POWER AND TRADE: THE ISRAELI-PALESTINIAN ECONOMIC PROTOCOL

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Economics have been so central to the Arab-Israeli accommodation effort over the last two years that there sometimes appears to be a deliberate attempt to submerge political issues. As an example of the intimate interaction between politics and economics, accommodation has been marketed as the road to regional prosperity while the prosperity—coupled with the creation of economic interdependencies—is being billed as the guarantee for the accommodation's durability. These premises are exemplified in the "Casablanca Declaration" issued on 1 November 1994 at the end of the two-day Middle East/North Africa Economic Summit that was attended by high-level official delegates, businessmen, and specialists from the two regions, Europe, the United States, and other countries.*

The premises can be argued and deserve a separate analysis. Nonetheless, the "vision" of mutually-reinforcing peace and prosperity has been very much in evidence in the Palestinian-Israeli accommodation process as well. It underlies, in particular, the pledge of $2.4 billion by

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the international community to aid in the reconstruction of Gaza and the West Bank. Where the Palestinian-Israeli case vitally differs from the others is that the web of economic links does not have to be created; unlike, say, in the Israeli-Jordanian case, it has been in existence since the beginning of the occupation.

This web, woven by Israel to serve its own economic and strategic interests, has kept the Palestinian economy in a state of underdevelopment and subordination to the Israeli economy. The Palestinians tried unsuccessfully during the intifada to unravel this web by boycotting Israeli goods, resisting tax payments, and encouraging local production. Subsequently, Palestinian negotiators tried to renegotiate the economic relationship between the occupied Palestinian territory (OPT) and Israel. The first of the resulting two agreements consists of the economic provisions (a statement of general principles and an outline of areas of cooperation) of the Declaration of Principles (DOP) signed by Israel and the Palestine Liberation Organization (PLO) on 13 September 1993 (Article XI, Annexes III and IV). The second agreement was the "Paris Protocol on Economic Relations between the Government of Israel and the PLO Representing the Palestinian People," signed in Paris on 29 April 1994 and subsequently incorporated as Annex IV in the Gaza-Jericho agreement signed in Cairo on 4 May 1994.[1] It is this latter agreement that is the focus of this paper.

The Paris Protocol, which consists of a preamble and a dozen articles and annexes covering banking, trade, taxes, labor, insurance, tourism, and so forth, delineates the spheres of Palestinian autonomous decision making as well as the rules that will govern the economic relationship that will emerge between the self-governing Palestinian areas and Israel. It also sets the framework for and the constraints on the development of the Palestinian economy over the next few years. The extent to which the Palestinians take advantage of the opportunities and mitigate the constraints will depend on the ability of the Palestinian National Authority (PNA) to build the prerequisite institutions and legal environment and to formulate proper policies. It will also depend on the security situation, on Israel's goodwill, and on the PNA's relations with other Arab countries.

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Although articles have been written about the protocol, none to our knowledge has attempted a detailed analysis of its possible impact on the Palestinian economy. The present article aims to do so by examining the conditions set out in the trade and labor articles of the protocol, the entire document being too long and complicated to be handled in a single writing. Trade and labor represent the major forms of economic transactions between the two sides and heavily influence the behavior of the Palestinian economy. In the course of our inquiry, we will consider such questions as whether the new trade and customs union regime will reduce the OPT trade deficit with Israel, diversify the Palestinians' trading partners, lead to economic development, help integrate Gaza and the West Bank, and stabilize the job market for Palestinian workers in Israel.

Economic Relations on the Eve of the Protocol

Prior to its occupation by Israel in 1967, the West Bank was an integral part of Jordan both politically and economically. Gaza, on the other hand, was administered by Egypt and had economic links with Egypt and Eastern Europe, then Egypt's main trading partner. Economic ties between the West Bank and Gaza, geographically separated by Israel, were nonexistent.

The situation changed dramatically with the occupation,[2] after which both the West Bank and Gaza were enveloped in a one-sided customs union with Israel. This customs union entailed exports from Israel to the two regions and labor flows in the opposite direction. But while the economies of the West Bank and Gaza became extensively linked to Israel, they remained isolated from each other in a way reminiscent of the classical dependency syndrome in which third world countries were tied to Europe and the United States but not to one another. At the same time, the West Bank's economic ties with Jordan and Gaza's with Egypt diminished. Israel did not allow goods from Jordan to the OPT, and the rules of the Arab boycott of Israel inadvertently limited the flow of goods from the OPT to Jordan and the rest of the Arab world.[3]

An outline of the economic relationship between Israel and the West Bank and Gaza both before and under the protocol is illustrated in table 1. Before the protocol, Israel controlled banking operations in the OPT, and the Israeli currency became the main legal tender there. In fact, the banking services were minimal, and little credit was disbursed. As for trade, Israel set tariffs according to its perceived economic advantage, which was not necessarily beneficial to the OPT. The same was true of the value-added tax (VAT), the monies of which were retained by Israel together with other monies.[4] The World Bank euphemistically dubbed Israel's extraction of such economic surplus "fiscal compression."[5]

Trade between the OPT and Israel remained primarily a one-way activity. Israeli products and reexports flowed without impediment to the OPT, whereas numerous nontariff restrictions (security, health and

TABLE 1
Palestinian-Israeli Economic Relations
Before and According to the Protocol

Item	Before	According to
Customs union	One-sided	Attenuated one-sided
Decision making by	Israel	JEC + PNA
Currency	NIS + JD	NIS + JD
Monetary policies set by	Israel	Israel
Fiscal policies set by	Israel	PNA
Customs		
Value determination by	Israel	Israel + PNA
Revenues to	Israel	PNA
Direct tax		
Value determination by	Israel	PNA
Revenues to	Israel	PNA
VAT		
Value	17%	15-16%
Revenues to	Israel	PNA
Agriculture exports		
From OPT to Israel	severely restricted	quotas until 1998
From Israel to OPT	free flow	free flow
From OPT to other parties	Israeli control	control lifted
Industrial exports		
From OPT to Israel	severely restricted	regulated
From Israel to OPT	free flow	free flow
From OPT to other parties	Israel sets	PNA sets
Flow of OPT workers to Israel controlled by	Israel	Israel
Land and Water effective control by		
Gaza	Israel	Joint
West Bank (excl. Jericho)	Israel	Israel

JD = Jordanian dinar; JEC = Joint Economic Committee; NIS = new Israeli shekel; OPT = occupied Palestinian territory; PNA = Palestine National Authority; VAT = value-added tax; excl. = excluding.

safety, bans on imports) were imposed on Palestinian exports to Israel, to say nothing of the significant subsidies to Israeli producers. The Palestinians, for their part, were allowed to import only through Israel. An outcome of all these practices throughout the years of occupation was that the OPT had with Israel an extraordinary trade-partner concentration and an overwhelming chronic merchandise trade deficit (see table 2).[6]

Industrial and agricultural development was also subjected to the heavy hand of Israeli regulations and policies. Israel used its hold over licensing to stymie industrial development in the West Bank and Gaza by frequently refusing to grant permits to Palestinians wishing to establish factories. Industrialization was also impeded by the high prices resulting from extensive land expropriation and land use restrictions, the

TABLE 2
Main Economic Indicators and Trade of West Bank and Gaza

Item	West Bank	Gaza	Total
Indicator			
GNP ($millions)[a]	2,114	844	2,958
GNP/capita ($)[a]	2,257	1,347	1,893
GDP ($millions)[a]	1,629	553	2,182
of which:			
Agriculture (%)	37	25	34
Industry (%)	7	10	8
Construction (%)	11	17	13
Services (%)			
Public (%)	9	18	11
Other (%)	36	30	34
GDP/GNP (%)[a]	77	66	74
Merchandise Trade[b]			
Imports			
Total ($millions)	731	332	1,063
of which:			
From Israel ($millions)	638	291	929
From Jordan ($millions)	10	0	10
From Israel/ total (%)	87	88	87
Exports			
Total ($millions)	187	66	253
of which:			
To Israel ($millions)	152	53	205
To Jordan ($millions)	27	14	41
To Israel/ total (%)	83	80	82
Balance			
Total ($millions)	–544	–266	–810
With Israel ($millions)	–486	–238	–724
With Jordan ($millions)	17	14	31
With Israel/ total (%)	89	89	89

(–) = deficit

Source: Based primarily on State of Israel, Central Bureau of Statistics, *Statistical Abstract of Israel*, 1991-93.

[a] Average of two years, 1990-91. The GNP per capita is based on an average population of 9,365 thousand in the West Bank and 6,265 thousand in Gaza. Several independent studies, however, have disputed the Israeli official population estimates as undercounts; hence the GNP/capita in the table should be viewed as an upper bound [see summary on the population statistics in World Bank, *Developing the Occupied Territories*, vol. 6 (Washington, DC: Author, 1993), pp. 4-7].

[b] Average of three years, 1990-92.

absence of a banking system providing credit, and poor infrastructure and support services.

The Palestinian domestic production thus remained service- and agriculture-based, with agriculture contributing around one-third of the GDP in the last several years (see table 2). The agricultural sector grew, thanks mainly to investment by Palestinian farmers in the high-yielding, water-saving technology of drip irrigation. Despite the presence of large tracts of land in the West Bank that could readily have been reclaimed, there was no horizontal expansion because of the restrictions on Palestinian access to land and water, as will be discussed below.[7] The public infrastructure deteriorated, investments in this sector not exceeding 3 percent of the GDP according to World Bank estimates.[8] The major part of private investment went into housing.

The overall lack of investment impeded job creation; about one-third of the labor force had to seek employment in Israel and the settlements. The export of labor to Israel helps explain both the rise of income level in the OPT, despite the marked unemployment level, and the difference between the GDP and the GNP, the former averaging less than three-quarters of the latter in 1990-92. However, since the intifada and particularly since the Gulf War in 1991, employment in Israel has become hostage to political winds.

Israel was able to subordinate the economies of the West Bank and Gaza Strip not only because of its military and institutional hold, but more importantly because its economy was far larger, more sophisticated, and more diversified than the Palestinian. For example, the Israeli GDP averaged eighteen times the Palestinian GDP in the period 1990-92. Israel's industry supplied a wide range of consumer goods, especially plastics and electrical appliances, whereas Palestinian small industrial output consisted of low-value-added products, mainly simple processed foods, handicrafts, and shoes.

It is against this backdrop that the impact of the protocol, and, in a way, Palestinian future economic performance, must be assessed.

Overview of the Protocol

The protocol covers essentially all the Palestinian economic sectors, the Palestinian and Israeli roles, and Palestinian economic relations with Israel and other countries. Its implementation is to be overseen by a Joint Economic Committee or JEC (Art. II), which will decide on disputes and review any issue at the request of either party. It will also determine the quantities of various goods that Palestinians can import and other import rules.

The protocol does not permit the Palestinians to have their own currency (which would carry with it the symbolism of sovereignty); the official legal tender remains the Israeli new shekel (NIS), although the

Jordanian dinar and the dollar can still be used. In any case, the Palestinian economy is probably not in a position to support a convertible currency at present. Be that as it may, the absence of a separate currency automatically deprives the PNA of the instruments of making monetary policy, especially the determination of interest rates and currency value. Palestinian economic performance will thus be linked to the monetary conditions in Israel and, to a lesser extent, Jordan.

On the other hand, the protocol does enable the Palestinians to have significant control over banking operations, allowing them to set up for this purpose the Palestinian Monetary Authority (Art. IV.1). This authority is empowered to make a full range of fiscal policies that had been in the hands of the Israeli government: management of official reserves, bank licensing and regulation, and settlement of foreign exchange accounts with Israel and Jordan. Should a viable banking sector evolve, this could constitute one of the main missing instruments for encouraging savings and investment and facilitating trade.

The Palestinians will also be able, according to the protocol, to establish independent direct tax levels and to collect the taxes. They are much more bound when it comes to indirect taxation such as tariffs and the VAT, as will be explained below. But whereas in the past indirect tax revenues were channeled to the Israeli government, according to the protocol they will be transferred to the PNA and partly collected by it.

In the areas of trade and labor, the protocol spells out the rules governing imports and exports between the areas under the PNA and Israel, and between those areas and the rest of the world. Goods that Palestinians may import from places other than Israel are specified in three separate lists along with restrictions concerning quantity, origin, and standards. The protocol also deals with the free movement of exports between the autonomous areas and Israel, once again after health, safety, and other standards are met. It allows for the free movement of labor, but theoretically gives the two parties the freedom to restrict entry.

Imports

Article II regulates the OPT's imports from countries other than Israel. Imports from Israel to the West Bank would remain, as before, unhindered, and the protocol does not address how Israel makes its own trade policy.

The protocol lists the types of goods that Palestinians may import from places other than Israel under categories A1, A2, and B (petroleum and cars are dealt with separately). Goods not included in these categories are subject to the old import restrictions. Lists A1 and A2 contain food and agricultural products (not including fresh fruits and vegetables), basic construction materials (e.g., cement, steel), fertilizers, and household electric appliances (e.g., refrigerators, washing machines). The PNA will be able to set the customs levels on these goods based on the last General Agreement on Trade and Tariffs agreement (GATT; Uruguay Round) when it takes effect in Israel.[9] Construction materials (with the exception of aluminum), fertilizers, and household appliances would have to be imported from Jordan or Egypt, and the remaining items in these categories from these two and other Arab or Islamic countries. The commodities must not be final-assembly products; the domestic (Jordanian, Egyptian, or other) contribution must be 30 percent of the exports' value. The items must also comply with specified quantitative limitations determined by the two sides "up to the Palestinian market needs." The quantities of construction materials, fertilizers, and wheat, however, were preset in the protocol at levels equivalent to an estimated 50 percent of the market needs; others were to be negotiated subsequently. The quantities would be subject to periodic reviews to take into consideration changes in demand.

List B consists of capital goods for economic development, including agricultural equipment (e.g., harvesters, threshers), heavy construction and earth moving equipment, and factory and household textile machinery and tools. No tariff, origin, or quantity restrictions apply to these goods as they are deemed essential for the development of the Palestinian economy.

The protocol partially frees petroleum and cars from the one-sided customs union. Under the protocol, the PNA can import gasoline from Jordan or Egypt (if it meets European and American standards) in quantities fixed by the JEC and sell it to the consumers at prices 15 percent lower than in Israel. Other petroleum products, such as heating oil, can also be imported from Jordan, and without price restrictions. The PNA would be able to determine its own rates on motor vehicles, but cars more than three years old would not be allowed in.

The goods and quantities not fixed by the JEC or covered in the protocol will continue to be subject to tariff rates, purchase taxes, levies, and other charges that are at least equal to those prevailing in Israel; the PNA is entitled to set higher levels. Also, the PNA will levy VAT on *all* imports as well as on locally produced goods. The minimum rate of the VAT is 15-16 percent, nearly equal to the Israeli rate of 17 percent.

The Palestinians could achieve two types of financial gain from the new import regulations. First, import taxes and levies on *all* goods explicitly designated for Palestinians in the areas under the jurisdiction of the PNA will accrue to the PNA even if imported via Israeli middlemen. Such revenues were conservatively estimated by the World Bank at 8 percent of the Palestinian GDP.[10] But while theoretically this should be a straightforward gain, how much of it will actually be realized will depend on the Palestinians' ability speedily to establish a sophisticated network of wholesale importers. (Purchasing on a retail basis from Israeli importers, as has hitherto been the common practice, makes it much harder to designate goods for the Palestinian areas.)

A second import-related financial benefit could come from the import of goods from cheaper sources. In the case of petroleum, motor vehicles, and the capital goods in list B, this should be straightforward. Israeli tariffs on list B's capital investment goods are 21 percent,[11] too high for the OPT's development requirements, so freeing such goods from Israeli taxation is an important gain. But list B does not cover all capital investment equipment: computers, for example, or pesticides for agriculture continue to be subject to the previous customs union rules while the price of these materials has risen sharply in the last years and the price of output has fluctuated around the same level.[12]

The array of restrictions, especially on agricultural imports and lists A1 and A2, casts a long shadow on potential gains. The two sides are to refrain from importing "agricultural products" that may adversely affect the farmers of the other side, without prejudice to existing international arrangements (Art. VIII.12). As the Palestinians have no existing international arrangements, the clause is effectively a barrier to the Palestinians more than to the Israelis, especially since the Israelis can inspect Palestinian imports while the Palestinians do not have the corresponding right. The extent to which this would affect the Palestinians is difficult to ascertain without a detailed study of Israel's farm output, its international obligations, and its potential conflict with relation to Palestinian demand. Still, the fact that Israel saw the need to include such a clause indicates that it must have anticipated losses if the Palestinians purchased certain types of commodities from other sources, especially fruits and milk (still to be negotiated) but which Israel exports in large quantities to the West Bank and Gaza.

Restricting the import of household electric appliances in lists A1 and A2 to Jordan and Egypt may effectively keep the Palestinians from moving outside the customs union wall for these items. Not many such appliances are likely to be imported from Jordan or Egypt thanks to the generally low quality and the domestic-content requirements of these products. Most of these durables, then, will probably continue to come from Israel, thus earning Israel its traditional 70-percent import tariff. Israel's insistence on origin for these goods perhaps stems from the fact that such durables constitute 20 percent of its own industrial output.[13]

Further, the requirement that tariff rates on A1 and A2 be equal to the GATT rates denies the PNA the freedom to set its own tariff levels and draws it into joining the GATT whether it likes it or not. In any case, neither the PNA nor consumers are likely to gain or lose much financially from importing food and agricultural commodities from new sources, Israeli tariffs on foodstuffs being either low or nonexistent.

Many questions can be raised about the quantitative limitations on the goods in lists A1 and A2, which not only undermine many of the potential gains but also could illegitimately enrich wholesale merchants and induce collusion between them and PNA officials. Tying permissible import levels to "market needs" is problematic for a number of reasons, not least of which is the nonexistence of reliable household consumption surveys and the unreliability, in the view of most experts, of macro statistics, especially after the intifada. Even the population size in the West Bank and Gaza is uncertain. It often seems that the Israelis deduce West Bank and Gaza consumption as a residual of Israel's production, consumption, and trade estimates. Also, how can consumption levels be determined when income changes and when for many goods there are no reliable estimates on income elasticity of demand (which measures how demand responds to income change)? Further, the protocol's stipulation that imports cannot exceed market needs (are "up to the market needs") could encourage Israel to "err" on the lower side, to protect its own exports to the West Bank and Gaza.

The quantitative limitations on goods not only undermine many of the potential gains but also could encourage collusion between wholesale merchants and PNA officials.

Even if the quantities were commensurate with market needs, how can one guarantee, in the absence of borders, that the goods would not filter to the Israeli market where they could fetch higher prices, or, conversely, that goods from Israel would not continue to dominate the market? Merchants could reap windfall profits from the first instance, but the Palestinian consumers would lose. In the second instance, goods from Israel would enjoy a comparative advantage owing to the geographic proximity and the ease with which they can be brought in to the OPT.

The PNA is to set the allotment of quantities. Experience elsewhere suggests that giving bureaucrats such a responsibility is conducive to the creation of the "moral hazard" problem among them.[14] Indeed, charges have already been leveled against the leadership of the PNA that it has not made public auctions for the import of cement, communications equipment, and petroleum, and that it favored particular merchants.[15]

Exports

The protocol states that there is to be free movement of both agricultural produce and industrial goods between the two sides without additional customs and import taxes, subject to certain exceptions and arrangements (Art. VIII and IX). The Palestinians would be able to export their commodities to other countries as well, presumably without the earlier barriers. Within the constraints of the protocol, the Palestinians would be able to adopt policies promoting development in the areas of credit, research, development assistance, and direct-tax benefits (the VAT, as noted, is set at 15-16 percent).

Exports from the OPT to Israel would have to meet the environmental, health, and safety standards in force in Israel. Moreover, there are quantitative restrictions on the export by Palestinians to Israel of vegetable products, poultry, and eggs. These quotas are to be phased out and would be completely eliminated by 1998.

The extent to which the protocol would affect Palestinian exports and the attendant trade deficit is difficult to assess. In industry, it would depend on the growth of manufacturing and the diversification of the present structure (see below). In agriculture, the quotas put in place to protect Israeli produce from Palestinian competition nearly vitiate any export advantage: Only 25 percent of the OPT's vegetable production would have unrestricted access to the Israeli market.

In addition, according to our estimates, the quotas on some produce items to be exported by the Palestinians[16] are below the level of what used to be exported illegally.[17] It is unclear to us on what basis Palestinian negotiators accepted the quotas, unless they assumed that illegal exports would continue, or why Israel would restrict the export of Palestinian melons when it exports this crop to the OPT. And while Israel clearly set quotas on eggs and poultry to protect its own producers,[18] no commensurate restrictions were placed on Israeli fruits and vegetables to protect Palestinian farmers.[19]

Palestinian industry and agriculture would also be at a disadvantage vis-à-vis their Israeli counterparts because of the generous subsidies Israel gives to both sectors. For example, Israel's support for its agriculture in the form of credit on concessionary terms, subsidies of factors of production (especially water and land), export finance, and minimum price levels for certain products, averaged 32 percent of the value of that sector's output during 1984-90.[20] By contrast, support for Palestinian agriculture has been minimal, sporadic, and mainly from nongovernmental organizations. In order to give Palestinian exports a fair competitive edge, the support levels to both agricultural sectors would have had to be made even. The Palestinians can try to find other markets, but this is by no means an easy task, especially for agriculture, in light of regional production and marketing conditions.

Diversification of Trade Partners

Economic integration, or rather reintegration, with the countries of the region will not be easy. The imports provision in the protocol opens a window, albeit with the severe limitations mentioned earlier. The restriction that many goods be imported specifically from Egypt and Jordan narrows the window further. These restrictions may have been unavoidable, for, from an economic standpoint, Jordan would have insisted that its trade deficit with the West Bank and Gaza (see table 2) be addressed. From a political standpoint, Palestinians would want close trade ties with Jordan not only for geostrategic (if not Arab nationalist) reasons, but also because much of the trade in Jordan is in the hands of the Palestinian-Jordanians and because Jordan provides a key exit to the rest of the Arab world. Trade links with Egypt would provide balance, especially given its steady ties with the PLO leadership for over a decade. Israel, for its part, would have wanted to strengthen the position of Jordan and Egypt in the OPT for their expected moderating political influence. By strengthening Jordan's economic position in the OPT, Israel may also seek to fuel competition between Jordan and the PNA.[21] Whatever the reasons, the domestic-origin and country-restrictions exclude other potential regional trade partners and even undermine the possibility of importing goods from sources beyond the customs union wall, as was argued above.

But even if the trade gates were opened, would integration take place? Inter-Arab trade usually comprises less than 5 percent of the overall value of Arab trade. Jordan, whose economy is probably the most integrated with other Arab economies, usually receives more than three-quarters of its imports from outside the Arab region,[22] largely because of the region's lack of complementarity in production and diversified industrial structure, although inter-Arab political quarrels also take their toll. Similarly for the Palestinians, imports, especially of capital and durable consumer goods, would come from the industrialized countries and from Southeast Asia, at least for the medium term. Many foodstuffs, especially wheat and rice, would also come from outside the region.

In the export domain, however, Jordan was successful in finding a large niche in the Arab markets of Saudi Arabia, the Gulf, and Iraq: Even though these were disrupted, the example shows what can happen under normal conditions.[23] But the West Bank and Gaza would have more difficulty locating market outlets than Jordan, at least in the short term, because their production costs, greatly influenced by the Israeli cost structure, are higher than in the non-oil-producing states. It would also be more difficult for the Palestinians to find the least costly materials because of the import restrictions. In order to compete, Palestinian producers would have to become highly efficient, not an easy task considering the general state of underdevelopment in the OPT.

While integration with regional partners is vital and has been much stressed by analysts, we believe that priority should go to integrating Gaza and the West Bank, two pieces of territory separated by Israel. Such integration—neither encouraged nor discouraged by the protocol, which does not address the issue—will not be easy. It would require much planning owing to the two economies' similar production structures. It would also require lifting Gaza from its peripheral status, temporarily obscured by its position as seat of the PNA, with regard to the West Bank. Certainly, having the same currency (if it ever comes into being), banking systems, and legal and regulatory environment would help, but without the flow of goods, services, people, and information, integration cannot happen. The crucial importance of overcoming the territorial discontinuity becomes clear when one recalls that Pakistan's split in 1971 was caused by the lack of integration of the western and eastern parts of the country and the marginalization of East Pakistan (Bangladesh).

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Economic Growth and Diversification

Implementation of the protocol would give to the Palestinians, though not retroactively, most of the indirect tax monies (estimated conservatively by the World Bank at 8 percent of the Palestinian GDP in 1991[24]) that Israel appropriated until then. These funds can become an important source for investment. Although not part of the protocol, the money pledged by the donors, insufficient and slow in coming as it is, would also give a boost to growth.

The donor funds are largely earmarked for administrative costs and infrastructural projects. Economic growth from such outlays could occur as a result of the demands of goods and services that the projects would generate and the increased efficiency of the facilities and services on which economic activities depend. Even if the contribution to growth and diversification of the economic structure were small, the investment would improve the quality of roads, communications, health services, and education facilities—areas that touch the daily lives of the population.

The long-term sustainable growth would have to come from agriculture, industry, and services, especially tourism. We highlight here only the possibilities of agricultural and industrial development; tourism, though dealt with in the protocol, requires a different treatment.

Agricultural growth can come from either horizontal (land area) or vertical (intensification) expansion. Both face serious constraints in the OPT. Horizontal expansion is severely checked by land and water availability, even though there are more than 170,000 dunums of irrigable land without soil or topographic barriers in the West Bank that could be added to the present 90,000-100,000 dunums under cultivation. That they have not been reclaimed is the result of Israel's freeze on the Palestinians' irrigation water supply at 1967 levels, not to mention Israeli acquisition of parts of the land for settlements and alleged security reasons. Since land and water questions have been deferred—the former to the final status negotiations and the latter *sine die* despite the DOP's mention of water negotiations during the interim period—horizontal expansion is out.

As for vertical expansion, possibilities are seriously hampered by the uncertain access of Palestinian produce to markets. The Israeli market is protected by the protocol's quotas on Palestinian produce exports and by Israel's subsidies to its own farmers. In the regional markets, Palestinian produce would be disadvantaged by the higher production costs stemming from higher wages, import restrictions on fertilizers and pesticides, farm subsidies in the neighboring countries, and woefully inadequate institutional support. If despite these barriers intensification was to occur, it would be on a limited scale through greenhouse cultivation, which requires large amounts of water and pesticides that could have a hazardous impact on health and groundwater resources. Thus, short of removing onerous impediments or adopting environmentally unsound practices, the agricultural sector is likely to remain close to its present position.

Industry, meanwhile, basically of the family-operated, craft type, probably contributes less than 10 percent of the GDP. Manufacturing is currently centered on food processing, textiles, and soap-making. Some small-scale subcontracting operations, especially in Gaza, have been undertaken with Israeli firms seeking cheaper labor costs.

In theory, there is room for industrial expansion. The establishment of import-substitution manufacturing (e.g., textiles, shoes, cosmetics, cigarettes, household detergents, building materials) is one avenue. But while there is a base and experience in these branches, several constraints should be noted. Modern production methods and improved quality would be essential for the output to be competitive in the domestic market, and the small size of this market would make appreciable growth in manufacturing dependent on exports. There, the potential for inroads into the Israeli market is checked by the standards requirements and by the subsidies to Israeli industry, although room may exist for the low-value-added manufacture of shoes and textiles.

The protocol gives the PNA leeway to subsidize industry. The income tax of companies may be the main avenue, since the VAT is already predetermined. Tax "holidays," however, would deprive the PNA of sorely needed tax revenues and should be conditional on achievement. Diversification into regional markets may be possible in principle, as the Jordanian example would suggest, but would require access to capital equipment and intermediate inputs from cheap sources. The protocol's list B of imports frees many items of equipment and machinery from the customs union wall. But aside from a variety of wood products, it does not include much that would be considered intermediate inputs, especially chemicals. Also, the industrial inputs would depend on the type of industry to be established, and cannot conceivably be tallied in advance. Contingencies could be negotiated, of course, but it would seem that, even assuming good faith on the part of Israel (a dubious assumption considering the fifteen months or so since the DOP), the process of negotiations and approvals would cause costly delays. These uncertainties and complications could further discourage potential investors, who have commonly gravitated toward services and real estate, thanks in part to Palestinian inexperience in manufacturing.

Labor

Employment in Israel accounted for about 40 percent of the employment in the West Bank and Gaza and remained relatively stable before the intifada, involving some 109,000 workers in 1987.[25] Deductions from registered workers' wages to cover insurance payments and benefits to which they were entitled were retained by Israel.[26] Most of the Palestinian workers were employed in construction, agriculture, and services.

With the intifada, curfews and other security-related measures caused interruptions in the flow of Palestinian labor to Israel, but it was the Gulf War of 1991 that radically changed the situation. Israel sealed the West Bank and Gaza, preventing workers from crossing into Israel, and the prewar employment levels have never even been approached since then. Moreover, short-term as well as prolonged closures of the West Bank and Gaza continue sporadically, usually following either actual Palestinian attacks on Israelis inside Israel or Israeli government fears of the imminence of such attacks.[27] The result has been serious income drops for the workers and adverse impact for the Palestinian economy as a whole.

The protocol states that "Both sides will attempt to maintain the normality of movement of labor between them," with the proviso that this would be subject to each side's (essentially Israel's) right to "determine from time to time the extent and conditions of the labor movement in its area" (Art. VII). It was also agreed that Israel would pay to the PNA 75 percent of the income tax deductions, but no mention is made of retroactive payments.

Palestinian labor in Israel has become a "necessary evil" for both sides, albeit less necessary for Israel than for the Palestinians. For Israel, Palestinian workers take jobs that the Israelis themselves increasingly shun. Generally dependable and hardworking, they also could be paid less and receive smaller insurance, health, and other benefits than their

Israeli counterparts.[28] The fact that they have to leave Israel every day after work (although some stay the night illegally) in principle reduces social tensions. Still, many Israelis do not like to see Arabs working in their midst.

On the Palestinian side, work in Israel initially provoked controversy and sometimes armed attempts to stop it. Although lack of jobs in the West Bank and Gaza eventually reconciled many Palestinians to the realities, work in Israel was not without its social, economic, and political costs. For one thing, reliance on the Israeli markets means that decisions affecting the well-being of hundreds of thousands of people in the West Bank and Gaza are made by a government in which they have no voice. Israel appears also to have used the entry of workers to Israel for political ends, for example to pressure them to make concessions during the bilateral negotiations in Washington and to force the PNA to take tough measures against the opposition. Finally, for the Palestinians as a group, the social costs of their labor engaging in the low status jobs can be high: The psychosocial impact on the workers from this kind of relationship and the extent to which it conforms to the oppressor-oppressed distortions described by Paulo Freire and Frantz Fanon has yet to be investigated. In any case, it does not serve the goal of coexistence.

Nonetheless, the "employer-employee" relationship between Palestinians and Israelis cannot be terminated abruptly without considerable damage to the Palestinians: Israel must accept responsibility for the past benefits it reaped from Palestinian labor and for the policies it implemented in the West Bank and Gaza that led to the lack of job creation there. Unfortunately, the protocol gives Israel an opening to escape this responsibility. Israel has not hesitated to use this opening, as evidenced by its repeated closures of the OPT since signing the agreement and its recent announcement that some 19,000 foreign workers, largely from Asia, would be allowed into Israel, presumably as a substitute for Palestinian workers.[29]

Assessment

Past economic relations between Israel on the one hand and the West Bank and Gaza on the other were formulated by the dictates of Israeli power to serve its own interests. Whatever benefits accrued to the Palestinians often came as unintended consequences. The protocol reflects the historical reality, the continuing occupation during the interim period, and Israel's insistence on protecting its own producers and maintaining insofar as possible its dominant share in the Palestinian market.

It would have been nearly impossible to have two highly divergent customs regimes without demarcating the political boundaries between the two sides. The attenuated one-sided customs union that emerged was therefore predetermined by the DOP: politics shaped economics.

The attenuated one-sided customs union that emerged was predetermined by the DOP, but other parts of the protocol could have been different.

But other parts of the protocol could have been different. The import restrictions as well as the VAT could have been relaxed much more without appreciable adverse impact on Israeli producers. The protocol could have freed the import of pesticides, for example, and all rather than half of the estimated fertilizers they need. A measure of reciprocity regarding agricultural exports could have been stipulated: free access or quotas for both sides, for example, rather than quotas for Palestinians and free access for Israel. Israel could also have made water and farmland "advances" to boost Palestinian agriculture as well as land advances to relieve the pressure on land prices for industrial sites. Handing over the tariff, VAT, deductions from workers employed in Israel, and other revenues could have been done retroactively. Israel's ability to close the labor market to Palestinians could have been handled in a way that acknowledges accommodation as a long process not lending itself to retaliation after every act of violence, and that recognizes Israel's moral responsibility toward the welfare of the Palestinian population (especially since high unemployment jeopardizes the accommodation process itself). All of these suggestions fall within the framework of the DOP, and could have imbued the protocol with the spirit of generosity and neighborliness it sorely needs.

That the Palestinians were unable to obtain such concessions reflects, apart from the uneven balance of power, the uneven negotiating capability of the two sides. Israel, of course, benefitted from the mass of systematic information and analyses on the workings of its own economy as well as the economies of the West Bank and Gaza over the years. The Palestinians, by contrast, lacked detailed information and studies. They also failed to take full advantage of the available expertise because of the paralyzing centralism and preference for organizational and personal loyalties over expertise that have marred the conduct of negotiations. Samir Hulayli, a member of the team that negotiated the protocol, acknowledged the lack of consultation but attributed it to lack of time.[30] Still, considering what was at stake for Israel—the peace treaty with Jordan, for example—the Palestinians could have pressed harder.

Those who judge the protocol on the extent to which it frees the Palestinian economy from Israeli political, security, and economic shackles will be disappointed, but such expectations in any case would have been unjustified considering the constraints of the DOP and the long years of dependence on the Israeli economy. A better yardstick for evaluating the protocol would be the breeches it introduces in the wall of the one-sided customs union and the possibilities for immediate financial gain—here one would be less disappointed. But taking advantage of the small openings offered depends on many imponderables: the security situation, which could adversely affect the flow of goods and services and raise investment's risk premia; the ability of the Palestinians to build the institutional and regulatory framework for planning and policy formulation; and Israel's goodwill, especially regarding labor. The record on these matters is less than encouraging. Unless change is forthcoming, rebuilding the devastated economy and unravelling the web of dependence on the Israeli economy are a long way off.

NOTES

1. See "Israel-PLO Protocol on Economic Relations," Paris, 29 April 1994, in *JPS* 23, no. 4 (Sum. 94), pp. 103-18.
2. Much has been written about the Palestinian economy under Israeli occupation. The following summation draws heavily on this body of writing. For more details, see, among others, George Abed, *The Economic Viability of a Palestinian State* (Washington, DC: Institute for Palestine Studies, 1990); the articles in George Abed, ed., *The Palestinian Economy: Studies in Development Under Prolonged Occupation* (London: Routledge, 198t,, Meron Benvenisti, *The West Bank Data Project: A Survey of Israel's Policies* (Washington, DC: American Enterprise Institute, 1984); Osama Hamad and R. Shaban, "One-Sided Customs and Monetary Union: The Case of the West Bank and Gaza Strip under Israeli Occupation," in S. Fischer et al, eds., *The Economics of the Middle East* (Cambridge, MA: Massachusetts Institute of Technology Press, 1993), pp. 117-48; David Kahan, *Agriculture and Water Resources in the West Bank and Gaza (1967-1987)* (West Jerusalem: The Jerusalem Post, 1987); Mahmud El-Jaafari, "Non-Tariff Trade Barriers: The Case of the West Bank and Gaza Strip Agricultural Exports," *Journal of World Trade* 5, no. 3 (1991), pp. 15-32; Sara Roy, "The Gaza Strip: A Case of Economic De-Development," *JPS* 17, no. 1 (Aut. 87), pp. 56-88; World Bank, *Developing the Occupied Territories: An Investment in Peace*, 7 vols. (Washington, DC: Author, 1993).
3. In accordance with the Arab boycott rules, goods produced in the West Bank and Gaza using Israeli inputs or in plants established after 1967 were not permitted into Jordan. Sometimes, the rules of the Arab boycott were stretched to include other goods, especially after Jordan "disengaged" from the West Bank in 1988.
4. Other types of surplus included revenues generated from having Israel's new Israeli shekel (NIS) the main legal tender (seigniorage tax) and deductions collected from the Palestinians working in Israel.
5. World Bank, *Developing the Occupied Territories*, vol. 2, p. 28.
6. The reader ought to keep in mind that the statistics in this table rely, for the most part, on the annual editions of the *Statistical Abstract of Israel*. Though the abstracts have provided the most complete time-series data on the OPT's economy, they have been disputed by independent researchers. We use them here for illustration only. In particular, the open borders between Israel and the OPT make it difficult to have reliable trade data. Also, statistics in general since the intifada are believed by many analysts to be less reliable than before.
7. Sharif Elmusa, "Dividing the Common Palestinian-Israeli Water Resources: An International Water Law Approach," *JPS* 22, no. 3 (Spr. 93), pp. 57-77.
8. World Bank, *Developing the Occupied Territories*, vol. 2, p. 2.
9. Until GATT takes effect, customs levels will be based on the Brussels Definition of Valuation (BDV).
10. World Bank, *Developing the Occupied Territories*, vol. 2, p. 33.
11. Karim Nashashibi and Oussman Kanaan, "Which Trade Arrangements for the West Bank and Gaza?," *Finance and Development* 31, no. 3 (94), pp. 10-13.
12. The price index of pesticides nearly doubled between 1986 and 1992, while those of West Bank's vegetables increased by 25 percent and of Gaza's by less than 10 percent. State of Israel, Israeli Centeral Bureau of Statisitics, *Statistical Abstract*, 1993.
13. The statistics are from Nashashibi and Kanaan, "Which Trade Arrangments," p. 12.
14. The lists were not supposed to be made available to merchants, according to a statement by Samir Hulayli, a member of the team that negotiated the protocol, reported in *al-Quds*, 6 June 1994.
15. Julian Ozan, *al-Hayat*, 1 November 1994, p. 10.
16. The quotas target cucumbers, melons, potatoes, and tomatoes. Eggs and poultry are also subjected to quotas.
17. The cucumbers' quota reaches 15 thousand tons in 1996, whereas our estimates using an econometric model indicate that cucumber exports between 1990-92 averaged 19 thousand tons/year. The corresponding quota and export figures of potatoes are 15 thousand tons and 17 thousand tons.
18. Before the protocol, export of eggs and poultry to Israel was prohibited, but the quotas set today do not provide much relief. The difference between egg production over consumption in the West Bank and Gaza greatly surpasses the quotas, and there is no excess chicken (for meat) production. For exam-

ple, we estimate that excess egg production in the West Bank and Gaza amounted to 180-190 million eggs in 1992, or about six times the protocol's export quota for 1994 and three times of that for 1998, when the quotas would be terminated. Palestinian egg producers could switch from eggs to chickens for meat, but conversion would be relatively costly.

19. Israel sells large quantities of agricultural products (other than agricultural inputs, such as fertilizers and pesticides), especially fruits and vegetables, the value of which in 1986 was 15 percent of total Israeli agricultural exports. Estimates by Mahmud El-Jaafari, "Agricultural Imports of the West Bank and Gaza" (in two parts), *al-Bayydir al-Siyyasi*, 13 and 20 August 1988.

20. Nashashibi and Kanaan, "Which Trade Arrangements," p. 11.

21. Israel unilaterally agreed to allow Jordan to export $30 million worth of goods to the West Bank as part of an economic agreement it signed with Jordan on 16 August 1994. (See Qol Yisra'el, 16 August, and Radio Jordan Network, 16 August, as translated in FBIS, 17 August 1994.) On possible Israeli motivations for strengthening Jordan's position, see, for example, David Makovsky, *Jerusalem Post*, 22 July 1994.

22. Compare the figures for imports over the years as printed in the Central Bank of Jordan's annual reports.

23. For example, in 1985-86 Jordan's exports to these countries amounted to approximately 50 percent of its total exports. However, in 1992, after the Gulf War, that figure had dropped to less than 25 percent. See the Central Bank of Jordan's annual reports for 1988 and 1992.

24. World Bank, *Developing the Occupied Territories*, vol. 2, p. 28.

25. World Bank, *Developing the Occupied Territories*, vol. 2, p. 26.

26. Israel denies this accusation but has produced no evidence to support its claim. The deductions were estimated at $250 million, without the interest, over a 25-year period. See Stanley Fischer et al, eds., *Securing Peace in the Middle East* (Cambridge, MA: Massachusetts Institute of Technolody Press, 1994), pp. 84.

27. It is interesting to note that the closures are a Labor Party innovation, at odds with Likud's ideology of the OPT being integral parts of Israel.

28. See, for example, Fischer, *Securing the Peace*, pp. 69-82.

29. Clyde Haberman, *New York Times*, 31 October 1994, p. A11.

30. Quoted in *al-Quds*, 6 June 1994.