

# **Twenty Years after Oslo and the Paris Protocol**

## **Changing Course, Averting Crisis – From Dependency to Economic Sovereignty: Proposed Modifications to the *Protocol on Economic Relations between Israel and the PLO***

The Aix Group

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## **EXECUTIVE SUMMARY**

The Paris Protocol of 1994 (PP) was signed as an interim economic agreement for a period of five years, with the aim of correcting the flaws of previous arrangements, while maintaining the almost free movement of goods and labor between the Israeli and Palestinian economies within the framework of an impure customs union. Import taxes were to be collected by Israel on behalf of the Palestinian National Authority (PNA) in the interim-agreement period, with a view to allowing the PNA a period of grace in which to set up an independent fiscal system. Employment of Palestinian workers in Israel was to continue, while the establishment of the PNA was to have created a badly needed public sector and economic policymaking body. Foreign investment, stimulated by the new climate of peace, and the improved infrastructure financed by donations from abroad, was expected to encourage the emergence of a revitalized private sector and boost economic growth. The formation of a Palestinian Monetary Authority (PMA) was designed to improve financial intermediation.

In sum, the view held by the signatories was that – with international aid – the PP laid the basis for sustainable growth of the Palestinian economy. Real life on the ground, however, has been in sharp contrast with this vision. Although the *de jure* regime is still the Paris Protocol, the *de facto* reality has deviated from the concepts upon which the PP was devised. A complex system of one-sided, restrictive Israeli policies and measures has developed over the two decades since the signing of the PP. This system, in combination with the structural weaknesses of the Palestinian economy, resulted in the continuation, and even worsening, of the major economic flaws of the pre-Oslo, Israeli-rule period. Dependency on external sources continued, and even deepened. The huge structural economic imbalance was mirrored in enormous deficits in the balance of payments and the PNA's budget. These fundamental imbalances, coupled with Israel's control over the collection of a large part of the PNA's fiscal revenue, along with other specific aspects of the PP, perpetuated the overwhelming dependencies of the Palestinian economy on Israel.

Given the present political situation and the severity of the economic crisis in Palestine, we propose, as a modest goal that can start introducing economic sovereignty and improve economic conditions, a set of modifications to the Israeli-Palestinian Interim Economic Protocol which will address the most serious flaws of the present economic regime. Such a revised interim economic agreement can be negotiated and signed within a few months, correcting some of the flaws in the present arrangements, injecting new potential into the Palestinian economy, providing a platform for a renewed donor-supported effort to put the Palestinian economy on a track of sustainable, export-driven growth, and, most importantly, strengthening the economic sovereignty of the PNA.

### **Reforming the PP Trade Regime**

Palestine's huge trade deficit is one of the severest weaknesses that have developed under the PP regime. Moreover, as a very small economy, Palestine can achieve sustainable economic growth only by applying an aggressive export-driven growth strategy. The "joint customs envelope" which was established by the PP for the interim period, along with other related arrangements and practices that have developed over the last two decades, has become a major obstacle to Palestinian export growth, as analyzed in detail in this paper.

**We propose to amend the PP "joint customs envelope" in a way that will create a separate Palestinian Customs Territory, while maintaining the current situation of non-existence of agreed physical trade borders between the sides.** This change would provide the PNA with the missing trade policymaking autonomy needed for shaping Palestinian trade policy, based on the Palestinian development agenda, significantly strengthening the sovereignty of the PNA and indicating that it is on the way to full statehood. We propose to achieve this goal through a phased process, as detailed in this paper, which will include, *inter alia*, 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 integrated into 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.

**Another component of the proposed system will be 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, and where shipments that need special customs handling will be sent for clearance. All these arrangements will be based on modern and integrated customs and security management systems (procedures, standards) and infrastructure (technology, physical infrastructure), to be developed in close cooperation between the respective parties. It should be noted that such systems of inland customs houses interconnected with the work of customs officers stationed at crossing points already work efficiently in Jordan and other countries. Israel too has a well-working system of certified inland bonded storage compounds, based on controlled movement of trucks from entry points for clearance at these inland compounds. These well-functioning precedents can serve as models for the proposed Palestinian customs control system.

In addition to the key recommendation mentioned above, our proposals address various other trade-related impediments, including recommendations for: (a) relaxation of administrative, regulatory, logistical, access and movement constraints on Palestinian exports to Israel, aimed at gradually narrowing Palestine's huge trade deficit with Israel; (b) removal of obstacles to trade between the West Bank and Gaza, to be organized and monitored via a “safe passage”<sup>1</sup>; (c) phased application of a separate Palestinian tariff book, which will be constructed in accordance with Palestinian economic conditions and needs and encourage the diversification of Palestinian foreign trade; and (d) full removal of all trade constraints currently applied to the Gaza Strip, in view of Gaza's dire economic situation, as discussed in the box on Gaza later on in this paper.

### **Revising Tax Collection Arrangements, Fixing Fiscal Leakages**

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<sup>1</sup> See the Aix Group's paper on the “Territorial Link,” *Economic Dimensions of a Two-State Solution*, vol. II, 2010 ([www.aixgroup.org](http://www.aixgroup.org)).

The “clearance” of revenues collected by Israel on behalf of the PNA is a major source of budgetary revenue for the PNA. The repeated, arbitrary suspension of the transfer of these revenues by Israel poses a constant and severe threat to the financial stability of the Palestinian economy. In addition, the PP created a set of fiscal leakages with an overall cumulative value that is hard to calculate, although some estimates place it at hundreds of millions of dollars – about one-third of the PNA budget deficit in 2012.

**Hence, another major component of the modifications to the Israeli-Palestinian Interim Economic Protocol in general, and the establishment of a Palestinian Customs Territory in particular, should be new arrangements for self-collection of Palestinian customs revenues and indirect taxes by the PNA,** which will replace the present revenue clearance mechanism and eliminate Israeli control over Palestinian tax and customs revenue.

### **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 and the depressed economic situation in the West Bank, and more so in Gaza, especially in the short to medium term. **Hence we recommend a program for a phased increase in the number of Palestinian workers in Israel, under newly agreed arrangements** aimed at gradually replacing foreign workers in the Israeli construction, agricultural and industrial sectors with Palestinian workers, and modifications to the present entry-permit system, especially in regard to businesspeople.

### **Greater Palestinian Economic Sovereignty and Control over Economic Policymaking**

The Paris Protocol transferred to the PNA several powers relating to economic policy. On the ground, however, the PNA has no control over major aspects of economic policy, and only limited control over fiscal policy. The lack of economic sovereignty and powers is at the heart of the fundamental weaknesses of the Palestinian economy. **Given a phased shift towards the proposed separate Palestinian Customs**

**Territory, as recommended above, there is vast room for agreed amendments to various aspects of economic policymaking, which will allow the PNA a much wider scope for the application of autonomous economic policy measures.**

We recommend that such a new set of amendments, addressing the major weaknesses in this sphere, be discussed in the newly activated Joint Economic Committee (JEC). For example, 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 towards 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.

## 1. Introduction

The Oslo peace process, at present, is far removed from the high expectations held in September 1993, also as regards the economic dimension. The interim agreements were supposed to lead to a permanent agreement within five years, but as of writing this paper no permanent status negotiations are in sight. According to the view held at the inception of the Paris Protocol (PP) of 1994 – the agreement that shaped the economic regime in the Palestinian economy after Oslo – 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. In this paper we present the reality: disappointing performance of the Palestinian economy comprising the West Bank, East Jerusalem and Gaza, and its characteristic dependencies over the last twenty years. We then offer an analysis of the failure to achieve prosperity, distinguishing between reasons associated with the unfulfilled political assumptions and those resulting from fundamental weaknesses in the rationale and letter of the PP. In the last section we propose modifications to the PP regime, assuming no breakthrough in the negotiations. Such modifications could improve the economic conditions afflicting the Palestinians under the current status quo, while preparing the ground for a permanent agreement.

The Aix Group's position concerning the final economic agreement is derived from our analysis of future relations between the Palestinian and Israeli economies based 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, 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 enabling each side's customs authority to be a partner to the other without losing its basic independence.<sup>2</sup>

The regime created by the PP essentially envisaged, on the one hand, continued economic integration between the Palestinian and Israeli economies, as prevailed

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<sup>2</sup> For the Aix Group's vision regarding the final economic agreement, see the "Big Picture" in *Economic Dimensions of a Two-State Solution*, vol. II, 2010 ([www.aixgroup.org](http://www.aixgroup.org)). See also the "Economic Road Map" (2004).

since the early 1970s, while adding, on the other hand, a new variable to the economic formula of the region: the creation of the Palestinian National Authority (PNA). This newly created economic body was supposed to form the embryo of a future, sovereign policymaking apparatus, capable of administering internal economic affairs as well as external trade agreements, in place of the Israeli Civil Administration that directly managed the public sector before Oslo. In practice, however, the PNA's authority is curtailed and it has no full sovereignty, whether over internal economic affairs, trade agreements or budgetary, fiscal, and monetary policy.

Thus, the PP's economic regime assumed, fundamentally, free movement of goods and labor between Israel and the Palestinian economy, as in the years after 1967. Coupled with the transfer of sovereignty over the public sector to the PNA's control, the view held by the signatories was that – with international aid – the Protocol laid the foundation for a new path for the Palestinian economy, towards a more developed economy and sustainable growth.

### **1.1 Historical Background**

The Palestinian economy, defined in this paper as the economy in the areas occupied by Israel in 1967 (i.e. the West Bank, excluding Israeli settlements, East Jerusalem and the Gaza strip), is functioning under very exceptional circumstances. Following the 1967 war, Israel used its power to determine the most important parameters affecting the Palestinian economy, namely, its links with its much stronger Israeli counterpart (and, as a byproduct, other economies as well). Israel shaped these links taking into account first and foremost its own interests. Hence, following the war, economic relations between Israel and the Palestinian Authority comprised a *de-facto* semi-customs union based on two factors: (1) the Israeli trade regime, and (2) almost free access of Palestinian labor to the Israeli economy. In other words, 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. Indeed, high proportions of Palestinian

employment in the Israeli economy helped to solve some short-term issues, such as high unemployment and low incomes, but it also contributed to greater dependency of the Palestinian economy. Furthermore, a myriad of administrative measures impeded Palestinian development, prevented local Palestinian competition with Israeli entrepreneurs, and further contributed to the economic asymmetry between the two sides. Over the years, Israeli settlements in the occupied territories created more obstacles to economic development, among other things through the use of natural resources (water, the Dead Sea, land, stone, etc.) to their own benefit. In short, since 1967 there has been only one true economic sovereign between the Jordan River and the Mediterranean Sea that relied on a modest standard of living based on commuter employment in Israel to enable easy and cheap maintenance of the occupation and help suppress Palestinian resistance.

The start of the First Intifada at the end of 1987 shattered the Israeli conviction that the imposed economic regime would suffice as a substitute for the Palestinians' political aspirations. When for the first time Israelis and Palestinians negotiated directly in the early 1990s, they reached an interim agreement in 1993 – capped at five years – that was intended to address the economic dimension in addition to the political. After six months of negotiations, a new economic agreement was concluded between Israel and the PLO, with the preamble clearly describing **two parties** with legitimate interests and equal claims to economic policymaking:

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

This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities. The two parties recognize each other's economic ties with other markets and the need to create a better economic environment for their peoples and individuals (Preamble, the Paris Protocol, 29th April, 1994).

In other words, the fundamental new assumption of the negotiators negated the old Israeli “one sovereign” concept. Indeed, there were some positive developments in the area of Palestinian economic self-determination: the modifications to the trade regime included a new, more equitable “revenue sharing” scheme that, for the first time, aimed at using funds raised from taxes on Palestinians to service public expenditure in the Palestinian economy. In addition, some exceptions to a strict customs union regime were agreed to – for example, the tariff lists A and B.

Intentions aside, the Paris Protocol did not succeed in changing the fundamental characteristics of the post-1967 economic regime. Although some modifications to the customs union were put in place, the semi-customs union was essentially continued. The PNA was prevented from deciding or influencing trade policy through other mechanisms: Israel’s hold over external borders was maintained; the diversification of both imports and exports was still very much restricted by the tariff lists; and a large proportion of the future income of the PNA remained dependent on “clearances” (i.e. on funds to come from the Israeli side which collected them for the PNA), maintaining the Palestinian economy's dependency on Israel. Finally, although the agreement made provision for the establishment of a monetary authority and provided a tool for instituting public debt, in practice Palestine was prevented from doing so. Thus, the post-Oslo interim regime represented a type of economic “no man’s land,” with the end of the “one sovereign” concept on the one hand, but a continuation of the “imposed integration” strategy on the other.

## **1.2 Disappointing Performance**

The performance of the Palestinian economy under the arrangements dictated by the Paris Protocol was very disappointing and revealed the agreement as flawed. At best, the high expectations for a better economic environment did not materialize. To make matters worse, in 1995-96 the economy suffered the effects of increasing political violence, with the most fundamental assumptions of the PP regime – free movement of labor and goods – seriously curtailed. In 2000, with the failure to achieve a permanent status agreement at Camp David and the outbreak of the Second Intifada, an even more serious economic crisis followed. The assumption that the Paris Protocol would pave the way to prosperity and peace encountered a starkly different

reality: The “no borders” integration framework gave way to a unilateral separation framework, where flows of economic goods and labor stalled in the face of Israeli restrictive, security-related measures. Additionally, there were no serious efforts to balance Israeli security with Palestinian economic needs, and the few that were attempted – failed. Israel did not agree to borders where sophisticated gates could facilitate economic development. In many cases, it chose to disregard the Green Line as a parameter, while the Palestinians, for their part, did not agree to economic border lines other than the Green Line. As a result, the economy became just another pawn in the renewed conflict.

Today, of course, there are very real trade and labor borders between the two economies – albeit borders that Israel has set unilaterally. These borders, both with Gaza and, in a different shape, with the West Bank, contradict the Paris Protocol’s most primary assumptions. Thus, although the *de jure* regime is still the Paris Protocol, the *de facto* reality has deviated from the concepts upon which the PP was devised. Such a reality demonstrates the urgent need to rethink the economic regime.

### **1.3 Outline of the Paper**

The story of the Paris Protocol might be most succinctly described as a failed strategy in economic development, and a failed promise of economic sovereignty. Although the PNA was created to give the Palestinians a say in the economic regime, in practice most of the fundamental tools of economic policymaking – particularly in times of crisis, as was the case for most of the interim period until today – were left in Israeli hands. Thus, the hopes in 1994 that the Palestinians had finally won their sovereignty, including over economic matters, did not materialize.

Perhaps most importantly, the Paris Protocol was agreed upon and signed by the two sides as the economic regime for an *interim* period. Accordingly, it would seem obvious to posit that the PP is not suitable as a permanent agreement. In this paper the Aix Group addresses the dysfunctional economic arrangements that were either a direct result *de jure* of the Paris Protocol regime, or a byproduct of its weak implementation *de facto*. Either way, genuine development in the Palestinian economy lagged. Although we believe that permanent status negotiations yielding a

permanent status agreement within the framework of a Two-State Solution are preferable, we will make our recommendations assuming that there is no such agreement. In the event that a more optimistic scenario prevails, the framework outlined in the Aix Group's Economic Road Map (2004) should be useful. This paper thus seeks to identify the limitations of the PP regime (section II) and recommend short-term as well as longer-term modifications (section III). All of the proposed modifications take into consideration the dichotomous failure of the PP – to improve the performance of the Palestinian economy, while also paving the way towards a sovereign Palestinian state.

## **2. Macroeconomic Imbalances under the Paris Protocol Regime**

### **2.1 The Trade Imbalance**

One of the primary promises of the Paris Protocol was to grant the newly formed PNA policy space in the realm of trade, and the PNA indeed tried to utilize this new-found space in signing trade agreements with the EU, EFTA, Turkey and the Arab Free Trade Area, to name a few. Furthermore, 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 did encourage meetings of the Civil Affairs Committee, but it expanded the A-1 and A-2 lists only twice after the signing of the Paris Protocol in 1994. Thus, while the PNA was supposed to be granted (marginal) sovereignty over trade policy – the agreement states that these lists should be reviewed once a year – in practice, the “imposed integration” view continued to hold sway.

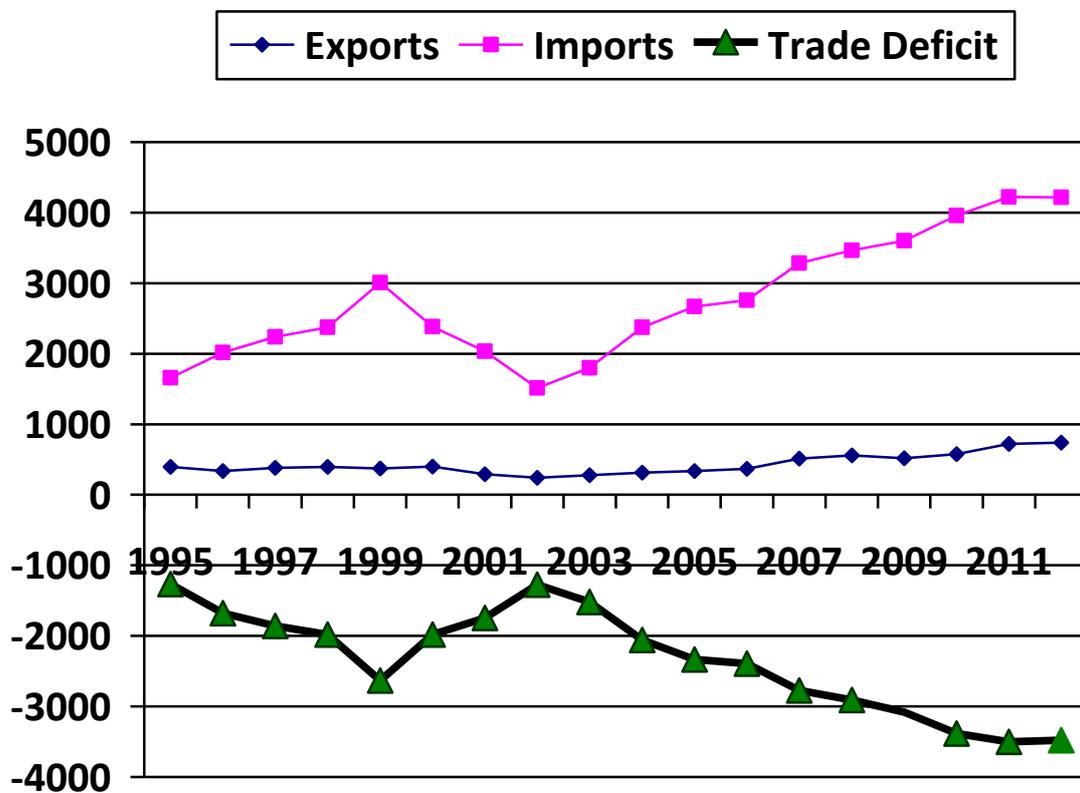
On the bilateral front, the “customs union” trade regime set out in the Paris Protocol made the PNA a captive market for Israeli products, which accounted for 70-75 percent of all Palestinian imports over most of the 2000s. Israel remained practically the sole market for Palestinian exports as well, absorbing 85-90 percent of Palestinian exports in this period.<sup>3</sup> Furthermore, since the Palestinian economy and the Israeli economy differ in most economic characteristics, the trade policy imposed by Israel, which reflected Israeli interests alone, made Palestinian products less competitive for exporting to countries other than Israel. Such constraints on Palestinian exports to non-Israeli markets had a profoundly negative effect on economic development prospects because, as an infant economy, Palestine can generate sustainable long-term growth only through exports. As a result, Palestine has developed a huge structural trade deficit that, in turn, has greatly increased Palestinian dependency on external

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<sup>3</sup> PCBS, Foreign Trade Statistics. For example: Palestinian exports to Israel of \$499 million in 2008, \$453 million in 2009, \$488 in 2010 and 618 in 2011, amounted to 85-89 percent of total Palestinian exports of \$558 million, \$518 million, \$576 million, and \$720 million, respectively (PCBS, Registered Foreign Trade Statistics for 2011 (December 2012) p. 33 and p. 35; PCBS, Registered Foreign Trade Statistics for 2010 (January 2012) p. 35; and PCBS, Registered Foreign Trade Statistics for 2009 (March 2011) p. 42

sources for financing this deficit. The rapid economic growth of recent years mirrors a steep increase in Palestinian imports, while exports showed only a modest increase, and the trade deficit surged upwards accordingly.<sup>4</sup> As shown in Chart 1, the gap between Palestinian exports and imports grew three-and-a-half times over the last ten years, from slightly above \$1 billion in 2002 to \$3.5 billion in 2011 and 2012.

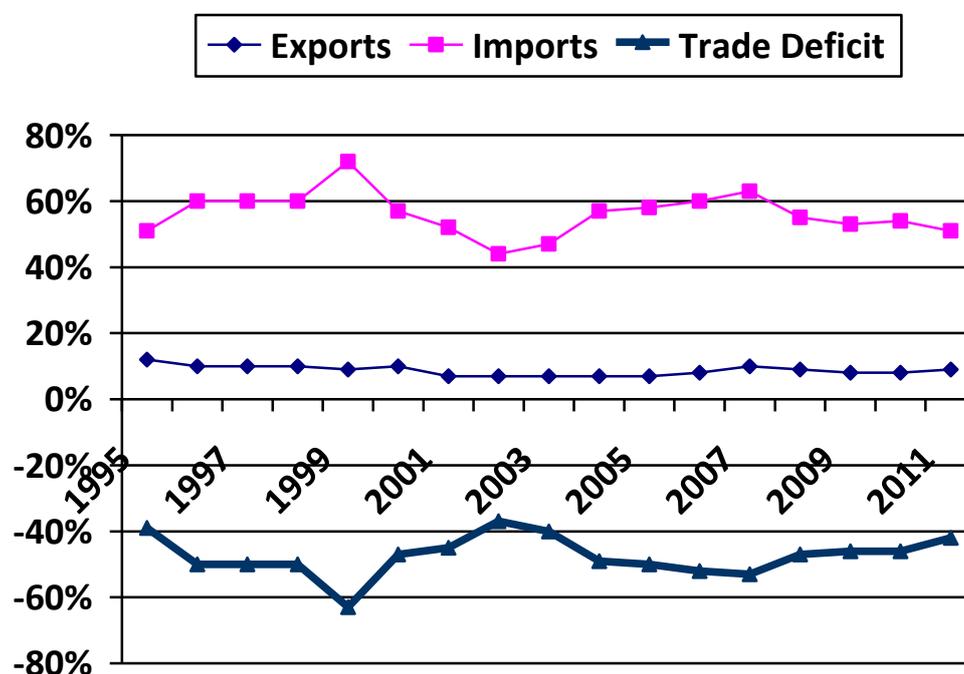
**Chart 1.1: Palestinian Exports and Imports of Goods 1995 – 2012**  
(\$ million, current prices)



Source: PCBS, Foreign Trade Statistics (registered trade data only, excluding East Jerusalem)

<sup>4</sup>PCBS, Foreign Trade Statistics.

**Chart 1.2: Palestinian Exports and Imports as Percentage of GDP 1995 – 2012**  
(Percent of GDP in current prices)



PCBS, Foreign Trade Statistics and National Accounts Statistics

The huge structural gap in Palestinian trade reflects the severe constraints of the PP-based regime on Palestinian exports and private sector growth, of which the lack of economic sovereignty, high transaction costs associated with movement and access restrictions, and the high cost of clearance of imported goods are but a few examples. The existing regime thus poses a barrier to Palestinian businesses' access to production inputs, by imposing restrictions on the supply chain and most importantly on markets. One must also consider that the West Bank and Gaza are no longer a unified market and that Gaza has evolved from a potential trade route to a recipient of humanitarian donations. In addition, the prevention of movement and access of Palestinian businesses to the East Jerusalem market has excised a prime center of economic activity from the Palestinian business map.

Potential growth in investment and production is dependent upon open trade within the region and internationally. This is especially true since the Israeli market, which

receives 85-90 percent of Palestinian exports<sup>5</sup>, has undergone changes that have minimized the potential for further penetration of traditional Palestinian products. The required access to alternative markets depends upon a change in the parameters currently offered by the PP's economic union.

## **2.2 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. This situation has yielded the huge trade deficit discussed above.

There are several mechanisms that can help close the deficit in the balance of payments: firstly, increasing the export of labor from Palestine to Israel; secondly, implementing a trade policy that encourages exports to Israel and the rest of the world; thirdly, 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**

From the start of the PP negotiations, the Palestinians raised demands for a different trade regime, preferring a Free Trade Area (FTA) to a Customs Union (CU), whereas the Israeli negotiators preferred the latter. The Palestinians were eventually convinced to accept the Israeli position, since an FTA, meaning a trade border, would ostensibly establish a labor border causing the Palestinians to lose their prior level of entrance to the Israeli labor market. This threat, and maybe other considerations, resulted in the present agreement.<sup>6</sup> While the agreement secured entrance of Palestinian workers to

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<sup>5</sup> PCBS, Foreign Trade Statistics.

<sup>6</sup> "Article VII

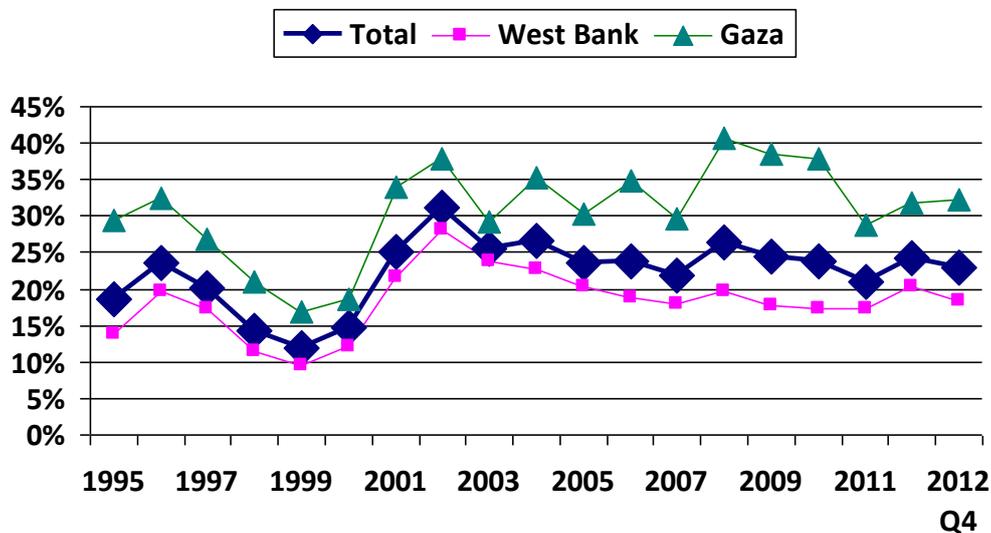
1. Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and conditions of the labor

the Israeli economy on paper, in reality the labor flows over the years were heavily restricted; it is a sad irony that the flows from Gaza to Israel have almost totally stopped since 2000 and have heavily declined over the years from the West Bank to Israel.<sup>7</sup>

Following the outbreak of the Second Intifada, the impact of the violent conflict on Palestinian employment was disastrous. Approximately 180,000 employees, equal to 28 percent of the Palestinian workforce, lost their jobs in the fourth quarter of the year 2000, of which about 100,000 lost jobs in Israel and about 80,000 lost private sector jobs in the West Bank and Gaza. Palestinian unemployment increased from 10 percent on the eve of the intifada, in the third quarter of the year 2000, to more than 35 percent in the third quarter of 2002. Unemployment decreased to some extent in the coming years, but has remained very high, ranging between 20-25 percent.<sup>8</sup>

**Chart 2: Palestinian Unemployment Rate 1995 – 2012**

(Percent, ILO strict definition)



Note: unemployment as per the strict ILO definitions. According to the relaxed definition of unemployment, namely, including persons who wish to work but have been discouraged from actively looking for a job, the rate is

movement into its area. If the normal movement is suspended temporarily by either side, it will give the other side immediate notification, and the other side may request that the matter be discussed in the Joint Economic Committee." (Paris Protocol)

<sup>7</sup> Jerusalem, which was to be negotiated in five years, was removed from the jurisdiction of the Protocol, and singular arrangements, enforced by the Israeli side, have made its status economically unique.

<sup>8</sup> PCBS, Palestinian Labor Force Surveys.

6-10 percentage points higher. For example, in 2002 the rate according to the relaxed definition was 41% instead of 31% according to the strict definition; and in 2010, 30% instead of 24%.

The jump in unemployment, from 10-15 percent in the pre-Second Intifada years (1998 – September 2000) to 20-25 percent in the post-intifada years (since 2005), stems largely from the sharp decline in Palestinian employment in Israel. As shown in Chart 3, about 10 percent of total Palestinian employment in recent years has come from the Israeli market (and the settlements), compared to above 20 percent in the pre-Second Intifada years and about 35 percent in the pre-Oslo years (until 1992).

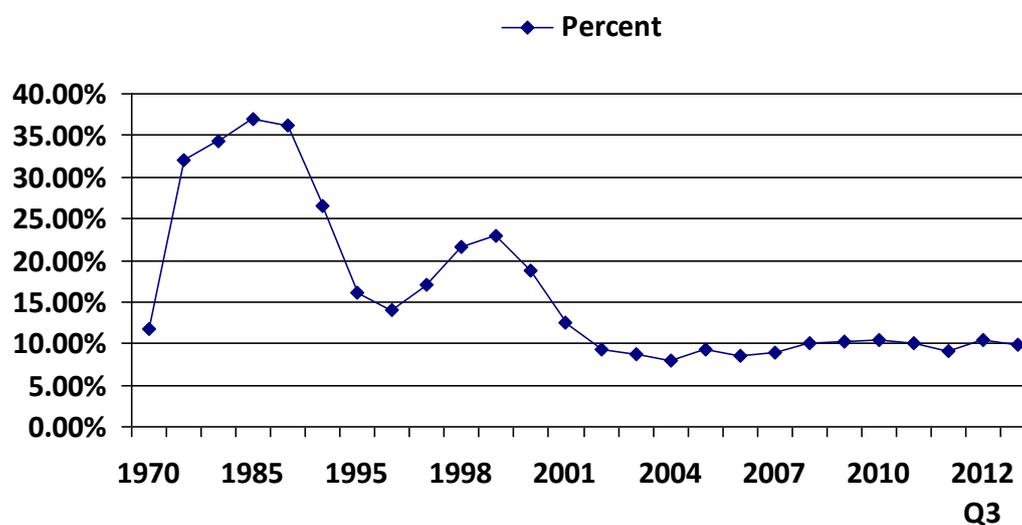
Nevertheless, employment in Israel still plays an important role in the West Bank labor market. The total number of Palestinians employed in Israel and the settlements doubled from around 45,000 at the height of the Second Intifada (2002-2004) to almost 90,000 in the second half of 2012. All Palestinian workers in Israel are West Bankers, and their share in total West Bank employment was about 15 percent in 2012.<sup>9</sup> 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 (87 NIS compared to 167 NIS per day)<sup>10</sup>, work in Israel still contributes more than one quarter of all wage income in the West Bank. It should also be noted that if not for the work in Israel, the unemployment rate in the West Bank would have been as high as in Gaza, 30-35 percent – or above 40 percent according to the relaxed definition of unemployment, namely, if persons who wish to work but have been discouraged from actively looking for a job are taken into account as well.

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<sup>9</sup> PCBS, Palestinian Labor Force Survey, Q3 and Q4 2012

<sup>10</sup> PCBS, labor force survey 3<sup>rd</sup> quarter 2012, p.6

**Chart 3: Palestinian Employment in Israel (and the Settlements) as a Percentage of Total Palestinian Employment 1970-2012**



Sources: 1995-2012 data - PCBS, Palestinian Labor Force Surveys; pre-Oslo data based on ICBS.

Note: Due to the move from ICBS to PCBS, there is a break in the series in 1995.

### **No Independent Currency, Exchange Rate Policy or Monetary Policy**

As part of the continued “imposed integration” manifested in the PP, the PNA has no currency and no exchange rate policy, and Israel alone controls the monetary policy. The Bank of Israel sets the short-term nominal interest rate based on considerations of stabilizing inflation and supporting employment, subject to inflation targeting. Needless to say, when the Bank of Israel sets the short-term interest rate, it does not take into account the implications of the interest rate for the Palestinian economy. Since inflation in the PNA and Israel is highly correlated (as expected), the loss for the Palestinians from a lack of monetary policy has been limited; but Palestinians in the West Bank and Gaza suffer from higher unemployment.<sup>11</sup> While part of the high unemployment is due to the decline in employment in Israel, as described above, and another part is structural, the monetary union and the lack of Palestinian monetary sovereignty damage the Palestinian economy, since the PNA does not have one of the most important tools for making policy to fight the deficits in the balance of payments

<sup>11</sup> In the Gaza Strip, inflation is lower than in the West Bank.

and high unemployment. We will elaborate on these crucial policy issues in future work.

### **2.3 Fiscal Imbalances**

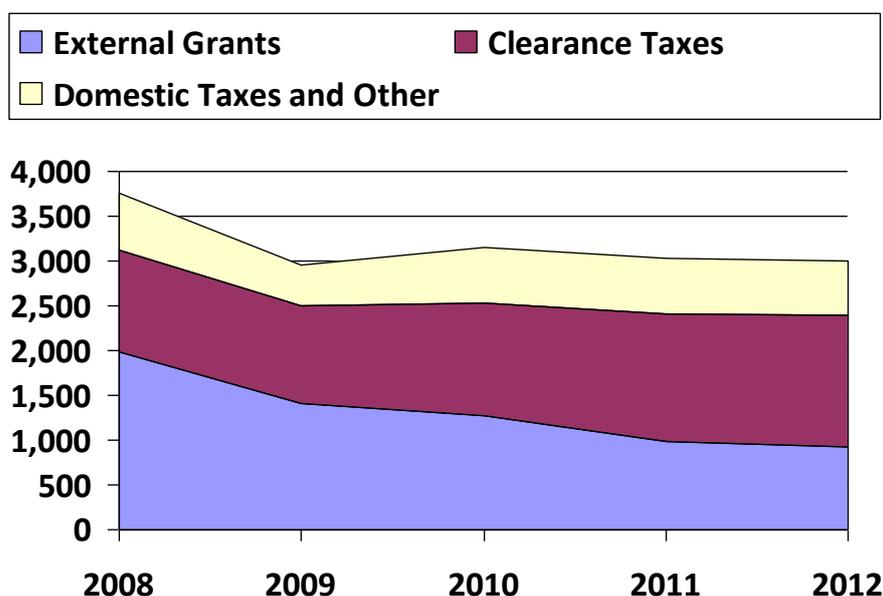
The economic limits imposed on the PNA as a result of the PP trade regime continue in the form of the so-called “customs envelope.” According to the agreement (Article III, Section 14), the “Palestinian Authority will have full responsibility and powers in the Palestinian customs points (freight-area) for the implementation of the agreed upon customs and importation policy as specified in this protocol, including the inspection and the collection of taxes and other charges, when due.” In practice, 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. Analysis of budget data for the years 2010-2012 shows that the PNA controlled only 20 percent of its budgetary sources, while Israel controlled 40 percent in 2010 and close to 50 percent in 2011 and 2012, and international donors provided more than 40 percent in 2010 and above 30 percent in 2011-2012.<sup>12</sup>

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<sup>12</sup> IMF, staff report prepared for the meeting of the Ad Hoc Liaison Committee, September 2012, p. 30; report for the AHLC meeting, March 2013, p. 27.

**Chart 5: PNA Central Government Budget Revenue 2008-2012**

(\$ million, current prices)



Source: IMF, report for the AHLC meeting, September 2012, p. 30, and report for the AHLC meeting, March 2013, p. 27; PMA, November 2012, Table 27

On the political level, 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 froze indefinitely the transfer of tax money to the PNA; in 2006, after the Hamas won the parliamentary elections and established a government in the Gaza Strip; 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. Two problems arise from this arrangement: Firstly, the system functions based on a company's reporting *via* the unified invoice. Thus, the PNA receives the unified invoice for VAT clearance from businesses, and then uses the invoice to effect

the transfer of all collected VAT to the Palestinian Ministry of Finance. Hence, if the transaction goes unreported, the amount is not transferred.

The second problem arises when an Israeli importer imports goods for use in the Israeli market, and then sells the goods to a Palestinian trader. This is known as indirect import, and the customs for such goods are not transferred to the PNA. In 1998, the Israeli government decided, in violation of the PP and the principle of free movement, to force Palestinian importers to sign a pledge that ensures that they do not sell their imported products in the Israeli market. Israeli importers were not forced to sign a similar pledge – therefore, Israeli importers can still import goods to the Israeli market, pay import taxes on the Israeli side, and then sell these goods in the Palestinian market. These indirect imports form a serious revenue leakage for the PNA, since the sale of these goods in the Palestinian market would otherwise result in the collection of VAT. This holds true for other taxes as well, such as customs and purchase tax. 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.

Another area of revenue leakage is the non-transfer of purchase tax, considered a local tax, on luxury goods bought by Palestinian traders from Israeli producers and importers. The purpose of the purchase tax is to provide additional income for the Israeli (or Palestinian) government on luxury goods. Non-transfer of purchase tax therefore is another source of fiscal leakage that the PNA incurs.

Similar to trade policy, the Joint Economic Committee (JEC) envisioned by the PP was supposed to provide a built-in dispute settlement mechanism for fiscal issues. However, once again, the JEC did not function as it was intended. Thus, issues related to implementation of the PP's fiscal provisions were not discussed and resolved efficiently.

## **International Dependencies**

Where Israel could not (or would not) provide the PNA with fiscal stability and sovereignty, the dependence on external support has filled this vacuum. However, here too the Palestinian economy has been subject to the cyclical behavior of others. Although total external revenue for the PNA's budget (for current and development expenditure) grew substantially over the 2000s, from below \$250 million in 1999 to about \$600 million a year in 2000-2005, and then to \$2 billion in 2008, since then, external aid has significantly declined every following year: to \$1.4 billion in 2009; below \$1.3 billion in 2010; slightly below \$1 billion in 2011; and finally to \$930 million in 2012.<sup>13</sup>

The increase in external revenues until 2008 generally matched and mitigated the steep rise in the PNA's budget deficit. Nevertheless, even the most generous revenues left the PNA with unfinanced deficits of \$200-400 million per year, financed mostly by borrowing from the local banking system. The year 2008 was an anomaly: in this year the PNA succeeded in generating a significant surplus, by a combination of an exceptionally high external support level and containment of the budget deficit.<sup>14</sup>

In 2009, as external revenues fell, the unfinanced deficit climbed back above the \$400 million mark, and the PNA again turned to the local banking system for supplementary financing, in turn significantly increasing public debt. By the end of 2011, public domestic debt exceeded \$1.1 billion, twice the 2008 level, in addition to which foreign debt stood at more than \$1 billion. This level of debt has severely limited the PNA's ability to take more loans or incur yet more substantially unfinanced deficits. In fact, the PNA has become almost completely dependent on external aid from donors and money transfers from Israel for its daily operation. Since

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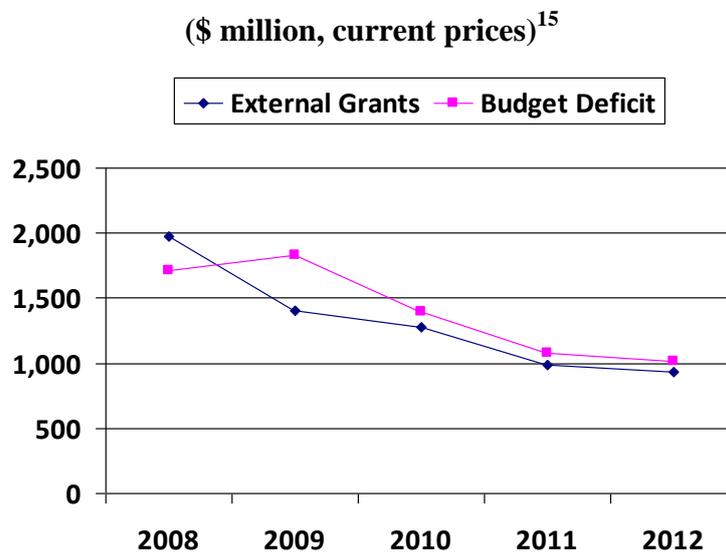
<sup>13</sup> IMF, *ibid.*

External support to the PNA's budget includes support for recurrent expenditures and for the development budget. It does not include direct supply of humanitarian aid by international official aid organizations or NGOs, through non-budgetary channels, or direct financing of development projects by such organizations. The magnitude of external aid to the WB&G through such non-budgetary channels, on top of the support to the PNA's budget, was estimated at around \$1 billion a year at the end of the 2000s.

<sup>14</sup> IMF WB&G reports: April 2011, September 2008, March 2007; PNA, Ministry of Finance, February 2011

2011, time and again, it has had no choice but to delay salary payments until the next monthly transfer of taxes from Israel or receipt of the next external aid payment. Added to this is an ever increasing accumulation of arrears to its suppliers.

**Chart 6: External Grants Compared to Budget Deficit, 2008-2012**



Note: Budget deficit - cash base, recurrent and development expenditures (net, after arrears, refunds, etc.).

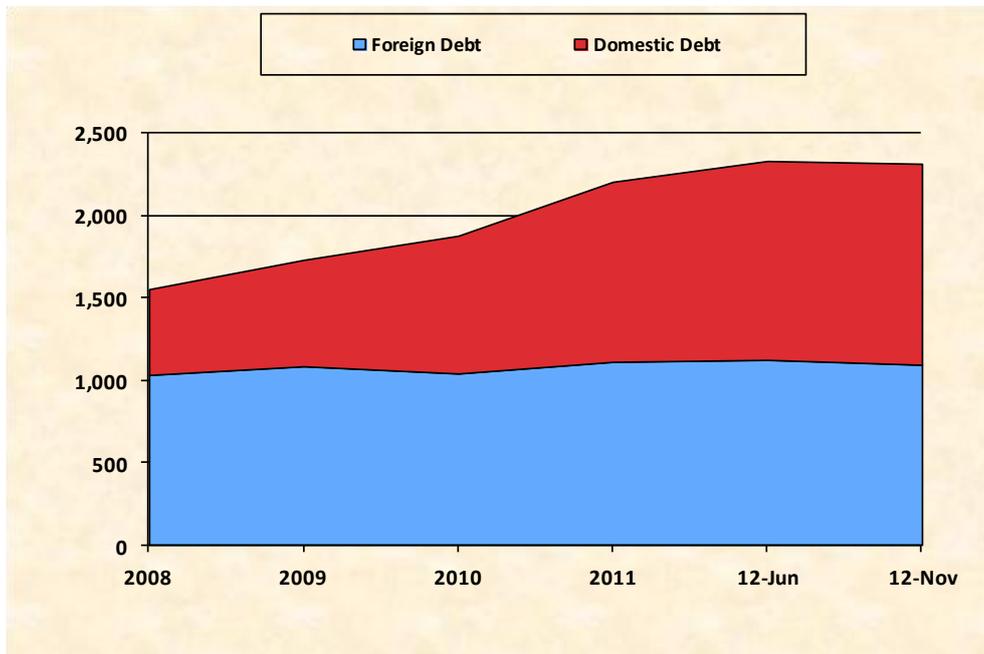
Source: PMA, November 2012, Table 27; IMF, report for the AHLC meeting, September 2012, p. 30, and March 2013, p. 27.

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<sup>15</sup> Excluding non-budgetary aid, humanitarian aid from international official organizations or NGOs, or direct financing of development projects by such organizations.

**Chart 7: PNA Public Debt by Main Components 2008-2012**

(\$ million, end of period)



Source: 2008-9 PMA; 2010-12 MOF, Monthly Reports, Public Debt (Table 8-a).

Since mid-2010, the flow of external aid has become more irregular, decreasing to \$70 million per month in the third quarter of 2010 and then jumping to \$165 million per month in the fourth quarter. As 2011 progressed, foreign aid yet again dove to \$60 million per month in the first quarter of 2011 and as low as \$50 million per month in the second quarter of that year. Since then, aid has trickled at rates of below \$10 million in certain months, rising to \$100-200 million for a month or two before plummeting again.<sup>16</sup>

#### **2.4 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.

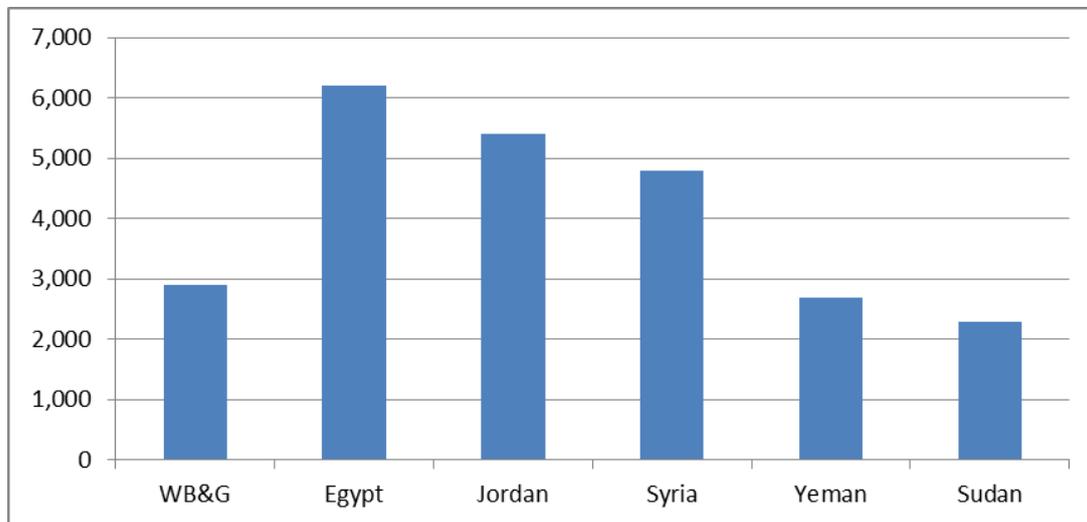
These challenges are woven into the political status quo and spill over into all aspects of Palestinian economic and social life, demonstrated below by three aspects. The first

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<sup>16</sup> PMA, Monthly Statistical Bulletin, October 2012 Update, Table 35.

relates to 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. International comparisons show that Palestinian GDP per capita, when adjusted to local purchasing power, is far lower than that of neighboring Arab countries, and is only slightly higher than that of countries as poor as Sudan or Yemen.

**Chart 9: PNA GDP per Capita, in Comparison to Selected Arab Countries**  
 (\$, adjusted to local purchasing power according to the PPP method, 2010)

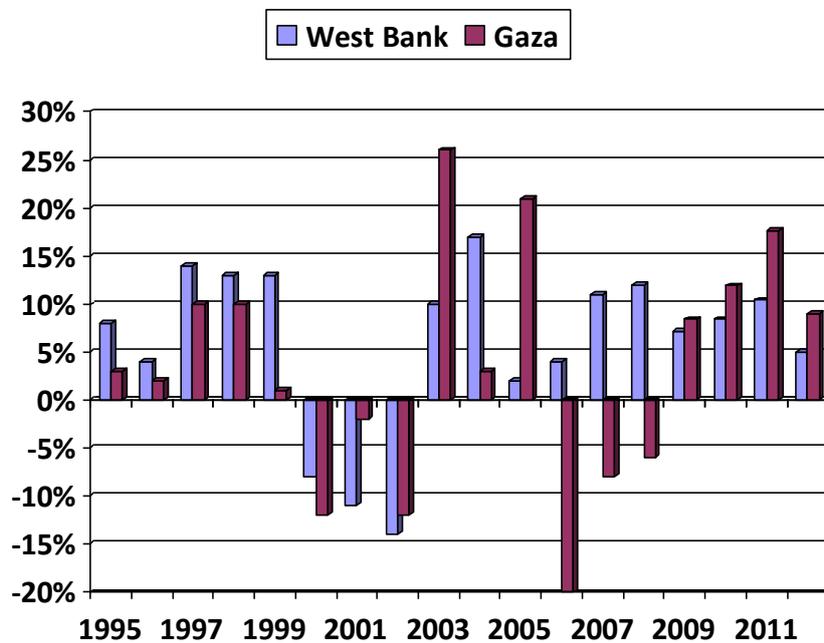


Source: CIA World Fact Book; Country Comparison: GDP per capita, as per the PPP method

The second example relates to Palestinian economic fragility – the extremely erratic nature of Palestinian economic growth over the last two decades, and the overriding influence of Israeli access and movement restrictions on it. The chart below shows the high real growth rates in the relatively relaxed period of 1997-1999, and the steep fall in the early years of the Second Intifada (2000-2002). An upward correction came in 2003-2005, mainly in Gaza, where Israeli restrictions were relatively easier in those years, however the data for 2006-2009 shows the strong impact of the much stricter measures on Gaza since the rise of the Hamas government in 2006 and the takeover of Gaza by Hamas in 2007, contrasted with the high growth in the West Bank under the Fayyad governments. Subsequently, in 2010-2011 we see the influence of the

relaxation of the siege on Gaza since the middle of 2010, and the relatively slower growth in the West Bank.

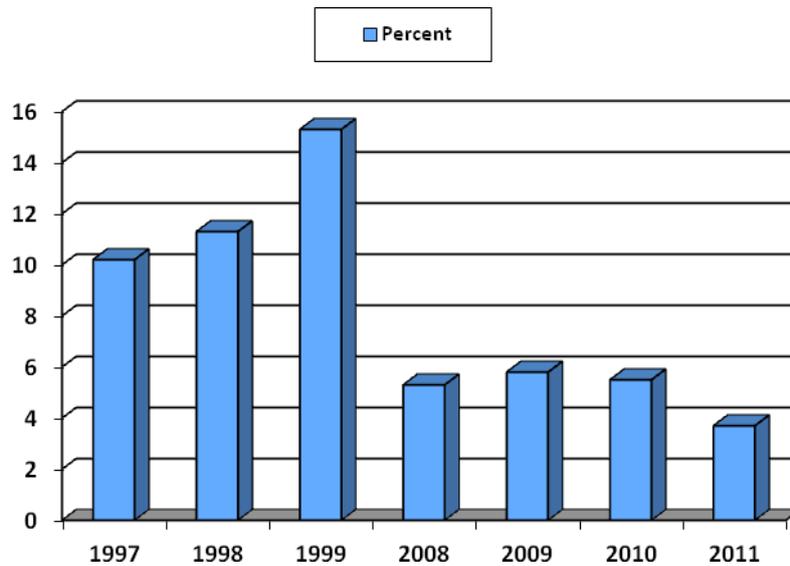
**Chart 10: GDP Real Growth in the West Bank and Gaza: 1995-2012**



Source: PCBS, National Accounts Statistics

A third victim of the PP regime is infrastructure development. Two-and-a-half decades of underinvestment in infrastructure, under Israeli rule, resulted in chronic public underinvestment. Investment in infrastructure lagged more deeply as a consequence of the Second Intifada's violence. Chart 4, which shows the low level of non-building investment in recent years compared to the pre-Second Intifada period, illustrates these constraints.

**Chart 4: Gross Fixed Capital Formation: Non-Building Investment**  
(Percentage of GDP)



Source: PCBS, National Accounts Statistics.

The economic provisions of the PP were drafted almost 20 years ago, when the PNA had no administrative capabilities. Today, however, the PNA is institutionally capable of providing customs services, customs police and effective administrative resources. With international support and development funding, the PA can enforce its own procedures and regulations suited to the Palestinian national economy and needs. Such a change would stand in stark contrast to the current ineffective administration of imports based on Israeli customs and taxes. The current situation does not acknowledge key realities of the Palestinian economy. Thus, it is both timely and feasible to form a new arrangement that will replace the ineffective and selectively enforced PP clearance arrangements.

## Gaza

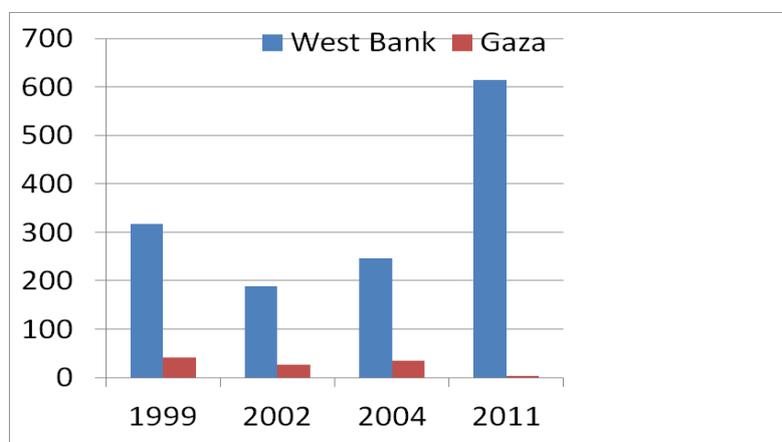
Gaza's economy has always been smaller and less developed than that of the West Bank (WB), and it has always been the poorer of the two Palestinian territories. The gap between the WB and Gaza widened considerably after the Hamas takeover in June 2007. This economic contraction stemmed from the Israeli blockade and military incursions into Gaza, as well as the freezing of funds to the Palestinian governments by the European Union, the United States and Canada, whose governments consider Hamas a terrorist organization. Since the middle of 2010, however, Gaza's official GDP measures have registered a steep recovery, following the partial relaxation of the harsh Israeli constraints on Gaza's external trade and the continued and even increased flow of international aid. Nevertheless, as of 2011, the GDP per capita in Gaza was still half that of the WB, in comparison to a gap of less than 15 percent in 2005 (\$1,535 per capita in Gaza and \$3,138 in the WB, in 2011, at current prices; PCBS National Accounts Statistics).

Given the miniscule nature of the Gazan economy, it is totally dependent on imports for the supply of almost all essential products and finished consumer products, including almost all raw materials, inputs and equipment for its economic activities (agricultural and industrial production, construction, transportation, etc.). Furthermore, Gaza is much more dependent than the WB on exports, which provide the only sustainable route to economic recovery and growth. Indeed, Gaza's progress in external trade with and through Israel suffered a severe setback in the second half of the 2000s, during which exports practically came to a halt. The alternative trade route through the underground "tunnel system" on the Gaza-Egypt border, which is used almost exclusively for imports into Gaza, has alleviated a large part of the supply shortages, primarily in essential goods such as fuels, cement, etc., as well as a wide range of consumer products. The tunnels, however, cannot help in answering much of the supply needs of the industrial manufacturing sectors, and they definitely do not provide an export route.

The partial relaxation of Israeli restrictions since 2010 has encompassed mainly imports, while exports to Israel, Gaza's only significant export market, are still almost totally prohibited, and outgoing trade with the WB is largely forbidden as well. Chart B-1 shows the deterioration of Gaza's exports to an almost non-existent level (less than \$4 million of exports in 2011). Chart B-2 shows that, as of 2011, total imports into Gaza from and through Israel were as low as one quarter of the 1999 level and one third of the 2004 level.

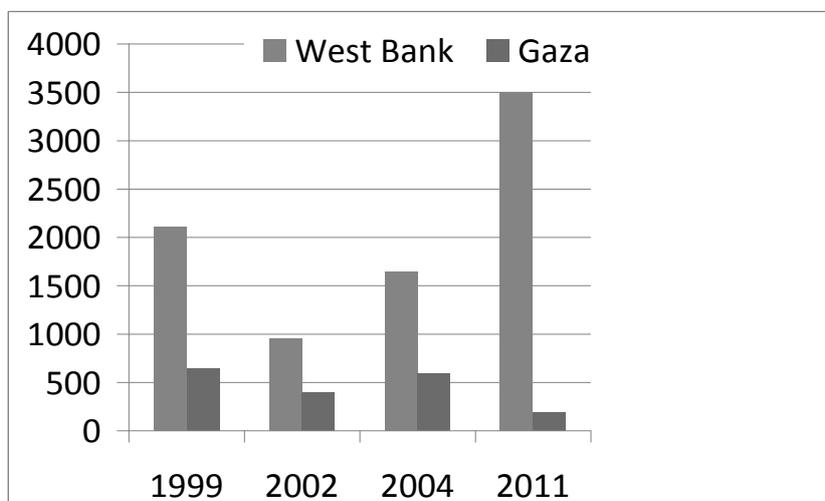
**Chart B-1: Palestinian Exports to Israel by Region 1999-2011**

(\$ million)



**Chart B-2: Palestinian Imports from and through Israel by Region 1999-2011**

(\$ million)



Source: PCBS, Trade statistics and entry/exit data by passage.

Note: Registered trade only.

In terms of employment, Gaza was more harshly impacted than the WB by the constraints on the entry of Palestinian workers into Israel. Over most of the Israeli direct-rule era, the number of Gazans working in Israel was almost the same as the number of employed persons in the Gaza Strip itself, and their remittances played an enormous role in the economy of Gaza and the income of Gazan households. The first turning point was in the early 1990s, starting with the first long closure on the WB&G at the time of the First Gulf War (1991). Subsequently, mainly in 1992 and early 1993, Israel introduced an increasingly strict “permit regime,” restricting the previously free entry of Palestinians into the Israeli labor market. The new restrictions continued after the signing of the Oslo Agreements and the PP (1993-1994), and by 1995, only 3 percent of the total number of Gazan employed persons was employed in Israel, and unemployment in Gaza jumped above 30 percent. In the West Bank, on the other hand, the unemployment rate stood at less than 15 percent of the total number of persons employed there in that year. Still, the number of Gazans working in Israel increased considerably over the second half of the 1990s, and the share of workers in Israel rose to 16 percent in 1998 and 1999 (the share of West Bankers working in Israel was still much higher, around 25 percent in 1998-1999). A second turning point came after the outbreak of the Second Intifada: the number of Gazan workers in Israel dropped to an insignificant 1 to 3 percent of total Gaza employment, and since 2006, the Israeli labor market has been completely closed to workers from Gaza. Unemployment in Gaza jumped accordingly, from below 20 percent in 1999 to above 35 percent in 2001, and since that year it has ranged between 30-40 percent.<sup>17</sup>

Another important aspect of the economic situation of Gaza relates to the unique way of financing the Hamas government, and the overwhelming burden it puts on the PNA budget. Though the PNA does not control Gaza, it has continued to pay the salaries of most public servants there, including in the civilian ministries, municipal councils, and many of the civilian agencies that maintain basic civilian public services. In addition, the PNA budget has continued to cover a significant part of the running costs of the health and education systems, as well as other basic public services. The

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<sup>17</sup> PCBS, labor force surveys for the relevant years

PNA budget figures do not disclose the breakdown of expenditure between the West Bank and Gaza. According to a detailed analysis prepared by us on the 2010 PNA budget figures, Gaza's share in the PNA's wage and non-wage expenditure was estimated at about \$1 billion (close to one-third of a total recurrent expenditure of slightly above \$3 billion). On the other hand, the PNA's income from VAT and other taxes on Gaza's imports from Israel (and through Israel), which had previously covered a large part of the recurrent expenditure, dropped to less than \$100 million, due essentially to the sharp drop in Gaza's imports from Israel. Hence, the PNA deficit on its "Gaza budget" was, in 2010, close to \$1 billion. In contrast, the PNA's tax and other revenues collected in the West Bank and on West Bank imports and trade with Israel were as high as \$1.85 billion in 2010. This rendered deficits into surpluses, covering almost all of the West Bank's recurrent expenditure budget of around \$2.1 billion.

In sum, most of the PNA's recurrent budget deficit of close to \$1.2 billion, in 2010, financed by donors' budget support, reflected the cost of financing public expenditure of the Hamas-controlled government in Gaza.<sup>18</sup> The situation today has not changed fundamentally since 2010.

Gaza's economy can be revitalized and achieve sustainable recovery only through (a) economic reunion between Gaza and the West bank, and (b) reopening of Israel, Gaza's main and practically only significant market, to Gazan exports. Hence, as far as Gaza is concerned, the key is full removal of all the trade constraints currently applied to the Gaza Strip, and primarily the ban on exports from Gaza to Israel, in addition to enabling and supporting trade between Gaza and the West Bank.

Another highly important measure, with special importance for Gaza, is phased reopening of the Israeli labor market to workers from Gaza. All the other recommendations for amending the PP, detailed in this paper, should be applied to

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<sup>18</sup> For a detailed analysis of the Gaza budget in 2010, see Peres Center for Peace, *Gaza Strip Crossings: Israeli Policies in a Broader Perspective*, 2011, p. 16-24.

The massive humanitarian aid infused into Gaza by the international donors and UNRWA, directly, added some \$500 million to the broader public sector budget of Hamas-controlled Gaza, in 2010.

Gaza as well, with consideration given to Gaza's special conditions as a Hamas-controlled territory.

**In other words, the story of Gaza represents a radical case of the dysfunction of the Paris Protocol regime, and should be urgently reconsidered.**

### **3. Modifications to the Paris Protocol Economic Regime**

As described in Chapter 2, the PP was intended to lay the groundwork for strengthening the economic base of the PNA through three basic macroeconomic assumptions: entry of Palestinian workers in substantial numbers into the Israeli labor market; free movement of Palestinian goods into the Israeli market and through Israeli exit points to other markets; and consistent implementation of the tax-collection mechanism. Just as important, the PP introduced the Palestinians, for the first time in the economic relations between the two sides, as a legitimate economic sovereign, both in principle and through the creation of the PNA. And yet, both the design and implementation of the PP remain incomplete, while the principle of sovereignty has been forgotten. Although the PP was designed as a framework establishing interim-period economic relations, for a period of five years, the regime has become (at best) an increasingly constraining factor for Palestinian economic development, and in other instances, a complicit tool in Israel's control over the Palestinian economy.

Today, we have the approval of Palestine by the UN as a non-member state, the election of a new Israeli government, and the new efforts to revive Israeli-Palestinian negotiations. These developments all represent an opportunity to reconsider the entire set of arrangements as established in the PP and implemented on the ground over the last twenty years. All of the parties (Palestinian, Israeli and international) share the view that advancement of both the Palestinian economy and the wellbeing of the Palestinians is a mainstay of peacebuilding.

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: firstly, 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 secondly, to support Palestinian state-building measures by allowing it increasing sovereignty over economic policy.

### **3.1 Towards an Independent Customs Territory**

The model established in the PP is based on a semi-customs union: while it assumes that no economic borders exist between the members of the union, the practical effect was the preservation of the trade relations that had existed until then, i.e. a Palestinian economy integrated into and dependent on the Israeli trade regime and political apparatus. As explained in detail in Chapter 2, the trade deficit – and the available mechanisms that any sovereign economy should have in combating this deficit – is one of the Palestinian economy's primary deficiencies under the PP regime.

**We thus propose that an important goal of trade relations between the two economies should be the creation of a separate Customs Territory, which would enable the PNA to shape and implement its own trade policy.** The Customs Territory would be based on the needs of the Palestinian development agenda, not necessarily in accordance with the Israeli policy. This will create the necessary trade policymaking autonomy to meet Palestinian development needs, and can be achieved through a phased change of the present situation, including the following steps:

- **Expansion of tariff lists A-1, A-2 and B:** In order to enable uninhibited and sovereign Palestinian trade at terms that contribute to the competitiveness of Palestinian products, Israel and Palestine should agree to expand the present lists. 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, first, to significantly expand the present lists. Second, we recommend that these lists be used as the basic components of a separate Palestinian tariff book, constructed in accordance with Palestinian economic conditions and needs.
- **Autonomous Palestinian exit/entry points:** Israel will hand over to the PNA 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; the first site will be the Allenby crossings, with a second on the Jordanian border. When possible, the arrangement will be implemented at other crossings, such as those bordering Gaza. Simultaneously, the parties will develop similar arrangements for Palestinian goods exported or imported both through the ports of Ashdod and Haifa and Ben Gurion airport.

- **Shared control over bilateral Israeli-Palestinian trade passing through all crossing points:** The complexity of the present system of cargo crossing points between Israel and the West Bank stifles potential Palestinian economic growth. It includes a few official cargo crossing points, about twenty “special crossings for Israelis,” and many other “unofficial” crossing points where cargo moves. We propose a two-part system for controlling bilateral trade, as well as application of the Palestinian separate tariff book to Israeli-Palestinian bilateral trade:

The first component will be the stationing of both Israeli and Palestinian customs officers at all the crossing point, to check and register all movement of trucks. The officers' work will be integrated into the present system of security and other regulatory checks at many of these crossing points, in ways that will not significantly affect the smoothness and speed of movement through the crossing points, in contrast to the present situation.

The second component of this system will be a number of Palestinian inland regional customs houses, established in key locations in the West Bank and Gaza. These customs houses will coordinate and oversee the work of the Palestinian customs officers stationed at the international entry/exit points (Haifa, Ashdod, Allenby, etc.). Most of the trucks carrying cargo from/to Palestine that pass through the crossing points will be registered and cleared by the customs officers stationed there. Border patrols will send only those shipments that need more thorough examination to the customs houses for detailed checks, etc.

These arrangements will use modern and integrated customs and security management systems (procedures, standards) and infrastructure (technology, physical infrastructure), developed through coordinated programs and with international support. Appropriate procedures, characterized by close cooperation between the respective parties, will be formulated for the ongoing management of these systems. It should be noted that such systems of inland customs houses interconnected with the work of customs officers stationed at crossing points already work efficiently in Jordan and other countries. Furthermore, Israel too has a well-working system of certified inland bonded storage compounds, based on controlled movement of trucks

from entry points for clearance at these inland compounds. The Jordanian and Israeli models thus serve as viable precedents for the design and operational procedures of the proposed Palestinian customs control system.

**The elements mentioned above will constitute a full-scale sovereign Palestinian Customs Territory** that will prepare the ground so that Palestine, under appropriate security arrangements, will be able to:

- ❖ Operate economic exit and entry points with Jordan and Egypt under Palestinian authority.
- ❖ Provide for the free movement of goods between the West Bank and Gaza and significantly greater freedom of movement between these two areas.
- ❖ Use Israeli exit/entry points for imports and exports, as well as effective transit of goods through Israel.

### **3.2 Improving Labor Flows**

The pressure on the Palestinian labor market is expected to increase significantly in the coming years, as a result of demographic trends. The Palestinian population is among the youngest in the Arab world: 62 percent are under the age of 24, of which 41 percent are under the age of 14. Furthermore, the number of young Palestinians entering the labor force is increasing each year: from 2001 to 2005, the working-age population grew by about 70-75 thousand *per annum*; this number grew to almost 100,000 per year in the early 2010s, and will increase to about 120,000 per year in the 2020s.<sup>19</sup> So too, trends in labor force participation are a growing concern. In 2000, only 41.5 percent of the working-age population was employed or actively searching for work. This rate of participation has remained static through the 2000s, except for a temporary decline in the early years of the intifada. However, even at this low rate of participation, the Palestinian labor force has grown at a rate of about 5 percent a year since 2003.<sup>20</sup> This low participation rate is expected to increase in coming years, reflecting a large latent demand for work opportunities by the young, frustrated

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<sup>19</sup> Authors' calculations based on PCBS, *Demographic and Social Survey of the Palestinian Population* (in Arabic), July 2011, p. 16;

<sup>20</sup> World Bank, *The Palestinian Economy and the Prospects of its Recovery*, March 2006, p. 9; PCBS, *Palestinian Labor Force Survey, Annual Report 2010*, April 2011, p. 57.

Palestinian working-age population. A quantitative analysis of latent Palestinian labor market trends shows that, under conditions of relative stability and economic recovery, the magnitude of Palestinian “hidden unemployment,” in conjunction with the fast-growing number of youth entering the labor market every year, could generate annual growth of about 8 percent in the labor force.<sup>21</sup>

Hence, the Palestinian economy needs to more than double the number of available jobs over this decade; the number of employed persons must rise from about 750,000 in 2010 to about 1.5 million in 2020, merely to contain Palestinian unemployment around the alarming, recent rate of 30 percent.<sup>22</sup> The number of new jobs needed in order to bring unemployment in 2020 back to the pre-intifada rates of 10 to 12 percent, is close to 1 million, equivalent to 100,000 new jobs per year created between 2011 and 2020, compared to an average of about 30,000 new jobs per year created from 2003 to 2010.<sup>23</sup>

In this context, increased access of Palestinian workers to the Israeli labor market could significantly help in easing the high Palestinian unemployment and the depressed economic situation in the West Bank. Thus, work in Israel has special importance for the short-medium term. Hence, we recommend negotiating the phased reopening of the Israeli labor market to Palestinian workers, with the aim of gradually replacing foreign workers in the Israeli construction, agricultural and industrial sectors with Palestinian workers. Such a policy will also provide a long-awaited solution to shortages of skilled workers in the Israeli construction and agricultural sectors. **We suggest adding between 50-60 thousand permits, in two to four phases,** under agreed-upon arrangements and modifications to the present entry-permit system.

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<sup>21</sup> Peres Center for Peace and PalTrade, *The Untapped Potential* (2006), p. 77; analysis based on of PCBS, *Palestinian Labor Force Survey*, 2010.

<sup>22</sup> According to the relaxed definition of unemployment, including persons who have "despaired" of finding a job and have ceased actively searching for work. The unemployment rate under the stricter ILO definition is around 25 percent.

<sup>23</sup> Authors' calculations.

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

As in the realm of trade, Israel's imposed integration in fiscal issues has, as shown in Chapter 2, generated a deeply rooted set of fiscal dependencies and leakages that we recommend 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 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. (To be completed in cooperation with Israeli 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, following which an inland customs (Palestinian) control system will be established for the direct collection of custom duties and all other taxes by the PA.
- It is time to reconsider the transformation of the PMA into a full-fledged central bank.

### **3.4 Towards Policymaking Symmetry: Reactivating the Joint Economic Committee**

The lack of control over economic policymaking impairs the PNA's ability to address economic developments and needs through basic economic policy measures. Given a phased shift towards the proposed separate Customs Territory, there is vast room for agreed amendments to various aspects of economic policymaking in the original arrangements. In order to ensure that the reformed regime will not fall into the same trap of disingenuous implementation as in the PP era, we propose to resurrect the JEC, but with some modifications. The committee's purpose will be, as it was originally intended, to consider various cases, disputes, and impediments facing the Palestinian economy and private sector, and to devise arrangements that address these issues. At the same time, the JEC will be redesigned with an active role for a third party, particularly in the dispute settlement mechanism. This modification will ensure that the JEC does not turn what is supposed to be a bilateral forum into a unilateral tool for Israel. A reinvigorated JEC may serve as a hedge for the Palestinian economy to reduce uncertainty, mitigate risks and encourage private investment.

The reactivated JEC will not only enforce the aforementioned reforms, but, in addition, can and should oversee the following issues:

- **Removal of obstacles to trade within the West Bank and between the West Bank and Gaza:** Increased facilitation and normalization of internal movement of goods within the West Bank; removal of checkpoints, roadblocks, barriers and earth mounds, and other physical or administrative encumbrances; free access to, and use of, all roads; and free movement of goods and people between the West Bank and the Gaza Strip, organized and monitored through a "safe passage."

- **Approval and support for solutions, specifically relating to storage and other logistical problems at and by the crossings**, such as lack of facilities or specific sectors' logistical issues. This includes, for example, cold storage and other facilities for fresh agricultural products, facilities for handling items like cement in bulk, etc.
- **Review and arbitration for reducing transaction costs and other administrative impediments for specific goods and sectors**. For example, in the case of Israeli standards, we propose to start with those Palestinian goods and those sectors whose products are already being exported to the US and EU markets. The Palestinian exporters can submit to the JEC documents showing that they meet the Israeli standards and conditions as applied to imports from other countries. The joint professional working groups will formulate the appropriate amendments and new procedures, using these companies as case studies, after which working groups will apply these new procedures to Palestinian exporters at large.
- **Removal of physical impediments and improvements in Palestinian control over resources and infrastructure development**: the PNA and Israel must work towards agreeing on a phased transfer of control over most physical resources in the West Bank, particularly Area C, to the PNA.