Long-Term Policy Options

for the

Palestinian Economy

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Acronyms and Abbreviations

AVE	Ad Valorem Equivalent
CACM	Central American Common Market
CPI	Consumer Price Index
CU	Customs Union
DW	Durbin Watson
EFTA	European Free Trade Area
EU	European Union
FIAS	Foreign Investment Advisory Service
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
GPA	Government Procurement Agreement
GS	Gaza Strip
IBRD	International Bank for Reconstruction and Development
ICBS	Israeli Central Bureau of Statistics
IFC	International Finance Corporation
IMF	International Monetary Fund
ITA	Information Technology Agreement
MENA	Middle East and North Africa
MFN	Most Favored Nation
NAFTA	North America Free Trade Agreement
NDTP	Non-Discriminatory Trade Policy
NIS	New Israeli Shekel
NTM	Non-Tariff Measure
OECD	Organization for Economic Cooperation and Development
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PLC	Palestinian Legislative Council
PLO	Palestine Liberation Organization
PM	Prime Minister
PP	Paris Protocol
PSI	Palestinian Standards Institute
ROO	Rules of Origin
ROW	Rest of the World
SACU	Southern African Customs Union
TFP	Total Factor Productivity
TRIPS	Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development

UNRWA	United Nations Relief & Works Agency
US	United States
US$	United States Dollar
USAID	United States Agency for International Development
VA	Value Added
VAT	Value-Add Tax
WB	West Bank
WBES	World Business Environment Survey
WBG	West Bank and Gaza
WBI	World Bank Institute
WTO	World Trade Organization

Executive Summary

Introduction

The Palestinian economy has been closely integrated with its larger and richer neighbor Israel since the 1967 Israeli occupation of the Palestinian Territories. Trade between the Palestinian Territories and Israel effectively became internal, reflecting a customs union trade regime, and a large share of the Palestinian labor force was employed by Israeli firms. The result today is a high degree of Palestinian dependence on the Israeli economy: trade volumes with Israel are very large – 96 percent of Palestinian exports are destined for Israel – and labor flows into the Israeli labor market account for nearly a quarter of total Palestinian employment. The main activities of the Palestinian economy are shaped by the nature of economic relations with Israel. Palestinian production is largely oriented toward providing inexpensive, low value-added products for Israeli consumption or re-export, and specialization in low-productivity construction and agriculture sector jobs.

The advent of the peace process in the early 1990s and the 1994 signing of the Paris Protocol formalized the Palestinian-Israeli economic relationship between two administratively and physically distinct entities, although considerable overlap remained. The Paris Protocol gave the Palestinians administrative autonomy over the Palestinian Territories in terms of public service delivery, and formalized policies of economic cooperation and integration with Israel relating to the exchange of goods, fiscal policy, currency arrangements, and labor services.

Economic outcomes post-Oslo. Despite high expectations for economic normalization and growth following the peace accord and Paris Protocol, economic performance was modest at best, and suffered periods of sharp decline. The deep recession of 1995-1996 was the result of Israeli security measures under which the West Bank and Gaza Strip were effectively cut off from Israel and from each other. The prospect and unpredictability of closures created an environment of uncertainty and risk. This in turn was compounded by extraordinarily high transactions costs and restrictions on access to alternative markets for import or export under the agreed trade regime. Domestic output and exports declined, private sector investment dried up, and labor flows to Israel were sharply curtailed, all of which contributed to joblessness and rising poverty.

When security measures eased, particularly in 1998, 1999 and the first part of 2000, the economy returned to its historical growth trend of 5 percent annual GDP growth. But the anticipated income convergence with Israel did not materialize for a variety of reasons. Although it provided preferential Palestinian access to Israeli markets, the customs union trade policy effectively limited Palestinian imports to relatively expensive Israeli goods. The net effect restricted domestic Palestinian productivity growth and hindered expansion of export products and markets beyond Israel. Palestinian and Israeli labor market integration produced mixed effects: whereas access to high-paying Israeli jobs increased Palestinian employment and household incomes, it also raised domestic Palestinian wages, dampening labor demand and diminishing Palestinian competitiveness on export markets. The uncertain business environment – exacerbated by closure policy and a weak institutional framework for promoting investment – discouraged investors due to the perceived risks. Together, these policies resulted in a development path of Palestinian economic dependence on Israel.

Although the Paris Protocol and the broader economic model of integration with Israel had many shortcomings, important progress was achieved during the Interim Period, generating optimism that a final status agreement based on the peaceful coexistence of two neighboring sovereign entities was attainable. But serious challenges emerged in 1999 and 2000 with the start of final status negotiations over the contentious issues of borders, Jerusalem, access to water resources, and the right of return of Palestinian refugees.

Negotiations broke down as tensions erupted into civil conflict in September 2000, plunging the Palestinians into political uncertainty and severe economic crisis that is ongoing today. Closures and confrontation resulted in a sharp drop in trade, employment, and investment, and a doubling of already high transport costs. Real GDP fell 6 percent for the year 2000 (despite robust growth during the first three quarters), and by an additional 12 percent in 2001, with critical implications for welfare: per capita income plummeted by 10 percent in 2000 and another 19 percent in 2001.

In light of deteriorating economic relations between Israel and the West Bank and Gaza, and suspended peace negotiations, it is timely at this juncture between the lapsed Interim Period and a final status agreement to examine past experience with a view to assessing the policy choices facing Palestinian policymakers in the future. The post-Oslo experience points to failed economic normalization and income convergence with Israel. Several reasons for these failures have been advanced, including poor implementation of the Paris Protocol, as well as fundamental flaws inherent to the protocol itself. For instance, loopholes in the trade rules for customs crossing procedures and inadequate dispute settlement mechanisms enabled Israel's politically-motivated closure policy to circumvent the agreed economic objectives of cooperation and Palestinian development. Arguments that the protocol was destined

to fail are based on continued Palestinian dependency and vulnerability doomed to generate poor growth outcomes due to low value-added activities and a lack of technology transfer, or simply the fact that the Paris Protocol represented a temporary agreement falling mid-way between sovereignty and full partnership, but with no Palestinian recourse to address shortcomings. In this sense, the protocol was an unenforceable and incomplete contract that worked to Israel's advantage.

Overlap of politics and economics. The experience under the Paris Protocol illustrates the degree to which political and economic factors are intertwined; both types of factors need to be addressed in a comprehensive framework. The fact that political pressures from Israeli security concerns introduced severe economic hardship on the Palestinians and threatened newly-gained Palestinian autonomy contributed to the unraveling of the interim agreement. The economic environment of uncertainty, risk, costly transactions, and inadequate legal, regulatory and financial institutions hampered private sector development and especially Palestinian–Israeli partnerships and business networks at the firm level, effectively weakening an important tie that holds civil society together. These factors further undermined Palestinian economic growth, laying the foundation for political crisis and civil conflict.

Study objectives. Given the problems associated with the existing policy framework, this analysis examines alternative policy options that will face Palestinian policymakers in the event of a peace agreement with Israel. These future policy choices relate to trade, labor mobility to Israel, and the business environment and associated public-private interactions. In a first stage, each policy area is analyzed separately, that is, in a partial equilibrium context independent of the others without accounting for broader intersectoral relationships.

In a second stage, the analysis brings together these separate areas into an integrated framework. A range of assumptions vis-à-vis the nature of borders between West Bank and Gaza and Israel is delineated, tying together the trade, labor and private sector development considerations to measure their combined impact on growth prospects. The analysis develops scenarios to reflect different combinations of future policy options linked to the nature of borders with Israel. This simulation exercise illustrates the relative merits of each scenario, the associated trade-offs, and the prospects for economic growth in the event of a peace agreement and a completion of final status negotiations. Welfare implications and the capacity of the social safety net to address present and future Palestinian needs are critically important, and will be addressed in a companion World Bank study under preparation.

Existing Trade Distortions and Future Policy Options

Pros and cons of the existing customs union. Israel is by far the West Bank and Gaza's most important trade partner, dominating both imports and exports (see Figures 1 and 2 below). The modified customs union currently in place is one-sided, favoring Israel in several ways. The external tariff on third-party countries is set by Israel without regard to Palestinian comparative advantage. Although Israeli tariffs plus purchase tax average 11 percent, the effective rate is a much higher 16.6 percent on Palestinian imports due to the different types of goods imported by West Bank and Gaza (WBG). Furthermore, the Paris Protocol allows only limited Palestinian access to Egyptian and Jordanian markets. Because Israel controls all borders in the Palestinian Territories, Palestinian trade must be conducted through Israel rather than directly with third-party countries.

Figure 1: WBG Imports by Origin

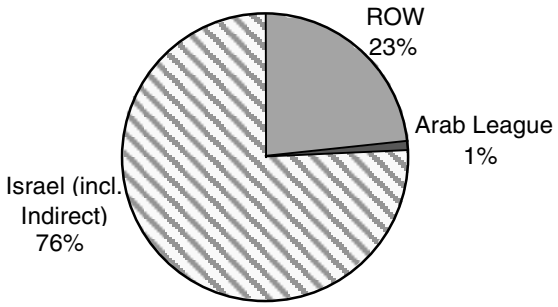
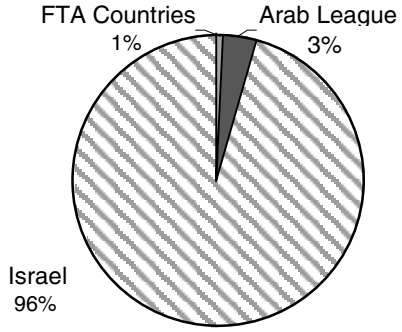


Figure 2: WBG Exports by Destination



Requiring all goods to pass through Israel or Israeli-controlled borders creates at least two problems:

(i) Palestinian traders incur higher transport costs than if trading directly; and

(ii) the Palestinian Authority (PA) loses out on trade tax and VAT revenue from goods nominally imported into Israel but subsequently re-exported to the West Bank and Gaza without being properly accounted for – and taxed – as a trade transaction.

This lost revenue associated with indirect imports amounts to an estimated US$174 million per year (see Table 1). Additional losses are incurred by WBG in welfare terms, because the US$900 million trade deficit with Israel constitutes a negative net

transfer equivalent to US$99-140 million (compared to a non-discriminatory trade policy). This means that Israel gains more than WBG from preferential access to Palestinian markets under the customs union.

On the other hand, WBG gains certain advantages from being in a customs union with Israel, such as preferential access to the large Israeli market, albeit still one-sided during closures. In addition, Israel's recent trade liberalization has allowed liberalization for Palestinian imports as well. And finally, the Israeli tax authority collects taxes on behalf of the PA and remits the proceeds to the PA (although currently suspended under the intifada), greatly simplifying the PA's role and reducing its administrative costs by an estimated US$48 million annually.

Comparing a CU, FTA and NDTP. In Table 1, the costs and benefits of a customs union (CU) are compared to alternative trade regimes possible under a final status agreement, namely a non-discriminatory trade policy (NDTP) and a free trade area (FTA). By making concrete estimates of the pros and cons of the customs union compared to an NDTP, the losses incurred by the Palestinian economy under the existing customs union are estimated at US$225-266 million annually (depending on the degree of smuggling).

Table 1: Net Gain of CU, FTA Compared to NDTP (US$ mn per year)

	No Smuggling	Smuggling
CU:		
Indirect imports (taxes)	-174	-174
Trade deficit (welfare)	-140	-99
Border cost savings	48	48
Net Gain of CU	**-266**	**-225**
FTA:		
Trade deficit (welfare)	-140	-99
Rules of Origin	-85	-85
Net Gain of FTA	**-225**	**-184**

An NDTP is also superior to an FTA, based on a tax revenue/welfare calculation (see Table 1). Under an FTA, trade between WBG and Israel is still free, implying the same welfare loss from the trade deficit as under a CU (ranging from US$99-140 million). But there are additional costs for complying with rules of origin necessary to avoid trade deflection under an FTA. These costs are borne by the PA in terms of border administration, as well as by exporters and consumers through higher import prices. Moreover, there are no border savings to offset these losses, such that in net terms, an FTA would cost at least US$184-225 million annually (depending on the degree of smuggling). The costs of an FTA are even higher in light of the following related issues: potential trade diversion, welfare losses due to WBG's higher propensity to import, and enforcement complications resulting from multiple and overlapping FTAs.

When the customs union is weighed against an FTA, however, the CU is superior from the perspective of tax revenues and administrative costs. An FTA would require setting up and administering customs border stations, but this added cost would not be accompanied by the added benefit of tax revenues on Israeli imports, which would continue to be free. Moreover, the introduction of rules of

origin would reduce Palestinian access to Israeli markets. And finally, efficiency and welfare losses would arise under an FTA from trade diversion under which Palestinian producers use more expensive Israeli imports rather than less costly alternatives from third-party sources in order to meet rules of origin criteria for exporting final goods to Israel duty-free.

Analyzing trade policy choices in a partial equilibrium framework – that is, from a tax revenue and welfare perspective independent of other sectors of the economy – an NDTP is superior to both an FTA and the existing customs union, assuming open and transparent trade policy enforced by credible lock-in mechanisms. It is important to note, however, that the costs to a CU are offset to a large degree by Palestinian access to the Israeli labor market (addressed below). Furthermore, if for political reasons the customs union remains in effect under final status, several improvements could be made to counter Palestinian losses, for example by adopting a macro-based revenue sharing formula, and/or direct Israeli compensation of WBG for the losses it incurs under a CU.

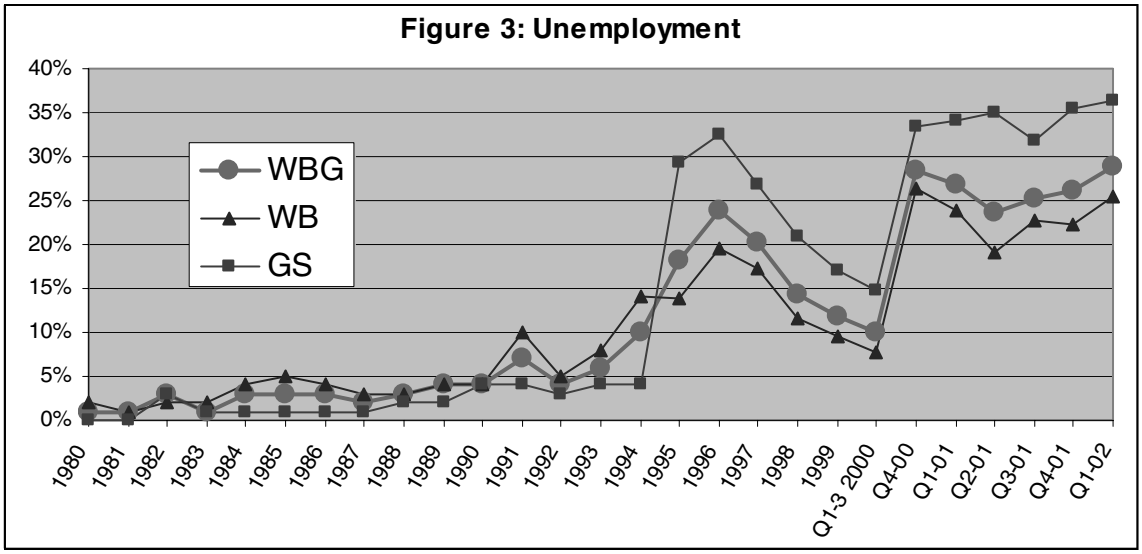
Labor Market Outcomes

Historical trends. The costs borne by WBG through its membership in a customs union with Israel are partly offset by Palestinian access to the Israeli job market, which increases aggregate employment and raises incomes. On the other hand, this access distorts wages within the Palestinian economy, hurting competitiveness. In the past, rapid population growth strained the capacity of the Palestinian economy, leading to excess labor supply despite low participation rates – particularly among women. As a result, many workers sought employment elsewhere, primarily in Israel. Prior to the ongoing crisis, nearly a quarter of Palestinian employment was in Israeli jobs, where wages are significantly higher than in WBG. Israel began to restrict Palestinian labor inflows in the early 1990s by introducing work permit requirements. But the Oslo accords marked a fundamental shift in Israeli labor policy, as mobility restrictions were enforced, including periodic border closures and at times extreme restrictions (i.e., internal closures) during which Palestinians could not leave their villages. During closures, very few workers from Gaza could reach their jobs in Israel or the settlements, but West Bankers had slightly more flexibility, due to the porous border with Israel.

Closures were particularly severe in 1995 and 1996, leading to a drop in labor flows to Israel and high Palestinian unemployment, which spiked to 25 percent in 1996, up from modest levels in the early 1990s (see Figure 3). This is a dramatic change from the 1980s when unemployment was negligible and movement restrictions did not exist. The PA responded to skyrocketing unemployment by creating jobs in the civil service. Although this strategy coincided with the PA's expanded responsibilities post-Oslo and the need to set up the main institutions of governance and public service delivery, public employment grew faster than

necessary, engendering an unsustainably large wage bill.

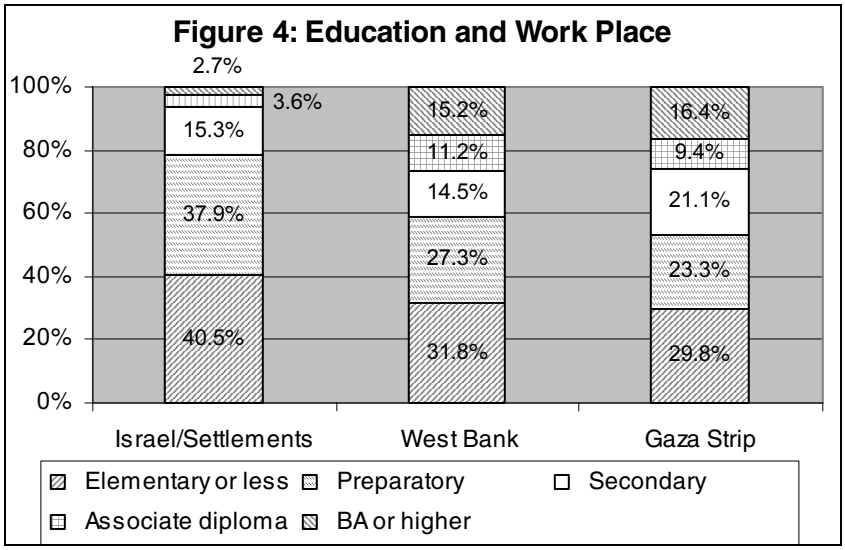
Figure 3: Unemployment



As the security climate improved, labor flows to Israel regained much of their earlier importance in providing Palestinian jobs, and unemployment declined in 1998 and 1999, falling below 10 percent in mid-2000. The September 2000 outbreak of the intifada led to sharply higher unemployment as closures precluded workers from reaching their jobs and prolonged civil strife disrupted domestic economic activity.

Profiles of the employed and unemployed. Labor force survey data from the Palestinian Central Bureau of Statistics provides information on the characteristics of the employed and unemployed. For example, the average age of employed workers (33 years for men and 35 years for women) is higher than the average for the unemployed (29 years for men and women), implying that the young are more affected by unemployment. Unemployed men have lower educational attainment than women; in fact, three-fourths of unemployed women have a post-secondary degree, compared to 13 percent of unemployed men. Educational profiles also vary by place of work. Figure 4 shows that almost 80 percent of Palestinians working in Israel have a preparatory education or less, reflecting a lower education level than among those employed domestically. Workers in Gaza have a slightly higher educational profile than those working in the West Bank.

The data also indicate that government employees are more educated than those in the private sector, with 52 percent holding a post-secondary degree or higher, compared to only 14 percent among non-PA workers. Similarly, government employment accounts for a majority of skilled occupations, suggesting little private sector demand for high skills.



Looking at the sectoral composition of employment, 59 percent of Palestinians employed in Israel work in construction and another 10 percent work in agriculture – both low productivity sectors. Israeli policy to limit Palestinian labor inflows effectively increases the wage gap between domestic and Israeli jobs, making jobs in Israel particularly attractive to less educated Palestinians in low-skill occupations.

Palestinian wages in WBG and Israel. Mincer-type wage regressions indicate that the returns to working in Israel are extremely high: 85 percent for a worker from Gaza, and 61 percent for a West Banker, controlling for individual characteristics. In this environment, the domestic economy struggles to create adequate jobs for the fast-growing but fairly well-educated labor force, putting pressure on the PA to step in by creating more civil service jobs.

Although the returns to education are positive and increasing, these are fully offset by the returns to working in Israel. Moreover, the higher Israeli wage actually draws up domestic wages in WBG, making them less competitive and dampening domestic labor demand. This very real distortion from limited access to Israeli jobs hurts Palestinian economic development by underutilizing available human capital resources and creating a labor market that specializes in low value-added activities. This in turn does not facilitate skills acquisition through knowledge-sharing or learning-by-doing – the expected gains from labor migration. In addition, the relatively high wage does not attract investors or technology to increase productivity in export sectors. During the Interim Period, Palestinian growth and economic development was not export-led but rather was driven by consumption through higher incomes from workers' remittances from Israeli jobs. The positive consequences of this growth model include higher household incomes and lower poverty when labor can move relatively freely. But the downside – especially during periods of closure – involves uncertainty, income volatility, high unemployment and poverty, uncompetitive domestic wages, and substantial vulnerability to external shocks.

Modeling the labor market. To assess the demand and supply pressures at work in the Palestinian and Israeli labor markets, this analysis develops a partial equilibrium model reflecting labor market segmentation, distorted wages, and structural unemployment in the Palestinian economy. Labor market equilibrium is characterized by wage gaps among domestic wages in the West Bank and Gaza Strip, and wages in Israel, which are the result of limited Palestinian labor supply to Israel, high unemployment, job search and transport costs for those commuting to Israel, and a risk premium incurred by Israeli employers due to absenteeism during closures. If the number of Palestinians allowed into Israel rises – treated as an exogenous shock – both unemployed and domestically employed Palestinians are drawn to the higher Israeli wage. Although unemployment falls, it falls by less than total new labor flows to Israel, pulling up domestic wages due to the decline in domestic labor supply.

At the same time, a more flexible border policy associated with higher labor flows reduces both Palestinian commuting costs and the unit labor cost to Israeli employers, leading to a narrowing of the wage gap between WBG and Israel. Because foreign workers in Israel are close technical substitutes for Palestinian labor, the inflow of Palestinians displaces a certain number of foreign workers, but less than one-for-one, given that foreign workers earn less on average than Palestinians. As reported in Table 2, simulations of the labor model indicate that an increase in labor flows to Israel by 10,000 workers (8,000 from the West Bank and 2,000 from the Gaza Strip) would reduce Palestinian unemployment by only 4,500 in total (3,300 in the West Bank and 1,200 in Gaza Strip). This would drive down the unemployment rate from 11.8 to 11.2 percent, and concurrently reduce employment within WBG by 5,500. Wages in both the West Bank and Gaza Strip would actually rise, slightly reducing the gap with wages in Israel.

Table 2: Predicted Results of Increased Labor Flows to Israel

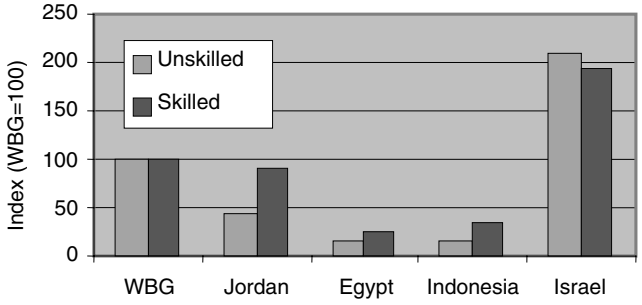
Variable	Initial Value (1999)	Change	New Value
Workers from West Bank:			
Employed in Israel	107,178	8,000	115,178
Employed in West Bank	314,465	-4,719	309,746
Unemployment rate	9.6%	-3,281	8.9%
Competing foreign employment in Israel	200,000	-4,290	195,710
Wage in Israel	104.4	1.5%	105.9
Wage in West Bank	67.5	3.8%	70.1
Workers from Gaza Strip:			
Employed in Israel	27,368	2,000	29,368
Employed in Gaza Strip	143,091	-779	142,312
Unemployment rate	17.0%	-1,221	16.4%
Competing foreign employment in Israel	50,000	-1,095	48,905
Wage in Israel	93.4	1.4%	94.7
Wage in Gaza Strip	53.4	3.6%	55.3

This estimation exercise demonstrates how increasing access to Israeli jobs produces both winners and losers. Clearly the Palestinians who find a new job in

Israel are better off, but so are those already employed in Israel, due to the marginal decline in commuting costs and the higher Israeli wage. Employers in Israel are winners as well, since the wage increase is offset by the decline in the risk premium, such that their net unit labor cost declines. Employers in WBG, however, bear the cost of increased labor flows to Israel through higher wages, making them less competitive. And finally, foreign workers who are displaced by incoming Palestinians also lose.

Even in the framework of this partial equilibrium labor analysis, the above quantitative estimates illustrate the trade-offs associated with Palestinian reliance on Israeli labor demand. On the one hand, labor market integration raises employment levels and incomes, with positive feedback effects on domestically produced goods and services. In the past, these domestic demand effects were inadequate to sustain robust private sector growth, however. The downside to Palestinian dependence on jobs in Israel includes vulnerability to border closures and – more importantly – distorted wages that inhibit the domestic labor market and private sector development through weak competitiveness and specialization in low-productivity occupations. Figure 5 shows how Palestinian wages compare unfavorably to competitor countries (other than Israel). Although not captured in the partial equilibrium labor market model presented in this analysis, noncompetitive wages hurt domestic output and productivity growth by dissuading investment due to the high cost of doing business.

Figure 5: Wage Comparisons



Source: World Bank and USAID (1996)

Future labor policy. The labor model's estimates shed light on the impact of future policy changes vis-à-vis labor flows between the Palestinian and Israeli economies. Against this background, the analysis considers potential labor policy changes in the event of a peace accord with Israel. The options depend on the nature of borders and the types of labor controls imposed by Israel, which are likely to differ from current arrangements. A certain degree of integration with the Israeli labor market will persist, however.

Under a continuation of relatively open borders between the West Bank and Israel, Palestinians would continue to commute to Israeli jobs at least at the current crisis level of 50-70,000 workers, even if Israel adopts a very restrictive policy toward Palestinian labor. However, it is more likely that a peace agreement will be accompanied by normalization of cross-border economic relations and a restoration of trust on the ground, thereby increasing labor mobility and reducing transactions costs. This suggests two possible scenarios:

i. Palestinian labor supply to Israeli jobs keeps pace with labor force growth in WBG; or

ii. Palestinians obtain increased access to Israeli jobs, but face higher transportation and search costs due to tighter border crossing procedures, resulting in slower growth of Palestinian employment in Israel.

The first scenario is consistent with a continuation of the customs union and free movement of goods between WBG and Israel. The second scenario could arise in the context of a change in trade regime to an FTA.

Under a third possible solution – less cooperative than the other two – economic separation under final status could involve physical borders across which the movement of all goods and factor services is tightly controlled. This scenario, consistent with an NDTP, would discourage Palestinian employment in Israel, keeping mostly informal Palestinian worker flows at low levels.

The above-described range of labor policy options under a final status agreement suggests that the potential magnitude of labor flows in the long run – say, in 2010 – is likely to fall between 70,000 and 165,000, compared to 128,000 in 1999 (excluding East Jerusalem). For any projection in this range, the distorting effects of a high Israeli wage will continue to pull domestic Palestinian wages above their market-clearing level and depress domestic labor demand. Likewise, the attendant underutilization of human capital will have important negative dynamic implications, namely continued depreciation of existing skills and low incentive for skills acquisition, both of which discourage human capital accumulation which is crucial to raising productivity in the long run.

The Business Environment and Private Sector Growth

Policy instability and uncertainty. The existing trade and labor distortions described above both lead to low-productivity, low-growth outcomes through export and labor specialization in low value-added activities. This distorted incentive framework is exacerbated by high risk and uncertainty linked to the interim political accord, unclear prospects for future economic and political arrangements, and a lack of reliable property rights in this context. Almost 80 percent of Palestinian private firms responding to a survey on the business environment in WBG prior to the intifada reported policy instability and uncertainty as the greatest impediment to operations. Another major source of difficulty for private agents are Israeli security measures that result in crippling transactions costs.

Taken together, these features do not create an environment conducive to private investment in start-ups or expansion of existing businesses. Although the

Paris Protocol attempted to address some of these constraints – through modifying the customs union to allow limited Palestinian trade with its Arab neighbors, creating the Palestine Monetary Authority which allowed the entrance of domestic and foreign banks, establishing legal institutions, and developing a regulatory framework – the resulting progress and improvements were severely challenged by the uncertainty, mobility restrictions, and high transactions costs attendant to security measures.

The economy's growth prospects (discussed below) are brighter under scenarios of normalization with Israel, assuming a resolution of the ongoing conflict. But addressing trade and labor policies alone will not automatically trigger a large private sector response, even though a negotiated settlement would greatly improve the business environment by reducing the risk associated with political and ultimately economic uncertainty. The current prospects for extensive job creation in the constrained Palestinian business environment are dim, especially in view of rapid labor force growth. The PA lacks the resources and capacity to continue absorbing job seekers, implying that the private sector will need to pick up the slack in order to support improved Palestinian economic performance.

High production costs. In addition to the high cost of Israeli security procedures, other distortions raise production costs, diminishing Palestinian competitiveness. High transportation costs for the effectively land-locked WBG raise the final price of exports as well as the cost of imported inputs. The relatively high market wage renders Palestinian labor-intensive products more expensive. Palestinian producers also face relatively high prices for production facilities such as land, electricity, and water. The expensive cost structure faced by manufacturers in WBG presents severe challenges for Palestinian competitiveness, many of which are by-products of the interim economic arrangements over which the PA has limited recourse in the present environment.

Corrective policies. The PA nevertheless has some tools at its disposal today to ease constraints facing private agents, improve the institutional framework for investment, and enhance public-private interactions. These include policy measures to address areas currently within Palestinian control – namely, strengthening the Rule of Law, promoting a strong financial system, reducing anticompetitive practices, increasing accountability of the public sector, improving revenue administration, and raising the efficiency of the public sector by allowing the private sector to compete in service delivery.

The existing institutional framework vis-à-vis legal and regulatory systems and property rights does not inspire confidence, dissuading potential investors due to the implied risks. Specifically, investors need assurances that commercial disputes can be resolved fairly and in a timely fashion through the court system. The Palestinian courts and judiciary are ranked lowest among PA services. Security and military courts have weakened the independence and effectiveness of the judiciary,

and Palestinians have resolved disputes through appeals to security personnel rather than in civil courts. The executive and judicial powers of government need to be separated – as laid out in the recently ratified *Basic Law* and *Independence of the Judiciary Law* – and a backlog of commercial legislation needs passing and implementation, in order to support the transactions of a market economy.

The PA also falls short in its regulatory functions. An efficient private sector in WBG requires regulatory institutions that are separate from both the policy-making functions of PA ministries and the investment activities of the government. This includes independent regulation of utilities and financial intermediaries, for example.

Although the banking sector has grown significantly post-Oslo, reflected by very large deposits, credit availability remains inadequate, with lending dependent on traditional collateral requirements that are particularly restrictive in the Palestinian environment of few land titles. This especially hurts small-scale entrepreneurs, who are forced to rely on self-financing rather than borrowing at high interest rates. Allowing a wider range of assets to be used as collateral, improving auditing and accounting standards, and adopting more flexible methods to assess credit risk are all measures that could promote investment by easing access to formal credit markets.

The investment climate in WBG is further marred by perceived anticompetitive practices by the PA – either through its direct involvement in productive activities such as import monopolies for gas and cement (imposed under the Paris Protocol to protect Israeli monopolies), or indirectly through PA equity participation in private firms. This lack of transparency, quite distinct from explicit forms of corruption, discourages investors for fear of unfair competition.

Related to transparency, PA consultation with the private sector has been weak in the past, according to firms surveyed in May 2000. International experience shows important benefits from business-government consultation, including:

- better information for public decisions;
- broader ownership of reforms and enhanced credibility of public sector decisions;
- improved accountability and transparency of decisions;
- increased resources to implement agreed policy by mobilizing financial support from the business community; and
- lower costs of business-government transactions through increased trust.

Recent PA efforts such as the National Trade Dialogue Conference suggest a shift in the PA's approach to setting policy, namely by taking on board the needs and concerns of private firms.

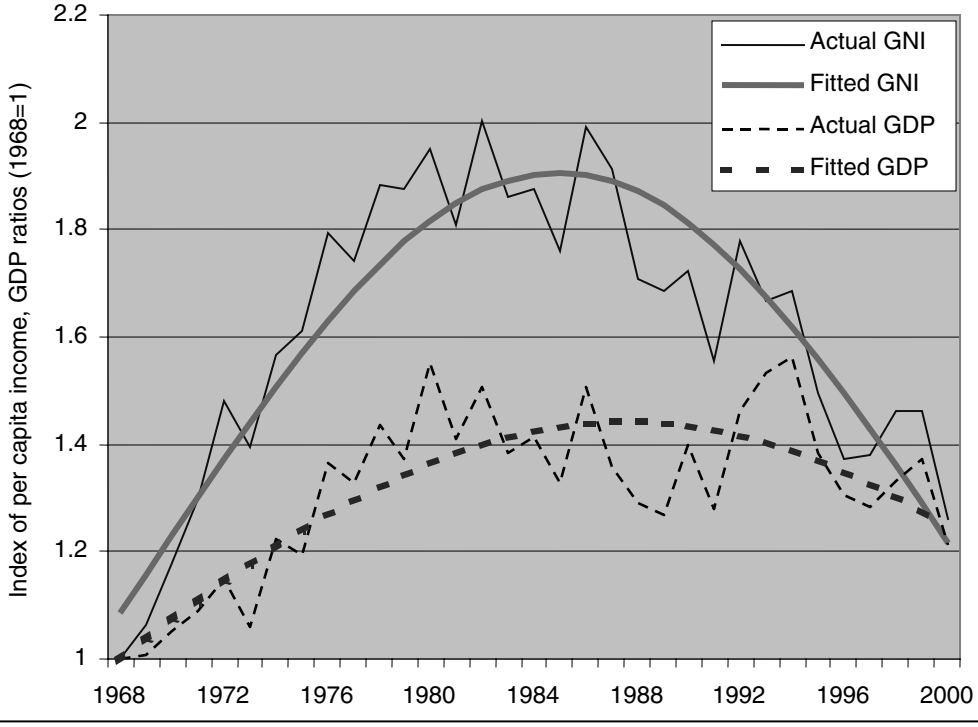
PA relations with the private sector could extend beyond taxation, regulation and policy consultation to a potentially deeper interdependence through public-private partnership in service delivery. The PA's record on the delivery of public services has been mixed, implying room for greater efficiency through competition from other (i.e., non-public) service providers. Although there are cases of private sector participation in investment and service delivery, particularly in health services, even greater partnership with the private sector and with NGOs would benefit the quality and efficiency of service delivery in WBG. By shifting toward an oversight and regulatory role – that is, setting standards for service delivery, coordinating with existing service providers (e.g., NGOs), and contracting out activities and monitoring service quality – the PA could enhance the efficiency of services delivered to the Palestinian population.

Looking ahead. The development of the private sector in WBG has been constrained foremost by the uncertain political situation and the resulting unstable policy environment in which it operates. Although the PA has built considerable capacity to provide public services, its institutional development has lagged behind. As a result, inadequate legal and regulatory institutions, auditing standards, and transparency impose costs on private agents by exacerbating rather than mitigating the uncertain environment. Under the present circumstances of suspended final status negotiations, the PA nevertheless has a range of policy options at its disposal to address these constraints and therefore stimulate a more dynamic private sector role in the future.

Palestinian Economic Growth, Past and Future

Analyzing trade and labor policies and the business environment both pre-Oslo and under the Paris Protocol points to a distorted incentive framework and dependence on the Israeli economy, with Palestinian production focused on low value-added activities. Since 1967, Palestinian economic development has followed a model of integration with Israel, characterized by convergence or catching up with the Israeli economy. But rapid growth did not materialize in WBG. There was some convergence in incomes, especially during the 1970s and early 1980s, driven by short-run gains from market access, worker remittances and higher incomes. But these were offset by long-run losses due to low productivity, vulnerability to external shocks, and weak competitiveness, which eventually led to diverging economic performance, as WBG fell further behind (see Figure 6).

Figure 6: Convergence in GNI and GDP per Capita between WBG and Israel



Paris Protocol and post-Oslo growth. The Paris Protocol aimed to correct some of the observed development disparities, especially on the trade and income side, by improving the environment for private investment and growth in WBG through eliminating Israeli trade barriers on Palestinian agricultural products, removing restrictions on economic activities, reducing political and economic uncertainty by phasing-out military occupation, developing financial institutions, and creating a legal and regulatory framework. The Paris Protocol also led to the revenue-sharing, or clearance, mechanism under which Israel transferred the taxes it collected from trade, purchase and value-added taxes on behalf of the PA, less a 3 percent administrative fee. These measures were accompanied by substantial donor support in terms of infrastructure investment and technical assistance. Nevertheless, the economic integration model failed as incomes diverged between Palestinians and Israelis during the Interim Period.

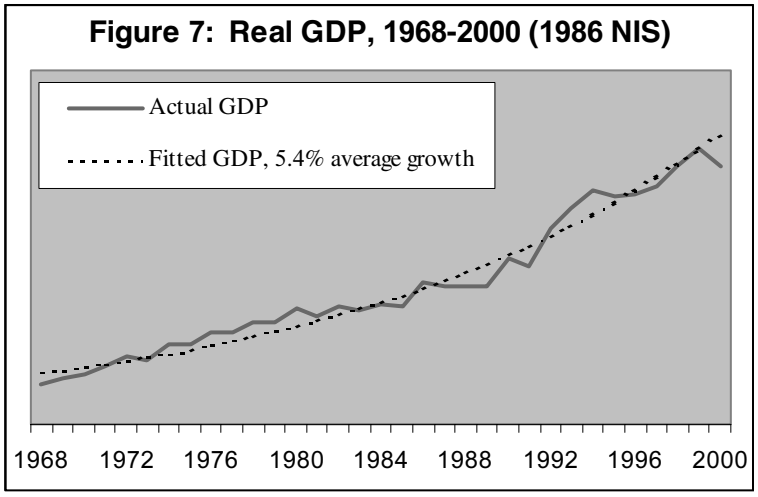
Palestinian economic output was erratic post-Oslo, with distinct episodes mirroring the volatile evolution of political relationships with Israel, particularly vis-à-vis the degree of internal and external closures. In the initial post-Oslo years the economy experienced a return of nationals and large inflows of public and private capital as the result of positive expectations regarding the peace process. But two years of intermittent external closures in 1995-96 and a sharp decline in Palestinian labor flows to Israel precipitated economic recession.

From 1997 to September 2000, closures were less frequent, labor flows to Israel grew dramatically, and transactions costs fell while private investment increased. The Palestinian economy also benefited from an economic boom in Israel, through enhanced opportunities for exports of Palestinian goods and labor. But the outbreak of the intifada in late September 2000 halted the economic recovery and again demonstrated the negative impact of closures on economic growth.

Palestinian economic growth measured by gross domestic product (GDP) is highly volatile, but nevertheless averaged 5.4 percent annually between 1968 and 2000, or 2.5 percent in per capita terms. The post-Oslo period did not lead to a higher growth path, as anticipated, and the improved performance from 1998 to the first part of 2000 merely returned GDP growth to its historical trend (see Figure 7).

This performance was driven by factor accumulation – that is, through added capital and labor – rather than productivity growth which averaged negligible levels. Total factor productivity growth averaged a disappointing 0.3-0.4 percent per year during 1969-2000. The fact that capital stock growth did not take off after Oslo in spite of large inflows of official development assistance implies no dramatic change in incentives to invest in business modernization or expansion. Moreover, most capital expenditures went to construction rather than to productive activities, suggesting limited imports of machinery and technology to raise productivity. The Palestinian economy continued to depend on Israeli goods and labor demand, which did not allow the Palestinian private sector to diversify its risk and entailed significant trade diversion and high domestic wages, as discussed in detail above.

Figure 7: Real GDP, 1968-2000 (1986 NIS)



Modeling future growth potential. Looking to the future, this analysis estimates Palestinian GDP growth over the next decade based on different scenarios of economic and political relations with Israel. In contrast to the partial equilibrium trade, labor and private sector assessments above, this portion of the analysis combines in a consistent framework the demand and supply conditions on goods and factor markets by describing the economic relations among households, producers, the government, and the rest of the world using a dynamic general equilibrium model calibrated for the Palestinian economy. Seven sectors are modeled – agriculture,

manufacturing, construction, transport and communications, commerce and tourism, other private services, public services – and two trade partners are considered, Israel and the rest of the world. The model also reflects the existing trade and fiscal arrangements with Israel as of September 2000. GDP growth in the model arises from endogenous labor supply, capital accumulation in productive activities, and productivity increases, the latter depending on the degree of competition, openness, and movement restrictions.

Five scenarios are constructed to reflect potential future economic relations between WBG and Israel. Together they represent a range of policy options and varying degrees of cooperation on the political and economic fronts. No particular likelihood is attached to any of these scenarios, given the uncertainty of future directions of the peace negotiations. The scenarios reflect possible growth paths for the Palestinian economy, from continued crisis under Scenario 1, to a return to pre-crisis conditions under Scenario 2, as well as more rosy prospects following a resolution of the ongoing crisis and a peace agreement (Scenarios 3, 4 and 5).

The latter scenarios reflect a range of economic strategies for WBG as follows:

- Scenario 3 describes continued economic integration with Israel and an improved customs union;
- Scenario 4 reflects more separate economies and a non-discriminatory trade policy; and
- Scenario 5 involves Palestinian policy autonomy in a cooperative environment and a free trade area between WBG and Israel.

Four different exogenous variables are used to build these scenarios: (i) the degree of closures and confrontations, (ii) the level of transactions costs, (iii) the number of Palestinian workers in Israel, and (iv) the nature of trade arrangements (see Table 3). The intensity of Israeli closures is directly linked to the mobility of goods and people within WBG and between WBG and external partners, thus affecting transport costs and transactions costs more broadly.

Table 3: Assumptions for Five Scenarios

Scenario	Closures & Confrontation	Transactions costs	Workers in Israel	Trade Regime
1	Persist until 2010	Very high until 2010	70,000 in 2010	Customs Union
2	Peak in 2002, end in 2003	Same as in 2000	145,000 in 2010	Customs Union
3	Peak in 2002, end in 2003	20% lower than in 2000	165,000 in 2010	Customs Union
4	Peak in 2002, end in 2003	20% higher than in 2000	70,000 in 2010	Non-Discriminatory
5	Peak in 2002, end in 2003	20% higher than in 2000	145,000 in 2010	Free Trade Area

Predicted outcomes. Testing these different scenarios of economic relations between WBG and Israel, the simulation exercise yields the following results for Scenarios 1-5:

(1) a continuation of the crisis would have dire consequences for the Palestinian economy and its population, including declining per capita incomes, stagnant exports, and poverty rates over 50 percent;

(2) a return to the situation prevailing in September 2000 represents a muddle-through solution of stagnation and increased reliance on Israel;

(3) a successfully implemented Paris Protocol would lead to high per capita incomes and modest unemployment, but would still fail to generate high sustainable economic growth through exports and productivity gains;

(4) an economic separation (through a more autonomous and neutral trade regime and lower labor outflows to Israel) aimed at diversifying the Palestinian economy away from Israel toward greater integration into global markets would bring important dynamic gains in terms of investment and productivity leading to strong export-driven GDP growth, but with costs to society through higher unemployment; and

(5) a further integration with Israel through an FTA would lead to mediocre GDP and export levels but also lower unemployment, increasing Palestinian economic dependency on Israel.

The simulation results of the five scenarios are illustrated in Figures 8, 9, 10 and 11 and reported in Table 4 below.

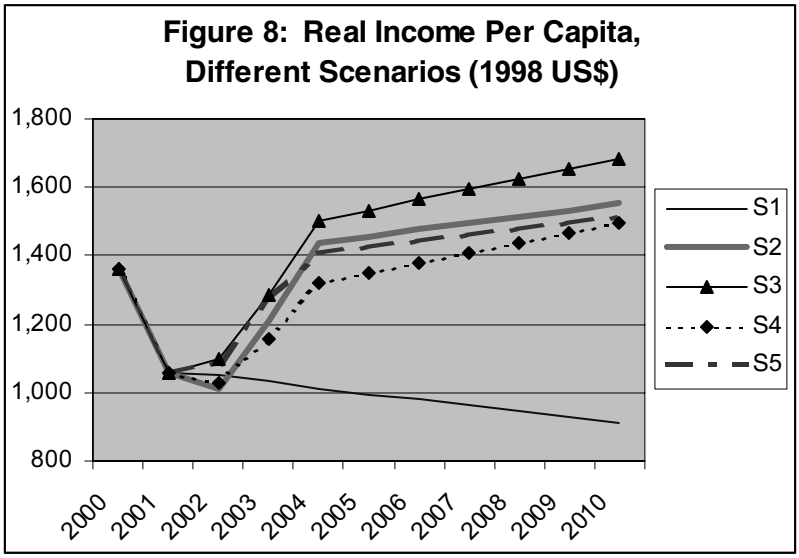


Figure 8: Real Income Per Capita, Different Scenarios (1998 US$)
1,800
1,600
1,400
1,200
1,000
800
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
S1
S2
S3
S4
S5

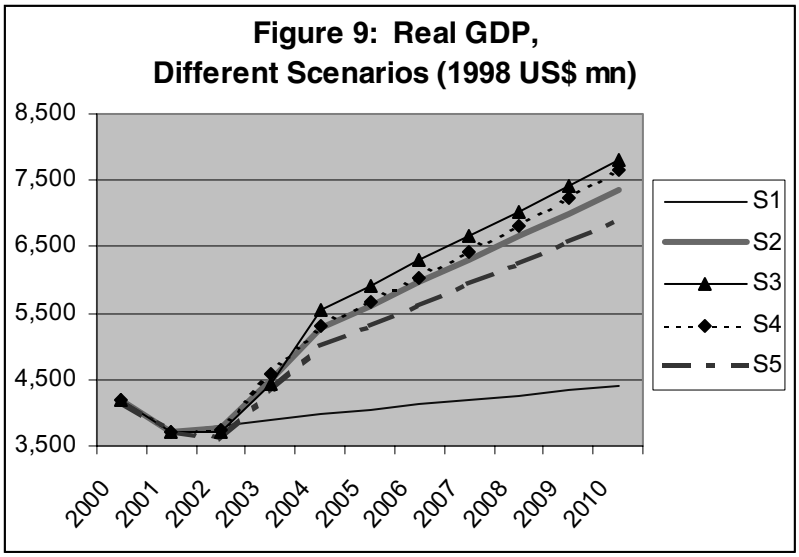


Figure 9: Real GDP, Different Scenarios (1998 US$ mn)
8,500
7,500
6,500
5,500
4,500
3,500
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
S1
S2
S3
S4
S5

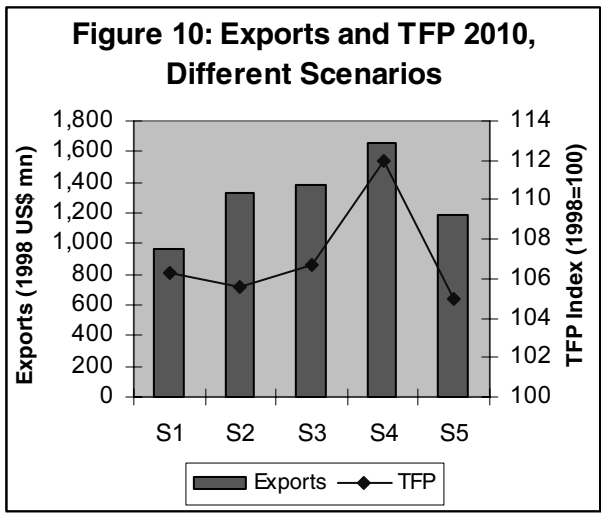


Figure 10: Exports and TFP 2010, Different Scenarios
Exports (1998 US$ mn)
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
TFP Index (1998=100)
114
112
110
108
106
104
102
100
S1
S2
S3
S4
S5
Exports
TFP

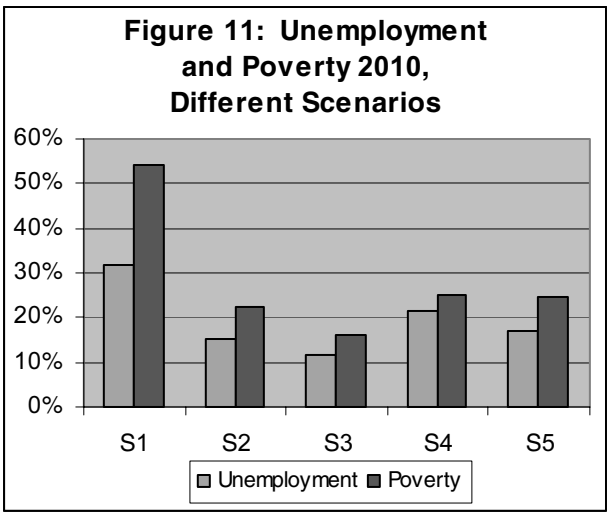


Figure 11: Unemployment and Poverty 2010, Different Scenarios
60%
50%
40%
30%
20%
10%
0%
S1
S2
S3
S4
S5
Unemployment
Poverty

Table 4: Simulation Results					
Scenarios	**1**	**2**	**3**	**4**	**5**
Growth rates 2000-2010 (%):					
Real Income per capita	-4.0	1.3	2.1	1.0	1.0
Real GDP	0.5	5.8	6.4	6.2	5.1
Growth rates 2005-2010 (%):					
Real income per capita	-1.8	1.3	1.9	2.1	1.2
Real GDP	1.7	5.6	5.7	6.2	5.4
Capital stock per capita	-3.7	3.8	4.4	4.6	3.4
Total factor productivity	0.3	0.5	0.3	1.0	0.5
Imports	0.4	2.7	3.2	3.3	2.6
Exports	3.2	6.4	6.0	8.6	6.2
Population	3.3	3.3	3.3	3.3	3.3
As a share of GDP in 2010 (%):					
Exports	22.0	18.0	17.7	21.7	17.2
of which to Israel	20.1	15.4	15.1	15.9	14.8
Imports	56.0	55.4	54.9	52.8	59.7
of which from Israel	41.6	40.9	40.6	39.5	40.7
Private consumption	93.6	84.6	85.3	78.9	88.2
Productive investment	10.5	20.5	20.5	22.0	20.4
Tax revenue	22.1	22.4	22.3	19.4	20.7
Other items (%):					
Unemployment rate in 2010	31.8	15.4	11.7	21.4	16.8
Labor flows to Israel (% employment)	11.2	21.5	25.2	9.6	22.4
Poverty rate in 2010	54.0	22.4	16.0	25.2	24.5
Real per capita income in 2010 (Index 2000 = 100)	66.7	114.2	123.7	110.0	111.0

Scenarios 1 and 2 represent political developments but no fundamental change in policies governing economic relations between WBG and Israel. The predicted outcomes suggest that under these assumptions the Palestinian economy is likely to remain trapped in a low-growth low-income equilibrium. Scenario 3 – representing no change in trade policy but improved mobility and lower transactions costs – predicts a small improvement over historical output growth, higher income growth, and the most rapid recovery in per capita incomes, but weak export performance and continued dependence on Israel through the de facto one-sided trade regime and the distorted labor market and attendant underutilization of human capital. Future scenarios characterized by new trade policy – either through economic separation and a non-discriminatory trade regime (Scenario 4) or through an FTA and continued

labor market integration (Scenario 5) – involve varying degrees of decision-making flexibility on the Palestinian side and different degrees of economic dependence on Israel. Scenario 4 shifts to a higher export and productivity growth path through trade diversification toward the rest of the world, but incomes recover more slowly due to smaller labor flows to Israel. Under the FTA in Scenario 5, continued dependence on Israel through trade and labor flows leads to only modest gains from Palestinian trade flexibility with other countries, while per capita incomes and poverty rates in 2010 are comparable to those under Scenario 4.

Trade-offs and welfare implications. The predicted outcomes of the five scenarios illustrate the complex interplay of economic variables associated with different trade regimes, border arrangements, and the implied transactions costs and labor flows. The preceding analysis spells out the trade-offs that are likely to face Palestinian policymakers in the context of a peace agreement with Israel. The various policy choices have very different implications for poverty in WBG. An improved CU (Scenario 3) generates the greatest gains with respect to per capita income and poverty. But this projected growth is driven by workers' remittances from Israel rather than domestic productivity growth, translating into larger near-term benefits but at a cost to long-term development.

On the other hand, economic growth is highest under an NDTP due to strong export and productivity performance (consistent with the partial equilibrium Chapter 2 conclusion that an NDTP leads to better trade outcomes than a CU and an FTA) and reduced vulnerability to external shocks, but unemployment and poverty are substantial. The challenge for policymakers will be to balance the near-term and long-term costs and benefits. Addressing welfare concerns adequately – particularly poverty – will continue to be crucial in the future, especially under Scenarios 4 and 5, reinforcing the need for well-targeted and comprehensive safety net programs to protect the poor.

High-case trade outcomes. Whereas Scenarios 1-5 represent most-likely outcomes, it is possible that a future peace agreement could be accompanied by greatly expanded Palestinian trade, particularly with Arab League countries. This type of "peace dividend" is modeled by a large cumulative decline in trade barriers with third-party markets excluding Israel. The result is higher annual growth rates by 0.5-0.7 percentage points per year, but with especially large gains under the NDTP of Scenario 4, in which annual export growth is estimated to reach 10 percent between 2005 and 2010 (compared to 8.6 percent in Table 4). These high-case scenarios of expanded trade involve higher per capita incomes and lower poverty relative to the most-likely outcomes.

Downside risks. The ability to implement policy changes effectively and the subsequent response of the Palestinian private sector will be central to future growth outcomes. There are very real downside risks relating to policy changes following a

final status agreement, such as increased transactions costs due to inefficient border administration or protective tariff rates, for example. Moreover, continued risk and uncertainty will cause further decline in private investment, leading to lower per capita income growth and very high poverty rates. Low-case scenario estimates suggest that future economic policy choices are not straightforward and the inherent risks under *any* scenario are non-negligible.

Conclusions

The Palestinian economy has exhibited modest economic performance for the past three decades, including the most recent Interim Period during which better economic outcomes were anticipated under the Paris Protocol. The growth outcomes observed post-Oslo illustrate the close inter-linkages between political and economic factors. The Paris Protocol provided for controlled Palestinian economic integration with Israel, but did not adequately separate political pressures from economic considerations. Disputes that emerged in the context of economic transactions lacked sufficient settlement mechanisms, leading to worse economic outcomes and at the same time inflaming political pressures. Economic arrangements favored Israel and maintained the dependent development path of the Palestinian economy. And Israeli closure policy created extreme economic hardship for the Palestinians and increased the level of frustration regarding unmet expectations and a lack of progress toward independence.

Factors other than distortionary trade and labor policies complicated the economic environment. The interim nature of the peace accords and the inherent limits on Palestinian sovereignty generated uncertainty and risk, especially in the context of periodic Israeli closures and severe mobility restrictions on goods and labor. The impact on transactions costs pushed Palestinian production costs above competitive levels. This uncertain climate was further hampered by weak institutional structures relating to investment, namely inadequate legal, regulatory and financial institutions to protect private investment, as well as anticompetitive practices effectively condoned by the PA. As a consequence, the stifled Palestinian private sector failed to stimulate sustained growth and job creation.

In light of Israel's central role in the Palestinian economy, alternative models of future Palestinian economic development will depend on the nature of political and economic relations with Israel under a final status agreement. The overriding objective of future economic relations between West Bank and Gaza and Israel should be sustained economic growth, mutual benefit, and a level playing field. Although final status negotiations are currently stalled, a future peace agreement could lead to one of the following options: continued economic integration, non-cooperative economic separation, or Palestinian economic policy autonomy in a cooperative environment. Scenarios 3, 4 and 5 developed herein illustrate the

projected economic outcomes associated with each policy option, and the implied trade-offs among GDP growth, productivity, incomes, unemployment and poverty.

Comparing the results of the different policy scenarios does not point to a unique or optimal solution, given that economic performance measured by real GDP growth does not differ significantly in the long run (except under a continuation of the crisis). But the factors driving growth vary significantly. Under increased economic integration but limited policy autonomy, slow productivity growth and capital accumulation are compensated by greater access to the Israeli labor market, whereas under economic separation, reduced access to the Israeli labor market and higher transactions costs are offset by a more liberal neutral trade regime that reduces trade diversion, promotes competition and encourages investment and more productive technologies, but at a higher social cost with respect to unemployment.

Each scenario involves different levels of policymaking autonomy and sovereignty for the Palestinians, and as such may be more or less politically tenable. Any future peace accord and related economic agreement will need to isolate political variables from the economic sphere, in order to avoid repeating the current situation in which economic objectives are undermined by competing constituent demands in an unsettled political environment. But under any scenario, Israel will continue to be a very important partner for the West Bank and Gaza.

Introduction

1

Introduction

1.1 The Palestinian economy's close ties with the larger Israeli economy stem from the occupation of the Palestinian Territories by Israel following the 1967 war. As a result, economic activity in the Palestinian Territories was partially incorporated into the more diversified and productive Israeli economy. Trade between the Territories and Israel was effectively internal, and a large share of the Palestinian labor force was employed by Israeli firms. The advent of the peace process in the early 1990s and the 1994 signing of the Protocol on Economic Relations – known as the Paris Protocol – formalized the Palestinian-Israeli economic relationship between two administratively and physically distinct entities, although considerable overlap remained. The Paris Protocol (PP) defined transitional economic arrangements over an Interim Period of six years.[1] This protocol granted the Palestinian Authority (PA) a degree of administrative autonomy over the Palestinian Territories with respect to public service delivery, and formalized policies of economic cooperation and integration with Israel relating to the exchange of goods, fiscal policy, currency arrangements, and labor services.

1.2 In principle, these economic arrangements broadly reflected a close integration of the two economies, with the expectation that economic development and political normalization would progress hand-in-hand. In its preamble, the PP states the objective that mutual economic relations between the two parties will "enhance their interest in the achievement of a just, lasting and comprehensive peace". In light of the current economic and political crisis, however, the hoped-for outcomes regarding Palestinian development and productive cross-border relations did not materialize.

[1] The Paris Protocol was originally planned to end in May 1999 but was effectively extended to September 2000.

1.3 Looking to the future, this analysis explores the policy options available to Palestinian policymakers in the event of a final peace accord with Israel. Important lessons can be drawn from past experience, particularly vis-à-vis the policy framework implemented under the PP. Furthermore, the range of economic policy choices will necessarily depend on the nature of key political variables agreed between Israel and the West Bank and Gaza, such as borders for example. This analysis examines the principle areas in which policy options arise, namely with respect to trade regime, labor policy, and the business environment to support private sector development.

1.4 Existing trade relations between West Bank and Gaza (WBG) and Israel are determined by the de facto customs union in effect since Israeli occupation, modified in the PP by exceptions lists to expand Palestinian trade with its Arab neighbors. Under the modified customs union, Palestinian trade with Israel is in principle free – in other words, Israeli goods have free access to Palestinian markets and vice versa – and Palestinian trade with third parties is subject to Israel's tariff rates. Although a customs union does not require an internal border to control goods passing between WBG and Israel, other trade policy options would necessitate customs stations at border crossings. Under a free trade area, for example, Palestinian-Israeli trade could continue to be free, subject to domestic content requirements (i.e., rules of origin), but Palestinian trade relations with other partners could be set independently of Israeli policy preferences. A third option for Palestinian trade – non-preferential policy – requires Palestinian control over its borders and tax collection on all trade transactions. A non-discriminatory trade regime in which WBG adopts identical tariffs for all trade partners would treat Israeli goods no differently than imports from Egypt or Jordan, for example, but Palestinian exports would lose their free or preferential access to Israeli markets. Although a free trade area and non-discriminatory trade policy represent unviable options in the framework of economic integration as defined in the PP, they become real policy options under a final status agreement allowing for Palestinian autonomy over policymaking and control of borders.

1.5 Labor policy, like trade, is crucial to Palestinian economic outcomes. Historically, the Palestinian and Israeli labor markets have been closely linked, with Israeli labor demand for low-skill workers largely met by relatively cheap Palestinian labor commuting daily to jobs in Israel and the settlements. The once-free movement of labor was restricted somewhat by the Israeli introduction of work permits to control the inflow of Palestinians. This was greatly exacerbated during the Interim Period by the security measures and closures imposed by Israel, during which Palestinian unemployment shot up from negligible levels to nearly 30 percent. Limiting the supply of Palestinian labor to Israel is currently facilitated by Israeli control of the crossing points from WBG into Israel and domestic Israeli labor policy. The extent of labor market integration in the future – i.e., the number of Palestinian workers permitted to cross into Israel – will depend on the nature of borders in

particular, and more broadly on the model of economic relations adopted between WBG and Israel, be it one of continued limited integration, separation, or increased integration with market-driven labor supply.

1.6 The prospects for economic development and sustainable growth in WBG are integrally linked to future trade and labor relations with Israel, but are also fundamentally tied to the private sector response to these policies. The volatile and generally modest growth performance observed during the Interim Period can be explained in part by the difficult business environment prevailing in WBG. Whereas a great deal of the perceived risk is the result of continued uncertainty with respect to a permanent peace accord with Israel, other factors discourage investment and diminish the potential response of private agents. These include high production and transactions costs, a weak regulatory framework, inadequate protection of property rights, credit constraints, and anti-competitive practices on the part of the government.

1.7 Critical parameters relating to trade, labor flows and the business climate are associated with a range of policy options that will face Palestinian policymakers under a final status agreement. This analysis develops scenarios to reflect different combinations of future policy options in order to assess the impact on economic performance and growth in the long run across the trade-labor-investment policy spectrum. In this context, it is important to examine the specific provisions of the PP and pre-existing policies that may have contributed to the observed poor economic outcomes, especially given that one of the future options under consideration is a continuation of economic integration with Israel in a customs union framework. Of considerable importance as well is the impact of periodic closures imposed by Israel which marred implementation of the Paris Protocol and severely disrupted Palestinian economic activity, imposing colossal transactions costs and severing economic relationships on the ground which later proved difficult to restore.

1.8 Despite the many shortcomings of the economic integration model, the PP itself, and the regular setbacks associated with closures, the considerable progress achieved on several fronts during the Interim Period generated optimism that a final status agreement based on the peaceful coexistence of two neighboring sovereign entities was attainable. The real challenge emerged in 1999 and 2000 in the context of negotiating highly contentious final status issues: the location and nature of borders, sovereignty over Jerusalem, access to water resources, and the right of return of Palestinian refugees. Negotiations faltered at the same time that Israeli Prime Minister Ehud Barak lost his once-broad political constituency, and subsequently broke down as tensions erupted into civil conflict in September 2000, plunging the Palestinians into political uncertainty and economic crisis (Box 1.1 provides a chronology of milestone events). Over the course of the last year, the situation has deteriorated sharply, reaching critical levels.

Box 1.1: Milestones of the Peace Process

October 1991	Madrid Peace Conference	Inaugurated bilateral and multilateral negotiations for a peace settlement
September 1993	Declaration of Principles on Interim Self-Government Arrangements	Set framework for the interim period; mutual recognition of the PLO, Israel; agreement to start permanent status negotiations
April 1994	Protocol on Economic Relations (Paris Protocol)	Formalized interim economic relations between Israel and Palestinian self-gov't re: monetary, fiscal and trade policy
May 1994	Agreement on the Gaza Strip and the Jericho Area (Oslo I Agreement)	Framework to transfer power, responsibilities to the PA; agreement on Israeli withdrawal from Gaza Strip and Jericho
August 1994	Agreement on Preparatory Transfer of Powers and Responsibilities	Transfer of authority from Israel to PA for education, culture, health, welfare, tourism, direct taxation and VAT on production in WB
August 1995	Protocol on Further Transfer of Powers and Responsibilities	Refers to agriculture, statistics, energy, insurance, labor, local gov't, postal service and trade and industry in WB
September 1995	Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip (Taba Agreement/Oslo II)	Confirmed PA's expanded role incl. police; defined composition of PLC; scheduled redeployments; recognized Palestinian water rights; set coordination mechanisms for security, legal, judicial and economic policies
November1995	Assassination of Israeli Prime Minister Rabin	Shimon Peres becomes PM of Israel, halts negotiations on Hebron
January 1996	Palestinian Legislative Council elections and presidential elections	Arafat elected President of the Palestinian Authority
April 1996	Early elections in Israel	Binyamin Netanyahu elected PM of Israel
January 1997	Agreement on Hebron	Redeployment of Israeli forces from Hebron
October 1998	Wye River Memorandum	Oslo II implemented, PLO Charter changed, agreement on future opening of Gaza airport, safe passage, prisoner release
May 1999	Barak elected Israeli Prime Minister	Runs on a peace platform
September 1999	Sharm Esh-Sheikh Agreement	Wye River accord implemented, opened safe passage and prisoner release, agreed to start final status negotiations
September 1999	Final Status Negotiations	Initiated discussions on final status issues of borders, water, Jerusalem, refugees
November 1999-January2000	Implementation of the second and third stages of the interim agreement	Israeli withdrawal (7.1% of area B and 1% of C become area A; 3% of area C becomes B)
February 2000	Framework for final agreement	Negotiators agreed on framework for final status agreement
July 2000	Camp David meetings	US-brokered summit between Arafat and Barak breaks down
September2000	Negotiations resumed in Washington	No agreement reached
September 2000	intifada erupts	Sharon's visit to Al-Aqsa Mosque sparks riots
December 2000	Senator Mitchell's Mission begins	Investigation into causes of the new conflict
January 2001	Taba negotiations	Palestinians and Israelis got closer to final agreement
March 2001	Sharon elected Prime Minister of Israel	Forms a "unity" government, suspends negotiations until violence subsides
April 2001	Mitchell Report published	Proposes plan to resume negotiations, confidence-building measures
June 2001-present	Escalation of conflict on both sides	Periods of Israeli reoccupation of parts of WBG, extensive closures, curfews

Source: Diwan and Shaban (1999); PASSIA (1999)

1.9 It is instructive at this stage of suspended peace negotiations following the Interim Period to take stock of Palestinian economic performance and review the policies adopted in conjunction with the Oslo agreements. Assessing the relative successes and shortcomings of past policies with respect to economic growth, per capita incomes, trade, unemployment, and private sector development provides a reference framework for examining policy options for the future.

Inadequate development outcomes in the West Bank and Gaza

1.10 Palestinian economic performance during the Interim Period can be characterized as highly volatile but broadly mediocre, due to inadequate investment, low productivity growth despite fairly strong factor accumulation, and most importantly the uncertain environment created by Israeli closure policy. These trends (discussed in Chapter 5) are consistent with historical growth patterns observed prior to the Oslo accords, in which gross domestic product (GDP) growth averaged 5.4 percent annually, equivalent to 2.5 percent in per capita terms. Although positive, this output and therefore income growth fell short of the gains expected from close economic integration with the larger and more developed Israeli economy. The anticipated income convergence did not materialize for a variety of reasons that are examined in this analysis. The policy environment relating to trade incentives and labor demand and supply resulted in a development path of Palestinian economic dependence on Israel. With respect to trade policy (addressed in Chapter 2), the customs union granted preferential Palestinian access to Israeli markets but effectively limited imports to relatively expensive Israeli goods, affecting the shape of domestic Palestinian production by restricting its capacity to develop more productive technologies (due to minimal technology transfer) and precluding expansion of export products and markets beyond Israel. The integration of the Palestinian and Israeli labor markets produced mixed effects: although access to high-paying Israeli jobs increased Palestinian employment and household incomes, it distorted labor supply decisions and raised domestic Palestinian wages, dampening labor demand and diminishing Palestinian competitiveness on export markets (addressed in Chapter 3).

1.11 The Paris Protocol was designed to formalize and improve the existing economic arrangements with Israel to promote Palestinian economic development and reduce disparities with Israel. To this end, the PP consisted of the following measures:

- a modified customs union allowing some Palestinian export diversification with its Arab neighbors;
- revenue-sharing through Israeli tax collection and remittance to the PA;
- coordination of VAT rates and other indirect tax rates;

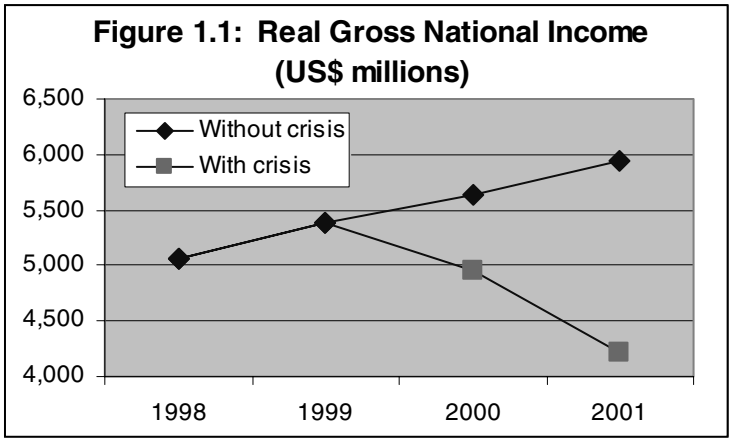
- continued access of Palestinian labor to the Israeli labor market through a regulated system of permits; and

- measures to promote private sector development such as through the development of financial institutions.

The PP was accompanied by substantial donor support for infrastructure and institutional development through investment and technical assistance. Despite significant progress, this model of economic integration formalized in the PP failed, as trade composition remained distorted, high Palestinian wages hurt competitiveness, human capital resources were underutilized, incomes diverged between Palestinians and Israelis during the Interim Period and the economy remained on a low-productivity equilibrium growth path (as will be illustrated in detail in Chapters 2, 3, 4 and 5).

Current crisis

1.12 The shortcomings of post-Oslo economic policy were exacerbated by Israeli closure policy and the volatility it introduced to the Palestinian economy, illustrated *in the extreme* by the current crisis. The conflict has engendered enormous costs for WBG (and to a lesser extent Israel) and diminished the already inadequate resource base. The outbreak of the intifada in late September 2000 disrupted the tenuous economic recovery of 1998-2000 following the closure-induced downturns of the mid-1990s. Since September 28, 2000, the situation has been characterized by unprecedented levels of conflict and the most severe sustained mobility restrictions imposed on the West Bank and Gaza since 1967 (see World Bank 2002 for a detailed analysis). Closures and confrontation resulted in a precipitous decline in trade, employment, and investment, and a doubling of already high transport costs (see Box 1.2). Real GDP declined by an estimated 6 percent for the year 2000 (despite robust growth during the first three quarters), and by an additional 12 percent in 2001. The estimated decline in gross national income (GNI) was even larger, reaching 15 percent in 2001, as worker remittances from Israel fell substantially (see Figure 1.1). The welfare implications are critical: per capita GNI plummeted by 10 percent in 2000 and another 19 percent in 2001. Available data suggest a sharp economic setback in the first three months of the intifada, followed by a slower rate of decline in the first half of 2001, and worsening



conditions thereafter. Unemployment in the fourth quarter of 2000 skyrocketed to 28 percent, moderated slightly in early 2001 with the resumption of Palestinian labor flows (mostly without permits) to Israeli jobs, but climbed even higher in 2002. Despite existing safety net programs and an infusion of donor support, the number of Palestinians below the poverty line (i.e., incomes of less than US$2 per day) rose from an estimated 600,000 pre-crisis to between 1.2 and 1.5 million by the end of 2001.

Box 1.2: The Impact of the Crisis on Transport Costs

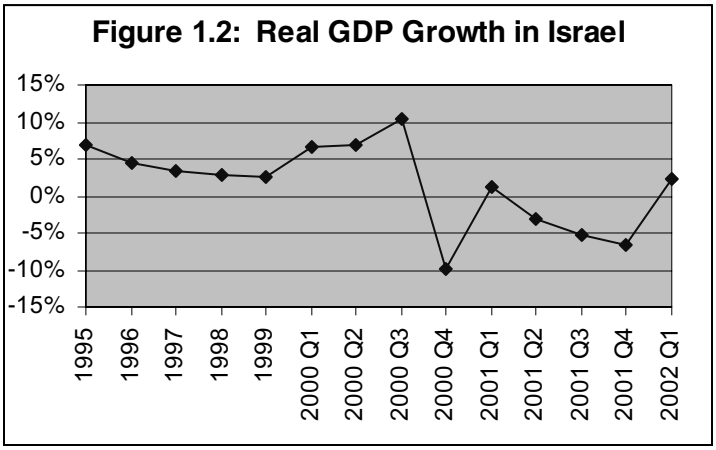
The World Bank commissioned a survey of 500 households and 188 firms to measure the degree to which transport times and costs – for travel to schooling, health services, place of employment, and markets – changed between June 2000 (i.e., pre-intifada) and June 2001.

The results summarized below report the percentage increase in distance, travel time and cost for individuals to travel to their place of employment and to shopping, and for firms to transport goods to domestic markets (for further details, see Annex I).

	Distance		Travel Time		Travel Cost	
Households:	**Job**	**Shopping**	**Job**	**Shopping**	**Job**	**Shopping**
West Bank	44%	77%	82%	130%	25%	102%
Gaza Strip	14%	-2%	66%	9%	-11%	3%
Rural Areas	44%	78%	95%	147%	20%	111%
Urban Areas	4%	90%	10%	59%	-7%	122%
Firms	102%		208%		82%	

1.13 More than a year of crisis has resulted in significant damage to the real sector and to investment prospects. The economic crisis induced a severe fiscal compression only partially offset by donor intervention, and the private sector was hit hard. Physical damages of approximately US$650 million (as of April 2002) pale in comparison to estimates for lost economic opportunities in investment (US$1.2 billion), tourism, and export sectors. Total GNI losses were estimated to reach US$2.4 billion by end-2001 (World Bank 2002). The intifada has not been good for the Israeli economy either. According to Bank of Israel data, the 7-9 percent GDP growth observed in the first 3 quarters of 2000 was rapidly reversed following the outbreak of the crisis (as depicted in Figure 1.2). Subsequent Israeli

Figure 1.2: Real GDP Growth in Israel



economic growth faltered, driven by depressed tourism and construction where typically a third of the workforce is Palestinian (Annex II contains a more detailed analysis).

Overlap of politics and economics

1.14 Because economic policies and political decisions are overlapping in time – as seen in WBG with the implementation of the Paris Protocol concurrent with periodic Israeli-imposed closures – it is impossible to disentangle perfectly the extent to which outcomes are the result of one or the other. For example, is poor Palestinian economic performance explained by inequitable trade provisions favoring Israeli producers and Palestinian reliance on Israeli jobs? Or does Israel's stance on security controls disrupt market activity to the degree that trade and labor policies are rendered irrelevant? The distinction between economics – as represented by the PP – and politics – reflecting for example Israeli closure policy – is somewhat artificial, given that policymakers represent constituent interests in their policy decisions. The Oslo agreements were the result of negotiations on political variables relating to sovereignty which in turn shaped the economic relations defined in the PP. Illustrating the interplay of economic and political factors, Kanafani (1998) and the European Commission (1999) identify loopholes in the trade provisions of the PP which led to poor trade outcomes, including:

(i) inadequately delineated customs crossing procedures;

(ii) vaguely defined processes of decision making, enforcement and arbitration by the Joint Economic Committee (responsible for implementing the PP and resolving problems), effectively providing no recourse to the weaker Palestinian side; and

(iii) the disregard of security concerns in the provisions of the PP, which led to the subversion of economic objectives by Israeli political pressure for security controls and closures.

Arnon and Weinblatt (2000) suggest causality in the opposite direction, namely that closures were used as "economic pressure" to affect the outcomes of political negotiations. An alternative explanation of poor economic performance may be that the underlying conditions in WBG with respect to factor endowments, institutional capacity, incentive framework, and legal and regulatory functions inhibited better economic outcomes. The effectiveness of future policies will depend on the underlying causes of past performance; it is therefore essential to understand the root causes to the extent possible in order to ensure that future policy choices address those constraints that are truly binding.

1.15 The interim nature of the Oslo accords, under which the final status issues of borders, Jerusalem, refugee return and water were left for a subsequent round of

negotiations, influenced the type of economic policies adopted under the PP. Without a firm commitment to a physical border separating the West Bank and Israel, any trade regime requiring customs stations at border controls – such as an FTA, for example – could not be implemented. Similarly, introducing strict controls on the flow of Palestinian construction workers rather than the more lax control actually observed due to porous borders could have constrained housing construction in Israel and the settlements, which in fact contributed to Israel's strong economic expansion during the 1990s. The PP in effect represents an awkward compromise between two distinct starting points vis-à-vis political objectives: the Palestinians favored interim provisions that would eventually lead to full statehood, whereas Israel avoided specific definition of physical borders so as not to pre-commit to territorial transfers in future negotiations on final status (Kleiman 1994).

1.16 This suggests that it was the interim nature of the agreement that contributed to its demise. Although it is possible to speculate about the nature of economic relations between Israel and WBG if a final agreement on statehood had been reached in 1993, it is impossible to know this counterfactual with certainty. For example, if the PA had autonomy in setting trade policy, problems might have been resolved through effective dispute settlement mechanisms that treated Israel and Palestine as more equal sovereign partners, rather than the circumstances prevailing under the PP in which asymmetric treatment of Palestinian goods and factors of production – effectively at the unilateral discretion of Israel – created tensions that were unsatisfactorily addressed by the Joint Economic Committee. Arnon and Weinblatt (2000) suggest that the PP failed by virtue of being an incomplete contract due to inadequate enforcement mechanisms and the infeasibility of re-negotiation given the imbalance of power between Israel and the PA. By generating conflicts of interest rather than building on mutual economic benefits, the PP detracted from reconciliation efforts (Kanafani 2001). Abed (1997) provides a more sweeping indictment of the incremental rather than fundamental approach to peace, charging that partial Palestinian gains under the Oslo accords could simultaneously be claimed as concrete progress toward statehood by the Palestinian leadership but denied by Israeli leaders as a permanent concession. The changes in Israeli leadership and the five-plus year gap between the interim agreement and final status negotiations (see Box 1.1) allowed shifts in political coalitions on the Israeli side and public support on both sides, which ultimately undermined progress in reaching an accord, illustrating additional risks associated with an interim rather than final agreement. On the other hand, perhaps the political will necessary to achieve a final agreement during the 1993 peace negotiations was not present on both sides, such that interim measures were the only feasible option.

Lessons from civil conflict

1.17 The preceding discussion considers the extent to which Palestinian economic performance in the mid-to-late 1990s can be explained by the inherent difficulties of

an interim agreement rather than a final agreement under which issues of sovereignty are resolved. The interplay of political and economic pressures is apparent not only in setting policy, but also with respect to outcomes and feedback effects that can ultimately escalate into conflict. In light of their incompatible objectives and competing territorial claims, the Palestinians and Israelis have been in conflict to varying degrees since 1948.[2] The current intifada is clearly an instance of open civil conflict. Although the causes of this historical conflict are political at heart – namely, the desire for Palestinian self-determination in a sovereign state – economic variables are also important. The transmission mechanisms through which feedback and escalation might occur are considered in the literature and are related not only to the political landscape but also to economic realities on the ground. This analysis therefore draws lessons from the literature that are relevant to current and future Palestinian prospects for peace.

1.18 Various economic theories to explain the occurrence of civil war are rooted in rational choice theory and the economic trade-offs to conflict. Observing that conflict is usually Pareto-inefficient, Hirschleifer (1995) describes a model in which the differing preferences and capabilities of the two parties create opportunities for fighting. In the Palestinian-Israeli case, although civil conflict had support – to varying degrees at various points in time – from both sides despite the associated costs, prolonged conflict led to significant losses, inducing Israel and the PLO to reach a land-for-peace deal in 1993, known as the Oslo Agreement. According to a large literature (Sambanis 2001a), violence arises due to information asymmetries, given that perfect foresight could lead to compromise in which both parties are better off. On the other hand, civil conflict would be rational if the long-run gains to weakening future opponents exceed the short-run costs (including opportunity costs) of war (Garfinkel and Skaperdas 2000). In this case, Palestinian long-run gains would be statehood on territory reclaimed from Israel, while for Israel the long-run gains would be a peaceful Jewish state on territory held in Biblical times.

1.19 Political science theories of the onset of conflict are framed in the context of political oppression and grievance. Supported by empirical evidence, Gurr (2000) posits four determinants of war:

(i) the link between ethno-cultural and socio-economic identities;

(ii) perceived or actual level of grievance;

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[2] According to the definition widely used in the literature (see Sambanis 2001a for an overview), the Palestinian-Israeli conflict can be characterized as a civil war. Singer and Small (1994) define civil war to involve at least 1,000 deaths in the first year in which rebels challenge the sovereignty of an internationally recognized state within its recognized boundaries.

(iii) the degree of cohesion and the resulting ability to mobilize ethno-political groups; and

(iv) access to and opportunities for political action.

International relations theory provides insights into contagion effects that are especially germane to the ongoing intifada, namely that as anarchy emerges, the conflict is likely to escalate since negotiating a credible end to the war becomes more difficult (Lake and Rothschild 1998). In addition to conflict onset and duration, the theoretical literature also addresses the prospects for ending conflict and the potential recurrence of violence. According to the "basic needs" approach (Azar and Burton 1986, Azar 1990), a lasting negotiated settlement is less attainable if the resulting power and resource allocations among the various parties to the agreement are inadequate to meet the basic needs of each group. Policymaking in the aftermath of conflict risks unhinging peace agreements by renewing tensions, especially with respect to redistribution policies such as safety net programs (Bodewig 2001 makes the case in the context of ethnic conflicts).

1.20 Empirical evidence on the determinants of civil war onset, duration, and the likelihood of recurrence (summarized in Box 1.3 below) suggests that many factors present in the Palestinian-Israeli context are conducive to conflict. These

Box 1.3: Determinants of Conflict

Cross-country studies of the determinants of civil war occurrence, duration and recurrence provide empirical evidence that economic outcomes in certain political environments are conducive to conflict. Collier and Hoeffler (2000) and Fearon and Laitin (2000) find that poverty and slow economic growth are the main determinants of civil war. Their more surprising result involves ethnic and religious fractionalization: both studies conclude that greater diversity reduces the probability of civil war, whereas ethnic dominance increases the likelihood through a group's ability to recruit support. Similarly, Collier, Hoeffler and Soderbom (1999) find that societies that are polarized along ethnic and/or linguistic lines have a greater likelihood of longer war duration. Elbadawi and Sambanis (2001) confirm this result using a different methodology and data set. The intuition behind this result is that by solidifying ethnic differences, civil conflicts are likely to last longer as conditions for reconciliation become more difficult (Kaufmann 1996). The presence of a large Diaspora also contributes to the probability of civil war through financial support (Collier and Hoeffler 2000; Fearon and Laitin 2000). With respect to the Palestinian Diaspora, however, the causality may go in the other direction if the large Palestinian population living abroad is *the result of* the civil conflict at home. In the Israeli case, the state benefits from direct and indirect financial support from the US and elsewhere.

There is mixed evidence on grievance and the role of democratic institutions – or lack thereof – as contributing factors to violence. Gurr (2000) suggests that in undemocratic societies, disenfranchised groups are more likely to rebel rather than engage in nonviolent forms of protest. Several recent studies establish a negative link between level of democracy and civil war onset (Elbadawi and Sambanis 2000, Sambanis 2001b), although these studies deal with democracy levels rather than changes in democratic institutions, which seem more likely to be associated with unrest (Gurr 2000, Sambanis 2001a).

preconditions are manifest in both the economic and political spheres and include pervasive poverty, slow growth, ethnic and linguistic polarization between Palestinians and Israelis, persistent imbalance of power which the PP did not ameliorate despite Palestinian expectations to the contrary, thereby fueling Palestinians' perception of grievance, limited political rights for Palestinians, inability to meet basic human needs, and ultimately the incomplete nature of the contract represented by the PP and the peace process as a whole under which setbacks and violations are not remedied through enforcement and dispute settlement mechanisms. In looking to the future, especially from the perspective of the current economic and political crisis, the prospects for normalization and meaningful Palestinian development in the long run will depend on eliminating or at least reducing the factors that foster conflict.

Study objectives

1.21 Policy options for future economic relations between Israel and WBG under a final peace accord are integrally linked to the ultimate shape of the accord. Moreover, in assessing economic policy options to replace the PP, it is crucial to consider the implications of policy choices on the preconditions of conflict, given that policy effectiveness will depend on the environment with respect to these preconditions. This analysis addresses issues central to Palestinian development options in the medium-to-long term within the framework of its economic relations with Israel: trade and labor policy, the business environment, and the resulting prospects for economic growth. Taking account of the uncertainty regarding future political and economic relations between the PA and Israel, the study identifies five scenarios reflecting different trade regimes, magnitude of labor flows to Israel, nature of borders and mobility of goods, inter alia. These scenarios reflect future options for economic relations between the two economies, ranging from increased economic integration – along the lines of the current arrangements of the PP and open borders – to more separate economies. The study's principal objective is to quantify the long-term economic dimensions of these options and the resulting growth and welfare implications, in order to inform the debate surrounding final status negotiations by clarifying the trade-offs associated with each policy choice. However, because of the fundamental role of political pressures and the tenuous present environment, the study refrains from drawing conclusions as to which path holds the best prospects for stabilization and growth in the broader political-economic context.

1.22 In light of the uncertainty surrounding the ongoing crisis and prospects for reaching a permanent peace agreement, this analysis does not explicitly tackle the role of the state and the PA, but instead approaches the issue indirectly by considering specific policy areas that are integral to the function of any state. Several policy areas important to economic development and growth which are not addressed in the analysis include social protection, fiscal policy, and monetary arrangements. Social protection issues are a priority in WBG, given the high incidence of poverty and

volatile economic environment, greatly exacerbated by the current crisis. For this reason, a separate analysis of Palestinian safety nets is being carried out by the World Bank in an effort to complement the findings herein but also to provide a thorough treatment of social protection. Fiscal management is an area in which considerable analysis has been conducted in the past. Nevertheless, trade-related fiscal policies – accounting for a majority of PA budget revenues – will be addressed in this study. And finally, although monetary policy and national currencies present perhaps the most visible day-to-day evidence of economic relations between separate economies, the current arrangement of multiple official circulating currencies (Israeli shekel, Jordanian dinar and US dollar) achieves the objectives of any monetary policy: financial stability, convertibility, low interest rates, access to foreign financial centers, and trade transactions efficiency. Although sovereignty is likely to bring pressures to introduce a national Palestinian currency, the substantial costs and risks of doing so suggest that policy considerations in this direction are premature in the current economic environment (see de la Piedra and Gulde 1999 for a detailed discussion).

1.23 The remainder of the study is organized as follows. The current Palestinian-Israeli trade policy is described in the next chapter, along with an accounting of the associated costs vis-à-vis alternative trade policies. The implications of labor market integration with Israel are examined in Chapter 3 with respect to the effects on aggregate Palestinian unemployment and domestic employment and wage outcomes in WBG. Chapter 4 addresses the mediocre economic performance observed post-Oslo in the context of poor private sector growth due to a constrained business environment. And finally, Chapter 5 examines historical growth trends and the failure of income convergence with Israel. Five scenarios are modeled to consider the long-term growth prospects under a range of policy options guiding future economic relations between WBG and Israel, and several high-case and low-case scenarios are discussed, all of which illustrate the growth-welfare trade-offs associated with future policy options.

Existing Trade Distortions and Future Policy Options

2

Existing Trade Distortions and Future Policy Options

2.1 From 1967 until the signing of the interim peace accord in 1993, Israel exercised full authority over the West Bank and Gaza Strip, including Palestinian trade policy. Despite free Israeli access to Palestinian markets, this arrangement was not reciprocal, evidenced by administrative controls and non-tariff barriers on Palestinian manufacturing goods, and tight limits on agricultural produce from WBG that competed with Israeli production. Moreover, Palestinian producers did not benefit from the extensive public subsidies available to Israeli producers. The de facto one-sided customs union with Israel was formalized under the PP but with three main modifications:

(i) free Palestinian access to the Israeli market, except for five agricultural products on which quotas applied until 1997;

(ii) limited direct Palestinian trade with its Arab neighbors; and

(iii) reimbursement of import taxes collected by Israel but due to the PA (i.e., based on import destination rather than point of entry (Kanafani 2001)).

This chapter describes the existing trade regime and its implications for trade outcomes, and examines a range of alternative trade arrangements that could be implemented under a final negotiated agreement, specifically a modified customs union, a non-discriminatory trade policy, and a free trade area.

2.2 Future trade policy options are constrained by today's starting point of high integration with the Israeli economy, especially with respect to trade. In 1998, WBG imported a total of US$3.2 billion in goods and services (75 percent of GDP), US$2.4 billion of which was imported from Israel including indirect imports (see Figure 2.1).[3] WBG exports amounted to US$730 million, with close to US$700 million or 96 percent destined to Israel (see Figure 2.2). The importance of Israel as a trading partner cannot be reversed overnight nor even in the long run; nevertheless, the shape of trade relations between WBG and Israel and the shared responsibility for managing them are central. The various policy options considered below not only affect economic outcomes, but also have implications for sovereignty and political control. A customs union (CU) allows free trade between member countries but constrains them to a common external trade policy – in this case determined by Israel. A free trade area (FTA) also frees trade between the member countries of the FTA, but each maintains its own trade policy with respect to third-party countries. A non-discriminatory trade policy (NDTP) implies that a country sets its trade policy unilaterally and provides no preferential access, charging the most favored nation (MFN) tariff.[4] Therefore, a CU provides less political control by the Palestinian authorities than an FTA, and an FTA provides less policy flexibility than an NDTP.

Figure 2.1: WBG Imports by Origin

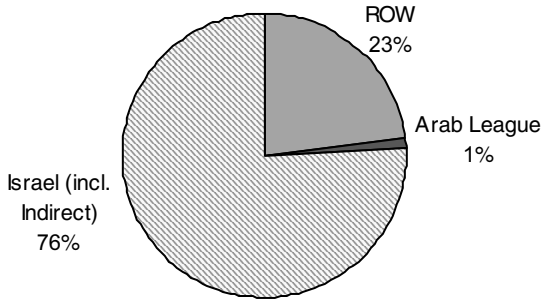
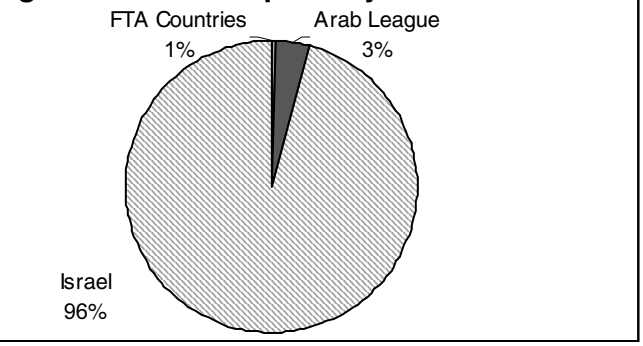


Figure 2.2: WBG Exports by Destination



2.3 Previous studies have argued that optimal Palestinian trade policy involves a regional FTA with Israel and Jordan in goods, services, capital and technology (see for example Fischer et al. 1994) on the basis that free trade provides the best

[3] All figures are for 1998, the most recent year for which a complete set of trade and other data is available from PCBS.

[4] The most favored nation (MFN) principle, the underlying principle for GATT and the WTO, states that a country will treat all countries equally from the viewpoint of access to its markets, providing no preferential access to any country.

opportunities for growth in the region. It is essential to note, however, that FTAs and other types of regional agreements represent second-best policies. Assessing the welfare impact of moving from one second-best (the existing CU) to another (the recommended FTA) is not straightforward: an FTA between Israel, WBG and Jordan is not the same as free trade, because it is not free with excluded countries.

2.4 Panagariya and Diwan (1997) recommend that Gaza be converted into a free port modeled on Hong Kong, the success of which hinges critically on a host of related policies including large investments to create a world-class port, warehousing facilities, communications and other infrastructure, and the acquisition of specific skills. A free port also requires simple and transparent rules and regulations, efficient public administration, and streamlined public services currently beyond the capacity of the PA. Whereas WBG could potentially benefit from this port structure, the downside risks are large with respect to sunk costs and low returns if transactions costs remain high due to cumbersome, non-transparent rules and widespread rent-seeking activities. In fact, the performance of free zones in the Middle East has been mediocre, largely attributable to the uncompetitive and restrictive policy frameworks within which these zones operate (Rao 2000).

2.5 This chapter takes a partial equilibrium approach to studying existing trade distortions and future trade policy options by assessing trade issues from a tax revenue and welfare perspective, independent of broader economic factors embodied in the labor market and business climate. The analysis that follows estimates the costs and benefits associated with three alternative trade regimes – CU, FTA, NDTP – assuming that the issue of high transactions costs due to security checks and periodic border closures will be resolved in the long run under a final agreement. This assumption is plausible in a situation of peace accepted by both populations; nevertheless, moving from a signed formal peace agreement to trust on the ground is likely to take time, implying continued high transactions costs for some period. In the former Yugoslavia, for example, trade among the constituent republics still has not returned to its pre-war level, albeit partly as a result of war-related destruction of productive resources (Kaminski and de la Rocha 2001).

Israel's trade regime

2.6 Between 1993 and 1999, Israel implemented an extensive program of trade liberalization, under which the simple average of Israel's MFN tariffs fell from 8.3 percent to 7.5 percent excluding ad valorem equivalents (AVEs) (according to the 1999 WTO Trade Policy Review for Israel). Average manufacturing tariffs declined from 8.5 percent to 7 percent, but average agriculture tariffs increased from 5 percent to 20.6 percent. The range of MFN tariff rates actually widened, from 0-100 percent to 0-250 percent (from 0-40 percent to 0-250 percent in agriculture, and from 0-66

percent to 0-215 percent in manufacturing), and exhibited a high degree of dispersion.[5]

2.7 Israel's recent trade liberalization expanded existing FTAs with the US, the EU and EFTA to include the following new FTA partners since 1993: Canada, the Czech Republic, Hungary, Jordan, Poland, the Slovak Republic, Slovenia and Turkey. Under an FTA, these countries have duty-free access, mainly on industrial products. The recent FTAs extend beyond trade preferences to include provisions on trade-related issues of competition, state aid, intellectual property rights, safeguards, government procurement, and dispute settlement. By increasing the number of FTAs, the average customs duties actually paid fell to only 1 percent (a 50 percent drop between 1993 and 1999). By 1998, 75 percent of Israeli manufacturing imports entered under preferential (mostly duty-free) rates. The increase in the MFN tariff rates on imports of agricultural products is mainly due to tariffication whereby non-tariff measures such as quantitative restrictions are replaced by equivalent tariffs, typically a first step in moving toward more liberal trade. Food, beverage, clothing and footwear receive the highest levels of protection.

2.8 Most imports and domestic products are subject to purchase taxes and the value-add tax (VAT), with goods such as tobacco and alcohol subject to additional taxes. The purchase tax averaged about 10 percent of the value of imports in 1998, or 10 times the average tariff rate, and the VAT is 17 percent.[6]

2.9 Israel further liberalized its trade regime through the following measures:

- coverage of an additional tariff, the safeguard levy, fell from 2.7 percent of tariff lines in 1992 to 0.8 percent in 1999;
- under the Uruguay Round Agreement and the more recent International Technology Agreement, Israel bound its rates on just over half its tariff lines by 1999;[7]
- Israel has not made active use of its anti-dumping legislation, given that no countervailing or safeguard measures allowing for a temporary increase in protection were taken between 1993 and 1999; and

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[5] Standard deviation was 15.5 percent on the 8.7 percent average MFN tariff including AVEs in 1999, with a coefficient of variation equal to 1.8.

[6] The average purchase tax was reduced by an estimated 10 percent in 2000.

[7] However, many of these were above the applied MFN rates, generating uncertainty for investors and importers. This could be mitigated by binding at applied rates and by increasing the tariff line coverage.

- Israel improved customs valuation and abolished the *harama* system which increased the value of imports by 2 to 10 percent before tariffs.[8]

2.10 With respect to non-tariff measures (NTMs), 8.5 percent of tariff lines were subject to import licenses as of 1999, and 39 percent of tariff lines were subject to standards. For agriculture, the ratios were 23.5 percent and 85.8 percent respectively, compared to 7.7 percent and 37.1 percent for manufacturing, implying that agriculture is the more protected sector, both in terms of tariffs and NTMs.[9]

2.11 Trade with WBG under the PP. By virtue of belonging to a modified CU, tariffs and purchase taxes on individual tariff lines are identical for Israel and WBG. The arrangement between Israel and the WBG codified in the PP is known as a "modified" CU because WBG has access to a limited range of imports from Arab League member countries (goods on lists A1, A2 and B of the PP), whose 1998 value amounted to US$35 million, just 1.1 percent of total WBG imports. Identical tariff and purchase tax rates do not imply that average protection rates are the same, however, due to differences in the composition of imports. WBG imports are in fact skewed towards high-protection goods, reflected by the high average tax rate (average MFN tariff rate plus purchase tax) of 16.6 percent in WBG, 50 percent higher than the 11 percent average rate observed in Israel (Astrup and Dessus 2001a; WTO 2000).

Pros and cons of a customs union with Israel

2.12 The following analysis examines the costs and benefits of maintaining a customs union with Israel (see Table 2.1 for a breakdown of gains and losses), and explores ways to make the CU more beneficial for WBG. The relative gains and losses of the CU are measured against an NDTP, assuming that WBG applies the same Israeli MFN tariff rates under the NDTP as under the CU.

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[8] On the other hand, seasonal tariffs and both MFN and preferential tariff quotas (tariff quotas provide concessional rates on imports up to a given quota) were recently introduced, reducing the transparency of the trade regime. Similarly, a wide range of end-use provisions (granting tariff reduction for specified end-users) were implemented. And for some MFN tariff quotas, the concessional rate is higher than the applied rate and is therefore redundant.

[9] Israel's mandatory standards are increasingly being aligned with international standards as part of obligations undertaken in the Uruguay round. By 1999, about 25 percent of the mandatory standards were equivalent to the international ones. Israel has also made extensive commitments under the GATT, especially in the financial services area, providing legal security for market access. It is also a party to the 1997 Agreement on Telecommunications Services (Fourth Protocol), the 1997 Information Technology Agreement (ITA), and the 1997 Agreement on Financial Services (Fifth Protocol), the WTO Trade-Related Aspects of Intellectual Property Rights (TRIPS) and the WTO Government Procurement Agreement (GPA).

Losses

2.13 There are three sources of economic losses for WBG under a CU arrangement with Israel. The first consists of lost revenue from border taxes and VAT leakage associated with indirect imports, the second consists of a net transfer due to the trade deficit with Israel and differences in average border taxes, and the third – harder to quantify – relates to standards. These costs are first calculated relative to an alternative NDTP trade policy by WBG toward Israel.

2.14 Tariff and purchase tax. Israel charges both a tariff and a purchase tax on imports from the rest of the world (ROW), including on imports that are destined for WBG. Palestinian imports from the ROW that transit through Israel enter in one of two ways, either as direct imports to WBG with the WBG destination clearly identified, or as indirect imports whose destination is declared as Israel and goods are subsequently exported to WBG. Indirect imports are imported by Israeli firms and then either re-exported to WBG (possibly without the knowledge of the original importer) or purchased by Palestinians such as those working in Israel and transported to WBG.

2.15 Tariff and purchase tax revenues on direct imports are transferred by Israel to the PA (less a 3 percent service charge) through a clearance system. This is not the case for indirect imports, however. Of the US$3.2 billion in total imports to WBG, direct imports from the ROW account for close to US$800 million (US$423 million from FTA countries, US$35 million from Arab League members, and US$312 million from others, as reported in Table 2.1). Imports from Israel – including both Israeli products and indirect imports – account for the rest (data are for 1998). Although the level of indirect imports is unknown, it is assumed equivalent to direct imports, implying that imports of Israeli products amounted to US$1.6 billion, or half of total of imports by WBG. WBG captures neither the import tax revenues nor the purchase tax revenues on indirect imports, although these taxes are included in the price that WBG pays for its indirect imports. Given an average Palestinian tax rate of 16.6 percent (import tariff plus purchase tax), tax revenue (and welfare) losses on indirect imports from the ROW amount to US$133 million, or 3.2 percent of GDP (refer to Table 2.1).[10, 11]

2.16 VAT. Israel charges a VAT of 17 percent on imports and domestic sales, and VAT revenues for direct imports into WBG are transferred to the PA. WBG importers of products from Israel (either produced in Israel or indirect imports) who

[10] This estimate is somewhat lower than the 4 percent of GDP in 1996 and 1997 (equivalent to US$160 million in 1998) estimated in European Commission (1999).

[11] There are no losses incurred on direct imports under the CU compared to an alternative NDTP, since switching to an NDTP would not change the level of border taxes collected on direct imports but only the location at which they are collected, i.e., on the border between WBG and Israel rather than the Israeli border with the ROW.

pay the Israeli VAT can apply for reimbursement; if so, the VAT will not affect the price of Israeli products sold in WBG. Some leakage is likely, however; not all transactions are reported, either because the transactions costs involved are higher than the expected refund, or to avoid paying the VAT. The size of this phenomenon is unknown, and similar leakage is likely under an NDTP, although probably to a lesser extent because an NDTP entails border controls. Assuming that leakage under the CU is larger than under an NDTP by 10 percent of imports (US$240 million), the loss of revenue (and welfare) for WBG amounts to an estimated 17 percent of US$240 million, or US$41 million.

2.17 Transfers. The WBG as a whole exports about US$700 million per year to Israel and imports US$1.6 billion worth of products *produced* in Israel, indicating a US$900 million trade deficit. The resulting negative transfer for WBG is exacerbated by its higher protection, as follows. WBG protects its domestic output through trade taxes amounting to 16.6 percent on imports from the ROW. Under the CU, Israel exports its own output to WBG at zero tariff, implying a loss of tax revenue for WBG, but this is partially offset by a revenue gain arising from Israel's lower average protection (11 percent), since WBG exports to Israel at a higher price because it does not pay the 11 percent trade taxes under the CU.[12]

2.18 These transfers are not simply equal to the product of the level of protection and the value of imports or exports, for the following reasons. First, part of that trade may be in non-tradable goods and services, and prices of non-tradables are not directly affected by protection.[13] Second, domestically produced goods and those imported from the partner and from the ROW may not be perfect substitutes, even within the same tariff line. Assuming heterogeneity, these goods are imperfect substitutes and their domestic price does not change by the full amount of protection; under homogeneity, however, prices do change by the full amount of the protection in small open economies like Israel and WBG.

2.19 With respect to services, those services produced by Israel and exported to WBG amount to some US$492 million (out of total exports of US$1.6 billion). The share of non-tradable services in these exports amounts to US$394 million, or about 80 percent (see Annex III), indicating that total exports of Israeli goods and services to WBG that are *internationally* tradable equal US$1.228 billion (see Table 2.1). On the other hand, WBG exports US$51 million of services to Israel, US$40 million of

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[12] The welfare gain for Israel of not paying these taxes is smaller than the loss for WBG because of the inefficiency due to the trade diversion associated with the CU (some of Israel's exports to WBG are produced at a higher cost than the cost of importing from the rest of the world). Similarly, the benefit for WBG from the higher export price is somewhat smaller than the revenue loss for Israel, because part of the WBG exports are produced at a higher cost than the cost of importing the same goods from the rest of the world.

[13] Even if prices of non-tradable goods and services are indirectly affected by protection, as long as there are no distortions in the non-tradable market, changes in their prices or output have no welfare implications.

which are assumed to be non- tradable (i.e., assuming the same degree of non-tradability – 80 percent). Furthermore, some merchandise exports from WBG to Israel are not traded internationally, namely stone exports, which amount to 11 percent of total WBG exports to Israel (US$77 million). Taken together, total WBG exports to Israel of internationally tradable goods and services is estimated at US$580 million (see Table 2.1).

2.20 These figures imply that, assuming perfect substitutability between domestically produced goods and imports (i.e., homogeneity), WBG loses a total of US$204 million on its imports of Israeli goods and services under the CU (16.6 percent of US$1.228 billion), because Israel can sell at the higher price in WBG due to WBG's tariffs with the ROW, but WBG does not collect any tariff revenue on these imports. On the other hand, WBG gains US$64 million (11 percent of US$580 million), leading to a net transfer loss of US$140 million. Under heterogeneity, on the other hand, the net loss may be smaller, but requires information on elasticities of substitution in production and consumption of domestic and imported products, which is not available.

2.21 Total losses to WBG arising from indirect imports (loss of tariff and purchase tax revenues and VAT leakage) and transfers together sum to US$314 million under the CU with Israel, compared to an NDTP (see Table 2.1).

2.22 Smuggling. The preceding calculation reflects perfect border tax collection assuming that the PA can control its borders completely. However, given the porous nature of the border – specifically between the West Bank and Israel – smuggling is likely to occur, such that WBG will collect only part of the border taxes due, even under an NDTP. A leakage of 20 percent may seem reasonable, but a leakage of 40 percent is assumed here to show that an NDTP is preferable to the CU even under assumptions that favor the CU. Therefore, if 40 percent of Israeli exports enter WBG undetected, the authorities will collect only 60 percent of the US$204 million in potential trade tax revenue, or US$122 million. Some of the US$82 million in lost trade tax revenue will be wasted in resources spent to avoid detection, but the rest is likely to accrue to Palestinian traders and customs officials. Assuming that half the lost revenue is wasted and half accrues to Palestinian traders, the welfare loss for WBG associated with the CU amounts to US$163 million (US$122 million of revenue plus US$41 million accruing to traders and customs officers). Given WBG's gains of US$64 million on exports to Israel, the *net* welfare loss for WBG with smuggling becomes US$99 million. Therefore, depending on the degree of leakage and the rents smugglers collect, the loss due to net transfers ranges between US$99 million and US$140 million (see Table 2.1).

Table 2.1. WBG Trade and Cost/Benefit Analysis of CU vs. NDTP				
	Trade values (US$ mn)	**Distortions of CU (relative to NDTP)**	**Net Gain, no smuggling**	**Net Gain, 40% smuggling**
Total Imports	3,192			
- from Rest of World	770			
FTA Countries	423			
Arab League	35			
Other	312			
- from Israel	2,422	VAT leakage on 10% of imports[a]	-41	-41
Indirect imports	800	Uncollected tax 16.6%	-133	-133
Israeli products	1,622	*A. Net taxes:*	*-174*	*-174*
- Non-tradable services	394			
- Tradable goods, services	1,228	Welfare loss from trade deficit (16.6%)	-204	-122 - 41[b]
Total Exports	727			
- to FTA Countries	5			
- to Arab League	25			
- to Israel	697			
Non-tradable services	40			
Non-tradable stones	77			
Tradable exports	580	Welfare loss from trade deficit (11%)	64	64
		B. Net transfers:	*-140*	*-99*
		Subtotal (A+B):	*-314*	*-273*
		Savings on border costs	48	48
		Net gain of CU:	**-266**	**-225**

[a] VAT is 17 percent.
[b] Lost smuggling revenue
Source: PCBS data for 1998, World Bank estimates

2.23 Sum of losses. The sum of WBG losses under the CU compared to an NDTP (i.e., lost revenues from tariff, purchase tax and VAT, and negative transfers due to the trade deficit with Israel) ranges from US$273 million to US$314 million, or between 6.4 percent and 7.3 percent of the GDP of WBG. In present value terms (with a real discount rate of 6 percent), this loss amounts to between US$4.5 billion and US$5.2 billion, or between 106 percent and 122 percent of GDP. Total tax revenue losses under the CU (without the US$64 million WBG welfare gain) amount to US$337 million in the presence of smuggling (6.9 percent of GDP) and US$378 million in the absence of smuggling (8.8 percent of GDP).[14] These estimates of welfare and tax losses under the CU therefore suggest that replacing the CU with an

[14] Total tax revenue losses exclude the welfare gain of US$64 million because it accrues to exporters and not to tax or customs authorities.

NDTP should enable the PA to lower border or other taxes significantly without incurring net revenue losses and simultaneously generating additional welfare gains.

2.24 Transactions costs. One issue not examined thus far is the impact of transactions costs. How will a reduction in transactions costs affect the comparison between the CU and an NDTP? If transactions costs decline in the context of a final status agreement, trade between Israel and WBG will increase. Pre-crisis transactions costs on exports from WBG are estimated at 35 percent (Astrup and Dessus 2001a), while those from Israel to WBG are smaller, probably around 15 percent. Assume that under a peace agreement transactions costs decline substantially for both trade parties, with a larger relative decline for Palestinian traders. The resulting higher volumes of trade between WBG and Israel lead to greater tax revenue losses under the CU compared to an NDTP, but these are offset by larger welfare gains from higher WBG exports to Israel (see Schiff 2001 for details of the calculation). The reduction in transactions costs does not have a significant impact on the welfare comparison between the CU and an NDTP because the two sets of effects effectively cancel each other out. The conclusion is the same with or without smuggling.

2.25 Standards. Israel imposes various standards on imports into the CU, affecting 39 percent of tariff lines. Standards requirements are imposed for the public good (e.g., sanitary and phyto-sanitary standards in agriculture, and technical standards in industry) but also as a protectionist device. Regardless of the underlying rationale, Israeli standards result in costs for WBG. The optimal level of public-good standards is in part a function of the income of the society that imposes them, such that Israeli standards are set too high for WBG, given its sharply lower income levels (WBG income per capita is only 10 percent of that of Israel). Furthermore, protectionist standards imposed to shield Israeli industry from competition do not necessarily benefit Palestinian industry. Under an NDTP, WBG could impose standards that suit its own development needs, but also with the option to protect its own inefficient sectors. The potential net impact of WBG-imposed standards is therefore unclear.

Benefits

2.26 There are two types of benefits from a CU, one associated with avoiding the costs of establishing and administering alternative trade arrangements with Israel, and the second relating to issues of political economy.

2.27 Customs administration. Under the CU, WBG avoids the costs associated with setting up customs borders (training personnel, building customs posts, buying computers and other administrative infrastructure) and collecting taxes to capture differences in VAT, excise and tariff rates on third-party trade. The operating cost of border stations has been estimated at 1.5 percent of the value of imports (Daoud

2000), implying savings of US$48 million on US$3.2 billion in imports.[15] The resulting net loss of the CU becomes US$262 million (6.1 percent of GDP) in the absence of smuggling, and US$222 million (5.2 percent of GDP) with smuggling (refer to Table 2.1).

2.28 Another important cost that would be avoided under a functioning CU (in the absence of security procedures and delays observed post-Oslo, especially under closures) is the lost income suffered by traders due to delays at the border. This cost could be reduced under an NDTP by simplifying the tariff structure and making it more uniform, thereby reducing the discretionary power of customs authorities and the accompanying lobbying and corruption that complex tariff structures typically entail (discussed further below).

2.29 Political economy. A CU with Israel in effect eliminates Palestinian decision-making over its trade policy, which clearly implies a loss of sovereignty compared to an FTA or an NDTP. It may generate economic benefits, however, contingent upon trade policy under the CU and the trade regime chosen to replace the CU.

2.30 Israel's external trade policy has been liberalized in recent years, as mentioned above, leading to a low average MFN tariff of 7 percent in 1999, overall average tariff of 1 percent, and import licenses on only 8.5 percent of tariff lines. There is room for further liberalization, but because WBG's net trade with Israel is weighted towards agricultural goods, WBG actually benefits from the higher protection provided to agriculture (for a given average protection rate). Although sovereign Palestinian decision-making over its trade policy may lead to a more liberal trade regime in WBG, this is by no means guaranteed.

2.31 Adopting a more liberal trade policy under an NDTP will require political will and political capital by policymakers to withstand pressure from groups with vested interests lobbying for protection. Making difficult decisions for the long-term benefit of the entire population rather than the short-term benefit of particular groups necessitates sufficiently-developed supporting public institutions and appropriate incentive structures. At present, WBG institutions are relatively weak and transparency in public affairs is inadequate (discussed in detail in Chapter 4). The big players on the economic and political fronts in WBG will continue to exert pressure on the government to obtain favors through the political system rather than through

[15] This represents the cost of subcontracting customs operations to a private firm, which is about twice as costly as directly establishing and operating five commercial and five passenger stations, but is likely to reduce leakages and revenue losses associated with PA customs personnel lack of experience and potentially weak enforcement of customs regulations (a universal concern that is mitigated through private contracting). An additional issue is the need for special trading and border arrangements with respect to Jerusalem.

the market.[16] The combination of these institutional and political factors suggests that a liberal and transparent independent Palestinian trade policy is unlikely in the near term, potentially leading to a more restrictive and distorted trade policy under an NDTP than under the existing CU. This in turn risks additional losses due to trade diversion, if WBG imposes significantly higher trade taxes relative to Israeli rates.

2.32 The discipline imposed on Palestinian trade policy resulting from the CU with Israel may represent a major benefit of maintaining the present trade arrangement, as observed in the case of Botswana, a member of the Southern African Customs Union (SACU) under which trade policy is determined by South Africa. Despite South Africa's much higher protection levels compared to Israel, Botswana achieved rapid growth – the fastest growing country in Sub-Saharan Africa in recent years – by taking trade policy out of the hands of its government and interest groups, and allowing energies to concentrate on using market activities rather than the political system to generate income. It is important to note, however, that Botswana received additional compensation from South Africa over and above direct revenue clearances.

Conclusions on CU

2.33 This analysis illustrates that an NDTP with the same structure of trade taxes as the CU is superior to the CU. Whether or not the PA has total control of its borders, the losses associated with the CU relative to an NDTP are large. These losses could be significantly reduced if revenues from border taxes were shared more equitably (such as on a macroeconomic basis similar to under SACU).[17] Welfare under an NDTP could be raised further by unilaterally lowering the level of trade taxes (i.e., MFN tariffs) and rationalizing them. On the other hand, moving to an NDTP risks a more protectionist trade regime in WBG due to strong political economy forces.[18] A "conditional NDTP" in which trade policies are constrained to be liberal is therefore superior to a CU, but a protectionist NDTP may well be inferior.

2.34 Improving the CU. The existing overall CU framework could be improved in several ways. To address WBG revenue losses on tax revenue from the ROW and transfers due to its trade deficit with Israel, one option would be to improve existing notional borders with better labeling and other means to identify goods whose final

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[16] For example, several monopolies were created in WBG in response to quotas on imports from Arab countries defined on lists A1 and A2 of the PP (European Commission 1999). This monopoly solution could be avoided by auctioning quotas in a competitive environment.

[17] South Africa collects all border taxes and shares them with the other members of SACU (Botswana, Lesotho, Namibia and Swaziland). The share of border taxes distributed to South Africa's partners corresponds to each partner's share in SACU's GDP, multiplied by a coefficient larger than one in order to compensate them for the fact that SACU's trade policy corresponds to South Africa's priorities rather than their own.

[18] The evidence from other newly independent states is not reassuring with respect to quality of governance. This is true of most developing countries that became independent following de-colonization, as well as for many of the republics of the former Soviet Union.

destination is WBG. Given the porosity of borders, however, a preferable option may be to share import taxes on a macroeconomic basis (i.e., subject to a macro formula rather than on the basis of individual tax receipts). WBG experiences real income losses due to its trade deficit with Israel (and its own higher average tariff under the CU). One solution would be for Israel to reimburse WBG for these losses. Similar arrangements have been used in other CUs in which the distribution of gains and losses was deemed asymmetric and threatened the survival of the CU. In fact, CUs in Africa, Latin America and Asia collapsed in the past because a favored member refused to renegotiate the distribution of gains and losses.[19] Another alternative would be for Israel to lower its purchase tax, which would also reduce the loss associated with the tax revenue problem.[20]

2.35 By remaining in a CU with Israel, WBG is unlikely to have any say regarding future changes in trade policy. This is clearly unattractive from the perspective of political sovereignty. However, since Israel has pursued trade liberalization in recent years and is more likely to continue in this direction rather than toward greater protection, the economic implications of Israeli control of the trade policy of WBG will not necessarily be adverse. Kessler (1999) argues that Israeli protection probably meets Palestinian needs relatively well, given low MFN tariffs on inputs, raw materials and investment goods, higher tariffs and NTMs on consumer goods, and the fact that most imports from the EU, US and EFTA enter duty-free. These advantages are offset by the costs to WBG through unfavorable Israeli standards by limiting Palestinian trade with members of the Arab League and thus constraining the future development of export markets beyond Israel.

Free trade area with Israel

2.36 Under an FTA with Israel, WBG would establish border controls, and taxes on WBG imports from the ROW would be collected by the PA rather than by the Israeli

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[19] This occurred in the 1960s with the EAC (East African Community) which fell apart because Tanzania and Uganda were dissatisfied with the transfers accruing to Kenya. The same occurred in the 1960s when Honduras left the CACM (Central American Common Market) in reaction to El Salvador's refusal to renegotiate the distribution of tariff revenues. This problem was also a factor in the war in the 1970s between East Pakistan (now Bangladesh) and West Pakistan (now Pakistan), as well as in the US Civil War between the North and the South (World Bank 2000).

[20] WBG uses the Israeli currency (NIS) for most of its transactions, but not as a reserve currency. If WBG had a CU with Israel that included a better distribution of revenues from trade taxes, its relationship with Israel would resemble the one between Luxembourg and Belgium. These two countries were members of a monetary union under which Belgium had a monopoly on monetary policy (until January 1, 2002), and they were members of a customs union (with the Netherlands). Another similarity is that Luxembourg is landlocked and part of its imports enter through the ports of Antwerp and Rotterdam, so that the reimbursement of trade taxes was also an issue. The arrangement seems to have benefited Luxembourg; on the other hand, Luxembourg has the advantages of large, rich and open neighbors (which, as Vamvakidis (1998) shows, has a strong impact on a country's growth) and status as a tax haven.

authorities.[21] The following assessment of the FTA option is first compared to an NDTP and subsequently to the CU. Some of the same costs incurred by WBG under the CU are also present under an FTA. In particular, the negative net transfer ranging between US$99 million and US$140 million under the CU associated with WBG's trade deficit with Israel remains under an FTA but not under a NTDP. In addition, an FTA – unlike a NTDP or the CU – requires rules of origin (ROO) which are costly for the authorities as well as for traders, and for the economy at large.

2.37 Rules of Origin. Replacing the CU with an FTA requires WBG to establish border controls involving a number of significant costs including the establishment and operation of an effective customs administration. Although these costs are also incurred under an NDTP, additional costs arise from controlling for ROO on goods exported by Israel to WBG, one of the principal functions of customs administration under an FTA. This control is necessary to avoid problems of trade deflection under which, for example, products for which WBG has a higher tariff than Israel could be imported by Israeli firms paying the lower tariff, and subsequently sold duty-free in the WBG. Under trade deflection, WBG would in effect lose control over its external trade policy, since deflected trade would become indirect imports and WBG would not collect any of the revenue associated with it; WBG would therefore be better off adopting the lower Israeli tariff in order to eliminate any incentive for trade deflection and so that WBG would at least collect some tariff revenue.

2.38 To avoid these potential losses to trade deflection, the Palestinian customs administration needs to control the origin of goods that it imports from Israel. Ideally, duty-free trade between WBG and Israel should apply to goods that are produced within the FTA bloc (WBG and Israel), and should not apply to goods imported from outside the FTA bloc. While simple in theory, the reality of controlling the origin of goods is complicated because goods may have inputs from multiple source countries. An FTA entails the free movement of *value added* produced inside the bloc, but trade takes place in final goods, not in value added. For example, goods exported by Israel to WBG are likely to incorporate inputs imported from outside the FTA bloc, in which case only the value added (VA) is considered to be produced inside the bloc, implying that only the portion of the good produced inside the bloc (i.e., the value added in Israel) enters duty-free, and the remainder is subject to the WBG tariff. To address this phenomenon, rules are implemented to control – imperfectly – for the origin of goods, by setting a threshold share of value-added produced inside the bloc over total product value above which a party obtains preferential access to its partner's market for a given product.[22]

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[21] As under an NDTP, special trading and border arrangements would be necessary vis-à-vis Jerusalem.

[22] Under other ROO, a product is considered to be produced inside the bloc if (i) it involves a substantial transformation of the inputs from outside the bloc, where the criterion typically is that the

2.39 Additional costs of ROO. Attempting to solve the problem of trade deflection through ROO creates added difficulties, however. This analysis considers five potential problems (based on Krueger 1997). First, ROO can lead to additional trade diversion and welfare loss, as follows. Assuming that WBG can import inputs either from Israel or from the ROW, inputs from the ROW will not comply with the ROO and thus WBG will not receive trade preferences on its exports to Israel (i.e., WBG will have to pay the tariff). If the cost of the inputs from the ROW is 50, for example, while the cost of the same inputs from Israel is 60 because of 20 percent protection on them, but the tariff that Israel charges on imports of the final good from the ROW is 20, then it is advantageous for WBG to buy the expensive inputs in Israel because, even though they cost 10 more, WBG avoids paying 20 on its exports to Israel. In this illustration of trade diversion, the ROO resulted in an efficiency loss of 10, a misallocation of resources (in this case to Israel, which is producing inputs inefficiently), and a transfer of 10 from WBG to Israel.

2.40 Second, complying with ROO is likely to be harder for small countries. WBG has a much smaller economy than Israel. As such, WBG is significantly more dependent on imported inputs and components needed for production compared to Israel, making it relatively harder to comply with ROO requirements. This implies that for a number of products, either WBG will have to pay the Israeli MFN tariff on its exports to Israel, or it will have to buy more expensive Israeli inputs.

2.41 Third, ROO are quite complex, and enforcing them is very costly for the authorities and even more so for exporters. The rule book describing NAFTA's ROO is 200 pages long. Enforcing such complex rules entails a variety of additional costs over and above the standard costs of customs administration in the case where MFN tariffs apply to all countries. Proving origin (including obtaining all the necessary documents) is costly for exporters, estimated by Herin (1986) at 3 to 5 percent of the f.o.b. price for EFTA countries. In WBG (poorer and less experienced in customs administration than EFTA countries), costs of border delays are likely to be even larger. By forming an FTA with Israel in addition to existing FTAs with the EU and the US, WBG imports from FTA regions would amount to about US$2.8 billion, implying exporters' compliance costs in the range of US$85-142 million, which gets passed on to importers through higher prices.[23] These additional costs reduce the net benefit of the FTA over the CU to near zero.

2.42 Fourth, ROO are used as protectionist devices to restrict the free movement of goods between partners. Under a future FTA, producers in Israel might insist on restrictive ROO to prevent competition from cheaper Palestinian imports, for example. This is what occurred under NAFTA in the textile sector. In order to protect its textile industry from Mexican imports, the US insisted on the "triple

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tariff line of the product differs from that of the inputs (e.g., automobiles versus steel), or (ii) an essential component is produced inside the bloc (e.g., the motherboard for computers).

[23] This estimate is consistent with Astrup and Dessus (2001a).

transformation test" as a ROO, requiring that the yarn, cloth and garments all have to be fully produced within NAFTA in order for Mexican exports to enter the US duty-free. As a result, Mexican producers must buy all their inputs from inside NAFTA – potentially at a higher costs – in order to obtain NAFTA preferences. This example illustrates how restrictive ROO reduce competitiveness and could potentially reduce the duty-free access of WBG exports to Israel.

2.43 Fifth, Israel currently has an FTA with Jordan, and WBG is likely to consider entering an FTA with Jordan under a final status agreement. Moreover, WBG already has FTAs with the US and the EU (and with Turkey through its CU with the EU), and may choose to enter into additional FTAs in the future (following Israel's example of FTAs with various Central and Eastern European countries). An independent Palestinian trade policy implies establishing ROO for each FTA, leading to a "spaghetti bowl" situation (a term originally applied to overlapping FTAs in Latin America) of overlapping FTAs, greatly complicating the administration of ROO and increasing its cost.

2.44 The five points enumerated above indicate that ROO can be very costly – both directly and indirectly through their distortionary effects – especially for a small economy like WBG whose growth relies on foreign markets. On the basis of direct costs alone, an FTA with Israel is less desirable than an NDTP, since the welfare gains from abandoning the CU are more than offset by the cost to exporters of establishing the origin of their goods (ranging from US$85 million to US$142 million) plus the negative transfers (ranging from US$99 million to US$140 million, under smuggling and no smuggling, respectively). The resulting benefit of an NDTP relative to an FTA ranges from US$184 million to US$282 million (see Table 2.2), or from 4.2 percent to 6.5 percent of GDP, not including other difficult-to-quantify FTA costs associated with ROO.

2.45 FTA with Jordan. A future trade policy in which WBG enters an FTA with Jordan only, and not with Israel, still requires rules of origin and the same large associated costs discussed above. Furthermore, Jordan has been liberalizing its economy in recent years as well, such that WBG is unlikely to gain more from new preferential access to Jordan than it will lose from providing preferential access to Jordan in its own market.

2.46 FTA with Israel versus CU. The above analysis illustrates that a liberal NDTP is superior to both the CU and an FTA. What about the choice between an FTA and the CU? Border taxes and VAT on indirect imports will be collected under an FTA but not under the CU, amounting to a gain of US$174 million for the former (net taxes identical to Table 2.1 above). On the other hand, an FTA requires border controls and customs administration, whose annual operating costs (exclusive of set-up costs) are estimated at US$48 million. The additional costs to exporters associated with ROO under an FTA will reach an estimated US$85 million to US$142 million

Table 2.2: Cost/Benefit Analysis of FTA vs. NDTP				
	Trade values (US$ mn)	**Distortions of FTA (relative to NDTP)**	**Net Gain, minimum**	**Net Gain, maximum**
Total Imports	3,192			
Arab League, Other	347			
FTA Countries incl. Israel	2,845	Exporters' compliance w/ ROO	-85[a]	-142[b]
		Net transfers, no smuggling (Table 2.1):	*-140*	*-140*
		Net transfers, smuggling (Table 2.1):	*-99*	*-99*
		Net Gain of FTA, no smuggling:	**-225**	**-282**
		Net Gain of FTA, smuggling:	**-184**	**-241**

[a] Compliance cost 3 percent of total imports.
[b] Compliance cost 5 percent of total imports.
Source: Based on PCBS data for 1998, World Bank estimates

(per Table 2.2). The resulting net gain of an FTA relative to a CU ranges from +US$41 million to -US$16 million, and averages 0.3 percent of GDP. This calculation does not include other important costs associated with ROO, including: trade diversion and welfare loss typically associated with ROO – a major problem for a very small economy like WBG; the tendency of ROO to become a protectionist device, creating additional welfare losses; and the cost of administering the ROO. Taking into account *all* the costs associated with the FTA, the CU with Israel is preferable to an FTA.

Conclusion on choice of trade regime: NDTP, FTA or CU

2.47 This analysis compares the costs and benefits associated with three different trade regimes potentially under consideration under a final status agreement between WBG and Israel, namely a CU, an FTA and an NDTP. In a partial equilibrium framework, the net welfare gains are greatest in moving from the CU to an NDTP, but only in the context of open and transparent trade policy enforced by credible lock-in mechanisms. Otherwise, a CU with Israel is likely to be preferable. An FTA involves larger direct and indirect net costs than either a CU or an NDTP.

2.48 The costs incurred by WBG associated with the CU trade regime with Israel – although large – are offset to a great degree by the integration of the Palestinian and Israeli labor markets through Palestinian access to high-paying Israeli jobs, as will be demonstrated in Chapters 3 and 5 below.

Labor Market Outcomes

3

Labor Market Outcomes

3.1 Labor outcomes in the Palestinian economy are the result of competing internal and external forces affecting labor supply and demand. The historical trends in Palestinian employment and unemployment both pre- and post-Oslo indicate an important role for Israeli labor demand of Palestinians and the de facto mobility of Palestinian workers. This analysis uses labor force survey data from PCBS to assess the key features of the Palestinian labor market, trends in employment outcomes, and distortions affecting labor supply and demand decisions. Based on an understanding of these factors, the analysis in this chapter models the partial equilibrium impact of future changes in labor flows to Israel. The prospects for continued or increased labor market integration under a final status agreement depend on the future nature of borders and trade policy, with significant implications for employment and wages in the domestic economy.

Historical labor trends

3.2 The Palestinian labor market can be broadly characterized by a rapidly expanding labor force with shifting age and educational attainment structures, large Palestinian labor flows to Israel, high unemployment, a large civil service, and regional differentiation between the West Bank and Gaza Strip.

3.3 Fast-growing labor force. The Palestinian labor force is currently growing at an annual rate of 4.4 percent, in response to two pressures: population growth and increasing labor force participation. Population growth during the 1980s averaged 3.2 percent, and domestic (i.e., within the Palestinian Territories) labor demand was insufficient to absorb the growing labor force, leading many to seek employment in other markets, notably in Israel and the Gulf states. Annual population growth surged to 6 percent in the early 1990s, driven by the repatriation of Palestinians following the

outbreak of the Gulf War. On top of natural demographic pressures, labor force participation rates rose steadily from 40 percent during the first half the 1980s to an average of 44 percent through 1993 (Diwan and Shaban 1999). The resulting labor force growth overwhelmed the domestic labor market and gave rise to unemployment and precipitated exit from the labor force. The decline in participation in the aftermath of the Oslo accord was followed by a gradual recovery as mobility constraints eased and Palestinian employment in Israel increased (discussed below).

3.4 In 2000, labor force participation averaged 41 percent of Palestinians age 15 and over, implying a labor force numbering nearly 700,000 out of a working-age population of 1.7 million. Note that of a total population of 3 million, nearly half are under age 15, suggesting a very young population structure. A closer look at participation rates reveals substantial regional segmentation. For example, Gaza exhibits a lower labor force participation rate of 38 percent compared to 44 percent in the West Bank in 2000; although one-third of the population resides in the Gaza Strip, only 29 percent of the total Palestinian labor force reside in Gaza.

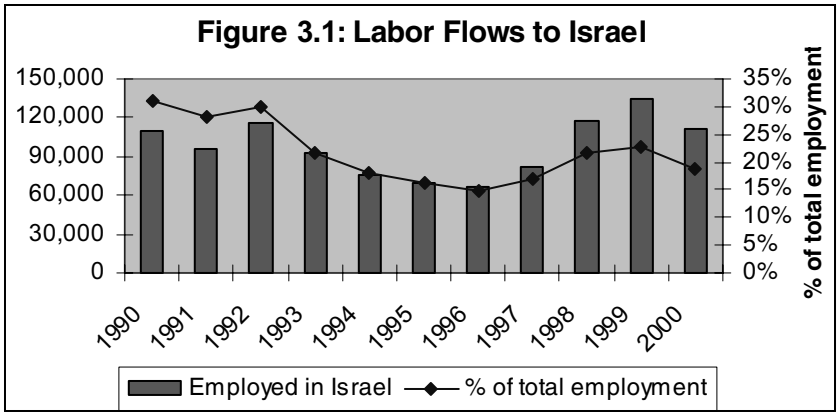
3.5 The observed low participation rates in WBG are driven by low female participation which averaged 13 percent in 2000, compared to 71 percent for males. As a result, women constitute 15 percent of the total Palestinian labor force, and only 10 percent of the Gazan labor force, pointing to even lower female participation rates in Gaza relative to the West Bank. Female labor force participation in WBG is low even compared to other countries in the MENA region, as illustrated in Table 3.1.

Table 3.1: Labor Force Participation in MENA Countries (%)[a]

	Female	Male
Algeria	24	76
Egypt	22	73
Iran	25	79
Jordan	22	76
Lebanon	27	76
Morocco	40	79
Syria	26	78
Tunisia	35	79
WBG[b]	13	71
Yemen	29	82

[a] Data from 1995-1997 [b] 2000
Sources: ILO, PCBS

3.6 Labor flows to Israel. The economic integration of the Palestinian and Israeli economies observed with respect to trade extends to a lesser but still important extent to labor services. Israel's 1967 occupation of the Palestinian Territories effectively opened the Israeli labor market to Palestinian job seekers. During the 1970s and 1980s, Palestinian workers could move freely into Israel, and jobs in Israel accounted for more than 30 percent of total Palestinian employment, peaking around 1987. Israel introduced work permit requirements in 1991 to control the entry of Palestinian workers, with permits issued subject to selective qualifying criteria (i.e., based on gender, age, and marital status) and prohibiting workers from spending the night in Israel. The resulting limits on labor mobility led to a decline in Palestinian employment in Israel, to 22 percent by 1993 (see Figure 3.1).



3.7 The Oslo accords marked a fundamental shift in Israeli labor policy, as permit requirements and other mobility restrictions such as border closures were enforced. Strict border controls were introduced along the perimeter of the Gaza Strip, but monitoring is less rigorous in the West Bank due to its porous borders. Workers commuting between Gaza and the West Bank, or between separated areas of the West Bank, are also subject to security checks and limits on their movements.[24] Since 1993, Israel has imposed periodic episodes of severely restricted labor mobility, especially in 1995 and 1996 and again most recently under the intifada. Under "comprehensive" closures, Palestinians are effectively constrained to remain in their home villages.[25] Although large numbers of Palestinians from the West Bank manage to cross illegally into Israel, total labor flows are reduced sharply during closures. The combined effect of permit requirements and closures discouraged Israeli labor demand for Palestinians by raising the cost of labor. Figure 3.1 illustrates the sharp decline in Palestinian labor flows to Israel during the post-Oslo period, to a low point of 15 percent of total employment in 1996 (Diwan and Shaban 1999). In response, Israeli employers sought alternative sources of labor, facilitated through liberal immigration policies adopted to encourage the importation of foreign workers into Israel (Bartram 1998). Israeli security controls eased during 1997 and 1998, and by 1999, labor flows to Israel rebounded to 23 percent of total Palestinian employment, with more than 130,000 Palestinians commuting daily to Israel. By the third quarter of 2000, labor flows to Israel reached 146,000, but fell sharply thereafter with the emergent crisis, pulling the yearly average share of labor flows below their 1999 level.

3.8 Israeli jobs pay considerably higher wages than jobs in the domestic Palestinian market, reflecting Israel's large and well-developed economy, more modern productive capacities, and high per capita income levels. Although the relatively free movement of Palestinian labor prior to the mid-1980s led to a near closing of the gap between wages earned by Palestinians employed in Israel and those employed within WBG, a significant wage gap re-emerged and has persisted since the

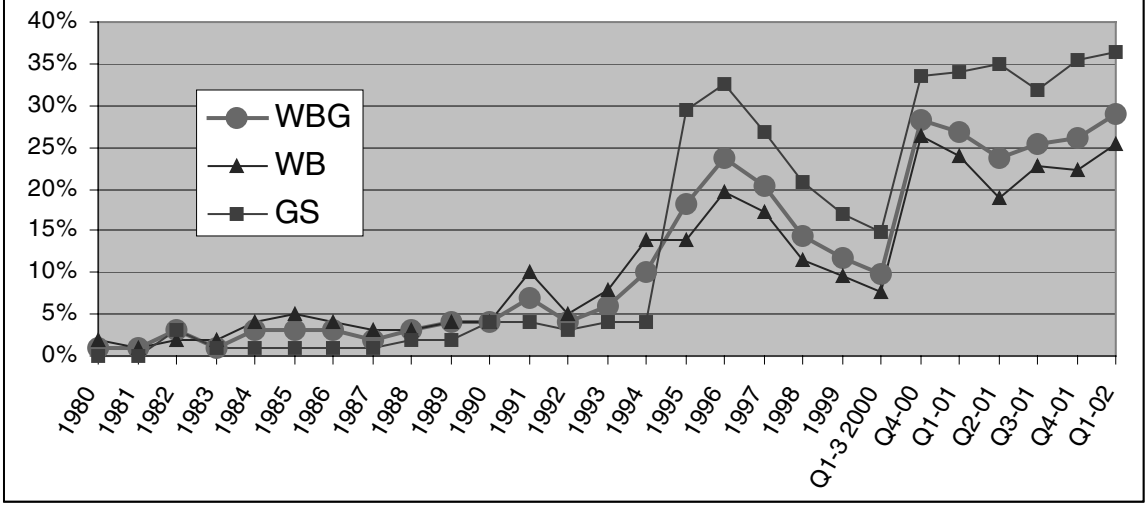
[24] The situation improved only marginally with the introduction of a "safe passage" between Gaza and the West Bank, because access remained subject to narrow qualifying criteria.

[25] During the current crisis, mobility restrictions reached their most extreme level to-date; border closures were in effect *total* for much of the period, and in several cities Palestinian residents were subject to round-the-clock curfews.

late 1980s. Many factors contribute to the higher Israeli wage, such as higher average productivity in Israel, excess Israeli demand for unskilled labor, and features of the Israeli regulatory framework including minimum wage, other protective labor legislation, and payroll tax financing (affecting formal sector workers only).

3.9 Unemployment. Constraints on Palestinian labor mobility – especially border closures – coincide with high rates of unemployment in WBG. Palestinian unemployment was low historically, averaging 3 percent during the 1980s (according to the Israeli Central Bureau of Statistics). Unemployment started to emerge as a problem in the early 1990s, however, and spiked sharply upwards beginning in 1995, reaching 28 percent during the second quarter of 1996 and averaging 24 percent for the year (see Figure 3.2). Because the Gaza Strip is physically cut off from Israel during periods of tight security restrictions, it experiences much higher rates of unemployment compared to the West Bank. Youth are most affected during periods of excess labor supply, as indicated by the 36 percent unemployment rate among workers age 15-24 during the second quarter of 1996 compared to 28 percent for all age groups.

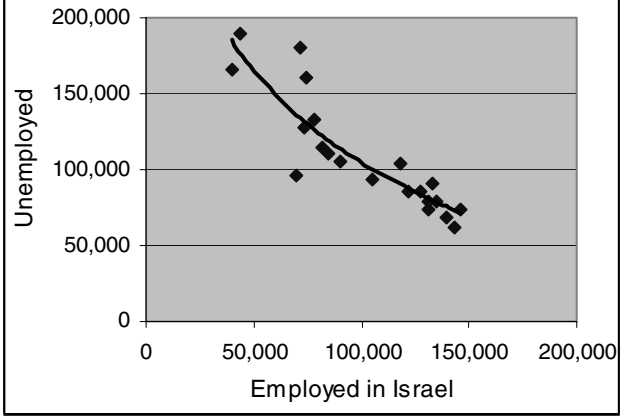
Figure 3.2: Unemployment



3.10 The employment situation improved substantially in 1998, 1999, and the first three quarters of 2000, when unemployment fell below 10 percent (see Figure 3.2). But when conflict erupted in September 2000, unemployment jumped to 28 percent by the end of the year (33 percent in the Gaza Strip) due to Israeli closure policy and the resulting economic recession. The imposition of comprehensive closures and periods of curfew led to the almost immediate loss of 100,000 Palestinian jobs in Israel. The situation improved somewhat during the first half of 2001, with the improvement due to regained access to Israeli jobs from the West Bank only; Gazan workers continued to suffer unemployment rates of 35 percent in Q2 2001 due to the de facto isolation of the Gazan economy. Unemployment subsequently deteriorated

with the intensification of Israeli closures during the second half of 2001 and 2002. Labor demand declined sharply, accompanied by diminishing labor force participation rates, as discouraged workers exited the labor force. The doubling of transportation costs and commuting times to Israel during the crisis (see Annex I for details of the Bank's transport survey) also lowered net real wages. Figure 3.3 illustrates the close negative link between Palestinian employment in Israel and domestic Palestinian unemployment, with a correlation coefficient of –0.88.

Figure 3.3
Correlation of Palestinian Unemployment & Employment in Israel



Profiles of the employed and unemployed

3.11 The preceding analysis of aggregate labor outcomes indicates that Israeli security policy affects Palestinian employment and unemployment levels. Data on individuals can provide additional insight into the factors contributing to labor supply and demand decisions at the level of the individual, that is, decisions by workers and employers. Using micro-level data from PCBS labor force surveys, the analysis that follows describes the profile of the employed compared to the unemployed based on worker characteristics, from which can be inferred the characteristics in demand by employers, as well as worker preferences reflected in labor supply behavior. The data presented below are from the second quarter 1999 labor force survey conducted in WBG with a sample size of about 7,600 households. The results do not differ significantly from surveys conducted in the second quarters of 1996, 1997 and 1998.

3.12 The male/female breakdown of the Palestinian labor force reported in Table 3.2 below is consistent across employment and unemployment, at 85 percent male and 15 percent female. Employed women are older than employed men (ages averaging 35 and 33, respectively), and younger population groups are harder hit by unemployment, reflected by the relatively low average age of the unemployed equal to 29 years. Comparing the educational profiles of workers, outcomes vary by gender. Among males, for example, employed males average 9 years of schooling compared to only 8 years for unemployed males, suggesting that more education increases the likelihood of finding employment. Disaggregating into categories of educational attainment, two-thirds of employed men have only a preparatory education or less. For women, the result is reverse, namely that women with more than a secondary education are more likely to be unemployed, reflected by the fact

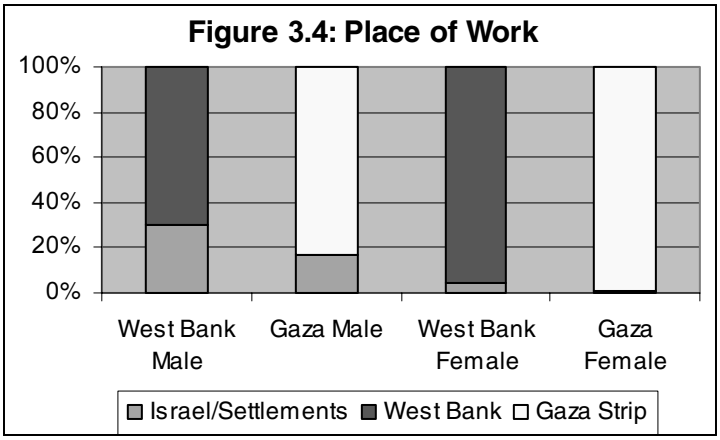
that nearly 90 percent of unemployed women have at least a secondary degree, and 31 percent have a university education (see below). This suggests that women's increasing educational attainment and labor force participation has outstripped private demand for their skills.

Table 3.2: Worker Characteristics[a]

	Employed		Unemployed	
	Male	**Female**	**Male**	**Female**
Share	85.4%	14.6%	85.0%	15.0%
Avg. age	32.8	35.1	29.3	29.3
Avg. years schooling	8.8	9.3	7.9	13.8
Educational attainment:				
Elementary or less	34.4%	37.1%	38.2%	4.7%
Preparatory	31.0%	14.6%	33.9%	7.4%
Secondary	16.8%	10.5%	14.8%	11.9%
Associate diploma	6.7%	20.4%	5.5%	45.1%
BA or higher	11.3%	17.4%	7.5%	30.9%
Resides in West Bank	71.1%	81.8%	55.0%	64.3%
Resides in Gaza Strip	28.9%	18.2%	45.0%	35.7%

NB: May be rounding errors
[a] Respondents age 15-64.
Source: PCBS labor force survey data, Q2 1999.

3.13 Employment outcomes in the Palestinian economy differ by region, with residents of the West Bank representing a majority of total employment disproportionate to the West Bank's population share (see Table 3.2). This is especially the case for employed women, 82 percent of whom reside in the West Bank, while only two-thirds of the female population live in the West Bank. Gaza's higher unemployment rate is linked to its limited access to the Israeli labor market due to physical realities. Nevertheless, a significant 17 percent of employed Gazan men hold jobs in Israel or Israeli settlements (shown in Figure 3.4). In the West Bank, by contrast, 30 percent of employed males work in Israel or the settlements. Few Palestinian women hold jobs in the Israeli market – only 3 percent of all employed women, 4 percent in the West Bank and effectively zero in Gaza. Figure 3.4 also illustrates the lack of inter-regional movement within the Palestinian labor market, whereby West Bankers do not work in Gaza, and Gazans do not work in the West Bank.



3.14 Educational profiles vary by place of work, as Palestinians employed in Israel have considerably less education than their counterparts employed in the domestic Palestinian economy. Figure 3.5 illustrates that nearly 80 percent of Palestinians working in Israel have a preparatory education or less, suggesting that workers with fewer skills have better job opportunities in the Israeli labor market. Workers in Gaza have a slightly higher educational profile compared to those in the West Bank, which may arise from Gaza's smaller market and lower labor demand, encouraging students to remain in school rather than entering the work force.

Figure 3.5: Education and Work Place

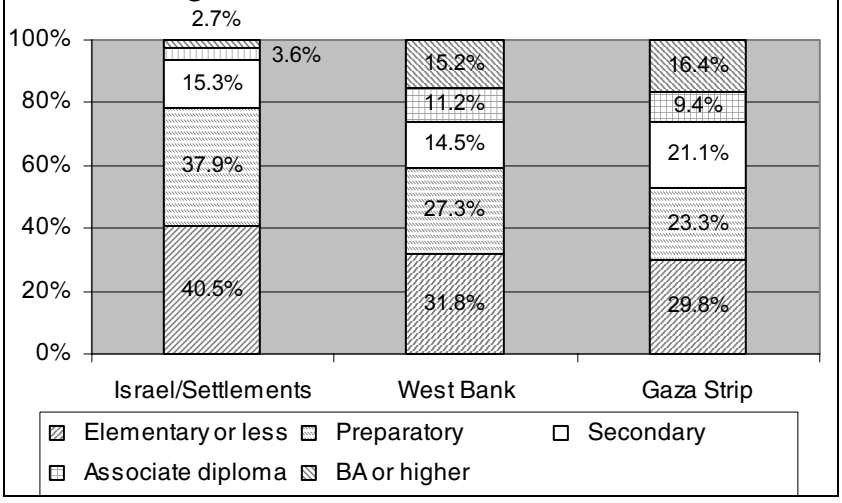
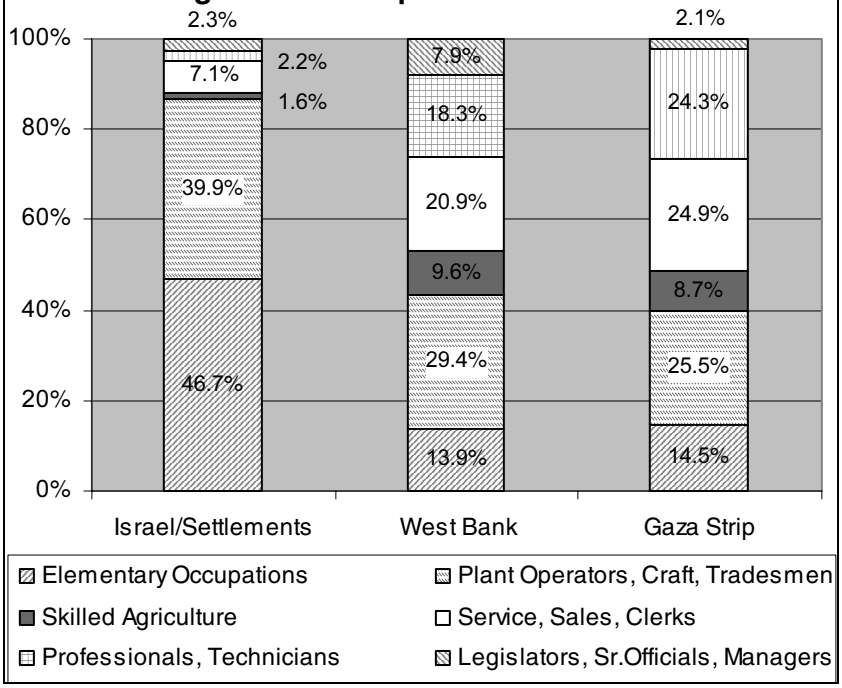


Figure 3.6: Occupational Distribution



3.15 The distribution of occupations depicted in Figure 3.6 roughly mirrors educational attainment across regions in Figure 3.5. For example, almost 90 percent of Palestinians employed in Israel work in elementary occupations or as plant operators, craftsmen and tradesmen. These shares are markedly lower for workers employed in the West Bank and Gaza. The highest occupation categories – professionals, technicians, and managers – account for about one-fourth of those employed domestically, also

broadly consistent with the proportion of workers holding associate diplomas, B.A. degrees or advanced degrees.

3.16 Earnings analysis. Whereas the preceding observations using summary statistics are indicative of trends, careful statistical analysis is necessary to evaluate the actual link between educational attainment and employment outcomes. The correlation coefficient between increasing education and higher skill occupations lies in the 0.5-0.6 range for the West Bank and Gaza (significant at the 0.01 level), but is quite low (0.15) for workers employed in Israel, suggesting misalignment of formal training and occupational choice. Mincer-type regression analysis of the determinants of earnings – in other words, how worker characteristics determine wages – provides a measure of the returns to education, occupational choice, sector, and place of work. The marginal returns to increasing education from a preparatory degree to a secondary degree or even higher to an associate diploma are negative when location of work is not unaccounted for (see Annex IV, Regression 1), reflecting the distortion arising from Israeli labor demand for low-skill jobs. In Q2 1999, Palestinian wages in Israel averaged NIS108 per day compared to NIS67 for those employed within the West Bank and only NIS53 in the Gaza Strip. This distortion can be factored into the earnings analysis by including dummy variables to account for location of employment in either the West Bank, Gaza Strip or Israel. By accounting for individual characteristics such as age, gender and educational attainment as well as place of work, regression results are more intuitive vis-à-vis schooling, that is, returns to education are positive. Employment in the West Bank compared to Gaza yields 24 percent higher wages (reflected by a regression coefficient of 0.213), controlling for individual characteristics. Most striking of all are the returns to employment in Israel, which are *85 percent higher than employment in Gaza (implied by coefficient value 0.613) and 61 percent higher than working in the West Bank* (results are reported in Annex IV, Regression 2).

3.17 In order to test the significance of industry, occupation and/or sector vis-à-vis wages, alternative specifications of the earnings equation are tested. The results have a somewhat higher explanatory power (i.e., higher adjusted R^2), and still show strong returns to working in Israel. Compared to the manufacturing sector, workers in mining, utilities, construction, hospitality and financial sectors and external organizations earn considerably higher wages, with returns ranging from 13-33 percent.[26] Construction sector jobs are particularly prominent in Israel, accounting for nearly two-thirds of commuting Palestinians but only 10-14 percent of domestic jobs (see Table 3.3). Occupational choice also appears to be an explanatory factor of earnings. Controlling for location of work, regression results indicate large positive returns for the highest occupation groups – legislators, senior officials, managers, and professionals – and slightly lower but still positive returns for associate professionals

[26] By accounting for sector of work, the coefficients on working in Israel and in the West Bank decline in Regression 3 relative to Regression 2 in Annex IV; this can be largely explained by the importance of construction in Israel and the settlements.

and clerks, compared to plant and machine operators. Sales and service workers and especially elementary occupations exhibit negative returns relative to a machine operator (see Regression 4 in Annex IV).

Table 3.3: Industry Decomposition of Palestinian Employment

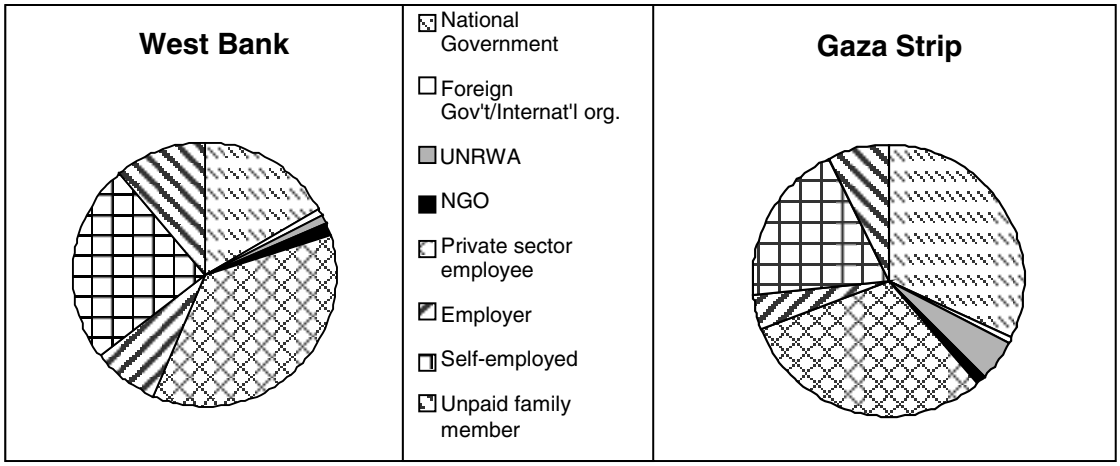
By region of employment:	**Israel/ Settlements**	**West Bank**	**Gaza Strip**
Agriculture and fishing	10%	14%	13%
Mining and quarrying	0%	1%	0%
Manufacturing	12%	17%	13%
Utilities	0%	0%	0%
Construction	59%	14%	10%
Wholesale and retail trade	7%	18%	13%
Hospitality industry		2%	1%
Transport, storage, communications	2%	5%	5%
Financial, real estate sectors	1%	3%	2%
Public administration	1%	9%	24%
Education, health, social work	2%	14%	15%
Community, social, personal services	2%	3%	2%
Extra-Territorial organizations	0%	0%	1%
Within Israel/Settlements by region of origin:		**West Bankers**	**Gazans**
Agriculture and fishing		9%	15%
Manufacturing		12%	10%
Construction		57%	66%
Wholesale and retail trade		7%	5%
Other		14%	4%

Source: PCBS labor force survey data, Q2 1999.

3.18 Public employment. Given the importance of government employment and generally low government wages, earnings analysis with respect to occupation should also account for possible distortions from the public sector. The Palestinian government sector today is significant in size and scope, as the PA increased employment rolls and expanded its responsibilities during the post-Oslo period in the course of establishing the institutions of governance. By 1999, government employment accounted for 17 percent of total domestic employment in the West Bank and 32 percent in the Gaza Strip (see Figure 3.7). The number of civil servants grew from 40,000 in 1994 to 89,000 in 1998 and an estimated 115,000 by end-2000 (central government only), implying much faster job growth than in the private economy. PA hiring was in effect used as a poverty alleviation mechanism, especially in the Gaza Strip where unemployment rates are particularly high. The World Bank's recent Poverty Assessment concluded that public sector hiring reduced the poverty rate by 0.5 percent between 1996 and 1998 (World Bank 2001). Comparing PA employee characteristics with those in the rest of the economy,

government workers have higher educational attainment, with 52 percent holding an associate diploma or higher, compared to only 14 percent among non-PA workers. Similarly, higher-skill occupations are more broadly represented in the government sector, both among professionals and technicians as well as among clerks and service workers (note that the data excludes police and security personnel).

Figure 3.7: Sector Breakdown of Employment



3.19 In light of the PA's large share in total employment and relatively low wages – civil servant wages average 26 percent less than private sector wages – the negative earnings effect of government employment is tested; regression analysis shows that government employees earn 13 percent less than their counterparts in the rest of the economy (denoted by coefficient value -0.14 on the National Government dummy variable in Regression 5, Annex IV). The resulting returns to occupational choice are magnified when government employment is accounted for, implying that the PA's employment policies are not distortionary through higher wages. Workers may nevertheless prefer government jobs due to other factors such as non-wage benefits like pension, job security, or low work effort, which affect labor supply decisions (Assaad 1999). Over the long run, overstaffing by the PA may lead to substantial productivity and efficiency losses for the economy at large. Women are actually better compensated in the government sector compared to the private sector (consistent with international experience), reflecting the fact that civil service wage policies are closely linked to educational attainment, leaving less opportunity for gender discrimination. When all categories of employers are considered – e.g., government, NGOs, foreign government/international organizations, UNRWA, and private – compensation is considerably higher in UNRWA and in foreign governments or international organizations compared to the private sector, and 13 percent lower in NGOs (see Regression 6, Annex IV).

3.20 Institutional environment. Labor outcomes are affected by the institutional and regulatory environment in which labor demand and supply decision are made. By international standards, the Palestinian labor market is flexible vis-à-vis labor regulations such as minimum wage, maximum working hours, and mandatory benefits financed by payroll taxes – none of these are in place. The PA drafted a Labor Code that has not yet been passed into law. Israeli labor law on the other hand affects Palestinians who are legally employed in Israel (i.e., registered workers) through mandatory payroll deductions despite workers' ineligibility for social security benefits. Although initially retained by the Israeli government, some proceeds (e.g., for health insurance) are remitted to the PA on behalf of workers, but the majority of Palestinian payroll deductions are retained in escrow, awaiting establishment of a national Palestinian pension institution. The PA's labor strategy during the post-Oslo period consisted of two objectives:

- to maintain Palestinian access to Israeli jobs, and
- to create government jobs for workers unable to find other employment.

In addition to direct job creation, the PA has programs targeted to the unemployed such as public works programs that are small-scale and labor intensive. The Bank's forthcoming analysis of social protection in WBG examines these issues in detail.

3.21 Summary of forces at work. The regression analysis on the determinants of earnings indicates that wages in the West Bank are 20-24 percent higher than in the Gaza Strip, controlling for worker characteristics, and the returns to working in Israel range from 60 to 91 percent, depending on region of origin. The observed wages and their variation by education, occupation, and industry, etc., reflect labor demand in Israel and the domestic Palestinian economy, and labor supply decisions of Palestinians. On the demand side, Israeli employers seek Palestinians to fill low-skilled jobs particularly in the construction sector. The more affluent Israeli economy pays higher wages than in WBG, and excess demand for Palestinian labor which is limited by Israeli border policy and security controls further drives up the price of labor. Although supply controls on Palestinian labor flows are at least partially binding, those on foreign workers – who constitute the majority of Israel's unskilled labor force – are not, implying competition and substitution between Palestinian and foreign workers in Israel. Employers in WBG face higher unit labor costs due to the availability of Israeli jobs, depressing labor demand. Unemployment therefore remains high, and the government intervenes by creating jobs to absorb those left behind.

3.22 On the supply side, Palestinians can choose to work domestically within WBG, but wages are lower than those paid by Israeli employers. If jobs in Israel were readily available, Palestinians would flow into Israel, driving the wage down to an equilibrium level that no longer provided an incentive for Palestinians to leave

WBG. However, labor supply to Israel is constrained by permit requirements, uncertain access due to security measures and border closures, and high transportation and search costs, such that wages are not market-clearing. The prospect of significantly higher wages leads many Palestinians – especially those with less education and thus fewer domestic work opportunities – to seek jobs in Israel despite the associated costs and risks of unemployment and income loss. The fact that some portion of the Palestinian labor force chooses to search for a job in Israel rather than accepting less remunerative work in WBG implies that high Israeli wages raise the market wage in the Palestinian labor market, reducing the level of domestic employment. Limited Palestinian labor supply to Israel leads to a persistent wage gap and gives rise to structural unemployment, implying that external job opportunities and wages in Israel affect Palestinian unemployment and domestic wages.

Modeling the Palestinian labor market

3.23 This analysis develops a model to reflect the observed features of the Palestinian labor market and the dynamic pressures at work (see Annex V for details of the model). The labor market segmentation and distorted wages in the Palestinian economy and in Israel supports the use of a theoretical approach based in labor market dualism and structural unemployment. Future policy changes vis-à-vis labor flows between the Palestinian and Israeli economies have far-reaching implications: although Israeli employers can substitute foreign workers for Palestinian labor – albeit at a higher social cost – the employment and earnings implications on the Palestinian side are significant.

3.24 The model developed in Annex V (based on Ruppert Bulmer 2001b) describes the equilibrium allocation of labor and wages under existing arrangements implemented during the 1990s. This equilibrium is characterized by wage gaps among domestic wages in the West Bank and Gaza Strip, and wages in Israel, which emerge as a result of limits on Palestinian labor supply to Israel, high unemployment, job search and transport costs, and a risk premium incurred by Israeli employers due to absenteeism during closures. This initial equilibrium is subsequently shocked by a change in the magnitude of Palestinian labor flows to Israel, to reflect changes in Israeli labor policy and analyze their long-run implications on aggregate employment, unemployment and wages.

3.25 As the number of Palestinians allowed into Israel rises, both unemployed and domestically employed Palestinians are drawn to the higher Israeli wage. Although unemployment falls, it falls by less than the new labor flows to Israel, pulling up domestic wages due to the decline in domestic labor supply. At the same time, the more flexible border policy associated with higher labor flows reduces both Palestinian commuting costs and the unit labor cost to Israeli employers due to a lower risk of absenteeism (captured in the model by a risk premium). This leads to a narrowing of the gap between domestic and Israeli wages. Because foreign workers

in Israel are close technical substitutes for Palestinian labor, the inflow of Palestinians displaces a certain number of foreign workers, but less than one-for-one, given that foreign workers earn less on average than Palestinians.

3.26 The calibrated results reported in Table 3.4 indicate the impact of a 7 percent increase in Palestinian labor flows to Israeli jobs, equivalent to an additional 10,000 workers. The inflow of 8,000 additional Palestinians from the West Bank and 2,000 from Gaza into Israeli jobs is predicted to displace 5,400 foreign workers from employment, leading to a net increase in Israel's unskilled employment by 4,600. Although the unit cost to Israeli employers of Palestinian labor (wage plus risk premium) declines slightly, due to the decline in the risk premium as more Palestinians are given access to Israeli jobs, the Israeli wage itself is predicted to rise by 1.4-1.5 percent, drawing more Palestinians to search for Israeli jobs. This effectively raises the domestic Palestinian wage by 3.6 percent in Gaza and 3.8 percent in the West Bank, and reduces domestic Palestinian labor demand. Domestic employment is estimated to fall by 4,700 in the West Bank, and by 800 in the Gaza Strip. The resulting wage gap vis-à-vis Israel is narrower, which is consistent with lower unemployment and lower commuting costs. The wage gap between average domestic wages in the West Bank and Gaza Strip widens, however. In net terms, the pool of unemployment declines by 4,500 workers – considerably less than the 10,000 new Palestinian jobs created in Israel – and the unemployment rate for WBG as a

Table 3.4: Predicted Results of Increased Labor Flows to Israel

Variable	Initial Value [a]	Change	New Value
Workers from West Bank:			
Employed in Israel	107,178	8,000	115,178
Employed in WB	314,465	-4,719	309,746
Unemployment rate	9.6%	-3,281	8.9%
Foreign employment (North) [b]	200,000	-4,290	195,710
Total unskilled employment (North) [b]	307,178	3,710	310,889
1/Commuting costs (β_{WB})	0.72	0.01	0.73
Risk premium Φ	1.15	-0.02	1.13
Wage in Israel: $w_{WB,I}$	104.4	1.5%	105.9
Wage in WB: $w_{WB,D}$	67.5	3.8%	70.1
Workers from Gaza Strip:			
Employed in Israel	27,368	2,000	29,368
Employed in GS	143,091	-779	142,312
Unemployment rate	17.0%	-1,221	16.4%
Foreign employment (South) [b]	50,000	-1,095	48,905
Total unskilled employment (South) [b]	77,368	905	78,272
1/Commuting costs (β_{GS})	0.69	0.01	0.70
Risk premium Φ	1.15	-0.02	1.13
Wage in Israel: $w_{GS,I}$	93.4	1.4%	94.7
Wage in GS: $w_{GS,D}$	53.4	3.6%	55.3

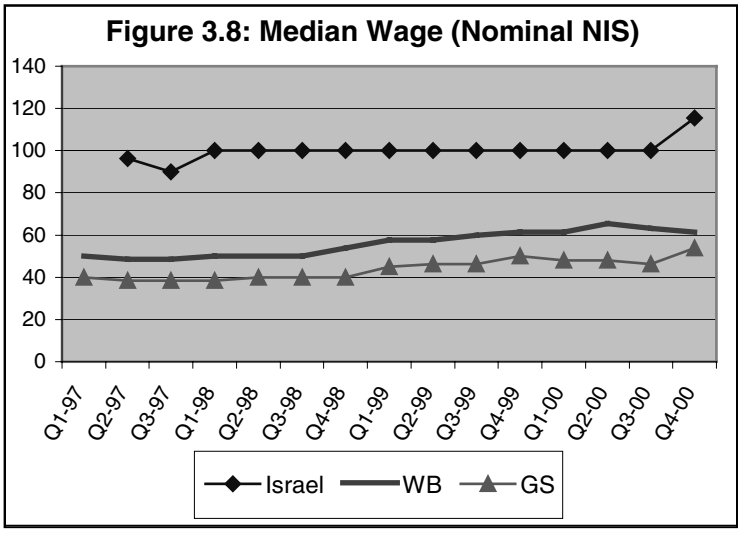
[a] 1999 data.

[b] Palestinians from WB are assumed to compete with foreign workers in the North of Israel only, while Palestinians from GS compete with a separate pool of foreign workers in the South.

whole falls from its initial rate of 11.8 percent to 11.2 percent (from 9.6 to 8.9 percent in the West Bank, and from 17.0 to 16.4 percent in the Gaza Strip). Sensitivity analysis indicates that the model's quantitative estimates of employment and wage outcomes are not particularly sensitive to parameter assumptions.

3.27 This estimation exercise illustrates how increasing access to Israeli jobs produces both winners and losers. Clearly the Palestinians who find new jobs in Israel are better off, but so are those already employed in Israel, due to the marginal decline in commuting costs and the higher Israeli wage. Employers in Israel are winners as well, since the wage increase is offset by the decline in the risk premium, such that their net unit labor cost declines. Employers in WBG, however, bear the cost of increased labor flows to Israel through higher wages, making them less competitive. And finally, foreign workers who are displaced by incoming Palestinians also lose.

3.28 The model's predicted results are consistent with trends in Palestinian wages and unemployment observed since 1995. Figure 3.8 illustrates the persistent wage gap between domestic and Israeli jobs, and average wages earned within the West Bank and Gaza Strip appreciated more than those earned by Palestinians working in Israel (except in Q4 2000), implying a narrowing of the wage gap concurrent with declining unemployment. In 1999, wages earned by Palestinians employed within the West Bank averaged nearly 60 percent of those earned by Palestinians working in Israel and the settlements, compared to only 47 percent for those employed in Gaza.



Implications of labor market integration

3.29 Trade-offs. Palestinian reliance on Israeli labor demand to provide jobs to the rapidly expanding Palestinian labor force has both positive and negative implications for Palestinian economic development. During the 1970s and 1980s, Palestinian labor was effectively integrated into the Israeli labor market: almost a third of Palestinian employment was in Israeli jobs, and Palestinian unemployment was modest (recall Figure 3.2). Palestinian and Israeli incomes converged over this period (discussed further in Chapter 5), and Palestinian wages in WBG and in Israel were

comparable during the mid-1980s, implying market-clearing wages and no major distortions in the Palestinian labor market. The situation changed following the shift in Israeli labor policy to limit Palestinian labor inflows in 1991; by 1993, unemployment was trending upward and a 50 percent wage gap had emerged (Diwan and Shaban 1999). Improved labor mobility toward the end of the Interim Period led to higher employment in Israel (accounting for 23 percent of total Palestinian employment and a third of total labor earnings by 1999) but also a large wage gap.

3.30 The positive implications of labor market integration include significant income effects from higher wages earned in Israel, higher aggregate employment, and increased domestic demand from repatriated wages from Israel (earnings less purchases of Israeli goods). These positive effects increase welfare through higher average household income and savings and lower unemployment, but also through feedback effects of increased incomes on aggregate demand for domestically produced goods and services. However, this resource inflow from the export of Palestinian labor failed to generate domestic job creation adequate to sustain robust economic growth.

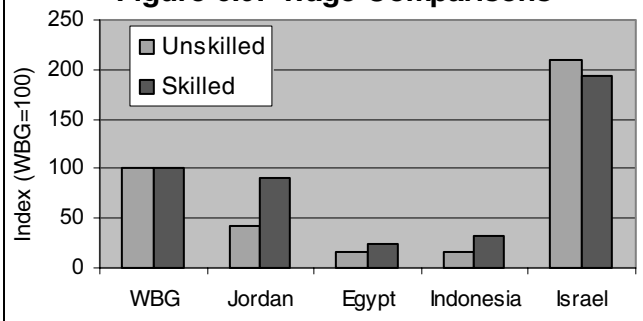
3.31 The gains from Palestinian integration into the Israeli labor market are offset by several negative effects. As illustrated by the data and reflected in the model, access to high-wage Israeli jobs pulls up the domestic wage rate and depresses labor demand in WBG, leading to income losses for the unemployed and underutilization of labor resources. Although significant, these direct effects are superseded by serious negative dynamic effects with respect to productivity, competitiveness, and volatility. By exporting labor services to Israel, the Palestinian labor market effectively specializes in low-skill jobs characterized by little knowledge transfer in general, but exacerbated by segmentation and a lack of vertical integration. This is compounded by the distorted trade regime which contributes to specialization in low value-added products for export to Israel due to limited access to other markets. Despite positive returns to higher education, the relatively high average skill level of Palestinians is underutilized, causing skills to depreciate.

3.32 Moreover, the high returns to unskilled labor in Israel lowers the relative returns to skill acquisition in WBG (Schiff 2001), reducing the equilibrium level of human capital in the Palestinian economy. Skilled Palestinians with more than a secondary education, many of whom worked in the Gulf labor markets prior to 1991, face little demand for their skills in the private sector, as 45 percent are employed by the PA (compared to a government share of 17 percent for total employment) and significant shares are employed by NGOs and foreign governments. Domestic private employment is dominated by manufacturing sector jobs, construction, and trading and repair activities (especially among the self-employed). With respect to occupation and skill level, the self-employed are primarily engaged as service and sales workers and skilled agriculture workers, and most of the remaining private

sector employees work in low-end jobs such as craft and related trades workers and in elementary occupations.

3.33 Low productivity gains stemming in part from underutilized human capital have long-term implications for growth, as will be seen in Chapter 5 below, by reducing competitiveness on global markets, thereby limiting demand for domestic output. This effect is exacerbated by the high domestic wage, compromising the international competitiveness of Palestinian producers of tradable goods and services. Figure 3.9 illustrates that although Palestinian wages are low relative to Israel, they are considerably higher than competitor countries such as Egypt and Jordan. The resulting lack of competitiveness poses an obstacle to investment and innovation, reinforcing the low-productivity equilibrium and thus constraining growth by precluding or at least delaying the shift to newer, more productive technologies. Additional potential losses arise from missed agglomeration benefits accruing to a large manufacturing sector supported by low cost, competitive services, implying permanently lower productivity (Schiff 2001).

Figure 3.9: Wage Comparisons



Source: World Bank and USAID (1996)

3.34 The dual nature of the Palestinian labor market vis-à-vis integration with Israel yields inferior outcomes compared to other examples of labor migration from low-income to high-income countries. This can be explained by two main factors. In the first place, labor flows to Israel constitute a very large share of total Palestinian employment – nearly one-fourth – which distorts wages in the domestic economy. And secondly, the lack of knowledge transfer, distortionary trade policy and weak business environment together discourage investment and human capital accumulation, contrary to the positive feedback effects typical of other dual labor markets.

3.35 The ad hoc and erratic Israeli policy changes regarding Palestinian labor mobility generate a high degree of volatility with respect to employment and incomes, but also affect transactions costs for Palestinian producers and traders. Periods of closure observed during the post-Oslo period, and especially during the current crisis, created sharp jumps in unemployment which, when sustained over time, have serious implications for household incomes and consumption, thereby raising poverty rates. The resulting strain on public resources through social safety nets risks further depressing domestic growth. Moreover, the uncertain environment relating to goods and factor mobility and the costs incurred in moving goods to

market pushes risk-averse producers toward low value-added, low return activities, compounding the low output equilibrium.

3.36 Palestinian labor outcomes differ markedly for women compared to men, driven in part by the effective lack of access by women to Israeli jobs (recall Figure 3.4). Women's exclusion from these job opportunities creates pressure on the PA to hire women, evidenced by the large number of women employed in the civil service. This trend is reinforced by PA wage policies which are more gender-neutral than the private sector, thereby increasing female labor supply to the public sector. The PA's de facto strategy for increasing female employment is insufficient to absorb the total female labor supply, however, despite relatively low female participation rates. Women with higher skills are particularly implicated – 76 percent of unemployed women have a post-secondary education – indicating the need for a new strategy, especially in light of future expected increases in educational attainment and labor force participation among women.

3.37 Future Palestinian labor policy. The preceding analysis highlights the policy challenges inherent to generating domestic employment growth. The PA's recent employment strategy to mitigate unemployment through expanded civil service employment is unsustainable, and private sector job creation in WBG is constrained on two fronts: domestic employers must compete with Israeli labor demand at a higher pay scale, and the business environment in WBG is not conducive to investment (discussed in Chapter 4). Moreover, private investment by itself is likely to be insufficient to attract Palestinians working in Israel to return to the domestic private sector. Is there scope for additional investment in education in order to raise productivity? Earnings regressions indicate positive returns to educational attainment, but these are fully offset by the returns to working in Israel. Because Palestinians employed in Israel have a lower average level of education compared to those working within the West Bank and Gaza, they have the least to gain by returning to the domestic labor market. This underutilization of human capital in WBG discourages human capital accumulation which is crucial to raising productivity in the long run. Before proceeding with policies of human capital investment, however, it will be essential to ascertain whether increasing educational attainment would generate the skills sought by Palestinian employers in the near term.

3.38 In the context of a future peace agreement between WBG and Israel, final status economic arrangements between the two sovereign states are likely to differ from current arrangements. With respect to labor, however, some degree of integration with the Israeli labor market will most likely continue. The potential implications depend on the magnitude of future labor flows, which in turn depends on the nature of borders. Under a continuation of relatively open borders between the West Bank and Israel, Palestinians will continue to commute to Israeli jobs at least at the current crisis level of 50-70,000 workers, even if Israel adopts a very restrictive policy toward Palestinian labor. However, it is more likely that a peace agreement

will be accompanied by normalization of cross-border economic relations and a restoration of trust on the ground, thereby increasing labor mobility and reducing transactions costs. This suggests two possible scenarios:

(i) Palestinian labor supply to Israeli jobs keeps pace with labor force growth in WBG – on the order of 4 percent a year; or

(ii) Palestinians obtain increased access to Israeli jobs, but face higher transactions costs (i.e., transportation and search costs) due to the introduction and enforcement of borders, resulting in slower growth of Palestinian employment in Israel.

The former situation would be consistent with a continuation of the customs union and free movement of goods between WBG and Israel, with labor flows to Israel reaching an estimated 165,000 by 2010 (excluding East Jerusalem). The latter, by contrast, could arise in the context of a change in trade regime to an FTA, generating labor flows on the order of 145,000 (excluding East Jerusalem).

3.39 It is possible that a less cooperative solution will emerge under final status, namely one of economic separation. In the event of separate economies divided by a physical border, the movement of all goods and factor services would be controlled at border stations and assessed taxes as relevant. This scenario, consistent with WBG adopting an NDTP toward Israel, would discourage Palestinian employment in Israel (Israeli work permits could be eliminated altogether). Nevertheless, imperfect border controls and continued Israeli demand for unskilled labor would likely result in informal Palestinian worker flows of at least 70,000 in the long run.

3.40 The above delineated range of labor policy options under a final status agreement suggests that the potential magnitude of labor flows in the long run – say, in 2010 – is likely to fall between 70,000 and 165,000 (excluding East Jerusalem). But for any projection in this range, the distorting effects of a high Israeli wage will continue to pull domestic Palestinian wages above their market-clearing level and depress domestic labor demand, with attendant productivity losses and other costs discussed above. Whereas opening the Palestinian-Israeli border to the free movement of labor would eliminate this distortion by allowing wages in the two economies to equilibrate, this scenario is highly unlikely given the evolution of Israeli immigration policy and the fact that most countries prefer to limit immigration.

3.41 An alternative to this quantity-control mechanism would be a price mechanism, namely the introduction of a *Palestinian* fee-based permit to work in Israel (as proposed in Schiff 2001). By imposing a tax on commuters to Israel, the PA would not only generate a potentially important source of revenue, but it would effectively reduce the incentive for Palestinians to seek low-skill high-paying Israeli jobs. The resulting increase in domestic labor supply would lower wages in WBG, thus mitigating problems of international competitiveness. One of the primary

advantages of the permit fee is that its cost is partially borne by Israeli employers (assuming that reduced labor flows raise Israeli wages), and actually benefits Palestinian employers.

3.42 This analysis of Palestinian labor market outcomes and their strong links to Israeli labor demand illustrates the trade-offs to labor market integration with Israel, namely higher Palestinian wages and household incomes on one hand, but underutilized human capital, low productivity and noncompetitive wages on the other hand. In the next chapter, issues of labor competitiveness are addressed in the broader context of the business climate in WBG.

The Business Environment and Private Sector Growth

4

The Business Environment and Private Sector Growth

4.1 The distortionary effects of the labor and trade regimes discussed in Chapters 2 and 3 resulted in low productivity growth, contributing to the modest economic performance observed since 1967 and particularly during the Interim Period. Private sector development was constrained not only by these distortions, but to a great extent by the costs and continued risk and uncertainty linked to border closures. The weak private sector response following the Oslo accords is particularly troubling in light of the anticipated and partially realized inflow of foreign investment beginning in 1994. Palestinians returning from the Diaspora brought with them capital, managerial experience and technical know-how, providing a potential infusion to the domestic private sector. Most external resources, however, were targeted for activities under the umbrella of the government: infrastructure, basic services, and technical assistance for institution-building. A small number of firms emerged as important players – mainly facilitated by direct government concessions or a lack of competition – but development of the small- and medium-enterprise sector was weak.

4.2 This can be explained by the significant challenges facing the Palestinian private sector on several fronts. The restricted customs union distorts trade with third parties by requiring all trade to be conducted through Israel or Israeli-controlled areas. Access to high-paying Israeli jobs distorts labor supply decisions and raises domestic wages, depressing labor demand and rendering export products less competitive. The changing policy environment and weak supporting institutional framework with respect to legal and regulatory systems and property rights dissuades potential investors due to the implied risks. The PA's opaque role vis-à-vis engagement in productive activities contributes to a perception of unequal access.

And the underdeveloped banking system limits the availability of capital, necessitating self-financing through savings rather than borrowing.

4.3 Taken together these features do not create an environment conducive to private investment in start-ups or expansion of existing businesses. Although the PP attempted to address some of these constraints – through modifying the customs union to allow limited Palestinian trade with its Arab neighbors, creating the Palestine Monetary Authority which allowed the entrance of domestic and foreign banks, establishing legal institutions, and developing a regulatory framework – the resulting progress and improvements were severely challenged by the uncertainty, mobility restrictions, and high transactions costs attendant to security measures.

4.4 The economy's future growth prospects discussed in Chapter 5 below are brighter under scenarios of normalization with Israel, assuming a resolution of the ongoing conflict and an end to closure policy. But addressing trade and labor policies alone will not automatically trigger a large private sector response, even though a negotiated settlement would greatly improve the business environment by reducing risk associated with political and ultimately economic uncertainty. The prospects for extensive job creation in the constrained Palestinian business environment are dim, especially in view of demographic pressures and rapid labor force growth. The PA since its inception has taken the lead in absorbing job seekers (as discussed in Chapter 3), but its capacity to continue to do so is limited. The PA wage bill already represents the highest share of recurrent expenditures relative to other countries in the MENA region, and much higher than average shares observed in other regions. Controlling and rationalizing public sector hiring will be critical to improving the government's effectiveness in budgetary and public sector management. The private sector therefore will need to provide the engine of growth and job creation to support improved performance of the Palestinian economy.

4.5 Policy measures to address the past shortcomings of private sector growth are not entirely dependent on a peace agreement between the Palestinians and Israelis, however. The PA has many tools at its disposal today to ease the constraints facing private agents. The analysis below examines these constraints – especially in the post-Oslo context – and identifies policies to enhance private sector growth in the future through a better institutional framework for investment and more productive public-private interactions.

4.6 A survey of Palestinian private sector firms, the World Business Environment Survey (WBES), was conducted by the World Bank in June 2000 to examine factors constraining private sector agents in WBG and quantify the extent to which these factors are binding. The survey of 93 firms representing a stratified sample based on size, sector, export/non-export activities and other characteristics provides a rich data source on issues relevant to governance and the business environment in WBG, including:

- quality of public services
- regulation
- judicial system
- support from central and local governments
- red tape
- corruption
- government consultation with business, and
- financial sector services.

Of particular interest are differences in responses by small (fewer than 10 full-time employees) and large (more than 50 employees) firms. This distinction is crucial in WBG, given that most Palestinian firms are small enterprises (97 percent, according the PCBS 1997 Establishment Survey). The WBES is an effective tool for assessing governance in WBG as it applies to the business environment (see Sewell 2001 for a complete analysis of the survey).

Unstable policy environment and crippling transactions costs

4.7 The missing link in Palestinian economic growth over the last several decades has been productive investment in the private sector. Despite large inflows of capital, most investment post-Oslo has been in construction, with 40 percent of total investment in 1998 targeted to residential housing. This lack of productive investment can be largely attributed to the unstable and uncertain policy environment in WBG. Nearly four-fifths of WBES respondents cited policy instability and uncertainty as the greatest constraint to business operations and growth. Many factors contribute to the perception of risk and uncertainty, including past experience, the capacity of the institutional framework to protect investments, and the predictability of future policies. The business environment in WBG suffers on all three fronts: growth has been highly volatile since 1967 (discussed below in Chapter 5), property rights and their enforcement is weak, due to shortcomings in the Rule of Law and the unsettled status of territorial claims, and the shape of final status economic arrangements under a future peace accord is unknown. Perceived risk and uncertainty therefore represent significant obstacles to productive investment and sustained private sector growth.

4.8 The limited export outlets and periodic closure of the Palestinian economy also dissuade investment due to a Rybczynski effect of lower returns to capital compared to an open economy. Seventy percent of WBES respondents reported that

Israeli security procedures constituted the biggest regulatory and administrative burden. The costs of Israeli security measures for Palestinian businesses are high (estimated in a number of studies including: the Bank's own transport survey detailed in Annex I; Federation of Palestinian Chambers of Commerce, Industry and Agriculture 1998; and Valdivieso et al. 2001), with broad implications for private sector development. Palestinian exporters, for example, incur substantially higher costs than their Israeli counterparts for security-related delays, administrative fees, damaged goods from delays and excess handling, and additional transport costs due to restrictions on Palestinian trucking (namely the requirement to unload Palestinian exports at border crossing points for Israeli inspection, and then reloading goods onto Israeli trucks for subsequent delivery). These directly higher costs lead to Palestinian subcontracting with Israeli trucking firms and marketing agents instead of relying on Palestinian service providers, discouraging the development of these industries within WBG. Whereas a political settlement of the current crisis and a peace accord will go a long way toward reducing elements of risk, uncertainty, and security-related costs, the degree to which these costs will decline is unclear.

High production costs

4.9 In addition to the high cost of Israeli security procedures reported in the WBES, other distortions raise production costs to the detriment of Palestinian competitiveness. High transportation costs for the effectively land-locked WBG raise the final price of exports as well as the cost of imported inputs (a case study of Taybeh Beer in Box 4.1 illustrates these effects). The high market wage prevailing in the WBG private sector – as discussed in Chapter 3 – renders Palestinian labor and therefore labor-intensive products more expensive than its competitors. Manufacturing wages across all skill levels average 1.5 to 3 times greater than competing countries in the MENA region, namely Jordan, Egypt, and Lebanon (Shunnar 2002). Skilled wages are also high but Palestinian productivity compares favorably to competitors in certain sectors. Palestinian producers also face relatively high prices for production facilities such as land, electricity, and water.

4.10 Land. Israeli occupation of and partial withdrawal from WBG rendered available land very scarce and therefore expensive, even by Israeli standards. For example, one square meter of undeveloped land in the Gaza Strip costs at least 10 times more than comparable land in Israel, and 100 times more than in Jordan (World Bank and USAID 1996). The cost of serviced land in WBG is closer to costs in neighboring countries: up to 3 times the cost in Egypt, 5 times the cost in Jordan, but only one-quarter to one-half the cost in Lebanon (FIAS 2001).

4.11 Electricity. Palestinian producers import most of their electricity services from Israel. Although this also brings advantages of better power infrastructure, it comes at a price – off-peak electricity rates are nearly three times higher in Gaza compared to Israel (World Bank and USAID 1996).

Box 4.1: A Case Study of Taybeh Beer

Established in 1995 by Palestinian Americans returning from Boston, Taybeh Beer produces un-pasteurized beer from local water and otherwise imported inputs. By 2000, production had reached more than 4,000 barrels (80 percent capacity), with exports to Jordan and sales in Israel accounting for about 20 percent of output. Several constraints present major obstacles for the firm's future viability:

- Since the start of the intifada, sales have fallen 75 percent. In response to periodic closures and limits on the mobility of Palestinians, the company shifted to more expensive delivery methods: hiring Palestinian residents of Jerusalem (whose wages are 60 percent higher than West Bank residents); and buying Israeli-plated trucks registered in their drivers' names (implying higher registration and insurance costs) to deliver beer in Jerusalem and Israel. Closure-induced delays and bottlenecks increased delivery-time four-fold since the beginning of the intifada, causing distribution costs to double.
- Taybeh imports bottles from Portugal, with shipments addressed to the company in "Taybeh, Israel" typically taking 2-3 weeks to clear customs and arrive at the plant. This compares to an average clearance time of 1 week for Israeli companies because they do not require security checks. An October 2001 bottle shipment addressed to "Taybeh, Ramallah, Palestine" took almost 7 weeks to clear customs. Port officials claim the delay was due to the need to test the bottles for standards certification, never raised as an issue with previous shipments. The delay led to additional costs of US$8,430 (for demurrage, container rental and certification test) to clear a shipment worth US$22,000, for a total transactions cost of US$16,340 (75 percent of the value). These charges were on top of already expensive requirements to use Israeli trucking companies from Ashdod port (since 1997, Palestinian trucks are forbidden to enter the port), raising the inbound transport charge by 50 percent.
- Taybeh beer export delays in Israeli ports render production for export non-competitive, leading Taybeh to abandon direct exports to Europe in favor of contract brewing and distribution in Germany. Taybeh's beer is unpasteurized, with a shelf life of six months if refrigerated but only four months if unchilled. Trial shipments languished for two months in Ashdod port awaiting a PA export stamp, Israeli customs export permit, and quality control testing for the German market deemed necessary by the Israeli government. These delays plus sea shipment to Germany amount to nearly 75 percent of the beer's shelf life, an unacceptable risk for exporter/manufacturer and importer/retailer alike.
- Total duty on Amstel beer imported from Jordan is 117 percent, while Taybeh exports to Jordan face duties of 180 percent.

4.12 Water. Water resources are similarly imported from Israel, because the PP did not accord Palestinians access to the aquifers under the West Bank and Gaza Strip. Moreover, the Israeli water authorities ration the water resources made available to WBG. As a result, water costs are relatively high, on par with Jordan. Consider, for example, the cost structure of the stone and marble industry. Table 4.1 compares unit production costs across WBG's main competitors in this sector: Jordan, Egypt, Turkey and Italy. The data illustrate that unit water costs are twice those in Egypt and Turkey, and nearly three times the cost in Italy, and represent a relatively large share of total unit production costs in WBG.

Table 4.1: Structure of Unit Cost of Marble Production (US$/sq. meter)										
	WBG		**Jordan**		**Egypt**		**Turkey**		**Italy**	
	US$	**%**	**US$**	**%**	**US$**	**%**	**US$**	**%**	**US$**	**%**
Labor	0.155	5.39	0.066	2.51	0.074	3.20	0.203	9.22	0.308	14.19
Electricity	0.426	14.81	0.266	10.12	0.533	23.00	0.284	12.94	0.391	17.98
Water	1.176	40.88	1.176	44.47	0.588	25.40	0.588	26.79	0.353	16.24
Tools	1.120	38.92	1.285	48.90	1.120	48.40	1.121	51.05	1.121	51.59
Total	2.877	100.00	2.628	100.00	2.315	100.00	2.195	100.0	2.172	100.00

Source: D'Alessandro (2000)

4.13 The high cost structure faced by manufacturers in WBG presents severe challenges with respect to Palestinian competitiveness, some of which are likely to persist in the long run but many of which are by-products of the interim economic arrangements over which the PA has limited recourse in the present environment. The discussion in the remainder of this chapter, by contrast, addresses issues currently within Palestinian control which represent areas in which good governance could strengthen the PA's legitimacy, undermined in the post-Oslo environment by various quarters. Specifically, the analysis identifies policy actions to reduce barriers to investment, namely by strengthening the Rule of Law, promoting a strong financial system, reducing anticompetitive practices, increasing accountability of the public sector, improving revenue administration, and raising the efficiency of the public sector by allowing the private sector to compete in service delivery.

Rule of Law

4.14 An appropriate legal framework for commercial activities and an effective and independent judicial system to implement and uphold laws, regulations and property rights are critical for the investment environment in WBG, by reducing the unpredictability and costs of doing business. Cross-country growth accounting studies conclude that differences in the quality of the institutional framework explain a large part of differences in economic development (Barro and Sala-I-Martin 1995; Hall and Jones 1999; Knack and Keefer 1995). The importance of an effective institutional framework may in fact exceed the potential of specific investment incentives such as the tax exemptions provided by the PA's 1998 *Investment Encouragement Law*, for instance, or the substantial reductions in corporate and personal tax rates passed by the Palestinian legislature in 1999. International experience suggests that in the absence of sound macroeconomic policies and an adequate institutional framework, tax and other incentives to encourage investment in export-oriented manufacturing industries have not entirely succeeded in promoting growth (Valdivieso et al. 2001; Madani 1999; Radelet 1999).

4.15 Respondents to the WBES ranked the courts and judiciary lowest among public institutions in terms of quality of service, a serious indictment for effective governance in WBG. The shortcomings of the Palestinian judicial system are widely acknowledged; moreover, there is broad consensus on the measures necessary to

strengthen the legal environment to support a market economy. Investors need assurances that commercial disputes can be resolved fairly and in a timely fashion through the court system, which will require a better functioning judicial system and civil/commercial courts in WBG. Most fundamentally, executive and judicial powers need to be separated. Security and military courts have weakened the independence and effectiveness of the judiciary, and Palestinians have resolved disputes through appeals to security personnel rather than in civil courts. President Arafat's only recent ratification of the *Basic Law* (which includes constitutional provisions) and the *Independence of the Judiciary Law*, passed by the Palestinian Legislative Council (PLC) in 1997 and 1998 respectively, will lay the foundation for the separation of executive and judicial powers and increase the powers and capacity of the civil courts to adjudicate commercial disputes.[27] Training and appropriate remuneration for judges would improve professional competence and reduce the risk of partiality through external pressures. And with respect to physical court infrastructure (i.e., bricks and mortar), adequate facilities in which civil courts can function are needed. The 100 Day Plan of the Palestinian Government – issued by the PA in early July 2002 – includes specific measures to improve the judiciary and the courts, namely the appointment of a full complement of judges by end-September 2002, and the removal of the security services from civil dispute resolution but increasing their role in enforcing court decisions.

4.16 Improving the judicial system and commercial courts requires an accompanying body of commercial legislation to provide the legal foundations to support a market economy. The existing legal and regulatory system constitutes a mixture of old Egyptian and Jordanian laws and newly drafted laws that are not uniform across the West Bank and Gaza Strip. While considerable progress has been made to fill gaps in commercial legislation in recent years – and the *Banking Law* was just recently passed – a significant backlog of un-passed laws that are fundamentally important to the commercial sector remains.[28] The Ministry of Economy, Trade and Industry supports the need to pass these laws and is pursuing their passage even in the difficult circumstances of the ongoing crisis. And the government's recently issued 100 Day Plan for reform also emphasizes the need to pass these laws. It is important to note that a suitable legal framework for commerce is ineffective without regulations to implement laws; legislation and regulations to implement the legislation are both necessary to render the legislation effective.

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[27] The *Independence of the Judiciary Law* is legally in force, and the 100 Day Plan of the Palestinian Government proposes mid-July 2002 for effectiveness of the *Basic Law*.

[28] The backlog includes: *Income Tax Law, Competition Law, Company Law, Intellectual Property Law, Securities Law (Capital Markets Authority Law), Insurance Law, Secured Lending and Leasing Law, International Commercial Arbitration Law, Rental Law, Pensions Law, Provident Funds Law, Mutual Funds Law, Accounting and Auditing Law*.

Regulation

4.17 Private sector development in WBG suffers from the weak regulatory functions currently performed by the PA. Regulatory institutions are needed that are separate from both the policy-making functions of PA ministries and the investment activities of the government. Independent regulation of financial intermediaries – including supervision of banks – is fundamentally important, but other areas such as utilities also need to be independently regulated. The telecommunications sector provides a good example. The PA is a part owner of Paltel, the telecommunications company with an exclusive license to supply various kinds of phone services subject to regulation of tariffs. The terms of the agreement with Paltel are not publicly available, however, and rates supervision is not effectively being carried out, implying a need for an independent regulator.

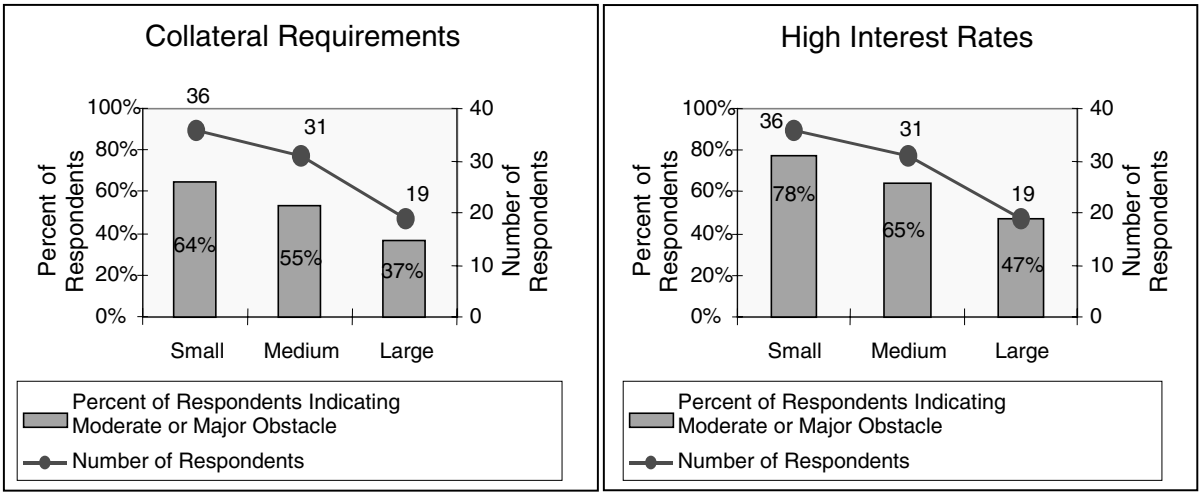
Banking and financial intermediation

4.18 Adequate business finance is critical to developing a flexible and productive private sector, but many Palestinian businesses are undercapitalized. There is no shortage of loanable funds in the Palestinian banking system, however. The PP facilitated the growth in banking services by allowing for the creation of new banks and the introduction of foreign (mostly Jordanian) banks in WBG. Bank deposits grew from US$170 million in 1992 to US$3.5 billion by the end of 1999. Lending also increased substantially during this period: the ratio of loans to deposits rose from 23 percent in 1996 to 29 percent in 1999, and survey respondents reported a marked reduction in financing difficulties between 1996 to 2000.[29] The rapid increase in lending flagged concerns over the regulatory structure for banks, supporting the above-mentioned need for independent regulation and oversight of the financial intermediation industries of banking, insurance and the stock market.

4.19 Despite the observed increase in credit growth prior to the current crisis, loan/deposit ratios in the Palestinian banking system remain low by international standards, equal to only half the level observed in Jordan. In addition, most credit is short term, with little credit allocated for long-term investment. One of the principal constraints on loan/deposit ratios in WBG is the bank requirement of substantial collateral for most loans, and in some cases even for overdrafts. Obtaining long-term finance for new firms – difficult anywhere – is considerably more difficult in WBG: more than half of WBES respondents cited collateral requirements and problems in getting long-term loans as moderate or major obstacles to the growth of their businesses. Figure 4.1 illustrates that collateral requirements and borrowing costs (i.e., interest rates) represent a significant burden across firms of different sizes, and a relatively greater burden for small firms.

[29] Nearly half of WBES respondents (49 percent) reported financing issues in 2000 to be a moderate or major obstacle to the operation and growth of their business, compared to 79 percent in a 1996 survey.

Figure 4.1: Views on Financing Issues by Firm Size



4.20 Low loan/deposit ratios, the predominance of short-term credit, and high collateral requirements reflect lenders' risk-aversion in the highly uncertain Palestinian environment of interim political and economic agreements, mobility restrictions, and periodic closures. But the perceived high risk in WBG is not the only reason for a lack of long-term business lending. Institutional factors crucially affect the credit environment, such as the legal framework and auditing and accounting standards. Problems in enforcing contracts and creditor rights through the court system dampen business lending in WBG, and the lack of accounting and auditing standards leads to less reliable business financial statements, making it difficult for lenders to make adequate risk assessments. Lenders, in turn, respond by relying more heavily on issuing credit subject to collateral and the client's track record. These requirements especially stifle small firms and start-ups, in effect limiting their access to formal credit markets.

4.21 Improving the legal framework and adopting accounting standards are central to increasing credit for long-term investment and therefore growth in WBG. Cross-country analysis indicates that differences in financial development and GDP growth are strongly associated with differences in systems of accounting, creditor rights and contract enforcement (Levine, Loayza and Beck 2000). Beyond addressing the legal system and accounting standards, however, banks' lending practices in WBG could be directly improved in a number of ways, including increasing the assets eligible for use as collateral for loans. The traditional assets required as security for loans comprise personal guarantees and land with clear title, the latter presenting particular difficulty in WBG in light of ownership and title issues complicated by continued Israeli occupation in Areas B and C (not to mention Israeli incursions in all areas under the current crisis). Nevertheless, the PA could have addressed land title issues

more diligently in Area A, but disputes over ministries' mandates held up progress on the issue. New financial instruments such as the Registry of Movable Assets proposed for WBG would allow plant and equipment, vehicles, inventories, and receivables to be used as collateral. Leasing represents another instrument that could be used to finance the acquisition of capital.

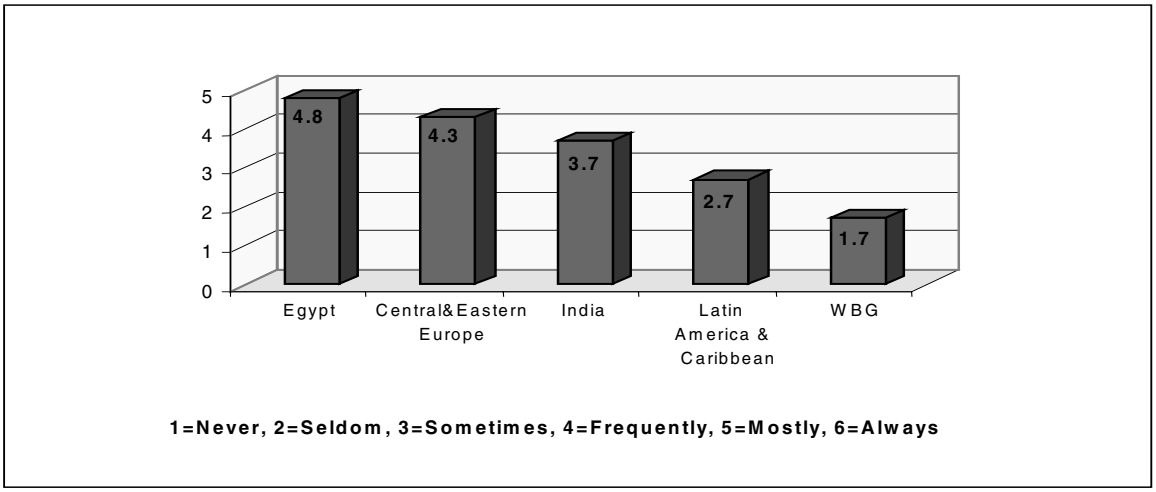
4.22 Additional measures to increase bank lending include promoting the use of alternative credit risk assessment techniques. Development organizations have had some success encouraging banks to lend to micro-enterprises using new project assessment techniques such as cash-flow analysis in place of traditional collateral lending. By March 2000, 695 loans for micro-enterprises with a value of US$7.9 million had been approved by three commercial banks with financing provided through the World Bank/IFC Micro-enterprise Project. Although an encouraging start, these measures represent marginal progress relative to the size of loanable funds available in the Palestinian banking sector.

Corruption, anticompetitive practices and lack of transparency

4.23 According to public opinion surveys conducted regularly by the Center for Palestinian Research and Studies in Nablus, most Palestinians perceive a degree of corruption in the PA. The WBES survey questions designed to elicit information on this issue provide a better substantiated and more balanced public discussion of the subject. Survey results from 2000 indicate that concerns about corruption do not relate to the types of corruption frequently encountered elsewhere, such as petty bribery (informal payments to officials) or corruption in procurement. Comparing WBG to other regions of the world in which similar surveys have been conducted, Palestinian firms report that they seldom make such payments, whereas firms in Latin America and the Caribbean claim to make informal payments sometimes, firms in India, Africa and the transition economies of Central and Eastern Europe claim informal payments occur frequently, and firms in Egypt say such payments occur most of the time (see Figure 4.2).[30] The frequency of informal payments to officials in WBG is roughly equivalent to that in OECD countries. WBES respondents in WBG do not judge corruption in procurement to be a problem; most believe it does not occur at all, and those who believe it does occur – about 5 percent of respondents – suggest it is of minor importance.

[30] Data from other countries and regions where the WBES has been administered were supplied as averages, where the averages were obtained by assigning values to the qualitative responses to the relevant question in the WBES concerning frequency of informal payments. These values are 1 = never, 2 = seldom, 3 = sometimes, 4 = frequently, 5 = mostly and 6 = always.

Figure 4.2: Frequency of Informal Payments, WBG and Elsewhere



4.24 These findings do not substantiate widespread claims of corruption within the PA, which are therefore more likely to reflect a general unease with the way the PA operates – specifically, its lack of transparency. The PA has recently taken steps to address concerns regarding openness, including the public disclosure of financial data for the holding company for PA investments. Further increases in transparency are desirable, for example by publishing the terms of exclusive licenses to firms such as Paltel, creating regulatory bodies that are independent of policy ministries, publishing an annual report by the PA's Auditor General, and adopting conflict of interest and financial disclosure provisions for senior government officials, most of which are common practices in other countries.

4.25 Although important, these measures to increase transparency may still be insufficient to eliminate concerns by firms expressing fear of unfair competition from businesses in which the PA is invested.[31] This type of concern is likely to have contributed to the perception among WBES respondents that "corruption" and anticompetitive practices constitute moderate or major obstacles to their growth and operations. One key issue relating to anticompetitive practices is the existence of import monopolies with PA involvement, namely for gasoline and cement. These monopolies were set up within the PP framework to protect existing Israeli monopolies. The small size of the Palestinian economy, with a population of 3 million people, suggests that its small markets could be easily dominated by a few firms. Although fear of competition from PA-related firms may be vague, it is

[31] WBES results indicate that some of these partnerships with the PA are involuntary, i.e., that the PA obtained equity holdings through pressure. In response to the survey question "Has any government agency, or government official, ever asked that they be given part ownership of your firm as a condition of your firm being allowed to operate?", 10 out of 92 respondents, or 11 percent, replied that they had, whereas the PA held an equity stake in only 5 firms in the sample, or 5 percent.

nevertheless cited as a particular concern among small firms. In 2000, the PA announced plans to address concerns over anticompetitive behavior and market power through a privatization strategy "under which we will gradually phase out the Palestinian Authority's equity holdings and privatize most public enterprises" (IMF 2000, p.5). Plans include provisions to ensure that public monopolies are not replaced by private monopolies. Increasing transparency will generate efficiency gains and lower transactions costs by reducing rent-seeking behavior and the need for insider-contracts whereby transactions are conducted within personal networks due to information asymmetries and opaque and poorly enforced rules and regulations.

Consultation with business

4.26 Some business disquiet with the PA – especially among small firms – is likely to reflect the lack of consultation of private firms when formulating policy. Dialogue between the public and private sectors has proved essential to private sector development. International experience suggests the following benefits of business-government consultation:

(i) improved information for public decisions;

(ii) broader ownership of reforms and enhanced credibility of public sector decisions;

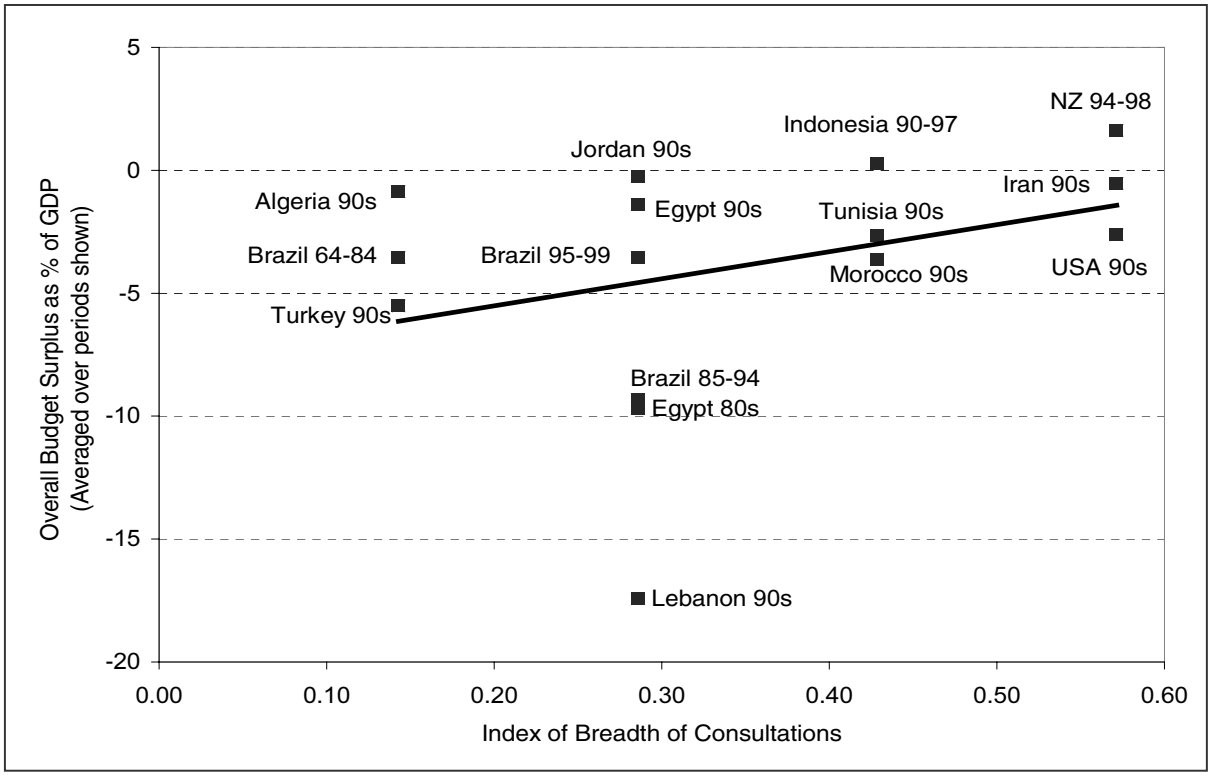
(iii) improved accountability and transparency of decisions;

(iv) increased resources to implement agreed policy by mobilizing financial support from the business community; and

(v) lower costs of business-government transactions through increased trust.

Figure 4.3 (derived from Esfahani 2000) illustrates a positive correlation between the extent to which governments consult with the private sector on fiscal policy and the success of such fiscal policy, measured by budget deficits or surpluses. This type of government consultation creates additional positive feedbacks for the economy at large, given that greater public saving – measured by smaller deficits or larger surpluses in recurrent budgets – is associated with higher GDP growth (Barro and Sala-I-Martin 1995; Sachs and Warner 1995).

Figure 4.3: Budget Discipline and Breadth of Consultation



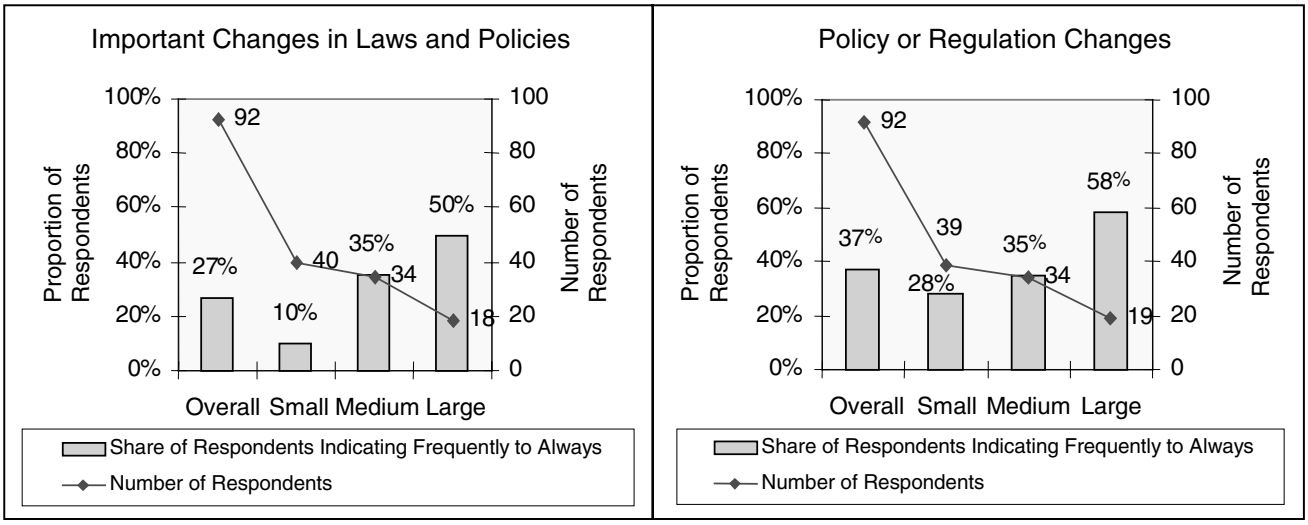
Source: Esfahani (2000)

4.27 The extent of consultation that precedes policy changes appears to be fundamentally different between developing countries and industrial countries. In industrial countries, substantial changes in fiscal policy such as the introduction or abolition of types of taxes like the VAT or estate taxes typically are debated widely before undertaken, and draft regulations are published when a policy is adopted to ensure its implementation is feasible. This does not mean that all members of the public agree with the policy change, but at least dissenting views are aired and considered, and consultation helps ensure successful policy execution.

4.28 How does this compare with policy formulation in WBG? Responses to a series of consultation-related survey questions reveal that a minority of respondents consider that they or their business associations are adequately consulted regarding policy or regulation changes affecting them. As illustrated in Figure 4.4, 37 percent of surveyed firms report that they are consulted "frequently or more often" in advance of policy or regulation changes affecting them, and an even fewer 27 percent report similar levels of consultation when the government makes important changes in law. Responses to these questions vary significantly by firm size: a majority of large firms (58 percent) report at least frequent consultation on policy and regulation compared to

only a 28 percent of small firms, and one-half of large firms and only 10 percent of small firms report at least frequent consultation prior to important changes in law.

Figure 4.4: Consultation Concerning Policy & Regulatory Changes



4.29 Acknowledging the importance of private sector consultation to support its policies, the PA has increased its efforts in this direction, as reflected by the mid-2000 convening of a National Trade Dialogue Conference to foster public-private sector dialogue. The conference produced a detailed agenda of suggested institutional reforms involving private/public collaboration (see Box 4.2) and established the Private Sector Coordinating Council consisting of the Federation of Chambers of Commerce, Federation of Industrial Associations, Paltrade, and the Palestinian Businessmen's Association to pursue this action agenda and institutionalize public-private consultation.[32]

[32] Much of this analysis was drawn from private sector recommendations made in papers presented to the National Trade Dialogue Conference, particularly "The Attitude of the Private Sector towards the Privatization of Government Companies and Private Monopolies", "The Determinations of Private Investment in Palestine: A Survey Study", and the Highlights Paper.

Box 4.2: National Trade Dialogue

A recent initiative by Paltrade (a private sector membership-based organization promoting Palestinian trade) led to the first National Trade Dialogue Conference in May 2000. Palestinian businesses represented there identified the following issues of concern: import quotas, burdensome tax and customs procedures that erode competitiveness, inadequacies in the legal and judicial systems, a weak regulatory framework for product and service standards, and public sector-owned or endorsed monopolies. The following action agenda was agreed with the PA to:

- set up a duty drawback system on imported manufacturing inputs for export products;
- develop an efficient computerized system for customs administration to streamline processes and improve monitoring of the flow of imported and exported goods;
- establish commercial courts to resolve trade disputes;
- enforce the public tender law to promote competitive tendering of contracts;
- create a Land Authority to link land survey and registration processes and thus provide collateral for commercial and mortgage financing; and
- bolster the capacity of the Palestinian Standards Institute (PSI) by increasing its technical staff, ensuring independence in its decision-making, and establishing a network of cooperation and information-sharing with similar international organizations.

Revenue administration

4.30 One important aspect of the interface between private businesses and the PA is tax policy and revenue administration. Although the PA has made notable progress in tax administration since the beginning of the Interim Period, serious problems exist, in particular with the administration of VAT, ranked among the lowest in terms of quality of public services by respondents to the WBES. Firms' resources – especially for relatively liquidity-constrained SMEs – are tied up by long delays in processing refunds of VAT paid on inputs by exporters (complaints along these lines were reported at the National Trade Dialogue Conference). The "partial and haphazard way in which the PA implements VAT refunds" introduces additional impediments to investment and growth by imposing unnecessary costs on the private sector (IMF 2001, p.50).

4.31 Any change in future trade arrangements in the context of a peace settlement will introduce additional challenges for PA tax administration by transferring the present system of Israeli collection of VAT, customs duties and excises to the sole responsibility of the PA. This risks problems on several fronts. The potential shortfall in PA revenue could be substantial, given that Israeli revenue clearances pre-crisis accounted for about 60 percent of total PA revenues. The situation of suspended Israeli clearances to the PA during the ongoing crisis demonstrates the potentially severe impact on fiscal balances, as well as the adverse indirect effects on private suppliers to the government due to PA arrears on domestic payments. Potential revenue shortfalls arising from a transfer of tax collection from Israel administration to the PA could be minimized through a phased transfer approach and close cooperation between the Israeli and Palestinian authorities. A change in regime

also risks increasing the burden on firms in light of already weak administration capacity in the current context of limited PA authority and jurisdiction. Despite these drawbacks, shifting to PA tax collection can in the long run contribute positively to governance and accountability. Substantial investment in training and facilities will be needed to address these challenges.

Non-public delivery of public services

4.32 The nature of government relations with the private sector extends beyond taxation, regulation and consultation on policy, to a potentially deeper interdependence through public-private partnership in service delivery. The PA's record on the delivery of public services has been mixed. For example, a Service Delivery Survey of end-users reports that hospital patients were least satisfied with treatment in government hospitals and most satisfied in NGO and private sector hospitals, and concurrent institutional assessments indicate that government facilities are least well-equipped (CIETinternational 1998). These findings suggest room for greater efficiency through increased non-public provision. Competition among service providers is broadly accepted as the best method to obtain efficient service provision, and these benefits of competition in infrastructure are generally sought through the participation of private sector for-profit firms in investment and service delivery. This type of arrangement exists in a few cases in WBG, such as for health services (World Bank 1999).

4.33 Public services could also be delivered through alternative institutional arrangements other than government and private firms. In WBG where there is a large and well-developed NGO sector, NGOs have traditionally provided a significant share of services in areas such as health, education, agriculture, low-cost housing, and micro-enterprise credit. An earlier study found that two-thirds of hospitals were owned by NGOs or private firms, and virtually all kindergartens were run by non-public agencies (World Bank 1999). Additional research on the extent of NGO activity is ongoing as part of the Bank's upcoming assessment of social protection in WBG. By shifting toward an oversight and regulatory role – i.e., setting standards for service delivery, coordinating with existing service providers (e.g., NGOs), and contracting out activities and monitoring service quality – the PA could enhance the efficiency of services delivered to the Palestinian population.

4.34 Any future government in WBG that follows the path of other market economies will reduce its direct service delivery and focus on a greater management role with respect to determining policy, setting service standards for government and non-government providers, and planning and regulating service provision. This shift in the fundamental role of the public sector would be facilitated by a number of changes to the legal and regulatory framework and financing structures, such as:

- introducing rules for enforcing quality standards for all service providers including government agencies;

- developing an effective contracting framework to facilitate out-sourcing of service provision; and

- leveling the playing field by permitting NGOs and private firms to compete on an equal basis with the public sector in providing services or facilities under government programs.

Conclusions

4.35 The development of the private sector in WBG has been constrained foremost by the uncertain political situation and the resulting unstable economic environment in which it operates. Although the PA has built considerable capacity to provide public services, its institutional development has lagged behind. As a result, inadequate legal and regulatory institutions, auditing standards, and transparency impose costs on private agents by exacerbating rather than mitigating the uncertain environment. Limited access to capital is a fundamental manifestation of insufficient financial intermediation, which in turn dampens economic growth by reducing potential investment and job creation. Despite considerable progress in domestic revenue collection since 1994, the PA's track record on revenue administration poses challenges in the context of a new and independent Palestinian trade and fiscal policy no longer carried out solely by Israel. And finally, the PA's interface with the private sector – although improving through recent initiatives – does not reflect a level of partnership that promotes private sector growth sufficiently to generate positive feedback through policy efficiency and effectiveness. Whereas the emergence of a dynamic private sector in WBG will require a vastly improved environment with respect to uncertainty and risk, the PA nevertheless has a range of policy options at its disposal to mitigate these constraints and therefore stimulate a stronger private sector response.

Palestinian Economic Growth Past and Future

5

Palestinian Economic Growth Past and Future

5.1 Palestinian economic performance in the past – dating to 1967 – was broadly characterized by output volatility, steady but modest economic growth averaging 5.4 percent annually, and production structures dependent on trade with Israel. This performance generally continued through the post-Oslo period, despite policy measures introduced under the Paris Protocol. Data on real gross domestic product (GDP), gross national income (GNI) and population are highly uncertain, especially in light of the shift in measurement from Israeli to Palestinian statistical offices.[33] Nevertheless, the overriding story is one of integration of the smaller Palestinian economy with its larger and more developed neighbor Israel.

5.2 The Palestinian economy has benefited from a catch-up, or convergence, phenomenon as a result of this integration. As discussed in Chapter 3, access to Israeli jobs and Israeli employers' access to a large and cheap Palestinian labor force are the main factors explaining this income convergence (Kleiman 1999). Although primarily confined to unskilled activities, Palestinian workers benefit from larger and more modern Israeli productive capacities, hence receiving higher remuneration than in jobs within WBG. On the other hand, other potentially more important sources of economic growth anticipated in the integration/convergence model did not materialize in practice; technological transfers from Israel to WBG remained

[33] Until 1994, Palestinian national accounts statistics were collected by the Israeli Central Bureau of Statistics (ICBS), and thereafter by the Palestinian Central Bureau of Statistics (PCBS), suggesting that the two series may not be strictly comparable, given possible differences in coverage and methodologies. Real economic aggregates for the period since 1994 are estimated by the World Bank, in the absence of national accounts data in constant prices.

extremely scarce, and trade was largely asymmetric, with imports from Israel far exceeding exports, as described in Chapter 2.[34] The one-sided trade policy resulted in high effective tariffs on Palestinian imports and limited access to third-party markets, leading to trade diversion and reducing Palestinian competitiveness. Output growth since 1967 was therefore fueled by worker remittances from Israel rather than by increased local productive capacities for exports and productivity growth. In fact, Israeli authorities discouraged Palestinian business initiatives that might compete with Israeli firms (Arnon and Weinblatt 2000). Non-tradable activities – notably services and construction – expanded quickly, constituting the bulk of wealth creation in WBG, while tradable activities in agriculture and manufacturing stagnated or in some cases were abandoned to foreign competitors. The difficult business environment with respect to uncertainty, property rights, financing, and transparency further dissuaded investment in growth-generating activities.

5.3 The PP aimed to correct some of the observed development disparities, especially on the trade and income side, by improving the environment for private investment and growth in WBG through eliminating Israeli trade barriers on Palestinian agricultural products, removing restrictions on economic activities, reducing political and economic uncertainty as a result of phasing-out military occupation, developing financial institutions, and creating a legal and regulatory framework. The PP also led to the revenue-sharing, or clearance, mechanism under which Israel transferred the taxes it collected from trade, purchase and VAT on behalf of the PA, less a 3 percent administrative fee. Accompanied by substantial donor support in terms of infrastructure investment and technical assistance, this model of economic integration nevertheless failed as incomes diverged between Palestinians and Israelis during this period. This failure can be attributed to several factors: an inadequate incentive structure to overcome the imbalance in trade and labor flows and thus undo the captive market nature of the Palestinian economy vis-à-vis Israeli producers (Arnon and Weinblatt 2000); the policy of internal and external closures[35] imposed sporadically by Israel since 1995, which in turn increased transactions costs and introduced additional uncertainty, further dissuading potential investors (Kanaan

[34] Naqib (2000) identifies two opposing effects of integration between a large, advanced and rich economy with a small, poor and underdeveloped economy: "a favorable repercussion is an increased demand for the products of the small economy, a diffusion of technology and knowledge, as well as other spread effects, resulting from the geographical proximity to a large market leading to subcontracting, joint ventures and coordination in tourism and other services. Unfavorable repercussions arise from the disappearance of many industries in the small economy, its confinement to producing low-skill goods, and the emigration of a sizeable segment of its labor force to the neighboring country, as well as to other countries." Vamvakidis's (1998) cross country analysis also suggests that North-South integration can boost GDP growth in the developing country through economies of scale, technological spillovers, and reduced costs of adaptation and innovation.

[35] "Closure" is a term referring to the restrictions placed by Israel on the free movement of Palestinian goods and labor across borders and within the West Bank and Gaza. The restrictions take three basic forms: internal closure within the West Bank and Gaza, closure of the border between Israel and the West Bank and Gaza, and closure of international crossings between the West Bank and Gaza and neighboring Jordan and Egypt.

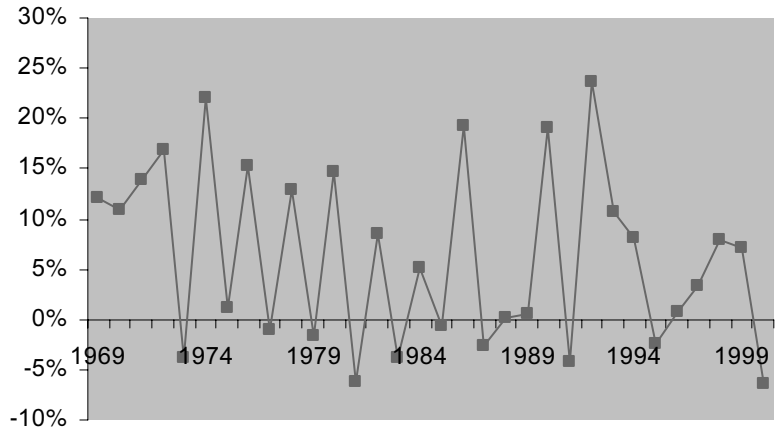
1998); and concurrent and related developments in the PA governance structure regarding import monopolies, concessions, and public sector hiring, which negatively affected economic efficiency.

5.4 This chapter examines the growth performance of the Palestinian economy and the key explanatory factors with respect to productivity growth and capital accumulation, the degree to which convergence with Israel has been achieved, and the prospects for economic growth under future policy scenarios using a dynamic computable general equilibrium (CGE) model to reflect the analytical features of past performance.

Palestinian growth history 1968-2000

5.5 Palestinian GDP growth is highly volatile, as depicted in Figure 5.1, comparable to the most volatile economies of Latin America (IMF 2001).[36] Several factors contribute to this high volatility, such as the bi-annual natural cycle of olive tree production, and political events.[37] It is likely that such a high degree of volatility lowered Palestinian GDP growth by discouraging savings and investment (Stiglitz 1993). In practical terms, it is important to note the difficulties in calculating an average growth rate that properly reflects historical growth patterns in West Bank and Gaza in the context of high volatility.[38]

Figure 5.1: Real GDP Growth 1968-2000[a]



[a] Data excludes East Jerusalem

5.6 To address these analytical difficulties, this analysis uses information from each year in the period 1968-2000 to measure the average GDP growth rate in WBG,

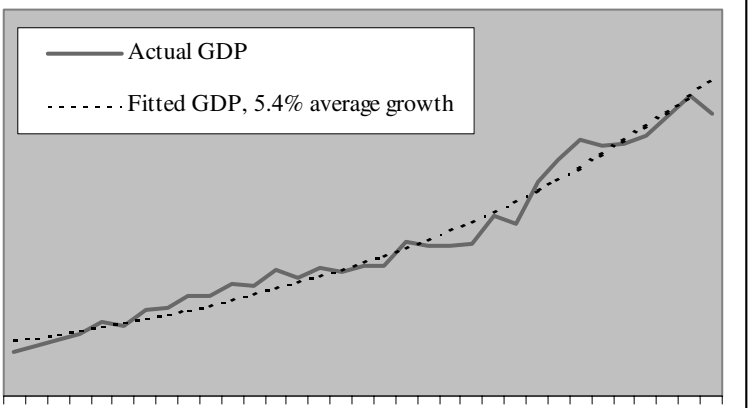
[36] Over the period 1968-2000, GDP growth volatility calculated as the ratio of its standard deviation over its average was a very high 1.4.

[37] A simple regression of GDP growth rates on (i) GDP growth rates in Israel, (ii) a dummy variable assigned a value of 1 in olive harvest years and 0 otherwise, and (iii) an index of internal and external closures (using UNSCO data) explains 46 percent of GDP growth variation over the period 1969-2000.

[38] Computing average GDP growth using data on the first and last years of any given period is highly variable with respect to the choice of end-dates.

by econometrically estimating a general production function: the results indicate average annual GDP growth rate of 5.4 percent (see Figure 5.2).[39]

Figure 5.2: Real GDP, 1968-2000 (1986 NIS)



Oslo and the Paris Protocol

5.7 Following the implementation of the Paris Protocol, the post-Oslo period did not introduce any structural break in GDP growth patterns with respect to the pre-Oslo period. Estimates of GDP growth do not change significantly when the specification allows the growth rate to follow a different path after 1994.[40] Analytically speaking, the post-Oslo period is too short to determine any definitive impact of the PP on growth. Moreover, economic output during this period was extremely erratic, with distinct episodes mirroring the volatile evolution of political relationships with Israel (recall Box 1.1), particularly vis-à-vis the degree of internal and external closures. In the initial post-Oslo years the economy experienced a return of nationals and large inflows of public and private capital as the result of positive expectations on the peace process. But two years of intermittent external closures in 1995-96 and a sharp decline in Palestinian labor flows to Israel precipitated economic recession (data reported in Table 5.1).

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[39] The production function $Y_t = Ae^{\beta t}$, where Y is real GDP, A an intercept, t a linear time trend and β the average growth rate, is transformed with logarithms and estimated over the period 1968-2000, with the following results (T-student statistics in parentheses):

$$\ln Y_t = -100.1 + 0.0543\,t$$

(27.5) (29.6) Adj. R^2 =0.965 DW=0.679

Unless otherwise specified, all growth rates reported in the remainder of this chapter are computed econometrically.

[40] This was tested by adding to the right-hand side of the growth equation a multiplicative variable *t * Oslo*, with *Oslo* taking the value 0 before 1994, and 1 from 1994 to 2000. This multiplicative variable is not significantly different from zero at the 10 percent level.

Table 5.1: Summary of Macroeconomic Trends from 1995 to 2000						
	1995	**1996**	**1997**	**1998**	**1999**	**2000**
Real Annual Change (%):						
GNI per capita	-8.6	-5.6	1.8	7.7	2.2	-11.7
GDP	-2.4	0.8	3.3	7.9	7.2	-6.4
Capital stock per capita	5.2	3.5	4.0	4.5	4.1	0.6
Total factor productivity	-8.9	-5.0	-2.5	2.1	1.4	-10.5
Imports	-2.0	2.0	8.0	7.4	9.2	-10.9
Exports	-10.0	3.0	4.0	6.6	3.3	-7.4
Population	5.9	5.1	4.4	3.9	4.0	4.4
As a share of GDP (%):						
Exports	16.9	17.2	17.4	17.2	16.6	16.4
of which to Israel	15.6	14.7	13.8	16.5	15.8	15.7
Imports	68.5	69.3	72.5	72.1	73.5	70.0
of which from Israel	61.3	59.6	57.0	54.1	55.1	52.5
Private consumption	95.0	93.3	94.0	94.9	94.0	93.6
Total investment	34.8	33.9	35.3	35.5	38.4	33.2
Tax revenue	11.8	18.9	21.6	22.0	23.4	21.2
Other items (%):						
Unemployment rate	18.2	22.8	20.0	14.5	11.9	14.1
Labor flows to Israel (% employment)	16.1	15.0	17.1	21.7	22.7	18.9
Poverty rate	n.a.	26.9	25.3	23.2	20.8	33.4

Note: All data excludes East Jerusalem
Sources: World Bank estimates, PCBS, IMF

5.8 From 1997 to September 2000, closures were less frequent, labor flows to Israel grew dramatically such that remittances from commuting Palestinian workers fuelled demand for domestic products, and transactions costs fell while private investment increased. The Palestinian economy also benefited from an economic boom in Israel, through enhanced opportunities for exports of Palestinian goods and labor. The outbreak of the second intifada in late September 2000 halted the economic recovery and again demonstrated the negative impact of closures on economic growth.

5.9 During the period 1997-1999, GDP was very close to its steady state growth path (as depicted in Figure 5.2), suggesting that the primary features of the Palestinian economy were not significantly modified by the Oslo agreements, with the exception of closures. Most economic policy decisions continued to be made by Israel, with little consultation with the Palestinian authorities or accounting for Palestinian interests, and high dependency on the Israeli labor market and goods did not allow the Palestinian private sector to diversify its risk, and entailed significant

trade diversion and high domestic wages. The fact that capital stock growth (see discussion below) did not significantly accelerate after Oslo in spite of large amounts of official assistance from foreign donors implies no dramatic change in incentives to invest in business modernization or expansion. And trade – an important source of growth through imports of technologies, increased competition and economies of scale on export markets – also remained very asymmetric, with imports from Israel far exceeding exports to Israel, as was the case before Oslo.

Growth accounting

5.10 GDP growth is a complex phenomenon driven in the long run by supply-side conditions – i.e., the change in the level of productive capacities (labor, human and physical capital, and technology) – and in the shorter run by demand conditions affecting the use of these capacities, together determining their growth paths. In WBG, as elsewhere, supply and demand conditions stem from a combination of domestic and external factors and policies. In this respect, the nature of economic relations with Israel is central to the growth story in light of the high degree of integration and very limited capacity for independent Palestinian policymaking, affecting not only the environment in which the Palestinian economy evolves but also the spectrum of policy instruments at the disposal of Palestinian policymakers to promote growth.

5.11 A growth accounting exercise is useful in measuring the different sources of growth, in particular by distinguishing between the growth contributions from factor accumulation and from productivity growth (defined as the better use of existing productive capacities and/or introduction of new technologies).[41] In a neoclassical analytical framework[42], this approach corresponds to distinguishing between transitional growth and long-term potential growth, respectively. Per capita GDP growth is expressed as the sum of (i) per capita capital stock growth multiplied by the elasticity of GDP with respect to capital and (ii) total factor productivity (TFP) growth (see Annex VI for details). Under reasonable estimates of capital stock, Palestinian growth has been transitional rather than sustainable because it was driven by capital accumulation. Total factor productivity growth contributed only marginally to GDP growth since 1968: annual TFP growth over the period 1969-2000 ranges between 0.3 and 0.4 percent, a disappointing performance.

5.12 There are several potential explanations for slow TFP growth. First, most capital expenditures went to construction rather than productive activities, implying that only limited amounts of machinery and equipment were imported by investors to modernize and upgrade their activities since 1967. Data for 1998 indicate that

[41] The strict independence between factor accumulation and factor productivity represents a simplifying assumption. In reality, productivity is likely to affect factor accumulation by influencing factors' rates of return, while technological progress is typically embodied in physical capital.

[42] That is, assuming constant returns to scale and the remuneration of factors at their marginal productivity.

investment expenditures devoted to building construction represented some four-fifths of total investment expenditures. Second, the manufacturing sector, where most productivity gains can potentially be achieved in the development process of a low- to middle-income economy, remained dormant. In economic development success stories such as Taiwan, for instance, sectoral reallocation of resources (especially labor) from agriculture to industry accounted for about half of the rapid TFP growth (Dessus et al. 1995). In WBG, by contrast, most of the labor force was reallocated to services with generally low levels of labor productivity. Human capital, although rapidly accumulated by Palestinians, was not used to modernize productive capacities. Moreover, a large part of human capital remained unutilized due to the low labor force participation and high unemployment rates of skilled Palestinian women. Low returns to education pushed skilled male workers out of the Palestinian-Israeli labor market and encouraged migration to other markets (Angrist 1995). A Dutch disease phenomenon fueled by large inflows of income from abroad may have reduced the need for innovation and therefore productivity growth (Shafik 1997; Dutz and Hayri 2000; Astrup and Dessus 2001b). The very low degree of Palestinian economic integration into global markets indicates – as a cause and/or a symptom – its weak competitiveness and productivity. Finally, this observed low productivity growth suggests that Palestinian economic integration with Israel since 1967 has not benefited from significant technology transfers (discussed further below).

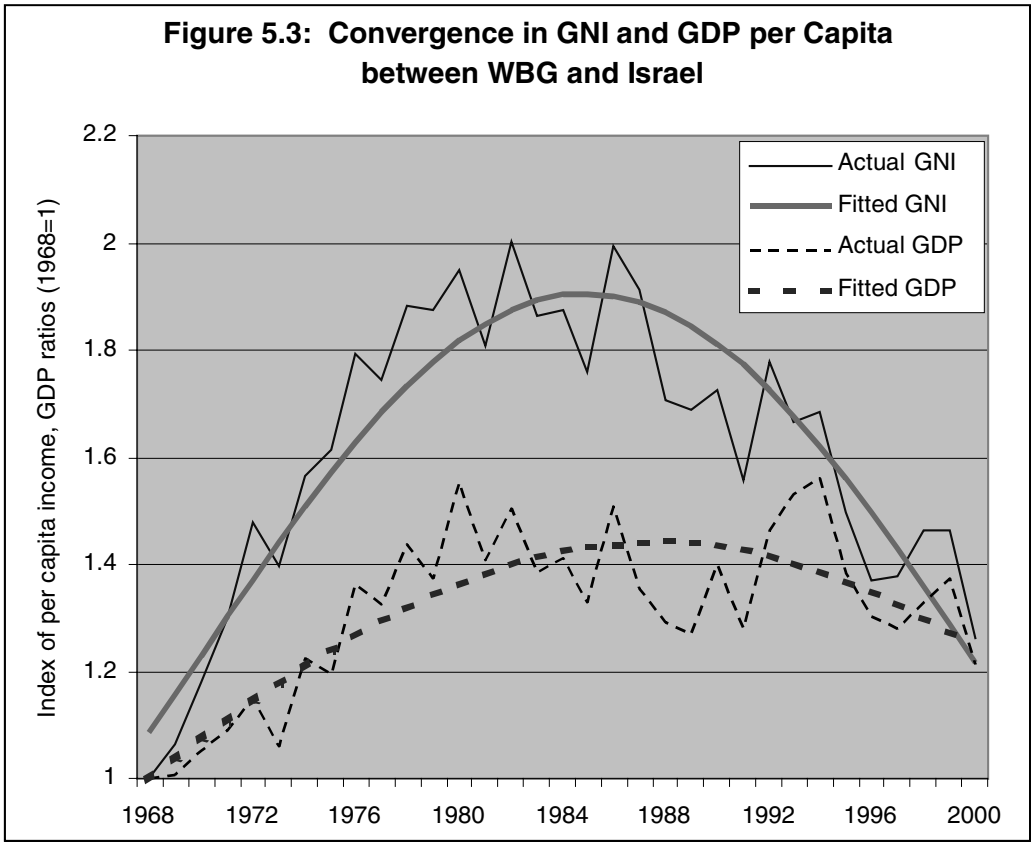
Income convergence with Israel

5.13 While WBG's real GDP grew annually by 5.4 percent on average from 1968 to 2000, the concurrent rapid population growth implies more modest GDP growth of 2.5 percent in per capita terms. Israel, on the other hand, witnessed slower per capita GDP growth of 1.8 percent during the same period, implying income convergence between WBG and Israel.[43] This catch-up phenomenon was not uniform between 1968 and 2000, however. After a period of rapid convergence in GDP per capita (from 1968 to the mid-1980s) during which the income gap narrowed by almost 50 percent, per capita GDP started to diverge from 1987 onwards, as depicted in Figure 5.3. To illustrate the implications with respect to income levels, an initial Palestinian-Israeli per capita GDP gap of approximately 1:10 in 1968 (measured at purchasing power parity) as suggested by Naqib (2000) would have declined to 1:6 in 1980 and rebounded back to 1:8 by 2000, reversing much of the earlier gains.

[43] Data for Israel (GDP, population, capital stock, total factor productivity) are from the Bank of Israel.

5.14 Income convergence is generally measured using data on GDP per capita (Barro and Lee 1995), given that convergence in theory stems from decreasing returns to human and physical capital accumulation and a catch-up phenomenon in productivity (e.g., through the imitation and adaptation of foreign technologies), both of which influence GDP rather than GNI.[44] Less attention has been paid in the empirical growth literature to income convergence through trade in production factors, and in particular through the export of labor services. This phenomenon most likely had a significant impact in WBG, as labor exports to Israel grew very rapidly after 1967. Moreover, net factor incomes from abroad represent a large share of total Palestinian income. In 1998, Palestinian households (excluding East Jerusalem) received some US$828 million of net income from abroad (of which US$724 million were workers' remittances from Israel), equivalent to 16.4 percent of GNI, far exceeding averages in the MENA region (less than 1 percent) and elsewhere.

Figure 5.3: Convergence in GNI and GDP per Capita between WBG and Israel



5.15 From 1968 to 2000, real GNI per capita in WBG grew by 2.5 percent annually compared to 2.1 percent in Israel, indicating income convergence. But similar to GDP, a rapid convergence in GNI from 1968 to the mid-1980s was followed by a widening of the income gap (see Figure 5.3).

[44] The difference between GDP and GNI is given by net income from abroad, which does not directly depend on capital stocks and productivity levels in the economy.

5.16 Many factors might explain this pattern of income convergence/divergence. For example, the degree of economic integration between WBG and Israel – although high in some markets – has never been total, and varied considerably over time (Naqib 2000; Farsakh 1998). Palestinian and Israeli households do not necessarily have the same economic preferences, leading to different savings rates and the use and retention of different currencies. In this context, external shocks and policy measures have different effects on income growth patterns in the two economies.

5.17 It is striking that the convergence-divergence pattern is more pronounced in GNI than in GDP (illustrated in Figure 5.3), suggesting that workers' remittances from Israel played a particular role in this regard.[45] The extent of this phenomenon is measured by decomposing the change in income ratio into three components: (i) the evolution of the capital ratio between the two economies, (ii) the evolution of the productivity ratio between the two economies, and (iii) a residual term capturing the impact of net incomes from abroad on GNI.[46]

5.18 Table 5.2 reports the results of this decomposition for different periods. The year 1987 is pivotal in that it marks the trend-shift from convergence to divergence. Over the whole period, annual per capita GNI grew 0.36 percent more rapidly in WBG than in Israel, primarily due to a more rapid capital accumulation in WBG than in Israel (1.3 percent higher every year in WBG). Conversely, the data indicate a divergence in productivity: each year between 1968 and 2000, productivity grew by an average 0.7 percent more rapidly in Israel than in WBG.

5.19 The structural break observed in the mid-1980s can be explained primarily by the 1987 outbreak of the first intifada, which was accompanied by strikes and economic recession in WBG concurrent with increasing per capita incomes in Israel, and subsequently by the dramatic drop in Palestinian incomes from abroad following the return of skilled Palestinian workers from Gulf countries in conjunction with the 1991 Gulf War.

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[45] The other mechanical explanation for the difference in convergence/divergence patterns measured with GDP and GNI could stem from the fact that GDP and GNI growth also widely differed in Israel. But it appears that the ratio of GNI/GDP has been much more stable in Israel than in WBG between 1968 and 2000: the volatility of this ratio, measured by the standard deviation over its average, is 3.8 percent in Israel and 8.1 percent in WBG.

[46] This calculation is made by expressing per capita GNI, $\overline{y}_{i,t}$, of country *i* in period *t* as:

$$\overline{y}_{i,t} = k_{i,t}^{\alpha_i} x_{i,t} z_{i,t}$$

with *k* the capital stock per capita, *x* the level of TFP and *z* the ratio of GNI over GDP, the income ratio between economies *i* and *j* in period *t*. Written in logarithms as:

$$\ln(\overline{y}_{i,t} / \overline{y}_{j,t}) = \ln(k_{i,t}^{\alpha_i} / k_{j,t}^{\alpha_j}) + \ln(x_{i,t} / x_{j,t}) + \ln(z_{i,t} / z_{j,t})$$

this equation can be time-differentiated to generate the decomposition. N.B. A positive growth rate denotes a convergence in factor endowments between the two economies if country *i* is initially the poorest.

Table 5.2: Income Convergence and Divergence Patterns between WBG and Israel			
	1968-2000	**1968-1987**	**1988-2000**
Net convergence effect	0.36%	3.13%	-2.29%
Capital	1.31%	2.22%	0.26%
Productivity	-0.74%	-0.41%	-0.39%
Income from abroad	-0.20%	1.33%	-2.16%

Source: Calculation based on PCBS and Bank of Israel data. For WBG, an initial capital stock/GDP ratio of 2 in 1968 is assumed, and for Israel, TFP and capital stock series are extracted from the Bank of Israel. The contribution of capital to GDP is obtained for Israel with an elasticity of GDP to capital of 0.32, consistent with the TFP time series computed by the Bank of Israel. The convergence effect is obtained by regressing the logarithm of the income ratio (GNI per capita in WBG over GNI per capita in Israel) over a time trend.

5.20 This analysis illustrates that economic integration of WBG with Israel has not produced the positive dynamic gains - notably in terms of productivity growth and technological transfers – predicted by the model of economic convergence. Estimating the potential growth of the Palestinian economy over the next decade needs to reflect these results as well as the nature of future economic relations with Israel, particularly regarding the degree of integration of product and factor markets.

Palestinian growth potential 2001-2010

5.21 The analysis that follows estimates future Palestinian GDP growth based on different scenarios of economic and political relations with Israel. A dynamic general equilibrium model calibrated for the Palestinian economy is used to build these scenarios. The model combines in a consistent framework demand and supply conditions on goods and factor markets by describing the economic relations among households, producers, the government, and the rest of the world with a set of accounting and behavioral equations (see Astrup and Dessus 2001a for details of the model). Demand (intermediate consumption, final consumption, investment, government expenditure, imports) and supply (domestic production, exports) are modeled with flexible prices clearing all markets. The model's parameters are calibrated using a social accounting matrix for 1998 which depicts the behaviors of Palestinian economic agents. Seven sectors are modeled separately – agriculture, manufacturing, construction, transport and communications, commerce and tourism, other private services, public services – and two trade partners are considered, Israel and the Rest of the World. The model also reflects the existing trade and fiscal arrangements with Israel as of September 2000. GDP growth in the model arises from endogenous labor supply, capital accumulation in productive activities, and productivity increases, the latter depending on the degree of competition, openness, and movement restrictions.

5.22 Scenarios are built under a set of exogenous assumptions regarding population growth and the external environment for the period 2001-2010 (see Table 5.3). These assumptions are the same for all scenarios, with the exception of Scenario 1. Other factors affecting income growth through higher capital accumulation, labor supply

and productivity gains respond directly to the future assumed nature and degree of integration with Israel, as well as to the policies implemented by the Palestinian Authority and Israel under the different scenarios.

Table 5.3: Exogenous Assumptions

Annual growth rate 2001-2010:	**Scenario 1**	**Scenarios 2-5**
Population growth	3.4%	3.4%
Working age population growth	4.4%	4.4%
Exogenous technical progress	0.0%	0.4%
Real public expenditures	0.0%	2.8%
World price of imports	0.0%	0.0%
World price of exports	0.0%	0.0%
Real wage in Israel	2.0%	2.0%
Net foreign savings	-4.7%	1.0%

5.23 Capital. Physical capital accumulation, or investment, depends on the availability of savings originating from households, the government, and the Rest of the World through foreign direct investment and official development assistance. Household savings depend positively on household incomes, and government savings depend positively on tax revenues (determined by the tax structure and the level of economic activity), and public expenditures are treated as exogenous. Foreign savings, which consist of investment spending financed by foreign aid and private transfers, are assumed to follow historical paths, particularly with respect to donor aid flows.[47] The model distinguishes between productive and unproductive capital (e.g., residential building); only the former contributes to GDP growth when accumulated. Increased access to external markets is assumed to expand investment opportunities and thus the share of savings invested in productive activities. Empirical studies indicate a positive relationship between investment and trade openness (Levine and Renelt 1992; Wacziarg 2001), and in this analysis, the ratio of productive investment over savings is modeled as a function of the share of exports in GDP (with an elasticity of one-third).[48] The initial productive capital stock is calibrated in 1998 to match the observed capital stock growth from 1998 to 1999, and the overall elasticity of GDP with respect to capital is fixed at 0.40, equal to the share of capital remuneration in total value-added.[49] The implied rate of return to capital (before tax) equals 12.5 percent in 1998.

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[47] Specifically, official development assistance which jumped to US$929 million in 2001 in response to the intifada is assumed to return to historical levels of US$462 million per year from 2003 onwards, two-thirds of which are allocated to public investment.

[48] This assumption differs from the preceding analysis in which the share of productive over non-productive investment was treated as constant. Re-estimating the growth equation assuming that the share of productive investment depends on trade yields slightly higher elasticities of GDP with respect to capital.

[49] Sectoral shares of capital remuneration over GDP are: 0.50 in agriculture, 0.58 in manufacturing, 0.58 in construction, 0.19 in commerce, 0.43 in transport, and 0.35 in services. These shares are estimated using a two-step procedure. Capital remuneration in each sector is obtained by the difference between the value added reported in the supply-use table built by PCBS for 1998, and the

5.24 Labor. In the model, labor supply depends positively on real wages and on the degree of closures. As illustrated in Chapter 3, closures increase unemployment, lower wages and reduce the probability of finding a job in Israel. At the same time, however, downward pressure on domestic wages actually raises the wage gap, thus increasing labor supply to Israeli jobs.

5.25 Productivity growth. A large literature supports the idea that outward orientation favors TFP growth by encouraging technological transfers, enlarging the choice of inputs and reinforcing competitive pressures. Following Dessus et al. (1999), an increase in the share of tradable activities in GDP is accompanied by an increase in total factor productivity; international experience is used to calibrate this phenomenon. This assumption is supported by the observed underutilization of human capital in WBG resulting from the distorting effects of Palestinian labor flows to Israel, and the one-sided nature of trade relations with Israel and limitations on third-party trade. Expanding tradable activities and reducing distorted incentives could enhance the use of available human capital in growth-generating activities. Total factor productivity growth is modeled as the sum of two components: (i) an exogenous trend reflecting exogenous technical progress – assumed low at 0.4 percent and consistent with historical trends; and (ii) an endogenous component in which TFP is a function of the share of exports in GDP (with an elasticity of 0.3).

5.26 Additional assumptions. Others factors influencing the evolution of the Palestinian economy are introduced in order to construct the different scenarios. The nature of Palestinian export opportunities in Israel are treated distinctly from those in the rest of the world. In light of the long-term Palestinian presence in Israeli markets, the close ties with Israeli businesses and consumers, and the significant market shares developed in Israel, the model assumes that Palestinian producers have some market power in the Israeli goods markets. But this advantage is counterbalanced by the relatively limited growth prospects of the Israeli market compared to the much larger world market. Palestinian producers do not hold strong positions on international markets, by contrast, and face tough competition to develop new markets; in the event that domestic agents produce goods at competitive prices however, the prospects for export outlets in the rest of the world are significantly larger than in Israel. The capacity of Palestinian producers to shift their targeted markets from external to domestic markets is assumed to be moderate vis-à-vis international standards, but producers are assumed to have low capacity for shifting production from Israeli markets to other external markets (to reflect difficulties in exporting abroad compared to Israel). Entrepreneurs have a greater capacity to adjust production techniques to new opportunities with the latest vintage of capital (i.e. investments) relative to

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corresponding labor remuneration extracted from PCBS labor force surveys. This generates an average share of 0.45, which is subsequently adjusted downward to 0.4 to reflect under-accounting of actual labor value added in the following sectors: agriculture, commerce, and other privates services.

already installed capital for which there is little substitution among intermediate inputs, labor and capital. Finally, in all scenarios except Scenario 1, real government expenditure is assumed to keep pace with population growth from 2004 onwards.

5.27 Five scenarios are constructed to reflect future economic relations between WBG and Israel. These prospective scenarios present a range of policy options and varying degrees of cooperation on the political front. No particular likelihood is attached to any of these scenarios, given the uncertainty of future directions of the peace negotiations. Political developments will be central to the ultimate shape of economic arrangements. The following analysis assesses the main forces at work and at the same time seeks to be comprehensive in assessing a broad range of options, from continued crisis and confrontation, to a return to the pre-crisis environment, to marginally improved relations, to non-cooperative economic separation, and finally cooperative economic policy autonomy.

5.28 Four different exogenous variables described in Table 5.4 below are used to build these scenarios: (i) the degree of closures and confrontations, (ii) the level of transactions costs, (iii) the number of Palestinian workers in Israel, and (iv) the nature of trade arrangements.

Table 5.4: Assumptions for Five Scenarios

Scenario	Closures & Confrontation	Transactions costs	Workers in Israel	Trade Regime
1	Persist until 2010	Very high until 2010	70,000 in 2010	Customs Union
2	Peak in 2002, end in 2003	Same as in 2000	145,000 in 2010	Customs Union
3	Peak in 2002, end in 2003	20% lower than in 2000	165,000 in 2010	Customs Union
4	Peak in 2002, end in 2003	20% higher than in 2000	70,000 in 2010	Non-Discriminatory
5	Peak in 2002, end in 2003	20% higher than in 2000	145,000 in 2010	Free Trade Area

N.B. 2000 refers to the pre-intifada period.

5.29 The intensity of Israeli closures is directly linked to the mobility of goods and people within WBG and between WBG and external partners, thus affecting transport costs and transactions costs more broadly. Future transactions costs will depend on the nature of border policy; the scenarios consider substantial improvement (Scenario 3) or deterioration (Scenarios 4 and 5) on the order of 20 percent. Assuming larger changes leads to slightly larger (but less than one-for-one) effects, as will be illustrated in the low-case scenarios below. The magnitude of Palestinian labor flows to Israel are assumed to range from the minimal levels observed during the ongoing crisis to a likely maximum of 165,000 by the year 2010, which reflects a constant share of the Palestinian labor force (as discussed in Chapter 3). Finally, with respect to trade regime, the scenarios compare the growth and income effects of a customs union, a non-discriminatory trade policy and an FTA, as outlined in Chapter 2.

Scenario 1: Continuation of the crisis

5.30 This first scenario envisages a continuation of the crisis ongoing since September 28, 2000. The level of external and internal closures observed in 2001 and 2002 are assumed to persist through 2010. The strict enforcement of closure policies will continue to impede Palestinian labor flows to Israel, but increased labor supply in WBG and a growing wage gap with Israel will steadily increase the number of candidates seeking work in Israel. By 2010, some 70,000 Palestinian workers are assumed to cross the border, compared to 55,000 in 2001. External closures increase the price of imported goods by an assumed 15 percent premium, and internal closures affect the overall productivity of the economy (captured in the model by a 25 percent decline with respect to the pre-crisis level). Confrontation entails a rapid depreciation of physical capital (assumed at 7 percent compared to 5 percent without crisis), and a combination of high risk with low prospects reduces the inflow of private foreign savings. Reduced public receipts lead to a decline in public expenditure per capita.

5.31 Under these assumptions, the model predicts that the Palestinian economy gets trapped in a low-level equilibrium of declining incomes and falling investment (results are reported in Table 5.5; note that projections can be compared with historical data reported in Table 5.1). Movement restrictions lead to a decline in incomes and higher unemployment; households deplete their savings to finance consumption of essential goods, and real income per capita drops by 4 percent each year between 2000 and 2010.[50] The unemployment rate rises steadily, reaching nearly 32 percent in 2010. Low household savings and higher transactions costs dissuade new investment, such that capital stock per capita is predicted to decline by 3.7 percent a year. High transactions costs particularly harm trade flows with the rest of the world, leading to increased dependence on exports to Israel (goods are almost exclusively traded with Israel), which in fact keeps total factor productivity near its historical trend. Total economic output stagnates as GDP grows by less than one percent every year from 2000 to 2010, compared to 5.4 percent from 1968 to 2000. Reduced incomes from abroad are accompanied by a strong depreciation of the real exchange rate (the price of value added expressed in foreign currency) in order to finance inelastic imports.[51] And in 2010, average real per capita incomes are one-third lower than in 2000.

[50] Real income per capita is measured by per capita household disposable income deflated by the consumer price index (CPI). It differs from real GDP per capita because it includes net revenues from abroad, but also because it is deflated by the CPI, which includes imported goods. The CPI and the GDP deflator typically diverge when the remuneration of factors deviates from international prices.

[51] The numeraire of the model is the nominal exchange rate.

Scenario 2: Back to September 2000

5.32 This scenario assumes that following a peak of the crisis in 2002, it takes nearly two years to return to the situation prevailing prior to the intifada. Internal and external closures are progressively removed in 2003, and confrontation ceases altogether. Palestinian labor flows to Israel are assumed to rebound to 125,000 by end-2003 and grow by 2 percent per year thereafter, reaching 145,000 in 2010. From 2004 to 2010, public indebtedness declines and real public expenditures grow at the same pace as the Palestinian population. There is no change in trade or fiscal policy, and the inflow of foreign savings (private or official) augments slowly.

5.33 Model simulations suggest that the economy's response to the removal of internal and external closures in 2003 is relatively rapid.[52] The Palestinian economy returns to its steady state growth path after only two years of economic recovery, with GDP growth averaging 5.6 percent annually from 2005 to 2010.[53] Most new entrants to the labor market are absorbed domestically, putting downward pressure on nominal wages, such that the purchasing power of imported products declines. Imports grow slowly, averaging only 2.7 percent per year, and real per capita incomes grow even slower, by 1.3 percent annually. The equity implications of these projections are significant: 15 percent of the labor force remains unemployed in 2010 and over 21 percent of the population are estimated to fall under the poverty line. In the absence of changes to the trade regime, Israel remains the dominant trading partner for West Bank and Gaza: in 2010, 74 percent of imports come from Israel and 86 percent of the exports are destined to Israel. Productivity growth in turn stagnates, implying that most of the economy's growth is driven by capital formation and the increase in labor supply. The Palestinian economy in effect returns to historical patterns of growth characterized by low competitiveness, slow productivity growth, rapid capital stock growth with only transitional contributions to GDP, high dependency on Israeli markets, a distorted labor market, modest per capita income growth, and a significant incidence of poverty.

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[52] This observation is consistent with estimates of the error-correction model in Annex VI which indicate that the Palestinian economy absorbs 40 to 70 percent of a shock (measured by the distance between actual GDP and capital stock) within a year.

[53] Table 5.5 distinguishes GDP and income growth rates for the period 2001-10 from the period 2005-10, the latter being more representative of the long-term growth potential of the Palestinian economy following peak-crisis in 2002 and three subsequent years of economic recovery, plus economic reforms in 2004 in some scenarios.

Table 5.5: Simulation Results					
Scenarios	**1**	**2**	**3**	**4**	**5**
Growth rates 2000-2010 (%):					
Real Income per capita	-4.0	1.3	2.1	1.0	1.0
Real GDP	0.5	5.8	6.4	6.2	5.1
Growth rates 2005-2010 (%):					
Real income per capita	-1.8	1.3	1.9	2.1	1.2
Real GDP	1.7	5.6	5.7	6.2	5.4
Capital stock per capita	-3.7	3.8	4.4	4.6	3.4
Total factor productivity	0.3	0.5	0.3	1.0	0.5
Imports	0.4	2.7	3.2	3.3	2.6
Exports	3.2	6.4	6.0	8.6	6.2
Population	3.3	3.3	3.3	3.3	3.3
As a share of GDP in 2010 (%):					
Exports	22.0	18.0	17.7	21.7	17.2
of which to Israel	20.1	15.4	15.1	15.9	14.8
Imports	56.0	55.4	54.9	52.8	59.7
of which from Israel	41.6	40.9	40.6	39.5	40.7
Private consumption	93.6	84.6	85.3	78.9	88.2
Productive investment	10.5	20.5	20.5	22.0	20.4
Tax revenue	22.1	22.4	22.3	19.4	20.7
Other items (%):					
Unemployment rate in 2010	31.8	15.4	11.7	21.4	16.8
Labor flows to Israel (% employment)	11.2	21.5	25.2	9.6	22.4
Poverty rate in 2010	54.0	22.4	16.0	25.2	24.5
Real income/capita in 2010 (Index 2000 = 100)	66.7	114.2	123.7	110.0	111.0

Scenario 3: Improved Customs Union

5.34 Numerous studies (UNCTAD 1998; Alonso-Gamo et al. 1999; European Commission 1999) attribute less-than-anticipated Palestinian growth performance between 1993 and 1999 to an imperfect implementation of the Paris Protocol, mainly as a result of Israeli restrictions on the movement of goods and people across borders and within WBG. Scenario 3 assesses the impact of easing these restrictions by assuming a full recovery to pre-intifada levels of labor mobility by end-2003 as in Scenario 2, followed by a more rapid increase in labor flows to Israel equivalent to 4

percent a year, reaching a level of 165,000 in 2010.[54] Additional progress in mitigating the negative impact of Israeli security measures on transactions costs is assumed through a one-time 20 percent increase in the productivity of the transport and commerce sectors in 2004.[55] The other features of this scenario are similar to the ones described in Scenario 2, including no change in trade policy.

5.35 Easing restrictions on access to the Israeli labor market has immediate consequences for the unemployment rate, which drops rapidly to 12 percent and remains at this level through 2010. The positive welfare implications are significant, as income gains lower the poverty rate to 16 percent (compared to 21 percent in 1999). Real GDP growth averages 5.7 percent between 2005 and 2010, and real per capita incomes grow by an estimated 1.9 percent, below its historical trend. GDP growth is fueled by domestic demand and investment in buildings. Although capital stock per capita grows by 4.4 percent a year from 2005 onwards, this rate of accumulation – combined with lower transactions costs – is insufficient to offset the negative effect of high wages (due to the opening of the Israeli labor market) on export competitiveness. From 2005 to 2010, exports grow by 6 percent a year, such that the ratio of exports over GDP increases only modestly, with negligible implications for total factor productivity and therefore investment incentives. The reduction in transactions costs results in a modest shift in trade flows from Israel to the rest of the world. Israel nevertheless remains a major Palestinian trade partner in 2010, with exports to Israel accounting for 85 percent of total exports and imports from Israel accounting for 74 percent of total imports. As a result, the Palestinian economy under this scenario of improved but structurally unchanged economic relations with Israel remains particularly vulnerable to shocks in Israel, with continued weak long-term productivity increases, marginally better growth prospects, and an improved environment with respect to equity.

Scenario 4: Non-cooperative economic separation

5.36 One potential scenario consists of a non-cooperative separation of the two economies following mutual agreement on borders (non-cooperative therefore does not refer to a lack of agreement but rather to the nature of economic relations). In this context, Israel is likely to limit the inflow of Palestinian workers and revoke

[54] This growth rate of 4 percent is estimated using an alternative dynamic model in which labor flows to Israel are endogenous (differing in this respect from the model presented in Chapter 3). Palestinian workers equalize their expected wages in Israel and WBG, Palestinian workers and foreign workers in Israel are perfect substitutes (Ruppert Bulmer 2001b), but the supply of foreign workers is not totally elastic but rather a function of the wage offered in Israel (with the same labor supply elasticity, 0.3, as Palestinian workers). Under this scenario, Israeli demand for Palestinian or foreign labor is assumed to grow by 2 percent per year.

[55] Although this increase in productivity is equivalent to 5 percent of GDP, it is still modest compared to the high level of transactions costs (estimated at 35 percent pre-crisis, according to Astrup and Dessus 2001a), and the observed doubling of transactions costs during the intifada (recall Box 1.1).

preferential access of Palestinian goods to Israeli markets. The Palestinian authorities would in turn adopt a more neutral trade regime vis-à-vis Israel through a low and uniform tariff structure (note that this differs from Chapter 2, in which the NDTP tax was maintained at 16.6 percent). The implied introduction of physical borders and/or the strict enforcement of border controls leads to an increase in transactions costs relative to the situation prevailing in September 2000.

5.37 After an end to closure policy similar to Scenarios 2 and 3, labor flows to Israel remain depressed due to a change in Israeli immigration policy. Productivity levels in the transport and commerce sectors are assumed to undergo a one-time drop of 20 percent in 2004 following stricter border controls between Israel and WBG.[56] The PA is assumed to implement a non-discriminatory trade regime in 2004 under which a uniform tariff (for all products from all origins) is set equal to 5 percent and purchase taxes are eliminated.[57] This assumption requires the Palestinian authorities to collect their own import duties, potentially leading to initially lower collection efficiency and/or higher collection costs compared to Scenario 3 under which Palestinians continue to benefit from the assistance of the Israeli fiscal administration. Beyond its economic desirability, a low and uniform tariff system presents the additional advantages of being relatively simple to implement and administer and limits incentives to bypass it. Palestinian exporters will lose their preferential access to Israel and thus will become subject to Israel's MFN tariff structure. With respect to labor mobility, worker flows to Israel are assumed to follow the same pattern as Scenario 1: the number of Palestinian workers commuting to Israel increases slowly from 55,000 in 2001 to 70,000 in 2010.

5.38 These assumptions generate mixed results for projected economic growth and welfare. Declining worker remittances and higher transactions costs offset the positive effects engendered by eliminating temporary closures and ending confrontation, such that by 2010, average real income per capita remains 11 percent lower than that estimated under the improved customs union of Scenario 3. On the other hand, the adoption of a non–discriminatory trade regime positively affects productive investment and productivity by opening new markets and creating opportunities to invest and import new technologies and inputs. The downward pressure exerted on wages by the permanent but no longer uncertain closure of the Israeli labor market improves competitiveness, thereby promoting exports to the rest of the world. Export growth averages 8.6 percent per year between 2005 and 2010,

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[56] This increase in transactions costs, equivalent to 5 percent of GDP, is the sum of (i) the cost of operating customs borders, implicitly charged to traders (Daoud 2000), and (ii) the direct cost for traders to comply with additional regulations, restricted routes, delays, etc.

[57] Under this assumption, the total tax on imports from all trade partners other than Israel diminishes. This is particularly true for countries that have an FTA with WBG, such as the US and the EU for which combined tariffs and purchase taxes significantly exceeded 5 percent under the Paris Protocol. This was driven by high purchase taxes on imported equipment goods mainly originating from OECD countries (Astrup and Dessus 2001a). Eliminating all purchase taxes and replacing it by a flat tax on all imports mitigates distortions and encourages investment.

considerably higher than in the other scenarios. A non-discriminatory trade regime has positive welfare implications through household-, producer- and investor-access to cheaper goods from the rest of the world. Long-term per capita income growth of 2.1 percent is slightly higher than in Scenario 3, and is driven not by greater access to the Israeli labor market but rather by capital accumulation and productivity growth. This scenario of non-cooperative economic separation is associated with the largest reduction in Palestinian vulnerability to Israeli shocks and policy changes. Only 10 percent of total Palestinian employment is in Israel (compared to 25 percent in Scenario 3), and 73 percent of exports are destined to Israel (compared to 85 percent in Scenario 3). Although reforming the tax system will involve a loss in public revenue compared to Scenario 3, since both the level of taxes and the level of imports are less important, tax revenues are nevertheless broadly sufficient to finance public consumption and a modest level of public investment (implying continued external assista/nce for investment). By 2010, the ratio of public tax receipts over GDP is estimated to be 19 percent, compared to 22 percent in 1998.[58]

Scenario 5: Cooperative economic policy autonomy

5.39 The fifth scenario considers the introduction of a free trade area between Israel and WBG in 2004. Scenario 5 is characterized as cooperative because the agreed trade regime fosters continued economic integration but with greater independent policymaking capacity for the Palestinians. On purely economic grounds, an FTA does not necessarily represent the best option, as discussed in Chapter 2. On the other hand, granting preferential access to Israeli goods in WBG could be exchanged for increased Palestinian access to the Israeli labor market (a fundamental Palestinian concern during the PP negotiations (Arnon and Weinblatt 2000)) and at the same time provide the Palestinian authorities with more autonomy vis-à-vis trade policy with third parties.

5.40 Because an FTA requires border stations and administrative procedures to control the movement of goods, transactions costs are assumed to rise in line with Scenario 4, namely by 20 percent. Additional costs of compliance with rules of origin under an FTA are estimated at 3 percent of the value of goods traded between Israel and WBG (consistent with Herin 1986). With respect to third parties, WBG adopts a uniform tariff structure with a 5 percent tariff on imports for products originating from third parties and zero purchase taxes. Labor flows to Israel are assumed to grow by 2 percent annually following a recovery period similar to those described in Scenarios 2 and 3, such that by 2010, 145,000 workers commute from WBG to Israeli jobs.

5.41 The predicted export performance under an FTA is worse than under the non-discriminatory trade regime posited in Scenario 4 due to weaker export competitiveness on two fronts: upward pressure on wages resulting from the outflow

[58] This figure excludes contributions to UNWRA's recurrent budget.

of workers to Israel, and higher prices on imported inputs from Israel. Integration into world markets is less pronounced, thus reducing incentives to invest and adopt more productive technologies. On the other hand, as in Scenario 3, the large outflow of workers to Israel has significant positive welfare effects through lower unemployment, but poverty rates and per capita income levels in 2010 are only marginally superior to those in Scenario 4. GDP growth is projected to be 5.4 percent a year, and income per capita growth lags somewhat at 1.2 percent per year, due to the limited trade gains.

5.42 The simulation results of the five different scenarios are illustrated below in Figures 5.4, 5.5, 5.6 and 5.7.

5.43 This simulation exercise testing various scenarios of economic relations between WBG and Israel indicates the following:

(i) a continuation of the crisis would have dire consequences for the Palestinian economy and its population, including declining per capita incomes, stagnant exports, and poverty rates over 50 percent (as depicted above);

(ii) a return to the situation prevailing in September 2000 represents a muddle-through solution of stagnation and increased reliance on Israel;

(iii) a successfully implemented PP would lead to high per capita incomes and modest unemployment, but would still fail to generate high sustainable economic growth through exports and productivity gains;

(iv) an economic separation (through a more autonomous and neutral trade regime and lower labor outflows to Israel) aimed at diversifying the Palestinian economy away from Israel toward greater integration into global markets would bring important dynamic gains in terms of investment and productivity leading to strong export-driven GDP growth, but with costs to society through higher unemployment; and

(v) a further integration with Israel through an FTA would lead to mediocre GDP and export levels but also lower unemployment, increasing Palestinian economic dependency on Israel.

Figure 5.4: Real Income Per Capita, Different Scenarios (1998 US$)

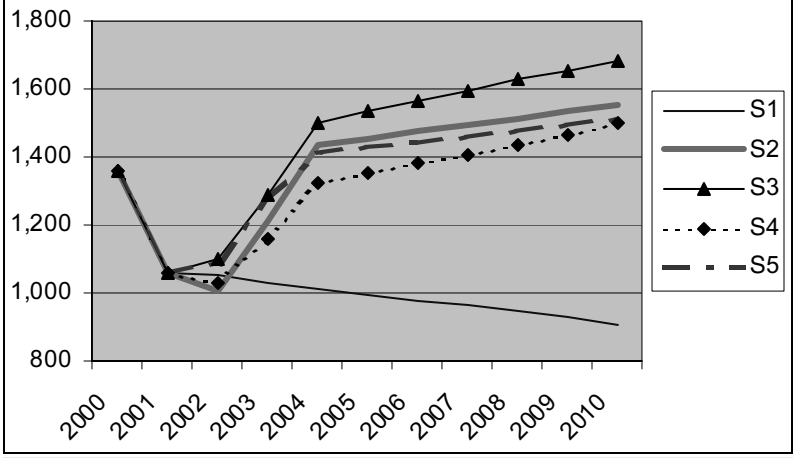


Figure 5.5: Real GDP, Different Scenarios (1998 US$ mn)

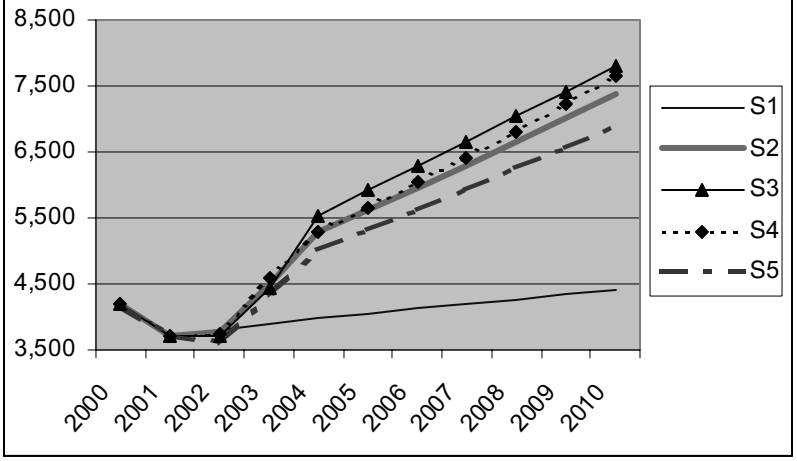


Figure 5.6: Exports and TFP 2010, Different Scenarios

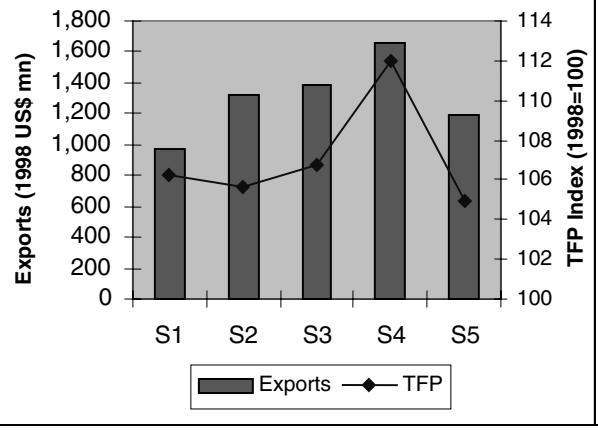
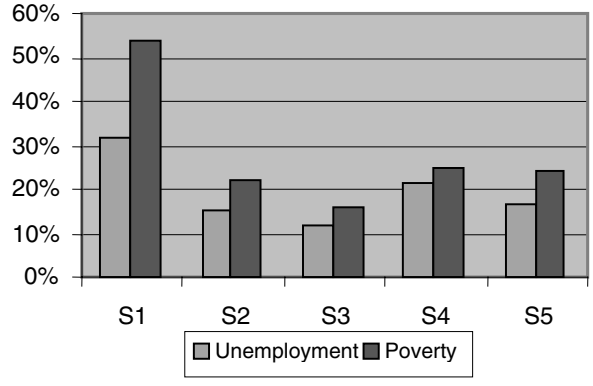


Figure 5.7: Unemployment and Poverty 2010, Different Scenarios



5.44 The first two scenarios represent political developments but no fundamental change in policies governing economic relations between WBG and Israel. The predicted outcomes suggest that under these assumptions the Palestinian economy is likely to remain trapped in a low-growth low-income equilibrium. Scenario 3 – representing no change in trade policy but improved mobility and lower transactions costs – indicates a small improvement over historical output growth, higher income growth, and the most rapid recovery in per capita incomes (see Figure 5.4), but weak export performance and continued dependence on Israel through the de facto one-sided trade regime (i.e., the customs union) and the distorted labor market and attendant underutilization of human capital. Future scenarios characterized by new trade policy – either through non-cooperative separation and a non-discriminatory trade regime (Scenario 4) or through an FTA and continued labor market integration (Scenario 5) – involve varying degrees of decision-making flexibility on the Palestinian side and different degrees of economic dependence on Israel. Scenario 4 shifts to a higher export and productivity growth path through trade diversification toward the rest of the world, but incomes recover more slowly due to smaller labor flows to Israel. Under the FTA in Scenario 5, continued dependence on Israel through trade and labor flows leads to only modest gains from Palestinian trade flexibility with other countries, while per capita incomes and poverty rates in 2010 are comparable to those under the NDTP.

5.45 Welfare implications. The predicted outcomes of the five scenarios illustrate the complex interplay of economic variables associated with different trade regimes, border arrangements, and the implied transactions costs and labor flows. The preceding analysis spells out the trade-offs that are likely to face Palestinian policymakers in the context of a peace agreement with Israel. The various policy choices have very different implications for poverty in WBG. An improved CU (Scenario 3) generates the greatest gains with respect to per capita income and poverty. But this projected growth is driven by income from Israel rather than domestic productivity growth, translating into larger near-term benefits but at a cost to long-term development. On the other hand, economic growth is highest under an NDTP due to strong export and productivity performance (consistent with the partial equilibrium Chapter 2 conclusion that an NDTP leads to better trade outcomes than a CU and an FTA) and reduced vulnerability to external shocks, but unemployment and poverty are substantial. The challenge for policymakers will be to balance the near-term and long-term costs and benefits. Addressing welfare concerns adequately – particularly poverty – is essential and will continue to be crucial in the future, especially under Scenarios 4 and 5, reinforcing the need for well-targeted and comprehensive safety net programs to protect the poor.

Box 5.1: Higher Aid Flows Following a Peace Agreement

The completion of a peace agreement may elicit a strong donor response to support reconstruction and institutional development in WBG. The scenarios described above assume continued international donor assistance at levels observed post-Oslo – namely, annual aid flows of US$462 million from 2003 onward. However, it is possible that additional resources will be forthcoming in the context of broad-based support for post-conflict recovery. To consider the impact of higher aid flows, the model is tested under the assumption that annual official development assistance is maintained at the high level observed in 2001: US$929 million. Although 80 percent of this total was allocated to budget support and emergency programs and the remainder to medium-term development activities, this allocation composition is assumed to change over time, such that by 2006, all aid goes to medium-term development activities, two-thirds of which is used to finance physical investment.

The resulting impact of additional assistance on Scenarios 3, 4 and 5 is marginal with respect to per capita income growth, generating an additional 0.1-0.2 percentage points gain per year in each scenario. This modest effect is explained by the fact that higher foreign savings reduce exports and productivity growth, raise the price of non-traded goods, and reduce external competitiveness. In Scenario 3, the already high wages and limited outward orientation constrain potential growth in the production of goods and services for local and external markets. In Scenarios 4 and 5, higher transactions costs and capital accumulation reduce the marginal impact of additional investments, due to decreasing returns to scale. The implied increase in imports suggests that the main beneficiaries of additional foreign assistance to WBG would be Israel and to a lesser extent the rest of the world, both of which benefit from increased demand for their products. These effects illustrate the significant degree of leakage from the Palestinian economy.

5.46 The simulation results of Scenarios 1-5 above represent the most-likely outcomes under normal conditions. Suppose, however, that a peace agreement is accompanied by the opening of new trade routes between WBG and the rest of the world, particularly with and via Arab League countries with which trade is highly restricted under the Paris Protocol. Although the nature and extent of a "peace dividend" of this sort is highly uncertain, it is useful to consider the potential effects of greater access to third-party markets in high-case versions of the scenarios presented above. Because expanded trade with Arab partners is impossible under the PP, the analysis that follows considers high-case versions of Scenarios 3, 4 and 5 only, all of which move beyond the strictures of the PP.

5.47 The basic underlying assumptions described in Table 5.3 are unchanged, but a new assumption is added, namely that external barriers to trade with third-party markets (excluding Israel) decline by 10 percent per year between 2005 and 2010. The resulting impact on output and trade volumes – especially exports – is significant. The increase in GDP growth in Scenarios 3^{High}, 4^{High} and 5^{High} ranges from 0.5-0.7 percentage points annually relative to most-likely Scenarios 3, 4 and 5 (comparing Tables 5.5 and 5.6). Gains in export growth are particularly large in Scenario 4^{High}, under which exports grow at an average rate of 10 percent per year between 2005 and 2010 (see Table 5.6). Expanded trade routes lead to higher export volumes equivalent to 1.4-2.1 percent of GDP, and the relative importance of Israeli markets

declines.[59] A positive impact on per capita incomes and poverty is observed in all scenarios, but the largest impact occurs under the NDTP of Scenario 4^{High}, in which per capita incomes grow by 3 percent annually (compared to only 2 percent in Scenario 4) and poverty falls to 19.2 percent in 2010 (from 25.2 percent in Scenario 4). These larger effects arise because Palestinian producers can take greater advantage of increased access to external markets under an NDTP compared to a CU or an FTA, and therefore more effectively reduce trade diversion and improve wage competitiveness.

Table 5.6: High-Case Scenario Results

Scenarios	3^{High}	4^{High}	5^{High}
Growth rates 2005-2010 (%):			
Real income per capita	2.4	3.0	1.6
Real GDP	6.2	6.9	5.9
Imports	3.7	4.5	3.1
Exports	7.2	10.1	7.5
Share of GDP (%):			
Exports	19.1	23.8	18.6
of which to Israel	14.7	14.8	14.4
Imports	55.2	54.7	59.9
of which from Israel	40.8	41.1	40.8
Other items (%):			
Poverty rate in 2010	12.7	19.2	21.6
Real per capita income in 2010 (Index 2000 = 100)	128.8	119.0	115.4

5.48 In contrast to these high-case scenarios, consider the other end of the spectrum. It is possible that implementing policy changes following a final status agreement will prove problematic; there are downside risks of a weak private sector response. The analysis that follows considers low-case versions of the most-likely policy scenarios laid out in Scenarios 1-5 above. The implications of poor implementation and other policy failures under Scenario 3 have already been studied at length because they reflect past circumstances (recall Scenario 2, and for an extreme version, Scenario 1). In order to assess the implications of similar downside risks under an NDTP in Scenario 4 and an FTA in Scenario 5, two low-case scenarios are considered under which transactions costs are assumed to increase by 40 percent rather than 20 percent, and the MFN tariff adopted under the NDTP and for third-party countries under an FTA remain unchanged from current levels (i.e., the average MFN tariff is 16.6 percent instead of the 5 percent assumed above). Continued uncertainty and costly border delays following policy changes by the PA under a final status agreement further discourage investment, particularly foreign direct investment.

[59] This increase is in line with IMF estimates suggesting that 1998 exports to the rest of the world were 80 percent below their potential (Valdivieso et al. 2001).

5.49 Reported in Table 5.7 below, the results of Scenarios 4^{Low} and 5^{Low} indicate the potentially costly impact of poor implementation and the resulting weak private sector response, illustrating the continued vulnerability of the Palestinian economy. Note that Scenario 5^{Low} also assumes a slower increase in Palestinian labor flows to Israel (only 1 percent annual growth compared to 2 percent under Scenario 5). Scenarios 4^{Low} and 5^{Low} are designed to capture the potential failures associated with a Palestinian policy shift toward an NDTP or an FTA under a final status agreement. The low predicted income per capita growth rates and sharply higher poverty rates could have serious implications for the recurrence of conflict following a peace accord in light of political-economic theory and evidence that slow growth, poverty, and an inability to meet basic needs increase the probability of conflict. Moreover, these low-case estimates further demonstrate that future economic policy choices are not perfectly straightforward; the inherent risks under *any* scenario are non-negligible.

Table 5.7: Low-Case Scenario Results

Scenarios	4^{Low}	5^{Low}
Growth rates 2005-2010 (%):		
Real income per capita	0.9	0.5
Real GDP	4.9	4.3
Capital stock per capita	2.4	1.3
Total factor productivity	0.9	0.6
Other items (%):		
Unemployment rate in 2010	24.4	19.0
Labor flows to Israel (% empl.)	10.0	23.2
Poverty rate in 2010	39.2	32.3
Real per capita income in 2010 (Index 2000 = 100)	89.0	99.3

Conclusions

5.50 The Palestinian economy has exhibited modest economic performance for the past three decades, including the most recent Interim Period during which better economic outcomes were anticipated under the PP. This analysis documents the details of output and income growth in the Palestinian economy over this period, and examines the various explanatory factors. As discussed in the preceding chapters, slow economic growth is not just the result of limited factor endowments, constrained physical resources within the Palestinian territories, and rapid population growth. On the contrary, growth accounting exercises indicate substantial capital accumulation per capita. The failed convergence of Palestinian and Israeli income and economic growth is explained primarily by slow productivity growth on the Palestinian side. The distorted trade and labor regimes described in detail in Chapters 2 and 3 generated asymmetric dependence on Israel that was not accompanied by knowledge sharing and technology transfer. The one-sided trade policy resulted in high effective tariffs on Palestinian imports and limited access to third-party markets, leading to trade diversion and reducing Palestinian competitiveness. This was exacerbated by labor market distortions arising from Palestinian access to Israeli jobs, which in turn raised wages on the domestic market. The policy framework guiding relations between the Palestinian and Israeli economies thus did not promote export-led

Palestinian economic development, but rather consumption-based growth, with large net imports from Israel financed by net income from abroad – mainly workers' remittances.

5.51 Factors other than distortionary trade and labor policies complicated the economic environment. The interim nature of the peace accords and the inherent limits on Palestinian sovereignty generated uncertainty and risk, especially in the context of periodic Israeli closures and severe mobility restrictions on goods and labor. The impact on transport costs and transactions costs more broadly pushed Palestinian production costs above competitive levels. This uncertain climate was further hampered by weak institutional structures relating to investment, namely inadequate legal, regulatory and financial institutions to protect private investment, as well as anticompetitive practices effectively condoned by the PA. As a consequence, the stifled Palestinian private sector failed to stimulate growth and job creation.

5.52 The model of Palestinian-Israeli economic integration reflected by the customs union and large labor flows to Israel did not succeed because of the flawed underlying incentive framework. The modifications introduced under the PP were insufficient to redirect the supply and demand pressures responding to these incentives. In light of Israel's central role in the Palestinian economy, alternative models of Palestinian economic development will depend on the nature of political and economic relations with Israel. The overriding objective of future economic relations between West Bank and Gaza and Israel should be sustained economic growth, mutual benefit, and a level playing field. Although final status negotiations are currently stalled, a future peace agreement could lead to one of the following options:

- continued economic integration;
- non-cooperative economic separation; or
- Palestinian economic policy autonomy in a cooperative environment.

Scenarios 3, 4 and 5 illustrate the projected economic outcomes associated with each policy option, and the implied trade-offs among GDP growth, productivity, incomes, unemployment and poverty. Furthermore, each scenario involves different levels of policymaking autonomy and sovereignty for the Palestinians.

5.53 Comparing the results of the different scenarios does not point to a unique or optimal solution, given that economic performance measured by real GDP growth does not differ significantly in the long run (except under a continuation of the crisis). But the factors driving growth vary significantly. Under increased economic integration but policy autonomy, slow productivity growth and capital accumulation are compensated by greater access to the Israeli labor market, whereas under

economic separation, reduced access to the Israeli labor market and higher transactions costs are offset by a more liberal neutral trade regime that reduces trade diversion, promotes competition and encourages investment and the adoption of more productive technologies, but at a higher social cost with respect to unemployment.

5.54 For the reasons delineated above, the historical growth patterns observed in WBG pre- and post-Oslo did not generate adequate income convergence with Israel, and thus failed to foster sustained productive cooperation and robust economic growth. Modest Palestinian economic performance exacerbated the pre-conditions for conflict described in Chapter 1, namely slow economic growth, substantial poverty, inability to meet the basic needs of the population, and unmet expectations of economic development following the Oslo Accord, all of which contribute to perceptions of grievance. Palestinian economic and political marginalization appear to go hand-in-hand, from limited access to external markets and domestic resources (e.g., water), to internal closures limiting domestic mobility and production, to limited political rights. The future growth prospects described in scenarios 3, 4 and 5 above – although positive – may not generate adequate growth and poverty reduction to mitigate the risk of future conflict.

5.55 This analysis of the economic costs and benefits associated with future policy options needs to be viewed in the context of political costs and benefits as well. Given the Palestinian objective of sovereignty, the un-quantifiable political gains vis-à-vis progress toward Palestinian statehood may offset the economic costs of moving toward an FTA, for example. Even if this is not the case, the cost of Palestinian sovereignty with respect to increased poverty under Scenario 4 or slower economic growth in Scenario 5 relative to Scenario 3 may be necessary to ensure minimally acceptable economic outcomes and avoid repeating the past experience with closures. Although it is theoretically possible that a peace agreement will bring cooperation, trust, and the fair settlement of trade and other disputes, it is not guaranteed. Consider the example of the PP, the result of an interim peace agreement accepted by both sides. Despite its stated objective to promote Palestinian economic development, loopholes in the economic protocol led to unsettled disputes and a lack of Palestinian recourse, due to its weak position. Under a scenario in which Palestinians gain control over their borders as well as policymaking autonomy, economic agreements with Israel would represent complete contracts, open to renegotiation by mutual decision. Any future trade disputes could be resolved through international bodies like the WTO, or by imposing bilateral sanctions such as higher tariffs.

5.56 Ultimately, Palestinian policymakers will not view the political economy factors discussed in Chapter 1 separately from the economic policy considerations analyzed in detail above. Although the choice of future economic relations between WBG and Israel could potentially be influenced by palliative measures such as security-screened work permits, safe passage between the Gaza Strip and the West

Bank, and proposed x-ray machines to accelerate security checks of goods, these measures failed in the past, primarily because they failed to separate political concerns from economic activities. If no closure-proof or otherwise credible policy measures can be found, then Palestinian economic survival and growth in the long run may necessitate independence from Israeli control and the end of the unequal partnership, despite the large associated costs. If, on the other hand, Israel desires continued partnership through economic integration, it could offer incentives to reduce the Palestinian cost to remaining in the integration model, such as by compensating lost revenue on indirect imports and trade diversion, and allowing unfettered access to the Israeli labor market. One striking fact that emerges in assessing the development path of the Palestinian economy to-date and options for future economic relations is that, under any scenario, Israel will continue to be a very important partner.

Annexes

ANNEX I

Transport Survey Results

In June 2001, the World Bank commissioned the Palestinian Center for Private Sector Development to carry out a survey of households and firms to assess the use of transport services, the distances, times and costs associated with such services, and the degree to which these were affected by mobility restrictions imposed in the context of closures during the intifada. Five hundred households (300 in the West Bank and 200 in the Gaza Strip) and 188 firms were surveyed in 29 different locations in the West Bank and 14 population centers in the Gaza Strip. Sample selection criteria included geographic location, poverty level, population size, and severity of closure. Individual survey respondents compared their transportation requirements for travel to public services, place of work, and shopping at the time of the survey in June 2001 relative to the period one year earlier, namely prior to the crisis when mobility restrictions were minimal. Firms compared travel times, costs, and damage to goods per shipment over the same reference period.

The survey objective was to quantify the impact of transport distortions by assessing changes in the transportation costs of individuals and in the cost structures of firms. The sharp increase in the number of Israeli checkpoints and the delays at each checkpoint are reflected in the survey results. The survey captures transport disruptions within the Palestinian Territories, between the Palestinian Territories and Israel, and between the territories and other countries (across Palestinian and Israeli border points).

It is important to note that the survey results are time-specific in that they reflect the realities at the time the survey was conducted: the second week of June, 2001. Mobility restrictions were subsequently tightened for varying periods, suggesting that the survey results do not reflect worst-case transport distortions.

The survey results indicate that movement restrictions reduced access to key public services such as health and education, households' usual place of shopping, and their workplace. The impact is larger in the West Bank compared to the Gaza Strip, reflecting the fact that movement restrictions during the intifada have been relatively tighter within the West Bank. In addition, rural households, which typically travel longer distances to services and shopping, were disproportionately affected compared to households in urban areas or refugee camps.

Access to services. The survey finds that households have to travel longer distances to health centers, primary schools, and universities in order to evade checkpoints. The time spent traveling increased even more, however, due to poorer road quality on alternative routes and delays incurred to pass through checkpoints.

Transport costs increased substantially in some instances, particularly for travel to health facilities and universities (see Table I.1).

Table I.1: Impact on Household Access to Public Services

	Distance (km)			Travel Time (min)			Travel Costs (RT, NIS)		
	June 2000	June 2001	% chg	June 2000	June 2001	%-chg	June 2000	June 2001	% chg
Households in:	To Health Care Facility								
West Bank	6.6	12.1	82.0	13.6	28.1	107.0	7.2	15.3	113.5
Gaza Strip	2.6	2.8	4.7	11.2	11.6	3.5	2.1	2.2	5.4
Rural area	7.2	13.6	89.3	14.5	31.2	115.2	7.1	15.7	120.9
Urban area	3.7	5.2	37.8	12.0	16.8	40.6	3.2	5.8	82.4
Refugee camp	3.1	3.9	23.9	10.6	12.6	19.8	3.3	4.4	34.6
	To Primary School								
West Bank	1.2	1.6	39.5	13.4	14.7	9.6	4.4	5.1	15.2
Gaza Strip	0.9	0.9	1.8	13.6	15.1	10.9	2.2	2.3	7.7
Rural area	1.2	1.7	43.4	14.1	15.9	12.8	3.7	4.6	25.3
Urban area	0.7	0.8	9.2	13.0	13.9	6.5	1.6	2.0	22.4
Refugee camp	1.1	1.2	12.5	12.7	13.9	9.7	4.4	4.5	2.8
	To University								
West Bank	26.8	48.3	80.6	29.9	71.4	138.8	11.1	23.5	112.8
Gaza Strip	14.6	16.0	9.8	25.0	53.0	112.0	4.7	9.1	96.6
Rural area	27.7	50.7	83.4	30.2	71.4	136.2	10.5	22.0	109.2
Urban area	20.6	27.7	34.0	28.0	64.2	129.1	6.2	12.1	93.6
Refugee camp	14.5	18.9	30.6	24.3	51.7	113.1	6.7	14.5	116.0

Compared to periods of relatively unconstrained mobility, the average distance between home and a medical facility in the West Bank increased 82 percent during the intifada, but was little changed in Gaza. The distance to primary and secondary schools were least affected, although even a small increase can impose a hardship on very young children walking to school. Travel times more than doubled in some cases. On average, survey respondents from the West Bank traveled 28 minutes to reach a medical facility in June 2001, compared to only 14 minutes a year earlier. In Gaza, by contrast, the travel distances and times experienced marginal increases, except for transport to university.

With respect to passenger transport costs, the survey finds that the cost of reaching a medical facility or a university increased dramatically, and more than doubled in the West Bank compared to pre-intifada levels. One explanation is the congestion and delays for motor vehicles – taxis, minibuses and private cars – to pass through checkpoints, leading to increased use of "back-to-back" transport in which individuals take a taxi to the checkpoint, for example, walk across the checkpoint (typically faster than passing by car), and take another taxi on the other side of the checkpoint.

Student attendance at universities declined during the intifada from an average 19 days to 16 days per month. This decline reflects increased difficulties traveling to the university as well as the forced closure of certain universities from time to time, Bir Zeit University in particular.

Access to work and shopping. Households' ability to reach their place of work and shopping was seriously impeded during the intifada. Travel time to work increased significantly in both the West Bank and Gaza Strip: from 28 minutes to 52 minutes in the West Bank, and from 31 minutes to 51 minutes in the Gaza Strip (see Table I.2). Although internal closures were relatively less damaging to households' ability to reach public services and shopping in the Gaza Strip, they severely disrupted an important element of economic life, access to the workplace. For workers employed in Israel, pre-intifada travel distances averaged 35 kilometers, and increased by more than 50 percent as a result of mobility restrictions. This primarily affects workers from the West Bank. Travel times more than doubled, and the round-trip cost of transport to jobs in Israel increased from 18NIS to 41NIS, accounting for 40 percent of the average daily wage.

Table I.2: Impact on Household Access to Work and Shopping

	Distance (km)			Travel Time (min)			Travel Costs (RT, NIS)		
	June 2000	June 2001	% chg	June 2000	June 2001	%-chg	June 2000	June 2001	% chg
Households in:	To Work								
West Bank	22.0	31.7	44.1	28.3	51.5	82.3	12.5	15.6	24.9
Gaza Strip	19.4	22.1	13.7	30.8	51.1	66.1	6.8	6.1	-10.7
Rural area	21.5	31.1	44.5	27.3	53.2	94.9	12.7	15.3	19.8
Urban area	27.8	29.0	4.2	41.3	45.4	10.0	10.8	10.0	-7.4
Refugee camp	16.8	23.5	39.7	25.1	51.1	103.3	7.2	9.0	25.2
Employment in Israel	34.7	53.0	52.7	39.2	85.5	118.1	17.9	40.7	127.3
	To Shopping								
West Bank	7.9	13.9	77.4	14.0	32.1	129.5	7.0	14.1	102.0
Gaza Strip	1.7	1.7	-2.4	11.1	12.2	9.3	2.4	2.5	2.9
Rural area	9.3	16.6	77.9	15.1	37.3	146.9	6.5	13.7	111.2
Urban area	2.0	3.9	89.5	11.0	17.5	58.8	3.9	8.6	122.5
Refugee camp	2.7	3.2	19.4	11.1	12.7	14.5	4.4	5.4	23.7

Whereas travel times to work did not increase markedly for urban households, they almost doubled for rural households and more than doubled for residents of refugee camps. The increase in the cost of going to work averaged 25 percent in the West Bank, while the cost of going to work in Gaza actually declined, which may be explained by substitution toward cheaper modes of transport such as greater use of car-sharing. Both travel distance and time to the usual place of shopping rose markedly in the West Bank during the intifada, but were broadly unchanged in Gaza

due to its much higher population density, and consequently shorter average travel distances to shops.

Households to some extent responded to the difficulties and increased travel costs by reducing travel. The survey indicates that in June 2001, households went shopping 6-7 times a month, compared to 8-9 times per month prior to the intifada. The effect was stronger in the West Bank than in Gaza, and among rural households compared to urban households. The reduction in monthly shopping trips may also be driven by the significant decline in household incomes and consumption.

Impact on firms. Movement restrictions have seriously impeded business operations by reducing access to markets and to inputs. The survey quantifies the impact using questions on the average distance to firms' usual markets, the time it takes to transport products to market, and the cost. The survey distinguishes between firms serving the domestic market and those primarily serving foreign markets, including Israel. The results indicate that firms serving the domestic market encountered even greater obstacles and costs than households. For example, the average distance to markets was approximately twice as long in June 2001 compared to a year earlier – 75 kilometers compared to 37 kilometers – and transport times actually tripled (see Table I.3).

Table I.3: Transport Impact on Firms Serving Domestic Markets

	June 2000	June 2001	% change
Distance to Markets (Kilometers)	37.1	74.8	102.0
Transport time (Minutes)	51.0	150.0	208.0
Costs per Shipment (NIS)	169.5	370.0	82.0

The large increases in travel distance and time are partly due to the fact that trucks cannot easily circumvent checkpoints using dirt roads. The average transport cost per truckload nearly doubled, from 170 NIS before the outbreak of the intifada to 370 NIS in June 2001, as a result of increased distance and travel times as well as more rapid depreciation of trucks due to the use of poorer quality roads. There are no obvious differences in impact on firms across sectors; for example, transport times for manufacturing firms increased from 55 minutes to 165 minutes, while agricultural producers experienced increases from 45 minutes to approximately 130 minutes.

Palestinian firms selling to external markets incurred particularly large costs resulting from movement restrictions; in addition to difficulties faced by other firms with respect to transporting goods within the West Bank and Gaza, they also experienced long delays at border crossings, either to Jordan from the West Bank, to Egypt from Gaza, or at the Israeli ports of Ashdod and Haifa. In fact, border crossings have been repeatedly sealed off, preventing any goods from exiting the Palestinian Territories. Although the survey yielded few observations of firms using border crossings to Jordan or Egypt, the responses indicate that average waiting times increased from 40 hours to 180 hours. Delays of this magnitude render the export of

perishable goods infeasible. Firms also reported a significant increase in the share of goods damaged at border crossings, from 2-4 percent per shipment before the intifada to 10-15 percent during the intifada.

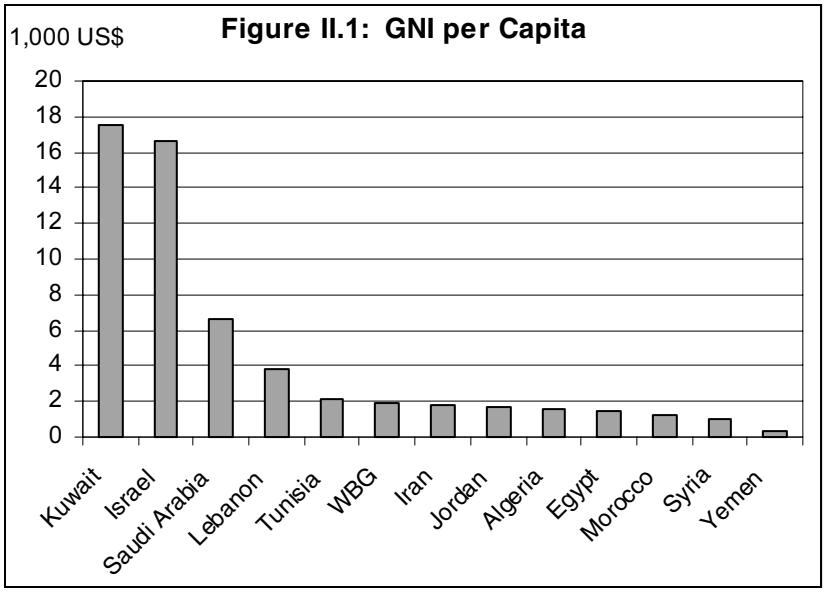
ANNEX II

The Impact of the Crisis on the Israeli Economy

The conflict in the West Bank and Gaza has been ongoing since September 28, 2000. The analysis presented in this annex focuses primarily on the short-run implications of the crisis, that is, during 2001 and the first few months of 2002. The crisis has affected the Israeli economy directly – and very rapidly – through three channels: (i) the supply of Palestinian labor to the Israeli construction and agricultural sectors; (ii) tourist arrivals into Israel; and (iii) trade between Israel and the Palestinian Territories.

Macroeconomic impact of the crisis. Israel's economy is the most advanced and diversified in the Middle East and North Africa region and has the second highest GNI per capita (see Figure II.1). At US$16,600, Israeli per capita income exceeds that of Spain and New Zealand, for example.[60] Until the mid-1980s Israel's economy suffered from chronic macro imbalances: high inflation, unsustainable budget deficits, and a deteriorating external balance. An Economic Stabilization Plan adopted in July 1985 included massive budget cuts and a more independent role for the Central Bank to reduce inflation averaging 400 percent.

Figure II.1: GNI per Capita

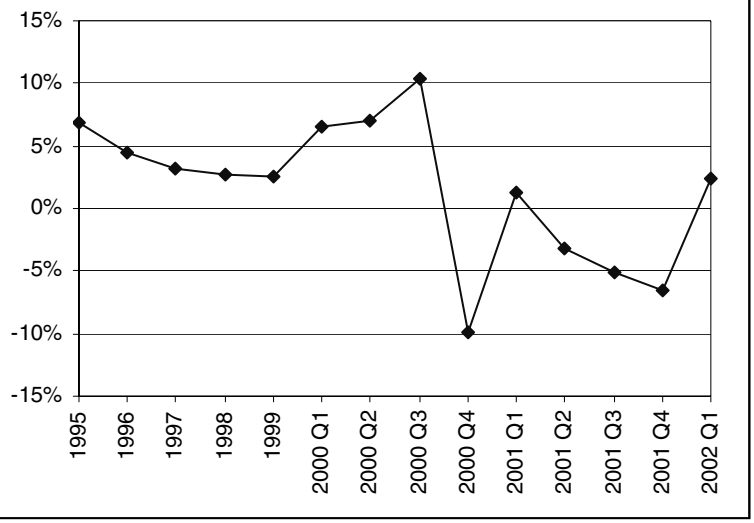


During the first half of the 1990s Israel experienced an economic upturn fuelled by a large influx of immigrants, an infusion of human capital (laying the foundation for the subsequent high tech boom), and improved prospects for regional peace. According to data from Israel's Ministry of Finance, the second half of the 1990s was characterized by more modest growth, due to lower residential investment as the number of new immigrants dwindled, high real interest rates, and possibly exacerbated by slower than expected progress in the peace process (see Figure II.2). The year 2000 appeared to be a turning point in the economy's performance. During

[60] Unless otherwise indicated, data are from the Bank of Israel.

the first 3 quarters of 2000, real GDP growth averaged 7-8 percent.[61] Following the outbreak of the crisis these trends were reversed: the annualized GDP growth rate in the last quarter of 2000 turned sharply negative, bringing the annual average down to 6.2 percent, 2 percentage points lower than projected pre-crisis. In absolute terms, the crisis cost the Israeli economy about US$2 billion in 2000.[62] Although growth rebounded to positive territory in the first quarter of 2001, the remainder of 2001 witnessed significantly negative growth as the economy fell into recession.

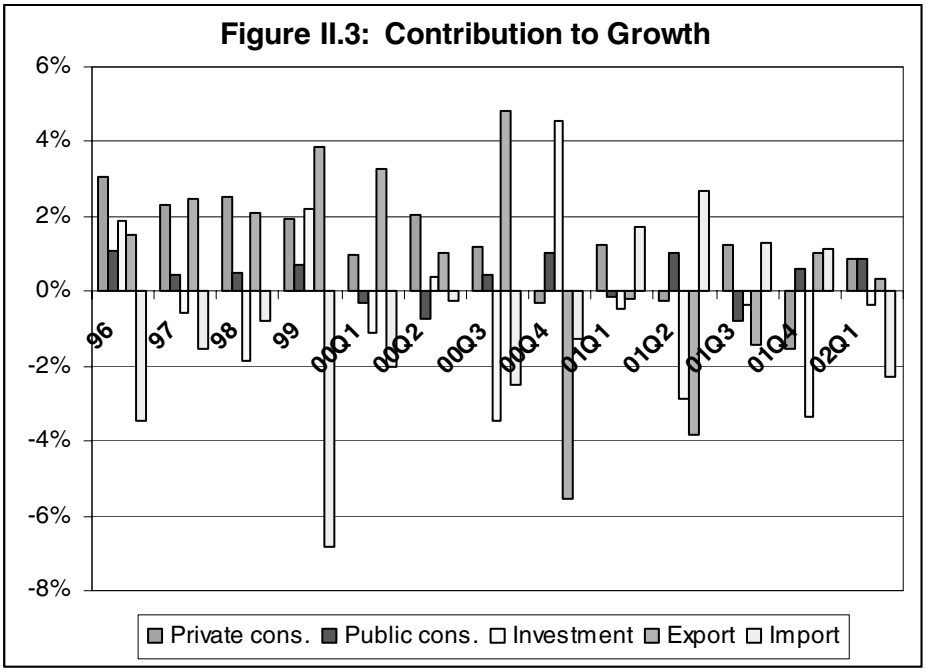
Figure II.2: Real GDP Growth



To understand the specific ways in which the crisis hurt Israeli economic growth, GDP growth before and during the crisis is decomposed into the separate effects of private consumption, public consumption, gross domestic investment, and export and import growth (see Figure II.3). Export growth was the driving factor behind the high growth rates immediately preceding the crisis (exports added about 3 percentage points to growth in the 3 first quarters of 2000). During the crisis, by contrast, the growth contribution from exports was negative. Although Israeli exports to the Palestinian market suffered substantially – declining by approximately 50 percent – this does not explain poor export performance at the aggregate level, given that exports to WBG account for only 6-7 percent of total Israeli exports, of which a significant share is transit trade with little value-added to the Israeli economy. The overall export decline is more likely the result of the slowdown in world demand.

[61] Quarter on quarter annualized growth rates, seasonally adjusted.

[62] Production losses were significantly larger in Israel than in the Palestinian economy, which incurred losses estimated at US$500million in 2000.



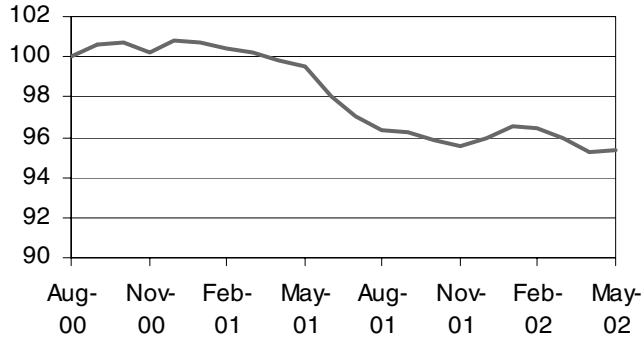
The short-term impact on the crisis can also be explained by domestic demand effects. The decomposition suggests that private consumption has been fairly resilient to the crisis, although real quarter-on-quarter growth in private consumption was negative in both Q1 2001 and Q4 2001. Public expenditures are largely growth neutral, with a modest trend towards expansionary policy during the crisis. Figure II.3 illustrates that gross domestic investment is the most volatile component of domestic demand, with a negative growth contribution during the crisis, as expected in an environment of increasing uncertainty. Historically, investment in Israel has had an ambiguous impact on growth.[63]

The diminished performance of the Israeli economy since the outbreak of the crisis is captured by the Bank of Israel's "State of the Economy Index" (SEI), an index of domestic demand reflected by industrial production, retail trade, imports and employment. The SEI has declined steadily since October 2000, falling 5 percent by May 2002 (see Figure II.4). Other indicators also suggest that the economy is struggling. For example, the number of persons claiming unemployment benefits increased 25 percent compared to the level before the outbreak of the intifada.

[63] The large swings in investment's growth contribution during Q3 2000 and Q4 2000 appear to be driven by significant changes in stocks.

To-date, financial market indicators have proved relatively resilient to the crisis, although bond spreads have widened somewhat. The spread in yields on one-year US and Israeli treasury bonds largely held steady at 2-3 percent through mid-2001, as Israeli interest rates followed the downward trend in US rates. But subsequent divergence in bond yields led to spreads exceeding 4 percentage points (see Figure II.5). At the same time, the shekel depreciated substantially against the US dollar, reaching 4.94NIS/US$ in June 2002 compared to 4.16 NIS/US$ a year earlier. The movements in bond spreads and the exchange rate reflect a gradual erosion of investor confidence in the Israeli policy stance. But Israeli creditworthiness has not been revised downward as a result of the crisis.[64]

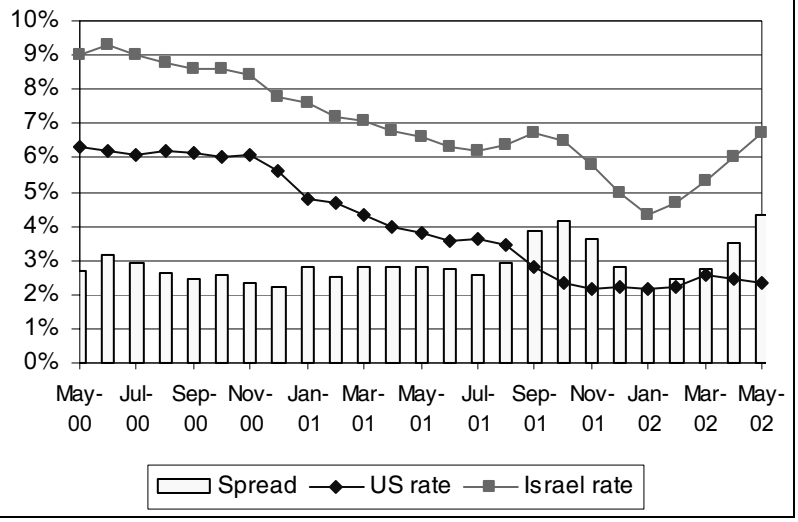
Figure II.4: State of Economy Index
(August 2000=100)



Source: Bank of Israel

Impact on selected sectors. Several specific areas of the economy have been particularly affected by the crisis, namely construction, agriculture and tourism. As shown in Table II.1 below, the construction and agriculture sectors rely heavily on Palestinian

Figure II.5: US-Israel Bond Spread



[64] Moody's investor service upgraded Israel's country rating in July 2000 just prior to the outbreak of the crisis. Their rationale for a higher rating is described as follows: "Israel's diversified modern economy, dominated by high-technology exports, is now on a path of accelerated sustainable growth, accompanied by lower inflation, lower budgetary deficits, and lower debt issuance. Second, the improved creditworthiness implied by this performance is less and less sensitive to potential risks from a geopolitical environment that reflects Israel's relations with Middle Eastern states and the Palestinian Authority" (according to the Israeli Ministry of Finance "Economic Outlook", Economic Research and State Revenue Division, November 2000).

labor, and as such suffered a supply side shock beginning in October 2000, as a large portion of Palestinian laborers were barred from entering Israel. The impact is particularly acute in the construction sector where a quarter of the workforce is Palestinian. Despite a lower share in agriculture (13 percent), the impact was similarly severe because the outbreak of the crisis coincided with the 2000 harvest of important crops like citrus and olives. In both sectors, the negative impact on the Israeli side is likely to be temporary, as employers substitute foreign workers into jobs formerly held by Palestinians.

Table II.1. Composition of employment in construction and agriculture

	1995	1996	1997	1998	1999	2000[1]
Construction:						
Total employment ('000)	227.6	245.7	257.5	252.5	241.2	224.4
Israelis	63.3%	61.3%	57.0%	52.0%	49.9%	50.9%
Palestinians	16.7%	13.5%	16.5%	23.9%	26.8%	24.4%
Foreign workers	20.0%	25.3%	26.6%	24.0%	23.3%	24.6%
Agriculture:						
Total employment ('000)	77.9	78.5	78.5	82.7	83.6	81.0
Israelis	72.9%	64.2%	61.4%	57.4%	59.3%	58.1%
Palestinians	7.7%	7.8%	9.9%	13.4%	12.0%	13.0%
Foreign workers	19.4%	28.0%	28.7%	29.1%	28.7%	28.9%

[1] Pre-crisis.

N.B. The data on Palestinian workers includes permit-holders and non-permit-holders.

Source: Israeli Ministry of Finance, November 2000.

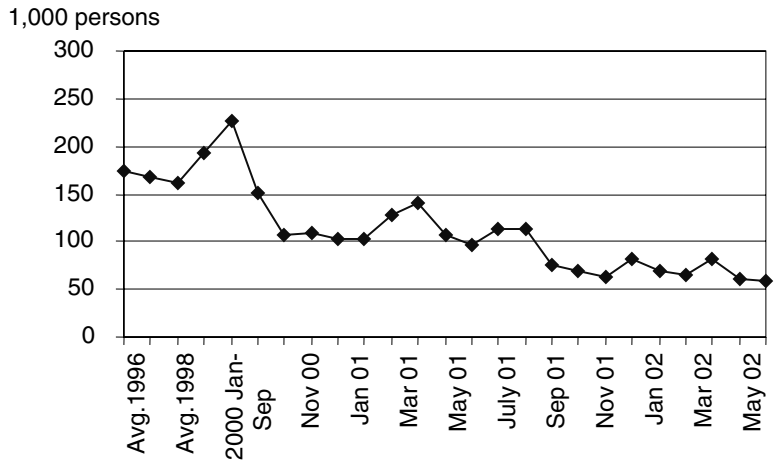
The construction sector was hardest hit with respect to output, posting a 6.9 percent decline between 1999 to 2000 (see Table II.2). By contrast, agricultural sector output growth kept pace with the economy as a whole at 6.4 percent in 2000. Sector composition data reported below indicate that private services and manufacturing were the main engines of growth in the second half of the 1990s, and together accounted for 5.2 of the total 6.4 percent growth in 2000. Given that these sectors are relatively less vulnerable to events in West Bank and Gaza but more vulnerable to global economic trends, a recovery in the world economy could provide considerable stimulus to the Israeli economy.

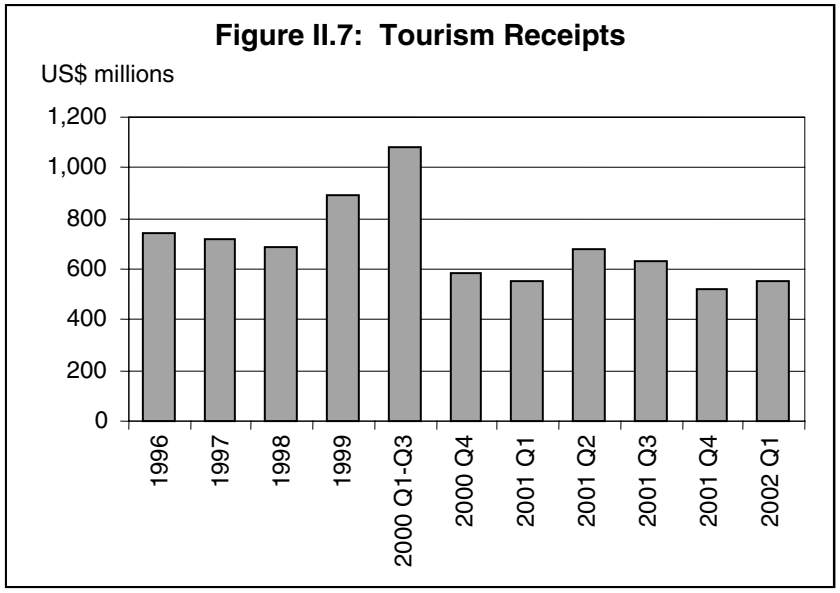
Table II.2. Sectoral Composition of GDP[a]							
	Share of GDP			Annual real growth		Contribution to growth	
	1995	1999	2000	1995 -1999	1999 -2000	1995 -1999	1999-2000
Agriculture	2.3%	2.4%	2.4%	3.9%	6.4%	0.1%	0.1%
Construction	7.8%	6.4%	5.6%	-2.2%	-6.9%	-0.2%	-0.4%
Manufacturing	19.4%	19.9%	20.7%	3.5%	10.7%	0.7%	1.9%
Commerce, restaurants and hotels	11.6%	11.6%	11.7%	2.8%	7.3%	0.3%	0.8%
Transport and communications	8.1%	9.0%	8.8%	5.5%	4.1%	0.5%	0.3%
Private services	21.0%	23.4%	26.1%	5.6%	18.7%	1.3%	3.3%
Public services	29.8%	29.6%	28.6%	2.5%	2.8%	0.8%	0.4%
Total	100.0%	100.0%	100.0%	2.8%	6.4%	2.8%	6.4%

[a] The data show net domestic product at basic 1995 prices, such that total aggregated growth rates differ slightly from GDP growth.
Source: Israeli Central Bureau of Statistics

Israel's tourism sector suffered an immediate decline at the inception of the crisis. During the first 9 months of the millennium year, a record average 225,000 tourists visited Israel each month. Tourist arrivals subsequently fell to 150,000 in October 2000 and diminished continuously thereafter, reaching 50,000 in May 2002 (see Figure II.6). Tourism receipts in the balance of payments figures mirror these trends: tourist spending in Israel amounted to approximately US$1billion per quarter – approximately 4 percent of GDP – during the first 3 quarters of 2000, but fell by half following the outbreak of the crisis (as depicted in Figure II.7). Tourist arrivals are likely to remain depressed as long as the crisis remains unresolved. And based on past experience, namely with the Gulf war in 1991, recovery could take up to 6 months following an end to the crisis.

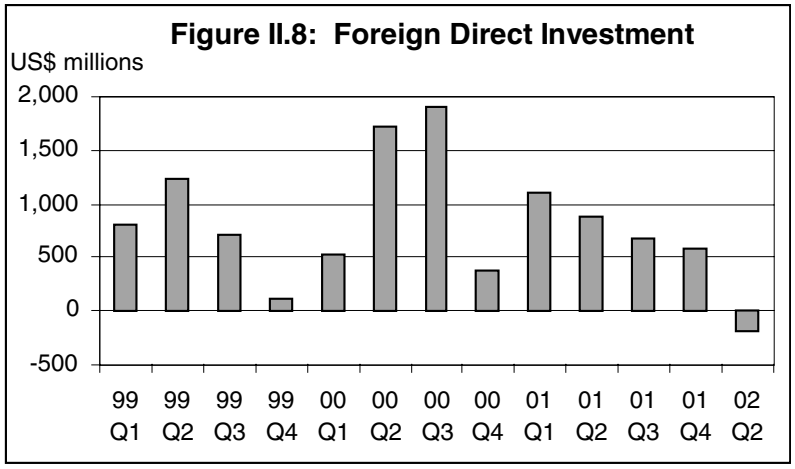
Figure II.6: Monthly Tourist Arrivals





Fiscal balance. The Israeli government's fiscal position is likely to worsen as a result of the crisis. From 1996 to 2000 the fiscal balance improved from a deficit of 4 percent of GDP to zero.[65] For 2001, a 1.8 percent deficit was originally budgeted, but lower-than-anticipated growth suggests a short-fall in revenues on the order of 0.8-1.8 percent of GDP (estimated by the Ministry of Finance). Moreover, these budget estimates do not include substantially higher defense-related expenditures likely to amount to another 1 percent of GDP, which will raise the fiscal deficit further.

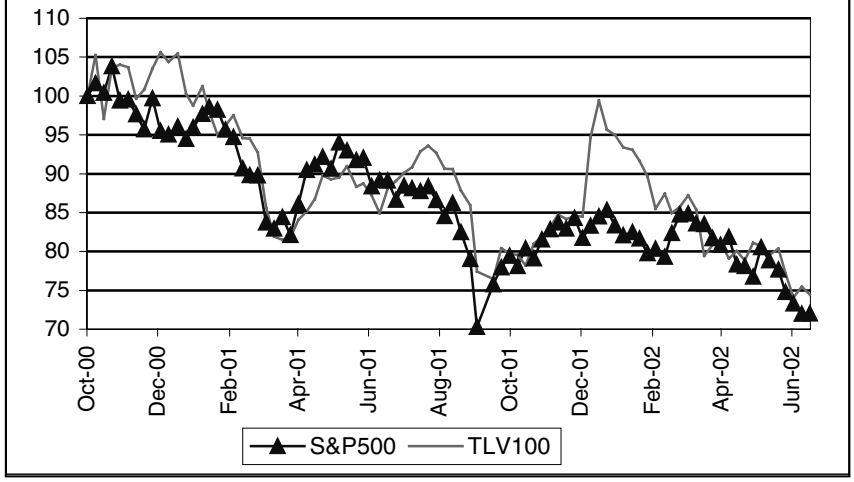
Financial sector. Financial flows have been seriously affected by the crisis, particularly foreign direct investment which declined sharply during the last quarter of 2000, as seen in Figure II.8. Investment flows recovered in the first quarter of 2001, but have declined steadily since. In the second quarter of 2002 there was a net out-flow of foreign direct investments. Whereas the observed decline in foreign direct investment can be explained in large part by the crisis, it is also affected by the persistent downward trend in global financial markets.



[65] See IMF (2001).

Share prices of companies listed on the Tel Aviv stock exchange closely follow those on the New York Stock Exchange irrespective of the crisis, as illustrated in Figure II.9 which plots weekly observations of the S&P500 index and the TLV-100 index since the outbreak of the crisis. In fact, a simple regression of the performance of the TLV100 on the S&P500 and an "intifada" dummy shows no decoupling since early October 2000.[66]

Figure II.9: Stock Markets (Oct. 9, 2000=100)



Conclusion. Although the impact of the crisis is largest at the crisis epicenter, namely in the West Bank and Gaza, it remains substantial in Israel as well. The crisis reduced Israeli economic growth in both 2000 and 2001 to some degree, but the full impact is difficult to measure given that Israeli economic performance was hindered by other exogenous shocks such as the slowing world economy and the events of September 11th. The cost of the crisis has nevertheless been significant for Israel, and could escalate in the future if the conflict takes on a regional dimension.

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[66] The following relation between the Standard and Poor's 500 index (S&P500) and the TLV 100 index was found: Dlog(TLV100) = 0.36 * Dlog(S&P500) - 0.05 * ID
(0.08) (-0.04)
ID is a dummy taking the value 1 during the crisis. Standard errors are in brackets. $R^2 = 0.12$. Weekly data, September 1998 to September 2001, 157 observations.

ANNEX III
West Bank and Gaza Imports of Services from Israel (US$'000 1998)[a]

Category	Description	Total	Tradable
P-E	Electricity, gas, water supply	138,604	0
P-F	Construction	0	0
P-G.5020	Maintenance and repair of motor vehicles	296	0
P-G.5050	Retail sale of automotive fuel	0	0
P-G.50R	Sale of motor vehicles and parts	0	0
P-G.51	Wholesale	0	0
P-G.5260	Repair of personal and household goods	2,362	0
P-G.52R	Other retail sale	0	0
P-H	Hotels, restaurants	61,548	30,774
P-I	Transport, storage, communications	88,159	44,080
P-I.6411	National post activities	1,069	0
P-I.64R	Remaining communication	45,399	22,700
P-J.6511	Central banking	0	0
P-J.6519	Other monetary intermediation	46	0
P-J.660	Insurance, pension funding, except compulsory social security	12,017	0
P-J.R	Other fin. interm., auxiliary activities	0	0
P-K	Real estate, renting, business activities	69,436	0
P-L	Public administration, defence; compulsory social security	28,924	0
P-M	Education	7,867	0
P-N	Health, social work	31,518	0
P-O	Other community, social, personal service activities	4,490	0
P-P	Private households with employed persons	0	0
	Total	491,734	97,554

[a] The calculation of tradables assumes that half of categories P-H, P-I and P-I.64R consist of tradables.

ANNEX IV
Regression Results for Wage Determinants

Reference: Male worker employed in Gaza in the manufacturing sector, plant or machinery operator, with preparatory educational attainment.
Dependent Variable: Log of daily wage (NIS)

	Coefficients B[a]					
Regression:	**1**	**2**	**3**	**4**	**5**	**6**
Constant	3.077	2.808	2.823	2.830	2.822	2.828
Age	6.05E-02	5.17E-02	4.99E-02	5.36E-02	5.52E-02	5.40E-02
Age squared	-6.51E-04	-5.30E-04	-5.02E-04	-5.80E-04	-5.95E-04	-5.86E-04
Female	-0.417	-0.327	-0.306	-0.337	-0.354	-0.359
Works in West Bank		0.213	0.185	0.207	0.195	0.212
Works in Israel or in settlement		0.613	0.559	0.645	0.620	0.627
College degree or higher	0.037	0.263	0.294			
Associate diploma	-0.047	0.119	0.142			
Secondary school degree	-7.18E-02	2.51E-02	3.42E-02			
Elementary schooling	-6.15E-02	-5.77E-02	-5.46E-02			
Less than elementary	-0.204	-0.188	-0.167			
Agriculture and fishing[b]			-0.293			
Mining and quarrying			0.289			
Utilities			0.235			
Construction			0.178			
Wholesale and retail trade			-3.95E-02			
Hospitality industry			0.120			
Transport, storage, communications			3.53E-02			
Financial, real estate sectors			0.162			
Public administration			-5.58E-02			
Education, health, social work			-1.68E-02			
Community, social and personal services			-1.20E-02			
Extra-Territorial organizations			0.274			
Legislators, senior officials, managers				0.417	0.494	0.460
Professionals				0.245	0.317	0.283
Assoc. professionals				8.83E-02	0.156	0.123
Clerks				4.44E-02	0.100	9.84E-02
Service and sales workers				-8.11E-02	-1.71E-02	-3.27E-02
Skilled agriculture workers, craft and tradesmen				1.30E-02	1.31E-02	1.88E-02
Elementary occupations				-0.168	-0.159	-0.164
National Government employee					-0.140	-9.94E-02
Foreign Government, International org. employee						0.191
UNRWA employee						0.350
Non-profit employee						-0.138
Adjusted R^2	**0.143**	**0.418**	**0.461**	**0.427**	**0.434**	**0.446**

[a] All significant at 0.01. [b] Agricultural and fishery workers had very low reporting of wages.

Source: PCBS Labor Force Survey, Round 13, Q2 1999

ANNEX V

A Model of the Palestinian Labor Market

A model of the Palestinian labor market and the important role of Israeli labor demand is developed in this annex to reflect the observed labor outcomes and the dynamic pressures at work (for a more detailed exposition, see Ruppert Bulmer 2001a, 2001b). Labor market segmentation and distorted wages in the Palestinian economy and in Israel support the use of a theoretical approach based in labor market dualism and structural unemployment. The model developed here describes the equilibrium allocation of labor and wages under existing arrangements implemented during the 1990s, and is subsequently used to examine the long-run impact of positive or negative changes in Palestinian labor mobility.

The model incorporates the interaction of labor demand in Israel and the West Bank and Gaza, but abstracts away from aggregate labor demand in Israel in order to focus on unskilled labor only.[67] Much of the literature on dual labor markets applies to the segmentation between the formal and informal sectors and the associated wage differentials (Dickens and Lang 1985). This analysis, in contrast, addresses the segmentation that arises in the Palestinian labor market among workers employed in the West Bank, in Gaza, and in Israel. The model incorporates total demand for Palestinian labor by including Israeli labor demand for unskilled workers, and allowing for substitution effects between foreign and Palestinian workers in Israel, such that changes in labor supply and demand are transmitted to the Israeli unskilled labor market and throughout the Palestinian labor market.

The size of the Palestinian labor force is treated as constant, such that the model does not account for labor force entry and exit due to demographic factors or the discouraged worker effect. In addition, feedback effects from employment and income growth on labor demand are not considered in this context (but are addressed in Chapter 5). The labor model also assumes a production function of fixed capital costs, thus abstracting away from substitution between labor and capital.

The level of Palestinian employment in Israel is determined by labor demand on the part of Israeli employers, the number of permits issued, and the effective control of labor flows across borders. Palestinians are drawn to better-paying Israeli jobs, but are limited by mobility constraints that affect legal and illegal workers alike.

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[67] The Israeli labor market is highly segmented between skilled and unskilled labor, where skilled jobs are typically held by Israelis, and unskilled jobs are held by Palestinians or foreign workers (in this analysis, "foreign" refers to non-Palestinian). Palestinian labor is assumed to have no role in the Israeli skilled sector, such that there is no substitution between skilled Israelis and all non-Israeli workers. There are, of course, skilled Palestinian and foreign workers employed in high productivity occupations in Israel, but this simplifying assumption enables the analysis to focus on the Israeli unskilled sector.

In the model, therefore, Palestinian labor supply to Israel is exogenously fixed below its market-clearing level (i.e., $L_{PI} = \overline{L}_{PI} = L_{WB,I} + L_{GS,I}$, where total labor supply L_{PI} is the sum of labor flows from the West Bank $L_{WB,I}$ and Gaza Strip $L_{GS,I}$) such that labor supply cannot respond fully to demand and therefore real wages are not equilibrated. However, the model assumes that *expected* wages are equilibrated through changes in labor supply and demand.[68] Specifically, a Palestinian worker is assumed to choose between a domestic job, which he/she can obtain with certainty but at a lower wage, or an Israeli job, which is available with some probability less than one, depending on labor mobility and the unemployment rate. That is, when the number of permits is restricted and Palestinian unemployment is high, the competition for obtaining an Israeli job increases, reducing the probability of earning the higher Israeli wage. Furthermore, Palestinians working in Israel incur additional costs for transportation, job search, and permit requirements (or permit evasion efforts), all of which further reduce the Israeli wage in real terms (i.e., the expected Israeli wage). In equilibrium – that is, at the margin – expected earnings are equalized when a worker is indifferent between working domestically in WBG or seeking employment in Israel.

In the model, the probability of obtaining an Israeli job is expressed as a linear function of the employment rate, or 1 minus the unemployment rate, which is less than 1. Because the Palestinian labor market is segmented between the West Bank and the Gaza Strip, each region has a different unemployment rate, denoted u_{WB} and u_{GS}. Domestic Palestinian wages in the West Bank and in the Gaza Strip are denoted by $w_{j,D}$ (j=WB, GS), and wages earned by Palestinians in Israel are denoted $w_{j,I}$ (j= WB, GS to reflect origination point).

The costs associated with working in Israel (e.g., for transportation, search and permits costs) are captured by the fraction β_j (j=WB, GS), defined inversely proportional to costs; in real terms, Palestinian workers in Israel earn $\beta_j w_{j,I}$ ($\beta<1$), and β_j depends positively on Palestinian labor mobility and thus the magnitude of labor flows to Israel, $L_{j,I}$. In other words, as the number of permits increases and security controls are eased, the transportation and search costs decline and the share β_j of the actual wage $w_{j,I}$ increases ($\beta_j'(L_{j,I})>0$). The equilibrium wage condition that describes the wage gap between domestic Palestinian wages and those earned by Palestinians in Israel is given by:

$$w_{j,D} = (1-u_j)\cdot \beta_j \cdot w_{j,I} \ , \ j = WB, GS \qquad \text{(V.1)}$$

Since $0<(1-u_j)<1$ and $0<\beta_j<1$, then $w_{j,D}<w_{j,I}$ in equilibrium. The intuition behind equation V.1 is that Palestinian workers search or queue for high-paying

[68] This approach was delineated in the migration literature by Harris and Todaro (1970) to describe the wage gap between rural and urban jobs.

Israeli jobs but are unemployed while searching.[69] The expected wage for an Israeli job depends on the actual Israeli wage $w_{j,I}$ discounted by costs β_j and the imperfect probability of finding employment ($1-u_j$), and in equilibrium, this is equal to the actual domestic wage $w_{j,D}$.

Palestinian employment in Israel depends on Israeli demand for unskilled workers, the supply of foreign workers, and the elasticity of substitution between Palestinian and foreign workers. Total Israeli demand for unskilled labor is met by a combination of Palestinian and foreign workers. Because Israeli employers of Palestinians incur additional costs due to absenteeism linked to security controls and closures, however, the unit labor cost of Palestinian workers is in fact higher than $w_{j,I}$: Palestinian workers are paid $w_{j,I}$ (equivalent to only $\beta_j w_{j,I}$ in real terms), but they cost their Israeli employers $w_{j,I}\Phi$, $\Phi>1$. The size of Φ depends negatively on the magnitude of Palestinian labor flows into Israel; as more Palestinians are allowed to cross into Israel and security restrictions are eased, the risk of absenteeism diminishes and Φ declines (i.e., $\Phi'(L_{PI}) < 0$).

The model assumes that wages of foreign workers are determined by labor market conditions in the sending, or labor-exporting, country, and that the supply of foreign workers is effectively infinite, due to non-binding controls. Although foreign work permits have a fixed duration (typically 1 year), most foreign workers remain longer – either through permit renewal or in informal jobs – suggesting an unconstrained supply of foreign labor. This is evidenced by the fact that illegal foreign workers are at least equal in number to legal foreigners, and by some estimates outnumber them three-to-one. Foreign wages therefore do not respond directly to changes in Israeli labor demand. Palestinian and foreign workers in Israel are assumed to be close technical substitutes, but have different unit labor costs.

The distortions reflected in the labor force survey data and captured by the model – namely the limits on Palestinian labor supply to Israel ($\bar{L}_{PI}$), the costs of commuting (β_j), the uncertainty of finding an Israeli job, the Israeli employer's cost of Palestinian absenteeism (Φ), and the difference in wages paid to Palestinian and foreign workers in Israel – create wedges that affect outcomes in equilibrium by preventing full employment and wage adjustment to equate labor supply and demand.

The model is solved to assess the impact of changes in Palestinian employment in Israel on the long-run allocation of Palestinian and foreign labor in Israel, domestic Palestinian employment, domestic and Israeli wages, and Palestinian unemployment. Comparative statics exercises describe the effect of exogenous changes in $L_{j,I}$ (j=WB, GS) as a result of potential future labor policies adopted in the

[69] The Q2 1999 labor force survey data show that 39 percent of unemployed Palestinians held their previous job in Israel, 4 percent worked in the settlements, and another 18 percent were first-time jobs seekers.

long run, and the results are calibrated to the Palestinian context using available data from the Q2 1999 labor force survey data and other available sources (see Ruppert Bulmer 2001b for details). The comparative statics results summarized here indicate the direction of impact on the model's endogenous variables (reflecting calibrated results):

$$\frac{dw_{j,I}}{d\bar{\bar{L}}_{j,I}} > 0 \tag{V.2}$$

$$\frac{dL_{j,D}}{d\bar{\bar{L}}_{j,I}} < 0 \tag{V.3}$$

$$\frac{dw_{j,D}}{d\bar{\bar{L}}_{j,I}} > 0 \tag{V.4}$$

$$\frac{du_{j}}{d\bar{\bar{L}}_{j,I}} < 0 \tag{V.5}$$

$$\frac{dL_{F,I}}{d\bar{\bar{L}}_{j,I}} < 0 \tag{V.6}$$

ANNEX VI

Estimates of Factor Accumulation and TFP Growth

Per capita GDP growth can be expressed as the sum of (i) per capita capital stock growth multiplied by the elasticity of GDP with respect to capital and (ii) total factor productivity growth, the latter determined residually by estimating:

$$\dot{y} / y = \alpha \dot{k} / k + \dot{x} / x \qquad \text{(VI.1)}$$

where y is real GDP per capita, k the physical capital stock per capita, α the elasticity of GDP with respect to capital, and x total factor productivity (TFP). The dot on top of a variable denotes the derivative of the variable with respect to time.

This approach requires information on the capital stock – generally unknown – and the elasticity of GDP with respect to capital. Data on capital stock can be derived using the perpetual inventory method (which consists of cumulating investments over time accounting for some physical depreciation of the capital stock, generally at an annual rate of 4 to 7 percent), but this requires identifying the capital stock at one point in time.[70] Various methods are used to identify capital stock, from defining steady state paths (Harberger 1978) to imposing a pre-determined value in line with international estimates (IMF 2001). The elasticity of GDP with respect to capital stock, α, can be extracted from national accounts as one minus the share of employees' compensation in total GDP at factor cost, under the assumptions that factors are remunerated at their marginal productivity and labor compensation statistics encompass all labor value-added. These two assumptions are not necessarily met, however, as labor market imperfections and under-accounting of real labor value-added are frequently observed (Young 1995).

Sensitivity analysis is used to address these shortcomings, namely by imposing arbitrary initial values of the capital stock and then econometrically estimating equation VI.1 to determine the elasticity of GDP with respect to the capital stock. Table VI.1 reports the estimates of a Cobb-Douglas production function with constant returns to scale under different assumptions for initial values of capital stock.[71] The production function is estimated using an error correction model to distinguish the short-term impact of capital accumulation from its long-term impact on GDP. It takes the form:

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[70] The perpetual inventory method consists of writing the law of motion of capital K_t as: $K_t=(1-\delta)K_{t-1} + I_t$, where δ is the depreciation rate (fixed in this paper at 5 percent) and I_t is the flow of contemporaneous investment.

[71] Wald tests cannot reject at the 10 percent level the null hypothesis of constant returns to scale in all five cases.

$$\ln(y_t / y_{t-1}) = \gamma + \beta \ln(k_t / k_{t-1}) + \phi (\ln y_{t-1} - \alpha \ln k_{t-1}) \quad \text{(VI.2)}$$

where β captures the short-term impact of capital accumulation on GDP, α reflects its long term impact, φ, the error correction coefficient, measures the pace at which the Palestinian economy corrects imbalances between GDP and capital stock levels (typically after a demand shock), and γ is an intercept. This equation is estimated using instrumental variables for the capital stock in order to avoid simultaneity bias.[72]

Table VI.1: Production Function Estimates under Different Initial Capital Stocks 1970-2000

Initial k/y:	1.0	1.5	2.0	2.5	3.0
γ	3.067 (3.69)	2.507 (3.68)	2.062 (3.73)	1.693 (3.76)	1.372 (3.49)
β	0.035 (0.19)	-0.004 (0.01)	-0.041 (0.15)	-0.069 (0.21)	-0.088 (0.24)
φ	-0.680 (3.02)	-0.602 (2.80)	-0.540 (2.64)	-0.491 (2.51)	-0.451 (2.40)
$\varphi\alpha$	0.230 (2.20)	0.229 (1.98)	0.228 (1.80)	0.229 (1.67)	0.232 (1.55)
Adj. R^2	0.333	0.311	0.293	0.277	0.261
Durbin Watson	2.199	2.267	2.327	2.381	2.432
α	0.338	0.380	0.422	0.466	0.514
Average Annual Growth rates, 1970-2000					
GDP per capita	2.18%	2.18%	2.18%	2.18%	2.18%
Capital per capita	5.57%	4.86%	4.28%	3.78%	3.35%
TFP	0.29%	0.33%	0.37%	0.41%	0.45%
Observations	31	31	31	31	31

N.B. *y is* GDP per capita; *k* physical capital per capita. T-student statistics in absolute value are in parentheses. The initial k/y ratio is computed for the year 1968. All reported growth rates are computed econometrically.

All parameters of interest have the expected sign, and are generally statistically different from zero at the 10 percent level.[73] The elasticity of GDP with respect to capital, α, ranges between 0.33 and 0.51, which is in line with international standards but lower than the ratio of capital remuneration over GDP reported by PCBS – 0.6 in 1998. On purely economic grounds, an elasticity of 0.40 looks plausible. Palestinian labor costs (pulled up by access to the Israeli labor market) are high compared to capital (whose price is determined on international markets), thus encouraging producers to adopt capital-intensive technologies. Whatever the assumption on capital stock, regression results from equation VI.1 indicate that

[72] The Hausman test of specification rejects at the 1 percent level the null hypothesis of exogeneity in all five cases. The instrumental variables retained for these estimations are World GDP, Israeli GDP, a linear trend time, a binary variable taking the value 1 the odd years and 0 the even years, and the number of closure days.

[73] These results are robust to the inclusion of variables describing potential short-term shocks such as closures, business cycles in Israel, and cycles of olive trees production. Under alternative specifications, the lower the initial capital/GDP ratio, the better the quality of estimates. Adding a linear time trend to measure directly the average growth rate in TFP does not alter the results. The estimated coefficient of this trend is not significantly different from zero, suggesting that TFP growth has not been constant over the period of estimation.

Palestinian growth has been transitional rather than sustainable in the long run because it was driven by capital accumulation. Total factor productivity growth contributed only marginally to GDP growth since 1968: TFP growth over the period 1969-2000 ranges between 0.3 and 0.4 percent (estimates are not sensitive to the initial capital/GDP ratio).

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