Reaching Economic Viability for a Palestinian State
A Solution Oriented Macro Assessment

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Al-Mustakbal Foundation (AMF) for Strategic and Policy Studies is an independent and not-for-profit institution that actively addresses pressing economic, legal and regulatory issues facing Palestinian society on the road to statehood.

AMF works toward strengthening the strategic partnership between the Palestinian public and private sectors by promoting collaboration and mutual understanding within the framework of democracy and free market principles.

As a think-tank, AMF undertakes research, analysis, and advocacy activities with the aim of defining a strategic direction for Palestinian economic and legal development efforts. AMF's programs help inform the public debate on critical questions of national policy, promoting the free and civil exchange of ideas in accordance with every Palestinian's right to self-expression. AMF regards these activities as among Palestinian civil society's most important contributions to concrete and positive state building.

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Introduction

The Road Map issued by the Quartet on May 1st 2003, visualizes "an independent, democratic and viable Palestinian State, living side by side in peace and security with Israel and its other neighbors". Consistent with the Road Map, the vision for this project is of a two state solution to the Palestinian/Israeli conflict, living side by side, not only in peace and security but also in shared prosperity, which is essential in cementing peaceful relations over time. Economic viability, coupled with growth opportunities and perceptions of possible prosperity would make a Palestinian State economically sustainable.

The viability of a Palestinian State rests primarily on economic viability. However, a viable Palestinian State will also require a democratic framework, good governance, security and the rule of law as well as a well performing public administration. While this report will focus on economic viability, it will also touch upon various elements of the institutional environment which are germane to economic viability such as security and the rule of law.

The report has three sections:

a) What kind of economic strategy and economic relations with Israel are most likely to lead to viability and prosperity? After defining economic viability for Palestine, the report will focus on the demographic and labor dynamics. The growth levels and sources of growth needed to attain both viability and prosperity will be identified together with the growth strategy which can achieve these objectives.

b) After articulating a vision of the Palestinian economy which would attain viability, the report will turn to more practical considerations: how do we get from here to there? The building blocs of the growth strategy will be reviewed: security, alternative trade regimes, and border crossings management.

c) Since both domestic and foreign investment will be key factors in attaining viability and prosperity, the third section of the report will address the policies, institutional reform and arrangements which would be most conducive to an investor friendly environment. Shared infrastructure with Israel, Egypt and Jordan, job creation, and reform of the judiciary will be discussed. Such policy orientations would be critical in providing investors with some assurances about long run sustainability. Finally, the report will address the major issue of competitiveness which needs to be firmly established and sustained by vigorous institutional development for the projected growth strategy to succeed.

A. A Vision of an Economically Sustainable Palestine

1. Economic viability and prosperity.

In general, economic viability can be achieved when the rate of growth of the economy exceeds the rate of population growth on a sustained basis over time. Furthermore, per capita income increases over time must be sufficient to absorb the yearly increase in labor force. Otherwise unemployment would increase, resulting in a combination of per capita income decline and migration abroad in search of work opportunities. As will be shown below,
in the case of Palestine the rate of growth of the labor force far exceeds that of the population, raising an additional challenge to the growth strategy.

Another important consideration which is particularly relevant to the bonding of peace and security between Israel and Palestine is the relative rates of growth of the two counties. Establishing peace and security between the two states may not be consistent with the impoverishment of the Palestinian population relative to the Israeli population. On the other hand, a convergence of the rates of growth between the two countries and growing prosperity in Palestine relative to Israel would certainly be an investment in cooperation and peace. Therefore, the objective of shared prosperity between Israel and Palestine, with the promotion of joint projects and infrastructure ventures would create strong vested interests in peace and provide the best guarantee for security.

2. The Demographic Challenge

Population growth in Palestine of 3.5 % is one of the highest in the world, due to continued high fertility rates (6.1 % children per woman vs. 2.9 % worldwide) as well as declining mortality rates. Half of the population is under 18 years old. The proportion of school age population is almost twice as large as in industrial countries and 25 % larger than in developing countries[1]. Given the very young age structure of the population, even if fertility rates were to decline over time, the number of births will expand substantially over the next decade as more girls enter the child bearing age (ages 15-44). Therefore the high population growth rate is expected to remain at current levels through the next decade. Even more dramatic is the increase in the active population (age 15-60) entering the labor force (4.5 % annual increase) as higher fertility rates over the last fifteen years were compounded by declining mortality rates. As a result, 50,000 new jobs have to be generated every year to absorb the increase in the active population.

Additional jobs will also have to be generated to reduce the current levels of unemployment (24 %) and to increase female participation in the labor force from 19% in 2006 to levels more representative of their graduation rates from universities which are equal to those of men. Additional job opportunities must be found to accommodate their skill profile. Finally, the private sector needs to become the driving force behind employment generation, shifting away from government employment, which has been the only source of new employment since 2000. The bloated 165,000 civil and security services will need to be reduced to about 90,000 under a peace scenario. These retrenched government employees will have to be absorbed by a dynamic private sector.

3. Growth convergence between Israel and Palestine

The issue of convergence between Israeli and Palestinian per capita income becomes particularly important under a peace scenario where the two economies are open to one another with a free flow of people and goods. Such convergence took place between 1968 and 1985 despite the occupation and the repression of Palestinian industrial and agricultural activity. It happened as a result of the movement of Palestinian labor to Israel and the subcontracting of labor intensive activities to the WBG, particularly in the garment industry, by Israeli companies. During the first Intifadah the ratio of Palestinian per capita income to the Israeli one declined from .22% to .08% but picked up again during the Oslo period to .09 %, although the real increase was understated by the technology boom which produced high rates of growth in Israel. With the second Intifadah and the restrictive closure regime on the movement of goods and people the ratio fell further to .06 % in 2006. With Israeli per capita income expected to rise by 1-2% annually, income convergence between the two countries would require Palestinian per capita income to rise by at least 3-4% per year. With free movement of labor and goods between the two countries, coupled with a full fledged development of Palestinian industry and agriculture, such convergence is likely to improve upon the performance attained in 1968-85.

Ratio of WBG per capita income to Israeli per capita income

1968 1975	1980 1985	1990 1995	2000 2006	
0.11 0.14	0.17 0.22	0.12 0.08	0.09 0.06	

4. The warranted rate of growth.

The high rate of growth of the working age population, coupled with the need to reduce unemployment and accommodate a higher labor participation rate for women, requires a sustained yearly rate of growth of 6 % over the next decade. However, this will be barely sufficient to maintain present levels of per capita income. Growth in per capita income of 2-3% annually over the next decade will be necessary to create an environment of hope and promise of prosperity. It will also gradually reverse the cumulative decline in per capita income between 1999 and 2006 of 40 %. Consequently the Palestinian State should target a growth rate of 8-10 % annually over the next decade, after which a small decline could be accommodated in line with an expected reduction in fertility rates.

While this target seems to be ambitious, episodes of economic dynamism during the Oslo period (1995-2000) attained 12.2 % in 1997, 11.8 % in 1998, and 9 % in 1999[2]. During this period the WBG was not only viable but also prosperous. This performance was achieved following substantial investment by Palestinians returning from abroad and a boom in the housing sector. In a post conflict situation, with the advent of a Palestinian State, this is likely to be exceeded- as was the case in Bosnia[3]. Similar rates of growth were projected under World Bank recovery scenarios and by the Rand Study[4]

5. Export Driven Growth Strategy

For a small economy with limited domestic demand, only an export oriented growth strategy would be able to achieve the growth performance described above. This was the strategy largely followed by the Palestinian Authority (PA) in 1997-99. By institutionalizing an open, free market economy and by maintaining the Customs Union with Israel[5] it integrated the two economies, potentially opening the Israeli and foreign markets to Palestinian exports. Other small economies have successfully followed this model, most notably Israel, Jordan, Mauritius and Tunisia not to mention Hong Kong and Singapore. The WBG had experienced a boom in commodity and services exports during the 1997-99 period despite the asymmetric implementation of the Customs Union by Israel[6] and all the other obstacles erected by the Israeli occupation.

Export capacity can rapidly expand on the existing core of commodities, such as high end agricultural products, cut stone and marble, textiles and leather goods. These can be augmented by exports of services, particularly tourism, telecommunications, software services directed to Arab markets as well as financial services. Housing and commercial real estate investments undertaken by Palestinians living abroad have shown considerable potential during 1995-2000. Under a peace scenario where normal relations are established between Israel and Arab countries, tourism would experience a quantum leap as tourists from neighboring countries would visit the WBG and the holy sites. Tourism is a particularly strong source of growth, not only in terms of its market reach but also in terms of employment and derived demand for hotel materials and local handicrafts. Its high spill over effects on other sectors, (retail trade, restaurants, transportation, and construction) makes it a powerful job generating sector.

While this export strategy should reduce the WBG dependency on the employment of Palestinian labor in Israel and Arab countries, it would take over a decade to build up export capacity and absorb the yearly increase in the labor force while reducing unemployment to acceptable levels. As discussed below, export of Palestinian labor to the Israeli and Arab markets would be an essential source of income during a transition period, generating domestic demand while at the same time reducing unemployment.

A second and critical source of growth would stem from higher productivity of both labor and capital. Under a peace scenario with a return to normalcy in Palestinian/Israeli relations, transaction and transportation costs would be reduced dramatically. This will encourage both foreign direct and domestic investment which will would restore the capital/ labor ratio to levels more typical for middle income countries. While the higher productivity stemming from a return to normalcy would unwind after a few years, it would dovetail with higher productivity resulting from higher investment and the introduction of improved technology.[7]

The third source of growth will be a substantial increase in investment both for new productive facilities, fueled by exports and domestic demand, replacement of outdated equipment, and investment in residential construction. Given the housing shortage in Palestine, particularly in Gaza, income generated from productive activities or from labor employed in Israel or abroad will spill over into demand for housing. However, political stability as well as the rule of law and an investor friendly environment will be critical in attracting both domestic and foreign investment.

Recommendation1. In a small open economy such as the WBG, domestic demand is limited and insufficient to generate rates of growth consistent with economic viability. Only an export driven growth strategy can fuel a high growth economic performance and ensure both economic viability for the WBG and prosperity.

6. Major Export Markets.

Under the Customs Union with Israel and due to the asymmetric implementation of this trade agreement by GOI, WBG imports from Israel accounted for 62 % of its total imports in 1999 while 97 % of WBG exports were destined to Israel. This skewed pattern of trade and overwhelming dependence on Israel for both imports and exports was mostly due to the restrictions imposed by GoI on the free flow of Palestinian products through Israeli border points and difficulties which Palestinian importers experienced in importing directly to WBG destinations. Some trade diversification took place by 2004, but external trade remained dominated by Israel[8].

With Security restrictions and delays incurred in checking WBG products increased transaction costs in trading with the rest of the world, thereby making many Palestinian products uncompetitive in foreign markets. It became easier and cheaper to trade in the Israeli market, as many Palestinian importers bought their merchandise from Israeli wholesalers, so as to forgo the long security checks at Israeli ports. Since 2000, Palestinian importers gained more experience in importing directly from abroad, minimizing port and demurrage charges. But security constraints became even more forbidding with the escalation of conflict since 2000, providing the incentive to import from Israeli wholesalers. As a result the import share from Israel increased from 62% in 1999 to 71 % in 2004 while exports to Israel declined from 97 % of total Palestinian exports in 1999 to 90% in 2004.

Notwithstanding the fact that the Palestinian dependence on the Israeli market is partly due to GoI security restrictions, the two economies remain very complementary with large potential gains from trading with one another. Israel is a $ 130 billion economy while WBG is a $ 5 billion economy. Thus, potentially, the WBG can benefit from large demand from the Israeli market. This is underpinned by favorable (to the WBG) structural transformation trends in the Israeli economy, which is withdrawing from labor intensive activities (textiles, garments, leather goods, construction material, agricultural products) in favor of more capital intensive, and higher technology fields. This provides the WBG with the opportunity to fill in the gap, provided it can be competitive with alternative sources of exports to Israel, particularly from Turkey, China and the Indian subcontinent.

The proximity of WBG producers to the Israeli market does offer many cost advantages to Israeli importers, provided transaction costs, which are now inflated by the closure regime, are reduced. It is assumed however that under our working assumption of a two state solution to the Palestinian Israeli conflict, these transaction costs would go down and Palestinian products would become more competitive. In addition, during the Oslo period, considerable border trade took place between the WBG and Israel across the green line, with substantial savings in packaging and transportation costs. Many of the traded products, particularly perishables, can be considered as non-tradable since they would not meet the strict specifications of the EU and other export markets and could not be exported abroad.

Palestinian exporters would also have greater access to markets abroad, both through Israeli ports but also through efficient transit routes across Jordan and Egypt and through its own seaport in Gaza. Nevertheless, while the dependency of WBG exporters on the Israeli market is likely to decline, it will still remain high, possibly around 50-60 % of their total exports.

The second largest export market for the WBG is expected to be the European Union (EU) which has established a free trade agreement with both the Palestinian Authority and GoI. A market which is larger than that of the United States provides great potential for WBG agricultural and tourism exports. While it is very competitive, it offers political good will, which has tended to accommodate WBG export increases. For instance, the European Commission has periodically raised quotas for Palestinian agricultural exports. It is the largest source of tourists to Palestinian holy sites, which under a resolution of conflict within the framework of a two state solution, would be expected to expand significantly. Because of the free trade agreements with Israel, Jordan and the WBG, there is also the possibility of cumulating value added between the three countries, thereby meeting minimum EC requirements.

Gulf Countries are also expected to become substantial buyers of Palestinian products in a peace environment. While these countries have a large purchasing power and their economies are complementary to that of the WBG, their markets are very competitive, with a strong presence of Turkey, and Arab countries such as Egypt, Jordan and Syria. However, demand for Palestinian products in non oil Arab Countries, particularly Jordan and Egypt is expected to be limited. These economies tend to be competitive with the WBG and have often used trade restrictions to protect their own competing production[9]. Consequently, there is only limited scope for expanding Palestinian exports to Arab neighboring countries. Under a separation scenario with Israel, even when assuming a free territorial link between the West Bank and Gaza, as well as a MFN trade regime between the two countries, some of the exports diverted away from Israel would have to be reoriented towards the EU a much more difficult and costly market.

Recommendation2. While export market diversification will occur under a two state solution, Israel should remain a major trading partner under an export driven growth strategy. Attempts at separation from Israel or the introduction of customs barriers will be costly in terms of exports foregone and will result in lower rates of economic growth.

7. Major export products

The Palestinian private sector has shown great resilience and adaptability under difficult circumstances to develop its production and broaden its range of exports. Major achievements were realized in exports of stone and marble, agricultural products, pharmaceuticals, processed foods, furniture and tourism. Internet and software technology has been recently developed and has shown scope for expansion. But the manufacturing sector has been repressed by denial of permits by GoI, destruction of plant and equipment during Israeli incursions, and denial of access to markets. As a result, the manufacturing sector only accounts for 13 % of GDP in the WBG whereas it should normally be in the range of 30% as in the case of manufacturing in Jordan. With the onset of peace between Israel and Palestine the manufacturing sector is bound to expand, and with it, export capacity.

However, a drive towards export expansion will have to overcome major constraints: the Palestinian firm structure tends to be small, undercapitalized and family oriented with cursory or inadequate accounting methods which typically do not qualify them for bank loans. Exporters will have to meet the standards and specifications of the importing countries, labeling and packaging will need to be upgraded and new instruments of financing and export guarantees will need to be established. The transition from family owned businesses to a corporate structure and the upgrading of export capacity will undoubtedly take time, the more so that major investments were undertaken during the Oslo period in manufacturing, on the assumption that the peace process was irreversible, only to be faced with a tighter closure regime and an intensification of conflict. Consequently, these investors have become risk-averse and are likely to await a firm and credible resolution to the Palestinian / Israeli conflict before venturing into new projects.

The many challenges facing the Palestinian manufacturing sector only underscores the importance of focusing on the rehabilitation of agriculture in the short run, as it can yield quick returns without major investments, provided movement and access to markets can be assured.

Reestablishing territorial contiguity will be critical in generating a dynamic export capacity in agriculture. The WBG have six climatic zones and the Jordan valley is the hub of agricultural production in the West Bank. The recent separation of the Jordan valley from the rest of the West Bank by GOI would be inconsistent with establishing a vibrant agricultural sector in the West Bank and economic viability for the WBG[10]. Similarly, the integration of the seam zone,-- i.e. the 10% of fertile West Bank territory between the separation barrier and the Green line—with the rest of the West Bank will be essential in the realization of the West Bank's full agricultural potential. The proximity of this land to Israeli territory makes it a natural source of exports to the Israeli market, as was the case prior to the erection of the separation barrier.

Gaza has different climatic zones than the West Bank and its production is complementary to that of the West Bank. Consequently, in addition to its exports of fruit and vegetables abroad, it is also expected to become a major exporter and importer of agricultural goods to and from the West Bank. This potential can only be realized with the establishment of a reliable transportation link between Gaza and the West Bank free from any interference. With the wage level lower in Gaza than in the West Bank the free movement of people would strengthen the competitiveness of the West Bank by moderating wage increases. Over time, the two economies would be integrated, with gains from trade and an overall increase in productivity.

Tourism is expected to be the main beneficiary from a termination of conflict between the Israel and Palestine. More than any other activity, the expansion in tourism will depend to a large extent on the freedom of movement between the two countries and free access to the various holy sites in Jerusalem, Bethlehem, Hebron and other cities in Israel and Palestine. The overall impact of an integrated approach to tourism between the two countries would be far greater than the sum of the parts. In any case, East Jerusalem would become the hub of tourism activity for the WBG as well as an anchor for Palestinian identity[11]. Without the pull of the economic and social activity emanating from East Jerusalem, the WBG would lose its major economic asset as well as its social and political identity.

Recmmendation3. Under an export oriented strategy to lead the Palestinian economy towards viability, the main exportable assets—agriculture and tourism—will require contiguity of Palestinian territory, integration of the Gaza and West Bank economies through a free transportation link and the integration of East Jerusalem in the Palestinian economy.

B. Getting from here to there: the building blocs of economic viability

1. Security

a. Establishing security in the WBG and in a Palestinian State

Establishing security and the rule of law in the WBG would be a first and essential building bloc of economic viability, not only for a future Palestinian state but also as a first step during the transition period, when moving from today's WBG to the future Palestinian state. Negotiations with Israel, establishing free movement of people and goods in the West Bank and moving away from conflict to cooperation with Israel, will require first and foremost for the Palestinian government getting a grip on security in areas under PA jurisdiction and establishing public order. Regaining credibility with donor countries and obtaining development assistance from them will also require the reestablishment of a secure environment in both the West Bank and in Gaza so that representatives of donor countries and international institutions can move about freely and focus on development and institution building.

There are many challenges facing this objective:

Establishing a sustainable unity government, taking control of armed militias, particularly in Gaza, disarming militia and clan members, eliminating rocket fire towards Israeli territory, and controlling Gaza's border with Egypt, particularly smuggling activity. This would entail integrating the Executive Force and the Presidential Guard into a coherent and sustainable security establishment in the WBG. These issues were debated in 2005 among members of the Wolfensohn team, the donor community particularly the US and UK, the PA and the Israeli authorities. In parallel, USSC under the Dayton team, with technical assistance towards the upgrading of Karni infrastructure and management, has elaborated a comprehensive security plan for the WBG.
The European Commission has also been discussing reforms of the civil police (EU-COPPS) and the possibility of financing it under the Temporary International Mechanism. Technical assistance in police training has been provided by Egypt, Jordan, the U.S. and Europe. EURO-COPPS has developed a blue print for police development over the next three years.

A lot of work has been done on most aspects of security and it is now an issue of political will on both the Palestinian and Israeli sides to establish an effective network.

A consensus was reached on the broad lines of a security reform as follows:

A national security system should be established which is effective, sustainable and accountable. To be effective it would need to have the capability of assessing and dealing with potential threats. To be sustainable it will require professional leadership, adequate incentives and, budgetary resources and protection from political upheavals. It also needs to be accountable by adhering to the rule of law, both domestic and international. It needs to be transparent and subject to judicial and legislative oversight.

A rational and effective national security governance would require the consolidation of the dozen existing security agencies into three: i) a national security force to protect Palestinian borders and territory, ii) an intelligence service to protect institutions against external threats and internal subversion and, iii) a law enforcement agency – a civil police—to enforce law and order, traffic, tax collection etc. These agencies should be under ministerial supervision (e-g. ministry of interior) and under judicial and legislative oversight. The judiciary would ensure that the national security decisions are legal and conform to human rights principles. The PLC should provide the legal framework for the activities of the security agencies as well as legislative oversight on their activities, compensation and benefits. These reforms have been discussed extensively within the PA governing structure but have never been implemented.[12]

Recommendation4. *Reform of WBG security apparatus is the first and foremost step in moving towards economic viability. PA and Presidential security forces should be consolidated into three agencies: national security, police and intelligence. They should operate under ministerial supervision and be subject to judicial and legislative oversight.*

A civil police force can be rapidly developed following the EU-COPPS program. This would also strengthen the judiciary by providing it with enforcement capability.

b. Coordination with Israeli Institutions

Under the export oriented strategy to attain economic viability for the WBG, trade will become the driving force of economic growth. The free access to foreign markets as well as the free flow of goods and people between Israel and the WBG will require a high degree of cooperation with the Israeli authorities, particularly on the security front.
An effective, though limited level of cooperation, has been recently achieved at the Karni crossing point, even under current conditions of high tension and conflict between the two sides. As a result, major progress has been attained at Karni between November 2006 and June 2007 in moving Palestinian exports out of Gaza and in receiving imports from the West Bank and Israel. Indeed, all of Gaza's agricultural exports destined to Israel or the West Bank have been shipped through Karni on a priority basis throughout the 06/07agricultural season, with minimal delays. This successful cooperation between the two sides can be attributed to three key elements:

i) The deployment of the Presidential Guard on the Gaza side of Karni coupled with an effective role played by the Palestinian Border Agency. Information on guards, border agency personnel and truck drivers (as well as truck license plates), their functions and background was communicated to the Israeli authorities who could express reservations on the presence of any member of the civilian or security personnel. Such cooperation provided the Israeli authorities with the necessary assurances that the Gaza side of Karni was secure and did not pose any threat to the Israeli side.

ii) The provision by the Palestinian border agency of timely information to the Israeli authorities on the goods being shipped and accompanying documentation, through electronic real time feed.

iii) The active involvement of a third party, namely in this case, members from the Dutch Representative office focusing on Gaza agricultural exports, and the US security presence at Karni (the Dayton team) who are facilitating the implementation of the Agreement on Movement and Access, (AMA). This third party played a critical role in coordinating between the Israeli and Palestinian authorities and resolving problems which have periodically arisen between the two sides.

This successful example of cooperation can be generalized and expanded to other border crossing points and to movement and access within the West Bank. Confidence building measures, such as a relaxation of movement and access within the West Bank and in and out of Jerusalem would provide a conducive environment for cooperation in the security field. Establishing a coordination mechanism between the two sides will be the key in attaining mutual security. The major elements of this coordination would be as follows:

- Transfer of information from the intelligence agency of each country to the other about the unfolding of a threat against either country in line with a crisis management model mutually established, and specifying the level of detail that needs to be provided, the type of response expected and a procedure detailing the mode of operation and potential sanctions.
- Security checks at border crossings would benefit from real time data and video feed to communicate the details about goods to be shipped, their destination, list of suppliers and drivers list and background of personnel on the two sides as well as customs detail and documentation.
- Establishing the necessary infrastructure of terminals, scanners screening compartments and computerized systems to process a high volume of trade and movement of people in an efficient manner.
- Establishing management systems on both sides to define various levels of responsibility and agencies in charge of checking and regulating the passage of people and goods, with the capacity of identifying problems and designing solutions
- Establishing a conflict resolution mechanism in case a disagreement occurs regarding the mode of operation, and a weekly schedule for meetings and progress reports

This process should guide the evolution from the current back to back system of shipping of goods to a door to door system and free movement of goods and people between the West Bank and Gaza.

Recommendation 5. *The successful pilot project in security coordination at Karni during November06/April07 should be built upon and expanded to other border crossing points. The key is to establish a management system and infrastructure on each side to share information on potential threats and to process the routine passage of goods and people in an effective way.*

A conflict resolution mechanism would be an essential element of this coordination system.

2. Trade Regimes

In an export driven growth strategy, the trade regime assumes a critical importance. A major objective of the trade regime would be to minimize transaction costs so as to maximize export competitiveness. Considering that Israel has been the largest trading partner for Palestine, it was rational for Palestinian negotiators of the Paris Protocol to enter into a Customs Union (CU) with Israel. The major advantage of the CU was that all Palestinian products could enter the Israeli market freely without the hindrance of border checks and custom duties[13]. Palestinian labor also had free access to the Israeli market. In return, the PA gave up the prerogative of setting its own external tariff and indirect taxes by adopting the Israeli taxes, tariff, and sanitary and industrial standards. In 1995 the Israeli tariff was quite protective of a number of industrial and agricultural sectors and was further reinforced by non-tariff barriers through the specification of technical standards for a large range of goods. In all likelihood this protective Israeli tariff was not optimal for Palestinian economic development in 1995, which would have required greater openness and lower protection. Nevertheless, Israel's trade liberalization and elimination of non tariff barriers under WTO rules, reduced the average Israeli tariff from 18% in 1995 to 6% in 2005, which is much closer to the external tariff which would be consistent with an open Palestinian economy[14]

While this may sound like a good model for the two complementary economies, particularly for the smaller one, the implementation was asymmetrical and damaging to Palestinian economic interests. Israeli goods destined to the WBG had free access to its market while Palestinian goods entering Israel or destined to foreign markets were increasingly restricted through security checks and discriminatory practices. Labor access to the Israeli market was also being increasingly restricted, particularly during the second Intifadah reducing access from 140,000 in 1999 to less than 20,000 in 2006. Nor was there a dispute resolution mechanism, to deal with day to day problems. In addition there were substantial leakages of tax revenues owed to the Palestinian side through indirect Palestinian imports from Israeli wholesalers[15]. Furthermore, in violation of the Paris Protocol, GoI froze the transfer of indirect tax revenue to the PA on three occasions for political reasons (in 1996, 2001 and in 2006), with the latest freeze still ongoing and crippling the PA's ability to function.

In moving towards the formation of a Palestinian State, a trade regime will have to be picked, consistent with achieving economic viability. There are basically three choices among alternative trade regimes: i) a modified Customs Union with Israel, ii) a low external tariff and a free trade agreement with Israel,(FTA) iii) a low external tariff a most favored nation (MFN) treatment of Israel.

- A modified Customs Union with Israel.

  Such an arrangement would require a high level of mutual trust and broad areas of collaboration.

  The first task of Palestinian decision makers in assessing the relative merits of this trade regime is to look closely at the Israeli tariff and technical standards to determine whether it is consistent with their vision of Palestinian economic development. Modifications to the tariff can be effected by expanding lists A1 and A2 or by introducing a new list. The tariff itself could be modified to accommodate Palestinian concerns, but considering that Israel would be the dominant partner, the room for maneuver in this respect would be limited. In any case, the customs envelope and labor movements applying to the two countries should be decided through joint negotiations and a collaborative effort.

  The second task for the decision makers would be to address the various failings and inadequacies of the arrangement's implementation. While the Palestinian experience with the CU arrangement with Israel has been intertwined with the consequences of conflict, a cessation of conflict may provide the opportunity for this trade regime to operate fully. Allowing free movement of people and goods within the customs envelope, ending any discriminatory practice against Palestinian products, compensating the Palestinian Treasury for any revenue leaks and establishing a joint management system and conflict resolution mechanism would be some of the key policy areas which would need to be addressed.

To the extent that these issues can be resolved, a modified customs union arrangement with Israel would have two major advantages: It would allow Palestinian goods and services to be sold in the Israeli market without going through an economic barrier of checks on the origin of goods and customs payments. The second advantage pertains to the labor market, where Palestinian labor should be allowed to seek employment in the Israeli market. This would be particularly important during the first decade after the establishment of a Palestinian State, when the Palestinian economic structure would be gradually building its productive and job creating capacity, but would still be dependent for employment on the Israeli market.

- Free trade agreement with Israel

Under this trade regime each country would have its own external tariff and technical standards but would allow their own goods to be freely traded in the other country's market. However, this regime would require a physical border and the ability to monitor trade flows.

Authorities on either side of the border would have to check for the origin of the traded goods to determine whether they would be exempted from custom duties or not and charge customs as well as indirect taxes on goods originating from third countries. Thus, Palestinian exports to Israel would have to be accompanied by a certificate of origin to ascertain that the good was produced in Palestine and that it has a minimum level of value added acceptable to both countries, thereby exempting the good from custom duties. However, even if it meets these requirements it would still be subject to Israel's VAT and any additional excises. Furthermore, some commodities may not be allowed in Israel altogether. If Gaza were to allow live animal and fruit and vegetables imports from Egypt, Gaza's agricultural exports Israel would be banned unless Phytosanitary and biological tests are undertaken in Gaza[16] to the satisfaction of the Israeli authorities, to ensure that pests or diseases imported from Egypt are not transmitted to Israel.

Furthermore, Palestinian labor would not be free to seek employment in Israel, unless a special agreement is reached on labor flows

The main advantage of this arrangement is that it would allow the Palestinian state to set its own external tariff and indirect taxes as well as collect its own taxes. However, from the perspective of an export driven growth strategy, it would reduce overall exports because of the higher transaction costs associated with border checks, production of certificate of origin and customs collection. From a fiscal perspective, and to the extent that the Palestinian indirect tax collection system would be less efficient than the Israeli tax collection system, a fall in tax revenue may result from the introduction of this arrangement.

- MFN agreement, under a separation scenario with Israel

  When Palestine becomes a member of the WTO it would be able to enter into a MFN agreement with Israel[17]. All Palestinian goods exported to Israel would be subject to the Israeli custom tariff, with the possibility of some exemptions which would be mutually negotiated. This is the least preferential of the three trade regimes, and would further reduce Palestinian exports, since most of its exports to Israel would be subject to customs duties.

Recommendation 6. Consistent with an export driven growth strategy, and provided the various issues associated with the implementation of the CU with Israel are addressed, a modified Customs Union arrangement with Israel would be the most appropriate trade regime for Palestine.

3. Border crossings.

The lifeline of an export driven growth strategy is efficient access to foreign markets. Transportation and transaction costs leading to these markets need to be minimized for the export products to be competitive. Consequently, border crossings and open access to markets become critical factors in the competitiveness equation. The on-going conflict between Israel and Palestine, with over 500 barriers and checkpoints within the West Bank and the channeling of all Gaza exports through a single border crossing controlled by Israel at Karni, has been particularly detrimental to Palestinian exports which have declined by 40% since their peak in 1999.

Over the last two years, efforts at reviving the Palestinian economy, focused on facilitating movement of people and trade across border crossings and the dismantling of the closure system in the West Bank. World Bank analysis leading up to the disengagement from Gaza, the work of the Quartet special envoy office, coupled with IMF work on border management within the customs envelope have contributed to the Agreement on Movement and Access of November 15, 2005. This agreement established several operational principles.

- Border crossings must operate continuously. This in turn has led to the principle of redundancy. Thus, if a passage is closed for security reasons, another passage should be available to process trade.
- Border crossings must be upgraded in terms of infrastructure and scanning equipment to allow for a much higher flow of trade which can meet demand. "Capacity should follow demand and not vice versa"[18]. This approach requires the use of a new generation of scanners which can scan trailers without unloading the goods (6 and 9 MeV scanners). With the upgrading of capacity at Karni the AMA set a target of 400 trucks of Gaza exports per day (tpd) by end 2006 (from 43 tpd before disengagement and 18 tpd in October 2005). When capacity reaches demand the bidding process for slots at Karni, which raises transportation costs considerably, will disappear.

- Establishing unified border management agencies on both sides. This has led to the establishment of a Palestinian Border Service Agency
- Establishing a security mechanism on the Palestinian side to coordinate with the Israeli side
- Facilitating the movement of people and goods in the West Bank and establishing similar arrangements to Karni to make West Bank passages fully operational
- Establishing a transportation link between the West Bank and Gaza with a view to integrating the two economies. This link would be initially served by bus and truck convoys
- Setting up Rafah under Palestinian Authority jurisdiction as the only border crossing between Egypt and Palestine. It will continue to apply the Paris Protocol of April 29 1994 under third party supervision and will be used for exports. Cars would also be allowed in and out of Rafah under strict inspection criteria. Imports from Egypt would be initially channeled through Kerem Shalom and processed by PA customs officials under GoI supervision. Once the training of PA officials is completed to the satisfaction of the third party, imports to Gaza from Egypt would shift to Rafah.
- Constructing a seaport in Gaza and reactivating the airport

This agreement has been a breakthrough, on paper at least, as it established benchmarks for the free movement of people and trade, consistent with Israeli security concerns and with achieving economic viability through an export oriented growth strategy. However it has been largely left without implementation by GoI, partly due to the boycott of the Hamas government after the January 29, 2006 elections. Nevertheless, a few provisions have been implemented:

- Rafah has been opened under PA jurisdiction and 3d party supervision for the movement of people. However it remains under the control of GoI which has elected to close Rafah 90 % of the time over the last year by denying entry through Kerem Shalom to the EU BAM observers. Neither exports through Rafah, nor movement of cars or imports from Egypt through Kerem Shalom have been implemented
- A Palestinian border agency has been established, ostensibly under the jurisdiction of the Ministry of Economy, but in effect, operating on its own.
- Security on the Palestinian side of Karni has been established with the deployment of the Presidential Guard. Close coordination with the Israeli side has also been established, allowing for Gaza agricultural exports during the 2006/07 season to move through Karni unhindered. Karni was able to increase its through put of Gaza exports from 363 trucks in October 2006 to 668 trucks of exports in March 2007[19]
- Karni's throughput capacity has been upgraded, and a second night shift has been introduced.
- A terminal dedicated to agricultural exports has been established in the West Bank—Bardalah—greatly facilitating exports from the Jordan Valley to the Israeli market and abroad.

On the negative side the situation in the West Bank has deteriorated markedly, with a 40% increase in checkpoints and barriers, a tightening of the closure and permit system and the division of the west Bank into three zones causing internal movements for Palestinians within the West Bank to be much more difficult and further undermining the viability of internal and external markets. A recent World Bank report has warned of the disastrous economic and humanitarian consequences of this policy[20]

The situation in Gaza has deteriorated significantly with loss of control by the PA and security services on various armed factions, and on establishing law and order. Nothing can be implemented in Gaza unless the PA demonstrates that it can control faction behavior and ensure overall security. Similarly, PA security must be able to control militia behavior in the WBG, particularly in Nablus and Jenin. Once the situation in Gaza and the West Bank is stabilized, moving the Palestinian economy towards viability would require, as a first step, to fully implement all the provisions of the AMA:

Recommendation 7. Implementation of the AMA provisions:

a) Allowing Gaza exports through Rafah[21]
b) Allowing the movement of cars in and out of Rafah in line with the AMA criteria[22]
c) Allowing imports from Egypt to Gaza through Kerem Shalom over a 12 months period, to be cleared by Palestinian Customs officials, under the supervision of Israeli customs agents
d) Shift Gaza imports from Egypt through Rafah after twelve months, provided EU-BAM observers deem PA's custom capacity to be ready for custom clearance.
e) Provision of technical assistance by EU-BAM to PA customs officials on custom clearance and border management
f) Establish a transportation link between Gaza and the West Bank through bus and truck convoys
g) Start construction of a seaport and move towards agreement with GoI on reactivating the airport
h) Facilitate movement and access within the West Bank by dismantling the closure system, consistent with maintaining Israeli security

In addition to the execution of AMA provisions which have not been implemented, there are a number of areas which the AMA did not specifically address, while pointing to the direction of reforms.

Recommendation 8.

- *Provide secure lodging quarters for EU-BAM observers in Gaza so that they can access their work stations at the Rafah border crossing without having to go through Israeli territory*

- *Extend the Karni management system to Eretz, Tulkarem and Tarqumiya.*

- *Upgrade the Allemby border crossing to international standards to facilitate Palestinian exports to Jordan*

- *Create a new terminal in southern Gaza dedicated to agricultural production*

- *Strengthen the Palestinian border authority with clear lines of authority and supervision with the ministry of economy. It also needs to establish strong working relationship with the PA's intelligence and security agencies.*

- *Establish a clear schedule of border fees and charges at all crossing points to eliminate corruption*

- *Publish Service Standards and Operational Procedures for all border crossings, with monthly updates.*

  Establish a joint crisis management system and a joint conflict resolution mechanism

3. Fostering an investor friendly environment.

An export oriented strategy for high growth and job creation will have to rely heavily on a rebound in investment to provide adequate infrastructure to meet future demand, to replace existing plant and machinery, which have become antiquated through years of economic repression, and to create new capacity both in export sectors and import substituting activities which will gain a boost from higher income and higher demand. All this will require a large degree of cooperation with Israel, Jordan and Egypt as well as a constructive relation between the Palestinian government, civil society and the business community.

The key to higher growth and job creation, after establishing security and law and order, is attracting foreign and domestic investment by establishing a friendly environment for investors. Economic development experience as well as the new growth theory has pointed to several factors which are all necessary to achieve a critical mass of conditions for a sustained economic take off. In the case of Palestine the challenge will be twice as difficult because of the lack of trust between the two sides and the history of conflict. Nevertheless it is worthwhile underscoring the following areas:

a) Promoting regional projects

One of the most powerful signals to investors occurs when two governments, hitherto in a state of conflict, undertake joint projects. Given the small areas of Israel, WBG and Jordan joint infrastructure projects are particularly appropriate, because of the large economies of scale involved. There are several possibilities

- Energy

Israel and the WBG have some of the highest energy prices in the world. A key factor in boosting export competitiveness in the WBG, particularly agriculture, would be to lower the price of energy. Exploiting the Gas reserves offshore from Gaza would not be cost effective, if only Gaza were to buy the output. Instead the market would dictate that it should serve both the Israeli and Palestinian markets, while at the same time obtaining gas from Egypt. This would be particularly important with the growing shortage of water and the need to rely on energy intensive desalination technology. Thus, gas can be a substitute for more expensive and more polluting coal and fuel. Some bilateral agreements on gas sales have already been reached between Israel, Egypt and the WBG. The next step would be offshore gas exploitation and sharing.

Similarly, there are major advantages at integrating the electricity grids of Jordan, Israel and Egypt. This would minimize loss of electricity by shortening high tension lines and provide a more rational allocation. Jordan is already providing electricity to the Jordan Valley in the West Bank and such joint projects are likely to expand. The first priority here is to rehabilitate the electricity sector in Gaza, where capacity is inadequate and losses of electricity are high due to a shortage of transformer stations and illegal hookups to the grid by residences and businesses. The PA is losing over $ 300 million per month of uncollected utility charges particularly electricity in Gaza. Therefore it is essential to establish an effective system of collecting electricity charges throughout the West Bank and Gaza.

- Environmental projects

The gradual drying up of the Dead Sea requires joint action by Israel, Jordan and Palestine. A concrete project to join the Red Sea with the Dead Sea is being discussed by Jordan and Israel

- Water

The growing shortage of water in Israel, Jordan and the WBG will require large desalination projects which benefit from economies of scale or water channels from Egypt or Turkey under regional agreements and financing

Recommendation 9. Progress needs to be made on the offshore Gas project in Gaza through a tripartite agreement among BP, Israel Electric and the Egyptian government to ensure supplies of gas to Gaza and to the Israeli market. Until this project is completed, priority should be given to the rehabilitation of electricity supply in Gaza by increasing transformer capacity and higher electricity purchases from Israel Electric. The PA should establish, with donor country technical assistance, an effective system for collection of electricity charges in the WBG

b) Job creation.

Following the conclusion of a peace agreement with Israel, a surge in investment and job creation is likely to occur. Export capacity will build up gradually but is likely to take at least a decade until it can fully absorb the influx of new entrants into the job market and significantly reduce unemployment. Until such productive capacity is attained, short term measures will have to be taken to provide jobs, which should be viewed as a major investment in political stability and security. Three major job creation avenues should be pursued:

- Expanding Palestinian employment in Israel. While it is not expected that such employment would reach the levels attained in 1999 (140,000), allowing even half this level would pump substantial purchasing power in the WBG with multiplier effects on domestic demand (for both Palestinian and Israeli goods) which will generate additional jobs.
- Promoting low income housing projects in Gaza and the West Bank. Such projects are both directly labor intensive and also intensive in locally produced material which are also labor intensive. They can be partly financed by donor countries and partly by the housing beneficiaries themselves through long term mortgage loans.
- Supporting the agricultural sector. This sector which has the strongest comparative advantage in the WBG has been egregiously neglected by both the occupation authorities and by the PA, resulting in a rural exodus. Lack of infrastructure, particularly rural roads, irrigation networks, and storage facilities has lowered productivity and increased costs. Lack of extension services by the PA such as seed selection, veterinary services, and marketing guidance has stymied agricultural exports. Focusing immediately on providing the sector with all the infrastructure and institutional support it needs, would result in a major employment surge in the sector

Recommendation 10. Following a peace agreement with Israel, it will be essential to establish a peace dividend with the Palestinian population by creating new jobs. The agreement should provide for an expansion of Palestinian employment in Israel, supplemented by large scale low income housing projects and a rehabilitation of the Palestinian agricultural sector.

c) Establishing the rule of law

An attractive investor environment requires a legislative, legal and regulatory framework which supports the functioning of a free market economy and protects it. Investors would want a legal framework which is able to rule effectively and impartially on contractual and commercial disputes. In turn, this requires an independent judiciary, which can resist political pressures and enforce competitive behavior and rule on contractual disputes. Consumer protection needs to be fully established through full disclosure of ingredients in labeling and in dating both production and consumption.

Enforcement of court decisions, repossession of assets under bankruptcy proceedings and effective pursuit of criminal behavior are the three “failure areas” cited by investor surveys. They are all linked to the lack of enforcement capacity in the Palestinian judiciary.

The passage of laws by the legislature must also be consistent with the principles of the free market. Thus, a constitutional court is required to ensure that laws passed by the PLC do not violate the Basic Law.

In all these areas, judicial reform in Palestine has along way to go. The most pressing problems are:

- Large backlog of cases
- 85% of detainees are not prosecuted, with most detainees held beyond six months, due to lack of sentencing
- No specialized criminal court
- Inadequate capacity to enforce court decisions, partly due to lack of overall security and barriers to movement within the West Bank
- Court adjournments and delays seem to be the norm rather than the exception
- Office of the public prosecutor is weak
- Shortage of judges and professional standards
- No judicial oversight or accountability
- No judicial police

There is currently a Primary Action Plan emanating from the Chief Justice Office under discussion. However, it is only a first step in a needed comprehensive judicial reform.

Recommendation 11. (Hiba, you can fill this one in)

d) Promoting higher productivity and competitiveness

Palestinian products have been losing their ability to compete in the Israeli and other export markets for several reasons.

- Employment of Palestinian workers in Israel has raised the wage level in the WBG, which stands substantially above wages in Jordan or in Egypt. This may have adverse consequences in the textiles and garment industries where Israeli manufacturers may find it more economical to subcontract their labor intensive tasks to Egyptian or Jordanian manufacturers.
- During the second Intifadah, the skill structure of Palestinian workers has deteriorated, partly due to out migration of highly skilled workers to Gulf and other countries, and partly due to the deterioration in education levels.
- Because of continuous conflict and Israel's closure policies, Palestinian manufacturers did not invest in upgrading their physical capital, allowing it to deteriorate and become archaic.

As a result, both labor and capital productivity have declined.

- Neglect of infrastructure, particularly roads and transportation has further reduced productivity and competitiveness, particularly in manufacturing.
- Remittances from Palestinian workers abroad, as well as net transfers from the Palestinian Diasporas and from donor countries have raised Palestinian consumption levels substantially above their production[23]. This has tended to appreciate the real

exchange rate, which favors the production of services rather than exports and the consumption of imports rather than the production of import substitutes.

Recommendation 12. *An export oriented growth strategy will have to improve competitiveness and raise both labor and capital productivity by addressing the issues mentioned above. Efforts will need to focus on several areas:*

- *Education reform. This should be the most important objective of public policy. In addition to the improvement of overall quality, the education curriculum will have to be reoriented towards subject matters and skills which are in demand. This would need to be supplemented by vocational and technical schools and adult education to upgrade the skills of the labor force.*
- *Investment in infrastructure. Here the priority would be to lower energy and transportation costs. Investment in electricity generation and distribution, enforcement of collection of electricity charges, and improvement of the road networks in both the West Bank and Gaza would be essential in lowering production costs and raising productivity*
- *Replacement of capital equipment. An end to the conflict with Israel and a rebound in economic activity will provide manufacturers with an incentive to renew and upgrade their fixed capital. Nevertheless, public policy may want to provide tax incentives to accelerate this trend and the banking system would need to provide financing instruments to facilitate the acquisition of new capital equipment.*
- *Pursue a flexible exchange rate policy. Addressing the overvaluation of the real exchange rate is best pursued by measures which would raise the productivity of capital and labor. Nevertheless, a flexible exchange rate policy for the Palestinian currency would be essential to prevent its appreciation with respect to the Israeli Shekel. This would argue for the Palestinian Monetary Authority to become a Central Bank with a flexible exchange rate policy rather than a currency Board with a fixed rate of exchange*

These policies would need to be accompanied by institutionalizing a stable and free market environment.

Among the supporting policies one would emphasize a conservative fiscal policy to maintain inflation within acceptable margins (2-3%), a strong Competition Law which protects the public against monopolistic practices, transparency in public policy to prevent corruption and encourage public debate, and strong judicial and legislative oversight to guard against conflict of interest among public officials. Finally the Palestinian government will need to establish an effective social safety net to ensure that everyone will benefit from the rebound in economic activity and to engage all segments of the population in the peace process.

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[1] "Building a Successful Palestinian State". The Rand Palestinian State Study Team. The Rand corporation, 2005

[2] "West Bank and Gaza: Economic Performance Under Conflict Conditions" Bennett and Nashashibi, IMF, 2003

[3] Bosnia achieved an annual rate of growth of 9.1% between 1997 and 2006. World Bank

[4] Rand, op.cit and World Bank: "Stagnation or Revival ?" December 2004

[5] This policy was tainted however by monopolistic practices pursued by the PA in the cement and petroleum product fields.

[6] While all Israeli goods were allowed freely in the WBG, accounting for 90% of its imports, Palestinian goods and labor faced a multiplicity of restrictions in the Israeli market, mostly due to trade and labor barriers, resulting in much higher transaction costs for Palestinian goods.

[7] WBG Country Economic Memorandum, World Bank, September 2006

[8] See WB CEM, op. cit. volume 1 p41

[9] Palestinian attempts at exporting olive oil and fruit and vegetables to Jordan were met with quantitative restrictions.

[10]"Planning Considerations for International Involvement in the Palestinian Security Sector, Strategic Assessment Initiative July 2005

[11] It is assumed that East Jerusalem would remain united physically, but divided politically with each country exercising sovereignty on its areas.

[12] President Arafat signed a decree on July 17 2004 calling for a consolidation and unification of security forces, and President Abbas also issued a decree on April 14, 2005 calling for a unification of security forces.

[13] Excluding a small list of products originating from Arab and Moslem countries specified in lists A1 and A2.

[14] Trade regime papers for the WBG presented in the London seminar in 2005 at the London School of Economics proposed a flat tariff of 5% on all goods.

[15] For a full discussion of the Customs Union with Israel see: "Evaluating the Paris Protocol" European Commission July 1999

[16] Such testing facilities and certified laboratories are not available in Gaza.

[17] The PLO expressed the intention of joining the WTO in 2005. However, until Palestine becomes a member, Israel will need to obtain WTO authorization to strike a MFN arrangement with Palestine, as it has done with Jordan which is still not a member.

[18] "Managing Transit Trade Across Borders", October 30, 2005 Quartet Special Envoy Office October 2005.

[19] UNSCO Socio Economic Report- April 2007

[20] Agreed Principles for Rafah Crossings. Annex to AMA, November 2005

[21] See " Potential Alternatives for Palestinian Trade: Developing the Rafah Corridor" World Bank, March 21 2007

[22] "Agreed Principles for Rafah Crossing" Annex to the Agreement on Movement and Access, November 15, 2005

[23] Gross disposable income (GDI) in Palestine is about 20% higher than Gross Domestic Product (GDP)