

May 2009

**The "Big Picture" 2009:
The Political and Economic Alternatives Facing
Israelis and Palestinians**

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**Based on the "Big Picture" presented in the Aix Group Phase IV Workshop
March 13-14, 2009, Paris**

¹ We would like to thank Hanoch Frankovits, Saad Khatib, Salim Tamari and Joseph Zeira for many discussions, comments, suggestions and corrections on previous drafts; of course, the usual caveat holds and the authors alone are responsible for the views presented in this draft.

1. Introduction

The Aix Group is a unique study group that has been active for seven years. The Group started its work in July 2002 following a seminar that took place in Aix-en-Provence – hence its name – 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 analyzing different scenarios and propositions. The Group is comprised of Israeli, Palestinian and international economists, policy-makers, members of economic organizations, and individuals from the academic and business spheres. Official observers from both the Israeli and the Palestinian side have met and shared their thoughts with the Group, and have incorporated some of the Group’s ideas into their policies. Within the deteriorating political circumstances in the region, the Aix Group has continuously served as one of the only economic forums where members of the two the sides can meet and continue rational discussions related to common concerns.

In 2003, the Group agreed on a basic concept which remains central in our discussions to this day. We came to the conclusion that one of the errors committed and followed by the two sides since 1993, when the Oslo process started, has been to base the peace process on “gradualism”. The right way forward, in our opinion, is to adopt what we have called a **“reverse engineering”** approach (see the “Economic Road Map”, 2004). In “reverse engineering”, the sides first agree on where they want to go, i.e. on the contours of a permanent agreement, and then decide how to reach that end. Gradualism, on the other hand, takes the form of an incremental approach, moving one step at a time with no agreement on, or even discussion of, the end result.

The concept of reverse engineering was developed and adopted by the Aix Group through a long process of discussion and dialogue. Within this concept, we have reached two main understandings which lie at the heart of the work we have done. The first one is the understanding that **all** outstanding issues between the two sides should be agreed upon first and at one time; thus the permanent agreement will constitute an historical compromise on all outstanding issues. Delaying agreement on any issue would mean leaving the contract incomplete and open to attacks and will

negatively affect the reconciliation process between the two sides and exacerbate mistrust. Hence, it is extremely important that the final outcome of any negotiations be comprehensive, final and clear and that gradualism be used only as a tool for smooth implementation. Any steps to be taken should be part of the reverse engineering concept, whereby the final outcome is well known and a series of steps are devised to ensure that the final outcome is achieved.

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

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

The calls to substitute a permanent political and economic agreement with "economic measures only" that will supposedly produce prosperity were raised by Israeli policy makers immediately after the 1967 war. Dayan, the Israeli defence minister, was the better known among them, but from time to time others repeat this argument.

However, in order to bring real new path of development to the Palestinian economy and make the convergence of standards of living between the two economies a real possibility, some basic requirements are needed. Among those requirements are: the need for stable and predicted macro environment; continuous exchanges of goods and factors of production between the economies; coordination of the financial and monetary spheres etc. These requirements, analyzed in our Economic Road Map, cannot be addressed unless the sides will reach an end to the conflict. Hence, the calls for "economics first" measures are at best naïve, or worse, are hiding the desire to avoid the difficult historical political compromise that is necessary in order to achieve the change we aspire.

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

Steps have been taken by both sides that have created seemingly irreversible "facts on the ground." Examples include the expansion of settlements, the closing of Jerusalem to the West Bank, the separation fence-wall, the lack of acceptance of the EC-PLO interim association agreement by Israel, and many other measures. In order to realize the critical concepts of reverse engineering and symmetry, it is of the utmost

importance that we create the necessary means to ensure that these facts are reversible.

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

We believe that the power imbalance between the two sides is partially responsible for the long delay in resuming meaningful negotiations. Another example of the consequences of this imbalance is the recent failure to achieve a permanent agreement in 2008, in the Annapolis process, contrary to the declarations in November 2007 that such an agreement was the aim of the process. A permanent agreement will be possible and stable only if it is based on symmetry between the two sides in important dimensions concerning sovereignty, in spite of the asymmetry in power they face currently; therefore, in order to reach such an agreement, the current imbalance in power must be addressed. Both the international community and regional players could play an important role in achieving a balance of power and in bridging the gap in confidence between the sides. We outline below the necessary first steps to be taken, based on the reverse engineering concept and in view of the power imbalance between the two sides that has contributed to the failure to achieve a breakthrough. The road to peace can be taken only if it is accompanied by a continuous effort to treat both sides more symmetrically. This is the abiding essence of the “Two State” solution.

2. Between “One” and “Two”

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

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

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

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

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

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

Demographics and Geography

Let us first remind the reader of some of the basic historical demographic facts in the contested land that too many tend to forget. In mandatory Palestine (Palestine in Arabic, Eretz Yisrael in Hebrew, as the land between the River and the Sea is known to the two sides), demographical changes were dramatic during the British mandate times:

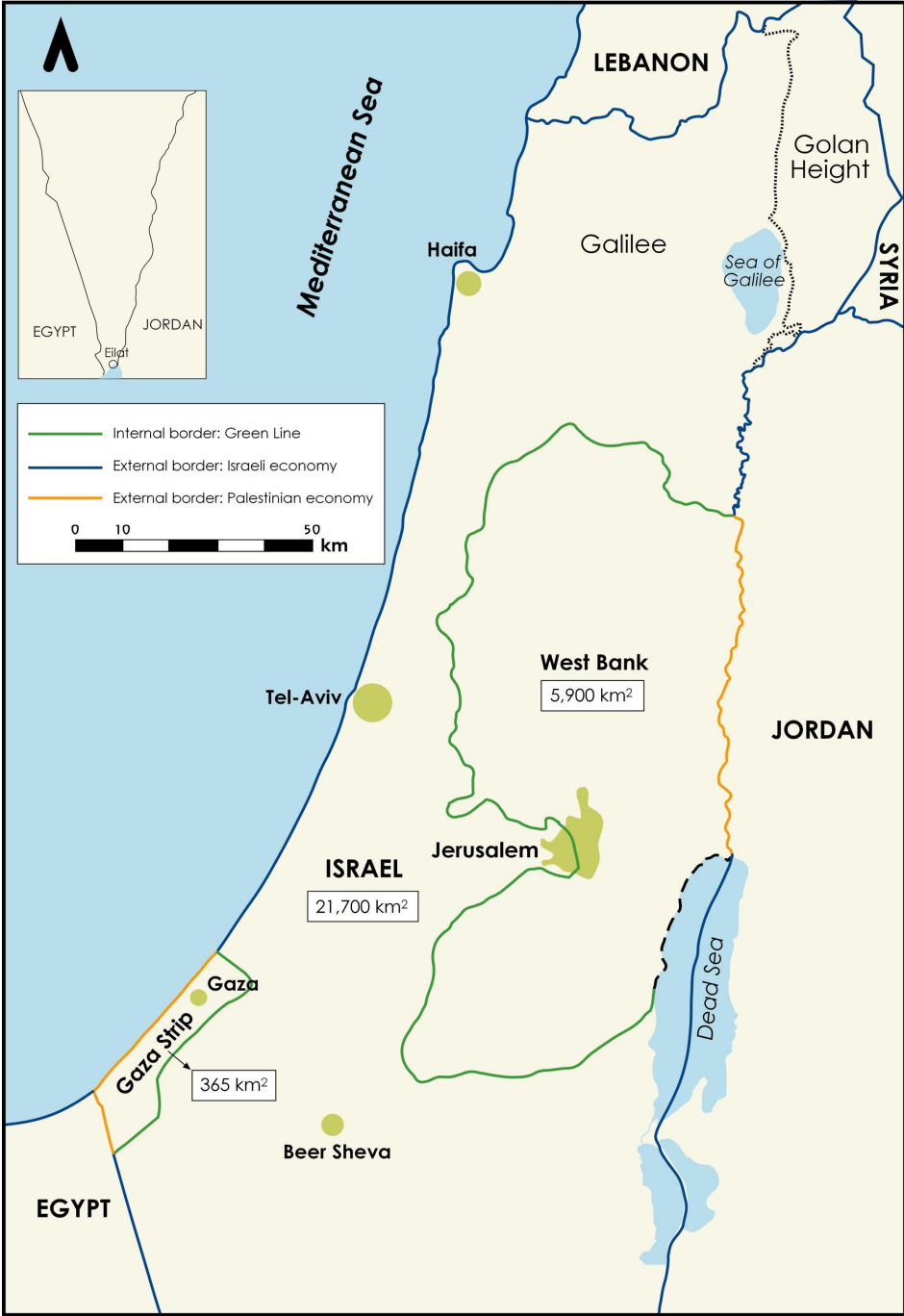
Table 1: Jewish and Arab Population in Mandatory Palestine

<u>Year</u>	<u>Jews</u>	<u>Arabs</u>
1922	84,000	680,000
1931	175,000	860,000
1935	322,000	940,000
1939	432,000	1,040,000
1947	610,000	1,325,000

Source: Metzger (1998).

Of the 1,325,000 Arabs living in Mandatory Palestine in 1947, about 625,000 stayed in their place of residence in 1949. Of this number, 150,000 stayed in Israel, 400,000 stayed in the West Bank and 75,000 stayed in Gaza (See Map 1). Around 700,000 who lived in areas that became Israel after the 1948 war did not stay where they had resided in 1947 and by 1949 became refugees.

**Map 1: Areas in Sq Km
 Israel Pre-1967 Borders (the "Green Line") the West Bank and Gaza**



The geographical facts in 1949 can be seen in Map 1. The area between the River and the Sea is around 28,000 sq km. Of this area, 21,700 sq km were within the Green Line and under Israeli control before 1967; 5,900 were within the West Bank and 365 were in Gaza. In 1949 the 700,000 refugees lived as follows:

- in the West Bank 300,000 [75% increase in the population]
- in Gaza 150,000 [200% increase in the population]
- in Jordan (and other locations) 250,000.

Demographic tendencies after the 1967 war can be seen in Table 2:

Table 2: Jewish and Arab Population
(in thousands)

	Israel		West Bank and Gaza	
	Jews	Arabs	Jews	Arabs
1967	2,400	350	--	1,000
1987	3,400	700	250	1,400
2007	5,000	1,200	450	3,800

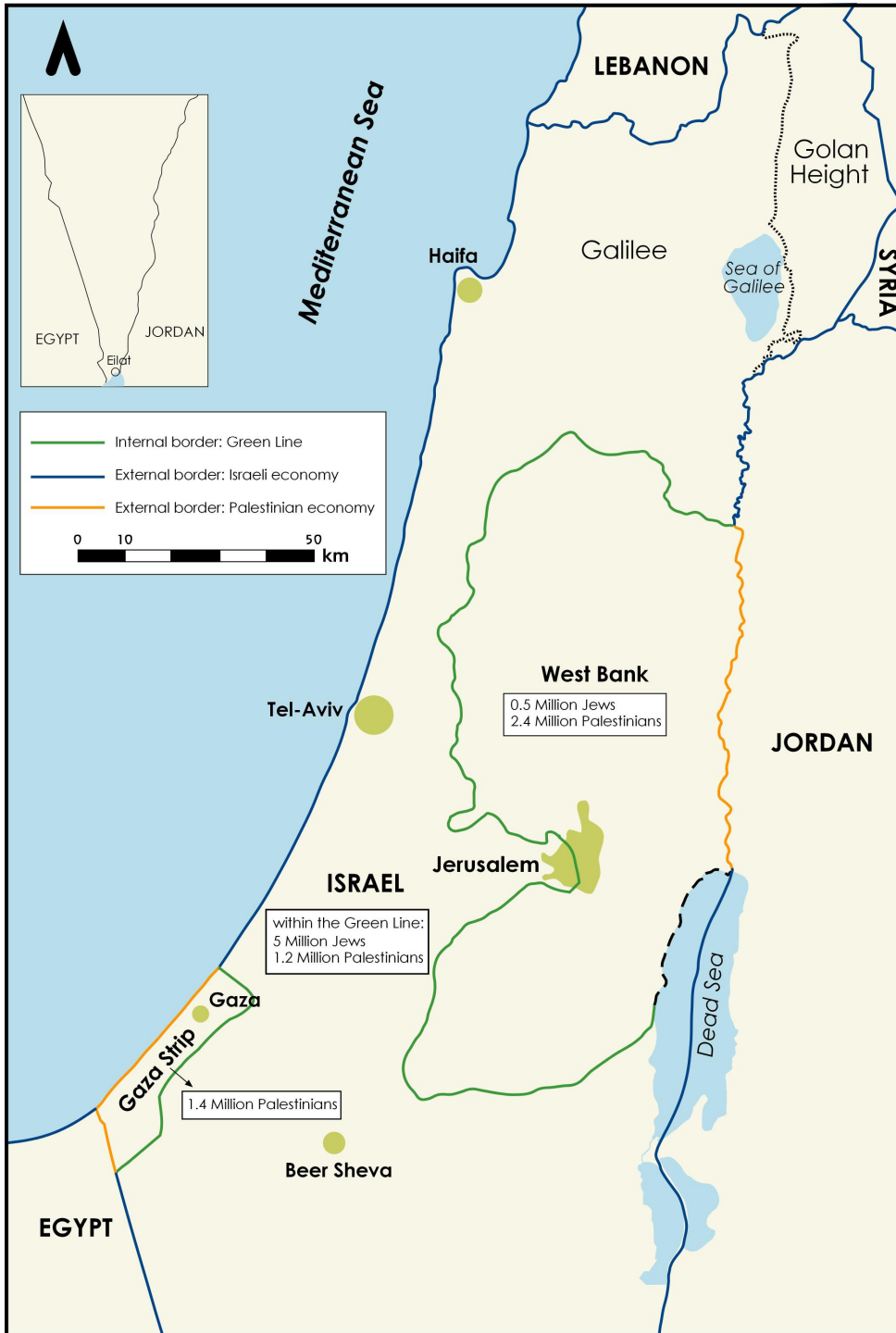
Source: ICBS & PCBS and authors' calculations.

Thus by 2007, due to many demographic changes, the population in the contested land and around it was comprised of:

- 5 million Israeli Jews within the Green line
- 3.8 million Palestinians (refugees and non-refugees) in the West Bank and Gaza
- 1.2 million Palestinians in Israel
- 0.5 million Israeli Jews beyond the Green line.

Thus, about 5.5 million Israeli Jews and almost 5 million Palestinian Arabs live in the area between the Jordan River and the Mediterranean Sea. About 4 million Palestinians (3 million of them Palestinian refugees) live outside Mandatory Palestine.

Map 2: Israeli Jews and Palestinians in 2007 (in millions)



Basic Economic Data

Since 1967, the Palestinian economy in the West Bank and Gaza has had less than 5% in GDP compared with the Israeli economy. The two economies have differed in their stages of development, occupational structures, industrial organizations, dependencies, etc. Changes in relative standards of living since 1967 are presented in Table 4. Although we will not discuss these issues here, it is important to note that the performance of the Palestinian economy since 1967 has been determined to a large extent by Israeli decisions concerning its trade regime, openness towards the Israeli economy and towards the Rest of the World, and by Israeli-imposed restrictions on internal entrepreneurships.

Table 3: Economic Data 1967 – 2007
(million 1994 \$)
(Average per year)

Years	Israel	Palestine		Total (as % of Israel)
	GDP	West Bank GDP	Gaza GDP	
1968-72	19,900	520	200	3.6
1994-96	74,900	2330	1040	4.5
2001-05	83,400	2590	1170	4.5

Table 4: Economic Data 1967 – 2007
(in dollars)

Year	Israel	Palestine			
	GNP-PC	West Bank		Gaza	
		GNP-PC (as % of Israel's)		GNP-PC (as % of Israel's)	
1968 ²	4,373	551	13%	375	9%
1993	8,194	2,073	25%	1,089	13%
1995/6 ³	15,115	1,698	11%	1,398	9%
2005/6	20,480	1,677	8%	1,242	6%

² Data for the years 1968 & 1993 in 1986 dollars; source: ICBS.

³ Data for the years 1995/6 and 2005/6 in current dollars; sources World Bank, ICBS and PCBS.

3. The Political Models

Palestinians and Israelis fight over core issues such as self determination, sovereignty, independence, collective identity, future prosperity and security, but also about individual rights and claims to land, property and justice. As we have already stated, there is a basic asymmetry between the two sides in these areas, including that the Jews in Israel have achieved self determination and sovereignty while the Palestinians have not. In a conflict where two legitimate sides fight over sovereignty -- over control over their own lives, hopefully exercised democratically through their representatives -- they can in principle agree to one of two models:

- One State
- Two States

Of course some hybrids are possible, but we will focus on these two options that cover the major differences. We will discuss them from a political perspective and, briefly, from an economic perspective, which is less common but vitally important.

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

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

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

- It is an agreement to run the polity in the contested land so that the territory will be divided geographically and a power sharing scheme will be agreed to. In principle each side will implement its sovereignty in its area of control. Again, politically the sides should find mechanisms that will guarantee the individual rights of all and also a scheme that will address the collective rights of the two sides. They will have to address the present balance of power but also possible changes in the balance of power. Specific internal policy issues such as economics, civilian affairs, education, health, and security (internally and towards the outside world) should all be addressed. But in this case some of the decisions can be separated and put in the hands of the two sides.

We would like to describe in more detail the “Two State” agreement that we still believe is feasible. It will answer the desires of the two sides to have sovereignty or self determination and address their core “legitimate claims” concerning land, Jerusalem, the Refugees, and Security, and it should create economic conditions for prosperity.

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

negotiated the economic aspects of the Oslo agreements supported integration and rejected borders. Thus, they supported, economically, the “One State” and rejected the “Two”. The arguments they made were very similar to those used by supporters of integration processes in other places, including NAFTA and Globalization. Of course, these arguments reflected the enormous asymmetry in power between the two sides.

The economic consequences of Oslo were very disappointing. The conflict continued and the economy was another of its victims. By the beginning of the current century many economists -- Israeli, Palestinian and those from the international community -- had adopted a very different approach from that of Oslo and the Paris Protocol. They reconsidered the arguments for and against integration and came to the conclusion that from an economic point of view there are good reasons to support two economic sovereigns, two sets of trade policies, and regulations concerning labour flows between Palestine and Israel. The work of the Aix Group was part of this change.

The main reason for this change was the realization that integration exacerbates the control of the strong side over the weak. Relations are never purely economic; they involve much politics. A lack of borders creates a situation wherein the strong side increases its control by mustering its political, military and economic superiority to create conditions that strengthen itself and weaken the other side. The fact that the policy of integration was implemented in the Oslo process as an interim solution was used as a justification to maintain and even increase the basic asymmetry between the two sides. This is one of the reasons why the Aix Group came to the conclusion that the right way forward is to adopt a “reverse engineering” approach.

We next outline the political and economic implications of a “Two State” permanent agreement concerning:

- Borders
- Jerusalem
- Refugees
- Security
- Economics

Borders and contiguity: the partition of the contested land should be more or less along the 1967 borders. These borders are chosen not because they are sacred, but because they provide a reference that has become acceptable. In other words, neither Palestinians nor Israelis will agree to less; perhaps they will agree to swap some minor areas. Critical questions are: will the borders be real ones; that is to say, will they exist on the ground? Will people be able to cross them and to do so easily? Will there be economic borders for trade, for labour, etc.? We in the Aix Group have concluded that the answers to all these questions should be positive. As mentioned above, the Group outlined in the Economic Road Map (2004) the basic economic elements of a possible agreement based on “Two States” wherein two sovereign sides have control over economic decisions, including control over their territory and borders. We recommended a Free Trade Area (FTA) regime and regulated labor flows between the sides, and also discussed the financial and monetary aspects of an agreement.

Jerusalem can be viewed as part of the borders issue, but one about which the two sides are more sensitive. In the Aix Group, we analyzed the possibilities for Jerusalem within the “Two States” formula. In our preferred solution, the two states will first establish their capitals in Jerusalem and the world will recognize both capitals. Second, economic difficulties must be addressed. There are in principle three possibilities that are consistent, again in the abstract, with a “Two State” agreement. One possibility is that the political border that divides the city will be an actual fence and the city will be physically divided. Another possibility is that the city will remain physically open but physically separated from the rest of the two states to avoid smuggling. The third possibility is to limit the open area to a small area in the city, such as the Old City. Our analysis of the various options revealed that none is ideal and all have pros and cons.

The Aix Group also analyzed various other financial and economic arrangements that are required in order to deal with existing difficulties and to divide Jerusalem. Some of the existing issues are: pre-emptive measures like creating and expanding Israeli settlements and neighbourhoods within East Jerusalem and house demolitions in East Jerusalem that cause migration of Jerusalemites either outside Jerusalem, or outside Palestine all together. Another harmful measure has been the closing of all Palestinian

institutions in Jerusalem, thereby reducing sovereignty and control of Palestinians and creating de-facto Israeli control in an attempt to reduce the Palestinian claim on the city. Such behaviour has even affected the rights of Palestinians living in Jerusalem, reducing them to second or third class citizens, and eliminating any sovereign claims of Palestinians to East Jerusalem.

Refugees: The contradictory claims concerning refugees makes this probably the most difficult issue between the two sides. The Aix analysis assumes that future agreements and the achievement of a practical solution will be based on two tenets: choices made by the individual refugees themselves and an agreement between the representatives of the two sides. A mechanism has been proposed to achieve compatible results between the individuals and their representatives. As for the refugees' choices, they themselves will assess what is best for them and will choose between alternative locations for residency, as explained in the Clinton parameters. The process of choosing will be done individually, in a well-organized procedure supervised by the International Agency for the Palestinian Refugees (IAPR), an international administration created for this purpose. The Aix Group proposes that the individuals will choose more than one alternative and rank their priorities. A timeframe for this process will be agreed upon.

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

The IAPR will also supervise the various arrangements, mechanisms and programs that will address the following four critical topics:

- ❖ Resettlement/Repatriation, or what we describe sometimes as Relocation programs
- ❖ Rehabilitation programs
- ❖ Claims concerning properties
- ❖ Compensation for refugehood

A long-term resolution of the Palestinian refugee issue should be based on all relevant UN resolutions, including GA Res. 194, while recognizing that a literal application of this Resolution is no longer possible given the substantial changes on the ground. As in the Clinton parameters, the parties would agree that the measures recommended implement resolution 194. The Aix Group considers that the right of return to their homeland, even in a modified and limited sense, together with the other measures discussed in the Aix Group's 2007 paper on the refugees, should be an essential component of closure to this issue.

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

Security: Security within a "Two State" agreement will be of utmost importance. If the rejectionists continue the conflict after the implementation of an agreement, the two sides will be put to a critical test. The fact that the Palestinian state will have control over its land and borders will force the sides to cooperate on security matters. The challenge for the two sides will be enormous; the stability of the agreements as well as the actual conditions for economic prosperity will depend on the success of providing security to the two sides. Clearly, our positive convergence scenarios are dependent on such occurrences.

Economic Regime: In the "Two State" agreement, each state will conduct its own economic policies and will have full control over its borders but will cooperate on many issues, including economics. They will have a trade agreement - we recommend an FTA - as well as understandings on other aspects of cooperation in the areas of labor, infrastructure, money and finance, etc. Many economists who follow the Israeli- Palestinian conflict, including those from international organizations like the World Bank, agree that such arrangements will provide the best conditions for economic development and for long-term convergence in standards of living. Economists remember that the Paris Protocol, which was the only past agreement

between the two sides on economic matters and a model that assumed economic integration, failed. We think that for both political and economic reasons, these two very different economies can prosper together only if they agree on political borders and if they benefit from the economic borders between them.

Table 5 summarizes the political and economic differences between a “One State” and a “Two State” agreement, under the strong assumption that there are two sides with legitimate claims.

Table 5

	One State	Two States
National aspirations	Ignores some national aspirations.	Fulfilled.
Political Stability	Low. Constant conflict between the sides over decisions.	Relatively high.
Jerusalem	Not a problem. The capital of the state.	Not a problem. Two capitals, one in east Jerusalem and one in west Jerusalem.
Borders	Not a problem.	Need to establish a border and to link Gaza and the West Bank.
Refugees	A threat to Jewish aspirations.	Limited return to Israel.
Economic Regime	One joint economy.	Free Trade Area (FTA).
Security	Potential risk of internal threats from the other population (for both populations).	Potential risk of external threat from the other state (for both).
Settlements	Relatively a minor problem.	Relatively a big issue.
Water	Joint Management	Coordinated Management

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4. Paving the Path to a “Two State” agreement

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

should be treated in the short-to-medium term in order to avoid pre-emption and to ensure working with reverse engineering towards a final agreement. These issues include:

1. The Separation Wall has eaten up a very large part of the West Bank, including agricultural areas; has cut the West Bank into unviable Bantustans; and has increased transaction costs. It is important initially to facilitate movement of goods and people through the passages in the Wall within the West Bank and to secure access to agricultural lands beyond the Wall, as well as to start moving the Wall to ensure that it is set on the 1967 borders.
2. All issues of movement and access, like check points and un-facilitative border crossings, are extremely harmful economically, as they make trade much costlier. Trade facilitation measures should be undertaken to guarantee that movement of goods and people is done in a facilitated fashion while ensuring that security requirements are met.
3. The current situation that prevents trade between the West Bank and Gaza and closes the Gaza Strip to all external trade is another important issue. It destroys the first rule of thumb in the “Two State” solution, namely that the West Bank and the Gaza Strip should be one unit whose integrity shall be maintained both politically and economically. This also includes the Israeli refusal to establish the land link between the two parts of the future Palestinian state.
4. In addition to negatively affecting movement and access, Israeli actions have affected a very significant part of the Palestinian – Israeli trade, as well as trade with other parties. Therefore, one of the major issues to be addressed in the build-up to the process of state-building is the diversification of trade for Palestinians and the potential diversification of trade routes. This should reduce the dependency of the Palestinian economy on the Israeli whim or on Israeli market and terminal access. Palestinian membership in international trade and trade facilitation organizations such as the World Customs Organization, the World Trade Organization, the World Tourism Organization, and the Organisation for Economic Co-operation and Development should be facilitated by the

international community and agreed to by Israel in order to bring the Palestinian trade regime into the international arena according to international rules.

It is important to pause to highlight the following points:

Negotiations unto themselves are not an end but simply a means to reaching the required compromise from both sides, thereby leaving the possibility for both sides to get some benefit and satisfaction from the process. The peace process should not be perceived as an end in itself, but rather as a process that will eventually lead to an actual peace agreement accepted by each side, thereby creating a win – win situation rather than a zero sum game.

It seems that the current negotiations have been running in a closed circle, with little by way of potential agreement, due to the fact that it is not clear or agreed to by all parties what the outcome or end result will be; no reverse engineering is being done. A framework agreement which sets out the parameters for an extended agreement should be reached in order to guarantee that the on-going negotiations are guided in body and spirit by the end results.

The settlement enterprise is both illegal and harmful, as it pre-empts the capacity of the Palestinian state to naturally expand and to be continuous and contiguous. The settlements tend to intersect the West Bank, and prevent work necessary for creation of infrastructure such as electric grids, water and roads networks and telecommunications networks, as well as housing and natural expansion of Palestinian cities and residential areas. It is imperative that Israel take the first steps of freezing the expansion of all settlements, and then proceed to dismantle them.

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

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

- In a "One State" agreement there are no satisfactory answers to Jewish-Israeli claims for self determination and independence.
- The question of Jewish collective rights becomes more severe in a "One State" framework with a resolution of the refugees' problem. The conflict between the return of the refugees to Israel and the Jewish Israeli desire to maintain collective identity, self determination and sovereignty, even in an Israeli state that has a Palestinian national minority but where the majority are Jews, is clearly the focus of many of the disagreements. Thus, no common ground exists today for a “One State” agreement that can receive the support of a majority of Israelis.
- There are no satisfactory answers concerning security, particularly in the face of a strong rejectionist presence, and there are no satisfactory answers to the economic questions. “One State” leaves security in the hands of one sovereign while there are those who do not recognize the existence and rights of the two sides. This cannot be considered an answer to the legitimate claim of most Jews in Israel to an agreement that will provide for their safe existence and the safeguarding of their collective rights.
- Legitimate Palestinian claims for self determination, including independence and control over various aspects of life, cannot be answered in a “One State” framework; certainly not in the near future when the Palestinians are a minority.
- As long as a very strong minority, maybe even a majority, on the two sides of the conflict (or on one side), rejects the "One State" arrangement, violence will likely continue. There will be constant conflict for the foreseeable future between the two populations within the one state, as well as conflict about power positions and allocation of resources. The risk is that the political environment will be unsustainable, which may even lead to a civil war.

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

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

There are several arguments raised against the idea that two states are possible and desirable, arguing that this model is not -- or is not any more -- an answer:

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

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

We have already mentioned that there is significant economic, military, and political asymmetry between the two sides, mainly with respect to international support. This tempted the Israeli negotiators to reach an agreement that would reflect this asymmetry to some extent (even beyond the basic asymmetry of partitioning the country in shares of 77% and 23%). Thus the Israeli negotiators tried to reach long-term Israeli control over the Jordan Valley, which is of critical importance to the Palestinians as a main agricultural area. Israeli negotiators also tried to maintain elements of control over Palestinian movements between the West Bank and Gaza, despite the impingement on Palestinian sovereignty. There are many more examples of Israeli attempts to reinforce the existing asymmetry.

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

- Israelis and Palestinians have not agreed so far to a “Two State” formula. The PLO agreed in principle in 1988, but there were always open questions about the refugees in a two state agreement. There was also strong opposition among Palestinians and Israelis to the "Two State" idea.
- The two sides to the potential agreement opted for gradualism and left too many ends open. The supporters of “Two State” underestimated the power of the two rejectionist fronts.

Taking into account the historical aspects that brought the conflict to where it is today, we believe that the “Two State” solution, while in deep trouble, is more practical than the “One State” solution and has better political chances. The “One State” solution cannot address the fact that there are now, always have been, and will continue to be those who deny the other side's claims. Thus, there is no way to agree on a consistent one-state framework that will guarantee security to the two sides. An agreement must not be vulnerable to political changes, and must provide answers to the basic fear that the other side will change its view or elect a rejectionist faction. Thus, a call for a two state solution with relatively open borders between the states is the only realistic alternative.

The next question is whether such a solution answers basic legitimate rights. The most difficult issue is the refugees’ demand to return to the specific locations from which their ancestors left. If the refugees will agree to return to their homeland but not to their original villages, and if the Israelis will accept the rights of the other side and agree to a full withdrawal, we will be able to test the above arguments. It calls for a major change in Israel. It calls for a major change in Palestine. It will enable two sovereign political entities to coexist. As a result of an agreement, a clear understanding will be established as to who “belongs” to each entity as far as citizenship, residency and property rights are concerned. It will also become clear what if any restrictions will exist on movements of persons, goods and services, and/or capital between the two states, and whether there will be any restrictions on property ownership. However, as stated in the introductory “rationale and assumptions” statement by the Aix Group (2007), developments in recent years make the issue of “pre-emption” (i.e. the establishment of “facts on the grounds”) in terms of settlement expansion and major changes in topographical contours in the West Bank and in the greater Jerusalem region, a major obstacle to the “Two States” option. If and when this option collapses, it will call for rethinking the options for both Palestinians and Israelis within the country as a whole, on the basis of common citizenship or bi-national citizenship. We don’t believe that this is an option for the foreseeable future.

This is also the place to clarify that there is no third option. Business as usual and a continuation of the occupation and the conflict as in these last years are not possible

for a long period of time. In the last years, eruptions of violence have become more frequent and the future looks bleak. A continuing escalation and intensification of the conflict will lead to great economic damages; to a weakening and, at some point, a collapse of the existing peace agreements with Egypt and Jordan; and to greater harm to both Palestinians and Israelis. This spiraling of violence will lead at some point to outside intervention. This is therefore, in our view, not a desired option.

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

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

7. What can be done Immediately

Within the Big Picture, there are a number of issues that need to be addressed in order to ensure that the spirits of reverse engineering and of symmetry are maintained in the implementation of the long-term resolution to be agreed upon by the parties, while ensuring that the end result is in itself guaranteed as a viable and sustainable agreement. These areas will be addressed by a number of additional papers which will be produced by the Aix Group to compliment the Big Picture.

The Territorial Link

From the onset of the Oslo agreement, Palestinian territory (the West Bank and the Gaza Strip) was considered to be one geographical, political and economic unit within the agreement. Although the letter of the agreement contained this concept, which is a necessary component for the viability of the Palestinian state, the implementation was less than diligent in this area, which is considered one of the most important parts of the Oslo agreement and any future agreements.

The failure to implement the rudimentary territorial link of the safe passage agreement was due to the demands placed by the Israeli side on the provision of permits for the movement of both people and goods to and from the West Bank (WB) to the Gaza Strip (GS). The movement of people from one side of the Palestinian territory to the other was time restricted; for example, individuals from the West Bank were given short-term permits to go to Gaza, after which their stay was considered illegal. This is not the type of arrangement that enhances and ensures the territorial integrity of the future Palestinian state. The movement of goods was also highly restricted between the WB and GS, thereby negatively affecting the Paris Protocol's clear concept of one market even though the existence of the semi-customs union guarantees that this movement would not cause any harm to either the Palestinian or Israeli markets. These issues demonstrate how lack of symmetry can be amplified by the abuse of these imbalances in power and can make things between the two peoples much worse than they used to be.

The Jordan Valley

The Jordan Valley is the most important area within the West Bank for the natural growth of the population, as well as the "Bread Basket" of the West Bank, with its highly fertile land and varied seasonal weather conditions. The Valley is the area necessary for Palestinian population expansion and absorption, as well as the agricultural land necessary for a growing population and for the export potential of agri-business. The Valley also provides the only real unutilized land within the West Bank, with potential for expansion and new development whether in agriculture, construction, tourism, energy and infrastructure or industry.

Currently, the Jordan Valley is the most restricted area for both movement and access, as well as for residential, agricultural and water rights within the West Bank. With few exceptions, the Palestinian population is unable to benefit from the area. In order to ensure the viability and sustainability of the future Palestinian state, the Jordan Valley needs to be opened to the Palestinian population immediately in order to ensure the potential for economic development for the Palestinian state in the future. The Aix Group paper on the Jordan Valley will provide insight to the importance and potential of the Valley, and the way forward, using the reverse engineering methodology in order to identify immediate, short and medium term actions in this area, and to eliminate pre-emptive actions to prevent access to the Jordan Valley.

In the Jordan Valley measures that will change its de-development should be implemented immediately, making the movement in the area and into and out of it easy. Agriculture should be allowed as well as planning and implementation of tourism projects.

Refugees

The refugee issue is a core problem which must be addressed on several levels in order to arrive at a lasting end to the conflict. The Aix Group has already addressed the economic overview of the refugee problem in previous publications. Additional work has been done by the Group in order to facilitate the implementation of any agreement which is reached between the sides on this issue. The paper on refugees will contain structural and functional descriptions of the mechanisms on the national and international levels which would implement this agreement. The paper will also highlight the roles and responsibilities of each party in the implementation, including the role of the international community and the host countries in the establishment and operation of the International Agency for the Palestinian Refugees.

The IAPR should be structured already now; planning and the creation of this institute should not be delayed.

Union for the Mediterranean

As a result of the signing of the Oslo agreement, which opened the door for the potential creation of an area of stability and prosperity in the southern Mediterranean, the European Union launched the Barcelona process. This Barcelona endeavor assumed that the peace process will work towards resolving the Palestinian/Arab – Israeli conflict, with potential benefits for the entire region. But the standstill of the peace process, the non-implementation of signed agreements, and even the non-recognition of the EC-PLO Interim Association Agreement all worked to slowly push the Barcelona concept into oblivion. The Union for the Med Initiative, an advanced step in the implementation of the Barcelona concept, holds benefits of great potential for all the partners in the southern Med and the EU, and requires proper resolution of the Arab-Israeli conflict. In order to realize the Union, serious steps and initiatives must be taken by the European partner in order to ensure the basic premise upon which this partnership is built: a peaceful resolution to the Arab – Israeli conflict and especially the central conflict of Palestine. The paper on the Union of the Med will address specific initiatives which need to be undertaken by all parties and especially by the EU in order to ensure that an equitable agreement between Israelis and Palestinians is reached so that the Union can be successful. If an agreement is not reached between the parties, it will mean the minimization of the utility of the Union and a serious threat to the Euro-Med Partnership.

The Euro-Med partnership issue is of strong relevance to our discussion, as it reveals the importance of symmetry for outside involvement in promoting a solution to the conflict. In the same way that a solution to the conflict can succeed only if it tries to preserve a minimal degree of symmetry between the two sides, an outside intervention in solving the conflict can succeed only if it treats the two sides symmetrically. In other words foreigners are required to be honest brokers for their support to be accepted; if not, the situation will deteriorate further. This holds with respect to the U.S. and the European Union.

8. Summary and Conclusion

A feasible agreement on two states will have to address the difficult trio of **Borders, Jerusalem and Refugees**. It will also have to deal with the question of “pre-emption”

and the long-term impact of creating “facts on the ground”. A positive conclusion that addresses the minimum and necessary requirements of the two sides will most probably look like the following:

- The borders between the two states will be drawn so that the two states will have continuity; the land will be divided 77% to 23% based on the 1967 borders, allowing for agreed and limited swaps of land along the “Green Line”; arrangements satisfying contiguity between Gaza and the West Bank will guarantee the free flow of people and goods within both Israel and Palestine so that travel between Gaza and the West Bank will not entail crossing a border.
- Jerusalem will be the capital of both Israel and Palestine. Two options for Jerusalem's borders can be thought of:
 - a. An “open” Jerusalem, necessitating the creation of borders around Jerusalem, or the part of the city that remains “open”.
 - b. A border that will bisect Jerusalem.
- An agreed, just and fair solution to the 1948 refugee problem will address both the individual claims and the collective considerations of the two sides and provide a way to reconcile the two. On the one hand, the Palestinian refugees will be able to choose a permanent place of residency; on the other hand, the implementation of these decisions will be agreed to by, and subject to the sovereignty of, all the countries that will be affected, including Palestine and Israel.

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

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

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

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

We believe that so far, an historical compromise along the lines described in this document has offered a realistic solution to the Palestinian-Israeli conflict; but this vision is not carved in stone and will eventually have to yield to changes in the reality of conditions on the ground.

The current widespread pessimism seems to choke any initiative that dares to think about a permanent arrangement and to present an alternative to the continuation of the

violent conflict. We should not surrender to the pessimists and should not accept their verdict of 40 more years of death and suffering. However, the Aix Group is aware of the fact that continued rejectionists' efforts on the one hand and pre-emption on the other hand will eventually undermine the two-state solution on which our efforts are based. Any reasonable solution therefore would require a reasonable timeline in which preemptive changes on the ground will be declared null and void, by a binding mutual agreement.

Time is running out for a two state arrangement. If this idea is not accepted and implemented relatively soon, the two sides will have to consider an alternative political economy. The "One State" alternative, while proposed and defended until recently by a minority among both sides, is today gaining ground due to the very conditions that undermine the possibility of territorial compromise. The Aix Group is convinced that if bold steps are not taken in the direction of rapid implementation of a territorial solution, then an alternative vision of one state for both people, on the basis of common citizenship and equality before the law, will increasingly be placed on the agenda. Such an agenda will require detailed new thinking about many of the elements of this document; but if the vision of "two states" crumbles, it will become the only alternative to the current conditions of continued occupation.

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

References