Israel and Palestine:

Between Disengagement and the Economic Road Map

Aix Group

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Foreword

The Aix Group

Following discussions with Israeli and Palestinian economic experts in the beginning of 2002, Professor Gilbert Benhayoun of the Université Paul Cézanne - Aix-Marseille III decided to contribute to researching a vision of the future economic relations between Israelis and Palestinians. To this end, he organized an International Workshop on The Potential for Economic Cooperation in the Middle East: the Israeli-Palestinian Perspective. The seminar took place in Aix-en-Provence in July 2002.

A workgroup was created after this seminar – hence the name "Aix Group" – in order to bring together Israeli and Palestinian perspectives on economic questions related to future permanent arrangements between the two sides and to create a forum for discussing and analyzing different scenarios and propositions. Focusing on developing an economic framework as a complement to the political process started by the Road Map and supported by the Quartet, the Aix Group has met regularly since – in Paris, Istanbul, Fontainebleau and Jerusalem – and in January 2004 published a paper entitled *Economic Road Map*. Since then the group has continued to meet and develop work plans for both short-term and long-term economic issues.

The Aix Group is comprised of Israeli and Palestinian academics, members of Israeli and Palestinian economic organizations, as well as participants from official institutions (acting as observers), particularly from ministries dealing with the economic sector. In addition the Aix Group includes international experts, academics and members of international institutions - the European Union, the World Bank and the International Monetary Fund - who also act as observers.

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Executive Summary[1]

In this paper the Aix Group analyses the risks and opportunities associated with the Israeli Unilateral Disengagement Plan. We assess the conditions created by disengagement, how they will affect the economic prospects for recovery in the Palestinian economy and what conditions must exist in order to link disengagement to the concepts presented by the group in the Economic Road Map (ERM).

The Aix Group notes the potential for a *positive context* for disengagement and the mutually declared policy to consider ways of improving the economic situation in the Palestinian Territory. The Group is also fully aware of the very *significant risks* associated with disengagement; it can, however, become an *opportunity* if a set of *conditions* is met. The focus of this paper is to discuss these *conditions* and connect disengagement to the ERM.

Implementing the Disengagement Plan will create a change in the economic status of the Gaza Strip and the northern West Bank. The new arrangements will end Israeli presence in those areas and change their links to Israel and the rest of the world. Although the Disengagement Plan states that the economic arrangements currently in effect (the Paris Protocol) will remain valid, certain parts of the plan suggest otherwise. From an economic point of view, unless the plan is reformed, the result will be that the Gaza Strip will have very restricted economic links to the Israeli market, the West Bank, Egypt and other foreign markets. If an extreme version of the plan is implemented, including closed external borders of the Gaza Strip, it will turn it into an isolated and economically weak region.

If the Disengagement Plan is to fall within the Road Map (RM) parameters, as its architects argue, the new arrangements should not lead to an economic regime in the Gaza Strip that differs from that in the West Bank or to separating the Gaza Strip from the West Bank.

Immediate Economic Recovery

Since the outbreak of the conflict in October 2000 the Palestinian economy has experienced severe difficulties. Deterioration is reflected in every aspect of the economy, including domestic production, net income, consumption, investments and exports. As a result, the West Bank and Gaza Strip suffer from very high rates of unemployment and widespread poverty.

[1] This position paper is based on a background paper written by Arie Arnon, Saeb Bamya, Alon Etkin and Saad Khatib for a meeting of the Aix Group held in Jerusalem on 20 March, 2005.

The target for immediate economic recovery should be a return to pre-conflict levels of economic activity, thereby opening the way for sustainable development within the framework of a viable, independent Palestinian state. Economic activity can be expected to show a strong recovery if key constraints are lifted:

- The removal of internal closures within the West Bank and Gaza Strip.
- The creation of a secure, efficient and reliable economic link between the West Bank and the Gaza Strip.
- The establishment of a secure, cost-effective, efficient and systemized border regime.[2]

Exporting Palestinian Labor

Despite projected improvements in local and export economic activities and a development effort targeted to evolve as the above listed restrictions are removed, even a full return to pre-2000 levels in these sectors cannot fill the economic gap left by restrictions on the export of Palestinian labor to Israel. The Unilateral Disengagement Plan includes the possibility of eliminating Palestinian labor exports – a policy which will severely undermine recovery efforts. Palestinian workers in Israel provide an important source of revenue and employment in the West Bank and Gaza Strip; in addition current restrictions on labor movement have an important social impact.

Territorial Link

In order to function as one economy and market, especially when we assume borders and not full integration, the geographic separation of the West Bank and the Gaza Strip requires the creation of a link between the two.

The functioning of a Territorial Link (TL) is crucial to the development of a Palestinian state and economy. In the long term it should address key issues including extensive infrastructure projects such as pipelines for water and gas, facilities for the transport of electricity, cables, road system(s), a train, etc. In the short term it should enable people and goods to move between the two regions in a manner similar to that of normal, internal Palestinian movement.

Security

In order to achieve economic recovery within the context of the ERM, Palestinians should increase the drive for internal reforms including implementing the rule of law, instituting a separation of powers, and developing mechanisms for legal recourse. This needs to be accompanied by the fulfillment of Palestinian commitments to improve the security situation as stated in the RM.

For disengagement to succeed, Palestinian access to Israeli export routes (ports and airports), and reliable export routes from Palestinian Territory to Jordan and Egypt, must be facilitated.

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2 The Separation Barrier currently under construction, should it prove to be a permanent structure, will have severe negative effects on Palestinian economic viability. In our view its permanency is incompatible with the economic vision reflected in this document.

Security arrangements must take into consideration the importance of allowing the free flow of trade. Existing technologies and administrative methods that allow the orderly and prompt flow of goods through export routes while maintaining security should be put into practice.Without this, the potential for achieving Palestinian economic sovereignty is non-existent.

Conclusion

The Disengagement Plan is diverting us from the present agreed-upon economic regime while not advancing the permanent arrangements as stipulated in the ERM. It is important that disengagement does not contradict existing agreements while unilaterally establishing final status economic issues. Its outcome might distort permanent status parameters by creating, for example, different economic regimes in the West Bank and Gaza Strip. If, on the other hand, preparations in the economic/trade sphere for independent statehood take place during the disengagement process, they will provide positive opportunities for economic recovery in the Palestinian Territory.

1. Introduction

The recent changes in Israel and Palestine puzzle many observers. In June 2004 the Israeli Government decided to unilaterally implement a Disengagement Plan from the Gaza Strip and the northern West Bank, contrary to the policy declared when Ariel Sharon was elected PM at the beginning of the second *intifada*. In January 2005 the newly elected president of the Palestinian National Authority, Mahmoud Abbas, undertook implementation of a ceasefire and declared that he would like to resume permanent status negotiations. In February in Sharm-e-Sheikh, it became clear that several channels for discussions and negotiations may resume shortly. In this paper we attempt to analyze the *economic dimensions* of these developments.

While writing this paper, during the first months of 2005, it seems that this fifth year since political negotiations collapsed in 2000 might signal a positive turn, indicating that a renewal of the political process is again a real option, but this rather optimistic view is far from certain. However we believe that new light can be shed on the complicated interactions between economics and politics, based on what we have learned from past experiences. That insight in itself has value, since it has the potential to improve the likelihood that the future of both politics and economics in the region will be brighter than in the recent past.

The last four years created such mistrust in the region that daring to talk about an agreement between the two sides sounded like a fantasy, a dream out of touch with reality. However we believe that we should examine the possibility of a new agreement between the sides because the alternatives are worse, and because we have good reason to argue that the two sides can conduct meaningful negotiations and solve this long and bitter conflict between Israel and Palestine.

The exact structure of the planned disengagement from the Gaza Strip is not finally shaped, or possibly not fully known, hence the disengagement economic regime is unclear – particularly regarding control over the external borders of the region and the types of links between it and the West Bank. Thus we must make specific assumptions concerning the disengagement economic regime and assess the pros and cons of alternative regimes. We will emphasize their implications for future economic arrangements between Israel and Palestine, particularly as described by the Aix Group in the Economic Road Map (ERM) of January 2004.

The Aix Group argued in the ERM that economic arrangements consistent with a 'two-state' solution, including the delineation of agreed borders, will be based upon a totally new economic regime between the two economies. As described in the Appendix *Past Economic Arrangements and the Long Term Future*, the proposed regime has not been tried for various reasons. The group concludes that, if implemented after an agreement between the two sides, this regime will provide the best environment for long-term economic growth of the two economies and for the required and desired convergence of standards of living between them. In the present paper we analyze the conditions necessary to follow a path that will lead us from unilateral disengagement to a reciprocal, stable, long-term, solution.

A two-state solution means agreed political borders. Economic analysts over the last few years have come to the conclusion that economic borders, if efficiently constructed through agreement, would improve rather than harm the prosperity of both economies.

The geographical separation of the two Palestinian regions calls for the creation of a link especially when we assume borders and not full integration. The unity of the West Bank and Gaza Strip is reflected in common history, current political structures, family ties, demography and culture, and has important economic dimensions concerning trade, labor, higher education, health care, etc. In the 1995 Interim Agreement Israel and the PLO agreed that:

> "The two sides view the West Bank and the Gaza Strip as a single territorial unit, the integrity and status of which will be preserved during the interim period.[3]"

The functioning of a Territorial Link (TL) is crucial to the development of a Palestinian state and economy in both the long term and the short term. In the long term, the TL should address key long-term interests including extensive infrastructure projects such as pipelines for water and gas, facilities for the transport of electricity, cables, road system(s), a train, etc. In the short term it should enable people and goods to move between the two regions in a manner similar to that of normal, internal Palestinian movement. Key to the TL concept is that traveling on the TL should not be like traveling through an international crossing point.

To summarize, the current structure of the short-term economic arrangements between the Israeli and Palestinian economies, constructed under the Paris Protocol, is based on:

1. Uniform economic envelope on external borders, known also as a semi custom union.

2. No internal economic borders.

3. Uniform arrangements in the West Bank and Gaza Strip which are treated as one economic (and political) unit.

We think that in the Israeli-Palestinian case, where there is not yet an independent nor viable Palestinian state, the architects of the Paris Protocol (and the Oslo process) avoided difficult issues of sovereignty (a state, borders, withdrawal, removing settlements, etc.) by creating a vague concept of Palestinian sovereignty. They designed an interim agreement where the two societies will first coexist under Israeli-controlled external borders, slowly moving towards

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[3] Ch. 2, Art XI in the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip, Washington D.C. September, 28, 1995.

the creation of a Palestinian state with Palestinian control of external borders, the creation of 'safe passages' and entry into permanent status negotiations whereby the borders will be demarcated and permanent territorial links will be discussed. This transitional framework promised the Palestinians high living standards and time to build their internal capacity to operate the institutions of a state. In 1999 these interim arrangements were supposed to terminate and the two sides were to reach a permanent agreement. This never happened.

The long-term permanent arrangements as recommended by the Aix Group, for phase III of the RM, assume:

1. Possible different external economic envelope on the outside borders of Israel and Palestine so that independent trade policies can be implemented.

2. Possible internal economic borders between Israel and Palestine.

and again

3. Uniform arrangements in the West Bank and the Gaza Strip which are treated as one (political) and economic unit.

The framework for the long term assumes stable agreements. The advantages of stability are clear but additionally the Aix Group has argued that exporting more goods and less labor will have significant advantages that will contribute to balancing future economic relations between the two sides.[4]

[4] See Astrup. and Dessus (2002), World Bank (2002), Aix (2004).

2. Economic Arrangements for the Short Term

The short-term arrangements, applicable during the transition from the present through disengagement and until the permanent status agreement is reached in phase III, will have to rely on the Paris Protocol (the first set of the above assumptions). Implementation of the Unilateral Disengagement Plan should not create conditions that contradict those assumptions. However on several important issues disengagement may depart from them and create conditions contrary to the Protocol:

- The uniform external borders concept will be challenged since in one of the disengagement scenarios the Gaza Strip border will deviate from the current uniform border regime. The reason for the deviation is the possible elimination of an Israeli presence along external borders, including the borders between it and Egypt (known as Philadelphi), sea and air ports. Possible solutions to this problem have been discussed and one proposal is to rely upon a third party functioning as agents to guarantee the present arrangements along all external borders.

- A second problem concerns the creation of internal economic borders. Trade between Israel and Palestine should not face any barriers according to the Paris Protocol, and labor flows should continue as closely as possible to 'normalcy'. However, the June decision of the Government of Israel (GoI) threatens this basic element of the protocol, and later discussions with international agencies have made the point even clearer. The Israeli decision – that by 2008 it will phase out Palestinian labor flows to Israel – contradicts the assumption of no permanent internal labor borders in the short term. The economic implications of such a decision are far-reaching and contrary to any reasonable development plan for the Palestinian economy.

- The third departure from the Paris Protocol concerns the treatment of the West Bank and Gaza Strip as one economy. For economic reasons as well as for maintaining the prospects of a permanent status agreement, the partition of the Palestinian Territory into separate economic units is undesirable and contradictory to the vision of peace based on the creation of a viable Palestinian state as stated in the Road Map (RM).

Unilateral Disengagement

In June 2004 the Israeli Cabinet accepted Prime Minister Sharon's Revised Disengagement Plan. The plan was approved by the Knesset in October. According to the plan, Israel will unilaterally end its permanent military and civilian presence in the Gaza Strip and in a limited part of the northern West Bank. Parallel to its withdrawal, Israel will continue to construct the separation barrier in the West Bank and maintain its military presence between the Gaza

Strip and Egypt (Philadelphi), the West Bank and Jordan, and its control over air and sea entry points.

If implemented, the plan will create a new situation. In January 2004 in the Economic Road Map (ERM) we analyzed the possibilities of a recovery in the Palestinian economy if the political Road Map (RM) is implemented. In the ERM the point of departure was the third phase of the RM, assuming that the sides agree upon the implementation of a permanent two-state solution to the conflict. Then, in a reverse engineering technique, we described the economic changes necessary during the first and second phases of the RM that would lead to a viable Palestinian economy in the third phase. In the present paper we will assess the conditions created by disengagement, how they will affect the economic prospects for recovery of the Palestinian economy and how they can be linked to our concepts as described in the ERM.

Implementation of the Disengagement Plan will create a change in the economic status of the Gaza Strip and the northern West Bank, ending Israeli presence in those areas and changing their links to Israel and the rest of the world. Although the Disengagement Plan states that the economic arrangements currently in effect (the Paris Protocol and quasi-customs union) will remain valid, certain parts of the plan suggest otherwise. The plan states that the completion of the withdrawal will "negate the validity of any claims against Israel regarding its responsibility for the Palestinian population of the Gaza Strip." In addition, it states that "Israel will monitor and supervise the outer envelope on land, will have exclusive control of Gaza airspace, and will continue its military activity along the Gaza Strip's coastline." If the plan is to fall within the RM parameters, as its architects argue, the new arrangements should not lead to an economic regime in the Gaza Strip that differs from that in the West Bank or to separating it from the West Bank. From an economic point of view, unless the plan is reformed, the result will be that the Gaza Strip will have very restricted economic links to the Israeli market, the West Bank, Egypt and other foreign markets. Furthermore, if an extreme version of the plan is implemented, including closed external borders of the Gaza Strip, it will turn it into an isolated and economically weak region.

Immediate Economic Recovery

Since the outbreak of the second Intifada in October 2000 economic deterioration has been reflected in every aspect of the Palestinian economy including domestic production, net income, consumption, investments and exports. As a result, it faces very high rates of unemployment, widespread poverty and significant fiscal difficulties for the Palestinian Authority.

The target for immediate economic recovery should be a return to pre-conflict levels of economic activity, thereby opening the way for sustainable development within the framework of a viable, independent Palestinian state. Economic activity can be expected to show a strong recovery provided key constraints are lifted:

- The removal of internal closures within the West Bank and Gaza.
- The creation of a secure, efficient and reliable economic link between the West Bank and Gaza.
- The establishment of a secure, cost-effective, efficient, systemized border regime.
- The implementation of an urgent recovery program.

World Bank projections estimate that such actions would significantly increase nominal per capita GDP over current levels with drastic decreases in unemployment and poverty rates.[5] Local market activity in particular is expected to surge with improved mobility and access within and between the West Bank and the Gaza Strip.

Commodity exports can also be expected to show an immediate positive response to such actions. Even though constrained and limited, current exports already demonstrate their important contribution to the national economy, but these figures do not sufficiently reflect the actual potential. The severe drop in exports over the last four years is related directly to imposed restrictions and not to a sudden deterioration of intrinsic export capacity. Furthermore an estimated 20% growth in total exports[6] can be safely projected if restrictions are removed and trade is restored with current main partners, particularly Israel, and with growing diversification into other markets, especially through trade agreements with Arab and EU countries.

Despite projected improvements in local and export economic sectors if restrictions are removed, the border regime is improved, and development is well-targeted, a full recovery to pre-2000 levels cannot fill the economic gap left by the restrictions on the export of Palestinian labor to Israel. Failure to address this important source of revenue and employment, and the social impact of its decline will undermine recovery efforts.

It is also important to note that economic recovery under the ERM will require Palestinians to continue and increase their drive for internal reforms, including implementation of the rule of law on a wider scale, the separation of powers and mechanisms for legal recourse. This must be accompanied by the implementation of Palestinian commitments to improve the security situation as stated in the RM.[7]

[5]World Bank 2004a.

[6]Realizing Export Potentials, Palestine Trade Center – Paltrade, (January, 2005) and World Bank (2004b).

[7]"24 Closures, however, cannot be viewed in isolation from security, in particular the threats posed by militants seeking to enter Israel. Security per se is beyond the scope of this paper, but a maximum PA effort to fulfill its security obligations under the Road Map is needed if the donor community is to argue for a major easing of today's closure regime." World Bank June 2004a.

3. The Disengagement Plan and the ERM

The proposed Disengagement Plan with its limited withdrawal from the Gaza Strip and the northern West Bank will not provide an adequate impetus for economic recovery since some of its broad economic implications may be detrimental to the potential for long-term development. On the other hand, removal of internal closures within the West Bank and Gaza Strip, the establishment of a territorial link between the two areas, and Palestinian control over border crossing points with Jordan and Egypt as well as Israel would provide an impetus for immediate short-term recovery of the Palestinian economy.[8] The World Bank estimates that an immediate easing of internal closures could raise the annual GDP growth rate by approximately 3 percentage points in the years to come.

The Disengagement Plan is diverting us from permanent arrangements as stipulated in the ERM. We recommended creating a FTA between Israel and Palestine in the final status as have other final-status studies of trade regime options.[9] It is important that disengagement does not contradict existing agreements and unilaterally establish the final status of economic issues. Its outcome might distort permanent status parameters by creating, for example, different economic regimes in the West Bank and the Gaza Strip. On the other hand, preparations in the economic/trade sphere for independent statehood may take place during the disengagement process.

The Economic Road Map was designed to be implemented together with the political Road Map for peace, the goal of which is the establishment of a viable and economically independent Palestinian State. The ERM focuses on the economic arrangements to be taken during Phase III of the political RM when the two sides negotiate a permanent status agreement. The ERM's recommendations for the interim period derive from the need to progress from the current situation to Phase III:

Phase I of the ERM is seen as a "rescue phase" and consists of measures to prevent further economic deterioration in the Palestinian Territory. Phase I calls for the following basic actions:

a) The free flow of goods inside the Palestinian Territory and to its export markets.

b) Free labor movement within the Territories and a stable level of Palestinian labor in Israel.

c) Uninterrupted fiscal transfers from Israel to the Palestinian National Authority.

Phase II consists of measures to promote the redevelopment of the Palestinian economy and to lay the foundations of economic independence. Consistent with the political Road Map's vision of a Palestinian state with provisional borders, the Economic Road Map calls

[8] The World Bank Group, Four Years - Intifada, Closures and Palestinian Economic Crisis, November 2004.

[9] See, The Peres Center for Peace, Future Economic Relations between Palestine and Israel, June 2004.

for full implementation of a modified Paris Protocol. **Phase III** should evolve from the previous measures, thereby leading to full Palestinian economic sovereignty and a FTA with Israel.

Below we examine the actions needed during the "rescue phase":

a) Free Flow of goods

During the past four years, the Palestinian economy has faced two main obstacles[10] in regards to the movement of goods: the first is internal barriers and closures; the second is external barriers. These obstacles, which Israel argues are necessary for its security and which the Palestinians interpret as economic sanctions, were the main catalysts for the economic crisis in the PA, leading to increased transaction costs[11] and undermining the predictability of the flow of goods. Furthermore, these restrictions limit the competitiveness and productive capacity of Palestinian economic sectors in general, handicapping their ability to develop export capacity.

The Disengagement Plan does not state that current arrangements regarding the movement of goods – closures, checkpoints, back-to-back systems – will change, thereby challenging any potential for economic recovery in the Palestinian economy. The Israeli withdrawal from the Gaza Strip and northern West Bank, especially the dismantling of settlements, is supposed to bring to an end the limitations on internal movement, especially important in the Gaza Strip. On the other hand, the tightening of security measures around the Gaza Strip implies that current limitations and barriers on the movement of goods will continue and possibly increase. The separation between the West Bank and the Gaza Strip will continue due to the absence of a corridor linking the two geographical parts of Palestinian Territory and restrictions will continue on internal trade between them.

Restoring the free flow of goods is a necessary first step for Palestinian economic recovery. Without a stable export market, Palestinian industries lack the scale to be competitive even in their domestic market. Simply put, Palestine cannot be economically viable under the current border control regime.

The free flow of goods should be targeted on three levels:

i. Within the Palestinian Territory.

ii. Between the Palestinian Territory and Israel.

iii. Between the Palestinian Territory and other foreign markets.

i) Free flow of goods within the Palestinian Territory

The absence of a physical or direct link between the Gaza Strip and the West Bank will have negative consequences on the economies of both areas. The separation barrier and the

[10] The World Bank, UNSCO and UNCTAD have stated that the direct cause for Palestinian economic distress is Israel's restrictions on economic activity – specifically on the movement of people and goods within and between the West Bank and the Gaza Strip, as well as the access of Palestinian trade (both imports and exports) to Israeli sea and air ports and to external markets.

[11] All outgoing cargo from the West Bank and Gaza is subject to restrictive security measures which increase transaction and transportation costs tremendously. See Palestine Trade Center, Trade Impediments, Issue No. 2 – April 2005.

maintenance of major settlements in the West Bank will keep large and important portions of the West Bank under Israeli control. The separation barrier has already caused damage to the economy in the West Bank by separating many towns from parts of their agricultural lands. The possibility of separating the West Bank into different units and the continuation and institutionalization of the closure system will undoubtedly incur very high transaction costs, especially if the back-to-back system continues.[12]

Thus one of the most important and urgent modifications of present conditions is the establishment of a stable, uninterrupted and secure link between the West Bank and Gaza Strip. Such a link does not contradict the essence of the Disengagement Plan nor is it contradictory to the parameters of the RM. The two sides, together with a third party involved in the economic aspects of implementation, should address this issue urgently. The World Bank predicts that the production capacity of the Gaza Strip will increase with the reacquisition of the approximately 15% of the Strip currently controlled by Israel. Assuming the GoI transfers the agricultural land with its capital improvements intact, it should provide an immediate production gain.[13] To reap the potential benefits associated with the additional production, it is critical that access be provided to all of the Palestinian territory.

Short-term Territorial Link

In the immediate term a link must be devised which will address the pressing economic (and other) needs of the Palestinians, without prejudicing any permanent status arrangements regarding the TL. Any arrangements made in the current context must safeguard the spirit of the previously agreed ‘safe passage’:

- Guaranteed to all people at all times.
- Safe from Israeli military activities.
- For public and private Palestinian vehicles, goods and people.
- Multiple routes.

The aim is to create a secure and safe road network exclusively for Palestinian use that links the West Bank to the Gaza Strip. A fenced road would be one ideal solution in the short to medium term as it would be in line with the future needs of a territorial link. Once the road is secured all vehicles and people would use it with no limitation and no security inspection. Movement of people must be significantly less restrictive than that of goods. A railway is a good option in addition to – and not instead of – secure, designated road(s). However, since the development of a railway system will require time, it should be considered for the permanent TL and not for the interim.

[12] The Beytounia crossing point between the Ramallah area and Israel is within Palestinian Territory, and in line with the Separation Barrier as reported by Trade Impediments, Issue No. 1 – February 2005, Palestine Trade Center – Paltrade, http://www.paltrade.org/Publications/Impediments%20issue%20021409.pdf.

[13] The agricultural land is among the best in Gaza, with essentially no soil fatigue, since only 10% of the 32 square kilometers of farmland within the settlements were in use.

People

Every person residing or visiting the West Bank and the Gaza Strip should be able to use the 'safe passage'. People may either use private cars (which Israel will need to check for security purposes) or public vehicles (which Israel will not need to check as a system of assurances will be put in place). People whose names appear on a 'negative list' will be allowed to move in public vehicles only. A third party will monitor the clearance of names (i.e. implementation of the negative list concerning those not allowed into Israel). Public vehicles (operated by private companies whether national or international) will have to give assurances to Israel that no weapons or explosives are in the vehicles.

The 'safe passage' should be open 24 hours a day, 7 days a week. Private and public vehicles will move on designated road(s). A system of ensuring that vehicles do not leave the safe passage will be put in place through monitoring departure and arrival times and other devices.

Goods

Palestinian vehicles and goods will be checked at the outer point upon departure. Technology will be used to ensure speedy checks without the need to unload.

ii) Free flow of goods between the Palestinian Territory and Israel

Israel has been the Palestinian economy's main trading partner since the late 1960s. The political changes, the interim economic agreements and the escalation of the conflict has not changed this reality. Moreover, for the Palestinian economy, the advantages of having a relatively large economy open to trade at their doorstep offers considerable potential. Though the Palestinian economy is very small compared to that of Israel, the latter also gains from trade with the Palestinians. This has become especially evident in the past year when the Karni crossing was closed to Israeli agricultural products and the results included a sharp decrease in prices and serious negative effects on Israeli producers.

Parallel to implementing disengagement, the sides should construct transport terminals for goods that will allow quick, safe and reliable transport between the sides. The terminals should be built between the Gaza Strip and Israel and between the West Bank and Israel. This first step – constructing transport terminals - is critical for reviving the Palestinian economy. The terminals will also offer basic infrastructure for facilitating customs checkpoints in a possible FTA agreement in the final status.

iii) Free flow of goods between the Palestinian Territory and other foreign markets

In the past decade, Israel has not only been the central market for Palestinian goods, but also served as the central passageway for goods from the Gaza Strip. In 2003, the Palestinians exported around US $50 million and imported around US $350 million through this route. The transport of goods to Egypt through the Rafah crossing has effectively stopped since Israel closed the commercial terminal in 2002, thus leaving the Karni crossing into Israel as the Gaza Strip's sole export and import channel.

The challenge of establishing economic stability and sustained development in light of the limited local market capacity should be geared towards developing an export-based economy linked to diverse markets. The World Bank clearly states that ending the Palestinian economic crisis depends upon the ability of the private sector to trade in international markets, that is, the opening of external borders. In order for the Palestinian export sector to grow it needs to restore and expand its export base and to improve the stability and credibility of the flow of goods. The natural markets for export, apart from Israel, are the Arab world, the EU and the U.S. The current main export route from the Gaza Strip is Ashdod port. Therefore it is important to develop systems that will allow the simple, safe and reliable transport of goods from the Gaza Strip to Ashdod. One possibility could be the construction of a railroad track that will provide a direct link. However basing the trade of goods from the PA to foreign markets exclusively on passage through Israel will create reliance on changes in the political realm and hence put the reliability of exports in question. Therefore other alternatives should be created.

The Disengagement Plan states that Israel will keep control over the air and sea entry points as well as over the border with Egypt. Moreover, construction of sea and air ports will be considered only in the future. A reassessment of this policy – which makes Palestinian trade completely dependent on Israel – should be undertaken.[14] To create a viable Palestinian trade system, it is imperative to develop a multi-modal transport system including:

- Cargo and transport facilities on land border points with Jordan, Egypt and Israel (Rafah, Al-Karamah and crossing points with Israel).
- Air and sea port facilities (for cargo and refrigeration) and interim cargo handling arrangements through neighboring Jordanian and Egyptian ports.
- Transit trade agreements with all three countries bordering Palestine (Egypt, Israel, Jordan).
- Upgrading of major trade access routes and trunk roads.
- Palestinian control over international borders and crossing points.

Security

The security arrangements must take into consideration the importance of allowing the free flow of trade. The back-to-back system which is applicable on all external passages from Palestinian areas to Israel (Karni and Erez) or to Jordan and Egypt (Allenby and Rafah respectively) has far-reaching negative economic effects and should be replaced by other means: door to door, through traffic with necessary security arrangements. Technological and administrative methods that allow the orderly flow of goods through export routes while maintaining security should be put into practice parallel to the disengagement.

[14] Although the Paris Protocol calls for the same economic and trade treatment concerning Palestinian and Israeli trade moving through Israeli ports and airports, Israeli security measures at the main border crossings have limited the ability of Palestinian industries to extend their reach beyond Israel.

Conclusion

With the Palestinian population growing at about 4% annually, Israel should allow the Palestinian export base to expand to create new jobs and avoid further economic deterioration. Although the Disengagement Plan makes reference to the possibility of reopening the Gaza Strip airport and developing a seaport, it stipulates that permission for these projects will be granted on security grounds rather than economic considerations, and makes no mention of a time line or date by which this is to be done. This approach is inconsistent with the goals of phases I and II of the Economic and Political Road Maps.

While the additional land in Gaza Strip promises greater output, free movement inside the Gaza Strip and reduced transportation costs, the current border trade regime will substantially diminish its effect on exports. This situation is unlikely to improve. Economic stabilization – which depends largely on re-establishing and expanding Palestinian exports – will not occur simply by restoring internal mobility to the Gaza Strip. The Disengagement Plan states that Israel will redeploy its military forces to the Philadelphi Route along the Egyptian border and maintain control over customs. Security arrangements that promise the free flow of goods between the West Bank and the Gaza Strip without exposing Israel to risks should be developed and put into practice parallel to the disengagement.

For the disengagement to succeed, Palestinian access to Israeli export routes (ports and airports) and reliable export routes from Palestinian Territory to Jordan and Egypt must be facilitated. Security arrangements must take into consideration the importance of allowing the free flow of trade. Existing technologies and administrative methods that allow the orderly and prompt flow of goods through export routes while maintaining security should be put into practice. Without this, the potential for achieving Palestinian economic independence is non-existent.

b) Labor

Until the beginning of the 1990s, over a third of the Palestinian work force was employed in Israel and unemployment rates were less than 5% both in the West Bank and the Gaza Strip. After 1993, parallel to the beginning of the Oslo process, the Israeli government started imposing restrictions on Palestinian employment in Israel. These restrictions led to a sharp decline in the number of Palestinians working in Israel in 1995-6, and to a concurrent rise in unemployment rates due to the lack of sufficient internal workplaces to absorb these workers.

A steady growth in the number of Palestinians employed in Israel (1997 to 1999) followed, just to crash again in 2000. The decrease in the number of Palestinians working in Israel in addition to the sharp decline in economic activity within the Palestinian Territory led to an overall unemployment rate of over 27% in 2004. In the Gaza Strip the unemployment rate was 35% and in the West Bank 23%.

Those affected the most by limitations on work in Israel were unskilled workers who were engaged in Israeli low-value-added jobs such as construction, agriculture and to some extent manufacturing. The relatively low participation rate of the workforce makes it even harder for Palestinian society to cope with these high rates of unemployment.

It is obvious that the vision of a stable and economically viable Palestinian state cannot be achieved if the current rates of poverty and unemployment persist. Hence, any potential for economic recovery will depend on short to medium term and long-term conditions which serve to reduce unemployment and pave the way for economic recovery.

In the Disengagement Plan the Israeli government has announced that the number of Palestinian workers allowed into Israel will be a maximum of 35,000, with a view to reducing this amount to zero by 2008.

As mentioned earlier, up until the mid-1990s, Israel was a major employer of Palestinians from the West Bank and the Gaza Strip (See Table 1). The Economic Road Map states that although the Israeli labor market will play a diminishing role in Palestinian development, its importance for an orderly economic transition is significant. Therefore, the ERM calls for a restored stable and predictable flow of Palestinian workers to Israel in Phase I. It suggests a regulated flow of labor that will meet both Israeli market demands and Palestinian employment needs. As the local Palestinian labor market expands, this number may be gradually decreased.

The Disengagement Plan proposes a different course. It suggests that in the short term the entry of Palestinian workers into Israel will remain in accord with existing criteria and be gradually reduced until it is completely ended by 2008. Implementation of such a policy will add to the pressures on the internal labor market and neutralize efforts to stabilize the Palestinian economy.

Table 1: Palestinian workers in Israel 1981-2004

(in thousands)

Year	West Bank	Gaza	Total
1981*	39.9	35.9	75.8
1982	43.0	36.1	79.1
1983	48.1	39.7	87.8
1984	50.1	40.2	90.3
1985	47.5	41.7	89.2
1986	51.1	43.4	94.5
1987	62.9	46.0	108.9
1988	64.0	45.4	109.4
1989	65.4	39.5	104.9
1990	64.6	43.1	107.7
1991	55.9	41.8	97.7
1992	72.5	43.1	115.6
1993	53.6	30.4	84.0
1994			
1995**	62.2	3.6	65.8
1996	52.3	9.2	61.5
1997	68.6	14.2	82.8
1998	96.0	24.1	120.1
1999	108.3	26.7	135.0
2000	95.2	22.2	117.4
2001	66.9	2.5	69.4
2002	46.6	3.5	50.1
2003	51.4	5.6	57.0
2004	48.6	1.8	50.4

* 1993-1981 according to Israeli statistics

** 2004-1995 according to Palestinian statistics *c) Fiscal transfers*

The continued deterioration of the Palestinian economy has forced the PA to play a greater role in welfare matters by hiring additional employees to provide more services, thus raising budgetary expenditure. At the same time, revenues declined sharply at the start of the Intifada, in line with the drop in economic activity. Even if the revenue performance recovered during the last couple of years, the PA's budget remains highly dependent on external budgetary support. Donor support in 2003 dropped to less than half its 2001 level, leaving the PA with a US$ 650 million budget deficit for the 2004 fiscal year.

Another important income source is tax revenue which, according to the Paris Protocol, the GoI is obliged to transfer fully and regularly to the PA. About two-thirds of PA's revenues were being collected by the GoI before 2000. However, these transfers were interrupted during 2001-2, and are often subject to attachments by Israeli courts in the context of legal cases of Israeli citizens against the PA.

The Disengagement Plan keeps GoI's economic agreements with the PA in tact. It does not, however, address revenue issues which are under dispute and have proven to be unreliable in the past.

The ERM suggests that during Phase I, in order to avoid further deterioration, there must be a continued uninterrupted flow of fiscal transfers from Israel to the PA.[15] In Phase II of the ERM Israel should commit to changes in the Paris Protocol to eliminate tax leakages. The World Bank suggests that fiscal leakages stemming from indirect imports into the Palestinian territory could be in the range of 3 to 4 percent of GDP. These additional transfers would lessen the PA's dependence on external financing, and free donor money for infrastructure development projects which would spur more investment.

Any future interruptions to its revenue streams will require the PA to curtail its basic public services and cut salaries. Thus, restoring the PA's fiscal health is a precondition for general economic and political stabilization in Phase I. This cannot occur unless the GoI addresses these issues and guarantees the timely transfer of revenues. The GoI's recent efforts to remove court attachments on some of the withheld revenues indicate that the problem is now better understood.

[15] Transfers were withheld between December 2000 and November 2002, when they resumed without further hindrance. Some US$ 100 million in withheld revenues were still retained by Israel at the end of 2004 as attachments to pending legal cases by Israeli citizens against the PA. The Government of Israel has been seeking, so far not entirely successfully, to argue with its justice system that these attachments are unnecessary because the regular flow of transfers provides a potential future source of deductions against any successful claims.

Appendix

Past economic arrangements and the long term future

A two-dimensional approach for analyzing the economic relations between Israel and Palestine can shed light on both past arrangements and future possibilities. We will examine: 1) whether relations are imposed by one side or agreed between the two; and 2) whether relations assume internal economic borders or not.[16]

In 1967-8 Israel unilaterally created an economic regime that can be described as 'imposed partial integration.' The outside borders of the entire area were controlled by Israel, which implemented its own trade protocol. Israel imposed a (quasi) customs union so that there were no trade borders within the combined area of Israel and the occupied Palestinian territories. It was not a 'pure' customs union in two respects: First, Israel created certain barriers to trade between the Palestinian Territory and Israel. Second, the revenue sharing mechanism, part and parcel of every customs union, did not exist so Israel collected all import taxes and held most of them.

In 1967-8, after an internal debate in Israel, it was also decided to allow Palestinians to enter the Israeli labor market. Five years after Palestinians started to work in Israel a 'steady-state' equilibrium was reached – since then about a third of total Palestinian employment has been in Israel. Palestinians working in Israel created income that contributed to high growth rates in the West Bank and the Gaza Strip in the 70s and the 80s but also explained, at least to some extent, the slow and weak performance of the Palestinian economy.

The weakness was also reflected in the Palestinian trade deficit, which was partially financed by wages earned in Israel and partly by income from abroad. The imposed integration regime may have had some advantages for Israeli producers and Palestinian consumers, but to a much lesser extent benefited domestic growth within the Palestinian economy which suffered from low private and public investment on top of its dependency on employment in Israel and a distorted balance of payments. All that was to be cured by the Paris Protocol.

The Paris Protocol was expected to promote economic development and the newly created prosperity should have supported the peace process. The negotiations resulted in giving the Palestinians some control over their future for the first time.

The preamble to the protocol states:

> "The two parties view the economic domain as one of the cornerstones in their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace. Both parties shall cooperate in this field

[16] Such a framework has been discussed in the Aix Group work in 2002-3. See also Ch. 4 – Trade Relations and the Epilogue in Arnon et al. (1997) Astrup and Dessus (2001,2002) and the important study of the World Bank (2002).

in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of mutual respect of each other's economic interests, reciprocity, equity and fairness.

This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities. The two parties recognize each other's economic ties with other markets and the need to create a better economic environment for their peoples and individuals." [Protocol, 1994, p. 1]

Thus, the protocol acknowledged the fact that there were two parties living side-by-side, which might sometimes have different interests and priorities. Those sides were to be represented by two separate decision-making bodies. The agreement was finalized in Paris[17] in 1994 and since then has been the official economic regime to which both sides were obliged.

However, the negotiations ended in a contract that was very similar to the imposed integration regime created after 1967 – a uniform external trade envelope, no internal trade borders and very restricted and ambiguous labor arrangements.

The important issue of labor flows is addressed in Article VII of the protocol. Its first controversial paragraph states:

"Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and conditions of the labor movement into its area. If the normal movement is suspended temporarily by either side, it will give the other side immediate notification, and the other side may request that the matter be discussed in the Joint Economic Committee."

Since it was written, there have been disagreements about the legal meaning of this paragraph and the degree to which the reality regarding labor flows actually corresponded to it. Thus an important distinction must be made after 1994 concerning the official, *de jure*, regime and the real, *de facto*, one. After the 1967 war, Israel imposed partial integration which was both *de jure* and *de facto* – that is, it was the official regime and the one implemented. After 1994, however, the Paris Protocol was the *de jure* regime, but *de facto*, a different regime clearly developed.

[17]The Protocol on Economic Relations was concluded on April 29, 1994 and signed officially in Cairo on May 5, as annex to the "Gaza-Jericho" agreement

Table 1: A schematic description of the economic regime

	Economic Borders	Economic Integration
Agreed	(ERM)	1994-2004 DE JURE: The Paris Protocol
Imposed	1994-2004 DE FACTO: Closures, partial separation	1967-1993 DE JURE & DE FACTO: Imposed partial integration

Why wasn't the protocol implemented? Some believe that part of the answer lies in incomplete contracts theory and time-inconsistency, but for our purposes now, it will suffice to say that the protocol was not implemented because the conflict and bargaining between the two sides continued. The economy became a victim of the transitory and partial nature of the process.

Closures have been an important factor in Palestinian-Israeli economic relations since 1994. In fact the severity of closures has increased and created a new economic regime which took us very far from integration. Rather, the unilateral creation of (economic) borders brought us closer to what could be called 'imposed separation' – the imposed economic borders option, no doubt the worst of the four options in Table 1.

The present economic crisis in the Palestinian economy is unprecedented both in its severity and longevity. While analyzing the possible path out of the crisis we would like to distinguish between two stages: the short term, during which the Paris Protocol will provide the framework, and the long term, when new permanent status arrangements will be agreed upon. We would like to emphasize that we believe that out of the four options in Table 1 the one that has not been explored – agreed economic borders – has the better potential to succeed as a long-term permanent system.[18] As for the short-term measures to be taken before a permanent agreement is reached – these were covered in the body of this paper.

The long-term option assumes that trade borders will be delineated where trade policy can be applied and a policy of regulated labor movements implemented. It calls for economic borders, through which trade and labor would flow at well-constructed crossing points that Palestinians and Israelis will shape and control. Assuming a permanent agreement is reached between the two sides, economic borders rather than full economic integration is the right long-term vision in the present state of the Israeli-Palestinian conflict.

[18] Certainly in due course, an agreed-borders regime can be transformed into an agreed -no-borders one.

On both sides it is well understood that the only possible political compromise is a two-state solution. We have assumed that a viable two-state solution will embody the following factors:

- The Palestinian state will have the power to define its economic objectives and strategies and to implement them freely within the parameters of a bilateral permanent agreement.
- Economic cooperation will be conducted in good faith and mutuality, free of any intention to dominate.
- There will be a clear, unambiguous agreement on borders.
- The Palestinian state will have full economic jurisdiction over its external borders with Jordan, Egypt and Israel, meaning that the Palestinian state and Israel will implement trade, labor and other regulatory policies in a manner congruent with normal relations between sovereign states.
- The Palestinian state will feature contiguity within the West Bank and efficient connections with the Gaza Strip.
- Borders in the Jerusalem area offer two options:

  Option A: An open Jerusalem, resulting inevitably in the creation of customs/economic borders around the city (i.e. the creation of a special economic area), unless the parties agree on a full customs union.

  Option B: The border will bisect Jerusalem, separating Jewish and Arab neighborhoods. In this case, a special economic status for the old, walled city can be devised, should both parties wish it.

A two-state solution means agreed political borders. As stated above, economic analysts over the last few years have come to the conclusion that economic borders, if efficiently constructed through agreement, would improve rather than harm the prosperity of both economies. The advantages of stability are clear but additionally, exporting more goods and less labor have significant advantages that will contribute to more balanced future economic relations between the two sides.

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The "Aix Group" was created in order to bring together Israeli and Palestinian perspectives on economic questions related to future permanent arrangements between the two sides and to create a forum for discussing and analyzing different scenarios and propositions.

The Aix Group is comprised of Israeli and Palestinian academics, members of Israeli and Palestinian economic organizations, as well as participants from official institutions (acting as observers), particularly from ministries dealing with the economic sector. In addition the Aix Group includes international experts, academics and members of international institutions – the European Union, the World Bank and the International Monetary Fund – who also act as observers.

In 2004 the Group published a position paper entitled the "Economic Road Map", which discusses alternatives for permanent economic arrangements that are consistent with a "two state" solution, as well as economic prerequisites for each phase of the Political Road Map proposed by the Quartet.

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