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THE PALESTINIAN ECONOMY AND PROSPECTS FOR REGIONAL COOPERATION

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THE PALESTINIAN ECONOMY AND PROSPECTS FOR REGIONAL COOPERATION*

EXECUTIVE SUMMARY

This study examines strategies and policies to promote and facilitate the integration of the Palestinian economy at the regional and global levels. The study suggests an analytical framework for investigating regional dimensions of the economy and explores issues of economic integration from the conceptual and empirical viewpoints. Lessons are deduced from the regional integration experiences of developing, especially Arab, economies.

Israeli-Palestinian economic relations are also examined in the context of the regional economy. Transitional arrangements are proposed to accommodate and redefine the reality of limited and controlled cross-border movement of goods and people, while allowing the Palestinian economy a fuller opening to other neighbours and further afield. Future economic relations, mixing coordination in some fields with separation in others, are identified, including opportunities and priorities for cooperation in rationalizing production and trade in agriculture, industry, and tourism.

The study further investigates the prospects for regional cooperation, including Arab-Israeli cooperation. The importance of normalizing Palestinian economic relations with Arab neighbours is also stressed, through collaboration in infrastructural projects, as well as in areas in which production and trade may benefit from new comparative advantages.

The study also examines the framework of Palestinian relations with industrialized, developing and transition economies, outlining the implications of recent trends in the world economy for a developing economy intent on integration into global markets. The study concludes with recommendations for policy action under three headings: relations with Israel, future regional arrangements and integration into world markets.

* This study has been prepared by the UNCTAD secretariat based on a contribution by a consultant, Prof. Fadle Naqib (Waterloo University, Canada). The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

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ABBREVIATIONS

AMF	Arab Monetary Fund
AMU	Arab Maghreb Union
ATFP	Arab Trade Finance Programme
ASEAN	Association of Southeast Asian Nations
CU	Customs union
EU	European Union
FDI	Foreign direct investment
FTA	Free trade area
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GIE	Gaza Industrial Estate
GNP	Gross national product
MERCOSUR	Common Market of the Southern Cone
MFN	Most Favoured Nation
MIDOR	Middle East Oil Refinery
NGO	Non-governmental organization
PADICO	The Palestinian Development and Investment Company
PECDAR	The Palestinian Economic Council for Development and Reconstruction
PLO	Palestinian Liberation Organization
PA	Palestinian Authority
PPP	Purchasing power parity
REDWG	Regional Economic Development Working Group
SACU	Southern Africa Customs Union
SMEs	Small and medium-sized enterprises
TNC	Transnational corporation
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organization

Overview

The establishment of Palestinian interim self-government arrangements in May 1994, as envisioned in the Declaration of Principles signed between Israel and Palestine in Washington, D.C. in September 1993, was expected to be accompanied by a significant transformation of economic conditions in the West Bank and Gaza Strip. The new situation engendered by the peace process was perceived to be able to bring about rapid economic change that would signal a departure from the economic legacy of occupation and create a new enabling environment for economic development. The defining stage in this process was anticipated for the interim period (1994-1999), in the form of a new economic relationship between Israel and the Palestinian Authority (PA) that would allow cooperation and coordination to replace past conflict and strife.

The new relationship was enshrined in the "Protocol on Economic Relations Between the Government of Israel and the Palestine Liberation Organization", signed in Paris on 21 April 1994. An essential component of the Protocol is the concept of relatively open borders for the movement of goods and labour between Israel and the Palestinian territory. Any interruptions of this movement were envisioned as temporary and engendered only by exceptional circumstances. Subsequent developments, however, prevented the Protocol from fully delivering on its promise. Due to political and security considerations, disruptions to the flow of goods and labour became the rule rather than the exception.

These interruptions, which have sometimes lasted for months, have adversely affected the Palestinian economy, in spite of many improvements that have been realized in the policy environment and through public expenditures on vital infrastructures. The border closures during 1996 and 1997 generated a sharp increase in unemployment, reduced household income, a decline in trade, a growing balance-of-payments deficit, and an unprecedented incidence of poverty, among other serious economic problems. All of this has underscored Palestinian dependency on the larger and much stronger Israeli economy and highlighted the need for fundamental rethinking of Palestinian external economic relations.

The restructuring of any economy to permit a reorientation of its domestic and external sectors is a complex and lengthy process, but particularly so in circumstances such as those currently prevailing in the Palestinian territory. This task requires, inter alia, that the following considerations be addressed:

* Economic relations between Israel and the PA should not continue to fluctuate in line with the turbulent political and security situation. There is an urgent need for both sides to agree on policies and measures to allow the interim period to proceed without further disruptions of the efforts at reconstruction and development of the Palestinian economy.

* To ensure that policies and measures aimed at alleviating current economic problems have an enduring effect they should be guided by a clear vision of a more balanced Israeli-Palestinian economic relationship in the future. Thus, the reorientation of the Palestinian

economy during the interim period should be compatible with future equitable and mutually beneficial relations with the Israeli economy.

* Both history and geography have combined to make Palestinian-Israeli relations closely intertwined with Arab-Israeli relations. Accordingly, the reorientation of the Palestinian economy must be compatible with a vision of future regional economic arrangements, including Arab-Israeli economic relations in an era of peace.

* Given the strong trend towards liberalization and globalization of the world economy, the reorientation of the Palestinian economy, whether at the bilateral or the regional levels, should be consistent with and complementary to the drive towards integration into world markets.

The UNCTAD secretariat’s recently completed intersectoral research project on prospects for the sustained development of the Palestinian economy, examined macro-economic and sectoral strategies and policies for managing the process of reconstruction and development. 1/ However, the regional and global dimensions of this process could not be addressed in a comprehensive and in-depth manner within that research project. Such an investigation was envisaged as part of the 1996-1997 work programme of the UNCTAD secretariat (as revised and approved by the Trade and Development Board in 1996 following UNCTAD IX). This was intended both to complement the intersectoral analysis of the Palestinian economy, and to address an area of increasing interest to the parties involved in the Middle East peace process since 1993. The purpose of this study therefore is to identify suitable strategies and policies that would promote and facilitate the integration of the Palestinian economy into the regional and global economies, in a manner consistent with the major trends emerging therein.

The first two chapters of this study lay the groundwork for subsequent analysis. Chapter I presents a brief description of the geographical setting of the Palestinian territory and its endowment of natural and human resources, featuring an economy which is small in size and poorly endowed in natural resources, but relatively rich in manpower. Chapter II examines economic developments following the establishment of the PA in 1994, identifies major macro-economic problems and explores some sectoral strategies to alleviate them.

Chapter III suggests a framework for investigating the regional dimensions of the Palestinian economy that serves as a guideline for analysis in subsequent chapters. It explores issues related to economic integration at both the conceptual and the empirical levels. At the former level, issues of dimension and stages are examined. The question of dimension involves the divergences between the processes of multilateral trade liberalization and regionalism. A new view of regionalism is envisaged, as one option available to developing countries intent on integrating their economies at the global level, while still providing them with means for dealing with the adverse effects of globalization. In this regard, some of the benefits of regional integration are identified. The question of stages involves different phases in economic integration that have been experienced in regional arrangements around the world. They include free trade agreements, customs unions, common markets and economic unions.

At the empirical level, the chapter examines the lessons deduced from experiences of past attempts at regional integration by developing countries, especially Arab countries. It is suggested that the conventional benchmarks used to evaluate different forms of regional and sub-regional cooperation and integration (associated with trade creation versus trade diversion) are not relevant in the present context. Accordingly, designing regional integration in the Middle East on the premise that liberalization of trade is the central goal may not be appropriate. An alternative design is thus outlined that calls for a more deliberate approach, emphasizing coordination among member countries with a view towards creating an enabling environment for economic growth, and addressing fundamental economic problems of the region.

Experience in economic integration among developing countries demonstrates that certain safeguards have to be observed to ensure the sustainability of a regional arrangement. In this regard, three issues are identified. First, the creation of a compensation scheme to ensure that the benefits of integration are fairly distributed. Second, the need to avoid regional integration patterned along a “hub-and-spoke” system. Third, to ensure that the dissociation costs of the regional arrangement are distributed equally among member countries.

Chapter IV examines current and prospective Israeli-Palestinian economic relations, and their place in regional economic arrangements. Present relations (during the interim period) have highlighted some shortcomings of the Protocol. These derive from the problems faced in realizing the vision of open borders within which the Protocol was framed, except partially and conditionally, and its apparent lack of feasibility for the foreseeable future. Accordingly, the parties appear to have two broad choices. They could resolve to insulate the movements of labour and goods from security exigencies, thus protecting the concept of open borders and actually allowing for its realization. Otherwise, it may have to be concluded that open borders are neither practical under present circumstances nor in the initial period after the resolution of the final-status issue.

Since both options for the interim period may be considered unattractive by one or both parties, a practical solution that contains elements from the two alternatives is presented in Chapter IV. It is compatible with the mechanism set up by the Protocol and calls for no new framework. A transitional arrangement of this kind would require agreement by the parties to modify the Protocol in a manner that accommodates and redefines the reality of limited and controlled cross-border movements of goods and people, while allowing the Palestinian economy a fuller opening to other neighbours and further afield.

Future economic relations between the Palestinian territory and Israel need to be cast within a framework that mixes coordination in some fields with separation in others. This approach is inherent to the process of achieving independent Palestinian economic management, a major goal explicitly addressed in the Protocol. It also befits a small and poor economy seeking to maximize its benefits from relations with an adjacent, large and advanced economy. It is thus demonstrated that the customs union with Israel (as it now exists) does not best serve Palestinian economic interests. On the other hand, there is ample room for cooperation between the two sides in rationalizing production and trade. Priorities are identified in agriculture, industry and tourism.

As regards Arab-Israeli economic relations, Chapter IV emphasizes the need to take into consideration concerns that are widely shared throughout the region. In particular, it is believed that, in the absence of safeguards at the national and regional levels, Israel may use normalization of economic relations to access markets in the region while maintaining significant advantages over other economies. This concern is based on the fact that Israel has free trade area (FTA) agreements with both the United States and the European Union.

In other words, a regional economic arrangement including Israel could move towards a “hub-and-spoke” system if adequate safeguards are not envisaged. In such a situation, Israel would maintain a “hub” position by benefiting from its preferential access to regional markets and to markets in Europe and the United States. Israel would attract the greatest proportion of foreign direct investment to the regional market, and thus maintain and strengthen the advantages arising from internal and external economies of scale. However, such a system may not be stable, and is unlikely to enhance regional integration. Measures to avoid such pitfalls in regional cooperation endeavours are discussed.

Chapter V examines Arab-Palestinian economic relations. It consists of three parts. The first emphasizes the importance of normalizing Palestinian economic relations with Arab neighbours as a natural first step towards regional economic cooperation and integration. The second outlines some of the important infrastructural projects needed by the Palestinian economy that could be carried out in collaboration with Arab neighbours. The third explores areas in which the Palestinian and Arab economies could rationalize production and trade regionally, with each one developing new comparative advantages.

The potential benefits obtainable from both internal and external dynamic economies of scale are stressed as the primary benefit to be derived from regional rationalization of production. Intra-industry trade could assume increasing importance both for expanding intra-regional trade and for adding to the region's competitive edge in world markets. The final part of the chapter focuses on economic policies that require collaboration with Arab neighbours in supply, demand, monetary, fiscal and labour issues.

Chapter VI is devoted to examining Palestinian economic relations with industrialized and developing countries and with economies in transition. The chapter outlines the implications of recent trends in the world economy for a developing economy intent on integration into global markets. This discussion provides a context within which challenges and opportunities facing the Palestinian economy on the global level are examined.

Palestinian trade with the major industrialized economies is greatly constrained by the absence of a domestic support system at the policy, procedural and institutional levels. Overcoming these constraints requires both a collaborative effort between the public and private sectors and cooperation at the regional level. New possibilities exist in both production and trade in emerging industries and services. A major improvement in the Palestinian scientific environment is called for in order to realize this potential. Similarities in per capita income, consumption patterns and trade regulations are factors that would facilitate trade with developing countries. There may also be ample room for exchange between the Palestinian economy and the economies in transition in Eastern Europe.

The final chapter of the study highlights the major findings of the study as a whole. These are presented, along with relevant recommendations for policy consideration and action under three priority headings: relations with Israel, future regional arrangements, and integration into world markets.

Chapter I

GEOGRAPHIC AND RESOURCE CONSIDERATIONS

The establishment and gradual extension of Palestinian interim self-government arrangements in the West Bank and Gaza Strip, commencing in May 1994, have been accompanied by continued economic hardship. This was intensified as a result of the border closures and related security measures imposed in the wake of violent incidents. In 1996 and 1997, adverse economic conditions were manifested in a sharp increase in unemployment, an unprecedented spread of poverty, a steady decline in external trade and sluggish growth of domestic output coupled with falls in per capita income levels. 2/ These continuing trends underscore the fragility of Palestinian dependency on the Israeli economy and highlight the need for a new orientation in external economic relations.

As the process of reorientation of the economy is a complex task, it is important to minimize the disruptions and possible setbacks that it entails. A strategy to ensure a smooth transformation needs to be founded on a clear appreciation of the economy’s resource potentials, especially physical and human resources. This chapter provides a brief evaluation of these issues. The geographic setting of the Palestinian territory, together with some salient features of its population, are outlined in section A. Section B briefly examines such resource endowments as land, water, human resources, and capital. The final section is devoted to an assessment of the relative position of the Palestinian economy and those of Arab countries and Israel, as well as of major economic groupings.

A. Geography and population

The combined area of the West Bank and Gaza Strip (6,165 sq km) constitutes 23 per cent of the area of pre-1948 British Mandate Palestine, and is approximately one third the area of the state of Israel. The West Bank is 5,800 sq km in area, 130 km long and ranges between 40 to 65 km in width; it lies between Israel to the West and Jordan to the East. The Gaza Strip is 365 sq km in area, 45 km long and between 5 and 12 km wide; it borders Israel to the north and east, the Egyptian Sinai peninsula to the south, and the Mediterranean Sea to the West. 3/

The Gaza Strip is mainly coastal plain and sand dunes while the West Bank is more diverse, featuring four topographic zones. The Jordan Valley along the Jordan river is a fertile plain of around 400 sq km, while the Eastern Slopes are a rocky semi-arid area of 1,500 sq km, leading down to the Dead Sea. The Central Highlands constitute the largest zone, of 3,500 sq km, rising 1,000 metres above sea level in places; while the Semi-Coastal zone consists of 400 sq km in the west and north-west. The West Bank is divided into three main districts with eight sub-districts, each of which is named after one of the main cities. The northern region comprises the sub-districts of Jenin, Tulkarem, and Nablus, while the central region includes Jerusalem, Jericho, Ramallah and Bethlehem; and the southern region is constituted by Hebron.

According to a demographic survey conducted by the Palestinian Central Bureau of Statistics (PCBS) prior to the recent census, the population of the West Bank and Gaza Strip is estimated to have reached 2.75 million in 1997 (1.70 million in the West Bank and 1.05 million in the Gaza Strip). The population density differs markedly between the two areas. In the West Bank population density is 284 persons per sq km, whereas in the Gaza Strip the comparable figure is 2,888. In Gaza city, population density is 14,000 persons per sq km, which is one of the highest in the world. According to PCBS projections, the population is expected to exceed 3 million by the turn of the century, reflecting an annual population growth rate of 5.4 per cent. This unusually high rate combines both natural increase (3.4 per cent per annum in the West Bank and 4.6 per cent in the Gaza Strip) and Palestinian returnees from the diaspora since 1994. Almost 40 per cent of the resident population are registered as refugees from the wars of 1948 and 1967 (28 per cent of the West Bank population and 64 per cent of the Gaza Strip population). 4/

Since 1967, and especially since the late 1970s, Israel has pursued a policy of building settlements in the West Bank and Gaza Strip, mainly on expropriated public and private Palestinian land. 5/ According to Palestinian estimates in 1994, the number of these settlements had reached 194, most of which are in the West Bank, including 28 constructed since 1967 within the expanded Jerusalem municipal boundaries. There are 18 Israeli settlements in the Gaza Strip. 6/ The total population of the Israeli settlements in both regions is estimated to have reached around 150,000 by 1995, excluding settlements in the east Jerusalem area. These settlements make intensive and disproportionate use of scarce natural resources. For instance, the population of the Israeli settlements in the Gaza Strip is 5,000, equivalent to less than half of one per cent of the area’s Palestinian population, yet they use 25 per cent of the Strip’s land area. 7/ In the West Bank, Israeli settlements account for one third of the total water consumption although their population is equivalent to under 9 per cent of the Palestinian population. 8/ In addition, Israeli settlements “have broken up areas of contiguous Arab settlements and bifurcated private farmers' agricultural land with roads and other infrastructures”. 9/

B. Resource endowments

1. Land and water

Notwithstanding the small size of the Palestinian territory, just one quarter of Palestinian land is under cultivation - around 1,500 sq km in the West Bank and 160 sq km in the Gaza Strip. According to some studies, the cultivated area of the West Bank could be increased to 2,000 sq km (through land reclamation) at reasonable cost, and could be increased further at higher cost. 10/ It should be noted that at present Palestinians do not control the totality of the available land in the West Bank and Gaza Strip. Palestinian sources have estimated that, by 1995, Israel had confiscated or otherwise controlled 73 per cent of the total land area of the West Bank and Gaza Strip combined. 11/

Relative to neighbouring countries, the West Bank and Gaza Strip receive a good quantity of rainfall. It is estimated that 68 per cent of the land surface receives an average annual precipitation of over 300 millimetres.12/ However, the quantity of rainfall varies considerably between seasons and regions. The bulk of the rain (75 per cent) falls during just four months (November-February), with an intensity that declines from its highest level in the northern mountain areas to its lowest level in the Jordan Valley and the southern part of the Gaza Strip. Of greater importance is the variability of rainfall from one year to the next, which renders the long-run average misleading. In some recent bad years, the quantity of rainfall did not exceed 25 per cent of the average, whereas it can be as high as 160 per cent of the average in good years. 13/

As a result of these fluctuations, farmers cannot depend on collecting and storing water for irrigation purposes. Instead, they must depend on groundwater sources for irrigation. The annually renewable water that is available as ground and spring water is estimated at around 600-800 million cubic metres (MCM) in the West Bank, and between 50-70 MCM in the Gaza Strip. Use of water by Palestinians in the two regions is estimated at about 200 to 230 MCM annually. The rest is used in Israeli settlements and in Israel proper. 14/

2. Human resources

It is widely considered that the most impressive asset of the Palestinian economy is its human resources. Throughout 50 years of conflict, dispersion and occupation, Palestinians have exhibited resilience and resourcefulness, and sustained a strong commitment to education. Palestinians are considered to be relatively well-educated, as measured by literacy rates, years of schooling completed, and enrolment rates (see Table 1).15/ Ironically, perhaps the only “advantage” of being a Palestinian refugee after 1948 was access to relatively modern primary and secondary education provided by the United Nations Relief and Works Agency (UNRWA). By most estimates, Palestinians have one of the highest ratios of university graduates to population in the region. 16/

These achievements, however, represent more of a potential asset for future economic development than a real resource already optimally allocated. The restrictive economic environment since 1967 has subjected Palestinian labour force development to many constraints upon growth and productivity. During the last decade, the natural growth of the labour force significantly outpaced the growth of employment opportunities. This compelled many to seek work outside the territory, forced others into prolonged unemployment or underemployment and discouraged some to leave the labour market altogether. As a result of these factors, the size of the active Palestinian labour force has been depleted.

The overall labour force participation rate (the proportion of the labour force to total population) has not risen above 21 per cent over the last five years (calculated from Table 2), whereas it stands at 25 per cent in Jordan and 40 per cent in Israel. 17/ Moreover, the crude activity rate is quite low (see Table 3). Out of an estimated 894,100 persons of 15 years of age or older, 38 per cent were economically active (including those workingin Israel). The crude activity rate for females is very low (and much lower than in other Arab countries), i.e. 9.1 per cent and 1.9 per cent in the West Bank and Gaza Strip, respectively. Male participation rates did not show much change in the last decade. In fact the 1993 rate of 72.7 per cent in the West Bank is identical to its average over the period 1987-1991, whereas in the Gaza Strip the 1993 rate (67.7 per cent) was marginally less than the average of the previous period (68.8 per cent). 18/

Two other important features of the labour force stand out. First, the average years of schooling for men aged 18-64 years has increased in the last decade, causing an increase in the participation rate. 19/ Second, around one third of the labour force is still employed in the agricultural sector and in unskilled occupations, while the percentage of workers in jobs requiring high technical skills has decreased slightly in recent years.

Another important aspect of the labour force which has been adversely affected by the lack of an enabling economic environment is its productivity. It is obvious that the productivity of labour depends mainly on the quantity and quality of the capital it works with, and the availability of a support system offering vocational and technical training. In the Palestinian case, both of these factors have been in a very poor condition over the last two decades, due especially to the sluggish growth rate of both private and public investment, which has led to stagnation in productivity growth, especially in industry. 20/ A large investment programme to augment the capital stock in both the private and public sectors, along with the establishment of training schools in priority areas, would contribute significantly to raising the productivity of labour.

While the low level of labour productivity is the principal reason behind the low standard of living in the Palestinian economy, the effects of prolonged high unemployment and limited labour force participation cannot be overlooked. For instance, it may be calculated that had the Palestinian economy exhibited the same rate of employment and labour participation as in Israel in 1993, its GDP per capita would have been greater by 150 per cent. 21/ If the Jordanian rates are applied, Palestinian per capita GDP would have been greater by 80 per cent.

3. Capital

During the 1970s and 1980s, the Palestinian economy witnessed a relatively large movement of capital inflows and outflows. The former arose from incomes of Palestinian workers in Israel, remittances from migrant Palestinian workers in the Gulf States, and from Arab and foreign financial assistance. Capital outflows constituted a transfer of savings from the territory to neighbouring economies and abroad, as their productive utilization was inhibited owing to poor financial intermediation in the economy and the uncertain, turbulent, policy environment. As Table 4 demonstrates, net capital inflow in the 1970s was higher than the average for neighbouring countries. This has continued to be the case in the 1990s, but with a marked change in the composition of the flow.

Income of workers in Israel and remittances from workers in the Gulf region have declined significantly since 1990, owing to the dramatic drop in the number of Palestinians working in these two major markets, which together employed almost half of the manpower from the territory by the end of the 1980s. On the other hand, foreign assistance has increased with the establishment of the PA. 22/ At the same time, there are indications that some of the accumulated capital of Palestinians abroad has started to flow into financial institutions established since 1993 to fund new investment projects, though reliable data is not yet available. 23/ Meanwhile, the rapid growth of modern Palestinian banking services since 1994 has slowed the outflow of savings. But the potential role of domestic capital and financial institutions has yet to be realized. While the prospects for the movement of capital are hard to forecast, inextricably linked as they are to future political developments, the following outlook seems reasonable under present circumstances.

First, resources arising from net factor income and workers' remittances will fluctuate around their present levels, and it is unlikely that the high levels of the 1980s will be regained in the near future. Second, official aid will become less significant and less certain after the transfer of the pledged amounts for the period 1994-1998. Though this process has already been signaled at the December 1997 meeting of the Consultative Group of Donors, official aid flows, including a larger loan component, are expected to continue for several more years at least. Third, the main source of capital inflow in the future will have to be accumulated Palestinian savings abroad and foreign direct investments (FDI) from Arab and non-Arab sources. While there is no accurate estimate of the size of the former source, one conservative forecast would be that Palestinian expatriate capital resources potentially available for domestic investment are between $4 and $5 billion. 24/ Bearing in mind that total foreign assistance pledged over five years is $2.4 billion, this represents a relatively large source of private capital for domestic investment purposes.

C. Economic structure

In the light of the above, it is clear that the Palestinian economy is operating substantially below its potential. This situation is due mainly to the following factors:

* The legacy of an inhospitable environment featuring a poor infrastructure, weak public services and obsolete legal and institutional frameworks.

* An economic orientation of asymmetric market relations with one partner, heavy dependence on the export of labour services, and vulnerability to external shocks and political instability.

Estimates of GNP per capita in the Palestinian economy place it within the group of lower middle-income countries. For instance, estimates of gross national product (GNP) per capita range from $1,323 to $1,696 for 1993, while the average for lower middle-income countries for the same year was $1,590. 25/ Table 5 presents some basic aggregate indicators of the Palestinian economy and selected neighbouring countries (Egypt, Israel, Jordan, Syrian Arab Republic). It shows that, while Palestinian per capita GNP is higher than in Egypt and Jordan, it amounts only to 12 per cent of Israeli per capita GNP. These comparisons should be considered with a caveat. The per capita measures are converted from local currencies to the dollar by using the nominal exchange rate, and thus ignore differences in domestic price levels between countries. Allowing for these differences is likely to make the Palestinian per capita GNP close to that of Egypt and Jordan and probably to 30 per cent of that of Israel (see also chapter V on this problem).

Bearing in mind that donor aid will soon decline, and that access to work in Israel remains highly dependent on the volatile political and security situation, 23/ action is called for to address the problems that emerge in this respect. This brings to the fore the need for efforts to adopt policies and measures that place the economy on a path leading to the following goals:

* Optimal use of natural resources: to be encouraged by adopting policies that expand supply and rationalize demand.

* Overhaul of the legal and institutional settings: this is needed to modernize laws and create an enabling environment for private sector activities.

* Expansion and diversification of production and trade: a reorientation of production and correct public policies can go a long way in supporting and enhancing the effort. Policies and measures that foster macro stability and micro efficiency would help to expand the economy, whereby part of the increased income is saved to finance investment and part of production is exported to finance imports.

Achieving these goals depends to a large extent on reorienting away from one predominant market towards greater integration with regional and global markets. This is the main focus of this study, as introduced in section D below and explored in greater detail in the following chapters.

D. The comparative position of the Palestinian territory vis-à-vis Arab neighbours, Israel and major international economic groupings

The preceding sections have shown that the Palestinian economy is small in size, poorly endowed with natural resources and currently featuring serious distortions and disequilibria which inhibit growth and development. Yet, as the UNCTAD secretariat intersectoral research project on prospects for the sustained development of the Palestinian economy has revealed, it is reasonable to expect sustainable growth once regional peace is achieved.26/ A combination of a geopolitical position of strategic importance, relatively high quality human resources and sound economic management could be decisive in overcoming the fragility and structural deformity of the economy. It is unlikely that significant foreign investment will be attracted to the region as long as the Palestinian economy is burdened by uncertainties arising from constraints on political rights, economic choices and territorial integrity. 27/ A peaceful future for the region could position the Palestinian economy as a transit site for trade and investment. Its advantages in this respect include the following:

* A relatively well-educated labour force;

* An aggressive and diversified entrepreneurial class that has strong extensions into wealthy expatriate communities and corporate structures in the Arab countries as well as in Europe and North America;

* Experience in trading with both the Arab countries and Israel, with a versatility acquired through operating in non-optimal circumstances;

* A readiness to open trade with other countries in the region, given that it does not have a large industrial base to protect; and

* Free trade arrangements with both the European Union (EU) and the United States.

Exploiting these important leverages within the framework of a well-defined development strategy could make the Palestinian economy an attractive place for investment. It offers a suitable place for producing both labour - intensive products targeting the Israeli, European and American markets, and skill-intensive products designed according to the specific demands of Arab markets. In addition, its distinctive religious and cultural heritage could easily allow it to become a centre of international and regional tourism, catering to both religious and recreational tourists. The holy shrines in Jerusalem, Hebron and Bethlehem have unique attractions for Muslims, Christians and Jews alike. The moderate Mediterranean seaboard climate, as well as the unique environment of the Dead Sea and Jordan River valley, offer Arabs residing in less hospitable climates a nearby site for pleasant vacations. 28/

The paucity of natural resources and the abundance of human resources point to the desirability of adopting a development strategy that maximizes human capital assets. Sound and innovative management should take advantage of changes in the global economy, which have rendered human talents more important than the traditional assets of natural resources and physical capital. Changes in modes of communication and transportation have extended trade to many service activities, which offer the Palestinian economy great opportunities. 29/ Palestinians outside the West Bank and Gaza Strip have had great success in these fields, and it is sensible to use their talents to integrate the service sectors of the Palestinian territory into the world economy.

A comprehensive strategy is required, aimed at focusing on long-term goals, and detailing the sequences to be followed in order to achieve the objectives outlined above. The elements of such a strategy are identified in the following chapters.

Chapter II

STRUCTURE AND PERFORMANCE OF THE PALESTINIAN ECONOMY

The preceding chapter has highlighted important aspects of the endowment of physical and human resources in the broad context of the Palestinian economy. This chapter elucidates some of the critical economic issues pertinent to both the present situation and the priorities of reconstruction and development in the coming years.

The following section presents a brief review of economic performance in the 1990s. Aggregate trends in production, employment and trade are depicted, underscoring internal and external imbalances and displaying the vulnerability that exists to external shocks. These macroeconomic imbalances, which reflect distortions and fragmentation in markets at the micro level, are examined as they relate to the four main sectors: agriculture, industry, construction and services. The salient features of each sector are outlined, and policies and strategies for improvement are discussed within the context of integration with markets at the subregional, regional and global levels. The final section of the chapter is devoted to problems in infrastructure and public utilities.

At the outset, a word of caution is in order concerning the data used in the study. Statistical data covering various aspects of Palestinian socio-economic sectors in the West Bank and Gaza Strip until 1994 suffer from major inconsistencies and variations corresponding to their different sources and methodologies. 30/ The situation became even more problematic in the 1990s owing to difficulties encountered in the compilation of data at the field level since the intifada. Furthermore, the transfer of responsibility since 1994 for statistical compilation and analysis from the Israel Central Bureau of Statistics (ICBS) to the Palestinian Central Bureau of Statistics (PCBS) has implied the adoption of a comprehensive and very different statistical approach. Since 1993, different Palestinian, Israeli and international estimates of major socio-economic indicators have been available, based on incomplete or inconsistent data sources, often lacking time-series applicability and with sometimes wide disparities in absolute and relative terms.

In its four years of operation, the PCBS has made unprecedented efforts to fill the data vacuum in most spheres of Palestinian social and economic life, with impressive results so far. It has conducted sectoral surveys and published many reports on demography, the labour force, household expenditure patterns, consumer price indices, industry and establishments and basic indicators of education. To the extent possible and relevant, statistics from those reports are used in this study. The PCBS has also started work on the construction of a national accounts series for the Palestinian economy, based on a consistent method for estimating value added in agriculture, and comprehensive censuses of establishments in manufacturing, services and construction, as well as public sector activities. Based on preliminary findings, the PCBS published national accounts estimates for 1994, which were at significant variance with most current international estimates. The PCBS also completed in late 1997 the first-ever Palestinian population census, from which important findings are expected. As the PCBS consolidates its position as a reliable and authoritative source of statistics on Palestinian socio-economic realities, other estimates are resorted to, but should continue to be treated with caution.

A. Economic performance in the 1990s

The economy of the West Bank and Gaza Strip entered the 1990s in a dismal condition. The Gulf crisis of 1990-1991 dealt the economy a severe blow that afflicted all sectors and activities, bringing main indicators down from pre-1990 highs (which the economy has only recently regained).31/ This entailed changes which fundamentally altered the direction and structure of Palestinian economic development: loss of employment for many thousands of Palestinians in the Gulf, disruption of trade with once-significant Gulf markets, losses in domestic production due to security measures, and a precipitous drop in official and private financial flows from the region. This external shock sent the economy into a tailspin resulting in widespread unemployment.

However, the economy started to recover slowly in 1992, with increases in production, employment and trade. The recovery was fuelled by a surge of private investment in residential construction, and by a sizeable increase in government investment and exports (see Tables 6 and 7). But this revival was short lived, as a fresh reversal occurred in 1993, when most expenditure categories registered negative annual percentage changes in real terms (see Table 8). In this case, the external shock came from the closure of external borders (especially with Israel) and restrictions on movement within the territory. These measures were first introduced in early 1993 and continued intermittently through 1995 and, with renewed intensity, in 1996-1997.32/ The rupture in the flow of labour and merchandise, added to the increased uncertainty and risk, reduced economic activities across the board.

Both GDP and GNP for 1993 declined in real terms, estimated at 1.3 and 10.7 per cent, respectively. This decline occurred in spite of the continuing strong performance in the construction sector, especially in the last quarter of the year following the signing of the Israeli-Palestinian accords. The decline in agricultural production, due to a poor olive crop whose cyclical behaviour has always widely affected the economy, contributed to the slowdown. The sluggish revival of economic activities in 1994-1995 was due mainly to increased government and private activities associated with the establishment of the PA, the removal of many pre-1993 restrictions on business activities, continuing strong growth in residential construction and a modest rebound in agricultural production owing to a good olive crop in two successive years.

The cumulative effect of these factors allowed for growth in real GDP, estimated at 7 per cent in 1994 and 3.5 per cent in 1995. Nevertheless, the adverse impact of a continuing decline in net factor income from work in Israel implied lower GNP growth rates and low GNP per capita growth rates as well. The length and intensity of these closures increased considerably in 1996, with GDP that year estimated to have fallen by between 5 to 15 per cent. 33/

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 is a range of infrastructural, institutional and procedural impediments to free access to export markets, as against 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 Palestinian export capacities.

This may be most graphically illustrated by a comparison of estimated data for 1996 with the figures for 1981, the year in which Palestinian export performance was at its strongest amidst steady economic growth (see Table 9). 34/ Total merchandise exports in 1996 are estimated at $266 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 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 to exports.

Another feature of the deterioration in Palestinian external trade is the almost total concentration of trade on one partner. Whereas trade with Israel in 1981 accounted for 85 per cent of total Palestinian imports and exports, by 1966 that proportion stood at around 90 per cent. While in 1981 a total of $111 million, or 28 per cent, of exports were destined for Jordanian, other Arab and international markets, by 1996 these markets absorbed $31 million, or only 12 per cent, of Palestinian exports. Thus, from a small trade surplus ($33 million) with markets other than Israel in 1981, the Palestinian economy in 1996 had a $144 million trade deficit with the rest of the world, and a $1,315 million deficit with Israel.

B. The distorted macro-structure

Underlying the poor economic performance outlined above are three major macro-imbalances, which have prevailed for the last two decades. 35/ First, there is a resource gap, displaying a large import surplus equivalent to 40 per cent of GNP in 1991, and an average of 33 per cent over 1992-1996. This recent decline should not necessarily be interpreted as indicating an improvement in the resource gap, as it does not stem from a faster increase of exports over imports. Rather, it manifests a contraction in both exports and imports.

This is evident from another expression of the resource gap - the investment surplus (Investment - Saving) - which has steadily increased over the whole period due to the sustained decline in net factor income which has adversely affected savings. 36/ Whereas net factor income was equivalent to 33 per cent of GDP in 1992, this ratio fell to 22 per cent in 1993, 16 per cent in 1994 and 10 per cent in 1995. 37/

The second macro-imbalance, which has paralleled the first, is related to the labour market. This exhibits a chronic inability to provide a satisfactory level of employment for a (potential) labour force growing at a strong rate. As may be calculated from Table 10, the domestic market provided employment for an average of only 57 per cent of the labour force during the period 1991-95. The rest of the labour force was either unemployed or employed only partially in Israel. 38/

These two imbalances demonstrate the extent to which the Palestinian economy is vulnerable to external shocks, especially those originating in Israel. The third imbalance involving government expenditures and revenues reveals the degree of dependence on external financial assistance, and is reflected in a large deficit in the PA budget, which reached 37 per cent of the total budget, or 7 per cent of GDP, in 1995 (see Table 11), but has been brought down since. This deficit, amid a host of other political and economic constraints, further complicates the task of the PA, particularly since the deficit is driven mainly by current, rather than investment, expenditures.39/ The main reason for the deficit lies in the low level of tax revenue. This amounted in 1995 to 10.5 percent of GDP, whereas it is around 19 per cent for countries with a comparable GDP per capita. 40/

The Palestinian administration faces extraordinary difficulties in collecting taxes, many of which were introduced during the pre-1994 period and continue to be perceived unfavourably by the public, while some important foreign trade taxes are not recovered from Israel under present arrangements. One study estimates this fiscal leakage to have reached around $150 million in 1995, and it has been reported as high as $250 million in 1997.41/ This is one important area where new arrangements between the PA and Israel might be considered to address this leakage, while also highlighting the importance of tax coordination and revenue recovery at the subregional and regional levels.

C. Sectoral development prospects

The macro imbalances outlined above are the aggregate expressions of distortions and fragmentation at the sectoral level. The inability of the Palestinian economy to provide reasonable employment for its labour force, adequate savings for investment and sufficient revenue for its public sector expenditures reflects a fundamental structural deformity that has prevented agriculture and industry from evolving along “normal” paths of development. Had the economy developed along the lines experienced by comparable economies, industry’s share in GDP over the last three decades would have grown steadily instead of stagnating at 8 to 10 per cent. In similar economies, industry accounts for as much as three times its share in the Palestinian economy (see Table 13). While recent PCBS data indicate that industry actually may account for up to 14 per cent of Palestinian GDP (in 1994), these preliminary data do not reveal a degree of significant growth in industry’s share that would confirm a trend of structural transformation. 42/

Concurrently, development in agriculture would have reduced the sector’s share in GDP to about half its present level (the average share over 1992-1995 was around 30 per cent, though preliminary PCBS data indicate that agriculture’s share may have declined to 15 per cent in 1994).43/ Such a decline would have been accompanied by a large increase in productivity and production, thus releasing a sizeable amount of labour to industry and services. The timing, sequence, and stages of the Palestinian reconstruction and development programme, therefore, should be formulated and directed towards creating an enabling environment within which the structural imbalances could be gradually removed. These would be replaced by more vigorous sectoral articulation that would move the economy along a path of sustainable growth and development. 44/

Guided by these considerations, the following paragraphs highlight policies and strategies essential for the development of major economic sectors.

1. Agriculture

The agricultural sector in the West Bank and Gaza Strip is of critical significance for both the short- and long-term prospects of the reconstruction and development effort. This is due to the relatively large size of the sector and of a rural population still partially dependent upon it, and to the important role it can play in redressing sectoral and structural distortions.

At present the agricultural sector employs around one quarter of the labour force, and contributes approximately one quarter of GDP (in this averaging PCBS and other estimates) and one third of exports. Given the importance of this sector, it is evident that an essential part of the effort directed at alleviating the problem of unemployment will depend on expanding agricultural activity, both horizontally and vertically. Such an expansion is needed also for its direct positive impact on the reconstruction programme in its early stages (in terms of employment generation and food security).

This will entail an increase in food production to meet the growing demand for food arising from the increase in both population and income, thus reducing pressure on real wages and on limited foreign exchange reserves. In addition to increasing food production, the expansion would also increase the supply of raw materials to other sectors, especially industry, which can easily develop viable processing of agricultural output. Provided the public sector plays an appropriate facilitating role, such an expansion can be carried out mostly by the private sector applying a combination of traditional labour-intensive and, in selected branches, capital-/technology-intensive production techniques. The following points summarize the priority policy measures needed to stimulate agricultural development in the coming stage:45/

(a) Development of a new legal framework for the ownership of land, zoning ordinances, tenancy and inheritance rights, allowing for a certain measure of reform of agricultural organization and consolidation of production;

(b) A comprehensive overhaul of agricultural infrastructures with a view to improving their effectiveness. Rehabilitation and reconstruction are urgently needed for agricultural roads, artesian wells, springs and cisterns, as well as a supply of electrical power at reasonable prices;

(c) A concerted effort to upgrade and expand the agricultural education institutions so as to maximize their efficiency and increase their orientation toward local needs. Improving the technical skills of labour is of crucial importance, especially in the areas of water conservation and irrigation techniques, and the application of fertilizer and other chemicals used in agriculture. Equally important is the development of management skills, including the use of proper cost-benefit methods;

(d) Establishment of an institutional framework to orchestrate the efforts of different official and private bodies providing credit and financial services to farmers at low cost; and

(e) Public sector efforts to improve both marketing facilities and access to foreign markets. Upgrading cold storage, packing and grading facilities, and quality control is of crucial importance. A parallel effort to create institutional arrangements for trade promotion and facilitation is needed to help farmers to export.

Concerted efforts along the above lines would enable the agricultural sector to fulfil its short- and medium-term roles in the reconstruction programme: the expansion of agricultural production, the employment of more labour, regaining some share of lost foreign markets and facilitating access to new ones. The latter objective is gaining in importance and requires not only increased access to the Israeli market but also to the markets of the Gulf States and those of the EU (these issues are discussed more fully in chapters IV, V and VI). 46/ Thereafter, the stage is set for agriculture to fulfil its long-term role of supplementing and enhancing growth in industry. To realize this would require a significant increase in agricultural productivity through mechanization and greater use of scientific methods. This change would gradually move the sector towards high-value and low-water intensive crops, and by doing so release skilled labour to industry while bringing about a corresponding increase in rural demand for industrial products.

2. Industry

The structural deficiencies of the Palestinian economy are exemplified by the condition of its industrial sector. At present it contributes significantly less than industry in comparable economies, while the sector is fragmented and dominated by small-scale workshops that account for 16 per cent of total employment, signifying a very low level of productivity.47/ Clearly, rectifying this situation is a major task of the reconstruction process, involving a huge infusion of investment in the sector from both domestic and external sources. The ability of the Palestinian economy to attract and absorb such investment will depend mainly on the following factors:

(a) A legal framework within which firms have secure property rights and are able to compete in an atmosphere conducive to efficient allocation of investment. Although the PA has frequently voiced its commitment to a free market environment, its performance in the last three years has not fully reassured investors. The licensing since 1995 of some firms with monopoly power in specific branches, partially owned by PA agencies, was construed by observers as an unwelcome sign of powerful rent seeking tendencies.48/ The involvement of the PA in market operations, albeit through recognizable intermediaries, has in some cases blurred the distinction between the private and public sectors, with adverse implications for efficiency and growth. It is now recognized that such practices must be curtailed, and the PA has pledged that its involvement in private sector activities will be phased out by the end of 1999. 49/ The PA can fruitfully concentrate on creating what may be referred to as a “level playing field”, providing a strategy to attract investment and reward efficiency, thus also increasing public revenue through the usual fiscal instruments.

(b) Private capital, whether from domestic or external sources, is attracted by profit, which in turn is heavily influenced by the quantity and quality of public and human capital. Accordingly, it is reasonable to expect that investment in the industrial sector would be contingent on advancement in rehabilitating the physical and social infrastructures. Of equal importance in the longer term is remedying the deficiencies in the educational system and substantially increasing the technical skills and scientific expertise of Palestinian manpower.

(c) Another important factor that influences the profitability of investment, and hence attracts private capital, is the nature of the domestic market. Given the small size of the Palestinian market, its integration in regional and world markets has significant implications for investment, in industry as well as in ancillary services.

3. Services

The services sector is expected to play a pivotal role in the growth and development of the Palestinian economy. It has two major potential functions: fostering growth in agriculture and industry, and generating its own growth by enhancing activities in trade. The former function is related to the need to significantly improve and expand certain branches in producer services whose contributions are essential to facilitate the projected increase in agricultural and industrial production. These branches include transport, engineering design, communications, software and financial services. The latter function takes advantage of the new trading opportunities in international business arising from the twin processes of technological advancement in communications and the continuous integration of markets into a globalized world economy. Guided by these two functions, the following paragraphs highlight some priority areas in major branches of the Palestinian services sector.

(a) Trade

Revitalizing the trade sector and providing it with all the necessary ingredients to act as an engine of growth will depend critically on two sets of strategic choices. First, those made in the domestic economy with the aim of increasing production capacity and supply responses to opportunities in world markets; second, choices for increasing accessibility to foreign markets by means of unilateral, bilateral and multilateral measures. The former concerns will be discussed under section D of the next chapter. The latter considerations will be analysed in chapters IV, V and VI. It is worth mentioning here, however, that the transborder flow of services between the Palestinian territory, Jordan, Egypt and Israel represents an important part of the interaction required for successful development of the Palestinian economy, as well as a viable area for regional cooperation.

(b) Transport and communications

For almost three decades, the transportation system in the Palestinian territory has had to rely on the private sector. The role of the public sector was relegated to that of regulating private transport and the provision of some basic infrastructure. 50/ As a result of this unusual situation, and given the general stagnation in the economy, investment in renovating and maintaining the system has been almost non-existent. At present, major roads are in such a bad condition that most of them are in need of reconstruction. The following are priority tasks, without which the transportation sector will continue to present a formidable impediment to the reconstruction effort.51/

(i) Rehabilitation and improvement of the road network with the aim of elevating the quality and quantity of the transport system so as to meet the economic needs of expanding both internal and external trade;

(ii) Establishment of a rural network to overcome decades of neglect and to facilitate the villagers' access to markets and urban centres.

(iii) Introduction of new traffic flow schemes to deal with increasing congestion in urban areas, ensure safety standards and secure smooth passage for people and goods between the West Bank and Gaza Strip.

(c) Tourism

As indicated in the previous chapter, the tourist industry stands to gain significantly from the conclusion of the peace process and the normalization of Palestinian-Arab-Israeli relations. Opening borders with the Arab countries is expected to bring a marked increase in both religious and recreational tourists. Normalization of relations with Israel would certainly result in a greater proportion of tourists visiting Israel (currently more than 2 million a year) and also visiting Palestinian sites. For such expectations to materialize, efforts and resources must be mobilized to meet the needs of this sector.

First, the private sector will be unable to carry out such a task successfully unless the Palestinian public sector provides an effective support system. This should focus on the enlistment of all governmental departments in a concerted effort aimed at attracting both domestic and foreign investment into hotels, tourist villages, restaurants and places of entertainment. Second, coordination with neighbouring countries is needed to establish a regional tourism framework to take advantage of wider markets and economies of scale. These two tasks have to be carried out simultaneously, and should be geared towards increasing the number, and upgrading the capabilities, of tourist guides, and establishing modern tourist information centres.

(d) Construction

Significant improvements in both demand and supply conditions are expected to enable the Palestinian construction sector to continue to perform a leading role in the first stages of the reconstruction and development process. A considerable increase in demand for construction activities is anticipated from both the public and the private sectors, and has, in fact, already begun to materialize. The former is associated with construction activities involved in rehabilitating infrastructures and resettlement of refugees, a process that will last for several years. The latter is anticipated to arise from a surge in residential housing demand, reflecting an increased confidence in the peace process, and the housing needs of Palestinian returnees. The supply response is also expected to be improved greatly as a result of the gradual opening to markets in neighbouring countries. This would allow Palestinians to import building materials at lower costs, and would increase competition in the sector as Palestinian expatriate companies are allowed to conduct business in the territory.

Construction activities will also encourage investment in related branches, especially quarrying, building materials, wood and furniture, and electrical facilities, while increasing demand for professional services in engineering, architecture and finance. It should be emphasized, however, that construction activities financed by the public sector (or by an international assistance programme) should be allocated to private sector firms with full regard to both efficiency and transparency.

D. Infrastructure and public services

After many years of neglect, physical infrastructures are in a very poor condition, including the road networks, artesian wells, reservoirs and springs, electricity networks and waste-water and sewage disposal facilities. All of these are in need of a comprehensive rehabilitation and reconstruction programme, a process which commenced with donor aid after 1994. Expansion of both agricultural and industrial production depends critically on the pace at which such a programme is implemented. 52/ Public services are entirely inadequate and remain well below those of neighbouring countries. The average water supply in urban areas is about 60 litres per capita per day compared to 115 for Tunisia, 137 for Jordan and 230 for Egypt. Electricity consumption is about 680 kWh per capita per year compared to 815 for Egypt and 1,055 for Jordan. Moreover, the Palestinian territory has neither modern sanitary landfills, nor adequate solid waste collection. Refuse is simply dumped outside municipal boundaries, causing serious health and environmental problems; when solid waste is burned to reduce its volume, this causes air pollution. 53/

Similarly, provision for social services covering school buildings, hospitals, health clinics, libraries and laboratories is inadequate and in urgent need of improvement. Inefficiency in these services is partly explained by the fact that they are produced privately, notwithstanding their nature as a “public good” and social cost considerations. For example, Palestinians spend about 7 per cent of GDP on health services, an unusually high share, but receive in return relatively inadequate health care.54/ This is one, less commonly considered, area in which regional cooperation could substantially lower the cost and increase the efficiency of both physical and social infrastructures.

Chapter III

THE PALESTINIAN ECONOMY IN THE REGIONAL AND GLOBAL CONTEXTS

During the 1970s and 1980s, the Palestinian economy grew mainly by exporting labour services to Israel and Arab oil-producing States, but for various political and economic reasons, the demand for these services diminished in the 1990s, a declining trend that shows no signs of reversal. Accordingly, the future growth of the Palestinian economy will depend crucially on its success in ensuring a better mobilization of natural, human and financial resources and expanding its exports of goods and services.

This calls for a comprehensive restructuring of the economy that achieves simultaneously a considerable enlargement of its productive capacity and a major reorientation of its external relations. This would entail diversifying trade flows into regional and international markets and no longer relying exclusively on a single trading partner. Achieving these goals involves all aspects of integrating a poor, less developed economy into markets with varying degrees of development. By and large, while the process of integration brings medium- to long-term benefits, it also entails immediate and short-term costs. The former include lower transaction costs, economies of scale and specialization and the discipline of competition associated with larger markets. The latter, however, involve unemployment and major human resource and productive dislocation, reduced autonomy in policy-making, and other transitional costs.

Much experience has shown that pursuing the integration process in an all-pervasive and hasty manner results in heavy costs and small benefits, thus undermining, if not aborting, the process. Alternatively, the process can be carried out in selected areas or sectors, and gradually, with clear sequential stages that allow adequate time for the development of a domestic economic environment fostering outwardly oriented business establishments. This would help to realize the full potential benefits of integration with an acceptable and manageable level of costs. The crucial issue that has to be considered is the identification of the areas and stages to be followed so that integration can be carried out smoothly and without harmful disruption. In the Palestinian context, this acquires added importance, given the present structure of production, employment and trade, because distorted markets magnify the costs of integration and prolong the time span required for its benefits to materialize.

Accordingly, the Palestinian economy needs to ensure certain prerequisites before, or as the initial phases of, its movement towards integration with wider markets. These involve a major improvement in the physical, legal and economic frameworks. But this cannot be achieved without the guidance to be obtained from a vision of the future place of the Palestinian economy in its regional and global contexts. Consequently, it is necessary to articulate a suitable strategy aimed at integrating the Palestinian economy into neighbouring and international markets, with a view to attracting investments and ushering in new growth opportunities based on comparative advantages and economies of scale. For such a strategy to be successful, it has to be grounded in the priorities of the Palestinian reconstruction and development programme over the medium and long term.

This chapter explores these issues at both the conceptual and the empirical level. Section A is devoted to analysing the conceptual framework of economic integration. It examines issues arising from the relation between multilateral trade liberalization and regionalism, and then considers the different stages of regional integration. Section B examines the application of the conceptual framework to past and present experiences of economic integration in various regions of the developing world. Section C reviews the experience of integration specific to Arab countries, while section D considers economic integration from the perspective of the Palestinian economy.

A. The conceptual framework of economic integration

Articulating a strategy for integrating the Palestinian economy into world markets requires an appreciation of two issues. First, the question of dimension concerns the available routes for integration: bilateral, regional and global. Second, the issue of stages concerns the proper sequencing of the three basic components of integration covering trade in goods and services, movements of capital and labour, and harmonization of economic policies.

1. Dimension

The strategic goal envisaged for the Palestinian economy, as elaborated by policy makers and most commentators, is integration into world markets, in line with trends in the region and globally. In this case, as in others, this raises the question of whether or not integration at the subregional and regional level is a step towards that goal or a step away from it?

In the 1960s and 1970s many regional cooperation arrangements among developing countries, especially in Latin America and Africa where they were aimed at economic integration, were considered as moves away from integrating the participating countries' economies into world markets. Most of these arrangements were based on the premise that member countries could achieve industrialization and growth by creating a wall of protection around their combined markets and allowing a strict import-substitution approach to development. The arrangements were, in effect, an application of an inward-looking approach to development on a scale larger than the national state. They were bound to fail, as they did, once the limitations of that strategy became self-evident. 55/

In contrast, a new view of regionalism has evolved since the late 1980s in which regional integration is considered as one of the options available to developing countries intent on coordinating and rationalizing their joint industrial growth through the adoption of a combination of outward- and inward-looking trade policies. Basically, regional integration is sought in order to ensure a larger market supportive of more efficient production units, which in turn allows the region to pursue a viable export-promotion strategy of development, and, where needed, import-substituting industrial activities are carried out at minimum cost. Regional integration may be undertaken after major structural economic reform is introduced in each member country, and where a commitment to maintain the course aspiring to greater micro-efficiency and macro-stability is backed by sufficient political resolve.

From this angle, the multilateral system of the World Trade Organization (WTO) may be viewed as a supportive system for the regional arrangement rather than a competing approach to trading relations. Adhering to the WTO framework, which promotes rules-based trade policies, allows regional integration to be pursued without adverse impacts on trade relations with the rest of the world, and Article XXIV of the WTO Charter explicitly addresses this. 56/ Furthermore, the larger market created by regional integration can open up new opportunities and challenges that induce other countries and regional blocs to move towards more liberal trade policies. Indeed, the evolution of the multilateral trading system (GATT) is seen to have been influenced by the advances in European regional integration efforts.57/ Regional integration among developing countries can also empower members to deal more successfully with discriminatory trade practices of third-party trade partners, 58/ and to adjust more smoothly to changes brought about by new WTO trade liberalization measures.

In this light it is reasonable to state that developing countries can seek regional integration as a mechanism to move their economies towards integration with the globalized economy, while still providing them with enhanced means for dealing with the impact of globalization. The following paragraphs list some of the specific opportunities and advantages offered by the regional route:

! *Regional integration can lead to improved infrastructures and thus enhance production and trade*. Some of the main infrastructures related to water, environmental management, energy, communications and transportation cannot be carried out without the cooperation of neighbouring countries. Projects of this kind usually have high returns and greatly contribute to rationalizing production and facilitating trade.

! *Regional integration can result in gains from economies of scale and reduce the need for protection.* The enlarged market allows each constituent economy to move resources from small inefficient firms that supplied domestic markets at high cost, into larger-scale, more efficient production units in specialized industries capable of international competition. Larger markets also allow for the emergence of more sophisticated industries that no country can afford to establish on its own.

! *Regional integration can increase intra-industry trade through further division of labour and product differentiation*. Economies of scale arising from enlarged markets can bring about another important benefit by allowing for a further division of labour within industries. Firms can specialize in differentiated products and generate regional intra-industry trade.

! *Regional integration can increase competition and thus enhance the ability of member countries to further international competitiveness*. The removal of tariff and other trade barriers among the member countries increases competition and eliminates the weakest and least efficient establishments, enhancing the ability of the stronger to compete in wider markets. 59/

! *Regional integration increases a region's bargaining power in its trade relations.* The larger market of a regional arrangement offers a better defence against the discriminatory practices of other trade partners. The increased power of integration also enhances bargaining power against non-tariff barriers (NTBs), widely held to be the major remaining obstacle to the further expansion of developing countries' manufacturing exports. 60/

2. Stages of regional integration

The preceding section has listed some of the advantages that a small developing country, seeking to integrate its economy into world markets, stands to gain from following the route of regional integration. These advantages, however, present potential gains rather than guaranteed outcomes. The fortunes of regional integration depend on many interrelated political and economic factors, including choices made concerning the stages of the process and measures taken to consolidate it and ensure its sustainability. The latter are examined in the next section, while the former is the concern of this section.

A country can start the task of integrating its economy with other markets by taking some unilateral steps. These include a non-discriminatory reduction of tariffs, the dismantling of some NTBs and the relaxation or removal of its restrictions on the movements of capital and labour. Countries, however, prefer to ensure reciprocity in their relations with other countries, and enter into agreements with them that spell out the scope and duration of different integration measures. Generally speaking, it is possible to discern three major steps which, alone or in combination, are capable of moving an economy towards greater economic integration with its neighbours.

(a) Free trade areas (FTAs)

This is usually the first step taken on the path of economic integration. Trade barriers among member countries are abolished, but each country retains the right to set its own tariffs and quotas with non-member countries. Examples of FTAs include the European Free Trade Association (EFTA), and the North American Free Trade Area (NAFTA). The most recent example of such an agreement is the Greater Arab Free Trade Area (GAFTA), announced in March 1997.

(b) Customs union (CU)

The second stage of economic integration goes beyond the FTA by setting a common external tariff (CET) against imports from non-member countries. Two prominent examples of customs unions are the Southern African Customs Union (SACU) that includes Botswana, Lesotho, Swaziland, Namibia and the Republic of South Africa, and the Central American Common Market (CACM) that comprises Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. Another successful and still-evolving regional integration arrangement is MERCOSUR (Common Market of the Southern Cone) comprising six South American countries, which has practically achieved the stage of a customs union.

(c) Common market and economic union

This is a more advanced stage of integration as it takes the member economies closer to full integration. In addition to free trade among members, and common external tariffs, a common market sets the stage for the complete withdrawal of restrictions on the movement of labour and capital among member countries. It is thus effectively the first necessary step, albeit over a long period, towards fuller economic union. The European Union (EU) is a common market that is considered to be the most integrated regional group in the world today. In addition to achieving the free movement of goods and factors, the EU has gone further and promoted coordination in economic policies that include some measures of fiscal and monetary policies as well as exchange-rate policy.

Economic union is the final stage of full economic integration ensuing from a common market, and the EU is expected to achieve it shortly when it adopts a single currency and establishes a European Central Bank entrusted with carrying out a union-wide monetary policy. 61/ In what now appears as something of a historical footnote, an early version of economic union was proposed as part of United Nations General Assembly resolution 181 of 1947, which provided for the partition of Palestine and the establishment of an Arab and a Jewish State, joined in an economic union as ambitious as that being forged in Europe.

This picture of a series of stages in economic integration appears both logical and simple; trade, followed by factors and finally policies. But in reality, there is some overlapping among stages, and it is rare for one, not to start until the other has been completed. For instance, removal of barriers to trade to ensure the success of an FTA requires harmonization of policies with regard to subsidies and taxes. More important, following a “bottom-up” approach to integration may be preferable to the “top-down” approach, especially at the subregional level. This calls for coordination and harmonization of policies, in addition to relaxation of the regulations covering the movement of specific factors. An agreement related to textiles and garments, for instance, might be a first step towards the integration of some neighbouring countries, and that requires effective coordination in policies and procedures that straddle the three stages. 62/

B. Experiences of developing countries in regional integration

The results of regional integration among developing countries so far are not very impressive. 63/ In particular, the drive in the Middle East towards economic cooperation among Arab countries has a long, but not very encouraging, record. 64/ Nonetheless, at present there are some successful examples of regional arrangements, whose experience may be contrasted with less successful experiments so as to draw some important lessons therefrom.

A relevant point to emerge from such an analysis is that emphasis on trade liberalization involving across-the-board removal of tariffs among member countries through the formation of a free trade area or customs union only, is not suitable to set the stage for integration. The standard test of success is to measure the extent to which “trade creation” among member markets outweighs “trade diversion” from other markets; in other words, the extent to which the scheme moves the region towards freer (and greater) trade. The suitability of this test, however, depends critically on a set of assumptions which include the full employment of labour, full capacity utilization and, apart from tariffs, the absence of serious distortions in the member markets. Under these conditions, prices reflect real opportunity costs, and market forces can be relied upon to provide the benefits contingent on a move towards freer trade.

But these assumptions are not applicable to most small developing countries, and in particular to most countries in the Middle East. Such countries suffer from chronic unemployment and underemployment, excess capacity, inadequate utilization of resources, and widespread distortions in most markets. Under these conditions, the effects of regional integration based mainly on trade liberalization are at best limited, and at worst harmful: such a path to integration accentuates economic disparity among member countries in a phenomenon known as polarization. 65/ This can occur as the more developed and stronger members of the FTA/CU can reap the benefits of liberalized trade at the expense of the less developed and weaker partners. Disillusionment with the negative consequences of polarization was one of the main reasons for the break-up of many regional schemes in Africa and Latin America. 66/

Designing an effective regional scheme suitable for Middle Eastern countries calls for a more deliberate approach that emphasizes cooperation and coordination among member countries with a view to creating an enabling environment better suited to tackling the fundamental economic problems of the region. Gains from regional integration may be measured by the extent to which the production structure of the region is rationalized, new opportunities for profitable domestic and foreign investment are created and unused resources are utilized. In other words, the “regional union should change the economic conditions in the member countries, so that the test should not be one of trade creation and diversion, but rather of development creation and diversion”. 67/

This approach requires an intergovernmental agreement specifying the appropriate scope of specialization in existing and new industries on a regional scale. Such an agreement constitutes a comprehensive development plan, based on the comparative advantage of the region as a whole and of each member within it, with due consideration for external and internal economies of scale. 68/ Carrying this out involves changing the regional pattern of production, employment and trade, a major task that demands the coordination of economic policies among member countries. Starting off with trade liberalization without coordinating economic policy will not bring about the benefits of a larger market because the principal constraints facing a unified market involving most Middle Eastern countries are policy-related.

The success of regional integration by the Association of Southeast Asian Nations (ASEAN), and post-apartheid southern Africa, is attributed at least in part to the fact that the architects in both schemes rejected the concept of trade liberalization as the chief organizing principle. From the outset, the organizing principle of ASEAN was the adoption of a detailed agreement for “the establishment of designated new plants or industries, coupled with the adoption of tariff or other policy measures to ensure implementation". 69/ To be sure, the success of ASEAN was accompanied by trade liberalization, but it was introduced for industries or group products at different stages, in the context of a planned rationalization of production. 70/

Thus, representing the issue as a dichotomy between import-substitution and export-promotion approaches may create a misconception about the fundamental dynamic at work. It is the degree of complementarity and consistency, rather than conflict, between the two approaches that is a key element in successful development experiences like those of the East Asian countries. In fact, the governments of those countries, in particular the Republic of Korea, used the traditional tools of import-substitution strategy as an inducement and disciplinary apparatus to orchestrate the promotion of exports. 71/

Contrasting the experiences of successful regional schemes with less successful ones points up a second important lesson. It shows that the success of a regional scheme in expanding economic activities and creating new wealth is not enough to ensure sustainability and progress. A fair distribution of benefits among the member countries is as important as creating them. A regional scheme that favours one member at the expense of others is unstable and bound to be dissolved. In this regard three issues have to be considered:

- Harmonization of economic measures among member countries in a regional arrangement can result in favouring one (or some) member(s), especially the more economically advanced. Failure to institute a mechanism whereby adversely affected members are compensated can lead to friction that threatens the proper functioning of the scheme. The South African Customs Union (SACU) tackled this problem by instituting a revenue-sharing formula to compensate the four small members of the union (Botswana, Lesotho, Namibia and Swaziland) for accepting a common external tariff that was designed by the larger member (South Africa) to protect its industries. 72/

- Regional integration may evolve through a proliferation of FTAs such that one country has an individual Free Trade Area (FTA) with each of the other countries in the region, while those countries have no comparable FTA with each other. This kind of an arrangement gives rise to a trade pattern that resembles the "hub-and-spoke" of airline operations. 73/ Obviously, the system confers on the "hub" country the advantage of being able to tailor the individual agreements in accordance with its interest. A "hub-and-spoke" system, moreover, creates a distortion, which is related to the problem of polarization noted above. In this situation, the "hub" country is likely to attract most of the foreign investment as it provides preferential access to all the "spoke" markets. To avoid such negative effects, a small country entering into an FTA with a potential "hub" country can insist on including in the agreement a guarantee of automatic entry for any willing country in the region. 74/

- A regional arrangement is sought for the gains it confers on member countries. Discontinuation of the arrangement, therefore, entails the cost of dissociation, which represents not only forgone gains but sunk costs arising from association. A skewed distribution of these costs among member countries could be a destabilizing factor. A country with disproportionately higher dissociation costs will be vulnerable to others' stronger bargaining power to extract economic or political concessions. A roughly equal distribution of dissociation costs for all members facilitates the building of stable interdependent relations.

It should be emphasized that at present the world economy is undergoing momentous changes. Important political events and rapid technological advances have set in motion a trend towards globalization of markets. This offers unprecedented opportunities in international trade, investment and finance for developing countries that are capable of performing under the discipline of competition and interdependent policy-making. Many countries, especially in East Asia, have been very successful in reaping advantages from globalization and have been able to use integration with the world market as an engine of growth.

An important factor underlying this success has been the ability of the public sector to curtail traditional interventionist activities that constrain the role of the private sector and retard growth, while consolidating its role in those activities that help to create a supporting system assisting the private sector. 75/ Among other issues, the East Asian experience has demonstrated that the relevant issue is not "large versus small" government, but "right versus wrong" roles. Liberalization of trade is not sufficient for an outward, export-oriented, strategy. It needs a supporting system of appropriate infrastructures, an institutional and legal framework and sound economic structure and policy.

A third important lesson that can be deduced from the historical record of attempts by developing countries at regional integration is perhaps the most relevant in the current examination. It is related to the role of politics in determining the fortunes of regional arrangement. Many schemes of regional integration among developing countries have achieved some economic success but were undermined, if not overwhelmed, by political differences among the governments of their member countries, and by political upheavals in some member countries. Both the Central American Common Market (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) and the East African Community (Kenya, Uganda, and the United Republic of Tanzania) were established in the 1960s. They had achieved considerable progress in economic integration until political differences among members disrupted their work, rendered the former ineffective and led to formal dissolution of the latter. 76/ Political considerations have also played a negative role in frustrating various attempts at economic integration among Arab countries, a topic examined in the following section.

C. Attempts at economic integration among Arab countries

For hundreds of years until the beginning of the century, most present-day Arab countries were part of the Ottoman Empire. Economic relations among them were patterned by a relatively easy movement of people, goods and capital. But long before the collapse of the Empire, European economic penetration had changed the orientation of many Arab countries towards trade with Europe, thus undermining intra-regional linkages. That process was greatly intensified and given prominence during the colonial era and until the middle of the century. Having achieved independence separately, at different times and in varied circumstances, each Arab country became interconnected with the world as a separate economic and political unit. A desire to change that and achieve some form of Arab unity has existed for many years at the popular level, alternatively spurred and frustrated by the political turbulence that has prevailed in the region in the post-Second World War period. This aspiration arises from a foundation that embraces historical, geo-strategic, cultural and political dimensions, and continues to feature on the contemporary Arab political agenda, albeit with a form and content that differ significantly from earlier expressions. Since the 1950s, Arab governments have repeatedly agreed upon various common plans for political coordination, often including provisions for economic integration.

The first of such attempts dates back to 1950 when members of the League of Arab States signed the Arab Joint Defence and Economic Cooperation Agreement. 77/ A more ambitious scheme was the Arab Common Market agreement, which was signed in 1964 by Egypt, the Syrian Arab Republic, Iraq and Jordan. This was fashioned after the model adopted by the original six members of the European Economic Community in the 1950s. In 1971 the Council of Arab Economic Unity was created by 11 Arab countries of the League of Arab States. Seven of these formed the expanded Arab Common Market: Egypt, the Syrian Arab Republic, Iraq, Jordan, the Libyan Arab Jamahiriya, Mauritania and Yemen.

While these regional agreements aspired to eliminate all trade barriers among member countries, and move their economies towards the goal of becoming a large single market, little was achieved in the way of increasing intra-regional trade, or rationalizing the productive structure at the regional level. Movements of labour and capital in the 1970s and 1980s became more economically significant within the region than the movements of goods and services. This was typified by the migration to the Gulf States, Iraq, and the Libyan Arab Jamahiriya, of Egyptian, Jordanian, Yemeni, Palestinian and Lebanese workers, and the movement of capital out of the region.

The mid-1980s witnessed the peak of labour migration in the region when there were some 2 million Arab migrants in Saudi Arabia, 1 million in Kuwait, and 200,000 in the Libyan Arab Jamahiriya and hundreds of thousands in other Gulf and Arab countries. 78/ In the 1990s, there has been a considerable decline in the number of Arab migrant workers in the Gulf. This has largely been due to the drastic fall in oil prices which resulted in fiscal contraction in the government budgets of oil-producing States and a corresponding decline in aggregate demand. Recently, the Gulf States have shown a preference for hiring workers from the Indian sub-continent at lower wages, and for awarding contracts to companies from the Far East who bring their labour with them. It should also be mentioned that the migration of Arab nationals to the Gulf States and the Libyan Arab Jamahiriya is transitory in nature. Arab migrants are given work permits for a fixed duration and they are usually not allowed to acquire properties or start a business of their own. 79/

The reasons for the poor record of Arab regional economic integration are many and varied but the following are usually cited as the most prominent. 80/

- The first consideration is related to the fact that Arab countries have divergent political orientations, involving conflicts over legitimacy, sovereignty, borders, and regional and subregional hegemony. This unstable political environment has rendered most aspects of intra-regional economic cooperation dependent upon shifting political alignments in the region, and between the region and external powers. Correspondingly, the long-term perspective for regional trade and investment is understandably fraught with risks and uncertainty.

- Another factor which has discouraged Arab economic integration is related to the type of economic development practised in most Arab countries between the early 1950s and mid-1980s. In many of these countries, most investments were undertaken by the public sector, resulting in protected industries that overlapped with each other, rather than being complementary. Opening up to intra-regional trade, therefore, may confront State-owned industries with the prospect of losing their domestic market share, with dire consequences for employment, the balance of payments and fiscal standing.

- The third factor pertains to the weak state of physical, financial and administrative infrastructures for regional trade, testifying to the lack of serious attention to the need for such pillars of regional integration. Some of the deficient infrastructures are inadequate transportation facilities, complicated and time-consuming customs procedures, complex and diverse exchange rate controls and the virtual absence of regional clearing and payments arrangements.

- A fourth and oft-cited reason for the failure of regional economic integration, especially in the Arab Mashreq (east of Suez), is the fact that the most populous Arab State, Egypt, is cut off from its eastern Arab neighbours by Israel. 81/ This geographic discontinuity, which only recently has become less significant, had an important role in effectively blocking intra-regional trade routes and in creating a psychological, if not economic and political, divide between the Arab Mashreq and Maghreb (the Arab States in north Africa west of Egypt).

Other attempts at economic integration have focused on the subregional levels rather than the whole region. Most notable among these are the Gulf Cooperation Council (GCC) and the Arab Maghreb Union (AMU). The GCC was established in 1981 by the six Gulf States of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (U.A.E.). Its aim, laid out in its basic agreement, was to move the six countries, gradually and in different stages, towards the creation of a common market that would allow for trade free of tariffs and all other impediments, a common external tariff against imports from non-member countries and complete freedom for the movement of capital and their nationals. In addition, the agreement stipulated coordination and cooperation among the members with the view to rationalizing efforts at industrialization, adopting a common oil policy and pooling resources to enhance bargaining power with trade partners.

After 15 years of existence, the record of the GCC is mixed. On the one hand, tariffs and other barriers to trade were removed and resulted in increasing intra-regional trade from 3 per cent of total exports in 1980 to 7 per cent in 1990. 82/ Furthermore, it is noteworthy that the eastern provinces of Saudi Arabia and Kuwait have become exporting centres for the rest of the GCC States, the former specializing in construction materials, and the latter in oil pipes. Bahrain and Dubai (U.A.E.) have also assumed special postures in the subregion, the former as an offshore financial centre, and the latter as a transit and warehouse centre with its highly successful duty-free zone at Jabal Ali.

On the other hand, the agreement to create a common external tariff has not been achieved. This is due to continuing negotiation over a host of issues that include levels of protection of industries, re-export trade and rules of origin. More importantly, however, is the fact that the basic economic orientation of the six countries has not changed substantively as a result of the GCC. Each country is heavily dependent on oil and has the bulk of its exports and imports with the European Union, the United States and Japan. The further success of the GCC is thus considered to depend on changing that orientation by diversifying its industrial base and developing complementarity among its members and with the rest of the Arab region.

The AMU was founded by the Marrakech Treaty of 1988 and signed by the heads of the Governments of Algeria, Tunisia, Morocco, Mauritania and Libyan Arab Jamahiriya. The treaty stipulated that the five economies should reach the stage of customs union before the end of 1995 and the stage of a common market in 2007. It emphasized a gradual and orderly route to opening up the economies so as to foster competition and the efficient allocation of resources, as well as to rationalize production at the sectoral level. Progress has been slow, however, due to both economic and political factors. The economic stumbling blocks include: differences in the scope and degree of structural reforms in the five countries; the weak state of all infrastructural aspects related to regional trade, transportation, communications and finance; and the lack of complementarity among the economies. The political dimension was also detrimental to the integration effort, as unrest in Algeria in latter years has eclipsed efforts to pursue the route of integration.

In the 1990s, a revival of interest in economic cooperation at the regional level occurred on two fronts. The first renewal of regional cooperation efforts started in conjunction with the Middle East peace process initiated at the Madrid Conference of 1991. This effort was sponsored by the international community, with the aim of fostering economic cooperation between the Arab countries and Israel, and in attracting foreign investment to the region to buttress the peace process. A more recent effort has been mounted by the League of Arab States (LAS). The former is discussed in chapter V, and this section briefly reviews the LAS initiative.

In 1981, the LAS Economic and Social Council adopted an “Agreement to Facilitate and Develop Trade among the Arab Countries”. 83/ Its purpose is to open up Arab economies to each other through the gradual removal of barriers to trade among them, and the creation of a supportive system to encourage the growth of such trade. Fifteen Arab countries subsequently signed the

Agreement, and the task of negotiating the gradual removal of trade barriers among them was entrusted to the Economic and Social Council of the Arab League. After years of negotiations, the Council reached an agreement on the complete removal of barriers to trade for certain commodities, and partial removal for others. However, the fact that the States concerned did not implement these agreements frustrated the work of the Council and cast doubt over the usefulness of continued negotiations on the Agreement.

Thus, by the beginning of the 1990s, the LAS "Committee on Trade Negotiations agreed that no further negotiations be undertaken for the removal of tariff and non-tariff barriers on the remaining product groups before governments had enacted laws to implement measures that have already been agreed upon". 84/ Further deliberation on the subject ended with an agreement adopted in early 1997, known as the "Executive Programme of the Agreement to Facilitate and Develop Trade among Arab Countries to create the Greater Arab Free Trade Area (GAFTA)". 85/ As its title implies, the new agreement is an activation of the agreement of 1981 along the lines of measures already agreed upon, and according to a specific timetable. Implementation was to start on 1 January 1998 and is supposed to be completed in 10 years. The Agreement, to which all LAS members are committed, also includes the establishment of an institutional framework responsible for monitoring and supervising the implementation.

Whether or not this Agreement will prove more successful than its predecessors is something that remains to be seen. However, there are some encouraging signs that favour the chances of this new attempt at economic integration of Arab countries. Arguably, the political situation has changed to a certain extent, in that political differences and divisions among Arab States have narrowed. This is accompanied by a growing realization throughout the region that market-oriented policies offer better prospects for dealing with the chronic problem of unemployment and accelerating growth. There is also a new sense of urgency as regards the need for Arab States to move towards some kind of regional arrangement so as to be able to increase their bargaining power with giant international blocs such as the EU and NAFTA.

D. Integrating the Palestinian economy at regional and global levels

In the previous sections a brief review was presented of the economics of integration and their relevance to developing economies in general and the Arab economies in particular. In the course of the review some important issues related to the formation, stability and sustainability of regional integration were highlighted. It was emphasized that proper resolution of these issues requires the participating countries to undertake a major structural economic reform aimed at bringing about a new mix of infrastructures, institutions and policies. Such a mix is necessary to allow the opportunities created by economic integration to be fully exploited and to minimize its potential adverse effects.

Understandably, this is a huge and complex task in the Palestinian context as it involves dismantling the legacy of decades of an inhospitable economic environment. It is expected, however, that this will be carried out gradually and in harmony with the sequential stages of integration with neighbouring economies. The following areas covering infrastructure, institutions and policies are identified as priorities for action, insofar as their present inadequate condition does not allow the Palestinian economy to realize its full potential for integration with wider markets.

1. Infrastructures

At present, the Palestinian economy in the West Bank and Gaza Strip has neither the facility of an airport nor of a sea port.86/ Almost all Palestinian external trade is conducted with or through Israel, and all imports and exports are subject to Israeli security checks. It is estimated that the clearing costs of Palestinian imports are twice those of Israel, and the cost of clearing exports adds 3 to 5 per cent to export prices.87/ To avoid paying these extra costs, Palestinian producers, wholesalers and retailers use Israeli commercial agents, who import the goods and clear them, and then transfer them to the West Bank and Gaza Strip. Their role as intermediaries "has deprived Palestinian business of contact with overseas markets, suppressed development of export market know-how and, overall, inhibited growth in foreign trade". 88/ As noted earlier this practice has the added disadvantage of causing a fiscal leakage in favour of Israel.89/

Clearly, the integration of the Palestinian economy with the rest of the world cannot continue to be carried out through intermediaries, and facilities such as a port and an airport are essential for establishing proper trade relations with the rest of the world. Overland trade, both internal and with neighbouring countries, is inhibited by the poor condition of the road network and the trucking fleet. Roads have not benefited from any significant investment in maintenance and modernization for the last 30 years. The network is in urgent need of rehabilitation and expansion. Trucks are old and inefficient, and their renewal is discouraged by costly replacement parts and high import and purchase taxes. 90/

2. Institutional framework

At present, Palestinian imports and exports through Israel have to satisfy Israeli standards as established by the Israeli Standards Institute (ISI). 91/ These standards are regarded as more stringent than the international norm. Many observers consider that the standards are used to protect Israeli producers rather than to benefit consumers.92/ Similarly, the tariff regime is designed in accordance with Israeli economic conditions and interests. There are three layers of taxes on imports. Customs duties are calculated on c.i.f. value and are generally 50 per cent. On top of these is the purchase tax, which ranges from 5 to 240 per cent, in addition to a 17 per cent value added tax (VAT). 93/ It is recognized that these taxes force Palestinian producers to pay high prices for their inputs. Clearly, the interests of the Palestinian economy are best served by designing a new set of standards and taxes reflecting its current condition and development choices. This would certainly result in lowering the prices of Palestinian inputs and outputs, which in turn would foster trade with neighbouring countries.

3. Financial sector

Despite the significant strides that have recently been made in developing banking activities, the Palestinian financial sector is still at an embryonic stage. 94/ Two major developments are required to allow the sector to fulfil its function in facilitating investment and trade activities. First, the development of a capital market providing financial instruments for mobilizing resources from domestic, regional and international sources, and allocating them to productive investments. Second, the development of a banking and insurance environment capable of providing the necessary blend of credit and insurance essential to supporting import and export activities with world markets.

4. Supply-side constraints

Finally, the Palestinian economy will not be able to grasp the benefits of integration into world markets as long as the present supply-side constraints continue to prevail. These include weak technological capacity, lack of entrepreneurial marketing skills and the absence of specialized institutions for agriculture and industrial products. A major improvement in quality control, grading, packing, and labelling is urgently needed to raise Palestinian exports to international standards. A detailed discussion of these issues is the subject of a separate study of Palestinian merchandise trade recently prepared by the UNCTAD secretariat. 95/

Chapter IV

FUTURE PROSPECTS FOR ISRAELI-PALESTINIAN ECONOMIC COOPERATION

Following the occupation of the West Bank and Gaza Strip in 1967, a customs union with Israel came into operation that increased effective tariff levels in the Palestinian territory approximately fourfold.96/ This significant increase, along with a host of non-tariff barriers, caused significant trade diversion away from neighbouring Arab countries and the rest of the world and towards concentration with the Israeli market. This raised the cost of capital and intermediate goods to Palestinian producers and effectively wiped out their competitive edge in foreign markets. Meanwhile, Palestinian products containing Israeli inputs were not allowed to enter Arab markets because of the Arab League boycott of Israeli inputs used in Palestinian production. Palestinian trade came to be dominated by one partner, with other markets featuring increasingly marginal commercial links. 97/ The informal customs union between the Israeli and Palestinian economies was one-sided; Israeli products were free to enter Palestinian markets, without reciprocal treatment for Palestinian products.98/ The scope for Palestinian exports narrowed, and a widening merchandise trade deficit emerged, underwritten by the export of labour services to Israel.

Relations between the two economies entered a new phase with the establishment of Palestinian self-government arrangements in the West Bank and Gaza Strip. The Israel-Palestine agreements designated a five-year interim period (commencing in May 1994), during which negotiations between the two parties were intended to reach an accord on “final status issues”, not resolved in the interim agreement. The terms and rules that govern economic relations between the two sides during the interim period are spelled out in the “Protocol on Economic Relations”, signed on 29 April 1994. One of the express purposes of the Protocol is laying the groundwork for “strengthening the economic base of the Palestinian side and for exercising its right of economic decision-making in accordance with its own development plan and priorities”. 99/

The Protocol envisages a path for the development of the Palestinian economy during the interim period and thereafter which depends critically on further developing economic relations with Israel, greater openness in mutual trade flows and initiation of cooperation and coordination in growth-enhancing projects. The Protocol adopts a framework for development based on linking the Palestinian economy to the Israeli economy on more equitable terms than in the past. However, the implementation of the Protocol has not been wholly successful. Since 1996, the two economies have drifted towards separation more than towards integration, largely because of political and security concerns. Consequently, the difficulties facing the Palestinian economy today result in part from a framework for integration that is deficient, especially insofar as it has not ensured the openness to the rest of the world promised by the agreements. Exploring a realistic way out of this impasse, and its impact on longer-term economic relations between the two sides, are the concerns of this chapter.

The next section briefly summarizes the main provisions of the Protocol and how economic relations between the two sides have evolved since its inception. The section considers some economic measures that could be introduced within the context of modifications allowed by the Protocol, with a view to alleviating certain problems and allowing the interim period to proceed without disruption to the reconstruction and development efforts. This is followed by an exploration of future economic relations and the conditions under which they could be based on mutual interdependence. Recognizing that such relations cannot be achieved unless they are embedded in stable regional arrangements based on a just and enduring peace, the final section of the chapter explores some aspects of future relations among Israel, Palestine and the Arab States.

A. Current Israeli-Palestinian economic relations

As noted earlier, within the context of a one-sided customs union, trade between the two economies during the pre-1994 period basically constituted an exchange of Palestinian labour services for Israeli goods. It was expected that the interim period (1994-1999) would bring about an orderly change in that relation by allowing the Palestinian economy gradually to substitute the export of goods for the export of labour services. It was widely hoped that the new environment of the interim period would allow the PA to adopt an economic policy emphasizing growth in agricultural and industrial production, geared towards creating more domestic employment as well as expanding exports and restraining imports. 100/ Such growth was envisaged in the light of three important factors.

First, in the new environment, both the public and the private sectors would enjoy more freedom to perform their economic activities and face fewer distortions. 101/ In the interim period the self-government authority has the power to use some important instruments of both macro- and micro-economic policy. These include full control over direct taxation, limited control over indirect taxation, the right to license and supervise financial institutions and commercial ventures and to offer incentives to attract both domestic and foreign investment. Private sector activities would be greatly encouraged by the removal of some of the restrictions and regulations that were prevalent prior to 1994. These were to include the establishment of financial intermediaries to stimulate savings and channel them to productive investment, changing the asymmetric pattern of the customs union through the removal of some of the restrictions on Palestinian exports to Israel,102/ and allowing a greater opening of trade with Jordan, Egypt and new markets further afield. 103/

Second, the new environment was to be reinforced by a commitment from the international community to extend financial aid, with some $2.5 billion pledged to help finance Palestinian reconstruction and development efforts. This was deemed essential to consolidate the above-mentioned legal and institutional changes with improvements in both the physical and social infrastructures.

Third, in the Protocol, the two sides agreed to maintain the normal movement of labour between them. This was intended to enable the Palestinian economy to rely on a sustained, though reduced, export of labour services to

Israel as a cushion to bolster income until reconstruction of the economy could generate adequate employment to absorb a rapidly growing labour force. 104/

Overall, therefore, the interim period was to be a period of expansion and growth generated by increases in production, a boost to trade arising from new market openings and the continued generation of national income from work in Israel. Accordingly, a key assumption of the new environment is a relatively open border between Israel and the Palestinian territory for the movement of goods and labour. While the Protocol does not embody any formal commitment regarding the number of Palestinian workers permitted to work in Israel, an implicit assumption was that their number would be under the pre-1993 level, i.e. between 75,000-100,000. 105/ The framers of the Protocol, therefore, counted on having around one-quarter of the Palestinian labour force working in Israel during the interim period. Any interruptions were expected to be temporary and brought on by exceptional circumstances. 106/

Unfortunately, the underlying promises of the Protocol have remained largely unfulfilled. Political and security factors have rendered interruptions in the flow of labour and goods the rule, rather than the exception. As seen in Table 15, the number of Palestinians working in Israel, far from recouping pre-1993 levels, has declined steadily from an average of 83,000 workers in 1993 to 25,000 by 1996, the lowest level in 25 years. Similarly, the closure of borders did not allow for an increase in Israeli-Palestinian trade. Table 16 shows that exports from the West Bank and Gaza Strip to Israel declined in the first three quarters of 1996 by some 50 per cent compared to their level in 1995. Israeli exports to the territory increased slightly, reflecting the differential impact of border closures on the movement of goods between the Palestinian territory and Israel. Palestinian trade with Jordan and Egypt is affected in a similar way, owing to Israeli control of borders and security in the interim period.

Naturally, the combined effect of a sustained decline in income from prolonged reduction or suspension of exports of labour and goods has had a dampening effect, which has spread through the economy as a whole. It has also disrupted the reconstruction programme by delaying the arrival of much-needed capital goods, and by the allocation of resources away from long-term investment projects to finance emergency work relief programmes. 107/ It is estimated by one source that the closure has been responsible for a 20 per cent annual average decline in Palestinian GDP between 1993 and 1996. 108/ Clearly, the concept of relatively open borders that underlies the economic framework created by the Protocol has not worked as it was intended to, thus undermining the premises and promises of the framework in general.

Accordingly, Israel and the PA appear to face two major choices. One would be to resolve to insulate the movement of labour and goods from security and political exigencies, thus shielding the concept of open borders and allowing it to function as intended by the Protocol. Alternatively, the two parties could agree to recognize that open borders are not feasible under the present circumstances. Accordingly, an agreement to re-orient the provisions of the Protocol to the reality of relatively closed borders, could be envisaged for the remainder of the interim period. This would aim at a fuller opening of the Palestinian economy to other markets than are provided for by the Protocol.

Either choice might be considered unacceptable by one side or the other, owing to lack of political feasibility or by being regarded as prejudicial to the final settlement negotiations. Yet, it is difficult to perceive a way out of the present impasse unless some combination of both choices is adopted and vigorously pursued. For a common position to emerge, however, both determination to resolve matters of discord swiftly, and political good-will combined with flexibility are required. Elements from the two choices could be used in complementary fashion, and address two important aspects of the current barriers to developing trade flows.

To begin with, the movement of goods and labour should not remain subject to the impact of violent incidents and overriding security measures. Whereas final status negotiations may address this issue, a rectification of the current situation is required for the remaining interim period. One practical step would be the designation of “safe passages” between Israel and the Palestinian territory; these would provide the two sides with the facilities to monitor the movement of goods, and separate facilities could be arranged to cater to labour flows. While the basic forms of these arrangements are already in place between the Gaza Strip and Israel, West Bank trade with Israel is less effectively channelled. Such arrangements, accompanied by streamlined crossing formalities and controls, would respond to the exigencies of security without prejudicing the outcome of the final status negotiations. 109/ The maintenance of passages for trade with/through Israel should be accompanied by secure transportation arrangements between the West Bank and Gaza Strip, an interim issue which was still under negotiation in mid-1998.

Second, a process of separation in the labour market between the two economies has been under way since the mid-1980s. As Table 15 shows, the movement toward integration of the two markets lasted until 1985. It was characterized by the fact that the increase in the number of Palestinians working in Israel exceeded the increase in the number employed domestically, and by the narrowing of the wage differentials between the two markets. A reversal of these two trends started after 1987. Since 1987, and especially after the Gulf War in 1991, Palestinians have been required to obtain special permits to work in Israel, issued according to security, rather than economic, considerations.

Israel has accommodated its economy to this change by allowing foreign workers to enter. It was estimated that 100,000 foreign workers were working in Israel in 1996 with official permits, and that another 100,000 foreign workers were in Israel in 1995 and 1996 without permits.110/ The Palestinian economy needs to take suitable measures to adapt itself to this process. The declining income earned by Palestinians working in Israel no longer provides an adequate supplement to GDP to cover the high cost of imports from/through Israel. Cheaper imports can be obtained from Arab countries, but this calls for a major relaxation of restrictions on passages to and trade with Jordan and Egypt. In this regard, a method must be found of replacing the inefficient transportation procedure in force at borders, known as back-to-back. 111/

These two measures, namely the establishment of controlled passages to monitor the movement of goods and labour with/through Israel, 112/ and the relaxation of restrictions on the movement of goods with Egypt and Jordan, could help to isolate the interim economic framework from the debilitating impact of political and security exigencies. Moreover, both can be addressed through the mechanism set up by the Protocol, they need no new framework and, in their technical aspects, they should not take more than a few months to design, agree and initiate. 113/ Agreement on these practical issues could also lay the groundwork for longer-term transport and trade arrangements.

A closely related issue that has to be addressed within the framework of the Protocol in order to improve the interim economic situation is the problem of fiscal leakage, which is undermining the revenues of the PA and contributing to its budget deficit. This leakage is caused by the absence of an equitable revenue-sharing arrangement in relation to the collection of tariffs, customs duties and purchase taxes. According to the Protocol, customs duties collected by Israel on imports are transferred to the PA only if the shipment is labelled as destined to the West Bank or Gaza Strip. 114/ Since the bulk of Palestinian imports come through Israeli intermediaries as part of shipments destined for Israeli corporations, customs duties paid on them are not transferred to the PA. 115/

According to one study, revenues on imports through Israeli intermediaries were between $88 to $195 million in 1992. 116/ If the procedures that yield the lowest estimate are used, the foregone revenue is estimated at $126 million in 1995 or 3.7 per cent of GDP. 117/ A practical solution to this problem could be for the two sides to agree upon a revenue-sharing formula based on aggregate flows of trade. This approach has been successfully used by the Southern African Customs Union (SACU). 118/ The absence of an agreed mechanism to deal with this leakage has led the PA to license Palestinian traders allowed to import from abroad. Local agents must be designated for all imports through Israel, in an attempt to circumvent the role of Israeli commercial agents. In addition to the disincentives created by such interventionist measures, this approach provides only a partial solution in that it cannot account for the non-Israeli content of the direct imports from Israel. Furthermore, such unilateral steps do not bode well for future economic relations between the two parties.

B. Prospects for future Israeli-Palestinian economic relations

Notwithstanding present difficulties, negotiations over final status issues, once initiated, should aim to reach a new, balanced Israeli-Palestinian relation based on reciprocity and cooperation. The mixture of coordination and separation that underlies the path to an improved economic relationship between the PA and Israel could also point to an approach for elaborating the relation between the two sides after the interim period. The suitability of this approach is not due only to the fact that it is inherent to the process of developing independent Palestinian economic management. It is equally suitable for a small and poor economy seeking to maximize benefits from its relations with an adjacent, large and advanced economy.

It is generally held that the dynamics of such a relation generate two opposing forces that disproportionately affect the smaller economy and shape its development. A favourable repercussion features an increased demand for the products of the small economy, a diffusion of technology and knowledge, as well as effects known as “trickle down” or “spread” effects, resulting from geographical proximity to a large market and from opportunities in subcontracting, joint ventures and coordination in tourism and other services. Unfavourable repercussions arise from the unsustainability of many industries in the small economy, confinement to the production of low-skilled goods and the emigration of a sizeable segment of its labour force to the neighbouring economy and to other nearby countries. These effects are generally known as “backwash” or “polarization” effects, and arise from the ability of efficient large-scale industries in the advanced economy to out-compete inefficient small-scale industries in the less advanced economy, and to attract its labour and capital. 119/

From the perspective of the small economy, therefore, a crucial problem is posed by the balance of the dynamic impacts induced by the more advanced economy. To what extent do these dynamic effects help to foster the development of the smaller economy, and conversely to what extent might they retard development? Among the factors that determine the relative strength of these two trends is the degree of integration between the two sides.

For example, a removal of tariff and other barriers to trade between the two economies increases the exports of the small economy to its neighbour, as trade between them assumes a pattern based on comparative advantage. This level of exports cannot be sustained, however, if free trade is accompanied by a common external tariff (customs union). In this kind of union, the tariff is generally determined by the interests of protecting the advanced economy’s industries, even in a context of gradual trade liberalization. Such protection increases the price of intermediate and capital goods imported by the small economy, and thus raises its costs of production. This dynamic can compromise its comparative advantages, unless the imports concerned are specifically exempted. Further integration between the two economies under these conditions, including the free movement of labour and capital, would reduce the export of goods from the small to the large economy in favour of the export of labour services.

In other words, free trade and free mobility of factors gradually eliminate trade based on comparative advantage and confine it to trade based on absolute advantage, with the result that the small economy exports low-skilled goods and imports high-skilled goods, thus “locking-in” its poverty. 120/ The small economy will then be relegated to the status of a backward region in an advanced country, such as southern Italy and central Appalachia in the United States.

On the other hand, integration between the two economies can be allowed to proceed at a slower pace - free trade between the two sides first, without a common external tariff and free mobility of factors. In this case, producers in the small economy would be better able to expand production by taking advantage of scale economies, thus enhancing their comparative advantage in trade. In short, a slow pace of integration can enhance the comparative advantage of the small economy by tapping the “spread” effects, whereas a hasty integration can destroy comparative advantage through the working of the “polarization” effects.

Guided by these considerations, it can be argued that a customs union with Israel is not necessarily in the Palestinian interest, either at present or in the foreseeable future. Recent studies have shown that the common external tariffs imposed by Israel in the pre-1994 period resulted in a significant increase in the cost of Palestinian production and a marked loss of its competitive position. 121/ For instance, the cost of garment production in the West Bank is on average greater than in Jordan by a factor of 2.17. An important portion of that difference is due to the fact that Palestinian producers pay double the price for their imported Turkish textiles, compared to the superior-quality East Asian material imported by Jordanian producers. The Palestinians cannot afford to import Asian textiles because of the (still) high tariffs which protect the Israeli garment industry. Owing partly to similar differences in the prices of imported inputs, the cost of agricultural products, pharmaceuticals and shoes in Jordan is lower than in the Palestinian territory.

Another reason for the high cost of Palestinian production in both agriculture and industry is the relatively high wage rates. It is estimated that wages of Palestinian workers exceed those in Jordan by a factor of 2 to 3 in agriculture, a factor of 2 in the garment industry, and a factor of 2.3 in the shoe industry. 122/ These high wages reflect distortions in the labour market created by the employment of Palestinians in Israel. Exporting labour services to Israel affects the economy in two ways that tend to reinforce each other. On the supply side, induced higher wages in the domestic economy that do not reflect domestic productivity gains, dampen agricultural and industrial production. This is due to higher production costs, falling profitability and loss of competitiveness in foreign markets. On the demand side, the increased income generated from work in Israel increases aggregate demand in the domestic economy without parallel increases in production. Thus, the increase in demand for traded goods is met by an increase in imports, and the increase in demand for non-tradeable goods is met by an increase in prices. This so-called “Dutch Disease” change in relative prices causes a contraction in tradeables, and stimulates the production of traditionally non-tradeables. 123/

Integration of the Palestinian economy with the Israeli economy, in the form of a customs union and employment of Palestinian workers in Israel, thus can lead to a situation where polarization effects have an adverse impact on Palestinian development potentials. Therefore, it may be in the longer-term interest of the Palestinian economy to reconsider a customs union, with a view to reorienting its trade regime independently of the protective policies of the Israeli economy, which are ill-suited to Palestinian economic structures.

The ability of the Palestinian economy to define its own tariff regime is important at this stage of its development. In doing so, it would aim at a reduction in the prices of inputs and outputs, thus removing some formidable distortions that have inhibited both domestic production and trade for a long time. Arrangements modelled on the current Joint Economic Committee (JEC) could ensure coordination between the two parties to decide in conjunction on tariff setting and tariff suspensions in order to allow Palestinian industries to import materials at lower tariffs when Israeli production is insufficient or particularly costly. Such a joint body could also provide a forum for designing improved border facilitation measures, monitoring their impact and periodically revising them as necessary.

An expansion in Palestinian production and trade, mainly directed towards outside markets and arising from a partial disengagement with the Israeli economy, could be reinforced by an expansion in other areas of cooperation with Israel. This new relation would exploit potentials for complementarity and rationalization, while acknowledging the necessity for the Palestinian economy to use reasonable measures to safeguard against dependence upon one major trade partner. The following paragraphs consider some of the issues pertinent to long-term Israeli-Palestinian economic relations.

1. Agriculture

Agriculture is a sector that has many of the ingredients for becoming a testing ground in any new relation between the two economies. Rationalizing agricultural production between the two sides requires major changes in policies, as well as serious efforts at cooperation and coordination. The agricultural sector remains important to the Palestinian economy in that it employs around one-quarter of the labour force, and contributes approximately the same proportion to GDP and exports. It uses highly labour-intensive methods of production and in general does not incorporate scientifically advanced methods of irrigation and fertilization. In contrast, Israeli agriculture is a very advanced and capital-intensive sector, but contributes no more than 2 per cent to GDP and less (1.7 per cent) to exports.124/

Trade based on comparative advantages may lead to Israeli specialization in high value seedlings and prototypes, and Palestinian specialization in labour-intensive fruit and vegetable branches. This division of labour could benefit both sides, but has not been possible until now owing to Israeli protective policies, which have allowed Israeli farmers to sell fruit and vegetables in the Palestinian territory and abroad at prices below real costs. 125/ Furthermore, the policy has adversely impacted Palestinian agriculture in that low-cost water supplied to Israeli farmers is not available to Palestinian farmers. 126/

While quotas on imports of Palestinian agricultural products are in principle to be phased out by 1998 in accordance with the Paris Protocol, phytosanitary and procedural impediments to agricultural exports to/through Israel remain in place. Removing this distortion requires the gradual dismantling of protective measures and a fairer distribution of water resources. These measures, accompanied by the development of adequate Palestinian phytosanitary and quality control capacities, would create a more level playing field in agriculture that would reduce prices, increase welfare and conserve water.

From the Palestinian perspective, the Israeli market is very important because of its size, geographical proximity and familiarity. Nonetheless, reviving the agricultural sector so as to enable it to play its developmental role successfully, as outlined in chapter II, also requires an expansion of Palestinian agricultural exports to regional markets, as well as to Eastern and Western European markets. In this regard, cooperation with Israel to transfer drip irrigation technology, and know-how on the application of fertilization and filtration systems, as well as on modern methods of storing, packaging and marketing, could be beneficial to both sides.

2. Industry

Israel has a strong advantage in most manufacturing branches, so industrial trade with the Palestinian territory will be in its favour for a long time. On the other hand, the Israeli economy is undergoing a structural change whereby labour is attracted to high-technology manufacturing establishments, thus reducing the supply of labour for more traditional industrial branches. So far, Israeli firms have been able to adjust through subcontracting with firms in the West Bank and Gaza Strip (and more recently, joint ventures in Jordan). Arrangements with Palestinian subcontractors involve neither a commitment of Israeli capital nor a transfer of technology. Palestinian firms “semi-finish” Israeli goods and contract processing according to certain specifications. 127/

This process is basically an indirect trade in labour services similar to the direct employment of Palestinian workers in Israel. In a new environment, characterized by more openings to the rest of the world, it is unlikely that such arrangements could survive. Inflows of capital, along with competition, would gradually replace foreign direct investment (FDI) and joint ventures would take over from subcontracting. From the Palestinian perspective, Israeli-Palestinian joint ventures are preferable to subcontracting. The involvement of Israeli capital reduces risk, while the domestic participation reduces the degree of dependency on Israel characteristic of subcontracting. To use the terminology of chapter III, joint ventures distribute dissociation costs more evenly.

There are many areas where joint ventures can be mutually beneficial in that factors of production from both could complement each other, and markets for products are accessible. Some examples are:

(a) Textiles and garments

This branch is highly developed in Israel, contributing around 9 per cent of total manufacturing value added and some 8-9 per cent of industrial exports. The Israeli fashion industry has secured access to European and North American markets through a variety of licensing and other production arrangements with firms in those markets. But the high and rising cost of labour in Israel is an obstacle to acquiring a competitive edge that would enable a policy of more aggressive penetration into those markets. Joint ventures with Palestinian firms would reduce labour costs in addition to expanding exports to Arab and Islamic countries with similar demand structures. In return, Palestinian firms would gain from technological transfer and the acquisition of new skills.

(b) Agro-industries

The Palestinian agro-industry includes food processing, olive pickling and oil processing, tobacco growing and dairy plants. Joint ventures with Israeli firms that improve technology in canning, drying and freezing of fruit and vegetables could go a long way towards enabling the branch to become an export industry as well as a supplier of the emerging local market. A demand for such products also exists in Arab and Islamic countries, as well as in Arab and Islamic expatriate communities in Europe and the Americas.

(c) Computer services

There are a number of successful Palestinian firms in the West Bank producing Arabic-language software, including word processing, graphics and Arabic calligraphy. It is expected that these firms will be able to export their services to neighbouring Arab countries once trade is normalized in the region. Joint ventures with Israeli firms could expand exports to include more sophisticated computer services such as information and communication systems, related consultancy services, and bulk data processing.

3. <u>Tourism</u>

Perhaps the most promising area for Israeli-Palestinian economic cooperation is the tourism sector. A peaceful environment would certainly increase significantly the number and variety of tourists to both areas. Accommodating that increase and expanding the sector to realize the full potential of the region's religious, cultural, natural and leisure attractions requires serious efforts of coordination, a topic addressed in the next chapter.

C. Economic relations in an era of peace between Israel and the Arab States

The geography and history of the Arab-Israeli conflict have combined to make Palestinian-Israeli relations closely intertwined with Arab-Israeli relations. Consequently, three preconditions appear relevant to make the peaceful, cooperative Palestinian-Israeli relationship contemplated in the preceding section a catalyst for regional economic integration. First, a successful conclusion of the permanent status negotiations. Second, the conclusion of peace treaties between the Syrian Arab Republic and Israel, and between Lebanon and Israel, to complement those already signed by Israel with its other Arab neighbours, Egypt and Jordan. Third, a reorientation of the steps so far taken towards regional cooperation in a manner that recognizes Arab concerns about Israel's economic predominance, and eventual policies, in the region. Given the political nature of the first two issues, the following discussion focuses on the third.

Economic relations between the Arab countries and Israel have proceeded along two tracks, bilateral and multilateral, as follows:

1. Egypt-Israel

Trade relations between the two countries are governed by an “Agreement on Trade and Commerce” which was signed in 1981. The Agreement allows for unrestricted trade between the two countries based on the principle of most-favoured-nation (MFN) treatment. 128/ Apart from oil, however, trade between the two countries in the first 13 years was modest, and did not exceed $25 million per annum. Since 1994, trade registered a significant increase, and is expected to reach $80 million by the turn of the century. 129/ Half of the non-oil Egyptian exports to Israel are yarn, whereas its imports from Israel are mainly chemicals and processed food. The volume of Israeli investment in Egypt is not known since most of it is undertaken through 'third parties' under other nationalities. 130/ The biggest joint venture project between the two countries is the Middle East Oil Refinery (MIDOR) at Alexandria which, at an estimated cost of $1.2 billion, is underwritten by the private and public sectors in both countries and the European Investment Bank. 131/

2. Jordan-Israel

An “Agreement on Trade and Economic Cooperation” between Israel and Jordan was signed in 1995. The agreement is also based on the MFN principle, and it expresses the intention of both sides to move gradually towards a free trade agreement. Since the signing of the peace treaty, officials from both sides have repeatedly declared their aim to move rapidly to the economic front. Joint committees have been established to study and plan major joint infrastructure projects, joint venture investment enterprises and the coordination of tourist services. Travel between the two countries has been opened through an airline joining Amman and Tel Aviv, and through direct bus routes. It is too early, however, to ascertain the likely pattern of economic cooperation between the two sides, though certain successful joint ventures in Jordan and subcontracting to Israeli garments industries have been reported since late 1997. Two observations are worth noting. First, it seems that there is an implicit understanding by both sides that cementing the peaceful relation between them requires greater economic cooperation. 132/ Second, there has been some disappointment felt by Jordanian agricultural exporters about Israel's refusal to import their produce on the grounds that it is not compatible with Israeli standards. 133/

3. Other Arab countries

Even though Egypt and Jordan are the only two Arab countries that have signed formal peace treaties with Israel, since 1994 other Arab countries have explored the establishment of economic relations with this country. The most active in this respect is Morocco, in that it has allowed indirect trade with Israel, the volume of which, according to some Israeli reports, is greater than between Israel and Egypt. 134/ Israel has also initiated informal economic relations with several Arab countries in the Gulf, at the level of representative offices primarily concerned with exploring future trade, investment and other economic cooperation opportunities. One project to transport natural gas from Qatar through pipelines to Haifa seaport has been under consideration for several years.

The multilateral track of regional cooperation was initiated at the Madrid Peace Conference of 1991, with the establishment of five multilateral working groups (consisting of representatives from most Arab countries, Israel, and other concerned States) dealing, respectively, with regional aspects of economic development, water, refugees, security and the environment. 135/ The groups met every six months until 1996, but apart from exchanging views and presenting position papers, little in the way of taking a collective stand towards the issues has emerged. The multilateral track took another route independently of the multilateral working group negotiations, with the convening of the Middle East and North Africa (MENA) Economic Summit Conference held at Casablanca in October 1994. The Conference brought together Heads of State, Government officials, academicians and businessmen from most of the Middle Eastern countries, all industrially advanced countries, and a large number of other States as well.

An institutional framework responsible for coordinating efforts aimed at regional economic integration was announced at both the governmental and private sector levels. The former consists of a Central Steering Committee made up of representatives of governments in the region, and an Executive Secretariat charged with identifying viable regional projects and overcoming obstacles to trade and investment. The latter consists of a regional Chamber of Commerce and a Business Council. A Regional Tourism Board was also announced, including both public and private representation, and entrusted with promoting the region as a unique and attractive tourist destination. In addition, it was agreed to establish a “Bank for Economic Cooperation and Development in the Middle East and North Africa” structured to “promote development of the private sector, support regional infrastructure projects, and provide a forum to promote regional economic cooperation”.136/ Since then, the summit was reconvened twice with a similar degree of attendance and interest, in Amman (1995) and Cairo (1996). However, the most recent session (in Qatar in 1997) was not attended by most Arab States, and the projects and coordination mechanisms initiated in previous years have not been launched or constituted. The lack of progress in the peace process was cited recently as the reason for an indefinite postponement of the next MENA Conference, originally intended for late 1998.

The foregoing review clearly shows that economic contacts and dialogue between Israel and its Arab neighbours have increased significantly in the last few years, based on the momentum and expectations of the peace process. Precisely where this may lead, given the political stalemate since 1996, remains to be seen. Israeli officials are, however, optimistic that the trend will continue. 137/ Furthermore, the peace process, initiated at the Madrid Conference, has legitimized Israeli involvement in regional arrangements aimed at economic integration, at least those which include extra-regional partners.

It would be misleading, however, to ignore the fact that dialogue between Israel and Arab countries has been mostly carried out at the level of governments on the Arab side, and still lacks wide popular support. The attitude of professional and labour organizations in the Arab countries against normalizing relations with Israel until peace is achieved, the cold reception given by the public to Israeli participation in trade exhibitions in Cairo and Amman and the relatively small number of Egyptians and Jordanians who travel to Israel testify to popular reluctance to embrace measures taken at the official levels. 138/ By and large, Arab popular disapproval of normalizing relations with Israel now is due to two factors. First, there is wide popular rejection of the continued occupation of Arab territories by Israel. Normalizing relations in these circumstances is considered a breach of a unified Arab stance, and a move that would strengthen Israel's position in negotiations with the PA, Lebanon and the Syrian Arab Republic. Second, an influential current of thought believes that Israel would view normalization of economic relations with Arab countries as a way to penetrate their markets and economies. 139/

Whereas these views are repeatedly expressed in the mass media in Arab countries, especially in Egypt, Jordan and the Gulf States, studies by professionals and academics have also expressed dismay at the manner in which economic relations with Israel are evolving. 140/ In this literature, both the bilateral and the multilateral tracks are viewed as deficient. The former is seen as granting Israel the role of "centre" in the new regional arrangements in that it is able to tailor its relations with the Arab countries according to its absolute trade advantages; in other words, the new regional arrangement would be patterned along the "hub-and-spoke" system outlined in chapter III. The fact that Israel is the only country in the region that has FTAs with the United States and the European Union, is seen to strengthen its "hub" position, through its preferential access to both the regional market and the European and American markets. The multilateral track, as epitomized by the manner in which decisions on new regional bodies and projects were made at the MENA Economic Summits, has been seen by many as serving mainly extra-regional economic and trade interests.

A widely-respected moderate Egyptian economist expressed the opinion of many Arab observers at the time of the first MENA Summit by saying: "Arab governments which participated in the Casablanca Summit were literally 'dragged' into the Casablanca Conference without full cognizance of its objectives and without adequate consultation on its list of participants, agenda, procedures or expected outcome. It is apparent that the prime beneficiaries are Israel and the United States ..." 141/ Similar views were voiced about the second Summit, particularly concerning the establishment of the regional bank noted above. 142/

It should be stressed that such critical views have not come from radical elements opposed to the peace process. Quite the contrary, they represent the concern of mainstream experts who support the peace process and are worried about its direction. From this vantage point, a "hub-and-spoke" system with Israel at the centre, is not seen as a stable system capable of surviving for long, and thus will not serve the cause of peace. However, their concern does not focus solely on Israel or its international supporters, but equally includes Arab governments, who are considered to be capable of influencing the direction of the process by coordinating with each other and presenting their own design, collective or otherwise, for future regional economic cooperation arrangements. 143/ The debate that has taken place in the region over the past years on this issue, involving both governments and civil society, can be construed as a positive and firm indication that greater regional cooperation, involving Israel, is inevitable, even if its direction and common benefits have still to be more clearly identified.

From the Palestinian perspective, the future Israeli economic role in the region is of the utmost importance. To a large extent, that role would shape Palestinian economic relations with both Arabs and Israel. In this respect, it appears to be in the Palestinian interest to play an active role in directing regional integration away from the “hub-and-spoke” system and towards a stable and equitable relation that would serve every country’s interest as well as the continuation of the peace process. Such a system requires better economic relations among the Arab countries, and between the Arab countries and the United States and European Union. This dimension is discussed in the next two chapters.

However, in view of Arab uncertainty regarding the economic role of Israel in the region, as discussed in the previous chapter, and in order to encourage the emergence of an acceptable arrangement for regional cooperation, leading towards greater integration at the subregional and/or regional level, the following suggestions are deemed appropriate:

* Future Israeli and Palestinian trade agreements should include a clause allowing the latter to conclude integration arrangements and bilateral preferential trade agreements with Arab and other developing countries - a common feature of many integration arrangements. The Globalized System of Trade Preferences Among Developing Countries (GSTP), to which Palestine is a party, could provide one possible framework for this.

* As a complementary step, the PA should also consider the inclusion of an accession clause in future trade and economic cooperation agreements with Israel, so as to allow for the automatic acceptance of any Arab country willing to enter the agreement and abide by its rules.

* The PA should give high priority to utilizing the preferential treatment accorded to its exports by the United States and the European Union, and explore all avenues to improve on it.

* The PA could take the lead in calling for the establishment of an independent organization entrusted with monitoring flows of trade and investment in the region, and with analysing and reporting on their differential impact on the countries concerned. This could help to provide a database, from which the appropriate policies and measures for economic cooperation could flow, with the interests of all the countries given careful consideration.

Chapter V

PROSPECTS FOR ENHANCING PALESTINIAN-ARAB ECONOMIC RELATIONS

The previous chapter suggested that a concomitant to normalizing Israeli-Palestinian economic relations is the normalization of Arab-Palestinian economic relations. An important aspect of the former is the need to diversify Palestinian economic relations with other States so as to reduce its dependence on one major economy. In this regard, and especially as concerns the movement of goods and people, Jordan is a gateway for the Palestinian economy to the Arab Mashreq and the Gulf States, and Egypt is a gateway to the Arab Maghreb and Europe. Nor is the normalization of relations between the Palestinian and Arab economies an artificial arrangement. It complements and cultivates strong and persisting bonds of history, culture and religion, resting on a common language and shared values. Moreover, half of all Palestinians are still refugees living in neighbouring Arab countries. 144/

Yet, discerning the appropriate shape and pace of normalization, even with immediate neighbours - Jordan and Egypt - is not an easy task. The difficulties are illustrated by the fact that the Palestinian economy has been set on quite a different path of development over the last three decades, and that the two neighbouring economies, like others in the Arab world, are not well integrated with each other. Arab countries, however, are in the process of moving towards more open economies aimed at achieving greater regional cooperation and eventually integrating their economies in the global setting. In this process, the role of the Palestinian economy is pivotal, as normalized relations with Israel would reduce the barriers that divide Arab countries, and serve as a bridge for regional cooperation.

The present chapter highlights some issues in this process by contrasting constraints and opportunities. The first section briefly surveys the current position of the Palestinian economy in relation to the Arab hinterland. The second section is concerned with infrastructures - projects the Palestinian economy has to undertake in conjunction with its Arab neighbours in order to limit its dependency on one trading partner and facilitate the move towards greater regional cooperation. The third section analyses prospects for the rationalization of production and trade in the region, and the final section addresses issues of coordination and harmonization of economic policies.

A. The Palestinian economy in the context of the Arab region

From the Palestinian perspective, the main Arab markets can be classified into the following groups:

* Neighbouring countries: Egypt, Iraq, Lebanon, Syrian Arab Republic and Jordan;

* Gulf States: Bahrain, Kuwait, Oman, Saudi Arabia, United Arab Emirates, Yemen and Qatar; and

* North African countries: Algeria, Libyan Arab Jamahiriya, Morocco and Tunisia.

Since the Second World War, economic relations among these countries have not contributed to the development of trade and investment, but rather revolved around factor movements, especially between the first and second groups. Workers emigrated from the West Bank and Gaza and neighbouring countries (with the exception of Iraq) to work in the Gulf States. In return, capital flowed in the opposite direction, in the form of workers' remittances and official aid, to Jordan, Lebanon, Syrian Arab Republic and the Palestinian territory. The ratio of intra-regional (merchandise) trade (in the region as a whole) to total trade is lower than for any other grouping in the world. 145/

Table 16 shows the population and GNP of representative countries of the three groups, in addition to that of Israel. Apart from the oil-rich States, Arab countries are classified either as low-income or middle-income countries. It is important to note at the outset that using GNP and GNP per capita in dollars for purposes of comparison poses a problem because it ignores varying purchasing powers in different countries. This problem is clearly illustrated by comparing the GNP of some Arab countries with that of Israel. As Table 16 shows, the total GNP of Egypt, Jordan, the Palestinian economy and the Syrian Arab Republic, expressed in 1993 dollars, was less than that of Israel. However, using UN "international dollar" figures derived according to purchasing power parity (PPP), it may be seen that the total GNP of the four Arab countries is larger than that of Israel by a factor of 4.

Two points related to the PPP measures are worth noting. First, even though the income disparity between Israel and its Arab neighbours is quite wide, it is not as large as is implied by their respective per capita GNP. Observations of Israel and Jordan would suggest that the per capita income of the latter relative to the former is closer to what is implied by PPP measures (27 per cent), than to that implied by GNP per capita (9 per cent). Second, while there is no PPP index for the Palestinian territory, the fact that its price level is influenced disproportionately by Israeli prices would suggest that it is misleading to interpret its higher per capita GNP as an indication of a higher standard of living. A PPP measure would most likely show that the Palestinian standard of living is less than that of Jordan and the Syrian Arab Republic. 146/ This would be consistent with the fact that basic infrastructure, social services and public utilities are superior in these countries. 147/ The key point here is to realize that it is reasonable to regard the Israeli real per capita income as exceeding those of its neighbours by a factor of 2 or 3 rather than 8-21 as implied by GNP per capita; real Palestinian per capita income is similar to, though probably lower, than that of the Syrian Arab Republic and Jordan.

Concentrating on the adjacent Arab countries, some important similarities are found between their economies and that of the Palestinian territory with regard to priority issues of development.148/ Parallel to Palestinian efforts at restructuring the domestic and external economic environment, the Egyptian, Jordanian and Syrian economies have been going through a process of reform aimed at providing a new impetus for sustained development. Although the reform process is proceeding at varying speeds, the move is towards greater emphasis on the role of the private sector in production and trade, and on shifting the public sector's role to that of creating a supportive environment.

The three economies have intensified measures to liberalize their trade relations, reduce the over-valuation of their exchange rates and encourage foreign investment. 149/ As in the Palestinian case, the three economies are also facing the problem of declining capital inflows, as remittances from their workers in the Gulf States and official Arab aid dwindle. The four economies are therefore bound to introduce adjustments that would attract more foreign capital, including the accumulated savings of expatriates abroad.150/

It seems reasonable to infer from these similarities that the four economies would benefit greatly from coordinating their policies and greater mutual openness. It is obvious that the cost of economic reform in each would be greatly reduced if policy cooperation were successful in sharing the risks and minimizing dislocations by providing adequate time for adjustments. The political feasibility of this, however, may not be assured. It is also self-evident that the ability of each economy to absorb a relatively substantial inflow of its expatriates' savings and foreign investments would be greatly enhanced by an enlarged market with improved infrastructures.

In addition to these economic considerations, there is an important political motivation for policy coordination among these economies as a prerequisite to any sub-regional/regional arrangement. Alleviating Arab concerns with regard to economic cooperation with Israel, as discussed earlier, necessitates the inclusion of both Egypt and the Syrian Arab Republic in any regional or sub-regional arrangement, especially given their status as regional poles of influence. 151/ It is widely considered that any regional arrangement that excludes one or both of these countries will not be stable or durable. 152/ Cooperation among them that would facilitate regional integration, including Israel, requires cooperation in building regional infrastructures, rationalizing production and trade and harmonizing economic reform measures.

B. Regional infrastructure

The success of Palestinian economic development will depend to a great extent on improved regional infrastructures. This is due to the fact that, as regards water, energy and transportation, Palestinians cannot obtain low cost structures without participation in regional projects. Serious problems of environmental degradation and water safety also need regional efforts to achieve adequate solutions. Recent research has shown that infrastructure projects can have high rates of return and that they foster growth by significantly reducing production costs in manufacturing.153/ Experience with regional infrastructural projects has also shown that success depends on being perceived by all countries as fair and equitable.

Priority infrastructure projects are examined below under the three headings of water, energy and transportation. 154/

1. Water

The region's water resources are not at present optimally used, thus creating both waste and regional tension. Israel has been "sharing" Palestinian, Jordanian and Lebanese water resources for the last 30 years, and countries in the region have not been managing their water resources in an effective and economic manner. 155/ Accordingly, a regional water arrangement has to address the three issues of distribution, conservation and expansion. First, a fair system of distribution of surface and groundwater resources shared by two or more countries is needed. A regional body equipped with both a conflict-resolution mechanism and technical expertise may be necessary to address this important issue.

Second, a systematic effort should be made to study the economic feasibility of using different techniques of managing and conserving water. Modern irrigation schemes, if used effectively, could significantly decrease the amount of water currently used in agriculture. Undoubtedly, Israel has much relevant experience to share in this regard. Similarly, modern methods of recycling sewage water could supply much of industrial and agricultural water needs, thus conserving fresh water for household and domestic purposes.

Third, while the first two issues are of short-term concern, expanding the supply of water by large-scale schemes is a long-term issue. Such schemes include fresh water transfer, hydropower projects and desalination. Some proposals have been made, including transfer of fresh water by pipes from Turkey to the Syrian-Israeli borders to supply the Yarmouk and the Sea of Galilee, as well as the hydropower schemes of the Mediterranean-Dead Sea Canal and the Red Sea-Dead Sea Canal. These large projects, however, are costly and require a high degree of regional cooperation. 156/

It should be emphasized that achieving a regional arrangement that successfully addresses these three issues is of crucial importance to the prospects for Palestinian economic development. At present, the availability of renewable resources of water in the West Bank is among the lowest in the world. 157/ This has suppressed the demand for water and generated a highly inefficient allocation of resources. A continuation of water scarcity threatens to impose severe constraints on agricultural and industrial expansion. It is, therefore, of the utmost importance that final status arrangements accord the Palestinians more equitable shares of the West Bank mountain aquifer and the lower Jordan River basin water resources.

2. Energy

From the Palestinian perspective, electric power is a top priority. At present the West Bank and Gaza have no independent electricity supply, and supplies from Israel are expensive and do not meet the requirements of future growth. 158/ A unified Palestinian power system operating as part of a regional grid that promotes interconnection with Egypt, Jordan, the Syrian Arab Republic and Lebanon is needed. This system could build on the existing links between Jordan, the Syrian Arab Republic and Lebanon, and increase their effectiveness. A regional scheme would benefit the Palestinian economy by making a more reliable supply available at cheaper prices, and would also be of benefit to the other countries.

3. Transportation

Revitalizing trade between the Palestinian economy and its Arab neighbours would require a major improvement in the traffic capacity of border crossings with Jordan and Egypt. Between the east and west banks of the Jordan river, there are six natural bridge locations, but only three bridges exist and just one (Allenby) is used for freight traffic. It is necessary for more bridges to be constructed and their capacity for traffic increased in order to accommodate the expansion of trade and increased tourist activities. It is also important to build terminal facilities on the Jordanian side of the border so as to eliminate the costly delays arising from the present procedure, which requires Palestinian exports to be transported to the Amman customs house for clearance. Moreover, there is only one border crossing between Egypt and Gaza through Rafah. Terminal facilities on both sides are in need of modernization and more effective clearance procedures. Of longer-term concern are projects to upgrade overland travel in the region by building modern highways. One such project proposed would involve the construction, improvement and upgrading of the road along the eastern Mediterranean coast from Turkey to Egypt.

C. Rationalization of production and trade

As was noted earlier, Palestinian trade is overwhelmingly anchored with one partner, leaving an insignificant amount of trade to be carried on with Jordan and the rest of the world. 159/ This lopsided trade pattern is the result of restrictions and arrangements introduced under occupation. Many studies have demonstrated that the removal of these restrictions would redirect trade towards Arab countries and the rest of the world.160/ Such a redirection would benefit the Palestinian side by increasing its exports and changing the terms of trade in its favour, as well as diversifying its trade and eliminating its dependency on one trading partner.161/

In a recent study, trade flows between the Palestinian territory, its Arab neighbours, Israel and the rest of the world were estimated under the assumption of a complete removal of current restrictions on trade. The results presented a completely different picture from actual flows.162/ Under the assumption of removal of non-tariff barriers (NTBs), 70 per cent of Palestinian exports in 1992 would have been directed towards neighbouring Arab countries, the Gulf States and Islamic countries. Similarly, under this assumption, 74 per cent of Palestinian imports would have come from neighbouring Arab countries, the United States, Japan, Republic of Korea, the EU and Turkey. An important conclusion of this study is that, although the removal of trade restrictions and opening up to neighbouring countries and the rest of the world would correct the Palestinian trade relation with Israel, it would not eliminate the trade deficit. In fact, the deficit for 1992 under the same assumption is reduced by only 13 per cent, and simply redirected towards Arab countries, the United States, Japan and the EU.163/

These findings concur with those of similar studies, and with the view stated in chapter III, that organizing regional integration among developing countries with trade liberalization as the chief principle would not address the primary problems of these countries. The fact that Egypt, the Syrian Arab

Republic, Lebanon and Jordan all suffer from recurrent, rather than cyclical, merchandise trade deficits calls attention to the need for coordinating regional efforts to address the problem.

Cultivating the advantages of regional integration as outlined earlier would aim to rationalize production among the countries so as to expand trade among them, and increase their capacity to export to the rest of the world. A concerted Palestinian export drive should be a key element of this package, directed at Arab and other countries in the region, including Turkey and the Islamic Republic of Iran. The possibility of bilateral agreements might be envisaged as well, in anticipation of the effective implementation of regional arrangements, as well as the deployment of the various traditional export promotion instruments, and government support campaigns. In this regard, the following points seem relevant.

1. Internal economies

By and large, a country intent on expanding its exports has to acquire new comparative advantages in the production of some commodities. This can be achieved by the exploitation of economies of scale within a regional context. The opening of trade between the Palestinian economy and its Arab neighbours can be expected to achieve such a goal. The larger market would induce firms operating in industries with increasing returns in each country to expand while narrowing the range of their products, thus specializing in some differentiated goods and producing on a larger scale with lower unit costs. As a result, specialization would lead to increased intra-regional trade at lower prices and with a greater variety of choice. Since this intra-industry trade is associated with higher productivity and lower prices, it is bound to increase the competitiveness of the region and enhance its capacity to export to other markets. This kind of trade could be especially relevant to Arab countries in the Mashreq, because, unlike inter-industry trade, it can flourish among countries that are similar in their level of development.164/

In Appendix 1, intra-industry trade indices are calculated for seven product groups in Egypt, Jordan, the Syrian Arab Republic and Tunisia. Two observations on these indices are worth noting. First, among Egypt, Jordan and the Syrian Arab Republic, the latter ranks first in both intra-Arab trade and intra-industry trade. Second, in all countries, manufacturing and chemical products generate more intra-industry trade than the other five groups, i.e. food items, fuels, ore and metals, machinery and transport equipment. Together, these observations cast a doubt on the oft repeated claim that there is no room for expanding trade among neighbouring Arab countries because “they produce the same things”. Even though there is not much room for trade in primary products or heavy machinery, there is certainly scope for expanding trade in manufactured goods. Such an expansion of intra-regional trade would help the region to increase its exports of industrial goods to world markets, and thus reduce its dependence on exports of primary products and labour services.

Arab firms and capital should seek joint venture arrangements with the Palestinians as a result of the free trade area agreements between the PA and the United States, and the PA and the EU. It is also expected that European and American firms will seek foreign direct investment (FDI) in the

Palestinian territory in order to acquire diverse connections to Arab markets. However, though the opening of neighbouring Arab countries to trade would result in expanding intra-industry trade, an equitable distribution of the benefits of this expansion is not guaranteed. Exploiting economies of scale would certainly benefit consumers by offering a larger variety of goods at lower prices. But increased competition is bound to result in some winners and some losers. Thus, a transitional cost in terms of a loss in income and employment might not be distributed evenly. This calls for regional coordination in creating schemes for compensation that ensure a fair distribution of benefits and losses.

2. External economies

While the preceding arguments pertain to economies of scale at the firm level - internal economies - a country can also realize an acquired comparative advantage by exploiting economies of scale at the industry level - external economies. In accordance with the historical pattern of international trade, some countries are large exporters of certain goods not because of any advantage related to factor endowments, natural resources or technology. They produce at lower cost than others because, for a variety of historical reasons, they concentrated on the production of that industry in one location. The concentration provides specific services and specialized labour skills that support the operation of the industry, and lead to higher productivity and lower unit costs. A strong external economy is self-reinforcing in the sense that it attracts new firms, which in turn expand the size of the industry and its external economies. A country that starts out as a large-scale producer in a certain industry tends to remain a large producer. 165/

Regional cooperation among the Middle Eastern countries would therefore have to deal with the question of industrial concentration. Acknowledgement of the suitability of some countries as centres for certain industries because they have a head start should be offset by helping others to become centres for new industries. A stable and enduring regional arrangement should include potential membership for Lebanon and Iraq once their reconstruction programmes are under way, especially in regard to Beirut as a financial centre and Iraq as a centre for the petrochemical industry.

3. The role of structural reform

It should be emphasized that expanding intra-Arab trade, whether through existing or acquired comparative advantages, will go hand-in-hand with efforts to reform the Arab economies. To a large extent, intra-Arab trade has been inhibited in the past by the fact that the public sector in most Arab countries assumed a leading role in large-scale production and external trade. This has resulted in the use of trade as an instrument of foreign policy in certain periods. 166/ In a sense, trade became hostage to constantly shifting political alignments in the region. An enhanced role for the private sector in each country would establish solid business links with regional and extra-regional partners, provided that an enabling environment is created to facilitate regional trade and promote joint economic activities.

Indeed, a more intensive effort at cooperation and integration with Arab countries should also place substantial emphasis on the full participation of the private sector and other civil society actors in the design and implementation of cooperation schemes and instruments. This would include the formation of advisory bodies and intensified linkages among private sector organizations. In that context, programmes might also be designed to facilitate and promote Arab investments bilaterally or within subregional arrangements, to remove current obstacles and to extend to such investors both investment protection and MFN treatment.

D. Coordination of economic policies

Economic integration among developing countries calls for a concerted effort of economic policy coordination, as was noted in chapter III. This applies to the Arab countries, whose lack of economic integration is partly policy-induced. Some of the pressing issues in this regard are discussed below under the headings of supply, demand, monetary and fiscal policies.

1. Supply policies

In addition to the task of modernizing infrastructures indicated above, fostering the capacity of the Palestinian economy, and the regional economy as a whole, for supply response to opportunities arising in the world market requires a regional environment conducive to capital accumulation. This involves policy harmonization to gradually eliminate capital market fragmentation. A homogeneous and vibrant capital market is necessary to mobilize national savings and to pool regional savings, thereby allowing optimal allocation among competing investment projects. Such a market is necessary both to finance regional joint-venture projects that are envisioned as playing a pivotal role in rationalizing regional production, and to allow the private sector to play its part in infrastructure investments.

Integrating capital markets, however, is a lengthy process involving harmonization of exchange rate policies, tax measures and other elements of fiscal and monetary policies. The process could be greatly assisted by modernizing the procedural and logistical dimensions of links among the countries concerned. Included in this is the establishment of regional information facilities that would help potential investors and traders, the modernization and simplification of the border-crossing facilities and procedures, which are currently a formidable impediment to the movement of both people and goods, and a start made on the difficult task of unifying standards.

2. Demand policies

There is ample room for coordinating policies aimed at demand management at the micro-level, especially in water and energy use. Given the scarcity of water, it is to be noted that farmers in Israel pay a low price for water use. Israel has specialized for many years in exporting water-intensive fruit, vegetables and (more recently) cut flowers at subsidized prices. Adopting realistic national price policies for water, coordinated at the regional level, would improve efficiency, rationalize trade and conserve a very scarce resource. Similarly, an integrated approach to the pricing of oil and electricity as sources of energy would improve the allocation of resources and reduce environmental costs. Other demand management policies at the macro-level aimed at harmonizing inflation rates and stabilizing exchange rate fluctuations would go a long way towards reducing the risks of regional investments and facilitating the expansion of trade.

3. Monetary policies

At present, there are two monetary issues, at the Palestinian and the regional levels, that have an important bearing on the drive towards regional economic integration. First, the Palestinian economy has no national currency; if the Israeli Shekel and the Jordanian Dinar circulate as legal tender, and the US dollar is used increasingly as a repository for savings. 167/ This multi-currency situation is inefficient in that it denies the Palestinian economy its seigniorage resources, and the use of an exchange rate as an instrument of macro-policy, in addition to the inefficiency it creates by multiple exchange rate fluctuations. 168/ Second, due to exchange rate policies, intra-Arab trade is carried out mainly by foreign exchange, facilitated partly by the Arab Monetary Fund (AMF) and its trade functioning scheme, the Arab Trade Finance Programme (ATFP). 169/ This is a situation that needs major improvement in order to activate the use of local currencies to finance intra-Arab trade and gradually reduce the dependence on foreign exchange.

Correcting these two inefficiencies requires the establishment of a Palestinian currency and the conclusion of agreements with neighbouring countries, especially Jordan, to harmonize monetary policies so as to increase exchange rate stability. Progress in regional integration would call for consideration of an eventual wider monetary union or common currency area, with neighbouring countries adopting one currency or linking their currencies through fixed exchange rates. Such monetary integration would simplify economic calculations, provide a more predictable basis for decisions involving joint investment projects and facilitate trade.

However, membership of a monetary union would deny each member the use of its exchange rate as an instrument of macro-policy to cushion the disruptive impacts of various supply and demand shocks. Understandably, both the need for, and effectiveness of, such an instrument would tend to diminish as the economic integration of the region proceeds, especially with regard to trade and factor mobility. Thus, any move towards monetary union in the region has to be gradual and in line with other integrating steps. 170/ Jordanian-Palestinian monetary union, however, could be accomplished sooner, since the West Bank is very close to Jordan and is attuned to dealing with the Jordanian Dinar. 171/ It should be stressed that a unified currency area is an ambitious objective for the region, even over the medium term. Regular consultations between Central Banks and an exchange of information on national monetary and exchange rate policies might be envisaged as a first step.

4. Fiscal policies

Similar to monetary integration, the move towards fiscal integration has to be gradual and in line with other integrative steps related to trade and factor mobility. 172/ The issue of tax harmonization, however, is of a more urgent nature because it has a strong and direct bearing on the development of regional investment and trade. As other barriers to product and capital mobility are removed, expansion of joint-venture investment and intra-regional trade become increasingly dependent on the abolition of tax obstacles to cross-border activities within the region. Capital tax differentials among the countries would induce capital to flow from the high-tax to the low-tax economies. This tax-induced distortion in the capital market would lead to an inefficient regional allocation of investment and possibly to tax competition, which will arise if members attempt to attract capital by offering tax incentives. Similarly, differences in the rates of indirect taxes among member countries would cause distortions in intra-regional trade flows.

Given geographical proximity and the high degree of capital mobility in the region, the potential for these two kinds of distortions could be considerable. Removing these distortions calls for an agreement among member countries which should contain two elements. An agreement on the choice of jurisdictional tax principle will be required for both direct and indirect taxation, i.e. residence vs. source principle for the former, and origin vs. destination principle for the latter. 173/ Measures consistent with these choices will then be adopted in order to remove differentiated treatment. As with the issue of monetary coordination, the move towards regional tax harmonization is by no means imminent, and even the EU has only recently begun tax harmonization steps. More limited and feasible objectives to tackle the latter problems could include regional disciplines on trade and production subsidies or consultations on investment incentives.

Chapter VI

THE PALESTINIAN ECONOMY IN THE EMERGING GLOBAL SETTING: OPPORTUNITIES AND CHALLENGES FOR INCREASED COOPERATION IN TRADE, INVESTMENT AND RELATED SERVICES

The previous two chapters have addressed some important issues in the economic relations between the Palestinian territory and its neighbours, the Arab countries and Israel. Normalizing these relations is anticipated to serve as a catalyst for regional economic integration. Regional integration, however, will enable the Palestinian economy to achieve necessary, but not sufficient, conditions for integrating into world markets. What are also needed are a clear vision and a strategy that supports the private sector in forming joint ventures with foreign companies, in entering new markets and in adopting new methods of production, marketing and finance. A strategy that is predicated on an adequate appreciation of present constraints and opportunities facing the economy, and a vision of its future place in a rapidly changing world economy, are examined in this chapter. The following section outlines very briefly current trends in the global economy, with a view to pointing out challenges and opportunities that face developing countries seeking integration. Section B explores specific prospects for the Palestinian economy in major markets; the European Union, the United States, developing countries and economies in transition. Section C analyses the roles of foreign direct investment (FDI) and transnational corporations (TNCs) in fostering domestic investment and the transfer of technology.

A. The global setting

At the end of this century, a developing country seeking to integrate its economy into world markets is confronted by numerous difficulties. The twin processes of globalization in production and finance and the liberalization of trade have intensified competition. Advanced economies, because of their strong and flexible economic structures, worldwide presence through TNCs and sophisticated information networks, are better poised to exploit increased market competition and maximize their advantages.174/ Developing countries are often placed at a disadvantage by the discriminatory measures practised by advanced countries against their exports. These measures, referred to traditionally as non-tariff barriers (NTBs), have grown in importance with the universal decline in tariffs. They include the use of restrictive technical, health and environmental standards and the arbitrary use of anti-dumping and countervailing duties. It is believed that these measures, which some observers have christened the “new protectionism”, currently pose the most difficult obstacle to the expansion of developing countries' exports. 175/ Furthermore, the potential polarization of the world economy into giant “trade blocs” - in Europe, North America, East Asia and the Western Pacific region - adds to a sense of vulnerability in many developing economies. Countries outside these blocs are likely to suffer from trade diversion, use of restrictive rules of origin and exclusion from global information networks.

On the other hand, global trends offer developing countries new opportunities in production and trade. UNCTAD noted in an early assessment of the emerging global trading system, which remains relevant today, that the successful conclusion of the Uruguay Round should result in a substantial strengthening of the multilateral trading system, essentially by:176/

> (i) providing much more detailed rules to govern the application of a variety of trade policy measures, particularly those where weak or unclear disciplines had consistently been a source of trade tensions and the subject of trade disputes; (ii) devising new multilateral trade rules to cover intellectual property and trade in services; (iii) achieving a substantial degree of tariff liberalization so as to maintain the momentum towards ever freer multilateral trade; (iv) reducing the discriminatory aspects of regional trade agreements; (v) effectively raising the multilateral obligations of all countries to broadly comparable levels, with differential and more favourable treatment for developing countries being delineated in a more specific, contractual manner; and (vi) linking together the various agreements concluded within a formal, institutional framework (i.e. WTO), subject to an integrated dispute settlement mechanism.

Meanwhile, accelerating advances in technology have given rise to various growth industries in new fields like micro-electronics, biotechnology, new materials, telecommunications, robotics and machine tools, computers and software. 177/ These new industries are more suited to developing countries than many traditional industries. In contrast to the latter, new industries require neither the commitment of large quantities of capital, nor the availability of natural resources. Instead, competitiveness in the new industries will be determined by the ability to accumulate human capital, the effective absorption of scientific innovations, the capacity to learn new methods and techniques and the adoption of modern organizational methods of production. Scientific knowledge, human skills and modern business organization are the three indispensable elements required by these new industries.

The potentials of such knowledge-based assets do exist in the Palestinian territory, provided that the human resources of Palestinian expatriates are tapped in conjunction with joint ventures with firms from neighbouring countries or further afield. While the development of a new concept of Palestinian trade competitiveness will call for a shift away from traditional export commodities and markets, the mobilization of Palestinian expatriate financial and human resources is a process that will not accelerate in the absence of very different political conditions. Accordingly, while some potential niches may exist for the Palestinian economy regionally and globally in new sectors, traditional merchandise production and exports will continue to play an important role in the immediate future.

For example, computer software is a very promising area due to the large Arab market for “Arabized” products, both in the region and beyond.178/ A second and closely related opportunity is opening for developing countries because of new advances in the technology of services provision. Information technology is rapidly changing the very concept of the services sector, especially with regard to trade and growth. The traditional view of the sector as a collection of non-traded activities is fast changing due to several developments. First, the expansion of electronic networks has introduced numerous new possibilities in long-distance services. Also, technological innovations have increased the services content of internationally traded goods. 179/ Similarly, producers' services are increasingly considered to be a precondition for economic growth rather than its consequence.

Information-intensive services activities, research and development, computing, inventory management, quality control, accounting, advertising, distribution and legal services play a fundamental role in all economic sectors and are thus important for generating overall economic growth.180/ The declining costs of information technology, which create opportunities for international out-sourcing, and the new multilateral trade liberalization in services, as established in the General Agreement on Trade in Services, create opportunities for developing countries "to leapfrog stages of technological development and explore new avenues of comparative advantage".181/ Meeting these challenges and grasping the opportunities requires detailed plans oriented to each of the major world markets. The next section highlights some points relevant to each.

B. Challenges and opportunities in major world markets

1. The European Union and the United States

The European Union (EU) has shown keen interest in participating in the efforts aimed at reconstructing the Palestinian economy. It has assumed the leading role in the international assistance effort as the largest donor.182/ The European Commission has been active in financing some investment projects and extending aid focusing on institution building, infrastructures development, and education. 183/ The EU has also been active in international efforts aimed at regional integration through the Multilateral Working Groups, the MENA Economic Summits, and its own Euro-Mediterranean initiative. Similar to the West Mediterranean Business Council, it has launched a council for the Eastern Mediterranean countries, including the PA. This is expected to provide an institutional framework for fostering cooperation in joint ventures, finance, investment and exports.

In the field of trade, the EU has also taken a leading role, as early as 1986, in issuing a number of directives in which certain Palestinian exports are accorded preferential treatment, especially agricultural products. Negotiations between the EU and the PA led to the signing in early 1997 of an Interim Association Agreement, along the lines of the Partnership Agreements signed or under negotiation with a number of Mediterranean Arab countries. Similarly, the United States, owing to its leading role in the Middle East peace process and its major interest in the area, has expressed its willingness to help the Palestinians to overcome their economic difficulties. 184/ It has also granted Palestinian products preferential treatment consisting of lower tariffs under the Generalized System of Preferences (GSP). 185/

Despite the preferential treatment accorded to Palestinian producers by the EU and United States, significant direct Palestinian exports to these two markets have yet to materialize. Palestinian exports to Europe are confined to some agricultural products "attempted mainly with an NGO framework with an in-built subsidy component". 186/ This is principally due to the absence of a domestic support system that would help producers to market their goods according to high international standards. No Palestinian firm or farmer can overcome these constraints individually, even with the aid of cooperative community efforts. Accordingly, there is an urgent need to encourage private enterprise initiatives to establish specialized exporting companies, allied to domestic producers of new goods and services.187/ Such companies would be able to spread the initial and recurrent costs of acquiring a foothold in the European and the American markets. In addition, they could develop and maintain shares in these markets by establishing connections, monitoring trends and acquiring the necessary expertise through “learning by doing”.

It is also evident that Palestinians cannot overcome the deficiencies they encounter in transportation, logistics, and related infrastructural areas in a short time. Collaborative efforts with Israel, Jordan and Egypt are needed, and would be beneficial to all concerned, as well as enhancing regional integration. This would aim at increased exports of some vegetables and fruit to Europe, certain garments and foodstuffs mainly targeting Arab and other Muslim communities in Europe and North America, and some semi-finished manufacturing products to various developed country markets.

A different adjustment process is required to allow the Palestinian economy to seize some of the opportunities that exist in new industries and services. A major enhancement of the scientific environment, technical skills and organizational capabilities are needed. Involvement in long-distance services, for instance, does not simply come about once the country joins the electronic networks. The precondition for such involvement is to be “scientifically-connected” rather than just “electronically-connected”. This, however, does not imply that the country has to be at the cutting edge of scientific research. Rather, its scientific institutions, in particular the universities, need to be well-connected with scientific and research centres in advanced countries. In this regard, Palestinian universities lack research facilities that deal with the new industries and information-based services, and maintain an institutional relationship with Western research centres. As was stressed earlier, the positive side of the new globalized economy is that a developing country can acquire these facilities at relatively low cost. Many international bodies extend aid for such undertakings.188/

Exploring new opportunities in trade with European and North American markets, therefore, calls for a collaborative effort between the Palestinian private and public sectors, in conjunction with international institutions, to improve the scientific environment. This should include:

* establishing exchange programmes between science and engineering faculties of Palestinian universities and European and American counterparts.

* establishing centres for the study of new industries and of the economics of information-based international services.

2. Developing countries

Generally speaking, the 1990s ushered in a marked improvement in the stature and performance of developing countries. Although there are large individual differences, the average rate of growth of the developing countries' GDP has been higher than that of the industrial countries (Group of Seven) since 1989. 189/ While an analysis of this performance is beyond the scope of this study, it seems important to note that, although developing countries have greatly expanded their trade relations with industrial countries, their growth is not primarily a result of this intensified link. Domestic economic reform, better macroeconomic management, and the international flow of private capital have been more important.190/

The implications of this are very clear; more diverse and active economic relations among developing countries could help them to develop with less dependence on the economies of industrial countries. The Palestinian economy can gain much from relations with developing countries, especially the emerging economies in East Asia. Per capita income in both are relatively low compared with industrial countries, implying a similarity in tastes and less restrictive standards. Joint ventures with companies from developing countries may in certain cases prove preferable to joint ventures with TNCs from industrial countries, whose choice of techniques and price policies may be deemed unfavourable to Palestinian development interests, at least in the short run. On another level, some scope may exist for expanding Palestinian exports and economic cooperation with certain sub-Saharan African markets.

3. Economies in transition

Developing Palestinian economic relations with the former planned economies of eastern Europe could open up various possibilities. The fact that both the Palestinian and the transition economies are moving away from restrictive trade environments could generate more mutual trade. This is due to the complementarity between transition economies and developing economies in general, as well as the similarity of their attitudes to non-tariff barriers. A collaborative approach between the Palestinian public and private sectors with the aim of founding a trading company specializing in trade with eastern Europe might be an appropriate step towards building a Palestinian bridge to that area.

C. Foreign direct investment (FDI) and transnational corporations (TNCs)

Following the conclusion of the Israeli-Palestinian agreements, the Palestinian territory has witnessed a substantial increase in investment activities and revealed longer-term potentials. The anticipation of a new era of peace and prosperity, the commencement of construction activities financed by the international assistance programme and the reopening of Palestinian and Arab banks closed for decades, have attracted private investment from both domestic and foreign sources. The latter mainly consists of expatriate Palestinian and Arab investors, who, in conjunction with the local business community, have founded a few large holding companies, each with autonomous enterprises specializing in infrastructure development, residential construction, tourism and industrial projects. 191/ In addition to providing equity finance, these companies are active in modernizing business activities and shaping the corporate structure of the economy. However, these activities have not represented a marked increase in FDI that could achieve significant improvements in the manufacturing and services sectors.

As the situation stood at the end of 1997, most of the foreign companies that had established a presence in the territory were either establishing agency rights for their products, or bidding for the reconstruction contracts financed by the international assistance programme.192/ It is worth noting that so far no major TNC has initiated an investment project in manufacturing, owing to two factors. First, the uncertainty and insecurity in the territory since 1996 has resulted in the replacement of the initial euphoria by a cautious “wait and see” attitude. Second, given the small size of the Palestinian economy, most TNCs would not be interested in investing in manufacturing projects unless they are guaranteed access to neighbouring markets, something evidently lacking in this case.193/

This underscores the importance of reaching regional agreements not only related to trade but also aimed at rationalizing the regional industrial structure, including the optimal allocation of FDI. Such an arrangement would increase each country’s bargaining power and allow for a useful “unbundling” of some of the TNC investment packages.194/ A pooling of regional managerial and technical skills and capital resources would allow for joint venture arrangements with TNCs that would expedite the transfer of technology. Regional cooperation would also allow for harmonized regulations to govern TNCs' behaviour with regard to taxes, profits, employment and other relevant aspects.

In this regard, precautions should be taken against granting TNCs excessive or monopolistic power. The experiences of third world countries have clearly demonstrated that the absence of competition could mean a TNC using unsuitable techniques, in addition to the waste of resources through mis-allocation, high prices and a low level of production.195/ Experience has also shown that the waste created by giving monopoly power to TNCs is compounded by granting unjustified tax holidays. Most empirical studies have shown that such discretionary tax exemptions have only marginal effects on TNCs' investment decisions; they reward them for doing what they would have done in any case. 196/ In this regard, the PA has reconsidered its initial law on encouragement of private investment, which included provisions for generous tax holidays. One of the ways of preventing the acquisition of monopolistic powers by TNCs and their local partners is to concentrate on export-oriented industries. A TNC that has to export to world markets (outside the region) would be encouraged to adopt the least costly techniques of production and competitive pricing policies.

With the aim of initiating industrial activities and creating an attractive environment for FDI, the PA has embarked upon a programme of industrial estate (IE) development. The first three estates are planned in Gaza, Jenin and Nablus. Negotiations are under way with Israel to ensure that these zones are insulated from the disruptions of border closures.197/ The Gaza Industrial Estate (GIE) is scheduled to be the first in operation and is targeted primarily for export markets. Other IEs are planned for Nablus, Jenin and Hebron in the West Bank. The GIE is financed by private investors, the International Finance Corporation (IFC), the European Investment Bank and the donor community, and is expected to employ 17,000 permanent workers and generate around 20,000 additional jobs in supporting services.198/

The establishment of the GIE and the construction of Gaza Port would make the Gaza Strip an attractive centre for industrial estates and a free export-processing zone that would serve both domestic and export markets.199/ Given its geographic position, and its relatively trained labour force, Gaza has the potential of attracting TNCs specializing in footloose industries, and becoming an export platform to the EU and the United States. In addition to its contribution to employment and exports, a free zone would also undermine and diminish the tendencies of rent-seeking activities as it reduces the role of government in trade and export activities. It is worth noting that a free zone will influence Palestinian factors of production to reallocate away from other uses. To the extent that footloose industries typically employ low-skill labour, a change of relative wages against skilled labour might be one of the negative effects of the project that would have harmful consequences for future investment in human capital. This highlights the need to consider all possible consequences of the project and design remedies for their adverse impact. The project should also be considered within the framework of regional arrangements so as to avoid competition with neighbouring countries over the attraction of similar processing activities.

In view of present investment conditions, as well as the constraints on Palestinian production and entrepreneurial capacities, other avenues might also be explored for integrating the Palestinian economy into the global economy. They might include international subcontracting, technology licensing and similar forms of international cooperation arrangements, in line with global trends of splitting production chains between various geographical locations. Likewise, stronger emphasis should be placed on cooperation with foreign SMEs, including investors from developing countries, as distinct from large-scale TNCs. This is especially pertinent in the Palestinian case, as the economy is dominated by SMEs, in industry, construction, most private sector services and, of course, agriculture. Development strategies and economic policies that fail to take this basic reality into account run the risk of providing irrelevant or diversionary solutions to the problems faced by most Palestinian entrepreneurs in gaining access to new production techniques, technology, finance, market information and outlets.

Chapter VII

CONCLUSIONS AND POLICY GUIDELINES FOR ACTION

The previous chapters have analysed various aspects of the difficult situation facing the Palestinian economy at present, and have explored a number of strategies and policies intended to set it on a path of sustainable growth. The analysis has focused on relations between the Palestinian economy and the economies of Israel, the Arab countries, and further afield. In particular, the examination has highlighted how current patterns could be changed so as to effect an expansion in Palestinian production and trade, and help to restructure the economy in harmony with global trends.

A thorough examination of the present economic difficulties in the context of regional and global conditions, and in conjunction with the troubled peace process in the Middle East, has highlighted two essential considerations that have underpinned the subsequent analysis. The first contends that it is inappropriate for an analysis of this issue to invariably emphasize the need to choose between two opposing and extreme alternatives: in development strategy between export promotion and import substitution; in economic integration between regional arrangements and multilateral agreements; and in trade relations between a customs union and free trade.

It was stressed repeatedly throughout the preceding chapters that such dichotomies, more often than not, end up obscuring rather than elucidating the issues at hand. In most cases, presenting the two alternatives in conflict with one another, supporting one and criticizing the other, is not appropriate. Rather it is necessary to understand the fundamental dynamics at work, which reveal complementarities and consistencies between elements of the dualisms. Equally futile is the practice of classifying countries according to one characteristic, and then treating the sum of these characteristics as a formula for all regional integrations. A typical example of such an approach is the often repeated formula of “Saudi oil + Turkish water + Egyptian labour + Israeli skills and know-how”, as a recipe for future Middle East regional cooperation. This sort of prescriptive political-economic analysis has been criticized by regional experts as simplistic. 200/

In summary, the first consideration that permeates the analysis of this study is the conviction that there is no easy solution, or ready formula, to any of the problems facing the Palestinian economy with regard to its relations with its neighbours and its future integration into regional and world markets. Economic relations should be evaluated by considering the comparative advantages of each country with regard to each specific project. It is a fact of economic life that the comparative advantages of any country vary from one project to another and from one area to the other.

The second consideration that is emphasized throughout the study is the need to take into account the popular perception in countries of the region as to what is fair and equitable for all concerned. In this respect, it is unwise to ignore the fact that a sizeable segment of Arab public opinion remains opposed to normalizing economic relations with Israel in the absence of a political settlement. The legacy of decades of conflict and mistrust cannot be dismantled solely through agreements between Governments, perceived by public opinion to have been concluded without a settlement of the fundamental conflict in the region, namely a resolution of the final status issues between Israel and Palestine. The widely-held perception in Arab countries “that Israeli peace dividends are massive and real, while Palestinian and Arab gains are conditional, precarious and highly illusory” 201/ must equally be addressed.

Economic relations need to be predicated on sound foundations of history, geography and the long-term common interests of all the countries concerned. The specificity of the Middle East as the birthplace and “home ground” of the Muslim-Arab civilization, alongside the Judeo-Christian civilization, with the attendant cultural, religious and political implications, should be recognized and respected. It is a situation in which all can gain, or all can lose. Any new economic arrangements that ignore this fundamental reality will produce a short-term fix that cannot survive political change.

Guided by these considerations, relations between the Palestinian economy and the economies of Israel, the Arab countries, and regional blocs in Europe and America have been analysed with a view to exploring channels for expanding Palestinian production and trade. In the following paragraphs a brief summary of these analyses is undertaken, which highlight priority recommendations. The summary is presented under the headings of relations with Israel, future regional arrangements and integration into world markets.

A. Palestinian economic relations with Israel

There are some short-term policy measures which, if agreed, could constitute a useful working basis for discussing permanent status economic issues between Israel and Palestine, which are soon due to be addressed. For the remaining interim period, Israel and the PA should move to introduce some changes, which are allowed by the terms of the interim agreements between them, to exempt their mutual economic relations from the impact of political instability, violent acts and overriding security measures. There is also an urgent need to modify some of the procedures that have proved detrimental to reviving trade between the two sides and diversifying Palestinian trade in general. In this context, the following recommendations could be considered:

- Designating “passages” between Israel and the Palestinian territory, to provide the two sides with the facility to monitor the movement of goods and labour with/through Israel, thereby reducing the threat posed by security issues, while not prejudicing the outcome of final status negotiations.

- Establishing secure and adequate passage arrangements between the West Bank and Gaza Strip, free from the disruption of border closures.

- Negotiating a major relaxation in the restriction on passages of people and goods to/from Jordan and Egypt.

- Devising an effective solution to replace the extremely inefficient transportation procedures at borders, commonly known as back-to-back.

- Negotiating an agreement specifying a revenue-sharing formula for customs duties based on aggregate flows of trade, so as to stop the present leakage which is undermining the Palestinian fiscal position.

Successful negotiations between Israel and the PA implementing changes in line with the above recommendations could foster an improved economic climate during the remaining interim period and create the right atmosphere for conducting the negotiations concerning the final settlement. The economic dimension will occupy an important part of these negotiations and will set the stage for future relations between Israel and Palestine, which in turn are bound to be the catalyst for restructuring Arab-Israeli economic relations. The only Israeli-Palestinian economic relation that would bode well for peace and regional integration is one based on equal status, mutual trust and a serious search for equitable benefits to both sides. That requires redesigning relations cemented over decades of occupation and strife. The task is difficult and complex as it entails a mixture of coordination and separation that is inherent in the nature of the independence process and the nature of the interactions between a poor, small economy and an adjacent, large, advanced one.

In this light, two major conclusions are drawn. First, from the Palestinian perspective, future Palestinian economic development may be constrained by maintaining relations with Israel in line with a customs union arrangement. Such an arrangement could be detrimental to the future development of Palestinian industry as it denies cheap sources for inputs, and to the future integration of the Palestinian economy into the Arab economies, as it enforces taxes and regulations designed for a more advanced economy. Second, Israeli-Palestinian coordination in areas where the two economies complement each other requires a major retrenchment of the Israeli system of NTBs, especially in agriculture, textiles and garments. To oversee this reorientation, arrangements modelled on those of the current Joint Economic Committee (JEC) could ensure coordination between the two parties to decide jointly on tariff setting and tariff suspensions in order to allow Palestinian industries to import materials at lower tariffs where Israeli production is insufficient, or particularly costly, as well as to agree upon and monitor border facilitation measures.

In any case, future Israeli and Palestinian trade agreements should include a clause allowing the latter to conclude integration arrangements and bilateral preferential trade agreements with Arab and other developing countries. As a complementary step, the PA should also consider having an accession clause in future trade and economic cooperation agreements with Israel, that would allow for the automatic acceptance of any Arab country willing to enter the agreement and abide by its rules. Furthermore, the PA should give high priority to utilizing the preferential treatment accorded to its exports by the United States and the European Union, and explore all avenues to improve on them.

B. Future regional economic cooperation arrangements

Prolonged war, conflict and political unrest in the Middle East have undermined all attempts at regional economic integration. Arab economies remain connected with world markets as separate units. Each lacks both the market size needed for successful exploitation of economies of scale, and the bargaining power necessary for effective dealing with giant economic blocs. Dismantling this legacy, and moving towards regional economic integration based on a search for mutual benefits for all countries of the Middle East, is essential to the future well-being of all the people of the region. From the Palestinian perspective, the issue is more urgent as it has a direct bearing on the PA policy preference to reduce its exclusive reliance on the Israeli economy in many spheres. This in turn is not possible unless Palestinian economic transactions with Arab and other countries are expanded in an integrative manner. In this connection, the PA should assume a very active role in efforts aimed at the economic integration of Arab countries. It should pursue both the bilateral track, especially with Jordan and Egypt, and the regional track within the institutional framework of the Economic and Social Council of the League of Arab States. The following are priorities:

1. <u>Infrastructure</u>

- At present the availability of renewable water resources in the West Bank and Gaza Strip is among the lowest in the world. It is of the utmost importance for the final status agreement to grant the Palestinians a more equitable share of water resources. Thereafter, a regional water arrangement could be established for Israel, Jordan, Lebanon, Palestine and the Syrian Arab Republic. This could include the creation of a regional body equipped with both conflict-resolution mechanisms and technical expertise to address related issues of conservation, distribution and expansion.

- The PA needs to enter into negotiations with neighbouring countries with a view to building a unified Palestinian electric power system operating as part of a regional development grid that promotes interconnection between Egypt, Jordan, the Syrian Arab Republic and Lebanon, as well as Israel.

- New bridges need to be constructed between the east and west banks of the Jordan River to accommodate the expansion of trade and increased tourist activities. Modernization of procedures for border crossing between Gaza and Egypt is also urgently required.

2. <u>Rationalization of production and trade</u>

- Trade between the Palestinian economy and the Arab economies should be gradually re-established, with a view to arriving at regional free trade in a reasonable amount of time. The phasing of this undertaking should be carried out within the context of regional arrangements designed to exploit complementarities among countries, opportunities for both external and internal economies of scale, and the comparative advantages of sub-regions and the region as a whole.

- The above objective cannot be achieved without initiating a serious effort at the regional level aimed at modernizing procedures at border crossings, unifying the legal and technical aspects of custom duties, measurements, standards and rules of origin, and pooling human and capital resources to create an adequate and efficient transport system.

- A regional body, preferably from pan-Arab professional organizations and independent of governments, should monitor the impact of regional integration on the economies of the countries concerned and suggest schemes of compensation for adjustment and transitional costs.

3. Coordination of economic policies

- There is an urgent need to start on the long and complex path of integrating the capital markets of the region. A vibrant regional capital market free of fragmentation is essential to pooling regional savings, absorbing Arab savings from abroad, and allowing the optimal allocation of resources among competing investment projects, especially regional joint venture projects.

- There is a need for a regional price policy for water, oil and electricity so as to rationalize demand, improve the allocation of resources at the regional level, and reduce environmental costs.

- The PA would be well advised to prepare for the issuing of a currency that is linked with the Jordanian Dinar at a fixed exchange rate. This could be taken as constituting the first step towards participation in a unified currency area in the Arab Mashreq that would go a long way towards increasing the efficiency of investment and trade in the region. 202/

- Tax harmonization among Arab countries in the Mashreq is needed so as to encourage joint venture investments and intraregional trade, and to remove tax-induced distortions in the capital market.

- In the last two areas, the move towards harmonization is by no means imminent, and more limited and feasible objectives should be pursued in the short term, including the exchange of information, consultations among Central Banks on national monetary policies and regional disciplines on trade and production subsidies.

C. Integration into global markets

The anticipated achievement by the Palestinian economy of larger markets and lower costs of production as a result of its integration into regional markets, is expected to attract the foreign direct investment that is essential to start the process of integration with world markets. In this respect, the Palestinian economy, given its geographic position and its endowment of human resources, has the potential to become an export platform for both footloose manufactured production for EU and United States markets, and high-tech production and services directed towards the Middle East and Africa. Achieving this goal, however, requires the adoption of an aggressive strategy that emphasizes effective collaboration between the public and private sectors in order to create an enabling environment for investment. In this regard the following are priority recommendations.

- Encouragement of private sector attempts to found specialized exporting companies that will strive to acquire a foothold in European and

American markets, given the preferential treatment accorded to Palestinian products in these two areas.

- Establishment of an institutional channel through which Palestinian universities can be connected with centres of scientific research and technical excellence in North America and Europe dealing with new products, information-based services and new organizational methods of production and marketing.

- Adoption of a collaborative approach between the public and private sectors to found a trading company specializing in trade with eastern European and other emerging markets.

- Exploration of the potential for regional cooperation in pooling human and capital resources in policies and measures towards FDI and TNCs. The aim of such cooperation would be to increase countries' bargaining power and enable joint ventures to take place in which a useful "unbundling" of the investment packages could be achieved.

- Concentration of joint venture initiatives with companies investing in exports to world markets (outside the region), and adopting the least costly techniques of efficient production and competitive pricing policies.

- Evaluation of the impact of the newly established industrial estate in the Gaza Strip on the Palestinian economy, with regard to its direct income and employment creation, and its indirect repercussions on the industrial sector. The evaluation could be a part of a more general examination of the option of rebuilding the Gaza Strip into a free export-processing zone.

- Exploration of other possibilities for integrating the Palestinian economy into the global economy, including international subcontracting, technology licensing and similar forms of international cooperation arrangements. Likewise, stronger emphasis to be placed on cooperation with foreign SMEs, including investors from developing countries, as distinct from large-scale TNCs.

Notes

1/ The final study to emanate from this project was entitled "Prospects for sustained development of the Palestinian economy: strategies and policies for reconstruction and development" (UNCTAD/ECDC/SEU/12).

2/ For a summary review of recent economic developments in the Palestinian territory, see "Report on UNCTAD'S assistance to the Palestinian people" (TD/B/44/10).

3/ Palestinian Academic Society for the Study of International Affairs (PASSIA), *Yearbook*, Jerusalem, 1996.

4/ Palestinian Central Bureau of Statistics (PCBS), *Demographic Survey of the West Bank and Gaza Strip*, Ramallah, 1996.

5/ There is extensive documentation of this process. See, for example, "Economic and social repercussions of the Israeli settlements on the Palestinian people in the Palestinian territory, including Jerusalem, occupied since 1967, and on the Arab population of the Syrian Golan" Note by the Secretary-General (A/52/172; E/1997/71). For regular updates on Israeli settlement activity in the Palestinian territory, see Geoffrey Aronson "Settlement Monitor", published quarterly for the past few years in the *Journal of Palestine Studies*.

6/ PASSIA, "Yearbook ...".

7/ See, Roy, S., *The Gaza Strip: the Political Economy of Development*, Washington, D.C., Institute for Palestine Studies, 1995, p. 176.

8/ See, Lonergan, S. and Brooks, D., *The Israeli Palestinian Conflict*, Ottawa, International Development Research Center, 1994, p. 129.

9/ See, Roy, S., "The Gaza Strip ...", p. 177.

10/ See, Heller, M., *A Palestinian State: the Implication for Israel*, Cambridge, MA, Harvard University Press, 1983.

11/ Forty-four per cent of the confiscated land was for military purposes, 20 per cent for security reasons, 12 per cent for "public use" (e.g. green areas or nature reserves), and 12 per cent due to absent owners. Total confiscated land amounts to around 4,500 sq km, of which around 280 sq km are in the Gaza Strip and the rest in the West Bank. See PASSIA, "Yearbook ...".

12/ See, Awartani, H., "Agriculture development and policies in the West Bank and Gaza Strip" in Abed, G. (ed). *The Palestinian Economy*, London, Routledge, 1988.

13/ See, World Bank, *Developing the Occupied Territories: An Investment in Peace*, Washington D.C., 1993, vol. 4, p. 53.

14/ See, “Prospects for sustained development ...” (UNCTAD/ECDC/SEU/12) p. 20.

15/ See, International Labour Office, “Report of the Director-General, Appendix”, International Labour Conference, 82nd Session, 1995.

16/ See, World Bank, “Developing ...”, vol. 6, p. 35.

17/ The figure for the Palestinian economy is taken from Table 2, and those for Jordan and Israel from the World Bank, *World Development Report*, Washington, D.C., 1995.

18/ Figures for 1993 are taken from Table 2, and those for 1987-1991 from World Bank, “Developing the occupied territories ...” , vol. 6, p. 12.

19/ Ibid. For men aged 15 and older the figures for years of schooling and the participation rate are not consistent.

20/ For a detailed analysis of sectoral productivity issues, see “Prospects for sustained development ...” (UNCTAD/ECDC/SEU/12), p. 123.

21/ GDP per capita can be written as:

(GDP/Population) = (GDP/Employment) * (Employment/Labour Force) * (Labour Force/Population).
The corresponding ratios for 1993 are in United States dollars:
Israeli: 13273.5 = (41486.6)(.799)(.4)
Palestinian: 1395 = (I 1022.4)(.603)(.209)
Had the Palestinian economy featured the Israeli or Jordanian employment/labour force, and labour force/population rates, its GDP per capita would have been:
(GDP/Population) = (1*1022.4)(.799)(.4) = 3522.8
(GDP/Population) = (1*1022.4)(.87)(.25) = 2397.4

22/ Immediately after the signature of the Declaration of Principles between Israel and Palestine on 13 September 1993, an international conference was convened in Washington, D.C., where donor countries pledged to allocate some $2.4 billion, over the period 1994-1998, as aid for the reconstruction of the Palestinian economy in the West Bank and Gaza Strip.

23/ See, Hamed, O. and Khano, M., “Palestinian banking sector: statistical review”, Issue 2, Ramallah, Palestinian Economic Policy Research Institute (MAS), December 1995.

24/ The World Bank estimated that accumulated savings abroad of Egypt, Jordan, the Syrian Arab Republic, and Israel in 1991 amounted on average to 120 per cent of GNP (see Table 4). On the assumption that this is a reasonable ratio for the West Bank and Gaza Strip, savings abroad would amount to $4.3 billion for 1995, given that GNP of that year was $3.58 billion (see Table 2). As circumstances in the West Bank and Gaza Strip are probably more conducive to the flight of capital than in neighbouring countries, this estimate is quite conservative.

25/ Aggregate macro-economic data for the West Bank and Gaza Strip since 1991 are estimates based on incomplete statistical series. There are several alternative estimates with significant differences (see chapter II).

26/ See “Prospects for sustained development ...” (UNCTAD/ECDC/SEU/12) for a detailed presentation of the findings of UNCTAD’s research on this issue.

27/ For an influential view of the role of Palestine in future regional arrangements see, Sayigh, Y.A., “Why Palestine is the proving ground for regional cooperation: strategies for the Middle East one year after autonomy”. This paper was submitted to a conference on regional cooperation organized by research groups in Europe at the University of Mainz and the Bertelsmann Foundation in Gutersol, and took place in Cairo, on 21-23 June 1995.

28/ For a detailed analysis of the tourist sector in the West Bank and Gaza Strip see “The tourism sector and related services in the Palestinian territory under Israeli occupation” (UNCTAD/RDP/SEU/7).

29/ The share of services in world trade rose from 17 per cent in 1980 to 22 per cent in 1993, and it looks set to accelerate due to the growth of long-distance services, according to the World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa*, Washington, D.C., 1995.

30/ For a thorough review of the subject see, “Sources of social and economic statistics on the West Bank and Gaza Strip” (UNCTAD/ECDC/SEU/10).

31/ For an evaluation of Palestinian economic losses in this period, see “Recent economic developments in the occupied Palestinian territory” (TD/B/1305).

32/ For an in-depth analysis of the impact of the closure policy and related measures on Palestinian external trade, see “Palestinian merchandise trade in the 1990s: challenges and opportunities” (UNCTAD/GDS/SEU/1).

33/ Israel has imposed intermittent closures for security purposes on the West Bank and Gaza Strip since 1993, impairing the entry of Palestinian workers and goods into Israel and their movement between different regions of the Palestinian territory. The closures that started in early 1996 also covered the West Bank-Jordan and Gaza Strip-Egypt borders for many weeks at a time, depriving thousands of workers of their income and disrupting trade as well as medical and educational services. An Israeli economist has estimated the short-term cost of the closures for the economy of the West Bank and Gaza Strip to be as follows (in terms of percentage decline in GDP):

	1990	1991	1992	1993	1994	1995	1996
West Bank	39	42	31	27	24	21	20
Gaza Strip	39	55	32	39	26	24	20

See Arie Arnon "Links between the Israeli and Palestinian economies" Mimeo. See also "Israel and the occupied territories", Economist Intelligence Unit, *Quarterly Report*, third quarter, 1996, p. 33.

34/ 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). Estimates in Table 9 for merchandise trade with Israel and estimates for 1992-1994 on trade with the rest of the world are calculated from Israel Central Bureau of Statistics (ICBS), *Israel's balance of payments*, Jerusalem, January 1997, and ICBS, *Israel Statistical Abstract 1996,* Jerusalem, 1997. Estimates for 1995-1996 on trade with the rest of the world are based on data provided by the PA Ministry of Economy and Trade as well as tables provided by Egypt, Ministry of Foreign Affairs, Palestine Affairs Department (on trade with Egypt) and also on information provided by Jordan, Ministry of Foreign Affairs, Palestinian Affairs Department, including a report prepared by the Amman Chamber of Commerce, published in "*Al-Quds*", 27/11/96 (in Arabic) (on trade with Jordan, excluding transit trade).

35/ For an analysis of these imbalances in the 1970s and 1980s, see "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip, 1990-2010: a quantitative framework" (UNCTAD/ECDC/SEU/6).

36/ Consider the national income identity:

GNP = Y = C + I + G + X - M + NFI

where

C - private consumption.
I - private and public investments.
G - public consumption.
X - exports.
M - imports.
NFI - net factor income.
Y - yields

Since public saving, S, is equal to Y - C - G, the identity can be written as:

(I - S) = (M - X) - NFI.

Dividing both sides by Y yields: Import Surplus = Import Surplus - Net Factor Income (all expressed as ratios of GNP).

The use of the data in Table 7 shows that while the import surplus declined from 40 per cent in 1991 to 34 per cent in 1995, the investment surplus increased from 16 per cent to 28 per cent. This is because the ratio of net factor income to GNP has declined from 25 per cent to 6.5 per cent in the same period.

37/ The fall in factor income during 1994-1995 reduced estimated national savings from $95 million in 1993 to $37 million in 1994, and to a negative figure of $271 million in 1995 (all at constant 1986 prices), as seen in Table 8.

38/ Some Palestinian and international observers believe that these unemployment figures are very conservative, and that the actual rates are much higher. See, for example, "Recent economic developments ..." (TD/B/1305) and International Labour Office, "Report of the Director-General, Appendix", International Labour Conference, 83rd Session, 1966.

39/ Part of the deficit is covered by international assistance through the "Holst Fund", administered by the World Bank.

40/ See, Burgess and Stern "Taxation and development", *Journal of Economic Literature*, vol. XXXI, June 1993, pp. 762-824.

41/ According to the Protocol that governs economic relationships between Israel and the PA, the former reimburses the latter for customs duties collected on goods passing through Israel and destined for the West Bank and Gaza Strip. Most Palestinian imports are brought in as part of Israeli imports and thus do not qualify for reimbursement. For more details see Naqib, F., *A Preliminary Evaluation of the Tax System in the West Bank and Gaza Strip*, Ramallah, Palestinian Economic Policy Research Institute (MAS), 1996, and Jawhary M., *"The Palestinian-Israeli trade arrangements: Searching for Fair Revenue-Sharing*", Ramallah, Palestinian Economic Policy Research Institute (MAS), 1995.

The 1997 figure was quoted by the Director-General for Customs and Excise, PA Ministry of Finance, at a meeting organized by the PA Ministry of Economy and Trade, Ramallah, January 1997.

42/ See PCBS, *Palestinian National Accounts - 1994, Preliminary Estimates*, Ramallah, 1997.

43/ These percentages are taken from the data used by the PA Ministry of Finance and the IMF. It should be noted, however, that PCBS estimates of national accounts for 1994 have raised some doubts concerning the contribution of agricultural and manufacturing to GDP, as their shares are estimated at 13 per cent and 12 per cent, respectively.

44/ For an analysis of the stages of the reconstruction and development programme, see, "Prospects ..." (UNCTAD/ECDC/SEU/12), chapter IV.

45/ For a detailed analysis of the required policies and strategies in the agricultural sector see "Prospects ..." (UNCTAD/ECDC/SEU/12) and "Agriculture in the West Bank and Gaza Strip" (UNCTAD/DSD/SEU/Misc.5). Also see World Bank "Developing ...", Washington, D.C., 1993, vol. 4, p. 39.

46/ Palestinian agriculture in the 1980s lost many of its traditional export markets as a result of increases in production costs. For details see

El-Jafari, M., “Non-tariff barriers: the case of the West Bank and Gaza Strip agriculture exports”, *Journal of World Trade*, vol. 25, No. 3, June 1991, pp. 15-31.

47/ For more details see “Prospects ...” (UNCTAD/ECDC/SEU/12), chapter IV.

48/ The PA has signed exclusive contracts with foreign companies and permitted the establishment of some companies with monopoly power. See Abdulla, S. “Evaluation and review of the reconstruction and development effort since the beginning of the transitional period”, a paper presented at the Symposium on the Reconstruction and Development of Palestine, Cairo, 7-9 November 1995 (in Arabic).

49/ This understanding between the PA and the donor community, originally reached in 1996, was again underlined at the most recent meeting of the Consultative Group of Donors in December 1997. See World Bank press release “International community reaffirms support for Palestinian development”, Paris, 15 December 1997.

50/ For a detailed description of the transport sector under Israeli occupation, see “Developments in the services sector in the West Bank and Gaza Strip, 1967-1990” (UNCTAD/ECDC/SEU/7).

51/ The following draws mainly on chapter IV of “Prospects ...” (UNCTAD/ECDC/SEU/12), pp. 78-84.

52/ A detailed programme for the rehabilitation and reconstruction of all vital infrastructure is included in: Palestine Liberation Organization, Department of Economic Affairs and Planning, “Program for Development of the Palestinian National Economy, 1994-2000 (PDP)”, Tunis, 1993.

53/ See, “Economic development and cooperation in the Middle East and North Africa”, Paper prepared by the World Bank at the request of the Multilateral Working Group on Regional Economic Development, October 1993 and “Public utilities in the West Bank and Gaza Strip” (UNCTAD/ECDC/SEU/2).

54/ As most health care is provided in the private sector, the following inefficient allocation of resources is conspicuous:

(i) Small-scale hospitals (over two thirds of all hospitals have fewer than 100 beds) dominate the sector and are not capable of exploiting economies of scale.

(ii) Some of these hospitals are equipped with costly high-technology equipment, and consequently charge very high fees that are affordable only by a small segment of society. See World Bank, “Economic development and cooperation ...”

55/ For an analysis of the failure of regional agreements in the 1960s among Latin American countries, see Bhagwati, J. “Regionalism and multilateralism: an overview”, in Demelo and Panagariya (eds), *New Dimensions in Regional Integration*, Cambridge University Press, 1993; Balassa, B. and Stoutjesdik, A. “Economic integration among developing countries”, IBRD, mimeo, 1974.

56/ In 1947 when the original GATT Charter was drafted, there were no major examples of regional arrangements in the form of a Customs Union (CU), or Free Trade Area (FTA). However, Article XXIV of the WTO Charter contains rules to ensure that members who entered into such arrangements do not increase duties and other regulations on imports from third countries. Since 1979, the Enabling Clause allowed developing countries to extend preferences to one another within the framework of regional arrangements that need to conform to Article XXIV. See Anderson and Blackhurst (eds.), *Regional Integration and the Global Trading System*, St. Martin's Press, 1993, chapter 19. The document issued by GATT entitled "Understanding on the interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994", specifies the rules that members of a CU or FTA have to satisfy in order to be consistent with Article XXIV.

57/ Richard Blackhurst and David Henderson state: "It is widely accepted that the signing of the Treaty of Rome was the major stimulus behind the decision to launch and successfully conclude the Dillon Round (1960-2) and the Kennedy Round (1964-7) of multilateral trade negotiations. The subsequent enlargement of the EC was a key factor behind the launching of the Tokyo Round (1973-9), and the inclusion of financial and other services in the EC's Single Market programme helped propel the negotiations on services in the Uruguay Round. The pace of post-1960 trade liberalization, and of the extension of the GATT into new areas such as services, might have been a good deal slower in the absence of the 'commercial challenge' posed by the evolution of the EC"; see "Regional integration agreements, world integration and the GATT" in "Regional Integration ...".

58/ Non-tariff barriers to trade, especially standards requirements, have acted as a barrier to developing countries' exports of manufactures to developed countries.

59/ It is widely believed that European economic integration (European Union) has greatly enhanced competition in European markets, and that, in turn, has been responsible for a large proportion of the gains attributed to integration. See, Demelo and Panagariya, "New Dimensions ...", chapter 7.

60/ The most important of these is the Multi-Fibre Arrangement, which restricts developing countries' textile exports to developed countries. This restriction is estimated to cost the developing countries $24 billion a year in lost textile and clothing export earnings. All restrictions by developed countries have been estimated to cost the developing countries $40 billion a year in exports, which amounts to lowering their GDP by more than 3 per cent. See, Todaro, M., *Economic Development*, fifth edition, New York, Longman, 1994, p. 491.

61/ In December 1991, the leaders of the EC countries signed the Maastricht Treaty, according to which full monetary union has to be achieved no later than 1 January 2001 for those countries that satisfy certain requirements. Beyond the monetary provision, the Treaty includes important measures aimed at harmonizing social policies among the European countries and concerning, among other aspects, immigration rules, consumer protection, and workplace safety.

62/ The "bottom-up" approach might be preferable for many reasons, including the fact that some sectors may be more ready than others for liberalization of trade, as there are varying degrees of complementarity among sectors in different countries.

63/ For detailed and informed analysis of past experience in regional integration among developing countries see: Demelo and Panagariya, "New Dimensions ...", chapters 8, 9, and 13. For further information on this concept, see *Economic Integration in West Asia*, United Nations Economic and Social Commission for Western Asia (ESCWA), Baghdad, 1985.

64/ For analysis of the reasons underlining the failure of past attempts at integration among Arab countries, see ESCWA, "Economic Integration..." and "*Report on a programme for technical cooperation for trade development in the Arab region*" (UNDP/UNCTAD/ITC), Geneva, March 1992.

65/ For an analysis of the difference between developed and developing countries in regard to the impact of liberalization of trade, see Robson, R., *The Economies of International Integration*, third revised edition, Allen and Unwin, 1987, chapter 11.

66/ For more details see Robson, R., "The Economies ...". Examples include the collapse of the Portuguese Community, the Central African Federation, the Central American Common Market and East African Community. The stronger partners who grasped the benefits of these schemes were Portugal, Southern Rhodesia, El Salvador and Kenya, respectively.

67/ See, Edwards, C., *The Fragmented World: Competing Perspectives on Trade, Money and Crisis*, Methuen, 1985, p. 229.

68/ Internal economies of scale are related to the increase in productivity arising from the increase in the scale of the firm. External economies occur when productivity of a firm increases as a result of an expansion of the industry or economy, independently of the scale of the firm.

69/ The Association of Southeast Asian Nations (ASEAN) was established at Bangkok in 1967 to accelerate economic progress and to increase the stability of the Southeast Asian Region. It began with four members, but now includes a total of six - Malaysia, Singapore, Thailand, Indonesia, Brunei and the Philippines. For more details see Hodder, R. "The West Pacific Rim" in Gibb, R. and Michalk, W. (eds.), *Continental Trading Blocs*, John Wiley and Sons, 1994.

70/ The insistence on including trade liberalization in restructuring reform policy packages has encouraged a mistaken belief that macro-economic stability cannot be achieved without simultaneous liberalization in the trade regime. In fact trade liberalization is neither necessary nor desirable for macro-stability. It is not necessary because trade policy determines the degree of openness of an economy, but not its trade balance (or current account). The latter is determined by the balance between national income and domestic absorption, which in turn is influenced by the exchange rate and the fiscal stance of the government. It is not desirable because it can put pressure on the exchange rate that is detrimental to macro-stability. During a period of macro-instability, say an inflationary period, stabilization requires an appreciation of the exchange rate to reduce expenditures, whereas a depreciation would be desirable if at the same time a major reduction in tariffs had taken place which might worsen the trade balance. For detailed analysis on the relationship between trade reform and macro-stability see Rodrik, D., "The limits of trade policy reform in developing countries", *The Journal of Economic Perspectives*, vol. 6, No. 1, winter 1992, pp. 87-105.

71/ One of the shining examples of an industry that started with full protection by the State and succeeded in becoming very efficient, export-oriented, and a world leader is the steel industry in the Republic of Korea. In *Embedded Autonomy*, Princeton University Press, 1995, pp. 74-77, Peter Evans recounts that in the 1960s the Government of the Republic of Korea approached the World Bank and the centres of Western finance with the request to finance a large-scale integrated steel plant on Korea's southeast coast. The request was rejected because "it made no sense for Korea to contemplate becoming a serious steel producer. Korea had no iron ore, it had no coking coal, and it had no tradition of heavy industry. Korea had better stick with its comparative advantage and work on making its cotton industry more competitive". The Government of the Republic of Korea was not deterred by this answer, and, with some financial and technical help from Japan, established the Pohang Iron and Steel Company Ltd. (POSCO). The investment was the largest ever attempted by the Republic of Korea ($3.6 billion), and its risk was completely assumed by the Government. Today, POSCO is one of the world's biggest and most efficient steel producers, making a profit while selling hot-rolled coil in Korea for half the United States list price; it also exports 30 per cent of its output. Moreover, POSCO was instrumental in the emergence of key industries such as shipbuilding and automobiles. It acquired a world reputation to the extent that "when US Steel (USX) wanted to modernize its Pittsburgh plant in 1986, it formed a joint venture with POSCO to take advantage of POSCO's design expertise".

72/ SACU as a customs union was established in 1910. Its structure was entirely renegotiated in 1969, and after that changes were introduced in 1976, 1981 and 1990. The union includes South Africa, Botswana, Lesotho, Namibia and Swaziland. The GDP of South Africa is almost equal to 25 times the sum of the other four countries (referred to as the BLNS countries). The union has a revenue pool into which customs duties on imports, excise taxes and additional taxes on domestic goods are transferred. This revenue is distributed according to the following formula:

Si = { (Mi + Di) / (M + D) } . P . (1.42), where;
Si = Share of country I from the BLNS countries.
Mi = Imports of country I including its imports from other members of the union.
Di = Value of all goods produced and consumed in country I that is subject to excise and additional taxes.
M = Total imports to the union.
D = Total value of goods produced and consumed in the union that is subject to excise and additional taxes.
P = Total revenues of customs, excise, and additional taxes in the pool.

The share of South Africa is the residual left after the other four countries have taken their share according to the above formula. Note that a BLNS country share is multiplied by 1.42 to compensate it for accepting a common external tariff (CET) designed by South Africa to protect its products, and to offset the problem of polarization, i.e., industrial and trade concentration in favour of South Africa. For more details concerning the mechanics of SACU, see Kanafani, N., *Trade Relations Between Israel and Palestine: Free Trade Area or Custom Union*, Ramallah, Palestine Economic Policy Research Institute (MAS), October 1996. Also see Jawhary, M., “The Palestinian-Israeli trade arrangements ...”, section 2.

73/ The words “hub” and “spoke” are used in their literal meaning; a “hub” is connected to each “spoke”, but a spoke is connected just to the “hub”.

74/ The “hub-and-spoke” system became a topic of interest during the negotiations between the United States, Canada, and Mexico over NAFTA. Canada entered the negotiations so as to avoid being a spoke with the United States as hub. After the signing of NAFTA many Latin American countries contemplating a FTA with the United States are wary of ending as spokes in a complex and discriminatory arrangement. For analysis of the “hub-and-spoke” system see Anderson and Blackhurst “Regional Integration ...”, p. 337, and Lipsey, R., “Getting there: the path to an hemispheric FTA”, a paper presented to a workshop on “US-Latin American Trade Relations in the 1990s”, Overseas Development Council, Washington, D.C., mimeo, 1991.

75/ In fact, many studies of East Asian successes emphasize the strong supportive role of governments. For a useful analysis of the role of government in East Asian economic growth, see Braford, C., “East Asian models: myths and lessons” in Lewis, J. and Kallab, V. (eds.), *Developing Strategies Reconsidered*, Washington, D.C., Overseas Development Council, 1996, chapter 5.

76/ For more details see Demelo and Panagariya, “New dimensions ...”.

77/ See Ghantus, E., *Arab Industrial Integration*, London, Croom Helm, 1982.

78/ See Wilson, R., *Economic Development in the Middle East*, London, Routledge, 1995.

79/ Ibid.

80/ UNDP/UNCTAD/ITC, “Report on a programme for technical cooperation ...”; also see Amin, S., *The Arab Economy Today*, London, Zed Books Ltd., 1982, and Wilson, R., “Economic development ...”.

81/ See Wilson, R., ibid., p. 173.

82/ See UNDP/UNCTAD/ITC, “Report on a programme for technical cooperation ...”, chapter III.

83/ Ibid.

84/ Ibid.

85/ See “Agreement to facilitate and develop trade among the Arab States”, published by the League of Arab States General Secretariat, Department of Economic Affairs, Tunis, 1982 (in Arabic).

86/ Construction of a small airport in Gaza was completed by 1997, but negotiations on its operation had not been concluded in early 1998.

87/ For a detailed description of the difficulties encountered by Palestinians in trade via Israeli points of entry see “*Trade for peace in the new Middle East: Measures to enhance trade between Egypt, Jordan, Israel and the Palestinian territories*”, a study conducted by the German-Arab Chamber of Commerce, Cairo, under contract to the Commission of the European Communities, October 1995.

88/ Ibid, p.26

89/ This procedure has the added disadvantage of causing a fiscal leakage in favour of Israel. The issue is discussed more fully in chapter IV.

90/ There are 700 km of main roads, 800 km of local roads and 500 km of regional roads. It is estimated that 40 per cent of West Bank roads require immediate rehabilitation. See “Trade for peace ...”, p. 20.

91/ Goods in lists A.1 and A.2 specified by the agreement between Israel and Palestine are not subject to Israeli standards regulation, and the PA has the right to choose their tariffs.

92/ See, Halevi, N., “International trade”, a paper presented to a Conference on Sustaining Middle East Peace Through Regional Cooperation, Amsterdam, 17-19 October, 1994.

93/ For a detailed description of taxes in Israel applicable to the West Bank and Gaza see Naqib, F., “A preliminary evaluation ...”.

94/ By the end of 1993, only two Arab banks with 13 branches were operating in the West Bank and Gaza Strip. By the end of June 1996 there were 13 banks with 60 branches. It should be noted that the banking system is dominated by foreign banks. As of June 1996 only three banks with 15 branches were locally chartered. The banks have been quite successful in mobilizing domestic services, but their ability to channel savings to local investors is very limited. The main factors that inhibit lending to investors are the lack of acceptable collateral (absence of a capital market) and political and economic uncertainties. For a detailed analysis of the banking activities in the West Bank and Gaza Strip in the last three years, see Hamed, O. *The Palestinian Banking System: Reality and Potential*, Ramallah, Palestinian Economic Policy Research Institute (MAS), December 1996.

95/ “Palestinian merchandise trade ...” (UNCTAD/GDS/SEU/1).

96/ See “Trade for peace ...”, p. 57.

97/ For example, the following show the composition of Palestinian exports and imports in 1986 and 1993.

1986

	Israel	Jordan	Other countries
	%	%	%
Exports	73	24	02
Imports	96	01	03

1993

	Israel	Jordan	Others
	%	%	%
Exports	82	14	04
Imports	94	03	01

Calculated from Tables 3, 4, 5 and 6 of El-Jafari, M., “External merchandise trade ...”.

98/ For a detailed analysis of the trade relationship between Israel and the Palestinian economy until the early 1990s, see: “Palestinian external trade under Israeli occupation” (UNCTAD/RDP/SEU/1); “Main features of domestic and external merchandise trade of the West Bank and Gaza Strip” (UNCTAD/ECDC/SEU/5); and “Developments in the economy of the occupied Palestinian territory” (TD/B/41(1)/3).

99/ The Israeli-Palestinian accords were also published as United Nations documents, see, *Protocol on Economic Relations between the Government of Israel and the PLO, representing the Palestinian People* (A/49/180, S/1994/727 of 20 June 1994), p. 125.

100/ For a detailed description of such growth-oriented plans see, “Prospects for sustained development ...” (UNCTAD/ECDC/SEU/6) and “Prospects ...” (UNCTAD/ECDC/SEU/12), chapters III and IV.

101/ For detailed analysis of the regulations governing the interim period as spelled out in the Protocol, see ibid., chapter II.

102/ Under the Protocol, Palestinian industrial goods can enter Israeli markets with no tariffs, though Israeli standards must be met. Palestinian agricultural goods are also free to enter with the exception of quotas until 1998 on poultry, eggs, potatoes, cucumbers, tomatoes and melons. See, “The Protocol ...” (A/49/180, S/1994/727), Art. VIII.

103/ Under the Protocol, the Palestinian side is allowed to import a limited number of goods from, and through, Jordan and Egypt. The goods are specified in three lists in Appendices I and II of the Protocol. List A.1 specifies goods that are produced in Egypt, Jordan, or other Arab countries (two-fifths of these goods may be produced in Egypt and Jordan only). List A.2 mostly consists of food items; these may originate in Arab or other countries, but their quantity is agreed upon by the two sides in a manner that reflects Palestinian consumption needs. Estimation of those needs will be based on the best available data regarding past consumption. Finally, list B specifies certain “development goods” needed for investment and reconstruction purposes.

104/ Arie Arnon states: “Though there are no explicit figures in the Protocol concerning the flow of labour from the Palestinian economy to Israel, the implicit figures were 70 to 120 thousands”. He also mentioned the figure 100-120 thousands as the number estimated in Ben-Shachar, H., “Israel and the Palestinians - towards integration or separation? The economic aspect”, Discussion Paper, The Steinmitz Center for Peace Research, Tel Aviv University, 1995.

105/ Employment in Israel was 30 per cent of the labour force in 1992, and 25 per cent in 1991. See Table 6.

106/ The Protocol states that “if the normal movement is suspended temporarily by either side, it will give the other side immediate notification, and the other side may request that the matter be discussed in the Joint Economic Committee”. “The Protocol ...”, (A/49/180, S/1994/727), Art. VII.

107/ See the Economist Intelligence Unit, “Israel and the occupied territories”, third quarter, 1996.

108/ Israel has imposed intermittent closures on the West Bank and Gaza Strip since 1990. Military checkpoints have been erected and Palestinian entrance to Israel denied, while access to Jerusalem and free movement between the southern and northern parts of the West Bank has been impaired. The closures that started in February 1996 covered the West Bank-Jordan and Gaza-Egypt borders for many weeks, depriving thousands of workers of their income, and disrupting trade as well as medical and educational services. The Israeli economist, Arie Arnon, has estimated the short-term cost of the closures for the economies of the West Bank and Gaza Strip to be as follows:

(In percentages of GNP)							
	1990	1991	1992	1993	1994	1995	1996
West Bank	39	42	31	27	24	21	20
Gaza Strip	39	55	32	39	26	24	20

109/ Obviously, these passages could be changed in accordance with the final agreement concerning borders.

110/ See Kleiman, E. “Does Israel need foreign workers”, Discussion Paper 96.03, Falk Institute for Economic Research, Jerusalem, 1996 (in Hebrew).

111/ For a detailed examination of the mechanics of trans-border procedures, including back-to-back, see “Palestinian merchandise trade ...” (UNCTAD/GDS/SEU/1). Another investigation of these issues finds that “one solution would be to deliver goods to an accredited local warehouse facility where security checks can be undertaken by the representatives of the relevant authorities. Transport would then be containerized from one warehouse to the next and the security problem is relieved by sealing the container. Border officials would have only to check the seal is intact”, in “Trade for Peace ...”, p. 10.

112/ There are already several relatively well-controlled “passages” between Israel and the Gaza Strip, dealing respectively with trade, labour flows and other movements of people.

113/ A Joint Economic Committee is entrusted by the Protocol to follow up its implementation and to “decide on problems related to it that may arise from time to time”, “The Protocol ...” (A/49/180, S/1994/727), Art. II.

114/ Article III, paragraph 15, of the Protocol states: “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 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”, ibid., (A/49/180, S/1994/727).

115/ Palestinian wholesalers and firms use Israeli traders to import from the rest of the world (excluding imports from Egypt and Jordan) for two main reasons. First, it is cheaper and time saving to import through Israeli traders (see chapter III). Second, Palestinian imports as a part of large Israeli import consignments can benefit from discounts on bulk shipments.

116/ See, Jawhary, M., “The Palestinian-Israeli trade arrangements ...”.

117/ The value of VAT on Palestinian imports from Israel in 1995 was $185 million. Given that customs duties are on average 24 per cent, and that the VAT rate is 17 per cent, the total value of imports may be calculated at (185)/((0.17) * (1 + 0.24)) = 876 (million dollars). Using Jawhary’s assumption that 60 per cent of imports are of non-Israeli origin, the foregone revenue on indirect imports would be $127 million. But there is reason to believe that the 60 per cent assumption is very conservative, and that the figure is more likely to be between 70 and 75 per cent, as was indicated by the annual report of the Bank of Israel (1988). These two figures raise the estimated foregone revenue to between $147 and $158 million, respectively.

118/ See chapter III.

119/ For an analysis of these effects see Krugman, P. and Obstfeld, M., *International Economies: Theory and Policy*, third edition, Harper Collins College Publisher, 1994, chapter 8, and Thirllwall, A., *Growth and Development*, fifth edition, Macmillan, 1994, chapter 5.

120/ The advanced economy is generally more productive in the majority of sectors. The small economy will be able to export to the large economy goods that have no absolute advantage in production, provided it has smaller productivity disadvantages and its labour accepts wages lower than those prevailing in the large economy. Free mobility of labour would induce labour to move from the low-wage small economy's industries to the high-wage large economy’s industries, gradually wiping out the former and expanding the latter. In the long run, no industry will survive in the small economy unless it enjoys an absolute advantage over its counterpart in the large economy, and that means predominance of low-skilled industries.

121/ For an analysis of the cost of agricultural production in the West Bank and Gaza Strip versus Jordan see, Awartani, H., *Palestinian-Jordanian Agricultural Relations: Constraints and Prospects*, Nablus, Center for Palestine Research and Studies (CPRS), 1994. For a similar analysis related to garments, pharmaceuticals and shoes, see, Makhool, B., “*Competitiveness of Palestinian Industry vs. Jordanian Industry*”, Ramallah, Palestinian Economic Policy Research Institute (MAS), 1996.

122/ Ibid.

123/ For detailed analysis of the Dutch Disease phenomenon, see, Gorden, W. and Neary, J. “Booming sector and de-industrialization in a small open economy” *Economic Journal*, 92, 1982, p. 114.

124/ The very low contribution of agriculture to GDP and exports reflects mainly the rapid transformation of the Israeli economy towards high-tech activities, as well as a considerable reduction in governments' subsidies to agriculture in recent years.

125/ See, Lonergan S. and D. Brooks, *Watershed: The Role of Fresh Water in the Israeli-Palestinian Conflict*, Ottawa, International Development Research Centre, 1994, p. 79.

126/ See, "Prospects for sustained ...", (UNCTAD/ECDC/SEU/12), p. 20.

127/ For more details concerning subcontracting in the pre-1990 period, see: "Palestinian external trade under Israeli occupation", (UNCTAD/RDP/SEU/1). A more recent in-depth treatment of the subject may be consulted in Mansour, A. and B. Destremau, *"Palestine and Israel: subcontracting in the garment industry"*, Ramallah, Palestinian Economic Policy Research Institute (MAS), December 1997.

128/ The principle of most-favoured-nation implies that any tariff reductions granted to one partner should be extended to all trading partners. It is considered as the cornerstone of GATT. It has very important exceptions, however, those of customs unions and free trade areas.

129/ See, "Trade for Peace ...", p. 26.

130/ Ibid.

131/ The refinery is owned by a private Israeli company, Merchav, (40 per cent), a private Egyptian company (40 per cent) and by the Egyptian General Petroleum Corporation (20 per cent). The project is financed by $240 million owner's equity, a $300 million European Investment Bank loan, a $150 million loan guarantee from the Israeli Government to Israeli suppliers, and commercial loans amounting to $570 million. The refinery will produce gasoline, jet oil and other middle distillates and is expected to generate considerable downstream activities. Ibid., p. 67.

132/ The speed of normalization between Jordan and Israel has impressed the international media, which have often referred to it as a "warm peace", implying a contrast with the "cold peace" between Israel and Egypt. There is a growing belief in some Arab circles, especially in Egypt, that the "warm peace" fits an Israeli policy goal of establishing an economic union with Jordan and the Palestinian economy, as a first step towards wider alliances within the Arab Mashreq as a whole, while marginalizing the role of Egypt. See, Sayyed-Ahmad, M. "Egypt and Israel and the nuclear treaty", *Journal of Palestinian Studies*, No. 22, Spring 1995, pp. 71-77 (in Arabic). Hufiz, S. "Middle-easternism: from normalization to integration", *Al-Ahram*, 16 November 1994 (in Arabic).

133/ Many in Jordan had hoped that the opening up of trade with Israel would compensate for the loss of export markets in Iraq and the Gulf, especially for agricultural products. Jordanian trade officials interviewed in the course of preparation of this study in April 1996 expressed disappointment that Israeli customs officials refused to allow Jordanian tomatoes to enter Israel on account of their failure to meet standard specifications.

134/ In June 1994, the Israeli Minister of Industry and Trade was quoted as saying that the volume of trade between Israel and Morocco was approximately $100 million (*Yediot Aharonot*, 20 June 1994 (in Hebrew)). He added that exports are almost equal to imports and involve textiles, agricultural products and tourism. It should be noted that trade with Arab countries, with the exception of Egypt, Jordan and the Palestinian territory, do not appear in the Israeli official statistics and thus such claims are difficult to substantiate.

135/ The Syrian Arab Republic and Lebanon did not participate in the multilateral negotiations groups on the grounds that a political settlement should be achieved prior to embarking on regional economic cooperation.

136/ See *The Economist*, 4-10 November 1995, p. 48.

137/ According to one earlier forecast, Israeli trade with Arab countries could reach $2.5 billion by the turn of the century - Deputy Director of the Economic Affairs Department of the Israeli Ministry of Foreign Affairs, quoted in *Yediot Aharonot*, 2 June 1994 (in Hebrew).

138/ It is estimated that in 1994 just 22,000 Egyptians visited Israel compared to 230,000 Israelis who visited Egypt. Similarly, it is estimated that 120,000 Israelis visited Jordan in 1995, while the number of Jordanians visiting Israel was just 10,000. On 8 January 1997, over 2,500 demonstrators from 20 of the 23 legally registered political parties, members of parliament, union activists, students and even businessmen protested against the Israeli trade fair at a site 20 km south of Amman. See *Middle East International*, No. 542, 24 January 1997, p. 6.

139/ See, Salama, S. (ed.), “Middle-easternism: is it the only choice?”, Cairo, Al-Ahram Centre for Translation and Publishing, 1995 (in Arabic).

140/ See, Abdul-Fadil, M. “The peace process and its repercussions on Arab development”, *Journal of Palestinian Studies*, No. 25, 1996, pp. 79-96, (in Arabic), and Sabri-Abdulah, I., *The Unity of the Arab Nation*, Cairo, Al-Ahram Centre for Translation and Publishing, 1995 (in Arabic).

141/ El-Naggar, S., “The Casablanca declaration in the balance”, Newsletter of the Economic Research Forum for the Arab Countries, Iran and Turkey, Vol. I, No. 4, December 1994, p. 8.

142/ There were strong Arab objections to establishing the Bank, on the grounds that there are five regional Arab banks already in existence. See *The Economist*, 4-10 November 1995.

143/ A leading Egyptian economist suggested that the Arab countries of the Mashreq (Egypt, Syrian Arab Republic, Jordan, Lebanon and Iraq) should form a customs union among themselves so as to strengthen their bargaining power with Israel. See Abdul-Fadil, M., “The peace process ...”.

144/ According to the United Nations Relief and Works Agency for Palestine Refugees (UNRWA), registered Palestinian refugees outside the West Bank and Gaza in 1995 numbered 1,971,669, distributed as follows:

Region	Population
Jordan	1,288,197
Lebanon	346,164
Syrian Arab Republic	337,308

Added to these registered refugees are an estimated 900,000 Palestinians not registered with UNRWA in Arab States, and about 400,000 in Europe and the Americas, according to PASSIA, “Yearbook ...”.

145/ See UNDP/UNCTAD/ITC “A program of technical cooperation ...”.

146/ As Table 16 shows, the Jordanian and Syrian PPP measures multiply their GNP per capita by a factor of 2.45 and 4.5 respectively. It is highly unlikely that a Palestinian PPP measure would generate a multiplier larger than 2.14, which is double that of Israel. Such a multiplier, however, would give a lower Palestinian GNP per capita in PPP units than that of Jordan and Syria.

147/ See chapter I.

148/ Iraq is not included here because its efforts at reconstruction are still subject to international sanctions imposed since 1991.

149/ For a survey of economic reform in Arab countries, see, Niblock, T. and Murphy, E., *Economic and Political Liberalization in the Middle East*, London, British Academic Press, 1993.

150/ See chapter I, section B (ii) and Table 4.

151/ The Fertile Crescent is the term that traditionally referred to Iraq, Syrian Arab Republic, Palestine and Lebanon. See, Hourani, A., *A History of the Arab Peoples*, Warner Books, 1991.

152/ See, Richards, A. and Waterbury, J., *A Political Economy of the Middle East*, Boulder, Westview Press, 1990.

153/ See, World Bank, *World Development Report 1994: Infrastructure for Development*, p. 15.

154/ See, World Bank, “Note on Priority Regional Infrastructure Projects”. Paper prepared at the request of the Multilateral Working Group on Regional Economic Development (REDWG) of the Middle East Peace Negotiations, October 1993.

155/ See, Lonergan and Brooks "Watershed ...", chapter six.

156/ Ibid.

157/ Based on the Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip, signed in Washington, D.C., 28 September 1995, the Palestinians are allowed the use of 264.5 million cubic metres of water (248 MCM renewable and 16.5 MCM from Israel). This amounted, in 1995, to 115 cubic metres per capita per year, whereas the corresponding figures for Israel and Jordan are 375 cu.m. and 213 cu.m., respectively.

158/ See chapter I.

159/ Since the establishment of the PA and the partial opening of trade with Jordan and Egypt, the situation has started to improve, although very slowly. Trade with Jordan marginally improved in 1994 and 1995 over the previous years, and trade with Egypt for 1994 did not exceed one million dollars. Both Jordan and Egypt have signed agreements with the PA to improve trade relations. The Jordanian-Palestinian agreement, signed in January 1995, emphasizes the commitment of the two sides to strengthen the special relation between them by coordinating all economic and development policies. The agreement states their joint commitment to move gradually towards free trade. The Egyptian-Palestinian draft trade accord was agreed in November 1994, though not signed, and expresses the commitment of both sides to improving trade flows between them. Negotiations on specific commodity lists and implementing mechanisms were expected to be completed in early 1998.

160/ See, World Bank, “Developing the occupied territories ...” , vol. 1, annex 3, and Luski, I. and Weinblatt, J., “The West Bank and Gaza Strip: a macroeconomics profile and simulation model”, the Phillipe Monaster for Economic Research, Ben-Gurion University, Beer Sheva, Israel, 1994.

161/ At present the Palestinian terms of trade are heavily influenced by the high prices of imports from Israel.

162/ See, El-Jafari, M., “External merchandise trade ...”.

163/ Ibid.

164/ The economics of intra-industry trade are outlined in Appendix I.

165/ This may be the case even when the historical reasons for it no longer exist. An example of this is the city of London. It became a global financial centre when Great Britain was the world’s greatest manufacturer and investor. It is still an important centre today even though the United Kingdom is no longer a world economic giant. Its GDP in 1990 was less than that of Germany, France and Italy. See, Krugman, P. and Obstfeld, M., “International economies ...”, chapter 6.

166/ The most recent example was in the post-1991 situation when Jordanian and Palestinian trade flows with the Gulf States were interrupted for a prolonged period.

167/ For detailed analysis of the current monetary situation in the West Bank and Gaza Strip see Hamed, O., The Palestinian Banking System ..., Ramallah, 1996.

168/ Seigniorage measures the real resources the government acquires by printing money and using it to make transfer payments or purchase goods and services. See, Auerbach and Kotlikoff, *Macroeconomics: An Integrated Approach*, Cincinnati, South-Western College Publication, 1995, p. 297.

169/ The AMF was established in 1976 by all Arab countries who were members of the Arab League except Djibouti. Its main objective is to promote closer cooperation and stronger economic ties among member countries. Recently, it has paid much attention to facilitating intra-Arab trade. This function is carried out by ATFP. The Programme's resources consist of its declared capital ($500 million), its reserves, deposits at financial institutions and borrowing from the financial markets. It helps with the financing of intra-Arab trade in all commodities with the exception of oil. It also provides re-export and export financing.

170/ For detailed discussions related to future Palestinian monetary arrangements see, "Prospects ..." (UNCTAD/ECDC/SEU/12), chapter III.

171/ Ibid.

172/ It is important to distinguish between fiscal coordination, fiscal harmonization and fiscal integration. The first refers to largely unenforceable and voluntary alignments of national policies. The second, refers to an agreement on the manner in which each member State will utilize a particular fiscal instrument over which it retains control. Fiscal integration implies fiscal union, a situation in which the choice of policy targets and the administration of policy instruments are a matter for the regional authority. See Robson, P., "The economics ...", chapter 7.

173/ For direct taxes there exist two alternative jurisdictional principles: the residence principle, under which taxation is applied to the total income of each resident regardless of the place where the income is earned, and the source principle, under which tax is applied to all income earned within the taxation jurisdiction whether by residents or non-residents. Similarly, there are two jurisdictional principles for indirect taxes. Under the origin principle, the tax is imposed on the domestic production of goods, whether they are exported or not, but not on imports. Under the destination principle, the same tax is imposed on imported goods as on domestically produced goods destined for consumption by domestic consumers, whereas domestically produced goods destined for consumption by foreigners are not subject to the tax, ibid., pp. 117-18.

174/ See Handoussa, H., "Promoting trade between developing countries and economies in transition", News Letter of the Economic Research Forum for the Arab Countries, Iran and Turkey, Vol. One, No. 2, May 1994, p. 6.

175/ See chapter III, section B.

176/ UNCTAD, *Trade and Development Report 1994* (UNCTAD/TDR/14), United Nations publication, Sales No.: E.94.II.D.26, pp. 119 and 121.

177/ Handoussa, H., "Promoting ...".

178/ "The Palestinian market has been witnessing also the 'migration' of some software houses, from Egypt or Jordan, and/or the opening of subsidiaries of software houses located in Egypt and Jordan", Charif, H., "The impact of the peace process on the electronics industries in the region", a paper presented at the Expert Group Meeting on the Impact of the Peace Process on Selected Sectors, ESCWA, Amman, 23-25 June 1997.

179/ Examples of long-distance services include data entry, analysis of income statements and development of computer software, financial products and chemical processes. Services in internationally traded goods include software diskettes, films on videotapes and music on compact discs. See World Bank, *Global Economic Prospects and the Developing Countries*, World Bank Publication, 1995, chapter 3.

180/ Ibid.

181/ Ibid.

182/ See, "Trade for peace ...".

183/ Ibid.

184/ In 1996, the United States amended the US-Israel Free Trade Area Implementation Act of 1985 to include articles from the West Bank and Gaza Strip. Under this Act, the President has the authority to eliminate or modify existing duties. See "Palestinian merchandise trade ..." (UNCTAD/GDS/SEU/1).

185/ The United States has strong political and economic ties with Israel and the Gulf States, whereas its economic relations with the other Arab countries are less crucial to its strategic interests in the region.

186/ See "Trade for Peace ...", p. 64.

187/ See, UNCTAD, "Private investment in the Palestinian territory: recent trends and immediate prospects" (UNCTAD/ECDC/SEU/13), p. 61.

188/ The Canadian International Development Agency (CIDA), for instance, allocates part of its aid programme to finance the activities of research centres in developing countries by establishing relationships between them and Canadian educational and research centres. It has been active in this manner in the framework of its contribution to the Palestinian development effort.

189/ About half the acceleration of developing-country growth since 1990 is due to East Asia, primarily China, where growth has averaged about 10 per cent a year since 1989. See World Bank, "Global Economic Prospects ...", p. 9.

190/ Ibid.

191/ The first of such holding companies was founded in 1993 under the name Palestine Development and Investment Limited (PADICO). It is financed by Palestinian investors, mainly in Jordan, and led by the Arab Bank Ltd. Its initial capital is $200 million, which is intended to be expanded to $1 billion as and when the investment climate improves. Two similar companies were established by Palestinian investors based in Saudi Arabia and Qatar. For more details see UNCTAD, "Private investment ..." (UNCTAD/ECDC/SEU/13), pp. 42-48.

192/ Interviews with PA officials in the Ministry of Economy and Trade, Ministry of Finance and PECDAR, 1996.

193/ Ibid.

194/ FDI often comes in "packages" incorporating equity capital (that is ownership and control), management, technology and marketing. In recent years, developing countries have made some progress in "unbundling" the package to capture more of its benefits for themselves. Different contractual forms have been developed to transfer elements of the old package to host countries, including joint ventures in which the foreign firm takes less than majority partnership, see Gillis, M. et al., *Economics of Development*, fourth edition, New York, W.W. Norton & Co., 1996, p. 407.

195/ See Guisinger, S. et al., *Investment Incentives and Performance Requirements*, New York, Praeger, 1985.

196/ Ibid.

197/ These negotiations are concerned with the Gaza Industrial Estate and involve security procedures and agreements on access to and from the estate site so as to insulate the zone from the impact of border closures.

198/ The total cost of the project is $64 million, of which $30 million will be the donors' contribution and the rest is expected to come from private investors, the International Finance Corporation and the European Investment Bank.

199/ Gaza port is planned to be located 5 km south of the Gaza city border. It is being designed with a view to providing international access to traders and facilitating a free-trade zone. It is planned to be constructed in three stages. The first phase involves a 600-metre deep water berth plus a petroleum products berth. The cost of this phase is estimated to be around $100 million.

200/ See Charif, H., "The peace process: potentialities and challenges for regional cooperation in industrial and technological development", Seminar at the European Parliament, Strasbourg, 29-30 June 1994: "One has to remember that Saudis do have more than just 'oil', and Egyptians more than just cheap unskilled labour, while Israeli skill and know-how is not always the most promising or the most suitable in all projects of cooperation".

201/ Kubursi, A., "The economics of peace: the Arab perspective", in *Selected Proceedings of the Expert Group Meeting on Industrial Strategies and Policies under Conditions of Global and Regional Change*, ESCWA, 1995.

202/ See "Prospects ..." (UNCTAD/ECDC/SEU/12), pp. 36-44, 93 and 134-140.

Tables

Table 1. Educational characteristics in the West Bank and Gaza Strip, 1997 (percentage of population)

	West Bank	Gaza Strip	Total
	%	%	%
Literacy rate (total population)	84.1	84.9	84.3
Literacy rate (male population)	91.7	91.1	91.5
Literacy rate (female population)	76.3	78.6	77.0
School enrolment rate (ages 6-17 years)	85.0	85.4	85.1
Persons who completed secondary education	11.6	18.7	13.8
Persons with bachelor degree and above	4.0	4.8	4.2

Source: Palestinian Central Bureau of Statistics (PCBS), *Demographic Survey for the West Bank and Gaza Strip*, Ramallah, 1997.

Table 2. West Bank and Gaza Strip: major economic aggregat

	1991	1992	1993
			(thousands)
Population	1 682.2	1 767.5	1 833.3
Labour force	355.1	379.1	384.7
Total domestic employed	189.4	203.3	232.0
Employed in Israel	89.0	116.0	83.0
			(millions of US$ at current
Gross domestic product (GDP)	2 161.0	2 685.0	2 557.2
Gross national product (GNP)	2 689.0	3 581.0	3 109.6
GDP per capita	1 285.0	1 519.0	1 395.0
GNP per capita	1 598.0	2 026.0	1 696.0
			(millions of US$ at 1986
Gross domestic product (GDP)	1 818.8	2 239.6	2 210.5
Gross national product (GNP)	2 414.7	2 239.6	2 210.5
GDP per capita	1 081.0	1 267.0	1 206.0
GNP per capita	1 435.0	1 690.0	1 455.0

Source: Calculated from estimates compiled by the Palestinian Authority, October 1995.

Table 3. Population and labour force participation, 1993

	West Bank		Gaza	
	Total	**CAR**	**Total**	**CAR**
Population (age 15+)	542 800	-	351 300	-
Labour force	218 300	40.2	120 200	34.2
Male	193 200	72.6	116 900	67.7
Female	25 100	9.1	3 300	1.9

Source: International Labour Office, “Report of the Director General, Appendix”. International Labour Conference, 82nd Session, 1995.

CAR: Crude Activity Rate (percentage of economically active to the total population aged 15 and over).

Table 4. Net capital inflows as a share of gross national product, West Bank and Gaza Strip (WB/GS) and selected countries in the region (percentages)

Country	1970-74	1975-79	1980-84	1985-89	1990	1991	1992
Egypt	7.85	18.80	16.95	15.42	13.28	7.39	11.48
Jordan	28.40	45.74	44.70	26.55	34.04	24.81	30.48
Lebanon	n.a.	n.a.	n.a.	n.a.	n.a.	62.62	68.11
WB/GS	30.60	33.03	37.27	34.45	30.69	41.42	34.22
Syrian Arab Republic	8.37	15.11	14.16	3.35	-10.00	-0.71	3.39
Mashreq a/	8.54	20.37	19.47	15.16	9.86	7.98	10.41
Israel	18.80	18.01	12.30	6.84	6.30	9.63	10.65
Region	12.47	19.54	16.97	11.76	8.04	8.87	10.53

Source: Ishac Diwan and Lyn Squire, “Private assets and public debits: External finance in a peaceful Middle East”, *Middle East Journal* vol. 19, No. 1, 1995, pp. 69-88.

a/ Includes Egypt, Jordan, Lebanon and the Syrian Arab Republic.

Table 5. Selected economic indicators of neighbouring countries

	WB/GS (1995)	Jordan (1995)	Syrian Arab Republic (1994)	Egypt (1995)	Israel (1995)
Population (million)	2.4	4.1	14.2	57.6	5.4
GDP ($ billion)	3.6	6.4	11.6	51.4	73.5
GDP per capita ($)	1 500	1 561	817	892	13 611
GDP by sector (%)					
Agriculture	33	6	21	16	2
Industry	8	16	27	27	19
Construction	17	7	3	5	10
Services	42	71	49	52	71

Sources: Annual Report of the Central Bank of Jordan, 1996; Estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995; The Economist Intelligence Unit Country Profiles of Egypt, Israel and Syria, 1996-1997.

Table 6. West Bank and Gaza Strip: growth rates of main aggregates, 1991-1995 (percentages)

	1991-92	1992-93	1993-94	1994-95
Population	5.1	3.7	4.0	4.0
Labour force	6.8	1.5	4.3	3.7
Total domestic employed	7.3	14.1	23.3	2.8
Employed in Israel	30.3	-28.4	-36.1	-52.8
	(at current prices)			
Gross domestic product (GDP)	24.2	-4.8	14.6	14.4
Gross national product (GNP)	33.2	-13.2	9.7	5.1
GDP per capita	18.2	-8.2	10.2	10.1
GNP per capita	26.8	-16.3	5.5	1.1
	(at 1986 prices)			
Gross domestic product (GDP)	23.1	-1.3	7.3	3.5
Gross national product (GNP)	23.7	-1.7	3.5	-4.9
GDP per capita	17.2	-4.8	3.2	-0.5
GNP per capita	17.8	-13.9	-0.5	-8.6

Source: Calculated from estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 7. West Bank and Gaza Strip: gross domestic product by type of expenditure, 1991-1995 (million US$ at 1986 prices)

	1991	1992	1993	1994	1995
Private consumption	2 130.9	2 382.3	2 359.6	2 483.0	2 530.7
Government consumption	198.1	239.7	234.5	239.0	366.8
Private investment	413.3	605.8	395.8	450.1	344.8
Government investment	49.4	65.4	107.4	69.5	115.2
Imports	1 226.8	1 354.4	1 085.6	1 070.7	1 159.9
Exports	253.9	300.6	197.5	198.7	255.2
Gross domestic product	1 818.8	2 239.6	2 210.5	2 371.9	2 454.8
Net factor income	595.9	748.0	477.5	389.0	170.6
Gross national product	2 414.7	2 987.6	2 668.0	2 760.9	2 625.4

Source: Calculated from estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 8. Gross domestic product by type of expenditure: annual percentage change, 1991-1995 (at constant 1986 prices)

	1991-92	1992-93	1993-94	1994-95
Private consumption	11.8	-1.0	5.2	1.9
Government consumption	21.0	-2.1	1.9	53.5
Private investment	46.6	-34.7	13.7	-23.4
Government investment	32.4	64.2	-35.3	65.8
Imports	10.4	-19.8	-1.4	9.3
Exports	18.4	-33.6	-0.4	28.4
Gross domestic product	23.0	-1.3	7.3	3.5
Net factor income	25.5	-36.2	-18.5	-56.1
Gross national income	23.7	-10.7	3.5	-4.9

Source: Calculated from estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 9: Palestinian merchandise trade, 1992-1996 (current million US$)

	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 rest of world	-111	-101	-117	-150	-144

Sources: 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), 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 10. West Bank and Gaza Strip: structural distortions in the economy (percentages)

	1991	1992	1993	1994	1995
Resource gap					
Import surplus a/	40.0	35.0	33.0	31.0	34.0
Investment surplus b/	16	10	15	17	28
GDP/GNP c/	75	75	83	86	93
National savings d/	5	2	4	4	-11
Labour market imbalance					
Unemployment	19.1	15.8	18.1	15.3	23.3
Employed in Israel	34.1	36.3	26.3	15.6	7.8

Source: Calculated from data compiled by the Palestinian Authority, Ministry of Finance, October 1995

a/ Defined as (imports-exports)/GNP.

b/ Defined as (investment-national savings)/GNP.

c/ Gross domestic product/gross national product.

d/ Defined as (GNP-private and public consumption)/GNP.

Table 11. The Palestinian Authority budget, 1995 (million US$ and percentage of GDP)

	million $	% of GDP
Total expenditure	648.82	19.35
Current expenditure	509.62	15.20
Capital expenditure	139.18	4.15
Total revenue	406.80	11.90
Domestic tax revenue	103.70	3.09
Revenue clearances	255.20	7.61
Non-tax revenue	47.90	1.42
Overall deficit	242.02	7.22

Source: Calculated from data compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 12. Sectoral origin of gross domestic product (GDP), 1992-1994 (million US$ at 1986 prices)

	1992		1993		1994	
	(million $)	(%)	(million $)	(%)	(million $)	(%)
Total GDP	2 239.6	100.0	2 210.5	100.0	2 371.9	100.0
Agriculture	796.0	35.5	647.6	29.3	781.2	32.9
Industry	166.0	7.4	187.1	8.5	181.9	7.6
Construction	290.0	12.9	365.1	16.5	405.4	17.1
Government	236.0	10.5	263.7	11.9	268.5	11.3
Other sectors	751.6	36.6	747.0	33.8	735.6	3.0

Source: Calculated from estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 13. Comparison of sectoral composition of gross domestic product between the Palestinian territory and developing countries (percentages)

Sector	**Palestinian territory (1992-94)**	**Average of developing countries (1991)**	**Average of middle-income developing countries (1991)**
Agriculture	33	17	16
Industry	8	28	30
Services	59	55	54

Sources: Table 12, and UNCTAD *Statistical Pocket Book*, 1994.

Table 14. Types of expenditure as percentage of gross domestic product, 1991-1995

	1991	1992	1993	1994	1995
Private consumption	117.2	106.4	106.7	104.7	103.1
Government consumption	10.9	10.7	10.6	10.1	14.9
Private investment	22.7	20.7	17.9	19.0	14.0
Government investment	2.7	2.9	4.9	2.9	4.7
Net factor income	32.8	33.4	21.6	16.4	6.9
Gross domestic product	132.8	133.4	120.7	116.4	106.9

Source: Calculated from estimates compiled by the Palestinian Authority, Ministry of Finance, October 1995.

Table 15. Wage comparison for Palestinian workers employed in Israel and in the Palestinian territory, selected years

	1972	1987	1990
Workers in Israel			
1. Income (million 1990 US$) a/	200.8	732.5	546.0
2. Number (thousands)	52.4	108.9	105.0
3. Average annual income (US$)	3 832.0	6 726.0	5 200.0
Workers in Palestinian territory			
4. Income (million 1990 US$) b/	373.0	1 254.9	868.4
5. Number (thousands)	136.4	168.9	175.0
6. Average annual income (US$)	2 460.0	6 612.0	4 416.0
Wage ratio/differential			
(3) / (6)	1.558	1.017	1.177

Source: "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip, 1990-2010: a quantitative framework" (UNCTAD/ECDC/SEU/6), table 6/2.

a/ Net factor income.

b/ Calculated as 60 per cent of GDP.

Table 16. Merchandise trade between the West Bank/Gaza Strip and Israel (current million US$)

	1992	1993	1994	1995			1996		
				Q1	Q1	Q1	Q1	Q2	Q3
Imports from Israel	1 106	1 015	920	382	374	375	353	395	393
Exports to Israel	249	178	205	115	89	72	45	53	41
Exports/imports	23	18	22	30	24	19	13	13	10

Source: Israel Central Bureau of Statistics, *Israel's Balance of Payments*, Jerusalem, January 1997.

Table 17. Selected economic indicators for Egypt, Syrian Arab Republic, Jordan, Palestinian territory (WB/GS), Israel, Tunisia and Kuwait, 1993

Country	Population (million)	GNP (billion US$)	GNP (ppp) a/ (billion)	GNP per capita (US$)	GNP (ppp) a/ per capita (US$)	Resource gap b/ (%)
Egypt	56.4	37.2	213.2	660	3 780	-11
Syrian Arab Republic c/	14.2	16.5	74.1	1 160	5 220	-9
Jordan	4.1	4.9	16.8	1 190	4 100	-43
WB/GS	1.8	3.1	n.a.	1 696	n.a.	-15
Israel	5.2	72.3	77.2	13 920	14 920	-9
Tunisia	8.7	15.0	41.6	1 720	4 780	-9
Kuwait	1.8	34.9	38.9	19 360	21 630	7

Source: World Bank, *World Development Report 1995*, and tables in chapter II.

a/ Ppp denotes purchasing power parity.

b/ The resource gap is defined as (savings-investment)/GNP.

c/ Figures for the Syrian Arab Republic are for 1992.

Appendix 1

INTRA-INDUSTRY TRADE

Intra-industry trade refers to the situation in which a country simultaneously imports and exports products grouped in the same industrial classification. Many countries, for instance, both export and import cars. Intra-industry trade, in contrast with inter-industry trade, does not reflect existing comparative advantages among countries, i.e. differences in the countries' endowment of labour, capital, natural resources and technology. Rather it reflects increasing returns or economies of scale. An industry characterized by economies of scale - a tendency of unit costs to decline with larger output - would not be operating under conditions of perfect competition. It is likely to be operating under oligopolistic or monopolistic competitive conditions. With these market structures, the expansion of market size arising from opening to trade would induce firms to specialize in differentiated goods that they can produce on a larger scale and at a lower unit cost.

Thus, each country can specialize in producing a narrower range of products and trade with others. In other words, intra-industry trade allows a country simultaneously to reduce the number of products it produces and increase the variety of goods available to its consumers. The advantages of intra-industry trade, therefore, come from allowing countries to produce on a larger scale with higher productivity and at lower prices without reducing consumer choice. Its other advantage is that the income distribution effects are very small compared to those of inter-industry trade. This is due to the fact that engaging in intra-industry trade does not cause such large dislocations since the same industries continue to produce but in a more specialized form. Intra-industry trade tends to flourish among countries with similar levels of development, i.e. similar capital-labour ratios, similar levels of skills and resources.

There is no perfect way to measure the degree of intra-industry trade, because any method chosen will depend upon how broadly the industry or product group is defined. One of the simplest methods is the construction of an index number according to the formula: $ITi = 1 - [(|Xi - Mi|) / (Xi + Mi)]$, where ITi denotes the intra-industry index on industry I, Xi and Mi represent, respectively, the value of exports and imports of industry I and the vertical bars in the number denote the absolute value. Obviously the value of IT varies from 0 to 1. IT = 0 indicates no intra-industry trade, that is, when a country only exports or only imports product I. On the other hand, ITi = 1, indicates perfect intra-industry trade, that is, when the exports and imports of I are equal.

In addition to the IT index, the tables below report two other measures. The values in the columns labeled Weight (W) measure the relative importance of each product group; thus the weight for product I is the ratio of its sum of exports and imports ($X_i + M_i$) to the sum of the country's total exports and imports ($X + M$). The last column gives the product of each IT_i index and its respective weight W_i. The sum of this column indicates the country's intra-industry trade index.

Employing this formula, intra-industry indices were calculated for Egypt, the Syrian Arab Republic, Jordan and Tunisia. All import and export figures are from UNCTAD, *Handbook of International Trade and Development Statistics*, 1994, tables 4.1 and 4.2.

Table A.1

Intra-industry trade in Egypt, 1993

Product Groups	**IT**	**W**	**WIT**
All food items	0.27	0.20	0,05
Agricultural raw materials	0.59	0.02	0.01
Fuels	0.11	0.14	0.02
Ores and metals	0.40	0.07	0.03
Chemical products	0.19	0.10	0.02
Other manufactured goods	0.68	0.23	0.16
Machinery and transport equipment	0.01	0.23	0.00
Egypt's intra-industry index			0.24

Table A.2

Intra-industry trade in the Syrian Arab Republic, 1992

Product Group	**IT**	**W**	**WIT**
All food items	0.76	0.16	0.12
Agricultural raw materials	0.55	0.04	0.02
Fuels	0.12	0.35	0.04
Ores and metals	0.91	0.02	0.02
Chemical products	0.03	0.07	0.00
Other manufactured goods	0.43	0.19	0.08
Machinery and transport equipment	0.02	0.17	0.00
Syrian Arab Republic’s intra-industry index			0.28

Table A.3

Intra-industry trade in Jordan, 1993

Product Group	**IT**	**W**	**WIT**
All food items	0.46	0.21	0.10
Agricultural raw materials	0.24	0.01	0.00
Fuels	0.00	0.10	0.00
Ores and metals	0.34	0.08	0.03
Chemical products	0.88	0.15	0.13
Other manufactured goods	0.35	0.26	0.09
Machinery and transport equipment	0.07	0.23	0.02
Jordan's intra-industry index			0.37

Table A.4

Intra-industry trade in Tunisia, 1993

Product Group	**IT**	**W**	**WIT**
All food items	0.91	0.09	0.09
Agricultural raw materials	0.21	0.02	0.01
Fuels	0.94	0.09	0.09
Ores and metals	0.50	0.02	0.01
Chemical products	0.91	0.09	0.08
Other manufactured goods	0.94	0.44	0.40
Machinery and transport equipment	0.31	0.24	0.07
Tunisia's intra-industry index			0.76

Table A.5

Openness, Intra-Arab and Intra-industry Trade, 1993 (1)

Country	**Degree of Openness** (2)	**Intra-Arab Trade** (3)	**Intra-industry Trade Index** (4)
Egypt	0.39	0.05	0.24
Syrian Arab Republic	0.50	0.10	0.28
Jordan	0.98	0.25	0.37
Tunisia	0.77	n.a.	0.76

(1) Ratios for the Syrian Arab Republic are for 1992.

(2) Calculated as the ratio of the sum of exports and imports to GDP, 1991.

(3) Calculated as the ratio of trade with Arab countries to total trade, 1992.

(4) Taken from tables A.1, A.2, A.3 and A.4.

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