of trade. The PNA tried to utilize this newfound space in signing trade agreements with the EU, EFTA, Turkey and the Arab Free Trade Area.

The PP provided the PNA with tariff lists A-1, A-2 and B, presumed to be the beginnings of a Palestinian tariff book, which would have deviated from the Israeli tariff book. In practice, however, with the Israeli decision to disempower the Joint Economic Committee (JEC), the body in charge of agreeing on Palestinian tariffs, these lists were not realized. Israel has expanded the lists A-1 and A-2 only twice since the signing of the Paris Protocol in 1994. Thus, while the PNA was supposed to be granted (marginal) sovereignty when it came to trade policy- the agreement states that the review of these lists should happen once a year- in practice the “imposed integration” view held its ground.

The “customs union” trade regime set out in the Paris Protocol made the PNA a captive market for Israeli products, which accounted for 70-75 percent of all Palestinian imports over most of the 2000s. Israel was also the sole market for Palestinian exports, absorbing 85-90 percent of Palestinian exports in this period. Furthermore, since the Palestinian economy and the Israeli economy are different in most economic characteristics, the trade policy Israel imposed, which reflected Israeli interests alone, made Palestinian producers less competitive for exporting to countries other than Israel. Such constraints on Palestinian exports to non-Israeli markets had a grave effect on economic development prospects because, as an infant economy, Palestine can generate sustainable long-term growth only through exports. As a result, Palestine developed a huge structural trade deficit that, in turn, greatly increased Palestinian dependency on external sources for financing this deficit. This structural gap in Palestinian trade reflects the severe constraints of the PP-based regime on Palestinian exports and private sector growth: lack of economic sovereignty, high transaction costs associated with movement and access restrictions, and the high cost of clearance of imported goods are a few examples.

### *Mechanisms for Countering the Trade Imbalance: Opportunities on Paper, Limits in Practice*

Under the PP regime, the PNA has no economic sovereignty and no tools to deal with the Palestinian economy’s severe dependencies and constraints on sustainable growth. Moreover, the joint customs envelope, resulting from the imposed integration of the Palestinian economy within Israel’s policymaking apparatus, coupled with the increasing transaction costs that Palestinian traders face as a result of the conflict, has led to a situation in which Palestine cannot exploit its comparative advantages – neither with Israel nor with the world. There are several mechanisms that can help close the deficit in the balance of payments: First, increasing the export of labor from Palestine to Israel; second, implementing a trade policy that encourages exports to Israel and the rest of the world; third, granting the PNA sovereignty over its exchange rates – since the PNA does not issue its own currency, it has no functioning exchange rate mechanism.

## **The Labor Market**

While the agreement secured entrance of Palestinian workers to the Israeli economy on paper, in reality the labor flows over the years were heavily restricted. Over the years, labor almost totally stopped flowing from Gaza to Israel, and the West Bank labor flows have heavily declined. The number of Palestinian workers in Israel dropped from 115,600 in 1992 to less than 36,000 in May, 1996.

Despite that, employment in Israel still plays an important role in the West Bank labor market. The total number of Palestinians employed in Israel and the settlements doubled from around 45,000 at the height of the Second Intifada (2002-2004) to almost 90,000 in the second half of 2012. All Palestinian workers in Israel are West Bankers, and their share in total West Bank employment was about 15 percent in 2012. Moreover, since the average daily wage of West Bankers working in Israel is twice as large as the average daily wage of workers inside the West Bank (167 NIS compared to 87 NIS per day), work in Israel still contributes more than one quarter of all wage income in the West Bank.

## **3. Fiscal Imbalances**

The economic limits imposed on the PNA as a result of the PP trade regime continue in the form of the so-called “customs envelope.” Israel collects the revenues on imports and transfers them to the PNA (after deducting collection charges). The main result is that the PP regime does not grant the PNA sovereignty over its budget and fiscal policy, since it can neither raise enough revenues due to restrictions on its tax structure nor can it issue debt. Thus, despite impressive progress in its own tax collection performance, the PNA is still dependent on Israel for collection of most of its tax revenues.

The lack of Palestinian sovereignty over fiscal issues makes the stability of the Palestinian economy especially vulnerable to the political whims of the Israeli government, which have manifested themselves time and again over the past decade: In late 2000, after the Second Intifada broke out, Israel indefinitely froze the transfer of tax money to the PNA; in 2006, after Hamas won the parliamentary elections and established a government in Gaza; in October, 2011, as punishment for the Palestinians’ appeal to the UN; and again in November, 2012, after the UN updated the PNA’s status to “non-member state.”

### **Bilateral Dependencies: Clearances with Israel and Fiscal Leakages**

The PP created a revenue-sharing mechanism with the aim of redirecting the benefits resulting from Palestinian trade to the Palestinian National Authority. This clearance mechanism is based on a unified invoice which is used for the exchange of VAT payments between the two sides according to where final consumption of the goods takes place. But if the businesses do not report the unified invoice, the PNA cannot claim the amount. Another problem related to the revenue sharing mechanism is the indirect import; when an Israeli importer imports goods for use in the Israeli market, and then sells the goods to a Palestinian trader while the customs for such goods are not transferred to the PNA.

Palestinian sources estimate that the losses incurred from the process of indirect importation is in the range of hundreds of millions of dollars per annum, constituting a major leakage of revenue from the coffers of the PNA.

#### 4. Some Implications of the Paris Protocol Regime

The Palestinian economy is riddled with structural weaknesses that are manifested in trade imbalances related to the customs union with Israel, labor shortages, monetary impotence, and extreme fiscal dependencies on Israeli clearances and external aid:

- **Purchasing power and standard of living:** Economic integration with Israel under the Paris Protocol is reflected in price levels similar or close to Israeli ones, while Palestinian wages are much lower than in Israel. As a result, the real purchasing power of Palestinian households is much lower than the nominal level shown in national accounts and household income statistics.
- **Palestinian economic fragility.** There has been extremely erratic Palestinian economic growth over the last two decades, and a dramatic impact from the overriding influence of Israeli access and movement restrictions on it.
- **Infrastructure development.** Two-and-a-half decades of underinvestment in infrastructure, under Israeli rule, has resulted in chronic public underinvestment.

#### 5. Modifications to the Paris Protocol Economic Regime

The following proposed set of amendments to the PP and the present economic regime can serve as a starting point for modifying the Israeli-Palestinian economic regime, instituting the first steps in creating Palestinian economic sovereignty. Such a revised regime will serve two purposes: First, to enable the Palestinian economy to take a much more viable and immediate course until a permanent status economic agreement replaces it as part of a negotiated political solution; and second, to support Palestinian state-building measures by allowing it increasing sovereignty over economic policy

##### *Create Independent Customs Territory*

This can be achieved through a phased change of the present situation, including the following steps:

1. **Expansion of tariff lists A-1, A-2 and B:** These lists are severely outdated, having been formulated in 1994 and adjusted only twice within the 19-year period of their implementation. Therefore, we propose expanding the present list and using it as the basic component of a separate Palestinian tariff book, constructed in accordance with Palestinian economic conditions and needs.
2. **Autonomous Palestinian exit/entry points:** Israel will give the PNA the responsibility for the management of the economic border-crossings between Palestine and the rest of the world, with an appropriate agreed-upon Israeli security presence and/or arrangements.

- 3. Shared control over bilateral Israeli-Palestinian trade passing through all crossing points:** It is proposed to have a two-part system for controlling bilateral trade, in addition to the application of the Palestinian separate tariff book to Israeli-Palestinian bilateral trade

It is proposed to achieve this goal through a phased process, which will include:

- The stationing of Palestinian customs officers at all international exit/entry points (Haifa, Ashdod, Allenby, etc.) to handle Palestinian imports and exports, and at all Israeli–Palestinian crossing points for control of bilateral Israeli-Palestinian trade, alongside the Israeli officers. The Palestinian customs officers’ work will be coordinated with the present system of security and other checks in ways that will not significantly affect the smoothness and speed of movement through the crossing points.
- Establish a number of Palestinian inland customs clearance houses which will coordinate and oversee the work of the Palestinian customs officers stationed at the international entry/exit points and the Israeli–Palestinian crossing points. This is where shipments that need special customs handling will be sent for clearance, and where the relevant Palestinian institutions will manage, monitor, and control the whole process for clearance. All of these arrangements will be based on modern and integrated customs and security management systems (procedures, standards) and infrastructure (technology, physical infrastructure)

### ***Improving Labor Flows***

Considering the strong impact of Palestinian work in Israel on Palestinian incomes, increased access of Palestinian workers to the Israeli labor market could significantly help in easing the high Palestinian unemployment rates and the depressed economic situations in the West Bank and Gaza, especially in the short to medium term. Hence it is recommended that a program be created for a phased increase in the number of Palestinian workers in Israel, under newly agreed arrangements aimed at gradually replacing foreign workers with Palestinian workers in the Israeli construction, agricultural and industrial sectors. This program should include modifications to the present entry permit system, especially with regard to business people.

### ***Guaranteeing Clearances, Fixing Fiscal Leakages***

Israel’s imposed integration in fiscal issues has generated a deeply rooted set of fiscal dependencies and leakages that the paper recommends remedying in the proposed modifications to the Israeli-Palestinian Interim Economic Protocol, as follows:

- A major component of the reformed regime must be an agreement on the self-collection of Palestinian customs revenues and indirect taxes by the PNA, as manifested in the inland customs clearing houses recommended above. This agreement will replace the present revenue clearance mechanism, thus eliminating Israeli control over Palestinian tax and customs revenue.

- Customs duties, excise and purchase taxes are all allocated on the basis of final destination for direct imports, but not for indirect imports. It is in the PA's interest to promote direct imports and to build the capacity of the Palestinian traders to become independent, including formulating ways to import products without the intermediation of an Israeli agent. Increasing direct imports will result in the transfer of more revenues to the PA, given that the final destination principle applies to all taxes on direct imports.
- Establish mechanisms by which import taxes paid by Israeli importers on specific products intended for sale in the Palestinian market are transferred to the Palestinian coffers.
- Implement the Paris Protocol articles stipulating that customs clearance at the crossings with Jordan and Egypt be done through Palestinian customs.
- Create a presence in Israeli ports for Palestinian customs, for the clearance of Palestinian goods through Palestinian customs.
- Create a system of goods in transit, by which goods imported by Palestinians are cleared at the Palestinian border, after completing their journey through Israeli territory first.
- Create customs clearance points between Palestine and Israel, at which third party goods are cleared.
- Create a mechanism through which VAT clearance is done through shared invoices, instead of clearance based on unilateral, unified invoices, to prevent tax evasion by either side's businesses.
- Improve the accuracy of revenues from direct and indirect imports transferred to the West Bank and Gaza through an effective customs clearance information system. This will allow an inland customs (Palestinian) control system to be established for the direct collection of custom duties and all other taxes by the PA.
- Reconsider the transformation of the PMA into a full-fledged central bank.

The paper recommends that such a set of amendments, addressing the major weaknesses in this sphere, be discussed in the newly activated Joint Economic Committee (JEC). For example, the power to apply autonomous indirect taxation policies will enable the PNA to adapt Palestinian indirect taxes to the conditions of the low-income Palestinian economy, protect infant or key industries, etc. Economic sovereignty in this sphere, in combination with the power to apply trade diversification policies, could enable the PNA to significantly reduce the prices of basic products, such as fuels, electricity, water, etc., and bring the cost of living in Palestine closer to that of neighboring low-income Arab countries, specifically Jordan. Reactivation of the JEC can also help toward removing the complex set of restrictions imposed on Palestinian control over physical resources, such as land, water, roads and other infrastructures, as well as improve the investment horizon, reduce uncertainty, mitigate risks and encourage investments in the private sector.



Summaries of Past Studies

SOME THOUGHTS ABOUT THE RECONSTRUCTION  
OF GAZA AFTER THE 2014 WAR

# SOME THOUGHTS ABOUT THE RECONSTRUCTION OF GAZA AFTER THE 2014 WAR

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Gaza has suffered drastically since the beginning of the siege in 2006. In addition, it has witnessed continuous military operations, with more severe eruptions in 2009, 2012 and lately in 2014. These operations left Gaza with massive destruction, poor infrastructure and without any potential for economic recovery. An international conference with the participation of more than 50 countries was held in Cairo after the last war on Gaza in October, 2014. Its goal was to raise funds for the reconstruction of Gaza and its economy. It is almost 2 years since the last war, but not much reconstruction has taken place. Though 25 countries pledged to donate more than US\$4 billion, they have transferred only US\$967 million for the reconstruction so far, according to a report prepared by the World Bank. Though many countries met their commitments, the seven major donors have transferred only 19 percent of their commitments. Also, a large portion of the funds are allocated for rebuilding public structures, but the restrictions on bringing in construction materials for those projects is significantly suspending Gaza's reconstruction.

In this project we focus not only on the physical reconstruction of Gaza, but also on ways to improve the standards of living and the economic potential. This includes allowing the movement of goods and people through a safe passage to the West Bank, as the contiguity between Gaza and the West Bank is crucially required economically (and was already agreed upon in the Oslo agreement). Lifting the siege also includes construction of a sea port and an international airport. Developing Gaza also requires a significant expansion of its infrastructure so it is able to absorb potential future economic growth. This paper also covers various political and security concerns that might arise due to the implementation of these suggestions.

## 1. A Brief Description of the Economic Situation in Gaza

Following the first Intifada, which started in Gaza in December, 1987, exports, imports and labor flows from Gaza started to decrease. This process intensified after 1991 as a result of a gradual closing of Gaza from Israel and from the West Bank, mainly through closures. The process began with the long closure of the Palestinian Territory during the Gulf War of 1991, and it gathered momentum later with more and longer closures over time until reaching a full siege in 2006.

In 2005, after the disengagement and the withdrawal of Israel from Gaza, Gazans were not allowed to work in Israel anymore. This reduced income per capita significantly, and since many of these workers began to work in Gaza, it should have lowered GDP per worker in Gaza relative to the 1990s. Indeed, the Aix Group (2015) did find that GDP per worker declined between 1995 and 2013 at an average annual rate of 3.4 percent. This was a huge decline in labor productivity.

This decline of productivity, coupled with the rise of unemployment, contributed to the decline of real wages by 21.4 percent, cumulative since 2005. More than 67 percent of the private sector wage employees in Gaza earned less than the minimum wage in 2013, which means that poverty has increased dramatically.

This long process of falling productivity, income as well as rising unemployment and poverty, implies that the recovery of Gaza must address not only the immediate impact of the war and the destruction it inflicted, but also the factors that led to the deterioration of the economy of Gaza prior to the war.

## 2. The Causes of the Economic Decline of Gaza Strip

A study conducted by the Aix Group in 2015 in order to understand the lack of economic development in Palestine identified two main obstacles to economic growth. The first was the restriction on access and movement of goods and people caused by checkpoints, walls, fences, siege and similar measures. The second was the restrictions on investment, which can be either administrative or a result of high risks due to the frequent outbursts of hostilities, both of which deter investments. These obstacles have been much harsher in Gaza than in the West Bank.

Gaza's export of labor to Israel stopped completely already at the disengagement in 2005 and the siege for people and commodities became almost complete since 2006, just after Hamas won the national election. Today, Gaza has only a few operating crossings to Israel and to Egypt with high restrictions on access and the movement of goods and people.<sup>1</sup>

The systematic constraints on mobility are clearly manifested by the volumes of imports and exports to and from Gaza. Since 1997, the number of imported truckloads to Gaza has decreased by 70 percent. During the seven years from 2008 to 2014, only 951 trucks crossed the border from Gaza to Israel, mainly with agricultural produce. These restrictions on mobility contributed much to the economic decline of Gaza. In Aix (2015), we show that between the years 2006 and 2008, the beginning years of the siege, labor productivity in Gaza declined by around 30 percent. A recent study by Etkes and Zimring (2015) calculates the welfare loss in Gaza due to the siege by using data on consumption. They find that welfare in Gaza declined by more than 20 percent.

The siege also had a major impact on water supply and electricity production. According to a World Bank report, by the end of 2008 approximately 50 percent of households had no access to a running water supply due to damages incurred by Israeli bombings during "Operation Cast Lead"

<sup>1</sup> More details on the crossings are available in the Gaza paper in Aix Group (2015).

in December, 2008. These damages were never fixed due to restrictions on the entry of construction materials. All these effects point at the urgent need for immediately lifting the siege and opening Gaza to the movement of people and goods.

In addition to the siege, the military operations have caused immense damage to already installed capital and infrastructure and deterred new investments. The most recent three bursts of violence were: Operation Cast Lead in 2008- 2009, Operation Pillar of Defense in 2012 and Operation Protective Edge in 2014. Most of the damages caused by these military confrontations, even before 2014, have not yet been repaired. The last war in 2014 was the longest and the most devastating military operation in Gaza since 1967. During 51 days, 2,145 people were killed, of which 1,523 were civilians, including 581 children. According to UNOCHA, approximately 490,000 people, more than a fourth of the population, lost their homes, and 60,000 homes were destroyed.

The war of 2014 also inflicted large losses on the economy. An estimation of total damages to agriculture reached US\$550 million, of which damage to plant infrastructure is US\$200 million, to animal production infrastructure is US\$81 million, to irrigation and soil (in an area of 34 square km) is US\$68 million and the opportunity costs were around US\$200 million.

The Information and Communication Technology (ICT) sector in Gaza has a large potential due to the high education levels of Gazans and because it enables exporting without crossing borders. The Ministry of Telecommunication and Palestinian Information Telecommunication Association of Companies (PITA) conducted a damage assessment for the ICT sector that includes both direct and indirect costs. According to this assessment, the losses to the telecommunications infrastructure and to the ICT sector exceeded US\$34 million, of which 92 percent is in infrastructure.

The war of 2014 had a significant effect on unemployment, as well. According to International Labor Organization (ILO) figures, the rate of unemployment increased significantly, as 6.4 percent of those previously employed in Gaza lost their jobs. According to the Palestinian Central Bureau of Statistics, Gaza witnessed an even higher unemployment rate in 2015, which reached 42.7 percent in the third quarter of 2015. The number of unemployed has exceeded 200,000 people. According to the World Bank, the unemployment rate in Gaza is the highest in the world, mainly among young people and graduates, where it is higher than 60 percent.

### **3. Required Steps for Economic Recovery**

It is important to stress that our specific suggestions do not in any way replace the reconstruction plan made by the Palestinian Unity Government, but only complements it with some additional economically required measures.

#### **a. Gaza Housing Crisis**

Gaza has already been suffering from high population density due to high birth rates and a lack of available housing units. According to the United Nations Relief and Works Agency (UNRWA),

during the war of 2014 over 12,600 housing units were totally destroyed and an additional 6,500 units sustained severe damage. Almost 150,000 additional housing units sustained various degrees of damage but remained inhabitable. This led to a homelessness crisis in Gaza, with 500,000 people displaced at its peak, although many thousands remain displaced to this day. Reconstruction of sufficient housing is critical for the people of Gaza. However, restrictions on imports of cement and building materials are causing serious delays in the reconstruction. Hence, a fast solution to the cement crisis is crucial.

**b. Reconstructing and Improving Electricity Supply**

The shortage of electricity also has a severe impact on the Palestinian economy and on the humanitarian and environmental situations in Gaza. The PA estimates that the overall total financing required to get full electricity supplied to Gaza, including repair and an increase of generation capacity, is US\$180 million. We believe that the 2014 plans of the Palestinian Unity Government for reconstruction of the electricity system are reasonable and sound. We only suggest that they should examine the possibility of putting as many lines as possible underground, to make them less vulnerable to war activities.

**c. The Water Crisis and the Need for Infrastructure Rehabilitation**

The 2014 war inflicted an estimated damage of US\$34 million on the water system, of which US\$17 million are required for urgent repairs. But, reconstruction should not only repair the damages from the 2014 war. It should also improve access to a reliable water supply and to sanitation services, in order to minimize public health hazards. Another important indirect effect of such an improvement could be on the environment, by reducing uncontrolled disposal of untreated or partially treated sewage.

**d. A Safe Passage between the West Bank and Gaza**

The lack of mobility between the West Bank and Gaza is a clear violation of the Oslo Accords that recognize the West Bank and Gaza as a single territorial unit and promise a 'safe passage' between the two regions. As shown above, its absence is a major cause for the economic decline in Gaza, and it affects the West Bank as well.

The economic benefits for Gaza from opening a direct free passage to the West Bank would be significant. It will reduce prices for consumers in Gaza and increase the returns of producers from Gaza for their current principal exports of strawberries, flowers and textiles. Enabling trade between the two regions can lead to further gains in a short time. Gaza can become a principal provider of perishable goods such as vegetables and fish, which require fast transit to the West Bank, and reduce dependency on Israeli products. In later periods the safe passage can provide a link between the West Bank and a future seaport and airport in Gaza, which will reduce transaction costs. The free flow of goods between the two regions can reduce the use of expensive Israeli raw

materials and industrial inputs. Movement of workers between the two regions can also reduce unemployment and raise wages in Gaza.

The Aix Group has already dealt with the connection between Gaza and the West Bank (Aix, 2010), and analyzed the issue of the Territorial Link in the final peace agreement. That research suggested building a ground level road between the Karni and El Majeed Crossings. The construction of such a route should cost US\$700 million, with an additional US\$180 million for expected security measures. Since implementing this route might take several years, Aix (2010) has recommended that construction should start immediately at the present, before the peace treaty. But this document suggests that even before beginning building the Territorial Link, a safe passage based on existing roads should be operated immediately. There were several attempts to operate such a safe passage in the past, as it is one of the requirements of the Oslo Accords, but each attempt stopped after some short period of operation, mostly as a sanction in reaction to some Palestinian violence. We suggest that Israel allow the operation of the short-run safe passage again, and this time not to use it for potential punishments on Palestinian general conduct.

e. **Gaza Strip Commercial Seaport**

The need for a seaport in Gaza has been recognized by Israel already in the Declaration of Principles (DOP), signed first in Oslo and then in Washington in September, 1993. It was reaffirmed in the interim agreement (1994). We base our recommendations on recent plans to establish a commercial seaport in Gaza. The first stage requires deepening and protecting the current harbor's basin, fortifying the breakwater structure, and repairing the northern coast in order to stop erosion in the area of Ash-Shati' refugee camp. The estimated cost of this stage is US\$16 million. The next step should be construction of a deep-water seaport. In 2000, a European Gaza Strip Development group signed a contract with the Gaza Strip Seaport Authority to build such a seaport. However, at the second Intifada the project and the funds were frozen and by the end of 2002, the Israeli Army had completely damaged the seaport facilities that were built and the installations on the construction site.

Relying on the previous construction plans, we outlined the main steps in building a deep-water seaport. According to our Gaza Strip Study (Aix, 2015), the planned total cost of the deep water seaport is estimated at US\$220 million.

f. **Gaza Strip International Airport**

The Gaza Strip International Airport (GIA) in Dahaniya opened in November 24, 1998. It operated for three years until Israel began to demolish it in December, 2001, during the Second Intifada. We estimate the cost of reconstructing the airport to be US\$86 million. Immediate priorities in the reconstruction plan are to repair the damaged parts of the GIA to enable it to resume operations, to introduce a computerized system in the operation of the airport and the Civil Aviation Authority, and to carry out technical training programs for the GIA staff. According to the Palestinian National

Development plan for 2014-2016, the Ministry of Transportation has planned to reconstruct 75 percent of the airport in 2014, 90 percent in 2015 and 100 percent in 2016. These plans were delayed in the aftermath of the war in 2014.

#### **4. Reconstruction and a Comprehensive Ceasefire Agreement**

One of the main problems with previous ceasefire agreements in Gaza was their implementation. There are four main reasons for such failures in implementation. One reason is the coexistence of many fighting organizations in Gaza. Another reason is the differential treatment of the West Bank and Gaza by Israel. Even if Israel respects the ceasefire in Gaza, but operates against the Hamas in the West Bank, it might lead Hamas to break the status quo in Gaza, as happened in 2014. A third reason for collapses in the ceasefire has been what Israel saw as a violation of the spirit of the ceasefire agreements by Hamas in its continuing efforts of armament during ceasefires. The fourth reason is that the non-military aspects of the ceasefires, mainly with respect to the siege on Gaza, are usually not respected by Israel. Clearly, there is a need to deal with all these four problems in order to reach a stable ceasefire agreement. Such a stable agreement will reduce suffering on both sides of the border, will enable reconstruction and most importantly, will enable a gradual economic revival of Gaza.

To tackle these four problems, we need to follow two complementing strategies. One is to make the ceasefire agreement between Israel and the Palestinian Unity Government, not between Israel and Hamas. The second is to change policies and attitudes with respect to the ceasefire agreement on both sides. Israel should accept the lifting of the siege on the one hand and Hamas should stop the process of armament during ceasefires on the other hand.

#### **5. Security Aspects**

Clearly, lifting the siege, which involves opening a safe passage, opening the port of Gaza and opening an airport raises serious security concerns on the Israeli side. While this document does not supply details on how to deal with these concerns, it analyzes the main concerns and shows that they can be dealt with in satisfactory ways.

##### **a. The Land Passage**

We turn first to the opening of the safe passage between Gaza and the West Bank. Such a passage raises concerns about possible movement of arms and fighters between the two regions, and of potential infiltration to Israel during the use of the passage. We suggest that the safe passage will operate by daily convoys from Gaza Strip to the West Bank and back. The Israeli military will check the convoys at the point of entry to Israel. To avoid costly back-to-back transfers, cargo trucks should use containers that can be checked by special equipment that is already available. Military forces will escort the convoys throughout their journey in Israeli territory to prevent infiltrations. We believe that these measures can handle the main potential security risks. This is

not just wishful thinking, but an assessment based on many previous agreements for safe passage between the West Bank and Gaza that Israel signed with the Palestinian Authority, the last of them on November 15, 2005, following the Israeli disengagement from Gaza. The implementation of these agreements did not fail, and they stopped only as general punishment on the Palestinian side for events that happened elsewhere.

**b. A Seaport in Gaza Strip**

A deep-water sea port in Gaza might lead to a number of security concerns in Israel. The main one is the possibility of the entry of military equipment into Gaza through the port. There are two main possible ways to cope with such security risks:

1. The expansion of the port should be done in three main stages. In the first stage, the port will transport commodities, but not in containers. In that case,

search-in-sea and similar security checks of incoming and outgoing ships will be possible at relatively low costs. After some period of operation, the port will go into a second phase of reconstruction and add a container terminal to the port. At this second stage, containers will be used for exports, but not for imports. Only after an additional period of operation, specified in time, but also in levels of adherence and performance, the port will move to the third stage of using containers for incoming cargo as well.

2. The Israeli Navy will search boats and ships entering the port of Gaza in-sea for military material. Initially they might search every boat and ship, but later the search will narrow to a sample of sea vessels.

**c. Airport in Dahaniya**

The potential security risks connected with the airport are mainly entry of combatants and light arms. There are many ways to reduce these risks and we mention just two. One possibility is that foreign inspectors will monitor the operation of the airport. Another possibility can use the fact that most of the incoming flights to Gaza will be from the nearby Arab countries like Egypt, Jordan, Saudi Arabia and the Gulf countries. Israel can reach agreements with these countries on monitoring incoming passengers to Gaza and their luggage. Two of these countries have formal relations with Israel, while the others have informal relations with Israel.

**d. Some General Comments on Security**

Controlling a nation of around 5 million people must be partial, since following everyone permanently is far too costly. Thus, Israeli forces monitor a statistical sample of people, which is not random of course, but is still a sample. As a result, the ability to detect every hostile activity is far from perfect. Hence, there is a need to discuss any change in control not in absolute terms but in relative terms. If we use economic terms, the cost of opening Gaza is not a total loss of security, but some reduction of security due to reduced control. However, one should compare this cost

with the security benefits of the opening of Gaza. First, lifting the siege will improve the standards of living for many people, especially the young. This will reduce the incentive to participate in armed activities. Second, sometimes a reduction of control can also improve security. The tight control imposed on Palestinians in general, and on Gaza in particular, is a terrible, suffocating burden on them and might motivate violence. We estimate that taking all of these issues into consideration, the cost-benefit analysis of security tilts strongly in favor of opening Gaza.

This idea is in line with one of the basic concepts of the Aix Group, namely “reverse engineering.” We have long reached the conclusion that the best way to reach a permanent agreement and to implement it is to first outline the contours of the final agreement and then to derive from that how to get from here to there. This holds for economic issues, but it should hold for security issues, as well.

## 6. Political Considerations

When this document recommends lifting the siege from Gaza, we are aware that this has also been a major demand of Hamas throughout the past decade. It therefore raises the question whether opening Gaza might be viewed as giving in to Hamas. The Aix Group is a think-tank that is committed to the Two-State solution and we view Hamas as an important opposition to this political solution. Hence, we wish to explain why we support the opening of Gaza, even if it seems to strengthen Hamas. We next offer three explanations, going from the more formal to the more substantial.

### a. The Unity Government

The Palestinian Unity Government was born on June 2, 2014 following an agreement of unity between the two leading movements, Fatah and Hamas. This agreement came after many previous failed attempts. Surprisingly, despite the difficult history of the relations between the two movements, and despite the harsh steps Israel has taken against the Unity Government, it has survived until now, although with some problems. Clearly, Hamas has a stake in the Unity Government, but it is definitely not theirs alone, as it is a government of technocrats with no representative of Hamas. Furthermore, the government has at least two members close to Fatah, so that it is much closer to Fatah than to Hamas. Until the founding of this government, Hamas was the only ruler of Gaza, and the operation of the Unity Government in Gaza can take the harness from Hamas, gradually but persistently. This will happen only if the siege is lifted.

### b. The Failure of the Siege Policy

The main political goals of the siege were to punish the population in Gaza for their support of Hamas and to lead to the collapse of Hamas and of its control. None of these goals were achieved. Hamas still controls Gaza and its population still supports it. The siege is ten years old and Gaza has not become quiet, but more rebellious. It is time to change this failing policy and shift to an

alternative. Actually, this document claims that removing the siege might yield an opposite result to what we have experienced so far.

**c. Economic and Political Impacts**

The great project of the reconstruction of Gaza by upgrading its infrastructure and opening it to the mobility of goods and people, is supposed to boost its economic situation, both in the short and in the long term. In the short run, the large investments will increase aggregate demand, which will improve employment in the area significantly. In the long run, these investments will increase the stock of capital in Gaza, both public and private, and will increase production from the supply-side. The ceasefire and the reconstruction agreement will not only improve the economic situation in Gaza, but will also improve the general mood, as people will be able to travel more, to meet family and friends, and to feel more free, in general.

All of these improvements will have a positive impact on the support for the Two-State solution in Gaza. Of course, economic improvement by itself will not be sufficient, since people also care about their freedom. But an economic improvement that is a result of a significant change in Israel's policy should clearly increase the political support for peace.

## **7. Conclusion**

We claim that reconstruction should include necessary measures that will contribute to the improvement of the economic situation in Gaza and even lay foundations for future economic growth. More specifically, we raise the following main points:

1. The siege on Gaza is a major obstacle to economic improvement. Any attempt to improve the standard of living in Gaza must include opening it to the mobility of people and goods.
2. Lifting the siege includes a set of measures which have already been part of the Oslo Accords: the safe passage between Gaza and the West Bank, the development of the seaport in Gaza, and the reconstruction and operation of Gaza Strip International Airport.
3. In addition, a large effort should be made to renovate and improve the failing infrastructure in Gaza, mainly electricity, water, sewage, and communication.
4. The opening of Gaza raises some security concerns on the Israeli side, but it can deal with them in reasonable ways.
5. After more than a decade, the siege is clearly a failed policy. Removing the siege in an agreement with the Palestinian government might be a much better policy to improve security and also increase the support for negotiation with Israel among Palestinians.

## Lessons Learnt

# FOUR MESSAGES FOR PEACE SEEKING ISRAELIS AND PALESTINIANS

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## Introduction

The Aix Group believes that it is of the highest importance to contribute to the efforts to move the two peoples, Palestinians and Israelis, from the current impasse towards the Two-State-Solution. The contribution of the Aix Group to these efforts is unique, because of the group's comparative advantage in the economics of the conflict, and because of its large accumulated knowledge on the practicalities of the Two-State-Solution.

The Aix Group has identified four main obstacles that face moving toward a solution to the conflict:

1. **Realism:** Many people view the Two-State-Solution as a desirable goal, but are afraid that it is impossible to implement it in reality, due to many reasons, such as the expansions of settlements, the burden of hostility between the two peoples, etc.
2. **The 'No Partner' syndrome:** Even people who support the Two-State-Solution are driven to despair by the fact that the two sides have failed to reach it after more than twenty years since the signing of the Oslo (Interim) Agreement.
3. **The illusion of the status quo:** When peace is not achieved, people tend to only see the positive aspects of the current situation and hope that the status quo can survive.
4. **The temporary solution approach:** Without progress toward a Two-State-Solution, many tend to place their hopes on a piecemeal approach that is short of the endgame, but appears to at least improve the situation on the ground.

In light of these obstacles, we present four messages that show that each one of these obstacles is based on either missing or manipulated information. These messages integrate the results and the insights gained in our research. Hence, they are unique to the Aix Group, to its vast research, to its methods of analysis of political economy, and to its commitment to contribute to the advancing of the Two-State-Solution to the Israeli-Palestinian conflict. The four messages are:

1. Why the Two-State-Solution has Not Been Achieved?
2. Are there Partners to the Two-State-Solution?
3. Why the Status Quo is Unsustainable?
4. Can We Improve the Situation in the Short-Run Without Harming the Two-State-Solution?

## Message 1: Why the Two-State-Solution has not Been Achieved?

The conflict between Israelis and Palestinians has torn this region and its people apart for almost a hundred years, since the end of World War I and the British occupation of Palestine. It has gone through many violent eruptions and through periods of relative, though tense, calm. Since 1967, the conflict became more intense as Israel controlled all of historic Palestine and all the Palestinians in the country. Throughout this long and bloody conflict, there have been many attempts to find a solution, either by short-term agreements or by trying to reach a long-run resolution. Today we find ourselves within the framework of the Oslo Agreements, which set a temporary Palestinian Autonomy, but this arrangement is not functioning well. This is a short-run agreement that is now being implemented for over 20 years, and that, in itself is a problem. Israel has not applied the agreement fully on one hand, and on the other hand, it has not prevented many rounds of violence, like the Second Intifada and the armed clashes around Gaza since its evacuation in 2005. Hence, we are still in search for a long-run solution to this conflict, and the need for such a solution seems to grow over time.

Of the many ideas for a long-run solution to the Israeli-Palestinian conflict, the Two-State-Solution is probably the oldest and most popular one. It appeared first in the Peel Commission Report in 1937. It stood at the heart of the Partition Decision by the UN in 1947, which enabled the founding of the State of Israel. This has been the only solution that came up in the negotiations that were initiated by the Oslo Agreements including at Camp-David in 2000 and during the Olmert government in 2007-2009. The Two-State-Solution has become the standard solution in all global political discussions and it enjoys the overwhelming support of the international community. Despite all that, however, 15 years of barren negotiations between the two sides have failed to achieve this solution, thereby shedding doubts regarding its potential implementation and success. These doubts are strongest among Israelis and Palestinians. In these messages, we wish to argue against such doubts. We do it under various hats. First, we are a group that studies the economics of the conflict and of the peace process. From this unique and special position and with the many lessons we learned from our studies, we have learned to appreciate the importance, the feasibility and the necessity of the Two-State-Solution. Second, we are a group of Israelis and Palestinians who have cooperated for more than 13 years, and continue to cooperate, in studying these issues and this experience has taught us that the Two-State-Solution is the only way to reach understanding and true cooperation between people on the two sides of the conflict.

We will devote much of this message to understanding why we did not reach the Two-State-Solution yet. There are three main types of opposition to this solution. The first is the opposition of Israeli extremists, which include supporters of greater Israel, settler organizations, political parties like the “Jewish House,” or even many politicians in the Likud. This opposition puts significant pressure, sometimes political, by promoting settlement expansion and harsh military measures, and sometimes

through violent means, like the murder of Rabin, that play a part in derailing the peace process. The second extremist opposition is on the Palestinian side, which consists mainly of Hamas and Jihad Islamimovements that oppose any long-run agreement with Israel. These movements also play a part in derailing the peace process, mainly by their involvement in military actions that often lead to violent eruptions of the conflict. This in turn increases Israelis' hesitation regarding the peace process. It is important to note that these two forms of opposition, by extremists on both sides, have much similarity in principle. Both oppose the idea of any peaceful solution between Israelis and Palestinians and both prefer to continue the conflict until one side reaches complete victory over the other side.

The third opposition to the Two-State-Solution is a less explicit opposition and is, in our view, the most potent in derailing the process. This third type of opposition consists of those in Israel that support a Two-State-Solution in principle, but are not willing to pay the full price of such an agreement. They are not ready to pay the required territorial price, of going back to the 1967 borders and they are not ready to lose control over the Palestinians and to grant them true independence. On June 14, 2016 "Haaretz" published a leak from a government meeting, in which Netanyahu said, that he has a mixed position on the Arab Peace Initiative. On one hand, he is ready to accept the Arab recognition and normalization of relations with Israel, but on the other hand, he will never accept the return to the 67 borders. Actually, this position is not unique to Netanyahu and the Likud. Large parts of the labor party and other centrist parties in Israel also share this view.

When we talk about the price of the Two-State-Solution people may ask why is this price so rigid? Why are the two sides not able to negotiate freely the territorial price of peace? Our analysis leads to the conclusion that the margins of a possible agreement between the Palestinians and the Israelis are indeed quite narrow and it is actually, a "take it or leave it" deal for both sides. The issue of agreement is crucial here. It is true that the Israeli side is much stronger than the Palestinian side. It is stronger militarily, economically, where the Israeli GDP is more than 50 times larger than the Palestinian GDP, and diplomatically, where Israel enjoys much closer relations with the US and with other Western powers. Despite this asymmetry, Israel cannot impose an agreement on the Palestinians, if it does not provide for their minimum requirements. It cannot force them to capitulate to an agreement that will be less than full independence and which they will view as extremely unfair. We next turn to outline the main ingredients of such an agreement.

A large part of our work in the Aix group has focused on the economic elements and aspects of a potential peace agreement. In order to do it, we had to analyze first how a potential political agreement between Israel and Palestine might look like, in order to add to it the economic building blocks. Thus, guessing the contours of a potential future peace agreement has been the first step in our analysis. Our first conclusion has been that the only possible agreement between the two sides, if reached, will be the Two-States solution. We have analyzed thoroughly the alternative long-run solution of one state, and

concluded that it cannot address the legitimate claims of both sides. It would not provide satisfactory answers to Jewish-Israeli claims for self-determination, and it would not meet the aspirations of the Palestinians for self-determination in their own state. Furthermore, the coexistence within one state of two peoples, of which one is much richer and much more developed economically than the other, will induce strong asymmetry in political power between the two communities. This will further amplify the economic gaps between them, mainly through control over land. Furthermore, history shows that Israelis were willing to accept the partition solution at some specific historical conditions. They never agreed and might probably never agree to give up their own state. Hence, the one state idea can never be a result of an agreement, and insisting on this option can only lead to continuation and intensification of the conflict. The analysis of how a future peace agreement will look like teaches us not only that it will probably be a Two-States agreement, but also how about its main features, if it is to be agreed upon by both sides.

In our analysis, we have reached the conclusion that such a Two-State-Solution must be based on the following seven major pillars. First, the borders between the two states should follow the green line, which is the June 4<sup>th</sup> 1967 border, with some swaps, which are equal in their total area and value on the two sides of the green line, and which are to be agreed upon by both sides. Second, on the two sides of the agreed political border in Jerusalem, two capitals will exist, the capital of Israel on the west and the capital of Palestine on the east. The research of Aix Group on Jerusalem elaborates the various options of how such a divided city can function and whether it should have a physical border or only a political border between the two cities. Third, each of the two states will have full independence within its territory, subject to the final status agreements. Economically, this means that each state will be able to conduct its independent economic policies. The Aix Group has found that the best way to reach such economic independence is to institute a Free Trade Zone between the two countries. This will enable the two states to enjoy the fruits of free economic contacts between them, without imposing economic policies on each other. Fourth, the two states will respect the desires of the other for peace, security and prosperity. Fifth, a 'territorial link' that passes through Israel, but operates under Palestinian jurisdiction, will connect the West Bank to Gaza and enable free mobility between the two parts of Palestine, which will constitute a unified single territory. The research of Aix Group has shown that the best mean for such a territorial link is a road, which will have the lowest costs of production and will allow greatest flexibility for future uses. Sixth, the final status should include a solution of the problem of Palestinian refugees, which will not affect the demographic balance within Israel. The Aix Group undertook extensive effort on this issue, which shows that such an agreement is possible. The estimated cost of such a solution to the refugees' problem is 100 billion dollars, but many donor countries are expected to share this cost, in addition to Israel and Palestine. Seventh and final, Jews, if they choose, will be able to live in Palestine, subject to Palestinian laws of immigration, citizenship and residency.

According to our analysis of the two sides and their minimum requirements, we have reached the conclusion that each of these pillars is a necessary part of the Two-State-Solution. When we observe

the current positions of the two sides, it appears that the major disagreements between them today are on the return to 1967 borders and on the partition of Jerusalem between the two states. While the Palestinians insist on return to the green line, with small swaps, and on regaining control over East Jerusalem, the Israeli positions still insist on annexation of large parts of the West Bank and on keeping all, or most, of Jerusalem within Israel. On the other issues, like the territorial link, economic agreements, and the problem of the refugees, the possibility of reaching an agreement seems to be more likely. These disagreements do not necessarily imply that a solution is not achievable. Israel and Palestine can reach an agreement once Israel will recognize the basic Palestinian territorial demands of return to the 1967 border with agreed upon swaps and partition of Jerusalem.

In our many discussions and deliberations the Israeli members of the Aix Group became convinced that Israel should accept the territorial principle of the return to the 1967 border with some possible agreed upon adjustments, for four main reasons. The First reason is that Israel cannot reach an agreement without such acceptance, thereby perpetuating the conflict. Faced with a choice between ending the conflict and the bloodshed against giving up on a limited territorial addition, we believe that saving human lives prevail. Second, all the international community accept these principles. Even when the US, Israel's closest ally, tried to mediate between the two sides in 2000, it issued the well known Clinton Parameters, which accepted the principles of return to the 1967 borders, with swaps, and of the partition of Jerusalem accordingly. Third, and very important, there is an element of fairness in these demands. The green line divides the country into two states for the two peoples, with 78 percent of historic Palestine going to the state of Israel and 22 percent to the state of Palestine. This partition is already highly asymmetric. The Palestinians have agreed to accept this partition and in doing so they admit that they are willing to accept, grudgingly, the outcome of the 1948 War. This is an enormous national sacrifice on their behalf. Hence, it is highly unfair to ask them to give up more land and settle for much less than these 22 percent. We can support this claim also by standard utilitarian economic theory. Since marginal utility is diminishing, and since the Palestinians have much less of the land than the Israelis, their marginal utility from any square meter of land is much higher than that of Israel. Fourth, in previous negotiations with other Arab countries Israel did not succeed to obtain territories beyond the 67 border. This was the case with the Peace agreement with Egypt, with the Peace agreement with Jordan and with the failed negotiations with Syria. The Palestinians are therefore under significant pressure from the Arab world not to agree to such concessions. All these arguments point in one direction, that Israel cannot reach an agreement unless it accepts the principle of the return to the green line with some swaps. In other words, this is the only game in town and the only way to reach an agreement and to end the cycle of violence between the two peoples.

If this is the only way to reach an agreement between the two sides, it becomes clearer why we did not reach such an agreement yet. It is because the mainstream Israeli establishment has not yet reached the point of willingness to pay the required territorial price for an Israeli-Palestinian agreement. We

learn it from the experience of the past negotiations on a permanent status solution, since 2000. The first round of negotiations began before the Camp David summit, reached its peak in this summit but actually continued later until the Taba meeting, just before the end of the premiership of Ehud Barak. In this round of negotiations, Barak insisted on keeping 10 percent of the West Bank under its control (at Taba, while in Camp David the figure was even higher). In these negotiations, Barak also insisted on keeping Jerusalem united under Israeli rule, and was willing to grant the Palestinian only a limited control over one or two villages east of Jerusalem (Abu-Dis), as a Palestinian capital. Clearly, this was much less than the Palestinian minimum demands, as described above. The next round of negotiations took place during the Olmert government during the years 2007-2009. There were two tracks in this round, one by the Minister of Foreign Affairs Livni, and one by the Prime Minister Olmert, who negotiated directly with the Palestinian president Abu-Mazen. The only track that progressed was the one led by Olmert and at the last week of his term he handed the Palestinian president Abu-Mazen a far-reaching proposal, that accepts in principle the return to the 67 borders with swaps and the division of Jerusalem. According to Abu-Mazen (in a later TV interview), the proposal was very good and the two sides were very close, but it still required some further negotiations. There were two problems attached. First, Olmert was leaving office due to severe charges of corruption and it was clear that he could not push the negotiations to a successful end. Second, Olmert was isolated in his government in support of these propositions. Both the minister of foreign affairs Livni and the minister of defense Barak passed warnings to the Palestinians that the Israeli government will not support the Olmert proposal. This episode highlights our main claim. First, once the principles of return to the 67 border and division of Jerusalem are accepted, there is a possibility of reaching an agreement. Second, the Israeli political mainstream was not ready to accept these principles in 2009 and hence the negotiations failed.

We can therefore conclude this discussion with the following conclusion. The fact that Israelis and Palestinians have failed to reach an agreement on the Two-State-Solution does not mean that this is a dead end. It is not because they cannot reach it ever. They will reach this solution on the day that the mainstream of the Israeli political spectrum will accept that reaching a peace agreement involves a territorial price and will be willing to pay this price. The price tag is clear and simple: a return, with small swaps, to the 67 borders and the division of Jerusalem between two capitals, to Israel and to Palestine.

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References from research by the Aix Group: *The Economic Road Map* (2003); *Economic Dimensions of a Two-State-Solution between Israel and Palestine*, volumes I (2007) and II (2010).

## Message 2: Are there Partners to the Two-State-Solution?

Upon his return from the Camp-David summit in July 2000, Prime Minister Ehud Barak said on a famous speech that to his sorrow he did not find a partner on the Palestinian side. Since then the term “No Partner” has become a cornerstone in the public discussion in Israel on the peace process. Many Israeli commentators have claimed that the Palestinian leadership is inherently unwilling to reach a peace agreement with Israel, either because it is not willing to accept the right of Israel to exist, or the right of Israel to exist as a Jewish State, or because it is afraid of facing the many responsibilities that come with political independence. Recently, there are also many Palestinians who raise an opposite complaint and claim that there is “No Partner” on the Israeli side. They say that the Israeli leadership is not honest in its verbal support of the Two-State-Solution and is actually planning to keep the occupation and to keep its control over Palestinians as long as it can. In this message, we discuss this issue in light of the lessons we derive from our studies and we reach a somewhat more optimistic, but reserved, conclusion.

When discussing the issue of partners to the Two-State-Solution it is important to remember that this solution is not just a nice slogan and it is not just a subject of endless negotiations as well. The Two-State-Solution means a quite specific deal, which the two sides need to embrace in order to reach an agreement. We next describe the main elements that this solution should consist of, according to our studies (these elements appear in Message 1 as well). These are seven main elements. First, the borders between the two states should follow the 1967 border, with some swaps, which are equal in their total area and value on the two sides of the green line, and which are to be agreed upon by both sides. Second, on the two sides of the agreed political border in Jerusalem, there will be two capitals, the capital of Israel on the west and the capital of Palestine on the east. Third, each of the two states will have full independence within its territory, subject to the final status agreements. Economically, this means that each state will be able to conduct its independent economic policies. Fourth, the two states will respect the desires of the other for peace, security and prosperity. Fifth, a ‘territorial link’ that passes through Israel, but operates under Palestinian jurisdiction, will connect the West Bank to Gaza and enable free mobility between the two parts of Palestine, which will constitute a unified single territory. Sixth, the final status should include a solution of the problem of Palestinian refugees, which will not affect the demographic balance within Israel. The Aix Group undertook extensive effort on this issue, which shows that such an agreement is possible. Seventh and final, Jews, if they choose, will be able to live in Palestine, subject to Palestinian laws of immigration, citizenship and residency.

This description of the potential Two-State-Solution is vital in order to understand the current Israeli debate whether or not Israel has a partner for peace. It means that they can have a partner, but only for the type of agreement described above, that comes with a certain territorial price tag. The Israelis cannot find a partner who will agree to annexation of wide areas of the West Bank or to leaving all Jerusalem under Israeli annexation. They will find that the Palestinian leadership is committed to the

Two-State-Solution and to coexistence with Israel if the borders are similar to the green line and if East Jerusalem will be the Capital of their state. This commitment has been expressed many times in many ways, both by Yasser Arafat and later by Abu-Mazen. It is part of the Oslo agreements, and it was part of the Palestinian positions in all the negotiations on the permanent status agreement.

We should of course be careful not to paint a too rosy picture. There is significant opposition to the Palestinian leadership, mainly by the Hamas and Islamic Jihad movements, which resist any agreement of Partition of Palestine and any recognition of Israel. It is hard to estimate the size of this opposition, but we cannot ignore the fact that in the last elections in Palestine, in 2006, the Hamas won. Nevertheless, it is reasonable to assume that not all the support Hamas received in that election was because of ideological identification. Much of this support reflected the failure of the PLO to reach an end to the occupation through negotiations with Israel. In contrast, Hamas could present the Israeli redeployment from Gaza in 2005 as a great achievement to the armed resistance and as another symbol to the failure of the strategy of negotiations. Remember that the Gaza redeployment was so unilateral, that it avoided even coordination with the Palestinian Authority. We can therefore conclude that if the Palestinian leadership will reach a negotiated agreement, it will enjoy a support of a majority of the Palestinian population. Interestingly, this analysis shows that the rejectionists gain support from the fact that the leadership has not reached an agreement yet and from the refusal of Israel to accept the principle of the 67 borders. Namely, the Israeli policies and attitudes affect the political balance within the Palestinian people. It also means that even if Israel has a partner on the Palestinian side, its power has been eroding continuously and dangerously, mainly because we fail to reach the Two-States solution.

On the other side of the border, there are many Palestinians, who also feel that they do not have a partner on the Israeli side. They identify the right-wing government of Israel as rejectionists, who prefer to hold the territory rather than reach an agreement, and they observe a continuous move of the other political forces in Israel, from the left and the center, towards this rejectionist position. We claim that although there is a serious element of truth in this narrative, it is still wrong to claim that the Palestinians do not have a partner in Israel. As in the Palestinian side, it is not an absolute partner, but a conditional partner. The main condition in Israel is not the type of agreement, as on the Palestinian side, but the type of consideration, namely whether Israelis base their decisions on short run or on long run considerations.

In order to understand this issue better, we need to report briefly the results of our latest study that focused on the cost of the status quo to Israel and to Palestine. Our study has shown that the costs of the status quo and of the continuing occupation are higher than people usually think. The formal defense costs of Israel are between 6 to 7 percent of GDP, but there are additional costs. The main one is the alternative cost of conscription through delay to accumulation of human capital. There are costs that citizens pay directly, like security guards or building a safe room in each apartment, or other public costs, which are not in the defense budget, like the civil administration of the territories.

All these costs add up to close to 13 percent of GDP. This is a significant burden. In addition, we have shown that the eruptions of violence in the Israeli-Palestinian conflict tend to cause recessions, which are also quite costly. These are high costs, but the costs of the conflict on the Palestinian side are much higher. We focused mainly on Palestinian economic growth and found that GDP per worker, also called labor productivity, declined significantly in Palestine since the Oslo Accords. We have also examined the causes of this decline and found two main explanations. One is the sharp decline in total factor productivity due to barriers to mobility, caused by the system of obstructions to mobility, through roadblocks, checkpoints, the separation wall, and the systematic separation of Gaza from the West Bank. The second cause for the decline in growth is the lack of capital deepening, which is a result of many restrictions on investment and by the high risk in Palestine. According to our calculations, the loss due to missing economic growth is above 80 percent of GDP annually. Our studies have therefore found that both sides suffer significant economic losses from the occupation and the continuation of the conflict, but the Palestinians suffer much higher losses. The same holds also with respect to losses of life, which we did not include in the calculation.

The fact that the Palestinians lose much more from the conflict than Israel points, through a standard cost-benefit analysis, at their interests in reaching the Two-States solution. They can gain significantly from it, both in the long run and in the short run. Reaching an agreement means for them an end to a continuing bloodshed, end of occupation that disrupts severely their daily lives, achieving national independence and gaining control over their own fate, and opening the road to economic development, once they remove the hurdles of occupation. Of course, economic growth takes time, but output can start growing immediately, and after more than twenty years of economic stagnation, this is very desirable. For the Israeli side reaching an agreement with the Palestinians is very rewarding in the long-run, as it reduces the continuing bloodshed in Israel, reduces the risk of recessions and increases disposable incomes significantly. But we need to remember that reaching an agreement also involves a considerable short term political cost to Israel. Israel will have to relocate large numbers of settlers and to evacuate occupied territory it feels strongly about. An agreement on a Two-State-Solution might involve Israel withdrawal from many small settlements across the West Bank, but also from large towns like Kiryat-Arba and Ariel. Such moves will create a great internal dispute in Israel and we cannot ignore the possibility that it even might lead to some internal violence, with a high probability that it can be very similar to the type of conflicts experienced by France during the French withdrawal from Algeria. Although the Israeli government will be able to overcome such difficulties with time, this is viewed as very costly.

In Message 1 we describe the reluctance of many in the Israeli political establishment to pay the territorial price required by the two state solution. Here we fine-tune this observation. There are indeed many Israelis, who oppose paying the territorial price. But there are many other Israelis who are willing to pay the territorial price, but are afraid of the high political price, of a massive evacuation of settlements, and of a deep Israeli political dispute that might become violent and might even lead to

some serious internal violence. There are no easy solutions to these fears, but there is one simple fact everyone needs to bear in mind. The political cost of the Two-State-Solution for Israel is not going to decline over time. On the contrary. The longer the settlements are there, the more they develop and expand, as more people are born and grow up in the settlements, the harder it will be to implement the agreement. Hence, the political cost of the Two-State-Solution is actually rising over time.

This analysis should touch on other worries as well. The main one is that we cannot implement the Two-State-Solution in reality any more, due to the large scale of Israeli settlement activities and due to the large changes on the ground, like the complete lack of contact between Gaza and the West Bank. People are afraid that these changes have become so deep that they are irreversible and thus, they might prevent the implementation of the Two-State-Solution. We interpret these worries as fears of the political cost to Israel from such an implementation. What is irreversible is not the physical settlement activity, but the political turmoil that will follow its dismantling in the short run. Relocation of the settlements is not a geographical problem, but it is a very big political problem. Adding Hamas in some form into the future relations between Israel and the Palestinians is not a security issue, but rather a political one. It is not certain, but we can assume that if the majority of the Palestinian society will adopt the agreement, Hamas will be under significant pressure to adjust to the new situation, just as it adjusted to the new Palestinian Authority. Such dramatic moves that come with the implementation of the Two-States solution, call for bold steps. Such steps might be very costly in the short run, but they carry the only hope that Israel might be able to base its future existence in the Middle East on sounder and safer foundations.

We can therefore summarize this message in an optimistic but reserved tone. We think that we can still achieve the Two-States solution. There are partners on both sides for this agreement, but they are not sufficiently strong. The Palestinians will be partners if Israel agrees to respect their minimum conditions. If not, the support to an agreement among them will decline. The Israelis, on the other hand, will be partners, if they internalize the willingness to accept the huge political short-run cost for the long run gains of such an agreement. In all cases, it is clear that the occupation will probably end at some point, either due to internal processes or due to international interventions, because the Palestinians will never accept life under occupation. But occupation might end in a terrible conflict, which will leave relations between the two sides completely ruined, or it can end in a political settlement, which may open the gate for better relations in the future. This is the option of the two-state-solution, which is still available. The future will tell which road will be taken.

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References from research by the Aix Group: *The Economic Road Map* (2003); *Economic Dimensions of a Two-State-Solution between Israel and Palestine*, volumes I (2007) and II (2010), *The Economic Costs of the Conflict to Israel*, *Palestinian Economic Development*, both in *Economics and Politics in the Israeli Palestinian Conflict* (2015).

### **Message 3: Why the Status Quo is Unsustainable?**

The status quo between Israelis and Palestinians is never a full status quo. It changes continuously, as more quiet periods turn sometimes into waves of violence, and then again, with the decline of violence, the status quo reaches a new equilibrium. Many forces work hard to keep the status quo. The Israeli government has more than once declared that its policy is to manage the conflict, not to solve it. It therefore exerts great efforts to preserve and continue the status quo. Many people have strong interests in the preservation of the status quo. The settlers, Israeli industrialists who export to the Palestinians, construction companies who employ Palestinian workers and some Palestinians as well, like those who work for Israeli contractors, and many others. Still, despite the efforts of the Israeli government and its powerful organization and the many people who share these interests, the status quo seems to be elusive than ever. It suffers many disruptions and it keeps changing continuously. This message claims that there are inherent forces that change the status quo, usually to the worse. In other words, the status quo is not actually a stable steady state and it is bound to deteriorate and lead to more intense confrontations.

This prediction, that the status quo between Israel and Palestine is unsustainable relies on a number of reasons. The first reason is the dynamics on the Israeli side. It is clear that as long as the status quo continues it strengthens the settlers. It increases their numbers, as their rate of population growth is higher than that of other Israelis. Also, there are strong economic pressures that push Israelis to move to the settlements, mainly cheaper housing in a country that suffers from extremely high housing prices. The continuation of the status quo also raises the political power of the settlers. The reason is that the continuing conflict raises tension and hatred between Arabs and Jews. This strengthens the political support to the right wing and that of course supplies greater political power to the settlers. The growing size and power of the settler population create pressures by them to expand their areas of living and of activity, which leads to increasing the pressure on the Palestinians. One example of such pressure is more land confiscation, in order to expand existing settlements, by adding extensions to existing settlements and even by building new settlements. Another example of such pressure is in the area of mobility within the West Bank. The growing number of settlers leads them to look for more roads at their disposal or to expand existing roads. That might lead to greater mobility restriction on Palestinians in roads that settlers use more, and even more land confiscation when new roads are built or older roads are expanded. A third example of such pressure is around places that are holy both for Jews and for Arabs, like in Jerusalem or in Hebron. When the settlers become stronger, they dare to try to increase their activity in these places beyond the status quo. Thus, they exert pressure to increase the hours of prayers in the Cave of the Patriarchs/Ibrahimi Mosque in Hebron and to restrict mobility of Palestinians in its vicinity. A similar effort was led by extreme groups in 2015 to begin Jewish prayers on Temple Mount/Haram esh-Sharif. These pressures on Palestinian land, on Palestinian mobility, on Palestinian way of life, create counter reactions and increase the frequency of

Palestinian bursts of violence. This of course leads to further oppression and to further restrictions on mobility of Palestinians and on their daily lives in general. Thus, the cycle of violence is intensified and disables a smooth continuation of the status quo.

The second reason why the status quo is continuously deteriorating is that it limits economic development of Palestinians, as shown in our studies. In the more than 20 years since the Oslo agreement GDP per capita in Palestine was quite stagnant. Labor productivity even declined, due to significant barriers to mobility, high risk, which deters investment, and due to Israeli restrictions on capital accumulation. The decline of labor productivity means that wages have become lower as well, so that the income distribution among Palestinians became more unequal. These developments lead to increasing social and economic tensions, especially as the economic needs of Palestinians increase. Their population increases, more of them become educated and look for a better future, while their standards of living are stagnant and even falling for many wage earners. An example for the effect of the growing Palestinian population can be its effect on food supply. While demand for food in Palestine is increasing, the area available for agriculture is decreasing, due to increased building for residence. The main area that the Palestinians could use for developing modern and efficient agriculture is the Jordan Valley, but since it is in area C, it is largely out of bound for Palestinians. As the situation in the Jourdan Valley and in area C in general does not improve and actually becomes worse over time, it increases the pressure on the Palestinian population, which faces rising prices to agricultural products. A similar process is raising the pressures in the area of human capital and employment. Many Palestinian acquire high education. There are more than ten universities and many Palestinians also study in Jordan. As a result, the number of people with high education increases constantly, but the demand for such workers does not. There is not enough investment and as a result, creation of new jobs is lagging behind the supply. This lack of jobs manifests itself in high unemployment but also in the fact that many Palestinians work in jobs for which they are highly over-qualified. This is another source of tension and anger. To these economic pressures, we can also add the general political distress created by the status quo. People who live under occupation and yearn for its end, for reaching national independence, for gaining more control over their lives, understand that the status quo is their worst enemy. As long as it continues, it pushes their hopes to a more distant future. These pressures increase the fragility of the status quo and lead sooner than later to new bursts of violence. These dynamics on the Israeli side and on the Palestinian side are two reasons why the status quo is actually not a status quo at all. It cannot be a sustainable policy. Not only that it is doomed to explode frequently, we expect these explosions to be harsher and more frequent over time.

Finally, there are the dynamics of the conflict itself, which make the status quo unsustainable. The Israeli-Arab conflict has gone through significant changes over the last hundred years. We have examined these changes in detail in our recent study, as they have strong economic consequences. Until 1948 the conflict was mainly between Jews/Zionists and Palestinians and it was an ethnic conflict between two communities. Militarily this was a conflict between militias, although the Jewish militia

was national while the Palestinian militia was mostly local. In 1948 the conflict moved one step up and became a conflict between states, namely between the state of Israel and the Arab States, mainly Egypt, Syria and Jordan. Militarily, it became a conflict of conventional warfare between armies, which is very costly economically. This stage ended with the Peace Treaty between Egypt and Israel, signed and implemented in 1978-1982. After this agreement it became clear that no military Arab coalition can start a war against Israel without Egypt. This development enabled Israel to reduce its military expenditures significantly, from more than 20 percent of GDP during the 1970s and early 1980s to around 7 percent of GDP today. In 1987 it became clear that the Israeli-Arab conflict returned from a conflict between states to a conflict similar to the one before 1948, the narrow Israeli-Palestinian conflict. Initially it was also a conflict of militias. On the Israeli side was a full army, the IDF, but its main fighting units were infantry units, or other units operating as infantry units. On the Palestinian side were two main militias, the Fatah and the newly created Hamas. Formally, this is the type of the conflict to this day, but in fact, it has dynamics of its own. In 1993 Israel signed an agreement with the PLO, which removed Fatah from the armed confrontation to a large extent. Hamas remained an active fighting militia, but after regaining control over the Gaza Strip in 2007, it lost some of its freedom to act as a militia. The control of a significant territory and population and the responsibilities it involves, led Hamas to reduce its activities and even make efforts to reduce the activity of much smaller organizations in Gaza.

The decline of militia activity left a vacuum and vacuums tend to be filled. The events in 2015 – 2016 clarify this well. When the activity of militias declines, individuals take the initiative and do sporadic acts of violence on their own. Interestingly, a recent news report tells that the new prisoners from this new uprising stay away from both Fatah and Hamas prisoners and are even hostile to them. It is too early to observe whether we are entering a completely new phase in the history of the conflict or not, but we definitely see a gradual change going on in front of our eyes. The once strict militia warfare, which narrowed the conflict to some segments of the population, is now widening to include more and more parts of the population. Interestingly, there is some similarity on the Israeli side as more people, who are neither police officers nor soldiers, use guns against Palestinians. It is therefore clear that this change is making it harder to control the conflict, on both sides. Hence, this development also makes the status quo less sustainable.

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## **Message 4: Can We Improve the Situation in the Short-Run Without Harming the Two-State-Solution?**

The Palestinians in the West Bank and Gaza live under Israeli occupation for almost 50 years. These have been years of suffering from loss of life in many confrontations, from land confiscations, mobility restrictions, house demolitions and lack of economic development. In some of these years, they have experienced better economic conditions, especially in the first twenty years, and in some years, they suffered worse economic conditions, especially since the Second Intifada. It is clear that the burden of life under occupation and the economic burdens are strongly related. We have shown it and elaborated on that in many of our research papers, especially in our recent paper on how the occupation hurts Palestinian economic growth. As stated in this paper and in many other papers of the Aix Group, we strongly think that a peace agreement, which brings with it an end to occupation, will reduce the Palestinian suffering significantly. It will reduce the daily suffering of life under occupation, but it will also reduce the long run suffering, as it will enable the Palestinian economy to grow and increase income levels in the future. But the strong connection between the occupation and Palestinian suffering raises a very difficult question, which is whether we can reduce the suffering even under the occupation. In other words, what can be done to reduce Palestinian suffering in the meanwhile, especially in the area of Economics, before the occupation ends?

This is not an academic question. There have been a lot of talk about improving the economic situation for the Palestinians. Israeli politicians even talked about ‘Economic Peace,’ meaning that in lack of a political agreement, they can at least improve the economic conditions of the Palestinians in order to reduce their suffering and as a result reduce their motivation to revolt against the occupation. Another example for such thinking has been the ‘Kerry Economic Plan,’ which accompanied the failed attempt to renew the peace talks in 2014. The intention of this plan was not to accompany the future peace agreement, but rather to improve the current conditions of Palestinians in the present, in order to help them move ahead toward a peace agreement. Another example for such thinking is the concept of ‘confidence building measures,’ or steps. These ideas surface once in a while, especially in periods of stalemate in the peace process, and they usually promote short-run measures like removal of barriers to mobility, some improvements in trade, some temporary halt to settlement building, etc.

The history of recent decades shows that such short-run plans or measures, which intend to have an immediate effect in improving the standards of living of Palestinians, fail miserably. Sometimes the Israeli government only declares on such moves, but does not implement them in reality. Sometimes implementation begins, but stops shortly afterwards, when bursts of violence lead to retreat from the measures taken. For example, the Netanyahu government from 2009 declared that it will reduce the number of roadblocks and checkpoints, to enable improvement of the Palestinian economic conditions, but a careful examination of the data shows that this did not happen. Barriers moved from

one region of the West Bank to another, but their overall number did not change, as shown in our paper on Palestinian development. The Kerry Economic Plan did not even start. In this message we claim that there is a deep reason why these attempts for short run improvements have failed, and that is because they did not fit progress toward the long-run political solution of the two states. We claim that as long as the short run measures contradict progress toward the long run Two-States solution, they cannot function, they cannot change the short run situation, and instead of building confidence, they fail, increase despair and reduce confidence between the two sides even more.

There are a number of explanations to this claim on the need to align the short run improvements with progress toward the long run solution. The first reason is purely economic. One of the main reasons for the lack of economic growth in Palestine are the grim expectations for the future, which deter investors from putting their money in what they view as very risky investments. Our study on Palestinian development shows that as a result, investment and capital accumulation in Palestine are very low and there is actually no capital deepening in the occupied territories. This means that the capital labor ratio does not grow, but remains at past levels. Any economic improvement at the present, which does not signal to investors that the future may be different and more positive for the Palestinians, cannot boost investment in Palestinian projects. This is due to the theory of Rational Expectations. This theory, which developed in the 1970s by Robert E. Lucas and other important economists, claims that the public forms its expectations about the future based on all the available information and not just on the immediate present. As a result, these expectations are very accurate. Hence, if investors see some economic improvements in the present, but understand that they do not harbor political progress in the future, they will deduce that there is no decline in future risk and as a result, they will still avoid investing their money in Palestine. Furthermore, many times the Israeli authorities try to improve short run Palestinian conditions as a way to avoid progress in negotiation on the long run solution, as some of the examples above show. In that case, the effect of rational expectations is amplified. The attempt to improve short run conditions sends a strong signal that chances for a long run solution become smaller and thus the prospects for future economic well-being should decline. Such negative expectations reduce investment even further and that hurts the Palestinian economy even more. Hence, the attempt to bootstrap the Palestinian economy is destined to fail.

The second explanation for our claim is a combination of politics and security. Actually, most of the economic restrictions and hardships that the Palestinians face are related to security. Such are the roadblocks and checkpoints of various types, such as the denied access to roads used by settlers, such as the restrictions to import certain investment goods due to possibility of 'dual use,' the limitations on labor of Palestinians in Israel and many other measures that the Israeli authorities impose due to security considerations. Even if some may claim that many of these measures use security only as a pretext and they actually serve other goals, like improving the situation of the settlers, security still

plays an important role in these measures. As a result, policies that aim at improving the present economic state of Palestinians involve lifting some security restrictions. Lifting roadblocks, increasing quotas of Palestinian workers, etc. are standard examples for such measures. The problem with such measures is that despite the fact that they can improve conditions in the short run, they leave the basic political situation in bad shape. As a result, the despair, lack of hope and frustration among Palestinians do not disappear, but keep boiling and at some point lead people to activities against the situation, to rebel against it. The resulting bursts of violence cause harshening of the security measures by Israel and that reverses the few positive measures that came before and worsens the economic situation even more. An interesting example is the recent wave of violence in East Jerusalem. Many Palestinians from the East part of the city work in the West to earn higher incomes. At the same time, the political situation in East Jerusalem is deteriorating, due to the continuous pressures by settlers and by their supporters in the government, in Silwan, in Sheikh Jarrah, in Haram Esh-Sharif and other places. This leads Palestinians to resistance, mainly by the very young ones. But this resistance affects all Palestinians of all ages, because it leads Israel to increase its security measures in East Jerusalem, which increases the costs of mobility between the two parts of the city, which also reduces labor in the west. Thus, economic measures intended to improve the life of Palestinians never operate for a long time, if they are not joined by moves to improve the political situation, namely to lift the burden caused by the occupation. As a result, such measures do not build confidence but rather destroy it on both sides. The Israelis feel that the measures they took did not pay back and the Palestinians feel that the change was fictitious and not real.

An interesting example for economic measures that fail because they do not fit the long term goal of the Two-State-Solution is the Paris Protocol, which is the economic agreement that accompanies the Oslo interim agreement. This agreement defines the whole area of Israel and the occupied Palestinian Territory as one 'customs envelope' and does not grant any independence to the Palestinians to run their own economic policies. The design of the protocol reflected mainly the previous concept of occupation instead of the need to build the seeds for future Palestinian independence. As a result, it began to hurt the Palestinians very soon and to derail their economic situation, as analyzed recently by the Aix Group. The main problem is that the Paris Protocol does not enable the Palestinians to import cheaper lower quality goods from the near Arab countries. As a result, they suffer from very high cost of living relative to their income. If such a policy could be justified in the past as a way to block such goods from reaching Israeli markets, this justification does not hold any longer. Today there is a serious wall between Israel and the Palestinian areas with very few border passes. Goods cannot travel any longer between the two areas without control, as used to be in the past. Hence, economic measures that did not fit the future goal of Palestinian independence hurt the Palestinians and have reduced their standards of living already at the present.

This analysis leads us to the conclusion, that the only measures that can really have positive economic effects at the present are steps, which are in tandem with the final two state solution, as implied by our concept of ‘reverse engineering.’ Only measures that send a strong signal of a shift toward the final status agreement can be effective in the short run as well. We list here a number of such steps, which we discussed in detail in our studies:

1. Israel and Palestine should move from the Paris Protocol to another economic regime in the West Bank and Gaza, as described in the *Economic Road Map* (2003). This should be a free trade regime, which enables the Palestinians to form their economic policies in greater independence within their territory, including an independent trade regime between them and other countries. While the Paris Protocol reflects the spirit of the occupation, increasing Palestinian economic independence points at the future relationship between two states.
2. Israel has committed itself in the Oslo Agreements to withdraw gradually from most of Area C in three separate redeployments until 1997. It never implemented this commitment. Beginning such redeployments now should be a significant confidence-building step, which also brings significant economic gains to the Palestinians.
3. For the Palestinians, the Jordan Valley is the main area for developing their future agriculture. It is their main land reservoir and it fits very well extensive agriculture. Currently, Palestinians have almost no access to this area, except around Jericho, and the few farmers scattered in the Jordan Valley suffer from continuous harassment. If Israel will enable the Palestinians to build large agricultural projects in the Jordan Valley, it will improve the current economic situation, but also signal a change toward a political settlement.
4. Israel should start planning and building the territorial link between Gaza and the West Bank. According to calculations made by the Aix Group, implementing such a project should take at least 10 years, due to the need to confiscate large areas of land from many current owners and due to the size of the project. Furthermore, there is no dispute between the sides on the location of the link, as both agree that Israel should determine the location and as it is the interest of both sides that the location should be as short as possible. Hence, there is no point in waiting for the final agreement to start building the territorial link and it should start immediately.
5. Israel has developed in the recent two decades a significant system of water desalination and does not suffer from water shortages any more, while the Palestinians still suffer significant water shortages. Israel can stop using the mountain water aquifer and enable the West Bank to increase its water consumption significantly.
6. Israel should remove the siege on Gaza. We have discussed this issue as well in the recent book of the Aix Group. The siege policy failed to stop violence from Gaza and Israel should seriously consider other ways to grant security to its southern citizens. One possibility is to ensure better

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life conditions for the population in Gaza. In this respect, the Palestinians can also contribute by making greater efforts to bridge the sharp political split between the West Bank and Gaza. This will have many results, including presentation of a stronger and more unified partner at the negotiation table. This can increase the willingness of Israelis to give peace a chance.

We can generalize the message we present above as a claim that the common view of economics and politics as substitutes is deeply flawed. If political progress is blocked, you cannot resort to economics to compensate for it. If the economic situation is deteriorating, it is not due to economic reasons alone. The right way to think about the two channels, the political and the economic, is as complements that must go together. Only steps that support the future goal of national independence to the Palestinians can support the economy in the short run as well. The reason is that only such measures will help to induce finance to flow to investments in Palestine and only such measures will reduce the tensions between the two sides and thus avoid renewed bloodshed every now and then.

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