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occupation: continuity and change in  
Israeli policy towards the Palestinian  
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**United Nations Conference on Trade and Development**

**The economic dimensions of prolonged occupation:  
Continuity and change in Israeli policy towards  
the Palestinian economy**

*A special report commemorating twenty-five years of UNCTAD's  
programme of assistance to the Palestinian people*

**Raja Khalidi and Sahar Taghdisi-Rad\***

August 2009

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## ***Key messages***

“The definition of insanity is doing the same thing over and over again expecting different results.” Benjamin Franklin (and Albert Einstein)

- There is no Israeli economic policy towards the Palestinian people or the occupied territory; rather there is a policy to maintain occupation and administration of the Palestinian territory by whatever means available, including economic strategies;
- Israeli strategies deployed since 1967 have included economic inducements to improve the quality of life, devolution, and other schemes focused on promoting individual welfare but not preventing communal poverty;
- The Oslo Accords and the Paris Protocol on Economic Relations (PER) of 1994 formalized the de facto customs union in operation under occupation and locked in the adverse path of dependence of the Palestinian economy upon Israel;
- Palestinian Authority institutions have been unable to establish sovereign or even autonomous institutions capable of expanding the space for economic policymaking and for economic policies promoting long-term development;
- The effects of Israel’s dual strategy of skewed economic integration coupled with physical separation has led, over forty years, to divergence in per capita incomes between Israel and the territory, rather than the convergence promised by economic theory and the premises of the customs union;
- Instead of continuing to repeatedly reform the facades of interim self-government, all efforts should aim to form the sovereign institutions for statehood;
- New Israeli overtures under the heading of “economic peace” risk not only diverting attention from political processes, but also hark back to an era of Israeli domination of the Palestinian economy, which demonstrably failed;
- Though the PER may have outlived its design and usefulness, it can only be superseded if a fundamentally different framework is envisaged, rooted in ensuring Palestinian sovereignty, statehood and economic viability;
- A Palestinian economic strategy for sovereignty and peace would entail seeking recognition of the Palestinian economy as a separate customs territory, and would become the reference point for formulation of economic policy, institution-building, decision-making, and international economic relations;
- Such a status would offer a platform for building a viable, vibrant and secure national economy for the envisioned State of Palestine, governed by a framework which adheres, among other principles, to the multilateral rules and disciplines embodied in the World Trade Organization;
- Only through a Palestinian economic policy framework that is predicated on the separate, internationally recognized status of the economy of the occupied territory, which in turn helps to create the conditions to end occupation, can a viable Palestinian economy and a sovereign State emerge to deliver the promise of peace.



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## I. Occupation, sovereignty and development

UNCTAD's Accra Accord of 2008 advocated sustained assistance to the Palestinian people, not only to reduce the negative impact of economic and social adversity in the Palestinian territory, but "with a view to creating the conditions conducive to building a sovereign and viable Palestinian State" (para. 44).<sup>1</sup> This commitment, reflecting an unprecedented global consensus on the need for a two-state solution, recognizes that the realization of such conditions has been undermined over past decades by the dynamics of conflict and the lasting legacy of a prolonged occupation. Indeed, the very economic, territorial and institutional policies needed to continue occupation are those which perpetuate conditions not at all conducive to Palestinian sovereignty and statehood.

The policy measures of successive Israeli governments towards the Palestinian economy have been the overriding determinants of Palestinian economic performance and developmental prospects. Since 1967, these have evolved from aiming to integrate Palestinian economic resources (especially land, water and labour) into Israel's "mainland" economy, to acting to marginalize and isolate the economy and markets of the Occupied Palestinian Territory. Whether by unilateral action or through economic and political agreements with Palestinian partners, this has contributed to a diminishing Palestinian economic and productive base. This has been accompanied more recently by stripping the putative Palestinian government and institutions of any means to expand or even sustain its policy space and attain control over its sovereign affairs. It is in this context that the early 2009 announcement of "economic peace" initiatives by the most recent Israeli government should be analyzed.

In 2009, as the envisioned viable and vibrant Palestinian state is again on the international agenda, concerned economic policymakers can benefit from a candid assessment of how prolonged occupation – and the economic strategies associated with it – have been an obstacle to such a solution. In whatever form a new offer of Israeli economic liberalization towards the Palestinian economy might come, as long as it is not underpinned by the establishment of sovereign Palestinian economic institutions and adequate national economic policy space, its impact will ultimately prolong and deepen occupation.

Drawing on the findings of UNCTAD's annual reports since 1985 on the Palestinian economy under occupation, this review examines whether the "new" Israeli "economic peace" initiatives differ in essence from previous Israeli strategies towards the economy of the Occupied Palestinian Territory. A coherent argument emerges, which, firstly, highlights a strong continuity in Israeli policy affecting the economy of the Occupied Palestinian Territory (despite the changing strategies deployed). Secondly, this analysis calls for a bold departure from conventional "Palestinian economic policy wisdom", which has left unchallenged the context, frameworks and policies of occupation, and which has advanced economic policy prescriptions oblivious to the impact of prolonged conflict. An alternative policy framework is needed, which recognizes the realities of the Palestinian economy and of what has been learnt of the uncomfortable truths about the incompatibility between occupation and development.

A careful review of the dynamics over time of Israeli–Palestinian economic relations, the corresponding policy framework, and the institutional arrangements designed to manage those relations, reveals that policy and regulatory reform to date has not tackled the core weakness arising from prolonged and continuing occupation. While the Palestinian Authority has acquired the attributes of an interim self-governing authority, the key to successful economic management

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<sup>1</sup> UNCTAD, 2008.



consistent with independence and statehood – sovereignty – remains off the agenda. Meanwhile, the economic policymaking space that is needed to ensure viability – Palestinian national economic security – has yet to be marshalled.

## **II. Israeli policies towards the Palestinian economy in the 1980s<sup>2</sup>**

For four decades, Israel's relations with the occupied territory have been managed by the Israel Defense Forces. In 1967, its "Civil Administration" (currently, the Coordinator of Government Affairs in the Territories (COGAT)) assumed authority for Palestinian economic, political and institutional affairs, some of which have since devolved into the Palestinian Authority. Many of the policies and regulations issued by the Civil Administration until the early 1980s directly concerned Palestinian economic affairs such as taxation, customs, banking, money and insurance, agriculture, industry and crafts, land and water, labour and other resources. The regulations devised in these areas were intended to ensure harmony with Israeli regional and international policy concerns, as summed up by the official stance that in the territories "there will be no development initiated by the Israeli Government, and no permits will be given for expanding agriculture or industry, which may compete with the State of Israel."<sup>3</sup>

### ***A. The careful integrationism of the early 1980s***

Israeli policy towards the economy of the Occupied Palestinian Territory until this period featured a careful integrationist strategy which deprived Palestinians of central requirements for independent economic development, particularly in the form of the free operation of endogenous development capacities and authorities. Israeli policies in this period were based on the three premises of maintaining minimum order in the economic affairs of the occupied territory, not committing to advancing its economic interests, and ensuring that the regulation of economic activity corresponded to the general pattern of relevant policy and legislation in Israel.

The result of this deliberate "integrationism" was increased vulnerability of the Palestinian economy to Israeli economic and political trends. For example, the 1986 recession in the Israeli economy, combined with the Government's austerity programme which aimed to increase wage and price controls inside Israel, had direct and dire consequences for the Palestinian labour market, social expenditure, and living conditions. This was particularly the case given the lack of domestic Palestinian institutions that could regulate the effect of these external factors.

Despite the "open bridges" policy pursued from the beginning of the occupation (allowing Palestinian exports to Arab and regional countries over the Jordan River bridges), the large number of obstacles related to customs, transportation and infrastructure prevented it from stimulating Palestinian trade with non-Israeli partners. Israeli-Palestinian trade relations were dominated by much higher levels of Israeli exports to the Occupied Palestinian Territory, while Palestinian agriculture and manufacturing remained focused on low value-added, uncompetitive, labour-intensive production processes. During this time, terms of trade were not defined by the market, but by the exigencies of Israeli economic activity and the extent to which Palestinian production conformed to that.

The phenomenon of Israeli firms subcontracting work to the Palestinian labour-surplus economy for re-export to Israel and beyond, which emerged in the 1980s, has since become one of the main features of Israeli-Palestinian trade and economic relations. Such economic relations had minimal spillover effects on the local Palestinian economy and productive capacity, as

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<sup>2</sup> The discussions and information in this section draw on the UNCTAD reports published since 1986. See the references section.

<sup>3</sup> UNCTAD, 1986.

subcontracting shifted from one branch to another in line with the changing trade dynamism of a liberalizing Israeli economy, while technology transfer was minimal.

A major missing element in this pre-Oslo period was the existence of any Palestinian authority to assess the socio-economic needs of the territory or to institute the relevant policies. During these years of direct military governance, the population under occupation was not given the space or freedom to entertain a reasonable level of control over its own economic affairs. This was the case despite the fact that Jordan unilaterally severed all legal and administrative ties with the West Bank in 1988, creating a vacuum that needed to be filled. As a result, in a manner that aimed to pre-empt Palestinian demands for institutional and political independence, the Israeli strategy throughout the 1980s – actively supported and funded by the United States – was conducted under the theme of “improving the quality of life”, which aimed at “permitting personal prosperity but forcibly restraining communal development.”<sup>4</sup>

### ***B. The mirage of power-sharing: “condominium” and “devolution” in the mid-1980s***

This overall strategy was proposed through various power-sharing arrangements under elaborate schemes announced and partially implemented by the Israeli authorities, such as “condominium” and “devolution”. The former referred to a sort of “shared autonomy” in parts of the occupied territory, with the engagement of regional actors, so that responsibility for internal affairs, health, sanitation and social services could be passed on to local authorities while essential resources/areas remained under Israeli control. “Devolution” implied giving local inhabitants some degree of self-governance through measures such as a new banking system and land classification. In all such schemes, the crucial aspect of economic development and territorial planning remained the prerogative of the occupying power, with no local influences and interests brought to bear upon that process. In this period, the Civil Administration also sponsored initiatives such as the “Village Leagues” – groups of local Palestinian community figures working together with the authorities to maintain order, deliver services and manage other local authority affairs. The distorted vision of development under occupation that guided Israeli policy towards the Palestinian economy ensured a cost-free, selective integration of the Palestinian infrastructure and economy to that of Israel.

This integrationist policy was aimed at projecting a notion of Palestinian autonomy, while effectively undermining even the simplest forms of self-government by measures on the ground such as the closure of all Palestinian banks (until 1994). Such a position deprived the economy of a dependable indigenous mechanism for financial intermediation, turning it into Israel’s largest export market until recently, while obliging Palestinian workers to seek employment in Israel. Such institutional constraints not only increased the Palestinian economy’s structural vulnerability to trends in the Israeli economy, but also handicapped its capacity for managing independent economic development and policymaking.

Various sectors of the Palestinian economy suffered as a result of Israeli settlement policies, which began to accelerate in this phase. In 1987, there were 150 non-military Israeli settlements in the West Bank and Gaza with a total population of 52,000 (excluding East Jerusalem).<sup>5</sup> The increase in settlements over the years had already reduced the cultivated area in the Palestinian territory from 36 per cent of total land area in the West Bank in 1966 to 27 per cent in 1984, and from 55 percent in 1966 to 28 per cent in 1985 in the Gaza Strip. Palestinian industry suffered as a result of the competitiveness from the highly subsidized Israeli industries, many of which were now also in very close proximity to the Israeli settlements in the territory. During this time, Israeli strategies focused on attracting Israeli industry and labour to settlements

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<sup>4</sup> Shadid, 1988.

<sup>5</sup> UNCTAD, 1987.

in the occupied territory, as the new frontier or “hinterland”, through the provision of public investment and concessional tax and credit facilities to Israeli enterprises operating there, while, at the same time, dispersing Palestinian industry outside urban centres. In 1987, the Civil Administration also increased the maximum income tax in the territory, and imposed new taxes to increase government revenue and to align the tax system to that of Israel. The tax system was subject to numerous military orders and proclamations over time: in 1987 alone it was subject to 177.

An enduring feature of the relationship of the occupied territory to the governing power has been the leakage of its resources to the Israeli economy, whereby most of the value added of the Palestinian economy would return to Israel in various forms, such as income, production, and value added tax and other transfers (duties, fees, fines). These trebled between 1978 and 1984, with the proportion of Palestinian gross national product (GNP) transferred to Israel through taxation alone rising from 6 per cent in 1978 to 12 per cent in 1984. For example, the amount of tax transferred to Israel in 1984 was equivalent to 46 per cent of gross factor income from employment in Israel, 16 per cent of gross domestic product (GDP), and more than double of all private transfers (remittances and aid) received from abroad.

The lack of an indigenous banking system had a dampening effect on many sectors of the Palestinian economy until 1994 – especially agriculture and the small private sector – and acted as a disincentive for entrepreneurs, while at the same time limiting productive investment opportunities. This encouraged capital flight or increasing reliance on external financial support. In the labour market, few new productive employment opportunities were being created in this period, resulting in a flight of labour from the declining and financially-deprived Palestinian traditional sectors, deprived of funding, to the labour-intensive Israeli economy. Hence, this period witnessed the neglect of the Palestinian productive sector, while aligning Palestinian aggregate demand to Israeli consumption and production needs.

### ***C. The first intifada, 1988: emergence of indigenous Palestinian economic initiatives and Israel’s selective integration strategies***

During the first intifada, Palestinians in the occupied territory pioneered a number of initiatives and measures aimed at reducing economic dependence on the Israeli economy. These measures included encouraging the boycotting of Israeli goods and jobs in Israel, promoting consumption of “national products”, encouraging a return to land and agriculture, and the generation of employment opportunities in local communities to compensate for job losses in Israel. This was the first time that an indigenous agenda was being elaborated for the Palestinian economy as part of a movement of national self-determination.

In response, Israel first tightened its dual policy of security measures combined with administrative and economic measures to “bring the level of violence in areas down to a minimum in a matter of weeks.”<sup>6</sup> However, this “semi economic war of attrition” was intended not only to contain the street clashes, but also to exert economic pressure on the inhabitants in order to reduce their ability to “resist”.<sup>7</sup>

During this time, the Palestinian labour market continued to suffer from a high level of inflation in the Israeli economy, which was channelled through rising wages in the Israeli

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<sup>6</sup> UNCTAD, 1988.

<sup>7</sup> These Israeli measures included: preventing food convoys from entering areas under curfew; bans on fuel oil and petrol deliveries; interruptions to electricity and water supplies to some Palestinian towns and villages; restrictions on the movement of people and goods between the West Bank and Gaza Strip and on exports from areas of unrest; arrest of Palestinian merchants for violation of military orders to remain open at hours specified by the military; and withholding identity cards, important export licences and travel permits until proof had been provided of taxes and payment of bills and fines (UNCTAD, 1988).

economy, further distorting the domestic labour market structure. The agriculture sector, although relatively isolated, faced restrictions on water access, confiscation of land, strict cropping patterns, restrictions on planting new fruit trees, the unfettered entry of cheap, subsidized Israeli agricultural imports to the territory, and strict control and regulation of agricultural marketing and exports. Out of a total annual water supply originating in the territory of 800 million cubic metres, the Palestinian inhabitants were allowed the use of only 110 million cubic metres, despite rapid population growth. High costs of fresh water forced many farmers to use brackish water mixed with fresh water from springs, which reduced the quality and competitiveness of their products even further.

Furthermore, production and marketing in Israel of Palestinian agricultural products were subject to strict Israeli licensing and quota regulations. Meanwhile, Israeli subcontracting in the occupied territory intensified, geared increasingly towards finishing, assembling or processing Israeli raw or semi-processed material. For Palestinian indigenous industries, maintaining supplies of raw materials from or through Israel became an impossible task in the absence of any financial or trade intermediation options. For the first time since 1967, measures that entailed physical separation between Israel and the population/economy of the occupied territory became an issue of daily concern.

By the 1990s, the Palestinian economy was showing sharp contractions compared to the preceding years, demonstrating its increased vulnerability after two decades of occupation and its inability to withstand internal and external economic and political volatility. However, this did not deter Palestinian initiatives aimed at self-sustainability, and it was in response to these measures that domestic economic initiatives were forthcoming, aimed at safeguarding the economy and fledgling non-governmental institutions, and ensuring a minimum basis for Palestinian economic activity.

These initiatives included, in the case of the agricultural sector, a “return to land” policy to encourage revitalization of the sector and to maintain a certain level of subsistence. Palestinian initiatives and Israeli measures resulted in labour “absenteeism” in Israel at levels not previously known among the Palestinian migrant labourers, who were increasingly obliged to seek gainful employment in Israel. These and other steps towards “disengagement” of the Palestinian productive sectors, whose labour-absorptive capacity had already been stretched by the losses sustained during the uprising, led to growing Palestinian unemployment. The flow of all financial transfers from outside – especially Palestine Liberation Organization (PLO) and Arab aid – was restricted, while rigorous and arbitrary collection of heavy taxes, duties and fines, and cutbacks in expenditure on social services created great pressures on all sectors of Palestinian society.

In this period, maintaining the occupation required, above all, quelling the Palestinian uprising and preventing the “disengagement” of the Palestinian economy from its chronic dependence on Israel. Israeli policies had by now evolved into a “selective integration”, entailing:

- An unbalanced tying of the economy of the territory to that of Israel;
- Free Israeli access to Palestinian natural and human resources;
- No Israeli allocation of resources to the productive sectors of the territory; and,
- No efforts at creating conditions for the establishment of an infrastructure for employment and expansion of the local economy.

Israeli authorities stated at the time that “we have to strike a balance between actions that could bring on terrible economic distress and a situation in which (the Palestinians) have nothing to lose, and measures which bind them to the Israeli administration and prevent civil

disobedience.”<sup>8</sup> In other words, these measures were aimed at compelling the Palestinians to acquiesce to continued Israeli occupation. The restrictive measures deployed during these years included a range of economic sanctions.<sup>9</sup> Palestinian responses came under two umbrellas, of “disengagement” from the Israeli economy and of “self-reliance” forms of economic activity to help the move away from the Israeli orbit.<sup>10</sup> For example, the impact of labour absenteeism was at first significant: by mid-1988, 20–40 per cent of Palestinians who had previously worked in Israel had withdrawn from their jobs. Major transformations were noted in the size and composition of Palestinian labour working in Israel. Given the impact of absenteeism on the Israeli labour market, the Israeli Minister of Finance declared that “ending the uprising is one of the top priorities for the Israeli economy.”<sup>11</sup>

Some of the Israeli measures which followed were therefore aimed at containing the damage to the Israeli economy resulting from disengaging from the Palestinian labour and markets. For example, the authorities began to selectively import Palestinian labour by imposing strict measures including passes, permits and restrictive transport arrangements. During this period, the industrial sector was also affected by the heightened Israeli measures and by Palestinian initiatives to strengthen the productive base of the domestic economy. Industrial activity faced practical difficulties in implementing subcontracting arrangements, while curfews and bans on transport hampered the harvesting of the strategically important olive crop.

The international community in this period first called for increased assistance to the Palestinian people in United Nations General Assembly resolution 43/178 of 20 December 1988. As early as 1989, UNCTAD argued that in addition to immediate humanitarian relief, “the international community needed to encourage Israel to allow wide-ranging economic policy reform and liberalization in the Occupied Palestinian Territory, including the right to economic policy formulation and management by the Palestinian people.”<sup>12</sup> Since this initial statement of the need for reform even within the parameters of occupation, the issue of creating sufficient policy space for Palestinian development has continued to figure in UNCTAD writings and recommendations – a concept that is explored further in its current context in a forthcoming UNCTAD study.<sup>13</sup>

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<sup>8</sup> UNCTAD, 1989.

<sup>9</sup> These included bans on the entry of basic food supplies to Palestinians towns and villages; destruction of crops, livestock, industrial and agricultural infrastructure; selective and arbitrary bans on irrigation and harvesting; measures to prevent the sale of Israeli livestock to Palestinian farmers; restrictions on Palestinian trade with Israel and Jordan; movement restrictions; preventing the activities of local service providers; withholding Palestinian permits for movement and trade; cutbacks on expenditure in the areas of welfare and health etc.

<sup>10</sup> These included: voluntary absenteeism of Palestinian workers from jobs in Israel and its settlements in the Occupied Palestinian Territory; the boycotting of imported agricultural and manufactured goods from Israel, especially where locally produced substitutes were available; minimizing the drain on Palestinian financial resources constituted by Israeli financial policies in the territories, especially in the form of “tax resistance”, and refusal to pay some of the Israeli-imposed taxes, especially given the inability to do so of many who had lost their incomes after the intifada.

<sup>11</sup> UNCTAD, 1989.

<sup>12</sup> UNCTAD, 1989.

<sup>13</sup> UNCTAD (forthcoming).



### III. Israeli policies of the early 1990s: the Gulf War and separationism<sup>14</sup>

The period until the first intifada was characterized by benign neglect of Palestinian development needs while offering inducements for individual prosperity and preventing competition with Israeli economic interests. After 1988, numerous economic and other measures were used, with varying degrees of severity, to assert Israeli authority in the Occupied Palestinian Territory. This escalation was combined with “remilitarization” of the administrative and decision-making apparatus of the Civil Administration in the Occupied Palestinian Territory, as Palestinian disobedience spread and as the Israeli “security first” logic acquired growing influence in policymaking.<sup>15</sup> This entailed collective as well as specific economic sanctions against sectors of the population and individuals.

Despite these, the Palestinian people managed to create the conditions for ceding a certain degree of policy space to allow the implementation of elements of recently elaborated strategies for economic survival and the eventual move towards independence. Indeed, the intifada had instilled new dynamics on the ground, and regional conditions in the wake of the 1990 Gulf War had brought to the forefront the need for a comprehensive peace in the region. This, in turn, paved the way for the launching of the Middle East Peace Conference in Madrid in 1991, and the negotiations that led to the Oslo Accords and the establishment of the Palestinian Authority. The stage, therefore, seemed to be set for some degree of separation of the Palestinian economy from that of the occupying power, even though the conditions may not have been ripened enough for a resolution of permanent status issues.

Following the Gulf War, Palestinian incomes and employment suffered dramatically from the sudden stop in remittances from tens of thousands of Palestinians previously employed in the Gulf economies. The impact of the Gulf crisis was also felt inside the territories directly, through curfews imposed following the outbreak of regional hostilities. This period also coincided with the expansion of Israeli settlement activities and creation of new, apparently irreversible, facts on the ground. By 1990, the expropriation of Palestinian land had put at least 54 per cent of the Occupied Palestinian Territory under the control of the Israeli military and settlers. This did not slow down, and only heightened in early 1990s in a swathe of land expropriations. Officials gave the signal at the time that Israel has “always built, is building and will continue to build” settlements in the West Bank and Gaza Strip.<sup>16</sup> By mid-1991, there were at least 216,000 Israeli settlers in the Occupied Palestinian Territory (including East Jerusalem).<sup>17</sup> Security concerns in Israel and the return of workers from the Gulf led to increased Israeli bans on movement of labour to Israel, leading to a debate in Israel about the “costs and benefits” of reliance on Palestinian labour, and efforts at replacing Palestinians with Israeli and, eventually, foreign workers.

This period led to a re-evaluation of Israeli strategies towards the Palestinian economy and to consideration of certain reorientations in strategies, as stated by an Israeli official: “There is no change in policy but there is a new approach.... Instead of having the workers from the

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<sup>14</sup> The discussions and information in this section draw on UNCTAD reports published in 1991, 1992, and 1993. See the references section.

<sup>15</sup> See section VII.

<sup>16</sup> UNCTAD, 1991.

<sup>17</sup> UNCTAD, 1991.



territories come to factories in Israel, we want those factories to go to the territories.”<sup>18</sup> Following this, the authorities announced tax relief measures for new industrial investment and for some existing enterprises in the Gaza Strip, as well as the establishment of an industrial zone in Gaza and consideration of possible alternatives for banking and credit facilities. This change in tone was motivated by several factors, including the sustenance and viability of most Palestinian initiatives despite restrictive Israeli policy measures; the increasingly active involvement of international donors in local Palestinian development projects; and perhaps most imperatively, considerations within Israel favouring less dependence on Palestinian labour (such as absorption of a million new immigrants from the former Soviet Union) and the consequent need to encourage job creation within the territory or face growing social discontent in Israel.

Hence, the Israeli “separation strategy”, pursued until today, was born. It offered the only way to retain control of the occupied territory and its resources, entrench Israeli settlements and the settler population, and ensure minimal contact with the indigenous Palestinian population. Therefore, the period that followed the Gulf War was one of Israeli “dis-integrationist” policies; according to Israeli officials at the time: “The less of them [Palestinians] that will work in Israel, the better... now is the time to bring about substantial change through separation... we must see to it that Palestinians do not swarm us.”<sup>19</sup>

With this in mind, after 1991 the occupation authorities adopted a new strategy of “liberalization” of some aspects of the economic policy environment, through tax exemptions for new industrial investments and relaxation of some of the long-standing restrictions on capital flows to the territories, and by easing the movement of export trucks across the border. In yet another permutation of an old theme, the lifting of these restrictions was officially referred to as improving “the welfare and standard of living of the Palestinian population... expanding employment opportunities and developing the local economy...”<sup>20</sup> These policies, at some level, reflected a realization on the part of the Israeli authorities about the deteriorating state of the Palestinian economy in the wake of the Gulf War, and on the other hand, their desire to limit the entry of Palestinians to Israel and hence to encourage employment opportunities inside the occupied territory. During this period, Israel encouraged subcontracting activities, as a more beneficial way of increasing the competitiveness of Israeli industrial products, rather than the higher cost of employing Palestinians inside Israel.

Containing the intifada and repositioning in line with the emerging regional peace process constituted the main driving force behind the Israeli policies and strategies of this period; it was within this vision that the idea of economic development “within” the occupied territory became the focus of Israeli attention. However, the strategies that were deployed to this effect were not part of a coherent and coordinated economic development policy for the territories. Many of these “liberalizing” measures were undermined by the ad hoc nature and interplay of other factors, such as the sluggish pace of “liberalization”, the lack of complementary infrastructure, and the “closure” of the occupied territory since 1993.

For example, granting numerous business licences without putting in place the infrastructure and financing required for their operations makes such regulatory relaxations somewhat redundant. In addition, Palestinian factories which received permission for operation had to use Israeli inputs, thus ensuring some level of basic dependency on, and also benefit for, the Israeli economy. Closures in this period substantially reduced the levels of trade with Jordan, despite the initial Israeli policies intended to ease these transactions. The average daily number of crossings to Jordan by truck transporting industrial goods alone fell from 33 per day in 1987 to 18 per day in 1990, and only 12 per day in 1991. As a result, ever since Israel first deployed this

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<sup>18</sup> UNCTAD, 1991.

<sup>19</sup> UNCTAD, 1993.

<sup>20</sup> UNCTAD, 1993.

strategy, physical separation did not allow for integration with alternative markets (West Bank–Jordan; Gaza–Egypt); if anything, it meant more isolation for the Palestinian economy.

The last phase of direct military administration of the occupied territory entailed, on the one hand, initiatives to create economic incentives, and on the other, the application of security measures which continued to limit the scope of Palestinian productive and income-generation activities. As early as 1992, UNCTAD argued that the way out for the Palestinian people was through viable legal and economic frameworks which can override Israeli occupation policies: “The Palestinian economy and its institutions need to be freed from arbitrary measures that distort economic structure and performance of the economy. As an initial step, the legal framework governing various aspects of the territory’s economy should be reviewed in the light of the immediate needs of the economy.”<sup>21</sup>

In tandem with these “separationist” measures, Palestinian initiatives continued to leave their mark on developments during this period with varying degrees of success. One initial package of interrelated measures aimed at employing an increasing number of Palestinian workers in domestic sectors, and simultaneously at reorienting consumption patterns away from imports in favour of domestic products from diversified agricultural and industrial bases. The policies of “self-reliance” in this period faced obstacles, such as the inability of the domestic economy to direct adequate resources towards new productive investment; inadequate infrastructure to permit full utilization of idle manufacturing capacities; the absence of comprehensive and integrated employment-generation programmes; higher wages from work in Israel; increasing pressure on the domestic labour market from the return of Palestinian workers after the Gulf War; and, finally, but most importantly, the absence of sovereign Palestinian institutions capable of establishing priorities and guiding development decisions.

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<sup>21</sup> UNCTAD, 1992.



## IV. The Paris Protocol: a quasi customs union

The Oslo Accords and the self-governing arrangements in the occupied territory that they conferred upon the PLO, to be managed by the Palestinian Authority, were heralded by their signatories as a break with the past. Much of that confidence was based on the agreement that the framework put in place by the Accords, including the Paris Protocol on Economic Relations (PER), would serve for an interim period of only five years, with permanent status issues – including those associated with sovereignty – to be negotiated and agreed within five years.

The economic institutions that the Palestinian Authority was enabled to build within the scope of the PER did entail a withdrawal of the Israeli Civil Administration from those areas where the Palestinian Authority was granted jurisdiction – an unprecedented ceding to Palestinian hands of economic and local management functions that hitherto had been under direct Israeli control. While the Palestinian Authority strove to portray institutions as “national” in their role and purpose, the actual limits to their regulatory or enforcement authorities soon became apparent (in areas such as trade, fiscal management, banking, industrial zoning, agricultural resources, land use etc.).<sup>22</sup> Furthermore, while the reality of direct Israeli rule was replaced by Palestinian “home rule” in the core “A” areas designated for Palestinian Authority jurisdiction under the Accords, the Israeli military remained in direct control of the surrounding “B” and “C” areas, while the Gaza Strip borders were and remain subject to Israeli control. Hence, while some policy-management space was gained, the more pertinent question is how much the economy gained. Did the PER result in a less adverse impact of occupation on prospects for development (more policy space)? Did long-term benefit accrue from the prolonged proximity to – and under the PER, enhanced intimacy with – the Israeli economy? Indeed, the limited policymaking space might have been tolerable, and in retrospect, justifiable, had the latter criterion alone been satisfied.

The PER formalized the de facto customs union between the Occupied Palestinian Territory and Israel that had come into existence during the period of direct Israeli military control. The choice of appropriate trade regime was a source of much tension in the PER. While Palestinian negotiators argued for a free trade agreement (FTA), which would require drawing customs borders between the territory and Israel, Israel called for a formalization of the customs union which had existed de facto since 1967 and for referral of all matters linked to borders to the permanent status negotiations. Many years later, in the context of negotiations launched in 2000 at Camp David, Israel came to accept the idea of an FTA with a future State of Palestine, under the condition that it would retain the prerogative to put restrictions on Palestinian labour flows to Israel according to its domestic or security considerations. Such a condition, at a time when labour remittances from Israel constituted a large part of domestic revenues, made the customs union proposed by Israel apparently more attractive. At the time, PLO negotiators presented the concept as a small Palestinian customs envelope within a larger Israeli customs envelope. However the manner in which Israel has since freed itself of any reliance on Palestinian labour has rendered somewhat moot the debate about the comparative economic benefits of this or that trade regime as far as labour is concerned.

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<sup>22</sup> This, however, is not how they were viewed by Israel, which agreed in the Oslo Accords to the establishment of the “Palestinian Authority”, while the PLO – with whom Israel signed the Oslo Accords – simultaneously established the “Palestinian National Authority (PNA)”, in whose name all the Oslo-related authorities of the Palestinian Authority devolved by the occupying power are administered and services delivered.

This final outcome, a quasi customs union, as it contains elements of an FTA and a customs union,<sup>23</sup> explicitly allowed Israel to “from time to time introduce changes in trade policy while notifying the Palestinian Authority”, hence institutionalizing the unequal trading relations between the parties.<sup>24</sup> In addition, as stated by one European Commission official:

The Protocol ... created a joint customs union. The Palestinians had to agree [to it] essentially for political reasons. It was a deal, essentially to avoid having to tackle the question of territory, postponing the issue of borders until final status. The Israelis told the Palestinians: “You shut up during the intermediary period and we let your workers work in Israel.” But it did not work, because trade and employment were undermined by the closure policy and by the prohibition of Palestinians to work in Israel.<sup>25</sup>

Therefore, far from granting the Palestinian Authority the freedom to import/export without Israeli supervision, the PER explicitly restricted the quantities of goods that could be imported/exported, giving Israel an effective veto power over Palestinian Authority requests regarding exports and imports. The intensifying Israeli closures during the 1990s were sufficient to offset much of the benefit that could have been gained from the proposed elimination of Israeli trade barriers on Palestinian agricultural products. How and on what basis Israel formulates its trade policies vis-à-vis the Palestinian Authority was not addressed by the Protocol. Article II of the Protocol also regulated Palestinian imports from countries other than Israel. It was expected that under the PER, Palestinians could achieve significant financial advantage from the new import regulations, through import taxes and levies on all goods explicitly designated for the Palestinian Authority, even if imported via Israel, as well as cheaper imports from alternative destinations. But this gain never materialized in the years following the signing of the Protocol.

One of the major flaws of the PER was that under the Protocol, all Palestinian imports would still go through the Israeli customs system. Most Palestinian businesses have limited access to, or knowledge of, Israeli customs regulations and logistical services. This information asymmetry has, over time, reduced the competitiveness of Palestinian shippers. Article II of the PER regulates imports to the West Bank and Gaza from countries other than Israel, while imports to Israel remain unhindered. There are also lists of products that it “might” be possible to import from places other than Israel under certain conditions, such as not being final-assembly products, and having at least 30 per cent of the country of origin’s contribution to the product’s value. Quantitative limitations are attached to such imports, depending on “Palestinian market needs”, which are, in turn, determined by the Israeli authorities. Various related regulations regarding tariffs and customs further limited the Palestinian Authority’s scope for formulating trade policy.

With regard to exports, the Protocol stated that there would be free movement of both agricultural produce and industrial goods between the two sides without additional customs and

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<sup>23</sup> The Protocol’s attempt to establish a Palestinian–Israeli trading relationship between a free trade agreement and a customs union was done through a number of channels, for example: (i) the PER formalized the de facto customs union in which the existing Israeli tariffs continued to serve as the common external tariff, while quantitative restrictions were imposed on the export of five specific agricultural products from Palestine. Israel also continued to maintain subsidies, indirect taxes and non-tariff barriers on a range of imports; (ii) the PER allowed a partial opening of the West Bank and Gaza’s trade with Jordan and Egypt and the rest of the world (through the latter two countries), but the quantities of this trade were to be agreed upon between the Palestinians and Israel, based on an assessment of Palestinian needs; (iii) the Israeli VAT system would be imposed on Palestine “to prevent illegal trade flows motivated by tax avoidance”; and finally, (iv) the PER recognized that Palestinians would continue to work in Israel, but did not guarantee unlimited access, and, in fact, gave the employing side the “right to determine from time to time the extent and conditions of the labour movement into its area” (Zagha, 2004).

<sup>24</sup> Article VII of the PEP, 1994.

<sup>25</sup> Le More, 2008.

import taxes, subject to certain exceptions and arrangements, hence giving the impression that the Palestinian Authority would be able to export commodities to other countries as well, without the earlier barriers. Within the constraints of the Protocol, Palestinian exporters would be able to benefit from trade-promotion measures in the areas of credit, research, development assistance and direct tax benefits. However, the widening trade deficit since the signing of the Oslo Accords and the Paris Protocol draws a fundamentally different picture of the extent to which these promises materialized.<sup>26</sup>

Under the PER, each side would administer its own trade tax policies, but the VAT rate in the Occupied Palestinian Territory could not be more than 2 percentage points lower than the 17 per cent in Israel. Taxes on international trade would be shared between both, according to the “destination principle”.<sup>27</sup> Receipts from taxes and fees paid by Palestinians inside Israel and Israeli settlements would be transferred to the Palestinian Authority. Israel would collect and transfer to the Palestinian Authority the indirect taxes and customs duty imposed on Palestinian imports from or via Israel, something which has since become a permanent instrument through which Israel exercises leverage over Palestinian economic and political affairs. Although the Palestinian Monetary Authority would be the sole and principal agent responsible for banking regulation in the territory, the issue of a Palestinian currency, which would carry with it the symbol of sovereignty, was postponed indefinitely under the PER, and the new Israeli shekel remained the main currency in circulation in the Occupied Palestinian Territory.

Although both sides were to maintain normal labour movement with each other, the PER failed to guarantee unlimited Palestinian access to the Israeli labour market since it granted Israel the right to determine the extent and conditions of this labour movement; in fact, if anything, the Protocol explicitly gave the employing side (Israel) the “right to determine from time to time the extent and conditions of the labour movement into its area”.<sup>28</sup>

Therefore, as is already evident, the PER inherently linked the Palestinian economy to the foreign trade regime of Israel and the latter’s rights and obligations under WTO and TRIPS, binding Palestinian trade with third parties to these rules, without enjoying any of the benefits of these agreements. This quasi customs union exposed the fragile Palestinian economy to the winds of globalization without any type of protection or transition during liberalization of the Israeli economy in the 1990s. Therefore, by virtue of the PER, the Palestinian economy was now paying the price of WTO membership, since its markets were now open through Israel to products from all WTO members, without benefiting from WTO rules to regulate the trade practices of WTO members, including Israel.

As a result, Israel remained the occupied territory’s main trading partner in the post-Oslo years, receiving more than 90 per cent of its exports. Under the PER, the Palestinian Authority has become critically dependent on Israeli rebates of customs and income taxes. However, the limits and costs of this dependence were soon realized. For example, Israel interpreted “imports” into the territory in a peculiarly restrictive way: they would only count as imports those goods directly imported by Palestinian companies via Israel, and not those imports into the territory that

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<sup>26</sup> As the former United States Consul-General in Jerusalem explained: “The European Union told Palestinians that they could export cut flowers and strawberries... At Karni and Erez (entry points between Israel and Gaza), the Israel Defence Forces trashed the boxes, in search for bombs. Then, Palestinians tried to export them via the Sinai. Yet the boxes of flowers and strawberries would remain for days at the border until they were spoilt. Eventually, the Palestinians were told they could export to Europe, provided they sold first to the Israeli firm Agrexco (which handles most Israeli agricultural exports). Agrexco would of course determine the price... This is an example of how the spirit of the agreement was undermined” (Le More, 2008).

<sup>27</sup> This means that collected tax revenues should be allocated to the Palestinian Authority, even if the importation was carried out by Israeli importers, when the final destination explicitly stated in the import documentation is a corporation registered by the Palestinian Authority and conducting business activity in the West Bank and Gaza Strip (Paris Economic Protocol: Article III-15).

<sup>28</sup> Article VII of the PER, 1994.

were first imported via an Israeli company for onward shipment to Palestinian traders. Reclaiming customs duties would not apply to the latter type of imports, although they constituted the bulk of imports to Palestine.

This, as well as many other terms of the PER, limited the Palestinian Authority's access to a large part of revenues from imports. The PER lacked any monitoring of implementation mechanisms, which was particularly harmful as such mechanisms could have prevented the persistent leakage of revenues collected by Israel on behalf of the Palestinian Authority. The Joint Economic Committee, established by the Protocol to manage its implementation, was an unwieldy, politicized body whose technical machinery never served an effective dispute resolution function. Hence, it failed to provide any governance role or address issues such as the leakage of revenues imposed on imports from the rest of the world through indirect Israeli routes and intermediaries, resulting in substantial revenue losses for the Palestinian Authority.<sup>29</sup> These leakages implied that the Palestinian Authority actually needed to divert imports away from Israel, something which was hard to do given the dependency situation of the post-1967 decades, reinforced by the Protocol.

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<sup>29</sup> According to the World Bank estimates, approximately one third of imports from Israel have been indirect imports, which are imported to Israel and then re-exported to the Occupied Palestinian Territory. For these, not only has the Palestinian Authority not received any tariff revenues, but their prices in the domestic Palestinian market have often been augmented by Israeli VAT. This "re-export" has had a very negative effect on fiscal leakage in Palestine. The World Bank estimated that, by February 2003, the revenue lost under this arrangement amounted to 3 per cent of Palestinian GDP (de Melo et al., 2003).

## V. The “skewed integration” of the 1990s: development under occupation?

Palestinian policymakers and most conventional wisdom of the period argued that remaining in the customs union saved the Palestinian Authority the costs of establishing and managing alternative trade arrangements with Israel. These included setting up customs borders (training personnel, building customs posts, buying computers) and collecting taxes on third-party trade. In addition, it was argued that staying in a customs union also dealt with issues of political economy, since alternative trade policies could also face the same restrictions, generate corruption, and hence be as harmful. Such viewpoints do not take into account the fact that the establishment of independent, indigenous trading institutions, however costly, confers strategic benefits rather than total dependence on existing ones which neither allow for free Palestinian exports nor ensure the Palestinian Authority’s receipt of import revenues withheld by Israel. After all, “development is about a costly process of change during which, despite short-term costs to the economy, the institutional structures which are essential for its long-term growth are established.”<sup>30</sup>

The restrictions on Palestinian exports to Israel – such as meeting various security, environmental, health and safety standards, and overcoming infrastructural barriers and lack of access to markets – were not only unaffected under the PER, but further restrictions and quantitative limitations aimed at protecting Israeli producers were added to Palestinian exports. Many of the critics of the PER have expressed disappointment at the acceptance by the Palestinian Authority of the terms of these quotas while Israel’s extensive subsidy programme for its agricultural producers includes credit on concessionary terms, subsidized factors of production (especially water and land), export finance, and minimum price levels for certain products. Given the nature of this agreement, the Israeli cost structure, high costs, and difficulty of access to cheap inputs, the Palestinian economy was unable to diversify its export range and its trading partners. In 2005, more than 90 per cent of Palestinian trade still took place with Israel, with the unbalanced trade ratio with Israel widening the Occupied Palestinian Territory’s already existing trade deficit.

In practice, the context in which the PER was managed undermined production and exports from both agriculture and industry in the territories. Both horizontal (land area) and vertical (intensification) expansion of the agriculture sector have been restricted for decades in the Occupied Palestinian Territory. During the PER years, horizontal expansion was limited by land and water availability, which resulted from confiscation of these resources by the occupational forces, and which was also due to expansion of Israeli settlements. Vertical expansion was limited too, mainly due to lack of access to markets, which itself was a result of high costs of production and inefficient production caused by lack of access to pesticides and equipment, as well as agricultural subsidies in Israel and other neighbouring Arab countries. The scope for industrial growth also remained limited, and industrial competitiveness was further undermined by inflated transaction costs. All this implied that the asymmetric relationship unilaterally imposed by Israel since 1967 was reinforced and institutionalized under the PER.

Any outcome of the negotiations depended on Israel’s “unique system of complex regulations and procedures mainly linked to Israeli security considerations”, which undermined the revival of the Palestinian agricultural sector and the potential for growth of an endogenous industrial base, making the Palestinian economy vulnerable to external shocks such as closures.<sup>31</sup>

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<sup>30</sup> Taghdisi-Rad, 2009.

<sup>31</sup> Salem, 2006.

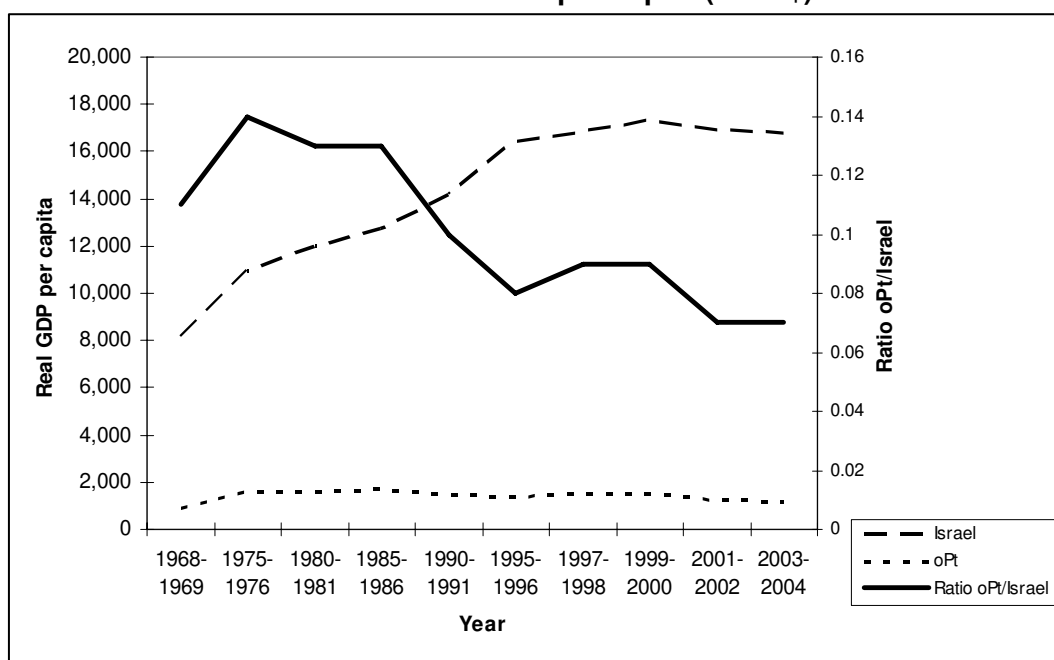


These restrictions, which act as non-tariff barriers against Palestinian trade, left little space for trade policymaking or for other aspects of sovereign economic action.<sup>32</sup>

Both theoretical analysis and empirical studies suggest that polarization effects are likely to be dominant in the early stages of integration. Under normal circumstances, the dynamics of integration display a pattern of divergence followed by convergence. In the early stages, the large economy, with a more developed manufacturing sector, enjoys increasing returns to scale, which tends to wipe out small industries and handicraft production in the small economy, and consequently the gap widens between the two economies. In later stages, a switch occurs in the dynamics, as the increasing costs in the large economy and the external diseconomies produced by congestion begin to outweigh the benefits of greater efficiency and higher return to capital and labour. Investment in the small economy becomes more attractive. As a result, the poor economy starts to grow faster than the rich economy, narrowing the gap.

Had economic relations between the Israeli and Palestinian economies been confined to the dynamics of normal free-market forces, the gap between per capita incomes should have widened in the first years of the occupation, and then become smaller. What happened was, in fact, the opposite. The pattern was one of a slow convergence during the first two decades of occupation, followed by divergence. Palestinian GDP per capita grew from 11 per cent of that of Israel to 14 per cent until the end of the 1970s, but then, the ratio declined almost continuously, except for a brief turnaround during the 1990s. At 9 per cent in 2000, it was still below its level prior to Oslo, and since then it has plunged further – to half its level of 30 years ago.

**Pattern of convergence/divergence between Israeli and Palestinian real GDP per capita (1995 \$)**



Source: Based on UNCTAD, 2006.

The reason for this abnormal pattern is that the economic relationship between the two economies was not confined to the working of the polarization and spread effects throughout markets. The economic strategies implemented since the start of the occupation, which increased in intensity over time, reinforced the effects of polarization and diminished the spread effects. Most of the convergence experienced in the 1970s–1980s was driven by income growth generated from exporting Palestinian labour to Israel. However, over the long term, along with

<sup>32</sup> Arnon, 2002: 11.

restrictions imposed on the flow of Palestinian exports of goods and services to non-Israeli markets, this has distorted the labour market, with the ultimate outcome of a reduction in domestic labour productivity.

Another feature of this integration-without-convergence syndrome has been the relative freedom of the Israeli economy to facilitate trade and factor mobility (labour or capital – e.g. the subcontracting and border industrial zone phenomena) between Israel and the territory according to various prerogatives. This has gradually eliminated trade based on comparative advantage, and has confined it to trade based on absolute advantage. As a result, the small economy exports low-skill goods and imports high-skill goods, thus “locking in” its poverty, and increasingly being relegated to the status of a backward region in an advanced country. This dynamic has reinforced adverse path dependence – distorting the development of the Palestinian economy – and has inhibited its growth. The negative impact of this dependence did not cease to be felt once the new policy framework of the PER was in place. Quite the contrary, the economy has remained along this path since then, and no mechanisms have been designed to mitigate or disengage from this integration-without-convergence.

Ultimately, the core flaw in PER, and as some argue, in the Oslo agreements as a whole, was the failure to address the issue of Palestinian sovereignty adequately, or even to envision it as an eventuality, leading to further dependency and irreversible loss for all aspects of the Palestinian economy. Amidst the euphoria surrounding the signing of the Oslo Accords, the late, eminent scholar Edward Said commented:

By accepting that questions of land and sovereignty are being postponed till “final status negotiations”, the Palestinians have in effect discounted their unilateral and internationally acknowledged claim to the West Bank and Gaza: these have now become “disputed territories”... Moreover, rather than becoming stronger during the interim period, the Palestinians may grow weaker, come more under the Israeli thumb, and therefore be less able to dispute the Israeli claim when the last set of negotiations begins. But on the matter of how, by what specific mechanism, to get from an interim status to a later one, the document is purposefully silent. Does this mean, ominously, that the interim stage may be the final one?<sup>33</sup>

The interim period arrangements therefore encouraged a skewed integration of the Palestinian economy with Israel and its settlements in the territory. But the architects of the PER had envisaged the interim period as one of reconstruction and growth. Indeed, the Palestinian Authority adhered faithfully to the Protocol, just as it tolerated its perceived weaknesses, on the assumption that it would ensure a new, hospitable economic environment markedly different from that of the direct occupation period. Underpinning that misplaced hope were three factors, which were regarded by policymakers as sufficient to enable the Palestinian Authority to adopt an economic policy emphasizing growth and development:

- (a) The expectation that a new era of peace and cooperation would be characterized by an open border policy, allowing the export of Palestinian labour services to Israel as a cushion to bolster income in the interim period;
- (b) The belief that the removal of occupation-related restrictions would also entail an end to the confiscation of land and the expansion of settlements, and hence create an atmosphere free of conflict that would promote private enterprise and public investment; and
- (c) The commitment of the international community to extend financial resources to help finance the Palestinian reconstruction and development effort, envisioned as an instrument to consolidate domestic savings and provide foreign exchange.

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<sup>33</sup> The Morning After. *London Review of Books*. 21 October 1993.

Ultimately, however, political factors combined to create an environment towards the end of the interim period different from that proclaimed by the PER, fraught with growing violence, mistrust and uncertainty. These engendered adverse repercussions, bringing down income levels for the average Palestinian during the interim period. While these setbacks did not halt the inexorable progress of Israeli–Palestinian negotiations, they dampened public satisfaction with the interim economic and trade arrangements. The first casualty of adverse political developments was the concept of an open border. Throughout the interim period, Israel adopted a strategy of intermittent “closures” – both external (with Israel, Jordan and Egypt) and internal (within and between regions of the West Bank and Gaza Strip). The economic losses resulting from these closures were considerable in terms of interruption to the movement of labour and goods between the Palestinian territory, Israel and the rest of the world, which, in turn, led to falls in production and income.

In addition, continuing Israeli settlement activity perpetuated conflict and mistrust. In June 2000, the parties finally resolved four pending interim-period economic and trade issues that had first been introduced for negotiation at Wye River in October 1998. Adverse political developments also counteracted the positive impact of financial resources injected into the economy by the donor countries, and reduced the expected flow of foreign investment. Resources earmarked for long-term investment were allocated instead to emergency efforts, such as job creation and financing the emerging budget deficit of the Palestinian Authority. The delay until 2000 in negotiations on permanent status issues infused economic activity with further uncertainty, discouraging both domestic and foreign investment.

## VI. The second intifada and the dysfunctional Paris Protocol since 2001

The realities created since the second intifada led to an even more dramatic change in the landscape of the occupied territory and its economic structure. The Palestinian economy underwent a deep crisis from October 2000 to the end of 2002, as reflected foremost in the trade sector: exports declined sharply, due to severe border restrictions and the discriminatory treatment that Palestinian products received at Israeli ports. The years 2003–2005 saw a gradual stabilization and recovery: there was some growth in GDP and a decline in the share of trade (mainly exports) with Israel, with some being replaced by trade with European, Asian and Arab countries. By 2004, 40 per cent of Palestinian exports were manufactured goods, while the rest consisted of agricultural products, mineral fuels, lubricants, and related materials.

Dependence on the export of labour services to Israel made the Palestinian economy particularly vulnerable to the frequent and irregular blockage of Palestinian labour flows to Israel in the aftermath of the second intifada. These “backwash” or “polarization” effects explained the disappearance of many industries in the small economy of the Occupied Palestinian Territory, with its “confinement to production of low-skilled goods, and emigration of a sizable segment of its labour force to the neighbouring economy”.<sup>34</sup> As noted above, the “economic integration/separation” cycle with Israel has led to massive divergence of the two economies and their per capita incomes.

Chronic Palestinian economic dependency upon Israel was perpetuated by the unchanging framework of the PER and the dysfunction of most of its machinery, especially during a time of great upheaval in the economy. The dependence on Israeli currency, foreign exchange, trade agreements, national priorities, and security concerns – which was reinforced in these agreements – meant that the status and stability of the Palestinian economy was further linked, even institutionally, to that of Israel. Towards the end of the five-year interim period, numerous Israeli–Palestinian study groups had advanced models for future economic relations between two sovereign states, but these were soon dashed against the rising tide of violence and the Israeli security-first logic which came to dominate economic relations, much as it had in the pre-Oslo period.

Following the second intifada, Israeli policies of land and water confiscation expanded, now based on “security concerns”. For example, by July 2004, 86 per cent of the land confiscated for the construction of the Separation Barrier in the West Bank was agricultural land, leading to the loss of some of the region’s most fertile agricultural lands. The land confiscated for the construction of the Barrier is among the richest and most productive agricultural land in the northern West Bank, and as a result of its construction, access to some of the best water sources in the West Bank have been and continue to be lost, while creating simultaneous access and land-ownership problems for Palestinian farmers. When completed, nearly 10 per cent of the overall land in the West Bank, including East Jerusalem, will lie in the area between the 1967 border and the Barrier in places where its alignment runs inside the West Bank. Meanwhile, Israel’s West Bank settler population has grown – from 116,300 in 1993 to 289,600 by 2009.<sup>35</sup> The numbers in East Jerusalem have increased from 152,800 to more than 186,000. After 40 years, almost half a million Israelis had settled in the occupied West Bank, equivalent to almost 15 per cent of the Palestinian population in the territory.

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<sup>34</sup> UNCTAD, 2006.

<sup>35</sup> Kurtzer, D. The settlement facts. In: *Washington Post*. 14 June 2009.

Political and security developments after 2000 brought a halt to the regular transfer of clearance revenues from Israel to the Palestinian Authority – a system which was established under the PER. Israel first refused to transfer any revenues to the Palestinian Authority between September 2000 and December 2002. The transfer of revenues then resumed, coming to another halt in 2006–2007. Irregular flows of donor support in this period – as well as Israel’s intermittent decisions regarding transfer of Palestinian Authority revenues – prevented the Palestinian Authority from fulfilling its normal obligations as a governing authority. Revenue clearance remains conditional upon parallel Palestinian Authority compliance with its security commitments under the Oslo Accords (and more recently, the Road Map). Since then, better Israeli–Palestinian Authority relations have ensured a regular functioning of the mechanism, but it remains one that is powered, above all, by political and security considerations.

To these should be added the general decline in the Palestinian Authority’s domestic tax revenues, due to high levels of unemployment and low levels of purchasing power. All this implies that the Palestinian Authority, as a self-governing entity, has been unable to contribute to the revival of the Palestinian trade sector through provision of subsidies or other incentive mechanisms and safety nets for import-competing sectors and infant industries. In turn, the revenues of the Palestinian Authority have also suffered as a result of the sharp decline in export revenues and trading activity. In these circumstances, across-the-board liberalization, as advocated by some observers, risks aggravating the budgetary constraints by reducing trade tax revenues even further.

Much of this dilemma can be framed by the “security first” logic underlying the Oslo Agreements and the subsequent Road Map. Within this framework, collection by Israel of Palestinian customs duties and VAT on imports effectively gives it control over significant parts of Palestinian public revenues. These and other economic aspects of the Oslo Agreements were justified on the ground of short-term expediency and the need to ensure compliance by the Palestinian side before greater sovereignty could be transferred. However, the prolonged interim period – originally intended to end by 1999 – has shown that the institutionalization of these measures has inflicted a heavy toll on the Palestinian economy in the context of what has been termed a policy of “asymmetric containment”.<sup>36</sup> By design, these measures are serious enough in their potential ability to harm Palestinian interests through the threat of asymmetric pressure, when Israel deems that a given situation constitutes a case of security non-compliance by the Palestinians.

While the post-Oslo institutional set-up features some integration aspects, these have been largely shaped by this asymmetric containment policy. The preceding examination of Palestinian–Israeli economic relations since 1967, and even since 1994, shows that any integration has been mainly confined to the use of unskilled Palestinian labour in low value-added and non-strategic activities in the construction, manufacturing and agricultural sectors, in addition to extraction of natural resources (such as water, and also stone and marble used to construct Israeli settlements). Moreover, although there has been some Israeli subcontracting investment in Palestinian industries, such as the garments industry, they are limited in scope and technological content.

The most prominent Israeli–Palestinian “joint ventures” since the 1990s have entailed monopolistic collaboration between suppliers of certain key commodities (e.g. petrol and cement). Within this strategic framework, therefore, the growth implications for the Palestinian economy are strikingly different from those inherent in a strategy of balanced integration. This is because the economic arrangements, particularly movement restrictions, have contributed to maintaining the vulnerability of the Palestinian economy to Israeli prerogatives. Therefore, during this period, the Palestinian economy has continued to feature shrinking policy autonomy and an absence of economic strategies that could eventually challenge asymmetric containment. The role

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<sup>36</sup> Khan, 2004

of the international community in this respect has not been especially bold, generally favouring neoliberal economic policy formulas and generous funding of a political-economic relation between the Palestinian Authority and Israel that does not challenge prolonged occupation, address its deep impact, or enable Palestinian economic self-determination.<sup>37</sup>

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<sup>37</sup> Taghdisi-Rad, 2009.



## VII. Israeli “economic peace” or a Palestinian economic strategy for peace?

By 2009, 15 years after the PER came into existence as an interim economic agreement valid for a five-year period that was never formally renewed, it remains the de facto economic law of the land. Whatever life it ever had in it – as a framework for revenue clearance, dispute resolution, banking regulation, import diversification or even economic convergence – has been dissipated by the effect of the past eight years of conflict, unilateralism on the part of Israel, Palestinian institutional attrition, and the failure of the political negotiation process between the parties to yield results. More recently, the economic-policy, if not the legal, implication of the Israeli disengagement of Gaza in 2005, and the state of isolation that the Strip has endured since, has been to effectively separate Gaza from the inner Palestinian customs envelope within the overall Israeli customs envelope. Today, Gaza remains suspended somewhere between the PER and the pre-Oslo arrangement of direct rule by the occupying power, with the PER effectively obsolete as far as its operations at Gaza’s borders is concerned.

As is manifest from the above review of the evolution of Israeli strategies towards the Palestinian economy, Palestinian policy space has continued to shrink over time – something which is in contradiction to one of the expressed purposes of the PER of laying the grounds 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.”<sup>38</sup> Therefore, although by the end of the 1990s it was clear that Palestinian Authority’s economic policies should focus on the growth of industrial and agricultural production, and be geared towards employment creation, the expansion of exports and the lowering of imports, the Palestinian Authority did not have the institutional or regulatory authority to carry forward such policies, and it was unable to take any new policy initiative in the face of the almost non-stop humanitarian crisis since 2000.<sup>39</sup>

Leaving the design, legality, implementation and other flaws of the PER aside, that policymakers can today seriously consider a continuation of the economic policy status quo as either optimal or even tolerable is difficult to comprehend. This is an historical moment when viable statehood and sovereignty should be the order of business, and the appropriate recognition of the need for a doctrine of Palestinian national economic security should be forthcoming. Instead, the Palestinian economy is held hostage to the PER, and its development prospects seem no better than they were during the phase of direct military occupation under the Israeli Civil Administration, however much Palestinians under occupation today enjoy the trappings of self-

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<sup>38</sup> Preamble to the PER cited in UNCTAD, 1998.

<sup>39</sup> The adverse effects of the PER are referred to specifically in one Palestinian Authority document (which has since been superseded by others), namely the Medium-term Development Plan for 2005–2007: “The Protocol on Economic Relations signed in Paris on 29 April 1994 resulted in the formalization of partial integration into the Israeli economy through a one-sided customs union. On the one hand, the customs union did not allow for full enough integration, having barred the benefits of a single market with Israel that would have provided free movement of all goods, services and factors of production. On the other hand, it resulted in domination of the Israeli economy: a more restrictive free trade agreement, as opposed to a customs union, would have allowed control of borders and thereby independent tariffs on the import of goods from other countries. This lack of sovereignty has sustained an element of dependency on the Israeli economy. Palestinian companies have had a hard time competing with Israeli companies even in the Palestinian market due to public subsidies to Israeli companies. Under this customs union, the Occupied Palestinian Territory has been subject to the Israeli tariff structure, which reflected Israeli developmental needs but not those of the Occupied Palestinian Territory.” Ministry of Planning (2004). *Medium-term Development Plan 2005–2007*.



rule and a measure of self-governance. While the latter is not an achievement that any responsible policymaker can easily jeopardize, the PER is neither sacrosanct nor etched in stone. The time is opportune for a new phase in Palestinian economic self-determination that supports the efforts to achieve national self-determination in the broader sense, in line with relevant United Nations resolutions.

The preceding analysis has demonstrated that whatever strategy towards the economy of the occupied territory was pursued unilaterally by Israel or bilaterally with the PLO/Palestinian Authority, there remains one constant in the equation: expanding Israeli settlement and occupation-related controls, as against diminished Palestinian economic policy space, territory and economic structure and scale from the Palestinian perspective. Such persistent asymmetry cannot provide for an equitable economic relationship between two sovereign economies, nor would it pass the test of compliance with multilateral trade laws and the standards of international economic relations that must be factored into any future political settlement. This is not to mention that the adverse trend of Palestinian economic path dependence on Israeli economic fortunes and prerequisites was not a Palestinian choice, nor is it a relationship that has conferred any lasting benefits on the Palestinian economy or its increasingly impoverished population.

Despite all this, in 2009, rather than acknowledging these realities and making a clean break with the occupation-first logic that has determined the path of Palestinian economic growth, no movement can be perceived on the economic-policy horizon. Indeed, the idea of reform of existing Palestinian Authority institutions to make them better serve the now much-prolonged interim period has taken precedence within Israeli, Palestinian and donor policymaking circles over the need to form the national economic policy and institutional framework for statehood. It is implausible that somehow with enough tinkering with Palestinian Authority reform and other preconditions being satisfied, the nascent Palestinian state will be better equipped to hit the ground running, so to speak, than it would have been either in 2000 at the end of the interim period, or in 2002 when the international community first endorsed its establishment, or even today. While it is generally acknowledged that the past five years of reform have delivered some governance outcomes, in terms of financial management and security restructuring, the Palestinian Authority political and constitutional system – one of the institutional achievements of the interim period which still operated into the first decade of the new millennium – is today fractured and itself of limited functionality.

It is within that perspective that the apparently new orientations in the policy towards the Palestinian Authority of the Israeli Government of 2009, with its emphasis on improving economic relations, should be understood and the appropriate policy response envisaged. Prior to his designation, the new Israeli Prime Minister had argued that the first step to a lasting peace needs to be the fostering of the Palestinians' economic situation. "We must weave an economic peace alongside a political process. That means that we have to strengthen the moderate parts of the Palestinian economy by handing rapid growth in those areas, rapid economic growth that gives a stake for peace for the ordinary Palestinians."<sup>40</sup> The formation of an "administrative body" that will be responsible for Israel's "economic peace" policies was one of the recommendations put forth by a panel of senior Israeli government advisers.<sup>41</sup> As outlined, such a body would coordinate activities with the international community and the Palestinian Authority.

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<sup>40</sup> Ahren R. Netanyahu: Economics, not politics, is the key to peace. In: *Haaretz*. 21 November 2008. Available at <http://www.haaretz.com/hasen/spages/1038970.html>.

<sup>41</sup> Ravid B and Harel A. Netanyahu's opening gambit: a special body on "economic peace". In: *Haaretz*. 26 March 2009. Available at <http://www.haaretz.co.il/hasen/spages/1074095.html>

This high-level committee is reportedly tasked with “developing the Palestinian economy” and “improving the quality of life”, through some 25 economic initiatives in the West Bank.<sup>42</sup>

In line with this, the Israeli Prime Minister has issued his appeal for an “economic peace,” to boost the Palestinians’ moribund economy and to lay the groundwork for future peace talks: “I call upon the leaders of the Arab countries to join together with the Palestinians and with us to promote economic peace. Economic peace is not a substitute for peace, but it is a very important component in achieving it. Together we can advance projects that can overcome the problems facing our region.”<sup>43</sup> Prior to that, a senior PLO negotiator had commented that “rather than ending the occupation” the Israeli Prime Minister “has proposed an ‘economic peace’ that would seek to normalize and better manage it. Instead of a viable Palestinian state, his vision extends no further than a series of disconnected cantons with limited self-rule.” Another PLO official has said that if the Israeli Prime Minister “insists on talking about the economic solution, then this will be a waste of time. Without moving on the political track ... it will not lead to peace or solutions. On the contrary, it will make things worse.”<sup>44</sup>

Regardless of the fate of such a strategy to improve the Palestinian quality of life, the fact that it forms the centrepiece of Israeli Government relations with the Palestinian Authority testifies to a failure to heed the lessons of 40 years of occupation. Even the most deliberately and elaborately designed instrument used to administer occupation since 1967, the PER, could not disengage the Palestinian economy from the economic integration-cum-physical separation dynamics within which Israel has administered its economic relations with the occupied territory. Indeed, the expectation that a series of economic inducements to improve individual welfare might succeed today where they failed a generation ago is somewhat short-sighted. Such measures serve only as temporary panacea in the absence of autonomous economic power. And that the bold promise of Oslo and the interim period of development and the premise that ultimately sovereignty and independence would ensue, may be abandoned for yet another indeterminate interim period, is tragic. This is especially so in the Palestinian context of prolonged occupation and the deteriorated Palestinian economic, political and social capacities – at a time when the much-postponed imperative of statehood could be destined for yet another delay until regional political factors are more favourably aligned.

The recent Israeli reorientation may be considered by most parties as a non-starter, at least to the extent that it would be a substitute for or would precede a political process. However, it is not adequate to simply dismiss this latest economic strategy towards the Palestinian Authority. Instead, it is incumbent on policymakers to carefully examine whether the lessons of 40 years of occupation do not call instead for an initiative to define a Palestinian economic strategy for peace and sovereignty. This should be predicated not only on the imminence of statehood, but should also be cognizant of the twin condition of dismantling occupation so that statehood can be viable.

Without delving into the full political, legal and territorial aspects that statehood and ending occupation in line with United Nations resolutions would entail, it is possible to envision some of the features of a viable economic policy framework for a peaceful, two-state resolution of the conflict. For Palestine to begin elaborating such principles at an early stage would certainly enhance its longer-term development prospects, or its national economic security, while also acting as an incentive towards peace by demonstrating Palestinian readiness to adopt the

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<sup>42</sup> Israel Ministry of Foreign Affairs. PM Netanyahu appoints ministerial committee to improve Palestinian economy and quality of life. 7 May 2009. Available at [http://www.mfa.gov.il/MFA/Government/Communiques/2009/PM\\_Netanyahu\\_appoints\\_ministerial\\_committee\\_improve\\_Palestinian\\_economy\\_7-May-2009](http://www.mfa.gov.il/MFA/Government/Communiques/2009/PM_Netanyahu_appoints_ministerial_committee_improve_Palestinian_economy_7-May-2009).

<sup>43</sup> <http://www.haaretz.com/hasen/spages/1092810.html>.

<sup>44</sup> Federman J. Palestinians give cool reception to Netanyahu’s “economic peace” plan. 7 May 2009. Available at <http://www.cnsnews.com/public/Content/Article.aspx?rsrcid=47796>.

economic policy and related legal and institutional frameworks necessary for the two-state solution to succeed.

What is needed is a shift in the dynamic that determines the Palestinian economic framework – away from a nominal bilateralism that actually masks a unilateralism driven by the prerequisites of occupation. Instead, a multilateral context is required that offers the Palestinian economy the protection of the rule of law and of the rules governing international economic relations. This would be in the spirit of the two-state solution and the concept of economic viability that is supposed to underpin it. Given that the institutions and much of the economic policy framework of the Palestinian Authority-governed economy are primarily defined by the PER, as are the economic borders between it and Israel, Jordan and Egypt, the existing legal framework remains the departure point for any repositioning of the Palestinian economy such that it can be the viable base for an independent State.

The PER should, therefore, no longer define the parameters or limits of the policy framework required for Palestine to be a viable and peaceful State from day one. Rather, a different set of principles should be highlighted in trying to carve out the economic policy space for a Palestinian State, in particular those which can safeguard its sovereignty in a world of global interdependence and market liberalism, such as:

- Restoring the territorial integrity of the West Bank and Gaza Strip, as affirmed in the PER and as undeniably necessary for viable statehood;
- Recognizing the separate status of the Palestinian customs territory, which is implicit in the choice made in 1994 by Palestine to opt for a customs union with the separate customs territory of Israel, regardless of the form of any permanent status economic arrangement between Israel and Palestine;
- Addressing the special needs of a newly independent, war-torn State as it emerges into the community of nations, and equipping it with multilateral means to enhance its economic policy space and development prospects; and
- Beginning today, to form the institutions for a viable State, rather than pursuing the incessant reform of institutions of self-government which were designed and still function according to a set of promises whose fulfilment remains elusive.

While both formal and effective sovereignty is a sine qua non for the success of any such Palestinian economic peace strategy, what emerges is the essential need to equip Palestinian decision-makers with a range of policy instruments premised on sovereignty. Although expanded policy space on its own cannot immunize the Palestinian economy from the impact of occupation as long as it endures, empowering national institutions (even under occupation) is essential to enhancing the private sector's resilience in the face of crisis. The search for stronger policy-implementing institutions should consider alternative trade regimes with Israel, Arab countries and the rest of the world, and explore how industrial policy can improve trade performance with government support measures influencing the environment in which the private sector operates.

One multilateral forum where Palestine can translate these principles into a case for securing the necessary platform for a sovereign national economy in the making is the World Trade Organization (WTO). In concrete terms, a new Palestinian economic strategy for peace and sovereignty should entail, among other moves, early consideration of acceptance of Palestine, in its capacity as representing the separate customs territory administered by the Palestinian Authority, as an observer in WTO (pending its eventual accession to the Organization and the trade negotiation process that that would entail). Such a move would require the support of all members of WTO, especially Palestine's current and future main trading partners, who would eventually shepherd an accession process once it begins.

While it would take several years to define the exact shape of the economic policy and institutions of the new State, such an initiative would confer immediate economic benefits and a measure of economic policy autonomy for Palestine:

- ☑ It would confirm the legal separateness of the Palestinian economy, which is a requirement for eventual statehood and for being a viable and reliable partner in international economic relations;
- ☑ It would affirm the commitment at an early stage of Palestine, as well as Israel and other partners, to resolving trade disputes within the rules-based disciplines and system of the multilateral trading system;
- ☑ Indeed, within the context of WTO pluralism, even the PER could remain the basic legal reference for Palestinian economic activity for as long as both sides consider it desirable, or until the Palestinian State is able to deploy an alternative trade regime that satisfies its development imperatives;
- ☑ In the meantime, principles such as free trade, trade facilitation, national treatment and special and differential measures for least developed economies that are embodied in WTO could serve as guiding principles for the resolution of current Israeli–Palestinian trade disputes (including those related to customs operations at borders, the trade link between the two parts of the territory etc.) even before independence;
- ☑ By re-anchoring the nominal autonomy of the Palestinian economy (even in this pre-independence stage) within a multilateral recognition framework, rather than in the redundant and dysfunctional bilateral framework of the PER, Palestine can define a benchmark and a broad reference platform for market liberalism, transparency and equity that could infuse economic policymaking in general and send a realistic message that Palestine would soon be open for business;
- ☑ In turn, this would help to shape sovereign national economic institutions in the areas of trade, public finance, monetary and macroeconomic policy, and intellectual property rights – as well as a wide swathe of economic regulation that all members of WTO adhere to and attempt to enact in order to level the playing field.

Such a strategy would reconfirm the Palestinian commitment to peace, but not at the expense of viable statehood and effective sovereignty – distinguishing it from the previous “accommodating” strategies adopted by the Palestinian Authority. By focusing on the real economic needs of statehood, it would also help to economize on the precious time that remains before realities on the ground have been transformed too drastically. It is high time to shift the paradigm of Israeli–Palestinian economic relations from one of occupation and denial of sovereignty to one of parity between partners within a multilateral framework of support and peaceful cooperation. Such a reorientation might even improve the chances of what is otherwise an unattractive and distant prospect for Palestinians today – namely, an emasculated, provisional, non-contiguous and economically dependent “state”, with a small “s” – being transformed into a realistic proposition of statehood and independence that would be hard to resist tomorrow.



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