Economics and Politics in the Israeli Palestinian Conflict

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The AIX Group
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To Ron

This volume of studies, “Economics & Politics in the Israeli-Palestinian Conflict”, was prepared between 2013 and 2015 by The AIX Group, and is dedicated to the memory of our late friend and partner, Ron Pundak. Ron, was only 59 when he passed away in April 2014, in the midst of intensive efforts to promote a better future for both Israelis and Palestinians.

Ron was one of the original initiators of The AIX Group, and a member of its steering committee for twelve years. As always, he contributed extensively to the planning of this volume and suggested many innovative ideas in the discussions of most of the chapters; one chapter, “alternative visions for the future”, was his last mission of writing for the Group, a mission that he attended to with burning urgency but, unfortunately, could not bring to completion.

Preface

The present volume of studies that The AIX Group completed, draws on our joint work as a think-tank over many years. We always encountered misunderstandings concerning the respective roles of politics and economics in the Israeli - Palestinian conflict. There were people, who continuously promoted ideas that underestimated the importance of politics in the conflict, choosing not to address the political sphere and instead to come up with “economics first” and “economics only”, strategies. Such approaches have long history and immense influence, and they had led too many to believe that the fundamental political dimensions of the conflict could be neglected.

As an economic think tank, where both Israelis and Palestinians participate as equals as well as partners, we have never thought that the economic aspects are negligible. They are certainly crucial for any imagined change in the current conditions especially, but not only, for the Palestinian society in the West Bank, East Jerusalem, Gaza and the diaspora. Facing the realities of the conflict, with the many asymmetries and disparities – Israeli statehood but no Palestinian sovereignty; an occupier versus an occupied; Israeli economy that is twenty times larger than the Palestinian one; Palestinian standards of living that are ten times lower than the Israeli ones – the ecosystem that will enable changing the relations between the two societies is of upmost importance. Any ecosystem is based on both political and economic decisions that are interwoven; hence, balancing properly the political and economic changes lies at the roots of moving to a new era we aspire.

In the present studies we review what we see as major faults in past policies; we explain the disadvantages in an unbalanced ecosystem, where economics is perceived as important while politics is ignored. We review examples of such strategies, starting with the infamous Israeli policy towards the occupied territory, shaped by Moshe Dayan the then Defense minister and implemented by the Israeli government in the years after 1967. The policy was supposed to decrease resistance to the occupation, by maintaining reasonable standards of living, and thus promote the new reality. The strategy allowed Palestinian workers to enter the Israeli labor market, while preventing real development within the occupied territory itself. Decisions were made by Israel alone; the policy created asymmetries and dependencies that characterized the conflict up to this day.

We criticize in the study the political and economic arrangements after Oslo, as articulated on the economic side in the 1994 Paris Protocol. These arrangements assumed a gradual political process to resolve the conflict that have never materialized, and carried on many aspects of the economic arrangements since 1967. Clearly, no Palestinian economic sovereignty, beyond a minimal control over the public sector, was on the cards. Now, more than twenty years since Oslo, all those who would like to see a resolution to the conflict, rather than the current Status Quo with intervals of a process for the sake of a process as we have had so far, are facing a serious challenge.

The recent Kerry economic plan received our scrutiny in these studies as well. In many respects, it did not address the prerequisite to balance properly economics and politics; too much weigh was given to economics and too little to politics. The important lesson concerning the negative consequences, for both Israelis and Palestinians, as a result of no economic sovereignty for the Palestinians and no political agreement characterize all above three cases.

Economics and politics are interwoven and future arrangements would have to relate to both and find the right balance and synchronization; this lesson is relevant to many in the region, and dramatically more so to those who suffered the most. In the Gaza Strip, more than 1.8 million people on an area of 365 sq.km, live under transitory, unacceptable, ecosystem: To let civilian population live with no normal movement provisions and no trading arrangements, under practical siege lasting more than seven years, is not acceptable. The argument that this is a response to a political decision of the population misses the point, since it is not only wrong butalso ineffective. In a study dedicated to Gaza, "Some Economic Aspects of the Reconstruction of Gaza", we propose ideas that will help get the dire situation a little better. We believe that the efforts, so far not successful, to see serious reconstruction after the war should be linked to attempts to change the current ecosystem in Gaza strip. The reconnection of Gaza and its people to the rest of the world cannot wait. Though, as in the West Bank and in Gaza, the path away from the Status Quo necessitate recalculation of strategy on the part of the leaderships.

The Status Quo (SQ) as defined in the studies, is perceived by many Israelis as sustainable. In the studies we assess some of costs of the SQ for the two sides: The costs are hard to compute and compare, but the studies clearly show that the costs for Israel, in terms of high losses for maintaining the SQ due to security costs, are even higher than many in Israel think, and very significant. The damages as a result of the SQ for the Palestinian economy are dramatic. There is no enough private and public investment; no sufficient productive employment creation; and no sustainable growth. The illusions in some circles that the SQ can continue as is, and it is the superior of the alternatives, can only be defended if one ignores its real costs. Partly, the international community carries those costs. This is not the result of well calculated decisions to support the SQ, but rather an unintended consequence of policies aimed twenty years ago at supporting the "peace process". We think that it is time for all stake holders to reconsider their policies. We, in The AIX Group, are not exception to this conclusion, and we engage our joint Israeli-Palestinian-International team in reassessing what is our role in the coming era.

In an attempt to look beyond the impasse, the paper "Palestinian/Israeli Relations: Alternative Visions of the Future" outlined some of the possibilities. The paper surveys the SQ and possible threatening deteriorations in it and then reviews alternatives to the SQ. The alternatives include (1) no agreement while Israel implement unilateral measures; (2) "one state", where two live in one space under one sovereign; and (3) the well-known "two state" formula that we analyzed in many past studies (see our site). Thus, we assess some adverse alternatives, an imaginary one, the "one state" that avoids addressing some of the basic issues, and a positive solution that after so many years seems to too many as far-removed from implementation. However, we belong to the optimists who think that the "two state" formula is superior to all other alternatives, points at the right direction and against the strong forces who contest it from all directions, and can yet become the reality. It is the only framework for having both political and economic arrangements that will address the desires of those living in the region, while seeking self-determination as well as prosperity.

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*In writing this paper we had important inputs from an Economist from Gaza (GE) ; for obvious reasons we use this pseudonym

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Executive Summary

The 1993 Oslo Accord was a significant step for the peace process between Palestinians and Israelis, which aimed to end the political conflict between the two parties. **An economic protocol** was formed in order to re-shape the economic system between the Palestinians and the Israelis to rectify the flaws of previous arrangements, while maintaining the almost free movement of goods and labor between the two economies within the framework of an impure customs union. This protocol which is known as the Paris Protocol (PP), was signed as a short-term economic agreement for a period of five years. During the interim-agreement period, import taxes were to be collected by Israel on behalf of the Palestinian National Authority (PNA), while taking into consideration providing PNA a period of grace in which to set up an independent fiscal system. Palestinian labor in Israel was to continue, while the establishment of the PNA was to have created a badly needed public sector and economic policymaking body. On the other hand, foreign-investment, stimulated by the new climate of peace, and the improved infrastructure financed by foreign donations, was expected to encourage the emergence of a revitalized private sector and boost economic growth. The formation of a Palestinian Monetary Authority (PMA) was designed to improve financial intermediation.

In general, the perspective of the signatories was that — with international aid — the PP formed the basis for sustainable growth of the Palestinian economy. However, the real situation has been in sharp contrast with this vision. Although the de jure regime is still the Paris Protocol, the de facto reality has swerve from the concepts upon which the PP was devise. A complex system of one-sided, restrictive Israeli policies and measures has developed over the past two decades since the PP had been signed. This system, in combination with the structural weaknesses of the Palestinian economy, resulted in the continuation, and even worsening, of the major economic flaws of the pre-Oslo, Israeli-rule period. Dependency on external sources continued, and even deepened. The huge structural economic imbalance was mirrored in enormous deficits in the balance of payment and the PNA's budget. These fundamental imbalances, along with Israel's control over the collection of a large part of the PNA's financial revenue, as well as other certain aspects of the PP, perpetuated the overwhelming dependencies of the Palestinian economy on Israel.

Because of the current political situation and the severity of the economic crisis in Palestine, we recommend to start introducing "economic sovereignty" to improve the economic conditions via a set of modifications to the "Israeli-Palestinian Interim Economic Protocol" which will address the most serious flaws of the present economic regime. Such a revised interim economic agreement can be negotiated and signed within a few months; correct some of the flaws in the present arrangements; inject new potentials to the Palestinian economy; provide a platform for a renewed donor-supported effort to put the Palestinian economy on a track of sustainable, export-driven growth; and, most importantly, strengthen the economic sovereignty of the PNA.

Reforming the PP trade regime

Palestine's huge trade deficit is one of the severest weaknesses that have developed under the PP regime. Moreover, as a very small economy, Palestine can have sustainable economic growth only by applying an aggressive export-driven growth strategy. The "joint customs envelope" which was established by the PP for the interim period, and other related arrangements and practices that developed over the last two decades, has become a major obstacle to Palestinian export-growth, as analyzed in detail in this paper.

We propose to amend the PP "joint customs envelope" in a way that will create a Separate Palestinian Customs Territory, while maintaining the non-existence of agreed physical trade borders between the sides, as it is now. This change would provide the PNA with the missing trade policymaking autonomy, needed for shaping Palestinian trade policy, based on the Palestinian development agenda. Hence, this will strengthen significantly the sovereignty of the PNA and indicate that the PNA is on its way to full Statehood. We propose to achieve this goal through a phased process as detailed in this paper, which will include, inter alia, positioning of Palestinian customs officers in all international exit/entry points (Haifa, Ashdod, Allenby, etc.) who will handle Palestinian imports and exports; and Palestinian customs officers on all Israeli–Palestinian crossing points to control the bilateral Israeli-Palestinian trade, alongside the Israeli officers. The Palestinian customs officers' work will be coordinated with the present system of security and other checks in ways that will not significantly affect the smoothness and speed of movement through the crossing points.

Another component of the proposed system will be a number of Palestinian inland customs clearing houses which will coordinate and oversee the work of the Palestinian customs officers positioned in the international entry/exit points and the Israeli–Palestinian crossing points, and where shipments that need special customs presence will be sent to for clearance. All these arrangements will be developed using modern and integrated customs and security management systems (procedures, standards) and infrastructure (technology, physical infrastructure), which will be developed in close cooperation between the interested parties. One should note that such systems of inland customs houses are interconnected with the work of customs officers positioned in the crossing points. This system already works efficiently in Jordan and other countries. Israel, as well, has a well-working system of certified inland bonded warehouses compounds, which is based on controlling the movement of trucks from the entry points of the inland compounds for clearance. These well-functioning suggested systems can serve as models for the proposed Palestinian customs control system.

Moreover, our suggestions relate to various other trade-related barriers: (a) recommendations to address the administrative, regulatory, logistical, and, movement and access restrictions which are imposed on the Palestinian exports to Israel, which aim at gradually narrowing Palestine's huge trade deficit with Israel; (b) removing trade barriers between the West Bank and Gaza Strip, and to be organized and monitored through a "safe passage"[1]; (c) phased application of a separate Palestinian tariff book, which will be constructed in accordance with Palestinian economic conditions and needs, and encourage the diversification of Palestinian foreign trade; and (d) full removal of all trade constraints, which are currently imposed on Gaza Strip, considering Gaza's most severe situation in this respect, as shown in the "box" on Gaza later on in the paper.

Revising tax-collection arrangements, fixing fiscal leakages

The "clearance" of revenues' income, collected by Israel on behalf of the PNA, is a major source of budgetary revenue for the PNA. The repetitive and arbitrary suspension of its transfer, which is caused by Israel, constantly and severely threaten the financial stability of the Palestinian economy. In addition, the PP created a set of fiscal leakages; the overall cumulative value of which is hard to calculate, however some estimates place it at hundreds of millions of dollars – about one-third of the PNA's budget deficit for 2012.

1. See The AIX Group's paper on the "Territorial Link," Economic Dimensions of a Two-State Solution, vol. II, 2010 (www.aix-group.org).

Hence, another major component of the modifications to the "Israeli-Palestinian Interim Economic Protocol" in general, and to the strengthening of a Palestinian Customs Territory in particular, should be new arrangements for self-collection of Palestinian customs revenues and indirect taxes by the PNA, which will replace the present revenue clearance mechanism, and eliminate Israeli control over Palestinian tax and customs revenue.

Improving labor flows

Considering the strong effect of Palestinian work in Israel on the Palestinian incomes, increasing the number of Palestinians entering the Israeli labor market could significantly help reduce the high percentage of the Palestinian unemployment, and the depressed economic situation in the West Bank, and the worse one in Gaza. It has special importance for the short-medium term. **Hence, we recommend a phased program works on increasing the number of the Palestinian workers in Israel, under newly agreed-upon arrangements, in order for gradual replacement of foreign workers in the Israeli construction, agricultural and industrial sectors with the Palestinian workers; and for modifications to the present entry-permit system, especially concerning laborers.**

More Palestinian economic sovereignty and control over economic policymaking

The Paris Protocol transferred to the PNA several powers relating to economic policy. In real life, however, the PNA has no control over many of the major aspects of economic policy, except for a limited control over fiscal policy. The absence of economic sovereignty and authorization constitute a major weakness in the Palestinian economy. **Given a phased shift towards the proposed separate customs territory, as recommended above, there is vast room for agreed amendments in various aspects of economic policymaking, which will allow the PNA much wider room for application of autonomous economic policy measures.**

We recommend that such a new set of amendments, addressing the major weaknesses in this sphere, will be discussed in the newly activated Joint Economic Committee (JEC). For example, power to apply autonomous indirect taxation policies will enable the PNA to adapt Palestinian indirect taxes to the conditions of the low-income Palestinian economy, protect infant or key industries, etc. Economic sovereignty in this sphere, in combination with the power to apply trade diversification policies, could enable the PNA to significantly decrease the prices of basic products, such as fuels, electricity, water, etc., and bring the cost of living in Palestine closer to that of neighboring low-income Arab countries, namely Jordan. Reactivation of the JEC can also help move the parties towards removing the complex set of restrictions in relation to Palestinian control over physical resources, such as land, water, roads, and other infrastructures, as well as improve the investment horizon, reduce uncertainty, mitigate risks, and encourage investments in the private sector.

1. Introduction

The Oslo peace process, at present, is far removed from the high expectations which were held in September 1993; this is also true with regards to the economic dimension. The interim agreements were supposed to lead to a permanent agreement within five years; as of writing this paper no permanent status negotiations are in sight. According to the view which was held at the inception of the Paris Protocol (PP) in 1994 – the agreement that shaped the economic regime in the Palestinian economy after Oslo – the PP was supposed to sustain prosperous economic development, an essential ingredient for the success of the peace process. Thus, the PP was

developed with the intention of creating the required conditions for such positive performance. In this paper we present the reality: First, disappointing performance in the Palestinian economy comprising the West Bank, East Jerusalem, and Gaza, and its characteristic dependencies over the last twenty years. Then, we propose an analysis of the failure to achieve prosperity, distinction between the reasons associated with the unfulfilled political assumptions and those resulting from fundamental weaknesses in the rationale and letter of the PP. In the last section, we propose modifications to the PP regime, assuming no breakthrough in the negotiations. Such modifications could improve the economic conditions afflicting the Palestinians under the status quo while still preparing the ground for a permanent agreement.

The AIX Group's position concerning the final economic agreement is derived from our analysis of future relations between Palestinian and Israeli economies based 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.[2]

The regime created by the PP essentially presumed, on one hand, continued economic integration between the Palestinian and Israeli economies, which had prevailed since early 1970s. On the other hand, the agreement added a new variable to the economic formula of the region: the creation of the Palestinian National Authority (PNA). This newly created economic body was supposed to represent the embryo of a future, sovereign policymaking apparatus, capable of implementing internal economic affairs as well as external trade agreements. It was supposed to take the place of the Israeli Civil Administration that directly managed the public sector before Oslo. In practice, however, the PNA's authority is curbed and it has no full sovereignty, whether over internal economic affairs, trade agreements, or budgetary, fiscal, and monetary policy.

Thus the PP's economic regime assumed, fundamentally, free movement of goods and labor between Israel and the Palestinian economy, as in the years after 1967. Coupled with the transfer of sovereignty over the public sector to the PNA's control, the view held by the signatories was that — with international aid — the Protocol laid the foundation for a new path for the Palestinian economy, towards a more developed economy and sustainable growth.

1.1 Historical Background

The Palestinian economy, defined in this paper as the economy in the areas occupied by Israel in 1967 (i.e. the West Bank, excluding Israeli settlements, East Jerusalem, and the Gaza strip), is functioning under very exceptional circumstances. Following the 1967 war, Israel used its power to determine the most important parameters concerning the Palestinian economy, namely its links with its much stronger Israeli counterpart (and, as a byproduct, other economies as well), and to shape these links, taking into account, first and foremost, its own interests. Hence, following the war, a de-facto semi-customs union comprised the economic relations between Israel and the Palestinian Authority based on two factors: (1) the Israeli trade regime, and (2) almost free access of Palestinian laborers to the Israeli economy. In other words, Israel determined

2. For The AIX Group's vision regarding the final economic agreement, see the "Big Picture" in Economic Dimensions of a Two-State Solution, vol. II, 2010 (www.aixgroup.org). See also the "Economic Road Map" (2004).

that the Green Line would no longer exist as a comprehensive economic border. A process of "imposed integration" began, where the trade and labor borders between the two very uneven economies tended to disappear.

The new arrangement yielded obvious results: the more advanced economy attracted cheap labor from the less developed one. Indeed high proportions of Palestinian employment in the Israeli economy helped to solve some short-term issues, such as high unemployment rates and low incomes. However, it contributed to greater dependency on the part of the Palestinian economy. Furthermore, a myriad of administrative measures curtailed Palestinian development, prevented local Palestinian entrepreneurs from competing with Israeli ones, and further contributed to the economic asymmetry between the two sides. Over the years, Israeli settlements in the occupied territories brought more obstacles to economic development; these settlements also used natural resources (water, the Dead Sea, land, stone, etc.) to their own benefit. In short, since 1967 there has been only one true economic sovereign between the Jordan River and the Mediterranean Sea, accordingly, the modest standard of living based on the commuters' employment in Israel was supposed to enable an easy and cheap maintenance of the occupation and help suppress the Palestinians' resistance.

The beginning of the First Intifada at the end of 1987 shattered the Israeli conviction that the imposed economic regime would suffice as a substitute for the Palestinians' political desires. When, for the first time, Israelis and Palestinians negotiated directly in the early 1990s, they reached in 1993 an interim agreement – capped at five years –that was designed to address the economic dimension in addition to the political. After six months of negotiations, the parties concluded a new economic agreement between Israel and the PLO, with the preamble clearly describing two parties with legitimate interests and equal claims to economic policymaking:

> The two parties view the economic domain as one of the cornerstones in their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace. Both parties shall cooperate in this field in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of mutual respect of each other's economic interests, reciprocity, equity and fairness.
>
> This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities. The two parties recognize each other's economic ties with other markets and the need to create a better economic environment for their peoples and individuals (Preamble, the Paris Protocol, 29th April, 1994).

In other words, the fundamental new assumption of the negotiators negated the old Israeli "one sovereign" concept. In fact, there were some positive developments concerning Palestinian economic self-determination: the modifications to the trade regime included a new, more equity based "revenue sharing" scheme that, for the first time, aimed at using funds raised from taxes on Palestinians to service public expenditure in the Palestinian economy. In addition, some exceptions to a strict customs union regime were agreed upon – for example, the tariff lists A and B.

Intentions aside, the Paris Protocol did not succeed in changing the fundamental characteristics of the post-1967 economic regime. Although some modifications to the customs union were designed, the semi-customs union was in its essence continued. The PNA was prevented from deciding or influencing trade policy through other mechanisms: Israel's hold over external borders were maintained; the diversification of both imports and exports were still very much restricted by the tariff lists; and a large proportion of the future income of the PNA depended on "clearances" (i.e. on funds to come from the Israeli side who collected them for the PNA), maintaining the Palestinian economy dependence on Israel. Finally, although the agreement instituted the establishment of a monetary authority and provided a tool for instituting public debt, in practice Palestine was refrained from this. Thus, the post-Oslo interim regime represented a type of economic "no man's land," with the end of the "one sovereign" concept on the one hand, but a continuation of the "imposed integration" strategy on the other.

1.2 Disappointing Performance

The performance of the Palestinian economy under the arrangements dictated by the Paris Protocol was very disappointing and revealed the agreement as flawed; at best, the high expectations for a better economic environment did not materialize. To make matters worse, in 1995-96, the economy endured the effects of increasing political violence: the most fundamental assumptions of the PP regime – free movement of labor and goods – were seriously curtailed. In 2000, with the failure to achieve a permanent status agreement in Camp David and the outbreak of the second Intifada, an even more serious economic crisis followed. The assumption that the Paris Protocol would pave the way to prosperity and peace encountered a starkly different reality. The "no borders" integration framework provided way to a unilateral separation framework, where flows of economic goods and labor stalled in the face of Israeli restrictive, security-related measures. Additionally, there were no serious efforts to balance Israeli security with Palestinian economic needs – the few that were attempted failed. Israel did not agree on borders where sophisticated gates could facilitate economic development; in many cases, it chose to disregard the Green Line as a parameter. The Palestinians, for their part, did not agree on economic border sites other than the Green Line. As a result, the economy became just another pawn in the renewed conflict.

Today, of course, there are very real trade and labor borders between the two economies – albeit borders that Israel has set unilaterally; these borders, both with Gaza and, in a different shape, with the West Bank, contradict the Paris Protocol's most primary assumptions. Thus, although the de jure regime is still the Paris Protocol, the de facto reality has deviated from the concepts upon which the PP was devised; such a reality demonstrates the urgent need to rethink the economic regime.

1.3 Outline of the Paper

The story of the Paris Protocol might be most succinctly described as a failed strategy in economic development, and a failed promise of economic sovereignty. Although the PNA was created to give the Palestinians a say in the economic regime, in practice most of the most fundamental tools of economic policy making – particularly in times of crisis, as was the case for the majority of the interim period and until today – were left in Israeli hands. Thus, the hopes in 1994 that the Palestinians have finally won their sovereignty, including over economic matters, have not materialize yet.

Perhaps most importantly, the Paris Protocol was agreed upon and signed by the two sides as the economic regime for an interim period. Accordingly, it should be natural to pose that the

PP is not suitable for a permanent agreement. In this paper The AIX Group addresses the dysfunctional economic arrangements that were either a direct result de jure of the Paris Protocol regime, or a byproduct of its weak implementation de facto; in both cases, genuine development in the Palestinian economy lagged. Although we believe that permanent status negotiations yielding a permanent status agreement within the realm of the two-state-solution are preferable, we will make our recommendations assuming that there is no such agreement; in case a more optimistic scenario should be materialized, the framework outlined in The AIX Group's "Economic Road Map" (2004) would be useful. Therefore, this paper seeks to identify the limitations of the PP regime (section II) and recommend short-term as well as longer-term modifications (section III). All of the modifications forwarded seek to respect the dichotomous failure of the PP – to improve the performance of the Palestinian economy, while also paving the way towards a sovereign Palestinian state.

2. Macroeconomic Imbalances under the Paris Protocol Regime

2.1 Trade Imbalance

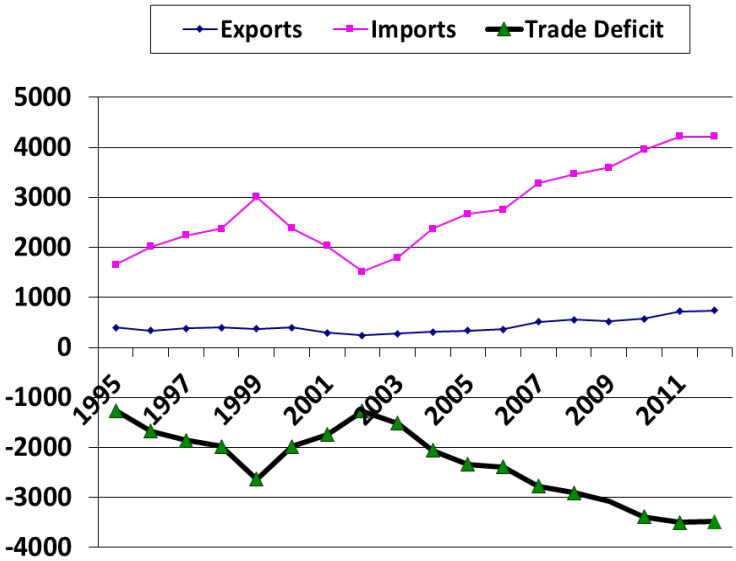
One of the primary promises of the Paris Protocol was to grant the newly formed PNA policy space when it came to trade, and the PNA indeed tried to utilize it in signing trade agreements with the EU, EFTA, Turkey, and the Arab Free Trade Area, to name a few. Furthermore, the PP provided the PNA tariff lists A-1, A-2, and B, presumed to be the beginnings of a Palestinian tariff book, which would have deviated from the Israeli tariff book. In practice, however, with the Israeli decision to disempower the Joint Economic Committee (JEC), the body in charge of agreeing on Palestinian tariffs, these lists were not realized. Israel did encourage meetings of the Civil Affairs Committee, but expanded the lists A-1 and A-2 only twice since the signing of the Paris Protocol in 1994. Thus, while the PNA was supposed to be granted (marginal) sovereignty when it came to trade policy – the agreement states that the review of these lists should happen once a year – in practice the "imposed integration" view held its ground.

On the other hand, the "customs union" trade regime set out in the Paris Protocol made the PNA a captive market for Israel, in which Israeli imports accounted for 70-75 percent of all Palestinian imports over most of the 2000s. Israel remained practically the sole market for Palestinian exports as well, absorbing about 85-90 percent of them in this period.[3] Furthermore, since the Palestinian economy and the Israeli economy are different in most economic characteristics, the trade policy Israel imposed, which reflected Israeli interests alone, made the Palestinian producers less competitive for exporting to countries other than Israel. Such constraints on Palestinian exports to non-Israeli markets had a very grave effect on economic development prospects because, as an infant economy, Palestine can generate sustainable long-term growth only through exports. As a result, Palestine has developed a huge structural trade deficit that, in turn, has greatly increased Palestinian dependency on external sources for financing this deficit. The rapid economic growth of recent years echoes a steep increase in Palestinian imports, while exports showed only modest increase;

PCBS, Foreign Trade Statistics. For example: Palestinian exports to Israel of $499 million in 2008, $453 million in 2009, $488 in 2010 and 618 in 2011, amounted to 85 - 89 percent of total Palestinian exports of $558 million, $518 million, $576 million, and $720 million, respectively (PCBS, Registered Foreign Trade Statistics for 2011 (December 2012) p. 33, and p. 35; PCBS, Registered Foreign Trade Statistics for 2010 (January 2012) p. 35; and PCBS, Registered Foreign Trade Statistics for 2009 (March 2011) p. 42

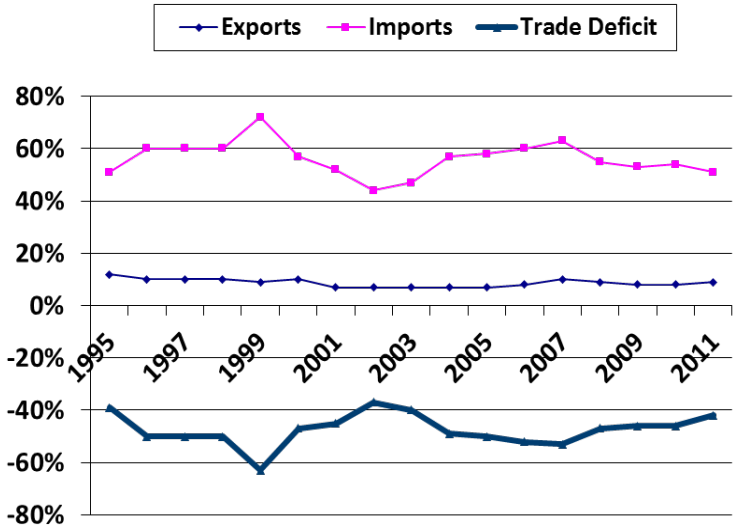
the trade deficit surged upwards accordingly.[4] As shown in Chart 1, the gap between Palestinian exports and imports grew three-and-a-half times over the last ten years, from slightly above $1 billion in 2002 to $3.5 billion in 2011 and 2012.

Chart 1.1: Palestinian Exports and Imports of Goods 1995 – 2012 ($ million, current prices)



Source: PCBS, Foreign Trade Statistics (registered trade data only, excluding East Jerusalem)

Chart 1.2: Palestinian Exports and Imports as Percentage of GDP 1995 – 2012 (Percent of GDP in current prices)



PCBS, Foreign Trade Statistics and National Accounts Statistics

4. PCBS, Foreign Trade Statistics.

The huge structural gap in Palestinian trade reflects the severe constraints of the PP-based regime on Palestinian exports and private sector growth: lack of economic sovereignty; high transaction costs affiliated with movement and access restrictions; and the high cost of clearance of imported goods are but a few examples. Hence, the existing regime presents a barrier to the Palestinian businesses' access to production inputs; these restrictions impose themselves on the supply chain and most importantly on markets. One must also consider that the West Bank and Gaza are no longer a unified market and Gaza has revolved from a potential trade route to a recipient of humanitarian donations. In addition, the prevention of movement and access of Palestinian businesses to the East Jerusalem market has carved out a main center of economic activity from the Palestinian business map.

Potential growth in investment and production depends on an open regional and international trade. This is especially true since the Israeli market, which makes up 85-90 percent of Palestinian exports[5], has undergone changes that have minimized the potential for further penetration of traditional Palestinian products. The required access to alternative markets depends upon a change from what is currently offered by the PP's economic union.

2.2 Mechanisms for Countering the Trade Imbalance: Opportunities on Paper, Limits in Practice

The joint customs envelope, resulting from the imposed integration of the Palestinian economy to Israel's policymaking apparatus, coupled with the increasing transaction costs that Palestinian traders face as a result of the conflict, has yielded a situation in which Palestine cannot exploit its comparative advantages – neither with Israel nor with the world. This situation has yielded the huge trade deficit shown above.

There are several mechanisms that can help closing the deficit in the balance of payments. First, increasing the export of labor from Palestine to Israel; second, trade policy to encourage exports to Israel and the rest of the world; third, granting the Palestinian sovereignty over its exchange rates. Since the PNA does not issue its own currency, the exchange rate mechanism is not at work. Under the PP regime the PNA has no economic sovereignty, and no tools to deal with the Palestinian economy severe dependencies and constraints for sustainable growth.

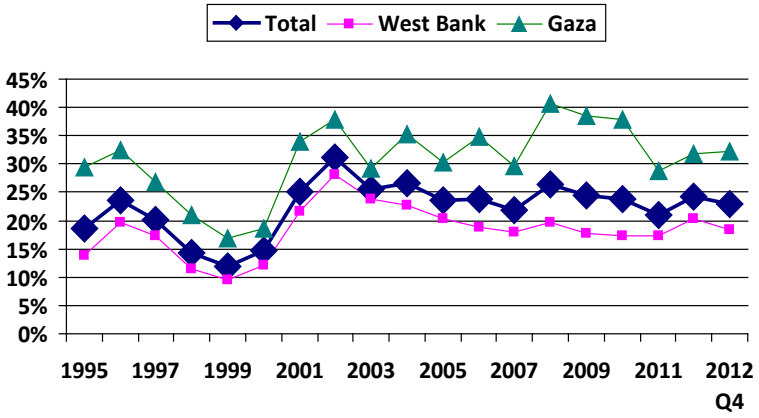
The Labor Market

Since the PP negotiations start, the Palestinians demanded a different trade regime, preferring a Free Trade Area (FTA) to a Customs Union (CU); the Israeli negotiators preferred the latter one. The Palestinians were eventually convinced to accept the Israeli position since the FTA, meaning a trade border, would ostensibly establish a labor border and the Palestinians could lose their prior level of entrance to the Israeli labor market. This threat, and maybe other considerations, resulted in the present agreement.[6] While the agreement secured entrance of Palestinian laborers to the Israeli economy on paper, yet, the labor flows over the years were heavily restricted in reality. How ironic it is that Gaza Labors almost totally stopped flowing from Gaza to Israel since 2000 and, over the years, heavily declined from the West Bank to Israel. [7]

5. PCBS, PCBS, Foreign Trade Statistics.
6. "Article VII 1. Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and conditions of the labor movement into its area. If the normal movement is suspended temporarily by either side, it will give the other side immediate notification, and the other side may request that the matter be discussed in the Joint Economic Committee." (Paris Protocol)
7. Jerusalem, which was to be negotiated in five years, was removed from the jurisdiction of the Protocol, and singular arrangements, enforced by the Israeli side, have made its status economically unique.

With the outbreak of the second intifada, the impact of the violent conflict on Palestinian employment was disastrous. Approximately 180 thousand employees, 28 percent of the Palestinian workforce, lost their jobs in the fourth quarter of the year 2000, of which about 100,000 lost jobs in Israel, and about 80,000 lost private sector jobs the in the West Bank and Gaza. Palestinian unemployment percentage increased from 10 percent on the eve of the intifada, in the third quarter of the year 2000, to more than 35 percent in the third quarter of 2002. Unemployment percentage decreased to some extent in the coming years, but has remained very high, ranging between 20-25 percent.[8]

Chart 2: Palestinian Unemployment Rate 1995 – 2012 (Percent, ILO strict definition)



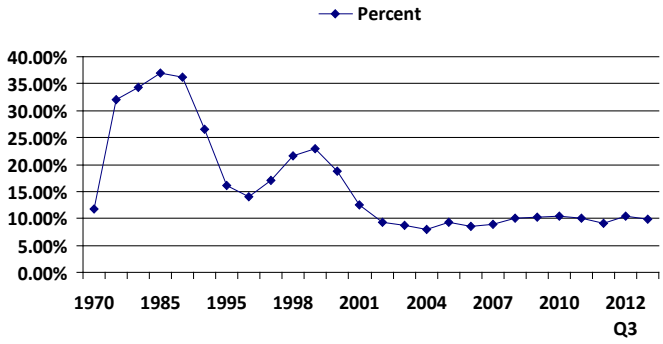
Note: unemployment as per the strict ILO definitions. According to the relaxed definition of unemployment, namely, including persons who wish to work but have been discouraged from actively looking for job, the rate is 6 – 10 percentage points higher. For example, in 2002 the rate according to the relaxed definition was 41% instead of 31% according to the strict definition; and in 2010, 30% instead of 24%.

This leap of unemployment, from 10-15 percent in the pre-Second Intifada years (1998-September 2000) to 20-25 percent in the post Intifada years (since 2005), stems largely from the sharp decline in Palestinian employment in Israel. As shown in Chart 3, about 10 percent of total Palestinian employment in recent years has come from the Israeli market (and the settlements), compared to above 20 percent in the pre-Second Intifada years, and about 35 percent in the pre-Oslo years (until 1992).

Nevertheless, employment in Israel still plays an important role in the West Bank labor market. The total number of Palestinians employed in Israel and the settlements doubled from around 45 thousands in the height of the Second Intifada (2002 – 2004) to almost 90 thousands in the second half of 2012. All Palestinian workers in Israel are West Bankers, and their share in total West Bank employment was about 15 percent in 2012.[9] Moreover, since the average daily wage of West Bankers working in Israel is twice as large as the average daily wage of workers inside the West Bank (87 NIS compared to 167 NIS per day)[10], work in Israel still contributes more than one quarter of all wage income in the West Bank. One should also notice that if not for the work in Israel, the unemployment rate in the West Bank would have been as high as in Gaza, 30 to 35 percent; or above 40 percent according to the relaxed definition of unemployment, namely, if persons who wish to work but have been discouraged from actively looking for job are taken into account as well.

8. PCBS, Palestinian Labor Force Surveys
9. PCBS, Palestinian Labor Force Survey, Q3 and Q4 2012
10. PCBS, labor force survey 3rd quarter 2012, p.6

Chart 3: Palestinian Employment in Israel (and the Settlements) as a Percentage of Total Palestinian Employment 1970 – 2012



Sources: 1995-2012 data - PCBS, Palestinian Labor Force Surveys; pre-Oslo data based on ICBS.
Note: Due to the move from ICBS to PCBS the series have a break in 1995.

No Independent Currency, Exchange Rates Policy or Monetary Policy

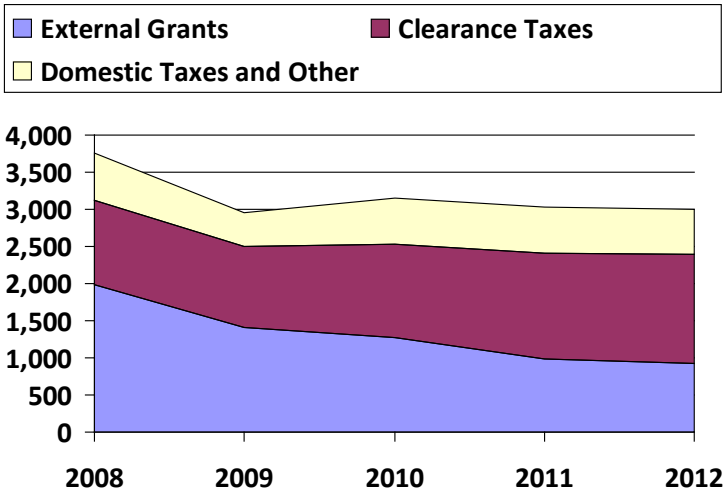
As part of the continued "imposed integration" manifested in the PP, the PNA has no currency, there is no exchange rates policy, and Israel alone controls the monetary policy. The bank of Israel sets the short-term nominal interest rate according to its considerations to stabilize inflation and support employment, subject to inflation targeting. Accordingly, when the Bank of Israel sets the short-term interest rate, it does not take into account the implications of the interest rate for the Palestinian economy. Since inflation in the PNA and Israel were highly correlated (as expected), the loss for the Palestinians because of the lack of monetary policy were limited; but Palestinians in the West Bank and Gaza suffer from higher unemployment.[11] While part of the high unemployment is due to the decline in employment in Israel as described above; another part is structural. In other words, the monetary union and the lack of Palestinian monetary sovereignty damage the Palestinian economy, since the PNA does not have one of the most important tools for making policy relevant to fighting the deficits in the balance of payments and high unemployment. We will elaborate on these crucial policy issues in future work.

2.3. Fiscal Imbalances

The economic limits imposed on the PNA as a result of the PP's trade regime continue in the form of what is known as the "customs envelope." According to the agreement (Article III, Section 14), it was agreed that the "Palestinian Authority will have full responsibility and powers in the Palestinian customs points (freight-area) for the implementation of the agreed upon customs and importation policy as specified in this protocol, including the inspection and the collection of taxes and other charges, when due." In practice, Israel collects the revenues on imports and transfers them to the PNA (after deducting collection charges). The main result is that the PP regime does not grant the PNA sovereignty over its own budget and fiscal policy, since it could neither raise enough revenues due to restrictions on its tax structure; nor it could issue debt. Thus, despite impressive progress in its own tax collection performance, the PNA is still depending on Israel for collection of most of its tax revenues. The analysis of budget data for the years 2010-2012 shows that the PNA controlled only 20 percent of its budgetary sources; Israel controlled 40 percent in 2010 and close to 50 percent in 2011 and 2012; and international donors provided more than 40 percent in 2010 and above 30 percent in 2011-2012.[12]

11. In Gaza Strip, inflation is lower than in the West Bank.
12. IMF, Staff report prepared for the meeting of the Ad Hoc Liaison Committee, September 2012, p. 30; Report for the AHLC meeting, March 2013, p. 27

Chart 5: PNA Central Government Budget Revenue 2008 – 2012 ($ million, current prices)



Source: IMF, Report for the AHLC meeting, September 2012, p. 30, and Report for the AHLC meeting, March 2013, p. 27; PMA, November 2012, Table 27

On a political level, the lack of Palestinian sovereignty over fiscal issues makes the stability of the Palestinian economy mainly fragile to the political whim of the Israeli government, which has manifested itself time and again over the past decade: in late 2000, after the Second Intifada broke out Israel froze indefinitely the transfer of tax money to the PNA; in 2006, after the Hamas won the parliamentary elections and established a government in the Gaza Strip; in October 2011, as punishment for Palestinians' appeal to the UN; and again in November 2012 after the UN updated the PNA's status to "non-member state."

Bilateral Dependencies: the Clearances with Israel and Fiscal Leakages

The PP created a revenue-sharing mechanism that aimed to re-direct the benefits resulting from Palestinian trade to the Palestinian National Authority. This clearance mechanism is based on the unified invoice, which is utilized for the exchange of VAT payments between the two sides and based on where final consumption of the goods takes place. Two problems arise from this arrangement. The first problem is that the system functions based on a company's reporting via the unified invoice. Hence, the PNA receives the unified invoice for VAT clearance from businesses, and then utilizes the invoice to affect the transfer of all collected VAT to the Palestinian Ministry of Finance. Therefore, if the transaction goes unreported, the amount is not transferred.

The second problem arises when an Israeli importer imports goods to be used in the Israeli market, and then sells the goods to a Palestinian trader. This is known as indirect imports, however, the customs for those goods are not transferred to the PNA. In 1998, the Israeli government decided, in violation of the PP and the principle of free movement, to force Palestinian importers to sign a pledge that ensures that they do not sell their imported products in the Israeli market. Israeli importers were not forced to sign a similar pledge – therefore, Israeli importers can still import goods for the Israeli market, pay import taxes to the Israeli side, and then sell these goods in the Palestinian market. These indirect imports formulate a serious

revenue leakage for the PNA, since the sale of these goods in the Palestinian market results in the collection of VAT; other taxes such as customs and purchase taxes are also included here. Palestinian sources estimate that the losses incurred from the process of indirect importation is in the range of hundreds of millions of dollars per annum. It is a major leakage of revenue from the coffers of the PNA.

Another aspect of revenue leakage is the non-transfer of purchase tax, considered a local tax, on luxury goods bought by Palestinian traders from Israeli producers and importers. The purpose of the purchase tax is to provide additional income for the Israeli (or Palestinian) government on luxury goods. Non-transfer of purchase tax therefore is another source of fiscal leakage that the PNA experiences.

Similar to trade policy, the Joint Economic Committee (JEC) envisioned by the PP was supposed to provide a built-in mechanism for dispute settlement on fiscal issues. However, once again, the JEC did not function as it was intended. Thus, issues related to implementation of the PP's fiscal provisions were not discussed and resolved efficiently.

International Dependencies

Where Israel could not (or would not) provide the PNA with fiscal stability and sovereignty, the dependence on external support has filled this vacuum. However, here too the Palestinian economy has been subject to the cyclical behavior of others. Although total external revenue for the PNA's budget (for current and development expenditure) grew substantially over the 2000s, from less $250 million in 1999, to about $600 million a year in 2000-2005, and then to $2 billion in 2008, since then, external aid has significantly declined every following year: to $1.4 billion in 2009; below $1.3 billion in 2010; slightly less $1 billion in 2011; and finally to $930 million in 2012.[13]

The increase in external revenues until 2008 generally matched and mitigated the steep rise of the PNA's budget deficit. Nevertheless, even the most generous revenues left the PNA with unfinanced deficits of $200-400 million per year, financed mostly by borrowing from within the local banking system. In 2008, the anomaly occurred: the PNA succeeded in generating a significant surplus, with an exceptionally high external support level and containment of the budget deficit working hand in hand.[14]

In 2009, as external revenues fell, the unfinanced deficit rebounded to above $400 million. The PNA returned to approaching the local banking system for supplementary financing, in turn significantly increasing public debt. By the end of 2011, public domestic debt exceeded $1.1 billion, twice the 2008 level; in addition, there existed a foreign debt of more than $1 billion. With this level of debt, the PNA was (and still is) severely limited in its ability to take more loans, or incur more substantially unfinanced deficits. In fact, the PNA has become almost completely dependent on external aid from donors and money transfers from Israel for its daily operation. Since 2011, one more time, it has had no choice but to delay salary payments until the next monthly transfer of taxes from Israel or the imbursement of a next external aid payment. All this is complemented by the accumulation of more and more arrears to its suppliers.

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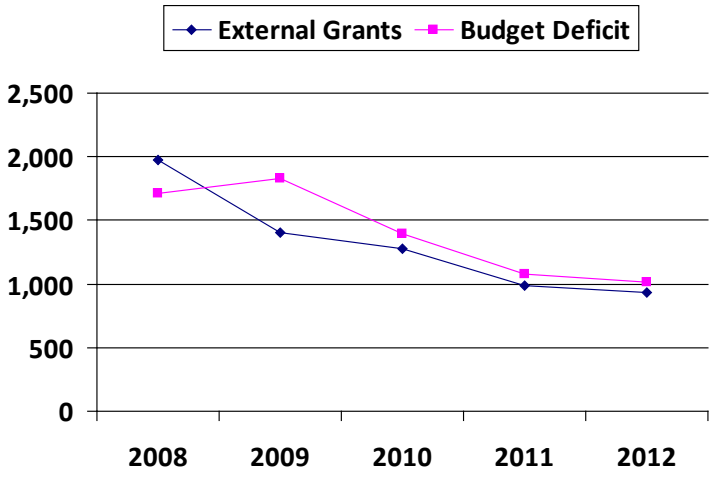
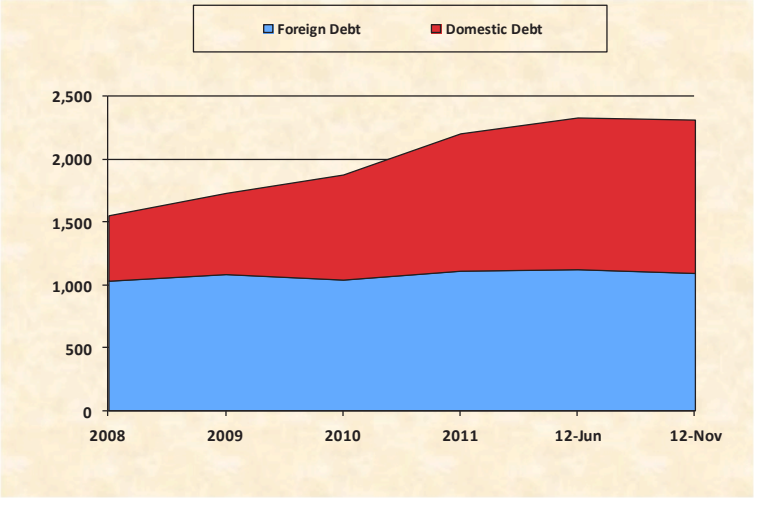
13. IMF, ibid.
External support to the PNA's budget includes support for recurrent expenditures and for the development budget. It does not include direct supply of humanitarian aid by international official aid organization or NGOs, through non-budgetary channels, or direct financing of development projects by such organizations. The magnitude of external aid to the WB&G through such non-budgetary channels, on top of the support to the PNA's budget, was estimated at around $1 billion a year at the end of the 2000s.
14. IMF WB&G reports: April 2011, September 2008, March 2007; PNA, Ministry of Finance, February

Chart 6: External Grants Compared to Budget Deficit, 2008 – 2012 ($ million, current prices)[15]



Note: Budget deficit - cash base, recurrent and development expenditures (net, after arrears, refunds, etc.)
Source: PMA, November 2012, Table 27; IMF, Report for the AHLC meeting, September 2012, p. 30, and March 2013, p. 27

Chart 7: PNA Public Debt by Main Components 2008 – 2012 ($ million, end of period)



Source: 2008 - 09 PMA; 2010- 12 MOF, Monthly Reports, Public Debt (Table 8-a)

Since mid-2010, the flow of external aid has become more irregular, decreasing to $70 million per month in the third quarter of 2010 and then jumping to $165 million per month in the fourth quarter. As 2011 progressed, foreign aid yet again dove to $60 million per month in the first quarter of 2011 and as low as $50 million per month in the second quarter of that year. Since then, aid has trickled at rates of less $10 million in certain months and then jumped to $100-200 million for a month or two before diving again.[16]

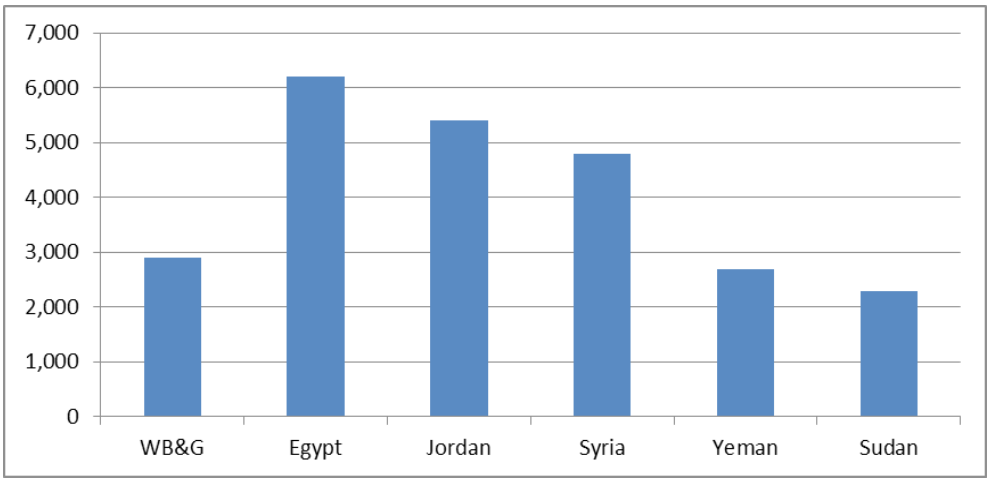
15. Not including non-budgetary aid, humanitarian aid by international official organization or NGOs, or direct financing of development projects by such organizations.
16. PMA, Monthly Statistical Bulletin, October 2012 Update, Table 35.

2.4 Some Implications of the Paris Protocol Regime

The Palestinian economy is overridden by structural weaknesses that have manifested themselves in trade imbalances related to the customs union with Israel, labor shortages, monetary impotence, and extreme fiscal dependencies on Israeli clearances and external aid.

These challenges are woven into the political status quo and spill over into all aspects of Palestinian economic and social life, demonstrated below by three trends. The first facet relates to purchasing power and standard of living. Economic integration with Israel under the Paris Protocol is reflected in price levels similar or close to Israeli ones, while Palestinian wages are much lower than in Israel. As a result, the real purchasing power of Palestinian households is much lower than the nominal level shown in national accounts and household income statistics. International comparisons show that Palestinian GDP per capita, when adjusted to local purchasing power, is far lower than that of neighboring Arab countries, and is only slightly higher than that of countries as poor as Sudan or Yemen.

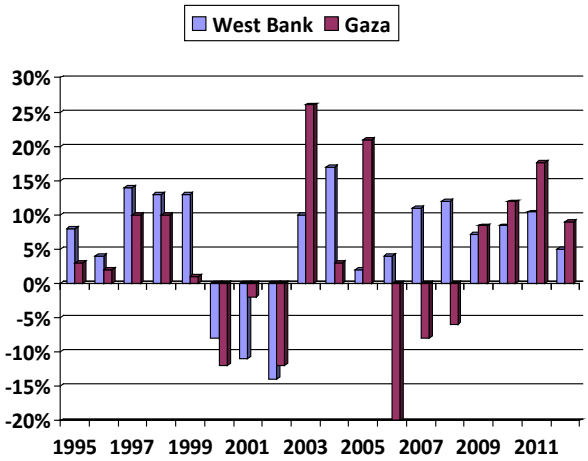
Chart 9: PNA GDP per Capita, in Comparison to Selected Arab Countries
($, adjusted to local purchasing power according to the PPP method, 2010)



Source: CIA World Fact Book; Country Comparison: GDP per capita, as per the PPP method

The second aspect relates to Palestinian economic fragility – the extremely erratic nature of Palestinian economic growth over the last two decades, and the overriding influence of Israeli access and movement restrictions on it. The chart below shows the high real growth rates in the relatively relaxed period of 1997-1999, and the steep fall in the early years of the Second Intifada (2000-2002). An upward correction came in 2003-2005, mainly in Gaza, where Israeli restrictions were relatively easier in those years, however the data for 2006-2009 shows the strong impact of the much stricter measures on Gaza since the rise of the Hamas government in 2006, the takeover of Gaza by Hamas in 2007, and the high growth in the West Bank under the Fayyad governments. Meanwhile, in 2010 -2011 we see the influence of the relaxation of the siege on Gaza since the middle of 2010, and the relatively slower growth in the West Bank.

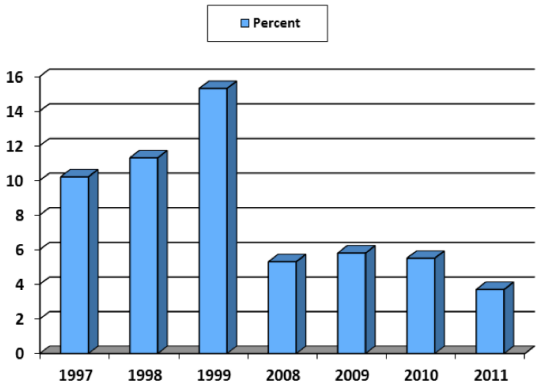
Chart 10: GDP Real Growth in the West Bank and Gaza: 1995-2012



Source: PCBS, National Accounts Statistics

The third effect of the PP regime is infrastructure development. Two-and-a-half decades of under-investment in infrastructure, under Israeli rule, yielded to continued public under-investment. Investment in infrastructure lagged more deeply as a consequence of the Second Intifada's violence. Chart 4, which shows the low level of non-building investment in recent years compared to the pre-Second Intifada period, illustrates these constraints.

Chart 4: Gross Fixed Capital Formation: Non-Building Investment (Percentage of GDP)



Source: PCBS, National Accounts Statistics

The economic provisions of the PP were drafted almost 20 years ago, when the PNA had no administrative capabilities. Nowadays, however, the PNA is institutionally capable of providing customs services, customs police, and effective administrative resources. With international support and development funding, the PA is able to enforce its own procedures and regulations, designed to satisfy the Palestinian national economy and needs. Such a change would stand in stark contrast to the current ineffective administration of imports based on Israeli customs and taxes; the current situation does not acknowledge key realities of the Palestinian economy. Thus, it is both timely and feasible to form a new arrangement that will replace the ineffective and selectively enforced PP clearance arrangements.

Gaza

Gaza's economy has always been smaller and less developed than that of the West Bank (WB), and it has always been the poorer of the two Palestinian territories. The gap between the WB and Gaza widened considerably after the Hamas' takeover in June 2007. This economic contraction stemmed from the Israeli blockade and military incursions into Gaza, as well as freezing of funds to the Palestinian governments by the European Union, the United States, and Canada. These governments view Hamas as a terrorist organization. Since the middle of 2010, however, a steep recovery has been registered in Gaza's official GDP measures; this followed partial relaxation of the harsh Israeli constraints on Gaza's external trade and the continued and even increased flow of international aid. Nevertheless, as of 2011, the GDP per capita in Gaza was still half that of the WB, in comparison to a gap of less than 15 percent in 2005 ($1,535 per capita in Gaza, and $3,138 in the WB, in 2011, at current prices; PCBS National Accounts Statistics).

Considering the miniscule nature of the economy of Gaza, it is totally dependent on imports to supply almost all the essential products and consumption products; this also includes almost all raw materials, inputs, and equipment for its economic activities (agricultural and industrial production, construction, transportation, etc.). Furthermore, Gaza is much more dependent than the WB on exports, which is considered as its only sustainable way for economic recovery and growth. Actually, Gaza's reliance on external trade with and through Israel lead to a pummeling in the second half of the 2000s; its exports practically halted. The alternative trade route through the underground "tunnel system" across Gaza-Egypt border is used almost exclusively to import into Gaza. It has alleviated a large part of the supply shortages, primarily, the essential goods such as fuels, cement, etc., as well as wide range of consumption products. The tunnels can't help, however, in satisfying the needs of the industrial manufacturing sectors, and it is definitely not an export route.

The partial relaxation of Israeli restrictions, since 2010, has related mainly to imports, while exports to Israel, Gaza's only significant export market, are still almost totally prohibited; outgoing trade with the WB is largely forbidden as well. Chart B-1 mirrors the deterioration of Gaza's exports, to a situation of almost non-existence (less than $4 million of exports in 2011). Chart B-2 shows that, as of 2011, total imports into Gaza from and through Israel, were as low as one quarter of the 1999 level, or one third of the 2004 level.

Chart B-1: Palestinian Exports to Israel by Region 1999-2011 ($ million)

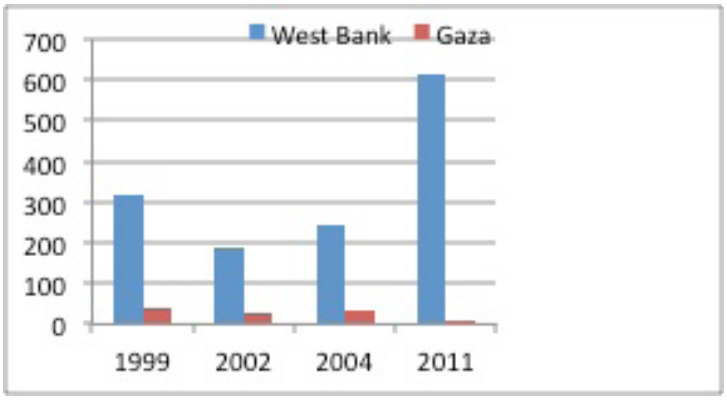
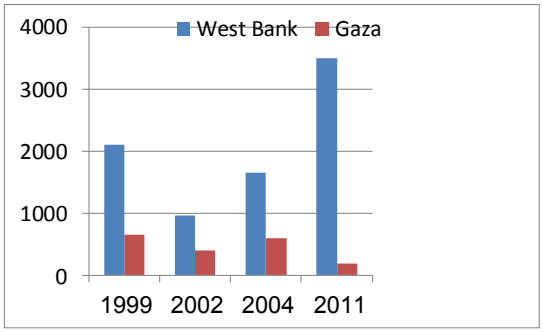


Chart B-2: Palestinian Imports from and through Israel by Region 1999-2011 ($ million)



Source: PCBS, Trade statistics and entry/exit data by passage
Note: registered trade only

In terms of employment, Gaza was more harshly impacted from the restrictions imposed upon the entry of Palestinian workers into Israel, in comparison to the WB. Over most of the Israeli direct rule era, the number of Gazans working in Israel was almost as large as the number of employed persons in Gaza Strip itself; their remittances played an enormous role in the economy of Gaza and the income of Gazan households. The first turning point was in the early 1990s; it started with a first long closure on the WB&G when the First Gulf War (1991) broke out. Then, mainly in 1992 and early 1993, Israel introduced an increasingly strict "permit regime," constraining the previous free entry for Palestinians into the Israeli labor market. The new restrictions continued after the signing of the Oslo Agreements and the PP (1993-1994), and by 1995, only 3 percent of the total number of Gaza's employed individuals were employed in Israel, which caused more than 30 percent of an unemployment in Gaza; compared to a 20 percent share of workers in Israel. In the West Bank, on the other hand, out of the total individuals employed there in that year, the percentage of the unemployment remained 15 percent. Still, the number of Gazans working in Israel increased considerably over the second half of the 1990s, and the share of workers in Israel rose to 16 percent in 1998 and 1999 (the share of West Bankers working in Israel was still much higher, around 25 percent in 1998-1999). Then, a second turning point came after the outbreak of the Second Intifada: the number of Gazan workers in Israel dropped to an insignificant share of 1 to 3 percent of total Gaza employment, and since 2006, the Israeli labor market has been completely closed to workers from Gaza. Unemployment in Gaza jumped accordingly, from below 20 percent in 1999, to above 35 percent in 2001; since that year, it is ranging between 30 – 40 percent. [17]

Another important aspect of the economic situation of Gaza relates to the unique way of financing the Hamas' government, and the overwhelming burden it puts on the PNA budget. Though the PNA is not controlling Gaza, it has continued to pay the salaries of most public servants there. This includes those in the civilian ministries, municipal councils, and many of the civilian agencies that maintain basic civilian public services. In addition, the PNA budget has continued to cover a significant part of the running costs of health and education systems, as well as other basic public services. Moreover, the PNA budget figures do not disclose the breakdown of expenditure between the West Bank and Gaza. According

17. PCBS, labor force surveys for the relevant years

to a detailed analysis prepared by us on the 2010 PNA budget figures, Gaza's share in the PNA's wage and non-wage expenditure was estimated at about $1 billion (close to one third of total recurrent expenditure of slightly above $3 billion). On the other hand, the PNA's income from VAT and other taxes on Gaza's imports from Israel (and through Israel), which had previously covered a large part of recurrent expenditure, dropped to less than $100 million; this was, essentially, a result of the sharp drop in Gaza's imports from Israel. Hence, the PNA deficit on its "Gaza budget" was, in 2010, close to $1 billion. In contrast, the PNA's tax and other revenues collected in the West Bank and on West Bank's imports and trade with Israel, were as high as about $1.85 billion in 2010. This turned deficits into surpluses, covering almost all of the West Bank's recurrent expenditure budget of around $2.1 billion.

In summary, most of the PNA's recurrent budget shortfall to $1.2 billion, in 2010, financed by donors' budget support, has reflected the cost of financing public expenditure of the Hamas-controlled government in Gaza.[18] The situation today has not changed, fundamentally, since 2010.

Gaza's economy can achieve revitalization and sustainable recovery only through (a) economic reunion between Gaza and the West bank, and (b) re-opening of Israel, Gaza's main and practically only significant market, to Gaza's exports.
Hence, as far as Gaza is concerned, the key is a full removal of all trade constraints, which are currently applied on Gaza Strip, and primarily the ban that is imposed on exports from Gaza to Israel. Also, to enable and support trade between Gaza and the West Bank.

Another most important measure, with special importance for Gaza, is the phased re-opening of the Israeli labor market for the workers from Gaza. All other recommendations for amending the PP, detailed in this paper, should be applied to Gaza as well, with consideration to Gaza's special conditions as a Hamas-controlled territory.

In other words, the story of Gaza represents a radical case of the dysfunction of the Paris Protocol regime, and should be urgently reconsidered.

3. Modifications to the Paris Protocol Economic Regime

As described in section 2, the PP intended to lay the groundwork for strengthening the economic base of the PNA through three basic macroeconomic assumptions: entry of Palestinian workers in substantial numbers into the Israeli labor market; free movement of Palestinian goods into the Israeli market and through Israeli exit points to other markets; and consistent implementation of the tax-collection mechanism. It is as important, the PP introduced the Palestinians, for the first time in the economic relations between the two sides, as a legitimate economic sovereign, both in principle and through the creation of the PNA. Yet, both the design and implementation of the PP have become incomplete, while the principle of sovereignty has gone forgotten. Although the PP was designed as a framework establishing interim-period economic relations, for a period of five years, the regime has become (at

18. For the detailed analysis of the "Gaza budget" in 2010 see The Peres Center for Peace, Gaza Strip Crossings: Israeli Policies in a Broader Perspective, 2011, p. 16-24.
The massive humanitarian aid infused into Gaza by the International donors and UNRWA, directly, added some $500 million to the broader public sector budget of Hamas-controlled Gaza, in 2010

best) an increasingly constraining factor for the Palestinian economic development; and ,in other instances, a complicit tool helps Israel to control over the Palestinian economy.

Today, we have the approval of Palestine by the UN as a non-member state, the election of a new Israeli government, and the new efforts to revive Israeli-Palestinian negotiations. These developments represent an opportunity to reconsider the whole set of arrangements as set in the PP and implemented on ground over the last twenty years. All the parties (Palestinian, Israeli, and international) share the view that advancement of both the Palestinian economy and the well being of the Palestinians is a mainstay of peace building.

The following proposed set of amendments to the PP and the current economic regime can serve as a first step for modifying the Israeli-Palestinian economic regime, and paving the way to create Palestinian economic sovereignty. Such a revised regime will serve two purposes: first, to enable the Palestinian economy to take a much more and immediate viable course, until a permanent status economic agreement replaces it as part of a negotiated political solution; and second, to support Palestinian state-building measures by enabling it increasing sovereignty over economic policy.

3.1. Towards an Independent Customs Territory

The model that was established in the PP is based on a semi-customs union: while it assumes that no economic borders exist between the members of the union, the practical effect was preservation of trade relations that had existed until then, i.e. a Palestinian economy integrated into and dependent on the Israeli trade regime and political apparatus. As explained in detail in Chapter 2, the trade deficit – and the available mechanisms that any sovereign economy should have in combating this deficit – is one of the Palestinian economy's primary deficiencies under the PP regime.

Thus, we propose that an important goal of trade relations between the two economies should be the creation of a separate customs territory, which would enable the PNA to shape and implement its own trade policy. The customs territory would be based on needs of the Palestinian development agenda, and not necessarily in accordance with the Israeli policy. This will create the necessary trade policymaking autonomy to meet Palestinian development needs, and can be achieved through a phased change of the present situation, including the following steps:

- **Expansion of tariff lists A-1, A-2 and B:** in order to enable uninhibited and sovereign Palestinian trade at terms that contribute to the competitive capacity of Palestinian products, Israel and Palestine should agree to expand the present lists. These lists are severely outdated, formulated in 1994 and adjusted only twice within the 19-year period of their implementation. Therefore, we propose, first, to significantly expand the present lists; second, we recommend that these lists be used as the basic components of a separate Palestinian tariff book, constructed in accordance with Palestinian economic conditions and needs.

- **Autonomous Palestinian exit/entry points:** Israel will hand over to the PNA the management of the economic border-crossings between Palestine and the rest of the world, with appropriate agreed upon Israeli security presence and/or arrangements; the first site will

be the Allenby crossings, with a second on the Jordanian border. When it is possible, the arrangement will be implemented in other crossings, such as Gaza borders. Simultaneously, the parties will develop similar arrangements for Palestinian goods exported or imported both through the ports of Ashdod and Haifa and to Ben Gurion airport.

· **Share control over bilateral Israeli-Palestinian trade passing through all crossing points:** The complexity of the present system of cargo crossing points between Israel and the West Bank stifles potential Palestinian economic growth. It includes a few official cargo crossing points, about twenty "special crossings for Israelis," and many other "unofficial" crossing points where cargo moves. We propose a two-part system for controlling bilateral trade, as well as application of the Palestinian separate tariff book to Israeli-Palestinian bilateral trade:

The first component will be positioning custom officers, Israeli and Palestinian, who will take positions on all crossing points. The officers will check and register all movement of trucks; their work will be coordinated with the present system of security and other regulatory checks on many of these crossing points. This will occur in ways that will not significantly affect the smoothness and speed of movement through the crossing points, in contrast to the present situation.

The second component of this system will be a number of Palestinian inland regional customs houses, established in key locations of the West Bank and Gaza. These customs houses will coordinate and oversee the work of the Palestinian customs officers positioned in the international entry / exit points (Haifa, Ashdod, Allenby, etc.). Most of the trucks carrying cargo from / to Palestine that pass through the crossing points will be registered and cleared by the customs officers positioned there. Border patrol will send only those shipments that need more thorough examination to the customs houses for detailed checks, etc.

These arrangements will use modern and integrated customs and security management systems (procedures, standards) and infrastructure (technology, physical infrastructure). These systems will be developed through coordinated program and with international support. Appropriate procedures, characterized by close cooperation between the interested parties, will be developed for the on-going management of these systems. One should note that such systems of inland customs houses, interconnected with the work of customs officers positioned in the crossing points, already work efficiently in Jordan and other countries. Furthermore, Israel too has a well-working system of certified inland compounds for clearance, based on controlled movement of trucks from entry points for clearance in these inland compounds. The Jordanian and Israeli models thus serve as viable precedents for the design and operational procedures of the proposed Palestinian customs control system.

The elements mentioned above will constitute a full-scale sovereign Palestinian Customs Territory that will prepare the ground so that Palestine, under appropriate security arrangements, will be able to:

· Operate economic exit and entry points with Jordan and Egypt under Palestinian authority

· Provide for the free movement of goods between the West Bank and Gaza and, between these two areas, a significantly larger degree of freedom of movement.

· Use Israeli exit/entry points for imports and exports, as well as effective transit of goods through Israel.

3.2. Improving Labor Flows

The pressure on the Palestinian labor market is expected to increase significantly in the coming years, as a result of demographic trends. The Palestinian population is among the youngest in the Arab world: 62 percent of it is under the age of 24, of which 41 percent is under the age of 14. Furthermore, the number of young Palestinians entering the labor force becomes larger and larger each year: from 2001 to 2005, the working age population grew by about 70-75 thousand per annum; this number has grown to almost 100,000 per year in the early 2010s, and will increase to about 120,000 per year in the 2020s[19] and so are trends in labor force participation a growing concern. In 2000, only 41.5 percent of the working age population was employed or actively searching for work. The rate of participation has remained around here through the 2000s, except for a temporary decline in the early years of the Intifada. Even at this low rate of participation, however, the Palestinian labor force has grown at a rate of about 5 percent a year since 2003.[20] This low participation rate is expected to increase in coming years, reflecting a large latent demand for work opportunities by the young, frustrated Palestinian work-age population. A quantitative analysis of latent Palestinian labor market trends shows that, under conditions of relative stability and economic recovery, the magnitude of Palestinian "hidden unemployment," in conjunction with the fast-growing numbers of youth entering the labor market every year, may generate annual growth of about 8 percent in the labor force. [21]

Hence, the Palestinian economy needs redouble the number of available jobs over this decade; the number of employed individuals must rise from about 750,000 in 2010 to about 1.5 million in 2020, merely to contain Palestinian unemployment around the alarming, recent rate of 30 percent. The number of new jobs needed in order to bring unemployment in 2020 back to the pre-Intifada rates of 10 to 12 percent, is close to 1 million; this would account for about 100,000 new jobs per year, between 2011 and 2020, compared to an average of about 30,000 new jobs per year created from 2003 to 2010.

In this vein, increased access of Palestinian workers to the Israeli labor market could significantly help in easing the high Palestinian unemployment percentage and the depressed economic situation in the West Bank. Consequently, work in Israel has special importance for the short-medium term. Hence, we recommend negotiating phased re-opening of the Israeli labor market to Palestinian workers; the aim will be to gradually replace foreign workers in the Israeli construction, agricultural and industrial sectors with Palestinian workers. Such a policy will also provide a long-awaited solution to shortages of skilled workers in the Israeli construction and agricultural sectors. **We suggest adding between 50-60 thousand permits, in 2-4 phases,** under agreed-upon arrangements and modifications to the present entry-permit system.

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19. Authors' calculations based on PCBS, Demographic and Social Survey of the Palestinian Population (in Arabic), July 2011, p. 16; and.
20. World Bank, The Palestinian Economy and the Prospects of its Recovery, March 2006, p. 9; PCBS, Palestinian Labor Force Survey, Annual Report 2010, April 2011, p. 57
21. Peres Center for Peace and PalTrade, The Untapped Potential (2006), p. 77; analysis based on of PCBS, Palestinian Labor Force Survey, 2010.
22. According to the relaxed definition of unemployment, including "despaired persons" who ceased actively searching for work. The unemployment rate under the stricter ILO definition is around 25 percent.
23. Authors' calculations.

3.3. Guaranteeing Clearances, Fixing Fiscal Leakages

As in the world of trade, Israel's imposed integration in fiscal issues have, as shown in section 2, generated a deeply rooted set of fiscal dependencies and leakages that we recommend remedying in the proposed "Israeli-Palestinian Interim Economic Protocol," as follows:

- A major component of the reformed regime must be an agreement on self-collection of Palestinian customs revenues and indirect taxes by the PNA, as manifested in the inland customs clearing houses recommended above. This agreement will replace the present revenue clearance mechanism, accordingly, eliminating Israeli control over Palestinian tax and customs revenue.

- The customs duties, excise and purchase taxes are all allocated on the basis of final destination for direct imports, but not for indirect imports. It is in the PA's interest to promote direct imports and to build the capacity of the Palestinian traders to become independent, thereby formulating ways to import products without going through an Israeli agent. The increase of the direct imports will generate a transfer of more revenues to the PA as the final destination principle applies to all taxes to direct imports.

- Mechanisms by which import taxes paid by Israeli importers on specific products, intended for sale in the Palestinian market, are transferred to the Palestinian coffers.

- Implement the Paris Protocol articles stipulating that customs clearance on the crossings with Jordan and Egypt is done via Palestinian customs.

- Create a presence in Israeli ports for Palestinian customs, through which clearance for Palestinian goods is done via Palestinian customs. (To be completed in cooperation with Israeli customs.)

- Create a system of goods in transit, through which goods imported by Palestinians are cleared through the Palestinian border, but after completing their journey through Israeli territory first.

- Create customs clearance points between Palestine and Israel, through which third party goods are cleared.

- Create a mechanism through which VAT clearance is done through shared invoice, instead of the clearance based on unilateral invoice. This will avoid tax evasion activities by either side's businesses.

- Improve the accuracy of revenues transfer on direct and indirect imports to West Bank and Gaza through an effective customs-clearance information system. Then, an inland customs (Palestinian) control system, where the PA directly collects custom duties and all other taxes, will be established.

- It is time to reconsider the transformation of the PMA into a full-fledged central bank.

3.4. Towards Policymaking Symmetry: Reactivating the Joint Economic Committee

The lack of control over economic policy-making impairs the PNA's ability to address economic developments and needs through basic economic policy measures.

With a phased shift towards the proposed separate customs territory, there is vast room for agreed amendments to the original arrangements in various aspects of economic policymaking. In order to ensure that the reformed regime will not fall into the same trap of disingenuous implementation as the PP era, we propose to resurrect the JEC, but with some modifications. The committee's purpose will be, as it was originally intended, to consider various cases, disputes, and impediments facing the Palestinian economy and private sector, also, will attend to devising arrangements that would address these issues. In meantime, the JEC will be redesigned with an active role for a third party, particularly in the dispute settlement mechanism. This modification will ensure that the JEC will not turn what is supposed to be a bilateral forum into a unilateral tool for Israel. A reinvigorated JEC may serve as a hedge for the Palestinian economy to reduce uncertainty, mitigate risks, and encourage private investment.

The reactivated JEC will not only enforce the aforementioned reforms, it can and should oversee the following issues:

- **Removing all barriers to trade throughout the West Bank and Between the West Bank and Gaza:** increased facilitation and normalization of internal movement of goods throughout the West Bank; removal of checkpoints, roadblocks, barriers and earth mounds, and other physical or administrative encumbrances; free access to, and use of, all roads; and free movement of goods and people between the West Bank and the Gaza Strip, organized and monitored through the "safe passage".

- **Approving and supporting solutions, specifically relating to storage and other logistical problems in and by the crossings,** such as lack of facilities or specific sectors' logistical issues. This includes, for example, cold warehouse and other facilities for fresh agricultural products, facilities for handling items like cement in bulk, etc.

- **Review and arbitration for reducing transaction costs and other administrative impediments for specific goods and sectors.** For example, in the case of Israeli standards, we propose to start with the Palestinian goods and sectors that are already being exported to the US and EU markets; then, they can submit to the JEC documents showing that they meet the Israeli standards and conditions as applied to imports from other countries. The joint professional working groups will construct the appropriate amendments and new procedures using these companies as case studies; then, working groups will apply these new procedures to Palestinian exporters at large.

- **Removing the physical impediments and improvements in Palestinian control over resources and infrastructure development:** the PNA and Israel must work towards agreeing on a phase transfer in order to control over most physical resources in the West Bank, particularly Area C, to the PNA.

Palestinian Economic Development: The Destructive Effects of Occupation

The AIX Group

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. We are grateful to comments by Arie Arnon, Avi Ben-Bassat, Saeb Bamya, Hagai Etkes, Karim Nashashibi, Danny Rubinstein, Michele Di Maio and many other participants in the meetings of The AIX Group.

Table of Contents:

Executive Summary

This paper tries to estimate the cost of occupation for Palestine in one dimension only, its effect on Palestinian economic development, or growth of GDP. We begin with the observation that Palestinian GDP per capita did not grow by much since 1993, and income did not grow at all, since the mild growth of GDP was accompanied by a significant loss of labor income from Israel. We then turn to measure the growth of output per worker, which is the main measure of productivity and find that this variable also declined since 1993, in general in Palestine and especially in Gaza. In order to analyze this decline we apply the standard tools of studying economic growth. We calculate the changes in capital over this period and from that we can calculate Total Factor Productivity, TFP, over time. We then can also examine how capital accumulation adjusted to changes in TFP. We come up with two main findings. The first is that in the initial period of the PA, in 1993-2002, TFP declined significantly. In Gaza it further declined in 2006-2008. We also find that investment is quite limited in Palestine, so it does not experience capital deepening at all. Capital is only adjusted to match changes in labor. We then turn to explain these two developments. We raise the possibility that all the decline in TFP was due to the increase in barriers to mobility in Palestine, like road blocks, checkpoints, the fence, closures, closing of Gaza, and similar measures. As for limitations on investment we show that these can be caused both by administrative measure enacted by the occupation and also by the effect of security risk in Palestine.

1. Introduction

The Oslo Accords were signed in September 1993. The following year, the Palestinian Authority was formed and the Autonomy for Palestinians began. In 1995 it expanded from the Gaza Strip and the area of Jericho to include parts of the West Bank as well. This process was accompanied by great hopes for rapid economic growth. These hopes have not materialized yet, after more than twenty years. The main measure of economic growth, namely output per worker, revels that since 1994 the Palestinian economy did not take off, and it actually grew very little during the last 20 years. Until 2009 output per worker, or as it is also defined labor productivity, did not rise at all. During the two years 2010-2011 the output increased, but mainly in the public sector. Furthermore, this public sector growth has faced severe dangers recently, due to reductions in transfers from the donor countries. Our main goal in this paper is to understand the causes that stood behind this stagnation, namely to try to identify the main reasons why the Palestinian economy is mired in such a development trap.

We approach this question by doing a macroeconomic analysis first and then a microeconomic analysis. Our macro analysis uses the standard aggregate production function approach, and tries to identify the changes in output as related to the changes in the three factors that contribute to economic growth: labor, capital, and productivity. By productivity we mean 'Total Factor Productivity,' denoted also TFP. We calculate the dynamics of productivity by using the standard method of 'growth accounting,' namely subtracting the contributions of labor and capital from output and attributing the residual to total factor productivity. Once we calculate the path of productivity over time we can calculate the equilibrium level of output given this productivity under various assumptions. Comparing these potential paths with the actual historical path enables us to learn much about what happened in the last 20 years.

Our main conclusion is that capital did not fully catch up with the rise of productivity, but only caught up with the rise of labor. Namely, the Palestinian economy was severely constrained in its ability to invest, so that there was no capital deepening, nor a major element in Economic growth. Hence, even when productivity increased it did not materialize its full potential for Economic Growth. In the second part of our paper, where we run the microeconomic analysis, we show that many of the constraints to investment have been administrative and were the result of the occupation regime in the Palestinian territory. The limitations on investment can be of many types, like refuse to import machines or materials on account of 'dual use' claims, limitations on access to land, limitations on road and infrastructure constructions and constraints on entry of international investors and experts. We also show that many investments are adversely affected by high risk, which is also a result of the occupation and the violence it creates. All these deter the investment significantly.

A second result of our macroeconomic analysis is that for half of the period, during the years 1994-2004, productivity declined. Such a decline overlaps with the period of increasing restrictions to mobility, between the West Bank and Gaza and within these areas as well. In the microeconomic part of the paper we analyze these barriers to mobility in details and calculate by how much they increase the costs of mobility and as a result by how much they have reduced total factor productivity. We realize that their effect on productivity is very large, and it is capable of explaining most of the decline in productivity that we have found.

Hence, our conclusion from the combined macroeconomic and microeconomic analysis of the lack of economic growth in Palestine shows that there has been insufficient investment in physical capital and also a long period of reduced productivity due to the impediments to mobility that began in the 1990s. We also calculate by how much the Palestinian economy could have grown without these two impediments and find that the lost output in these two decades could be as high as 80 percent of GDP per worker or per capita. Namely, output today could have been almost twice as high and we claim that this is a very conservative estimate.[1]

Therefore, we conclude that, the low average rates of growth in the Palestinian economy are -to a large extent- the result of the occupation. This of course does not mean that there is no room for mistakes or failures on the Palestinian side, but usually long-run growth is not strongly affected by such failures. It is mainly driven by the basic conditions in which the economy performs. It is therefore hard to ignore the fact that Israel controls -to a large extent- most of the conditions in which the Palestinian economy functions. It definitely controls the ability to invest and it also controls the ability to move goods across the Palestinian areas.

The paper is constructed as follows. Section 2 shows that there was no economic growth in Palestine since 1993. Section 3 analyzes this finding by the using the aggregate production function and points at impediments to investment and to mobility as the main suspects for low growth. Section 4 describes the barriers to mobility and Section 5 shows how such barriers reduce productivity. Section 6 describes the various obstacles to investment. Section 7 calculates by how much the Palestinian economy could have grown without these two impediments. Section 8 concludes and the Appendix contains the required economic theories and sector details on barriers to mobility and investment.

2. The Growth of the Palestinian Economy

We begin by describing the basic facts of economic growth in Palestine since 1994. Our data on output is up to the year 2013, so we present in this Section the growth in 1994-2013, over 19 years. Our unit of measurement is GDP per capita in 2004 US dollars, namely in real terms. Table 1 presents the average rates of growth of output in the Palestinian economy since 1994 for the aggregate economy, and separately for its two main regions, the West Bank and the Gaza Strip. The average rate of growth is calculated for specific periods, reflecting mainly the political developments over time. The years 1994-1996 are the first years of the Palestinian Authority, 1997-1999 are the years of the decline of the Oslo Process, 2000-2004 are the years of the Second Intifada, 2005-2007 are the years of the complete split between the two regions, and the years 2008-2013 reflect the gradual establishment of a new political equilibrium of a split rule. These are also the years of the global financial crisis that had some effects on Palestine, mainly by reducing the donations from the donor countries.

Table 1: Average Real Rates of Growth of GDP in 1994-2013 (in %)[2]

Years	1994-1996	1996-1999	1999-2004	2004-2007	2007-2013	1994-2013
Palestine	4.2	12.4	-1.2	4.5	7.3	5.1
West Bank	5.2	14.3	-2.2	7.6	7.6	5.8
Gaza Strip	2.2	8.7	1.1	-1.3	6.8	3.8

1. Note that investment is important not only to materialize gains from productivity, but also to increase productivity itself. Many technologies are embedded in capital goods, mainly machines and these technologies are adopted only by purchasing these machines. This negative effect on productivity is not estimated in this paper.
2. The Data are from PCBS. The growth rate in 1994-1996 is actually an average of two years, 1995 and 1996.

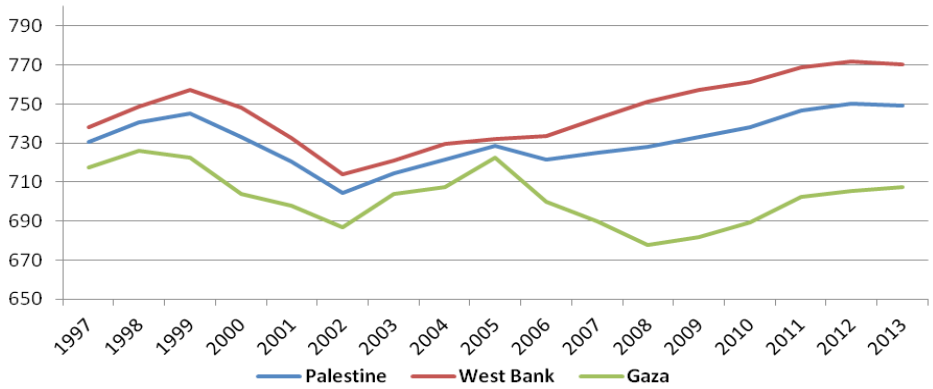
Table 1 is revealing in many ways. It shows that the rate of growth fluctuates significantly over time and also across regions. But, this paper focuses on the long-run performance and not on the volatility of economic growth. Taking into consideration that the long-run is disappointing, the average Palestinian rate of growth over the whole period for Palestine as a whole is 5.1%. It is not a high rate of growth for Palestine for three reasons. First, it has a high rate of population growth, so income increased by much less. Second, the growth of output in the last sub-period comes mainly from the public sector, namely from donor countries' money. Third, after many years of direct occupation and slow growth, it was expected that the Palestinian Authority will start a fast process of catching up. This did not happen. Table 1 also shows that the rate of growth in the West Bank was higher than in the Gaza Strip. It means that per capita, the Gaza Strip did much more poorly, since its rate of population growth is higher. We show it below.

Table 2: Average Rates of Growth of Real GDP per Capita in 1997-2013 (%)

Years	1997-1999	1999-2004	2004-2007	2007-2013	1997-2013
Palestine	7.7	-4.1	1.3	4.2	1.5
West Bank	10.3	-4.8	4.6	4.7	2.4
Gaza Strip	2.7	-2.1	-4.6	3.3	0.0

We next turn to describe the rates of growth of GDP per capita over the years 1997-2013. Table 2 presents averages of these rates of growth over sub-periods and over the whole period in a similar way to Table 1. The choice of sub-periods is the same as in Table 1, except that we omit the first one for lack of data. The story revealed by Table 2 is much grimmer than the one told by Table 1. The average rate of growth in Gaza is negative, namely in these 16 years Gaza has stagnated economically. The average rate of growth at the West Bank is higher, but does not look like a dynamic catching up economy at all. The aggregate rate of growth over the period is only 1.5%, which is low and if we omit the year 2011 it is close to 0.

Figure 1: GDP per Capita in Palestine 1997-2011 (natural logarithm times 100)



In order to see the growth performance more graphically we present the data from Table 2 in Figure 1. This figure depicts GDP per capita in Palestine and in the two regions from 1997 to 2013. In order to gain more information on the rates of growth we calculate for each year

the natural logarithm of GDP per capita and multiply it by 100. This presentation is very useful, since the figures on the vertical axis can be easily translated to percentage changes of average rates of growth. Thus, if we look at the curve that describes Palestine, it goes from 750 in 1997 to around 762 in 2011, which means an average rise of 12/14=0.9 percent. What Figure 1 reveals is that if we omit the years 2010-2013, then between 1997 and 2009, over 12 years, GDP per capita in Palestine did not grow at all. This finding requires further research, to which we turn below.

Before we explore the factors that determine GDP, we compare the growth of the Palestinian economy to the neighboring Arab countries, which are, to a large extent, similar countries, in geography and culture. We compare the Palestinian growth rates of GDP per capita with those of Egypt, Jordan, Lebanon, Syria, and Tunisia. These are close Arab countries, which are not oil producers, hence similar to Palestine. We remove from the comparison the years 2011-2013, in order to remove the effect of the 'Arab Spring' from the comparison. What Table 3 clearly shows is that economic growth of Palestine was significantly lower than in the neighboring Arab countries. It was slower even compared to Syria, who suffered from a severe economic crisis during that period. This leads us to the conclusion that the disappointing economic performance does not reflect some general Arab phenomenon and it is specific to the Palestinian economy and its specific conditions. We turn to this analysis in the next Section.

Table 3: Average Growth Rates of GDP per Capita in Some Arab Countries, 1997-2010 (%)

Years	1997-1999	1999-2004	2004-2007	2007-2010	1997-2010
Palestine	7.7	-4.1	1.3	4.2	1.0
Egypt	3.38	1.61	5.05	3.12	3.16
Jordan	0.72	3.32	5.57	1.61	3.17
Lebanon	0.51	0.03	2.03	5.64	1.59
Syria	-1.39	2.60	1.51	1.65	1.39
Tunisia	3.99	3.53	4.71	1.93	3.49

3. Analysis of Palestinian Economic Growth

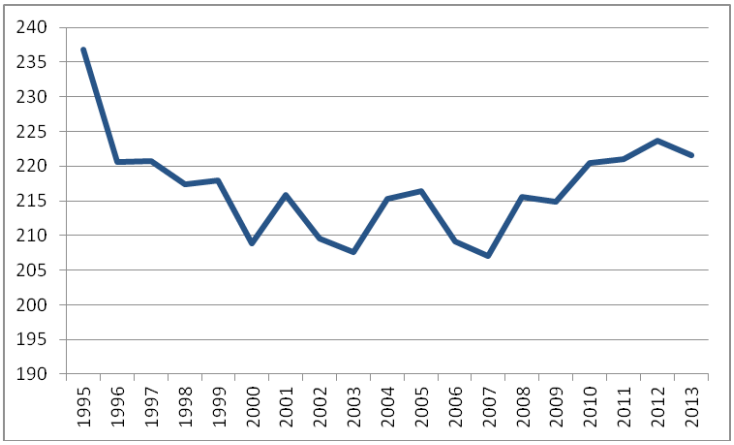
Analysis of economic growth, which is essentially a long-run economic phenomenon, focuses on the supply side of the economy and follows the basic method of an aggregate production function. According to this method, output (GDP), depends on three main elements. One is labor input, which can be measured in number of workers, or in hours worked in a year, depending on the available data. The second element is capital, namely all the equipment, buildings and infrastructures used in the process of production. The third is total factor productivity, or TFP, which is a measure of how productive the economy is. Usually, productivity reflects many ingredients, like level of technology in the country, human capital of workers, namely level of education, quality of institutions, and geographical factors, etc. While labor and capital are 'factors of production', productivity is more elusive to define and to analyze.[3] We usually assume that TFP accounts for a variety of factors, like the

3. Labor is a flow variable, and it is thus measured as number of labor units employed during a year. Capital is a stock variable, namely it is the existing quantity of capital in operation. It is usually measured in the end of the year, December 31. TFP is a ratio variable and is neither a stock nor a flow.

level of human capital, level of technology, quality of institutions, geographical conditions and other factors that affect production. TFP is not observed directly, but is calculated as a residual. Namely, the annual change in TFP is all the change in output that is not a direct result of changes in labor and in capital.[4]

We begin the analysis by plotting GDP per worker in the Palestinian economy. This variable is also called 'labor productivity' and it removes the effect of labor in order to better assess how productive the economy is, but it does not remove the effect of the other factor of production, nor capital, so it is still not a measure of total factor productivity. As Figure 2 shows, output per worker declined significantly in the initial years of the Palestinian Authority, in spite of the high rate of growth at that time. The decline of output per worker is also in contrast to the rise of output per capita in these years, implied by Figure 1. As Figure 2 shows, from 1996 to 1999 output per worker fell by more than five percent annually and since then it remained low, though fluctuating a bit, namely it did not recover from the decline of the 1990s. The difference between the two Figures is easy to explain. During the 1990s Palestinian labor in Israel was gradually reduced, due to mobility regulations and a wave of foreign workers that arrived in Israel. As a result these workers moved to Palestine and increased output and output per capita, though not by much. Output per worker fell, for reasons to be discussed below. Furthermore, income in Palestine decreased, because although domestic output per capita remained about the same, the high income from working in Israel was reduced drastically, thus average income fell.

Figure 2: Output per Worker in 1995-2013 (natural logarithm times 100)



We next turn to calculate Total Factor Productivity. For that we need first to find the amount of capital in each period. We calculate it using the Perpetual Inventory Method. We first assume some initial values of capital. We then add every period the amount of gross investment, namely the gross increase of capital, to last period capital. We then deduct the depreciation of last period capital, using some rate of depreciation, and that sums in current period capital. This method depends on some assumptions. We assume in this calculation that the rate of depreciation is 8%. This is due to the fact that most of the capital in general, and especially in Palestine, is structurs. As for the initial level of capital we assume that it is somewhere between 1 to 1.5

4. Appendix I describes the production function, the derivation of TFP and other calculations more technically.

times initial output. This fits well the results of calculations of the Palestinian stock of capital before 1994, in Arnon and Gotlieb (1996). We then check whether this ratio remains stable throughout the period, as a robustness check.

After calculating the quantities of capital, we turn to calculate Total Factor Productivity in the Palestinian economy, using the classic method of Solow (1957). This method calculates the rate of growth of productivity as a residual of the rate of growth of output, minus the contributions of the growth of labor and of capital. This calculation requires in addition to data on GDP, labor, and capital also the shares of capital and labor. Since we do not have data on these shares in Palestine, we just assume that these shares are 1/3 for capital and 2/3 for labor, as in most countries around the world. Following this assumption we calculate the Total Factor Productivity over the period 1996-2011.

Productivity affects output through two channels. One is direct, as it increases output, even for the same inputs of labor and capital. The other channel is indirect. An increase in productivity increases the rate of return from capital. As a result it induces investment and the amount of capital increases. This also affects output, which increases when capital is accumulated. Actually we can calculate the two effects of TFP on output if capital is assumed to adjust freely to increased profitability, and if we postulate a specific production function, as explained technically in Appendix I. Figure 3 presents the results of this calculation. The blue line is output per worker. The red line is output per worker if capital could be invested freely in the economy (both are in logarithms multiplied by 100). The two lines were made to coincide artificially in the year 2003. This is possible because we do not calculate the value of productivity, but only by how much it changes over time. Hence, shifting the red curve up or down does not change the dynamic picture at all, but it helps to compare the two curves to one another.

Figure 3: Output per Worker and Implied Output under Free Investment

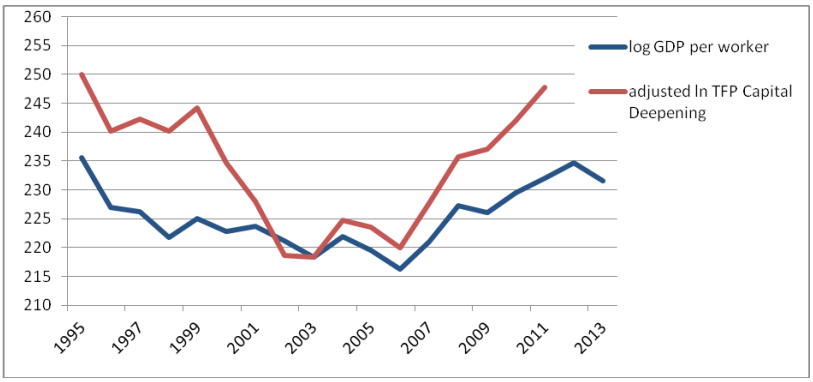
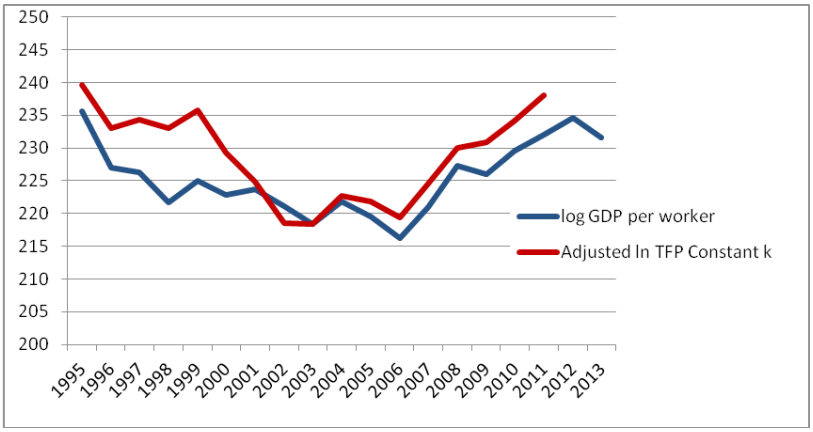


Figure 3 shows clearly that the model of free investment fails to account for the actual changes in the Palestinian economy. The virtual output per worker, which is described by the red line, falls by much more than actual output per worker in some periods and rises by more in other periods. During the years 1996-2003 output per worker fell by 4% annually on average, while the equilibrium output per worker according to this model fell by more than 8% annually, twice as much. In the years 2008-2011 output per worker increased by 4% annually on average, while the model output per worker increased by more than 10% annually. Hence the free investment model fails dramatically.

Figure 4: Output per Worker and Implied Output under Depressed Investment



We therefore examine another possibility, namely that capital is not fully adjusted and that investment is indeed constrained. More specifically we assume that the capital-labor ratio is constant over time. That means that firms cannot invest freely and they can only cover physical depreciation and invest the amount required to fit the increase in labor. In other words, the model assumes that there is no capital deepening in the economy, even if productivity changes. In Figure 4 we present the calculation of the virtual equilibrium output per worker under this assumption, the red curve, and compare it with the actual GDP per worker, the blue curve. As Figure 4 shows, the model fits actual output per worker pretty well. Hence we deduce from Figures 3 and 4 that investment in the Palestinian economy has been constrained significantly during these years. This is clearly one of the main explanations to the slow economic growth in the Palestinian economy, since capital deepening is important for economic growth. In the period 2003-2011 this could have more than doubled the Palestinian rate of economic growth, as implied by the two figures.

The conclusions derived from Figures 3 and 4, that investment is highly constrained in Palestine, receive support in a recent study of the World Bank (2014). According to this research the level of capital per worker in the West Bank and Gaza is much lower than in the neighboring Arab countries, and is even lower than in Palestinian East Jerusalem. Another recent research that tends to support this conclusion is Amodio and Di Maio (2015), which is a microeconomic study over firms in Palestine during the Second Intifada. They found out among other things that that the capital labor ratio was quite stable across regions, despite other differences they find. Hence, this study also points at the relative stable relationship between capital and labor, which we interpret as lack of capital deepening.

Figure 4 tells us also an additional important story about Palestinian development. A large part of the grim record of economic growth lies in the period between 1996 and 2003, when productivity declined sharply, as shown by the red curve in the figure. What caused this decline in TFP? There can be two possible explanations. One is the return of the Palestinian workers from the Israeli labor market, if they were less productive than the workers in the Palestinian labor market. But this explanation is dubious for two reasons. First, workers in Israel were usually of high productivity, as these jobs attracted stronger, more flexible and more ambitious workers. Second, even if these workers required some period of adjustment

to the domestic job market, it could not explain a permanent decline of productivity. The second possible explanation to the decline in productivity is related to the gradual rise of movement restrictions in the Palestinian areas. Initially, the restrictions were mainly between the West Bank and Gaza, called 'closures,' but gradually movement within these two regions also became restricted and things deteriorated rapidly during the second Intifada. We show below that these barriers to mobility could explain most of the large decline in productivity.

We performed similar calculations for the West Bank and Gaza separately and the results are quite similar, as presented in Figures 5 and 6, for the West Bank and for Gaza strip respectively. This figures show that the model of no capital deepening fits the data best in the two regions. We therefore conclude that both regions suffered from similar problems, a sharp decline in productivity in the first ten years of Oslo, and limited investment throughout the period.

Figure 5: Output per Worker and Implied Output under Depressed Investment in the West Bank

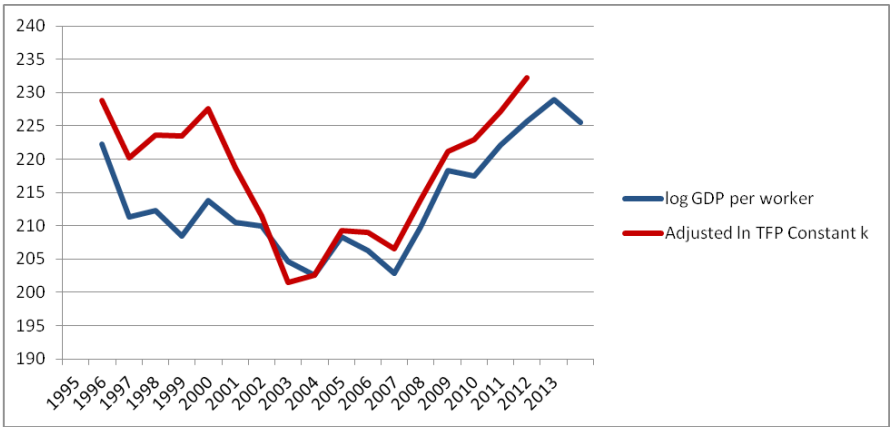
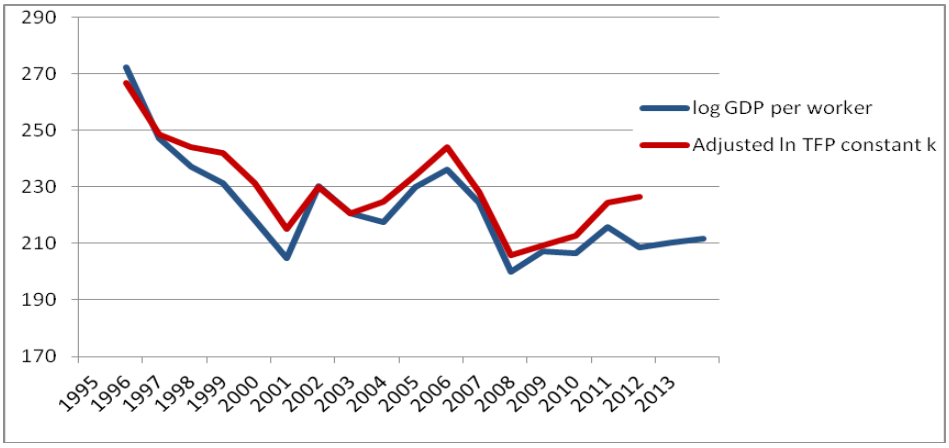


Figure 6: Output per Worker and Implied Output under Depressed Investment in Gaza Strip



4. Barriers to Mobility under Occupation

Until the end of the 1980s Palestinians enjoyed fairly free mobility both in the occupied territory and in Israel itself. The building of more and more settlements and the first Intifada started to gradually reduce this free mobility. But the first massive restriction was enforced during the first Gulf War in 1991. During that year, Israel imposed a full closure of the occupied territory for the first time. This closure, which was imposed for a relatively long period of time, started a trend that became harsher over time. During the 1990s, closures became more and more common. The excuse has been mainly security reasons, but it has been clear that this policy became easier to implement because of the Russian immigration to Israel. This immigration marked a decreasing to the rate of Palestinian unemployment in the early 1990s,, and the beginning of the inflow of foreign workers to Israel. The main sectors of employment for these foreign workers were construction, agriculture and services, which were also where most Palestinians used to work. Hence, the main developments that helped to facilitate the policy of closures were deep changes in the Israeli labor market.

Clearly, the closures badly affected the Palestinians who worked in Israel, and the mobility in general between the West Bank and Gaza strip in general, and the mobility of goods in particular. As a result, these closures raised the costs of transportation for Palestinian production and reduced potential markets for Palestinian enterprises. It is important to note that the closures hurt not only mobility of goods between the West Bank and Gaza, it affected the mobility of individuals also. This was a gross violation of the Oslo Accords, which states that both areas belong to a unified territory and should be connected. There were many discussions between Israel and the Palestinians on a 'safe passage' between the two regions, but it was not implemented most of the time. The lack of such "safe passage" also had economic effects that include Palestinian labor and goods markets. It is also important to note that the closures hurt Palestinian enterprises also by making their access to ports in Israel, mainly Ashdod, more costly. This had a significant impact on the ability of Palestinians to export and import to other countries and even to Israel.

However, the 1990s witnessed more than the imposed restrictions on mobility between the West Bank and Gaza strip, or between them and Israel, it witnessed the increased pressure on mobility within each area. The Oslo Accords led the Israeli government to be more receptive to the demands of the settlements. Accordingly, it began to dedicate many roads to be used by settlers only, and Palestinians have been driven to use longer streets, which were, as a result, more costly. Things deteriorated more drastically with the outbreak of the Second Intifada in 2000. Checkpoints, road blocks, Bulldozing roads to many villages and other obstacles of transportation had abounded and increased the cost of transportation significantly.

According to International Law Israel is responsible, as an occupying power, for the welfare of the Palestinian population under its control and for ensuring that they are able to exercise their basic human rights. While Israel is allowed, under international law, to restrict the freedom of movement of Palestinians due to legitimate security needs, it can do so only "to the extent strictly required by the exigencies of the situation, in a non-discriminatory manner and taking into account other legal obligations."(OCHA, 2012). Nevertheless, as observed by the World Bank (2008): "While Israeli security concerns are undeniable and must be addressed, it is often difficult to reconcile the use of

movement and access restrictions for security purposes from their use to expand and protect settlement activity and the relatively unhindered movement of settlers and other Israelis in and out of the West Bank."

Two more developments further reduced mobility of Palestinians and thus contributed to the rise of transportation costs. The first one was the building of the separation wall since 2003, which physically closed Israel to the West Bank, and left only a small number of checkpoints for passage between them. The second development relates to Gaza. In 2005, Israel unilaterally withdrew from the Gaza Strip and began to isolate Gaza from the outer world (first to workers traveling to Israel and then the passage to Egypt). This policy became harsher in 2006 when Hamas won the Palestinian elections, and even more after the taking over of Gaza by Hamas. Following these events, the Gaza Strip became completely closed to the outside world and the siege continues until today. The siege clearly affected the economy of Gaza and as shown in Table 2. During the years 2004-2007, the output per capita in Gaza declined by more than 15%. The siege has an effect on the economy of the West Bank as well. It reduces markets significantly for West Bank producers, both markets for inputs and for outputs. This increases the costs of starting a new business, namely it reduces productivity. In the rest of this section we analyze in more detail the various impediments to mobility in more details.

4.1. The Separation Wall

According to UNOCHA (2012), the Separation Wall's total length is approximately 709 km, 62.3% of it has been constructed; a further 9.1% is under construction and 28.6% is planned but not yet constructed. When it is completed, the Wall will isolate approximately 9.4 percent of the West Bank territory from its main area (UNOCHA, 2012). According to a recent report by the Israeli Human Rights group B'Tselem (B'Tselem, 2012), the Separation Wall has completely destroyed many economic ties between Palestinian business owners in communities all over the West Bank, as the movement of people and goods have become highly restricted.[5] UNOCHA(2012) adds that "The barrier has also cut off land and resources needed for Palestinian land and development, resulting in the curtailment of agricultural practice."

4.2. Access to East Jerusalem

Since the mid of the year 2000, East Jerusalem has been almost completely cut off from the West Bank, by the Separation Wall, by the small number of checkpoints that lead to the city, and mainly by a strict regime of almost no entry from the West Bank to East Jerusalem. The closure of East Jerusalem from the West Bank and Gaza Strip businesses is a major loss to Palestinians, since the East Jerusalem market is an important and integral part of their markets. The losses are estimated in tens of millions of dollars annually, which for Palestinian producers is a large sum of business that is not easily recoverable. Another result of this closing of East Jerusalem for Palestinians is that it de facto splits the north of the West Bank from its south. In the past the territorial link between these two regions went mainly through East Jerusalem. Today it goes through roads to the east of the Jerusalem Separation Wall. These are much longer streets of much lower quality, which makes traffic much more hazardous. This clearly increases significantly the cost of mobility between the various parts of the West Bank.

5. B'Tselem 2012. Arrested Development Report on the Long Term Impact of the Israel's Separation Barrier in the West Bank.

Tourism is an important area where the closing of East Jerusalem is crucial. East Jerusalem is central to tourism development in Palestine as a whole, as it is an important destination for tourism, both general and religious purposes of Christians and Muslims from all over the world. The construction of the Wall and the restrictions on movement through its passages highly restricts tourists' free movement. Therefore, it greatly limits the ability of Palestinians to use tourism in East Jerusalem as a lever to increase tourism in other historical and touristic attractions in the West Bank. Furthermore, tourism in Palestine has lost opportunities to welcome Muslim tourists from countries that do not have diplomatic relations with Israel; since they are not allowed to access Palestine, mainly by denying their visa. The potential embodied in Muslim pilgrims who can visit East Jerusalem to complete their Hajj is enormous. The annual number of Muslim pilgrims in Saudi Arabia during the pilgrimage period is 2 million, and this is the amount of potential pilgrims who could visit Palestine, if Israel's restrictions were lifted. The estimate is that such tourism could double the income from tourism in Palestine, from 3% to 6% of GDP.

4.3. Movement Restrictions within the West Bank

Movement of Palestinians inside the West Bank is restricted by a combination of physical obstacles – checkpoints, roadblocks and the Separation Wall – and by bureaucratic constraints, such as permits and areas that are closed or restricted to Palestinians. These restrictions are compounding the fragmentation of Palestinian Territory and increasing the difficulty of doing business or promoting investment. These restrictions affect the access of businesses to markets, increases the cost of transactions through greater transportation costs, through delays, and through increased risk due to unpredictability of movement and unreliability of access determination, which is vital for business commitments to delivery of goods and services. Restrictions to access to the land and to water resources also undermine productivity of the agricultural sector, which is important in Palestine. In 2013, some 180,000 Palestinians were forced to take detours two to five times longer to reach their destination. But this is of course an underestimate of this effect, as we don't know the number of Palestinians who did not do the way at all, once it became so costly. Furthermore, access to 43 percent of the West Bank, mainly in area "C," remains largely off-limits to Palestinian use, earmarked instead for the use of Israeli settlements.

Tables 4 and 5 below present mobility restrictions and how they changed over time since the end of the second Intifada. Sources for these tables are taken from the annual reports of UNOCHA (Movement and Access Maps). Table 4 describes the obstacles by regions (governorates), while Table 5 presents barriers by method of operation. Table 4 reveals that the total sum of obstacles did not decline much over time, contrary to declarations of Israel. There were regional changes in the intensity of movement barriers, but not in the overall burden. In one hand, Nablus, which was practically under siege during the Second Intifada, witnessed a decrease in the number of barriers from 117 in 2005 to 68 in 2014. Hebron, Jenin, Bethlehem and Jericho also enjoy an overall reduction. On the other hand Tubas, Qualqilya, East Jerusalem and Hebron H2 suffered from an increasing number of obstacles, while in the three remaining governorates: Ramallah, Tulkarem and Salfit the level of barriers has remained the same as nine years ago.

Table 4: Movement Barriers in the West Bank by Governorate: 2005-2014

	2005	2006	2007	2008	2009	2010	2011	2012	2014
Jenin	30	22	17	21	21	13	13	11	16
Tubas	6	10	10	13	14	12	14	14	14
Tulkarem	23	30	22	26	28	31	26	26	25
Nablus	117	86	102	128	117	80	82	77	68
Salfit	34	30	33	36	35	27	28	32	32
Qualqilya	11	10	20	20	29	33	37	36	34
Ramallah	93	64	82	97	97	103	104	93	101
Jericho	14	14	11	14	14	12	13	10	9
Jerusalem	43	43	40	41	41	53	51	56	59
Bethlehem	53	35	30	32	27	23	24	26	23
Hebron	181	174	191	202	191	117	127	151	109
Sub–Total	**605**	**518**	**558**	**630**	**614**	**504**	**519**	**532**	**490**
Hebron H2[6]	0	0	0	58	56	60	96	96	95
Grand Total	**605**	**518**	**558**	**688**	**670**	**564**	**615**	**628**	**585**

Table 5: Obstacles by Type of Operation: 2005-2014 (w/o H2)

	2005	2006	2007	2008	2009	2010	2011	2012	2014
Green Line	0	0	8	8	8	8	9	9	10
Permanent	57	68	67	75	68	64	60	59	60
Partial	7	8	20	18	23	25	26	28	25
Sub-total Staffed obstacles	**64**	**76**	**87**	**93**	**91**	**89**	**86**	**87**	**85**
Roadblock	118	50	68	68	69	66	59	62	61
Earthmound	282	275	209	230	203	162	194	185	147
Earth wall	35	15	25	46	50	20	22	24	26
Trench	55	10	17	22	21	10	8	8	9
Road Barrier	0	25	67	74	75	45	45	50	57
Sub-total Unstaffed obstacles	**490**	**375**	**386**	**440**	**418**	**303**	**328**	**329**	**300**
Road Gate	51	67	85	97	105	112	105	116	105
Grand total (w/o Green Line)	**605**	**518**	**558**	**630**	**614**	**504**	**519**	**532**	**490**

6. Hebron H2 is the Israeli controlled area in Hebron which is separated from the rest of the city by many obstacles. It seems that recording the obstacles in this area started only in 2008.

Table 5 reveals a shift from unstaffed to staffed obstacles. At the beginning of 2008, there has been a gradual transition from permanent checkpoints to partially staffed checkpoints and to road gates, which are generally open. The number of manned obstacles almost doubled throughout the period, whereas the number of unmanned obstacles declined. Also the number of earth-mounds and trenches declined, too. However, caution should be taken with regard to these numbers, since the period of putting a barrier is crucial in evaluating its impact. Most importantly, the tables do not include flying checkpoints.[7] These are hard to record, but they might be even more disruptive due to their unpredictability and the longer delays they inflict. For these reasons, the number of obstacles is not a sufficient statistic for the degree of reduction of mobility, and yet it give a sense of the dynamics of barriers in the West Bank. The fact that the Palestinian economy did not follow up as it supposed to be since the end of the Second Intifada is related to the insufficient ease in access and movement restrictions.

Moreover, additional time and distance created by the checkpoints regime affect both workers and goods. A World Bank report from 2011 found a spatial unemployment pattern in the West Bank. The main findings are concentration of "unemployment pockets" in the area of Hebron and west of Ramallah because they were highly dependent on Israel for employment, and because the second intifada remained with excess supply of labor. Barriers to mobility of workers affect also businesses as well, since commuting workers become more expensive. Barriers also make commercial transport more costly and may lead producers to cut back on production. In addition, barriers have not only a direct effect on transport costs, but also indirect, due to increased uncertainty. For example, transport companies tend to commit to only one or two trips a day in certain routes, which reduces utilization of trucking fleets and raises fixed costs per kilometer. Also, many alternative roads were not made for commercial trucks - a fact that increases maintenance costs as well as driving time (World Bank, 2008c). The barriers affect inter-regional travelling as well as the movement within a governorate, since the movement between the center and close towns and villages take longer roads and time. This increases separation between economic centers and their potential pool of consumers, workers and suppliers. A major effect is recorded with respect to internal trade patterns. In 2000 nearly 60% of West Bank enterprises made a significant share of their sales outside their home city, while in 2006 this number had dropped to less than 40% (World Bank, 2008b).

4.4. Back to Back

Likewise the system of transferring goods from Palestinian to Israeli trucks at security checkpoints along the barrier, which developed into borders crossings is considered an additional threat. This method of unloading and reloading is known as 'back -to- back' and it adds to the cost of transportation and increases the potential for delays in moving goods. The back to back system forces Palestinians to use Israeli trucks, which cost more than Palestinian trucks in delivery either to Israeli buyers, or to Israeli ports to be shipped abroad.

In addition to increasing costs, the back-to-back system, which is imposed on trucks leaving the West Bank since 2005, leads to fewer loads per truck, due to the risk of damage as well as other costs of using two different cargo companies. The transfer of raw materials from one truck to another, costs about $80. Vegetable exporters reported that the back-to-back arrangement created on average a 24-hour delay, crucial in this industry of fresh produce (World Bank,

7. Flying checkpoints are defined according to OCHA as: "checkpoints deployed on an ad hoc basis in places without pre-existing infrastructure" (OCHA, 2010)

2008). Furthermore, Garb (2008) estimates that back-to-back facilities at Tarqumia Crossing, for example, cause an average waiting time for Palestinian trucks of over an hour and a half, which add at least 15% to the cost of transport. The travel costs caused by the back-to-back method are estimated by Garb to be almost 50% higher than the costs under free movement conditions.

4.5. Gaza Siege

Gaza people are banned from traveling through the Erez Crossing by the Israeli authorities, they are banned also from traveling to the West Bank. Access to land within 300 meters from the fence surrounding Gaza is generally prohibited, and access to farming areas several hundred meters beyond is risky, due to the enforcement of access restrictions. Fishermen are allowed to access less than one-third of the fishing areas allocated to them under the Oslo Accords: six out of 20 nautical miles. In addition, to that Israel has damaged in its military operations in Gaza much infrastructure, including water systems, electricity systems, the airport and more. This worsened dramatically in the summer of 2014.[8] A recent estimate of the cost of the blockade on Gaza, ARIJ (2011), reaches a cost of 1.908 billion USD at 2010 prices. This amount is equal of one quarter of total Palestinian GDP.[9] Etkes and Zimring (2015) study the economic consequences of the siege on Gaza, using the West Bank as a counterfactual. They have come up with the conclusion that the economic restrictions lead to reallocation of resources from manufacturing to services and to reduction of labor productivity. This has decreased social welfare, as estimated by expenditure levels of private consumption before and after the beginning of the siege.

The major economic cost is Gaza's inability to trade, with the West Bank, and internationally. According to ARIJ, this issue by itself increased the costs of inputs, mainly because the economy in Gaza is small and dependent on imports for production and consumption. The Siege has a major impact on water supply and electricity production. According to a World Bank report in 2009, 50% of households in that year were without access to water network due to damages caused to the network throughout the Israeli bombing during "Operation Cast Lead". This damage was never fixed due to the Israeli prevention of entry of the needed construction materials needed to repair the network. At the same time, most water wells stopped working because of lack of spares for pumps, also due to the blockade. In addition, the only power plant in Gaza was severely damaged by Israeli bombing at that time, and is still suffering from the lack of spare parts and from a shortage of diesel fuel; which is imported from Israel and is restricted under the blockade. The power plant suffered from a new attack in 2014. The severe fuel and electricity shortage results in outages of up to 12 hours a day (UNOCHA, 2012). Besides, Israel prohibits entry of gas to Gaza. All of these steps left the economy of Gaza with insufficient basic inputs, which drove many businesses to collapse.

5. Effects of Barriers to Mobility on Productivity

The various restrictions on mobility in the Palestinian areas and between them received much attention and several studies tried to estimate their adverse economic effects. These estimates include reports by the World Bank, by the UN, by ARIJ and other agencies. There are even some academic economic studies that try to estimate the economic costs of such restrictions, mainly on labor markets. One such study is by Cali and Miaari (2013), which finds that the costs of

8. The work on this paper went on mainly in 2013 and hence it does not include information on the damage of the conflict in the summer of 2014.
9. See ARIJ 2011.

barriers to mobility on wages of Palestinian workers are significant. In a recent Ph.D. thesis, written in Brown University, Abrahams (2014) examines separately localities that supply labor and localities that demand labor. He finds that the costs are concentrated in towns and villages that supply labor and do not have much employment opportunities. In all these papers the focus is on the direct costs and aggregate costs of barriers to mobility. We follow in this paper a different strategy. We try to estimate, in a very preliminary way, the costs of barriers per unit of good transferred and not the total costs. Then, we use this additional cost of transportation per unit to estimate by how much productivity declined as a result of these higher costs. Later on, we compare this estimation to our above mentioned results, from the Macroeconomic analysis of growth accounting which state that there has been a significant decline in aggregate productivity from the mid of 1990s to the mid of 2000s and in Gaza, and a renewed decline in the years 2005-2007. Accordingly, we examine by how much this decline is because of the impediments to mobility.

To begin with, we will consider an estimation of the additional costs of transportation in Palestine, which is taken from the report on "Doing Business" prepared jointly by the World Bank and the International Finance Corporation in 2015, using 2014 data. The following table compares the transportation costs of exports and imports for Israel and Palestine:

Table 6: Costs of Exports and Imports in Israel and Palestine

Type of Cost	Israel		Palestine	
	duration (Days)	Cost ($US)	duration (Days)	Cost ($US)
Export				
Documents preparation	4	110	10	325
Customs clearance and inspections	1	110	6	300
Ports and terminal handling	3	200	3	300
Inland transportation and handling	2	200	4	825
Total Cost to export (USD per container)	10	820	23	1,980
Import				
Documents preparation	4	120	17	320
Customs clearance and inspections	1	7.0	10	285
Ports and terminal handling	3	200	7	370
Inland transportation and handling	2	175	4	450
Total Cost to Import (USD per container)	10	665	38	1,805

Source: "Doing Business 2015", Trading Across borders.

Note that both exports and imports are done at the same ports, using the same shipping lines and are formally within the same trade regime, due to the Paris Protocol. The differences in cost are due to checkpoints, back -to- back system and other transaction costs. One shall note also that the monetary costs are direct costs, but they can increase if we add the cost of waiting between 13 to 28 more days for the transaction to be performed. Therefore, we can conclude that moving a container is much more costly for the Palestinians, and the additional direct costs are around $1,200 per container. If we add the cost of time, assuming that any day costs at least $20, then additional 20 days on average sum up in $400. That raises total costs to $1600 at least. The overall costs are, of course, higher, since many costs cannot be quantified, like the costs of shutting down traffic from Gaza entirely. Adding mobility costs to the cost of production not only by making transports of goods more expensive, and increasing the costs of labor and other inputs as well. That is not shown in Table 6, but we can add it to our estimates for sure.

Afterward, we use the estimate for additional costs of transportation, to infer from it the decline in productivity. Appendix II presents a model calculation of the decline in productivity due to barriers to mobility. It shows that the decline in productivity is equal to b times Q*/Y, where b is the dollar additional cost due to barriers per dollar value of merchandize, and Q*/Y is the ratio between quantity produced and output (value added) in an economy without barriers to mobility, for example: as in Israel. This variable differs from one sector to the other.

Let us consider first the agricultural sector, the value of a 20 feet container of fresh agricultural goods is between $7,000 to $10,000. Since the additional costs per container are at least $1,600, the value of b in this sector should be between 16% to 23%. The ratio between production Q* and output Y in agriculture in Israel was equal in 2010 to 2.1. Hence, multiplying this ratio with b shows that the decline in productivity in agriculture due to barriers to mobility was between 34% and 45%. This is not far from the overall decline in productivity in the 1990s and the early 2000s, which was around 40%. Actually, the World Bank (2014) estimates that productivity in agriculture sector declined by 50% between 1995 and 2011. We can conduct a similar calculation in the food industry. The value of a 20 feet container full of processed food is around $20,000. Hence b in this industry is at least 8%. The product to output ratio of this sector in Israel is 1.4. Consequently, the calculation above yields a loss of productivity of 11% in the food industry. One shall note that taking the figure of Q*/Y, product relative to added value, from Israeli data is problematic. Palestinian producers use much less capital, as noted above. As a result, this ratio should be much higher for them. This implies that the decline of productivity implied by our calculation should actually be much higher.

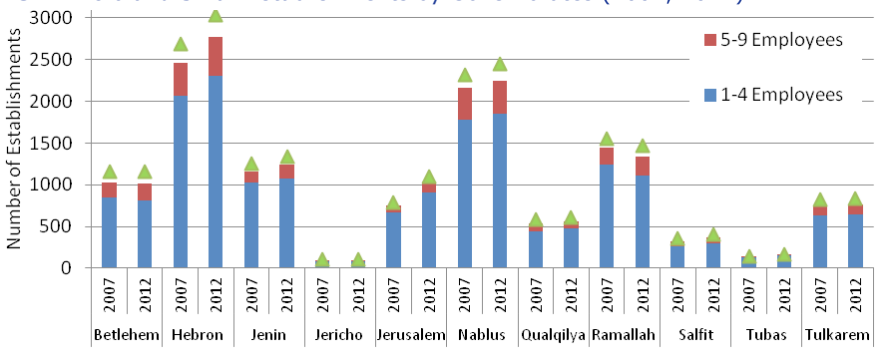
Also note that the costs in Table 6 are only part of the actual costs of mobility, due to longer routes, closed areas, and other reasons. Our calculations are only partial, but they show that much of the decline in productivity in the first ten years of the Oslo Accords can be attributed to increasing barriers to mobility. This conclusion is further supported by the decline in Productivity in Gaza in the years 2005-2007, when productivity declined by 30% within less than 3 years. This is clearly strongly related to the siege of on Gaza.

6. Impediments to Investment Caused by the Occupation

As shown in Section 3, the poor growth record of the Palestinian economy should be partly attributed to the decline in productivity until 2003, and to the lack of capital deepening. This raises the question that are, why investment in Palestine is so low? and why capital does not follow the changes in productivity throughout periods when productivity is on the rise? In this section, we try to list some samples of living under occupation adversely affects investment, and to claim that these effects are significant enough to explain the low investment record. The deterrents of investment have various types, mainly the risk of investment in Palestine, the impediments to trade, regulatory impediments of various types, limited access to most of the available land in the West Bank and more. Interestingly, the World Bank reaches similar conclusions. In 2007, it conducted a West Bank and Gaza Investment Climate Assessment (ICA). The findings of this ICA, which included a survey of enterprises throughout West Bank and Gaza strip, reveal that shrinking market access and the lack of free movement are the main constraints to growth for Palestinian enterprises. Relative to other countries in the region, the Palestinian investment climate is acceptable: petty corruption is low, the bureaucracy is relatively efficient and financial markets are well developed. Despite this, Palestinian enterprises have not invested enough to maintain their international competitiveness.

More support to our claims on impediments that investment can be derived from data on size of businesses. The average size of an industrial establishment is 5 workers, which is considered a micro establishment in any country. The share of micro (1-4 workers) and small (5-9) establishments in the West Bank is 92%, according to the PCBS enterprise survey from 2012, and this rate is similar to the one reported in the 2007 enterprise survey. Moreover, only 23 establishments in the entire West Bank employ more than 100 individuals. The Palestinian enterprises' extremely small size limits their ability to reach minimum efficient economies of scale. Figure 7 presents the size distribution of the manufacturing sector by districts in 2007 and in 2012. The green marks are the total number of establishments in each governorate and the bars show the size distribution of establishments with less than 10 employees. According to Figure 7 the number of small establishments has neither changed dramatically during the last 6 years, nor has their share in the total number changed. However, there has been a slight increase in the number of small establishments over microenterprises. While cross section view of the share of establishments with less than 10 employees in each governorate reveals that all governorates have about a 90% share of micro and small establishments.

Figure 7: Micro and Small Establishments by Governorates (2007, 2012)



According to the World Bank Enterprise Survey in 2013, labor productivity is about $30,000 for the median large firm in the West Bank and Gaza strip, compared to about $10,000 for the median of small and medium-sized firms. Differences are also found on a regional level as the median firm in East Jerusalem produces about $23,000 of output per worker as compared with only $10,000 for the median firms in the West Bank, and about $6,800 for the median firms in Gaza (World Bank, 2014). These regional differences can also be explained by the impediments to investment discussed below.

6.1. Administrative Impediments

The Israeli administration has limited the ability of Palestinian to invest from the early days of the occupation in the year 1967. One reason was to reduce as much as possible the willingness of Palestinians to work within their territory and thus to attract them to work in Israel. Another reason was the pressure of some members of the Israeli business community, especially those who export goods to the occupied territories. They preferred to have as less competition as possible. The army, indeed, was in position to restrict investment significantly, as any operation needed licensing. Since the beginning of the establishment of the Palestinian Authority, this full control of the army in licensing has been reduced, but investments are controlled through other means. Note that most invested goods are imported, and since all imports pass through the Israeli ports they are still under control. One such type of control is well known as 'dual use.' These are machines and materials that can be used militarily, in addition to their civil use, therefore, import of such goods is prohibited. When used extensively, this is a serious impediment to investment. Another form of administrative constraint on investment are permits to build in many areas in the West Bank, mainly in Area 'C.' It is known that construction is considered a large part of investment (more than half of capital in the advanced countries is structures, even more so in Palestine). It is also known that such permits are not granted in large areas of the West Bank. Hence, restrictions on building permits affect the investments.

Another indication for administrative impediments to investment is the ill performance of the Joint Investment Committee (JIC). This is part of the Israeli – Palestinian Joint Economic Committee, which was created by the Paris Protocol to address all issues related to investor's access and promotion of investment in Palestine. This joint committee has failed to meet since late 2000 - with the exception of meetings held for the purpose of Palestinian investment conferences in 2008 and 2010. This poor record of performance is an indication in itself.

6.2. Risk

The political instability caused the occupation is a major impediment to investment in many ways. Investment in the Gaza Electric Plant, for example, arrived from local investors, the Palestinian government in the form of the Palestine Investment Fund, donor contribution from various European Donor Countries and private foreign investors. In 2006, Israel bombed and severely damaged the power plant's three turbines, which supply about a third of the electricity used by Gaza's 1.5 million residents. Since the 2006 bombing, Israel has further crippled electricity supplies by severely limiting the transfer of spare parts and fuel into Gaza. Upon the Israeli invasion of the Gaza Strip in 2008/2009, the Israeli Air Force bombed around the power plant, thereby destroyed significant part of the re-investment. During the Gaza war of 2014, the same power station was bombed again. This is an example that has an effect not only on this investment, but on potential foreign investments in the

Palestinian economy as a whole. This damage to such productive capacity causes power shortages that sometime can be for up to 12 hours per day.

6.3. Access to "Area C"

Given the fundamental importance of land to economic activity and development, the impact of continued Israeli full control of "Area C" (61 % of the West Bank) cannot be underestimated. Land is a common means of storing wealth and a powerful economic asset. It is an important economic input in every sector, and especially in sectors such as agriculture, industry, housing, and tourism. Thus, the effects of the limits on "Area C" on the Palestinian economy and investment are large. The land use and planning regulations in "Area C" limit development within existing villages, restrict space for demographic growth and create environmental risks. As expected, economic activity in "Area C" is limited primarily to low intensity agriculture. High intensity agricultural, industrial, housing, tourism, and other investments are hindered by the lack of construction permits from the Israeli authorities and the limited amount of titled land available. This is shown in the Economic Monitoring Report to the Ad Hoc Liaison Committee (2010).

According to the 1993 Oslo Accords, "Area C" was supposed to be gradually transferred to the Palestinian Authority (PA) for full control and administration.[10] This has never occurred. On the contrary, the Israeli administration confiscated many areas to establish settlements in "Area C." As a result the fragmentation of Palestinian land is increasing due to continuous establishment of new Israeli settlements and outposts, which disconnect Palestinian communities and cities.[11] According to the World Bank, the areas controlled by settlers exceed 68 percent of "Area C". This has significant economic implications. Only 1% of "Area C" is already built up for Palestinian use and only 18 to 20 percent is accessible agricultural land.[12] The remainder of the area is heavily restricted or off-limits to Palestinians. In fact, even the small percent is practically unavailable and inaccessible for Palestinians for use and development, since it still requires Israeli licensing, which is close to impossible to get.

According to the same report: "Freeing economic activity in "Area C" would have a particularly high impact on the development of businesses in agriculture and Dead Sea minerals exploitation, stone mining and quarrying, construction, tourism, and telecommunications." That of course would indirectly benefit other sectors as well. The World Bank report estimates that if businesses and farms were permitted to develop in "Area C", 35 percent would be added to the Palestinian GDP. This will have a strong effect on other sectors in the economy, but also on fiscal policy and on fiscal stability as well. The World Bank found that Palestinian economic activity in "Area C" will directly benefit most the sectors of agriculture and Dead Sea minerals, which are currently under full Israeli control. The Bank also considered construction, telecommunications and tourism as key sectors for the development of the Palestine, and which are constrained by the lack of access to Area "C". It is estimated that the potential additional output from these sectors would amount to at least $2.2 billion annually, which is 23 percent of the

10. The Oslo Accords, Annex I: Protocol Concerning Redeployment and Security Arrangements, Article I—Redeployment of Israeli Military Forces and Transfer of Responsibility. Oslo II defines "Area C" as: "areas of the West Bank outside Areas A and B, which, except for the issues that will be negotiated in the permanent status negotiations, will be gradually transferred to Palestinian jurisdiction in accordance with this Agreement".
11. See UN Committee on the Elimination of Racial Discrimination Eightieth session. Israel Report: Concluding observations of the Committee on the Elimination of Racial Discrimination. March 09, 2012. and see Al-Haq 2012. "Apartheid, segregation and institutionalised racism: UN Committee "Appalled" by Israel's Racial Discrimination." March 14, 2012
12. World Bank, 2013. "West Bank and Gaza: Area C and the Future of the Palestinian Economy", p. 4

Palestinian GDP of the 2011. This estimate might be even higher if the supply of water to the area would be increased as well. Note that one sector that can benefit from access to "Area C" is quarrying. Currently, stone mining and quarrying industrial sector is the largest Palestinian exporter, based on the well-known «Jerusalem Gold Stone.» This industry suffers from the inability to obtain permits to open new quarries in "Area C", or renew existing ones. "If these restrictions are lifted, we estimate that the industry could double in size, increasing value added by some USD 241 million - and adding 2 percent to 2011 Palestinian GDP."[13]

"Area C" is also important for the housing sector, since currently population density in Areas A and B is very high. Another sector that depends crucially on access to "Area C" is tourism. The reason is that many of the tourist attractions in Palestine are in "Area C" or require passing through this area to reach them easily. Hence, a development of such industry is seriously delayed by these restraints. It is also important to note that road building through "Area C" can significantly reduce distances and raise overall productivity.

6.4. Impediments to Trade

The Palestinian-Israeli economic cooperation and trade relations are governed by the Paris Protocol, which was signed in 1994 between the Palestine Liberation Organization (PLO), representing the Palestinian people and the Palestinian Authority of the West Bank and the Gaza Strip, and the Government of Israel, as Annex V of the Oslo Accords. Since its signature, and apart from the fact that the protocol has already expired more than 15 years ago, there were no significant adjustments to its articles, despite the fact that the reality on the ground changed dramatically. The main underlying principles of the Paris Protocol are creating customs union, guaranteeing free movement of goods to the Israeli market and through Israeli ports and airports to the international market, and the potential of creating a future Palestinian Tariff Book.

But the Paris Protocol did not take into consideration a situation where there is no free mobility for people and goods between Israel and Palestine, and within the Palestinian areas itself. Therefore, the combination of the customs-union trade regime with the many Israeli restrictions has made the Palestinian market a captive market for Israel. Imports from Israel accounted for 70-75 percent of all Palestinian imports over most of the 2000s. Israel remained practically the dominant market for Palestinian exports as well, absorbing about 90 percent of total Palestinian exports in this period. As a result, Palestine has developed a huge structural trade deficit.[14] This deficit increased from $1 billion in 2002 to $3.5 billion in 2011 and 2012.

Israel is also blocking trade agreements signed by the Palestinian Authority with many countries. The Paris Protocol opened the door for the Palestine Liberation Organization (PLO) on behalf of the Palestinian Authority to sign trade agreements with trade partners such as the EU, EFTA and others, as long as they do not derogate from the principles of the customs union, on which the Paris Protocol was based. Once these agreements were signed, Israeli customs, opposing such agreements, simply refused to recognize them and refused to clear Palestinian imports under these agreements, thereby causing additional costs and delays to the products, and reducing their ability to compete against similar products imported by Israeli traders to be sold in the Palestinian market. Such impediments also reduce the incentives to invest.

13. See World Bank, "West Bank and Gaza: Area C and the Future of the Palestinian Economy".
14. PCBS, Foreign Trade Statistics.

7. Potential Loss of GDP

This paper shows that Palestinian development has been very low during the last twenty years. This has been a result of declining productivity and also of lack of capital deepening. In this section we examine how much could the Palestinian economy grow in the absence of these impediments, which are caused by the occupation. Such calculations are of course highly speculative and hence cannot be very accurate, but we need to make them nonetheless. It is better to have an imprecise estimate than to have no estimate at all. We just warn that these results should be taken with some caution. We also present two alternative calculations in order to add robustness to our results.

We begin to measure the dynamic economic costs of occupation to Palestinian economic growth by conducting a counterfactual exercise. We ask what would have been the level of GDP per worker in Palestine at 2011 if the Palestinian economy would have been on a sustainable growth path. We consider two such possible growth paths. The first counterfactual exercise assumes that the average growth rate of Palestinian productivity, namely TFP, throughout the period, has been the same as after the Second Intifada. We then assume furthermore that investment has been free so that it could deepen capital in accordance with the changes in productivity. The second counterfactual assumes that the average growth rate of Palestinian GDP per worker is equal to the growth rate of Jordanian GDP per capita. The results are very revealing: we find in the first scenario that Palestinian GDP per worker would have been higher by 72% by 2011 than its actual level, while in the second scenario its level would have exceeded its actual level by 85%.

7.1. First Scenario

In this scenario we analyze what would have been the level of TFP had the Palestinian economy grown since 1996 by the same growth rate as in the West Bank after the Second Intifada. The period after the Second Intifada is characterized by a relatively sustainable growth in the West Bank. In this period, from 2004 until 2011, TFP grew at an average annual rate of 2.43% (note that this is a lower bound, since part of the period experienced a decline in productivity due to the events in Gaza). If we apply this rate of growth of TFP to the whole period in all Palestine we get that TFP would have grown by 43.5%. If we have capital deepening the increase in GDP per worker should be higher by a factor of 1.5. Hence, GDP per worker would have been 72% higher than its actual level. We conclude that the increasing impediments to movements within Palestine and between Palestine and the rest of the world and impediments to investment caused a loss of at least 72% to GDP per worker. This is translated to a loss of similar proportion to GDP per capita. Of course, the decline in income was much higher due to loss of jobs in Israel throughout this period.

7.2. Second Scenario

As mentioned above, our second counterfactual exercise is to analyze what would have been the Palestinian GDP per worker in 2011, had the Palestinian economy grew at the same average rate as Jordan in the same period. We choose Jordan, since it resembles the Palestinian economy in several aspects: It is a small open economy, with population of a similar size. Like Palestine, it is a non-oil-producing Arab economy; and its main sectors are agriculture and construction. We use data from the World Bank, according to which between the years 1996-2011, Jordanian GDP per capita grew by an average rate of 2.6% per annum. We then compute what would have been the Palestinian GDP per worker in 2011, had the economy

grown at this rate, and we find that it would have been 85% higher than its actual level. Interestingly the two results are not too far away from one another.

Finally, we would like to note that our estimates in this Section are only partial. Impediments to investment themselves cause a delay in technology adoption and hence in the growth of productivity, of TFP. This is because many technologies are embedded in machines, like computers, like tractors, etc. Therefore, constraints on investment might be translated to constraint on growth of TFP as well. In other words, limited investment causes an economy not to fully apply any rise in productivity, and it reduces the rise in productivity itself. This understanding is quite new in economic research, so we do not know yet how to estimate its effect quantitatively, but it is clearly significant. Consequently, it is important to keep in mind that our estimates of lost output in Palestine are partial, and the actual losses should be even higher.

8. Summary and Conclusions

This paper focuses on one important cost of the Occupation to the Palestinians, on the slowing of economic growth. We begin by observing that in the last 20 years GDP per worker, or what is called the labor productivity, has not increased and it even declined over these years by close to 15%. Next, we use the standard tools of analysis to study economic growth within a country and find out that the lack of economic growth was caused by two reasons. The first is the decline in Total Factor Productivity (TFP) in the initial years after the Oslo Accords, namely in 1994-2003. The second is the lack of sufficient investment throughout the whole period. It seems that instead of capital deepening Palestinian businesses keep the level of capital to labor constant. Then, we claim that these two causes of decline were caused by the Occupation. The decline in productivity in the years 1994-2003 was caused by the increasingly harsher barriers to mobility, within the West Bank, from the West Bank to Gaza, from the West Bank to East Jerusalem, and from the two Palestinian areas to the outside world. The impediments to investment were caused by a myriad of means, mainly administrative constraints, huge risk, limited access to “Area C”, and more.

We then show that these two developments, falling productivity during 1994-2003 (and some additional decline after 2005, mainly in Gaza), and limited investment in capital, cost the Palestinian economy a decline of GDP per worker of 70-80 percent. This is a very significant cost. But as it is mentioned in Section 7, the cost is actually much higher and output in Palestine could grow even by more in those crucial 20 years since Oslo Accords. That is sad, but it is also saying something about the potential that lies ahead. If the Palestinians can regain their independence and begin their economic development, they will be able to rush forward quite fast. Doubling GDP per worker in each fifteen years might not be imaginary, at least in the first decades. Israel did it in the 1950s and the 1960s. The Palestinians can do it too.

Appendix I: Output and Productivity

Assume that output is described by the Cobb-Douglas production function:

1. $Y = AK^{\alpha}L^{1-\alpha}$.

We calculate A by using the method of growth accounting. We calculate it over time using the following rate of growth equation:

2. $$\frac{\Delta A}{A} = \frac{\Delta Y}{Y} - s_K \frac{\Delta K}{K} - s_L \frac{\Delta L}{L}.$$

The coefficients sK and sL are the shares of capital and labor in GDP, respectively. In the case of the Cobb-Douglas function $s_K = \alpha$. Calculating the rate of change of A helps us to construct a series of A by assuming an arbitrary initial value.

Next we calculate equilibrium output under two alternative setups. One is full capital mobility and free investment, and the other is constrained investment. In the first case we get:

3. $MPK = r + d$

where r is the global interest rate and d is the rate of depreciation. Calculating the marginal productivity of capital and substituting in (3) we get the following equilibrium amount of capital:

4. $$K = L\left(\frac{\alpha A}{r+d}\right)^{\frac{1}{1-\alpha}}.$$

Substituting (4) in the production function (1) yields the following output per worker:

5. $$y = \frac{Y}{L} = A^{\frac{1}{1-\alpha}}\left(\frac{\alpha}{r+d}\right)^{\frac{\alpha}{1-\alpha}}.$$

In natural logarithms we get:

6. $$\ln y = \frac{1}{1-\alpha}\ln A + \frac{\alpha}{1-\alpha}\ln\frac{\alpha}{r+d}.$$

Assuming that r and d are constant over time and that α is close to 1/3 we can calculate the equilibrium output per worker in this case, as driven by the rise in productivity.

An alternative assumption is that investment is significantly limited and as a result capital is not reflected by (3), but is assumed to be of a fixed proportion of labor only. Namely, it is assumed that the capital labor ratio in the economy is constant over time (we assume that capital accumulation takes care only of the physical depreciation and of the increase in the labor force). This assumption amounts to:

6. $K = k^* L.$

We substitute this equilibrium condition in the production function (1) and get:

7. $$y = \frac{Y}{L} = A(k^*)^{\alpha}.$$

In logarithms we get:

8. $\ln y = \ln A + \alpha \ln k^*.$

Namely, the rate of change of output per worker is equal only to the rate of change of productivity. We can plot this graph as well and fit it at some point to output per worker and examine which model fits better the actual data of output per worker, (5) or (8).

Appendix II: Effect of Mobility Costs on Productivity

The (gross) profits from production are described by:

9. $PR = Q - IN - M - W$

Where *PR* are profits, *Q* is value of good produced, *IN* is the value of the intermediate goods used in production, *M* are mobility costs and *W* is the wage bill paid to the workers. Let us further assume that the amount of intermediate goods is proportional to the quantity produced: $IN = nQ$. Let us also assume that the cost of transportation is also proportional to the quantity produced, but the coefficient of proportion includes regular cost per unit (dollar) *m* and additional cost per unit due to occupation barriers to mobility, which we denote by *b*. Hence mobility costs are:

$$M = (m + b)Q$$

Substituting these costs in (9) and moving the wage bill to the LHS we get:

10. $PR + W = Q(1 - n - m - b) = Q(1 - n - m) - bQ.$

Note that the LHS is actually the gross output of the firm (value added), which is denoted by *Y*. Hence, we can write:

11. $Y = Q(1 - n - m) - bQ.$

Consider next a similar Israeli company, which does not face barrier costs. The output of this firm is equal to:

12. $Y^* = Q(1 - n - m).$

If we substitute (12) in (11) we get:

13. $Y = Y^* - b\dfrac{Y^*}{1 - n - m} = Y^*\left(1 - \dfrac{b}{1 - n - m}\right).$

This equation means that output in Palestinian firms is lower than that in similar Israeli firms by a factor of:

14. $\dfrac{b}{1 - n - m}.$

This is therefore the rate of decline of productivity due to barriers to mobility. Applying equation (12) we get that productivity declines by the following ratio:

15. $b\dfrac{Q}{Y^*}.$

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The Economic Costs of the Conflict to Israel: The Burden and Potential Risks

The AIX Group

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Executive Summary

This paper estimates various costs of the Israeli-Arab conflict on Israel. It begins with observing that the conflict changed significantly following the peace agreement with Egypt. Before it the conflict was between conventional armies and was quite costly. After the peace, when the option of Arab war coalition against Israel practically disappeared, the conflict returned to its original phase, Israeli-Palestinian. Such a conflict is more between militias than between armies and it is much less costly. We show that in the previous state of the conflicts the military costs, especially between 1967 and 1985, were so high that they almost caused fiscal collapse. Hence, any collapse of the peace with Egypt poses a great risk to the economy of Israel. The Israeli-Palestinian conflict is much less costly, but that also reduces aggregate demand in the economy, which makes it more prone to recessions. Furthermore, conflict eruptions of this conflict (like Intifadas) are long, reduce investors' optimism, reduce tourism, and reduce demand for consumption, as they hit populated areas. That too increases Israel's exposure to business cycles. Indeed, while in 1950-1985 Israel experienced only two recessions, in 1985-2014 it experienced four recessions. Finally we also present new estimates for costs of the conflict in addition to the formal defense budget. These costs are on land, civil defense, security guards, and more. But the main additional cost is the loss of human capital of conscripts, due to the delay in labor and study. We show that this loss in itself can account to 4.3 percent of GDP. Overall these additional costs raise the cost of the conflict from the formal cost of 7 percent of GDP to almost 13 percent of GDP, which is around 15 percent of income.

1. Introduction

This paper analyzes the economic costs of the Israeli-Arab conflict. Understanding the current and the potential costs of the conflict requires a broad historical and economic analysis. Hence, we begin with a brief history of the conflict, which focuses only on the issues that are significant for understanding the economic aspects of this conflict. Of course, no history of this conflict can be objective and readers usually judge carefully any such history looking for potential biases. This is not our game. We present only the elements of this story that help to explain its economic effects on Israel. Hence, it necessarily affects the way it is told.

The Zionist settlement in Palestine began in 1882. The first waves of immigration were quite small, but the main patterns of settlement became clear early on. The Jews avoided as much as possible settling in existing Arab villages or towns and created separate settlements. First they built their own villages, then neighborhoods outside towns and later separate towns. The new immigrants were also different in their economic status, having relatively high education and having some financial wealth, coming from European middle-class background (though from poor countries in East Europe). The Jewish immigration and settlement began to create tensions between the immigrants and the Palestinian population, which sometimes led to violent confrontations, but these were still at a personal and limited level.

Things began to change in the 1920s due to two main developments. The first one was the British occupation of the country in 1917, which was formalized in 1922 by the Mandate given to the British rule by the League of Nations. The British occupation was accompanied by two conflicting promises, of national character. On the one hand was the Balfour declaration from 1917, which promised to enable the Zionist movement to build a 'national home to the Jewish people.' On the other hand, the British promised the Arab forces that helped them fight the Ottomans to help them to reach Arab national independence. These two conflicting promises intensified the tensions in Palestine (since then also called Eretz Yisrael). The second development was the closing of the US gates to immigration in 1924. This left Jews in Europe and mainly in East Europe desperate, as they felt that staying there became more dangerous by the day. Although previously the option of immigration to Palestine, a poor and dangerous country, was viewed by them as much inferior, now they had no choice. This changed the demography and geography of the country dramatically. In 1922, at the first British Census, there were only 84 thousand Jews in the country, around 10 percent. After 25 years, in 1947, there were 630 thousand Jews, around a third of the population. This change imposed a threat on the Palestinian population that could not be ignored any longer and the conflict between the two populations was actually unavoidable. Initially it erupted in local but coordinated clashes in 1921 and later in 1929. These clashes were short and were quickly contained by the British. The clashes in 1936 were already much more intense, and continued until 1939. [1]

The next round in the Jewish-Palestinian conflict began in November 1947, after the decision of the UN to end the British Mandate and to partition the country between Jews and Arabs. At the beginning of this round, the conflict was still taking place between militias and was fought at local levels, but gradually the Jewish side was organizing more and more like a conventional army. The conflict changed completely on May 15 1948, when the British left the country. First, the Jews formed a state, Israel, and turned their previous militias into an army. Second, the neighboring Arab states, Egypt, Trans-Jordan, Syria and to some extent Lebanon, invaded the

1. These clashes, also called the Arab Rebellion, were finally crashed by a special British force led by General Montgomery, who used extremely harsh measures. See Segev (2000).

country.[2] This led to the widening of the conflict, from a Jewish-Palestinian conflict into a wide Israeli-Arab conflict. Actually it was more than a wider conflict. It turned from a conflict between militias to a fully conventional military conflict. Instead of rifles, machine guns and hand grenades, it began to use tanks, guns and aircraft, which made the conflict much more costly. The war ended in 1949 with the armistice agreements, but the conflict stayed on. As before, it was dormant most of the time, but once in a while it erupted, and these eruptions became more and more intense over time. The first one was a rather small eruption in 1956, when Israel fought against Egypt in Sinai, allied with France and the UK. This conflict ended rather quickly due to the joint intervention by the US and the USSR.

The second eruption was at 1967, when Israel fought against Egypt, Jordan and Syria and ended the war controlling large territories from these countries: Sinai, Gaza, the West Bank and the Golan. This war led to a significant intensification of the Israeli-Arab conflict, first during the war of attrition in 1968-1970, and later the Yom Kippur War (October War) in 1973, between Israel and Egypt and Syria. These years of intensification of the conflict were also years of spiraling military costs for Israel (also for the neighboring Arab countries, but to a lesser extent). Actually, during the 1970s these military costs threatened Israel's fiscal sustainability, as shown below.

The period of intensification of the Israeli-Arab conflict came to an end in 1978-1982, with signing of the peace agreement between Israel and Egypt and implementing it. This was a bi-lateral agreement that traded peace with the territory of Sinai, but it had far reaching implications. Without Egypt it became impossible to create an Arab military threat on Israel. Hence, the wide Israeli-Arab conflict that began in 1948 came to an end de-facto. As a result Israel could reduce its defense costs significantly and that also enabled the fiscal stabilization of 1985, which saved the economy from a fiscal catastrophe. With no Arab military coalition in sight, the Palestinians were left alone and felt that they have to conduct their struggle for independence by themselves. This started in 1987 with the first Intifada. Thus, the conflict returned to its original form, a bi-lateral Israeli-Palestinian conflict. Although the two sides were organized differently, as Israel had a state and a powerful army and the Palestinians were united under the PLO, the conflict returned in many aspects to its origin, as a conflict of militias, of low arms use, and low costs.

The change in the pattern of the conflict in the 1980s reduced the direct economic costs, but it had other economic effects on Israel. The main one was that Israel became much more vulnerable to business cycles and mainly to recessions. Previous wars were costly, but they increased aggregate demand and thus helped to avoid recessions or to make them short. The eruptions of the Israeli-Palestinian conflict are very different from previous wars. Each is much longer, it involves the two populations intensively, and it ends in a non-decisive way.[3] Hence, these eruptions create pessimism and reduce the demand for investment significantly. Indeed, while before 1980 Israel suffered from two short recessions only, after 1980 it experienced already four recessions, of which two were very long.

As mentioned above, currently the costs of the Israeli-Arab conflict are much lower. But even if they don't pose a fiscal threat as before 1985, these costs are still very high in international comparison, and they pose a serious burden on Israelis. The direct costs amount to 7 percent of GDP. But there are additional costs to the conflict which are not included in the defense budget,

2. The formal excuse was to help the Palestinians, but clearly each state wanted to carve out part, or all, of the country to itself.
3. This article was written during the Gaza conflict of 2014, which fits this description quite well.

like alternative cost of conscripts, alternative use of land, security guards, civil defense costs and more. Adding these additional costs increases total costs of defense to 12.7 percent of GDP, which is the same as 15 percent of their income. This is a very heavy burden. The international average of defense costs in advanced countries like Israel is 1.5 percent of GDP.

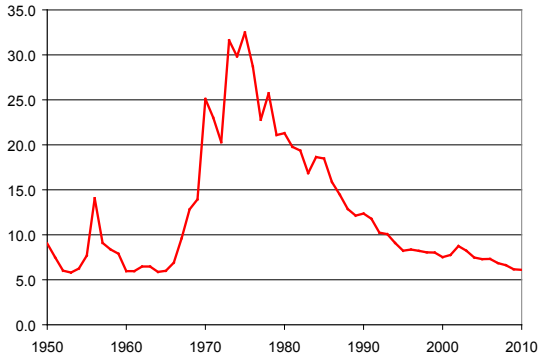
In addition to the direct and indirect costs of the conflict, there are costs involved in the specific project of building and developing settlements in the West Bank. This cost is very well disguised in the Israeli Statistics, but we will try to give some rough estimates based on a survey by Hever (2013). Another potential future cost could be caused by the boycotts on Israel and on Israeli settlements that are gaining momentum recently. We will try to estimate how serious these effects can be. The Arab Spring that shakes the Arab world since 2011 can also have an effect on potential widening of the Israeli-Arab conflict. We discuss that as well together with other potential conflicts in the region.

The paper is structured as follows. Section 2 describes the costs of the wide military Israeli-Arab conflicts and discusses the potential of its resurgence. Section 3 describes the cyclical effects of the Israeli-Palestinian conflict. Section 4 presents an estimate to the loss of human capital caused by conscription. Section 5 lists additional defense costs, which are not taken into account in the official data. Section 6 presents some estimates on the costs of settlements and Section 7 analyzes the potential costs of boycotts. Section 8 discusses some economic benefits of the conflict to the Israeli economy and section 9 summarizes.

2. The Israeli Costs of the Wide Israeli-Arab Conflict

Figure 1 presents the defense costs as percent of GDP in Israel from 1950 until 2010. These data are taken from CBS (2013). As Figure 1 shows the military costs increased significantly after 1967 and went down only during the 1980s. While before 1967 the costs were around 7 percent of GDP, after 1967 they reached an average level of 20 percent of GDP. Actually after the 1973 War the costs climbed even further and exceeded 30 percent of GDP for a few years. These high costs reflect the re-armament after the war, upgrading of Israeli military equipment and increasing the size of the army, mainly in the reserves. After these few years the costs went down again to around 20 percent of GDP, and remained at that level until 1980, when they started to gradually decline. By the mid 1990s the defense costs already went below 10 percent of GDP and by 2010 they reached 7 percent of GDP.

Figure 1: Israeli Defense Costs as Percent of GDP, 1950-2010

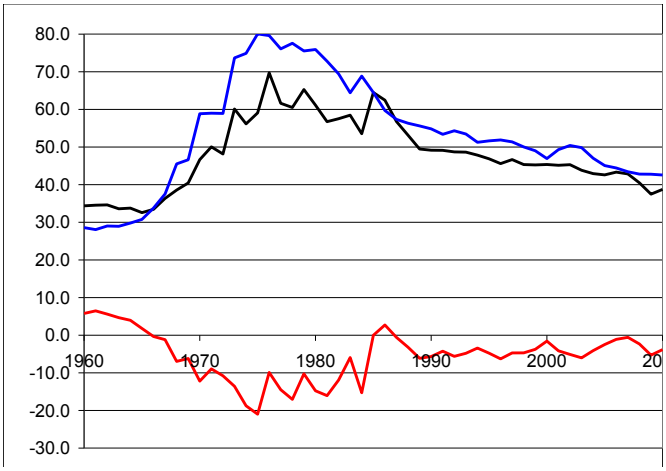


The decline of defense costs after 1980 is interpreted in the introduction as a result of the end of the conventional military stage in the Israeli-Arab conflict. The inability to form an Arab military coalition without Egypt reduced significantly the military threat on Israel and enabled a significant decline of defense costs since then. In order to further support this claim, we turn to the results of an analysis of Israeli defense costs in Strawczynski and Zeira (2002). They estimated the dynamic correlation between these costs and three main explanatory variables, the defense costs of the conflict countries, Egypt, Jordan and Syria, the defense costs of the US, and the relative price of defense in Israel.[4] One major finding of Strawczynski and Zeira (2002) is that the correlations between the Israeli defense costs and these explanatory variables changes significantly in 1985. Our main interest should be the correlation between the Israeli defense costs and the neighboring countries defense costs. Before 1985 this correlation was positive and highly significant, namely the military costs on both sides were highly correlated. This correlation changes sign after 1985 and becomes negative and much less significant. It means that after 1985 a rise in Arab military costs does not any longer cause Israel to increase its defense costs. This finding strongly supports our hypothesis, that after the Peace with Egypt, the military threat on Israel declined significantly and helped Israel reduce its military costs.

The defense costs during the high years of the conflict were very high, whether at the level of 20 percent of GDP or even at more than 30 percent of GDP during 1973-1976. These high costs increased other costs and led to a larger increase in public expenditures, which led to a fiscal crisis. This is demonstrated in Figure 2, which shows the public expenditures, the blue line, public income, the black curve, and the resulting public deficit, the red line, in Israel in the years 1960-2010, in percentages of GDP. Figure 2 shows that the overall rise in expenditures in the public sector was from a level of 30 percent of GDP, during the 1960s, to a level of 75 percent of GDP, during the years 1973-1985. Clearly the rise in public expenditures exceeds the rise in defense costs, since those increased by more than 20 percent of GDP, while total costs increased by more than 40 percent of GDP. But we claim that the increase in public costs was driven mainly by the rise in defense costs. Note that although the rise in defense costs was accompanied by a rise in public income through higher taxes after 1967 and new military transfers from the US, but this higher public income did not fully match the rise in expenditures, so that a deficit was created. The deficit increased and after 1973 the deficit averaged 15 percent of GDP, which is very high. Most of the deficit, around 10 percent of GDP, was financed by debt and one third, 5 percent of GDP, was financed by printing money.[5] The rise in debt increased interest payments by the government, which increased public expenditures by even more. While in the years 1961-1965 interest payments were 2 percent of GDP, in the years 1977-1980 they reached an average of 9.1 percent of GDP and they increased later even more. Money printing by the government led to inflation and that led to a vast subsidization of basic consumption goods. This also increased public expenditures. Public support to producers, direct and by credit, was only 2.7 percent of GDP in the years 1961-1965, but went up to 11.3 percent in 1977-1980. Hence, a large part of the additional rise in public expenditures was driven by the rise in defense expenditures, both directly and indirectly.

4. The tests are performed by use of cointegration regressions. They are performed both with logarithms of the absolute real levels of the costs and also with costs as percent of GDP.
5. See Sargent and Zeira (2011).

Figure 2: Public Expenditures, Income and Deficit in Percentage of GDP: 1960-2010[6]



Therefore, the rise in defense costs increased additional public expenditures and was the main reason for the rise of public expenditures to more than 70 percent of GDP during the years 1973-1985 and to the rise in deficit to an average level of 15 percent of GDP during those years. This led to a significant fiscal crisis. The public debt increased during this period and in 1984, on the eve of the stabilization plan, the net debt reached a level of 150 percent of GDP. This is clearly very high debt. As a result Israel began to face difficulties in borrowing abroad in 1983-1985. But the large deficit created not only debt, but also spiraling inflation. While the rate of inflation during the 1960s was quite low, it began to rise in the early 1970s and during the years 1973-1978, it reached an average annual rate of 45 percent. In 1979, inflation jumped to a higher rate and was around an annual rate of 120 percent in the years 1979-1983. In October 1983 inflation jumped to a higher annual rate of 400 percent and remained at that rate until the stabilization in July 1985. Although the jumps in inflation in 1979 and in 1983 were caused by severe mistakes in economic policy making, the basic cause of the inflationary process was the budget deficit caused mainly by the defense costs.[7]

Hence, the intensification of the Israeli-Arab conflict after 1967 led to a significant fiscal crisis. The crisis was finally solved in the stabilization plan of 1985, which was enabled mainly by the reduction of defense costs due to the peace with Egypt. This episode shows how dangerous economically was the Israeli-Arab conflict in its wide stage, as a military conflict between Israel and a wide coalition of Arab states, which is fought in conventional military warfare. This raises a serious question, on the likelihood that the current Israeli-Palestinian conflict might again evolve into a total Israeli-Arab conflict. This question was seriously raised when the Arab Spring erupted in 2011. One of the main significant results of the Arab Spring has been the new voice given to the Arab masses. A possible result of this new voice is more pressure on the leadership in Egypt and elsewhere to show greater solidarity with the Palestinian struggle. It is hard to tell how serious such a pressure can be and whether it can put the Israeli-Egyptian peace into serious problems. But if it does, the economic pressure on Israel might rise significantly.

6. Source: Bank of Israel Report 2011.
7. The jumps in Israeli inflation are analyzed in Sussman (1992) and in Sargent and Zeira (2011).

3. The Israeli-Palestinian Conflict and Israeli Business Cycles

As figure 1 shows the military costs of Israel declined sharply during the 1980s and became much smaller afterwards. That means that the aggregate demand in the economy, namely the sum of private consumption, public consumption, investment and net exports, was reduced as well. That in itself made the economy more vulnerable to recessions, namely to economic fluctuations, or business cycles. We know that there are a number of theories of business cycles, the Keynesian or Neo-Keynesian theory that focuses on aggregate demand, the RBC model of Long and Plosser (1983), among others, that focuses on shocks to productivity and supply, and the financial theory of Bernanke and Gertler (1989) that deals mainly with financial shocks and constraints. Studying business cycles in Israel leads to the conclusion that most fluctuations were of the Keynesian type and were triggered and propagated by shocks to aggregate demand. Thus, reduction of defense costs after 1980 heralds a period of greater sensitivity to recessions, if aggregate demand falls and defense costs do not act as automatic stabilizers. This is further exacerbated by the decline in immigration, which is also a strong stimulator of aggregate demand.

Figure 3: Annual Rate of Growth of GDP in Israel: 1951-2010[8]

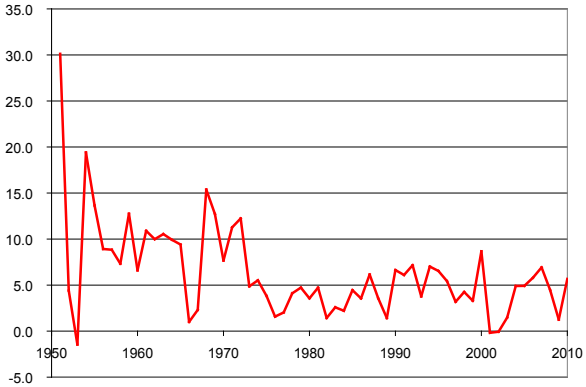


Figure 3 presents the annual rate of growth of output, which enables us to identify the main business cycles, or the main recessions, in the economic history of Israel. Note that the average annual rate of growth of output until 1973 has been 10 percent and after 1973 it has been only 3.5 percent. We should therefore search for recessions as years in which output went down significantly relative to these long-run trends.[9] As Figure 3 indicates there were two major recessions in the initial years of Israel, namely 1952-1953 and 1966-1967. The first recession was caused by lack of foreign currency in the first years of the state and it ended when the reparation agreement with Germany was signed and began to operate and when the US began to supply some loans to the new state. The second recession began with a fiscal contraction in 1966, when the German reparation money came to an end, and it ended in 1967 with the outbreak of the War.

The period that followed was more stable until a severe recession began in 1989. That recession is hard to analyze as it did not last long and it ended after one year in 1990, when the large immigration from Ex-USSR began and started an economic boom. Our best guess is that this

8. Source: Central Bureau of Statistics in Israel (2012).
9. We have identified business cycles in Israel with the use of additional dynamic variables, like rate of growth of the business sector, rate of growth of investments, rate of unemployment, and by identifying shocks to output using an ARMA (1, 1) model.

recession, or rather beginning of recession, was triggered by the first Intifada, which began in December 1987. The next recession was milder though longer in the years 1997-1999. This recession had two main causes. One was the end of the investments triggered by the wave of immigration of the early 1990s. The second was the decline in optimism from the Oslo process after the murder of Rabin in 1995, the violence in 1996 and the rise to power of Netanyahu in the same year. The next recession was during the years 2000-2004 and was the longest and deepest in Israel. It was caused mainly by the second Intifada, but it also reflected a global recession at the time. The last recession is in 2009, it was caused by the global financial crisis, but it did not last long, since the Israeli banking system was relatively clean of toxic assets.

We therefore see that the first 30 years of Israel witnessed only 2 recessions, while the following 30 years witnessed 4 recessions. But the decline of defense costs was not the only cause for the rise of vulnerability to business cycles. The Israeli-Palestinian conflict tends to push the Israeli economy to a recession whenever it shows signs of escalation. Three of the four recessions were caused by such escalations of the conflict: 1989, 1997-1999, and 2000-2004. Thus any escalation of the Israeli-Palestinian conflict has an opposite cyclical effect than the conventional wars of the past. The reason is that such eruptions are very different from the conventional wars. An eruption of the Israeli-Palestinian conflict is usually protracted and continues a number of years, while the longest conventional war lasted only three weeks. Conventional wars usually end with a clear result, clear victory, while Israeli-Palestinian confrontations never end with a clear outcome. As a result such confrontations increase pessimism and doubt and tend to reduce business investment. This clearly reduces aggregate demand, which leads to recessions. Furthermore, Israeli-Palestinian confrontations tend to hurt daily life in Israel, which reduces business activities. People go less for shopping and as a result purchase less. This also reduces aggregate demand. We therefore deduce that the decline of the wide conflict and the rise of the narrow Israeli-Palestinian conflict increased significantly business cycles and especially recessions in Israel.

4. Loss of Human Capital from Conscription

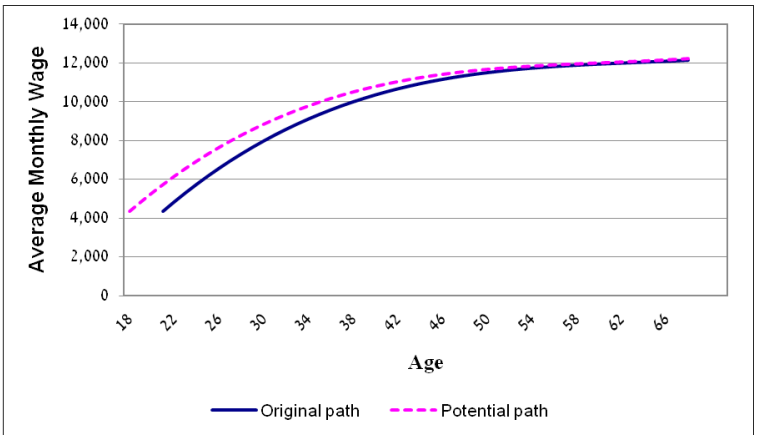
The costs of the conflict include the formal defense budget, but also include additional costs, which are not part of that budget, and some of them are not even budgetary. Berglas (1986) was the first to analyze these costs. Wolfson (2010) updated the results of Berglas to the year 2008 and in this paper we further update these results to 2011 and also change the method of calculating some of these costs. This section and the next one present and discuss these additional costs. In this section we deal with the main cost, which is the loss of human capital due to conscription. When young people are recruited to serve 3 or 2 years, for men and women respectively, their contribution to the labor market is not taken into consideration, since they do not receive a salary for their labor.[10] But the economic cost of conscription is not limited to the alternative loss of labor of the conscripts during their military service, but to the loss of human capital throughout their lifetime career. The reason for that is that human capital tends to rise over a person's lifetime career due to acquisition of education, on the job training and acquisition of experience. Conscription delays this human capital accumulation by three or two years and that increases the loss of human capital.

In order to demonstrate this point we use Figure 4, which describes the lifetime path of monthly wages of average Jewish men in Israel in the year 2011. This lifetime path is described by the

10. The military salary for conscripts is very low. The monthly pay is around 500 NIS, which is around 10% of the alternative average salary at this age.

blue curve, which increases from 4000 NIS at the age of 21 to 12000 NIS at the age of 67, which is the age of retirement. This curve is based on the income survey of the Israeli Central Bureau of Statistics and on smoothing these observations to obtain a trend which is described by this curve. The purple line is the same lifetime path of wages of a Jewish man if he did not have to serve in the army and could begin his professional process three years earlier, at the age 18. If we adopt the overall proportionality of wages and human capital, which is formally analyzed in Appendix 1, we can claim that these paths describe the human capital accumulation of conscripts in contrast with their potential paths of human capital. Hence, the loss of human capital is not only during the years of military service, but also throughout the whole career.

Figure 4: Lifetime Wages of Male Conscripts and Non-Conscripts, 2011



Some might argue that this loss of human capital, which is described by the gap between the purple and the blue curves in Figure 4, does not take into consideration potential contributions of the military to human capital, especially with respect to soldiers who serve in high-tech units, as in the Intelligence. This is a serious claim, but it holds for only a small share of the conscripts, which we cannot measure exactly due to secrecy of data. Furthermore, even people who serve in such high-tech units need to complete formal higher education later on, if they want to pursue a career in high-tech. Actually our measured loss of human capital is a lower bound for a number of reasons. First, it does not take into consideration the fact that most conscripts go for a tour in exotic countries after the military service and are therefore absent from the labor force for 4 and 3 years for men and women respectively instead of 3 and 2 years. Second, delaying the period of higher education and work causes Israelis to marry and raise a family relatively earlier in their career. This reduces their ability to devote sufficient time to accumulation of human capital. For example, PhD students in Israel are much older than similar students abroad, they devote less time to their studies and as a result it takes them longer to finish them. While such studies last 5 years in the US, they last more than 8 years in Israel.[11] We therefore think that our calculations of the loss of human capital actually underestimate the true costs.

The calculation of the potential loss of human capital is conducted in the following way. First the calculation is done separately for men and for women. For men, for each age group, from 18 to 67, we multiply the number of working people at this age by the percentage of men at this

11. We compare studies in graduate schools in the US, which are equivalent to an M.A. and Ph.D. studies in Israel.

age who served in the army. This is based on the implicit assumption that the probabilities to stop work at each age are independent of service in the army. Service percentages were found by use of many sources.[12] As shown in Appendix II these service shares decline over the years. We also subtract the percentage of people who were recruited but were discharged in mid-service, remembering that this group is around 10% of the conscripts, and we assume that each of them served half time on average. We then multiply the result, namely the number of workers of each age who served in the army, by the loss of human capital at this age, namely by the vertical distance between the blue and the purple curve in Figure 4 for this age. This is how we get the total amount of loss of human capital, measured by the wage equivalent, as explained in Appendix 1, for each wage group. Adding up all the age groups together we get the overall loss of human capital for men. A similar calculation is made for women.

Adding up the potential loss for men and women leads to the potential rise in total human capital H that is not fulfilled as a result of conscription. In the year 2011 this loss amounted to 12,875 million NIS annually. In order to find its relative size to human capital we divide this sum by the total wages paid in 2011. We get that the loss to human capital relative to the current human capital is 4.3%. This means that without conscription the human capital could be 4.3% higher. Since we show in Appendix 1 that equilibrium output is proportional to human capital, it means that without conscription GDP would have been 4.3% larger. This is a very large alternative cost of the conflict. It is important to stress that our estimate here is higher than the estimate of Wolfson (2010), which was 3.7% of GDP in 2008. The reason is that he measured only the direct cost of missing human capital, while in this paper we add also the indirect costs, due to lower investment in physical capital.

5. Additional Defense Costs

Figure 1 describes the official actual defense costs of Israel. These include the defense budget but also some additional defense costs, like the costs of the secret services, which are not included in the budget initially, but are added secretly during the year. But there are some additional costs, which are not included in the official costs. The main costs are of course the alternative costs of serving in the conscript army, which are analyzed in Section 4. In this section we list other costs of defense, or costs of the conflict which are not included in the formal defense costs. These costs are also an update of Wolfson (2010), which itself updated the original paper on this issue by Berglas (1986). While the original paper by Berglas estimated the additional costs to be around 50% of the domestic costs (around 7% of GDP at his time), Wolfson (2010) found that in 2008 the additional costs amount to around 50% of total defense costs at the time (4.5% of GDP). This study recalculates these costs using a different method for calculating the cost of conscripts, as described in Section 4. As a result this paper reaches a higher estimate, namely that the additional costs almost double the defense costs. All the costs in this paper are calculated for the year 2011.

Before describing in detail the additional costs of defense we should clarify also the distinction between the formal defense costs and the defense budget. The defense budget consists of planned expenditures by the Ministry of Defense at the beginning of the year, which is also the budget year. During the fiscal year additional budget is transferred to the Ministry of Defense

12. Sources for calculation of the rate of conscripts are Nevo and Shur (2002), Barda (2007), Mei-Ami (2007) and Almassi (2012) from the Knesset Research Center, Israel State Comptroller (2002), and Cohen (2007). Missing data were calculated by the authors by extrapolation.

by the finance committee in the Israeli Parliament (Vaadat Haksafim in the Knesset). Some of it is for unanticipated events, mainly related to military operations of large scale. But the main transfer finances the secret services, which do not appear in the original defense budget for reasons of secrecy.[13] In our year of reference, 2011, the gross budget of defense was 54 billion NIS (5.8% of GDP), while the expenditure by the end of the year was 62.5 billion NIS (6.8% of GDP). The addition is therefore significant and it reached 1 percent of GDP in 2011. Most of this addition went to the secret services, as there were not significant military events in 2011. Our point of reference in this section is the end of year actual defense costs, namely 6.8% of GDP. The Central Bureau of Statistics publishes another estimate of the defense costs, which is the one used also in Section 2 in this paper, which does not include the pension payments to the professional army in Israel. Until recently most military personnel received a Pay as You Go pension, which is financed by the state. The Israeli Central Bureau of Statistics does not include these payments, which are part of the defense budget, as part of defense costs, according to international standards.[14] Hence, in 2011 the defense costs calculated by the CBS reached only 6.2% of GDP. We prefer to keep the pension costs in the overall defense costs for two main reasons. First, pension is part of the wage bill and should be included. Second, military personnel reach retirement at an early age and as a result have relatively high pension costs. Hence, all costs listed in this section are in addition to the ex-post costs of the Ministry of Defense, namely 6.8% of GDP in 2011.

In our analysis below we list three types of additional defense costs. The first are costs that are not traded in markets and are thus only estimated. These are mainly alternative costs, like the cost of conscripts, alternative costs of land use, etc. The second type consists of costs that are paid directly by the citizens, like civil defense construction and security guards. The third type consists of costs of the conflict that appear in other budgets but not in the formal defense budget, like the Fund for Veterans.[15]

5.1 Alternative Additional Costs

· The first and largest of these costs is the loss of human capital due to service of conscripts. This cost is estimated in Section 4 to be equal to 4.3% of GDP, or 39.39 billion NIS.

· Another alternative cost of defense, which does not appear in the statistics is the use of land. Schiffer and Oren (2008) find that almost 50% of the land in Israel is under some control of the army, some fully used as military facilities, and some of limited access due firearms training. According to Israel State Comptroller (2010) the army holds 39% of the land in Israel and enforces limitations on additional 40%, which is an even higher estimate than that of Schiffer and Oren (2008). One way to estimate the cost of using this land is the following. Following the government decision to transfer IDF camps to the Negev, the value of the evacuated areas was calculated, as some of it is in quite lucrative locations. The Finance Ministry estimated the value of this area by 30 billion NIS, while the Ministry of Defense estimated the value to be 90 billion NIS. Assuming that both sides exaggerate, we choose an average of

13. These secret services are budgeted initially in the general reserve of the budget. This budget is transferred to the Ministry of Defense during the fiscal year in a closed meeting of the committee.
14. The CBS uses instead of the Pay as You Go payments the implied provisions to a pension fund, if it would have replaced the existing system. This is of course a much lower amount.
15. Note that the Central Bureau of Statistics also calculates additional costs of defense, but does it in a minimal way. For comparison they calculated total defense costs in 2011 to be only 7.7% of GDP.

60 billion NIS. The annual rate between rent to value of land was 3.4% in 2011. Hence, the annual cost of these areas to the military is around 2 billion NIS. We could not find a satisfactory estimate to the cost of the other land used by the army, which is mostly area closed for military training (Shetach Esh).

· An additional alternative cost of defense is the lost output of people who lost their lives in the conflict, as indicated by Berglas (1986). This cost is in addition to the payments to families of casualties. Our estimates are that as a result of the death of soldiers in the conflict, Israel would have had additional 6,500 workers (taking into consideration rates of participation, etc.). The alternative annual contribution to output would be 1.8 billion NIS, using the average output per worker in 2011. A similar calculation applies to the loss of civilians in the conflict, which amounts to 700 who would be working in 2011. This alternative cost is 200 million NIS. To that we should add the National Insurance payments to the civilian casualties and their families, which were half a billion NIS in 2011.

5.2. Additional Defense Costs Paid by Citizens

· Most civil defense costs in Israel are born directly by the citizens. The law stipulates that any new apartment built in Israel must add to it a "protected area," namely a room that serves as a shelter, with special security requirements.[16] The cost of construction of such a room was 100,000 NIS in 2011 and in that year 45.5 thousand new apartments of more than 2 bedrooms were built. Hence, this cost of civil defense for civilians in 2011 was 4.5 billion NIS.

· Another defense cost that is born by civilians is employment of security guards. Security guards operate both in public institutions and in private businesses, mainly since the Second Intifada, that started in 2000. The use of security guards, which differs from regular guards, started to increase after 2000 and remained high since. In 2011 there were 45 thousand workers in the sector of security, of which 39 thousand were security guards and 6 thousands were managers. We assume that the wage paid to security guards is the minimum wage, while the wage to managers is the average wage in the country. According to these assumptions the overall annual cost of security services in Israel in 2011 was 3.4 billion NIS.

5.3. Defense Costs in Non-Defense Items in the Budget

All figures of this type are actual ex-post costs and not planned budget:[17]

· The cost of the Committee for Atomic Energy is 145 million NIS and is mainly for military use. It is important to note that this is not the cost of the atomic enterprise near Dimona, which we could not estimate.

· The cost of the Coordinator of Government Activities in the Territories (COGAT) was 184 million NIS in 2011. This is clearly a defense related cost but it is not included in the defense costs.

16. Before the 1990s such shelters were built per building and not per apartment. The new room shelter per each apartment is called Mamad.
17. This list does not include another cost of past defense expenditures, which is interest payments on public debt that was accumulated in the 1970s and the early 1980s. As explained in Section 2 these expenditures increased debt significantly. We do not include such costs in this list because they are bygones and cannot be affected by current policies.

· Civil defense costs related to defense, like protection of the population against atomic, chemical and biological warfare, building public shelters, and building shelters in the area around the Gaza Strip, have been 276 million NIS in 2011.

· Israel has a special fund that financially supports veterans after their service. The budget of this fund is also not part of the defense budget. Its cost in 2011 was 1.6 billion NIS.

· The costs of managing and renewing emergency stocks, of food and oil, which are coordinated by the defense system, were 201 million NIS.

5.4. Summary of Additional Costs

Table 1 below summarizes the total additional costs of the conflict for the year 2011 in current prices and in percentages of GDP. This year has been a fairly quiet one and hence these figures provide a fairly good estimate of average annual costs of the conflict. Of course these costs rise significantly in years of conflict, like 2014, where the defense sector already demands an increase of its budget by more than one percent of GDP. Table 1 clearly shows that the additional defense costs almost double the actual defense cost from 6.8% to 12.7%. The cost of defense is therefore equal to 15% of income (which is lower than GDP). This means that Israelis are left with only 85% of their income after defense costs are taken into account. It is important to note that our calculations are pretty conservative and the actual costs might even be higher. The results of this table should therefore be on the agenda when issues of defense and national security are discussed, as we need a better estimate than the current defense costs on the full cost of the conflict.

Table 1: Additional Defense Costs

Component	Cost in current prices (billions NIS)	Cost in percent of GDP
Initial defense budget	54	5.8%
Additional budget	8.4	0.9%
Conscription	39.4	4.3%
Land	2	0.22%
Alternative cost of military casualties	1.8	0.19%
Alternative cost of civilian casualties	0.7	0.08%
Private civil defense costs	4.55	0.49%
Security services	3.4	0.37%
Atomic Energy Committee	0.15	0.02%
COGAT	0.18	0.02%
Civil emergency	0.27	0.03%
Veterans' fund	1.6	0.17%
Emergency stocks	0.2	0.02%
Total	**115.8**	**12.7%**

6. The Direct Costs of Settlements

Israel began settling in the Occupied Territories already in 1967, in the Golan Heights and in Gush Etzion (in the West Bank). The settlement activity continued since then and accelerated over time. The number of Israelis who live on the Palestinian side of the Green Line today is more than half a million. One can claim that the cost of the settlements is as high as the cost of the conflict, since the settlements and the insistence of Israel to leave them within Israel, are the main obstacle to peace. But the settlements are also a costly project in itself. Keeping a dispersed population in hostile areas requires high expenditures: on defense, infrastructure and supply of various public services to small communities, thus losing returns to scale. Since labor opportunities in the settlements are scarce, a large number of settlers are employed by the public sector and it seems that this also constitutes a significant cost. These direct costs of the settlements are hard to measure, since the data are usually not available and the existing statistics are not transparent.

One rare attempt to estimate the figures related to the settlements, or more precisely to the post-1967 areas controlled by Israel, was published by the OECD (2011). The main goal of the document was to try to clarify how the Israeli statistics can be reconciled with the OECD standards on fitting population and territory in the data. But from this document we can learn a few things about public budgets directed to the settlements. Interestingly the document calculates public expenditures on all post-1967 population behind the green line, and that includes also the population of Palestinians in East Jerusalem, which are known to receive very meager services, definitely less than the Israeli average. According to the OECD report the population that lived in post-1967 areas in 2009 was 775 thousands people, which added 11.5 percent to the population of pre-1967 Israel. If we subtract from this figure 265 thousand Palestinians from East Jerusalem, we get a population of settlers (including a small number in the Golan) of 510 thousands people, which are equal to 6.8 percent of the population of Israel. According to the calculations of the OECD, presented in Table 12 of the report, this population receives 7.4 percent of government consumption. Namely, this population receives a share of government outlays that is larger than its actual share in the population, but the gap is not that high.

The calculations of the OECD are problematic, as they include only government consumption but ignore many services that are supplied by the wide public sector, in addition to the central government. These calculations also ignore excess employment of settlers in the public sector, which is also an excessive cost. In order to get some idea on the size of this cost, note Figure 8 of the OECD report, which examines the contribution of settlers to output in general and in various sectors. While the overall contribution of settlers to GDP is less than 4 percent, the contribution of settlers to the sector of public administration is higher than 11 percent. This confirms our initial guess that one of the ways the government subsidizes the settlements is by excess employment in the public sector.

Another study that tries to measure the public spending on the settlements is a study by Hever (2013) that tries to estimate the overall economic costs of the occupation on Israel since 1970. Hever (2013) cites previous studies and estimates, mainly Svirsky (2008). Since the main problem facing any such work is the lack of transparent data, Hever tries to estimate each type of subsidy to the settlements in years in which the information is available. He then calculates the cost per settler, and then extends the calculation for the whole period 1970-2008, based on the known number of settlers in each year. He then discounts all these sums for the year 2008 in real terms (prices of 2007).

Hever (2013) divides the subsidies to a number of categories:

1. **Agriculture:** Most agricultural investments in settlements are performed by the World Zionist Organization, which channels government budgets to the settlements. It is estimated that during 2000-2002 it invested 450 million NIS on settlements.
2. **Education:** Schools in settlements cost more per student than in pre-1967 Israel, due to special benefits to teachers, special transportation to students and more. These additional budgets are estimated to be 118 million NIS in 2003 alone.
3. **Health:** Medical services are better supplied in the settlements and also carry additional costs such as subsidies to doctors who work there. These total additional costs reached 2.07 billion NIS until 2002.
4. **Housing:** Housing in the settlements is heavily subsidized. This additional subsidy during the years 1990-1999 is estimated to be 3.4 billion NIS.
5. **Industry:** Industrial zones in settlements received in the years 1997-2001 an additional sum of 280 million NIS.
6. **Local Government:** The settlements receive much higher supplementary budgets than Israeli pre-1967 municipalities, estimated to be twice as high per capita. These high budgets have survived even the recent severe cuts of government budgets to local government. The additional support to settler municipalities during the 1990s is estimated to be 2.7 billion NIS.
7. **Roads:** The settlements enjoy a high quality system of roads, which are usually Palestinian-free. A preliminary estimate of the roads built in 1993-2002 is 1.47 billion NIS. We need to keep in mind that this was the main period of such road construction for settlers, during the implementation of the Oslo Agreements.
8. **Tax Credits**: Settlers receive reductions in Income Tax automatically if they reside in a settlement. There are a few estimates of the costs of this reduction. The most conservative one is 1.7 billion NIS until 2003.
9. **Water:** Israel invested large sums in developing an advanced water system for the settlements, which uses the Mountain Aquifer and reduces significantly the amount of water left for the use by the Palestinians. The cost of this water infrastructure in the years 1994-2003 was 560 million NIS.

Hever then summarizes all these subsidies after extending the calculation to the whole period and reaches a number of accumulated 105 billion NIS in prices of 2007 during the years 1970-2008 (in addition to pure defense costs related to the settlements, which we are counting out here). Note that this is not a flow but a stock of accumulated costs over a long period of time. It is equivalent to an annual stream of income of 3 billion NIS in 2007 prices. This is equivalent to 0.5 percent of GDP. Since the settler population increases faster than the pre-1967 Israeli population, this total subsidy is expected to rise over time.

In addition to subsidies to settlements Hever (2013) also estimates the specific defense costs that are caused by the settlements and the occupation. These include the costs of guarding the settlements, guarding the roads where settlers travel, manning the road blocks, suppressing Palestinian efforts to fight the settlements and more. Hever (2013) includes in these costs also extra policing costs, which he claims increased Police budgets by 17.3 percent over the years 1968-2008. He also includes the building of the separation wall, which cost 13 billion NIS and the cost of the Disengagement from Gaza, which cost more than 11 billion NIS. The overall sum of defense costs caused directly by the occupation during the years 1970-2008 is estimated to be equal to 315 billion NIS in 2007 prices, which is very high.

7. The Cost of a Potential Boycott

In recent years the tendency to boycott contacts with Israel, with or without the settlements, and to boycott investment in Israel or in specific areas in Israel, is gaining momentum. It reflects growing discontent with the continuing occupation of the Palestinian territory and growing anger at the political impasse. The scope of the boycott is still small, but it causes great anxiety within Israel and it seems to annoy decision makers in Israel significantly. This is definitely a potential cost of the conflict, but it seems to be more annoying than a serious economic cost. There are a few reasons for that.

A similar historical example is the Arab Boycott that was directed against Israel since 1948 and that collapsed finally after the Oslo agreements in 1993. That policy included a boycott by the Arab countries of any economic contacts with Israel and also a boycott of firms in other countries that trade with Israel. The direct boycott did not affect Israel much, since it always viewed the Arab markets as relatively small, which do not constitute important trading partners. But the boycott of other firms that traded in Israel had a more significant effect. For many years Israel did not import Coca Cola, McDonalds, Japanese cars and more. But Israel found ways to grow and develop despite the Boycott. It found firms and countries that preferred to avoid the Boycott and traded with them. So the historical experience shows that the economic cost of a boycott is not very high. Still, the new boycotts differ from the old one in a very significant way, which we will explain below.

Another reason for the low ability of boycotts to create significant economic damage is the fact that Israel's trade and mainly Israel's exports are highly diversified across countries. In 2010, 32 percent of Israel's exports went to Europe, 37 percent to America (North and South), 24 percent to Asia and 2.5 percent to Africa. Today it seems that the main pressure of boycotts is from Europe, but if exports from Israel are so diversified, it seems that the direct economic cost is not expected to be very high. Of course, this assessment should be taken with caution. The 2014 Gaza conflict intensified global opposition to Israel's policies and the boycott increased. Latin American countries led the criticism on Israel. World organization of port workers discussed a proposal to deny service to Israeli ships. It decided against due to American pressure, but that might change in the future and then deal a serious blow on Israel's international trade. In other words, such developments are hard to predict.

But there is one clear and very painful element in the current boycott, which also makes it very different from the old Arab Boycott. It reflects a moral indictment of Israel and its policies and thus it casts a giant shadow on the self-esteem of Israelis. The firms that gave up to the old Arab Boycott did so because of financial interests. The current organizations and individuals that join the boycott, do it because of their own conviction, because they feel strongly about it. This is not just an issue of trade and income, but it is an issue of morality. It therefore hurts Israelis deeply, because like all human beings they want to believe that they are just, that they do the right thing. And now more and more people are telling them that this is not the case. This is the main strength of the boycott and this is why it is so dreaded in Israel. Israelis love to travel abroad, mainly to Europe. If they walk in European cities and know that more and more of the people around them condemn them and think that they are wrong, they will feel very bad. In our view this is the main cost of the boycott. More than an economic cost, it carries with it a great moral burden.

While we discuss the potential effects of boycotts in Europe and other global regions, it is time to direct our analysis to the effect of the conflict on Israel's economic ties with another region, the

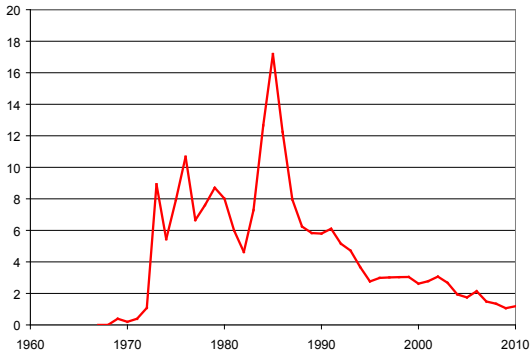
Middle East. It is true that currently the Middle East is not an attractive trading partner, as it suffers from severe obstacles to economic growth. But it is not doomed to stay like that forever, and it can experience a transition to economic growth and development similar to China or to India nowadays. This is possible. In that case Israel might find it very hard to create good trading relationship with the Arab countries, especially if peace with the Palestinians is further delayed. Hostility in the Arab countries toward Israel is high, not only due to the Israeli-Palestinian conflict, but also because Israel is closely tied to interests of the West, which is viewed as hostile to Arab interests by many in the region. Hostility is high also because Israel intervenes in many conflicts within the Middle East. It supports Christians against Muslims, Sunnis against Shiites, etc. If the Arab world becomes less and less tolerant toward Israel, even if a settlement with the Palestinians will be reached at some point, the future of our economic relations with the region might be uncertain, which could be quite costly.

8. Potential Economic Benefits to the Conflict and to Occupation

Although war and occupation seem to be negative phenomena in essence, they might sometimes create economic benefits, at least to one of the sides in the conflict. In this Section, we briefly explore this possibility, although it is clearly very hard, because much of the data are inaccessible. Following is a list of potential economic benefits to Israel and their discussion.

The first potential benefit to Israel is US aid. Clearly this aid, which is military mainly, would have not arrived if Israel were not in a conflict with the Arab countries. Whether the aid is given for Israel's survival in its defense against its enemies, or it is given for Israel's role as a strategic ally in an area of vital strategic importance to the US is not for us to judge. But, we know that the aid began to flow to Israel only after the 1967 War, which ended with a great Israeli victory, and hence, it can be viewed as a result of the Israeli-Arab Conflict. Figure 4 below, describes the dynamics of this aid over the years, in percent of GDP. It clearly shows that this aid was quite high during some periods, but it reached low levels recently. The main reason for that is that since the late 1980s, aid has been constant in its dollar nominal value, and thus its percent of GDP is shrinking continuously and reached a low level of 1 percent recently.[18] Hence, although this has been a significant benefit to the Israeli economy in the past, it has become negligible and it is expected to decline even more in the coming years.

Figure 4: US Aid to Israel as Percent of GDP: 1960-2010



18 Note that the peak of the aid was reached in 1985-1986 when the US gave a special transfer to help the economic stabilization program.

Another potential benefit of the conflict can be Israel's prestige in the area of defense industries. Israeli weapons, drones and similar equipment are in high demand in many countries. One of the main reasons for that is that these weapon systems are experimented in real battle, as the military industry advertisements stress over and over. This is clearly a benefit that is hard to deny, but it is even harder to estimate it. The data on defense exports are usually unavailable. Recently, the government published these data for recent years and it seems that the exports of this industry are equal on average to 5 billion US dollars. This is equivalent to 2 percent of GDP. Clearly, the value added of this amount, namely its contribution to output, is lower (probably around half). But we can also ask what happens to output if the defense industry will reduce its exports in the future, due to a reduction in the intensity of the conflict and of the Israeli prestige as a weapon supplier? If the demand for one good declines, the demand for other goods can replace it. In its short history, Israel has proved its ability to shift from declining sectors into rising sectors fast and efficiently. Hence, it seems to us that this is not a solid benefit to the Israeli Economy, in the sense that losing it will cause only a temporary loss due to adjustment, but not a permanent loss.

Another potential benefit to the economy is the training of many young soldiers in technical warfare during their mandatory service. Later on many of these conscripts find their way, after finishing the military service, to the famous Israeli High-Tech industry (and sometimes they even go directly to the US High-Tech industry). Indeed, such implicit subsidization has played a decisive role in the development of the High-Tech sector in Israel. But again, such subsidization is clearly not a pure economic benefit of the conflict, since without the conflict subsidization of the High-Tech sector could be done through other channels and could even be more efficient and involve fewer costs.

Finally, Hever (2013) lists a number of ways in which Israel exploited the Palestinians and gained from the occupation. One is by collecting National Insurance payments from Palestinian workers under occupation without any return on these contributions. Second, Palestinian workers in Israel were forced to set aside a number of payments from their wages, like a 'security tax,' which financed monitoring them during their labor. Third, Palestinian workers in Israel paid a fee to the Histadrut, the Israeli labor union, without receiving any services. Fourth, Israel confiscated large plots of land and large amounts of resources in the West Bank and Gaza. These resources include water, stone, agricultural production, Dead Sea minerals, oil, gas, and more. Since Oslo much of these resources are concentrated in Area 'C.' Fifth, many Israeli companies could export to the Occupied Territories low quality goods at high prices, using lack of competition from other markets. Hever estimates all these benefits over the years 1970-2008 by 40 billion NIS. This is clearly a large amount, but it was higher in the first years of occupation and it is much lower now. It is clearly much lower than the various costs of the occupation, which are described above. We therefore conclude that the overall financial balance of the occupation is not positive and that it constitutes a burden rather than a source of income.

9. Summary

This paper describes the various economic effects of the Israeli-Arab conflict, both current and potential. Nowadays it is mainly the Israeli-Palestinian conflict. These costs are quite high, especially if we add costs which are not part of the defense budget, like the alternative costs of conscription. Such additional costs raise the average annual costs of defense from 6-7% of GDP to around 13% of

GDP. This is already a large burden of defense. But defense costs might be even much higher if the conflict expands again to a wider Israeli-Arab conflict. This could happen for example if the peace agreement with Egypt might collapse. In that case defense costs might reach very high levels, as experienced in the episode of increased intensity of the conflict in the years 1967 – 1981. In those years Israel was close to fiscal bankruptcy and survived only due to the peace treaty with Egypt. An expansion of the conflict, which might occur if the Israeli-Palestinian conflict intensifies, therefore might raise the defense costs significantly and even raise the risk of fiscal instability.

Clearly, the high defense costs will not disappear immediately upon reaching a peace agreement with the Palestinians. Israel will still have higher than ordinary defense costs for a long period. But the costs are expected to decline significantly. We can use the case of the Peace with Egypt as a guide. Within 10 years the defense costs were reduced to half, from more than 20% of GDP to less than 10% of GDP. If a similar decline is expected for an Israeli-Palestinian peace agreement as well, it means that defense costs, direct and indirect, will be reduced from more than 13 percent of GDP to less than 7 percent of GDP. This is a significant decline. Furthermore, as the Israeli-Palestinian peace will bring with it peace with all Arab countries, according to the Arab Peace Initiative, it reduces significantly the risk for an expansion of the conflict, which is a large risk to the economy. Hence, a final agreement with the Palestinians will benefit the Israeli Economy both directly and indirectly by reducing potential risks.

But it is important to clarify that the figures in this paper are not the main reason why Israel should take the extra steps required to reach a peace agreement. Such an agreement is needed mainly to save lives. Writing this document in July-August 2014, when more than 2,000 people lost their lives, enhanced and confirmed this point. Such a peace agreement is needed in order to stop the occupation of the Palestinian people, which affects their economy, but even more it affects their dignity and self-respect. Such an agreement is needed in order to help Israelis treat their neighbors as human beings with equal rights. Such an agreement is also needed in order to help the Palestinians to treat the Israelis as human beings and not as military occupiers. Such an agreement is needed in order to enable children on both sides to grow up free of fear and of hatred. We need such an agreement to fulfill these essential human and moral goals. If such an agreement will also create some economic benefits, it is a blessed addition, but it should not be the main motive for peace. We know well that any attempt to reach a lasting agreement between the two sides, will ignite large opposition. Both nations are required to make great concessions over parts of their joint homeland. These concessions cannot be justified by economic benefits alone, but they can be justified by the human and moral gains of peace.

Appendix

1. Human Capital, Wages and Output

In order to demonstrate the proportionality of human capital to wages and to output assume a standard Cobb-Douglas production function, that describes output in the aggregate economy:

1. $Y = AK^{\alpha}\left(\sum_{j=1}^{N} h_j l_j\right)^{-\alpha}.$

In this equation *Y* is output, *K* is capital, there are *N* workers, indexed by *j*, with labor input *lj* and human capital *hj* for each worker *j*. This is the most well known way to embed human capital in the production function.

Note first that the wage of worker j is the marginal productivity of this worker which is given by:

2. $w_j = (1-\alpha)AK^{\alpha}\left(\sum_{i=1}^{N} h_i l_i\right)^{-\alpha} h_j = \overline{w} h_j.$

Note that $\overline{w}$ does not depend on the specific worker *j*, it is common to all workers and it can be defined as the wage per unit of human capital. Hence, wages are proportional to human capital and we can infer from examination of wage the changes in human capital. This is a very well known result in the analysis of human capital.

We next turn to calculate output in the economy.

Note that if *L* is the overall supply of labor, namely if $L = \sum_{j=1}^{N} l_j$, we get:

3. $\sum_{j=1}^{N} h_j l_j = \left(\sum_{j=1}^{N} h_j \frac{l_j}{L}\right) L = \overline{h} L,$

where $\overline{h}$ is the average human capital. Substituting in the production function (1) we get:

4. $Y = AK^{\alpha}\left(\overline{h} L\right)^{1-\alpha}.$

It is important to note that human capital increases output not only directly, as shown in the production function (4), but also indirectly through its effect on accumulation of physical capital *K*. Higher human capital increases the marginal productivity of capital, which raises the incentive to invest and as a result *K* increases. This is the indirect effect of human capital on output. In order to calculate it we apply the following standard equilibrium condition, which claims that the marginal productivity of capital becomes equal to the marginal cost of capital, namely the sum of the interest rate r and the rate of depreciation *d*:

5. $MPK = \alpha AK^{\alpha-1}\left(\overline{h} L\right)^{1-\alpha} = r + d.$

We assume that the interest rate is constant and so is the rate of depreciation. These are standard assumptions for a small open economy. From equation (5) we can calculate the equilibrium level of capital and then substitute it back in equation (4). We get the following equilibrium level of output:

6. $Y = A\left(\frac{\alpha A}{r+d}\right)^{\frac{\alpha}{1-\alpha}} \overline{h} L.$

Hence, output is proportional to human capital. If we denote the total amount of human capital in the economy by $H = \overline{h} L$, we get that output is proportional to total human capital in the economy:

7. $$Y = A\left(\frac{\alpha A}{r+d}\right)^{\frac{\alpha}{1-\alpha}} H.$$

It is clear from equation (7) that if we can raise *H* by some percentage, it will increase GDP or Y by the same percentage as well. This is the basis for our calculations of the loss of human capital and its effect on potential output in this paper.

2. Rates of Service in the Israeli Military

The following Table 2 presents the percentage of those who served in the military for each year of birth. The shares are relative to the Jewish population:

Year of birth	Men (in %)	Woman (in %)	Year of birth	Men (in %)	Woman (in %)
1944	89.7		1968	79.2	61.0
1945	89.3		1969	78.8	62.1
1946	88.8		1970	78.3	63.3
1947	88.4		1971	77.9	66.5
1948	88.0		1972	77.5	65.9
1949	87.5	38.8	1973	77.0	65.3
1950	87.1	40.0	1974	76.6	64.6
1951	86.6	41.2	1975	76.2	64.0
1952	86.2	42.3	1976	75.7	63.4
1953	85.8	43.5	1977	75.3	62.7
1954	85.3	44.6	1978	74.8	62.1
1955	84.9	45.8	1979	74.4	61.5
1956	84.5	47.0	1980	74.0	60.8
1957	84.0	48.1	1981	73.5	60.2
1958	83.6	49.3	1982	73.1	59.6
1959	83.1	50.5	1983	72.7	58.9
1960	82.7	51.6	1984	72.2	58.3
1961	82.3	52.8	1985	71.8	57.7
1962	81.8	54.0	1986	71.3	57.0
1963	81.4	55.1	1987	70.9	56.4
1964	81.0	56.3	1988	70.5	55.8
1965	80.5	57.5	1989	70.0	55.1
1966	80.1	58.6	1990	69.6	54.5
1967	79.6	59.8	1991		53.9

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The Role of Economics in the Israeli-Palestinian Conflict: Analysis from Dayan's to Kerry's Economic Plan

The AIX Group

January 2015

List of Acronyms and Abbreviations

BiH ..... Bosnia and Herzegovina
CBI ..... Confederation of British Industry
CU ..... Customs Union
DPA..... Dayton Peace Accords
EBRD..... European Bank for Reconstruction and Development
EPPU ..... Economic Policy Planning Unit
EU..... European Union
FDI ..... Foreign Direct Investment
FTA ..... Free Trade Area
GDP..... Gross Domestic Product
GoI ..... Government of Israel
IBEC ..... Irish Business and Employer's Confederation
ICT ..... Information and communication technology
IFI..... International Fund for Ireland
IMF ..... International Monetary Fund
IPE..... Initiative for the Palestinian Economy
JBC ..... Joint Business Council
JWC..... Jerusalem Water Committee
NAFTA..... North American Free Trade Agreement
NDTP ..... Non-discriminatory Trade Policy
NIGC ..... Northern Ireland Growth Challenge
OPT ..... Occupied Palestinian Territory(West Bank, Gaza Strip, East Jerusalem)
OQR ..... Office of the Quartet Representative
PCBS ..... Palestinian Central Bureau of Statistics
PNA..... Palestinian National Authority
PP ..... Paris Protocol
PPP ..... Public-Private Partnership
R&D ..... Research and Development
SME..... Small and Medium Enterprise
SOE ..... State Owned Enterprise
UK ..... United Kingdom
UN..... United Nations
UNCTAD ..... United Nations Conference on Trade and Development
US..... United States
USD..... United States dollar

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Executive Summary

This Aix Group report sets out to assess and critique some of the latest proposals for Palestinian economic development within the broader framework of political reconciliation between Israel and the Palestinians. The proposals take two forms, one known as the Kerry Plan (an intensive three-year plan) or a longer-term and intensely researched initiative called the Initiative for the Palestinian Economy (IPE). The former proposal was first formulated in 2013; it is currently being driven as the IPE by the Middle East Quartet, headed by Tony Blair. The IPE aims to infuse eight key Palestinian private sector industries with private investment in what its supporters see as an unprecedented catalyst to economic development in the occupied Palestinian territory (OPT).

The present Aix Group report concludes that the appropriate relationship between economic development and political reconciliation will determine the success or failure of the IPE and other similar initiatives, just as this relationship saw the failure of many economic-oriented initiatives in the OPT in recent years. Their failures were due to the inability to combine economic development with political change by realizing enablers–conditions on the ground needed to promote economic and in turn political progress. Such failed initiatives span back to the signing of the Oslo Accords in 1993, which ushered in a brief period of optimism characterized by expectations for rapid economic growth in the OPt, though sufficient political steps (enablers) were not taken to transform the territory into a sovereign Palestinian state and maintain long-term economic growth. The lack of supporting political moves after the signing of the Oslo Accords eventually led to violence and economic troubles.

While the IPE links economics to political enablers, its scope is limited to a sectorial approach with parallel sector-linked enablers, which do not tackle cross-cutting political factors that will boost the drivers of economic growth as well as contribute to a political resolution to the conflict. These range from one-issue factors such as the status of Jerusalem to broad structural considerations such as economic sovereignty, the definition of economic borders and transfer of administrative control from the Israeli Civil Administration to the Palestinian National Authority. Other cross-cutting factors discussed in this report are:

- Palestinian sovereignty (lack of an agreed ending point)
- Labor flows
- Import and export impediments and restrictions
- Lack of Palestinian control over borders
- Control of Area C and its resources

This report re-envisions certain aspects of the IPE to realize positive change by integrating the above cross-cutting political factors in a logical hierarchy starting with Palestinian sovereignty that will be part of any comprehensive agreement; the argument draws on the analysis and understanding of the relation between sustainable economic growth and a permanent political settlement between Israel and Palestine.

1. Introduction

It is amazing, or rather disappointing, that the fundamental problems of the Palestinian economy are today, at the end of 2014, very similar to those that existed more than twenty years ago when the Palestinian National Authority (PNA) was established. The persisting problems include underdevelopment, the lack of adequate physical infrastructure, insufficient social services in health, education and welfare, an unhealthy industrial-economic structure, limited mobility of people and merchandise within the OPT and between the OPT and the rest of the world, and a high degree of uncertainty concerning the future that provides negative incentives to invest. These come on top of a high level of unemployment, a heavy dependence on the Israeli economy and on workers' remittances, a heavy dependence on foreign aid mainly for the funding of public finance and trade deficits, the high degree of openness to trade (regarding imports) together with a significant aforementioned import surplus.[1]

The Oslo Process was initially planned to end in 1999 with a final settlement that would include a viable political agreement (a peace treaty between two states) and an economic regime that would stimulate sustainable economic growth and bring prosperity to all parties involved. So far, none of these goals have been realized. Nevertheless, all agree that a political settlement needs to include an economic component that will support it and contribute to its success.

This raises both theoretical and practical question of the interaction between politics and economics in achieving, preserving and contributing to peace, friendly relations and understanding among nations. Many wars have sprung out of political turmoil linked to economic crisis. Once started, most conflicts cause high levels of collateral damage (physical, emotional, and economic due to halting normal business activity and destruction of property) unrelated to the initial pretexts of conflict, resulting in economic ruin for one or multiple parties involved. As such, the right status quo economic conditions can help prevent parties from descending into conflict in the first place while, perhaps more importantly for our world today, a proper alignment of economic interests can help conflicts end and/ or post conflict areas regain stability.

The Second World War, the deadliest conventional war of the twentieth century, began in part due to jingoistic national aims that grew out of economic instability. Indeed, in his 1919 essay, "The Economic Consequences of the Peace", British economist John Maynard Keynes warned of the political instability that economic hardship would foment in Germany and the rest of continental Europe following the First World War. His fortuitous warning, "who can say how much is endurable, or in what direction men will seek at last to escape from their misfortunes?"[2] speaks in hindsight to the dangerous interplay between poor economic planning and the risk of conflict.

While warfare often brought riches to the victor through pillage and conquest before the advent of modern weaponry and in particular high explosives, the equalizing effect of modern technology has proven to assure mutual ruin in contemporary armed conflicts. The bombing of civilian centers, mass mobilization, and universal destruction associated with the Second World War stunted European economic growth. Likewise, contemporary conflicts such as the American-led engagement in Iraq and Afghanistan brought severe economic hardships to the

1. Detailed descriptions of the economic conditions and fundamental problems of the Palestinian economy at the beginning of the Oslo process and in recent times may be found in: Arie Arnon et al, The Palestinian Economy Between Imposed Integration and Volunary Separation (Leiden: Brill, 1997); World Bank, "Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth (Washington DC, 2012); unpublished paper of the Office of the Quartet (2013).
2. John Maynard Keynes, "The Economic Consequences of the Peace" (New York: Harcourt, Brace, and Howe, Inc. VI.) 33.

United States as well as general paralysis to Iraq and Afghanistan. Operation Protective Edge in Gaza during the summer of 2014 crippled Israel's economy and set the development of the Gaza Strip back by years.

While economic hardship can edge parties towards conflict that then often hurts the economy further, positive economic planning can provide a disincentive for parties to engage in conflict, pull parties out of ongoing conflicts, and improve the chances that peace is maintained once conflicts come to a conclusion. The most outstanding example is Europe after the Second World War, which was able to support the goal of protecting peace by establishing an economic union. Other countries also used international economic agreements (bilateral or multilateral) and modules of cooperation to reinforce amiable relations with other countries.

Economic interests have historically been unable to stem the onset of violent conflict, as a nation's political life often focuses around certain concerns without taking into account all possible outcomes, however likely they may be. That said, once conflict has proven to be mutually destructive, economic interests can serve to ease tensions, help restore peace, and maintain cooperation between the parties.

The famous Dutch philosopher Benedict (Baruch) de Spinoza wrote: "…Peace is not the absence of war, it is a virtue that springs from the force of character…"[3]. There is no doubt that a good economic regime that would benefit all parties is an important instrument in generating the Spinozan virtue and creating the force of character necessary for the establishment of a lasting peace. It seems that such a state of mind is badly needed in the negotiations toward a permanent settlement in the Israeli-Palestinian conflict.

2. The role of the Economy in Peace Making

This section outlines how economics and politics reciprocally affect each other and how both may be leveraged to create and maintain peace and prosperity in and between Israel and the OPT. The effect of economics on politics and peacemaking will be presented to illustrate how the economic prosperity of Israel and the OPT in general, and the economic interrelations between the two in particular, may promote the resolution of the ongoing political conflict. There are several explanations for this connection: 1)Economic relations between the two parties may yield interdependence between the two economies. This interdependence may be the result of international trade between the two economies or due to access to global capital markets. In both cases, the opportunity costs of maintaining an interstate conflict increase greatly. As such, the risk of such a conflict to proceed or escalate declines. 2) Economic interdependence between the two economies usually involves political agreements and formal meeting of politicians from both sides. These meetings facilitate the building of trust as well as personal relations on the political level, which are an important part of diplomacy in the service of peace. 3) From a microeconomic perspective, economic relations between the two sides usually make it profitable for people on both sides to trade with one another. This can lead to the establishment of political lobbies and interest groups to support further deepening of relations.

These explanations highlight the importance of economics in peace making, yet one should note, as will be elaborated in section 6, that none of these potential channels for mutual eco-

3. Baruch, Spinoza, A Treatise on Politics, trans. William Maccall (Holyaoke: 1854.) Chapter 5, Section 4.

nomic relations function if the necessary political conditions do not exist in the first place. For instance, an entrepreneur will invest in another country only if he has enough confidence that his investment has a long enough horizon to prosper given the stability of political relations between the two countries. This horizon depends mainly on political institutions and political mechanisms. Hence, politics is the foundation of the economy's positive externality on peacemaking by strengthening bilateral ties in the economic realm that in turn generate positive feedback to the political arena. In the following we provide a conceptual analysis, based on the economic literature, on the mutual effects of politics and economics and their potential contribution to peacemaking.

2.1. The economy and its impact on politics and peacebuilding: A General Overview

Economic relations between two economies materialize in several forms. The first direct channel is international trade between the two economies. This channel affects the two economies both on a macroeconomic and a microeconomic level, and is especially important in this discussion, as detailed below. Another form of economic interdependence may materialize in the form of capital interdependence to third parties, as many countries rely on capital inflows from global capital markets, which may decline in case of a military conflict.

During the past several decades, the world has experienced a spike in international trade. This wave has some winners and losers, yet its impact on sustainable economic growth is beyond question. International trade usually takes the form of entrepreneurs establishing relations with traders in the other side. Needless to say, such entrepreneurship is costly, as not only does it require finding trade partners on the other side, but exporters are also exposed to greater competition, and hence must invest in order to increase their productivity. Yet once the partnership is established, both importers and exporters benefit with positive externalities for the political arena. The impact of trade on the economy as a whole includes job creation as well. The production chain of every imported good includes several domestic production processes. According to Friedman and Herkovitz each imported good to Israel contains 30 percent of Israeli value added.[4] This implies that not only the exporting country, but also the importing one, may experience a higher employment rate when trade takes place. This channel of trade generates interdependence between the two economies, which in turn may yield a reduction in the probability of a violent conflict. Indeed, empirical evidence suggests that trade flows and trade relations are negatively correlated with violent conflicts between countries.[5]

Another level of interdependence and cooperation between different countries on the economic level is access to global capital markets. Most countries are today integrated into world capital markets. The access to capital enables countries to borrow at a lower rate (or lend at a higher rate) than would be possible on the domestic level. Access to global capital markets therefore accelerates sustained economic growth. Note that a key factor that determines the profitability of access to global capital markets is the price of capital in these markets. This depends, among other factors, on the level and risk of violent disputes in any given country; the higher the political risk, the higher the price of capital, and hence the lower the capital inflow into the economy. Broadly speaking, the rate of return on capital borrowed is the international rate of return

4. Amit Friedman and Zvi Herkovitz, "A Real Model of the Israeli Economy, Discussion Paper No. 13 (Bank of Israel, 2012).
5. Solomon Polachek et al., Liberalism and Interdependence: Extending the Trade-Conflict Model, in: Journal of Peace Research, Vol. 36, No. 4, 1999, 405-422.; John R. Oneal, Assessing the Liberal Peace with Alternative Specification: Trade Still Reduces Conflict, in: Journal of Peace Research, Vol. 36, Issue 4, 1999, 423-442.; and John R. Oneal and Bruce Russett, The Classical Liberals Were Right: Democracy, Interdependence and Conflict, 1950-1985, in: International Studies Quarterly, Vol. 41, No. 2, 1997, pp. 267-293. There are studies that suggest that trade accelerates rather than reduces the military conflicts, but the underlying mechanism that are at work are absent in these studies.

plus the risk premium, which is country specific. When a conflict emerges (or the probability of conflict increases), the risk premium increases and so does the cost of borrowing capital. As borrowing capital declines, so does investment in the economy.

These phenomena of economic interdependence – international trade and access to global capital markets – yield different mechanisms through which economics reduces the emergence of violent conflict. The first channel is the rise in opportunity costs stemming from the microeconomic level and the second is the prospect of a decline in capital inflows, due to a rise in the cost of borrowing as stability decreases.

The second arena through which economic interdependence reduces the occurrence of violent conflicts is through building trust between the leaders of the two states. Initiating trade between two countries requires establishing certain institutions such as a mechanism for business conflict resolution, trade policies coordination, etc. These institutions are established by bureau personnel after bilateral meetings between politicians and businessmen from both sides. These meeting create working relations and eventually trust between leaders in the two countries, which helps to facilitate peace talks between the parties in parallel to or after economic relations have been settled. Interestingly, Bearce and Omori find empirical evidence that the trust created by the establishment of commercial institutions realizes more concrete gains in peace making than the significant opportunity costs businesses and industries might face after economic relations become strong.[6]

The third area in which interdependence reduces the occurrence of violent conflicts comes from the realm of political economy. As with all other economic developments, peaceful bilateral economic relations between two countries create winners and, albeit to a lesser extent, losers as well. Since the benefits from peace dwarf potential losses, peaceful economic relations yield the birth of lobbies and pressure groups that pursue the deepening of economic relations. Since these usually require further political connection between the two states, these private-sector-oriented lobbies conduct public campaigns that attempt to pressure the governments to settle disputes and reach a peace agreement. The Israeli-Palestinian conflict is not an exception in this regard, and many advocacy groups, such as “Breaking the Impasse”, have recently called on Israeli Prime Minister Benjamin Netanyahu and the Palestinian President Mahmoud Abbas to reach a peace agreement with economic interests in mind.

Moreover, political leaders tend to shift public opinion towards security problems with neighboring countries in the face of a deteriorating economy. Thus an isolated and poorly functioning economy is ripe for exploitation in the political arena that may foment conflict. Sustained economic growth due to higher trade flows between neighboring countries prevents this process and hence helps to maintain a peaceful environment.

In this section, the importance of good economic relations in promoting peace has been highlighted. Yet, one should note that for economic relations to prosper and support peace between two countries, the two countries also should pursue key political actions to underlie economic performance. These actions might take the form of political institutions such as bilateral organizations or signed agreements, or simply enabling policy measures such as easing of trade restrictions, trust-gaining measures, etc. In the absence of such political steps, the economy will not be able to fulfill its potential in supporting the peace process at the political level.

6. David H. Bearce and Sawa Omori, How do Commercial Institutions Promote Peace?, in: Journal of Peace Research, Vol. 46, No. 6, 2005, pp. 659-678.

2.2. Politics and its effect on the economy and peacebuilding

As discussed above, for economics to interface with politics in order to promote peace, enabling political institutions and actions are required. Evidently, not only do these factors create the necessary conditions for the economy to promote peace, but they also increase the productivity of the economy, and hence yield a spike in economic prosperity. From an international perspective, these political steps are usually related to government activity in the realm of trade or bilateral government activity between two parties to a conflict, which either reduces future uncertainty or facilitates international trade and international movement of factors of production. This means that politics in general, and international political agreements in particular, play a key role in promoting economic prosperity and are crucial for an economy to flourish. In this section we explain in detail why this is true.

Politics and economics share many similarities. The basic assumptions underlying the two disciplines, for example, is that resources, and thus wealth, are scarce. As such, these two disciplines ask how to allocate the scarce resources among all individuals in a given group. The difference between the two disciplines lies in the questions they ask in light of the problem of allocating scarce resources: Economics seeks to find what allocation is efficient (in the sense that an improvement in the wealth of one agent does not come at the expense of another), and what market structure yields an efficient distribution; the discipline of politics asks how to allocate the scarce resources between the agents, given their power, or influence on the political decision makers.[7] Clearly, these two questions need not have the same answer.

Yet politics play a key role in promoting economic activity, not only through the allocation of scarce resources, but also by setting the rules for economic activity. Unlike economic theory, market structure is designed according to laws enforced by different government agencies. In any country, for example, the government is the entity that sets the minimal age at which a person might work; likewise the central bank sets the nominal interest rate so as to reduce fluctuations in the inflation rate and unemployment. Clearly, the structure of these rules and their enforcement affect the decisions taken by individuals, firms and entrepreneurs, and therefore politics have the power to accelerate or impede economic prosperity.

Hall and Jones use development accounting methodology and argue that most of the diversity in output per capita between countries can be explained by differences in productivity.[8] They then suggest that differences in productivity do not stem from large differences in the technologies used in production. Instead, the major difference between countries lies in the institutions of social infrastructure. If these institutions work properly, firms find it optimal to invest, individuals find it optimal to invest in human capital and economic development is on track. Consequently, social infrastructure can also explain the differences in capital accumulation, and therefore its long-run impact is substantial. While Hall and Jones emphasize the role of the social infrastructure in general, in this section we emphasize the role of the political institutions in several key factors in resolving the Israeli-Palestinian conflict: the trade agreements between the two economies, the labor movement between the two economies and the reduction of geopolitical risk.[9]

One of the most direct channels through which politics affect the economy is by reducing (or increasing) the country risk. The country risk is an index produced by many rating agencies and,

7 Note that none of these disciplines asks as their main question the just allocation of resources.
8 Robert E. Hall and Charles I. Jones, Why Do Some Countries Produce So Much More Output per Worker Than Others?, in: The Quarterly Journal of Economics, Vol. 114, No. 1, 1999, pp. 83-116.
9 Ibid.

according to Erb et al., the country risk is a weighted average of several components including financial factors (such as expropriation of private investments, delayed payments of suppliers credits and such), economic factors (debt service, the trade balance, inflation etc) and political factors (such as political leadership, external conflict, corruption in the government etc).[10] Interestingly, many rating agencies place a relatively large weight on political factors when they measure the country risk.

The country risk affects the economy in many channels. First, the higher the country risk, the higher the expected return needed for investment in this economy. This implies that countries with higher country risk are less integrated to global financial markets and are less attractive for foreign direct investment. In fact, Hayakawa et al. find empirical evidence that political risk is negatively associated with foreign direct investment.[11] Second, in an open economy, an increase in the country risk yields an increase in the nominal interest rate paid by borrowers in this economy. This in turn may also negatively affect the stability of the financial system, as the profitability of the financial institutions declines as the country risk increases.

Clearly, political agreements between two countries can reduce the countries' risk, meaning a higher expected return for investment.[12] The country risk is higher the less available information there is on the economy. International agreements often include trade agreements that facilitate bilateral or multilateral trade, and hence they usually further expose foreigners to the domestic market and strengthen data infrastructure surrounding the economy.[13]

International trade is of major importance for understanding the role of politics in forming the market structure for exporters and importers. Furthermore, it is well known how international trade is important in fostering economic growth. Helpman along with Jones and Romer emphasize the role of international trade in accelerating economic growth.[14] Their argument is that entrepreneurs in an open economy face more competition from other entrepreneurs in other countries, and the high level of competitiveness forces them to be productive. In fact, within sectors, exporting firms usually are more productive both in terms of labor productivity and utilization of productive capacity than non-exporting firms. Second, trade openness implies that exporting entrepreneurs face a larger market for their product. This yields an incentive to invest in R&D, because R&D helps to achieve and thrive in economies of scale.[15] This, in turn, implies that a larger market yields a higher expected profitability for a new product, and therefore open markets experience higher R&D rate and higher growth. Finally, open economies experience higher growth, since a large share of the technology adopted by countries is embedded in machines. Since most of the machines are imported, openness to trade enables countries to use the newest machines and most advanced technologies that are on the world technology frontier.

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10 Claude B. Erb et al., Political Risk, Economic Risk and Financial Risk, in: Financial Analysts Journal, Vol. 52, No. 6, 1996, pp. 29-46.
11 Kazunobu Hayakawa, Fukunari Kimura, and Hyun-Hun Lee, How Does Country Risk Matter for Foreign Direct Investment?, in: The Developing Economies, Vol. 51, No. 1, 2013, pp. 60-78.
12 This is especially true in the case of Israel and Palestine.
13 Note that other government policies, such as monetary policy, can further reduce the country risk, as they affect economic factors such as inflation, debt service etc. Nevertheless, in this study we focus mainly on international institutions, rather than all government institutions.
14 Elhanan Helpman, The Mystery of Economic Growth, (Cambridge: Harvard University Press, 2004). Charles Jones and Paul M. Romer, The New Kaldor Facts: Ideas, Institutions, Population and Human Capital, in: American Economic Journal: Macroeconomics, Vol. 2, No. 1, 2010, pp. 224-245.
15 Economies of scale are the case in which the average cost in producing the product declines as the quantity increases. R&D activities have these characteristics, since they have a high fixed cost in research, but a low marginal cost once the new product is invented.

Political institutions in general, and international agreements in particular, form the market structure that an entrepreneur faces. International agreements affect both directly and indirectly the terms of trade: they may include regulations for reducing trade barriers (as in many free trade agreements signed in the past few decades); countries may decide on establishing free trade areas, or they can decide on tariff rates or export subsidies. Clearly, such agreements form the market structure that face entrepreneurs, and hence they foster economic activity.

3. A History of Economics and Politics in the Israeli-Palestinian Conflict

Over almost fifty years, since 1967, economics and politics were interwoven in shaping the Palestinian economy in the West Bank and Gaza Strip and its relation to the Israeli economy. Some characteristics of the developments in the Palestinian economy were the results of "pure" economic factors while others were determined by political considerations; the interplay of economics and politics in the actual history of the Palestinian economy in the West Bank and Gaza Strip is often a neglected topic, though politics have been a major factor in shaping Israeli economic policies for the Palestinian economy since 1967 and still play a major role. During the first phase, between 1967 until 1993 (from the occupation of the Palestinian territory until the Oslo Agreement), the determination of policies was made unilaterally by Israel. In later years, after Oslo, there were officially two sides, the Palestinian (represented by the PNA) and the Israeli (represented by GoI), which have been formally, mutually involved in designing economic policies. However, their roles have been very unequal and asymmetrical.

3.1. Israeli Policy after 1967: The Dayan Strategy

In 1967-8 Israel established an economic regime that can be described as a "partial imposed integration," in which the external borders of Israel and the OPT were controlled by Israel and the trade regime was determined by Israel to meet its national interest. Thus, Israel imposed a quasi-customs union: There were no trade borders within the combined area of Israel and the OPT, there was formal free trade within the combined area and eventually a free flow of labor, and there was a single monetary policy imposed through the Israeli currency. These elements turned this combined economic system into a de facto economic union as a result of ad-hoc policies. However, it was not a 'pure' economic union in several ways, two of which are described below.

a. Israel created trade barriers on exports from the OPT to Israel. This, of course, is contrary to the essence of a customs union whereby trade is expected to be free within the shared customs area. The revenue sharing mechanism, which is part of every customs union package, did not exist, so that Israel collected all and held most of the import taxes.

b. As aforementioned, there were a few features that are normally characteristic to a limited economic union such as the monetary union that involved, in most cases, the use of the Israeli currency as a major legal tender and the relative freedom for Palestinian workers to be employed in the Israeli labor market.

In fact, during the five-year adaptation period that began in 1968 and lasted through 1972, many Palestinian workers switched from the Palestinian to the Israeli labor market, where they

could earn higher wages. By 1972 more than 50,000 Palestinian workers, out of a labor force of close to 200,000, had found jobs in the Israeli economy. Between 1967 and 1993 approximately 40 percent of the Gaza Strip's labor force and 30 percent of West Bank's labor force were employed in Israel. The workers' remittances became a significant part of disposable income in the Palestinian economy, amounting to 30 percent of GDP in the West Bank and even more in the Gaza Strip[16]. While this process undoubtedly raised the standard of living in terms of GNP per capita, it generated a heavy dependence of the Palestinians on the Israeli economy. The imposed (and incomplete) economic integration between the Israeli and Palestinian economies, combined with a state of underdevelopment in the OPT due to the inadequate levels of private and public investments, created a very low economic capacity in the OPT and in particular in the production of tradable goods. This resulted in a Palestinian structural trade deficit, and, more specifically, in very low levels of exports (excluding labor services) and high levels of imports. The bilateral trade deficit with Israel was thus another form of dependence.

One might have expected a higher level of exports to Israel and a lower level of imports from Israel under such a (imposed) customs union. This did not occur because of political intervention in the economic process. One such major intervention took the form of direct administrative measures that prevented the development of a productive capacity in the Palestinian economy. Palestinian entrepreneurs had to apply for licenses from the Israeli authorities for many of the economic activities they sought to initiate. Israel's practice, at least until the 1990s, was to slow down local economic development. This policy, and the measures taken to implement it, also contributed to transforming important parts of the Palestinian economy into a captive market for Israeli producers. Thus the competition that should have evolved between Israeli and Palestinian producers, had the integration been 'normal', did not materialize. The resulting trade figures reveal that 60 percent of West Bank's exports and more than 90 percent of its imports in 2012 were to and from Israel. The trade deficit amounted to an average of 45 percent of GDP in the West Bank.[17] This high trade deficit was financed mostly by workers' remittances, but also by capital inflows and unilateral transfers. The trade policies responsible for much of the above outcome were shaped by Israel immediately after the war. During the next two years, 1967 and 1968, after an internal debate in the government, Israel decided also to allow Palestinian laborers to work in the Israeli labor market. Israeli policy was shaped to a large degree by Defense Minister Moshe Dayan, (1967-1974) who played a crucial role in the government.

3.1.1 The Rationale for the Dayan Strategy

Dayan led the pro integration push in the government that was favorable to the free movement of both labor and goods. The other option, presented by Finance Minister Pinhas Sapir, was opposed to the abolition of the labor border. Sapir considered the occupation of the OPT as temporary and therefore did not aim at creating permanent economic conditions that would be an obstacle to a political solution. Dayan believed that the post-1967 occupation would last a long time and was politically preferential; thus, in his opinion, the Israeli government should create conditions that would contribute to the efficient control of the OPT. He believed that creating conditions enabling the Palestinian population to generate high income and make a good living would serve this purpose.

He stated his views in a famous speech in Beersheva in November 1968, in which he favored integration of the two economies and explained that the Hebron-Beersheva area, on both sides

16 PCBS National Statistics, 2013
17 PCBS Foreign Trade Statistics, 2013.

of the pre-1967 border, should become a single economic unit. He argued that this area should form a single organizational and economic entity in order to remove barriers and reduce political tension and national hatred. His ultimate target, however, was to maintain Israeli access to and links with the OPT.[18] The economic integration that Dayan recommended was essential for maintaining Israeli control over the OPT. Aspiring to integrate without formally annexing it, Dayan believed that economic development and better living conditions would replace the Palestinian desire for political rights.

The policy adopted by the government, on the initiative and under the management of Dayan (who was formally responsible for the Palestinian Territories via a body of military governors) was to become known as the "stick and carrot policy"; Shlomo Gazit, who served as the Coordinator of the [Palestinian] Territories[19] for seven years, chose this phrase as the title of his important book on the administration of the OPT. The stick was military rule: curfews, water shortages, detentions, etc. The carrot included, among other things, visits to and from Jordan and permitting Jordanian public-sector employees (e.g., teachers) to continue receiving salaries from Amman. Other important components of the relief provided by the Israeli government included allowing vegetable growers to transport their produce to Jordan, their traditional market and, later, to sell it in Israel. Most importantly, the carrot included permitting Palestinian workers to work in Israel. These were economic measures that had the goal of improving the living conditions of the population. Gazit summarizes the policy and its consequences as follows:

"Israeli policy in the administered territories created a peculiar combination of economic welfare and rising standards of living for individuals ... combined with ... no development within the territories themselves.... The Israeli authorities and the military government did almost nothing to develop the local economic infrastructure (apart from the modernization of local agriculture)....".[20]

3.2 The Oslo Agenda: Economics and Politics in the Paris Protocol

In December 1987 the first Intifada broke out, causing a severe economic crisis in its first year, though limited to specific areas. During the next few years, ties to Israel continued in both areas of employment, and trade. The main disruptions to the economy were due to curfews imposed by Israeli military forces upon areas that were especially active in the uprising. However there were not yet severe limitations on movement of workers and goods, so there was a rapid return to the conditions that had prevailed in the previous twenty years.

The First Intifada and the Gulf War, with its consequences on the region, contributed to the start of political negotiations. Those Arab leaders who supported the United States in the 1991 Gulf War expected the implementation of a 'Territories for Peace' policy in the Israeli-Palestinian conflict. The US signalled that it intended to push for such a policy at the 1991 peace

18 In Mr. Dayan's own words: "In this southern part of the land, with its Jewish and Arab communities, we can weave our lives together. We can try to change two things: First, as far as it depends upon us, we can destroy barriers and prevail over hatred; secondly we can create economic integration – link the electric grid, the water system, set up a joint transportation system. … It's possible to organize this economically within one framework. Moreover, we can allow Arabs from Hebron to work in Beersheva because in Hebron there is unemployment and in Beersheva there is a need for workers. … We should connect the two entities, if we, on our part and for ourselves, do not want to sever connections with these areas.' (Emphasis added) Quoted from the Defense Minister's answer to a question about his Beersheva speech in the Knesset [Israeli Parliament] 17.11.1968. See; Shlomo Gazit, The Carrot and the Stick: Israel's Policy in Judea and Samaria, 1967-1968 (Tel Aviv: Zmora-Bitan, 1985), 350. (English version; Washington DC: B'nai B'rith Books, 1995). See the same source, pp. 147-150 entitled 'Integration to Israel'.The speech has been translated from the Hebrew by the authors of this paper.

19 This was the official title of the government post. It is to be noted that the plural 'territories' used in this case contravenes The AIX Group's terminology of 'Territory', which stresses the territorial integrity of the West Bank, East Jerusalem, and the Gaza Strip.

20 Gazit, ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron, 266. emphasis added.

conference in Madrid. In September, 1993, with the signing of the Oslo Accords between the Government of Israel and the Palestine Liberation Organization, the exclusive Israeli power over economic policies concerning the West Bank and Gaza Strip ended. Paradoxically, just as the new economic regime with the declared objective of encouraging economic development and eventual political sovereignty was adopted, a serious economic crisis commenced in the OPT and, in various ways, continues until today. The Israeli strategic decision not to conclude a permanent status agreement, not to depart from the status quo, and to avoid the exclusive implementation of policies geared towards either 'Two States' or 'One State' is partly responsible for this failure.

3.2.1 'The Paris Protocol' (1994): Continued Integration

Negotiations on the economic aspects of the Oslo Accords continued for six months after they were signed. In April 1994, after agreeing to implement the Declaration of Principles (DOP) in Gaza and Jericho, 'The Protocol on Economic Relations between the Government of Israel and the PLO Representing the Palestinian People' (known as the Paris Protocol) was signed in its namesake capital city.[21] The following important declaration appears in the Preamble to the agreement:

"The two parties view the economic domain as one of the cornerstone [sic] in their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace. Both parties shall cooperate in this field in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of mutual respect…"

"This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities." [22]

After more than a quarter of a century the era of the imposed Israeli economic policy on the OPT formally ended, at least according to the agreement. One might ask if the economic agreement represented the best interests of the two sides and whose representatives were signatories to the Protocol? Do the signatures represent willing agreement or did the historic asymmetry between the parties hold sway? The economic regime of the Paris Protocol is very similar to that designed at the end of the 1960s with few significant modifications. The Protocol assumed that no trade border would exist between the Israeli and Palestinian economies with some important exceptions, (See lists A and B in the agreement). When the agreement was signed in 1994, it in many ways simply prolonged the existing trade regime.

As mentioned above, the trade regime that existed between Israel and the OPT since 1967 corresponded to the conceptual framework of a Customs Union but it was implemented by Israel unilaterally – an 'Imposed Customs Union'. An important change concerned revenue

21 The full title: Protocol on Economic Relations between the Government of the State of Israel and the P.L.O., Representing the Palestinian People. The economic agreement known as 'The Paris Protocol' was signed on April 29, 1994 in Paris. One week later it was one of the annexes to the Cairo Agreement that dealt with implementing the Oslo Accords first in Gaza and Jericho. See the English version in Arnon et al., The Palestinian Economy: Between Imposed Integration and Voluntary Separation, 1997; the text can also be found on the PLO, Negotiations Affairs Department website http://www.nad-plo.org/nego/permanent/economic/primary/ParisPro.pdf and on the Israel Ministry of Foreign Affairs website http://www.israel-mfa.gov.il/MFA/Peace%20Process/Guide%20to%20the%20Peace%20Process/Gaza-Jericho%20Agreement%20Annex%20IV%20-%20Economic%20Protoco.

22 Paris Protocol, Preamble, 1994.

sharing; from 1967 to 1993 the lion's share of the revenues from imports to the West Bank and Gaza were transferred to Israel. One of the major innovations of the Paris Protocol was the Israeli commitment to collect import taxes and Value Added Taxes on imports to Palestinians in the OPT and transfer them to the newly created Palestinian Authority. This service had to be fulfilled by the Israeli authorities since all imports to Palestine from third countries had to pass through an Israeli entry point. The arrangement could have provided a certain element of sovereignty to the Palestinian Authority since it would have its own revenue from imports and use it according to its perceived national needs. Paradoxically, the procedure became also another element in increasing the dependence of the Palestinian Authority on Israel since the Israeli government, in times of tension, often withheld the transfer of these funds to the Palestinian Authority in order to apply pressure and, by doing so, accentuated the asymmetry between the two parties that were supposedly equal signatories of the Paris Protocol.

One of the important policy issues concerning trade and development, which is also closely linked to politics, is the question regarding the trade regime that will prevail in a permanent settlement. The debate is on the desired trade regime that ought to prevail which may vary on a continuum from a full economic union at one extreme through a custom union (CU), a free trade area (FTA) to a non-discriminatory trade policy (NDTP) agreement.

The preference for one trade regime or another has varied between parties and over time; in the Paris Protocol of 1994 the parties chose to continue the de facto custom union regime (that was in fact more of a de facto economic union) that had prevailed since 1967. It was designated to last temporarily during the interim period while decisions concerning the long run were left for the permanent settlement. On the Israeli side there were officials (among them Prime Minister Rabin) who thought it is convenient to leave questions involving border issues until the settlement of a permanent agreement. There were economists who keenly believed that a custom union was the optimal trade regime, which would be best for the development of the Palestinian economy. There were others who believed that the 'economics first' strategy should involve political drawbacks (in limiting the sovereignty of the PA and its freedom in determining the preferred trade and development policies).[23] Proponents of this strategy recommended a FTA as a second best solution. On the Palestinian side the positions were split between the supporters of the CU and the supporters of a lesser degree of integration in the form of a FTA or a Non-Discriminatory regime. The former were mostly economists and officials who were close to the Palestinian business sector. They believed that a CU would lead to the best growth trajectory. The supporters of a lesser integration scheme believed that a lesser degree of integration would lead faster to sovereignty and set the Palestinian economy on an independent path of development.

The Paris Protocol and the developments since its institution represent a clear case whereby economics were subordinated to politics. Thus, no economic regime, good as might be, could be adopted if it was perceived to contradict any political or security interest, especially if the concerns were on the Israeli side. The most salient example, as mentioned above, was the continuation of the CU regime after the Oslo Agreement. The motivation of Israel was to avoid any new economic arrangement that would have implications on the final border between Israel and Palestine; since any economic integration lesser than a CU (e.g. a Free Trade Agreement or a Non-Discriminatory Trade Arrangement) would

23 See Arnon et al., The Palestinian Economy between Imposed Integration and Voluntary Separation, 1997.

have required the demarcation of an economic border, Israel insisted on continuing the existing CU.

In recent years, during Netanyahu's time as prime minister, the concept of "economic peace" has been floated again in Israeli government circles. Indeed, the approach has become a major element of Israeli policy towards the Palestinian Authority. The idea is based on the concept that economic prosperity in the OPT will generate the conditions for a lasting peace. However, experience shows that economic prosperity cannot substitute for political solutions to the conflict; for example, the economic conditions in the OPT on the eve of the two Intifadas in 1987 and 2000 were relatively good, yet obviously did not prevent the uprisings, which grew to a large degree out of political frustrations. This reinforces the understanding that politics and economics cannot be separated and any peaceful solution will have to combine both in a comprehensive settlement.

4. The Current Economic Situation in the OPT

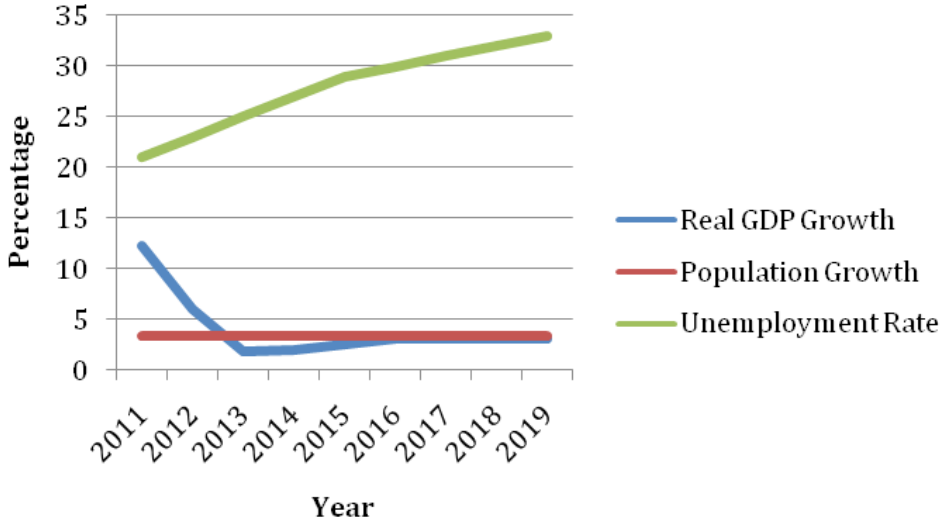
The failure of the Oslo process to conclude the negotiations on final status over a period of twenty years has hampered the development of a dynamic and sustainable Palestinian economy. Since the mid-1990s, the fortunes of the PNA and the Palestinian economy remained vulnerable to events on the ground and dependent on aid flows from external donors. Over the past twenty years, donors have provided more than USD 15 billion to the PNA and external budget support still averaged around USD 1 billion per year (comprising about a third of the PNA's budget).[24] In addition, Palestinian economic prospects are still hindered by the controlled environment of occupation, which affects all aspects of economic life in the West Bank and Gaza Strip.

Despite the constraints, Palestinian economic growth from 2009-2011 was relatively high, underpinned by a mixture of Palestinian reforms and donor assistance as well as the improvement in the security situation. During the same period, a development agenda was put forward by the PNA, in coordination with donors, focused on consolidating the PNA's fiscal situation and spurring on economic growth. The PNA was not only tasked with ways to grow the economy, but also with methods for consolidating its budgetary position by mobilizing direct budget support and unblocking the flow of clearance revenues from Israel. An additional imperative part of fostering Palestinian economic growth is easing movement and access restrictions and facilitating Palestinian trade.

At the end of June 2014, the IMF published a report assessing recent macroeconomic developments in the OPT and providing forecasts for future growth.[25] Experts warn that amid declining growth, rising unemployment and poor social and business indicators, the suspension of peace talks between the PNA and GoI in April and the summer months of conflict further diminished the prospects of economic recovery. The IMF considers that successful peace negotiations would boost investment by enhancing confidence in the economy, attract donor funds to develop effective economic programs and allow for the implementation of private sector-led economic initiatives. Deterioration on the political front, on the other hand, could result in substantially weaker growth prospects, increased unemployment and, potentially, greater social unrest.

24 Retrieved from: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2006/08/29/000160016_20060829135329/Rendered/INDEX/371370ENGLISH0GZ0Update01Public1.txt
25 IMF, 2014.

Figure 4.1: Real GDP growth, unemployment and population growth in the oPt, 2011 – 2013 (actual) / 2014 – 2019 (forecast – baseline scenario)



Source: IMF (2014)

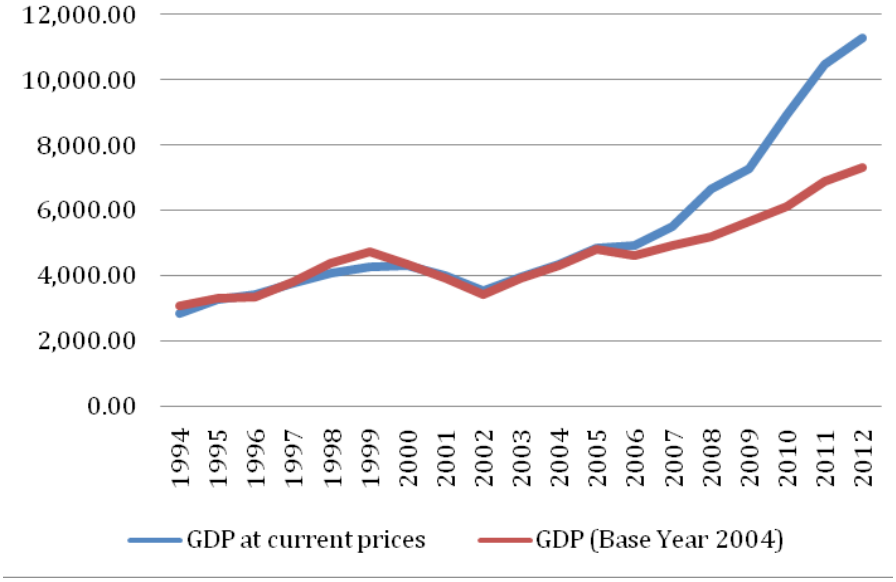
The baseline scenario for the IMF projections assumes a continuation of political efforts towards internal Palestinian reconciliation, peace negotiations with GoI remaining suspended, and a continuation of what the organization characterizes as an economic model of large recurrent deficits being financed by unpredictable aid flows under broadly unchanged policies. Under the status quo scenario, the IMF expects country-level real GDP growth to reach a low of 2 percent in 2014, to grow slightly to 2.5 percent in 2015-2017, and to converge to 3 percent in the years up to 2019. These growth rates would imply a decline in GDP per capita in real terms, since they are below historic population growth rates (~3 percent). Baseline forecasts expect unemployment to further increase from its currently high level by 1-2 percentage points per annum, to reach an all-time high of 33 percent in 2019.[26]

The discouraging growth performance in 2013 and the projections for 2014 through 2019, with rates below the population growth rate result in a year-to-year total decrease in GDP per capita. The reasons for this economic deceleration stem from a number of factors including regional instability, political deadlock between GoI and the PNA, donor fatigue, and, most importantly, the absence of continued and broad-based Israeli measures to ease restrictions on Palestinian economic life.

Figure 4.2, depicting Palestinian GDP from 1994 to 2012, shows clearly the link between the political situation and the drop in GDP, as can be seen during the period of wide-ranging Israeli incursions into the West Bank in 2002/ 2003 and in the Hamas takeover of the Gaza Strip in 2007.

26 International Monetary Fund-West Bank And Gaza, Report On Macroeconomic Developments And Outlook, June 30, 2014.

Figure 4.2: Palestinian GDP from 1994 to 2012 in Nominal and Fixed Prices



Source: PCBS 2013

Hence, the need for a comprehensive outlook and implementation of constructive political processes is key in improving economic conditions. That said, political action alone would be moot without tangible easing of restrictions affecting trade and economic development.

The present state of the Palestinian economy reflects many of the issues analyzed above in section 2. For example, political instability generates heavy country risk to potential investors on the OPT. Clearly, with the absence of political agreements with Israel (among other factors), the Palestinian country risk will remain high due to uncertainty, instability, and conflict. As a result, the interest rate paid by borrowers in the OPT will remain relatively high. Due to other high costs caused by occupation (discussed in Chapter 6 of The AIX Group's Palestinian Economic Development: The Destructive Effect of Occupation, Published in August, 2014), very few firms, Palestinian and foreign alike, find it optimal to borrow from Palestinian banks and invest in the OPT. One undesirable result is that most Palestinian banks invest abroad, as indicated in the International Investment Position and External Debt for the Palestinian Territory 2011, published by the PCBS, which shows that the total stocks of External Assets for the Palestinian Territory (Stocks of residents in the Palestinian Territory invested abroad) had amounted to USD 5,233 million; the Foreign Direct Investment abroad had contributed to 3.7 percent, Portfolio Investments abroad reached 21.9 percent, Other Foreign Investments abroad reached 64.9 percent, and Reserve Assets amounted to 9.5 percent. Hence, banking investments abroad totaled USD 3,793 million out of a total of USD 8 billion in deposits, which formulates around 47.41 percent of all deposits in Palestinian banks. This is a strong indication of the low level of trust that Palestinian banks and even the Palestinian Monetary Authority have in the potential for local investment and, therefore, in the potential for attracting Foreign Direct Investment.

Another important element in profiling the Palestinian economy is Palestinian labour participation in Israel, the regulation of which will be central to any future agreement between the

PNA and GoI. Since 1967, Palestinian workers have always been part of the Israeli labour force. During the 1990s, however, Palestinian labour participation in Israel declined, partially due to the Oslo Accords and also because Israel imposed movement restrictions on Palestinians. Nevertheless, even today the Israeli labour market still employs several dozens of thousands of Palestinian workers every day.

In 2013, according to latest Labour Force Survey published by PCBS, the employed persons were distributed according to place of work with 58.6 percent working in West Bank, 30.2 percent working in the Gaza Strip, and 11.2 percent working in Israel and Israeli settlements. The percentage of employed persons from the West Bank in Israel and Israeli settlements was 16.1 percent in 2013 compared to 13.8 percent in 2012, while workers from the Gaza Strip had not been able to access work in Israel or Israeli settlements since 2006.[27]

5. International Involvement in Promoting Economic Development and Political Issues

5.1. Tony Blair & the Quartet

The Quartet on the Middle East (the Quartet) is a foursome of nations and international and supranational entities involved in mediating the peace process in the Israeli-Palestinian conflict. The Quartet is formed of high-level representatives from the United Nations, the United States, the European Union, and Russia. The group was established in Madrid in 2002, recalling the Madrid Conference of 1991, as a result of the escalating conflict in the Middle East. Tony Blair is the Quartet's current Special Envoy. While the Quartet has launched several political and economic initiatives, which currently include the Initiative for the Palestinian Economy (IPE), the group's difficulty in realizing enabling political change in support of its ambitious goals has hindered its success.

The initiative to establish the Quartet evolved following the outbreak of the Second Intifada in September 2000 and multiple futile "cease-fire" attempts. On October 25, 2001, representatives of the EU, UN and the US and Russian governments met Palestinian leader Yasser Arafat and jointly expressed support for his policy of implementing a cease-fire and security reforms in the Palestinian Authority. During the Israeli incursions into Palestinian controlled areas in April 2002, the representatives of the same four entities met in Madrid and again called for implementation of cease-fire agreements previously brokered by the US government. In the same meeting, they also agreed to transform their quadripartite cooperation into a permanent forum for follow-up on the Israeli-Palestinian peace process. The United Nations oversees the finances and security of Tony Blair's extended mission and maintains the Office of Quartet Representative (OQR) in East Jerusalem.

In May 2008 Blair announced a new plan for peace and for Palestinian rights, based heavily on the ideas proposed in the Valley of Peace plan. In an August 2009 interview, Blair said he would like to see Hamas and Hezbollah included in peace talks under the right conditions, that religious leaders should be more involved in the peace process, and that resolving the conflict could be easier than it was in Northern Ireland.

27 For more detailed information on the economic situation in Palestine, see The AIX Group publication "Cost of Occupation".

Despite the significance officially attached to the Quartet's part in promoting the peace process, many of its statements and initiatives are merely repetition of previous positions that do not realize significant changes in policy by either GoI or the PNA. Although Mr. Blair's first priority mandate is to help the Palestinians create the foundations of a future state and improve their economy, very little has been accomplished in this direction. In addition, the perception of the OQR's very strong relationship with GoI has damaged its image in the eyes of the Palestinian public and leadership and thereby decreased its effectiveness.

The Quartet's performance and impact on the ground has a mixed report card. Allies point to a string of concrete economic gains, but critics say that little of real substance has been achieved. Blair had a limited mandate to work on the economic track while the US took the lead on the political track. This placed the Quartet Representative in a position of having a mandate that is far too narrow, fragmented and detached from the political process to have any meaningful impact.

Without the political power to make changes in the economic dynamics between the Palestinian and Israeli sides, the Quartet has not been able to affect serious change on the ground. The initial actions required to improve Palestinian economic performance are not economic but political in nature, and require serious political will, rather than economic utterances. In dealing with the Gaza blockade, for example, the OQR worked on the potential for importing construction materials into the Gaza Strip to no avail. As for the potential of export of Gaza products, Mr. Blair and his team claimed success when they were able to convince the Israeli authorities overseeing various aspects of the occupation to allow for goods to go from Gaza to Jordan and through Jordan to the Persian Gulf, which formulated less than 10 percent of total Gaza exports prior to 2006. The OQR, however, failed to convince the Israeli side to allow for Gaza trade with either the Israeli market or the West Bank market, which comprised around 75 percent of Gaza trade before 2007. Hence, the Quartet's success was not highly effective in improving the Gaza economy due to the lack of political actions to parallel economic ideas and initiatives.

The success of the OQR's various economic initiatives will always be tied to political steps towards scaling back the negative impact of the occupation on the daily life of Palestinians and their business activity, hence eliminating the high transaction costs and barriers to trade which hurt the competitive capacity of the Palestinian economy, and invariably block the potential for any investment which is aimed at development.

5.2. The Kerry Plan /Initiative for the Palestinian Economy (IPE)

Before veteran United States politician and former US Presidential candidate John Kerry took office as the US secretary of state in early 2013, a group of Palestinian and Israeli businessmen announced during the 2012 World Economic Forum an initiative they called "Breaking the Impasse"[28]. The initiative acknowledges a connection between a political settlement and peace on the one hand and the economic plans for the OPT and Israel on the other. This is especially so since the PNA has endured a financial and economic crisis in recent years, which has threatened its very existence. After becoming US secretary of state, John Kerry coordinated with Quartet representative and former British Prime Minister Tony Bair to back and expand the initiative, partly in support of the renewed Palestinian-Israeli political negotiations that lasted from 2013 to early 2014.

A team of policy advisors, external economic analysts and international domain experts under the leadership of Quartet Representative Blair completed during the summer of 2014 an ambi-

28 The group maintains a website, found at http://www.breakingtheimpasse.org/en/about-bti

tious three year plan entitled the 'Initiative for the Palestinian Economy' designed to yield broad, positive change in the Palestinian economy. The IPE focuses on catalyzing private sector-led growth in the West Bank and the Gaza Strip, and covers eight key economic sectors: agriculture, construction, tourism, information and communication technology (ICT), light manufacturing, building materials, energy and water. The initiative recognizes that success relies heavily on the inflow of foreign investment into the Palestinian economy (particular from the private sector); further easing of Israeli restrictions on movement, access, and trade; and boosted institutional capacity within the PNA.

In August 2013 the initiative was submitted in draft form to the PNA, which showed great interest under the caveat that the ambitious economic proposal would be complementary to the political negotiations and not serve as an alternative. Hence, the PNA foresaw the importance of an economic initiative to accompany the political negotiations while making clear that an economic initiative must not replace political action. The IPE was also shared in parallel with GoI, which indicated its willingness to enact a preliminary set of enabling measures for the initiative's realization.[29]

5.3. Objectives and Outlook of the IPE

The overriding objective of the IPE is to "catalyze transformative and accelerated change in the Palestinian economy"[30]. The initiative aspires to the rapid growth of the Palestinian economy across the entirety of the West Bank, including Area C and East Jerusalem, as well as the Gaza Strip over a three-year period from 2014-2016. It aims to achieve a significant reduction in joblessness, a substantial increase in average Palestinian household income, a large surge in investment flows - both domestic and foreign - and a significant decline in PNA reliance on direct budgetary assistance. It is estimated that the IPE would increase Palestinian GDP up to 50 percent over three years. In the "most optimistic estimates," the initiative would create enough new jobs to cut unemployment to 8 percent from 21 percent, according to the OQR team assessment in the presentation of the IPE made public online in March, 2014. This presentation will be cited as "Initiative for the Palestinian Economy: Summary Overview" with page numbers corresponding to slide numbers.[31]

The initiative aims to engender, over the medium-term, a substantial shift in the Palestinian economy away from the public sector 'aid economy' of the last decade towards private sector-led development. By focusing on the growth of key private industries, assisted by a mix of enabling factors, the initiative aims to shift the Palestinian economy towards a model of private-sector-led development and economic sustainability ahead of Palestinian statehood.

The IPE is based on three pillars, which strategically aim to 1) provide private sector-driven infrastructure; 2) unlock the intrinsic potential of the economy; and 3) accelerate flagship sectors, to be achieved through specific high-level interventions. The implementation and progress of the IPE depend on three key areas:

29 These measures, which included approval for the importation of greater quantities of construction material and water into Gaza, the reduction of movement and access restrictions and providing Palestinian businesses more access to Area C, however, were never actually enacted. This highlights the difficulty faced by the Quartet and other international institutions in realizing the political change necessary to enact economic development plans.

30 See http://www.breakingtheimpasse.org/en/about-bti

31 Office of the Quartet Representative, Initiative for the Palestinian Economy – Summary Overview, March, 2014. At the time of writing, a summary of the IPE and a document detailing its objectives could be found at http://www.quartetrep.org/quartet/news-entry/ipe-overview/

· The political environment: This includes many enablers and sector projects that require co-operation from GoI, as well as enablers involving political progress, which formulate a major portion of economic growth potential.

· Policy effectiveness: The initiative addresses the efficacy of PNA policy including both immediate policy initiatives that can realize short-term impact, which include legislative reform, training and further development of Public Private Partnerships (PPP), this should take place alongside realization of increased private sector investment through further engagement of the private sector.

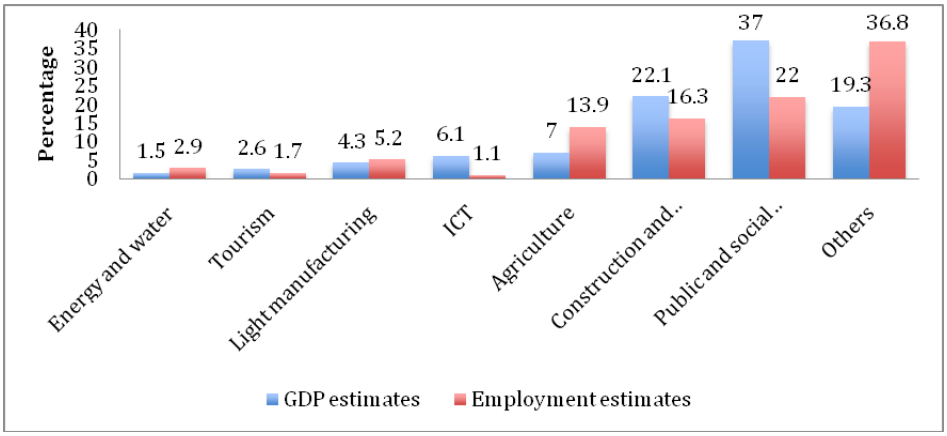
· Delivery mechanisms for enablers: The OQR is committed to provide, along with donors, support to PNA ministries and agencies to better assist the private sector, as well as liaise with both the PNA and GoI to ensure support for the implementation of the initiative based on the enablers described in section (4.3).

5.4. The Sectoral Approach

The IPE aims to unlock the economic potential of the Palestinian private sector through a mixture of private sector investments, donor development assistance, Israeli measures necessary for implementation, and expanded PNA capacity. The mixture of positive interventions is permutated across a number of key sectors deemed to underlie a potential Palestinian growth engine.

The eight sectors highlighted in the IPE were chosen based on their private sector orientation, relative contribution to GDP and employment figures, and their potential for economic growth. Current sector contributions indicate the relative significance of the construction and agricultural sectors and it is expected that these sectors will offer the greatest potential for growth and job creation over the medium-term. Other sectors, such as tourism, currently contribute less to overall economic activity and employment but have vast potential to grow particularly under conditions of greater peace and stability within the region.

Figure 5.1: IPE Prioritized and major sectors of Palestinian economy, 2013 estimates



Source: Initiative for the Palestinian Economy, Summary Overview. March 2014.

5.5. The Concept of Enablers

Implementing the IPE requires significant cooperation and support from GoI and the PNA. This initiative identifies a large set of immediate and medium-term enablers necessary for the implementation of each sector strategy, and for the creation of a secure environment to enable accelerated Palestinian economic growth.

The slides outlining the IPE released by the Quartet in March 2014 make clear that progress is dependent on the "political environment, policy effectiveness and increased private sector investment."[32] The IPE displays these three enabling categories sequentially, beginning with the political environment and ending with the goal of private sector investment. The IPE states that "many enablers and sector projects require cooperation from the Government of Israel".[33] This could range from expediting the implementation of critical infrastructure in the water and energy sectors in the West Bank and the Gaza Strip to restoring two-way commercial relations between the West Bank and the Gaza Strip. The next enablers are those that "the PA can engage on immediately to attain near term success". This would include "legislative reform, increasing focus on training, and developing public-private-partnerships". The last set of enablers follow as a result of the first two outlined above. Namely, the IPE states that "demonstrated impact on enablers where progress is possible is a key factor in attracting major private sector investment, and will be critical to the success of economic growth."[34]

While the IPE outlines a hierarchy of enabling areas, the focus of the Quartet's strategy lies ultimately in its sectoral approach to economic development. While the IPE acknowledges the prime importance of the political enablers that underlie the entire initiative, the Quartet's approach of formulating a detailed economic plan with the help of over a dozen experts and in consultation with the World Bank and IMF does not bring the foundational political actions any closer to realization.

5.6. Analysis of Expected Outputs

Recognition of the inherent linkage that begins with increased Palestinian sovereignty, leads to economic development, and then feeds back into full Palestinian sovereignty, underlies any positive change on the ground. Without tying the basic enablers into a vision for Palestinian sovereignty, the "transformative" IPE resembles many failed economic growth plans that the US and EU have championed in the OPT since the early 1990s. Instead of tackling the political obstacles to a peace agreement head-on, historic economic plans and indeed the IPE lead the international community in pursuit of economic growth in the hope of delivering tangible benefits to the Palestinian population and create momentum towards peace. However, because the focus on economic growth was never accompanied by political change, the situation on the ground remained much the same.

The economic strategies and integration agreements put forth by the US and the EU, such as the Interim Association Agreement between the EU and the PLO, and the US-PNA free trade arrangements, lacked any political enforcement mechanisms –both when it came to Israeli policies that interfered with economic growth and in terms of Palestinian lack of vision and leadership. Repeated and prolonged Israeli border closures from 1994 to 1999 choked off Palestinian trade and led to a net drop in per capita income. "The IDF [Israeli Defense Force's] Defensive Shield

32 Office of the Quartet Representative, "Initiative for the Palestinian Economy: Summary Overview" (March 2014), 8.
33 Ibid., 8.
34 Ibid., 8.

and Determined Path operations in Spring 2002 caused USD 361 million of damages to donor-funded civilian infrastructure and institutions in the West Bank, out of all proportion to the actual scale and intensity of combat, as the international community sat unable to intervene to put an end to the destruction on both sides by enforcing visionary political steps".[35] And when the US and the World Bank brokered the Agreement on Movement and Access in November 2005 –which epitomized the donor strategy of developing the Palestinian economy within the matrix of Israeli security, territorial, and administrative control – the Israeli security establishment refused to implement it, resulting in its complete and speedy demise.

Despite this dismal track record, the US and the EU revived the economic growth strategy again in the wake of the Palestinian Authority's split into two rival governments in the West Bank and the Gaza Strip in June 2007. Yet only two years later, the World Bank concluded that the Palestinian economy was "dramatically failing to fulfill its potential, even in periods of relative stability in the security situation," and had "hollowed out, with the productive sectors declining and...a growing dependency on donor aid for the prevention of fiscal collapse." [36] Ironically, despite a sharp increase in donor assistance to the PNA government of Prime Minister Salam Fayyad, the impact fell short of expectations due to the lack of a political resolution as well as continued Israeli impediments in the way of trade.

The past 20 years have seen international assistance to the Palestinians diverted from its original purpose of economic growth, private sector development, and institution building to humanitarian relief, emergency job generation, and budgetary assistance. The ultimate goals and underlying assumptions of the economic strategy have been almost entirely subverted: the result has not been sustainable development and credible institutions, let alone an end to Israeli occupation and establishment of Palestinian statehood in the context of a durable peace treaty with Israel, but rather chronic aid dependence. In its latest report issued on October 2, 2013, the World Bank estimated that Israel's direct control of 61 percent of the West Bank alone – not counting East Jerusalem or indirect control of the rest of the West Bank and of Gaza – costs the Palestinian economy USD 3.4 billion a year, or 35 percent of GDP.[37] The US and the EU might have salvaged the economic growth strategy by insisting on setting up formal enforcement and dispute settlement mechanisms so as to ensure proper implementation of agreed economic arrangements and to deter violations by enabling the application of appropriate sanctions. But they quickly abandoned the one attempt they made to establish a monitoring mechanism – originally included as part of the US-led Quartet's "Roadmap for Peace" of April 2003 – in the face of Israeli objections. Time and again, the deeper the crisis in peacemaking, the weaker international powers become in demanding political action, the greater their proclivity towards the purely economic option, and the more eager the acceptance of such plans by certain elements in the PNA and GoI, all of which has delayed serious political work for twenty years.

The IPE offers "a glimmer of hope" by proposing to focus on the private sector's recovery capacity, and integrate the economic component with an agreement that ends Israeli control, albeit incrementally and divided by sector-specific interventions. As stated above, the success of the IPE and, for that matter, any future economic development plan, rests entirely on maintaining the integral connection between economic development and the ending of Israeli control over the OPT. Without it, the initiative simply becomes the next tedious iteration of a failed strategy

35 Retreived from: http://carnegie-mec.org/2013/11/15/kerry-s-plan-for-palestine-economic-boom-or-occupation-bust
36 IBID
37 World Bank, "West Bank and Gaza: Area C and the Future of the Palestinian Economy," (October 2, 2013).

and contributes to an inherently degenerative status quo that will become harder and harder to reverse. The failure of the process of negotiations unfortunately foreshadows the failure of the IPE, which is fully reliant on positive political outcomes in order to entice investment, initiating a positive feedback of political change and economic development.

The integral relationship between political action and investment in the Palestinian private sector leads back to the policy arena, and to one central question: Does GoI intend to accept the IPE's full package of political and economic resolutions? This now seems very unlikely, since GoI has pursued a policy in recent years of enacting only limited changes on the ground that hold a primarily symbolic importance. In addition, the collapse of the most recent round of peace negotiations on the 29th of April, 2014 foreshadows significant difficulty in enacting an economic initiative that is only more complex than the failed negotiations.

This also presents the question of guaranteeing the fruits of these investments. Private sector investment is based on every businessperson making individual calculations and studies before embarking upon a project. The liberty of the private sector to invest or not weakens the outlook of the plan; while the experts at the OQR are working to secure investment, a critical mass of businesspersons' decisions to invest may never materialize in the turbulent currents of the political environment. The impossibility of guaranteeing that critical mass of investment means that the IPE might be forever condemned to beg for the toleration of the status quo while pointing to modest economic gains as evidence of forward momentum, making this latest economic proposal just barely promising enough to keep the international community on board.

Any projects perpetuated by the IPE, if implemented under the status quo without significant political changes, could also complicate prospects for a two-state solution as they would entail further Israeli interference within a relationship defined by Palestinian dependency. All of this would mean a distorted, dependent economy (even if it becomes stronger) and a lack of freedom of movement and development in accordance with independent national decisions and agendas. Hence, all of this will only serve as a recipe for renewed conflict.

The success of the IPE hinges on the ability of the Quartet, Kerry, and their allies to remove the political obstacles in the way of economic development; any success by the OQR in the economic realm must be accompanied by political steps towards eliminating the negative impact of the occupation on the Palestinian daily life, as well as on the doing business environment, hence eliminating the exorbitantly high transaction costs which eliminate the competitive capacity of the Palestinian economy, and invariably block the potential for any investment which is aimed at developing the economy.

6. Re-Envisioning the IPE for Greater Efficacy

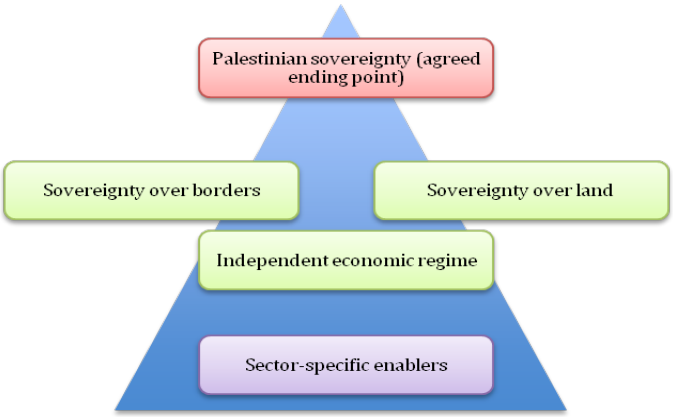
The IPE is inherently related to a political track and, as such, the success of the IPE depends largely on the ability of the OQR, PNA, GoI, and other key stakeholders to change the political environment. The only envisaged change in the political environment from The AIX Group's perspective is a move towards the implementation of the two-state solution, being the only acceptable solution on the table. The two-state solution as it clearly implies, means the establishment of a Palestinian State on land occupied by Israel in 1967, to exist side by side with Israel in peace and potential cooperation. Inherent within the concept of establishing a Palestinian

state are basic principles and issues to be settled in a bilateral agreement, including the issue of sovereignty, an agreed end point to negotiations, agreement on final status issues such as Jerusalem, borders, and other major issues.

While the IPE calls for a number of enabling interventions such as easing border restrictions on tourists coming to the OPT, streamlining the export procedures facing Palestinian goods, increasing power supply in the OPT, and ensuring access to land for key Palestinian sectors, these individual enablers do not build up to a unified strategy on Palestinian sovereignty over land, borders, and an independent economic regime, all of which are the basic building blocks and components for the envisaged two-state solution. When looked at in their totality, the many distinct enablers listed in the IPE all fall under the prime enabler of Palestinian sovereignty. These include the movement and access of people and goods, the utilization of Area C (including importantly the issue of Israeli settlements), access to natural resources, and the ability to construct Palestinian concrete mills and power plants (now desperately needed in Gaza).

The IPE must be re-envisioned to include a hierarchy of enablers that would orient intermediate enabling interventions towards the agreed ending point of Palestinian sovereignty. This ending point would also be based on key final status issues such as the status of Jerusalem and labor flows between the future states of Palestine and Israel. By creating a hierarchy of enablers beginning with Palestinian sovereignty and working down to specific short-term enablers to kick start economic growth, the IPE can utilize the concept of reverse engineering to arrive at the desired outcome. Enablers for the tourism, agricultural, light manufacturing, and power sectors (which are identified as the key economic sectors pivotal to the IPE) may be grouped under higher-level enablers such as Palestinian control of borders, Palestinian sovereignty over the land of the OPT, and an independent Palestinian economic regime.

Figure 6.1: Hierarchy of enablers, beginning with Palestinian sovereignty



6.1. Palestinian Sovereignty Over Tterritory and Borders: The Primary Enabler

As outlined earlier, the IPE can realize maximum positive affect by applying not only a sectoral approach to enablers, but also a hierarchy of enablers stemming from the ultimate need for Palestinian sovereignty over land and borders with an independent Palestinian economic regime as an integral part of the independent state of Palestine. The following demonstrates how key concerns raised by the IPE in a sectoral context in fact link back to the core enabler of Palestinian sovereignty,

whether in the tourism, light manufacturing, agricultural, and power sectors:
The IPE's strategy to encourage growth in the tourism sector includes encouraging tourism to the OPT from other Middle Eastern and Muslim countries (primarily religious tourism). The Quartet's March 2014 document states that more Arab and Muslim tourists might visit by "facilitating … access for visitors from Arab and Muslim [sic] countries".[38] While Israeli authorities do allow a small number of Arab and Muslim tourists to visit, the control of border crossings (especially from Jordan into the West Bank) and checkpoints separating the West Bank from the holy sites in Jerusalem is the primary concern constricting inflow of tourists. The sovereign control of borders with a balanced view between the economic growth potential of increased openness and the security concerns of monitoring entries is the underlying enabler of the Palestinian tourist sector.

In the same direction of sovereignty, the concepts regarding the IPE's analysis of the light manufacturing sector includes the concern of "unpredictable import and export processes". While these may encompass issues relating to the inability of exporters to plan due to poor infrastructure, wait times at crossings, and other logistic concerns, it also relates to the macro issue of an independent Palestinian economic policy that would encompass administrative procedures currently in place due to the joint customs union between Israel and the OPT. Issues relating to tariffs, exchange rates, and securing bank guarantees and letters of credit are greatly complicated by the fact that Palestine is not recognized by Israel, in many of these arenas as an independent international trading partner.

In the Agriculture sector, the IPE recommends that in order to make the agricultural sector more productive, it must have increased use of irrigation as well as increased access to land. The majority of the land in the West Bank (60 percent) is currently designated as Area C, which remains under complete Israeli control. The Palestinian agricultural sector could greatly benefit from these lands as well as the water and other natural resources contained therein. Without sovereignty over such lands, Palestinians are many times denied access to Area C, precluding its exploitation by the Palestinian economy.

Economic capacity and growth potential can be increased through facilitating power generation capacity in the Gaza Strip, where, before the deadly conflict of July-August 2014, there were frequent power shortages, 12 – 16 hours of daily electricity outages, and increasing demand for electricity from a growing population. The bout of violence in the summer of 2014 only three months after the Quartet released the summary of the IPE highlighted the severe economic consequences of political instability. The Gaza power plant was bombed by the Israeli Air Force during the course of the conflict, causing massive power outages and what some deem years' worth of damage to Gaza's power infrastructure. The IPE pre-conflict recommendation to "perform essential maintenance on [the] Gaza power plant" and to "build [a] gas pipeline to the plant," while no doubt important, now seems almost absurd given recent events.[39] This is perhaps the most dramatic example of the serious need to ensure political progress and stability before counting on economic gains.

6.2. The Importance of an Agreed Ending Point

While Palestinian sovereignty is the prime enabler, realizing immediate, full Palestinian sovereignty would prove politically difficult and could also engender instability. That said, the core enabler of sovereignty presented in section 5.1 reveals that pinpointed, unrelated enabling

38 Office of the Quartet Representative, "Initiative for the Palestinian Economy: Summary Review", 17.
39 Ibid., 39.

interventions will not build towards an agreed ending point and will see the IPE go the way of many failed initiatives before it. An alternative could take the form of concrete intermediate political steps aimed at an agreed ending point. While the IPE recognizes the goal of economic development geared towards paving the way for Palestinian sovereignty, the link between the political enablers, goals for economic growth, and the final picture, so to speak, is unclear. Re-structuring the IPE's suggested interventions to encompass midterm goals and an agreed ending point would set a specific action plan and link economic development with concrete political steps. This can be clearly seen in the following table, which outlines and mainstreams current problems with midterm goals oriented towards a final agreed ending point.

Table 6.1: Maintaining an agreed ending point alongside midterm goals

Sector	CURRENT PROBLEM	MIDTERM GOAL	AGREED ENDING POINT
Tourism	Restricted access at borders	Joint coordination of Palestine-Jordan border	Palestinian sovereignty over borders
Light manufacturing	Unpredictable export procedures	Install Palestinian customs officials	Independent Palestinian economic regime
Agriculture	Limited access to Area C lands	Transfer Area C lands to Areas A and B	Palestinian sovereignty over the land of the OPT
Power	Limited power supply in Gaza, limited domestic generation capacity in West Bank	Opening of Gaza Strip to encourage economic and political stability	Greatly increased domestic production through high-value investment in power infrastructure

The approach of setting an endpoint before embarking on a no-doubt difficult voyage adheres very much to The AIX Group's proposed strategy of reverse engineering as exemplified in The Economic Road Map. The need to make such an agreed ending point explicit and to design economic development initiative around it will help keep the IPE from going the route of so many failed initiatives before it, including most recently the negotiations that ended in the Spring of 2014. The details of any agreed ending point would be outlined through discussions with stakeholders and experts and goes beyond the scope of this paper. However, any sustainable final destination would provide a vision for key final status issues. These issues, some of which are outlined below, paint a more detailed picture of what Palestinian sovereignty in fact looks like.

6.3. The Status of Jerusalem

While the Kerry Plan addresses the tourism sector and other economic areas important to the West Bank, Gaza, and East Jerusalem economies, it does not explicitly address the loss to the Palestinian economy due to the isolation of East Jerusalem from the rest of the West Bank. While the Aix Group believes that any sustainable political agreement will divide Jerusalem politically between West Jerusalem/ Yerushalayim, the capital of Israel, and East Jerusalem/ Al Quds, the capital of The OPT, the united city has been part of Israel since the annexation of East Jerusalem in 1967 and the entire city has effectively been cut off from the rest of the West Bank in recent years since the erection of permanent checkpoints and increased restriction on Palestinian entry to the city from the West Bank. East Jerusalem's severance from the Palestinian

economy is not a loss for which the IPE's recommendations can compensate without integrating this political concern into an economic discussion.

The East Jerusalem private sector is the main driver of the local economy and would contribute greatly to the Palestinian economy as a whole if integrated into the West Bank. The potential of the East Jerusalem economy to contribute to a unified Palestinian economy and the negative feedback imposed by separation is highlighted by a review of the city's gradual separation from its Palestinian hinterland; before the signing of the Oslo Accords in 1993 the East Jerusalem economy constituted 15 percent of the Palestinian economy. This has shrunk to around 7 percent in recent years due to lack of development compared to the rest of the Palestinian economy, and also due to an estimated USD 1 billion in losses to the East Jerusalem economy as a result of the separation wall. The enduring losses due to the wall, which bisects the greater Jerusalem metropolitan area and thus limits trade and labor opportunities, are estimated at USD 200 million every year.[40]

UNCTAD also notes that the East Jerusalem economy is effectively neither part of the West Bank economy nor the Israeli economy, forcing it into the uncomfortable position of being dependent on West Bank production, trade, and employment (despite the hurtles imposed by the physical barrier) and dependent on Israeli market regulations and the remunerations from employees working in West Jerusalem and the rest of Israel. Even with a low labor participation rate of 37.2 percent, the Arab East Jerusalem labor force consisted of 64,000 people in 2011, which would represent 30.5 percent of the Palestinian labor force if added to that of the West Bank.[41]

The main economic sectors in East Jerusalem are housing and construction, tourism and transportation, small to medium size manufacturing, and retail and commerce. East Jerusalem was home to 5,921 economic establishments in 2005, compared with 5,135 in 2001.[42] The public sector revenues of East Jerusalem are transferred to Israel rather than the West Bank, representing an added loss for the PNA, as cited by the World Bank in 2012 in its report entitled "Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth". So long as the economy of East Jerusalem remains stagnant and physically isolated, the rest of the Palestinian economy will not realize its full agglomeration potential.

While Jerusalem poses an economic and political problem from the perspective of borders and lost markets, the creation of two capitals out of what is currently considered to be one city has strong bearing on the economy of both future states and capitals. That said, East Jerusalem's contribution to the Palestinian economy would be critical even in its current form, let alone with the multiplier effect of removing the economic barriers imposed by the separation wall, which would allow the East Jerusalem economy to fuel and be fueled by that of the West Bank. Losses to the Israeli and Palestinian sides of Jerusalem due to eventual separation could be offset not only by the gains realized by East Jerusalem's integration into the West Bank but also provisions for the passage of goods and workers between the sides for an extended but fixed period of time based on those transactions and labor flows present at the time of separation as well as the prevention of current black market activities.

40 UNCTAD, "The Palestinian Economy in East Jerusalem: Enduring Annexation, Isolation and Disintegration," (2012).
41 Palestinian Central Bureau of Statistics, 2012; Arie Arnon and Saeb Bamya, Ed, Economic Dimensions of a Two-State Agreement Between Israel and The OPT (Aix, November 2007), 38.
42 Arie Arnon and Saeb Bamya, Economic Dimensions of a Two-State Agreement Between Israel and The oPt, 41.

There are several options for the establishment of an economic and political border between East and West Jerusalem. A Divided City would feature a political border doubling as a physical border between the two cities. An Open City would be characterized by free movement of people and goods between the two cities. The third option is a Semi-Open City that has a political and physical border between the two cities but has a shared core, which would most likely be comprised of the Old City of Jerusalem. Different provisions for the flow of goods and labor can be designed to cater to each of the final status options.

While these final status issues are key to guiding sustainable economic plans towards a lasting peace, the IPE cannot directly touch such issues as an economic initiative. The final status of Jerusalem depends on a macroeconomic decision regarding the status of the Customs Union, which in turn depends on the final political status of Israel and The OPT. Even so, highlighting such far-sighted issues will guide the IPE towards concrete goals that tie political realities to the economy.

6.4. Labor Flows

The labor market in the OPT is structured unsustainably. Mirroring the OPT's output profile, the distribution of employment among various sectors reveals an emphasis on public and non-tradable sectors and weakness in the productive industries. This comes on top of a slowly decreasing, but still high level of employment in Israel and a very high rate of unemployment in the West Bank and Gaza Strip. Moreover, labor productivity in the OPT is inadequate,[43] certainly considering that the wages there are higher than in competing countries.[44] In the past there was a feeling that the low wages in the OPT , combined with the relative high (compared to other countries in the third world) levels of skilled workers would provide a positive incentive to attract investments in labor intensive industries. In order to achieve this goal (and others such as reducing domestic unemployment and diminishing the over-dependence on the Israeli economy), recommendations were floated to gradually decrease the Palestinian employment in Israel so that real Palestinian wages would slowly fall and generate the development of comparative advantages and export goods in the Palestinian economy. The process was expected to take place over time in order not to impose a sudden decrease in incomes, especially when the Palestinian economy was not yet ready to absorb the extra workers who were previously employed in Israel.

The Palestinian economy will have to adopt a different strategy of development in light of the current labor flows. A process of phasing out employment of Palestinian workers in Israel will cause a decrease in wages that will lead to rising levels of poverty and inequality, even if domestic employment will improve. Therefore the investment policy will have to be geared at developing production in industries that are not necessarily labor intensive, do not rely on low wages and do not compete with low wage economies. Given the small size of the Palestinian economy, the OPT will have to develop production in niches where the advantage will be in specific know-how, in specific human capital and even in specific technologies. They will be based on exports mainly, but not exclusively, to neighboring markets (including Israel).

These products (as mentioned in the 2012 World Bank Report) might be both final and intermediate goods and services in order to take advantage of the fact that most international trade involves goods and services in the chain of production. They should not require large-scale pro-

43 See our chapter in the Aix paper entitled "The Cost of Occupation", 2014.
44 See World Bank (2012), 92.

duction, in order for the economy to avoid the heavy and risky concentration of its productive sector. If and when such scheme of production will evolve, it will not be based on low wages and on the permanent prevalence of poverty and inequality. Nevertheless, it will attract business investments from domestic and foreign capital formation to potentially competitive industries, thus will contribute to labor and total productivity, will ensure a stable level of employment and, at least, a reasonable standard of living.

6.5. Impediments and Restrictions on International Trade

The trade regime and the question of economic borders have a direct bearing on the political arena both before and after a permanent settlement. While there is currently a customs union in place, the debate on this issue has ranged on a continuum from a full economic union at one extreme through a custom union (CU), a free trade area (FTA) to a non-discriminatory trade policy (NDTP) agreement. The phased establishment of an independent Palestinian Customs Territory, however, would allow the PNA a much wider scope for the application of autonomous economic policy measures that would leverage economic development rather than hinder it with uncoordinated policies (see section 3.2.1)

The trade regime between the two future countries has a strong bearing on the comparative advantage of the two economies. For instance, the CU does not cater to the OPt's competitive advantage in labor because it makes the OPT a captive market. That said, the CU represents a potential benefit to the high-tech industry in the OPT.

As a result of the final decision to impose a de-facto CU, while the PP transferred some sovereignty to the PNA, the PNA has very little control on trade on the ground nor over fiscal policy. This fundamental lack of sovereignty over fiscal planning and economic policy underlies the weakness of the Palestinian economy. Currently, the Bank of Israel decides on the interest rate applied both in Israel and in the West Bank, though it does not doesn't take into account the different economic reality in the West Bank. Because the PNA has little sovereignty in fiscal matters, this decision is made unilaterally by Israel, ostensibly to meet Israeli needs.

Compounding the problem is the fact that the PNA does not print its own currency. This means once again that the PNA cannot set interest rates, but also means that it has no control over its exchange rates. The lack of economic sovereignty over these matters implies that Palestinian economic policy cannot be optimized because the PNA has little say in the matter and adjustments are made in the interest of the Israeli economy alone. If the OPT had its own currency, its interest rate would adjust sharply to be more appropriate for the economic reality in the West Bank and Gaza Strip. In addition to the problems stated above, banks in the West Bank and Gaza Strip work through the monetary authority with the Bank of Israel, incurring many transaction costs that don't exist for Israeli banks.

Critical issues that may be addressed under economic sovereignty would include the power to apply autonomous indirect taxation policies, which would allow the PNA to adapt indirect taxes to the conditions of the low-income Palestinian economy and protect immature and key industries alike. The power to implement trade diversification policies would bring the prices of basic products and the cost of living in the OPT as a whole to the level of comparable neighboring countries such as Jordan. Palestinian sovereignty over economic and political borders would also allow the PNA (or more likely its successor government) to directly collect and refund tar-

iffs (as opposed to relying on Israeli customs authorities which slows business processes), set its own import lists to allow for greater trade with the Arab world, and allow for more rapid and predictable border crossing procedures.

As mentioned before, the decision to change the infrastructure of international trade, from determining the proper economic regime to the Palestinian control of borders, lies squarely in the political arena. Nevertheless, such forward-looking considerations can help direct an economic initiative such as the IPE towards fruitful and important areas of focus to pave the economic path to final status agreements of a political nature. The IPE as it stands does not fully incorporate the importance of such issues.

6.6. Control of Area C and its Resources

While the IPE addresses the importance of agriculture and light manufacturing for the Palestinian economy, it does not devote significant attention to addressing the need to release land to encourage the growth of these two sectors as well as many others.

The Palestinian economy is endowed primarily with unskilled labor, perhaps most prominently in the agriculture sector. This endowment of unskilled labor can be leveraged towards existing sectors, as proposed in the IPE, and can in the future be expanded towards light manufacturing as the sector emerges as a major player in the Palestinian market. The emphasis on agriculture and eventually the expansion of light manufacturing in the West Bank means that non-urban open areas are economically important. In reality, however, the division of the West Bank into Areas A, B, and C, means that lands ideal for the incubation of the OPT's competitive advantage in unskilled labor and other non-skilled, labor intensive sectors are unavailable for use due to Israeli restrictions on access, tenure, and development.

The major natural resources needed for agricultural production are land and water. This is assuming that human resources and capital are available. The problem of water scarcity seems to be partially solved with water desalination and sewage water treatment. But while the IPE addresses these issues as enablers, it does not highlight sufficiently that without land none of the inputs to agricultural growth will lead to development. Indeed, while the Jordan Valley can provide large swathes of land, much of it is currently underutilized due to Area C restrictions. While the combination of these factors along with the appropriate technologies and investments could transform the Jordan Valley and other areas of the West Bank into prosperous sources of food and agricultural products, the political reality imposes serious impediments. Even though the economic opportunity is ripe for the taking, the lack of a political plan or agreement makes this impossible.

Among the top export market products produced in the West Bank are oranges and cucumbers, emphasizing the need to release Area C lands for use by the Palestinian economy for further agricultural utilization. These agricultural products are second only to the stone industry, which also requires open land in Areas B or C for processing and storage facilities.[45] The Pal Trade top priority sectors for development include footwear, leather, textiles, metal products, and plastics, all light-manufacturing sectors that, like the agricultural and stone sectors, will need open land in opportune areas on the outskirts of urban centers or near border crossings.

45 UNCTAD, "Rebuilding the Palestinian Tradable Goods Sector: Towards Economic Recovery and State Formation" (New York and Geneva, 2011).

The Civil Administration only allows Palestinian construction in less than 1 percent of Area C, which greatly increases the cost of land and infrastructure.[46] This stunts the Palestinian economy by precluding large swaths of land from investment and development and driving up the price of the few registered, developable plots (in Ramallah land for development costs USD 100-200 perm2), negatively affecting light industrial sector growth. Suitable land for industrial parks and development is mostly in the vicinity of checkpoints and crossings, although often in Area C, making it difficult or impossible to obtain the proper documentation for development.

The difficulty of obtaining new land or developing land already in one's ownership has stunted the growth of many Palestinian businesses. It is common to see small business owners operate their enterprises out of a front room of their home due to the difficulty of scaling the enterprise up into a separate building or relocating to another plot of land. This lack of suitable land for businesses and industry will continue to impose restrictions on the development of not only agricultural enterprises on open area C land but also light manufacturing businesses looking for area to locate warehouses on the outskirts of urban centers.

Even though water is already available to Palestinian agricultural and light manufacturing enterprises, there exist difficulties that stymie potential economic growth. The World Bank has documented the negative impact of water price and restrictions on businesses, in part due to the fact that water infrastructure often must cross Area C.[47] The Joint Water Committee (JWC) that was established under Oslo II, remains active to this day. Israel has veto power on the JWC, which is responsible for the management of all water resources and systems in the West Bank and imposes a high rate of denials to Palestinian requests for extended infrastructure or new water projects. In addition, the tariff structure for water consumption in the West Bank, Israel, and Gaza are such that low Palestinian consumers, who may be the least able to pay utility bills, cross-subsidize low Israeli consumers. That said, high Israeli consumers also cross-subsidize high Palestinian consumers (which would presumably include Palestinian industries).

Table 6.2: Price for one cubic meter of water in NIS

Consumer	Low Price (Basic Consumption)	High Price (Elevated Consumption)
Ariel / Karney Shomron (Israeli West Bank settlements)	1.556	5.734
Givatayim (Israel)	1.408	5.678
West Bank (Palestinian consumers)	2.64	2.64
Gaza (Palestinian consumers)	2.38	2.38

Source: Elisabeth Koek, "Water for One People Only: Discriminatory Access and 'Water-Apartheid' in the OPT," Ramallah: Al Haq Organisation. 50; Amir Hass, "Palestinian Authority: Israel violating Oslo deal on water prices,"Haaretz, October 11, 2012.

Like the issue of impediments to trade that call for a political consideration of Palestinian sovereignty from the Israeli economic and trade system, the Israeli control of large swaths of the West Bank to the detriment of the Palestinian economy's competitive advantage again raises the political question of Palestinian sovereignty over land in the West Bank and East Jerusalem. While a plan such as the IPE may face dim prospects by recommending from the start full Palestinian independence as a starting point, it faces even more difficulties if it does not raise

46 World Bank, "West Bank and Gaza: Area C and the Future of the Palestinian Economy" (Poverty Reduction and Economic Management Department, 2013), 15.
47 Ibid., 31

the issue at all within the framework of its economic considerations. Because while Palestinian independence without provisions for economic growth is a recipe for instability and unrest, a plan for Palestinian economic development without provisions for Palestinian independence is a recipe for equivocation and inaction in the political sphere.

7. Conclusions and Recommendations

The Initiative for the Palestinian Economy proposed by the Middle East Quartet holds potential promise for invigorating the Palestinian economy while realizing political change that would lead to Palestinian statehood. That said, the track record of such economic initiatives over the last twenty years is not encouraging due to the perennial problem of convincing the Government of Israel and the Palestinian National Authority to enact political steps to encourage economic development and reach a conclusion to the Israeli-Palestinian conflict.

Economic initiatives aimed at enhancing the Palestinian economy must be rooted in a real political process that brings out the potential for reaching a resolution to the conflict and the implementation of the two-state solution. Until now, all the economic initiatives have been aimed at alleviating the impact of the lack of a solution and the negative results of the occupation on the Palestinian economy. What is required is an economic initiative that accompanies a political process that clearly leads to the implementation of the two-state solution, including the creation of a business-enabling environment within the realm of issues to be tackled on the political side that would influence the spurring of economic potential for Palestine.

While the IPE proposes many prudent political enablers as part of its economic vision, it does not recognize the central and basic importance of Palestinian sovereignty from which all other enablers stem. This paper suggests that the IPE present a hierarchy of enablers to both determine an agreed ending point and devise a series of intermediate enabling interventions that would build towards that goal. The agreed ending point would have to be outlined in detail and encompass key final status issues. The following summarizes this proposed strategy:

> **Create a hierarchy of enablers and set an agreed ending point:** By creating a hierarchy of enablers that begins with Palestinian sovereignty and works down to specific short-term enablers to kick start economic growth, the IPE might inspire more confidence and offer an action plan to address key political barriers to economic growth and Palestinian independence. Enablers for the tourism, agricultural, light manufacturing, and power sectors may be grouped in the IPE under different higher-level enablers such as Palestinian control of borders, land, and an independent Palestinian economic regime. This hierarchy also would encompass an agreed ending point including intermediate enablers to create momentum towards Palestinian independence. This agreed ending point would be based on several economic-political pillars, including the following:
>
> > **Create a plan for the status of Jerusalem:** The economic importance of Jerusalem for both the Palestinian and Israeli economies is critical and must be taken into account in any consideration of the West Bank economy as well as peace between Israel and the OPT. Creating a plan for the separation of the city into the respective capitals of Israel and the OPT is an economic necessity for the West Bank economy and a political necessity to reach a lasting peace agreement.

Ensure continuation of labor flows with provisions for slow disintegration: While Palestinian labor flows into Israel is currently an underpinning part of the Palestinian economy, the political and economic necessity to create two independent states raises the need for specific plans to avoid an abrupt end to labor flows (especially within Jerusalem) while acknowledging that these flows must eventually end as the Israeli and Palestinian economies evolve from an undeveloped economy dependent on a developed economy to two independent economies.

Outline provisions to alleviate impediments and restrictions on international trade: There are many bottlenecks to economic growth in the OPT that will slow the implementation of any economic initiative and continue to suppress existing economic activity and entrepreneurship. These exist in part due to Israeli restrictions on Palestinian trade stemming from Israeli control of borders, and also Israeli administrative frameworks such as the joint customs union which Israeli and the OPT now share. The IPE can set a political path alongside its economic interventions so that Palestinian leadership might assume the economic responsibilities now fulfilled by Israel in the OPT and, in so doing, realize Palestinian sovereignty over the Palestinian economy and, by default, over Palestinian borders. This consideration would expand the IPE to establishing the basis for Palestinian political independence alongside economic development.

Ensure the eventual full transfer of Area C and its resources to Palestinian control: Like the issue of impediments to international trade, Palestinian economic growth can only reach a certain point without greater Palestinian access to land and resources locked in Area C. The IPE can propose a staged transfer of lands to the PNA so that the Palestinian economy might reap the resources therein and form a growing territorial basis for a Palestinian state with full sovereignty over the area within its concurrently established economic and political borders.

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Palestine - Israel Relations: Alternative Visions for the Future

Looking Ahead – Alternative Strategies towards a Final Status Agreement

The AIX Group

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Preamble

Palestine – Israel And The Status Quo: Is It Viable?

There are two people living in Palestine\Eretz-Yisrael. It is the land between the Jordan River and the Mediterranean Sea,. Since, the Balfour Declaration of November 1917, the conflict and thoughts about finding a resolution, have never stopped. Since then, on both sides of the divide among the indigenous population, as well as the incoming waves of immigrant communities, political debates which at times were violent, intertwined with domestic debate over the nature of the conflict and ideas about its resolution. The issue of accepting the reality of two living on one, small land, while both seek self-determination, was at the core of debates. The issue of partition, enabling the right for self-determination for both, emerged as a central focus.

For both, partition was not a preferred option during the formative years of the Mandatory British rule. On the critical date – 29.11.47, when the UN General Assembly voted in favor of expiry for the British Mandate and the partition of the land into two separate and independent states, a war break out. The majority in the Jewish leadership chose partition while the majority in the Palestinian Arab leadership refused it Sixty years later, we are having a mirror image: The majority in the Palestinian leadership has based its entire political vision on partition. The majority in the Israeli leadership is refusing it. Given that partition, is the only realistic path to achieve a self-determination for both, Israelis and Palestinians and a solution for the Arab – Israeli conflict, we have to change this political reality.

Is the Status Quo viable?

The two essays which follow, will take a look at this issue from two different aspects. Dr. Karim Nashashibi, a senior economist who escorted the fledgling Palestinian economy since its re-inception in the Paris Protocol which was embedded in the Oslo Accords, will take an analytical look at the economic aspects of the question. Mr. Ilan Baruch, who took active part in the negotiations with the PLO, when in government service, and later as a political observer, will examine the issue of Status Quo in comparison with other alternatives which are debated in the Israeli political conversation, wish the pros and cons from an Israeli point of view of the different options.

The Present

In July 2013, Secretary of State, John Kerry, offered two protagonists in the Holy Land a last chance to entertain American facilitation of negotiations on a comprehensive peace agreement, which could lay the foundation for the transformation of Palestine – Israel relations from occupation to peaceful neighborhood. Negotiations were launched after a number of commitments that were taken by both sides. The talks were time framed, and the two sides vowed to leave all media handling to the American hosts.

By April 2014, the Kerry Initiative was grounded, primarily as a result of Israeli failure to respect its commitment to release the fourth batch of prisoners. Pundits warned of the vacuum caused by what looked like a collapse of the American initiative, even more – the American appetite to get proactively involved, beyond the obvious minimal containment of the conflict. Soon after, three Jewish students were kidnapped and murdered in the vicinity of Hebron. This led to a large military operation conducted by the IDF, with a dovetailed mission to find the three and their kidnappers, along with a retaliatory operation against Hamas on the West Bank in its entirety. The move against Hamas included the blocking of money transfers to Gaza banks in the payments of salaries to Hamas personnel. This accelerated tension, which in its turn, ignited the Gaza border, lead to the eruption of the Gaza War, a military conflict, resulting in catastrophic loss of life and damage in Gaza, but with no clear transformation of the security climate and no clear victory for Israel.

The international community has committed itself to large scale reconstruction operation in Gaza, with the PA as the principal recipient of the funds and provider for the Gaza Strip humanitarian needs as well as infrastructure and housing reconstruction and development projects. In the meantime, while embarking on a negotiation mode, attempts were made to consolidate the ceasefire in the Gaza Strip and create conditions conducive to humanitarian aid as well as extensive reconstruction efforts. These efforts were halted as well. In spite Donor conferences that took place in New York (AHLC) and Cairo (Arab states), pledging some USD 7 billion, very little has been implemented so far. Negotiations conducted under the helm of the UN provided the parties with agreed procedures, to be overseen by the UNSG Rep. in the region, and which should regulate transfer of building materials directly to building contractors, denying Hamas any such materials for the reconstruction of military underground tunnels and any other military infrastructure.

Among the barriers to any accelerated rehabilitation and reconstruction of Gaza one can add the lingering rift between the Palestinian Authority in Ramallah and the Hamas leadership in Gaza, failing to allow a smooth operation of the Joint Government of Prime Minister Rami Hamdallah. Inconsistent salary transfers to Hamas government service employees, including the armed wing recruits, insufficient electricity supplies, water, fuel, and municipal services, intense unemployment, lack of food security, all contribute to the stressful life in Gaza, which is leading to potential explosion.

Egypt, in its resolve to stabilize the security situation in the Sinai, where it believes terrorism instigated by local tribesmen is inflamed by pro-Islamic Brotherhood collaboration with Hamas. Hence the Egyptian decision to evacuate and knock down that part of Rafah City adjacent to the border with Palestine. It is currently embarked on creating a cordon sanitaire by totally destroying the tunnels which had been dug under the border into the Palestinian Rafah City.

When it comes to the West Bank and East Jerusalem, it seems that while the Netanyahu government is leading Israel towards the de facto annexation of Area C and consolidate its hold on East Jerusalem, approximately 60% of the territory designated to become Palestine. The Palestinian leadership is adamant to commit itself internally to the consensus coalition government, including Hamas affiliates, and externally – towards the international community, hoping to gain a leaning point which allows a leverage effective enough to shift the Middle East conflict from debilitating bilateralism into the dynamics of multilateralism. This is seen in Ramallah as an effective prescription for moving forward with the hope of salvaging the Two State Solution paradigm. Parallel to the Palestinian initiative to advance its agenda in the UNSC, we see a deep plunge in the Israeli standing both in the US and the EU, with a Swedish official recognition of the State of Palestine is driving a new wave of support for Palestine in the EU. We witness a far more assertive Brussels towards Jerusalem on economic issues, developing a rather new emphasis on "sticks" toward Israel, compared with the language in place up to two years ago which was accentuated "carrots".

On the Middle East scene, we see a shift of world alarmed attention to the collapse of Nation States as the overriding political phenomenon, caving in to the tribal or radical Islamist thrusts like ISIS and Al Quaeda, thriving on religious Shia vs. Sunna schism and the vacuum created by violent revolutions and wars. In the aftermath of the Arab Spring Libya, Syria, the Yemen and Iraq are showing clear signs of loss of controlling powers of central governments and of territorial disintegration. Such tendencies interfere with the Palestinian attempt to regain international attention, in itself a cause for concern in light of the tendency to revert to violence. Jerusalem has seen in recent weeks a surge of such bottom up violence, which is in most cases the making of deeply frustrated anonymous individuals who resort to terror.

Methodology:

Against this backdrop, our study will look at a set of visions for the future relations between Palestine and Israel with a comparative analysis. The political conversation in both societies carries a variety of options, which are a blend of political observations analyzing the present reality, with policy planning for the future. Some of it is more realistic, while others are Utopian. We will concentrate on the following:

1. Status Quo. Allowing the current political situation to prevail, with no negotiations bound for a change in the nature of Israel – Palestine relations. Status quo stipulates a continuous and transformation of the West Bank and East Jerusalem into a de facto part of Israel, while the Palestinians keep on controlling to a limited extent the autonomous regime in about 40% of the land mass of the West Bank in addition to the Gaza Strip.

2. Unilateral Disengagement: Within the Israeli political conversation there are several versions to this paradigm of partial and unilateral withdrawal. By and large, this school of policy planning stipulates withdrawal by Israel from segments of area C to allow contiguity for Palestinian controlled areas A+B. The Beit Yehudi party leaders argue that Israel should assume full annexation of the South Hebron Mountain Range, Jordan Valley and East Jerusalem. On the other hand, some protagonists in the Israeli peace camp are advocating a second interim agreement, suggesting that none of the two leaders, Abbas and Netanyahu, can garner sufficient political support domestically for a final status agreement. But both, however, are facing pressures on the security and diplomatic levels

to move forward. If they are convinced that negotiating such an agreement will allow security and political relaxation of tensions, steering the region away from explosive escalation, they might find a common ground serving the long term interests of both. Such an arrangement could include the transfer of territory from area C to area B, from B to A, upgrade the Paris Protocol, renewal of security cooperation concerning trade between Gaza and the West Bank, and other issues.

3. One State Solution: The entire territory comes under the single shared sovereignty, shared governance, shared economy and shared security. This includes one option which is currently discussed in peace activist circles, namely the Two States in One Space solution, in which the entire territory comes under two separate governments, ruling two separate peoples on a shared territory.

Needless to say, it is hardly possible that a Palestinian leadership at present or in the future would be prepared to consider such an option, let alone negotiate it as a solution to the Palestine – Israel conflict.

4. Two State Solution: Agreed partition of the territory into two separate sovereignties, agreed end of occupation, establishment of Palestine in a stable and prosperous neighborhood with Israel. Reconciliation. Peace.

It will comparatively examine the three scenarios above in light of the following principal aspects:

- Internal scope: consequences and options.
- External scope: on the social and political scene.
- Security scope: consequences and options.

Alternative Visions For The Future:

1. Status Quo:

Given the fact that this policy is currently unilaterally executed by the Government of Israel, its implications for Palestine are bleak: continuous and consistent erosion of the feasibility of gaining statehood in the foreseeable future. For Israel, this means a growing risk of losing its credibility in the international community, facing a rising and universal boycott movement, while security instability persists. Economically, the vital lines of communication, international finance and export markets are threatened by chronic corrosion.

Israel:

Closing on the 50th anniversary of the occupation of the West Bank and East Jerusalem, with nearly 10 percent of the Israeli citizenry residing on occupied territory. The very fact that this territory is under occupation does not meet the minds of most Israelis. If the Israeli population in 1967 was less than 3 million strong, it is 8.5 today. The vast majority of Israelis never experienced living in Israel within the Green Line. This majority either immigrated into the country, or was born here after 1967. The line demarcating the territories from Israel itself have been under constant erosion from the collective political psyche ever since, either spontaneously of as the result of an effective political drive, to build up a constituency for which the land belongs to the Jews and any concession on it is detrimental to the security and stability of Israel. One brand of Israeli religious nationalism produced a political force tightly dedicated to annex, by means of settlement activity blended with political activism, the entire territory of the state of Israel. Its leaders, mostly rabbinical, are entertaining visions of expulsion of the Palestinian population to Jordan, or allow them minimal political, social and economic sovereignty over a limited space, roughly 40 percent of the West Bank and the Gaza Strip, while the rest becomes part of Israel.

Internal Scope:

The Israeli society is currently undergoing a stressful crisis over identity issues. Legislation motioned by Nationalist parties, reflecting a notion that the Jews in Israel (and abroad) entertains exclusivity over the right of indigenousness in the land, while Arabs are entitled to equal rights as citizens of Israel, but not as an indigenous people on their land, has important ramifications on the way the West Bank and Jerusalem are perceived by Jews and Arabs alike. The absence of a border demarcating where Israel ends and Palestine begins generates an expansionist drive, judging the intrinsic military advantage Israel entertains as an opportunity to implement, while the Palestinian community in Israel itself is developing a separate conversation. Palestinian flags are hoisted in football tournaments as well as political rallies. Issues of loyalty to the State of Israel are increasingly debated. The absence of a demarcated partition is at the root cause of increasing tension between Arabs and Jews within Israel itself.

Jerusalem is another area of endemic stress. Tensions in and around the Temple Mount are increasing, as the result of consistent efforts emanating from extreme religious Nationalists, with the tacit support from the government and City Hall politicians, to change the status quo. Such dynamics radiate corrosive forces into the West Bank as well. Arab communities are increasingly threatened by potential acts aimed at their forced removal and community eradication.

The settler society has entrenched itself, throughout the last three decades, in every form of government. There is a notion in the air, that the settler establishment is convinced that this is

the golden opportunity to change the status of the City of Jerusalem forever. To change it from a multinational multicultural and multi-religious urban center, into the exclusive undivided and the monochromatic Capital City of Israel.

External Scope:

Since March 2009, the time when the second Netanyahu government took office, it has been consistent in its quest to drop the Oslo paradigm, which is based on the commitment to pursue a Two State Solution, and developed an alternative paradigm. This is based on the notion that the Palestine – Israel conflict cannot be resolved in a way which serves Israeli expansionist visions, without a price too high to pay. Against this backdrop, the government developed the strategy and tools for the implementation of conflict management rather than conflict resolution. The Netanyahu - Lieberman team, later Netanyahu – Lieberman – Yaalon - Benet team, developed a policy , which aspires to achieve a fundamental transformation of the traditional pro-peace partition agenda to a nationalist and ethnocentric agenda of conquest. Security based on reconciliation is now totally removed from the political debate in Israel, as well as from its diplomatic efforts overseas. If hitherto the prevailing perception of the Palestinian National Authority (PNA) was of a temporary autonomous entity and its president Abbas as a credible partner with whom Israel could conduct negotiations for a final status agreement. The current policy is based on the perception of the PNA as a plausible collaborator in an "ad hoc" sustainable long term arrangement, not time framed but purpose framed – Israeli security. This political design is based on the Acxiom, which is adopted by the nationalist government, state that a Palestinian sovereign state alongside Israel harbors by definition a security threat to Israel, and that Israeli security is overriding any Palestinian considerations for self-determination.

This strategy is veiled by political ambiguity and arguments concerning the lack of feasibility of a viable state of Palestine to emerge out of a peace process. A careful analysis of the formative speech Netanyahu delivered at Bar Ilan University (June 2009), shows there is no distinct message of adherence to the Israeli official commitment to the Two State Solution, even though spin doctors managed to instill in the collective minds of even the shrewdest observers the notion that he is committed to the partition of the country. But the truth is, that

Netanyahu, consistent in his political speeches, including the one he delivered in Bar Ilan, shows dedication to educate the world that the Land of Israel exclusively belongs to the People of Israel, and there is no other nation which is entitled to the rights of indigenous in this country, namely the Palestinians.

Netanyahu designed Israel's relations with the major players overseas based on the notion that the Palestinian issue could be removed from the center stage, by applying two principal codes. The first was directed towards the Palestinians and claimed negotiations on a peace agreement are to be based on the principle of "no preconditions". It took a long time before the Palestinians realized it will be too costly for them to condition their entry into the negotiation room with a clear vision of what will be discussed once the negotiations are underway, with the clear demand to deal first with the borders. A long period of informal deliberations in Washington and Amman ended with disappointment. The Israeli side refused any demand for a reference to borders, let alone the 1967 borders as the base for further negotiations. The second ploy was the Iran card. Netanyahu managed to dictate to the international community a clear preference in prioritizing the Iran case over the Palestine case. True, the Iranian potential nuclear threat

towards Israel is a genuine concern and carries a greater merit. However, the end result of five years in office, is that the Netanyahu government managed to deflect pressure from the US and the EU and divert attention of the world agenda towards the theater farther afield – Iran, and away from the closer one, Palestine.

The status quo served the Netanyahu government well. It allowed a relative stability in his home political front as well as the security front, without paying a price too high on the external hemisphere. This was made possible by the very effective advocacy in the US, on legislative level and the media, while intense and escalating stress in its relations with the White House. This strategy brought the relations between Israel and the Obama administration to unprecedented depression of credibility and high levels of negativity, which is considered by most commentators as a serious impediment to the national security of Israel, and the ability to promote any peace process. This phenomenon evolves in spite of the consistency and intensity by which officials on both sides are quoted expressing loyalty to the outstanding partnership between the two countries. This dangerous tension in US-Israel relations are characterized mainly by the personal rift between president Obama and Prime Minister Netanyahu. This divide seems to stay with us as a political fixture, as long as both are in office. It could see a marked shift only if the status quo is replaced by a bold political initiative, which is aimed at breaking the Middle East impasse. Such a shift looks unimaginable unless the Netanyahu government is replaced by Labor led coalition in the March 2015 elections.

Increasingly, we find in the media abroad a reflection of the stress developing around the issue of the donor countries footing the reconstruction bills of the wars between Israel and Hamas. This phenomenon is coupled with the long standing claim, which echoes in official circles and diplomatic missions, of donor fatigue, or the reluctance governments in Europe detect in their support base when it comes to tax payers money being diverted to sustaining the Palestinian economy. However, it is evident in diplomatic talks, that any navigational change from the status quo to a permanent and viable political solution would markedly benefit both Israel and Palestine, and could ameliorate relations with the United States and the European Union dramatically.

The European Union is also developing a new phase in its fundamental perceptions of its relations with Israel. Since 2012, we see political statements issued by the Council of Ministers, which suggests a shift in the way the Israeli government and its policies are being judged, when it comes to the West Bank and East Jerusalem: the land grab and expedited settlement activities, as well as manifestations of human rights violations, forced evictions of Beduine communities in Area C in the Jordan Valley and South Hebron Mountain Range, as well as house demolitions in East Jerusalem. While on official country level and in Brussels, the slow movement of negotiations over guidelines and directives concerning the Israel/Palestine are being met by a far more dynamic commotion in the campuses and on the streets. This environment is open to a surge in demonstrations, condemnations, at times exploited by activists who serve another agenda, mixing anti-Israel with Anti-Semitism. Beyond this we find increasingly more cases of BDS (boycott, divestment, sanctions) with frequent calls for the boycotting of Israel itself and not only the settlements of the occupation of the West Bank and East Jerusalem. Campuses abroad, mainly in the UK, and also in the European continent as well as in North America, we see a distinct shift into a gathering tide which is critical of the occupation.

The puzzle articulated above, suggests that the status quo policy, which is leading towards the abolition of any chance to implement the Two State Solution, is triggering an international movement towards public opinion and even diplomatic isolation of Israel, as a means to generate balancing pressure on the policy navigators in Jerusalem. The up and coming elections, due on March 17th 2015, indicate political unrest, which has to do with a variety of reasons, of which the mounting international pressure is not the least.

Security Scope:

The status quo is maintained and balanced by the application of deterrence. The IDF, GSS, Police, armed settlers, are positioned throughout the West Bank, dictating a stressful stability. To that one, should be added the tight security cooperation Israel receives from the Preventive Security of the Palestinian Authority, as well as the Police and other security organs. This phenomenon is the result of an American post Second Intifada initiative, to strengthen the Palestinian Security capacity by training and funding, coupled with an operation to induce members of armed groups controlling the old urban centers (Kasbahs) and refugee camps of the West Bank to give up their arms and join the Police forces.

Such a formula is excluding Hamas, Palestinian Islamic Jihad and other armed organizations. The split dictated by Hamas in 2007, taking over the Gaza Strip and establishing a separately governed enclave, led to the creation of an entirely different regime in the military relations between Israel and the two Palestinian governments. While in the West Bank the security bodies developed interdependency, in the case of Gaza, a standoff deterrence/retaliation relations led to endemic instability and the occasional eruptions of open military conflicts.

While the PNA collaborated in the creation of an intelligence network aimed at the joint resolution to clamp down on Hamas and Islamic Jihadists, in Gaza the conflict transformed into a war of attrition. Israel developed an international commitment to deny Hamas any access to the diplomatic world, as long as it does not abide by the three "gate principles" of the Quartet: recognize Israel, abide by former agreements, take a commitment to end violence. On the other hand, Israel applied a strict embargo on the movement of goods and people through Israel to the West Bank or overseas. Egypt applied its own restrictions. This has led to the digging and activation of a web of tunnels under the border barrier demarcating Gaza from the Sinai district of Egypt. The two halves of Rafah, a town split between Egypt and Palestine, were used as a base for the tunnel industry. At its peak, underground movement generated a steady source of income for the Hamas government, taxing all movement of goods and people. At the same time, substantial shipments of rockets and mortars were traveling into Gaza, mainly from Iran and Syria via the Sinai. In addition, Hamas developed an engineering capacity to dig extensive tunnel webs into Israel. This is for the purpose of threatening the population on the Israeli side of the border. Thus, creating diverse deterrence in addition to the accumulation of imported hardware and production technology of rockets against a hostage society in residence adjacent to the border. The ballistic capability accumulated in Gaza both in range and numbers. But as yet without effective accuracy, allowed the extension of threat farther into the depth of densely populated Greater Tel Aviv and Greater Jerusalem. On this backdrop, the Gaza War escalated into unprecedented proportions of retaliatory air, sea and ground attacks by the IDF, with rather limited damage to Israel thanks to the Iron Dome anti rocket system. Hamas invested in the development of other modes of deterrence as well, of which the most severe, with dire consequences to the Gaza population was the offensive tunnels, penetrating into Israel and inflicting fear on the civilian population living across the border from Gaza, within Israel. The actual use of

such tunnels to attack IDF units within Israel played a decisive role in Israel's decision to move the ground attack on Gaza, which led to the staggering damage and the high number of casualties.

The Gaza War is very much the result of the status quo, and its outcome – with no clear decisive end game, left both Israel and Hamas with no appetite for another round for some time to come, but with no base for a long term cease fire, which could allow relaxation of guards on the border and the development of a stable neighborly relationship.

2. Unilateral Disengagement:

In summer 2005, the Sharon government started preparations for full disengagement from the entire Gaza Strip to the Green Line demarcating the 4.6.67 border between Israel and Palestine. Bound to be transferred to Palestinian rule, was a large area in the northwestern territory of the West Bank as well. All in all, the entire IDF forces and (20?) settlements, home to 8000 settlers, were vacated from the designated areas in one move, claiming that the status of occupation of this area has been terminated with the departure of the last Israeli from them. Prior to the implementation of disengagement, negotiations were undertaken with the donor community, represented by the World Bank envoy to Palestine, Mr. Nigel Roberts, aiming to secure a smooth transfer of any assets left behind, particularly roads, water, power and communications infrastructure, as well as industrial parks and green houses. The World Bank, on its side, conducted negotiations with the PNA officials in order to secure the transfer of any such assets to Palestinian control. In this respect, the two protagonists never officially negotiated the disengagement directly, thus leaving substantial issues pertaining to such a far reaching operation without any direct commitment to the results of this move.

At the time, the Israeli government, serving domestic political ends, portrayed the operation as a barrier to any further Palestinian claims on the West Bank "for ten years or more". In reality, it was seen as a way out of the political impasse and the dreaded stagnation, which was thought to lead into renewed violence and increasing diplomatic pressure coming from overseas, mainly the US. Hamas, on its end, portrayed a narrative of military success in ousting Israel from parts of Palestine by shear force, taking this logic to the extreme, claiming that this has proven Israel understands violence only, and in the Palestine – Israel context, no other means but violence could regain the control over the entirety of Palestine, hence it is taking to the armed struggle. When later on Hamas took control over the Gaza Strip by violently confronting the Palestinian Authority over the control of Gaza, the enclave has been virtually split from the West Bank and gradually emerged as a separate political entity with a separate administration, vision and narrative, threatening the mere existence of Palestine as a serious candidate for statehood.

At the outset, one can safely stipulate a flat Palestinian refusal to give its tacit, let alone vocal consent to a unilateral withdrawal from parts of the West Bank in exchange for recognition of a Palestinian partial sovereignty in areas A+B. The insistence on the Israeli side, including amongst leading policy pundits and peace activists, claiming this option is seriously considered, or can seriously be considered given the right political circumstances, looks to us divorced from reality.

Israel:
Internal Scope:

The political conversation in Israel, either on the nationalist end of the spectrum or on the left side where peace activism is vibrant, unilateralism as a paradigm for settling the Palestine – Is-

rael conflict is present. Different peace organizations are advocating a novel perception of the conflict and its solution, namely – deal with the internal rift in the Israeli society first, prepare settlers to the eventual necessity to leave their homes and resettle within the Green Line, or even further – develop financial and other instruments of assistance for those who wish to make an individual move back into Israel, regardless of any political solution or the absence of it, of the conflict. This program is reflective of the notion that the settlement project is so extensively entrenched and the number of settlers so high. That there is no possibility, what so ever, that any Israeli government, presently of in the future, which will dare accept an international Diktat of rolling the settlement project back.

On the nationalist side, we see in the last two years a strong tendency by Likud right wing activists and even more so by the Beit Yehudi party, to advocate for a unilateral initiative to abandon the Oslo related commitments to the Palestinian Authority and declare Area C and East Jerusalem as an annexed territory to Israel. In fact, one can describe the unilateral act of annexation based on the stipulation that there will never be, by definition, a leader on the Palestinian side who would seriously consider such a move as viable. Nor would any international player support such a move. In this case, the unilateral approach is developed mainly on the logic that external pressure will not mount to a critical point (see external scope) that will harm Israeli interests. At the same time, there is no force in sight on the domestic platform, which can derail an annexationist thrust by the settlers. Thus, the March 2015 elections have a great significance. Neither the Likud nor the Beit Yehudi has on their platform any mention of the Two State Solution, nor do they advocate in their party line a One State Solution, even if individual politicians do so on their own behalf.

However, the nationalist ideals served by this approach are far from nearing any consensus. In a way, the unilateral approach is a continuation of the Status Quo situation, but with a legal structure that is fundamentally different, stipulating a historic opportunity of changing the base: partition of the land is ruled out by reality on the ground. The Palestinians claim to self-determination is not morally superior to the claim of the Jewish people to their ancestral land and cannot come at the expense of Israeli security. Hence, the practical solution would be to offer the Palestinian population of areas A+B upgraded Autonomy coupled with a Jordanian citizenship. Those residing in area C should be offered residence rights, similar to the status of Palestinian residents in East Jerusalem.

In the course of the last two years, prominent leaders on the right, mainly Knesset Members of the Likud, Israel Beitenu and Beit Yehudi party, expressed intentions to initiate laws that will make forced removal of Arab population, mainly Bedouins, from the Jordan Valley, which is almost entirely in Area C, to predestinated neighborhoods in or adjacent to Area A or B, in order to make room for new settlement projects, thus, enhance what is already a developing phenomenon, whereby a Jewish majority is sustained and the Arab minority dwindled. Figures coming from official spokespeople close to the Beit Yehudi are openly claiming that currently the Jewish population in the Jordan Valley outnumbers the 60,000 Bedouins call this area home. This figure stands in stark contrast to Palestinian official l data on the demography of this area, claiming the presence of 180,000 Palestinians in residence. This vulnerable population is systematically being pushed out by means of water and electricity denial, access denial, housing permit denial etc. towards Nuaimah, a suburban village north of Jericho, leaving the area close to the main artery from Jericho to Jerusalem and the Jordan Valley itself, vacated from any Palestinians.

As annexation of Area C and East Jerusalem could never be reached by agreement. It needs to be done unilaterally. Unilateral steps taken, based on the exponential advantage of force on the ground, should allow de-facto acquiescence with the emerging reality by the US and EU (see external dimension) and the Palestinian leadership.

On the other side of the spectrum, the prevailing argument for any unilateral initiative is primarily reflective of the fast spreading notion that the settlements in the West Bank and East Jerusalem are there to stay. On one hand, the entrenchment of the settler establishment, the long standing proximity of the settler leaders to the state leadership, and the fact that the disengagement from the Gaza Strip was so traumatic. So goes the narrative, no Israeli government in the foreseeable future could ever develop a large enough political support base for the removal of settlers against their will, let alone in much larger numbers, compared with the 2005 disengagement. For this reason, unilateral disengagement seems to be the lesser of two threats to the very existence of the State of Israel.

Unilateral disengagement could be the result of another cycle of violence, the magnitude of the Second Intifada, where a political "Two State Solution" is defeated and ruled out as the result, indefinitely. Violence could suspend the viability of the Status Quo scenario, but not replace it with a negotiated partition of the land. That is where the nationalists in Israel might intend to declare annexation, or retain tactical ambiguity by developing "step by step" modality, in order to avoid external pressure.

External Scope:

In recent years, the Middle East has turned into a nasty neighborhood, where Israel is facing challenging transformation of various threat factors. Notwithstanding the strategic threat, such as the Iran ascent to a regional power position coupled with its alleged ambitions to obtain a nuclear arsenal, or the fallout of the Arab Spring, with the collapse of an effective central government control and the disintegration of a neighboring nation-states such as Syria and Iraq, with violent formations of radical brands of Islamic Jihad. Against this backdrop, any government in power would need to negotiate the chronic inflammatory conflict with the Palestinians. It seems that the current nationalist government, in pursuing a de-facto change of the fundamentals in the Palestine/Israel relationship, is defying the fact that Israel, unlike most countries, requires a high degree dependence on its external relations. This is the result of its vulnerability due to size, political and military instability in its environment, history of conflict and repetitive war situations.

New trends are detected in the Western Hemisphere. Since 2009, during the parallel term in office of President Barak Obama and Prime Minister Netanyahu, the US/Israel has witnessed unprecedented low in the personal relations between the two Heads of State, and their distrust in each other radiates into the fabric of government. No doubt, this relationship would have been taking a dramatic change for the better, had Israel been treating the Palestine issue on a different note.

This extreme vision of the nationalists in Israel, currently harbored by parts of the Likud led coalition, has the potential of unleashing strong and intensifying criticism from overseas, to the point it actually undermines Israeli fundamental interests pertaining its national security. This tendency is already taking a corrosive form of de-legitimization, not only by the Israeli occupa-

tion and denial of statehood to the Palestinians, but that of Israel itself. So far, as long as the principle of partition was adhered to, even in theory, the international community was prepared to allow time for a viable peace process to be held in due time, and allow the Americans to lead as facilitators, as the only power which exerts influence on both parties. Once the principle of partition is abandoned, this balance, however fragile, has a good chance of caving in, while the Donor Community keeps financing the Palestinian Authority as a way to achieve the necessary stability which allows continuation of the peace process.

The European Union is signaling, since 2012, a more vigorous tone when it comes to the Palestine – Israel conflict. On the backdrop of a tightly restrained policy position towards the two protagonists, and the consistency by which Europe restricted itself from any visible application of pressure on the parties, maintaining a high profile of donor support for the Palestinian Authority institution building and running costs. Compared with the "pay, but don't play" posture, leaving the facilitation of negotiations entirely in American hands, in the last two years we see a new approach, by which the EU is signaling to Israel its displeasure of the settlement activities, by reinforcing guidelines which distinguish between Israel within the Green Line, and the Occupied Palestinian Territory beyond that line of 4.6.67. More and more manifestations to insistence to restrict the scope Israel's privileged economic partnership with the EU to Israel per se. European banks and pension funds are removing their investments from projects and institutions cooperating with settlements in the West Bank and East Jerusalem. Labeling of settlement products is discussed in many European countries. In some countries such labeling is already implemented.

Below the official level, we detect a rather new phenomenon which is incrementally spreading in the US and Europe – the BDS (boycott, divestment, sanctions). The BDS movement is aspiring to develop a universal action directed at the Israeli stance overseas, both as a trade and investment partner, as well as a legitimate member of the world academic community. BDS is not considered in Israel, at present, as a serious imminent threat to its trade, arts and culture, or academia. But the thrust generated by it is clearly felt at the base. The government is showing signs of concern. It reacts towards with campaigns countering it on European and American campuses, in supermarket chains, and in the media. However, it is being acknowledged as having a corrosive effect on the position of Israel in public opinion in Europe and North America, delegitimizing not only the occupation but its very existence.

Security Scope:

The extreme case of unilateralism exercised by Israel in 2005, the Disengagement, exposed the security relations on the Gaza border to extensive corrosion. As the result of the Hamas victory in the general elections held in 2006 in Palestine, and the internal conflict in its wake, Hamas removed by force its rival Fatah from government in the Gaza strip, seeking to establish a base for further consolidation of power in the West Bank as well. True to its cause, it has strained its relations with the Palestinian Authority on one hand and intensified its military standoff with Israel. Tunnels under the border with Egypt allowed a degree of freedom of movement, even when the Rafah border crossing was closed. The Arab Spring of 2011, which resulted in the removal of President Mubarak from office, and the eventual ascension to power of president Morsi of the Muslim Brotherhood movement. The presidency of Morsi did not last for long, but in this period Hamas succeeded in mastering a considerable rocket fire power with the help of Iran, Syria and Hezbollah, an infrastructure for the production of ammunition, the training

of its troops and upgrading its military infrastructure, in spite of an extensive Israeli effort to curtail such development of the application of an effective land, air and sea siege on the Gaza Strip. Throughout this phase, endemic security instability was characterized by frequent shelling by Palestinian militants, either the Hamas military wing, the Kassam Brigades, or other organizations and armed factions, of the Israeli population adjacent to the border. With time, the actions and retaliatory reactions between Israel and Gaza intensified tensions and deteriorated to larger military operations, including incursions into Gaza, causing heavy damage and high death toll.

Learning from the case of Gaza, a similar situation could be stipulated for the West Bank. Unilateralism leaves the Palestinian Authority out of the security equation. It is inconceivable that the Palestinian Authority and its security organs will be prepared to cooperate with the IDF on policing the West Bank, either the part left for the Palestinian autonomous rule or the areas annexed to Israel. This cooperation is critical for the maintenance of security stability in the area. One could anticipate violent resistance to such a scenario, including the disintegration of the Palestinian security forces and the creation of a military capacity by higher caliber professionals. The case of Hamas in Gaza is also leading to the conclusion that efforts will be made to connect with players outside of the West Bank. This can shape up in collaboration with terror organizations in a highly mercurial Levant, where Al Quaeda and Isis are the prominent powers. Iran is a constant player in a Middle East where proxies are in demand. Such a scenario is not only weakening the Palestinian Authority and the credibility of Abbas and the Fatah led PLO, but also undermining the stability of the Hashemite Kingdom of Jordan, on the East Bank of the Jordan Valley.

Given the fact that such a solution will be the result of a unilateral decision taken by the Government of Israel, and might not even be a declared policy but executed incrementally, the internal implications for Israel will be moderate, but externally harsh and from the security perspective, this might be disastrous.

3. One State Solution:

Since the very beginning of the Jewish immigration to Palestine, the question of Jewish/Palestinian relations preoccupied political leaders and thinkers on both sides of the divide. From a very early start, on both sides a debate emanated on the One State versus Two State solution for the Palestine question. Removing for the sake of argument the very extreme ends of the spectrum – Hamas on one hand and Beit Yehudi on the other – two paradigms with regard to conflicting political rights prevail: partition of the land – the Two State Solution, and unification of the land – the One State Solution. The first is aiming at the creation of two Nation States, sharing the territory to allow the fundamental manifestations of self-determination, allowing the emergence of the emancipation of the collective self, in a democratic and pluralistic society. The latter is in a way the shadow of the first, claiming that there is no real possibility to lead this conflict towards the Two State Solution. Hence is the attempt to envisage and plan a bi-national society and country, which will allow through its democratic and pluralistic constitution, a fair opportunity for all to achieve self-determination and emancipation.

Evidently, some Palestinians pundits argue for a One State Solution as well. It is, however, very difficult to see a Palestinian leadership, presently or in any time in the future,

prepared to abandon its fundamental objective and vision of creating a Palestinian nation state, the State of Palestine, which will be the embodiment of emancipation and self-determination. The narrative of struggle does not leave space for any other option but the Two State Solution. It is strongly argued that a sovereign and independent State of Palestine could generate a political conversation advocating for a federal or a confederated state with Israel and Jordan, but only after Palestine gains its liberation from the Israeli occupation.

Israel:

Pertinent to the case of a partition of the land stands the question of indigenousness. Since the early beginning of Jewish immigration to the Holy Land in the 1880s, and more so with the waves of immigrants arriving here after WW1, when in 1917 the British Expeditionary forces under General Allenby conquered Palestine from the Othman Empire. The Zionist movement leadership consolidated the immigration around a narrative of entitlement to the biblical land, and the Balfour Declaration (November 1917) expressed an official view supporting this claim of the Jewish nation, to its ancestral land, the cradle of the Jewish civilization, Jerusalem is seen as the city where the forefathers of modern time Jews, the Biblical Prophets and Kings, had resided. Political scholars and leaders were wrestling with the conflicting claims to exclusive rights to indigenousness, which is reflected in the way the two rival narratives deal with the question whom this land belongs to. The Balfour Declaration, however, acknowledges in clear words that the Jews are not the only people whose claims are entitled to consideration. In that respect, this declaration is a very early manifestation of the principle of partition, which is in the heart of the Two State Solution.

Most Israelis perceive the One State Solution as the ultimate alternative to the Two State Solution. Most Israelis acknowledge the fact that on this land two people reside, with conflicting narratives, for which the most logical solution would be the partition of the territory into two sovereign states. However, for most Israelis, defense requirements for their state in the intensely hostile environment mean that it cannot allow itself to terminate military control from the entirety of the land west of the Jordan River, even at the expense of denying the Palestinians, who in theory are entitled to their sovereign state as well, the realization of it. The defense argument blends also with the perception routed amongst the more ideological settler society and their supporters in Israel, claiming that the Israelis of today are the descendants of the Biblical Jewish nation, residing in this country from the time of Abraham, and that it is the Promised land for the Jews, who are the sole indigenous community here.

If the Israeli nationalists harbor people with convictions as above, on the left side one finds a variety of thinkers who are convinced this land should have been divided between the two people, but in reality it is too late. Facts on the ground, namely settlements, make any contemplation of second large scale disengagement a case in wishful thinking. The settler lobby in government, Parliament, their presence in the top echelons of the IDF, their bridgehead in the US, will not allow a repetition of the 2005 disengagement. In recent years, the idea that a significant part of the settler society is resolved enough to stay put even if Israel withdraws, leads a sizable part of the Israeli society to look for alternatives, which will allow the settlements to stay where they are while the Palestine – Israel conflict is sorted out in a final status agreement which is the form of a One State Solution.

Internal Scope:

The question which stands in every aspect of the One State Solution has to do with demography vs. democracy. At present we have two societies which are almost similar in size, but with a clear hegemony entertained by one nation only, the Jewish nation. In a few years, given the current birth statistics on both, there will be more Arabs living in the combined territory than Jews. Are the Jews going to allow the reflection of a formative majority the Palestinians will retain in a One State within the next decade? It seems hard to contemplate. The fabric of the Jewish society and its political set up are suggesting Israel is still in its nascent phase, when it comes to the various identity factors and the national narrative outline. Questions pertaining to its identity, the role Zionism as a universal movement of self-emancipation, the centrality of the Jewish faith in the political conversation in Israel, and above all – the unfinished debate over the issue of ethnicity in the Jewish/Arab context and relationship within present Israel.

Ethnocentric tendencies ruled the political culture and conversation in the Israeli society, in spite of its adherence and commitment to liberal and democratic universal values. The 70 long years of hegemony manifested in the struggle to create the State of Israel as the redemption of the Jewish people, with the Palestinian Naqba which entailed and

then almost 50 years of occupation and settlement construction in the West Bank and East Jerusalem. It is hard to see how the Jewish society in this One State, will be capable to deal with the steep demotion from its hegemonic position, ruling by military means the neighboring Palestinian society, in what is described by some as subjugation and deprivation through occupation.

In line with this analysis, it is almost a given that the institutionalization of the One State paradigm will call for mounting tension with high probability for violence at the seam lines of the joint society. The outcome might serve the interests of the annexationists: in the process of negotiating the One State, the parties will get stranded on issues of narrative, constitution, balancing the interests of both sides of this partnership. A single state with two societies that are distinct from each other by ethnic definition of religion, which have no real horizon for blending, and with one society dominant over the other, democracy has a high chance of collapse, giving way to a new mutation of Apartheid. The One State will challenge the Zionist vision of Israel as a Jewish and democratic state, harboring liberal and egalitarian values.

The first and ultimate test for a One State solution would be the challenge of formulating a joint constitution, which will serve as a viable ideological base for viable democracy and governance to function. It is hard to imagine how Israel, which failed so far to agree on a constitution reflective of its own universal values, and is running its legislative agenda on Basic Laws, could take part in formulating a constitution relevant and valid for a bi-national state.

External Scope:

From a theoretical point of view, the conflictual relationship with the Palestinians is the singular source of contention which undermines Israel's standing internationally. Hence, the transformation of the Palestine/Israel relationship from occupation which entails human rights violations, into a reasonable and legitimate form of agreed bi-national partnership, should solve this matter, regardless if it takes the form of One State or Two State solution to this conflict. As it stands now, Israel entertains solid and positive relations, even friendship, with most nations in the Western Hemisphere. It also succeeded in stepping further into positive relations with the

big players in Asia, namely India and China, both maintaining distance from the Jewish state on grounds of solidarity the Non Aligned Movement (NAM). One can stipulate an acceptance of Israel into the Arab and Islamic fold of normalization, as well as in the NAM countries, where Israel entertains a degree of openness bilaterally, but a rigid remoteness multilaterally.

This, however, is expected to get marred by a new source of contention, which emanates from the intra Jewish/Arab relationship within the One State that replaces the current situation. Any departure from the fundamental components of constitutional democracy, where the majority is taking the lead within constitutional brackets, leading to a Parliament that reflects the demographic majority of Arabs versus a minority of Jews, will be seen as a breach of a universal commitment to democracy. The feasibility that the Jewish polity in Israel will give up its hegemony even in case it realizes the Palestinians are the majority is slim. A situation where a minority entertains political privileges denied to the majority will be calling for worldwide condemnation of Apartheid-like reality the One State is confined to. Such a scenario will gradually lead to a diplomatic and economic siege, which in itself will export tension from the external relations into the internal political space and will exacerbate an already tense and disturbed relationship.

Security Scope:

The One State solution stipulates a political situation that is not on the table at present and for the foreseeable future: mending the rift within the Palestinian society, and seeing the reconciliation between Fatah and Hamas accomplished. This means a profound change in the Hamas DNA readiness to give up its military arsenal and the independence in operating its armed wing. That is at a priory and a sine qua non combined in any deal Israel could be expected to weigh for a One State solution to be a success from its security point of view.

Against the backdrop of Hamas/Israel rivalry, Israel and the PLO have a relatively positive record of security cooperation, since the signing of the Oslo Interim Agreement in 1995, and furthermore so in the aftermath of the Second Intifada a decade later. This security cooperation is primarily assigned to policing missions, intelligence gathering, and the maintenance of the day to day security situation. One cannot ignore the exponential disparity in military might and capacity. The Palestinian Authority is committed to policing capacity, for which no military is necessary. If, however, the parties move towards the merging of the Palestinian Authority and the State of Israel according to the One State vision, then the question of merging the security and military establishment will come about, as well as the redefinition of the threats emanating from the volatile environment and the offensive attitude the One State solution might generate from rogue players in our vicinity, like Al Qaeda or Isis.

When it comes to the stability within the Israeli society, obviously a solution that legitimizes the settlements in the West Bank and East Jerusalem in Palestinian eyes reduces internal tensions. However, the erosion of the Israeli/Jewish hegemony and entailing tensions between the two societies as a result of it has the capacity of destabilizing the internal security within the Israeli society as well.

This can be expected to exacerbate even further, when the issue of repatriation of Palestinian refugees is discussed and the arrival of those who are entitled to it is becoming a reality. This might send stark tensions both within the Israeli Jewish debate, with possible security ramifications, as well as on the seam line between Israelis and Palestinians.

4. The Two-State Solution:

The Two State solution is based on the fundamental, one could say - biblical, logic of partition. Behind it, we find the biggest challenge, the acknowledgement of both sides of the right of both to indigenousness in the country that is called by Palestinians Palestine and by Israelis the Land of Israel. Both societies will have to grapple with this historic crossing of the Rubicon, as the indigenousness issue lies in the very heart of the conflict, and in the gap not bridged yet, between the two narratives.

The Two State solution allows an element of exclusivity for each nation in its own territory. This exclusivity is the engine for a healthy sense of emancipation, of self-definition as a nation, a community, an individual. The lack of it deprives a nation of its immunity of fanaticism and violence. Most nations on the globe managed to create a nation state for themselves, a feature denied to most in the colonial era, and is today embraced as a given by most. When the UN General Assembly voted on the draft resolution suggesting the termination of the Mandatory Government of Palestine under British rule and the creation of two states, one for the Jews and one for the Arabs, the number of UN member states was 57. Today it is 193.

Some argue that a State of Palestine cannot be viable even if the stated vision of the Palestinian Authority comes to full implementation and the State of Palestine will emerge in the West Bank and the Gaza Strip, with East Jerusalem as its Capital. Another argument heard in Israel expresses the notion that the Two State solution contradicts the minimum security requirements of Israel, a reason for the objection stated by the current Israeli leadership to any territorial concessions. Both arguments are valid, but should be addressed in the peace negotiations. They cannot rule out genuine negotiations on full statehood. Only full statehood can serve as a base for any future arrangements that will serve as the political architecture for the Middle East: federation, confederation, or a Middle East ''Benelux'', tripartite structure inclusive of the Kingdom of Jordan.

Israel:

Given that the Two State Solution will be the result of a bilateral agreement between Israel and Palestine, possibly also in an environment of mounting international pressure, there is for Israel a high probability of immediate improvement of its relations with the US and the EU (new neighborhood partnership), and the Arab World (within the context of the Arab Peace Initiative - API). On the other hand, in the internal arena this solution will create high political tensions, which could destabilize the government and reduce short term security. Such a solution, if implemented without extreme caution and over a long period of time, might send structural shock waves into the very foundations of the Israeli society and the State of Israel as such. It might actually fall into a civil inner conflict with manifestations of violence, not far short of a civil war.

Internal Scope:

Clearly, the Two State Solution (2SS) is standing in the eyes of the settler society and its support base in Israel itself, as a fundamental threat to their pure conviction that it is the role and duty of this generation to establish the State of Israel over the entirety of the Land of Israel and in the Temple Mount Shrines. This vision is based on the transformation of the Israel/Palestine future relations from the symmetrical notion of partition which is encapsulated in the 2SS, into an asymmetrical formula, where the Jewish Nation is indigenous in the land, while the Palestinian society is in residence on Jewish land, thus it is entitled to autonomous areas, where they

can exercise a limited autonomy and restricted self-determination but not fully emancipated Palestinian nation state, the State of Palestine.

In the year 2005 the late Prime Minister Sharon, whose reputation hitherto was of backing vigorous settlement activities, strategized a move which was aimed at shutting down both the Second Intifada and the international pressure mounting at the time as the result of the stagnation that characterized the peace process. About 8000 settlers and all the IDF units were evacuated from the Gaza Strip overnight. The giant move was planned and executed unilaterally, even though the Donor Community, coordinated by the World Bank envoy based in Ramallah, were invited to play an intermediary role between the Government of Israel and the Palestinian Authority. Some contacts were made, to coordinate the transfer intact of industrial zones and greenhouses – property of Jewish owners which all sides were hoping to keep generating income and providing job opportunities. In reality, the intention of the GoI to save the investment and to mute the shock anticipated in Gaza as the as a result of the disengagement.

In light of the above, implementation of the 2SS with a very high probability will ignite a high speed storm in the Israeli polity and in the short run the Israeli society might be shaving civil war as a result of a diplomatic commitment taken, either in bowing to external pressure on a nationalist government, or a policy pursued by a center/left government, to either swap or evacuate the territory where the majority of the West Bank and East Jerusalem settlers reside. The idea that Israelis will evacuate settled areas in the West Bank in favor of Palestinian interests is almost inconceivable at present and will require huge amount of political currency, without which it will destabilize the government, the Parliament, the judiciary, the civil order to the point of deliberate attempts to undermine the capacity of the government to exercise governance.

Once Israel has weathered the short term storm, it will have to sustain long term repercussions. A heavy toll on the economy, as the result of military redeployment, presumably the swap of 2 percent of its territory, the removal and repatriation of up to 80 000 settlers residing in settlements which are outside of the agreed swaps, and the possible removal of Israeli population from areas that are destined to be handed over to Palestine.

A long term phase out of the Israeli presence in the West Bank will be required, in order to make a Two State solution credible and feasible, both in the civic aspects of it as well as the military ones. This will color an extended time frame with the attributes of a society in transition and traumatized. The country will physically transform, the people will psychologically do. In a short span of time Israel will lose control over a large space, which has become for many an integral part of it. For most Israelis, who were either born after 1967 or immigrated to Israel since then, the shrinkage of the country in about 25 percent of its space, the arrival of a large number of Israelis, hitherto settlers, the exceptionally large budget prioritized and made available for repatriation, all of this will create a dramatic change in the life of Israelis.

This even takes a bigger turn, in the case of Jerusalem. The fact that the eastern part of the city, including a large part of the Old City, will become Palestine will be shocking for many. The fact that the municipal space, however united physically, is divided into two separate territories between Palestine and Israel and the two governments are in residence in the same city. This phenomenon will surely spark short term as well as long term resistance to the new deal. It will

take considerable time before the resentment and the objection to the partition of Jerusalem will subside.

External Scope:

The moment the two protagonists in this conflict declare their genuine intention to broker a solution that will bring the state of occupation to full termination with the creation of the State of Palestine in good neighborhood with Israel, the international community will open up to Israel and remove the closing diplomatic barriers on it. The time framed negotiations will create an entirely new wave of acceptance of Israel as a full member of the international community. Israel will most probably regain the world recognition of the right of the Jewish People to the land within the new borders, thus expecting a Palestinian disclaimer on the land. This will have far reaching implications concerning the refugee issue.

The world should be expected to contribute with confidence building measures. The first should be the symbolic recognition of Jerusalem, the West part of it, as the official Capital City of Israel and move all embassies from Tel Aviv to Jerusalem.

The Arab World will open up to Israel, by normalizing relations with it. This should be manifested by the exchange of diplomatic missions between Jerusalem and the Arab Capitals. Trade will expand between Israel and the Middle East in a way never experienced before.

The European Union is expected to extend an unprecedented status, similar to that of Norway and Switzerland. All reservations on relations with Israel will be removed, the BDS campaign should be brought to a standstill.

Security Scope:

Defense wise, serious questions will arise on traditional security paradigms, on the degree of freedom of military action, on new requirements concerning cooperation with foreign security players, unseen in the region before. Cooperation with the Palestinian government will also fundamentally change. In essence, Israel will have to reduce its reliance on military capacity of deterrence, and lean more on coalitions pursued and established, with governments in the region. Logically speaking, with the Two State solution implemented Israel is gaining a new horizon for its national security.

Short Summary:

We have been examining four basic scenarios against four principal aspects of each, namely – the internal, external, security and economic scope, in line with the existing state of affairs.

We concluded that from an Israeli official point of view under the Netanyahu Government, the Status Quo gives Israel a relative stability, has positive prospects internally, sticking to the inertia, using the time to advance their own ends concerning the West Bank and East Jerusalem, namely – encroaching de facto annexation. Internationally, this scenario takes Israel on a collision course with the Western World, as well as the Arab League. On the official level, increasingly messages will be delivered to Israel in line with the statements made recently by the European Parliaments, and debates over resolutions aiming at the re launch of an effective peace process. Security wise, this scenario leads to more tension with Hamas, possibly also in the West Bank and East Jerusalem, with potential outbursts of violence, either Intifada style on

the West Bank, or entry into escalating exchanges of fire, occasional cease-fire agreements, with no vision for the future.

The unilateral disengagement is taking Israel into a domestic strife, but then it gains only temporary relaxation on the external front. However, this invites a scenario of similar qualities to the disengagement of 2005, mainly from the Gaza Strip. It has the potential of turning into a hostile territory, with no brakes and balances, which differentiate between Hamas led Gaza and PNA led West Bank. The security cooperation which is in place will deplete as well.

The One State solution looks Utopian when considered in light of the current standoff. Internally, if accepted, it might prove a stabilizing factor in the region. Internationally it will gain attention and support. In theory it should be rewarded similarly to the Two State solution. On the other hand, it is hard to believe the Israeli society and polity will sustain equality at its base. Very easily political forces, either on the surface or under the cover of political agenda, will develop legal and political instruments of separation which will acquire manifestations of Apartheid. This, in itself, will invite Palestinian endemic resentment and international corrosive pressures through BDS and the likes.

The Two State Solution is going to put the Israeli society to a historical test. It will most probably require outstanding political skills to navigate between the conflicting powers and players. It is very likely that advancing negotiations on the ending of occupation and replacing it with good neighborhood will run through domestic political crises, and an internal conflict, including violence, will spread while implementation of an agreed swap takes place. Externally, this scenario will open the world to Israel, sheer benefit. Security wise, this scenario calls for a far reaching strategic and tactical diversion from the current defense paradigm.

Palestine - Israel Relations: Alternative Visions for the Future

The Palestinian Economy under Restrictions: Where Do We Go from Here?

The AIX Group

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A. Palestinian Economy under Status quo conditions

This section reviews the key factors underpinning the Palestinian economy from the signing of the Oslo agreements until 2014 and assesses economic conditions under the status quo. It analyzes Palestinian economic performance under the occupation and its evolution through successive phases: the Oslo period (1995-2000), the Intifada period and its aftermath (2001-07) and the State building period 2007-14. The Oslo period was not representative of the status quo as it is today because it was driven by false expectations of a Final Status Agreement. Nor was the subsequent period (2001-07) which was characterized by violent conflict and political upheavals. Rather, it is the current period, since 2007 which best characterizes the status quo: a stable, though divided, Palestinian entity which has established security, strong government institutions and an investor friendly economic environment all operating under a strict occupying regime. Yet, the major ingredients of success are missing: lack of sustained economic growth; lack of any political horizon; high level of uncertainty and lack of confidence. While we will briefly review the Oslo and the Intifada periods, we shall concentrate our analysis on the more representative current period (2007-14).

While the status quo is not a static concept, and certainly changes over time, the Israeli occupation and its economic restrictions remains the underlying constant and determines the behavior of various aspects of the economy as actors and stakeholders. Looking ahead, this section will project a vision under the status quo and its economic prospects over the next few years. It will also speculate about two possible variations of the status quo: a partial rollback of the occupation, with an expansion of the Palestinian economic space, and the economic and social consequences of a deterioration in the overall political and economic framework.

1. The Oslo period (1995-2000)

In the aftermath of the Oslo interim Agreements, and the Paris Protocol (PP) which governed economic relations between Israel and Palestine, there was a brief period of euphoria among the Palestinian private sector, in anticipation of final status accords and the establishment of a Palestinian State. Total investment averaged 37.2% of GDP annually during 1994-99, a high ratio by international standards. There was substantial subcontracting to Israeli companies and large investment in manufacturing, as indicated in capital formation in machinery and equipment (non-building) which increased from 8.5% of GDP in 1996 to 12% of GDP in 1999. Exports increased from 14% of GDP in 1994 to 18% in 1998-99. For a small open economy like Palestine, export should have been in the 40% of GDP range, as in the case of Jordan (44% of GDP) and Tunisia (61% of GDP), if it were not for Israeli restrictions on access to markets and inflated costs of transportation (see below). Nevertheless, exports trends were on an upward trajectory. Worker's remittances reached 15% of GDP in 98-99 and private transfers from abroad were another 8% of GDP fueling income and purchasing power (table 1).

These endogenous growth factors, particularly investment resulted in a double digit rate of economic growth averaging 12.4 % in 1997-99. High growth contributed high Palestinian Authority tax revenue, resulting in a fiscal balance. The recurrent fiscal deficit was only 1.5% of GDP in 1997 but moved to a small surplus in 1998 (0.7% of GDP) and was balanced in 1999.

The Oslo period also suffered from the excesses of the occupation. In 1996 and 1997 there were widespread closures in the Palestinian territories due to acts of violence and in anticipation of the Israeli elections. Palestinian indirect tax revenues (VAT, customs tariffs and excises), collected by Israel under the monthly "Clearance" process, were withheld for the first time in 1997 for a few months, in violation of the Paris Protocol.

But, despite these restrictions on movement of goods and labor and access to foreign markets, positive perceptions and expectations of a "permanent status agreement" within five years of the Oslo accord, brought about a burst of energy and investment in the Palestinian economy.

Economic viability was achieved triggering fiscal sustainability. There was no external budget support, as is the case today, and Official Development Assistance (ODA) for humanitarian and development support was 15% of GDP, half of what it became in the 2007-14. The Palestinian economy was positioning itself for takeoff under Palestinian sovereignty.

Table 1: Major economic Indicators in percent of GDP, unless otherwise indicated

	1997-99	2007	2008	2009	2010	2011	2012	2013
Real growth	12.4	6.6	6.1	8.7	8.1	12.4	6.3	1.9
West Bank	14.3	12.7	11.8	9.0	7.1	10.7	6.0	0.5
Gaza	8.7	-2.4	-5.1	16.0	30.1	17.7	7.0	6.0
Cost of living (average)	6.2	1.9	9.9	2.7	3.8	3.2	2.8	1.7
Exports (goods & services)	18.0	19.3	17.4	15.6	15.3	17.2	16.6	16.5
Gross Investment	37.6	21.0	19.7	20.2	20.5	22.5	22.1	24.3
o/w plant , equipment	12.8	7.5	6.6	7.5	10.8	4.8	4.8	4.6
External transfers to private sector	8.8	23.9	21.6	10.8	10.8	5.4	10.3	9.8
Worker's remittances	15.5	10.9	11.2	11.4	12.1	12.0	10.0	10.2
ODA	15.2	31.2	37.0	38.7	28.3	21.4	18.0	15.9
Budget Deficit	0.0	24.5	20.1	22.3	13.9	12.2	12.9	11.0
External budget support $ million	4	1,012	1,763	1,348	1,147	814	925**	992**
% of GDP		18.4	26.4	18.5	10.5	7.8	7.6	7.5
Unemployment (%)	12	22	27	25	24	21	23	24
GDP at current prices US $ million	3942	5506	6673	7268	8913	10,465	11,279	12,575

Source: PCBS National Accounts; Economic and Social Monitor 2014, balance of payments; OECD-DAC data base,

2. The Intifada and The Control Regime (2001-07)

The failure to reach a permanent status agreement by 2000, as predicated in Oslo, was followed by the Intifada with armed resistance and a spate of suicide bombings. This ushered an era of political strife and instability with large economic and financial losses and a draconian and complex web of economic restrictions imposed by Israel on Palestinian activities. Israel froze Palestinian tax revenues in December 2000 for two years but the European Union and Arab countries set up a transfer mechanism to make up for frozen revenues and to maintain PA solvency. This period provides a preview of deterioration possibilities in the current status quo should the on-going political and diplomatic attempts to establish a Palestinian state fail.

The restrictions imposed on Palestinian economic activities became the hallmark of the status quo and epitomized the occupying regime by establishing full Israeli control over borders, airspace and market access abroad; control of mineral and natural resources, particularly water; and control of 62% of the West Bank—area C—removing it from Palestinian economic development. Even the population registry is controlled by Israel. These restrictions, under four categories: Permits; restrictions on movement and access; limitations on use of natural resources; and territorial fragmentation. They are summarized in Annex A.

Between 2001 and 2007, Palestinian output declined in 2001-03 and recovered somewhat during 2004-07. Nevertheless, for the whole period 2001-07 per capita income remained stagnant (chart 1). Palestinian society was breaking down from centralist vision of government to local communities controlled by local clans. Both governance and public financial management (PFM) deteriorated. In the West Bank armed militias emerged with occasional extortion of business enterprises. Law and order collapsed and Palestinian society regressed to community modes of conflict resolution.

Israel decided unilaterally to withdraw from Gaza in August 2005, and the Gaza authorities were not able to keep control of the assets left behind by Israeli settlers. In particular, settler's greenhouses which produced substantial exports of fruits and vegetables were left to deteriorate. Effective governance in Gaza could not be established amidst the on-going strife between Hamas and Fatah. A contributing factor to this deterioration was the siege imposed on Gaza in the aftermath of Hamas's election victory in January 2006 and the failure to implement the November 2005 Agreement on movement and access.

On the PFM front, a civil service reform resulted in a major salary increase over two phases (in 2003 and 2005). This, coupled with large increase in PA employment which threw the Palestinian budget off-track causing the minister of Finance (Dr. Fayyad) to resign and the donor community to express its dismay at the fiscal deterioration during the December 2005 AHLC. The Hamas victory in the January 2006 elections, resulting in a financial siege of the PA which in turn resulted in the breakdown of public services and governance with crippling strikes and PA employees left unpaid for several months[1].

3. State Building, Growth Spurt, and Economic Stagnation

In 2007 three significant events took place: i) Hamas took over Gaza in June 2007, prompting an Israeli siege of the Strip; ii) a caretaker government headed by Salam Fayyad was established in the West Bank at the same time; and iii) the Annapolis Peace Conference took place in Novem-

ber 2007, followed by a donor's pledging conference in Paris in December. The Paris pledging Conference and the formation of a credible Palestinian government ushered a new wave of optimism and an exceptional level of support from donor countries. In 2008, the PA received $1.76 billion in budget support, not only to cover the 2008 budget deficit but also to finance PA salary arrears to its employees incurred in 2006-07 during its financial crisis. This was a huge fiscal stimulus to the economy, equivalent to 26% of GDP[2], with a clear focus on reviving the economy and preparing for economic and political sovereignty.

Reviving economic activity was based on a three pronged strategy: a) establishing security and law and order; b) using the generous external assistance to reorient development expenditures; and c) building state institutions.

Reviving domestic trade and small enterprise activity through a fiscal stimulus could not be achieved without establishing security and law and order. Nor could the PNA focus on community development implementation throughout the West Bank without first establishing a secure environment free of lawlessness. Thus, deploying security personnel in various areas of the West Bank under Palestinian control became a single minded focus of the emergency government since June 2007. This required a major logistical and managerial effort. The command structure of the security personnel had to be unified and reformed. Senior officers' managerial capabilities had to be strengthened. It also required considerable training, restructuring and reequipping with the technical assistance of donor countries. As a result, the discipline of the security personnel was vastly improved and so has their morale.

After the lawlessness that prevailed in Palestine since 2001, the visible presence of Palestinian security forces on the ground brought with it a good measure of stability and raised the confidence level among the population, particularly with the business community. With the restoration of a modicum of normalcy and predictability, businessmen started undertaking small investments and some planning for the coming years. But beyond these economic benefits, a sense of self-empowerment and resilience emerged, with a more favorable outlook for the future.

Since the inception of the PNA, development expenditures, financed by donors, faced a major problem: large commitments were listed annually by donors for major infrastructure projects, but with little control over their capacity to execute them. Israeli restrictions on movement and access, security considerations, permit procedures and the various elements of unpredictability and hardship associated with economic and movement restrictions imposed by Israel, all conspired to cause major delays or outright cancellation of a number of projects. In 2008, the PRDP listed $492 million in development expenditures, mostly on infrastructure projects. Yet, actual disbursements on such projects may not have exceeded $ 190 million because of delays or denial by GoI in obtaining import permits for machinery and equipment[3].

To break away from the frustration caused by the failure of this standard development strategy in the Palestinian territories, the PNA adopted an alternative, home grown strategy, which was much less vulnerable to Israeli restrictions on movement and access. Under this strategy,

1. See Nashashibi, Karim "Palestinian Finance under Siege: Economic Decline and Institutional Degradation" Special Focus, United Nations Office for the Coordination of Humanitarian Affairs, April 2007.
2. In comparison, the US Treasury Stimulus of $ 760 billion at the height of the 2009 recession was 6% of GDP.
3. MoPAD, PRDP 2008-10; MoF monthly fiscal reports.

beginning in the first quarter of 2008, the PNA reached out to cities and communities in the West Bank, to identify their infrastructure as well as their socio economic needs. This approach was particularly welcome, considering that West Bank infrastructure had been neglected under the occupation and closure regime and that small socio economic projects were not given the attention they deserved under the standard development strategy adopted since 1995.

Initially, during the first quarter of 2008, 100 small projects were identified, such as providing water sanitation, improving irrigation, hooking up a village to the electricity network or paving a rural road. Some community buildings or local councils facilities were established in some areas, while in others, underutilized public buildings were partly converted to schools. Public services were provided to refugee camps and to communities cut off by the separation wall.

These projects were small, averaging $250,000 each although most of them cost less than $100,000; they were labor intensive and utilized local material. Consequently they had a high multiplier effect in terms of providing a boost to the economy. In addition, this bottom-up approach, as opposed to the large infrastructure projects, had the major advantage of being responsive to local needs and spreading the benefits across a large segment of the population. This had democratized the development process, and generated a lot of good will at the local community level. By end 2009 over 400 projects had been implemented. Despite the implementation and distributional success of these projects, they did not benefit from donor financing. Donors prefer to finance large and identifiable projects from which they can derive political credit.

The third component of the strategy was the buildup of state institutions. The focus was on establishing an independent judiciary, a private sector friendly regulatory system, a state audit independent institution and achieving fiscal transparency. Most of these objectives were realized with detailed accounts in the IMF and World Bank AHLC reports in September 2010 and April 2011. The AHLC Chair's summary stated on April 13 2011 "according to reports of this meeting from the World Bank, the IMF, and the UN, the PA is above the threshold for a functioning state in key sectors they studied[4].

There was a burst of real economic growth in 2008-11, averaging 9.7%. External budget support averaged 16% of GDP annually during this period. Thus, economic growth was mostly driven by PNA fiscal deficits and the external assistance that financed them. Hence, despite the advances made in institution building and fiscal performance, the private sector was reluctant to invest, given the adverse political environment in Israel with respect to the peace process. Having been burnt already during 1995-2000, with the failure of Camp David, the private sector was not about to repeat the same experience and kept on the sidelines. Most private investment was focused on residential housing, which was stimulated by the PA salary bill and payment of wage arrears, but very little went into productive capacity.

Endogenous sources of growth in the Palestinian economy, such as investment, exports, workers' remittances and private sector transfers from abroad were either stagnant or declining. Gross Investment, which was 38% of GDP in 1997-99 declined to 20% of GDP in 2007 and gradually rose to 24% in 2013 under the lagged effects of the burst of financing in 2008-10 and a lot of residential housing construction. In effect, the composition of investment changed away

4. Ad Hoc Liaison Committee Chair's summary, April 13, 2011

from machinery and equipment and towards residential housing. Investment in machinery and equipment[5], which is a major indicator of development in manufacturing and agriculture, declined from 11% of GDP in 2010 to 4.6% of GDP in 2007-13, which is hardly sufficient for depreciation, implying that net investment may be close to zero (table 1)

Exports of goods and services, that were at 19% of GDP in 2007, declined to 16.5% of GDP in 2013. Difficulties in diversifying exports, due to constrained access to markets under Israeli restrictions, as well as high transportation costs[6] and loss of competitiveness, explain the weakening of export performance. Gaza exports, which were 3% of GDP in 2005 declined to 1.2% of GDP by 2013, as a result of the Israeli siege, following Hamas' victory during the January 2006 elections. Gaza's main export market is Israel, followed by sales to the West Bank. Banning these exports and sales, as Israel has done since 2007 cuts off Gaza's lifeline.

The decline in endogenous sources of growth left the budget deficit as the only substantial source of growth. At an annual average of 22% of GDP in 2007-09 it exceeded very other source of growth and stimulated the economy towards double digit growth rates (11.2% annually 2007-09). However, with receding prospects for a successful peace process, recurrent budget support went down from $18% 0f GDP in 2007 and 2009 (2008 was exceptional) to 7% in 2014. Development spending declined as well from 6% of GDP in 2007 to 1.6 % in 2013. Donor fatigue set in, particularly among Arab countries, which became increasingly reluctant to pay the bill for an occupation with no end in sight. The growth spurt witnessed in the West Bank in 2007-09 was an artificial bubble, entirely dependent on donor financial support and high fiscal deficits. It also led to a boom in real estate development which may result in excess capacity under a stagnant economy. This may have negative consequences on the banking system.

With the only engine of economic growth—the recurrent fiscal deficit—declining by over ten percentage points of GDP between 2009 and 2014 (from 22% to 11%), without any compensating development spending or private sector investment, growth in the West Bank, which contributes the virtual totality of PNA revenues, fell by half in 2012 (6%) relatively its Annapolis levels, and went further down to stagnation in 2013 (0.5%) into negative per capita income growth. Palestinian GDP in 2014 declined by 2.5% and projections for 2015-17 point towards further stagnation[7].

The downward cycle of fiscal retrenchment which reduces both growth and public revenues, makes it that much harder to further reduce the budget deficit, and is self-defeating[8]. The contractionary impact of reducing the fiscal deficit, without any alternative increase in aggregate demand was compounded by the contractionary monetary impact of the buildup of Palestinian assets abroad, for lack of investment opportunities at home[9].

Gaza's stifling siege, periodic bouts of warfare, and the destruction of the tunnel trade has robbed it of its energy and productive resources, reducing it to a welfare state, where over 70% of the population receives humanitarian aid. It will take a decade to repair the damage caused by the latest devastating war, adding further financial burdens on the government. By end 2014,

5. PCBS National Accounts break down investment in "buildings" and non-buildings, mostly machinery and equipment.
6. Shipping a container from the city of Nablus to European ports costs twice as much as shipping the container from Tel Aviv.
7. PCBS press release on December 30 2014. PCBS projects growth in 2015 at 2.8%, but consensus among business leaders is for continued stagnation. Also see IMF, WBG AHLC report September 22nd New York; 0.5% for the WB, and -15% for Gaza in 2014.
8. Karim Nashashibi: "Palestinian public Finance under Crisis Management: Restoring Fiscal Sustainability" UNDP. December 2014. Chart 4
9. Karim Nashashibi: "Palestinian public Finance under Crisis Management: Restoring Fiscal Sustainability" UNDP. December 2014 table 2

the Palestinian government was on life support, unable to pay full salaries to its employees[10], with a large unfinanced gap, rising payment arrears to the private sector, urgent relief expenses in Gaza and an open ended financial and political crisis.

Economic prospects for 2015-17 point towards more stagnation and a steady fall in per capita income. Gaza reconstruction has been very slow to take off and the Government of National Consensus has not been able to share governance with Hamas. There are no indications that, under current leaderships in the West Bank and Gaza, Gaza can emerge out of its welfare status into economic viability.

With the absence of any political horizon towards establishing a Palestinian State economic viability has been lost. With declining economic growth that reduces public revenue, the budget deficit is likely to increase, while external financing remains stagnant at around $1 billion. Fiscal sustainability has been lost as well.

4. Economic Distortions Under The Control Regime

A small economy such as Palestine depends on trade as a major source of growth and its ability to adapt quickly to globalization and technological change. The economic restrictions described in the annex, coupled with the erosion of economic space and the lack of any political horizon for investors, has cut off this lifeline at four levels:

- It has distorted the production structure towards retail trade, construction and government.
- It has suppressed exports and skewed trade relation towards a large dependence on trade with Israel.
- It has repressed economic growth generating a large output gap relative to what a "normal" economy would have had.
- It has undermined fiscal sustainability and generated a dependence on external budget support.

The lack of predictability, inherent in the capricious implementation of the economic restrictions, has disrupted supply chains and relations with clients both domestically and abroad. These two factors have removed a broad array of activities dependent on trade, from profitable production. The complementarities between the West Bank and Gaza economies could not be exploited. The inability to develop area C and undertake long term investments in large plants and equipment, and to develop agriculture at a profitable level, has denied the Palestinian business community the benefits of economies of scale.

Consequently, the incentive structure of the business community has been distorted towards quick turnover activities, retail trade, services and residential housing. The production structure has moved away from manufacturing 18% 0f GDP in 1995 to 13% of GDP in 2013. Likewise agriculture has declined from 11% of GDP in 1995 to 4% in 2013. By contrast, retail trade hasgrown as a share of GDP from 10% in 2005 to 17% in 2013. Construction went up from 6% in 2005 to 11% in 2013[11].

10. Israel withheld the transfer of PNA clearance revenues which it collected in December 2014 following the PNA resort to the UN Security Council and the ICC. As a result, the GNC was only able to pay its employees 60% of their salaries.
11. PCBS, National Accounts at constant prices, (2004 base year) by economic activity. www.PCBS.ps.gov

A second distortion affected the level and structure of foreign trade. Exports declined from 20% of GDP in 2000 to 18% in 2013. Obstacles which have been raised in conducting direct trade with other countries (security delays and higher transportation costs), have favored the Israeli market and channeled Palestinian exports and imports through Israeli companies and agents.

Exports of fruit, vegetables and flowers, in which the West Bank and Gaza have a comparative advantage, are particularly sensitive to delays in transportation caused by security checks. This, coupled with the construction of the separation wall and increasing trade restrictions on Palestinian agricultural exports to Israel, has sharply reduced high end agricultural exports to Israel. There was substantial border trade between the Northern West Bank cities (Qualkilya and Tul Karem) and Israel which was entirely cut off by the separation wall. Other exports also declined by the fall in Israeli subcontracting to West Bank workshops and by separating East Jerusalem from the West Bank. The siege imposed on Gaza, particularly after the Hamas election victory in 2006 virtually cut off all exports to the Israeli market and to the West Bank.

In 2013, 70% of Palestinian imports of goods came from Israel ($3.6 billion) while 86% of Palestinian exports of goods ($775 million) were destined to Israel[12]. This large trade dependency on Israel, partly forced on Palestinian traders in their attempt to avoid economic restrictions, also carries with it a large measure of unpredictability, which has been damaging to Palestinian businesses. Concentration of Palestinian exports on the Israeli market, which is protected by non-tariff barriers puts Palestinian exports at a competitive disadvantage. When access to foreign markets is fully restored, Palestinian exporters will have to upgrade their products to be able to compete abroad.

The shrinking of the most productive sectors of the Palestinian economy due to the Israeli control regime in the 2000s, and the decline in both internal and external trade, has lowered Palestinian economic growth over the 2000-10 decade to an average annual rate of 2.6%, creating a large output gap estimated at 88%[13]. Since 2010, after the artificial growth bubble in the West Bank, financed by foreign aid in 2010-11, growth went down to stagnation levels in 2013-14. Total productivity of labor, management and capital (TFP) declined between 1994 and 2010 by an annual average of -0.5 %, whereas other middle income countries experienced a yearly increase of 3%[14].

The repression of growth in the West Bank, coupled with the shift in the production structure towards trade, construction and services has undercut public revenues and increased expenditure at two levels:

Public revenues are largely a function of economic growth. With the decline in growth in both 2013 and 2014, the net revenue annual rate of increase declines. Net revenue for the PNA in 2013 increased by only 4.5% barely above price increases. This raises pressures on the Ministry of Finance in its efforts to reduce the fiscal deficit.

12. PCBS Annual Trade Statistics, 2013
13. The IMF has calculated the output gap between Palestine and a “normal” lower middle income country. IMF Staff Report AHLC meeting Brussels April 13 2011, Box 2, p8
14. If the period analyzed had been broken down in two (1994-2000 and 2001-2009) the decline in TFP during 2001- would have been much greater. See IMF, Staff report for the meeting of the Ad Hoc Liaison Committee, box 2, p.18, September 21, 2010.

As mentioned above, there has been a change in the composition of GDP with rising trade and construction shares, where the informal sector is strong with low tax compliance and a decline in more "formal" sectors with higher tax compliance such as manufacturing, agriculture and services. Tax administration was not able to capture the higher shares of economic activity in its tax nets. Revenues from the domestic VAT estimated at NIS 840 million in 2013 account for only 2% of GDP. This extremely low payment indicates large scale tax avoidance and undervaluation of gross revenues by registered taxpayers. As a result of this shift in output the public revenue ratio to GDP declined from 27% of West Bank GDP in 2007 to 21% in 2012-13, a very substantial decline.

5. Lessons From The Status Quo Periods

Four lessons can be drawn from the three status quo periods:

- When a credible political horizon emerges towards a two state solution to the Palestinian/Israeli conflict, with a time frame, as was the case during 1995-2000, the Palestinian private sector both at home and abroad, responds immediately by investing heavily into the Palestinian economy. Should a similar political environment emerge again with a time frame, economic growth would soar to double digit levels as has happened in other post conflict situations (Bosnia)

- A deterioration in the political outlook may lead to episodes of violence, either individual or organized with a further breakdown in the Palestinian economy and society. It took 10 years for per capita income to recover from the Intifada. Markets shrink to local levels, society regresses to community modes of governance, and armed militias may emerge with extortion of the business community. Today's Gaza's per capita income at constant prices ($1,187) is lower than it was twenty years ago ($1,347)[15].

- The status quo can be artificially sustained by financial aid from the donor community for a period of time, as it has been in 2007-10 but the private sector becomes reluctant to invest in an environment of uncertainty, political instability and open ended occupation. Eventually growth declines, aid fatigue sets in, and the economy grounds to a halt, as has happened in 2013-14.

- Without a political horizon towards Palestinian statehood and sovereignty, the governing body is weakened and robbed of its legitimacy. No "deliverables" can be had and the political establishment regresses into internal strife, bouts of autocracy and uncertainty.

The analysis of the status quo in the West Bank and Gaza leads us to the conclusion that Palestine has lost its economic viability and, with the decline in growth, fiscal sustainability. Endogenous sources of growth, particularly private investment have been weakening and are unlikely to recover without the emergence of a political horizon towards the realization of Palestinian economic and political sovereignty. Economic stagnation as has been forecasted for 2015-17 will result in decline in per capita income higher unemployment and possibly opportunistic episodes of individual acts of violence.

15 PCBS National Accounts: $ 1187 is for 2013, $ 1347 is for 1994. 2004 is the base year.

Therefore, the status quo in its present configuration, is unsustainable. The PNA can be sustained artificially for some time by donor aid, but external budget support has stabilized at about $1 billion over the last three years and is unlikely to increase. By contrast, the recurrent deficit in the Palestinian budget for 2014, is about $1.33 billion, with virtually no alternative means of financing other than accumulating payment arrears to the private sector. A reduction of the budget deficit to a level which can be readily financed, if not compensated by higher private investment or development spending financed by donors, would bring with it a downward spiral of lower growth, lower tax revenue and higher unemployment.

B. Possible Evolution of The Present Status Quo: West Bank Annexation, or Roll Back of Some Restrictions

1. Consolidation of West Bank Annexation

Under a pessimistic scenario in 2015-17, Israel would continue settlement expansion in both the West Bank and East Jerusalem; the Gaza siege would be maintained with very little progress in reconstruction. There would be no progress in negotiations towards final status and the Palestinian government would continue to experience severe financial problems. Israel would be increasingly isolated internationally, with a deterioration of economic relations with the European Union. Individual acts of violence would occur by both Palestinians and settlers in the West Bank and East Jerusalem. Another military confrontation in Gaza would be likely.

This is an inherently unstable scenario, with loss of financial sustainability of the PNA and declining per capita income and rising unemployment to 32-35% levels. Because the scenario is unstable one cannot predict specific outcomes. Security coordination with Israel would cease, with offsetting IDF incursions in the West Bank. Hamas's popularity will grow and armed resistance to the occupation will become more likely. An organized uprising may occur in the West Bank with large losses of life, property and income.

Alternatively, the Palestinian population may hunker down to survival mechanisms with fragmentation of society to local community structures and breakdown of production chains to local markets. There would be a further decline in manufacturing and agriculture and a shift in economic activities towards labor intensive sectors which would downgrade Palestinian human capital and provide a disincentive towards higher education. In either case, substantial Palestinian net migration abroad would take place, weakening the demographic advantage that proponents of the "One State" solution to the conflict claim to ultimately prevail in assuring a Palestinian majority.

The Palestinian government may implode and hand over its governance to the Israeli Civil Administration while Hamas takes over Gaza again. Israel will be saddled with a recurrent budget of NIS 15 billion and development expenditures of NIS 1 billion. Tax revenue may decline from about NIS 10 billion to NIS 7 billion with further territorial fragmentation and market segmentation. The Israeli administration will inherit a recurrent deficit of NIS 8-9 billion with no external financing. From an Israeli perspective this would only be 1% of Israeli GDP which would be easy to absorb. Israel may shed all Gaza expenditure, about NIS 4 billion annually, leaving 65,000 PNA employees in Gaza unemployed, and virtually no elec-

tricity. With NIS 4 billion removed from the income stream, a closed Egyptian border and continued Israeli siege, Gaza's only option would be to resume armed conflict with Israel. Again, this is a very unstable scenario.

2. Unilateral Roll Back of The Occupation in The West Bank

One approach to "managing the occupation" would be to provide Palestinian communities greater economic space and governance autonomy. This could be done unilaterally, following South Africa's path under Apartheid, towards establishing Bantustans. Areas in the northern West Bank around Jenin and Tul Karem can be converted from C to A and B, with IDF redeployment towards areas of greater settlement concentration. Similar redeployments may take place in the southern West Bank. IDF incursions in these areas would largely disappear and movement of people and goods within the West bank would be facilitated. More permits would be granted to Palestinian workers, and greater access to water resources as well as water and sanitation infrastructure. This would improve the quality of life for Palestinians in the favored areas but it would be difficult to assess the economic benefits and political outcomes without more specific delineation of this Bantustan policy.

Such an approach is bound to fail, as it will only reinforce the perception that annexation of the West Bank is being institutionalized. Private sector investment may fall further and there would be greater emphasis on local markets, short supply chains and quick turnover activities. The Palestinian government would have to be actively engaged in a redeployment of the IDF, with the coordination of its security services and expansion of its service delivery to areas falling under Palestinian sovereignty. More importantly, this roll back of the occupation would need to be portrayed as an initial step in resuming negotiations and moving towards full sovereignty over the Palestinian territory. A more enlightened Israeli government may elect to pursue such a course with the lifting of most economic restrictions, opening area C for some development projects, lifting the siege on Gaza and facilitating Palestinian external trade. This would stimulate economic activity in the short term, but unless there is a clear movement towards economic and political sovereignty, investment and economic growth would decline.

C. The Two-State Solution to The Palestinian/Israeli Conflict

1. Parameters of a Final Status Agreement

The parameters of a Final Status agreement will be based on the Saudi Peace Initiative, which has become the Arab League Peace Initiative. The parameters have been drawn from previous discussions between the two parties and articulated in the Clinton Parameters (December 2000); the Taba agreements (January 2001), and the Geneva Accords (December 2003). The key parameters can be broadly summarized as follows:

- Borders between Israel and Palestine would be set in line with the 1967 borders, with agreed upon territorial swaps.
- Contiguity of Palestinian territory would be assured by a free passage between Gaza and the West Bank and free access of Palestinian to East Jerusalem
- Jerusalem would be defined as the capital city of both countries. The borders between East Jerusalem and West Jerusalem would be established and there would be free movement within the Old City which would benefit from a special regime

· Palestine will be a non-militarized state with a robust security force
· The rights of the Palestinian refugees would be recognized in line with General Assembly Resolution 194 and UNSC Resolution 242. Several options would be offered to refugees to reside in Palestine, in third countries and In Israel in accordance with a number acceptable to it.

2. Palestinian Accession to Political and Economic Sovereignty

a) Establishing a sovereign state

The framework of a Palestinian State which will generate a dynamic economy by maximizing opportunities for private sector investment, and which will meet the needs and expectations of a growing population. A sovereign Palestinian State would focus on good governance with an independent Judiciary; reuniting Palestinian territory; strengthening infrastructure, including construction of a sea port in Gaza and an international airport in the Jordan Valley; connecting with the rest of the world under an independent trade regime; establishing an independent Central Bank and regaining fiscal sustainability.

Good governance would be anchored in the fundamental principles of democracy, free speech and an open economy which should constitute the building blocks of a new Palestinian State. After years of struggle against occupation and autocratic rule, the Palestinian population deserve a state which would respect basic human rights and equal treatment of all its citizens under the law.

The Palestinian government would be guided by International law, engaging all sectors of society. It would be fully committed to the rule of law, weeding out corruption and nepotism and would emphasize openness, both in its economic orientation and in its interaction with the rest of the world. Palestine would be a peace loving state that rejects violence, builds bridges with neighbors and the international community, and commits to live in peace and security along the State of Israel. Upon attainment of sovereignty, the Palestinian State would engage in cooperative relations with Israel and other countries.

Considerable progress has been made in institution building, particularly in areas of public policy and infrastructure development where the PNA could control execution and service delivery[16]. Without going into an exhaustive list of achievements, there are four areas of reform worth mentioning: i) the security network established in the West Bank has ushered some degree of confidence and stability among the business community and the population at large. ii) the justice system has undergone major improvements by shortening the backlog of cases, and by strengthening enforcement of court decisions. Iii) public financial management has undergone a considerable improvement in quality over the last three years, including a greater degree of transparency and strengthening public accounting and external audit and iv) a strengthening of the banking and financial system to the point where it has become a major success story in the region.

The World Bank has highlighted service delivery in terms of child health, nutrition, and education enrolment placing Palestine, well above the performance of other middle income coun-

16. This progress has been highlighted in "Homestretch to freedom: the second year of the 13th government program", and more recently, in the PNA submission to the AHLC on April 13, 2011: "Building Palestine: achievements and challenges".

tries[17]. At the AHLC held in April 2011, there was a broad consensus that the PNA has achieved readiness in its institution building to establish an effective governing State. In effect, the PNA had crossed the finish line and was ready to establish a state.

Looking forward, the government would be expected to build on these achievements and establish an investor friendly environment to take full advantage of large inflows of investment capital.

Reuniting the Palestinian territory. To ensure economic viability territorial linkage must be established, for both people and goods, through a reliable and effective transportation and trade network, between Gaza and the West Bank. East Jerusalem needs to be reintegrated into the West Bank economy through unimpeded transportation and trade links. Areas which have been isolated by the Separation Wall would be reunified with the rest of the West Bank. Area C would be fully reintegrated with the West Bank, particularly the Jordan Valley which has been depopulated and borne the brunt of the isolation imposed by the occupation.

Infrastructure. The most critical government task towards inducing private sector investment, facilitating internal and external trade and reducing transaction costs is the upgrading of Palestinian infrastructure to middle income country standards. In addition to the infrastructure necessary to reconnect with the rest of the world mentioned earlier--port and airports and adequate border posts and custom services--the Palestinian State should focus on upgrading the road network in Palestinian territories and on creating a public transportation system linking the major urban centers, including a rail system[18]. This will facilitate the movement of people and goods, promote labor mobility, and reduce costs of servicing the rural areas[19].

The Palestinian State will need to focus on bringing Gaza's infrastructure, housing and public facilities to the levels attained in the West Bank. The rebuilding plan, partly outlined in the Palestinian National Early Recovery and Reconstruction Plan for Gaza following the Cairo Conference in October 2014[20] during which $4.5 billion was pledged, should be revisited and updated, and the institutional upgrading can also draw on the Gaza Economic Strategy[21].

East Jerusalem, which was the hub of Palestinian economic and cultural activity, has been cut off from the West Bank and Gaza through the separation wall and the denial of movement of Palestinians in and out of their capital. Its 250,000 residents, with the highest per capita income in Palestine, should have benefited from infrastructure and public service commensurate with their per capita income and facilities available in West Jerusalem. Yet their schools and health facilities have fallen below acceptable standards and are overcrowded. Housing construction has been severely restricted through denial of permits and house demolition. Upgrading East Jerusalem infrastructure and service facilities and remedying the acute shortage of housing should constitute a key priority for the Palestinian State.

17. World Bank, "Building the Palestinian State, Sustaining Growth, Institutions, and Service Delivery", paper submitted to the AHLC, Brussels, 26, April 13, 2011
18. The Rand proposal for a north/south transportation system linking West Bank cities, can be a starting point in elaborating a public transportation master plan. See "The arc" A formal structure for a Palestinian State. Rand Corporation, 2005
19. See Annex 1 of the NDP; Establishing the State, Building our Future p 102
20. International Conference in support of the Palestinian Economy for the Reconstruction of Gaza, Cairo, October 12, 2014
21. Palestinian National Authority, Ministry of Economy: Gaza Economic Strategy, March 2011

Trade regime. The first step in Palestinian accession to economic sovereignty would be to establish a customs presence at border posts and decide on a trade regime. Openness to foreign trade and low tariff protection will be critical in promoting its economic development along the most productive trajectory. Indeed, together with good governance, foreign trade has been listed by numerous economic studies as the two singular factors in explaining differences in rates of economic growth across countries. The Palestinian government would be committed to an open and transparent trade regime, with low protection and full compliance to WTO rules and obligations.

Under Palestinian sovereignty the main trade policy objective would be to diversify Palestinian trade away from its skewed dependence on Israel and to reset trade relations with Israel on an equal footing, consistent with each country's interests. Palestinian society may undergo a catharsis in its reaction to past Israeli occupation practices by adopting separate policies in various areas, including in trade relations, even if they may not be optimal from a Palestinian economic perspective.

From this perspective, the Palestinian State is likely to move away from the Customs Union it has with Israel, as established under the Paris Protocol, due to its asymmetric implementation by Israel, lack of any recourse to challenge its abuses, and all the distortions it has caused in the Palestinian production and trade structure. Consequently, the Palestinian State will be choosing between a Free Trade (FT) regime with Israel and a Most Favored Nation (MFN) trade regime. Under the FT it will have free trade with Israel, subject to rules of origin for its exports to Israel. It will need to formulate a customs tariff for all goods imported or exported to other countries. It will also have a customs presence at all border posts with Israel and other countries. Under the MFN trade , Israel would be subjected to the Palestinian and Israeli tariff and Israel would be treated as any other country. The advantages and disadvantages of alternative trade regimes with Israel have been discussed at various venues, by the IMF, the World Bank, the PIBF and The AIX Group.

Fiscal sustainability. A major objective of the PNA over the last three years has been to reduce its dependence on external budget support and move decisively on attaining fiscal sustainability. A fiscal deficit which is perceived by markets as sustainable would be reduced to a level which could be readily financed through borrowing, without crowding out the private sector or raising sovereign risk beyond prudential norms, while maintaining public debt within manageable limits[22]. The Maastricht treaty of the European Union had urged member countries to maintain their fiscal deficits within 3% of GDP and keep their public debt below 60% of GDP.

Should credible prospects for a peace agreement and the establishment of a Palestinian State emerge, economic growth would ratchet upwards to the two digit levels, bringing with it much higher PNA revenues and lower fiscal deficits (see below).

Optimistic MOF medium term scenarios show that if economic growth were to reach 10% in each of 2016, 2017, and 2018, the recurrent fiscal deficit would decline from 11% of GDP in 2015 to 2% of GDP in 2018 thereby achieving fiscal sustainability. The lifting of the siege on Gaza and the rolling back of the occupation in the West Bank, particularly in area C may trigger such a burst in growth, even if peace negotiations become protracted. However if an end of conflict

22. One criterion for managing public debt is to ensure that public debt does not grow faster than the public revenue base.

were to be achieved, higher rates of growth would materialize, as has occurred in other post conflict situations, resulting in a surplus or at least a balanced budget on recurrent expenditures.

External budget support for recurrent expenditures would be phased out with such growth performance under a clear path towards statehood. As mentioned earlier, the donor community would shift its external aid to development spending, in line with the large infrastructure needs outlined above and the immediate development priorities associated with the establishment of a state. Thus, a Palestinian State would achieve one of its main objectives, consistent with attaining economic sovereignty: reducing its dependence on budget support and foreign aid.

Monetary and exchange rate policy. In its Staff Report to the AHLC on April 13, 2011, the IMF stated: "Following steady institutional reforms implemented since 2007, the Palestine Monetary Authority is now in a position to carry out the functions of a central bank"[23].

Given the depth of its institutional development, the PMA would be converted to a Central Bank and issue a currency. It will conduct monetary and exchange rate policy, and act as a lender of last resort, should a financial institution undergo a liquidity crisis. It would also provide the Palestinian government with seigniorage revenue from the issuance of a currency, which can be conservatively estimated at 2-3% of GDP, an annual average of $ 400 million during the first 5 years[24], declining subsequently to 1.5% of GDP ($ 200 million at the 2010 GDP level). A Central Bank Law has been completed, but the timing of the PMA being converted into a central bank and issuing a currency would critically depend on attaining fiscal sustainability.

A successful launching of a Palestinian currency must be able to convey to the public that the currency is credible and stable. The credibility and stability of the currency would be provided by several ground rules, many of which have been operational during the last decade under the Paris Protocol.

- Full convertibility of the Palestinian currency into any other currency upon demand.
- An open capital account with the freedom of transferring funds in and out of the country.
- Allowing other currencies to circulate freely, including freedom for the public to hold deposits in US dollars, NIS, Euros and Jordanian Dinars, as is the case today, with free currency substitution
- The introduction of a Palestinian currency would be gradual, starting with the public sector salaries and payments to suppliers and tax receipts. It has been preceded by legislation providing for deposit insurance. After this transitional period, private sector payments and transactions would be increasingly conducted in the Palestinian currency.
- Having a provision in the Central Bank Law forbidding the government from borrowing from the Central Bank.
- Pursuing a tight fiscal and monetary policy, to ensure price and exchange rate stability.

23. IMF Staff Report to the AHLC, April 13, 2011, op cit
24. PMA estimates. Also, Bank of Israel. Arie Arnon and Avia Spivak "A seignorage perspective on the introduction of a Palestinian Currency" May 1995. Their estimates are much higher, amounting to 22% of GDP during the first 5 years and subsequently declining to an annual 1.4% of GDP.

· Ensuring that the public debt remains within prudential limits.

In the initial period after the launching of a currency, the Palestinian Central Bank may receive support from other Arab central banks in the form of deposits or swap agreements. This would strengthen confidence in the Palestinian currency and deter the possibility of speculative attacks.

A major objective of the government's macroeconomic policy would be to maintain price and exchange rate stability, while promoting economic growth and full employment. There are other social objectives as well: spreading the benefits of growth broadly across the population, maintaining social cohesion and having a robust social safety net.

High dependence on external trade and the pursuit of a multiplicity of objectives[25], in addition to price stability, would argue for a flexible exchange rate regime, as opposed to a fixed exchange rate under a currency board arrangement[26]. With strong productivity growth expected for several years after the establishment of a state, and the prospect of substantial net capital inflows, a flexible exchange rate policy would moderate the currency's appreciation and maintain export competitiveness. It would also be able to respond to the occurrence of adverse external conditions (crop failure, disruption of external trade), allowing the exchange rate to depreciate, without a sharp downward adjustment in nominal wages.

The Central Bank would be able to manage the exchange rate and to pursue a discretionary monetary policy, within a certain margin[27]. Such independent monetary policy for a small country like Palestine would be quite limited and would mostly follow international monetary developments. Nevertheless, it may be able to influence short term interest rates, while avoiding unwarranted exchange rate movements and the emergence of a risk premium on investments in the Palestinian currency. It would also be able to act as a lender of last resort, which would not be unlikely in the Palestinian banking system, with too many small banks[28].

b) Economic Growth Under Statehood

A major economic consequence of the control regime has been not only the rise in transaction costs and loss in competitiveness, but also a loss in labor and capital productivity. Long delays at checkpoints, the rise in labor absenteeism, the drop in working hours because of late arrivals, have all contributed to a fall in labor productivity. In many enterprises, professional workers were laid off under the economic repression, and replaced by less productive family members. In addition, the inability to train workers both in Palestine and abroad because of restrictions on travel, has inhibited the upgrading of skills and rise in labor productivity. Similarly, Palestinian management, unable to travel or receive training abroad was unable to learn and implement best practices and adapt to a rapidly changing competitive environment.

With the removal of restrictions on internal movement of labor and management, and access to foreign countries for training and hiring, both labor and management productivity would rise. Similarly, the lifting of restrictions on imports of new equipment and machinery would boost capital productivity. By restoring a territorial linkage with Gaza, and by reintegrating area C and East Jerusalem into the West Bank, economies of scale, which had been denied to the Palestinian economy till now, would emerge at a much higher level than ever experienced.

25. The Tinbergen principle states that policy makers must have at least as many policy instruments as they have objectives.
26. Nouriel Roubini: Debunking 10 myths about the benefits of Currency Boards. www.stern.nyu.edu June 1999
27. This policy would be similar to the exchange rate and monetary policy pursued by the Bank of Israel, which has been quite successful during the last decade.
28. The PMA has already acted in this capacity in 2010 by liquidating the Palestine International Bank.

All of these factors would coalesce to boost total factor productivity. Annual increases in TFP may range yearly around 5-6% over a decade, as has happened in other post conflict situations[29].

Rise in Competitiveness

Transaction and transportation costs related to trade within the West Bank and in and out of Gaza would be expected to come down, once restrictions on movement are lifted and a free passage to Gaza is established. Costs related to trade with Israel may come down as well, regardless of the trade regime agreed to between the two countries. With the upgrading of border facilities under Palestinian sovereignty, (Allenby Bridge, Rafah) and lower shipping costs than those presently incurred through Israeli ports, transportation costs to external markets would also come down. All of the costs associated with impediments to movement, access, and transportation would decline and would strengthen Palestinian competitiveness of both exports and import substitutes. Estimates of the economic costs of the occupation indicate that costs related to movement restrictions and restrictions on exports and imports amount to 6.4% of GDP[30]. To the extent that these costs can be fully phased out, a major boost to Palestinian competitiveness would occur.

The removal of uncertainty from the supply chain, the restoration of reliability in the delivery of goods and compliance with contracts, will restore some of the export markets which had been lost, as well as adding new export markets. Competitiveness of Palestinian production would also benefit from lower energy costs through off shore gas exploitation in Gaza and diversification of sources of supply, such as obtaining petroleum products directly from Arab countries. These gains in competitiveness would raise demand for Palestinian products both at home and abroad.

Gains from Trade

Major gains from trade would be achieved by unimpeded imports from abroad and an expansion in exports. Even more substantial may be the gains from trade restoration internally. Reestablishing territorial contiguity within Palestine, particularly with Gaza, East Jerusalem, and the Jordan Valley will be accompanied by a major expansion in internal trade. With its broad range of enterprises, skilled labor, resourceful entrepreneurial class and lower wages, Gaza can produce a range of goods for the West Bank and vice versa. Its proximity to the Egyptian market and development of port facilities would channel a large share of Palestine's external trade through Gaza.

The Demographic Dividend

Palestine has benefited from both high fertility rates and declining mortality rates, consistent with its health and education services performance which has far exceeded that of its income level in other countries[31]. Population growth has slowed down to 2.7% in 2013, from about 3.8% in 1999[32]. This would lead to a rise in the share of the population at working age (15 years to

29. IMF "West Bank and Gaza: Demographics and Long Term Growth in the Palestinian Economy" H. Davoodi and U. Erickson von Allmen pp29-33, 2001
30. Ministry of National Economy and ARIJ: The Bulletin on the economic costs of the occupation for Palestine, September 2011, p.4
31. World Bank, op. cit Para. 55, p 28
32. PCBS population censuses for 1997, and 2007.

60) out of the total population. These trends are expected to prevail over the next decade; with a gradual shift in the age of the population from about half the population under the age of 15 in the 1990's to about 60% of the population over the age of 15 by 2025. As a result, the labor force is projected to grow at 4.2 % over the next decade. With the right socio-economic environment this demographic transition can contribute substantially to a rapid increase in growth and in per capita income[33].

The large yearly increase in new additions to the labor force, coupled with a drawdown on unemployment and higher labor participation rates[34], particularly among women, would provide the private sector with a large pool of available labor, expanding annually at about 6% over a decade, with the rate of increase declining thereafter[35]. A double digit real economic growth rate, driven by the private sector on a sustained basis for a decade, would easily absorb such an increase. This supply aspect of the demographic dividend enables the private sector to absorb the additional labor without a significant increase in wages over productivity increases. This is the demographic dividend. It would be critical in maintaining Palestinian competitiveness and reducing unemployment.

The fiscal aspect of the demographic dividend is twofold: a larger labor force as a proportion of the population increases the tax base and reduces the dependency ratio. To put it differently, the additional labor absorbed by the private sector would be contributing higher tax revenues to the Palestinian government through its consumption and income taxes. On the expenditure side, the decline in fertility rates and population growth results in fewer children and people older than 60, in relation to the total population. This reduces the yearly increase of government expenditures on education, health and social allowances. Both factors would combine to reduce the government's fiscal deficit and help in regaining fiscal sustainability.

A growth analysis of the West Bank and Gaza over a thirty year period (1970-99), has shown that a 1 percentage point higher growth in the working age population than in the total population was associated with higher real per capita GDP growth by around 2.2 percentage points a year. The current difference between the growth in working age population and total population is 1.3 percentage points, which would be expected to contribute 2.9 percentage points in per capita income annual growth[36] over the next decade.

While this ongoing demographic shift would provide major benefits under a high economic growth scenario, the opposite would happen under the existing situation of declining growth. The large increase in the labor force would not find employment and far from contributing to PNA revenues it would raise PNA expenditures and fiscal deficits through higher unemployment benefits and poverty reduction expenses.

Influx of Palestinians from Abroad

In 1999, PCBS estimated an influx of 500,000 returnees, over several years, following a final status agreement with Israel[37]. If a peace agreement were to occur over the next two to three

34. The participation rates will increase on two counts: more people will enter age groups with higher participation rates and the participation rates for women will increase. This has already happened, with women participation rates in the labor force rising from 11.3 in 1999 to 19 in Jul-Aug 2014. PCBS labor force surveys.
35. To the annual increase in the labor force of 4% an increase in the participation of women would take place by about 2%.
36. See Hamid R. Davoodi and Ulric von Allmen in "Demographics and Long Term Growth in the Palestinian Economy" pp 43-48 in "West Bank and Gaza Economic performance, Prospects and Policies" IMF, 2001.
37. PCBS, 1999, "Population in the Palestinian Territory: 1997-2025"

years with actual implementation of a Palestinian State, the influx of Palestinians from abroad, including under a settlement on refugees, may amount to 1 million over a few years. Similar to the demographic dividend, such immigration tends to have a positive impact on the rate of growth. As mentioned above, returnees also bring with them management skills, transfer of technology, and capital, all of which would contribute to growth, beyond the initial positive impact of raising the ratio of working population to the total population.

The immigration of Palestinians into Jordan following the first Gulf War, the large Russian immigration into Israel in the early 1990s[38], and the immigration of Palestinians into the West Bank and Gaza following the Oslo agreements were all associated with an uptick in economic growth.

Revival of Repressed Economic Sectors

With the accession to Palestinian independence and statehood, a fundamental change in the economic environment would be expected to occur. Not all sectors have been equally affected by the occupation and therefore the lifting of restrictions will benefit some more than others. Some sectors may not have been able to emerge at all under occupation conditions. Therefore, the Palestinian economy might undergo a major transformation, during which entirely new leading growth sectors might emerge. It would be essentially knowledge based, benefiting over time from a redesigned education system and from transfer of technology from abroad. Research and development should gradually assume a greater role in Palestinian economic development. While it would be difficult to forecast in advance which sectors will gain prominence over time, the existing structure of the economy can be used as a starting point to project how various sectors might respond to a complete lifting of restrictions and free access to external markets.

Agriculture, manufacturing, tourism and ICT, which were all repressed under the occupation, will become unshackled and free to seek their own equilibrium within the new Palestinian economy. Construction would also become a source of growth as it attempts to meet the backlog demand for housing in area C and in East Jerusalem from a rapidly growing population, and the resurgence in infrastructure projects. All this newly generated economic activity would also spill over into a large increase in demand for services. By contrast, government would step back from its leading role in stimulating economic growth over the past three years, and resume its normal role of regulator and policy maker.

38. See Cohen, S and C. Hsieh, 2000, "Macroeconomic and labor Market Impact of Russian Immigration in Israel" http://www.wws.princeton.edu/-chsieh/

Annex A: Restrictions Imposed by Israel on Palestinian Economic Activities.

Economic restrictions can be summarized under four categories:

• **Permits**.

Permitting requirements have targeted construction of new housing and expansion of existing housing in area C and in East Jerusalem. The denial of most permit requests has forced Palestinian residents to build without permits, which in turn, has led to house demolitions by the Israeli authorities. Over 10,000 houses have been demolished since 2001[39]. This, coupled with higher demand for housing by a rapidly growing Palestinian population, has forced many residents to live in overcrowded conditions, move to areas A or B or migrate abroad. Importing capital equipment by Palestinian enterprises require permits, ostensibly for security reasons, or are prevented altogether, under "dual use" list. Farms and factories have been denied permits to import a wide variety of raw material, inputs such as chemicals and fertilizers, and capital equipment, all under "Dual Use" concerns, although protectionist pressures may also play a major role. Aside from the cost entailed in seeking approval, and the long delays incurred in obtaining them, sometimes stretching into years, the private sector has been inhibited from replacing obsolete machinery, upgrading technology, and improving labor productivity. Restrictions under dual use in agriculture, industry and ICT are estimated to have cost the West Bank economy at least $ 160 million per year or 5% of GDP[40]. Infrastructure projects in area C, such as building a school, digging a well or paving a road, must be approved by the Civil Administration (COGAT), in charge of the occupied territory.

• **Restrictions on movement and access**[41]

Palestinians cannot move between the West Bank and Gaza or within the West Bank, to the Jordan Valley, unless they get permission from the Israeli authorities. This undermines labor mobility and makes it difficult for students to study at the Palestinian university of their choice. Most students in Gaza had to forego higher education for lack of permit to travel to the West Bank or abroad. Moreover, many Palestinians residing in East Jerusalem or the West Bank are reluctant to travel abroad for extended periods for training, education, or work for fear of losing their residency. Under this pretext, over 9,000 Jerusalem residence permits have been withdrawn from Jerusalemites since 2001.

Movement of Palestinian labor into Israel has also been highly restricted reducing the number of workers allowed to work in Israel from 132,000 in the third quarter of 2000 to about 50,000 in 2014[42]. The 500 checkpoints and barriers within the West Bank, the inability of most West Bankers to access the Jordan Valley without a permit, the isolation of the West Bank from East Jerusalem and from Gaza, the loading and unloading of goods going in and out of the West Bank and the inability to travel freely in and out of Palestine, have raised

39. Israeli Committee against House Demolitions Press Statement, August 2013. Amnesty International: Under the Rubble: House demolition and destruction of land and property. May 18, 2004.
40. See: The Impact of Israeli restrictions on the Transfer of Dual-Use goods to the West Bank; USAID, Trade Facilitation Project January 2010.
41. Restrictions on movement and access, within the West Bank and between the West Bank and Gaza and East Jerusalem, have been amply documented in World Bank, PALTRADE, OCHA and UNSCO reports41.
42. In addition, in 2013, there were about 30,000 working in Israel without permits, and 22,200 working in settlements. PCBS labor surveys, and Israel's Central Bureau of Statistics.

transaction costs, undermined competitiveness, and stymied investment and technological change.
Severe limitations imposed on trade links with Gaza undermined its export oriented economy and hindered economic integration with the West Bank. These trade links were expected to be institutionalized and expanded under "The Agreement on Movement and Access" of November 15, 2005, drafted by the World Bank, the US, the PNA and the GoI. However, under adverse political pressures, including the election victory of Hamas in January 2006, this agreement was never implemented[43]. Nor are Israelis allowed to go to area A, unless they obtain a permit. This has markedly reduced business interaction between Israel and the West Bank, particularly Israeli subcontracting to Palestinian enterprises, or the initiation of any joint projects.

Control by Israel of all external borders have also prevented most Palestinians from traveling abroad and for many Diaspora Palestinians from visiting Palestine, through denial of permits or visas. This has been particularly costly for industries which needed to invite professionals from abroad or send workers and management to other countries for training. These travel restrictions have severely limited transfers of technology, stymied innovation and inhibited the exchange of ideas which is becoming all the more critical, as Palestinian exporters, including knowledge based industries, attempt to position their products favorably in the global economy.

- **Limitations on use of natural resources**

Palestine has substantial natural resources which are left largely unexploited due to Israeli imposed restrictions on land utilization, water usage, energy resources and mineral deposits.

Land utilization is limited by virtue of Israel's full sovereignty over area C which accounts for 62% of the West Bank. Public infrastructure, such as access roads, towers for mobile service, or the laying of landlines and ADSL cable has not been granted permission. Land contiguous to the Dead Sea is also being denied for tourism projects or for mineral exploitation.

Water usage has also been restricted under the Oslo agreements to 17% of joint water allocation of 601 MCM while Israel has appropriated 83 %. It should be pointed out that the Mountain Aquifer which is the source of most of the water for both countries lies essentially under the West Bank. Yet only 20% of its discharge benefits the West Bank. Moreover, after 1967, when Israel took control of all water resources in Palestine, Palestinians lost access to water from the Jordan River[44].

Energy resources. Natural gas resources have been discovered offshore from Gaza about eight years ago. Crude oil has also been discovered in the northern West Bank over the last two years. Yet the Israeli Government has held up the development of these resources. In the case of natural gas, a full-fledged extraction project—Gaza Marine-- has been elaborated and ready for execution for several years. However, it cannot be implemented unless approval is provided by Israel.

Mineral deposits. Extraction of potash, bromine and magnesium from the Dead Sea has been a major source of income and employment for both Israel and Jordan. Israel generates annual sales of $ 3 billion of Dead Sea minerals while Jordan earns $ 1.2 billion or 4% of its GDP. The

43. See the former World Bank President, Jim Wolfensohn's interview with Haaretz, March 2006.
44. World Bank: West Bank and Gaza: assessment of water restrictions on the Palestinian Economy April 18, 2009.

World Bank estimates that Palestine could generate yearly income equivalent to 9% of GDP if it had access to Dead Sea minerals.

- **Territorial fragmentation**

The West Bank and Gaza, with different resource endowments, investment potentials and income levels are complementary economies. Yet Gaza has been cut off from the West Bank and East Jerusalem, either through movement restrictions or through the imposition of a siege, which has now been lasting for eight years[45]. By 2014 the Gaza economy has been completely delinked from the West Bank due to the siege. East Jerusalem, which was the hub of Palestinian economic and cultural activity, has also been cut off from the West Bank. Its 250,000 residents, with the highest per capita income in Palestine, constituted a major market for West Bank and Gaza producers. The West Bank has suffered its own fragmentation. The proliferation of Israeli settlements in area C, and associated "closed military zones", checkpoints and road networks required to protect them have taken away most of the West Bank agricultural land from economic development. This is particularly true of the Jordan Valley which has been depopulated due to restrictions on access and the loss of investment and job opportunities. The construction of the separation wall, in some areas deep into the West Bank, has taken out another 8% of West Bank land.

Some Economic Aspects of the Reconstruction of Gaza

The AIX Group

January 2015

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Executive Summary

This paper suggests that the effort of the reconstruction of Gaza should be supplemented by a number of measures that would enable the people of Gaza not only to rebuild their destroyed homes, but also to rebuild their destroyed economy. We show based on various studies, that the main reason for the economic decline of Gaza has been the siege policy that closed the Gaza strip almost completely since 2006. Hence, we suggest that the required immediate steps for economic recovery should be opening Gaza to movement of people and goods. These are mainly three measures. The first is to reopen the 'Safe Passage' from Gaza to the West Bank, which will operate by convoys. The second is to begin a gradual improvement of the Gaza port and to continue to a commercial port. The third is to rebuild the Gaza International Airport. All three measures were agreed in the past between Israel and the Palestinians, and implemented for limited periods of time. The paper then discusses the various security risks that these measures might create and how they can be dealt with. Finally the paper discusses the political concerns with respect to the opening of Gaza, which might appear as a concession to Hamas. It claims that since the siege policy failed, it should be stopped, since it is a harmful policy that punishes a large population and makes it hostile and radical. The paper also claims that opening Gaza in an agreement between Israel and the Unity Government might even weaken Hamas.

1. Introduction

Gaza suffered severe damage during the summer of 2014. To that we should add some of the destructions inflicted on Gaza during the wars of 2009 and in 2012, which have not been repaired yet. As a result, the need for an urgent thorough reconstruction for Gaza is obvious and recognized by almost everyone. A testimony for that has been the conference of many countries (more than 50) and international organizations in Cairo in October 2014 showed a wide support for this reconstruction and even committed to contribute $5 billion to fund the reconstruction. The main decision of the conference was that the reconstruction will be led and implemented mainly by the Government of Palestine, and will be supported by the UN, which plays a prominent role in the Gaza Strip, mainly through UNRWA. In this document, we focus on some important additions to the reconstruction efforts, which will improve the economic situation. This will help the people of Gaza not only to reconstruct their houses, but also to rebuild their standard of living, which has been significantly deteriorated over the past twenty years of economic stagnation.

Our argument is based on three main steps. First, we claim, and support this claim by evidence, that the economic decline of income in Gaza has been caused mainly because of the closing of Gaza. Next, we suggest that the reconstruction should be complemented along with opening Gaza to mobility of people and goods. Accordingly, that should be done by renewing the 'Safe Passage' between Gaza strip and the West Bank through convoys, by rebuilding and operating the International Airport of Gaza, and by developing the Sea-Port of Gaza. In addition, to these three measures there is an urgent need to rebuild and even upgrade the infrastructure of Gaza, namely electricity, water and sewage. This renovation is part of the current reconstruction plan, but we think that it should be further expanded, not only to serve the population, but also to serve potential future economic development. Finally, our report addresses the potential political and security concerns.

Our call to accompany the reconstruction of Gaza by opening it for mobility of people and goods might raise many potential disagreements. We will deal with them in detail in the document, but we will outline the main points here.

1. Some Israelis may claim that opening Gaza will make it easier to enter weapons to Gaza strip and thus will be a continuous security threat to Israelis. We believe that after almost ten years of the full siege policy since 2006, it is quite clear that this policy has failed. During the siege period arms kept entering Gaza and the Hamas regime did not collapse. The siege did not give security to Israel, on the contrary. Violence broke out again and again, with increasing frequency and intensity. The last round has taken 2,200 Palestinian lives and 70 Israeli lives, more than ever before on both sides. The siege policy failed and it is time to consider a different new strategy.

2. We claim that opening Gaza is not going to increase security risks, but might even reduce them, as it will decrease the feeling of Gazans that they are living in a big jail. Furthermore, the security issues of opening Gaza can be dealt with using specific measures. All the steps we suggest were agreed upon between Israel and the Palestinians in the past and operated for some time. These security arrangements did not fail per se, but were interrupted as punishments for the Palestinians on unrelated events, like violence elsewhere, or the election of Hamas, or just as a way to exert pressure.

3. Some may claim that the budgets for reconstruction should go just to rebuild homes, schools and hospitals and not to reconstruct airport and port. However, we maintain that these latter costs are relatively low. We believe that people in Gaza strip need reintegration to the world, jobs, and decent living beside their residences.

4. Others might claim that opening Gaza strip has been the demand of Hamas for a long time and thus our proposal might benefit the Hamas, who is an enemy of the Two-States-Solution. This is of course a problematic argument. One should not oppose any good measure just because it is demanded by Hamas. Furthermore, opening Gaza should be done by the Compromise Unity Government of Palestine in an agreement with Israel, as otherwise it cannot be implemented. If such an opening will happen, it will strengthen the support for peace and coexistence, not weaken them.

5. Others might claim that what we suggest brings us back to the well-known myth of 'Economic Peace,' which is supposed to reduce current suffering and help postponing the political peace for a long time. The AIX Group is a solid supporter of the two-states-solution and of reaching it soon, not in the far future. But, we also think that reaching peace and Palestinian self- determination, should not be preconditions or stand in contradiction to the well-being of the people of Gaza. Furthermore, we don't think the Palestinian economy, in the West Bank and in Gaza, will enjoy sustainable development if there is no agreement in the horizon. Investors will not invest their money if they don't expect freedom as well as economic sovereignty soon. Our analysis therefore views the concept of 'economic peace' as wrong and we reject it. Hence, the measures we propose, should be viewed as first aid and not as a long-run solution. They cannot improve significantly the economic situation if they are accompanied by serious progress toward a final peace agreement.

The paper is constructed as follows. Section 2 describes briefly the history of Gaza and its economy. Section 3 tackles the argument that closing Gaza had a significant role in causing its economic decline. Section 4 describes the required measures to open Gaza and to repair and improve its infrastructure. Section 5 discusses the required ceasefire agreement. Section 6 deals with the security concerns. Section 7 deals with political concerns, and finally Section 8 concludes.

2. History of Gaza: Economics and Politics

In 1947, the Gaza Strip was mainly an agricultural area, with a population of around 75,000 people who live in an area of less than 370 square km (around 150 square miles). During the 1948 war, the population increased three times up to 225,000, due to many refugees who fled from the southern shore region and from the Beer Sheba area.[1] From the year 1949 to the year 1967, the Gaza Strip was under Egyptian control with a special status. Economic data from those days are scarce, as stressed by Gharaibeh (1985), but clearly the demographic changes of 1948 had huge impact that transformed the population from farmers (fellahin) to mainly wage earners. The economic situation in Gaza during the Egyptian period was harsh. The rate of unemployment was close to a third. Of the employed, a third worked in the public sector and

1. For a comprehensive history of Gaza see Filiu, (2014), Gaza: A History.

a third in agriculture and salaries were very low. Since 1949, UNRWA has been responsible for the refugees' housing, education, health and basic welfare. Thus, it became a central player in the public sector in Gaza. The first census in Gaza since 1948 was conducted under the Israeli military occupation in September 1967, and according to it, 350 thousand people lived in Gaza then, of which 200 thousands were refugees.

In the first two years, after 1967, the Israeli government made some decisions that shaped the economic dynamics in Gaza for a long period and to some extent until today.[2] The main decision was to enable Palestinians to work in Israel. A second decision, though less formal, was to deter investments in Gaza and in the Palestinian territory in general, in order to support purchase of Israeli goods. The resulting weakness of the local labor market in Gaza pushed Palestinians to seek work in Israel in large numbers. By the mid-of 1970s, third of employed Gazans worked in Israel and by the mid of -1980s more than 45%. These policies made Israel the major trading partner with Gaza. Its trade deficit (excluding remittances from work in Israel, formally called Factor Income from Abroad, FIA) became very high. The average trade deficit of Gaza during the years 1968-1987 was 68 percent of GDP, and 64 percent during the years 1988-1993. FIA financed 55 percent of the trade deficit from the year1973 to 1987.

Following the first Intifada, which started in Gaza in December 1987, exports, imports and labor flows began to decrease.[3] But from 1991, this process intensifies as a result of a gradual closing of Gaza from Israel and from the West Bank, through closures and similar measures of separation. It began with the long closure of the Palestinian territory during the Gulf War of 1991, and it gathered momentum later with more closures over time until reaching full siege in 2006.

The Oslo Accord was signed in September 1993, followed by the Gaza-Jericho agreement in 1994 and its extension to the West Bank in 1995. These agreements raised dramatic hopes for rapid economic development in Palestine. The results have been very disappointing. Real GDP per capita in Gaza has grown from 1997 to 2013 at an average rate of 0.0 percent.[4] But, the picture has been much worse, since in the 1990s many Gazans worked in Israel, while since 2005 no one works in Israel. So, income per capita has dropped significantly. Since many of these workers now work in Gaza, it means that GDP per worker is much lower in Gaza now than in the mid 1990s. Indeed, we find in AIX (2015) that GDP per worker declined between 1995 and 2013 at an average annual rate of 3.4 percent. This was a huge decline in labor productivity.

The economic decline in Gaza was manifested not only in output, but in employment and income, while poverty rates soared. The total population of Gaza by mid-2014 was 1.76 million with 43.1 percent below the age 14 and 30 percent in ages 15-29. Approximately 68 percent of the people of Gaza are refugees. Employment was estimated at 449,500 in 2014 and the unemployment rate reached 44.5 percent. Youth unemployment, for age group from 15-24 was 57.2 percent in 2013, while for young women it was 86.3 percent. Of the 128,700 unemployed in Gaza in 2013, 80% were under the age of 35 years and 42 percent under the age of 25. Woman's situation in the labor market has been especially dismal. While less than 19 percent of the employed are woman, 31 percent of the unemployed are woman. To add to the frustration, the unemployed in Gaza have relatively high levels of educational attainment, especially women. 63 percent of unemployed men and 98 percent of unemployed women had 10 or more years

2 See a full description in Arnon et al (1997) and Arnon (2007).
3 See ICBS (1996) and Arnon et al (1997).
4 See AIX (2015).

of schooling on average in 2013. Of the employed, 40.7 percent worked in the public sector in 2014. This includes employees of the Palestinian Authority and of the Hamas government. By contrast, public sector employment in the West Bank accounted for only 15.6 percent in 2014. Note that some of the private employers, like UNRWA, are actually suppliers of public services as well.

Unemployment and general economic decline have real wages by 21.4 percent since 2005. The median monthly wage in Gaza in 2013 is about $328.4, which is 18.3 percent below the legal monthly minimum wage in Palestine of $375. More than 67 percent of the private sector wage employees in Gaza earned less than the minimum wage in 2013. Falling incomes have increased poverty dramatically. The estimated 2011 poverty lines for a household of two adults, and three children were $637 in monthly household consumption, and the deep poverty line was $509. PCBS estimated that 38.8 percent of people in Gaza consumed below the poverty line in 2013 and 21.1 percent consumed below the deep poverty line that year. This long process of increasing poverty, implies that Gaza's recovery and reconstruction must address not only the immediate impact of the war and the destruction it inflicted on Gaza, but also the reasons that led to the deterioration of the economy of Gaza prior to the war.

3. The Causes of the Economic Decline of Gaza

A recent study of AIX (2015), which tries to understand the lack of economic development in Palestine since 1993, has come to the conclusion that it can be attributed mainly to two types of obstacles imposed by the occupation regime. First, there are obstacles regarding mobility of goods and people, caused by checkpoints, walls, fences, siege and similar measures. These obstacles raise the cost of transportation and as a result, they reduce total factor productivity (TFP), which in turn reduces the output. Second, there are obstacles regarding investment, which can be either administrative or a result of the high risk due to the frequent outbursts of hostilities, and both deter investments. These obstacles have been much harsher in Gaza than in the West Bank. Gaza has become completely closed for labor in Israel already since the disengagement in 2005 and became under siege for people and commodities since 2006, just after Hamas won the election. The famous tunnel system that transported goods to and from Egypt, had limited capacity and was also very costly, so it did not change the siege in a significant way. In addition to the siege, the risks facing Gaza have been higher than the risks in the West Bank, especially in the last ten years, when Gaza went through a number of military confrontations, with increasing intensity, in 2006, 2009, 2012 and recently in 2014. These clashes caused increasing destruction and further deterred investment. These risks were amplified by the lack of hope for a political solution.

3.1. The Siege and its Economic Effects

The 2008 World Bank Report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza" stated that the Israeli-imposed restrictions on mobility "extend to a system of physical, institutional and administrative restrictions that form an 'impermeable barrier' against the realization of Palestinian economic potential." That conclusion remains valid until today. The following list of the gates of Gaza makes this point clear:

Beit Hanoun: The only crossing for workers and traders with valid permits to enter Israel. Currently, the crossing is used by very few Palestinians, who can obtain permits to leave Gaza,

mainly for humanitarian reasons (like medical treatment), family visits, and by the staff of international organizations that provide humanitarian assistance to the Gaza Strip.

Al-Montar (Erez): This used to be commercial crossing in Gaza for goods and workers in the past. Al-Montar (Erez) crossing is closed since 11 June 2007. Its grain conveyor is closed since March 2011. Its cement lane has been completely closed since 29 October 2008.

Sufa: In the past, this crossing was open for some Palestinians who worked in agriculture. Since May 2004 the crossing was used only for importing construction materials, mainly gravel. Sufa crossing has been closed since September 2008 (exceptionally opened in March and April 2011).

Nahal Oz: Nahal Oz is a small crossing, and was used for importing fuel. It is closed since January 2010.

Karm Abu Salem (Kerem Shalom): This Crossing is located in the southern Gaza Strip, near the Israeli-Palestinian-Egyptian border. It operates since March 22, 2006 as a small and temporary crossing when Al Muntar (Erez) was closed. Now it is the only operational commercial crossing between Gaza and Israel. Only authorized imports and exports pass.

Rafah: This is a passengers' crossing between Gaza and Egypt that was severely limited during the Mubarak years. Since June 2013 it is limited again and open for medical and humanitarian cases only. In exceptional cases, the Egyptian authorities allow import of construction materials for the Qatari projects, but this has recently stopped.

The systematic constraints on mobility are clearly shown in the volumes of imports and exports as well. Since 1997, the number of imported truckloads to Gaza has decreased by 70%. In 1997, 119,000 trucks entered Gaza, while in 2014 this number was down to 36,419 trucks.[5] Of the goods imported, 51% came from Israel and 14% from the West Bank. The exports from Gaza experienced a far greater reduction. In 2014 only 84 trucks left Gaza with goods for export compared to 19,151 trucks in 1997. Indeed, during the seven years, from 2008 to 2014, only 951 trucks crossed the border from Gaza to Israel, mainly with agricultural produce.

These restrictions on mobility, contributed much to the economic decline of Gaza. In AIX (2015), we show that, between the years 2006 and 2008, the beginning years of the siege, labor productivity in Gaza declined by around 30 percent. A recent paper by Etkes and Zimring (2015) calculates the welfare decline in Gaza as a result of the siege. They use for this calculation mainly data on consumption. They find that, welfare in Gaza declined by more than 20%. They also identify a large decline in labor productivity and changes in allocation as well. For example, many workers have moved from manufacturing to services as a result of the siege. Another study, ARIJ (2011), estimated the economic cost of the siege on Gaza between 2007 and 2010 by $1.9 billion, which is a quarter of total Palestinian GDP.

The siege also has a major impact on water supply and electricity production. According to a World Bank report, approximately 50% of households by the end of 2008 had no access to pipe water supply due to damages incurred by Israeli bombings during "Operation Cast Lead" in

5 The data in this section are mainly from Paltrade (2015).

December, 2008. These damages were never fixed, due to restrictions on the entry of various construction materials. Also, most water wells stopped working because of lack of spares for pumps, due to the blockade. Additionally, the power plant in Gaza was highly damaged by Israeli bombing at 2008, and is still suffering from the lack of spare parts and a shortage of diesel fuel which is imported from Israel, and is also restricted by the blockade. The severe fuel and electricity shortages have resulted in outages of up to 12 hours a day (UNOCHA, 2012). Gaza firms have reported estimated losses of 22 percent of sales caused by 232 hours of power outages on average each month (World Bank, 2014).

As a result of the above analysis, we reach a clear conclusion ,which is that any economic improvement in Gaza, requires an immediate lifting of the siege and opening Gaza to movement of people and goods. This dramatic change in the policy of Israel toward Gaza is detailed below, we also discuss in length its security and political implications in the following sections of this paper.

3.2. The Impact of the Military Operations

As explained above, the economic losses of Gaza were inflicted not only by the siege, but also by the repeated military confrontations. Those have caused immense direct damage to capital and infrastructure, and have also had an indirect effect by deterring investments. Next, we turn to a more detailed description of the recent three bursts of violence, Operation Cast Lead in 2008-2009, Operation Pillar of Defense in 2012 and Operation Protective Edge in 2014, which can actually be described as a war. Most of the damages caused by these military confrontations, even before 2014, has not been repaired yet.

Operation Cast Lead:

This military operation lasted from December 27, 2008 to January 18, 2009. It resulted with 1,440 Palestinians killed, 5,380 wounded and more than 100,000 displaced. According to the Palestinian Authority, 4,036 housing units were destroyed and a further 11,514 were partially damaged. More than 700 commercial, industrial and service businesses sustained direct damage, and 268 were totally destroyed. The sector that suffered most was industry, in particular construction, food processing and metal.

Operation Pillar of Defence:

This military operation lasted 8 days in November 2012 and resulted with 133 Palestinians killed and 840 wounded. The damage assessment conducted by the Islamic Development Bank found that 559 enterprises were affected, and estimated the loss in assets by $13.7 million. The most damaged industrial sectors were metal, wood and furniture, and paper.

The 2014 War:

Operation Protective Edge, which lasted from mid June to mid August 2014, was the longest and the most devastating military operation on Gaza since 1967. During 51 days, 2,145 people were killed, of which 1,523 are believed to be civilians, including 581 children. According to UNOCHA, approximately 490,000 people, which is more than a fourth of the population, were displaced from their homes and 60,000 homes were destroyed.

We next turn to describe the economical damages of the war:

1. The agriculture sector in Gaza Strip is limited due to lack of land in this densely populated area, which is further intensified by access restrictions to areas designated as buffer zones with Israel. The sector consists of orchards, fruit plantations, oil producing palm trees, vegetables and other legumes, animal farming, cattle herding, poultry and offshore fishing. Total losses inflicted by the war on agriculture were estimated to be $550 million.[6] This does not include future lost production due to destroyed orchards and plantations that take several years to repair. The losses and damages to plant infrastructure were 200 million USD, to animal production infrastructure $81 million, to irrigation and to soil (hit area of 34 square kilometers) 68 million USD, and the opportunity costs were around $200 million.

2. The tourism sector in Gaza has experienced some rise after the 2008-2009 war, despite the siege, with 45 new facilities and an improvement in quality of services at hotels, restaurants, and resorts. This was mainly for local tourism, but also for foreign visitors, international delegations, journalists, and solidarity campaigns that increased sharply. The damage to this sector was not severe, only $3 million, since most tourism facilities are located in the west of Gaza, while the war was concentrated in its east side.

3. The ICT sector in Gaza has much potential due to the high education levels of the population and also because it enables exports without crossing borders. According to PCBS (2011), 46.5% of the households in Gaza have a computer, 30% are connected to the Internet and 94.7% have mobile phones. The Ministry of Telecommunication and PITA (Palestinian Information Telecommunication Association of Companies) have conducted damage assessment for the ICT sector that includes both direct and indirect damages. According to this assessment, the losses to telecommunications infrastructure and to the ITC sector exceeded 34 million USD, 92 percent of which in infrastructure.

4. The war of 2014 had a significant effect on unemployment as well. According to ILO figures the rate of unemployment increased significantly, as 6.4 percent of the previously employed in Gaza lost their jobs. This had created larger social costs that added to the direct economic costs. We can add to that other social costs, as a result of scarcity of water, energy, food, and shelter. Up to 30% of water and sewage networks were damaged, and only 50% of waste-water is now treated. A large number of 450,000 people, do not have access to municipal water. The damage resulting from the war only compounds the difficult living conditions that already existed in Gaza previously. When discussing the social conditions in Gaza, it is important to note the high resilience of people in Gaza, who survive terrible conditions, which only become worse over time. But this resilience has a negative impact as well, since people who become used to live in such abnormal conditions might lose the ability to live differently, or even believe that different life is possible.

This section therefore shows that the economic decline in Gaza was a result of two main factors. The first is the closing of Gaza, which reduces productivity and output significantly. The other was the increasing of military risk, which deters investment and thus further reduces output. Therefore, we conclude that the way out from this trap is to open Gaza to mobility and to solidify the ceasefire agreement. These recommendations are discussed in the following sections.

6 Source: Ministry of Agriculture, Palestinian Authority.

4. Required Steps to Economic Recovery

It is important to stress that our specific suggestions do not replace in any way the reconstruction plan made by the Palestinian Unity Government. We only add two types of measures. One, in Sub-Sections 4.1 and 4.2, consists of improvements in the infrastructure system, mainly to make it more resilient to potential future waves of violence. The second, which is described in Sub-Sections 4.3-4.5, consists of all measures that are needed to open the Gaza economy to mobility of people and goods.

4.1 Reconstructing and Improving Electricity Supply

There are three sources of electricity for Gaza: Israeli imported electricity (120 MW) from the Israeli Electricity Company (IEC); imports from Egypt (32 MW) and the Gaza Power Plant (GPP) which had as a capacity of 140MW until it was damaged by Israel in 2006. Before the recent war, GPP provided 30-60 MW, depending on the availability of diesel. The total consumption of electricity in Gaza was in the range of 182 to 212 MW before the recent conflict. Also, some 30 percent of the electricity was wasted due to inadequate distribution equipment. The overall damage to the electricity network in the war of 2014 was assessed to be $ 42.5 million, not including damage to the Gaza Power Plant and other sources of local electricity generation.

The overall total financing required to recover full electricity supply to Gaza, including repair and increasing generation capacity, is estimated by the PA to be 180 million USD.[7] In the words of the Palestinian Recovery Plan for Gaza: "planned early recovery will see the restoration of the main power lines for supply from Israel and the provision of electrical materials to repair networks. These plans are estimated to cost $32 million during the early recovery stage and $153 million during the reconstruction stage, which should bring Gaza's energy infrastructure to better terms than the previous status quo."[8]

The shortage of electricity has a severe impact on the Palestinian economy and on the humanitarian and environmental situation in Gaza. The World Bank began in 2012 a project for Gaza Electricity Network Rehabilitation. Until October 2014, it had some achievements: new distribution and transmission lines were constructed, pre-paid meters were purchased and tariff collection increased.[9] The 2014 war set back these achievements. According to the World Bank, the reconstruction of the electric system can have the following benefits:

- Currently 190,000 people, 97 water pumping stations, nine hospitals/clinics and 950 commercial consumers are not connected to electricity and would be re-connected.
- Around 1.8 million people currently receive only six hours of electricity per day in areas where distribution infrastructure was not hurt. For them the reliability of electricity supply will be improved.
- Basic humanitarian services providers, who rely on electricity like hospitals, water supply and waste-water treatment plants, will improve their services.
- Gaza Electric Company (GEDCO) has lost all equipment and materials required to repair and maintain the electricity system, due to the destruction of the GEDCO warehouse. The reconstruction should improve its functioning.

7 See World Bank (2014), Report No: PAD1143.
8 Palestinian National and Early Recovery Plan for Gaza, Oct. 2014
9 See International Development Association Project Paper on a proposed additional grant from the trust fund for gaza and west bank in the amount of us$15 million for the Gaza Electricity Network Rehabilitation Project. Report no: PAD1143, October 17, 2014.

- Furthermore, hiring locals for this reconstruction will provide them with technical experience and skills required for sustained maintenance and expansion of the electricity networks in Gaza, and raise specific human capital. It would also contribute indirectly through improved electricity to the economy.[10]

In general we believe that the 2014 plans of the Palestinian Unity Government for reconstruction of the electricity system are sound. We only suggest that they should examine the possibility of putting as many lines as possible underground, to make them less vulnerable to war activities.

4.2 The Water Crisis and the Need for Infrastructure Rehabilitation

According to a World Bank 2012 Report, the water situation in Gaza has been acute already then. It finds that 95 percent of the water demand in Gaza is supplied by the Gaza aquifer. I also states that "the over-drafting of the aquifer is causing a rapid decline of the groundwater table, seawater intrusion, and deterioration of the aquifer's water quality… Most households in Gaza are connected to the water supply networks, however, the water supply is intermittent: A household's average access to piped water is less than eight hours daily and so the population relies mainly on rooftop water tanks." [11] Moreover, years of neglect and destruction of the water system added to the limited supply a great waste of water. A research on Rafah, Khan Younis and Deir Al Balah governorates, estimated losses of up to 39 percent of water supply in 2012 (Abdullah, 2012). Note that there is a strong relation between the supply of water and electric power supply, since operation of water pumps and sewage facilities is dependent on a regular supply of electricity.

The 2014 war inflicted an estimated damage of $34 million on the water system, out of which $17 million are required for most urgent repairs. But, the reconstruction should not only repair the damages from this summer. It should improve access to reliable water supply and to sanitation services, in order to minimize consequential public health negative effects. Another important indirect effect of such improvement could be on the environment, by reducing uncontrolled disposal of untreated or partially treated sewage.

Reconstruction of the infrastructure of water can meet not only important and urgent humanitarian needs, but also contribute to the Gaza economy. In the short term, it will create jobs and increase local demand. In the long term it will reduce manufacturing costs, meet the water and sanitation requirement of commercial and industrial enterprises and of public services, and thus, it will benefit the entire economy.

4.3 A Safe Passage between the West Bank and Gaza strip

The Palestinian West Bank and the Gaza Strip have been separated geographically after 1949, when Jordan gained control over the West Bank, and Egypt over the Gaza Strip. Following the Israeli occupation of the Territories in 1967, Palestinians enjoyed fairly free mobility between the two regions in 1967-91. Since 1991 mobility restrictions increased, and after the disengagement from Gaza in 2005 and especially since 2007's Hamas takeover, the two regions have been completely cut off from one another. The lack of mobility between the West Bank and Gaza is a clear violation of the Oslo Accords that recognizes the West Bank and Gaza as a single territorial unit and promises a 'safe passage' between the two regions.

10 Ibid.
11 See World Bank (2012), Stagnation or Revival? Palestinian Economic Prospects.

The physical separation between Gaza and the West Bank is not only a violation of the agreements, but a major cause for economic decline in Gaza and it affects the West Bank as well. The West Bank, which is a land-locked territory, needs the connection with Gaza, although clearly the lack of it affects Gaza even more. The widening of trading possibilities is critical for the Palestinian economy, which due to its small size and limited resources is highly dependent on trade. Expansion of foreign and internal trade can reduce dependence on Israel as a main trade partner and reduce vulnerability to political and security shocks.

The economic benefits for Gaza from opening a passage to the West Bank would be great. Such a connection could reduce the price that consumers in Gaza pay for the West Bank exports of olives, fruits, vegetables and limestone and increase the returns of producers from Gaza for their principal exports of citrus, flowers, and textiles. Extensive trade between the two regions can lead to more specialization and thus to increased production. Gaza can become a principal provider of perishable products such as vegetables and fish, requiring fast transit to the West Bank, thus, eliminating the need for Israeli products. Moreover, Gaza could become the main supplier of sand to the Palestinian construction sector, again cutting costs and reducing dependence on Israel. The safe passage will provide a pathway between the economy of the West Bank and future seaport and airport in Gaza, and reduce transaction costs. The free flow of goods between the two regions, will also reduce dependence on Israeli raw materials and industrial inputs.[12] In addition to goods, movement of workers between the two regions can reduce unemployment, raise wages in Gaza, and support the private sector by higher flows of human capital.

The AIX Group dealt before with the connection between Gaza and the West Bank, in AIX (2010), which analyzes the issue of the territorial link in the final peace agreement. That research suggested that the link should be constructed as a vehicular road between the Karni Crossing and El Majed Crossing. The construction of such a route should cost $700 million, with additional $180 Million for the expected security measures. Since implementing this route might take several years, AIX (2010) recommended that construction should start immediately at the present. But the work on the road has not yet started and if we wish to reduce a bit the current suffering of Gaza, we need to issue an immediate solution. This brings us back to the old solution of the 'safe passage,' that functioned in the past some of the time, where the last agreement on it has been the 2005 Access and Movement Agreement (AMA). This is done by using an existing road between Erez and Tarkumiya, and by operating regular authorized convoys. Those will transfer passengers and will be escorted by the Israeli military to prevent militant acts or illegal immigration. The convoys would also transport goods in containers that would be scanned and sealed at the exit points.

4.4 Gaza Commercial Seaport

The need for a seaport in Gaza has been recognized by Israel already in the Declaration of Principles (DOP), signed first in Oslo and then in Washington on September 13th 1993.[13] It was reaffirmed in the interim agreement (1994) where it was stated that "plans for the establishment of a port in the Gaza Strip in accordance with the DOP… will be discussed and agreed upon between Israel and the Council." The 2005 Access and Movement Agreement (AMA) identified six border crossings for commercial and traveler use, as well as the international airport and a seaport. Israel's commitment in that matter was to "assure donors that it will not interfere

12 See Aix (2010).
13 "co-operation in the field of transport and communications, including a Program, which will define guidelines for the establishment of a Gaza Sea Port Area."

with operation of the port. The parties will establish a U.S. led tripartite committee to develop security and other relevant arrangements for the port prior to its opening."

The Israeli-Palestinian custom union, which was established in the Paris Protocol in 1994, was supposed to improve Palestinians' terms of trade through Israel. However, security measures taken by Israel have in general discriminated Palestinian products at the Israeli ports and airport. In addition, Israeli standards requirements have changed several times with no prior notice to the Palestinian side. The JEC (Joint Economic Committee), which was supposed to decide on these kind of matter jointly, has met irregularly throughout the years and did not prove to be effective in such decisions.

As a result, transaction costs for Palestinian trade increased significantly. A survey in 2004 estimated that Palestinian enterprises faced prohibitive transaction costs at least 30 percent higher than those accrued by their Israeli counterparts (UNCTAD, 2004). More recent data taken from the report "Doing Business," published jointly by the World Bank and the International Finance Corporation in 2015, enables a more precise comparison of trading costs between Israel and Palestine. While the overall cost of exporting a container costs Israelis is $820 on average, it costs Palestinians $1,980 on average. Similarly, importing a container costs Israelis $ 665, while it costs Palestinians $1,805 on average. Palestinian Trade faces also higher additional costs in terms of time of exporting and importing. Exporting a container takes 10 days on average for an Israeli, while 23 days for a Palestinian. Importing takes 10 days for an Israeli and 38 days for a Palestinian. Note, that both exports and imports are implemented at the same ports, using the same shipping lines, and formally within the same trade regime, due to the Paris Protocol. However, the security checks and other restrictions raise the difference between Israel and Palestine to be far higher than the estimates in 2004. Exporting a container costs Palestinians 140 percent more than exporting an Israeli one and importers pay 170 percent more.

AIX (2015) shows that such large additional transaction costs cause a significant decline in productivity, which is part of the explanation for the terrible record of economic growth in Palestine in general and especially in Gaza. Hence, the facts on the high costs facing Palestinian exporters and importers, and the significant effects of these costs call for an immediate action plan that will provide Palestinians with an independent seaport. This is the only way to improve Palestinian market access and competitiveness.

Our recommendations are based on plans from the last decade for the establishment of a commercial seaport in Gaza. We do not ignore the question of Israeli security concerns, which is of utmost importance, but we address it separately in Section 6. Here we outline the main stages of building such a seaport. The first and immediate measure should be to repair and upgrade the current fishing port, which will boost development of the fishing sector. This stage requires a deepening and protecting of the harbor's basin, fortifying the breakwater structure, and repairing the northern coast in order to stop erosion in the area of Ash-Shati' refugee camp. The cost of this stage is estimated to be $16 million.

The next steps should be construction of a deep-water seaport. In 2000, the European Gaza development group signed a contract with the Gaza Seaport Authority. The funding to the project, was estimated at about $68.5 million, of which the Dutch government pledged to donate 23 million Euros, and France pledged another 20 million Euros. The rest was to be funded with

a loan from the European Investment Bank in addition to contribution from the PA(UNCTAD, 2004). The location of the deep-water seaport was planned 5 kilometers south of Gaza city. The seaport was planned to serve not only Palestine, but Jordan as well, providing Jordanian traders with an alternative corridor to Europe and North America (Awadallah, 2011) The Seaport Authority was planned to own the infrastructure and the intermodal transport system inside and outside the port area, but port operations were planned to be privatized. The construction of the seaport began in July 2000 and the first phase was scheduled to be completed within 25 months. Construction was stopped with the breaking of the second Intifada. By the end of 2002, the Israeli forces completely damaged the seaport facilities that were built and the installations on the construction site. International contractors withdrew from construction and donors froze the implementation of the project. Direct damages were estimated at $1.56 million, while indirect damages reached 11.02 million.

Relying on the previous construction plans, we can outline the main steps in building a deep-water seaport. The first step includes a 730m long breakwater, a General cargo terminal (Lift-on/lift-off) of 200m long and a Roll-on/Roll-off terminal with length of 140m. The Depth of water should be around 11m, so that 15-25 thousand ton ships can be served and a total of 12 million ton will be handled each year. In the second and third steps, the port should reach water depth of 14 meters, a berth of 600 meters and a Container terminal with capacity of 500,000 TEU per year. Finally, it will become a multi-purposes port: electrical substation, communication system, water supply system, surface water drainage system, waste disposal facility, storage facilities, and access roads. An industrial zone, including cement and other heavy industries was also considered. The planned total cost of the Deep-Sea Port is estimated at US$220 million.[14]

4.5 Gaza International Airport

The Gaza International Airport in Dahaniya was opened in November 24, 1998 in a ceremony participated by the PLO Chairman Yasser Arafat and by the President of the USA Bill Clinton. It was opened for three years until Israel began to demolish it on December 2001, during the Second Intifada. The Palestinian Civil Aviation Authority (CAA) was created to administer and operate the airport. CAA also owned Palestinian Airlines (PAL), which was operating from Al-Areesh from 1997 to 1999, until regular flights from GIA began. The airport had one runway, which was 3080 meters long and 60 meters wide asphalt pavement. The Palestinian Airlines owned and operated three airplanes. Most flights were either to Cairo or to Amman, but they also had limited scheduled flights to Doha in Qatar, Abu Dhabi and Dubai in the United Arab Emirates, Jeddah in Saudi Arabia, Larnaca in Cyprus, and Istanbul (Awadallah, 2011). GIA's capacity was about 650 thousand passengers per year, however only a third of the Palestinians had access to the airport and due to additional Israeli restrictions the airport operated in low capacity utilization of around 9% during 1999 (Abu-Eisheh, 2004). Palestinian Airlines data on number of passengers, shows the development of avian traffic before using GIA (1998), during its two years of operation (1999-2000) and after, it was banned from operating and damaged by the Israeli army (2001). The most important figure is that in the year of 1999 the number of passengers that passed through Gaza International Airport was 87,036. Namely, the GIA showed potential for high activity.

The reconstruction of the Airport is estimated to cost at least $86 million. Immediate priorities in the reconstruction plan are to repair the damaged parts of the GIA to enable it to resume operations, to introduce a computerized system in the operation of the airport and the Civil

14 See PECDAR (2014), Rehabilitation and Development Plan in Gaza – Rebuilding the Gaza Strip.

Aviation Authority, and to carry out technical training programs for the GIA staff. According to the Palestinian National Development plan for 2014-2016, the Ministry of Transportation is planning to rehabilitate 75% of the airport in 2014, 90% in 2015 and 100% in 2016.

5. Reconstruction and a Comprehensive Ceasefire Agreement

The reconstruction of Gaza cannot begin without a more comprehensive ceasefire agreement between Gaza and Israel. Such an agreement was briefly on the table at the end of the 2014 Gaza War, but the negotiations on its completion stopped and it was not finalized. Reaching a solid, comprehensive, and more stable agreement is crucial for two main reasons. First, as long as there is no sustainable ceasefire agreement, the possibility of repeated, frequent, new eruptions of hostility puts into risk all the efforts of reconstruction. The private residences and the public structures and infrastructure that will be built might be bombed and destroyed again. The second reason is that extending reconstruction to economic progress is impossible without agreement of Israel. The new 'safe passage' between Gaza and the West Bank should pass within Israel, which can close it at any time. It therefore cannot function without reaching a solid ceasefire agreement that includes also renewal of this passage. The widening of the sea port and the reconstruction of the airport also depend on an agreement, since Israel fully controls the sea outside Gaza and it fully controls the sky above Gaza. Rebuilding and upgrading the infrastructure of Gaza, namely electricity, water and sewage, can be done to some extent without an agreement with Israel, but only to a very limited extent. Israel controls entry of all construction materials into Gaza, and has the ability to destroy every project within Gaza and might even do it, if it views such a project as constituting security risk. Hence, both the opening of Gaza and the reconstruction of its infrastructure require an Israeli-Palestinian agreement on a long-run ceasefire between the two sides.

One of the main problems with previous ceasefire agreements was their implementation. There are four main reasons for such failures in implementation, and understanding them might help in avoiding their collapse. One reason is the coexistence of many fighting organizations in Gaza. Another reason has been the different policies applied by Israel in Gaza and in the West Bank. Even if Israel respects the ceasefire in Gaza, but operates against the Hamas in the West Bank, it might break the status quo in Gaza, as happened in 2014. The third reason for the collapses in the ceasefire has been what Israel saw as violation of the spirit of the ceasefire agreements by Hamas, in its continuing efforts of armament during ceasefires. The fourth reason is related to the non-military aspects of the ceasefires, mainly with respect to the siege on Gaza. The ceasefire agreements in 2008, 2009, 2012, and 2014 contained a component relating to lifting the siege and enabling mobility of people and goods, to be finalized through additional negotiations. This part in the agreements was never concluded finally and never implemented by Israel. Clearly, these four problems need to be confronted in order to reach a stable ceasefire agreement, in order to avoid suffering of the populations on both sides of the border and to enable reconstruction. There are two main channels to tackle these four problems. One is to make the ceasefire agreement not between Israel and Hamas, but between Israel and the Unity Government. The latter has higher authority, will be able to keep the ceasefire agreement better than Hamas. The second way to improve the ceasefire agreement is that both Israel and Hamas should change their policies and attitudes with respect to such an agreement. Israel should accept the lifting of the siege and Hamas should stop the process of armament during the

ceasefires. In other words, both sides should learn how to respect the agreement not only by the letter, but by its spirit as well.

6. Security Concerns

Our proposal to open Gaza Strip immediately to mobility of goods and people raises a number of concerns, mainly on the side of Israel, but also on the Palestinian side. We turn here to address these concerns. First, is the security concern, which is considered to be the top one among the Israeli concerns. Although we are not experts in matters of security, as our main specialty is Economics, we try to analyze this issue in a direct and logical way, to the best of our understanding. We believe that such an analysis is possible. In the following sub-sections we discuss separately the opening of the land passage and each of the other openings. We then add some general comments on the issue of security.

6.1. The Land Passage

We turn first to the opening of the land 'safe passage' between Gaza and the West Bank. The main security risks that might arise as a result of this opening are three:

1. Infiltration of armed people into Israel.
2. Passage of weapons and explosives from Gaza to the West Bank and back.
3. Passage of people who pose a security risk from Gaza to the West Bank and back.

We suggest that the safe passage will operate in daily convoys from Gaza to the West Bank and back. The convoys will be checked at the point of exit. To avoid costly and time consuming Back to Back methods, the cargo trucks should use containers that can be checked by special equipment that is already available. The convoys will also be escorted by military forces throughout their journey to avoid any infiltration into the Israeli territory when the convoy passes through it. We anticipate that these measures can handle the three potential risks mentioned above. This is not just a wishful thinking, but it is based on many agreements for safe passage between the West Bank and Gaza that Israel signed with the Palestinian Authority, the last of them in November 15, 2005, following the Israeli disengagement from Gaza.[15] All these agreements were signed by Israel and were clearly authorized by the defense authorities. Hence, they were considered to be satisfactory in reducing the above risks. It is true that the implementation of these agreements stopped after some time, but it never stopped because the agreements failed, or because they became risky. In all cases the agreements were stopped due to Israeli counter-measures to eruption of violence elsewhere. The violence was not directly related to the 'safe passage' itself, but the ability to close it gave Israel an easy way to punish the Palestinians for any violence. Sometimes the reasons for closing the safe passage were not even directly defense related, like the victory of Hamas in the 2006 elections. We therefore assume that although the opening of a land passage between Gaza and the West Bank might create some security risks, they can be handled well by the measures described above, namely by checking the convoys and escorting them within the territory of Israel.

6.2. A Seaport in Gaza

A deep-sea port in Gaza might lead to a number of security concerns to Israel. The main risk is the possibility of entry of military equipment into Gaza through the port. Note that mobility of

15 See Agreement on Movement and Access (2005).

people through the port is expected to be marginal, once there is land passage between Gaza and the West Bank.[16] Hence this analysis focuses mainly on imports of goods to the port. There are three main possible ways to cope with such security risks:

1. The expansion of the port should be done in three main stages. In the first stage, the port will be expanded to a port that transports commodities, but not in containers. In that case, search in sea and similar security checks of incoming and outgoing ships will be possible at relatively low costs. After some period of operation the port will go into a second phase of reconstruction and a container terminal will be added to the port. At this second stage, containers will be used only for exports, but not for imports. Only after some period of operation of the agreement, specified in time, but also in levels of adherence and performance, the port will move to the third stage of using containers for incoming cargo as well.

2. Boats and ships entering the port of Gaza will be searched in sea for military material by the Israeli Navy. The search can be of every boat and ship at the beginning, and later only a sample of the sea vessels will be searched. This search is more effective and less costly if the cargo is not in containers. Once the container terminal in Gaza will begin to operate for incoming imports, the search methods should adjust to it.[17]

There is a possibility to monitor shipped imports by making ships first dock in Greece, Cyprus or Turkey for inspection and only then allow and escort them into Gaza waters.

6.3. Airport in Dahaniya

The Gaza International Airport at Dahaniya was opened in November 24, 1998. The construction of the airport was agreed between Israel and the Palestinians in the Oslo II Agreement of 1995. This agreement shows that the security aspects were taken care of by the Israeli defense authorities, which found appropriate solutions to the security problems raised by the operation of the airport. As shown above more than 100,000 Palestinians passed through the airport. It operated for 2 years, until October 2000, and then it closed operation shortly after the outbreak of the Second Intifada. Again, the closing and destruction of the airport was not done due to breaches of security in the airport, but as a general punishment to the PA. The operation of the airport for 2 years indicates that the specific security issues received a reasonable solution at the time.

The initial security arrangements in 1998 were very strict. All travelers on the scheduled flights had to go to the Rafah border crossing in a bus before entering the airplane or after landing. The Rafah border control is about one kilometer from the airport and it was then under full Israeli control. At the Rafah border control, the passengers and their luggage were checked by Israeli border control personnel. Clearly, such measures are impossible today, as Israeli personnel cannot enter Gaza or the Rafah passage any longer on a regular basis. Clearly, alternative ways to deal with potential security risks connected with the airport could be found. We cannot supply a full list of such ways but we can mention two. One possibility is that foreign inspectors can monitor the operation of the airport. Another possibility can use the fact that most of the

16 A possible security concern that might arise from mobility of people from the port to other countries is ability of people wanted by the Israeli security services to escape. This is less a direct security risk, as it is mainly related to the ability of Israel to impose punishment. Another possible concern is that a port might enable transfer of a kidnapped soldier like Shalit to other countries. One way to cope with such complications is to add to the ceasefire agreement clauses related to such events.

17 We assume that search within containers in sea is possible, though might be more costly. In cases of severe suspicion the ship can be taken to Ashdod Port for inspection.

incoming flights to Gaza are expected to be from the near Arab countries, like Egypt, Jordan, Saudi Arabia and the Gulf countries. Israel can reach agreements with these countries on monitoring incoming passengers to Gaza and their luggage. Two of these countries have formal relations with Israel, while the others have informal relations with Israel.

6.4. Some General Comments on Security

We would like to use this opportunity to broaden the scope of the discussion on security. Israel follows a very clear policy with respect to security, which is based on two main pillars. One is sharp and immediate punishments, both personal and collective, on any act of Palestinian violence. Such punishments sometimes seem to be out of proportion with respect to the initial act of violence, but that is part of their logic. This policy is called in Israel deterrence. The other pillar of the security policy, which is less in the open but is also very prominent, and has increased over the years, is that there is a very tight control over the Palestinians. The security services, the military, the Civil Administration, the army intelligence, all are checking and monitoring Palestinians, their moves, their activities, etc. This second pillar of the security policy is the one that might be affected by the opening of Gaza. Of course, the effect of this opening on Israeli control is limited, as Israel will still retain many alternative means of control, and some of the lost control can be restored through different means, as described above. But the possibility of opening Gaza supplies a good opportunity to discuss the efficiency of this policy of control, its successes and its limitations.

Any control of a nation of around 5 million people must be partial, since following everyone permanently is far too costly. Thus, Israeli forces monitor a statistical sample of people, not random of course, but still a sample. As a result, the ability to fully detect every hostile activity is far from full.[18] Hence, a change in the degree of control should not be discussed in absolute terms, but rather as a change of the degree of monitoring and control. In economic terms, the cost of opening Gaza is not a total loss of security, but a marginal reduction of security due to reduced control. However, the marginal cost should be compared to the marginal security benefits of the opening of Gaza and these are two. First, is the improvement in standards of living it, will bring with it to many people, especially young, which might also lead to reduce the incentive to participate in armed activities. Second, benefit to security aspect, leads to reduction in control itself. The tight control imposed on Palestinians in general, and on Gaza in particular is a terrible suffocating burden on them. Their inability to join family, to see friends, to get required healthcare, to continue studies, and even to move around, are provoking great anger. This anger is a boost to the deep hostility among the Palestinian side and to the ease with which eruptions of fighting occur so often. When all these issues are taken into consideration, we believe that the bottom line calculation of the marginal costs and benefits to security tilts strongly in favor of opening Gaza.

This question also brings us back to one of the basic concepts of The AIX Group, namely reverse engineering. We have long reached the conclusion that the best way to reach a permanent agreement and to implement it, is to first outline the contours of the final agreement and then to derive from that the road from here to there. This holds for economic issues and many other issues, but it holds for security as well. At the end of the day, if there will be a Two-State-Solution, control should disappear from the picture, since it is completely in contradiction with Palestinian independence. Israel's security will depend on its ability to defend itself along its borders on the one hand, and on the willingness of Palestinians to avoid hostility toward their

18 This is especially true in the context of Gaza, as all the control measures imposed on Gaza did not stop arms smuggling, tunnel building, rocket construction, etc. This has been true both before and after the disengagement from Gaza.

neighbors for various reasons.[19] If this is how the end of the process will look like, and if Israel has an honest intention to reach this endgame, it should begin to build new tenets of security policy already today, so that when the final agreement is reached and control has to end, the new tools will already be in operation.

7. Political Considerations

The closing of Gaza has been a long process, beginning in 1991, as described in Section 2. The closing intensified after the victory of Hamas in the Palestinian elections of 2006 and it became a complete siege after Hamas took over Gaza in 2007. Hence the siege could be viewed as a punishment to Hamas. The Israeli opposition to Hamas is mainly because of its adherence to the armed struggle, and its ideological opposition to the right of self-determination of Israel, to the Two-State-Solution and to the Oslo accords. The policy of closing Gaza fully as a measure against Hamas was performed to a large extent by Israel, but it was supported, at least during the first part of the period, by the US, Egypt, the EU, the Quartet, UN and Russia. This policy therefore follows a wide consensus among many powers inside and outside the region that oppose any strengthening of Hamas.

When this document suggests to stop the siege on Gaza, and to open it to movement of people and goods, we are aware that this has also been a major demand of Hamas throughout the past ten years. It therefore raises the question whether opening Gaza might be viewed as giving up to Hamas. The AIX Group is a think-tank that is committed to the Two-States-Solution. Hence, we also view Hamas as an important opposition to this political solution. If so, we would like to explain why we support the opening of Gaza, when it seems to some as a measure that can strengthen Hamas. In the rest of this section we offer three explanations, going from the more formal to the more substantial.

7.1. The Unity Government

The Palestinian Unity Government was born on June 2, 2014 following an agreement of unity between the two leading movements in the Palestinian public, Fatah and Hamas. This agreement was reached after many previous failed attempts. Surprisingly, despite the difficult history of the relations between the two movements, and despite the harsh steps Israel has taken against the Unity Government, it has survived until now and is operating fairly well under the circumstances of geographical separation. Actually, during the negotiations on ceasefire in August 2014 in Cairo, Israel negotiated intensively, though indirectly, with a delegation of the Unity Government. All the current negotiations and agreements on the reconstruction of Gaza acknowledge that this job will be performed by the Unity Government and not by Hamas. Clearly, Hamas has a stake at the Unity Government, but it is definitely not his alone, as it is a government of technocrats with no representative of Hamas. Furthermore, the government has at least two members close to Fatah, so that it has a much closer to Fatah than to Hamas. But the operation of the Unity Government in Gaza, if it develops and deepens, means a weakening of Hamas in Gaza. Until the founding of this government, Hamas was the only ruler of Gaza, while the operation of the Unity Government in Gaza will take the harness from Hamas, gradually but persistently. There are many signs that Hamas is aware of and worried by this potential development. Hence, we have many reasons to conclude that the opening of Gaza and its reconstruction will not strengthen Hamas, but might even reduce its control over Gaza.

19 Like being busy in economic development, having too much to lose, etc.

7.2. The Failure of the Siege Policy

Israel has tightened the closure on Gaza since 1991, but this policy has become harsher after the victory of Hamas in the Palestinian elections in 2006 and became a complete siege after the full control of Gaza by Hamas in 2007. This policy was aimed to punish the population in Gaza for their support to Hamas and to lead to the collapse of Hamas and of its control over Gaza. None of these goals was achieved. Hamas still controls Gaza and its population still supports it. This reaction can be attributed partly to coercion, but mainly to the natural reaction of people who are punished and direct their anger towards those who punish them, not at those whom they elected. The policy of siege lasts for almost ten years, and Gaza did not become quiet but more and more rebellious. It is time to change a failing policy, and shift to an alternative. Actually, this document claims, that removing the siege might yield an opposite result to what we have experienced so far. We claim that it is likely to weaken Hamas rather than to solidify it.

7.3. Reducing Support for Hamas

The repeated eruptions of fighting in Gaza since 2005 have, revealed that the population of Gaza supports the struggle and supports Hamas, mainly its military wing, Ezzedine al-Qassam Brigades. This support is a result of a number of deep reasons. The first is the high percentage of refugees in Gaza, which are usually poorer, more desperate and tend as a result to be more supportive of the armed struggle. To this we can add the fact that Gaza is very densely populated with fewer sources of employment and income than the West Bank, so that it is much poorer. Poverty and hopelessness tend to breed anger and violence. Gaza has also suffered much from the siege and as shown in Section 3, it deteriorated its economy and reduced income significantly. Also, the support for Hamas in Gaza is also fed by the fact that the population is traditional and religious. Even so, no one can claim that the harsh economic situation did not contribute significantly to the support to Hamas, combined with the desperation of being locked in a small area for so long. The great project of reconstruction of Gaza, upgrading its infrastructure, and opening it to mobility of goods and people, is supposed to boost its economic situation, both at the short and at the long-run. In the short-run the large investments will increase aggregate demand, which will improve employment in the narrow strip significantly. In the long-run these investments will increase the stock of capital in Gaza, both public and private, and will thus boost production from the supply-side. The ceasefire and reconstruction agreement will not only improve the economic situation in Gaza, but will also improve the general mood, as people will be able to travel more, to meet family and friends, and to feel freer in general.

All these improvements will reduce the active support for Hamas. This is true, especially if these improvements result from an agreement with Israel. One of the main reasons to the success of Hamas in the 2006 elections, was the failure of the PLO to end the occupation by diplomatic means. Hence, the support for Hamas can be reduced only if there will be signs that negotiations can work and can lead to improvements. Economic improvement by itself will not be sufficient, since people care also about their freedom. But, an economic improvement that is a result of a significant change in Israel's policy, which is reflected in an agreement on ceasefire and reconstruction, can shift political support from Hamas to other parties.

8. Conclusions

This document presents a contribution to the ongoing international discussion on the reconstruction of Gaza, after the war at the summer of 2014. We claim that reconstruction should include necessary measures that will contribute to improvement of the economic situation in Gaza and even

lay foundations for future economic growth. More specifically we raise the following main points:

1. The siege on Gaza is a major obstacle to economic improvement. Any attempt to improve the standard of living in Gaza must include opening Gaza to mobility of people and goods.

2. This opening will consist of renewing the old 'safe passage' between Gaza and the West Bank, through convoys from Erez to Tarkumiya, expansion and development of the sea port in Gaza and reconstruction and operation of Gaza International Airport. All these measures are part of the Oslo Agreements.

3. In addition, a large effort should be made to renovate and improve the failing infrastructure in Gaza, namely Electricity, water, sewage, and communication.

4. The opening of Gaza raises some security concerns on the Israeli side, but these concerns can be dealt with in reasonable ways.

5. Although the opening of Gaza should not be interpreted as giving up to Hamas. It is giving up on a policy to fight Hamas, which failed miserably. After more than ten years of siege it is clearly a failed policy. Removing the siege in an agreement with the Palestinian government might be a much better policy to reduce the power of Hamas and to increase the support for negotiation with Israel among Palestinians.

One important issue that should be further discussed is the relation between the proposals we raise and the final peace agreement. Our proposals are short-run and can be implemented without reaching the final agreement. But their implementation will contribute significantly to the advancing of this long-term agreement in two main ways. First, it will improve the economic situation in Gaza to some extent. This is a very densely populated and very poor region that needs every source of income. Improving the standard of living in Gaza will increase moderation and will increase the support for the peace process in Gaza. But economic progress in Gaza and the moderation that comes with it will also reduce hostilities and armed clashes with Israel. This will make life of Israelis in the South safer and will therefore encourage them to support the peace process more than today. Some might worry of course whether economic improvements might reduce the need and urge to pursue peace. To that we can only say that there are some things money cannot buy. Even if their economic situation will improve, Palestinians will not give up their dream to be free and independent, and Israelis will not give up their dream to live securely in peace.

The reconstruction of Gaza is stalling and faces severe difficulties. The money was promised, but the implementation has hardly begun and it is running at a very slow pace. At this situation, adding more tasks to the reconstruction might look unrealistic. Being aware of it, we still believe that the role of a professional analysis is to point at the full set of policies that are required. Supplying houses to the people of Gaza who lost their homes is very important, but giving them also better options to alleviate themselves out of extreme poverty is important just as well. What this paper shows is that this can be done and that the cost in terms of finance, security and politics is rather low. We therefore put the issue on the agenda and at the doorsteps of our leaders and policy-makers. This is what we can do and this is what we should do.

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