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PALESTINIAN MERCHANDISE TRADE IN THE 1990s: OPPORTUNITIES AND CHALLENGES*

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INTRODUCTION

Recent Palestinian external trade performance reveals that the operation of fundamental political processes continues to govern the development Palestinian economy in the occupied Palestinian territory (West Bank and Gaza Strip). 1/ What in other circumstances would be straightforward economic transactions are often determined by political or security considerations. After a prolonged period of conflict and economic deterioration, the signing of the Declaration of Principles between the Government of Israel and the Palestine Liberation Organization (PLO) in September 1993 and the establishment of the Palestinian Authority (PA) generated widespread hopes and expectations for economic recovery within a context of peace, stability and cooperation. While important steps have been taken in that direction, political uncertainty and uncertainty about security in the period since 1993 have reinforced a declining trend in Palestinian domestic and international trade, which first emerged in the late 1980s.

Notwithstanding the terms of the Israel-Palestine accords that give the PA control over some key trade issues, the economy remains largely influenced by external political and economic imperatives. This has been demonstrated most notably by the increased restrictions on the movement of goods and people imposed since 1994, especially the border closures since early 1996. Palestinian exporters have suffered large losses due mainly to protracted border closures and complex crossing procedures. Since 1994, the private sector has experienced few of the potential economic benefits expected from the Israel-Palestine accords and from the peace process in general. Moreover, the highly visible nature of the border closures and their impact in 1996 and 1997 have eroded earlier optimism and confidence in the Palestinian territory as potentially attractive for domestic and foreign investment and trade. The continued presence of such exogenous factors constitutes an overriding obstacle to the development of the external trade sector. Without sustained lessening of these barriers, the prospects for reinvigorating Palestinian external trade and pursuing an export-led growth strategy seem distant.

Analysis of the trade environment naturally reflects the ways in which the Palestinian economy as a whole has been operating since 1993. The Protocol on Economic Relations between Israel and Palestine was intended to empower the PA with some of the essential instruments of trade policy, yet neither the PA nor the exporting community at large has been able to harness the promises of the Protocol to affect growth in the Palestinian industrial, agro-industrial or agricultural sectors. Instead, informal importing has grown, local production has stagnated because of difficulties in moving goods, monopolistic practices have developed at times of closure and crisis, and the enterprise climate as a whole has become increasingly hostile. The effective subordination of trade performance to the volatility of the security situation and attendant measures continues to constrain the ability of the Palestinian economy to move beyond those structural economic distortions, inherited by the PA from the pre-1993 period. However necessary it may be to emphasize positive developments since 1993, it is equally important to examine the realities of Palestinian external trade in the light of those developments.

This study is the most recent examination by the UNCTAD secretariat of developments affecting Palestinian external trade, based on regular monitoring and investigation by the secretariat. It was initiated in the context of background research for use as an input to the secretariat's report to the Trade and Development Board on assistance to the Palestinian people, in the context of implementation of the 1996-1997 biennium work programme. In particular, the study draws on extensive field research, conducted in 1996 by an UNCTAD consultant, Mr. Ala'edeen Shawa (Development Resources Centre, Gaza), focusing on the problems confronting the normal operation of the trade sector and their consequences for domestic and international trade performance. It has also benefited from insights into factors affecting external trade performance, generated by the secretariat's advisory services and other technical cooperation activities implemented as part of the biennium work programme. As such, it is both informed by the experience obtained through technical cooperation activities, and intended to serve as a comprehensive and integrated reference in this area for further activities by the secretariat and others concerned, in cooperation with the PA.

The study analyses the opportunities and challenges facing Palestinian external trade by investigating three major issues: the role of external merchandise trade in the light of recent external trade performance (chapter I); the complex and uncertain trade policy and regulatory environment (chapter II); and the capacity of Palestinian merchandise production and allied sectors to engage in sustained exporting, assuming that a more favourable trading environment is established (discussed in chapter III). That chapter, devoted to assessing supply capacity with regard to international trade potential, tackles separately (i) agricultural production patterns and limitations, (ii) existing merchandise production capacities and limitations, and (iii) relevant service and support capacities to help Palestinian products enter export markets.

The main objective of the research underlying this study is to compile reliable substantive information on the range of factors affecting the performance of Palestinian external trade, in particular those areas where technical, managerial and institutional capacities require strengthening. This effort has supported the secretariat's technical cooperation activities initiated since 1995 at the request of the PA in the sectors of trade, finance and related services. Accordingly, research for this study has also revealed promising areas where Palestinian manufacturers, growers and service providers could export competitively in the absence of prevailing constraints. The conclusions and recommendations of the study, presented in chapter IV, suggest areas of action both on the broader level of mitigating the adverse impact of border control issues and on the specific levels of sectoral interventions, institutional development, especially in the public sector, and realizing export potential. As such, this investigation of the external trade sector focuses more on the operational and technical aspects of trade performance and prospects than on issues of trade policy, which remain the subject of interim and final status negotiations between the parties.

Chapter I

MERCHANDISE TRADE AND THE DEVELOPMENT OF THE PALESTINIAN ECONOMY IN THE 1990s

This chapter aims to place the performance of the Palestinian merchandise trade sector within the context of recent developments in the Palestinian economy, bearing in mind longer-term trends which underlay their closely related fortunes in recent years. This examination begins with a brief assessment of the role of merchandise trade in the external sector and the economy as a whole, both before 1993 and since. This is followed by an analysis of some of the key features of the Palestinian economy which represent a potential for external trade. The chapter then reviews the broad market orientation of Palestinian trade, taking into account regional trends and potentials for diversifying Palestinian external trade links. The examination concludes with an account of recent external trade performance, drawing on available aggregate and micro-data in this regard.

A. The role of trade in the Palestinian economy until 1993

Since 1967, the Palestinian economy had operated under an abnormal set of circumstances that entailed weak economic performance and a lack of coherent economic development. Prolonged occupation of the West Bank and Gaza Strip resulted in orienting the Palestinian economy towards a dependent relationship with the much stronger and complex Israeli economy. This relationship emerged in such a manner that the West Bank economy was largely separated from that of the Gaza Strip, whereby the scale and significance of each region's transactions (in goods, labour and other services) with the Israeli economy surpassed economic relations with each other. Under occupation, Palestinian production and trade were oriented in line with trends in Israeli production, export and consumption, which did not necessarily reflect the long-term needs of the Palestinian economy. 2/

This orientation resulted in erratic growth and minimal structural change in domestic production over the years. Consider briefly the historical trends in Palestinian exports, whose more recent performance is discussed later in this chapter. After 1967, there was a steady increase in the value of exports from the Palestinian territory, reaching a high of over $400 million in 1981. This was mostly due to external imperatives, including strong regional demand for agricultural exports and the increasing use of Palestinian subcontracting services, which involved further integration of Palestinian production into trends in the Israeli economy.

Up to the early 1980s, the Palestinian economy as a whole experienced growth due to factors that were not a consequence of sustained growth in domestic output. Rather, the motor for growth was factor income, especially payments for labour employed in Israel, and migrants' transfers, 3/ neither of which reflected or directly contributed to development of the local economy, with the exception of private residential construction. Indeed, there was a systematic decline in the contribution of gross domestic output (GDP) to gross national product (GNP), from 98 per cent in 1968 to a low of 66 per cent by 1983, with the proportion not rising above 75 per cent since then. 4/ This indicates that the growth of the economy and the rise in standards of living were not accompanied by a structural development of the productive sectors of the domestic economy. Furthermore, if subcontracted exports to Israel are considered as trade in labour services rather than merchandise re-exports, the weaknesses in the domestic productive base are further highlighted. 5/ In short, although the economy has grown over the past 30 years, it has not substantially developed its capacity to generate wealth, through diversification of domestic production, trade and services sectors or through expanding merchandise and service exports.

The net effect of the imbalance between domestic and external sources of income has been to render the Palestinian economy extremely vulnerable to external shocks. And the fragile and underdeveloped trade sector has usually been the first area in the economy to feel the impact of changes in external circumstances. Since 1981, a steady downward trend emerged in the value of Palestinian exports, arising from the erosion of competitiveness owing to very high inflation in Israel in the first half of the decade. This was coupled with the loss of lucrative regional markets for Palestinian agricultural exports following the outbreak of the Iran-Iraq war. By 1989, the value of Palestinian merchandise exports had fallen to some $160 million. Subsequently, the position improved slightly with a stabilization in exports to Israel, only to decline again as from 1994 (see below).

The historical trend of decline in exports was matched by a steady increase in the value of imports, particularly from Israel. Despite a growing surplus in the labour services component of the trade balance, high private consumption, fuelled largely by external income, generated a sustained increase in the Palestinian trade deficit. Between 1969 and 1982, the Palestinian economy had a positive balance in agricultural trade (with the exception of slight deficits in two years); however, beginning in 1983, a growing deficit in agricultural trade developed. 6/ Again, the impact of external shocks, such as the disturbances of the intifada and the Gulf crisis, took their toll on Palestinian domestic output and merchandise exports after 1988. In 1990, agricultural imports were estimated at $110 million, over 90 per cent of which came from Israel. Agricultural exports totalled $73 million, resulting in a deficit of $37 million for 1990. 7/ On the other hand, the Palestinian balance of trade in industrial products has been negative since 1968, and that gap has continued to increase. 8/ These deficits have been financed mainly by increasingly lucrative income from labour in Israel and remittances from abroad. 9/ Effectively, the role of merchandise trade as an income-generating sector was superseded as of the 1980s by factor income and remittances from Palestinian migrant workers in the Arab Gulf countries, coupled with steady growth in factor income from labour in Israel.

The trade regime established since 1967 allowed full access for Israeli goods into the Palestinian market, with selective access for Palestinian exports to Israel, and limited interaction with Jordanian and Arab markets (the “open bridges” policy). This created a situation whereby Palestinian labour in Israel became the most important single source of Palestinian household income (effectively akin to a supplementary domestic economic sector), much of which was redirected into consumption of imports from Israel. The economy thus acquired a high external trade orientation - with merchandise trade mainly in one direction and with trade in labour services mainly in the other direction. Non-tariff barriers affecting trade with neighbouring markets reinforced this dichotomy, including security measures and quota systems applied to Palestinian exports and subsidies to domestic producers and other measures with a net protective impact.

Furthermore, the growing disarticulation between the West Bank and Gaza Strip economies since the late 1980s has been further exacerbated since 1993 owing to the lack of free access between the West Bank and Gaza Strip, the continued and repeated border closures imposed on the two areas, and the increasing difficulty for Palestinians from the West Bank to access east Jerusalem. These issues underscore how trade between the Gaza Strip and the West Bank can be conceptualized as being both an intranational and an international issue, since moving goods and people to areas outside the territory has often proved easier than moving goods and people between the Gaza Strip and the West Bank. Thus, the Palestinian economy has become heavily centred on trade, but on trade which it cannot guarantee, as access to movement of goods and people lies largely beyond its control. Israel, on the other hand, continues to have free access to both markets and to be the primary export market for Palestinian goods.

The impact of the post-1993 trade regime on Palestinian external trade is discussed more fully in the following sections and the next chapter. As is detailed therein, available data on post-1993 trade performance suggest that the Israel-Palestine economic accords have not been implemented in a way that has changed the basic features of the Israeli-Palestinian economic relationship since 1967. Israel retains sovereignty over its own economic policy, with normal access to public instruments of economic management, whereas the Palestinian Authority (PA) pursues an economic policy which falls short of these basic requirements. This has special significance for the Palestinian trade sector, which remains highly dependent on transactions and flows with/through Israel.

However, as will be seen, the economic accords have achieved a change in the formal structure of the relationship and introduced the principle of common economic and trade interests between the two parties. More specifically, the accords turned a de facto customs union into a de jure customs union. With the PA being given a limited degree of self-government, though not enough to alter the structure of the relationship during the 1994-1999 interim period, the historical economic distinction between Israel and the Palestinian territory is maintained. In other words, although the accords allow the PA a significant degree of economic decision-making, the inclusion of the Palestinian economy in the Israeli “customs envelope” means that broad Israeli economic policy objectives effectively define Palestinian trade policy options in the interim period.

B. Potentials for merchandise export development

The current poor performance of the Palestinian trade sector may be understood as the outcome of an interplay between restrictions on production and barriers to trade. These two factors have distorted the trade sector in terms of what is produced and traded, and in which markets trade is conducted. While increasing merchandise exports are a key to economic development in the Gaza Strip and the West Bank, it is important not to simplify the problem to one which can be corrected by simply increasing exports of current products through improved export systems. Although greater access to international markets and improved marketing are important elements of any strategy, significant production constraints and trade barriers require attention. It is necessary to address both issues and the manner in which they interact, with a view to correcting these distortions and beginning to expand and reorient the trade sector.

Restrictions on the use of natural resources (especially land and water) in the West Bank and Gaza Strip, coupled with controls over the import of raw materials, greatly reduce the competitiveness of Palestinian products. Security measures affecting the economy, which have been implemented with greater scope and impact since 1994, add additional transportation and transaction costs which further erode the competitiveness of Palestinian products by the time they reach external markets. These measures have a similar effect on trade between the Gaza Strip and the West Bank. At the same time, favourable market conditions are created for the flow of Israeli imports into the West Bank and Gaza Strip. In addition to issues of competitiveness, restrictions on the movement of Palestinian products reduce the demand for Palestinian products, leading to a further deterioration in domestic production and employment. 10/

To end this continuing cycle and expand and deepen trade, measures are required in order to reduce and eliminate the two types of barriers, namely barriers to enhanced and diversified production, and barriers to normal access to external markets. Action against the first entails removing restrictions on the use of natural resources and on access to raw materials, capital and other services at competitive rates. At the same time as such barriers are being addressed, efforts must be made to pursue all possibilities for reopening neighbouring, and new, markets to Palestinian products. 11/ It is in the context of these policy prerequisites that the potentials for expanding trade can be best assessed.

Certain industries and products embody greater potential for external trade, provided that the issues of access and movement of goods are resolved. The Palestinian economy has been traditionally oriented towards agriculture, which still produced up to a third of GDP until recent years. Agriculture and agro-industry offer perhaps the most immediate possibilities for revival of Palestinian export trade. Some provisions of the interim economic accords and basic market realities mean that much of Palestinian agricultural output would not be marketable in Israel. Thus, agriculture may have a potential for spurring export growth through supplying Europe and other lucrative markets with off-season, high-quality and speciality vegetables. Issues related to access to water resources continue to bear heavily on agriculture production and must also be addressed before agriculture can thrive as an export sector.

Although the export of agricultural goods, once a major component of exports, has been increasingly marginalized in the composition of Palestinian exports, it should not be ignored as a source of significant trade potential. The ability to grow off-season vegetables and fruits gives Palestinians an advantage in exporting to Europe and to Arab countries. However, for Palestinians to compete effectively in such markets, many of the barriers to production, both technical and economic, will have to be addressed and support institutions and facilities will have to be created or improved. The packaging branch, for example, must develop alongside agriculture and agro-industries for these gains to be realized. The same development must also be sought in maintaining the quality of production, through grading and quarantine centres, and coordinating seasonal cultivation patterns with the needs of agro-industry. Continued attention to the agricultural sector is important since increased production will help to reduce the trade deficit (especially given the population growth rate) and assist in financing the expansion of industry.

Manufacturing represents only a very small share of the Palestinian economy (between 10 and 15 per cent according to different estimates). For the most part, Palestinian industry supplies Israel with very specific products, many of which are semi-finished or produced under subcontracting arrangements. The industrial sector is made up of very small firms (most with fewer than 10 employees) and is highly fragmented. With most products being expensive and of low quality, the export options for these firms is very limited. Although the manufacturing sector in its current form cannot be expected to “lead” economic development, it is important to actively promote this sector given its importance for medium- and long-term growth and development. With constraints on land and water, there are limits to expansion of the agricultural sector (in value terms), while even greater limits are placed on its labour-absorptive capacity, given trends in modern agriculture. Industry will have to move from concentration on import substitution efforts to developing new light industries, in order to provide the basis for the introduction of more sophisticated production enterprises in high-skill industries. 12/

Although there are negative implications for dependence on one market, there is no doubt that Israel represents a market with tremendous potential for Palestinian products. Proximity to and knowledge of the Israeli market, coupled with lower wage levels, give Palestinian producers an advantage in that market, assuming that greater access is established. This could, in the short run, be an important avenue to reducing the trade deficit. Within the current industrial structure, improving production performance in certain key areas offers the best potential for export development. The potentials for export development in branches such as ready-to-wear garments, footwear and pharmaceuticals are explored later in this study.

C. Regional market opportunities

Since 1967, the primary markets for Palestinian exports have been Israel and to a lesser extent Jordan, with minimal exports to other countries. For example, between 1971 and 1990 the average share of direct industrial exports from the West Bank to countries other than Israel and Jordan was only 1.25 per cent of total exports, while for agricultural products, the share was equally insignificant. In the case of the Gaza Strip, the export of agricultural products to Israel and Jordan increased from 1971 through the early 1980s. Exports to countries other than Israel and Jordan declined from a high of $15 million in 1971 to $8 million in 1990, equivalent to 18 per cent of agricultural exports from the Gaza Strip. 13/ As from 1967, the only exports of manufactured goods from the Gaza Strip went to Israel, largely through labour-intensive industrial subcontracting.

Manufacturing patterns in the Gaza Strip and the West Bank have developed largely on the basis of the degree of access to, and needs of, the Israeli market, shaped by the thrust of Israeli economic and trade priorities, in addition to standard issues of costs, complementarities and comparative advantage. This bias complicates the issue of developing exports which can compete in other markets, including other regional markets. On the other hand, since 1981, exports to Jordan were regulated by a quota system reflecting Jordanian local market needs, through an elaborate seasonal crop planning, certification and commission agent system, administered by Jordanian institutions. The system was applied until 1988, when Jordan ended its legal and administrative ties with the West Bank. It allowed for a significant flow of Palestinian products into Jordanian markets. Manufactured products were required to have certificates of origin issued by Palestinian chambers of commerce in order to prove that the raw materials were not of Israeli origin, in compliance with Arab League boycott provisions.

Export through Jordan to the Arab world decreased steadily since the early 1980s, mainly owing to important transformations in regional market conditions, but also because of the inability to obtain lines of credit or credit export guarantees. Palestinian exporters also lack experience in these markets as a result of the Arab League boycott, a policy which began to effectively be ignored in some Arab markets only after 1993. Agricultural exports were able to enter those markets only because they were considered to be Jordanian produce until the end of the 1980s. In the meantime, Palestinian exports have faced growing competition in Gulf markets from other countries, including Jordan, Syria, Lebanon and Turkey.

It is likely that Palestinians can benefit from harmonizing their trade with other Arab and Islamic countries, as similarities exist in terms of consumer tastes, economic structure and (to a lesser extent) income levels. 14/ Attempting to redirect some Palestinian trade to the Arab world could be seen as strategically and economically necessary. Recent agreements have offered a limited opportunity for regional trade, particularly with Jordan and Egypt, but even if trade opportunities were wide open, immediate trade potential would remain weak. Generally speaking, interregional trade in the Middle East is weak and lacks complementarity in terms of production and industrial structure. Jordan, which has probably one of the most integrated economies in the region, obtains about three quarters of its total imports from outside the region. On average, regional trade constitutes only about 8 per cent of the external trade of Arab countries. Thus, care should be exercised when discussing regional trade opportunities. What is needed is not just reintegration of the Palestinian economy into the area, but rather a larger-scale development of regional trade in the context of peace for regional trade opportunities to be fully realized for the Palestinian economy (and for other Arab countries and neighbouring countries, such as Israel, the Islamic Republic of Iran and Turkey). A separate study by the UNCTAD secretariat, soon to be published, examines the regional dimensions of the Palestinian economy. 15/

As trade becomes increasingly global, many of the advantages associated with more traditional markets are reduced, especially since no regional trading blocs exist and many of the countries in the region look to outside markets for trading partners. Issues of price and quality tend to be of greater importance, given the increase in the range of products now available in most regional markets. In the case of Palestinian products, the potential market in the Gulf States may very well be the expatriate (often non-Arab) residents, who tend to have lower income levels and demand lower-quality products.

Although Jordan has been successful in developing market outlets in Saudi Arabia, the Gulf and Iraq, Palestinian exports would encounter more difficulty, at least in the short run. A major reason for this lies in production costs, which are greatly influenced by Israeli cost structures. Continued import restrictions make it difficult for the Palestinians to find the least costly materials. The absence of well-administered drawbacks on temporary imports makes this all the more difficult. Furthermore, many of the products which are produced in the Palestinian territory are already imported into regional markets from other countries. For example, Turkey and Jordan enjoy some of the same advantages in regional trade (similarities in taste and proximity), but they have greater access to less costly materials and can benefit from functioning State structures that can support export-oriented production. In addition, less expensive substitutes from outside the region further complicate the case for Palestinian competitiveness in regional trade. Much agricultural produce comes from Greece and Turkey at lower cost than locally produced commodities; manufactured products from Asian, European and North American markets are available in regional markets at significantly lower cost and better quality than locally produced goods.

Thus, a key issue arises as to whether Palestinian industrial policies can be feasibly coordinated with neighbouring countries in order to produce competitive production patterns in the long run. As long as the historical trade relationship between Israel and the Palestinian economy remains, generally maintained by the interim period economic accords, the possibility of significant regional integration seems less likely since the PA cannot act to correct distortions in domestic production patterns through trade policy instruments. In fact, the low level of interregional trade and the lack of flexibility allowed in the prevailing policy framework present formidable barriers to an increased share of regional trade in overall Palestinian external trade. Therefore, efforts to identify new markets outside the traditional areas - such as high-quality, off-season agricultural products for Europe, or manufactured consumer goods for sub-Saharan Africa - may offer greater benefits for Palestinian producers and exporters.

D. External trade and recent aggregate economic performance

The problems affecting the compilation of reliable and comprehensive statistics on the Palestinian economy are well documented in the reports and studies of a wide range of local and international sources. 16/ Data on external trade are no exception, especially as political and administrative boundaries between the Palestinian territory and Israel do not demarcate clearly defined statistical areas for the purposes of monitoring Palestinian external trade performance. Fairly comprehensive Israeli economic and trade statistical series for the West Bank and Gaza Strip extend only up to 1993, after which the Israeli authorities relinquished responsibilities in this sphere to the Palestinian Central Bureau of Statistics (PCBS). Since 1993, several sources have issued statistical series on the Palestinian economy based on different methodologies and assumptions. 17/ These estimates for the post-1993 period are combinations of statistical series compiled by different PA ministries, extrapolations of pre-1993 Israeli statistical series and new series generated by the PCBS. The latter has initiated a wide range of sectoral surveys, culminating in the first, preliminary national accounts series for 1994, soon to be updated for 1995-1996.

However, foreign trade statistics constitute an area which has proved more difficult to monitor and record according to international standards and classifications. In this regard, compilation and verification of data on the Gaza Strip may result in more reliable estimates, as the areas under PA jurisdiction constitute contiguous land and more of a unitary administrative entity. Among the factors that complicate similar endeavours in the West Bank are the following: the West Bank is under three distinct jurisdictions during the interim period, although in principle the PA's civil functions and PCBS surveys extend over all three areas; east Jerusalem is not recognized as a part of the West Bank by Israeli statistics, and according to the interim agreements, the PA have no jurisdiction in the city; and the West Bank's formal and informal borders with Israel (over 20 official crossing points and approximately 140 unofficial ones) are far more porous than between the Gaza Strip and Israel. Owing to divergences in methodologies and estimates by different sources, it would appear useful to draw upon the range of available estimates in attempting to identify common elements of an assessment of the Palestinian economy and recent trade performance. 18/ Subsequent sections of this study draw upon findings of field research and different empirical sources to elaborate the investigation of the Palestinian external trade sector.

1. Recent aggregate economic performance

In the period since 1994, aggregate economic indicators have exhibited trends consistent with those prevailing in previous years, with an overall adverse impact on standards of living. The high exposure and vulnerability of the economy to external shocks continue to reveal major structural weaknesses. These include weak domestic employment capacity, uneven sectoral growth, weak intersectoral articulation, severe marketing bottlenecks, poorly coordinated and fragmented new investments in both public and private ventures, and structural imbalances among macroeconomic aggregates. These features become more critical when viewed against stagnation in income and growing poverty among marginalized segments of population. Human resource development and growing unemployment since 1992 have posed critical challenges for the performance of the economy, with important political, social and economic ramifications. Quarterly unemployment rates in 1996 ranged from 29 per cent in periods of strict closure to 19 per cent during periods when Palestinian workers were able to reach jobs in Israel. 19/ Only since late 1996 has a gradual reduction of critical rates of unemployment been possible, through short-term employment generation alternatives, including relief-work programmes, and further relaxation of closure measures in 1997.

Palestinian GDP in 1996 is estimated at $3.4-$3.9 billion, by different sources. The sectoral structure of the economy has remained essentially the same since 1992, with transport, trade and private services accounting for the largest share of GDP. Notwithstanding new investments since 1993 and improvements in the institutional and regulatory framework, no clear positive impact is noted on such structural aspects as the size and share of the industrial sector, agricultural diversification or emergence of new producer services. While positive growth rates of real GDP of over 7 per cent annually are noted in most years since 1992 (generated in construction, agriculture and public services) GNP has stagnated owing to a contraction in labour income from Israel since 1992. It is estimated at $4.1-$4.4 billion in 1996. The decline in the scale and significance of such income has not been matched by adequate external transfers and their deployment into employment- and output-generating investments. While restructuring and reinvigorating domestic output are essential to sustained growth and long-term development, external income and investment are needed to ensure rapid recovery and lay the foundation for sustained growth. The need to promote domestic and foreign private investment and improve its allocation thus remains a top priority for domestic policy makers and for international assistance in this regard.

The low export ratio, of 10 to 15 per cent of GDP, is well below pre-1988 levels of 25 to 35 per cent. A large deficit in trade of around 45 per cent of GDP in 1996 reflects a precarious external payments position which places a considerable burden on the meagre resources of the economy. The decline in factor income from abroad, coupled with high and growing private and public consumption in recent years, has thus restrained domestic savings. Investment levels since 1993 have yet to surpass those of preceding years: investment in 1996 is estimated at $600-$1,000 million (equivalent to 15-30 per cent of GDP). Intensive investment in private residential construction still accounts for the bulk of investment despite a growing share of public investment in infrastructures, financed largely through official transfers since 1994.

According to some calculations, losses sustained in national income in 1996 as a result of closure and related measures are estimated at around $600 million, a magnitude which is lower than estimates by other sources. 20/ This is equivalent to some 20 per cent of GDP and 15 per cent of GNP in 1995, and to over 70 per cent of private investment in 1996. However, by most accounts, the real decline in GNP in 1996 was between 3 and 6 per cent (and even higher on a per capita basis), rates which imply that factors such as GDP recovery in late 1996 helped to mitigate income losses. 21/ Greater stability in the policy environment in 1997 could allow the recouping of 1996 losses from both domestic and external sources. Prolonged economic hardship and uncertainty would at best reduce public confidence in the “peace dividend”, and at worst produce economic stagnation and deprivation that could undermine the peace process.

2. Recent external trade performance

The new policy environment and related measures aimed at improving the performance of the Palestinian economy since 1993 have not reversed a long-term decline in the export sector, nor counterbalanced a sustained growth in imports. Underlying these trends are a range of infrastructural, institutional and procedural impediments to free access to export markets, as against an open and largely uncontrolled exposure to imports from one predominant trading partner. This process, which began to unfold in the early 1980s, has created a growing trade deficit which highlights the challenges of developing export capacities.

Since 1987, trends in Palestinian export and import performance have exhibited continuous fluctuations. Following the sharp contraction in economic activity and external trade during the 1988-1989 intifada period, both exports and imports began to recover in 1990. By 1992, pre-1987 levels of imports had been restored, but exports had recovered to only three-fourths of 1987 levels. From 1992 to 1994, merchandise imports decreased by 15 per cent, whereas exports decreased by slightly more, around 17 per cent (see table 1). After a significant 35 per cent recovery in exports in 1995, accompanied by a 60 per cent expansion of imports, exports again slumped in 1996, while imports continued to rise, albeit moderately.

The transformation in the role and performance of the external trade sector may be graphically illustrated by comparison of estimated data for 1996 with figures for 1981, the year in which Palestinian export performance was at its strongest, amidst steady economic growth. 22/ Total merchandise exports in 1996 are estimated at $265 million, down from $400 million in 1981. Out of a total value of trade in 1996 of almost $2,000 million, exports represented only 13 per cent, down from 36 per cent in 1981. Since 1981, imports more than doubled, from $748 million to $1,725 million while the merchandise trade deficit grew almost five-fold, from $350 million to almost $1,500 million. This translates into a merchandise trade deficit whose proportions grew from 35 per cent of GDP in 1981 to around 45 per cent by 1996. When trade in non-factor services is examined, the position of the Palestinian economy appears even more precarious, owing to the greater proportion of imports of non-factor services as compared with exports.

Another key feature in Palestinian external trade patterns is the almost total concentration of trade with one partner. Whereas trade with Israel in 1981 accounted for 85 per cent of total Palestinian imports and exports, that proportion now stands at around 90 per cent. While in 1981 a total of $111 million, or 28 per cent, of exports was destined for Jordanian, other Arab and international markets, by 1996 these markets absorbed $31 million, or only 12 per cent, of Palestinian exports (see table 2). Thus, from a position of a small trade surplus ($33 million) with markets other than Israel in 1981, the Palestinian economy today has a $144 million trade deficit with the rest of the world, and a $1,315 million deficit with Israel.

Israeli prominence in the Gaza Strip's external trade is more pronounced than in the West Bank, owing to current geographical realities as well as historical patterns: the Gaza Strip's greater exposure to Israel and the West Bank’s traditional economic and social ties with Jordan and the Arab hinterland. Thus, in the first post-1993 expansion of trade, in 1995, Gaza Strip exports recovered while imports grew dramatically, most of which growth was with Israel, which has maintained its 90 per cent share of Gaza Strip imports since the early 1990s, as compared with under 85 per cent in the case of the West Bank. Aggregate data for the 1994-1996 period thus confirm field research findings, namely that a much anticipated diversification of trading partners in the post-1993 period has not occurred. Furthermore, both aggregate and partial data series confirm that the three-decade-old trends of Palestinian trade, such as the diminished trade relationship between the West Bank and Gaza Strip, continue, and have in fact intensified. 23/

3. Salient features of external trade: channels and composition

As examined in greater depth in the next chapter, the Protocol on Economic Relations between Israel and Palestine was expected to result in much-needed diversification of trade. Despite the customs union and other measures in the Protocol that asserted a continuity rather than a break with the economic relations of the pre-1993 period, it was intended that the various items exempt or partially exempt from the customs union would help reduce dependence on Israeli markets as sole suppliers (see appendix 1 for a complete listing of items). Under the Protocol's provisions, import permits are issued by the PA for goods imported from any trade partner other than Israel. If the goods are still within the quotas of the different lists, PA customs rates then apply (along with Israeli value added tax (VAT) and purchase tax rates). Table 3 shows the value of import licences issued in 1995 in the West Bank and Gaza. While these do not necessarily indicate actual imports finally effected that year, they are considered by PA officials to provide a reliable indication of some of the features of post-1993 trade patterns.

An examination of this data source indicates that in terms of the overall value of imports, licences issued constitute about $180 million, or only 11 per cent of the year's total imports. Most of the licences (73 per cent by value) were issued in Gaza and yet constitute under 35 per cent of the Gaza Strip's imports in 1995. Import permits issued in the Gaza Strip for Egyptian goods were only 16 per cent of the total value of permits, and Jordanian goods were only 3 per cent, with the rest going mostly to imports from other countries. This indicates that there is no immediate gravitation towards the Gaza Strip's closest regional partner, Egypt, a goal implicit in the Protocol and Palestinian trade policy since 1993. Import permits for the West Bank were more evenly distributed, with 43 per cent imports from Jordan, 18 per cent from Egypt and 39 per cent from other markets.

Estimates for actual imports into the Gaza Strip from countries other than Israel place these as low as $30 million, according to one PA source, or merely 6 per cent of total Gaza Strip imports, and under one-fifth of the estimated value of West Bank imports from non-Israeli markets. While it is possible that a large number of import permits were not actually utilized, it is likely that a proportion of “permitted” imports were effected through the intermediary of Israeli import agents, in conformity with well-established channels and practices. Besides questioning the usefulness of permits as a measure of actual imports, this casts doubt on the significance of the PA's ability to use customs policy to promote diversification of trade specifically, and economic development more generally.

On the other hand, the fact that the number of permits issued constituted by value more than 30 per cent of total imports into the Gaza Strip is encouraging. 24/ However, indications that a possibly significant proportion of those permits were not actually executed might have the effect of discouraging further attempts at direct importing, especially with the additional constraints imposed on the flow of trade from non-Israeli sources since 1996. This may be particularly true in the case of most first-time importing or new entrants into importing. Moreover, even if it is assumed that all the import-licensed goods entering the Gaza Strip were from lists covered by PA customs policies, this implies a capacity to influence some 6 per cent of total Gaza Strip imports, providing very little leverage in setting trade policy or economic policy more generally. 25/ In the case of the West Bank, the PA's ability to control/monitor trade flows and to use customs policy as an instrument of trade and development policy is surely more attenuated. This issue must be distinguished from the PA's relative success in collecting customs and VAT receivable for items imported through Israel.

No reliable statistical series are available for the post-1992 period regarding the commodity composition of Palestinian external trade, even in broad aggregate terms of industrial and agricultural trade. The general trend has been that industrial goods predominate in the Palestinian import bill, while agricultural goods are relatively more prominent in export trade, although industrial goods, mainly subcontracted with Israel, predominate in exports as well. As may be discerned from one partial data source, no industrial branch in the Gaza Strip appears to have emerged as a particularly promising export sector since 1993 (see table 4). Trade in foodstuffs and agro-industrial products dominate trade, especially in imports, followed by building materials, imports of which are also very high. These constitute almost 20 per cent of the Gaza Strip's total, reflecting the construction boom since 1993. Garment production constituted the strongest export branch, around $30 million worth of exports, all to Israel. This was more than offset by imports in the same branch.

Comparison with the import permits issued for the same period suggests that product distribution of actual imports tends to match the product distribution of import permits, with construction supplies and foodstuff/ grains constituting about 32 per cent and 30 per cent, respectively, of total permits issued (by value). These are followed by livestock and vehicles at 14 per cent and 12 per cent each. Equipment for development projects, one of the listed PA imports excluded from Israeli tariffs, constituted only 1 per cent of import permits issued by value, a fact which suggests that the investment climate was so discouraging that even the formal procedures for importing were not initiated. This might also indicate that Gaza Strip entrepreneurs have opted to continue to buy from Israeli sources or through Israeli channels rather than take advantage of what was expected to be favourable import terms for capital goods. In 1994, Israel's investment goods imports were valued at around $3 billion, or about 13 per cent of total imports. 26/

Although not categorized as external trade, the flow of goods between the Gaza Strip and the West Bank has important implications for the growth and development of the Palestinian economy and external trade. Although the two economies have been disarticulated in many ways since 1948, the trade links between the two regions developed relatively unhindered during the occupation period, at least until 1990. In terms of both balanced regional development and integration of the economy at the production and market levels, internal trade between these discontinuous regions can play an important role in rationalizing and harmonizing external trade patterns. Given the small size of the Palestinian economy and the difficulties which industries face in achieving economies of scale, such barriers are more extreme if the Gaza Strip and the West Bank are separated.

The issue of Gaza Strip-West Bank trade itself is of sufficient importance to merit its own detailed examination. Although this study concentrates on Palestinian external trade, it also considers the Gaza Strip-West Bank trade situation (as well as trade between east Jerusalem and the rest of the Palestinian territory) when appropriate, since these trade flows suffer from vulnerabilities similar to those of external trade. This has an impact on Palestinian external trade in two ways. On the one hand, the more protracted the separation of the Gaza Strip, the West Bank and Jerusalem, the more that important domestic markets (i.e. the West Bank market for Gaza Strip producers and the converse, and the east Jerusalem market for both) are lost to local competition, and to imports from Israel, Egypt and Jordan. On the other hand, separation has a more long-term consequence, namely that in the absence of compensating increases in exports to Israel or other countries, the loss of economies of scale due to the loss of domestic market shares weakens the competitiveness of Palestinian manufacturers and growers.

In 1990, the last year for which some comprehensive data are available, the West Bank purchased over $24 million of agricultural products from the Gaza Strip, while the Gaza Strip purchased almost $9 million of agricultural products from the West Bank. Trade in industrial products (such as agro-industrial products, textiles and footwear) was more developed, though aggregate data are not available. Barriers to Gaza Strip-West Bank trade (see chapter II) over the past two years have led to a decrease in this form of trade (see table 5). Since 1994, many producers in the Gaza Strip and the West Bank have reported serious drops in West Bank-Gaza Strip trade. The findings of field research, documented elsewhere in this study, provide a concrete sense of the impact of the steady deterioration in interregional trade in the Palestinian territory over recent years. According to one PA source, in 1995 total trade between the two regions was estimated at around $50 million, equivalent to under 3 per cent of all Gaza Strip and West Bank external trade. 27/ Trade flows between the two regions are estimated to have declined to under $40 million in 1996, around 2 per cent of the total value of external trade.

Chapter II

THE NEW POLICY ENVIRONMENT AFFECTING TRADE

A. Economic opportunities and challenges of the peace process: an overview of developments in the policy and regulatory framework since 1993

Two powerful, yet opposing, factors have influenced the overall policy environment underlying the recent performance of the Palestinian economy and immediate prospects for its revival, particularly of the external trade sector. On the one hand, Israel-Palestine economic accords since 1993, especially the Protocol on Economic Relations, set the scene for a significant transformation in relations between the two parties and in the policy environment affecting Palestinian economic activity in several key areas. 28/ The Protocol is examined in depth in the following section. On the other hand, the parties have yet to resolve a range of outstanding issues, falling mainly outside the economic domain, against a backdrop since 1996 of violence and strict security measures. These are also analysed in detail later in this chapter. Accordingly, the Palestinian economy, weakened by prolonged negligence and isolation, is increasingly dependent on the changing fortunes of the peace process. It has exhibited accelerating entrepreneurial activity and growing investor confidence in times of progress, and contraction in business activity and income loss in periods of stalemate or disruption of the Israeli-Palestinian peace process.

The vulnerability of the Palestinian economy to the interaction of such factors has been compounded by a range of inherent weaknesses coupled with the absence of an adequate regulatory and institutional framework at the public and private sector levels. Some progress has been achieved by the PA since 1995 with regard to drafting essential legal instruments governing economic activity in areas such as private investment, enterprise activity, banking, public finance, industrial zones, standards and safety, the civil service and intellectual property. However, most are not yet formally adopted and procedures and institutions to ensure their application are yet to be established. The pace and orientation of institution-building in the public sector alone have been subject to the influence of a variety of factors which reflect the difficulties of isolating the development of effective PA institutions from the realities imposed by political exigencies, economic pressures and human resource limitations. The emerging private sector has, on the other hand, shown resilience and a capacity to adapt to a still-uncertain policy environment. This has involved intensified cooperation with PA institutions to establish the basis for a liberal, modern and efficient Palestinian economy, capable of meeting the challenges ahead.

Notwithstanding the efforts made, repeated closures of the Palestinian territory since 1996 signify the interplay of forces promoting or inhibiting economic activities. A prominent example is the sensitive investment climate, which had begun to stabilize in 1995 following the adoption of a Law for the Promotion of Investment, the consolidation of the local banking system, and related regulatory and institutional developments. 29/ Events on the ground since 1996 have prompted caution on the part of investors and financial institutions, which remain in need of sustained political, legal and institutional stability. Nevertheless, moves such as the opening of the Palestinian Securities Exchange in early 1997 continue to indicate the commitment of the private sector to develop in cooperation with the PA the range of institutions and instruments required for vibrant and efficient financial intermediation and enterprise development.

Despite the opportunities offered by post-1993 trade accords with Egypt, Israel, Jordan and other partners, prolonged obstacles and complex procedures affecting the movement of goods have highlighted the weaknesses in the orientation of the external trade regime, calling for the strict application or renegotiation of accords with trading partners. 30/ In particular, aspects of the Israel-Palestine accords covering movement of labour, trade and customs and other duties are considered to require serious scrutiny by both sides as they move to reinvigorate economic relations in the coming period. While current preoccupations embrace the interrelated issues of trade policy and practices, options facing the PA with regard to the former continue to be dominated by the day-to-day realities imposed by the latter. Meanwhile, in the context of preparations for final status negotiations with Israel, the future of Palestinian economic strategies, policies and relations is a subject of growing interest to decision makers in the public and private sectors. 31/

The reconvening of the Israeli-Palestinian Joint Economic Committee since late 1996 reflects a clear recognition by the parties of the need to deal with outstanding issues that hamper progress in the interim period. A number of measures were announced in 1997, including enhanced arrangements at the border for movement of merchandise trade with/through Israel and with Jordan and Egypt, addition of new items and quantities on Lists of goals the PA may import from abroad (see section B.1 below) and improved arrangements for travel of Palestinian businessmen to Israel. 32/ Their implementation and impact remain to be seen, however.

B. Trade agreements and the trade policy framework

Restrictions affecting Palestinian external trade until 1993 played a major role in shaping the orientation and composition of Palestinian trade relations. Such an impact has extended to the operation and characteristics of Palestinian firms further upstream in the production process, thereby further discouraging trade opportunities in the near future. While much restructuring is called for to improve the prospects for trade, both in the trade environment and in production, any restructuring of this trade-dependent economy requires that a fair trading environment exist for Palestinian firms.

Although some important changes have been agreed and implemented in the trade policy environment since 1993, the scope for developing Palestinian external trade remains defined by the terms of the interim period accords and attendant political and security considerations. The new trade regime has created opportunities where none previously existed, while the economic situation on the ground has significantly worsened in recent years. The analysis of the trade environment in this section focuses on three levels: first, the overall framework that was set in place by the Protocol on Economic Relations, which gave the PA control of some of the nominal instruments of trade policy; second, the implementation of the Protocol as regards the customs revenue scheme prevailing in 1996; and third, how the various trade agreements in the region and internationally between the parties to the peace process interact with the emerging trade regime. This is followed by an examination of the operation and regulation of the trade sector, the extent to which agreed procedures (and the policies informing them) are being applied, as well as other factors influencing external trade performance.

1. Protocol on economic relations: trade issues

The Protocol creates a trade regime between areas under PA control and Israel that is something of a hybrid between a free trade area and a customs union. It stipulates that:

(i) The flow of agricultural and industrial goods between Israel and the West Bank/Gaza Strip will be free of any restrictions, including payment of customs and import taxes, with the exception of quotas placed on six Palestinian agricultural exports to Israel (melons, tomatoes, cucumbers, potatoes, eggs and poultry), which will be subject to Israeli quotas. Quotas will be removed over a four-year period (articles VIII and IX).

(ii) “The Israeli rates of customs, purchase tax, levies, excises and other charges, prevailing at the date of signing of the Agreement ... shall serve as the minimum basis for the Palestinian Authority. The Palestinian Authority may decide on any upward changes [in these rates]” (article III, paragraph 5a).

Although these provisions in the Protocol preserve the overall framework of a customs union between Israel and the West Bank and Gaza Strip, other provisions allow significant exceptions that could, in principle, help promote West Bank/Gaza Strip development and trade objectives. The provisions (in article III) are complex:

(i) For products on Lists A1 and A2 and in quantities agreed upon by the two sides, "the Palestinian Authority will have all powers and responsibilities in the sphere of import and customs policy and procedures" (paragraph 2a). These goods (mostly food products and construction material) can be imported from Jordan and Egypt in particular, and from other Arab and Islamic countries in general.

(ii) For products on List B, the PA was granted the powers to determine the rates of customs, purchase taxes, levies, excise and other charges on some capital goods used in construction, industry, agriculture, medicines and the Palestinian development programme.

(iii) Products not on Lists A1 or A2 or B, or those on Lists A1 or A2 but exceeding the quotas, will be subject to a minimum of Israeli rates. The possibility of the PA's levying higher rates than Israel is somewhat theoretical since there is no provision to prevent the entry of the same goods via Israel, subject to lower rates and thus at lower prices. If the PA deems it in the interest of developmental goals to raise some of the rates, this would have to be combined with other instruments of trade policy (i.e. non-tariff barriers). However, in order to effectively apply such instruments, which invariably entail further complicating trade procedures, the PA would have to ensure a high degree of bureaucratic efficiency.

(iv) For other special products, such as fuel and automobiles, other provisions apply. "The PA will determine its own rates of customs and purchase tax on motor vehicles imported as such, to be registered with the Palestinian Authority” (paragraph 11a).

(v) The Protocol stipulates that “the clearance of revenues from all import taxes and levies between Israel and the Palestinian Authority will be based on the principle of the place of final destination. In addition, these tax revenues will be allocated to the Palestinian Authority even if the importation was carried out by Israeli importers when the final destination explicitly stated in the import documentation is a corporation registered by the Palestinian Authority and conducting business activity in the Areas” (paragraph 15). Procedures for administering and transferring customs and related revenues are complicated, and are discussed below.

The Protocol aimed to confer upon the Palestinian economy and trade sector significant benefits, as addressed in the Preamble and relevant articles, namely:

- Strengthening the base of the Palestinian economy and the PA’s independent and institutional economic decision-making processes, in accordance with its own development plan and priorities;

- Assisting in diversifying external trade arrangements by establishing direct economic links with Arab countries, particularly Jordan and Egypt;

- Opening up the Israeli market to Palestinian agricultural and manufactured products by allowing goods to move freely, not subject to customs duties, taxes or quotas (except selectively until 1998);

- Allowing the PA to receive tax revenues for goods imported by the West Bank/Gaza Strip via Israeli channels, if certain conditions are met;

- Allowing the PA to establish its own import policy and tariff structure for certain products, quantities and countries. Here the Protocol gave the PA an opportunity to import a range of capital equipment and foodstuffs from the cheapest sources and impose its own tariffs on these imports;

- Giving the PA authority in respect of important revenue-enhancing items, such as motor vehicle imports, a major source of budgetary revenue; and

- Allowing the PA to import petroleum products for sale in areas under its jurisdiction at cheaper prices than in Israel.

Since 1994, the Protocol has been the subject of growing analysis and debate, from different conceptual and policy viewpoints. Many of these examinations have highlighted some of the major omissions or shortcomings of the Protocol, aspects which are considered to diminish the potential benefits of this agreement for Palestinian external trade. Without making a detailed analysis of the Protocol from the viewpoint of trade, it is nevertheless worth while to note some major weaknesses which could be addressed in order to enhance the contribution of the Protocol in the interim period and as a basis for future final-status arrangements yet to be negotiated. Some of the key limitations, requiring further consideration, are:

- The quantitative restrictions placed on Palestinian imports, which limit the latter to amounts that are expected to be sold within the Palestinian economy according to “market needs”. Imports from Arab countries are limited by “market needs” as determined by the Joint Economic Committee established under the Protocol. Some imports can originate only from Egypt or Jordan;

- As there are no reliable data for making accurate estimates of “market needs”, limiting imports to the West Bank/Gaza Strip by this measure is seen as an interference in the operation of market mechanisms. Disagreement can arise over actual market needs if imports from alternative sources begin to replace imports from Israel; conversely, these quantitative limits can act as effective incentives to monopolistic or price-distorting practices by Palestinian importers with favoured links with Jordanian or Egyptian markets;

- Facilitating fiscal leakage: the “re-export” clause (paragraph 15) should ensure that the PA will receive customs revenues on goods sold in the West Bank/Gaza Strip by Israelis that are not of Israeli origin, but are imported from outside Israel with little or no transformation in their value taking place in Israel. These goods would still be classified as non-Israeli or Israeli re-exports. As such, their customs revenues should accrue to the PA, and not to Israel, if the provisions of normal customs union are to be applied to the Palestinian-Israeli situation. Although this has added to the revenues of the PA, the loss of revenue to the Palestinian treasury (“fiscal leakage” caused by the inability to adequately monitor imports from Israel) is estimated to be between $166 million and $275 million a year during the period from 1994 to 1996; 33/

- Failing to capture all the trade tax on goods imported from outside the customs union through the use of “point of destination” as the method of accruing revenue to the PA. By some accounts, as much as 60 per cent of Israeli exports to the West Bank/Gaza Strip were originally imported into Israel. 34/ A “point of consumption” system would more accurately reflect the trade tax to which the PA is entitled;

- Not addressing the wide array of subsidies and other non-tariff barriers that benefit some Israeli sectors and products, leaving Palestinian industry and agriculture at a disadvantage. While such support measures are gradually being phased out as Israeli trade is liberalized, they continue to operate in some areas with a bearing on the Palestinian market and similar productive branches;

- While the Protocol calls for free movement of goods between Israel and Palestinian self-rule areas, such movement is subject to the security measures stipulated in Annex 1, articles IX and X. Although the border closures which were imposed after a series of violent incidents in 1996 are the most prominent example, limitations on the movement of goods was experienced even earlier. Such measures constrain the quantities of goods that do actually pass, significantly reducing the PA customs revenue. The closures create both an immediate financial risk for producers and traders, and significant indirect costs such as inconsistencies in supplies and unreliable delivery times, as well as the opportunity costs which are thus incurred.

2. Regional and international trade agreements

Jordan is the PA's closest regional trade partner, after Israel. Much trade in Jordan is conducted by Palestinians who have been resident in Jordan for many years, and significant trade contacts already exist. In addition, Jordan provides a key gateway to the rest of the Arab world and has always been the transit point for Palestinian exports. Current Palestinian exports to Jordan include agricultural products, building stones, samneh (ghee) and light industrial products, most of which are also produced in Jordan for domestic and export markets.

A trade agreement between Jordan and the PA was signed on 14 January 1995, modified in May 1995, and only came into force as of 1996. This agreement exempts specified commodities from customs duty in six major categories: processed foods, agricultural products, mechanical or electrical equipment, household or domestic items, agricultural equipment, and chemical and pharmaceutical products. As indicated in table 2, trade with Jordan doubled in 1996, from $17 million (in 1995) to $35 million. This is still well below 1993 levels of over $60 million, and much higher historical levels, indicating that much still remains to be done to achieve the broad goal of $200 million of trade between the two sides, as hoped for by Jordanian and PA officials.

In the context of the Middle East peace process, a separate Agreement on Trade and Economic Cooperation between Israel and Jordan was signed in 1995, providing customs tariff reductions for goods of Jordanian origin and customs tariff reductions for goods of Israeli origin. The only two components of Israel's imports which represent potential exports from Jordan are fruits and vegetables, and textile products. Jordan will be competing here with West Bank/Gaza Strip exports to Israel. If these items are imported to Israel from Jordan, it will most probably be because some trade has been diverted away from the areas rather than because net trade has been created. Israeli merchants will import these goods from Jordan rather than from the

West Bank/Gaza Strip as long as the price difference justifies the higher cost of transportation. Transportation should be one of the advantages that Palestinian exports have over Jordanian products; however, the prevailing situation in the Gaza Strip, and often in the West Bank, reduces this advantage because of large increases in transaction costs.

No formal trade agreement yet exists for trade between Egypt and the PA. Although an interim cooperation agreement between the two sides has been initialled, it cannot be considered a full trade agreement. It neither specifies the terms and conditions of trade, nor details tariffs, duties or commodities to be covered by preferential treatment. Economic similarities and other realities affecting the Egyptian and Palestinian (especially Gaza Strip) markets imply that even in the absence of specific agreements, there is already room for expansion of trade, particularly imports from Egypt, provided that transportation, logistical and other trade-related services are improved. However, the quantitative limits on imports from Egypt framed within the Protocol could restrict further progress in this respect.

Meanwhile, a number of Arab countries, including Saudi Arabia, Qatar, the United Arab Emirates, Bahrain and Tunisia, have announced that Palestinian products may enter their markets free of any customs duties, but so far no agreements have been signed to formalize these concessions. The PA aims to formalize them, however, in addition to agreements with other regional partners, such as Turkey. Recent initiatives within the context of a plan by the League of Arab States to facilitate and invigorate inter-Arab trade and to establish an Arab Free Trade Area have particular importance for the future of the Palestinian economy, including trade expansion. 35/

Since 1986, Palestinian trade with the European Union (EU) has benefited from preferential treatment accorded to certain products, such as selected agricultural produce, and flowers. The EU and the PA developed their relationship further with the signing of an Interim Agreement on Trade and Cooperation in February 1997. The Agreement builds on the earlier preferential treatment accorded to Palestinian exports, with a range of reciprocal measures aimed at integrating the PA within the EU’s regional and subregional systems of trade relations. 36/ Meanwhile, bilateral economic and trade negotiations have been conducted since 1995 with a number of other emerging trading partners. These include Canada, the European Free Trade Association, the Russian Federation and the United States of America.

In 1996, the United States amended the US-Israel Free Trade Area Implementation Act of 1985 to include articles on the West Bank and Gaza Strip as a qualifying industrial zone. Under this Act, the President has the authority to eliminate or modify existing duties. Since garments, textiles and leather apparel were not covered in the Act but were covered under separate trade agreements, the amendment did not apply to those products. Subsequent legislation extended existing Israeli trade provisions on these products to those produced in the West Bank and Gaza Strip. Prior to the amendment, export to the United States under these terms was possible only if the trade was conducted through an Israeli agent or producer. Although it is now possible for Palestinians to take advantage of this access to the

United States market, barriers to exporting to the United States - in terms of quality, price and transaction costs - have prevented any significant increase in direct export to date.

C. Implementation of trade regulations under the customs union

1. Issues of control

In practice, Palestinian customs and trade regulations apply more comprehensively in the Gaza Strip than in the West Bank, since the latter is under a multi-layered jurisdiction and merchants can bypass PA procedures entirely and work only through Israeli authorities, especially when that can facilitate their business activities. This is a particularly material issue for the economy not only because it represents a loss to the PA treasury, but also because control over administering customs regulations is ideally associated with administering various kinds of trade promotion packages. Under current arrangements, the PA's ability to encourage exports through credit facilities, export promotion, trade information services or other support measures is severely limited. As a consequence, the elaboration of a coherent trade policy is complicated, and initiatives to encourage exports can expect little financial inputs from the stretched PA budget.

An example of this potential problem is that of drawbacks on “temporary imports”, i.e. imported raw materials and unfinished inputs that go into the production of export-bound goods. An exporter can wait about three months until customs duties, VAT and purchase taxes are reimbursed. 37/ Once a more vibrant export sector emerges, such drawbacks could be financed through specially allocated credit facilities in order to alleviate any cash-flow burdens on the exporter. Drawbacks and other important instruments of export facilitation are best covered through customs revenues rather than other government revenue sources. Even such essential support, which need not imply any final expenditure commitment, is beyond the financial means of the PA, which has been operating with a small budget deficit since its inception.

2. Terms of applying trade taxes

Under the customs union, goods entering the Israeli-Palestinian customs area are subject to three taxes: tariffs and duties, purchase tax and VAT. Palestinian tariffs and duties can deviate only upwards on all the items, and downwards or upwards on those listed in Lists A1, A2 and B of the Protocol. The Protocol allows for only a two-percentage point deviation from Israeli VAT, and maintains the purchase tax entirely according to Israeli procedures. Purchase taxes are applied to all imports regardless of origin, and range from 5 per cent to 100 per cent of the total assessed value. These rates may include “TAMA” mark-ups when applicable, used to adjust the basis for calculating the purchase tax when an imported item potentially competes with Israeli-produced products. TAMA is an “arbitrarily assigned mark-up ... designed to reflect an increase to wholesale prices”, 38/ decreasing or even eliminating any price advantage a foreign competitor might have. Since 1991, the mark-up has begun to reflect actual mark-ups of wholesale prices. For products not produced in Israel, the TAMA is not included in the calculation of the purchase tax. The TAMA mark-up also applies to imports destined for PA territory, thus reducing the possibility of importing goods at substantially cheaper rates than wholesale prices in Israel, even when permitted by the Protocol lists.

Other than the duty-free treatment of trade in listed goods with Jordan and Egypt in accordance with trade agreements with these two partners, by 1997 the PA had not instituted customs or VAT rates different from Israeli ones for goods on Lists A1, A2 and B. This has been based on a perception that the goods listed and quotas approved on Lists A1 and A2 from markets other than Egypt and Jordan are so small in quantity that the impact of using different rates would not justify the efforts required to design and administer them. Indeed, all quotas of Lists A1 and A2 are reported to have been met since 1995, and were to be subject to upward revision agreed in principle in 1996 and finally signed at the end of 1997. List B, however, which comprises capital goods, has hardly been used, and only construction equipment was imported at significant levels under this list. 39/

Under current arrangements, all customs duties and taxes exacted at Israel's ports of entry are transferred to the PA Ministry of Finance if two conditions are met: the point of destination of the goods specifies Palestinian territory rather than Israel, and the importing trader is a Palestinian business registered with the PA. If the second condition is not met (and there are strong incentives for the importer not to meet it since the chances of Israeli security-related delays decreases significantly with an Israeli middleman), then only the VAT is transferred to the PA. If the first condition is not met (and thus the second one is also not met), all taxes without exception will accrue to the Israeli Ministry of Finance. These complicated terms are set out in table 6. 40/

The incentives for Palestinian buyers to comply with both conditions (destination and importer of record) are not yet strong enough to counterbalance the obstacles that have disrupted the flow of goods at borders, especially since 1996. It has been the experience of Palestinians that their goods are subject to less inspection, damage and delay by port and security authorities if the goods are imported through Israeli importers and with Israel marked as the destination. In the absence of a temporary import drawback system, even exporters may be inclined to import raw materials through Israeli channels. In fact, prior to 1993 some Palestinian manufacturers tried to establish operations in Israel in order not only to avoid delays and extra costs, but also to benefit from drawbacks on temporary imports. Additionally, these operations allowed the manufacturers to benefit from having an Israeli certificate of origin that allows excellent access to major markets in developed countries and on favourable terms. 41/ Since the signing of the Israeli-Palestinian agreements, many of these favourable terms have been extended to Palestinian products. For example, both the United States and the European Union now allow Palestinian products to be imported under conditions similar to those under which Israeli products are imported.

In 1996, the PA attempted to demarcate Israeli and Palestinian channels of import procurement. Under a directive issued by the PA in early 1996, Israeli agents for international suppliers or Israeli manufacturers can no longer sell directly to Palestinian businesses. Rather, there are two options available: either Israeli and international suppliers have a Palestinian agent or representative registered with the PA Ministry of Economy and Trade, or the Palestinian importer imports directly from international or Israeli suppliers, without the intermediation of the Israeli distributor/agent. 42/ While this regulation may have entailed additional administrative and other costs, its potential advantages are evident in terms of capturing a larger share of forgone Palestinian customs revenue.

From the perspective of the PA as a nascent government apparatus, and of the economy as a whole, the continued loss of income from imports that accrue to the Israeli treasury needs to be addressed. There is also an opportunity cost to this leakage that directly affects export potential: funds that could have been used to facilitate export development are lost. Although the long-term redress of this problem (and others) must be fundamentally resolved at the political level between Israel and the PA, this should not prevent the PA from demonstrating to the Palestinian business community the immediate benefits of importing through it. Indeed, with the emergence of monopolies within the Palestinian business community that can secure export and import of goods through special arrangements and with high commissions, the incentive to import through Israeli channels is increased.

From the perspective of industrial, agricultural and trade development, high tariffs impair the ability to achieve competitiveness, both in the export sector and in maintaining local market positions. Indeed, it could be argued that certain industries will fail to achieve viability in such circumstances unless two very difficult conditions are met: first, that drawbacks on temporary inputs be instituted with advanced financing schemes, and secondly, that a large portion of firms' production be dedicated to export. Fulfilment of the second condition is complicated by the possible loss of domestic markets to Israeli and other sources of more efficiently produced manufactures. These issues are examined in greater detail later in this study

D. Factors affecting merchandise trade flows: border restrictions

1. Border closures

The most conspicuous and the greatest impediment affecting external trade since 1996 has been the series of border closures and related security measures imposed in the Gaza Strip and the West Bank in the wake of violent incidents. Between 1993 and 1996, there were 342 days in the Gaza Strip and 291 days in the West Bank of total or partial closure. 43/ In 1996 alone the territory was under border closure for around 135 days, an increase of 35 per cent in the Gaza Strip and 57 per cent in the West Bank. In the remaining time, the norm has been limited freedom of movement, with open borders being a rare luxury for the inhabitants of the Gaza Strip. Total closure locks West Bank and Gaza Strip residents into their respective areas, eliminating the possibility of travel not only to Israel but also between the two regions (in the most severe case, total closure seals West Bank residents into their towns, preventing them from travelling within the West Bank). In times of limited closure, some workers are permitted entry into Israel, and there is additionally some movement of goods between the territories and Israel. The impact of the closures is acutely felt by the Palestinian economy in three ways.

First, income is denied to Palestinians who work inside Israel. The Israeli economy has maintained a steady demand for Palestinian labour from the territories. Compared with over 120,000 Palestinians working in Israel prior to 1993, PA estimates in 1996 reveal at least 50,000 workers with permits, and some 22,000 undocumented, bringing the total to around 75,000 Palestinian day workers in Israel in “normal” circumstances. 44/ Loss of income to Palestinians effectively dampens purchasing power in the territories, in turn reducing consumer demand and local manufacturing, as well as tax revenues to the economy. The local economy is simply unprepared and structurally unequipped to absorb such a huge influx of workers for unpredictable periods.

Lost wages reverberate throughout the economy, and secondary losses can safely be assessed by multiplying four or five times the amount of lost wages (an average of $30-$35 a day). These losses may be mitigated initially by accumulated savings, although in the case of low-income families dependent on work in Israel these are typically quickly exhausted. Using the figure of 70,000 workers as the pre-closure total and an average wage of $35 a day, one source has put the losses in labour income from Israel at around $2.5 million a day. 45/ Another source estimates that during the period from 25 February to 4 April 1996 (one of the initial periods of strict closure), lost wages amounted to $78 million. 46/

On another level, closure, whether limited or total, has equally disruptive effects on commercial activity. For example, citrus exports, once the mainstay of the Gaza Strip economy, decreased dramatically during the month of March 1996, one of the first months of full closure. The first two months of 1996, with exports of around $2 million, were in line with 1995 third-quarter citrus exports of $4 million. March 1996 exports to/through Jordan, however, are estimated at $440,000, with no exports reaching Israel or the West Bank. 47/ Similar trends are observed in other export branches. Wages also declined during these periods, as the level of commercial activity declined. Workers in the clothing sector, for example, saw daily wages drop from an average of $10.40 to $9.30 in May 1996. Food sector wages fell from $11.80 to $9.80 from February to May. Most sectors report a loss of over a dollar a day in May, with the chemical sector experiencing the largest fall (from $13.20 to $9.40). 48/

With the loss of markets and income, the impact of the closures are felt by all sectors of the population. It often takes many weeks to regain pre-closure production levels, and the effects of closure continue to reverberate, even after a closure has been eased. Table 7 reveals the impact of the closure on Gaza Strip exports in 1996, as evidenced by the far lower March figures, and the slow growth back to pre-closure levels during limited closure (second-quarter figures). While the frequency of total closure decreased in 1997, the long-term drain on the economy due to prolonged uncertainty and debilitating security measures continues to be evident.

A third major impact of closures is found in the lack of access to inputs, outputs, and travel in order to make payments. In many cases, local workers are unable to travel to work, and manufacturers lose access to inputs. Furthermore, many manufacturers cannot collect payment on their products and are forced to reduce production (because of loss of inputs, labour and markets). Manufacturers also lose access to markets in Israel and in the

Gaza Strip or the West Bank. Many are also prevented from delivering on their contractual obligations, thereby increasing the potential misgivings of international importers interested in Palestinian exports. Prices in turn are affected by closure. For example, closures in harvest season entail severe agricultural costs, with prices for Gaza Strip seasonal vegetable produce around half normal price levels. 49/ Fresh food imports from Israel, such as imports of poultry, experienced significant price increases as border procedures were intensified.

Both the primary and secondary effects of closure are related, and the possible development of a sustainable, broad-based export sector in Palestinian industry requires the problem of border closures to be addressed. The Gaza Strip, which is more isolated by closures, is affected more sharply than the West Bank (although with the establishment of the PA in the Gaza Strip, unemployment can be alleviated somewhat by PA employment). Since the geography of the Gaza Strip is such that the latter is far more easily isolated than the West Bank, closures have caused more severe hardship in the Gaza Strip, which already suffers from higher poverty levels than the West Bank. For example, the Gaza Strip's monthly industrial revenue in December 1995 amounted to 13.3 million new Israeli shekels (NIS), while in the second quarter of 1996, after the period of tightest closure in 1996, revenue reached NIS 12 million for the quarter as a whole, well short of previous quarterly levels. In March, the industrial sector purchased inputs totalling NIS 1.1 million. By June, that figure had regained pre-closure levels, at around NIS 3.2 million.

As with full closure, limited border closures, although less severe on the population, hinder the development of a trade-oriented economy. In such conditions, difficulties remain in predicting the flow of goods, whose prices rise because of increased transportation costs and reduced supply, while the financial sector is weakened because of large withdrawals from the local population to make up for lost revenue. Border closures, which tend to be accepted as a temporary state of affairs, are an extraordinary situation with widely recognized adverse economic effects. They should be viewed as a problem in need of a solution, rather than patience. Until such time, there is little chance of developing the capabilities and skills needed for a viable export sector in the Palestinian economy (meeting production schedules, organized high-quality production, efficient transportation networks, etc).

2. Other border restrictions

Since the signing of the September 1995 interim accords, which extended the PA throughout the West Bank cities and towns, the situation at the various border crossings has become more complicated and restrictive, with fewer Palestinian exporters and importers able to understand or negotiate the procedures and security measures. Documentation requirements have increased, as the coming of the PA has meant another level of bureaucracy, and the complex trade regime of the Protocol has meant that the levels of treatment for different commodities have increased as well.

Furthermore, the system of importing and exporting goods has not been rationalized at the different entry points. Different requirements exist for different checkpoints, even ones which share a national border (for example, the import requirements at Rafah and Soufah in the Gaza Strip are different, though they both share the Egyptian border). Also, the Israeli authorities have begun to direct different imported commodities to different checkpoints, increasing the cost and complexity of moving goods. The Carni crossing was opened specifically to keep goods flowing in the event of a border closure, and was subsequently closed during the total closures of 1996 and occasionally since then. A new checkpoint for construction materials in the Gaza Strip was opened at Soufah, incurring further controls, and hence higher prices, of construction materials entering the Gaza Strip. Such difficulties also lead to increased opportunities for monopolistic trading practices, thereby increasing the costs of transportation.

The problems encountered by Palestinian trucks crossing the border areas with merchandise are exacerbated during periods of closure. For example, before closure the number of trucks crossing the Gaza Strip/Israel border averaged 700, 250 of which exported goods. 50/ Table 8 shows the sharp decline in transportation that closure brings. Transportation levels did not return to normal levels until May 1996. Since that date there have been several full closures and extended partial closures.

Even in non-closure times, the treatment of Palestinian shippers and their commodities at Israeli border points tends to marginalize the role of PA customs officers, and makes shipping difficult and expensive. According to the PA, on borders which have shared control, Israeli customs agents have maintained a high profile in respect of Palestinian customs officers through various means. 51/ At borders which are exclusively under Israeli control, goods have generally flowed more smoothly. This has in turn encouraged Palestinian importers to label the destination of their goods as Israel, as procedures are more streamlined. Palestinian customs administration is in dire need of technical assistance and human resource development at all levels so that it can fully exercise its intended powers and responsibilities under the Protocol. 52/

The unreliability of transportation in and out of the territories has serious consequences for developing an economy with an external trade component. Not only does this situation make it extremely difficult for exporters to meet shipping deadlines with their cargo intact, but also it adds to the economic separation of the West Bank and Gaza Strip, as shipping between the territories has become more difficult. Such division further limits the growth of a Palestinian economy by reducing opportunities for increasing competitiveness in the Palestinian private sector through economies of scale.

E. Factors affecting merchandise trade flows: transportation and shipping procedures

1. Back-to-back

Israeli security measures prohibit the use of the same vehicle to move goods across the borders at Allenby Bridge (West Bank with Jordan), Rafah (Gaza Strip with Egypt) and Netsana, Soufah and Carni (Gaza Strip with Israel). The procedure followed is commonly called “back-to-back” and involves a time-consuming unloading and reloading of goods, which often results in damaged goods and packaging. It is not uncommon for an importer to reject a shipment which has undergone back-to-back loading because of the resulting damage.

Trucks forced to undergo back-to-back need to coordinate with the authorities on the opposite side of the border the morning the shipment is to pass. Only one truck is allowed to enter the Israeli security checkpoint at a time, and no Palestinian is allowed to enter. After the lengthy check, the goods are then placed on the ground and in turn loaded onto the Palestinian truck. Palestinian trucks need to be certified by the Palestinian Coordination Office and customs duties are then paid to a local bank. The importer must pay all fees, including entrance fees, to the Palestinian treasury and loading/unloading fees to the Israeli company handling this task (since no Palestinians are allowed in the security area).

Back-to-back is an inefficient and expensive process. Even when justified in terms of Israeli security requirements, this is less evident with regard to Palestinian exports to neighbouring countries. Owing to the excessive amount of time required for back-to-back loading, the number of trucks that could possibly be processed is small. For example, the Rafah checkpoint routinely processes at most 15 trucks daily (from 7.30 a.m. to 4.30 p.m.), and it is not uncommon for the Palestinian shipper to wait the whole day before being able to continue.

2. “Green trucks”

Since 1967, strict security guidelines have been applied to the kinds of trucks allowed to transport goods (mainly agricultural) from the West Bank and Gaza Strip to Jordan. These uncovered, flatbed trucks, known as “green trucks”, were required to conform to strict specifications. 53/ “Green trucks” could not transport perishable items with much success, as dirt and sun would often spoil the shipment. The drivers suffered from exhaustion due to the lack of ventilation and comfort in the truck. Also, the trucks frequently required repairs. If a truck was on the road, repairs had to be completed in the presence of the accompanying Israeli military security and had to be completed swiftly, or else it would be towed at a cost of over $1,000.

“Green trucks” still exist in the Gaza Strip and West Bank, but their numbers have decreased significantly, because of unreliability and their limited usefulness for modern road transport (all of them are over 20 years old). The use of regular trucks has increased, but these are required to undergo extensive security checks such as back-to-back, described above. “Green trucks”, along with regular trucks, are used in transportation convoys.

3. Convoys

For the transport of goods between the Gaza Strip and the West Bank, Israeli military convoys are mandatory. The maximum number of trucks allowed in a convoy is 10. The daily total permitted is 15 “green trucks” and 25 other vehicles. Convoys, however, are scheduled randomly according to security considerations, regardless of the need for transportation. Conversely, they are frequently left waiting for days before moving. Because of this wait, many Gaza Strip “green truck” drivers rent apartments in Jericho, awaiting the next convoy to move between the West Bank and Gaza Strip, thereby adding additional cost (and time) to shipping. 54/

4. Clearance procedures

Israeli customs agents make the final determination as to whether a shipment can enter or leave the border. The list of products has been determined by the schedules in the Protocol; however, goods may be refused entry on security grounds. Many products (such as floor tiles and plastic mats) have been rejected because of such considerations. 55/ Additionally, certain chemical products are refused entry, whereas Israeli merchants import them freely.

5. Additional costs

The average cost of shipping goods between the West Bank and Gaza Strip is $530 per truckload, $300 of which is needed to ship from the West Bank to Erez, and another $230 to ship from Erez to Gaza City. These costs are high for the short distances involved (around 100 kilometres), and many other, incidental and opportunity costs are incurred. Such costs include extra transportation costs: since Palestinian shippers are not allowed in the Israeli clearance area or in the border area without certification, they often send taxis - at great cost - to deliver documents. Other extra opportunity costs include lost time and extra damage to goods, which are difficult to quantify but are nonetheless significant.

Additional costs also arise with goods exported to Jordan. Importers in Jordan set a fixed daily rate to retrieve goods; thus, when there are delays extra costs are incurred by the Palestinian exporter. Similarly, Palestinian importers incur additional costs when importing goods from Jordan because of delays in transportation and damage during shipping. When all the attendant costs are calculated, the price of a commodity could double by the time it retails in the West Bank. Several commodities imported from Jordan retail for 250 per cent more in the West Bank than in Jordan.

6. Banking

Because of the inability to guarantee a schedule of delivery, Palestinian merchants are forced by banks to open letters of credit with the full value paid up front - a tremendous drain and risk for the merchants. Furthermore, import/export documents are not sent directly to a local bank but must travel through either Israeli or Jordanian banks. Not only do these procedures delay the shipments and add levels of needless bureaucratic intervention, but also they increase the price of transportation as each bank collects its required commission.

7. Standards and specifications

Imported goods, when subject to quality and specification controls, must be tested in accordance with the procedures laid down by the Standards Institute of Israel and in an Israeli laboratory. In one case, an importer’s goods were tested by Israeli authorities, which determined the product to be vegetable oil (which is taxed) rather than ghee (which is not taxed). Palestinian officials inspected the product and found it to be indeed ghee. 56/ No properly equipped laboratory exists on the Palestinian side. Such procedures are costly in comparison with the value of Palestinian inputs, time-consuming given the lack of a testing laboratory on the Palestinian side, and thus often avoided by Palestinian merchants. Palestinian veterinarians and agricultural experts are not allowed entry to border areas to conduct health or other controls on certain foodstuffs.

Furthermore, the strict enforcement of Israeli standards can act as a type of non-tariff barrier. Shipments to the Palestinian territory may be rejected on the ground that they do not meet standards, yet these standards are often not congruent with the level of development in the Palestinian economy and the purchasing power of Palestinian consumers and producers. Currently lacking are official and accessible Palestinian standards, developed to augment Palestinian needs, and laboratories that can perform testing services locally.

8. Administrative procedures

The system for export which the PA has established is relatively well documented and rationalized. However, it is still excessively complicated and little effort has been made to streamline it or to help exporters deal with its complications. The PA has established many new areas of governance, and at times their specific jurisdiction seems unclear. This remains particularly true as regards government officers at the border control areas, who are frequently unable to fully perform their functions. Strengthening the ability of government departments responsible for borders and entry points, external trade, internal trade, customs and other areas will improve fair access to borders.

On the other hand, procedures are sometimes revised unilaterally or not expeditiously completed. For example, new Israeli regulations require the PA to receive notification (and all documentation) from Palestinian merchants two days before their goods arrive at the checkpoint, for subsequent review by the Israeli authorities. Furthermore, the PA committee responsible for processing these notifications has often delayed informing the Israeli authorities of incoming shipments when all the paperwork is complete and in order. Trucks may thus wait for two days at the border, at cost to the local merchant in extra transportation and grounding charges.

9. Trade with Jordan

Although the trade agreement between Jordan and the PA indicates possibilities for regular and effective trading practices with Jordan, the actual level of export to Jordan has been exceedingly small. Exports to that country still seem to attract heavy charges (for example, a truckload of building stones would incur a duty of 180 Jordanian dinars (JD), or some $270). This has had the effect over the past two years of gradually limiting the import of soap and stone, two once-competitive Palestinian products.

Other restrictions apply. All Palestinian drivers entering Jordan are required to have both Jordanian and Palestinian registration, as well as a

Jordanian driver's licence. They must also hold a Jordanian passport, which is now extremely difficult to obtain since Jordan has stopped issuing passports to Palestinians from the West Bank and Gaza Strip now that PA passports are issued. After delivering goods, drivers are not permitted to have more than JD 500 and NIS 50 when leaving Jordan, subject to fines of JD 300, impoundment of the vehicle for one week, and revoking of the driver's licence.

10. Trade with Egypt

Trade between Egypt and the PA has flowed mainly in one direction, as potentially competitive Palestinian goods have not been able to make inroads into Egyptian markets. In 1995, a total of nearly $4.5 million worth of imports (mainly) to the Gaza Strip passed through Rafah, this figure soaring to over $14 million in 1996 (see table 2). These imports consisted mainly of Egyptian food products, building materials, beverages, household appliances, wood, and other finished and semi-finished products. 57/

However, Egyptian goods are sometimes packaged poorly and cannot withstand the rigorous loading and unloading procedures; this results in return of shipments and increases in prices of goods. There has been virtually no trade in the other direction. Shipping costs from Rafah to Cairo are roughly $300-400 per truck. These are considered high by most Palestinians, who are also subject to additional costs if there is a delay at the border ($100 a day). Furthermore, the Egyptian side of the border is lacking in properly equipped trucks, and this limits the type of exports that can travel to Egypt. Similarly, refrigerated trucks are not available, and this makes the transport of food products and flowers (two of the Gaza Strip's main export commodities) to or through Egypt impracticable. Several potential Egyptian exporters have refrained from transacting business with West Bank importers until the trade regime and border issues are more stable and clearly articulated.

F. Other factors affecting trade flows

One problematic, and new, factor affecting trade flows to/from the Palestinian territory since 1994 has been the emergence of monopolistic practices affecting certain imports, some of which have been indirectly caused by restrictions reviewed above. Such practices have been noted with regard to the import and local supply of some important commodities, such as sugar, wheat flour, vegetable oils, frozen meats, live animals, concrete, wood, steel, gravel and cement. 58/ The most durable monopoly has been that involved in concrete imports from Jordan. The range of factors discussed above which effectively control, or limit, the import of many key items has led to price-fixing market distortions that have contributed to price rises, especially in times of border closures. For example, in the Gaza Strip, where greater control is possible over imports than in the West Bank, the price of a sack of flour rose from $15 to $40 over the course of 1996. The greatest increase, from $23 to $40, was largely due to pricing arrangements agreed between the few importers involved. 59/ In such cases, differential access by businessmen and importers to PA-issued import licences can encourage favouritism, collusion or corruption in the absence of clear, transparent and fair trading practices and their strict application by the PA.

A further example of factors which reduce competition in the Palestinian market relates to border control. Some importers have developed “special commercial relationships with certain Israeli suppliers”, 60/ which allow for the import of specific Israeli goods over and above other Israeli, Palestinian or third-party goods over the borders. The ability to carry out border control depends on access to the border control areas, and the cooperation of both Israeli and PA officials. In one example, the Israeli authorities agreed to ease the import of gravel over the Soufah crossing as part of easing of closures. However, the border remained closed for two weeks after this announcement until the terms for such imports were agreed for goods coming through this crossing point. Accordingly, the price of gravel rose from $15 to $30 per metric ton between January and July 1996. 61/ Such problems have been felt most acutely in the Gaza Strip, where the fenced geography and fewer entry points allow greater control. 62/ In this situation, where the movement of goods is the overwhelming obstacle to successful importing and exporting, restrictive practices produce an unfair competitive advantage for a handful of enterprises, whose relations with the PA can be a decisive factor for success or failure. 63/

The PA has yet to devise effective and transparent regulations and measures for addressing such phenomena without undue interference in market mechanisms. 64/ Nor has it been able to resist the temptation of engaging in commercial and other business transactions in the open market, albeit through publicly identified intermediaries and trading companies which have recently been made subject by the PA to formal declaration of ownership (or majority control). The distortions in trade patterns made possible by the procedural and other restrictions mentioned in previous sections provide much of the underlying incentive to collusion and other distorting business practices. To the extent that those basic restrictions on movement of goods are transitory and can be addressed as part of an improved security and policy environment, the conditions which have fuelled restrictive business practices will be rendered less valid.

For the moment, the PA has been able to utilize the additional revenue accruing through collection of excise, customs duties, levies and other charges on controlled imports in order to supplement government expenditures which are inflated owing to the continuing tense security situation, and most of which are not financed by the international donor community. 65/ Such a strategy can be viewed as a measure of the degree of economic and financial distress facing the PA. By most accounts the revenue generated through such indirect sources has been as significant to the PA budget as direct and indirect taxation collection, the two major sources of government revenue.

However, the continued operation of monopolistic practices, regardless of the extent to which they ensure uninterrupted supply of basic commodities and of the income they generate to alleviate the financial burden of the PA, does not contribute to the short- or long-term investment climate envisaged for the Palestinian economy. The distortions in the cost structures of the productive sectors and in the allocation of resources of private households are detrimental to efforts to bring down the costs of various inputs. Such practices further discourage investment, especially foreign and expatriate investors, who increasingly feel that export-bound manufacturing in the West Bank and Gaza Strip is influenced by an uncertain and distorting trading environment.

Some local manufacturers - especially successful subcontractors - have been seriously considering relocating to Jordan and taking their acquired skills and contacts to less restrictive business environments. Under the Israeli-Jordanian trade agreement, they will be able to maintain business links while benefiting from the less risky environment, the more developed private and public support institutions, and the cheaper labour and other inputs (especially raw materials and energy). With the normalization of trade relations between Israel and Jordan, these manufacturers expect to benefit from the above advantages while maintaining their contacts with Israeli contractors.

The reasons continually given by these manufacturers for possible relocation to Jordan are the problems of border restrictions, which, even if relaxed, could be reimposed for a variety of security considerations. The slow development and uncertain direction of the PA legal and institutional framework affecting trade are also often cited: PA trade and economic institutions are still considered weak, trade promotion organizations and related facilities are neglected, and basic laws, regulations and procedures are still incoherent and incomplete. The loss of these firms would present a serious threat to the prospects of a home-grown exporting sector, as they are among the most innovative and experienced exporters, and the closest to being the industry leaders in their respective sectors. Those in subcontracting work for international brand leaders, and those exporting final products, have established export markets in Africa and other developing markets.

Another discouraging factor cited by the business community has been the collection of taxes by the PA from businesses on unfavourable terms. 66/ For example, large firms have been denied permits required to do business until they settle their accounts completely rather than making payment arrangements. Given the cash shortages experienced by virtually every branch of business, such revenue-maximizing practices could threaten businesses with serious liquidity problems and discourage the expansion or maintenance of market positions.

Chapter III

SUPPLY CAPACITY OF PALESTINIAN MERCHANDISE SECTORS

Alleviation of the constraints on external trade described in chapter II constitutes the *sine qua non* for restoring the levels of trade prevailing before 1988. However, a comprehensive consideration of export prospects and the development of a vibrant export sector must address the issue of supply capacity, i.e. the ability of the domestic economy to supply goods for external trade. Although issues of supply capacity are addressed here separately from those of the trade environment, it is important to note that the underdeveloped capacity of the economy to engage in external trade has been largely the result of prolonged neglect and isolation since 1967. For the Palestinian economy to engage freely in international commerce, removal of current barriers to trade needs to be accompanied by efforts to correct structural distortions. In addition, the development of a range of associated service industries also capable of export (especially certain producer and private service branches, tourism above all) constitutes a related area of endeavour in developing a vibrant Palestinian external sector, albeit outside the scope of this study.

While this is a longer-term issue that requires extensive restructuring of the economy under more favourable circumstances, 67/ an examination of current merchandise supply capacity is useful for two reasons: (i) immediate attempts at export promotion should bear in mind the current state of production in the West Bank/Gaza Strip, and accordingly recognize the limits to programmes that begin “ex works” and do not also address production problems; and (ii) the need to address the question of restructuring production capacity in the context of the fundamental problem of trade regimes. This chapter analyses the issue of supply from two broad angles: merchandise production - agricultural and manufacturing; and trade-related services.

A. Agricultural production

In terms of quality and cost, supply capacity is fairly developed in agricultural production; however, in terms of the local market there is excess production of some commodities as there is limited access to and/or demand for external markets. The main immediate obstacle to the export of fresh agricultural products seems to be the myriad restrictions on the rapid movement of goods. On the other hand, agricultural export is less dependent on various State-administered customs drawbacks on imported inputs, by virtue of its high local content. In the long run, certain structural constraints militate against significant growth of agricultural exports since land and water are scarce and expensive, with no clear indication that the peace process will resolve these issues favourably for Palestinian agriculturists. However, export-marketing successes in various products, such as citrus and olives, bear witness to the quality and viability of Palestinian agriculture.

1. Agricultural production patterns

Agricultural production in the West Bank/Gaza Strip is highly diversified because of varied climate zones. The variation in zones also allows year-round production, as well as off-season production. These attributes provide an advantage for Palestinian exports, particularly to Europe. According to 1996 estimates by the PA Ministry of Agriculture, the agricultural sector constitutes 22 per cent of GDP, 17 per cent of employment and 25 per cent of exports. 68/

According to the same estimates, approximately 32 per cent of Palestinian land is cultivated, of which 29 per cent is rain-fed and only 3 per cent is irrigated. In terms of production value, 70 per cent of the total value of agricultural production is from vegetables and olives. Approximately 9 per cent of production value is from citrus; however, this has been declining in recent years and the decline is expected to continue. Animal production constitutes approximately 30 per cent of agricultural output in the Gaza Strip and 49 per cent of West Bank output. 69/

Despite the fact that agricultural production makes up a large share of GDP (second only to services), it has little value added for exports. Over the last few years, there has been a decrease in the value and quantity of exports from the agricultural sector. This, coupled with the increase in productivity and output, has led to a drop in local market prices. 70/

The decline in exports is linked to a decline in citrus production and export, primarily from the Gaza Strip, and increased competition from other countries in the region, particularly Jordan. For example, Palestinian olive oil exports have declined because of competition from Jordanian production, which has become more efficient and of a higher quality recently. Meanwhile, the agriculture deficit has grown because of an increase in imports of products such as meat, dairy products, cereals and fodder. There has been an increase in the production of certain products, such as bananas and vegetables, which have not traditionally been exported; however, there is little experience in exporting these products. 71/

Once a major export (especially from the Gaza Strip), citrus is no longer considered to be a competitive area of export development, because of water shortages, declining water quality and market changes. This is largely due to increased competition from other regional producers, particularly in North Africa, the high demand for water, and an increase in land prices in the Gaza Strip. Efforts to revitalize citrus production would depend on improving production by introducing new technology, irrigation and extension services. They would also depend on identifying new markets for export. Historically, eastern Europe was a major importer of Palestinian citrus and this market should be considered once again.

The production of olives, although having increased over the past 20 years, remains below full capacity. For many years, Palestinians have turned to planting olive trees in an attempt to prevent land confiscations. Production has increased because of the increase in cultivation; however, per dunum (1 dunum = 1,000 square metres) production rates have not increased. As in the case of citrus, it is necessary to introduce new techniques and capital and identify new products or markets. 72/

Vegetable production has greatly expanded over the past 20 years, particularly in the Gaza Strip. This has been largely due to the introduction of plastic greenhouse technology. The number of greenhouses in the Gaza Strip increased from an estimated 20 in 1980 to around 6,500 in 1992-1993. Approximately 25 per cent of the total value of vegetable production in the Gaza Strip comes from tomatoes and 22 per cent is from potatoes. 73/

Other products, such as grapes, have been overproduced, particularly in the Hebron region. Unlike other products, grapes have very limited diversification possibilities. In other commodities, including olives, citrus, eggs and poultry, meat, and fruits and vegetables, production has exceeded local demand. Because of the difficulties in exporting such products due to closures or a lack of access to outside markets, the surplus has often remained in local markets, forcing down prices. In the long term, weak prices could have a negative effect on production levels.

In addition to the prospects for export of fresh fruits and vegetables, there is potential for developing an agro-industrial sector which could increase the export of Palestinian products. This, however, requires coordination on the part of both the industrial and agricultural sectors, which is currently lacking. Growers have little information on appropriate cultivars and harvest specifications for processing in order to meet the demands of agro-industries. For example, in August 1996, a tomato paste factory opened in the Gaza Strip, but the owner of the factory could not find a sufficient supply of tomatoes suitable for processing. At the same time, however, there was a surplus of other types of tomatoes. There are very few food processing facilities which are integrated with the agricultural sector and use locally produced raw material.

Development of the agro-industrial sector will require a shift to varieties suitable for processing. Growers currently concentrate on varieties of products which have high water content and short storage life. Lack of agriculture extension services and research has prevented identification of new crops and research into more suitable varieties. Growers have very little information on local markets and almost no information on export market requirements and demands. Transportation is another component of agro-industry which will need further development, as quick and carefully scheduled deliveries are vital.

2. Agricultural exports

Palestinian producers have responded to Israeli quality and control specifications and to Israeli grading standards; however, quantities graded for export represent only a small percentage of exports. The lack of market information, cold storage facilities, agro-processing and crop planning has increased the instability of local prices. Furthermore, health and safety standards must be developed, particularly for industries such as the meat industry, if these products are going to be exported.

The advantages of Palestinian produce in European markets are likely to be in off-season production and speciality high-quality products, such as flowers, medicinal herbs, asparagus, celery, onion seed, cantaloupe, avocados and dates. In terms of exporting products to Israel, Palestinian producers have an advantage in labour-intensive production, such as greenhouse production, poultry, citrus, grapes and olives. For now, Palestinians do not enjoy an advantage in production which requires a higher degree of technology, such as livestock-breeding.

Agricultural exporters are concentrated in Nablus, where there are 30 of them. West Bank exporters trade mostly with Jordan through Jordanian intermediaries and, to a lesser extent, with Israeli intermediaries. A few citrus and banana exporters from the Gaza Strip have established offices in Amman. In the West Bank Tulkarem/Qalkilya area the informal wholesale market is dominated by two traders who handle sales across the green line.

There is no significant direct trade with the EU, although historically there has been trade with eastern Europe, but only through Israeli agents or marketing agencies. At one time, eastern Europe constituted a strong market for Palestinian citrus exports, but the economic situation there led to a drastic drop in imports. In the last few years, however, exports to eastern Europe have been slowly increasing again.

Exports to European markets remain very risky because of a lack of experience, management and market information, and adequate infrastructure. The high risk has made exporters reluctant to grant lines of credit or export guarantees for export to Europe. Together with assistance from the EU, the Italian Government provided loans to facilitate exports of a few shipments, but a more systematic approach is required if Europe is eventually to become a significant market for Palestinian products. 74/ There is growing competition from EU Mediterranean countries, and market entry into Europe is difficult.

Agricultural export to the Arab world has decreased, partly because of the inability to obtain lines of credit or credit export guarantees. Also, Palestinian exporters lack experience in these markets as a result of the prolonged Arab boycott and face growing competition from other countries, including Jordan, the Syrian Arab Republic, and Turkey. Furthermore, it should be noted that Israeli products could in the future be competing for a share of these markets, depending on progress in the peace process. The Gulf States represent a large regional market and West Bank/Gaza Strip producers still have an advantage in terms of seasons. To compete, greater attention will need to be paid to quality and packaging in order to regain some of the position lost in these traditional markets.

B. Manufacturing patterns

This part of the chapter first presents a profile of some key indicators of West Bank/Gaza Strip industrial branches, highlighting shared characteristics and differences between the West Bank and Gaza Strip. This is followed by an examination of the organization of production, emphasizing the problem of current scales of production. This section then considers the nature of industrial trade (in the form of subcontracting) and what issues are thus raised for future trade goals. Finally, issues of competitiveness and possible directions of key industries are reviewed, with reference to a detailed field examination of key branches with export potential (annexed to the study). The last part of the chapter examines non-production aspects of relevance to development of external trade (support services, especially in manufacturing).

1. Industry in the West Bank/Gaza Strip

Most Palestinian manufacturing sub-sectors are highly underdeveloped and generally unprepared for exporting on a large, regular basis. Production patterns remain highly underdeveloped and are in the nature of cottage industries. Persons engaged in industrial activity contribute less to GDP than those in agriculture: in 1993, industry's share of GDP was 7.5 per cent in the Gaza Strip and 11 per cent in the West Bank, while industry is estimated to employ around 15 per cent of the total Palestinian labour force. 75/ A few studies suggest that these figures probably underestimate both employment and the contribution to GDP: most recently, the first official Palestinian national accounts estimates for 1994 confirm that industry’s share of GDP may have risen to as high as 13 per cent. 76/ In contrast, Jordan's manufacturing sector, for example, contributes 14 per cent to Jordan's GDP, and employs only 8 per cent of the total labour force. 77/

Table 9 summarizes some of the key features of West Bank/Gaza Strip manufacturing branches, as they appeared in 1992. Figures were taken from Israeli data sources because of relative consistency in methodology, although alternative figures for the post-1994 situation have recently become available from the PCBS, the implications of which remain to be analysed. While the profile of the manufacturing sector is on the whole very similar in the West Bank and Gaza Strip, table 9 shows that there are some features that distinguish the two areas.

Although firms are still very small (on average there are about four employees per firm), West Bank firms are reported to employ about twice as many employees (i.e. paid hire) per firm as in the Gaza Strip, i.e. six compared with three. Especially in key trade sectors such as leather, garments/textiles, food processing and non-metallic minerals (including quarrying), West Bank industrial firms are more consolidated than in the Gaza Strip. The average annual revenue per firm is thus lower in the Gaza Strip, at about $5,000, compared with $11,000 in the West Bank.

It has been argued that Gaza Strip manufacturing experienced considerable growth under Israeli occupation without the fundamental structural transformations that are required for the emergence of a vibrant agricultural or industrial sector. 78/ The same can be said of the West Bank, where there is little evidence of major differences in the organization of production. Labour skills, modern management skills, investment in technology, and other such factors are very low. Furthermore, agricultural and industrial firms hardly function as institutions capable of organizing these elements of production and of arranging for international marketing on a competitive and consistent basis.

The expansion of the manufacturing sector in the past 30 years has not been accompanied by a process of consolidation, thus reinforcing the fragmentary, cottage industry character prevailing before 1967. For example, according to one study, in the Gaza Strip only 10 manufacturing firms have capital of $700,000 or more. 79/ Seventy-two per cent employ fewer than four persons (including the owners). Only 1 per cent, or about 50, of establishments employ over 50 people. Only 3 per cent of firms, or about 200, employ over 20 people. 80/ By comparison, over a third of Israeli firms employ at least 300. 81/ These levels of fragmentation are evident across all major manufacturing branches. In none of the high-employment branches surveyed by the PCBS in 1994 do firms employing over four persons constitute over half the number of firms. 82/ Consideration of prospects for sustained manufactured exports needs to account for this structural phenomenon.

Capital-to-labour ratios are extremely low, at about $3,000 per worker in the Gaza Strip (and only slightly higher in the West Bank), which is about one tenth of Israel's across most sectors. 83/ In certain sectors, such as garments, average investment per employee is one twentieth of Israel's, 84/ and this accounts for the low industrial productivity and very low average industrial revenues per establishment. 85/ Consequently, retained earnings available for reinvestment for the development of production capacity or for hiring mid-level technical or business staff needed for the initiation (and maintenance) of export contracts are practically unimaginable on a firm-by-firm level.

A related issue is that of wasted productive capacity, which is estimated at over 50 per cent. 86/ Exacerbating this problem is the lack of widespread sharing of capital equipment or of local subcontracting between Palestinian firms. 87/ There is little evidence of vertical inter-firm trade: industrial inputs acquired through local suppliers constitute only a small fraction of inputs across all branches, thus reducing total local content and increasing vulnerability to external shocks. Furthermore, imported inputs carry a price premium over international prices because of weak bargaining power in relation to suppliers, and lack of systematic access to various customs drawbacks for temporary inputs. Clusters of manufacturing establishments hardly exist in the form of integrated industrial branches with leaders and intrasectoral competition.

2. Industrial trade and subcontracting with Israel

In 1995, Palestinian industrial products were estimated to constitute about 80 per cent of merchandise exports to Israel (including exports overseas, under Israeli labels), and 88 per cent in the case of the Gaza Strip. 88/ Since 1994, Palestinian industrial exports to Israel are estimated to have dropped to $38 million, but still constitute 82 per cent of total Gaza Strip merchandise exports to Israel. 89/ In absolute terms, this represents a significant decline in industrial exports in just two years, and is attributed in the first instance to the restrictions on the movement of goods and persons imposed since 1994.

Industrial trade with Israel has been overwhelmingly in the form of semi-finished products manufactured under arrangements that are frequently described as “subcontracting” but are in fact more akin to “trade in labour services”. In the final analysis, it is often just the labour value-added that is exported rather than Palestinian-processed merchandise, as Israeli raw materials and semi-finished components are frequently brought in by the contractor, with the Palestinian counterpart processing them exactly according to the contractor's instructions. 90/ This trend has transformed much of the Palestinian industrial base into a complement of Israeli production, with a high vulnerability to Israeli demand that is undiversified by links to other markets. This has had unfavourable consequences for the development of the supply capacity of the industrial sector as a whole, and leaves a legacy which Palestinian development must grapple with in coming years.

Some salient features of Palestinian-Israeli subcontracting relationships have a direct bearing on the future of Palestinian industrial exports:

(1) Subcontracting is the largest component of Palestinian merchandise exports to Israel. 91/ There is also a strong correlation between the largest manufacturing branches and those that engage in subcontracting with Israel. This probably reflects some competitive advantages enjoyed by Palestinian firms in relation to Israeli branches in the pre-1994 trade regime. Also, it suggests that this is a strong indicator of competitive sectors for the future, at least for the short term.

(2) In many respects, the most technically (and to a limited extent, managerially) developed segments of Palestinian industry have engaged in subcontracting with Israeli counterparts, and are thus often suggested as potential leaders for direct export of finished products.

(3) Most manufacturing firms are too small to engage in direct exporting and can therefore participate in exports only as subcontractors. Thus, the experience gained in subcontracting with Israelis could be useful for developing direct subcontracting links to other countries, especially European ones.

However, firms engaged in subcontracting for Israeli counterparts have not fared much better in terms of the problems of capital formation, firm size and organizational capacity. The 1993 World Bank report suggests that subcontractors have had a higher average capacity utilization than the rest of the manufacturing sector (68 per cent compared with 56 per cent), 92/ and have grown more rapidly (in terms of sales, operating profits, assets and capital). However, their capacity to handle the financial overheads associated with direct marketing in Israel (as opposed to subcontracting) remains very limited. The same study found that “the principal reason for entering into subcontracting was the lack of market access, which was provided by the Israeli firm. However, having commenced subcontracting, the principal reason for continuing to do so was the lack of working capital to sustain the same level of operations”. 93/ This suggests that at that stage, crucial financing problems arrested development.

According to local experts on trade, the overwhelming majority of Palestinian manufacturers have failed to create a cadre of mid-level managers on-site because of their proximity to their contractors. Too frequently, both parties have been content with the owners acting as production, quality control and procurement managers. This is due to the fact that higher-level technical and management roles are not complex: subcontractors generally do not make serious efforts in product development and marketing.

These features are proving to be a serious liability today. Indeed, with the advent of the PA and the entry of other countries such as Jordan into trade relations with Israel (and other factors such as border closures), previous conditions of Israeli-Palestinian trade are eroding, and Palestinian firms are experiencing crises as a result. Consequently, existing assumptions about subcontracting need to be revised since (i) a significant portion of subcontracting with Israel is being (or expected to be) shifted to Jordan; and (ii) successful Palestinian subcontractors in garments and flower production are considering shifting their operations to Jordan while maintaining the linkages to Israeli contractors (see above).

3. Performance, competitiveness and immediate prospects

Regionally and internationally, Palestinian competitiveness cannot rely on factor-based advantages and on strictly lower prices, the path hitherto followed by most Palestinian manufacturers in the context of the pre-1994 customs union with Israel. In order to attain a certain level of competitiveness, Palestinian industry must break with past trends - moving from factor-based advantages possible only under distorted economic relations with Israel to investment-based ones that can find niches for Palestinian exports in international markets and technologically beneficial exports and joint ventures in Israeli markets.

Only in relation to Israel is Palestinian labour cheap in the region; furthermore, Palestinian competitiveness is poorly endowed with natural resources, and many factors of production in agriculture and manufacturing, such as water, land and energy, are scarce and extremely expensive. With the evolution of trade relations in the region, the Palestinian economy's factor advantages in relation to Israel have slowly eroded as competition from Jordanian competitors have entered the picture. There is evidence that real industrial wages declined as of mid-1996, given the closures and the massive unemployment prevailing in the West Bank/Gaza Strip, but not to a level that matches Jordanian wages. 94/ Labour productivity, however, is often considered to be more competitive; with higher capital-to-labour ratios, Palestinian labour has the potential to be competitive.

Other inputs, such as energy, water and land are limited and expensive, thus increasing start-up and operating costs. Moreover, raw materials and other intermediate inputs are up to 30 per cent more expensive than international prices, according to one study. 95/ This is due to the customs union maintained between the PA and Israel and the lack of administrative mechanisms to administer tariff exemptions efficiently on export-bound temporary inputs. Other factors that have disadvantaged the cost structure of the manufacturing sector are the high financing costs associated with the high-risk atmosphere and the penalties of not achieving economies of scale.

The performance and competitiveness of Palestinian products differ widely from branch to branch and from firm to firm. Palestinian firms do not seem to benefit from sector-wide advantages, as intra- and intersectoral linkages within the various branches are weak, in terms of both integration and competition. Vigorous local competition is something that most branches do not seem to experience. 96/ In most branches, the stronger firms subcontract to Israeli counterparts and competition does not occur in the product development and marketing process. Rather, in negotiations with the contractor, who determines product adjustments or cost cuts, the entrepreneur is reduced to production management functions.

Furthermore, Israeli-Palestinian subcontracting is with a few exceptions entirely based on cheaper labour in relation to Israel. Those not engaged in subcontracting relationships tend to limit marketing to the immediate vicinity and compete only with imported (often Israeli) products on the basis of price. Palestinian merchandise production therefore suffers from “competitiveness” based almost entirely on lower prices, with little opportunity to develop other quality/skill-based competitive advantages. Widespread, dynamic local competition would have the effect of eliminating the factor-based competitiveness in relation to imports (labour cost) that is uniform across all firms engaged in a particular area. The fact that this has not happened helps to explain the cottage industry nature of most firms and the lack of industry consolidation and development. As things stand, an environment for innovation in production, product and business does not exist.

Appendix 3 presents some findings of field research into the performance and export prospects of key manufacturing branches: ready-to-wear garments, footwear, pharmaceuticals, food processing, metalworking and plastics.

C. Non-production issues and support services

In addition to production, infrastructural and organizational problems, manufacturers and cultivators are unable to improve competitiveness because crucial private sector (non-production) services do not exist. Many of the activities covered in this section would be considered production-related issues in a different economy, such as procurement and warehousing. However, they are analysed here separately as this more accurately reflects present realities and the immediate future form of most industrial branches, i.e. as vertically unintegrated, but (ideally) highly networked, small and medium-sized firms. Large, vertically integrated firms are largely absent from the Palestinian private sector. Small firms will have no choice but to outsource through intermediaries for various export and non-export transactions, such as procurement, maintenance, marketing, distribution and consulting.

This section also reviews vital public and private sector support services that are common to all modern economies, such as centres for monitoring and ensuring quality and health standards and specifications, centres dealing with intellectual property rights, and export market information and promotion institutions, all of which are lacking in the Palestinian case.

1. Procurement of production inputs

Among the most important non-production problems confronting virtually every Palestinian manufacturing firm is procurement of manufacturing inputs, both raw materials and semi-finished, with some key branches paying up to 30 per cent more for inputs than prevailing international prices. 97/ Frequently, products do not meet the specifications of the order and are increasingly on a cash-at-order basis, even within a subcontracting relationship. These long-standing problems have not been alleviated since 1994, and, on the contrary, have in many cases worsened. They persist owing to factors examined earlier, especially the import channels and sources implied by the prevailing customs union and the myriad restrictions on the flow of goods and persons.

Some attempts to provide market information about suppliers of raw materials for direct import from overseas have been made. Obtaining and disseminating information regarding international vendors is the least complex of problems. However, securing competitive prices, assured quality and favourable terms requires more than the provision of information - it requires the establishment of business links that are perceived to be beneficial to the vendor as well as the buyers. Attempts have been made in this direction but have yielded minimal results. 98/ One reason for this is that Palestinian buying power has not been organized (directly or through intermediaries) into more efficient procurements. This has meant that bulk discounts are not being achieved and that a negotiating position that would ensure compliance and reliability does not exist.

Moreover, the fragmentation of procurement means that potential economies of scale are not achieved in selection and inspection processes, which today are not carried out in a scientific manner in any branch, except to some extent in pharmaceuticals. Typically, the owner of a firm will inspect raw materials with the naked eye or by tactile sensation, and although over 20 years of experience have accumulated some measure of expertise for some manufacturers, their exposure and their choices remain limited. Most manufacturers recognize that they are using inferior inputs but explain that under current conditions they would not be able to compete in the market with higher-cost inputs.

Some local organizations have attempted to promote a greater awareness of selection and inspection methods, and further introduce the practice of integrating design phases (however rudimentary they may be) with the selection of raw materials, attention to quality and standards, costing and other stages. 99/ The success of these efforts cannot be gauged as they have largely come in the aftermath of border closures, when imports have been reduced to low levels.

2. Transportation, facilities and warehousing

Road networks, like the rest of the infrastructure, are extremely underdeveloped, particularly in the Gaza Strip. Furthermore, these physically inadequate routes are subject to complicated Israeli security arrangements, which further hamper the movement of goods and people. The “safe passage” arrangements agreed in principle as part of the Israeli-Palestinian accords, to connect the Gaza Strip and the West Bank, had yet to be implemented at the end of 1997. Coupled with the isolation of east Jerusalem from the West Bank and Gaza Strip, this geographical discontinuity has rendered shipment of goods logistically difficult and expensive. Despite the media attention it has generated, commercially viable air freight from the Gaza Strip still remains a distant possibility, and the functioning of a commercial seaport in Gaza is, at best, several years away.

Space is a major problem for most manufacturing firms, which operate in small, dim, badly ventilated and unsafe physical settings. They are, moreover, located in residential and urban areas, with no control over their environmental impact. It is now widely recognized that well-planned industrial zones could alleviate both of these problems if proper incentives, along with improved infrastructure and services, could create benefits for individual firms which outweigh the costs of relocating. A situation in which firms are forced to move to industrial zones without the accompanying benefits would address the environmental problems; however, the costs to firms and the manufacturing sector would be very high.

In the short term, warehousing capacities need to be significantly improved if procurement and shipping reliability and efficiency are to be achieved. No private or public warehousing facility for small manufacturers exists, even near the borders, thus further adding to transaction costs. Given the particularly complicated problems of the movement of goods in and out of the West Bank/Gaza Strip, ability to stock efficiently and to spread the costs could prove to be useful.

3. Consultancy services and technical support

Given the fact that extremely small firms and farms are likely to continue in the medium term to constitute the bulk of the Palestinian private enterprise community, the need for technical consultancy services will remain acute. There are very few specialized firms offering the range of agricultural, engineering and manufacturing-related services required in such a situation. Part of the problem is the very fragmented nature of local firms, where production has not centred on a domestic market and thus mechanisms for meeting industrial interests, such as trade associations, have not emerged. In part, this is due to the low demand that is generated by the current population of very small, cottage industry firms and the limited capacities of firms in the territories, rendering such services unprofitable. However, essential services that are in demand, such as machinery maintenance, do not exist in a well-organized manner. Even a branch as important as garment production has only recently organized an active trade association. Efforts are being made by non-governmental organizations (NGOs) to assist in the formation of such associations.

Chambers of Commerce, though still very rudimentary in their services, have received some significant attention from international development agencies. International market information and research services now exist in various forms, such as the European Information Correspondence Centre and the UNCTAD-sponsored Trade Point, as well as export promotion NGOs such as the Palestine Trade Promotion Organization, the Export Promotion Department, USAID’s Small Business Support Project and the Gaza World Trade Centre. The impact of these projects has been minimal since in themselves they are (i) unable to address the problems of border closures and bureaucratic obstacles; and (ii) do not address the upstream problems in production, management and capital endowment that would allow target firms to respond to new information and contacts regarding export opportunities.

At every level, Palestinian firms require training. There are vocational schools in both the West Bank and the Gaza Strip, but they are inadequate in number, quality and equipment to meet the challenges facing industry. If the general consensus is that the Palestinian economy needs to be geared towards skill-intensive (and capital-intensive) competitiveness, this area merits far more attention. There are established technical training programmes with regular visits by foreign experts in specific agricultural and manufacturing sectors. However, the resources available to organizations conducting such services remain extremeley limited. Again, with inadequate integration into the business community, these efforts at training of technical and non-technical staff have limited effect.

Since 1994, there has been a boom in the establishment of private consulting firms in various areas of business, and many non-profit institutions have consulting services (including universities). Most of these services have concentrated on investment studies and export marketing, and given the small population of potential investors and likely exporters, they are probably underutilized. Construction, architecture, tourism and some other sectors can probably in time be well serviced by these firms. While there is a need for such services in agriculture, it is less acute than in manufacturing, where management and technical problems abound. Consulting firms have been less successful in acting as catalysts for increasing efficiency in manufacturing, partly because of the cottage industry nature of firms. Since consulting is limited to advisory services, efficacy is limited in the face of the massive challenges facing the firms' clients and the painful restructuring required in most branches.

4. Quality control, standards, and research and development facilities

The Palestinian economy suffers additionally from not having local testing facilities for industrial inputs to check for quality, and most individual firms do not have even the most elementary equipment to conduct routine tests. Some of the universities, Bir Zeit in particular, provide such services, but given the isolation of the West Bank from the Gaza Strip, and West Bank cities from one another, their role has been minimal. Some officials have stated that the PA does not intend to establish industrial laboratories, leaving the task to the private sector. 100/ Thus, in all likelihood, such laboratories will not emerge until investors are again confident of the potential for local development.

Furthermore, the absence of both a national standards institute and a regulatory environment enforcing standards has delayed the creation of quality control and research and development facilities. The net effect is not merely the lack of competitive development and product improvement, but also a potential danger to the welfare of domestic consumers. In the whole of the West Bank and Gaza Strip, there is no library with comprehensive Arab, Israeli and international standards, and there is no accredited institution to certify product and process compliance with them in any of the merchandise production sectors. Laboratory equipment required to test for these standards is also largely unavailable.

Engineering firms capable of assisting in research, product design or machinery design do not exist. This is particularly unfortunate given the relatively large number of Palestinian engineers graduating every year. The number of engineers absorbed into the manufacturing sectors is extremely small, concentrated in very few branches such as pharmaceuticals and chemicals. Moreover, in most cases, engineers who are hired by such firms tend not to utilize their technical education, but rather simply comply with the limited requirements of the employer. There is no sustained attempt to connect the formal education sector and local industry, and there is a very wide gap in knowledge, disposition and experience between these two segments of Palestinian society. In agriculture, there is the problem of the absence of institutions to serve as bridges between the two communities, although there has been some measure of technology transfer from Israel over the years. 101/ Slightly better support services exist for agriculture than for industry, although they are still inadequate to respond to the wide and complex needs of that sector. Nevertheless, most of the points pertaining to manufacturing are also reflected in agriculture.

5. Financial and investment services

A crucial need exists for financial services and investment, or merchant banking, to play a more vigorous role in consolidating existing production capacity, investing in upstream or downstream activities, and optimizing resource allocation. Whereas some major investment companies have studied such possibilities with the more successful existing firms, the present investment climate and the extremely uncertain future militates against change for the moment. These investment companies would be able to act upon findings, unlike consulting and other advisory services, as they would have equity positions in target firms. Existing investment corporations, some of which are well capitalized, have been investing very cautiously, but not enough to offset capital depreciation in the territories, whose rate has been growing for almost a decade as new investments have slowed. Investment has concentrated on services and real estate, and not on manufacturing or production.

Despite the proliferation of commercial banking institutions since 1994 and the marked improvement in depository services, credit facilities have not kept up with deposits received, as the loans-to-deposit ratio remains at 30 per cent, and a significant portion of loans are going to non-productive uses, such as government bureaucracies and housing. 102/ Thus, the crucial role of banks as financial intermediaries is constricted, effectively reducing the circulation of money in the economy. 103/ These issues were recently addressed in a study by the UNCTAD secretariat on private investment trends in the Palestinian territory since 1993. 104/

For the overwhelming majority of firms, the only sources of credit are informal networks (relatives, money changers) or the Palestine Development Fund (previously three separate non-profit finance organizations funded by the European Commission). The latter’s credit portfolio is equivalent in magnitude to those of local banks, and thus has a minor influence over the economy. Many firms experience major liquidity crises during a production run (even in the best of times) and frequently raise working capital to buy raw materials and pay for labour by selling land to financiers with an option to buy back or other unorthodox methods. As creditworthiness with Israeli contractors erodes and cash-on-delivery practices predominate, manufacturers are forced to raise more and more cash, and are thus forced to finance a larger portion of production on their own. Risk capital for new ventures or for capital expansion is always more difficult to raise than working capital, and local manufacturers/cultivators or entrepreneurs rarely obtain institutional funds for these activities. Thus, in this context, export financing for existing producers is not available on any regular, programmatic basis.

6. Trading companies

The initial and recurrent costs of developing and maintaining new markets are very high and, for most Palestinian firms, prohibitively so at the individual firm level. Most successful firm managers/owners do not have the money, time, skills and experience to engage profitably in international marketing. To engage in export trade, these firms have to work through subcontracting or with sophisticated, well-financed trading companies.

The World Bank has stated that it sees a number of roles that general or specialized trading companies can play:

1. Bearing the costs of maintaining reliable information about the international market that most individual firms would tend to find prohibitively expensive;

2. Buying raw materials and other imported industrial inputs in bulk, thus commanding better prices from international (including Israeli) vendors;

3. Achieving economies in marketing costs, developing wider market contacts and commanding better shipment terms than individual firms;

4. Introducing new designs, fostering improved management, technology and skills, and preparing producers for direct exporting. 105/

In the West Bank/Gaza Strip, there are no prominent trading companies engaged in exporting, except in fresh agricultural exports, especially citrus. Most trading companies are engaged in importing, and only a few of those are involved in importing industrial inputs and raw materials. The largest importers deal in consumer goods, foodstuffs and construction material. Furthermore, specialized trading companies with strong expertise in a branch of manufacturing (e.g. metal works, plastics, garment and textiles) and with expert knowledge of international suppliers and export markets do not exist. None of these firms have sufficient access to strong working capital or finance which would allow them to invest in entry into export markets. More crucially, very few firms seem to have the skills required for international marketing, such as international market research, benchmarking, product development and modification, packaging, promotion design and brand development.

Some new firms are being established, and one general trading company has been recruiting mid-level managers. Two specialized export marketing and trading companies are being set up in Ramallah, in the areas of garments and traditional products. A catalyst for a vigorous external trade sector would be to have several strong, general trading companies or specialized trading companies (without monopolies in any specialization) competing strongly with one another. This remains a possibility in the event of an improvement and prolonged stability in the general environment affecting investment in such crucial, though high-risk, commercial ventures.

Chapter IV

CONCLUSIONS AND RECOMMENDATIONS

This study has provided a comprehensive account of recent developments in the Palestinian external trade sector, covering performance, the policy and regulatory environment, procedures and related issues of supply (merchandise production). Given the deterioration of the situation over the past two years, it is not known whether the Protocol on Economic Relations can be exploited to the full in the coming period for the benefit of both parties. This is an especially crucial question for the PA, which has a special interest in seeing concrete changes in the Palestinian economy as a key achievement of the peace process. Notwithstanding the ongoing debate about short-term policy options and final status economic arrangements, no clear consensus has yet emerged on an overall strategy for the coming years. Nor should it be expected, with preoccupations focused on restarting the stalled peace process, that any strategic vision of Palestinian economic development will be elaborated in such fluid and uncertain circumstances.

Much has been written and stated over the past year on this issue: 106/ should efforts focus on working to better implement the Protocol, perhaps building on it as a basis for future economic relations, discarding it as a long-term framework and instead conceiving a different set of relations, or extending it, with some enhancements, as a final economic arrangement between Israel and Palestine? While these are questions that this study cannot address and remain principally in the domain of Palestinian policy-making and negotiations with Israel, the preceding examination has revealed a number of considerations that can be identified as “signposts” on the path to an improved policy framework for future Palestinian external trade development. These are discussed in the following section, and are followed by a presentation of the main areas for reform of the regulatory and procedural framework affecting external trade, as well as of the range of marketing, production, investment and related services associated with this vital sector.

A. Policy considerations in the interim period and beyond

A number of issues may be considered in discussing optional future trade regimes.

First, it should be stressed that the scope for developing the external trade regime will be subject to compatibility with the security concerns and interests of both sides, and especially Israel, which remains in control of borders during the interim period at least. Furthermore, for the short term, Palestinians do not have jurisdiction over a port or any other type of trade facility with direct access to countries other than Israel. Although there are plans for an international airport and a sea port in Gaza, negotiations on the operation of these projects have been prolonged, work on the port has yet to begin (though the airport has been built) and disagreements over security arrangements have delayed resolution of these sensitive issues, in addition to that of “safe passage” between the West Bank and Gaza Strip.

Furthermore, the time factor is a vital element in any discussion of optimal trade regimes. 107/ In order to successfully correct inherited trade distortions, there will have to be fundamental corrections in the production sector and advances will be needed in the development of institutions to support trade initiatives and more advanced production patterns.

On another level, policy formation must consider the actual situation on the ground and the manner in which agreements are or are not being implemented. In many cases the dynamics of the Palestinian-Israeli relationship requires that the Palestinians be flexible and able to react to Israeli policies regarding trade. For this reason, it is useful to consider relevant trade experiences and agreements, as well as the changing political situation. Developments so far indicate that economic cooperation and coordination cannot precede settlement of the political issues, on the Israeli-Palestinian track as well as at the regional and subregional levels. 108/

An important element of redressing imbalances in trade relations with Israel through ensuring equitable access to each other's markets requires that the PA attempt to address the impact of Israeli subsidies on competitiveness of Palestinian exports. The PA also needs to develop more systematic and transparent ways to facilitate trade so that trade barriers can be more easily identified and their costs be quantified. Such knowledge will greatly increase the PA's ability to address these issues with Israel in the context of negotiation mechanisms established by the Protocol. 109/

With regard to trade with other countries, especially in the region, the Palestinian ability to negotiate down import barriers is limited by the tariff band and related trade measures preserved under the customs union. This limits the concessions the Palestinians are able to offer in attempts to gain concessions from other markets. For example, for products such as electronics, which are marginally produced in the West Bank and Gaza Strip, Palestinians pay the costs of Israel's protection of its own electronics industry with higher prices and with the inability to import products from other producers. Trade policy can be designed and conducted effectively only with regional partners, such as Egypt and Jordan, with which Israel also has political and economic relations treaties. It is likely that the ability of the PA to trade with Lebanon, the Syrian Arab Republic and other Arab countries will be contingent on substantial progress in the peace process, thus placing further constraints on the scope and patterns of Palestinian external trade. 110/

Trade policy, of course, interacts with and informs production and overall development policy, in the Palestinian case no less than in others. The challenges ahead for the Palestinians to develop a productive economy are enormous. With limited natural resources, restrictions on production, and the small size of the Palestinian economy, an export-oriented economy is optimal in the long term. However, given the historical distortions and continuing problems of market access, a largely open economy could result in an unrewarding trade-off. For example, to adopt a free trade policy without removal of existing barriers to production or trade could put the Palestinian economy at a greater disadvantage, since the size of the local market makes it difficult for manufacturers in many branches to achieve economies of scale without free and dynamic access to other markets. 111/ Trade policy, therefore, needs to carefully balance the amount and type of access which the Palestinian economy allows other partners with the level and access it has with other economies.

Most importantly, this needs to be measured on the basis of a careful monitoring of developments on the ground, rather than solely by agreements. For example, after the signing of the Protocol, which stipulates that Palestinians could begin exporting to Israel yearly quantities of six competitive products (eggs, poultry, cucumbers, tomatoes, potatoes and melons), many farmers in the Gaza Strip and the West Bank were optimistic about being able to finally compete in the Israeli market. Palestinians enjoy a price advantage in these products; however, they have so far not approached the allowed quantities each year since the agreement. This is largely due to closures, delays at checkpoints and other non-tariff barriers, although quality and health standards have also been cited. 112/

Most Palestinian industries continue to face structural bias which effectively disqualifies them from competing on “fair terms” against more advanced Israeli, Jordanian or Egyptian products. It is, therefore, important to consider what level of protection of Palestinian industries would be appropriate in order to allow some time for restructuring and “re-tooling”. Failure to do so could undermine industrial development to the point that the benefits of a free trade regime are unattainable, and this could further weaken the economy. Also, policies which support the agriculture sector should be encouraged. This sector is vital in addressing the short- to medium-term trade imbalance. Furthermore, it is a sector in which Palestinian exports have a historical advantage and have been successful in the past. This is, however, not to ignore the fact that the market has changed since then. Improved credit facilities and the institutional facilities needed to export agricultural goods are areas whose development could promote trade in this sector.

Until more progress can be made in removing the barriers to production and markets, more import-substitution initiatives may be attractive to investors, particularly in the short run. These could be formulated in a way that supports improvement in the competitiveness of industrial activities in which Palestinians have a comparative advantage, rather than as supply protection for inefficient industries. There is much potential in food processing and agro-industrial branches, for example. Furthermore, a significant option would also be to encourage the development of cooperative wholesale distribution networks, where scale could provide incentives for surmounting the difficulties of transporting goods and people over the borders.

B. Barriers to export

1. Border-crossing issues

Most projects being prepared or implemented by international donors and agencies assume that the political situation and the related border-crossing issues will, at some point, be corrected or improved. When this is achieved, there will need to be provision for recourse to methods to prevent the reintroduction of such barriers. Since no planning processes can effectively provide for such contingencies, the costs and risks of doing business increase beyond capacity. Border delays and restrictions are particularly damaging to agricultural exports. Accordingly, a priority area for action is reaching arrangements to ensure that goods pass through borders unhindered. Efforts to increase exports or improve production in the Gaza Strip and the West Bank are clearly defined by the range of barriers to trade, particularly those affecting the free movement of goods.

For this reason, strategies and projects to develop trade need to be finely tuned to the impact of closures and the turbulent political climate. In addition to addressing the general issue of border closures and restrictions in designing and implementing related programmes and projects, the donor community could promote arrangements to ensure free access for trade and related flows between the Gaza Strip and the West Bank, in the context of expected Israeli-Palestinian agreements on the issue. Steps could include funding feasibility and design studies in order to develop possible solutions which would be acceptable to the Palestinians and the Israelis.

In the remaining interim period, attention can be given to the mechanics of the border situation. Palestinian veterinarians and agricultural engineers should be allowed access to border areas, Palestinian officials should be involved more directly in the inspection of goods, and Palestinian merchants and officials should have more freedom of movement in the border areas. An increase in the number of Israeli employees would allow more vigorous processing. Opening the market for shipping agents would diminish the chances of monopolies developing and weakening the hold that back-to-back shipping has in the area.

Notwithstanding the limitations on its powers, there are also steps the PA can take to improve the flow of goods. First, it needs to streamline and rationalize its procedures for facilitating trade. The lack of transparent procedures and regulations invites poor management at all levels and renders the PA ineffective in actively addressing barriers to trade. Training and professional assistance to Palestinian officials involved in trade, as well as to Palestinian firms which engage in trade, should be provided as a high priority.

Furthermore, the PA may wish to consider the creation of support programmes to provide either direct or indirect compensation to firms which rely on the import and export of goods, in order to partially reduce the added costs generated by the closures. While it is impossible to compensate for the costs of a sustained failure to deliver to a market or a contractor, programmes could focus on transportation and transaction costs as well as drawbacks on tariffs. Support should be designed to alleviate very specific costs, and be administered at the firm level, while also minimizing the institutionalization of the closures. More areas for developing the PA's role are presented separately below.

2. <u>Joint ventures and subcontracting with international companies</u>

One of the potential benefits of relationships with international firms is that it provides Palestinian firms with extra support in overcoming arbitrary restrictions. Palestinian firms are often unaware of exactly what may be slowing down their exports and in most cases they cannot have direct contact with Israeli customs officials because of the restrictions on travel. If a firm has an international partner or is doing business with an international firm, it may be able to understand more easily the procedures and identify the bottlenecks. Also, international firms may enlist the support and assistance of national consulates and trade offices in Israel.

In order to attract international partners or subcontracting agreements, incentives for international firms (such as tax incentives and risk insurance subsidized by the international community) and mechanisms by which Palestinian firms can access these firms should be encouraged. Special attention needs to be paid to export potential in order to prevent such business partners from becoming simply import facilitators.

Furthermore, Palestinian firms should be encouraged to seek licensing options from international manufacturers. Licensing would provide many of the same benefits of joint ventures with less risk involved for the international investor. It thus offers the potential for bringing much-needed capital investment into the economy, and directly into production for the industrial sector. In addition, the links with international capital could provide more incentive for the Israeli authorities to facilitate and rationalize border-crossing policies.

C. Improving public sector performance

In the post-1993 environment, the PA has had an opportunity to create both public and private sectors and institutions capable of mobilizing the talents and resources of a people who learned a great deal about self-sufficiency in the past decades. However, developments since 1996 have not been conducive to this spirit of growth; instead, limited achievements may be cited in both public and private sector development, while an expanding share of GDP has been devoted to public sector expenditures and an overburdened government budget. 113/ Understandably, issues of implementation of many important political clauses of the Israel-Palestine agreements, and the need to provide services and security for some 2.5 million Palestinians under PA jurisdiction, have taken policy and operational precedence over developing the external trade sector. Furthermore, the overall security/political climate has provided little incentive for introducing innovative methods of governance and policy formulation or advanced managerial and technical skills into an already uncertain situation. Thus, many of the hopes and expectations for the interim period, especially with regard to governance, have yet to materialize in concrete, lasting achievements.

The interim period remains extremely important in terms of providing a framework for the general principles and ground rules for governance that will prevail in the future. Linked to this is the manner in which the PA will be able to encourage economic development and shared growth across public and private sectors. Admittedly, the PA has not been empowered in all areas and its priorities have remained focused on resolving the pending interim and final status issues with Israel, within the context of its declared national, state-building aspirations. However, the PA has been able to institute some initial measures of economic policy and regulation (especially in trade and finance), while success in elaborating global and intersectoral economic policy has been more limited. It is expected, however, that with the launching in December 1997 of the Palestinian Development Plan, 1998-2000 (PDP), the PA has now set a clear course for its own development efforts and the associated assistance of the international community. Though essentially an aid-programming document, the PDP should reflect the immediate vision of the PA with regard to medium-term policy goals for economic, social and human development, the elaboration of which is long overdue.

The important issues of good governance and financial accountability received growing attention in 1997, at the levels of Palestinian public opinion, and legislative and executive branches of the PA, as well as in donor and international forums. These and related issues were addressed openly for the first time at the December 1997 meeting of the World Bank Consultative Group for the West Bank and Gaza Strip. In particular, donors "indicated that they expected the Palestinian Authority to redouble their efforts to improve the regulatory framework and to ensure a transparent and efficient fiscal process, including the consolidation of all fiscal accounts under the control of the Ministry of Finance". 114/ Of equal interest to donors have been the steps taken since the submission of PA internal reports in 1997 on financial management and public sector performance. Also, the phasing out of commercial monopolies linked to or facilitated by the PA is considered essential to maintaining donor and private sector confidence in the development process.

Another issue of growing concern has been the need to address the procedures for recruiting civil servants, which have been subject to a range of political, factional, personal and other non-technical criteria. A stable and efficient governing structure demands that this element of the system be developed and promoted on the basis of merit. While the PA appears aware of the pitfalls of continued unrestrained growth and inadequate qualifications of the government bureaucracy, concrete steps to address these problems have yet to be taken. Programmes need to be established, linked to training institutions, in-house training and special funding to attract expatriate and other expertise, so as to assist the PA in developing the specific skills needed for management and governance. Programmes could include the establishment of institutes of management and public administration, and development of a national civil service examination. Adequate pay scales are needed for civil servants, and an independent judicial process is one of the keys to rationalizing the behaviour of the Government.

Taxation policy needs to be further developed in a manner that promotes investment and shared growth; similarly, there is a need for improved financial management, transparency and accountability. The PA has reportedly been considering reductions in direct taxation rates combined with improved and wider indirect taxation collection. Clearly, the problems with collecting indirect tax revenue, particularly in border areas, persist. In addition to improving customs revenue collection, the PA needs to develop a taxation policy that can offer credits for export, that promotes growth, and that is viewed as clear, fair and accessible.

A related issue is the development of the constitutional framework and legal environment of Palestinian governance, especially in the long run. This has been the subject of intensive consultation between the legislative and executive branches of the PA and a rich public debate over the past two years.

Whatever final shape this issue is accorded, there is wide agreement that the Palestinian system of governance should be capable of self-regulation, be (and be perceived as) fair, and be designed and applied in a comprehensive, rather than a piecemeal or selective, manner. International legal development associations can be further consulted in this important area.

Job creation, investment promotion and technology transfer must be short-, medium, and long-term goals of the PA. The most effective means for producing results in these fields would be to support training and education institutions (described below) and work closely with non-governmental organizations dedicated to such objectives. Priority must be given to small and medium-sized enterprises, as they constitute the overwhelming majority of firms and thus provide a large base of employment. Linkages must be promoted between smaller firms and existing or future larger enterprises, since the smaller firms spread the distribution of growth and add stability. The PA can play a crucial role in helping foster links between manufacturing and agriculture, and aid other sectors of society that need to be mobilized in an effort to transform the economy into one that is knowledge- and skills-based. The Palestinian economy shows great potential in this area.

D. Improving production for external trade

As was noted earlier, the Palestinian industrial sector and related services are primarily oriented towards subcontracting arrangements with Israeli producers. In order to improve the potential for exporting to Israel and other markets, there must be some restructuring. The mechanisms for doing this vary from branch to branch; however, this study has identified major branches which seem to offer the brightest prospects for trade, provided that the necessary structural adjustments can be made, in agriculture, food processing, garments, and related semi-finished products and plastics.

1. Promoting investment and consolidating production

In virtually every sector, there are two sets of related investment and organizational needs: to expand existing firms through growth and consolidation; and to initiate new ventures characterized by modern production and management. In the final analysis, it is necessary to increase the average capital invested in firms across the board in order to increase the value added. If the industrial sector is to grow to contribute a share of GDP that is more appropriate for the territory's income levels, a large increase in the rate of capital investment is required, and industry must grow at a substantially faster rate than the rest of the economy. UNCTAD's estimates puts this rate at 12 per cent per year, from 2000-2010, or an average of $190 million per year. 115/ Today, there are indications of a net depreciation in capital formation in Palestinian manufacturing.

Under current circumstances, such ambitious rates of investment are not feasible, and the focus would have to remain on strengthening existing firms, except in a few sectors where slightly more investment and capital-good maintenance might be expected (construction, food processing, and perhaps garments). With existing firms, at least net depreciation must be reversed where firms are viable and rational capital goods must be modernized.

Furthermore, much needs to be done to concretely prepare firms for future investment by increasing performance, human resource capacities and product quality.

A widespread reorganization of existing firms is unlikely since consolidation will occur only if market circumstances require and warrant it. However, one possibility is to try to develop mechanisms that would emulate the benefits of consolidation in terms of scale, integration and market power. Possible programmes include capital leasing; cooperative procurement, marketing and exporting; establishment of engineering and design centres; financing of working capital; and factoring (especially in the garments). Furthermore, assistance is needed for promising firms involved in subcontracting to strategically expand (vertically) their scope of production activities, either downstream or upstream.

2. Education and technology transfer

Labour costs in the West Bank and Gaza Strip are too high to make labour cost the competitive edge that Palestinians could have in the world economy. Instead, the competitive advantages must eventually become investment-based and innovation-based so as to lead to wider economic empowerment. Thus a premium needs to be placed on technology acquisition and development. To these ends, the education and research and development sectors should be reconceptualized and integrated into the productive sectors of the economy. Technology transfer therefore needs to be a priority for the future of a growth economy, but one that aims to foster domestic technology capabilities rather than the mere acquisition of capital goods.

Two modes of action can be pursued. First, institutions of learning need to be fostered and linked to the needs of industry. These institutions could include an advanced school of management, schools for the gifted, science and technology institutes, and a centre for basic research in the sciences. Such efforts need to be coordinated with the PA Ministry of Higher Education. Progress can also be made without substantial expenditures and without delay by allowing senior students in the engineering and management sciences to work with local industries, thus better orienting them for subsequent employment while also introducing some of the benefits of formal training to management, shop floor and design activities of Palestinian industry and agriculture.

A second avenue to pursue relates to supporting private institutions devoted to technology transfer and technical training. Such institutions, particularly in this phase when the government apparatus is not fully operative, fulfil the very important function of responding quickly and accurately to the technology needs of business. International donor organizations need to continue their support to such bodies, particularly in the interim phase.

3. Agriculture

Programmes to promote the targeted export of agricultural products within and beyond the region should be developed. Such a move is, however, dependent to a large degree on the successful resolution of the issues of natural resources, especially land and common water resources, with Israel and regionally. Many Palestinian agricultural products are available at below Israeli costs, and could prove attractive in international markets if access is possible in competitive conditions. Israeli firms, for example, have been very successful in providing off-season produce to Europe. Efforts should concentrate on identifying and gaining access to markets, as well as on assistance in meeting export and packing requirements. Promoting agricultural products will also involve adjustments in production patterns. Rather than simply relying on exporting surpluses, production decisions should be based on systematic assessment of market demand, both locally and internationally.

4. Agro-industries

There is also long-term potential for export development in the agro-industrial sector, as well as short-term viability. The availability of certain base materials provides an obvious competitive edge. The primary barriers to exporting in this industry are related to quality and technology and standards and regulations. Efforts to develop quality and testing standards and procedures for areas under PA control are under way; however, this will take time. In the meantime, Palestinians who want to export food products to Israel continue to have their products tested in Israeli facilities and to Israeli specifications.

In addition, laboratory facilities for testing and implementation of quality control standards are needed. In many countries these services are performed by a combination of public and private entities and through manufacturing associations. There is also a need for training in order to promote minimal quality control and facilitate technology transfer. To facilitate exports, it is also necessary to provide producers with information on international regulations, standards and guidelines. Support for the agro-industry should be coordinated with the PA Ministry of Agriculture and Ministry of Industry as well as with product development and technology specialists.

The agricultural sector needs to be much more closely integrated with the agro-industrial production patterns of the Palestinian economy. This can be accomplished by greater information sharing between the two sectors, which in turn depends on the generation of reliable statistical data by the PA, and the PCBS in particular. The results of the first industrial census and preliminary agricultural accounts have recently been published by the PCBS, and they constitute a sound basis for accurate sectoral planning. Furthermore, developing manufacturing and trade organizations (see below) would also aid in the same direction of greater sharing of information and thereby creating networks of coordinated production and trade.

Agro-industry also needs to develop and implement a reliable and efficient grading scheme for foodstuffs. Such a programme can be undertaken by or with the cooperation of the PA, and individual laboratories and facilities in the private sector could be licensed to perform these functions. In addition, quarantine centres are needed in order to prevent the spread of dangerous bacteria and toxins to foodstuffs. Such measures would not only increase the quality of the goods produced by Palestinian farmers, but also increase the confidence of international importers that Palestinian goods can be measured to an international standard. The development of such facilities could be accomplished within the context of a programme to develop a Palestinian Standards Institute, in the light of the related goals and objectives.

Many of the requirements for developing an agro-industrial sector, such as familiarity with regulations and testing facilities, can also benefit the general food processing industry (i.e. including industries not mainly dependent on local inputs). Currently, the majority of locally produced goods are not of export quality; however, improvements in technology and attention to quality control could increase export viability, at least as regards exports to neighbouring markets. Most firms in this sector are in need of technical assistance, particularly in the area of product development and improvement. Regulatory and standard capacities are similar to those used in agro-industries and could be developed so as to promote both types of food industries.

5. Garments

The issue of drawbacks is particularly relevant to the garment industry since textile prices are significantly inflated by tariffs on fabric. The long-term potential for garment exports is specific to upscale garments, rather than mass-produced items. A primary problem facing the garment industry is the gaps in production, for which manufacturers must rely on Israeli firms. Incentives for investment are needed in these specific areas of production in order to limit the entry costs and reduce some of the risks and costs to a range of garment manufacturers who rely on Israeli firms at these stages of the production process, such as finishing.

In particular, firms lack design capabilities and pattern-making skills along with other important steps in production. Programmes in the garments sector should focus on training Palestinians in these skills as well. In addition to developing the necessary skills, trade associations and other public programmes can provide vital support services to enable producers to develop direct relationships with buyers.

6. Semi-finished products

The production of semi-finished products and parts is also an area in which Palestinian manufacturers can specialize and compete without having to develop extensive product lines just in order to interest buyers. While there is a potential for this type of activity, most firms lack the ability to meet strict specifications and delivery and costing schedules. These factors are essential in order to compete in this market. Training and assistance to do this are necessary in order to bring Gaza Strip firms up to a level at which they can compete. Here again, the issue of smooth delivery of goods depends on reducing existing barriers to trade.

7. Plastics

Palestinian plastics manufacturers produce a range of household goods and construction materials using a number of different processes and materials. The range of processes provide a strong basis for expansion and could support a number of industries which require plastic parts and products. The primary problem which this industry faces is the lack of facilities for conducting tests on raw materials and finished products, together with a lack of access to a consistent supply of raw materials, primarily plastic pellets. The creation of a testing centre which could test to international specifications for finished products is essential if this industry is to begin exporting. A consistent supply of raw materials is also required in order to maintain standards and comply with international certification requirements. Border-crossing issues and access to international suppliers are relevant here as well.

8. Manufacturing associations

Every major sector of Palestinian industry should have a manufacturing association attached to it. Such associations can provide local support and information sharing services. Beyond this service, however, manufacturing associations can produce two very important effects. First, some experience has shown that such associations are better able to procure the necessary documents and permits from the Israeli authorities. Secondly, they can also be linked to international counterparts, thus increasing contacts and links with the outside world. These will prove useful for facilitating the movement of goods and people across borders as well as for developing needed business ties to the world market.

9. Import substitution efforts

Recent years have shown the feasibility of domestic production of many of the goods currently imported from Israel without the aid of protectionist measures, which are in any case virtually non-existent on the Palestinian side. Given the short- and medium-term limits to exports (to Israel and overseas), one option to help address the immense trade deficit is to engage in selective and competitive import substitution efforts. Little attention has been paid to this area of growth by development organizations, although entrepreneurs have been more sensitive to the possibilities. However, most entrepreneurs need much technical and business assistance in order to study these possibilities thoroughly.

E. Export facilitation

1. Import/export processing centres (trade points)

An effective and relevant component of efforts to facilitate and expedite trade procedures and operations is the establishment of import/export processing centres to create a one-stop-shop system for all import, export, customs, licensing, testing, certification, drawback financing, and other activities. This concept, already embodied in the World Trade Centres Association, has been further developed by UNCTAD in the context of the Global Trade Point Network, linking hundreds of Trade Points around the world which provide such services under a physical or virtual roof. Centralized management of these functions and pooling of information and resources allow for the development of expertise and specialization, and facilitate trade procedures and flows. While the establishment of Palestinian Trade Points is envisaged for Ramallah and Gaza, they have yet to develop into full-fledged service providers pending the securing of necessary project resources.

2. <u>Industrial estates</u>

While industrial estates, such as the one to open soon at Carni and others planned for the West Bank and Gaza Strip, may be a means of reducing some barriers to trade, they need to be integrated with the Palestinian economy. Furthermore, they should be viewed not only in terms of their potential for generating (relatively stable) employment and trade flows with Israel, but also as export platforms to reach markets otherwise unattainable for most Palestinian manufacturers. Given the advantage which Israeli firms have in terms of capacity as well as the advantage of protection and the preferential treatment received by Israeli firms due to the border restrictions, integration of the industrial estates into the Palestinian economy will not necessarily occur through market mechanisms. If Palestinian firms outside industrial estates are going to provide services and semi-finished parts to manufacturers located in the estates, support and incentives will need to be developed. Such support should not stifle competition or create inefficiencies, but should be designed to create a more even plateau from which to compete with Israeli firms expected to invest in some of the planned estates.

3. <u>Export credit</u>

Palestinian exporters currently suffer from a gross lack of capital upon which they can draw in order to export their goods and products. A system of providing export credit, particularly for the agricultural sector, needs to be developed, probably within the PA as part of its taxation scheme. International agencies can assist by providing export credit start-up programmes that function along lines similar to those of successful micro-credit programmes around the developing world. Such programmes should be related to developing an efficient and fair banking sector, at both the central and private levels.

4. <u>General trading companies</u>

As indicated earlier, the ability of Palestinian producers to export regularly will probably depend on the existence of private export marketing and trading firms, capable of providing information, finance, contacts and know-how to producers, thus allowing the latter to concentrate on production issues and domestic markets in the near future. What is vital, however, is to ensure that these firms do not obtain monopolistic positions in the economy, in imports or in exports. Crucial to the success of trading companies is that they be allowed to work in a highly competitive atmosphere without the intermediation of the PA. Also, they should be sufficiently consolidated to have the long-term financial commitment and contacts to be able to handle contracts, finance exports and arrange delivery in a high-risk environment.

Notes

1/ Unless stated otherwise, in accordance with the relevant United Nations resolutions the terms “Palestinian territory” and “territory” refer to the occupied Palestinian territory (the Gaza Strip and the West Bank, including east Jerusalem).

2/ See “Palestinian external trade under Israeli occupation” (UNCTAD/RDP/SEU/1), 1989.

3/ Ibid., p. 3.

4/ Ibid.

5/ See chapter II for further discussion of industrial trade and subcontracting with Israel.

6/ “The agricultural sector of the West Bank and the Gaza Strip” (UNCTAD/DSD/SEU/Misc.5), p. 16.

7/ Derived using data from “Main features of domestic and external merchandise trade of the West Bank and Gaza Strip” (UNCTAD/ECDC/SEU/5).

8/ Israel Central Bureau of Statistics, *Statistical Abstract of Israel 1994*, p. 795, table 27.11.

9/ Economist Intelligence Unit, “Country Report: Israel and the occupied territories”, 1995-1996, p. 80.

10/ “Prospects for sustained development of the Palestinian economy: Strategies and policies for reconstruction and development”, (UNCTAD/ECDC/SEU/12), p. 45.

11/ Ibid., p. 46.

12/ Ibid., p. 71.

13/ “Main features of ...” (UNCTAD/ECDC/SEU/5), p. 70, table 2-5.

14/ This point is strongly contested by some analysts, who find a greater potential through economic relations (albeit of a very different form than existing ones) with a more advanced economy, i.e. Israel's. See, for example, George Abed, “The Palestinian economy: The prospects for long-run sustainable growth”, paper presented at a conference at Bir Zeit University, West Bank, 12 June 1996.

15/ “The Palestinian economy in the context of regional economic cooperation” (UNCTAD/GDS/SEU/2), 1998.

16/ See, for example, “Sources of economic and social statistics on the West Bank and Gaza Strip” (UNCTAD/ECDC/SEU/10) for a comprehensive treatment of statistical sources until 1994.

17/ Some estimates of economic performance for the period 1993-1996 draw on official Palestinian, Israeli and other primary sources using various methodologies. Such estimates, based on data provided by different PA sources, have been published or otherwise compiled since 1995 by four sources, namely the International Monetary Fund, the World Bank, the Office of the United Nations Special Coordinator in the Occupied Territories (UNSCO) and the United Nations Economic and Social Commission for West Asia. Recently, the Palestinian Central Bureau of Statistics (PCBS) published the first Palestinian national accounts series, for 1994, based on field surveys and in accordance with the standard System of National Accounts (SNA 1993), in *National Accounts - 1994: Preliminary estimates* (Ramallah, PCBS, 1997).

PCBS data provide estimates for economic aggregates which diverge from other available estimates for the same year. While the latter estimates differ as to the levels, rates of change and interrelation between major economic aggregates, they provide generally higher, and structurally different, indicators than implied by the PCBS data. Projections for 1991-1996, prepared by the UNCTAD secretariat on the basis of historical trends and underlying structural features of the economy, provide another set of estimates. For 1994, these are close in absolute terms to, and share some features with, PCBS data. As such they are equally indicative as available estimates and have been referred to in compiling the estimates quoted in this section.

18/ Figures quoted in subsequent paragraphs refer to the Palestinian economy in the Gaza Strip and West Bank, excluding east Jerusalem, for which data are not available.

19/ PCBS, *Labour Force Survey: Main Findings*, Nos. 1-3, Ramallah, 1996.

20/ The lower figure is based on extrapolation of data published in “Evaluation of the losses of the Palestinian economy as a result of the closure, 2/25 - 4/4/1996”, Ramallah, PCBS, 4 September 1996 (in Arabic). Higher figures, of over $1 billion, have been quoted by some Palestinian officials.

21/ UNSCO, “Economic and social conditions in the West Bank and Gaza Strip, Quarterly Report, Winter-Spring 1997”, Gaza, April 1997.

22/ Data for 1981 are from “Selected statistical series on the balance of payments, foreign trade, population, labour force and employment of the occupied Palestinian territory (West Bank and Gaza Strip), 1968-1987” (UNCTAD/DSD/SEU/1).

23/ For similar findings, see, for example, Sharif El-Musa and Mahmud El-Jaafari, “Power and trade: The Israeli-Palestinian Economic Protocol”, *Journal of Palestine Studies*, vol. XXIV, No. 2, Winter 1995, p. 18, and United States Embassy, Tel Aviv, “The Gaza economy: How bad is it?”, September 1996, p. 10.

24/ Although the Protocol lists are given in terms of volumes (usually in tons), the Ministry of Economy and Trade cites these figures in dollar values, which makes it difficult to examine the degree to which quotas have been used up.

25/ The PA has minimal leeway on some items imported from Israel - petrol - automobiles, for instance. The tariff and VAT rates, however, must remain within a very narrow bandwidth set by Israel. These items constitute only a small portion of imports.

26/ Israel Central Bureau of Statistics, *Statistical Abstract of Israel 1995*, Jerusalem.

27/ PA Ministry of Planning and International Cooperation, Central Statistics Department, “Statistical Abstract of 1995”, March 1996, p. 94. The figures cited above are based on Gaza Strip statistics, which are virtually impossible to corroborate from the perspective of the West Bank, where areas are divided into A, B and C.

28/ These include the Declaration of Principles on Interim Self-Government Arrangements (of 13 September 1993), the Agreement on the Gaza Strip and the Jericho Area (of 4 May 1994) and the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip (of 28 September 1995), including the Protocol on Economic Relations annexed to the latter two accords.

29/ See UNCTAD, “Developments in the economy of the occupied Palestinian territory” (TD/B/42(1)/8) and “Private investment in the Palestinian territory: Recent trends and immediate prospects” (UNCTAD/ECDC/SEU/13).

30/ See statement by Mr. Yasir Arafat, Chairman of the Executive Committee of the PLO, President of the Palestinian National Authority, to the meeting of the Consultative Group of Donors, November 1996, and Economist Intelligence Unit, “The occupied territories”, Country Report, 4th Quarter 1996.

31/ The report by the Palestinian National Authority, Ministry of Economy and Trade, on the UNCTAD/UNDP workshop on “The emerging international trading system and its implications for the Palestinian economy” (2-6 March 1997) states that “a differentiation should be made between the short-term conditions imposed by the Paris Protocol and the long-term need to formulate strategies and policies in the context of final status negotiations”.

32/ This refers to Lists “A” and “B” of imports from Jordan, Egypt and other countries for which the PA can pursue a tariff regime independent of that agreed in the Protocol with Israel, which stipulates that Israeli customs policy and tariffs apply to the bulk of Palestinian imports.

33/ Muna Jawhary, “*The Palestinian-Israeli trade agreements: searching for fair revenue sharing*” Jerusalem, Palestine Economic Policy Research Institute, (MAS), December 1995, p. ii.

34/ Ibid.

35/ The implementation plan for this initiative was adopted by the League's Economic and Social Council meeting in Cairo in February 1997.

36/ As part of preparations for the Interim Agreement, the PA Ministry of Economy and Trade, with support from the EU Economic Policy Programme, convened a workshop to examine the Agreement from various angles, including the important issue of cumulation, a key mechanism to allow the PA to benefit from the full potential of the new arrangements through subregional cooperation (with other EU partners such as Jordan, Egypt and Israel).

37/ Correspondence with the PA Ministry of Economy and Trade, Ramallah, December 1996.

38/ The World Bank, *Developing the Occupied Territories: An Investment in Peace*, vol. 3, Private Sector Development, Washington D.C., 1993, p. 56.

39/ Correspondence with the PA Ministry of Economy and Trade, Ramallah, December 1996.

40/ Interview with the Director-General of Customs, Gaza, June 1996.

41/ Interview with the Director, Palestine Trade Promotion Organization, June 1996.

42/ Correspondence with the Ministry of Trade, Ramallah, December 1996.

43/ Palestine Economic Policy Research Institute (MAS), *MAS Economic Monitor*, No. 1, Ramallah, 1997.

44/ PA Ministry of Labour.

45/ UNSCO, “Costs of closure: Some preliminary indicators on costs of closure in the Gaza Strip”, Gaza, April 1996, p. 13.

46/ Cited in Sara Roy, “Economic deterioration in the Gaza Strip”, *Middle East Report*, July-September 1996, p. 36.

47/ Ibid., p. 36.

48/ United States Embassy, Tel Aviv, “The Gaza economy ...”, p. 14.

49/ Ibid., pp. 7-8.

50/ UNSCO, “Costs of closure ...”, p. 12.

51/ PA Ministry of Economy and Trade, “From back to back: The Palestinian trade situation on the borders”, February 1996, (in Arabic), especially section 6: “Problems facing Palestinian exports at Rafah and Allenby”. Means listed include encouraging delays at Rafah so that

Palestinian trade will go through Netsana (where there is no Palestinian presence), Palestinian officers being unable to monitor the flow of trucks and goods, and not allowing PA officers into inspection areas, thereby denying the Palestinian inspectors the opportunity to corroborate the customs statements filed by the importer without a costly delay in unloading once again. See also Massar Associates, “Procedures for exporting Palestinian goods through the Damia and Rafah crossing points” (prepared for USAID Small Business Support Project), May 1996.

52/ PA Ministry of Economy and Trade, op. cit., section 4.

53/ Ibid., p. 12. These were as follows:

- load area must be uncovered;
- no engine cap;
- no lock on fuel tank cap;
- no dashboard, except for speedometer and fuel gauge;
- driver's seat made of bare metal bars (no other seats allowed);
- tyres, tyre screws and all external screws to be sealed by security authorities with a lead seal.

54/ Ibid., p. 10.

55/ Interview with an official of the United Nations Relief and Works Agency (UNRWA), June 1996.

56/ PA Ministry of Economy and Trade, “From back to back ...”, section 6.2.

57/ MASSAR Associates, “Procedures for exporting ...”, p. 7.

58/ Roy, “Economic deterioration ...”, p. 38. See also United States Embassy, Tel Aviv, “The Gaza economy ...”, p. 11.

59/ Roy, “Economic deterioration ...”, p. 38.

60/ United States Embassy, Tel Aviv, “The Gaza economy ...”, p. 11.

61/ Roy, “Economic deterioration ...”, p. 38.

62/ Since the West Bank remains largely under Israeli security control, and since there are over 20 official points of entry into Israel and another 140 unofficial ones, these trade channels are beyond the control of the PA.

63/ See Aisling Byrne's article in *News from Within*, vol. XII, No. 6, June 1996, no. 6, published by the Alternative Information Centre, Jerusalem.

64/ United States Embassy, Tel Aviv, “The Gaza economy ...”, p. 7.

65/ Roy, “Economic deterioration ...”, p. 38.

66/ Cited in the report of a Gaza Chamber of Commerce meeting, June 1996.

67/ "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/12), pp. 46, 48.

68/ Nasrat Fadda, "Palestine agriculture institutional and policy study: An overview", in proceedings of the PA Ministry of Agriculture and Palestinian Economic Council for Development and Reconstruction (PECDAR) workshop, Bethlehem, July 1996, p. 10.

69/ Ibid., p. 15.

70/ Akef Zou'bi, Abdel-Rahman Abu Arafeh, Daoud Istanbuli and Omar Daoudi, "The structure and organization of agricultural marketing for fresh fruits and vegetables in Palestine", Jerusalem, Society for Austro-Arab Relations, 1995, p. 22.

71/ Ibid.

72/ "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/12), p. 65.

73/ Zou'bi et al., "The structure and organization ...", p. 20.

74/ Ibid., p. 23.

75/ El-Musa and El-Jaafari, "Power and trade ...", p. 24. These figures were derived from the World Bank, *Developing the Occupied Territories ...*, vol. 3, and Samir Hazboun et al., *Possibilities for Industrial and Entrepreneurial Development in the West Bank and Gaza Strip*, Jerusalem, Jerusalem Institute of Israel Studies, 1995.

76/ PCBS, "National Accounts 1994 ...". According to one source, Palestinian estimates of the manufacturing sector put the number of firms and persons engaged at almost three times the number in the Israeli estimates. See Richard S. Lissak, "Industrial strategy and policy issues for Palestine", UNIDO consultant's paper prepared for workshop in East Jerusalem, 9-12 October 1995, p. 23. See also Hazboun et al., *Possibilities for Industrial ...*, pp. 12-19. However, neither source suggests that the average labour productivity is any higher than generally estimated.

77/ El-Musa and El-Jaafari, "Power and trade ...", p. 26.

78/ Sara Roy, *The Gaza Strip: The Political Economy of De-development*, Washington D.C., Institute for Palestine Studies, 1995.

79/ Mahmoud Okasha and Sami Abu Tharifa, "Prospects and constraints of manufacturing in the Gaza Strip", Jerusalem, Arab Thought Forum, 1992, p. 52 (in Arabic).

80/ Ibid. Looked at slightly differently, the percentage of employees working in firms with more than 20 workers in 1989 was 11 to 15 per cent, and the percentage for firms with over 100 workers was 4 to 8 per cent. In contrast, almost 50 per cent of Jordanian employees were employed in firms with over 100 workers. See also Hazboun et al., *Possibilities for Industrial ...*, p. 18.

81/ Roy, "The Gaza Strip ...", p. 235.

82/ Ibid., p. 24.

83/ Ibid., p. 234.

84/ Ibid., p. 236.

85/ Defined as contribution to GDP divided by industrial employment.

86/ World Bank, *Developing the Occupied Territories ...*, vol. 3, p. 36. Moreover, experts agree that West Bank/Gaza Strip firms are usually over-equipped with obsolete machinery (which is often down) acquired from the Israeli second-hand equipment market. The reasons for this are complicated and merit a detailed study.

87/ No Palestinian study exists of the exact extent of subcontracting with Israel or with domestic partners.

88/ See Roy, *The Gaza Strip ...*, p. 244.

89/ PA Ministry of Planning and International Cooperation, Central Statistics Department, Annual Statistical Abstract (1995) for Gaza Strip, Gaza, March 1996. Other than to Israel, Palestinian industrial products constitute only a small fraction of merchandise exports, and have declined steadily since 1968. Furthermore, Arab markets were restricted from 1967 for various reasons, ranging from border problems to the Arab boycott.

90/ See "Palestinian external trade ..." (UNCTAD/RDP/SEU/1), p. 24.

91/ Historical estimates of the volume of subcontracting between the Palestinian territories differ widely. A 1989 UNCTAD study ("Palestinian external trade ...") offers two estimates for the period up to 1984. One estimate (taking the difference between total service exports and gross pre-tax factor income paid to Palestinian commuter labour) puts the figure at $18 to $27 million per year for the period from 1980 to 1984. Another estimate (based on different calculations of factor income) ranges between $150 and $225 million for the 1980-1984 period as a whole.

92/ World Bank, *Developing the Occupied Territories ...*, vol. 3, p. 34.

93/ Ibid., p. 33.

94/ Roy, *The Gaza Strip ...*, p. 14.

95/ Basem Makhoul, "The competitiveness of Palestinian manufacturing in comparison with Jordanian manufacturing", Jerusalem, Palestine Economic Policy Research Institute (MAS), January 1996, p. 5 (in Arabic).

96/ In manufacturing, the primary channel of distribution in the West Bank/Gaza Strip is direct sales to customers, practised by almost 80 per cent of industrial enterprises in 1989. Given the size of the average manufacturing operation and the underdeveloped state of merchandise distribution, this has resulted in the concentration of marketing channels in a highly localized geographical area. The underdevelopment of marketing systems and distributive channels has reduced competition and affected efficiency by limiting the capacity of manufacturers to expand markets.

97/ See appendix 3.

98/ The Development Resource Centre (DRC) in Gaza has attempted this at the level of information provision in the fields of raw materials and machinery, and discovered that without more business involvement (requiring a lower-risk environment), the potential for changing the situation is minimal.

99/ The DRC actively works on such programmes in virtually every industrial branch in the Gaza Strip.

100/ Interview with a Department Director at the PA Ministry of Economy and Trade, June 1996.

101/ "Private investment ..." (UNCTAD/ECDC/SEU/13), p. 29.

102/ Ibid., p. 31.

103/ "Banks frustrate West Bank Palestinians", *Wall Street Journal*, 18 July 1995, p. A11.

104/ "Private investment ..." (UNCTAD/ECDC/SEU/13).

105/ Cited in Lissak, "Industrial strategy ...", p. 29.

106/ Studies and workshops addressing these issues are cited in several of the notes to chapters I and II.

107/ "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/12), p. 46.

108/ Ibid., p. 48. The unfavourable political environment in much of the 1996-1997 period has taken its toll not only of the cooperative spirit of the post-1993 peace process, but also of the efforts to establish frameworks for regional cooperation, such as the 1997 annual Middle East and North Africa Economic Summit, which was less successful than preceding meetings. In addition, the work of the Middle East Multilateral Regional Economic Development Working Group (REDWG) has been effectively suspended for over a year.

109/ "Private investment ..." (UNCTAD/ECDC/SEU/13), p. 59.

110/ "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/12), pp. 20-21.

111/ Ibid., p. 72.

112/ Roy, *The Gaza Strip ...*, p. 16.

113/ George Abed states: "public wages [are] already 12 per cent of GDP - higher than every country in sub-Saharan Africa except one, and government consumption is higher than sub-Saharan Africa and more than twice the average in the fast growing East Asian countries" ("The Palestinian economy ...", p. 23).

114/ World Bank press release, "International community reaffirms support for Palestinian development", Paris, 15 December 1997.

115/ "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/12), pp. 71, 109f.

TABLES

**Table 1. Palestinian merchandise trade, 1992-1996,
(in current million US dollars)**

	1992	1993	1994	1995	1996
Merchandise exports total	292	234	243	326	266
to Israel	249	178	205	306	235
to rest of world	43	56	38	20	31
Merchandise imports total	1 260	1 173	1 075	1 690	1 725
from Israel	1 106	1 015	920	1 520	1 550
from rest of world	154	158	155	170	175
Merchandise balance total	−968	−938	−832	−1 364	−1 459
with Israel	−857	−837	−715	−1 214	−1 315
with the rest of world	−111	−101	−117	−150	−144

Source: UNCTAD secretariat estimates, compiled from:

Israel Central Bureau of Statistics, "Israel's balance of payments" (Jerusalem, ICBS, 1997), and *Statistical Abstract of Israel 1996* (Jerusalem, ICBS, 1997), for merchandise trade with Israel and trade with the rest of the world for 1992-1994;

PA Ministry of Economy and Trade, Egyptian Ministry of Foreign Affairs, (Palestine Affairs Department) and Jordanian Ministry of Foreign Affairs (Palestinian Affairs Department), for 1995-1996 figures on trade with the rest of the world, with Egypt and with Jordan, respectively.

Table 2. Palestinian merchandise trade with Egypt and Jordan, 1992-1996 (in current million US dollars)

	1992	1993	1994	1995	1996
Merchandise exports total	38.0	52.6	31.3	15.3	26.5
to Jordan	38.0	52.4	31.3	14.8	25.4
to Egypt	0.0	0.2	0.0	0.5	1.1
Merchandise imports total	9.6	9.9	7.3	6.7	23.5
from Jordan	9.5	9.6	6.6	2.3	9.2
from Egypt	0.1	0.3	0.7	4.4	14.3
Merchandise balance total	28.5	42.7	24.0	8.6	3.0
with Jordan	28.5	42.8	24.7	12.5	16.2
with Egypt	0.0	-0.1	-0.7	-3.9	-13.2

Source: UNCTAD secretariat estimates, compiled from PA Ministry of Economy and Trade, Egyptian Ministry of Foreign Affairs (Palestine Affairs Department), Jordanian Ministry of Foreign Affairs (Palestinian Affairs Department), for 1995-1996 figures on trade with the rest of the world, with Egypt and with Jordan, respectively.

Table 3. Import licences issued by the Palestinian Authority in the Gaza Strip (GS) and West Bank (WB), 1995 (million US dollars)

	GS	%	WB	%	Total	%
Construction materials	48.6	37	10.5	20	59.1	32
Foodstuffs, grains	23.2	17	30.8	60	54.0	30
Industrial raw materials	3.8	3	0.9	2	4.6	3
Machinery, motors, spares	1.5	1	0.3	1	1.8	1
Electrical and electronic	3.4	3	1.2	2	4.6	3
Clothing and textiles	1.0	1	0.0	0	1.0	1
Cigarettes	1.2	1	2.5	5	3.6	2
Livestock	25.7	19	0.1	0	25.7	14
Pharmaceuticals	0.6	0	0.0	0	0.6	0
Vehicles and spare parts	20.9	16	0.3	1	21.2	12
Fish	1.6	1	0.0	0	1.6	1
Miscellaneous	1.3	1	0.9	2	0.9	0
Alcoholic products	0.0	0	4.0	8	4.0	2
Total	**132.6**	100	**51.4**	100	**182.7**	100

Source: PA Ministry of Economy and Trade, 1996.

Table 4. Gaza Strip's external trade activity by sector, 1995 (million US dollars)

Destination	Grand total	Agro-industries	Foods	Building materials	Wood products & household articles	Engineering	Clothing & textiles	Medical supplies	Others
Exports									
Total	58.45	17.29	0.84	2.54	1.66	1.48	29.63	0	1.86
Israel	49.32	8.16	0.84	2.54	1.66	1.48	29.63	0	1.86
Other	9.13	9.13	0	0	0	0	0	0	0
Imports									
Total	448.24	66.24	100.35	101.11	16.77	24.63	37.25	6.02	54.46
Israel	418.97	64.08	88.45	93.47	16.07	24.49	36.58	5.96	49.31
Other	29.27	2.16	11.9	7.64	0.7	0.14	0.67	0.06	5.15
Balance									
Total	-389.79	-48.95	-99.51	-98.57	-15.11	-23.14	-7.61	-6.02	-52.6
Israel	-369.65	-55.92	-87.61	-90.93	-14.41	-23	-6.94	-5.96	-47.45
Other	-20.14	6.97	-11.9	-7.64	-0.7	-0.14	-0.67	-0.06	-5.15

Source: PA Ministry of Planning and International Cooperation, Central Statistics Department, “Statistical Abstract of 1995”, March 1996.

Table 5. Gaza Strip-West Bank trade, 1994-1996 (million US dollars)

	1994	1995	1996
Gaza Strip exports to West Bank	22.7	25.8	22.7
West Bank exports to Gaza Strip	27.3	22.7	16.3
Total	50.0	48.5	39.0

Sources: PA Ministry of Planning and International Cooperation for 1994 data, extrapolated without seasonal adjustment from April-December figures for 1994-1995; United States Embassy, Tel Aviv, “The Gaza economy: How bad is it?”, September 1996, extrapolated without seasonal adjustment from First Quarter and Second Quarter figures for 1996.

Table 6. Tax collection terms under the Protocol on Economic Relations

Declared destination	West Bank/ Gaza Strip	West Bank/ Gaza Strip	Israel
Importer of record	Palestinian	Israeli	Israeli
Tariffs and duties	Palestine	Israel	Israel
Purchase tax (including on TAMA mark-up)	Palestine	Israel	Israel
VAT	Palestine	Palestine	Israel

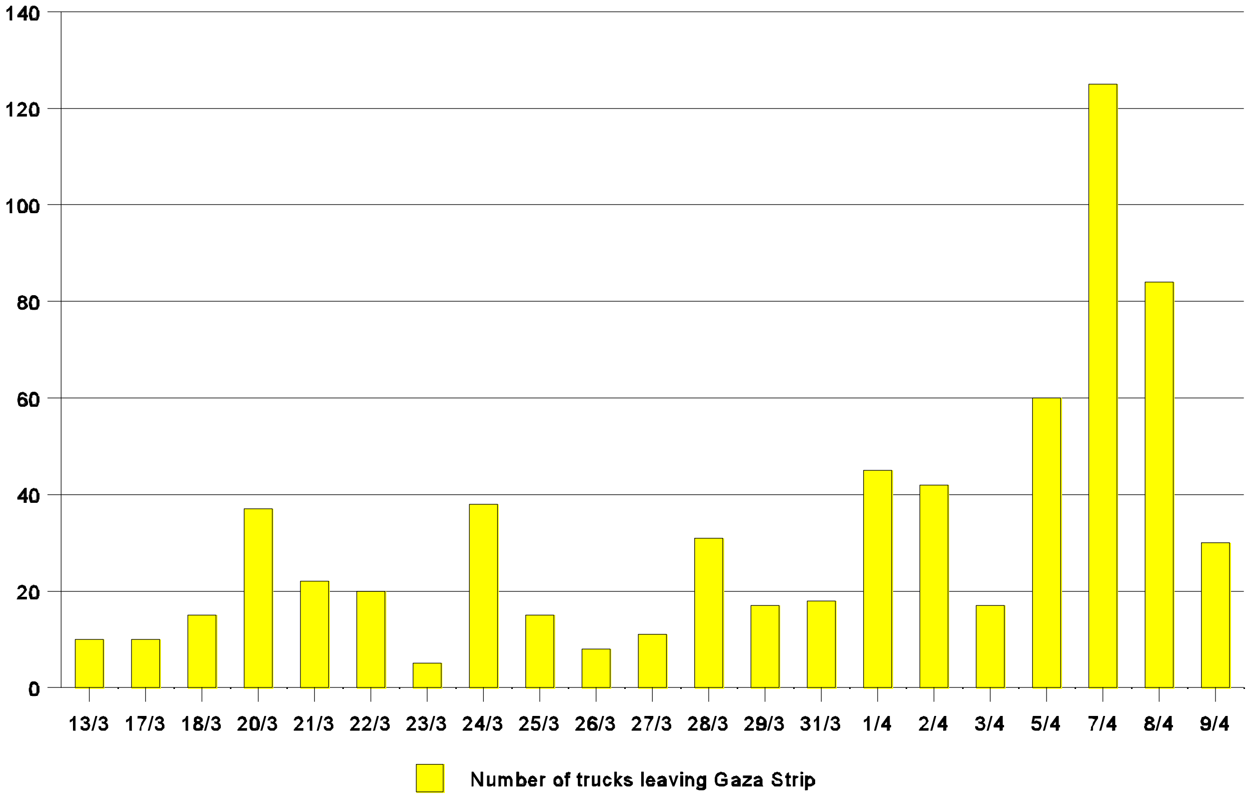
Source: Deduced from the Protocol on Economic Relations, 1994.

Table 7. Gaza Strip exports and imports, 1995-1996
(million new Israeli shekels)

EXPORTS	Fourth Quarter	First Quarter	March	Second Quarter
Israel	44.9	42.3	5.9	33.7
West Bank	29.4	16	0.8	8.4
Abroad	9.7	14.8	3.5	18.4
Total	83.9	73.1	10.2	60.5
IMPORTS				
Israel	404.1	321.5	33.4	471.8
West Bank	29.9	11.6	1.8	18.8
Abroad	25.6	12	3.9	28.9
Total	459.7	345.1	39.1	519.6

Sources: United States Department of State, *"Gaza trade statistics show impact of closure"*, May 1996; United States Embassy, Tel Aviv, *"The Gaza Economy: How bad is it?"*, September 1996.

Table 8. Movement of trucks exporting goods from the Gaza Strip, 13 March - 9 April 1996



Source: UNSCO, "The costs of closure", Gaza, April 1996.

Table 9. Manufacturing patterns by branch, West Bank and Gaza Strip, 1992

West Bank (excluding east Jerusalem)	**Number of firms**	**Employees**	**Firms with 20+ employed**
Food beverages	251	2 592	21
Garments	322	2 217	20
Textiles, leather	132	851	8
Wood products	404	1 030	2
Plastics, rubber	88	1 627	20
Non-metallic	227	1 818	9
Metal products	545	1 569	8
Others	128	718	6
Total West Bank	2 097	12 422	94
Gaza Strip			
Food, beverages	115	405	4
Garmets	472	1 844	6
Textiles, leather	98	180	1
Wood products	320	590	4
Plastics, rubber			
Non-metallic	274	653	2
Metal products	380	643	3
Others	54	210	2
Total Gaza Strip	1 713	4 525	22

Source: Israel Central Bureau of Statistics, *Statistical Abstract of Israel 1994*, Jerusalem, ICBS, 1995.

Appendix 1

ANNUAL QUANTITIES OF IMPORTS ON SCHEDULES ATTACHED TO LISTS A1 AND A2 OF THE PROTOCOL ON ECONOMIC RELATIONS BETWEEN ISRAEL AND PALESTINE*

List A1

Item	Quantities (tons)	Provisions
Sugar	75 000	
Rice	50 000	
Dried beans, etc.	15 000	
Other beans	10 000	
Cotton (not carded or combed)	tba	
Maize (corn)	10 000	
Dried yoghurt	2 000	
Live sheep	25 000 hds	
Silica sands, quartz sands	tba	
Rye	tba	
Barley	75 000	
Unwrought aluminium	4 000	
Cocoa beans	tba	
Cement	400 000	JE, 50% of market needs
Steel bars	60 000	50% of market needs
Steel bars (with indentations)		JE
Mineral/chemical fertilizers	15 000	
Palm kernel oil etc.	14 000	
Carpets/floor coverings	tbd	
Dishwashing machines (household)	7 500	
Washing machines (household)		JE
Gas/fuel stoves		JE
Liquid fuel heating stoves		JE
Electric space heaters	5 000	
Storage heating radiators		JE
Other heating apparatus		JE
Electric ovens etc.	5 000	JE
Gas/fuel cooking appliances		JE
Colour televisions	7 000	JE
Monochrome televisions		JE
Air-conditioners	2 500	JE
Refrigerators/freezers (household)	2 500	JE

Source: PA Ministry of Economy and Trade, June 1996.

tba = to be agreed according to Palestinian proved needs.
tbd = to be discussed by the Joint Economic Committee subcommittee
JE = From Jordan or Egypt only.
hds = heads.

* Figures presented are quotas revised upwards and agreed by the Joint Economic Committee in early 1996; it is not known whether they have since been formally approved. On average, these quotas are at least twice the levels originally agreed in 1994.

List A2		
Item	**Quantities (tons)**	**Provisions**
Sugar	75 000	
Rice	50 000	
Dried beans, etc.	15 000	
Other beans	10 000	
Cotton (not carded or combed)	tba	
Wheat, meslin	30 000	tbd
Wheat, meslin flour	50 000	tbd
Maize (corn)	10 000	
Dried yoghurt	2 000	
Live sheep	25 000 hds	
Silica sands, quartz sands	tba	
Rye	tba	
Barley	75 000	
Coffee, unroasted	5 500	
Tea (loose bulk)	1 000	
Cocoa beans	tba	
Palm kernel oil etc.	14 000	
Bovine meat, chilled and frozen	12 500	
Sesame seeds	5 000	
Potato seeds	2 000	
Live cattle	2 000 hds	

Source: PA Ministry of Economy and Trade, June 1996.

tba = to be agreed according to Palestinian proved needs.

tbd = to be discussed by the Joint Economic Committee subcommittee after six months.

hds = heads.

Appendix 2

IMPACT OF BORDER CLOSURES: CASE STUDIES a/

The following case studies, drawn from the closures of 1996, highlight the complexities of the border problem. Although the statistics cited in this study indicate the severity of the impact of border closures on the Palestinian economy, they do not accurately reveal the depth of the problem. Many areas of impact are non-quantifiable and certain losses due to opportunity costs are difficult to convey adequately. The information presented here is drawn from primary research data and attempts to portray the full complexity of the border closures and their reverberations as regards the economy, using both quantifiable and non-quantifiable data. Although the following examples are drawn from the specific closure period in the first half of 1996, similar problems are reported with the closures that have occurred since then. Thus, the problems described below are relevant to the policy of closure in general and not incidentally related to one specific closure.

Liquidity problems

The largest Palestinian manufacturer of chocolates, confectionery and biscuits had, before the 25 February closure, an annual turnover of between NIS 13-18 million. The company is resident in the West Bank, and the Gaza Strip market normally constitutes about 40 per cent of its sales. That market also consumes 90 per cent of its main line, a brand of chocolate, and has been purchasing the product for the past 20 years. Fifty per cent of the workforce was employed in this line of production. With the closure, company sales dropped from NIS 1.7 million to NIS 800,000 in March. The company ceased that line of production (which employs about 50 per cent of its workforce) and continued to hold about 70,000 boxes of the chocolate in stock. Total production levels dropped to 60 per cent of regular output and the workforce was reduced by eight workers. During the first two weeks of the closure, most workers were unable to travel to the plant and production was halted completely.

Like many, this company faced liquidity problems with the advent of the closure. Specifically, the company was unable to collect outstanding debts, which reached NIS 700,000, from its distributor in Gaza. Restrictions on movement made it impossible for company staff to travel to Gaza to collect those debts, and the distributor had trouble in collecting from clients in economic distress due to the same circumstances.

The company also faced severe shortages of packaging materials imported from Europe. The initial closure suspended all imports. It then became feasible to import to resupply the company's inventory; however, lack of funds forced a reduction in raw inputs and packaging materials. Consequently, the company reintroduced an older product line that had not been on the market for 10 years. Such a move would be likely to be unfeasible in an export situation (assuming that the product would be allowed outside the territories), considering the ever-changing requirements for food packaging for different international markets.

Accessing raw materials

A metalworking factory in the West Bank produces for the local, Israeli and export markets. Supplies of chemical raw materials are purchased from Israel. For the first three weeks after the 25 February closure, the company was totally unable to restock its requisite raw materials and had to suspend production until 13 March. Supplies subsequently became available, but at an enormous increase in cost. Before the closure, the company worked with a supplier in the West Bank; since the closure, the local supplier has been unable to travel inside Israel and the company has been forced to use a Jerusalem supplier. Whereas before the closure the company paid NIS 80 for one cylinder of ammonia, costs have now escalated to NIS 160. A cylinder of nitrogen increased from NIS 80 to NIS 200.

The company also faced increased shipping costs. It hoped to ship an order placed in January for 16 tons of goods with an estimated value of NIS 200,000, but could do so only with a substantial increase in cost. Whereas shipments to the Gaza Strip would normally cost NIS 300-500, arrangements under closure sets transportation costs at NIS 1,000. The company can no longer use local vehicles for transport and must use Jerusalem vehicles instead.

The company has been expanding into the Jordanian market since 1994. Previously, that market was difficult to penetrate as the supply of inexpensive products from the Pacific Rim dominated. However, with the ability to supply goods faster and in specialized quantities, the company had made inroads into this market. The closures, however, severely impacted on the company's ability to supply on time. Whereas orders were normally shipped within a month, shipments under closure took three months to complete.

Contract losses

A company in the West Bank is the sole importer and exclusive agent for a United States-based heavy equipment manufacturing firm in both the West Bank and the Gaza Strip. Since the Israeli agent for the same manufacturer does not operate in the Palestinian areas, this company believed it had good opportunities for growth. Under the closure, however, it was largely unable to import and deliver its merchandise, and was prevented from providing agency services and maintenance to its machines. The company's credibility was therefore threatened under such circumstances.

Furthermore, the company was unable to fulfil contracts completed before the closure. One such contract is with the PA, and the company faced a contractual fine of $500 a day for non-compliance. The machinery remained for months in the port of Ashdod. Normally, clearance requirements take a week, but Israeli security held the machines for seven weeks. After they had finally been cleared, they were transported to Erez for entry into the Gaza Strip, only to be turned back on the basis that nothing could cross the border. Since workers from the West Bank were also unable to enter the Gaza Strip, maintenance programmes were also halted. The company was thus unable to fulfil the agency requirements of the United States firm, owing to the lack of access to free and secure travel.

Opportunity losses

A food processing company in the West Bank was forced to cease production entirely for the first five days of closure, as the majority of the workforce was unable to reach the plant. During the first 12 days of closure, losses were also incurred because of damage to raw materials that were spoiled by the delays in processing. The company forecast monthly sales of NIS 708,000 for 1996, 80 per cent of which were for the West Bank market, 15 per cent for the Gaza Strip and 5 per cent for Israel. After the closure, Israel and Gaza Strip sales ground to a complete halt and West Bank sales declined to the point where monthly sales for March were NIS 140,000. Four out of 15 workers were placed on paid holiday, and shift hours were cut from 12 hours to 8.

The company had recently brokered an agreement to begin testing powder fruit drinks for eventual licensing from an Austrian firm. Closure, however, prevented the receipt of samples and other materials needed to produce and test the product, and it became too late to produce the product for the busy summer season. The company estimated that the licence would have added NIS 3 million to annual sales.

Shipping losses

One of the leading pharmaceutical companies in the West Bank lost access to markets outside the Bethlehem area after the 25 February closure. The consequent reduction in purchasing power and in the use of medical services caused the company a substantial loss of income. Pre-closure monthly sales amounted to NIS 500,000; March and April sales accounted for NIS 300,000.

The company lost stock because of the closures. A shipment of $5,000 worth of chemicals from Italy was delivered to the Israeli airport. The company, which had paid the VAT and customs on the shipment in advance (but no insurance, in an effort to reduce costs), was faced with liquidity problems due to the closure and could not pay the rest of the fees. The shipment was eventually destroyed by the airport authorities. Similarly, the company was unable to raise sufficient funds for an order of one of its main ingredients and after three months of closure had only enough stock for another month's production.

Also, the company is facing a breach in its contract with the PA Ministry of Health. It had submitted a $100,000 tender which specifies delivery within 60 days of finalizing the contract. Breaching the contract would result in its being awarded to the second most competitive bidder, and the company would be liable to the PA for the difference. Further difficulties with the PA involve new PA regulations which require VAT certificates and income tax compliance for cross-territory customers. The company, which regularly sends one consignment to the Gaza Strip, is facing difficulty with this requirement since the majority of sales in the Gaza Strip are effected by individual merchants who have no experience of obtaining this certification. Furthermore, a sizeable component of the company's Gaza Strip business comes from non-profit organizations, which, because of their charitable status, are unable to obtain the relevant VAT certificates.

Supplier problems

A carton producer in the West Bank experienced considerable complications in procuring raw materials from its Israeli supplier. Immediately following the closure, the Israeli supplier began requesting prepayment for goods ordered, unlike in the past when payment was provided upon receipt of merchandise or in instalments. Furthermore, past purchases were based on visual inspection of the materials, with company employees travelling to the agent and inspecting the purchased material. After the closure, the company began to have repeated problems caused by the supply of unsuitable materials. The same problem occurred with machine tools that had been ordered. The company paid for parts from the Israeli agent and was supplied with parts with different specifications. The company was unable for several months to visit the agent, who was unwilling to agree to the return or replacement of parts.

Movement of goods

Since the February closure coincided with the turnip and cauliflower harvest, one food producer in the West Bank was hit especially hard. A hundred tons of pickled turnips and cauliflowers was being held in storage for several months at the plant. If it cannot be marketed, the stock must be discarded in order to free up space for the forthcoming cucumber season. The company has NIS 600,000 worth of products in storage at the plant. Eggplant, which is processed in January, normally accounts for NIS 500,000 in sales, of which 80-90 per cent are sold in Israel. Owing to the closure, eggplant sales accounted only for NIS 100,000 in sales by June. The company had to slow production by 40 per cent, and this affected not only the company itself but also its agricultural suppliers.

Construction activity: supplies and domestic employment

The Gaza Strip construction industry, which normally employs 23,000 workers, requires approximately 3,000 tons of cement to maintain normal capacity and employment levels. During the first three weeks of the closure, no building materials entered the Gaza Strip. After 19 March, the flow was restarted but only at a rate of 300 tons per day. These amounts increased with the easing of border restrictions and decreased with the reimposition of the closure. This demonstrates one clear indirect impact on domestic employment as a result of the interruption of the movement of goods. In addition, spare parts for construction equipment are extremely difficult to procure during closure.

Fishing industry losses

Fishing is a vibrant industry in the Gaza Strip, employing 2,000 fishermen and another 1,000 in related activities. Two thirds of the catch is normally exported to Israel. From 8 to 12 March 1996 (and on subsequent occasions), fishermen were prohibited by the Israeli authorities from setting out to sea. Losses can be estimated at around $400,000 per day of full closure. After 12 March, fishing was allowed but only to the 6-mile limit, not the usual 12-mile limit (which still falls short of the 20 miles stipulated in the Gaza-Jericho Agreement). The fish for that season, however, are to be found mostly beyond the six-mile limit. On the night of 7 March, before the Israelis issued the order preventing fishing, nets had been placed by fishermen up to an eight-mile limit. When the order forbidding fishing was issued, fishermen were unable to retrieve their nets, and this led to an additional loss of at least $300,000 in damaged or destroyed nets. b/

Subcontracting

Prior to the closure, garment manufacturers had been importing 25 truckloads of fabric and exporting an equal amount, almost exclusively because of subcontracting arrangements with Israeli manufacturers. That figure is reduced to six truckloads of fabric in periods of limited closure.

Erez industrial zone

Over 40 businesses employ approximately 2,000 people in the Erez industrial zone (in the Gaza Strip, at the border with Israel, but under Israeli jurisdiction). In 1996, for the first time since closures had been applied, the Erez zone was affected. From 25 February until 12 March, no workers were engaged. Between 12 march and 19 March, approximately 300 workers returned, and not until after 19 March did work resume as normal at Erez. Such work stoppages have accompanied most periods of total and partial closure since that time.

Spoilage of produce

For perishable items, closures threaten to cause losses due to spoilage, either because workers are denied access to their jobs as harvesters, or because transportation routes are closed or severely restricted, thus causing produce to remain in non-refrigerated trucks for long periods. Without export to Israel, there is an abundance of crops in the Gaza Strip in certain agricultural products (citrus, strawberries, etc.), and with little or no import from Israel, staples such as flour fall into short supply. Farmers in the Gaza Strip have routinely invited local inhabitants to harvest any amount of crops for free, as this produce can no longer command prices sufficient to pay workers to do the harvesting. If the crops are not harvested, they would merely spoil.

The Gaza Strip also has a cut flower industry that is export-driven. After the closure, one company was confronted with possible losses of around $200,000 for a shipment that was to be delivered to the Netherlands. Faced with these losses, the company contacted the PA Ministry of Agriculture to seek export channels through Egypt. Security controls detained the shipment for eight hours at the Israeli border with Egypt, and then an additional three hours were needed to transport the flowers from Rafah to Cairo. There were no refrigerated trucks on the Egyptian side to transport the flowers. Owing to these delays, the shipment could not be flown out of Cairo until the next day. Upon arrival in Europe, the full shipment was rejected because of excessive damage.

East Jerusalem

Although east Jerusalem is not a production centre, it is central to Palestinian tourism, internal trade, business and employment. Under the closure, firms' entire workforces were unable to reach their places of employment, and the local business environment rapidly stagnated. Tourism, central to the economic life of east Jerusalem, declined sharply during this period and hotels and restaurants were deprived of their staff, most of whom commute from the West Bank on a daily basis. Also, business persons from the West Bank who regularly use east Jerusalem for meetings and residence, and to complete official paperwork, are unable to enter the city to conduct their business. Thus, the costs of closure in east Jerusalem are related to lack of both supply and labour.

One well-established hotel in east Jerusalem, currently with 105 rooms, was hit hard by the closure. The entire West Bank labour force (50 per cent of the total workforce) was unable to reach it without risking a fine or imprisonment. During the first week of closure, the remaining employees were forced to work overtime shifts and placed in many different types of service for which they had had no training. Ten West Bank staff who were in the hotel when closure was decreed were unable to leave the hotel. They remained there at the hotel's expense. Overtime costs were approximately $750 for the first week, and staff meals and accommodation cost an additional $100 a day. After the first week, other hotel employees began to cross into Jerusalem using back roads and evading Israeli checkpoints. The hotel faced fines amounting to $26,000 for employing West Bank workers in violation of the closure regulation.

Since 25 February, the hotel restaurant's revenues declined from around $25,000 a month to $5,000 a month, mainly because of the loss of the custom of West Bank clients. The hotel was in the process of renovating and upgrading its facilities in order to attract a larger clientele and reduce its dependence on religious group tours. However, after the closure, construction workers from the West Bank were unable to travel to the hotel, and this forced a rethinking of the plan at a late stage. Virtually all the hotels in east Jerusalem report similar problems.

Notes

a/ The following examples are drawn largely from direct field research by the Development Resource Centre (DRC) in Gaza and by Claire Woodcraft of the Palestinian Trade Promotion Organization in Ramallah. The research was conducted using interviews with either the owners or the production managers of the businesses involved. The figures cited are consistent with DRC's research elsewhere regarding firm output.

b/ The Palestine Centre for Human Rights has also reported on the losses in the fishing industry, although it puts losses due to damage in the first few weeks of the 1996 closures at $236,325. See “Closure Update”, No. 2, 11 March 1996, p. 5, and “Closure Update”, No. 3, 18 March 1996, pp. 4-5.

Appendix 3

PALESTINIAN INDUSTRIAL BRANCHES EXHIBITING EXPORT POTENTIAL

Ready-to-wear garments manufacturing is the largest industrial branch in the West Bank/Gaza Strip, and also the largest single component of Palestinian exports to Israel. According to the PCBS, in 1994 there were 1,697 firms active in garment manufacturing, employing 12,458 workers, most of them heavily involved in subcontracting. It is estimated that 70 per cent of their production is bound for Israel, mostly in the form of subcontracting. a/ Although they are quite skilled and experienced in the production of garments (having been locked into the role of subcontractor for 30 years), their size and organizational sophistication tend to be limited, with only 340 firms (33 per cent) employing more than 10 workers. b/

However, even within production and production management, there is ample room for improvement. According to visiting experts in garment production, there is weak and wasteful management of material, space and quality control, as well as a generalized lack of good manufacturing practices. c/ Furthermore, the firms tend to be limited to assembling and trimming, or sometimes cutting. However, few firms engage in pattern making, and few have trained personnel or equipment to do this to a high standard. There are no firms designing garments intended to appeal to Israeli or international markets. Any long-term sustenance of this branch in the international market will require it to move rapidly upstream in the production process and eventually in some of the elementary design processes.

The garments branch is generally recognized as a very promising export branch, especially with subcontractors in the high-end, speciality clothing market, as labour is far too expensive to compete on commodity garments. Labour skills are on the whole better than in Jordan, for example. d/ Technology used in Palestinian firms is reported to be more modern, and the experience of international manufacturing quality requirements is more extensive as a result of sustained penetration of international markets (albeit via Israeli contractors). e/

MAS, a Palestinian economic policy research institute, has compared the cost structures of Palestinian and Jordanian firms. It found that it costs Palestinian firms generally twice as much as Jordanian ones to produce a piece of garment. Wages in this branch are about $285 per month, which is about double those in Jordan, and Palestinian firms can maintain viability only through higher-end items and by increasing productivity. The main area of short-run improvement, therefore, needs to be in the cost of fabrics. Jordanian firms import fabric from the Far East of equal or higher quality at 47 per cent of the average prevailing in the West Bank/Gaza Strip (80 per cent of the imports are from Turkey). The high tariffs that Palestinians must pay on fabric from East Asia can reach 75 per cent. f/ MAS estimates that production costs can be reduced by 36.6 per cent if fabric could be imported without restrictions. g/

Moreover, few firms are able to benefit from “temporary input” rebates (available to Israeli and Jordanian producers), because of both PA administrative deficiencies and the possibility of complications in the clearance of goods that are imported specifically into the West Bank/ Gaza Strip. Other declared and undeclared assistance to garments export is available to Jordanian (and Israeli) manufacturers in the form of tax breaks, special financing, etc., measures which are unavailable to Palestinian manufacturers.

Garment production is receiving much attention from public and private sources, and there is growing concern that garment manufacturing should move from what amounts to the sale of labour to more comprehensive business provision of products. The branch would have to advance in three directions:

(1) First, the firms must secure direct access to international buyers for subcontracting and access to suppliers of inputs. These involve acquiring international business contacts and marketing skills, and developing more efficient production methods that will ensure profit and quality. The firms would need cheaper access to quality fabrics and other material, as well as reliable access to ports of entry, since international buyers work on seasonal, short delivery schedules.

(2) Secondly, the branch would have to acquire the technical skills of production upstream, such as cutting, pattern making and eventually designing. There are several elaborate training programmes under way to develop these technical skills over the next few years. However, such efforts to integrate vertically require the development of management and marketing skills, and the consolidation (or at least local organization) of the fragmented operations.

(3) Thirdly, a host of support services are needed by this branch, the provision of which would also help to create a level of local market cohesion. Trade associations, legal services, advocacy, marketing services and perhaps a specialized financial service for international subcontracting arrangements are widely needed. Numerous technical support services, such as equipment maintenance, quality control and laboratories, are equally vital.

Footwear production is governed by similar characteristics and conditions as garments. Raw materials are 20 per cent more expensive to acquire in the West Bank/Gaza Strip than in Jordan. Wages are over twice as much, and average production costs are thus lower. The technology utilized, however, is more advanced in the West Bank/Gaza Strip, especially in the production of sports shoes, artificial leather and sandals. In each of these three areas, Palestinian producers enjoy a significant lead in terms of quality. As in garments, Palestinian manufacturers export about 60 per cent of output to or through Israel, which has given this branch significant experience in producing expert-quality footwear. However, very few of the non-production skills, such as marketing and design, have been developed for these firms to enter into more profitable higher-end markets.

Pharmaceuticals, unlike garments, are based largely on skilled human resources and technology. Investment per firm is relatively high by Palestinian standards, as the nature of such operations requires greater technical facilities. The six major pharmaceutical companies, all in the West Bank, have been operating under particularly restricted conditions, where they have not been allowed to sell directly in Israel. These firms have acquired an organizational structure of a significant degree of complexity. This is due to the great emphasis on production quality that local (and Israeli) regulations require for this industry, and the fact that these firms had to capture up to 50 per cent of local markets and compete for them among themselves rather than simply concentrate on producing commissioned batches for an Israeli contractor, as in garments and footwear subcontracting.

According to manufacturers in the West Bank and Jordan, product quality is very similar to that of Jordanian manufacturers, which in 1993 exported about 70 per cent of output. h/ Very similar technology is used. Prices, furthermore, are fairly similar (± 10 per cent), although Jordanian goods are on the whole slightly cheaper. However, the scale of production in the West Bank is considerably smaller, with only 600 workers employed in the industry, generating about $26 million in revenues in 1994. Profit margins are about 30 per cent lower than Jordan's, mainly because of the lack of government export incentives and the lack of economies of scale associated with experts. i/ If profit margins remain so unfavourable, the possibility of funding investment from profits diminishes considerably.

Perhaps unexpectedly, the MAS study reveals that in comparison with the Jordanian cost structures, West Bank firms' cost structures are not disadvantaged because of wages (which is the case in garments and other labour-intensive fields). Average wages are similar, at about $500 per month, and Jordanian wages were only 6 per cent lower than Palestinian wages. Various inefficiencies associated with procurement of raw materials and customs-related factors account for most of the extra costs: (i) customs and border regulations; (ii) extra commissions paid to Israeli importing agents; and (iii) procurement in small batches without the bulk discounts available to Jordanian manufacturers. j/ There is evidence that Palestinian pharmaceuticals manufacturers have good prospects on the international market as long as raw material prices are reduced and brought into line with international costs; financing is made available for expansion; the various certification requirements are met; and the necessary administrative infrastructure for facilitating international trade is made available. These firms must rapidly acquire international marketing capacities, either through in-house departments devoted to export marketing or through qualified and capable intermediaries. The will and the potential exist, four firms having recently participated in a major German pharmaceuticals fair.

The recent Jordanian-Palestinian trade agreement allows Jordanian goods to enter the PA areas without tariffs. However, since pharmaceuticals fall under Schedule B of the Paris Protocol, Jordanian products must receive Israeli licences before entering the West Bank/Gaza Strip, a costly and lengthy process. Nevertheless, the financial mass and international marketing expertise acquired over the years mean that Jordanian firms are probably very capable of absorbing these costs and entering the Palestinian (and Israeli) market aggressively. The Jordanian-Palestinian trade agreement did not permit Palestinian goods to enter Jordanian markets or pass through Jordanian territory for export to third countries. k/ Although there are success stories of Palestinian exports across a variety of industrial branches, they tend to be concentrated in high value-added products in each of these branches.

In the **food processing** branch, the quality of agricultural production in the West Bank/Gaza Strip could be an impetus to an active role from the perspectives of exporting and of meeting local market needs. However, the linkage between agriculture and food processing is very limited, and practised on a wide scale only in traditional industries such as olive pressing in the West Bank. In the Gaza Strip, there is no equivalent relationship between citrus and juice, preserves or other derivative products of citrus. Moreover, there are few linkages with national cuisine, either as pre-prepared or semi-prepared products for local culinary needs, nor are products currently being produced stamped in any way with local tastes that might give them a market advantage over imported goods or in the export market.

Instead, a large number of firms are engaged in the production of lower-quality snack foods that compete on the basis of price alone, such as biscuits and ice cream. Frequently, the quality, safety and packaging of these products are unreliable. Nevertheless, some snack foods have been consistently exported to Israel and to eastern Europe on the basis of price, although their positions in these markets do not seem to be secure and little effort is made to ensure that they keep up with the competition. To date, more dynamic exporting (i.e. in terms of scientifically seeking out and planning exports) has been restricted to a few industries, especially preserved delicacies such as pickles. 1/

To achieve higher levels of local content and value added, a certain integration with local agriculture needs to be developed; furthermore, a reorientation of production towards quality and uniqueness is necessary. However, given the small local markets and the relatively high costs of local agricultural products, the branch would benefit from focusing on small-scale, health-conscious “traditional” or “organic” production that would tap more from local traditions than from advanced processing technologies. In this regard, fewer large-scale processing plants but more smaller-scale, higher-quality cottage operations would be more appropriate. Technology can play a greater role in quality control, sanitation and, to some extent, packaging, than in processing. To support these firms, a Palestinian marketing outlet (cooperative, marketing organization, etc.) to promote products locally and internationally would need to be developed. In the absence of this, an Israeli firm has succeeded in repackaging Palestinian-processed foods and exporting them to United States markets.

The **metalworking** branch has about five to seven years of experience in very minimal exporting beyond Israel, some firms through Israeli subcontracting and some directly. Quality is fairly good, given the limited capital invested, with particular successes in sheet metal, wire products, car parts and non-electronic household appliances. Some engineers observe that the metalworking-appliance branch has the greatest number of locally produced machines. Though these are of low quality, they represent the seeds of capacity-building in rationalized product and process design, rather than mere labour.

The production of some sheet metal products and allied engineering production (such as appliances and agricultural tools and vehicles) have been quite impressive, with significant achievements in exporting to Israel and, in some instances, certification from the Israeli Standards Institute. This is particularly promising as it emphasizes more sophisticated production procedures with engineers and other professionals involved in the design phase and with shop-floor foremen able to read engineering drawings and execute production accordingly. This represents a move away from the crafts/workshop atmosphere to something more organizationally complex.

Other categories of metalworking, such as casting, mould and die making, and other precision-machining capacities, are still underdeveloped. Also, they require more capital and skills, and entail higher costs in production because of the need for better raw materials, energy costs and more professional training.

Plastics manufacturers in the Gaza Strip and the West Bank have been fairly strongly integrated into Israeli subcontracting and are heavily dependent on Israeli inputs and markets for survival, like many other branches. They have, however, developed fairly quickly a capacity to produce quality products (though they feel that domestic market conditions do not allow them to do so) and are quite aware of production issues. Provided that more formal training is available, this constitutes a promising branch. Indeed, some firms have in recent years, despite great adversity, exported to Africa, Germany and other European countries, though in relatively small quantities.

With technical and market access support, firms could viably supply high-quality/high-tolerance plastic and rubber components for regional and international plants. In recent years, product quality has deteriorated because of a decline in the purchasing power of local consumers and the increased demand for low-priced products. The inability to obtain suitable polymers and additives on a consistent basis and at reasonable cost is perhaps one of the greatest problems facing manufacturers of plastic products. In addition, a testing centre for finished and semi-finished products is needed if firms wish to enter new markets.

Notes

a/ Basem Makhoul, “The competitiveness of Palestinian manufacturing in comparison with Jordanian manufacturing”, Jerusalem, Palestine Economic Policy Research Institute (MAS), January 1996, p. 34.

b/ This is clearly above the general average for Palestinian firms, but well below required levels of consolidation for such industries. See Richard S. Lissak, “Industrial strategy and policy issues for Palestine”, UNIDO consultant's paper prepared for workshop in East Jerusalem, 9-12 October 1995, p. 24.

c/ Alice Moulin and the Development Resource Centre, “Garment factories in Gaza”, 1996 (unpublished document).

d/ Makhoul, “The competitiveness of Palestinian manufacturing ...”, pp. 35, 39.

e/ Ibid., p. 37.

f/ Ibid., p. 36. Originally cited in World Bank, *Developing the Occupied Territories: An Instrument in World Peace*, vol. 3, Private Sector Development, Washington D.C., 1993, p. 56.

g/ Makhoul, "The competitiveness of ...".

h/ Ibid., pp. 28, 33. Makhoul compared Palestinian products with Jordanian products because, among other things, "there is a great similarity in the mercantile composition of industrial products and in the structure of the industrial sector". Moreover, the various advantages enjoyed by Jordan "may lead to the emergence of strong competition between Palestinian and Jordanian products in the event [of] free trade", p. 7.

i/ Ibid., pp. 28, 31. Jordanian manufacturers employ almost 3,000 workers and earned $141 million in 1993.

j/ Ibid., p. 30 f.

k/ Ibid., p. 34.

l/ Paradoxically, available data seem to suggest that the food processing branch is the most profitable and largest branch. The reason for this is that the carbonated beverage firms, and cigarette and citrus packaging firms, are categorized together. These are the largest firms in the Gaza Strip and the West Bank that dominate the local market in very specific products which do not necessarily have significant potential for export, as they would have to compete with the highly brand-conscious international industry in snack products. The only exception to this is citrus, which is in actuality an agricultural product with an industrial component by virtue of the packaging requirement for export.
