Office of the Quartet Representative Tony Blair

Office of the Quartet Representative (OQR)

Report for the Ad Hoc Liaison Committee AHLC

Back to the Future: Integrating the Political and Economic Tracks

Brussels

March 19, 2013

Table of Contents

Table of Figures

Acknowledgements

This paper was prepared by a team consisting of Firas Raad (Head of Mission, OQR), Bader Rock (Private Sector Development Advisor, OQR) and Mahmoud Al-Jafari (Dean of the Management and Economic Department, Al-Quds University). The authors would like to acknowledge and thank Samir Abdullah (Director General, MAS), Hanan Taha (CEO, PalTrade), Hassan Abu Latifah (Economics Department, Al-Quds University), Ali Shu'fat (National Insurance Company in Hebron), Rob Danin (Senior Fellow, Council of Foreign Relations) and the Palestinian Border Management Authority for the sharing of data and information during the preparation of this report. The team would also like to express its appreciation to Udo Kock (Resident Representative, IMF), Mark Singleton (Deputy Head of Mission, OQR), Ruti Winterstein (Political and Media Advisor, OQR), and Kelly Wright (Special Advisor, OQR) for reviewing the paper and providing useful comments.

Executive Summary

Background

The Palestinian Authority (PA), established in 1994, served as an important building-block for the Palestinian drive toward statehood but has well-exceeded its five-year interim time horizon. The Oslo framework also led to the 1994 economic agreement (otherwise known as the 'Paris Protocol') governing Palestinian-Israeli relations in four important sectors: trade, labor, fiscal affairs and monetary issues. The absence of political progress on permanent status arrangements during the Oslo process and at Camp David in 2000 was followed by the outbreak of the Second Intifada and a breakdown in Palestinian-Israeli relations. After many years of economic difficulty and an internal Palestinian disagreement between Fatah and Hamas, renewed Palestinian and international efforts were exerted in 2007 to rebuild the Palestinian Authority and invigorate economic conditions on the ground. The Palestinian Reform and Development Plan (PRDP) implemented by the Government of Prime Minister Salam Fayyad from 2008-2010, aimed to prepare the institutions of the Palestinian Authority for statehood in line with the objectives of the political negotiating process.

The deepening fiscal predicament of the PA is connected to the current consequences of the political process but also flows from the cumulative effect of long-term restrictions on the Palestinian economy. Apart from the shortfalls in donor assistance, tax revenues, and private investment as a result of political uncertainty, there are important Israeli restrictions affecting the sustainability of Palestinian economic growth and job creation. The two most important restrictions relate to economic cohesiveness and access to natural resources. The physical separation between the West Bank, East Jerusalem and the Gaza Strip, has led to insufficient cohesiveness in the Palestinian economy to support rapid growth and expanded job creation. This problem is further compounded by a restriction on Palestinian use of land and water in Area C in the West Bank, especially in the Jordan Valley, and by constraints on the competitive use of the electro-magnetic spectrum to grow the Palestinian telecommunications sector.

This paper, entitled 'Back to the Future: Integrating the Political and Economic Tracks' takes stock of the Palestinian economic context since Oslo and emphasizes the importance of adopting a multi-track approach (akin to the Annapolis process during 2007-2008) on the path to reaching a final status agreement. Chapter II of the paper, following an introduction, reviews the evolving context of the Palestinian economy and the constraints placed on its growth due to shifts in Israeli-Palestinian relations and changes on the ground. Chapter III of the paper argues in favor of integrating the political process with negotiations on the economic track. The economic track can proceed at three levels: (i) focusing on permanent status economic negotiations alongside the political negotiations; (ii) improving the implementation of current economic arrangements pending final status; and (iii) generating a positive surrounding environment for average Palestinians residing in the West Bank and Gaza Strip. Giving Palestinians and Israelis a true sense of transformative change on the ground will reinforce public readiness to support positions negotiated by Palestinian and Israeli officials.

The paper also focuses on ways to better implement the interim economic arrangements between Palestinians and Israelis and examines the growing importance of the service sector within the Palestinian economy, particularly its export component. Chapter IV of the paper reviews in detail the context and implementation difficulties of the 'Paris Protocol' arrangements between the Palestinians and Israelis, and provides recommendations on how to strengthen the implementation of these arrangements ahead of a permanent status economic relationship between the two sides. These recommendations can be examined and implemented in the current period until a permanent status agreement is reached. Chapter V examines private sector development in the West Bank and Gaza Strip with a special focus on the growing role of services within the Palestinian economy. Specific attention is paid to the export of services especially in the tourism, travel, and telecommunications and information technology (ICT) sectors. Chapter VI provides conclusions and recommendations.

Economic Context since Oslo

The Protocol on Economic Relations (or 'Paris Protocol) covered a range of economic sectors and established a mechanism for Palestinian-Israeli economic consultation and tax collection. The Protocol explicitly mentioned five economic sectors (labor, agriculture, industry, tourism and insurance) and established the Joint Economic Committee (JEC) as the agreed mechanism for consultation and joint decision-making. The deterioration in Israeli-Palestinian relations towards the late 1990s severely weakened the implementation of the Protocol and adversely affected the Palestinian economy. Three important factors shaped by the protracted occupation and changing events on the ground, continue to restrict economic growth: (i) the evolving physical separation between the major internal Palestinian markets; (ii) limitations on access to natural resources; and (iii) continuing restrictions on access to an effective investment horizon.

Integrating the Political and Economic Tracks

There are two important reasons for integrating the political and economic tracks with any diplomatic initiative aimed at achieving a permanent status settlement. First, agreement on the economic track serves as a litmus test for prospects of a breakthrough in political negotiations. If it is not possible to reach an agreement on the economic issues concerning both sides, there is little chance of reaching true consensus on the sensitive core political issues of the conflict. Second, in view of the well-entrenched cynicism on both sides given the long-history of repeated attempts at progress and a daily reality which provides no grounds for optimism about an alternative, it is important to give public opinion a true sense of impending positive change on the ground. Such changes will have to be far-reaching along the path towards a two-state solution to be effective. If the Palestinian and Israeli populations are able to get a glimpse of how things can be under a new peaceful framework between both sides, they would be more ready to support political negotiations.

There are three important dimensions to the integration of the political and economic tracks. The first dimension is the formal economic negotiations on the permanent status economic relations between Israel and Palestine in the future. This economic track can run in parallel or closely behind progress achieved on the political track. The second dimension relates to the full implementation of the current interim economic agreements ahead of full agreement and implementation of a new permanent status economic framework. The third dimension relates to the surrounding environment and effecting positive change on the ground. Achieving such change will boost the sustainability of the Palestinian Authority, encourage donors to increase development assistance flows to the Palestinian Authority (especially if the changes are large and transformative), and counter the deeply held doubts about the possibility of a comprehensive peace settlement.

Improving the Implementation of the Paris Protocol

Since its signing in 1994, the Paris Protocol has served as the governing framework for economic relations between the Israel and the Palestinian Authority. The Protocol was meant to be in place for five years and covers taxation, trade policy, monetary and financial issues and five different economic sectors (labor, agriculture, industry, tourism and insurance). During the ensuing nineteen year period, only parts of the Paris Protocol have been fully implemented whilst other parts have been neglected as a result of the fluctuations in Israeli-Palestinian relations and the changing situation on the ground in the West Bank and Gaza Strip.

There are different ways to strengthen the implementation of the Paris Protocol pending an agreement on permanent status economic issues. The key recommendations of this report are as follows: (i) re-activating the Joint Economic Committee (JEC) and its sub-committees to agree and implement a joint agenda to improve implementation; (ii) updating the lists of items eligible for import by Palestinian business people under a different tariff regime; (iii) facilitating the return of Palestinian customs control at key border crossings; (iv) opening up normalized two-way trade between the Gaza Strip and the West Bank; and iv) Israeli recognition of the free trade agreements signed between the Palestine Liberation Organization (PLO) and other countries for the benefit of the PA. Chapter IV examines in detail the provisions of the Paris Protocol, assesses overall progress enacting the provisions, and provides recommendations on how to improve implementation. A summary list of these recommendations is provided in Box 2 in the last chapter of the report.

Spurring Palestinian Economic Growth: A Focus on Services

Rejuvenating private sector-led development is a top Palestinian economic priority. A growing and prosperous private sector would create jobs, improve living standards, accelerate economic growth, and greatly support the fiscal position of the PA. One segment of the Palestinian private sector with immense growth potential is services, particularly in external trade. The contribution of the service sectors to Palestinian GDP has increased from 60 percent in 1995 to about 72 percent in 2011 whereas the productive sectors declined from 40 percent in 1995 to just below 30 percent in 2011. Two important service markets in the private sector are tourism and ICT.

The report's key recommendations to promote these important services in the Palestinian economy are as follows: (i) locations in the West Bank are opened to Palestinian investment in tourism infrastructure, particularly in the area of the Jordan Valley and the Dead Sea; (ii) large scale investments are made in a wide range of Palestinian tourism services and infrastructure in support of the hotel and restaurant markets, including tour operators, travel agents, tour guides, food and beverage agents, museums, cultural heritage sites and sporting activities; (iii) Palestinian telecommunication companies are given larger allocations of additional 2G frequencies and new allocations for 3G/4G frequencies, allowing them to compete with Israeli companies; (iv) Palestinian companies are more readily allowed to build telecommunication infrastructure in Area C to ensure appropriate coverage for customers; and (v) imports of required network hardware for Palestinian companies are permitted and facilitated for both the West Bank and the Gaza Strip.

Chapter I - Introduction

A comprehensive resolution to the Arab-Israeli conflict continues to elude the efforts of Middle East peace negotiators. Ever since the Egyptian-Israeli peace treaty in 1978, attempts at realizing a wider Arab-Israeli peace settlement and Palestinian self-determination have resulted in a mixed outcome of successes and setbacks beginning with the Madrid Peace Conference in 1991 and ending more recently with the Annapolis Conference in 2007 and the subsequent diplomatic efforts of the American Government. The 1993-5 Oslo Accords between the Palestinians and the Israelis and the 1994 Jordanian-Israel Peace Treaty were significant way-stations on the path to achieving Palestinian independence and a more comprehensive resolution to the Arab-Israeli conflict. After the Oslo 'process' failed to achieve a Palestinian state in the 1990s, further attempts were made at Camp David in 2000 and through the Road Map initiative in 2002.

The Palestinian Authority (PA), established in 1994, served as an important building-block for the Palestinian drive toward statehood but has well-exceeded its five-year interim time horizon. The Oslo framework also led to the 1994 economic agreement (otherwise known as the 'Paris Protocol') governing Palestinian-Israeli relations in four important sectors: trade, labor, fiscal affairs and monetary issues. The absence of political progress on permanent status arrangements during the Oslo process and at Camp David in 2000 was followed by the outbreak of the Second Intifada and a breakdown in Palestinian-Israeli relations. After many years of economic difficulty and an internal Palestinian disagreement between Fatah and Hamas, renewed Palestinian and international efforts were exerted in 2007 to rebuild the PA and invigorate economic conditions on the ground. The Palestinian Reform and Development Plan (PRDP) implemented by the Government of Prime Minister Salam Fayyad from 2008-2010, aimed to prepare the institutions of the Palestinian Authority for statehood in line with the objectives of the political negotiating process.

Current Context

The long-term nature of the Israeli occupation and the interim Israeli-Palestinian Oslo arrangements, coupled with the absence of political progress on a permanent status solution, have increasingly harmed the PA and the end goal of the peace process. The impressive state-building plans of PA in the last five years have not been accompanied by similar progress on the negotiations front resulting in the Palestinian decision to seek statehood status through a vote in the United Nations General Assembly in November 2012. In the aftermath of the UN vote, overall financial conditions for the PA have deteriorated following disruptions in the transfer of clearance revenues by the Israeli Government and shortfalls in donor assistance. The deepening fiscal crisis of the PA also dimmed Palestinian private sector activity because of greater arrears accumulation owed to private contractors.

The growing fragility of the PA flows from the consequences of the stalled political process and from the cumulative effect of long-term restrictions on the Palestinian economy. Apart from the shortfalls in donor assistance, tax revenues, and private investment as a result of political uncertainty, there are important Israeli restrictions affecting the sustainability of Palestinian economic growth and job creation. The two most important restrictions relate to economic cohesiveness and access to natural resources. The physical separation between the West Bank, East Jerusalem and the Gaza Strip inhibits rapid growth and expanded job creation. This problem is further compounded by a restriction on Palestinian use of land and water in Area C in the West Bank, especially in the Jordan Valley; and by constraints on the competitive use of the electro-magnetic spectrum to grow the Palestinian telecommunications sector.

Looking Forward

In the wake of the American and Israeli elections in 2012 and 2013, renewed diplomatic efforts are expected to help re-start Israeli-Palestinian negotiations around permanent status arrangements. In recent months, the Quartet members (the United Nations, United States of America, European Union and Russia), the Arab League and other parties have stated that the Middle East peace process remains a high priority amidst other growing challenges in the region. Efforts will likely aim at defining a framework within which the parties could begin to discuss the permanent status issues of borders, security, Jerusalem, refugees and water, in order to reach an agreement within an acceptable timeframe. Such a framework, at a minimum, would serve as clear terms of reference for negotiations and a mechanism to monitor progress and ensure accountability.

Alongside a revitalized political track, serious efforts must be undertaken to effect greater positive change to conditions on the ground in the West Bank and the Gaza Strip, and to shore up wider financial support to the PA by regional and international donors. Diplomatic efforts focused on permanent status must be accompanied by far-reaching measures on the ground to provide greater credibility to the negotiating process and to create greater political space for compromises by both sides. This 'on the ground' change must also be underpinned by expanded financial and political support to the PA by the members of the Arab League, particularly those countries closest to the PA (Egypt and Jordan) and the high-income countries of the Gulf Cooperation Council. Such an approach consisting of a renewed political negotiation, transformative change on the ground, and much greater regional buy-in offers the best prospects for a sustained drive towards a permanent status resolution.

Focus of Paper

This paper, entitled 'Back to the Future: Integrating the Political and Economic Tracks' takes stock of the Palestinian economic context since Oslo and emphasizes the importance of adopting a multi-track approach (akin to the Annapolis process during 2007-2008) on the path to reaching a final status agreement. Chapter II of the paper, following an introduction, reviews the evolving context of the Palestinian economy and the constraints placed on its growth due to shifts in Israeli-Palestinian relations and changes on the ground. Chapter III of the paper argues in favor of integrating the political process with negotiations on the economic track. The economic track can proceed at three levels: (i) focusing on permanent status economic negotiations alongside the political negotiations; (ii) improving the implementation of current economic arrangements pending final status; and (iii) generating a positive surrounding environment for average Palestinians residing in the West Bank and Gaza Strip. Giving Palestinians and Israelis a true sense of transformative change on the ground will reinforce public readiness to support positions negotiated by Palestinian and Israeli officials.

The paper also focuses on ways to better implement the interim economic arrangements between Palestinians and Israelis and examines the growing importance of the service sector within the Palestinian economy, particularly its export component. Chapter IV of the paper reviews in detail the context and implementation difficulties of the Paris Protocol arrangements between the Palestinians and the Israelis; and provides recommendations on how to strengthen the implementation of these arrangements ahead of a permanent status economic relationship between both sides. These recommendations can be examined and applied in any transitional period on the path to the establishment of the Palestinian State. Chapter V examines private sector development in the West Bank and Gaza Strip with a special focus on the growing role of services within the Palestinian economy. Specific attention is paid to the export of services especially in the tourism, travel, and telecommunications and information technology (ICT) sectors. Chapter VI provides conclusions and recommendations.

Chapter II - Context since the Oslo Agreements

The Oslo Agreements, negotiated and agreed to by the Israeli Government and the Palestine Liberation Organization (PLO) from 1993-1995, were designed to serve as a five-year 'interim mechanism' leading to a permanent status solution – but this time horizon was overtaken by divergent political positions and changing events on the ground. Over the last thirteen years and despite numerous setbacks in the Palestinian-Israeli relationship during this period, these agreements have remained the de facto arrangement governing the on-the-ground relationship between the Palestinian Authority and the State of Israel. The protracted state of the Israeli occupation, and shifting events both on the ground and within the Israeli-Palestinian relationship since 1995, have increasingly called into question the current suitability of the Oslo economic arrangements in their original form. These circumstances, too, have restricted Palestinian economic cohesion and robustness.

The peace accords reached by the PLO and the Israeli Government from 1993-1995 consisted of a series of agreements governing mutual recognition, the establishment of an interim Palestinian Authority, a temporary framework for economic relations, and Israeli redeployment in the West Bank. The accords comprised: (i) letters of mutual recognition and commitments dated September 9, 1993; (ii) the Declaration of Principles on Interim Self-Government Arrangements and annexes on September 13, 1993; (iii) the Protocol on Economic Relations signed in Paris on April 9, 1994; (iv) the Gaza Strip & Jericho Agreement signed in Cairo on May 9 1994 (v) the Agreement on the Preparatory Transfer of Powers and Responsibilities signed in Erez on August 29, 1994 for the further transfer of powers; and (vi) the Palestinian-Israeli Interim Agreement on the West Bank and the Gaza Strip signed on September 28, 1995 in Washington DC (otherwise known as Oslo II).

The Protocol on Economic Relations (or 'Paris Protocol') covered a range of economic sectors and established a mechanism for Palestinian-Israeli economic consultation and tax collection. The Paris Protocol explicitly mentioned five economic sectors (labor, agriculture, industry, tourism and insurance) and discussed import, monetary, taxation and financial issues. The mechanism for economic consultation and joint decision-making was designated the 'Joint Economic Committee' (JEC). The main implementation difficulties and areas for improvement with regard to the Paris Protocol are examined closely in Chapter IV of this report, providing a detailed review of the Protocol's framework and status and looking at ways to enhance the implementation of this temporary economic framework ahead of permanent status arrangements between the two sides.

Since the Wye River memorandum in 1998 which reaffirmed the implementation of Israeli redeployment from Hebron, pursuant to the 1995 Interim Agreement, institutional relations between Israel and the Palestinian Authority have not witnessed significant progress. After the failure of the Camp David peace efforts in 2000 and the Taba talks in 2001, relations between the two sides deteriorated and conflict erupted with the beginning of the 2nd Palestinian Intifada. Further peace efforts were exerted during 2002-2003 with the launch of performance-based road-map. On the ground, conditions did not improve after the Israeli Disengagement from Gaza in 2005 and were further complicated by the Hamas takeover of Gaza in 2007. After the Annapolis peace talks started in November 2007, PA efforts to promote economic recovery and institution-building took off with the appointment of Prime Minister Salam Fayyad and generous support from the donor community. Israel, too, undertook many easing measures to support the Palestinian economy after 2008. Despite this progress on the ground, JEC meetings were not convened on a regular basis given the surrounding political environment. Only some of its technical sub-committees have been meeting in a more consistent manner.

Constraints on Palestinian Economic Cohesiveness and Robustness

Since the early 1990s, Palestinian economic cohesiveness and robustness have been circumscribed by several important factors. These factors are: (i) the evolving physical separation between major internal Palestinian markets; (ii) limitations on access to natural resources; and (iii) continuing restrictions on access to an effective long-term investment horizon.

A) Geographic Separation

Over the last decade, three large Palestinian markets consisting of the West Bank, East Jerusalem and the Gaza Strip, have witnessed varying levels of physical separation. The separation between these internal markets has evolved much more sharply following both the erection of the Israeli Separation Barrier cutting off East Jerusalem from the West Bank and the Hamas takeover of the Gaza Strip.

- **Separation of East Jerusalem from West Bank and Gazan markets**

Normalized commercial trade in goods and services – and the movement of consumers – between East Jerusalem and the West Bank and Gazan markets is highly constrained. These constraints can be grouped into separate categories: (i) Palestinian West Bank traders and manufacturers generally not being able to sell their retail products in the largest Palestinian urban center (East Jerusalem); (ii) Palestinian West Bank consumers not being able to purchase products and services in East Jerusalem retail markets without an Israeli entry permit; (iii) Palestinian East Jerusalem service providers, whether hospitals, schools or housing development companies, suffering from access problems related to the movement of individuals, products and finance from the West Bank; and (iv) Palestinian West Bank and East Jerusalem traders not being able to buy Gazan products, coupled with Palestinian West Bank and East Jerusalem consumers not being able to travel to Gaza to purchase products off-the-shelf.

A prominent example of a constraint related to the first category is the movement of Palestinian West Bank pharmaceutical products into Jerusalem for use by the six Palestinian hospitals that form the East Jerusalem Hospital Network. This issue has not yet been resolved and is causing financial difficulty to the hospitals (which as a group form the largest employer of West Bank Palestinians) given the high cost of Israeli pharmaceutical products that they are obliged to procure instead of the more inexpensive products available in the West Bank.[1] In the agricultural sector, a similar constraint on Palestinian meat and dairy products was lifted after being successfully addressed through coordinated action between Palestinian officials, Israeli authorities and concerned international donors.

The second category severely reduces consumer demand for Palestinian retail products and services in East Jerusalem. Palestinian residents of the West Bank are not able to visit East Jerusalem and its Holy Sites for general retail or tourism purposes without an Israeli permit. This restriction is usually relaxed during religious days of observance in Ramadan for certain age brackets but does not allow for free movement and access to East Jerusalem service and product markets. As to the third category, Palestinians in the West Bank have had difficulties accessing hospitals and schools in East Jerusalem either as employees or consumers of services[2] and Palestinian-based financing for mortgage or construction lending is restricted due to the high rates of commercial risk.[3] The fourth category relates to the Israeli security regime governing relations with the Gaza Strip and is discussed in more detail below.

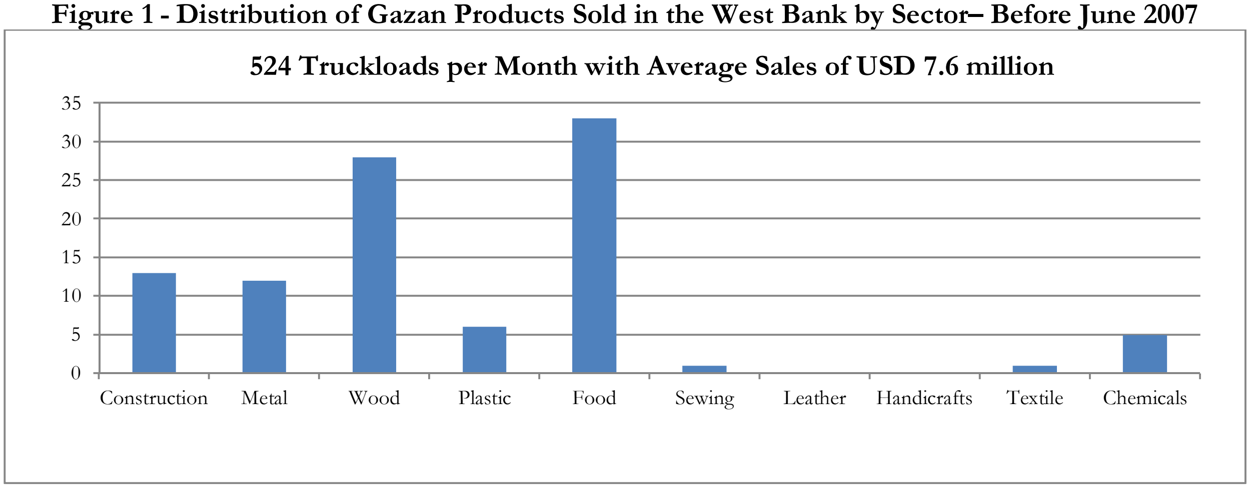
---

[1] Source: East Jerusalem Hospital Network, 2013
[2] World Health Organization, Health Access Barriers in the oPt, March 5, 2013
[3] Office of the Quartet Representative, 'Scaling Up Housing Opportunities in East Jerusalem', July 28, 2011

- **Separation of Gaza from West Bank and Jerusalem markets**

The separation of Gaza from West Bank and Jerusalem markets reached its height following the Hamas takeover of the Gaza Strip in mid-2007. In September of that year, Israel formally declared Gaza a 'hostile entity' and imposed an economic blockade prohibiting all trade except for the importation of basic humanitarian goods based on an approved 'positive list of goods.' The imposition of this blockade effectively cut off Gaza from West Bank and Jerusalem markets and the movement of goods into the Gaza Strip dropped to a minimum. Figure 1 below shows the movement of goods from Gaza to the West Bank before the imposition of the blockade. The Israeli closure regime was partially lifted in mid-2010 following a decision to allow all imports into Gaza from the West Bank except for items listed on specific control lists (shifting from a more restrictive positive list policy to a more accommodating negative list policy). Since 2011, international donors including the OQR have been pressing for opening two-way trade between the West Bank and the Gaza Strip, including further reducing the adopted controlled items (negative) list by allowing the entry of all construction material for the private sector, and revising the list of items viewed as having a 'dual-use' (i.e. an industrial input which could also be used for military purposes).

Figure 1 - Distribution of Gazan Products Sold in the West Bank by Sector– Before June 2007



Source: PalTrade, 2013

B) Limitations on Access to Natural Resources

The 'Oslo II' Interim Agreement, signed in 1995, split the territorial space of the West Bank into three distinct zones (Areas A, B, and C) with separate legal designations. Area A included most of the large Palestinian urban centers in which the PA had exclusive administrative and security control. Area B included territory in which Israel had security control and the PA oversaw its civil administration. Both territorial zones consisted of a non-contiguous patchwork of 227 tracts of land representing around 40 percent of the territory of the West Bank.

Area C consists of about 60 percent of the West Bank in which Israel retained control over issues related to territory and security. The majority of Area C is out of bounds for Palestinian private sector investment and use and has been demarcated by Israeli authorities as nature reserves (13 percent), military areas (20 percent) or areas for settlement construction (39 percent).[4] Only 1

[4] World Bank, September 23, 2012, 'Fiscal Crisis, Economic Prospects', The Imperative for Economic Cohesion in the Palestinian Territories.

percent of Area C has been designated for Palestinian private sector development despite the fact that an estimated 150,000 Palestinians reside in Area C locations. Significantly, this estimate of Palestinian inhabitants has remained fairly consistent in recent decades. The population of Israeli settlers in Area C is now estimated at around 360,000 individuals, rising from around 81,100 individuals in 1990.[5]

The natural resources of Area C (land and water), as well as access to the electromagnetic spectrum, represent the strategic economic depth of the future Palestinian state and are vital for future economic growth and sustainability. The current Palestinian population residing in the West Bank is estimated to be around 2.65 million (2013) rising at annual rate of 2.6 percent per year.[6] Over the next decade, this growing population will require access to the natural resources of the West Bank to sustain a high rate of private sector development.

The lifting of current restrictions on potential Palestinian development and investment in large parts of Area C could have a transformative economic effect on Palestinian economic growth and job creation. The World Bank highlighted in its September 2012 Economic Monitoring Report to the Ad Hoc Liaison Committee (AHLC) meeting the untapped potential of five economic growth areas in Area C: telecommunications, tourism, housing and construction, small-and-medium enterprises and agriculture.[7] The easing of restrictions related to private sector use of land and water in Area C and related to access to telecommunication frequencies and technologies could help engender much faster rates of private sector growth and development.

The Palestinian National Development Plan (2011-2013) laid out a vision and national targets for enhancing the competitiveness of Palestinian products and services and for promoting economic integration and access to international markets. The overall target of the national plan is for the Palestinian economy to grow by 12 percent in 2013 with rapid growth enabled by policy initiatives on the ground including in parts of Area C. Some of these initiatives include: '(i) agricultural land reclamation and rehabilitation and the upgrading of agricultural extension services to help farmers increase crop and livestock productivity; (ii) rehabilitation of archaeological and cultural heritage sites and establishing tourism information sites at key locations to raise awareness of Palestine's rich heritage; and (iii) completing the existing industrial park projects in Jericho and Jenin, and to work on establishing three additional parks focusing on the high-tech and alternative energy industries.'[8]

There are significant opportunities for developing Area C to promote the Palestinian economy, particularly in the tourism, telecommunications and housing sectors. Some detail on these examples is given below.

- **Tourism -** The Palestinian tourism sector has immense potential. Tapping that potential requires a stable surrounding environment, greater investment in tourism infrastructure and the right kind of marketing focused on the promotion of Holy Land tourism.[9] Israeli tourism revenues and employment generation are about 15-16 times greater than Palestinian tourism revenues and job creation figures, proving that with the right promotion strategy, Palestinian tourism could develop rapidly. Initiatives on the ground might include: (i) allowing for large-scale Palestinian development of tourism infrastructure in the Jordan Valley, particularly along the shores of the Dead Sea (similar to the development of the

[5] Yesha Council Data, 2013
[6] Palestinian Central Bureau of Statistics, 2013
[7] World Bank, September 23, 2012, 'Fiscal Crisis, Economic Prospects', The Imperative for Economic Cohesion in the Palestinian Territories.
[8] The Palestinian National Authority, National Development Plan 2011-2013, 'Establishing the State, Building our Future', April 2011.
[9] Monitor, OQR Palestinian Tourism Strategy, April 2010

tourism sector on the Jordanian side); (ii) permitting greater Palestinian access, rehabilitation and use of archaeological and cultural heritage sites throughout the West Bank (Sebastiya is one example); and (iii) allowing for the establishment of tourism infrastructure linked specifically to activities targeting Holy Land tourism promotion (e.g. Footsteps of Christ, Abraham Path initiative).

- **Telecommunications –** The telecommunications sector is one the most productive segments of the Palestinian private sector, already contributing up to 6.4 percent of Palestinian GDP and up to 6.1 percent of private sector job creation.[10] Amongst the challenges preventing greater growth in this sector are access to 3G/4G technologies and access to Area C locations in which to build required infrastructure (i.e. transmission towers). Both are issues over which the Israeli authorities have control. There is strong international evidence linking the diffusion of telecommunication technology and private sector development in growing economies around the world.[11]

- **Housing -** Creating new, large-scale and affordable housing for the growing Palestinian population in the West Bank will require greater use in the future of lands in Areas B and C (since much of Area A is largely built up). Already, there are successful housing development projects being implemented in Area B by the Palestine Investment Fund (e.g. Al-Reehan Neighborhood) and by private developers (e.g. Rawabi). For example Rawabi, when fully completed, will provide housing for up to 40,000 individuals. To replicate these housing initiatives and provide opportunities for middle-income and lower middle-income families, the Palestinian public and private sectors require greater access to large tracts of usable West Bank land, particularly in Area C.

C) Access to an Effective Investment Horizon

An important constraint on access to an effective investment horizon in the West Bank is the design of the Israeli immigration system governing the issuance of visas or entry-permits for overseas investors.[12] Although the PA has enacted its own legislation to promote domestic and foreign investment in the Palestinian economy over the years, ultimate authority to allow the entry of potential investors into the West Bank still lies with the Israeli Government. Although several system improvements were made by the Coordinator for Government Activities in the Territories (COGAT) and the Israeli Ministry for Regional Cooperation in 2010-2011 (e.g. providing for the possibility of short-term multiple-entry visas for potential investors from countries with a prior visa arrangement with Israel), overall problems related to transparency and bureaucracy still remain.

One change that would improve the current Israeli system (pending final status economic arrangements) would be to make the process for granting entry permits or visas to potential investors much more transparent. The Israeli authorities should clearly post on-line in English and in Arabic the required procedures and associated timeline for the granting and renewal of entry permits and visas for all potential investors. This measure was adopted temporarily but then dropped. There is no clear explanation of the current system easily accessible in English or in Arabic. The amount of information required for the granting of visas and entry permits could also be reduced to help encourage interest from overseas investors.

---

[10] Office of the Quartet Representative, 'The Unfinished Agenda for Growing the Palestinian Telecommunication Sector', 2013
[11] Information from the International Telecommunications Union, April 2012.
[12] Office of the Quartet Representative, 'Strengthening the Palestinian Investment Climate', 2010

More system-level improvements to the rules affecting the investment climate in the West Bank are required to enhance the robustness of the Palestinian economy. Such improvements will contribute, inter alia, to greater foreign direct investment (FDI) as interested overseas investors will be able to visit their investments and grow their businesses more easily.

Economic Developments and a Severe Fiscal Crisis

Although the Palestinian economy in the West Bank and the Gaza Strip witnessed relatively rapid expansion from 2008-2011 averaging around 9 percent, economic growth during 2012 slowed considerably. The story of high growth during the last five years stems from a combination of factors including increases in external donor assistance following the Paris Donor Conference in December 2007, implementation of the policy reforms embedded in the Palestinian Reform and Development Plan for 2008-2010, successful security sector reforms supported by the American and European governments, and economic easing measures implemented by the Israeli authorities. The growth trends for the Palestinian economy, broken down for the West Bank and the Gaza Strip, are shown below in Figure 2. The data for 2012 and 2013 are projections.

Figure 2 - Annual Economic Growth Rates for the Palestinian Economy

Source: IMF AHLC reports 2013, 2011

This positive growth story for the Palestinian economy, particularly during a time of global recession and financial crisis, masks other important sub-narratives about Palestinian economic trends. The first sub-narrative is that the recent improvement was largely about the Palestinian economy 'catching up' to previous real GDP levels after experiencing external shocks (i.e. real GDP in 2010 recovered to its 2000 level). The second sub-narrative is that much of the economic expansion was fuelled by external donor stimulus and not by increases in private sector productivity. The third sub-narrative is that economic activity in Gaza plummeted to extremely low levels following Operation Cast Lead in 2008 (as shown in Figure 2 above) and therefore witnessed relatively high growth rates during a recovery period from 2009-2011. The fourth sub-narrative is that the Palestinian economy has experienced a shift in the composition of its GDP from the tradable sectors (i.e. manufacturing) to the non-tradable sectors, in large measure due to a boom in the construction sector.

The growth of the Palestinian economy is projected to decline to 6 percent in 2012 and dip to 4.7 percent in 2013 (or possibly even further depending on the PA's current fiscal crisis). Slowing economic growth in 2012 and during the first part of 2013 is a result of reductions in external stimulus (i.e. shortfalls in expected donor funding), continued political instability in the region including the absence of final status negotiations, and a tapering off of further Israeli easing measures to support the Palestinian economy, especially in relation to the Gaza Strip.

The recent economic slowdown has also engendered increases in the already high rates of unemployment in the West Bank and Gaza Strip. Overall unemployment in both the West Bank and the Gaza Strip is expected to rise from 21 percent in 2011 to 23 percent in 2012. In the West Bank, the youth unemployment rate (workers aged 15-24 years) rose from 26 percent during the period 2006-2011 to 28 percent in the fourth quarter of 2012. As to Gaza, youth unemployment increased to 49 percent in the last quarter of 2012; nearly half of Gaza's youth and young adults are out of work.[13] Aside from general and youth unemployment levels, labor force participation by females in both the West Bank and Gaza is quite low at 17.3 percent in the second quarter of 2012 (compared to 69.2 percent among males).

A contributing factor to the slowing Palestinian macro-economy has been the increasingly crushing fiscal crisis experienced by the Palestinian Authority. The PA is a very large employer in the West Bank and contracts heavily with the Palestinian private sector. PA employees also borrow heavily from local banks. The inability of the PA to finance its budgeted recurrent expenditures has led to substantial increases in accumulated arrears, including to the private sector. The slowing Palestinian economy has also contributed to the deepening fiscal crisis in the formal of lower tax revenues.

The PA recurrent budget deficit in 2012 was USD 1.45 billion and the financing gap by the end of the year was USD 400 million.[14] The main causes of this financing problem flowed from substantial shortfalls in external donor assistance and lower than expected tax revenues. Local tax revenue declined in 2012 due to political instability and uncertainty as well as slowing business activity in both the West Bank and Gaza Strip. PA fiscal balances also suffer from zero revenue flowing from the Gaza Strip despite receiving a large share of PA recurrent expenditures. Notwithstanding receipt of several advances by the Israeli authorities in 2012, disruptions to the transfer of clearance revenues have also contributed to budget predictability problems for the PA in 2013. Lower than expected revenue streams in 2012, coupled with shortfalls in donor assistance led to the accumulation of large arrears and increased local borrowing from banks. Total arrears accumulation in 2012 equaled USD 600 million including USD 201 million owed to the private sector and USD 64.2 million to tax fund recipients. The total exposure of local banks to the PA amounted to USD 1.4 billion. With individual borrowing by PA employees taken into account, overall exposure levels rise to USD 2.1 billion. This path of continued local borrowing is not sustainable in 2013, or indeed beyond.

The financing gap in the draft 2013 PA budget is expected to be to the order of USD 400 million. In the absence of transferred clearance revenues, the financing gap could easily rise to USD 700 million in 2013.[15] In order to finance this expected funding deficit and to avoid excessive reliance on external donor assistance flows into the future, the PA will be taking measures to reduce the expenditure side of the budget. These measures could include: i) containment of the PA wage bill through a net freeze on hiring; ii) further limitations on cash transfers; iii) reviewing and adjusting the current system of PA staff allowances; and iv) adjusting budget expenditures for PA

---

[13] IMF AHLC Report, March 2013
14 Palestinian Central Bureau of Statistics (PCBS), 2012 Labor Force Statistics
[14] PA Ministry of Finance, Fiscal Developments and Macroeconomic Performance, March 3, 2013
[15] IMF AHLC Report, March 2013

development projects. Even with sufficient external donor assistance in 2013, it is advisable for the PA to consolidate its fiscal control policies in the future

Summary Conclusion

The Palestinian-Israeli context since the Oslo Agreements has grown in complexity and the status quo is necessarily limiting the future sustainability of economic growth in the West Bank and the Gaza Strip. The five year horizon of the 'interim' Oslo Accords has long passed and two decades on, there are important features of the current situation - the physical separation of internal Palestinian markets, restricted access to natural resources and constrained access to an effective investment horizon – that significantly weaken the cohesiveness and robustness of the Palestinian economy. High economic growth rates seen during 2008-2011 are now dipping sharply and the PA is facing a grave fiscal predicament in 2013. Without bountiful donor assistance and exceptionally large easing measures on the ground, it will be difficult to maintain the viability the PA. Whether all parties can work together to effect the necessary changes for an enabling environment that supports the Palestinian economy is a litmus test for whether the more difficult decisions on permanent status issues are indeed negotiable in the foreseeable future.

Chapter III - Integrating the Political and Economic Tracks

Since the beginning of direct Palestinian-Israeli political negotiations in the early 1990s, there has been little sustained integration of the political and economic tracks during rounds of final status discussions. Prior to the Camp David talks in 2000, there was insufficient development work to prepare public opinion in support of final status positions pursued by the negotiators. After the Annapolis Peace Conference in 2007, significant economic and security improvements achieved on the ground with the implementation of the Fayyad 'state-building' plan were not integrated formally with final status negotiations between President Abbas and Prime Minister Ehud Olmert during 2008. During 2009-2012, 'ground up efforts' to build up the Palestinian economy and security sectors continued whereas the political track on permanent status did not witness concomitant moves forward.

In 2013, following the recent American and Israeli elections, there are expectations of another diplomatic initiative attempting to resume political permanent status negotiations between the Palestinians and Israelis. It would be vitally important that such an initiative fully integrates the economic and 'ground up' agenda with any timetable to discuss, agree and implement ideas on borders, security, Jerusalem, refugees and water. The economic track can never substitute for progress on the political track, including discussions on security, but it can serve to create a positive surrounding environment to support negotiations on final status. The most important dimension of this surrounding context is a fully-functioning and viable Palestinian public sector delivering effective services to its people in the West Bank and Gaza Strip.

There are two important reasons for integrating the political and economic tracks. Firstly, agreement on economic issues, as mentioned above, can serve as a litmus test for the prospects of a significant breakthrough in political negotiations. If agreement cannot be reached on economic issues, there is little possibility of reaching true consensus on the conflict's sensitive core political issues. Second, in view of well-entrenched cynicism on both sides following a long-history of repeated attempts to make progress and a daily reality which provides no grounds for optimism about an alternative, it is important to give public opinion a true sense of impending positive changes on the ground. These changes need to be much more far-reaching along the path of a two-state solution. If the Palestinian and Israeli populations are able to get a glimpse of how things can be under a new framework for peace, they would be more ready to support a political negotiation.

There are three important dimensions to the integration of the political and economic tracks. The first dimension is the formal economic negotiations on permanent status economic relations between Israel and Palestine for the future. This economic track can run in parallel with or closely behind progress achieved on the political track. The second dimension relates to the full implementation of current interim economic agreements (i.e. the Paris Protocol) ahead of full agreement and implementation of a new permanent status economic framework. The third dimension relates to the surrounding environment and effecting positive change on the ground. Achieving such change will boost the sustainability of the Palestinian Authority, encourage donors to augment flows of development assistance to the Palestinian Authority (especially if the changes are large, transformative and pointing to eventual Palestinian statehood), and will counter deeply-entrenched doubts about the possibility of a comprehensive peace settlement.

These three dimensions to an integrated approach are discussed below. The first dimension is examined briefly in this section while the second and third dimensions are the subject of the next two chapters of the report.

Economic Permanent Status Issues

There are important 'economic' permanent status issues that will have to be negotiated alongside progress in the political track. The most important of these is the question of the appropriate trade regime between Israel and Palestine in the future covering the commercial exchange of goods and services. There are different models that have been examined and discussed by Palestinian negotiators, economic research organizations and international development organizations.[16] These models include: (i) a renewed customs unions; (ii) a free trade agreement between Israel and Palestine; or (iii) a non-discriminatory open regime – and variants in between. If Palestinian economic negotiators lean toward the second model, a free trade agreement, in the future, serious investment by the Palestinian border management authorities will have to be undertaken to build capacity related to implementing the complicated 'rules of origins' requirements.

Aside from the question of the trade regime, there are other important economic topics for the negotiators to address. Given the geographical closeness and natural links between Israel, the West Bank, and the Gaza Strip, there will probably have to be separate economic discussions and agreements on transport, telecommunications, and energy sector issues. For transport, these will center on the physical corridor between the West Bank and Gaza Strip, the re-opening of the Palestinian airport and seaport, and use of Israeli airports, airspace, seaports and sea lanes for Palestinian trade. Discussion on telecommunication will focus naturally on the use of the shared electromagnetic spectrum for telecommunication frequencies. For the energy sector, Israel and Palestine will need to decide how best to cooperate in the generation and transmission of energy to Israeli and Palestinian households and businesses.

Fuller Implementation of the Paris Protocol

Since its signing in 1994, the Paris Protocol has served as the governing framework for economic relations between Israel and the Palestinian Authority. The Protocol, as discussed above, was meant to be in place for a five year period and covers taxation, trade policy, monetary and financial issues and five different economic sectors (labor, agriculture, industry, tourism and insurance). During the subsequent nineteen year period, only some of the Paris Protocol has been fully implemented. Other parts have not received sufficient attention as practices and on the ground realities; given the shifting Israeli-Palestinian relations they have evolved in a separate direction.

There are different ways to strengthen the implementation of the Paris Protocol pending an agreement on permanent status economic issues. These proposals would require the re-activation of the Joint Economic Committee (JEC) framework and a political agreement to actively cooperate. The key economic issues include: i) revisiting the lists of items eligible for import by Palestinian importers under a different tariff regime; ii) greater Palestinian customs control at key border crossings; iii) opening up normalized two-way trade between the Gaza Strip and the West Bank; and iv) Israeli recognition of the free trade agreements signed between the PLO and other countries for the benefit of the PA. The next chapter examines in detail the provisions of the Paris Protocol, assesses overall progress, and provides recommendations on how to improve implementation.

---

[16] See example: World Bank, February 2001, 'Trade Options for the Palestinian Economy: Some Orders of Magnitude, Astrup C and Dessus S

Creating a Positive Surrounding Environment

The agenda for transformative change on the ground is a necessary but not sufficient ingredient in the overall diplomatic effort to reach a comprehensive Middle East peace settlement. The vehicle for this accelerated change is the Palestinian private sector. Its ability to play this role depends on: i) continuous improvements in the Palestinians trade, energy, telecommunications, water and banking infrastructure; and ii) the opening up of new business opportunities within and between the three internal Palestinian markets (West Bank, Gaza Strip and East Jerusalem) and between the Palestinian economy and overseas markets. The last chapter of this report will examine the Palestinian economy with a special focus on services as a driver of economic growth and development (i.e. tourism, ICT).

Chapter IV - Improving the Implementation of the Paris Protocol

The interim economic arrangements defined by the Paris Protocol between Israel and the PLO should be examined with the purpose of ensuring fuller implementation pending agreement on final status economic relations. Such a step can help to strengthen, perhaps significantly, the financial viability of the Palestinian Authority without having to negotiate another interim agreement independent of a drive towards a permanent political and economic framework. Prior to examining the provisions of the Protocol and providing recommendations on ways to strengthen its implementation, a brief discussion of the historical context and the way in which the Protocol was incorporated into Israeli Law is provided below.

Context Since 1967

After the 1967 war, Israel severed previous normal economic relations between the West Bank/Gaza and the rest of the world including Jordan and Egypt. Using military orders, Israel amended the laws governing all aspects of trade and economic activity in place prior to its takeover. It introduced Israeli currency as the legal means of payment and applied Israeli foreign trade policy and customs tariffs for the West Bank and Gaza Strip. It subjected all imports to Israeli restrictions, standards and import taxes, stipulated that Israel would collect income and property tax, and would introduce new taxes on imports (e.g. value-added) and on local transactions in accordance with the tax laws of Israel.

The Israeli Government introduced additional policies affecting the lives of the population in the West Bank and Gaza Strip. Vehicle insurance laws became compulsory using military orders, and employment of Palestinian labor in Israel was made subject to Israeli labor and national security laws. The Israeli Government allowed Palestinians to sell their products, including vegetables, in Israeli markets. Israeli private and governmental companies supplied the West Bank and Gaza with energy and water resources. The borders between Israel and the West Bank and Gaza Strip were kept open for the free movement of vehicles, people and goods in both directions.

The restrictions imposed by the military regime on investments and economic development prevented the development of a productive economic base in support of an independent and viable economy. The Palestinian economy became dependent on external remittances especially, from Palestinian labor working in Israel who in 1988 represented 40 percent of the Palestinian labor force.[17] The occupation authorities also prevented the development of independent Palestinian governmental institutions beyond local city and village councils. Israeli military commanders in the West Bank and the Gaza Strip were responsible for both security and civil affairs. In 1981, Israel created the Civil Administration, a branch of the Israeli Military, to manage all civilian affairs in the West Bank and Gaza Strip pursuant to the policies of the office of the 'Coordinator of Government Activities in the Territories' (COGAT). These policies resulted in a high level of economic integration between Israel and the West Bank/Gaza Strip and created Palestinian dependence on the Israeli market for the supply of goods, services and labor opportunities.[18]

After the signing of the Declaration of Principles in 1993, the PLO and the Government of Israel (GOI) held negotiations on a protocol to govern the economic relations between the Palestinian Authority and the State of Israel for an interim period. The Protocol, including its appendices, was incorporated into Annex IV of the Gaza and Jericho Agreement. It was envisaged that the Protocol would first be implemented in the Gaza Strip and the Jericho Area; and at a later

---

[17] "The external trade of the occupied Palestinian territories" UNCTAD, 1988.
unispal.un.org/UNISPAL.NSF/0/82CB65C6C7A3F9AB052567FA0050C3A9
See also: Shlomo Gazit "The Stick and the Carrot, the Israeli Government in Judea & Samaria" Zmura Bitan, 1985
[18] See Footnote 17.

stage be implemented to the rest of the West Bank, according to the provisions of the Interim Agreement.

In 1995, Israel and the PLO concluded a 'Supplement to the Protocol on Economic Relations' that amended the Protocol's provisions. The amended Protocol was incorporated into Annex V of the 1995 Interim Agreement on the West Bank & the Gaza Strip. As part of the Wye River Memorandum, the parties agreed, inter alia, to launch a strategic economic dialogue through an Ad Hoc Economic Committee. Two years later on 6 July, 2000, the parties signed an agreement to complement the Protocol that covered several outstanding issues.[19] A full explanation of how the interim economic agreements with the PLO were incorporated into Israel law is provided below in Box I.

Box 1 - Incorporation of Interim Economic Agreements into Israeli Law

Background

According to Israeli Constitutional Law[1], the Paris Protocol, similar to any other international agreement that Israel is signatory to, is not part of Israeli law nor the law that applies in the occupied territory. To grant the Protocol validity as part of the laws that apply in Israel, the Knesset had to pass a separate law. Similarly, to grant the Protocol validity as part of the law that applies in the occupied territory, the Israeli commander had to issue a military order. Moreover, the executive authorities of the State of Israel (Ministries and other Authorities) can only act according to a law or to regulations issued in accordance with a valid law. Any other action would be illegal. In fact, the Interim Agreement required the parties to pass all necessary legislation to implement the agreement.[2] It is therefore important to review all Israeli laws and military orders to understand the full extent of the framework governing Israeli-Palestinian economic relations.

After the signing of the Interim Agreement in 1995, the Israeli Commanders of the West Bank[3] and the Gaza Strip[4] respectively issued two manifests to implement the Interim Agreement in its entirety in the West Bank and the Gaza Strip. The Knesset, on the other hand, did not pass a law to implement the agreements reached with the PLO similar to the law it passed to implement the Peace Agreement with the Hashemite Kingdom of Jordan[5]. It only passed a number of laws to implement certain elements of these agreements.

With regards to the Gaza & Jericho Agreement, the Knesset passed the following two laws:

1. *The Law for the Implementation of the Gaza Strip and Jericho Agreement (Economic Arrangements and Miscellaneous Provisions) (Law Amendments) – 1994. This Law partially applied elements of the 1994 Protocol to a limited geographical area of the West Bank (Jericho) and to the Gaza Strip. Additionally, it granted Israel absolute discretion over the transfer of clearance revenues to the Palestinian Authority. It also allowed it to unilaterally deduct any PA liabilities owed to the Israeli authorities or companies prior to the transfer of these revenues. Furthermore, this law extended the territorial application of a number of Israeli laws to the occupied territories including the Israeli Import Laws, Income Tax Law, VAT Law, National Insurance Law, Employment Services Law, Animal Disease Law, Motor Vehicle Insurance Law and the Law for Compensating Road Accident Casualties.*

[19] The issues were: (i) clearance of purchase tax from local production; (ii) expansion of the Protocol's A1 list by an additional 1,333 tariff items (items eligible for importation by Palestinians under a different tariff and standards regime); (iii) settling outstanding PA debts to Israeli institutions; and iv) cooperation in combating motor vehicle theft.

Box I: CONTINUED

2. *The Law for Implementing the Agreement on Preparatory Transfer of Powers and Responsibilities (Law Amendments and Miscellaneous Provisions) – 1995. This law did not amend or cancel the aforementioned 1994 law. However, it added new provisions regarding the transfer of clearance revenues to the PA, and applied them to the entirety of the Gaza Strip and the West Bank - except Israeli settlement areas and military sites. It preserved Israel's absolute discretion over the transfer of these revenues to the Palestinian Authority and the unilateral deduction of any PA liabilities prior to their transfer. It also amended the provisions on Road Accidents. Strikingly, however, it did not expand the geographical application of other parts of the 1994 Protocol beyond the Gaza and Jericho Area.*

3. *To implement the recommendations of the Wye River Ad Hoc Economic committee, the Minister of Finance enacted the Regulations for Implementing the Agreement on Preparatory Transfer of Powers and Responsibilities (Directives Regarding the Transfer of Additional Tax Revenues) – 2001. The Regulations stipulate that Israel should transfer to the Palestinian Authority the purchase tax paid on Israeli locally manufactured goods sold to dealers in the Palestinian Authority, collected since November 1, 1999.*

In 1996, following the signing of the 1995 Interim Agreement, the Government of Israel prepared a Bill entitled the Law Proposal for the Implementation of the Interim Agreement on the West Bank and the Gaza Strip (Economic Arrangements and Miscellaneous Provisions) (Law Amendments) – 1996. The explanatory notes attached to the Bill confirm that its key purpose was to adapt the provisions of the 1994 law to the 1995 Interim Agreement. However, the Knesset did not pass this Bill, and hence it did not materialize into a law. Another attempt by the Government of Israel in 1997 to pass this Bill[6] also failed.

Annex I provides a brief summary of key discrepancies between the Paris Protocol and the Israeli implementing Laws.

Footnotes

1 - Israel Supreme Court Case 2717/96 Wafa et al v. The Minister of Defense et. al.
2 - See Article XXXI(4) of the Interim Agreement
3 - Manifest Regarding the Implementation of the Interim Agreement (Judea & Samaria) (No. 7) – 1995
4- Manifest Regarding the Implementation of the Interim Agreement (The Gaza Strip Area) (No. 5) – 1995.
5 - Law for Implementing the Peace Agreement between the State of Israel and the Hashemite Kingdom of Jordan – 1995. This law clearly states in Article 2 that the "Peace Agreement will be regarded as valid for all purposes".
6 - Law Proposal for the Implementation of the Interim Agreement on the West Bank and the Gaza Strip (Economic Arrangements and Miscellaneous Provisions) (Law Amendments) – 1997.

The Framework and Reality of the Protocol

When the parties negotiated the Protocol in 1994 and the Protocol Supplement in 1995, they did so in the context of realities on the ground, namely Palestinian economic dependence on Israel, an open border that did not allow for customs control, and the lack of Palestinian self-governing institutions. The development of required PA capacity for generating independent policy and legal frameworks, if done immediately, would have resulted in a shock to the Palestinian economy, and therefore had to be introduced gradually.

The Paris Protocol, in its essence, preserved and codified the existing arrangements with Israel while transferring limited authorities to the Palestinian Authority. However, the Protocol was only intended to serve for a short interim period of five years. Palestinians expected that by the end of the interim period, the parties would reach a permanent status agreement that would guarantee Palestinian political and economic independence[20].

The failure of the permanent status negotiations between the parties, however, led to the extension of the Protocol well beyond its intended lifespan. The wave of violence that swept Israel and the West Bank and Gaza Strip following September 2001 had a devastating effect on the Palestinian economy[21] among other factors. Unilateral measures applied by the Government of Israel, especially the closure regime and severe restrictions on movement and access for both goods and people[22], resulted in a growing gap between the vision and framework of the Protocol on the one hand, and realities on the ground on the other.

The section below examines the implementation status of the elements of the Paris Protocol and provides recommendations for improvement to both sides.

Issue A - Scope of the Protocol[23]

The Protocol established the contractual agreement that governs the economic relations between the PA and Israel during the interim period. The five year interim period referred to in the Protocol commenced on the date of signing the Agreement on the Gaza Strip and the Jericho Area on May 4, 1994 and therefore should have ended on May 4, 1999. In practice, however, the parties continue to apply the provisions of the Protocol as the basis for economic relations between the PA and Israel.[24] The Protocol covers the West Bank and the Gaza Strip as a single territorial unit, the integrity and status of which the Parties agreed to preserve during the interim period.[25]

Since June 2007, however, Israel has restricted the movement of commercial goods and people between Gaza, Israel and the West Bank. Until June 2010 Israel allowed the entry of certain quantities of humanitarian goods to the Gaza Strip from Israel and the West Bank and banned the movement of goods from the Gaza Strip to Israel, the West Bank and the rest of the world. This closure regime had a devastating impact on the economy in Gaza.

Since June 2010, Israel has permitted the entry of goods from Israel and the West Bank and imports from the rest of the world into Gaza, except for those deemed as having a dual use purpose and other restricted goods that require a special transfer license issued by the Israeli military. Israel, however, continued to ban the movement of goods from Gaza to Israel or to the West Bank except for purchases made by the PA from Gazan businesses, which have to be approved by Israel. Israel allowed coordinated exports from Gaza to the rest of the world[26].

Although the easing of restrictions in mid-2010 and early 2011 had a positive impact on the Gazan economy, the remaining restrictions on the outflow of goods, services and people to

---

20 A. Arnon, J. Weinblatt "Sovereignty and Economic Development: The Case of Israel and Palestine" *The Economic Journal 111* June 2001 P.291, 295.
21 'Four Years - Intifada, Closures and Palestinian Economic Crisis' The World Bank, October 2004 http://siteresources.worldbank.org/INTWESTBANKGAZA/Resources/4yrassessment.pdf
22 'Movement and Access Restrictions in the West Bank: Uncertainty and Inefficiency in the Palestinian Economy' The World Bank, May 2007. http://siteresources.worldbank.org/INTWESTBANKGAZA/Resources/WestBankrestrictions9Mayfinal.pdf
23 Article I of the Protocol.
24 See Paragraph (5) in the preamble to the 1995 Interim Agreement.
25 See Article XXXI(8) of the 1995 Interim Agreement.
26 For more information on the Israeli closure regime see 'A Guide to the Gaza Closure' GISHA, Septmber 2011 http://www.gisha.org/UserFiles/File/publications/gisha_closure/gisha_brief_docs_eng_sep_2011.pdf

Israel and West Bank markets continue to impede a full economic recovery in Gaza. The population of Gazan is still worse off than in the 1990s, and living in greater poverty.[27]

Recommendations

Israel allows for the free movement of goods including construction materials into Gaza and the sale of Gazan products in Israel and the West Bank to enable a full recovery of the Gazan economy.

Issue B - The Joint Economic Committee[28]

Given the high level of economic integration and need for close coordination and cooperation between the parties, the Protocol required the establishment of a Joint Economic Committee (JEC) and a number of specialized sub-committees to follow up on the implementation of the Protocol and deal with related problems that may arise. The JEC also serves as the economic cooperation committee between the parties. One of the obvious weaknesses of the JEC, however, is that all decisions must be reached by full agreement. As a result, many issues brought to the JEC remain unresolved. The JEC was also highly susceptible to security and political developments with meetings interrupted and ultimately suspended after the eruption of the Second Intifada in September 2000. JEC meetings resumed for a short period between January 2008 and September 2009 but then again ceased.

Recommendations

Reconvening the JEC and its subcommittees on a regular basis is essential for renewing dialogue and building trust between the parties, and for addressing many of the problems facing the implementation of the Protocol and the development of the Palestinian economy. A special sub-committee could be established to work on improving implementation in all sectors covered by the JEC or this could be left to the work of the sub-committees. In any case the parties need to agree on a procedure to address unresolved economic disputes between them making use of the arbitration provision in Article XXI of the Interim Agreement. Once reconvened, every effort should be exerted to protect it from political fluctuations of the surrounding environment.

Issue C - Import Policy

1. **Goods Subject to Palestinian Policies**

The Palestinian Authority has all powers and responsibilities over imports, customs policy and procedures related to the goods on Lists A1[29] and A2[30] of the Paris Protocol. These lists specify the quantities of goods that Palestinians are able to import under a different regime from Jordan and Egypt (A1 countries) and from other Arab and Islamic countries (A2 countries). The import policy of the Palestinian Authority for Lists A1 and A2 includes independently determining

27 For a review of the economic and social situation in Gaza see:
'Gaza in 2020: a livable place?' the United Nations, August 2012
http://www.unrwa.org/userfiles/file/publications/gaza/Gaza%20in%202020.pdf
Also see "Coping with Conflict: Poverty and Inclusion in the West Bank and Gaza" the World Bank, October 2011
http://go.worldbank.org/JKWJB8XGB0

28 Article II of the Protocol.

29 List A1 applies to products that are imported directly from Jordan and Egypt and that meet the requirements of the Rules of Origins as set in the Protocol Article III(8).

30 List A2 applies to products from Arab, Islamic and other countries.

the rates of customs and other import charges, the regulation of licensing requirements and procedures, and regulation of standard requirements.

In June 2000, following the recommendations of the Wye River Ad Hoc Economic Committee, the parties agreed to add 1,300 additional tariff items to List A1. The additional items are limited to goods produced and imported directly from Jordan or Egypt. According to the Protocol, a subcommittee of experts should have been convened to review and update the Palestinian market needs in Lists A1 and A2. However this committee was never formed and the lists were not updated as envisaged, restricting the power and authority of the PA to limited items and in limited quantities.

In addition to the goods in lists A1 and A2 the Palestinian Authority has all power and responsibility for independently determining and changing the customs rates and other import charges on goods specified in List B (e.g. goods in the form of heavy machinery) and on motor vehicles. As opposed to the goods in lists A1 and A2, however, the Palestinian Authority is obliged to apply the same Israeli import regulations including licensing and standards as applied by Israel with respect to its import policy.

The Protocol also stipulates that the Palestinian Authority must apply a single VAT rate on locally produced goods and services and on imports by Palestinians whether covered by the three lists mentioned above or not.

Recommendations

Updating the A1, A2 and B Lists ought to be prioritized by both parties to enable the Palestinian Authority to have greater jurisdiction over its foreign trade with third countries. It can also serve to lower the costs of raw materials and commodities by allowing imports from cheaper markets. This fact is especially true for fresh and processed food products to which Israel continues to apply very high customs. Allowing the import of cheaper products from markets other than Israel would contribute to lowering living costs and inflation and thus raising the value of wages.

2. Goods Subject to Israeli Policies

With respect to all goods not specified in Lists A1, A2 and B, and to quantities exceeding the quotas set in these lists, the Israeli customs rates and other charges apply as a minimum basis for the Palestinian Authority. The Palestinian Authority may decide on any upward changes in the rates on these goods and exceeding quantities when imported by Palestinians to areas under PA jurisdiction. The ability to do so is important to protect promising local industries against foreign competition. It can also be used to enforce necessary safeguards and anti-dumping measures in trade with third countries.

Under the current circumstances, however, the PA has no control over the crossing of goods from Israel to the PA including indirect imports by Israeli traders. The PA therefore cannot use this tool effectively. In fact, increases in customs may potentially backfire on the PA as Palestinian traders would simply buy these products through Israeli importers and the PA would lose any accrued import taxes.

Recommendations

In order for the PA to effectively decide on and implement upward changes in customs rates on these goods, the PA must have control over the crossing of indirect imports from Israel. Israel must guarantee the transfer of import taxes and the PA should be allowed to collect the difference between the customs paid and the Palestinian customs rates that apply to these goods.

The Protocol further requires Israel and the PA to apply the same import policy (licensing and standards) and customs procedures that Israel applies to all its imported goods.

In practice, however, Israeli authorities apply different procedures for imports to Israel and imports to the Palestinian Authority (e.g. customs clearance and standards certification procedures). In many cases, the difference favors Israeli importers who can clear their goods more quickly and cheaply (e.g. storage and handling). In some instances (e.g. import of pharmaceuticals and their raw materials) the procedural differences compel Palestinian importers to import products through an Israeli partner. This practice not only results in higher transaction costs for the Palestinian importer but also lost tax revenue to the PA and higher prices passed onto the Palestinian consumer.

Palestinian importers also lose out in other ways. They do not receive support services (e.g. issuing of telecommunication import licenses) equal to their Israeli counterparts, since Israeli departments that deal with Palestinian importers are often understaffed and lack the necessary resources to provide efficient services. Moreover, Israeli laws, regulations and procedures are available only in Hebrew. This means that Palestinian importers do not have the knowledge and tools for fulfilling the import requirements, often leading to delays in the clearance of their imported goods and therefore increased storage and other transportation costs (including fees to Israeli service providers such as customs agents, freight forwarders and lawyers). Israeli laws, regulations and procedures that are applied to Palestinian traders must be made readily available in Arabic.

Recommendations

Israel ought to coordinate the customs, standards and other administrative procedures it applies to Palestinian imports with the PA, reforming them to be more efficient and granting Palestinian importers equal treatment. Israel should make laws, regulations and procedures readily available in Arabic and allocate sufficient staff and resources to be able to provide equal services to Palestinian importers. When security reasons make this infeasible, Palestinian importers ought to be compensated to maintain a level playing field between Palestinian importers and their Israeli competitors.

3. Petroleum Products

The Palestinian Authority has the right to determine the consumption prices of petroleum products, other than gasoline, in the areas of the Palestinian Authority. The final price of gasoline to consumers in Israel and in the PA may not exceed 15 percent of the official final consumer price in Israel. In theory, the Protocol allows the PA to import petroleum products that meet Jordanian standards, including Egyptian gasoline, conditional on these products also meeting the technical specifications and standards set in Appendix I of the Protocol. In practice, however, Jordanian standards fall below required standards and the PA imports all of its petroleum products almost exclusively from Israel.

Recommendations

The parties should make use of the joint committee mechanism foreseen in the Protocol to mutually acknowledge different standards of gasoline. Such a committee to discuss and agree new standards that permit PA imports of cheaper petroleum from other markets is important to shore up the competitiveness of the Palestinian economy and private sector.

4. Customs Control

According to the Protocol, the Palestinian Authority should have full customs responsibility over Palestinian cargo and passenger lanes at the Allenby Bridge with Jordan, and at the Rafah Crossing with Egypt. This includes exercising responsibility over the inspection of cargo and passenger luggage, and the collection of taxes and other charges subject to Israeli Customs supervision. The Protocol also allows Palestinians to use Israeli entry and exit points for freight shipment subject to the inspection and clearance procedures of Israeli Customs.

The 2005 Agreement on Movement and Access replaced the provisions of the Protocol related to the operation of the Rafah Crossing. After the Second Intifada in September 2000, Israel retracted permission for the PA to exercise agreed responsibilities at the Allenby Bridge. Israeli Customs assumed full control over its cargo and passengers lanes. Due to the political and security developments in Gaza since 2006, Israeli Customs also assumed full control over the Kerem Shalom crossing.

Therefore, in practice, Israeli Customs have full control over clearance procedures for imported goods to PA areas. There is no Palestinian Customs presence at any border crossing and therefore no PA control over the collection of import taxes and the implementation of its import policy. Moreover, Israel deducts 3 percent from the taxes it transfers to the PA as service fees.

Recommendations

PA Customs should be allowed to assume customs responsibility and powers in the Palestinian cargo and passenger lanes at the Allenby Bridge in accordance with the Protocol. In addition, efforts should be made between the PA and Egypt to agree an arrangement for the operation of the Rafah Crossing for commercial imports and exports in line with the objectives of the 2005 Agreement on Movement and Access.

5. Import Tax Clearance

In principle, revenue clearance from all import taxes between Israel and the PA is based on the principle of the final destination of the goods regardless of whether the goods are imported through Israeli or Palestinian points of entry. The Protocol states that when goods are imported by an Israeli importer, the PA should receive the import taxes only if the final destination explicitly stated in the import documentation is a corporation registered by the PA and conducting business activity in the territories.

Palestinian importers are required to sign a declaration that the entire imported shipment is destined for the PA before the goods are cleared by Israeli Customs. The shipment has to be transferred from the port or bonded warehouse directly to the PA without stopping in Israel. In case of doubt, Israeli Customs may track the shipment. These requirements do not apply to Israeli importers who are not required to sign an equivalent declaration and are not subject to any limitation on reselling imported goods to the PA.

According to a 2010 Bank of Israel report[31] a significant share of the goods sold from Israel to the PA are foreign goods imported to Israel and resold to the PA at a later stage. Given that Israel accounts for 78 percent of all Palestinian imports of goods, such a loophole results in significant losses to the PA treasury. Both Palestinian and Israeli importers have a clear incentive not to specify the PA as a final destination due to the stricter security and clearance procedures that apply. There is no current system for monitoring the transfer of foreign goods between Israel and the PA.

[31] Bank of Israel, "Recent Economic Developments No. 128 May – August 2010", Bank of Israel Research Department, October 2010 P. 22

Recommendation

The JEC should form a joint expert committee to develop a mechanism for the clearance of import taxes collected on goods imported by an importer from one side but sold and consumed on the other side (e.g. Israeli importer who brings in European goods into Israel but then sells them in the West Bank) according to the principle of the final destination of the goods.

D) Monetary and Financial Issues

The Protocol transferred limited power and responsibility over monetary issues to the Palestinian Monetary Authority (PMA) for the regulation and implementation of monetary policies including: (i) providing official economic and financial advice to the PA; (ii) acting as the sole financial agent to the PA and all public entities, locally and internationally; (iii) acting as the depositor and manager of foreign currency reserves (including gold) for the PA and all Palestinian public sector entities; (iv) acting as the lender of last resort for the banking system in the territories; (v) responsibility for the proper functioning, stability, solvency and liquidity of banks operating in the Palestinian territories; and (vi) establishing a clearing house in order to clear money orders between the banks operating in the Palestinian territories, and with other clearing houses.

The Protocol stipulates that the New Israeli Shekel (NIS) will continue to be one of the circulating currencies in the PA and that the PMA will have the right to convert at the Bank of Israel (BOI) excess NIS received from banks operating in the territories into foreign currency. In recent years, however, the PMA has complained of restrictions imposed by the Israeli authorities on the transfer on excess cash reserves on NIS held at the Palestinian banks resulting in financial damages to the Palestinian banking system. The BOI, on the other hand, argues that part of the excess amounts of NIS in Palestinian banks is as a result of money laundering and therefore should be restricted.

The PMA also continues to face difficulties transferring cash into Gaza. Moving money to Gaza requires coordination with the Israeli Authorities, and the PMA reports that it has not been able to obtain permission to transfer cash with the required regularity and in sufficient quantities. This problem creates a shortage of cash in banks and erodes the credibility of the formal banking sector in Gaza, strengthening the role of the unregulated sector.

Recommendations

The PMA and the BOI should agree on transferring and converting excess NIS received by the PMA from banks operating in the PA, as well as on a mechanism for the routine transfer of money to Gaza in the required quantities for the normal functioning of the formal banking sector in Gaza.

E) Direct Taxation

The Protocol allows each of the parties to determine and regulate independently its own tax policy in matters of direct taxation, including income tax on individuals and corporations, property taxes, municipal taxes and fees. It was agreed that Israel would transfer to the PA 75 percent of the income taxes collected from Palestinians from the West Bank[32] and the Gaza Strip employed in Israel and the full amount of the income taxes collected from Palestinians from the West Bank and the Gaza Strip employed in Israeli settlements.

[32] This rule does not apply to Palestinians living in East Jerusalem and employed in Israel or in Israeli settlements.

The income tax levied on Palestinians working in Israel is according to Israeli income tax legislation and the tax levied on Palestinians working in Israeli settlements is according to the Jordanian Law that existed prior to the Israeli occupation and military orders issued afterwards. Since the average Palestinian wage in Israel and/or in Israeli settlements does not usually exceed the minimum wage in Israel, Palestinian workers are exempted from paying income tax in Israel leading to only small amounts of income tax transferred by Israel to the PA. Although the Protocol allows the parties to impose additional taxes on its residents (individuals and corporations) who conduct economic activities in areas under the tax responsibility of the other side, the PA did not impose any additional taxes on Palestinians working in Israel, despite the average salary differential between Israel and the Palestinian territories being almost 2:1.

Recommendation

The PA should consider imposing its income tax legislation on Palestinians working in Israel and collecting income tax on the difference between the tax collected by Israel and the tax due had the income been generated in the Palestinian territories.

F) Indirect Taxation

Given the proximity between the occupied territories and Israel and the lack of a physical border or customs stations, it was necessary to maintain similar indirect tax rates to avoid serious trade diversion to the market through lower tax rates. It was agreed in the Protocol that both sides would levy and collect VAT and purchase taxes in their respective areas. The purchase tax rates were to be identical but the Palestinian VAT rate should not be lower than two percent below the Israeli VAT rate.

While the export of goods to third countries is exempted from VAT, the sale of goods between the parties is subject to VAT according the rate applicable at the place of sale. In other words, a Palestinian dealer buying goods from an Israeli business will pay the Israeli VAT rate and receive a special VAT invoice and vice versa. The VAT on purchases by dealers registered for VAT purposes accrues to the VAT administration with which the dealer is registered and VAT revenues are cleared between the Israeli side and the Palestinian on the 25th of each month according to the mechanism set in amended Article VI.[33]

This system works as long as dealers submit to the relevant Ministry of Finance all VAT invoices received for the transaction made and as long as the VAT invoices are genuine and represent the real value of the transaction. In reality, traders do not always follow these rules and that results in tax losses to both parties. The PA is concerned about the loss of significant VAT revenues because Israel does not share information on VAT invoices issued by Israeli dealers to Palestinian dealers. The PA cannot submit them for clearance because the Palestinian dealers do not submit copies of those invoices to the PA, since they wish to avoid exposing the transaction to Palestinian tax authorities.

The PA is also prevented from presenting Israeli VAT invoices paid by Gaza merchants to Israel for clearance since it cannot collect them. Israel does not transfer VAT revenues for these invoices despite having copies of the original invoices and having full control over the crossing of goods into the Gaza Strip. In their turn, Israelis are concerned that many of the Israeli VAT invoices submitted by the PA are in fact fictitious, and that many of the Palestinian VAT invoices issued to Israeli dealers are issued at lower value than the real transaction resulting in losses to the Israeli treasury.

---

[33] For more information on revenue clearance see the IMF report: "Recent Experience And Prospects Of The Economy Of The West Bank And Gaza Staff Report Prepared For The Meeting Of The Ad Hoc Liaison Committee", New York, September 23, 2012

In July 2012, the PA Prime Minister and the Israeli Minister of Finance agreed, inter alia, to form a joint committee to agree on new procedures for VAT clearance to minimize the losses to the parties as result of VAT leakages.[34] The meetings of the committee, however, were suspended in November 2012 and have not been resumed.

Recommendation

The joint MOF-MOF teams should resume their meetings as soon as possible and agree on new arrangements to minimize the losses to all parties as result of VAT leakages, also addressing the limitations faced by the PA in collecting VAT invoices in Gaza.

G) Labor[35]

After 1967, the West Bank and the Gaza Strip were severed from their traditional markets, especially Jordan. Public servants lost their employer and the security situation and political uncertainty resulted in a sharp drop in investments. This led to a severe economic crisis and to high unemployment rates.[36]

In October 1968, the Israeli military commander responsible for the Palestinian territories submitted a plan to the Government of Israel with the objective of raising living standards to prevent the outbreak of violent resistance by the occupied population. The plan recommended to, inter alia, allow Palestinian employment in Israel. In November of the same year, the Government adopted these recommendations and allowed unskilled Palestinian employment in Israel according to fixed quotas, mainly in agriculture and construction.

In order to protect the Israeli labor force, the Israeli Government decided that wages paid to Palestinian laborers would be equal to wages paid to equivalent Israeli laborers. To achieve that equalization, Palestinian laborers were required to pay Israeli income tax, national security payments and an 'equalization levy' to render their salaries equal to Israeli salaries. However, the subsequent decision in 1971 to allow for the free movement of Palestinians to Israel motivated many to seek illegal work in Israel and therefore the quota restriction and the 'equalization' payments became ineffective. By 1992 more than a third of the Palestinian work force was employed in Israel.

In 1993, and in response to the deteriorating security situation, the Israeli Government imposed closures on Gaza and later on the West Bank, decreasing the number of Palestinians employed in Israel. These measures had an immediate negative impact on the Israeli agriculture and construction sectors. In response to market demand the Israeli government allowed the employment of foreign labor from other countries. In essence, the Protocol preserved the existing arrangement for the employment of Palestinian laborers in Israel for the interim period by stating that both sides would attempt to maintain the normality of movement of labor between them while preserving the right of each side to unilaterally determine the quota and conditions for employing labor from the other side in its area.

It was agreed that the PA would have the right to regulate the employment of Palestinian labor in Israel through the Palestinian employment service in coordination with the Israeli employment service. In the case of normal movement of labor being suspended by either side, the other side would be immediately notified, and would be able to request that the matter be discussed in the Joint Economic Committee.

---

34 http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/pressReleases/20120801.doc

35 The background information is based on Ruth Kleinov article "Palestinian Labor and Foreign Labor" published in the Book 'Crossroads of Decisions in Israel', Editors: Dvora Hacohen, Moshe Lissak, Ben Gurion Institute, 2010 (In Hebrew).

36 The unemployment rate in 1968 increased to 11 percent in the West Bank and 17 percent in the Gaza Strip as opposed to 8 percent before the war. Source: Footnote 35.

The number of Palestinian laborers in Israel dropped drastically following the deteriorating security and political situation on the ground. Numbers fell from 116,000 in 1992 to only 65,000 in 1995, gradually rising to 110,000 in 1999. After the Second Intifada, the number plummeted to a few thousand laborers, mainly from the West Bank, again gradually increasing to about 50,000 by the end of 2012. Since 2006 Israel has banned the entry of Palestinian labor from the Gaza Strip. In addition to Palestinian labor employed in Israel, an additional 35,000 Palestinians are employed in Israeli settlements and industrial zones in the West Bank.[37]

Notwithstanding substantial decline in numbers, Palestinian laborers in Israel continue to contribute significantly to the Palestinian economy. 10 percent of the Palestinian work force is employed in Israel and their higher wages (2.5 times the average Palestinian wage) contribute around 13 percent to Palestinian GDP. Moreover, between the years 2006 and 2010 more than a third of all new Palestinian jobs were created in Israel.[38] On the other hand, the employment of Palestinians in Israel has also had a negative impact on the Palestinian economy inhibiting the development of the local productive sectors and infrastructure. The Palestinian private sector also finds itself competing against Israeli employers, leading to an increase in local wages and limits on competitive advantage.

On 31 January 2010, the Israeli Government appointed a Special Committee (the Eckstein Committee) to review the employment of Palestinian labor in Israel.[39] On 6 July, 2011 the Committee submitted its report and recommendations to the Government of Israel, finding that the employment of Palestinian labor has a significant advantage over the employment of foreign labor in Israel due to the relatively low negative impact on Israeli society, and benefits to the Palestinian economy, the peace process, and Israel's security. The Committee also found that current regulations and procedures for the employment of Palestinian labor in Israel are inefficient, making recommendations for reform in three main areas regarding: (i) the entrance and exit of Palestinian laborers to Israel; (ii) setting of the labor quota; and (iii) the distribution of labor permits between different sectors.

Although it is unclear whether the Israeli Government adopted the Committee's recommendations in full, there has been an increase in the quota for Palestinian laborers with an additional 10,000 permits granted in the construction and agricultural sectors. The PA needs to maximize gains from the employment of labor in Israel while minimizing its adverse effects on the Palestinian economy.

Recommendations

Israel should reform its policies and regulations regarding the employment of Palestinian labor in Israel in line with the recommendations of the Eckstein Committee and the PA should develop a clear policy regarding the employment of Palestinian labor in Israel. The PA employment service should play a more active role in this process. Moreover, the PA and Israel should discuss and coordinate their employment policies through the JEC.

The Protocol also requires Israel to transfer part of the equalization and pension payments paid by Palestinian labor and their employers in Israel to Palestinian dedicated funds that would administer these payments and provide requisite social and pension services. Since such dedicated funds were not established by the PA, Israel delayed the transfer of these payments. The parties should review and agreed arrangements for implementing this requirement for the

---

37 In 2010, the PA enacted a Law No. (4) For the Year 2010 on the Ban and Combat of Settlement Products. This law bans the sale and trade in settlement products and bans the provision of services to these Settlements. Currently, however, the PA does not enforce this law on Palestinian labor in the Settlements until alternative jobs can be provided for them in the PA.

38 The Palestine Economic Research Institute (MAS) 2012, Mahrene Larudee, "Who shared the fruits of growth in the Palestinian economy, 2006-2010?" http://www.mas.ps/2012/node/510

39 Report of the Committee for the regulation, supervision and enforcement in the employment of Palestinian workers in Israel, The Government of Israel, July 2011 (In Hebrew).

benefit of Palestinian labor, perhaps using the services of Palestinian private sector insurance companies as part of such an arrangement.

H) Agriculture

The Protocol allows for free trade in agricultural produce, free of customs and import taxes, between the two sides.[40] These products must satisfy the standards and inspection conditions set by each side before they can be transferred. In 2011, Israel exported 225,963 tons of agricultural produce to the PA and imported 66,250 tons of agricultural produce from the PA.

Israel currently allows the importation of plant products from the PA subject to receiving a marketing license from the Israeli Plant Protection Authority. The Civil Administration agriculture officer collects samples of the products before they are harvested for biological testing in Israel as a condition for issuing the license. The Civil Administration does biological testing to detect any biological contamination and chemical testing to check pesticide residue limits. Plant products that pass this test and receive the license can be sold to Israel and transported through designated back to back crossings. Plant products from the settlement areas are not subject to these restrictions. In recent years there has been a growing phenomenon of 'plants laundering' in which PA produce is mixed with settlement products and sold to Israel.[41]

In contrast, the sale of animals and animal products from the PA to Israel is banned. It is contended that PA veterinary services do not meet OIE (world organization for animal health) international standards. Palestinian factories are not believed to comply with Israeli requirements for the export of animal products, and the security situation is considered to prevent Israeli inspectors from entering areas under PA jurisdiction to inspect Palestinian factories (required by Israeli law).[42]

Israel currently allows the restricted sale of dairy and meat products by six Palestinian manufacturers in possession of a special license from Israel to sell their products in East Jerusalem. These licenses are valid for six months only and Israel conditioned their renewal on the PA taking immediate measures to reform its veterinary services to meet OIE standards. With the assistance of the donor community, the PA has developed a plan for reforming its veterinary services and appointed four veterinary physicians responsible for inspecting factories and issuing the required veterinary certificates. The implementation of this plan should be accelerated and scaled up.

The PA generally allows the import of animal and plant products from Israel with restrictions on certain plant products (e.g. onions, watermelons and potatoes) for perceived public health reasons. Palestinian agriculture suffers from Israeli restrictions on access to land in Area C, as well as to water, electricity, chemicals and equipment, and the movement of goods and people. These restrictions increase production costs for Palestinian farmers who then cannot compete with farmers from Israel and elsewhere in the region. Lifting the constraints would allow the Palestinian agribusiness sector to grow and benefit from the free trade provisions in the Protocol related to agricultural produce.[43]

Recommendations

The PA should continue to reform its veterinary services to meet international standards and support Palestinian private sector companies to receive the relevant ISO and GMP (good

---

40 Palestinian and Israeli Central Bureaus of Statistics, 2013

41 "Summary of Activities Report for the Year 2011" Department of the Agriculture Officer in the Civil Administration (In Hebrew).

42 Ditto

43 USAID 2012, "AgBEE Snapshot of the Business Enabling Environment for Agriculture in the West Bank", USAID Enabling Agriculture Trade Project (EAT) http://www.fintrac.com/cpanelx_pu/EAT/14_43_3601_EAT_AgBEE_Snapshot_PalestinianEconomy_fin_06Feb12.pdf

management in production) standards that would allow them to market their products in Israel and other countries.

Israel should then allow Palestinian manufacturers who meet the required standards to market their products in the Israeli market. The parties need to agree on a mechanism to allow the certification of these factories. Israel should continue to allow Palestinian manufacturers to market their products in East Jerusalem. It is also important that Israel lifts restrictions on access to land in Area C for agriculture, water, electricity, chemicals and equipment and the movement of goods and people.

I) Industry

The Protocol allows for the free movement of industrial goods free of any restrictions including customs and import taxes between the two sides, subject to the legislation of each party. In practice, trade in industrial goods has remained free and faces fewer trade restrictions than trade in agricultural goods. One of the main restrictions imposed by Israel relates to items and goods that it considers as having a 'dual use' (i.e. both civilian and military). The list of 'dual use goods' includes many chemicals essential in different industries and with industrial application, equipment and machinery for metalworking, machinery spare parts, lab equipment and any equipment that can be used for chemical or physical analysis.[44]

In most cases, Israeli authorities reject Palestinian license requests to transfer such material and equipment to the PA. When such transfers are permitted, it usually involves complicated bureaucratic procedures and delays of at least three to six months in order to obtain licenses and subsequently get the goods cleared. The time lag considerably raises transaction costs, creates uncertainty and limits the competitive advantage of Palestinian manufacturers. Without access to these essential inputs, the West Bank's industrial sector cannot compete successfully in local, Israeli, or export markets. Key subsectors affected by the restrictions include producers of food and beverages, metal products, and pharmaceuticals.

Additionally, constraints imposed by Israel on the development of Palestinian infrastructure in Area C, on Palestinian use of natural resources including quarries, and on access for foreign investors to the West Bank place additional burdens on Palestinian industrial development and its export potential.

Recommendations

Israel should give serious consideration to easing the restrictions it imposes on the transfer of 'dual use goods' to minimize the negative impact the Palestinian economy. The list of restricted goods must be reviewed and revised to include items that only pose a concrete security threat in line with international standards in this regard. In addition, the licensing process must be transparent and efficient to allow the issuance of the required standards in a reasonable timeframe. The PA and Israel could cooperate in licensing and monitoring the use of licensed dual use goods.

J) Tourism

Tourism is an important economic growth sector for both the PA and Israel. No Christian pilgrimage is complete without visits to the holy sites in both Israel and the Palestinian territories, the constituent parts of the 'Holy Land'. As such, the Protocol includes arrangements to enable the free movement or tourists and tourism service providers between the two sides. However in practice, Israel is not implementing these arrangements, resulting in significant economic losses to the Palestinian side.

---

[44] The Defense Export Control (Controlled Dual-Use Equipment Transferred to Areas under the Palestinian Authority Jurisdiction) Order 2008. http://www.exportctrl.mod.gov.il/ExportCtrl/

1 - Protection of Historical Sites

The Protocol provides that each side shall protect and maintain historical, archaeological, cultural and religious sites and all other tourism locations, as befits their status as well as their purpose as a destination for visitors. Israel, however, does not allow the PA to preserve some of the most important historical sites in Area C of the West Bank, nor does it take the necessary actions to protect these sites themselves. A prominent example is Sebastiya. Palestinians have been prevented from preserving parts of the site that fall into Area C resulting in an immensely important (and potentially lucrative) site that is undeveloped and unprotected against archeological looting. Another important location, and candidate for designation as a World Heritage Site, is the West Bank village of Battir where Israeli construction of the Separation Wall endangers nearby ancient terraces.

2 - Free Movement of Tourist Buses

The Protocol provides that tourist buses or any other form of tourist transport authorized by either side, and operated by companies registered and licensed by it, will be allowed to enter and proceed on their tour within the area under the jurisdiction of the other side. Israeli tourist buses are currently allowed to enter and proceed on their tour within areas under the jurisdiction of the PA. Israel has not extended the same right to Palestinian tours. The entry of Palestinian registered tourist buses, or any other form of transportation, to Israel or East Jerusalem, is banned by Israel. Tourists, wishing to visit sites in both in Israel and the Palestinian territories must therefore use Israeli buses operated by Israeli-registered companies. This restriction of course results in financial losses to Palestinian companies and to the PA which is not receiving the taxes and license fees.

3 - Cross Border Services Provision

The Protocol stipulates that tourism entities authorized by either side, will be allowed to conduct tours that include the area under the jurisdiction of the other side, according to the rules set in agreement by the JEC sub-committee for tourism. The Protocol provides that until the relevant subcommittee agrees to these rules, existing tourism entities in the PA which were allowed to conduct tours that include Israel before the signing of the Protocol, would be allowed to continue to do so. Israeli authorized tourism entities would also continue to be allowed to conduct tours that include the Palestinian territories. The JEC sub-committee was unable to reach an agreement on this issue.

Recommendations

Israel should allow the PA to protect, preserve and develop tourist and historical sites in Area C including in Sebastiya, and should reconsider any action that may endanger historical sites in the West Bank including the Battir ancient terraces. Via the JEC subcommittee on tourism, the parties need to discuss ways to implement the Protocol arrangements on the movement of tourist buses from the Palestinian Territories to Israel and the provision of tour guide services by Palestinian tour guides.

Recent Efforts to Reform the Protocol Framework

On 31 July 2012, the Palestinian Prime Minister Salam Fayyad and the Israeli Minister of Finance Yuval Steinitz announced that they had agreed, in principle, on a new arrangement for the transfer of goods between Israel and the PA and on tax clearance procedures.[45] The main purpose of the agreement was to reduce tax leakage and tax evasion through several measures:

1. Enhancing the exchange of information on the transfer of goods between both sides
2. Tax clearance to be based on the actual transfer of goods between the parties
3. Establishing PA bonded warehouses to clear Palestinian imports
4. Constructing pipes for the transfer of petroleum products from Israel to the PA

With respect to the first measure, the PA signed an agreement with the Israeli company MALAM on 5 September, 2012, to receive customs information on imports to the PA that are cleared through the Israeli customs system. According to this agreement, the PA would be able to receive the information on a daily basis through the internet which would allow the PA customs officials to verify that the import declarations submitted by PA traders represent the real value of the imported goods for customs. However, the implementation of this agreement was delayed until 27 February, 2013, and MALAM subsequently notified Palestinian Customs that, per a request from Israeli Customs, implementation of this agreement would be postponed until further notice.

Negotiating teams were also formed to discuss details of the new arrangement for the clearance of import taxes and VAT, and for the establishment of Palestinian bonded warehouses for the clearance of imports to the PA. These teams held several meetings between July and November 2012, after which the meetings were suspended by the Israeli side and have yet to be resumed.

The parties should resume these discussions as soon as possible to effectively address the significant tax leakage and tax evasion problems affecting both sides.

Recommendations to Improve the Implementation of the Protocol

As outlined above, the Paris Protocol was designed in 1994 to serve the parties for a short interim period ending on 4 May, 1999. The failure of the permanent status negotiations and inability of the parties to reach an agreement necessitated the extension of the Protocol much beyond the intended period. The deteriorating political and security situation thereafter, the lack of coordination through official forums (the JEC and its subcommittees), together with unilateral decisions taken by both parties, resulted in poor implementation of the Protocol and economic harm, mainly to the Palestinian side. As part of any future permanent status negotiations, it will be necessary to reexamine the economic arrangements between the two parties and reach a new agreement that reflects the changing realities on the ground and that will enable the Palestinians to control their economy independently, while preserving normal trade relations with Israel.

In the immediate term, it would be advisable if the parties reconvene the JEC. The purpose would be to review the state of implementation of the Protocol and agree on arrangements to facilitate trade in goods and services between the sides, to address the problems identified above, and to allow the transfer of authority and responsibilities to the PA in preparation for permanent status negotiations.

Box II in Chapter VI of this report summarizes the general recommendations of this chapter to improve the implementation of the Paris Protocol.

[45] [45] http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/pressReleases/20120801.doc

Chapter V – Spurring Palestinian Economic Growth: A Focus on Services

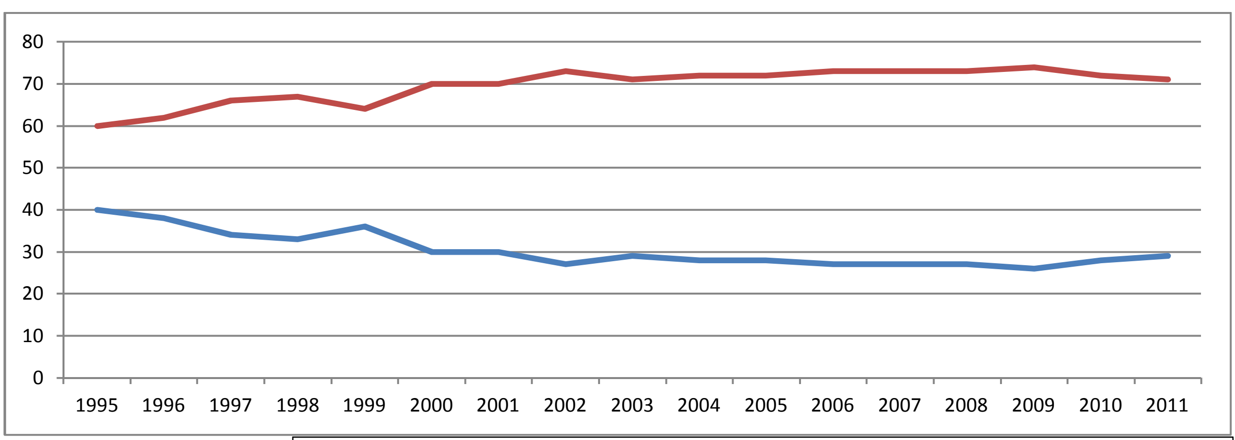
Introduction

Invigorating Palestinian private sector-led development is one the core priorities of the Palestinian National Development Plan for 2010-2013. A growing and prosperous private sector would create jobs, improve living standards, accelerate economic growth, and greatly benefit the fiscal position of the Palestinian public sector. One segment of the Palestinian private sector with immense growth potential is services, particularly in external trade. The most important business services targeting the export market are tourism, ICT and travel.

Services are becoming an increasingly important part of the growth story in many developing economies including in the Palestinian economy. The rapid technological growth and profusion of telecommunications and information technology (ICT) services in middle-income countries throughout the world has positively impacted other services such as tourism, transportation and insurance. The use of modern ICT has increased the efficiency of these sectors and particularly their export potential. Tourism and transportation services are sectors that have witnessed significantly positive changes in the countries of the Middle East and North Africa.

The Palestinian service sectors, both in production and export, are not too dissimilar from service sectors in other countries of the Middle East. Available Palestinian data[46] for 1995-2012 indicate an increase in the importance of services to GDP relative to the contributions of the 'productive' sectors (agriculture, industry and construction). The contribution of the service sectors to Palestinian GDP increased from 60 percent in 1995 to about 72 percent in 2011 whereas the productive sectors declined from 40 percent in 1995 to just below 30 percent in 2011. Figure 3 below shows the trends for these two groups of sectors.

Figure 3 - Contributions of the Service Sectors and Productive Sectors (Industry, Agriculture and Construction) to Palestinian GDP



Source: PCBS, MOF, PMA

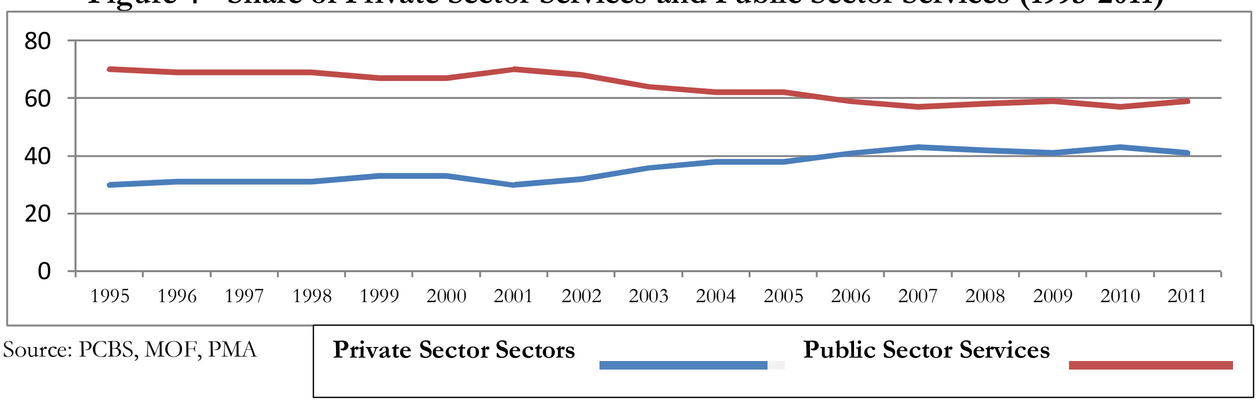
Service Sectors **Productive Sectors**

[46] Source: Palestinian Central Bureau of Statistics, Ministry of Finance, and Palestinian Monetary Authority data sources, 2011

The service sectors can be divided into two main categories: (i) services delivered by the private sector; and (ii) services provided by the public sector. The former category of services include travel, transportation, telecommunication, hotels, restaurants, wholesale and retail trade, storage, and financial intermediation. The second category of services includes health, education and public utilities. The share of the first category as a percentage of the total value of services in the Palestinian economy rose from 30 percent in 1995 to around 40 percent in 2011 while the share of the second category has declined from around 70 percent in 1995 to just below 60 percent in 2011. Figure 4 below shows these two trends over time.

The employment opportunities generated by the service sector in the Palestinian economy are quite significant. In 2011 around 40 percent of the private sector workforce was employed by the service sectors, 22 percent by the construction sector, and 17 percent respectively by the industrial and agricultural sectors. Of the entire Palestinian workforce, around 68 percent is employed in the private sector, 22 percent in the public sector and 10 percent in the Israel labor market. Figures 5 and 6 show the characteristics and trends of the Palestinian labor market. It is interesting to note the almost stable percentage of Palestinians working is Israel as laborers from 2002 to 2011. Although the number of permitted Palestinian workers in Israel has increased recently, their percentage in terms of the total Palestinian labor market has remained relatively stable. [47]

Figure 4 - Share of Private Sector Services and Public Sector Services (1995-2011)

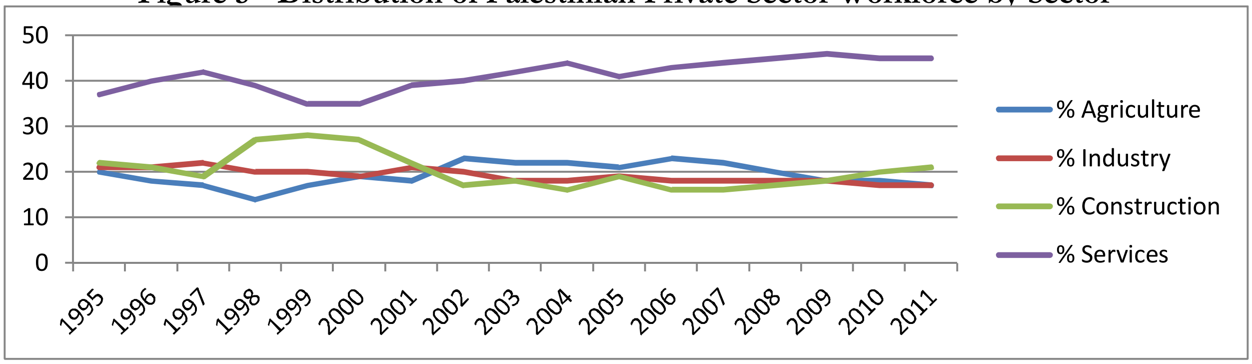


Source: PCBS, MOF, PMA

It is worth noting that the productivity of the average Palestinian worker engaged in services delivered by the private sector increased during the period 2000-2011. Labor productivity, estimated by dividing the total value of services by the number of workers in the service sectors was around USD 6,200 in 2000. This figure rose to USD 6,890 in 2006 and then USD 8,000 in 2010. In 2011, it declined to USD 6800.

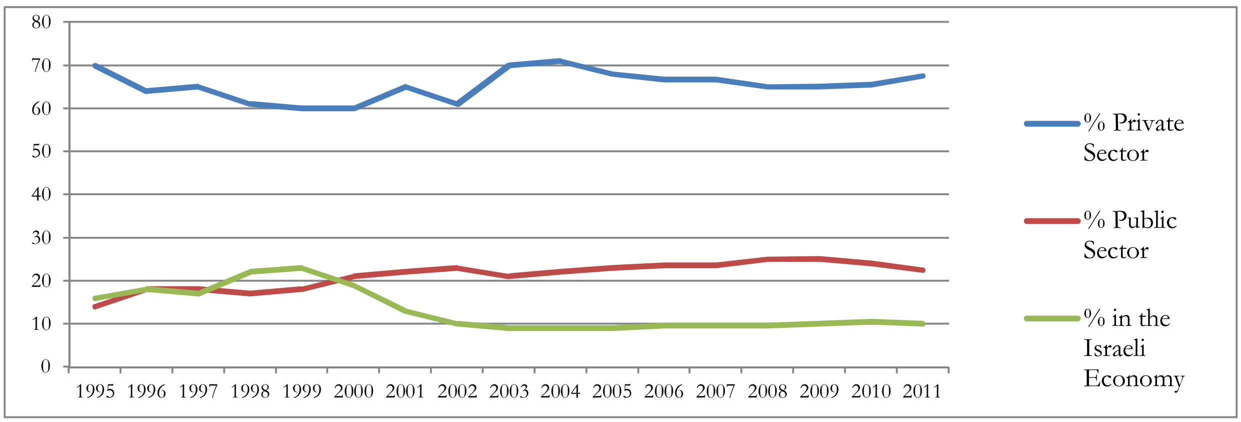
[47] Note: Income earned by Palestinian laborers in Israel is classified as 'income' in the Palestinian balance of payment and not considered an export of services.

Figure 5 - Distribution of Palestinian Private Sector Workforce by Sector



Source: PCBS, MOF, PMA

Figure 6 - Distribution of Palestinian Workforce by Sector (1995-2011)



Source: PCBS, MOF, PMA

The contribution of private sector services to GDP and their capacity to absorb employees fluctuated from 2000 through to 2011 due to the changing political and security environment in the Palestinian territories. Contribution to GDP grew from about 21 percent in 2000 to more than 27 percent in 2001 but then continued to drop to 24 percent in 2011. The capacity of private sector services to absorb new entrants increased from 33 percent in 2000 to about 40 percent in 2001 but then dropped sharply to below 35 percent in 2004. In 2011, it increased back again to about 40 percent. This fluctuation demonstrates the sensitivity of private sector services (category one) to the surrounding political environment where stability encourages expansion and instability invites an almost immediate contraction.

Despite the importance of the private sector as an important engine of growth, it is worth remembering that its share of GDP has tended to decrease over the period 1995-2011. The contribution of private sector produced goods and services to GDP decreased from 74 percent in 1995 to a low level of 60 percent in 2011. This overall trend points to a contracting private sector and an expanding public sector stimulated largely by donor assistance. The sustainability of the PA will hinge critically on enabling the private sector to grown again and contribute more to Palestinian GDP. Promoting trade in services could be an important part of that strategy.

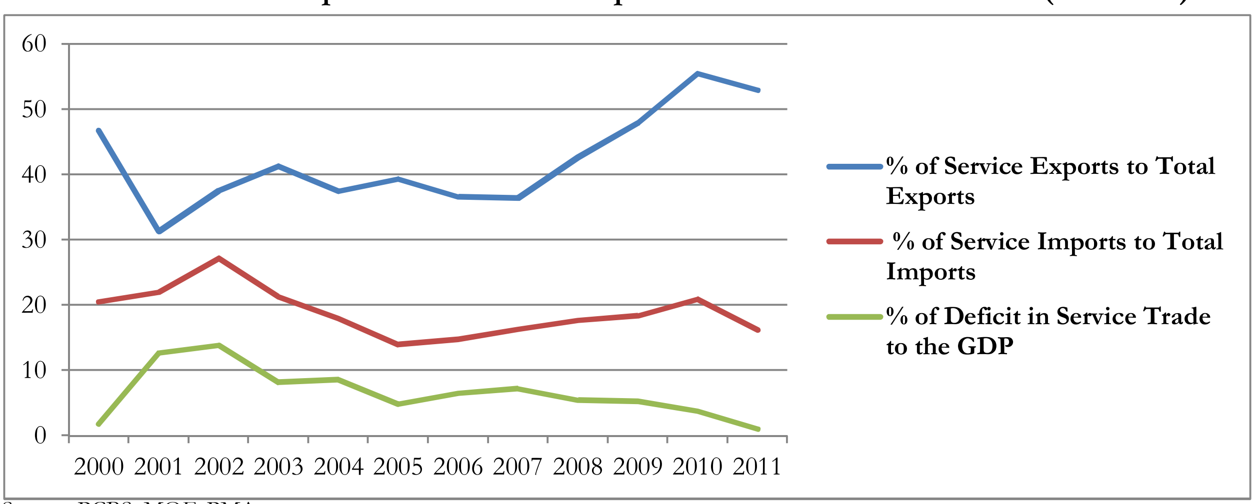
Palestinian Trade in Services

The growing importance of the service sector is also borne out by its contribution to Palestinian exports. The share of services out of total Palestinian exports (goods and services) increased from 30 percent in 2000 to about 52 percent in 2011, reaching a value of USD 954 million. This increase in the export of Palestinian services is mainly driven by improvements in the travel and tourism sector. With political instability after 2000, this share of exports naturally saw a drop but then increased markedly from 38 percent in 2006 to 55 percent in 2010, dipping again three percentage points to 52 percent in 2011.

By contrast, services as a proportion of total Palestinian imports declined between 2000 and 2011. In 2005, service imports reached an historic low at 15 percent but then increased gradually to 20 percent in 2010. As a result, the service trade deficit showed a declining trend from USD 495 million in 2001 to USD 104 million in 2011 and constituted less than 2 percent of GDP. This trend is especially striking when compared to a high trade deficit in goods which remained at about 50 percent during the period 2000-2011. Figure 7 below shows the trend in Palestinian service exports and imports and the service trade balance.

These services include travel, transportation, telecommunication, recreational services and government services abroad, representing 90 percent of all imported services by Palestinians. 60 percent of all imported services are in the travel sector alone. The travel sector includes all services related to the movement of Palestinians abroad irrespective of the period spent there. In recent years, serious investment has been made by the donor community, the PA and Israel in promoting greater passenger travel at key crossings, especially at the Allenby Bridge. These efforts contributed to the increase in service trade within the Palestinian economy. Large service imports include expenses paid for university tuition in Arab and foreign universities, for overseas hospital services especially in Egypt and Jordan, and travel services to Saudi Arabia to perform the Hajj and Umra pilgrimages.

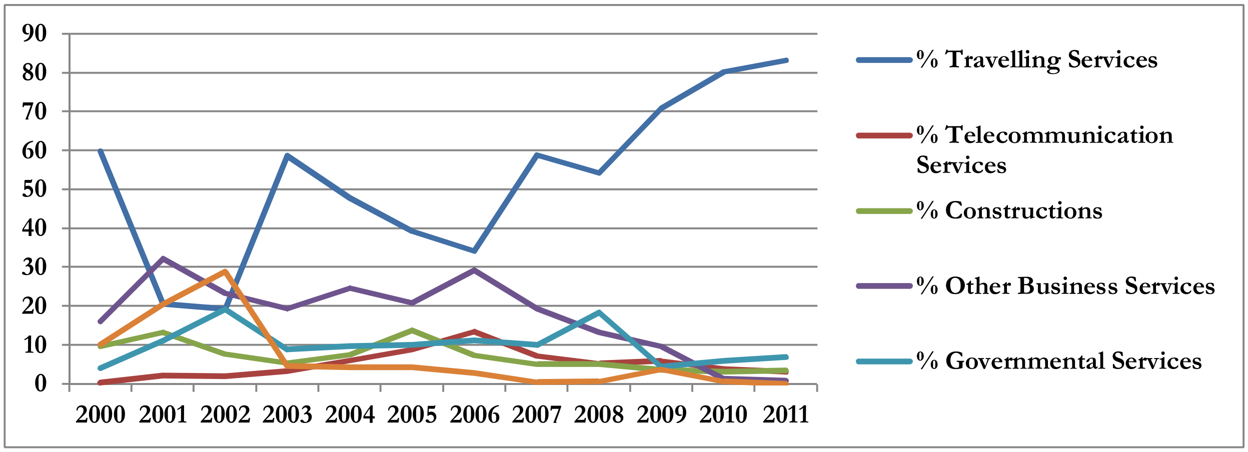
Figure 7 - Percent Share of Service Exports Out of Total Exports and Percent Share of Service Imports Out of Total Imports and Service Trade Deficit (2000-2011)



Source: PCBS, MOF, PMA

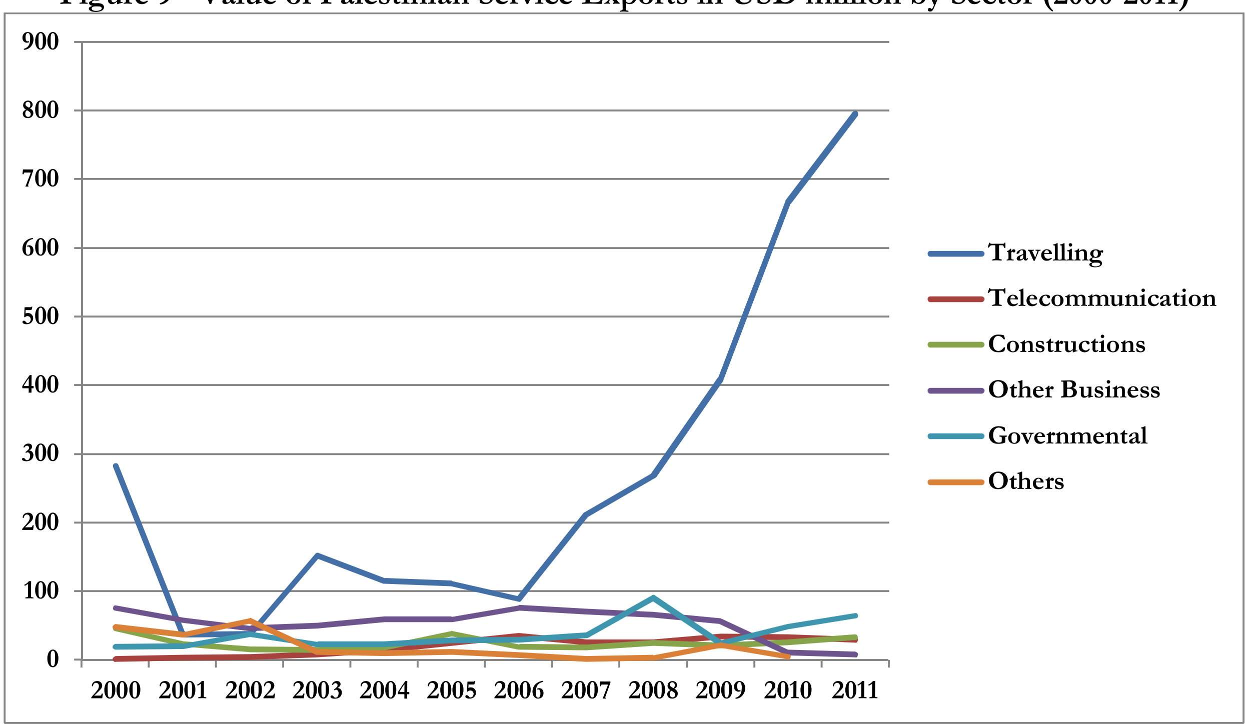
The increase in service exports was mainly driven by an increase in tourism service exports and flows from the continuous rise in the numbers of tourists visiting the Palestinian territories. Tourism service exports increased from USD 212 million in 2007 to about USD 795 million in 2011 and accounted for more than 70 percent of total service exports. Export of services in the construction and communication sectors, on the other hand, decreased from 18 percent in 2008 to only 9 percent in 2011. Other services classified as 'other business services' by the Palestinian Bureau of Central Statistics (PBCS) include insurance activities, information technology, cultural activities, franchise and licensing and other services and increased from 7 percent in 2007 to 15 percent in 2011. The distribution of Palestinian service exports and their value in millions of USD are shown below in Figures 8 and 9.

Figure 8: Percentage Distribution of Palestinian Service Exports by Sector (2000-2011)



Source: PCBS, MOF, PMA

Figure 9 - Value of Palestinian Service Exports in USD million by Sector (2000-2011)



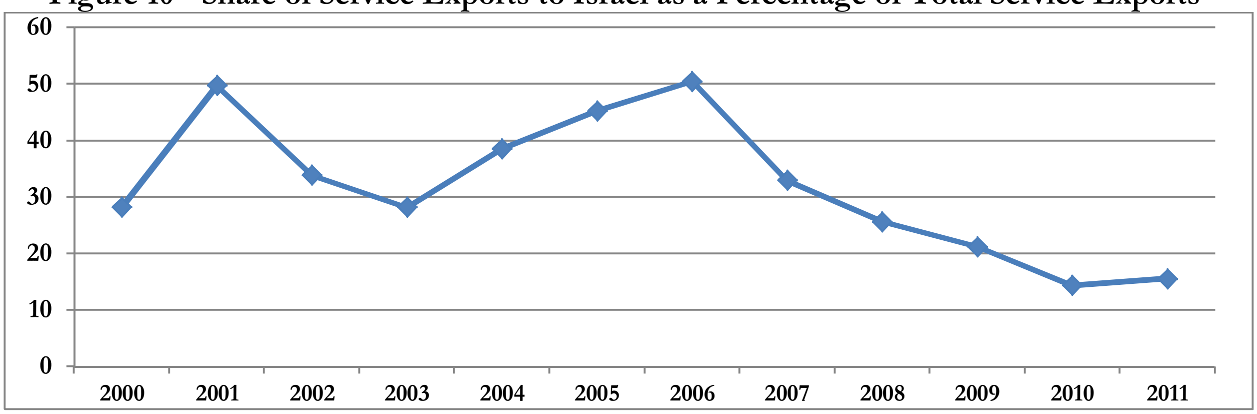
Source: PCBS, MOF, PMA

Palestinian Services Trade with Israel

Despite the fact that Israel is the Palestinian Territories' largest trading partner with respect to goods (80 percent), Palestinian trade with Israel in services only accounts for arounf than 15 percent of its overall trade in services. Palestinian service exports to Israel dropped from 50 percent in 2006 to about 15 percent in the years 2010-2011. Despite this general trend, some services did witness an increase in exports to the Israeli market. The export of computer services, for example, increased as Israeli software companies increasingly subcontracted Palestinian programmers because of their competitive prices. Contracting and construction services also increased to USD 32.9 million in 2011 or 20 percent of the total services exported to Israel. Notably, certain categories exported to Israel (including insurance services provided to Arab Israelis in the West Bank) are underreported by official Palestinian data sources because of difficulties with surveying.[48]

Transportation and telecommunications services are considered the most important ones imported by the Palestinian Territories from Israel, representing more than 50 percent of all imported services from Israel. The percentage of Palestinian imports of Israeli services continued to drop from 24 percent in 2005 to less than 10 percent in 2011. Yet the continued dependence on Israeli transportation services and infrastructure for the transport of Palestinian imports and exports to, from and through Israel maintains this type of service trade. Figure 10 shows the drop in Palestinian service exports to Israel as a proportion of total service exports.

Figure 10 - Share of Service Exports to Israel as a Percentage of Total Service Exports



Source: PCBS, MOF, PMA

[48] Note on insurance services and services provided to Arab Israelis. Palestinian insurance services are exported to Israel and East Jerusalem mainly to provide vehicle insurance coverage. According to estimates by the National Insurance Company, the largest Palestinian insurance company, 50 percent of sales of car insurance services are for Arab Israelis and Jerusalemites. Accordingly, the value of insurance installments coming from Israel is estimated to be USD 30 million. This means that the export of Palestinian insurance services to Israel in 2010 and 2011 could be 20 percent greater than what is reported. In light of the importance of exporting Palestinian insurance services to Israel, there are initiatives underway to establish a Palestinian insurance company in Israel. This company would include services for Arab Israelis traveling in the West Bank. These visitors normally consume restaurant services, hotels, cultural services, receive medical services and money changing services. Data shows that 20 percent of visitors coming to the West Bank are Arab Israelis. They visit for shopping, checking into hotels and spending money on food and beverages in restaurants. A study by the Jerusalem University Institute of Business and Economics found that about 432,900 Arab Israelis visited the West Bank in 2011 and that the minimum expenditure per visitor was USD 300. Accordingly, the travel expenses of Arab-Israelis during 2011 may have reached an average of USD 129.8 million - which is more than 85 percent of the value of services exports to Israel.

Prospects for a Growing Services Trade Sector

Notwithstanding its growing importance, trade in services still represents only 10 percent of overall Palestinian external trade and is therefore ripe for significant growth on the basis of larger investments, particularly in tourism, and in a context of greater political certainty about the future. The recent expansion of trade in services produced by the private sector was propelled forward primarily by improvements in the travel and tourism sector, but does not yet come close to the much greater role of trade in goods.

Increased travel and tourism in the West Bank has led to greater investment in the Palestinian hotel and restaurant industry. In the late 1990s, the average length of a visit to the West Bank by any tourist was about an hour. Visits now last about two days per tourist on average. Raising the competitiveness of the Palestinian tourism industry would require the development of a whole range of supporting infrastructure and services beyond hotels and restaurants. The supporting businesses to 'facilitate the experience' include more and better tour operators, travel agents, tour guides, food and beverage agents, event managers, and transport companies. There are other sub-clusters that are important to improving the travel and tourism experience namely retail markets, natural resources, cultural heritage sites, and sporting activities. This network of services also needs to be underpinned by modern 'hard infrastructure' such as roads, telecommunications and utilities.

Comprehensive development of the Palestinian tourism sector requires effective Palestinian planning and investment, and Israeli measures to facilitate implementing actions. Plans outlined by the Palestinian Ministry of Tourism to implement the Bethlehem master-plan could be replicated for other tourism centers in the West Bank. Greater investments could be made to raise the service standards of the Palestinian hospitality industry (the USAID hotel classification project is an example of an important donor-funded effort). The Israeli authorities could also build on previous easing measures (e.g. facilitating greater flows of tourist buses through the Rachel Crossing) to expand general movement and access for tourists wanting to visit the West Bank. The Palestinian private sector also needs proper access to locations in Area C, particularly in the Jordan Valley and around the shores of the Dead Sea to advance large-scale investments in tourism infrastructure and in archaeological and cultural heritage sites in the West Bank. These actions would strengthen Palestinian tour operators and travel agents in promoting Holy Land tourism for pilgrims from across the world.

Another important and growing service sector within the Palestinian economy is in ICT. There is a large number of growing Palestinian information technology (IT) companies with increasing export potential, selling information technology services domestically and overseas. This promising sector would benefit from greater advances in the communication technology market in the West Bank and Gaza Strip. This market witnessed significant expansion in recent years with the liberalization of the Palestinian telecommunications industry and the launch of a second mobile telephone operator. Greater measures are needed now to continue to grow this important industry, including allowing Palestinian telecommunication companies to use 3G/4G frequencies, to import network hardware into the West Bank and Gaza, and to install network hardware in Area C to ensure higher-quality phone coverage.

Sustained growth in all Palestinian service sectors depends on an improved higher education sector, thereby building a strong knowledge economy. Currently, only a quarter of Palestinian students enrolled in the public education system actually graduate from high school. Only eighteen percent of those graduating from high-school enter technical vocational training programs. The volume, quality and skills mix of post-secondary Palestinian graduates must improve to support the growing service sector, not least in the areas of hospitality, computer science, information and communication technology, engineering, financial services, recreation and cultural services. Investing in human capital development through improvements in education represents a prudent policy to promote long-term economy sustainability. The current fiscal pressures overwhelming Palestinian government services including the educational system need to be relieved immediately to protect the integrity and present gains of the Palestinian education system, and to allow for more medium-term actions to improve overall quality standards and outcomes.

Chapter VI – Conclusions and Recommendations

The unprecedented fiscal predicament of the Palestinian Authority in early 2013 has not emerged in a vacuum. The nearly twenty years since the signing of the Oslo Accords have not seen significant progress on permanent status negotiations, breeding much skepticism about the prospects for a final Palestinian-Israeli peace deal and a wider agreement to end the Israeli-Arab conflict. Such a chronic state of political paralysis has resulted in conflict, economic breakdown, political fragmentation and increasing donor fatigue, particularly following the events of the Arab Spring in 2011. Changes on the ground in both the West Bank and the Gaza Strip as a result of fluctuating – and worsening – Israeli-Palestinian relations continue to negatively impact the cohesiveness and the robustness of the Palestinian economy.

It is possible that 2013 will see a renewed diplomatic peace initiative following the American and Israeli elections, and it is critically important that such an initiative is underpinned by the integration of the political and economic tracks. The economic track cannot substitute for progress in the political track but can play an immensely important supporting role. Aside from serving as a litmus test for the seriousness of the parties to broach the more difficult subjects, it gives the Palestinian and Israeli publics a larger stake in the process, resulting from received, tangible economic benefits. The three levels at which the economic track can support the political track are: (i) 'economic negotiators' advance discussions on permanents status economic arrangements in conjunction with or closely behind progress on the political front; (ii) the parties work to implement the existing interim economic agreements pending a final status deal; and (iii) efforts are made to effect transformative change on the ground for Palestinians, not only creating jobs and raising Palestinian living standards, but also giving both sides a real sense of the final end game.

With respect to the second level, there are many ways in which the Paris Protocol can be better implemented for the benefit of both sides, but especially for Palestinians. First of all, the Joint Economic Committee (JEC) and its relevant sub-committees must be activated and kept apolitical. Secondly, an agenda to agree and implement the most time-relevant and high impact measures must be laid out. The recent understandings between the two Ministries of Finance on revenue enhancement mechanisms for the PA before November 2012 represent one example of a mutual attempt to 'see what can be done' under the de facto situation. A summary of all the general recommendations to improve the implementation of the Paris Protocol is provided below in Box 2.

Box 2 – Recommendations to Improve the Implementation of the Paris Protocol

1. **Joint Economic Committee and Renewing Normal Trade with the Gaza Strip**
   - The PA and Israel reconvene the JEC and its subcommittees on a regular basis to resolve all outstanding issues related to the Protocol.
   - Israel lifts the remaining restrictions on movement and access related to the Gaza Strip, specifically allowing for the free movement of goods including construction materials into Gaza and the sale of Gazan products to the private sector in Israel and the West Bank.

2. **Import Policy**
   - Implement the Wye River Economic Committee Recommendations of June 2000 regarding the expansion of List A1 and convene an expert committee under Protocol Article III (16) to further update the A1, A2 and B Lists for greater jurisdiction to the PA over its foreign trade with third countries.
   - Recognize the free trade and economic cooperation agreements signed by the PLO for the benefit of the PA.

2. Import Policy [continued]

- Ensure the PA receives all import taxes collected by Israel on goods imported by Israeli importers and sold in the PA market. The PA may also collect additional customs on these goods as set by the Palestinian tariff.
- Israel coordinates the customs, standards and administrative procedures it applies to Palestinian imports with the PA to improve efficiency and to equalize treatment between Palestinian importers and Israeli importers.
- Israel allocates additional staff and resources to provide equal services for Palestinian importers in terms of processing time and quality of service, per existing arrangements for Israeli importers
- Israeli laws, regulations and procedures that are applied to Palestinian importers are made readily available in Arabic.
- The JEC appoints an expert committee to agree on new petroleum standards that would allow the PA to import cheaper petroleum products from other markets.

3. Customs Control

- PA Customs assume customs responsibility and powers in the Palestinian cargo and passenger lanes at the Allenby Bridge in accordance with the Protocol.
- An arrangement for the operation of the Rafah Crossing for commercial imports and exports is agreed between the PA and Egypt in accordance with the 2005 Agreement on Movement and Access.
- PA Customs operate in all areas of the West Bank including in Area C to enforce customs laws.
- The PA is able to establish crossings to facilitate, monitor and control the movements of goods and people from and to Israel.

4. Import Taxes Clearance

- The JEC forms a joint expert committee to develop a mechanism for the clearance of import taxes collected on goods imported by an importer from one side but sold and consumed in the market of the other side, according to the principle of the final destination of the goods.
- Israeli Customs allows MALAM to transfer all customs information to the PA according to the contract signed between the PA and MALAM in September 2012.
- Palestinian managed bonded warehouses are licensed by Palestinian Customs in the West Bank and the Gaza Strip for the storage and clearance of Palestinian imports.

5. Monetary and Financial Arrangements

- The JEC agrees to the regularized transfer of excess NIS received by the PMA from banks operating in the PA.
- The JEC agrees on a mechanism to allow the routine transfer of money to Gaza in the required quantities to enable the normal functioning of the formal banking sector in Gaza.

6. Direct Taxation

- The PA considers imposing income tax legislation on Palestinians working in Israel to collect income tax on the difference between the tax collected by Israel and the tax due if the income was generated in the PA.
- The JEC agrees arrangements for the payment of Palestinian employees' salaries in a manner that will allow the PA to tax income as described above.

7. Indirect Taxation

- The July 2012 negotiating teams resume their meetings under the JEC to agree on new procedures for the clearance of indirect taxes to minimize losses incurred by both parties as result of VAT and import tax leakages and tax evasion.

7. Indirect Taxation [continued]

- Israel transfers to the PA all VAT paid by Gaza merchants for purchases in Israel. The VAT due will be calculated according to the original VAT invoices submitted by the Israeli sellers and verified at the Kerem Shalom Crossing.

8. Labor

- To maximize gains from the employment of labor in Israel while minimizing its adverse effects on the Palestinian economy, the PA develops a clear policy on the employment of Palestinian labor in Israel. The PA employment service plays a more active role in the process.
- Israel reconsiders its policies and regulations for the employment of Palestinian labor in Israel in line with the analysis and subsequent recommendations of the Eckstein Committee.
- The parties review and agree arrangements allowing for the equalization and transfer of pension payments to the Palestinian side for the benefit of Palestinian laborers, potentially using the services of Palestinian private sector insurance companies.
- The parties coordinate their policies through the JEC and its relevant subcommittees.

9. Agriculture

- The PA continues to reform its veterinary services in line with international standards and supports Palestinian private sector companies to receive the relevant ISO and GMP standards that would allow them to market their products in Israel and other countries.
- Israel allows Palestinian manufacturers who meet the required standards and who have obtained GMP requirements to market their products in the Israeli market. The parties will agree on a mechanism to allow the certification of these factories.
- Israel continues to allow Palestinian manufacturers to market their products in East Jerusalem.
- Israel lifts restrictions on access to land in Area C for agriculture, water, electricity, chemicals and equipment, and on the movement of goods and people to help Palestinian agribusiness grow and benefit from the free trade provision of the Protocol related to agriculture.

10. Industry

- Israel reconsiders its restrictions on the transfer of 'dual use goods' to the PA in the West Bank and Gaza to minimize the negative impact on the Palestinian economy.
- The list of restricted goods to be reviewed and revised to capture only those goods that pose a concrete security threat in line with international standards in this regard. In addition, the licensing process is amended to be more transparent and efficient, with the required standards issued within a reasonable timeframe. The PA and Israel should cooperate on licensing and monitoring the use of licensed dual use goods.

11. Tourism

- The PA has all power and authority to protect, preserve and develop tourist and historical sites in Area C
- Israel refrains from any action that may endanger historical sites in the West Bank
- Agree through the JEC ways to implement the Protocol arrangements on the movement of tourist buses from the Palestinian Territories to Israel and the provision of tour guide services by Palestinian tour guides.

Spurring Palestinian Economic Growth: A Focus on Services

Alongside progress on the political track, or indeed any related or separate implementation of economic agreements, it is vital in the short-term to re-invigorate Palestinian private sector development. The only way in which the Palestinian economy can prosper and sustain the PA over the medium to long term is if the private sector is allowed to grow, through greater access to internal and external markets, greater access to natural resources and more effective access to a credible investment horizon. An important part of this potential growth story will be the service sector, particularly in the tourism and travel markets, becoming an immense engine of economic growth for Palestinians in the future.

The key recommendations to energize the Palestinian service sector, particularly in tourism and ICT, are as follows:

Tourism

- Area C locations in the West Bank are opened to Palestinian investment in tourism infrastructure, particularly in the area of the Jordan Valley and the Dead Sea
- Large scale investments are made in a wide range of Palestinian tourism services and infrastructure and services in support of the hotel and restaurant markets, including tour operators, travel agents, tour guides, food and beverage agents, museums, cultural heritage sites and sporting activities
- Israeli authorities scale up easing measures to ensure freer movement and access by Palestinian tourism buses and tour guides to the important Holy Land tourism locations throughout the West Bank and in East Jerusalem

ICT

- Palestinian telecommunications companies are given larger allocations of additional 2G frequencies and new allocations for 3G/4G frequencies, allowing them to compete with Israeli companies
- Palestinian companies are more readily able to build telecommunications infrastructure in Area C to ensure appropriate coverage for customers
- Israel facilitates imports of required network hardware to the West Bank for Palestinian companies, also allowing the entry of new network hardware into the Gaza Strip

Annex I – Comparison Table

Legal Discrepancies between the Interim Agreement and Incorporation into Israeli Law

Issue	***The Interim Agreement***	***Israeli Law***
The Applicable Agreement	The Palestinian-Israeli Agreement on the West Bank and the Gaza Strip, Washington DC, Annex V	The Gaza Strip and Jericho Agreement, Cairo, 1994 A
Geographical Scope	The Areas under PA jurisdiction in the West Bank[49] and the Gaza Strip	The Jericho and Gaza Strip Area as defined in the 1994 Agreement
Covered Subjects	1. Coordination and Resolution of Disputes	1. Import Policy and Import Taxes
	2. Import Policy and Import Taxes	2. Direct Taxation
	3. Monetary and Financial Issues	3. Indirect Taxation
	4. Direct Taxation	4. Labor
	5. Indirect Taxation	5. Agriculture
	6. Labor	6. Insurance Issues
	7. Agriculture	
	8. Industry	
	9. Tourism	
	10. Insurance Issues	
The Applicable Provisions	Annex V Provisions on each subject	The Provisions of Israel legislation on each subject as amended by the Law for the Implementation of the Gaza Strip and Jericho Agreement (Economic Arrangements and Miscellaneous Provisions) (Law Amendments) – 1994
Transfer of Revenues	Obligatory and non-conditional	Subject to Israeli discretion after deducting PA debts to Israeli authorities or other bodies as decided by the Minister of Finance
Amendments	By mutual agreement	Unilateral

[49] This includes Areas A, B, and C in the West Bank. It does not include the Israeli settlement areas and Israeli military options.