ECONOMIC ROAD MAP

An Israeli-Palestinian Perspective on Permanent Status

The Aix Group

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Aix en Provence in Jerusalem

THE AIX GROUP

Following discussions with Israeli and Palestinian economic experts in the beginning of 2002, Professor Gilbert Benhayoun of the University of Law, Economics and Sciences of Aix-Marseilles III decided to contribute to researching a vision of the future economic relations between Israelis and Palestinians. To this end, he organized together with the Peres Center for Peace and the Palestinian Ministry of National Economy an International Workshop on "The Potential for Economic Cooperation in the Middle East: the Israeli-Palestinian Perspective". The seminar took place in Aix-en-Provence on July 2002.

A workgroup was created after this seminar – hence the name "Aix Group" – in order to bring together Israeli and Palestinian perspectives on economic questions related to future permanent arrangements between the two sides and to create a forum for discussing and analyzing different scenarios and propositions. Focusing on developing an "Economic Road Map" as a complement to the political process started by the "Road Map", and supported by the Quartet, the Aix Group has met regularly since – in Paris, Istanbul, Fontainebleau and Jerusalem.

The Aix Group includes Israeli and Palestinian academics, experts and members of Israeli and Palestinian official institutions – in particular, the Ministries of Finances and Economics - acting in an individual capacity. The Aix Group also includes international experts and academics and members of international institutions – European Union, World Bank, International Monetary Fund – also acting in their personal capacity.

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Executive Summary

a) This paper, prepared by a non-official group of Israeli, Palestinian and international economists, aims to establish an economic counterpart to the Road Map for Peace. The paper concentrates on economic arrangements associated with Phase III of the Road Map, since the group believes that the economic content of Phases I and II can only be determined correctly if a clear vision of permanent status arrangements first exists.

b) In accordance with the Road Map, the paper assumes the emergence of a two state-solution embodying Palestinian economic sovereignty, unambiguous borders and the conduct of economic relations in a spirit of cooperation and mutuality. The group's economic vision of permanent status is based on economic arrangements that will seek a convergence of Palestinian living standards with those of Israel and promote independence in economic policy-making while acknowledging economic interdependency.

c) Central to our discussion is a recognition that future Palestinian economic strategy can no longer afford to rely so heavily on the export of labor and remittance income. It is unlikely that the number of Palestinians working in Israel will again approach historical levels; moreover, domestic Palestinian production and exports are compromised by the upward pressure on domestic wages and prices exerted by higher Israeli wage levels.

d) The group assessed future policy options in the trade, labor, fiscal, monetary and investment policy areas.

e) **Trade**. The group recommends a Free Trade Area, consistent with World Trade Organization protocols. We believe that an FTA between a Palestinian state and Israel is likely to be feasible and efficient, as well as to offer exploitable development opportunities. It would provide Palestinians open access to the Israeli market, with Israel continuing to be a key trading partner. At the same time, an FTA will allow the Palestinian state to diversify its trade relations and implement development policies conducive to economic growth and prosperity. An FTA will be most efficient if accompanied by a friendly system of Rules of Origin. Israel would grant the

Palestinian state, as a developing economy, the option to temporarily protect selected sectors.

f) **Labor**. The group recommends the establishment of designated border passages through which labor flows would be unencumbered, while subject to regulation through taxes and/or permits. Palestinian workers should be given preferential access to the Israeli labor market, as compared to other foreign workers, reflecting the lower negative externalities for the Israeli economy. In addition, work permits should be granted to and held by individuals, not contractors. Although the Israeli labor market will play a diminishing role in Palestinian development, its importance in an orderly economic transition is significant.

g) **Fiscal Policy.** Under an FTA, each country would run an independent international customs policy, but would not impose duties on goods originating in Israel/the Palestinian state (with certain exceptions as defined under the agreement). To minimize smuggling, indirect tax policy needs to be closely coordinated, and VAT and other indirect tax rates (excises, purchase taxes) should only diverge marginally, if at all. Double taxation should be avoided since this would discourage cross-border economic activity. Accordingly, there is a case for applying lower income tax rates to Palestinian workers in Israel as compared to those applicable to Israelis or other foreign workers. Alternatively, Israel should continue to remit to the Palestinian state a large portion of the income tax it levies on Palestinians working in Israel, as well as any social security deductions.

h) **Monetary Policy**. We recommend that the restrictions embedded in the Paris Protocol preventing the Palestinian Monetary Authority from issuing Palestinian currency be lifted in Phase II (whether or not the PA then decides to create a new currency). At present, the Palestinian Authority does not receive revenue from issuing and circulating a currency, and this raises the possibility of the PA sharing the revenue derived from the issuance of Israeli Shekels while the current currency system continues. The two central banks should consult over the supervision of branches and subsidiaries operating within each other's jurisdiction.

i) **Investment.** The group recommends that both countries accord one another's investors and investments national treatment - with some exemptions in cases that bear upon special national interests. The future economic agreement should permit full repatriation of revenues and income, should preclude the possibility of double taxation, and should address expropriation and regulatory matters pertaining to facts and disputes created after its entry into force. Donors can contribute to cross-border investment by establishing funds that can be used to build equity positions in Palestinian firms and to create joint ventures with Palestinian partners, as well as by continuing to offer risk insurance and guarantees to investors.

j) The introduction of these new economic arrangements will require intensive bilateral cooperation. This would be facilitated in particular by the establishment of a Joint Israeli-Palestinian Economic Committee, as well as by regular dialogue at experts' level to exchange views on all areas of economic policy. The establishment of an Israeli-Palestinian Development Fund should be considered; this institution could play a major role in encouraging a variety of joint activities, such as industrial estates, business ventures for domestic and external markets, tourism projects and joint public/private infrastructure initiatives.

k) The transitional period requires, above all, a vigorous effort to stimulate Palestinian economic recovery. This can only be done by restoring movement and predictability in transactions. Three basic ingredients are required to achieve this: i) an unencumbered flow of goods across borders and within the West Bank and Gaza; ii) an unencumbered flow of persons within the Palestinian Territories, coupled with a flows of workers to Israel which regains some stability and predictability; and c) the continued uninterrupted flow of fiscal transfers from Israel to the Palestinian Authority. The meaning and operation of a Palestinian state with provisional borders, as envisaged under Phase II, needs thorough exploration, since it will serve as the precursor to full economic independence. Phase II arrangements must realistically be based on a "Paris Plus" formula – that is, the full implementation of the modified Paris Protocol. Phase II arrangements should include measures that ensure territorial viability, i.e. the creation of internal contiguity and the inception of economic control over external borders. Steps should be taken to denote emerging sovereignty, including the right to issue currency and the granting of observer status in the IMF, the UN, the World Bank and the WTO. Attention should also be given to the development of institutions that will reinforce cooperation and resolve disputes.

ECONOMIC ROAD MAP

A. Introduction

1. In the belief that a sound economic context is essential to building sustainable peace between Israelis and Palestinians, and that the economics of peace-building have not been given sufficient importance by policy-makers, a group of Israeli, Palestinian and international economists has worked together since July 2002 to establish an economic counterpart to the Road Map for Peace. The group has no official status, although we consulted closely with Israeli and Palestinian officials as our work progressed. Our group met at various occasions in Aix en Provence (hence the "Aix Group" name), Fontainebleau, Istanbul, Paris and Jerusalem, and this paper represents the fruits of our collaboration.

2. The Road Map for Peace (December 20, 2002 version) is scanty in its treatment of economic issues. Its three phases are defined principally in political terms:

- Phase I involves ending terror and violence, normalizing Palestinian life, comprehensive security reform, Israeli military withdrawals to the pre-Intifada positions of September 2000, cessation of settlement activity and free Palestinian elections.
- Phase II aims at the establishment of a Palestinian state with attributes of sovereignty, provisional borders and a new constitution.
- Phase III foresees the conclusion of a permanent status agreement and the creation of a sovereign Palestinian state.

Our paper concentrates on economic arrangements associated with Phase III. The group believes that the economic content of Phases I and II of the Road Map can only be determined correctly if a clear vision of final status arrangements first exists. To that end, we worked back from our vision of viable permanent status economic arrangements to assess the economic prerequisites that must be put in place in Phases I and II through backwards engineering. At the same time, each phase embodies particular economic challenges, and these need to be addressed in order to move from one phase to the next. Phase I should be viewed as a rescue phase wherein the challenge is to restore the fluidity of economic transactions. Phase II will be devoted to preparing Palestinian economic institutions for statehood so that eventually an economically viable state is created in Phase III. The challenges of transition are detailed in paragraphs 41- 45.

Some Assumptions

3. Phase III of the Road Map refers to "...a final, permanent status resolution in 2005" as "including borders, Jerusalem, refugees, settlements...." but leaves open the nature of the specific agreements to be reached. The Road Map's "vision of two states, Israel and sovereign, independent, democratic and viable Palestine, living side-by-side in peace and security" serves as our basic guideline, but additional assumptions are also needed in order to derive workable economic formulae. Accordingly, we have assumed that a viable two-state solution will embody the following factors[1] :

- The Palestinian state will have the power to define its economic objectives and strategies and to implement them freely, within the parameters of a bilateral permanent agreement;
- Economic cooperation will be conducted in good faith and mutuality, free of any intention to dominate;
- There will be a clear, unambiguous agreement on borders[2];

[1] The paper does not touch directly on several important issues which have significant economic implications, such as the future of Palestinian refugees, compensation, and the actual delineation of the borders between the two states.

[2] The Separation Barrier currently under construction, should it prove to be a permanent structure, will have severe negative effects on Palestinian economic viability. Its permanency is in our view incompatible with the economic vision reflected in this document.

- The Palestinian state will have full economic jurisdiction over its external borders with Jordan, Egypt and Israel, meaning that the Palestinian state and Israel will implement trade, labor and other regulatory policies in a manner congruent with normal relations between sovereign states;
- The Palestinian state will feature contiguity within the West Bank and efficient connections with Gaza;
- Borders in the Jerusalem area offer two options:

  Option A: An ‘open’ Jerusalem, resulting inevitably in the creation of customs/economic borders around Jerusalem (i.e. the creation of a special economic area), unless the parties agree on a full customs union;

  Option B: The border will bisect Jerusalem, separating Jewish and Arab neighborhoods. In this case, a special economic status for the old, walled city can be devised should both parties wish it.

4. A clear distinction should be made between independent economic policies which need no coordination with the other party, and interdependent policies which do. Thus in a permanent agreement both parties may forego aspects of their sovereignty (e.g. on borders) in order to pursue other policy goals. Such actions are compatible with ‘full sovereignty’ if they are entered into freely.

5. In this paper we evaluate several alternative economic arrangements between the two states, and between them and the rest of the world. Some options entailing different tax systems between Israel and a Palestinian state (e.g. to avoid smuggling) would require continuous borders, which is what we assume. Should this assumption be unrealistic, some of our recommendations will have to be reviewed; in particular the trade arrangements proposed below will have to be modified.

6. During Phases I and II, both sides must refrain from taking any steps that damage one another’s economy any further. To achieve this objective and to promote the economic revival which is a vital precursor to peace, both parties need to put economic issues back onto their primary agenda – which they are not currently doing

with certain exceptions[3] . They need to work with the international donor community to recreate investor confidence in the region. Their public statements about the conflict and the peace process must give adequate prominence to this neglected factor in the peace equation.

7. The economic regime – *de jure* and *de facto* – within which the sides now function is unlikely to change much before the conclusion of a permanent status agreement. The aim though, should first of all be a major easing of the closure regime and an improvement in security and next, adjustments of the 1994 Paris Protocol to address well-known weaknesses (e.g. fiscal leakages on indirect imports, the transfer of purchase taxes collected on Israeli products that are then exported to the Palestinian territories).

B. An Economic Vision for Phase III

Our economic vision for permanent status is founded on a belief in symmetry, mutual respect and cooperation based on common interests.

8. We propose the creation of new economic arrangements which will promote independence in defining economic objectives and strategies, growth in both economies, the pursuit of policies that acknowledge economic interdependencies, and the convergence of Palestinian living standards with those of Israel. The group acknowledges that cooperation can only grow on the basis of common interest, which exists in many spheres. We firmly believe that a permanent status agreement alone will address the fundamental causes of the current crises in both economies.

9. At the heart of future Palestinian economic policy lies the issue of remittances, or ‘net factor income from abroad’. Historically, a considerable portion of Palestinian Gross National Income (GNI) has derived from wages earned abroad, principally in Israel[4] . While this helped raise real incomes to levels that by mid-2000 compared

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[3] The principal one being the ongoing bilateral dialogue on “clearance revenue” transfers, see paragraph 43.

[4] In 1999, net factor income from abroad accounted for 17 percent of Palestinian Gross National Income (Source: Palestinian Central Bureau of Statistics).

favorably with other Arab states[5] , we believe that an economic strategy so strongly dependent on remittances has run its course, as recent economic history demonstrates. During the Oslo period, Palestinian economic growth was not export-led but rather was driven by consumption deriving from higher incomes from workers' remittances. The positive aspects of this growth pattern included higher incomes and reduced poverty, but were offset, especially during closures, by high uncertainty, income volatility, persistent poverty and non-competitive domestic wages.

10. Due to Intifada-related closures, labor flows have been depressed and erratic, and it seems unlikely that the numbers of Palestinians permitted to work in Israel in the future will approach pre-2000 levels[6] . Furthermore, while income from higher wages in Israel creates effective demand for locally produced goods, it hinders domestic production and exports because of the upward pressure these wage levels exert on domestic wages and prices. In addition, most labor exports to Israel are low-skilled and capture only a small portion of value-added, as well as having few backward technical linkages. A major policy challenge is how exports of domestically-produced goods and services can, at least partially, substitute for exports of labor (see Box 1 on labor market distortions).

Box 1: Labor Market Distortions and GDP Growth

In 1999, Palestinian workers in Israel were paid 61 percent more than workers with similar characteristics (qualifications, experience, sector of activity) in the West Bank, and 85 percent more than those in Gaza. This wage differential, which stems from restricted access to the Israeli labor market, inevitably exerts upward pressure on domestic wages since it reduces the number of candidates for low-wage jobs in the West Bank and Gaza. The effect is compounded by the fact that workers' remittances are mostly repatriated and consumed domestically. Additional income which does not originate from higher domestic productivity tends to raise the price of non-tradable goods, and hence wages in those sectors. One way to

[5] By way of comparison, per capita GNI in Jordan and Egypt were respectively 24 and 36 percent lower than in West Bank and Gaza in 1999 (measured in US$; source: World Bank).

[6] Let alone the levels reached prior to the first Intifada. In 1988, approximately 38 percent of Palestinian workers commuted to Israel or Israeli settlements; in 2000, on the eve of the second Intifada, this ratio had declined to some 22 percent. The ratio for the first nine months of 2003 was only 9 percent.

reduce this negative effect would be to lift restrictions on access to the labor market in Israel, which might imply growth of Palestinian labor in Israel of 4 - 5 percent a year. It is doubtful, however, that this would be acceptable to Israel in the foreseeable future, for obvious political and security reasons.

This distortion undermines potential GDP growth in the West Bank and Gaza. Although the returns to education in the West Bank and Gaza are positive, they are more than offset by the higher returns to work in Israel – resulting in underused human capital and creating a labor market that specializes in low value-added activities. This in turn has meant that skills acquisition through knowledge-sharing or learning-by-doing have not resulted. In addition, relatively high domestic wages do not attract either investors or technology that would increase productivity, including in export-oriented sectors.

11. The group in the course of its work assessed the following alternatives:

- Trade regime:
  1. Customs Union (CU)
  2. Free Trade Area (FTA)
  3. Most Favored Nation (MFN)
- Labor flows:
  1. Free flows
  2. Flows regulated by quotas and/or by differential wage taxes
- Fiscal regime:
  1. Coordinated
  2. Partially coordinated
  3. Uncoordinated
- Monetary policy
  1. Use of foreign currency as legal tender
  2. The issuance of domestic currency with three possible broad exchange rate regimes - (i) free float, (ii) adjusted peg, (iii) currency board.

12. In exploring future policy options, the group reviewed various scenarios that compared a post-conflict 'status quo' – i.e. a Customs Union between Israel and the Palestinian state and unregulated labor flows to Israel – with an independent trade regime (either a Free Trade Area or a Most Favored Nation regime) embodying regulated labor flows. The results indicated that in the short-run, overall employment levels and incomes would be higher under the 'status quo' scenario. However, under an independent regime an initial decline in domestic wages should bring about a more competitive Palestinian environment and higher levels of productive investment opportunities, leading to increased exports of goods and services and higher growth rates in GDP over time. Accordingly, in fostering per capita income growth and income convergence, we emphasize policies that promote domestic income growth rather than policies aiming at encouraging workers remittances from abroad.

Trade

13. The group recommends a Free Trade Area, consistent with World Trade Organization protocols. Under such an FTA regime, the Palestinian state would determine its trade arrangements vis-à-vis third parties, based on WTO rules and an MFN approach. As a developing economy, the Palestinian state would be granted by Israel the option to temporarily protect some sectors on an MFN basis. The group recommends the adoption of a system of Rules of Origin which is most conducive to both bilateral and regional trade.

14. When it comes to the choice of a trade regime, there are a number of options – the main ones being a Customs Union, a Free Trade Area and a Most Favored Nation regime. In reviewing the merits of each, we focused on several important components of the economic relationship between the two economies: access to markets; the ability to implement independent trade policy; the macroeconomic costs of a particular regime; and the complex relationship between trade in commodities and the exchange of production factors.

15. We believe that a FTA between a Palestinian state and Israel is likely to be feasible and efficient, as well as to offer exploitable development opportunities. A bilateral free trade agreement would provide the Palestinian state open access to the Israeli market, which will continue to be a key trading partner. At the same time, it will allow the Palestinian state to diversify its trade relations and implement

development policies conducive to economic growth and prosperity. A FTA model will be most efficient if accompanied by a friendly system of Rules of Origin which will minimize negative impacts on trade.

Box 2: Rules of Origin and Trade

A Free Trade Area regime exempts goods exported by one party from being taxed by the other. However, as the tax on goods imported from third parties may differ between the two partners, it is necessary to maintain controls on third-country goods crossing the border between them – the risk being that third party goods imported into the jurisdiction imposing the lowest taxes can otherwise be re-exported duty-free to the other party. Rules of Origin measures imposed to counter trade deflection need to be simple, or their imposition can offset the positive impact on trade of granting duty free access to the other FTA partner. A particular source of complication can be the signature of other FTA agreements by each partner. The best way to encourage trade in this case is to make all possible efforts to harmonize the sets of Rules of Origin.

16. As mentioned in paragraph 7, we assume that the economic regime in Phases I and II will be based on a modified version of the Paris Protocol. However, the creation in Phase II of "an independent Palestinian state with provisional borders" has important economic implications. As an independent state Palestine could then participate in the WTO and would have the prerogative to enter into independent trade agreements with third parties.

17. The FTA regime recommended by the group requires cooperation between the parties in the following areas:

- First, the FTA regime should allow for a degree of asymmetry - whereby for a temporary period Palestine can implement certain trade restrictions on imports from Israel on an MFN basis. The purpose of this would be to stimulate Palestinian economic growth and domestic employment, as was the case with the 1975 agreement between Israel and the EEC.
- Second, the Israeli and Palestinian governments would need to discuss and agree upon:
  - Rules of Origin
  - Standards

- Cooperation in export promotion.

- Third, the guiding principles for trade relations should be those enshrined in the WTO agreements, including the dispute settlement mechanisms applicable between members.

- Fourth, supervising the implementation of the agreement should be entrusted to a Joint Israeli–Palestinian Economic Committee, which should also be empowered to recommend revisions to the agreement where appropriate and mutually agreeable – see paragraph 40.

Human Capital and Labor Mobility

18. The group recommends the establishment of designated passages across which labor flows will be unencumbered, but subject to regulation through taxes and/or permits. The regulation of labor flows will need to address both sides' macroeconomic interests as well as security needs. Since this particular issue is of such importance to the two economies and societies, close coordination is essential.

19. Our recommendations stems from the following reasoning:

- Palestinian development strategy, particularly insofar as employment creation is concerned, should rely more on domestic economic growth – hence the importance of regulating labor flows to Israel.

- The existence of a developed Israeli labor market next door works against this policy priority, but the rate of growth in Israel's demand for foreign labor will fall substantially short of the very rapid increase in Palestinian labor supply . Thus we can assume that the Israeli labor market will play a decreasing though still important role in providing job opportunities to Palestinians.

- Palestinian workers should be given preferential access to the Israeli labor market over other foreign workers, reflecting the contribution of their

[7] Labor supply in the West Bank and Gaza is forecast to grow by 4 to 5 percent annually over the next decade, a rate likely to be much higher than the growth of labor demand in Israel – estimated at about 2 percent per annum.

employment to reducing the income gap between the two states, as well as the lower negative externalities for the Israeli economy.

- Although access to the Israeli labor market should not be a cause of negative long-term distortions to the efficient use of Palestinian human capital, intervention in and regulation of the flow of labor between the two economies should be applied only when necessary to ensure this objective. Price mechanisms (e.g. taxes) are preferable to quotas whenever possible, as they are less arbitrary and since tax income would accrue to the public authorities.

20. The implementation of almost all these policy measures can start in Phase I.

- *Designated Passages*: Labor flows would take place only through designated passages. These flows should be supervised, but should be as automatic as possible. A monitoring system should be developed and shared by the two states, and should allow for the implementation of relevant laws, rules and taxes.

- *Uniformity in Working Conditions*: In order to eliminate existing distortions as between Israeli, Palestinian and other (guest) foreign workers, greater uniformity in terms of employment are needed, to include common rates of income and other labor taxes, and identical regulations Such measures would immediately increase the demand for Palestinians workers in Israel while improving their working conditions.

- *De-monopolization of the Labor Market*: Work permits should be granted to and held by individual workers, not contractors, and all permit holders should be allowed to seek jobs in Israel freely. This would end the exercise of monopolistic power over foreign workers by Israeli employers.

- *Favoring Palestinian Workers*: An extra surcharge should be imposed on non-Palestinian foreign workers on account of the negative externalities resulting from their presence in Israel. This would help increase the share of Palestinian workers in the Israeli labor market in the short-term. Nonetheless, the focus of Palestinian employment policy should be on the creation of jobs in the Palestinian state.

Fiscal Issues

21. The group recommends that both parties closely coordinate indirect taxation policies and their administration, in order to avoid smuggling, enhance efficiency in collection, avoid double taxation on incomes and minimize fiscal leakage. Fiscal policy coordination will reflect the economic relations between the two countries in general, and their trade relationship in particular.

22. An FTA arrangement has clear implications for indirect tax systems. Each country would run an independent international customs policy, but would not impose any customs duties on goods originating in Israel/the Palestinian state (with certain exceptions as defined under the FTA agreement).

23. Even with the establishment of a border, some smuggling will remain if sufficient incentives exist. To minimize this, indirect tax policy needs to be closely coordinated. In particular, VAT and other indirect tax rates (excises, purchase taxes) should only diverge marginally, if at all. Both countries would need to share information and hold regular consultations to combat smuggling.

24. The administration of indirect taxes will also need close coordination. Customs at entry ports would need to be managed in cooperation, with the tax officers of both countries inspecting goods and determining indirect taxes on items destined for their respective countries. To permit this, the Palestinian tax administration structure should be ready by Phase III to collect indirect taxes on its own – if it is not, significant revenue shortfalls will occur.

25. Two independent and sovereign states can have different income tax systems but need to avoid double taxation, since this would discourage cross border economic activity. In the Israeli/Palestinian case, Palestinian workers in Israel should be given special consideration. Since these workers do not reside in Israel and do not enjoy full access to Israeli public and social services, there is a case for charging them lower income tax rates than those applicable to Israeli or other foreign workers. Alternatively, Israel should continue to remit to the Palestinian state a large portion of

the income tax it levies on Palestinians working in Israel[8]. Palestinian workers in Israel are also subject to social security deductions, but as non-residents are not entitled to most social security benefits. The Paris Protocol stipulates that all social security contributions should be transferred to specialized Palestinian institutions that will then use them to finance social benefits for the concerned workers. No such institutions have been created, however, and the social security contributions have been withheld thus far by Israel. We recommend that a joint Israeli-Palestinian working group be set up to effect transfer of these withheld contributions as soon as the necessary Palestinian institutions are established. The joint working group would need to assess the magnitude of the funds to be transferred, including any interest that may have accrued.

26. The current clearance system generates about 60 percent of Palestinian fiscal revenue. This system does not require sophisticated administration by the Palestinian Authority. In Phase III it is vital that Palestinian tax administrative capacity be built up so as to avoid revenue losses that the Palestinian budget can ill afford. Capacity building programs of this kind are often given low priority; the cost of neglect in this case would be immense for the Palestinian state as well as Israel, as the stability of both tax systems would be threatened.

The Monetary Regime and Financial Relations

27. The group encourages both parties to support liberalization of foreign currency transactions. We recommend that the restrictions embedded in the Paris Protocol, which prevent the Palestinian Monetary Authority (PMA) from issuing Palestinian currency, should be lifted in Phase II (whether or not the PA then decides to create a new currency would be its own decision). If the current regime persists, the seignorage[9] question should be reviewed by the two sides.

28. Financial stability is a precondition for sustained and harmonious economic development, and both parties should avoid actions that might have destabilizing and

[8] The share of income taxes to be remitted could be jointly reviewed, possibly on the basis of specific surveys that can be conducted on Palestinian workers in Israel.

[9] Seignorage refers to the ability of a state, through its Central Bank, to generate revenue from issuing currency.

negative effects on their neighbor. In order to facilitate bilateral trade and investment, payments and transfers for current or capital transactions should be kept free of restrictions (as is the case today). Correspondent relations between banks on both sides should also be facilitated, especially insofar as check clearing and reciprocal arrangements for letters of credit and letters of guarantee are concerned.

29. A sovereign Palestinian state can decide either to use one or several foreign currencies as legal tenders, or to introduce its own currency. In the latter case, the state also needs to decide what exchange rate regime to adopt. The options include a fully flexible exchange rate, an adjustable peg (linked to a foreign currency or a basket of foreign currencies), and a currency board[10] . In making its choice, the Palestinian state should review relevant international experience. Also to be considered are factors that will affect the credibility of a new Palestinian currency, if introduced. In addition to the political and economic environment, one factor will be the Palestinian government's track record in implementing a credible fiscal policy. Any decision will need to ensure that the Palestinian central bank has access to the monetary resources needed to exercise the full functions of a central bank. The seignorage derived from issuing a new Palestinian currency would provide such a resource base.

30. As long as the current currency regime continues, several foreign currencies will continue to circulate and be used, including the New Israeli Shekel (NIS). At present, the Palestinian Authority does not receive any revenue from issuing and circulating a currency, and this raises the possibility that the PA should share the seignorage derived from the issuance of NIS. This is a question that can be dealt with in Phase II. While the new Palestinian state could choose to implement monetary and exchange rate policies fully independently, coordination with Israel is obviously advisable in view of the interdependence of the two economies. In addition, the two central banks should consult over the supervision of branches and subsidiaries

[10] In a currency board, the central bank covers the amount of domestic currency it issues with foreign assets, with the parity of the domestic currency linked to a foreign currency, or basket of foreign currencies. This system provides a strong and credible commitment to monetary stability but sacrifices the freedom to use the exchange rate as an adjustment tool, thereby constraining the central bank's ability to alter monetary policy.

operating within each other's jurisdiction (the supervision of such branches and subsidiaries would have to be conducted in accordance with the international prudential rules defined by the "Basle Accord"). Another area of coordination could be the payment system and the existence of clearing houses.

Investment

31. The group encourages both parties to recognize the importance of promoting productive investments in the Palestinian state, by Israelis in particular, in order to support a sustainable process of economic convergence. While investment in the Palestinian state will be driven for the most part by greater returns and lower risks than today (largely the result of an improved political, macro-economic and institutional environment), specific provisions encouraging and protecting investment will be needed in any future economic agreement between Israel and the Palestinian state.

32. The group recommends that both countries accord one another's investors and investments treatment no less favorable than they will provide to their own investors and investments - with some exemptions in cases that bear upon special national interests[11] .

33. Beyond merchandise trade, there is undoubted potential for greater Palestinian trade in services with Israel, Arab countries and the rest of the world. We believe that growth in this area is best approached through incentives to Israeli investors to take equity positions and enter into joint ventures with Palestinian partners. This will require the elimination of discriminatory treatment, consistent with the obligations of the WTO Agreement on Trade-Related Investment Measures (TRIMs), in particular the clauses dealing with the prohibition of local content requirements. In order to aid the development of the Palestinian economy, however, some temporary exemption to local content rules could be maintained by mutual agreement in order to foster local production.

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[11] Sectoral exemptions, if any, would be based on mutual agreement, and would be justified on the grounds of appreciable national interest. Such exemptions could cater to the cultural and religious identity of each country, education, defense, and the promotion of domestic activities through explicit subsidies or foreign assistance.

34. Any agreement dealing with investment should specify procedural provisions. Critical to attracting foreign investors will be rapid and painless government authorization procedures, and we suggest that the Palestinian state and Israel should each strengthen their investment promotion agencies' capacities to offer guidance to investors interested in setting up operations in either territory. The agreement should permit full repatriation of revenues and income and should preclude the possibility of double taxation. It should address expropriation and regulatory matters pertaining to facts and disputes created after the entry into force of the agreement. Donors can contribute to fostering cross-border investment by establishing investment funds to be used to build equity positions in Palestinian firms and create joint ventures with Palestinian partners, and by continuing to offer risk insurance and guarantees to potential investors. Israel should extend Israeli government risk insurance to industrial zones.

35. Each state would bear full authority for providing adequate physical, institutional and legal infrastructure. However, we recommend that a specific effort be made to coordinate the development of utilities and infrastructure in which there is a common interest, such as public goods (environment and natural resources, territorial waters and airspace), border infrastructure, the main utility networks and insurance-related services.

36. Industrial estates may also offer opportunities for investment. These estates could be located along the border with Israel or within the Palestinian state; to attract Israeli investors, they would need to offer a rock-solid security environment[12] . An effective way to raise capital for investment projects is often to issue shares that can be traded in a capital market. This does not seem particularly practical in the formative stages of an independent Palestinian economy, and the opening of the Israeli stock exchanges to Palestinian investors appears a more practical early step.

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[12] Under Phase I and II, territorial and jurisdictional uncertainties are likely to be off-putting to many investors. Investors should therefore be given guarantees that any permanent status agreement will at a minimum offer them advantages equivalent to those they are being offered at entry.

Areas of Cooperation and Joint Institutions

37. To ensure that economic relations make a full contribution to peace and stability, we recommend that the economic arrangements we have laid out are complemented by active cooperation between the two states. The group acknowledges that cooperation is not a substitute for sound economic arrangements – it is, rather, a way to maximize the benefits of such arrangements. Cooperation should aim at developing the Palestinian economy and at strengthening the basis for independent Palestinian economic decision-making. In many fields, cooperation is also of utmost interest to Israel. There is particular merit in ensuring that mechanisms and institutions exist to resolve disputes between the parties. Economic cooperation would be facilitated in particular by a regular dialogue at experts' level to exchange views on all areas of economic policy, with special emphasis given to fiscal, balance of payments and monetary policy. Regular exchange of information and ideas in every sector of cooperation, in particular through meetings of official and experts and the distribution of information on the various programs and methods of cooperation, will also be of great value to both parties. The group recommends that economic cooperation focus principally on encouraging balanced economic and social development. Specific areas can include:

- Customs;
- Trade in goods and services;
- Investment, including investment protection;
- Technical and scientific research and cooperation;
- Cooperation between Israeli and Palestinian municipalities/local authorities/sub-regions;
- Education, in particular vocational training and tertiary education;
- Civil society/people-to-people and NGO networking.

38. The establishment of an Israeli-Palestinian Development Fund, as foreseen under the Paris Protocol but never implemented, should be reconsidered. This institution could play a major role in encouraging a variety of joint activities, such as

industrial estates, business ventures for domestic and external markets, tourism projects and joint public/private infrastructure initiatives.

39. Where possible, moreover, the group recommends a focus on operations with potential regional impact: this will associate other nearby countries and will help create a broader environment of cooperation and coordination and will thereby foster economic convergence. Regional cooperation initiatives might include:

- Trade, customs, finance and investment;
- Transport - railways and ports, civil aviation, highway infrastructure;
- Energy - linking the electricity grids of Israel, Palestine, Egypt and Jordan;
- Environment, in particular water and solid waste;
- Tourism and culture;
- Agriculture and industry,
- Scientific and technical research, including information technology and associated training.

40. Within the framework of a two-state solution, the group recommends the establishment of a Joint Israeli-Palestinian Economic Committee to facilitate economic cooperation between the parties. This Committee would

- Provide policy guidelines for all relevant ministries and governmental agencies;
- Supervise the implementation of the economic agreement;
- Oversee further negotiations;
- Address bottlenecks to Israeli-Palestinian economic relations and deal with urgent matters arising in the economic domain;
- Hold regular meetings with the aim of further developing the economic relationship between the two states.

If issues can not be resolved amicably by the Committee and its sub-committees, the parties would have recourse to dispute settlement procedures. To the extent possible, this should be avoided. The charter of the Committee should be one that elicits dedication by all its members to honoring a spirit of harmonious co-existence and problem-solving.

C. Transition

41. As stated in paragraph 2, the group has focused on permanent status, or Phase III of the Road Map. It is necessary, though, to review the intermediate period, including institutional arrangements needed in Phases I and II.

42. The main objective under Phase III is the creation of a viable Palestinian state. Critically this means achieving economic viability, vital if the Palestinian people are to aspire to a stable and peaceable future to which they will dedicate themselves wholeheartedly. Only then can the economic and social potential which has been stunted for so long by conflict be set free. A viable economic future for the Palestinian state entails a significant expansion of productive capacity in order to create jobs and incomes (including for those lost in Israel) for a population growing rapidly through natural increase and needing to provide for an influx of refugees. Such viability means a triple transition: from full economic dependency to greater autonomy; from asymmetrical to more balanced relations, and from a high degree of automaticity to truly sovereign decision-making. This demanding transition requires that preparatory steps begin without delay.

43. Phase I should be seen as a "rescue phase", and as such a prerequisite to further progress. Additional economic deterioration has to be avoided, as levels of unemployment and poverty are already excessive - close to a quarter of the active population is unemployed, and a significant proportion of Palestinians have fallen into poverty; Palestinian real per capita incomes have declined by more than a third since September 2000. An emergency of this nature cannot be solved through financial assistance - only the restoration of movement and predictability in transactions can achieve the necessary impact. Three basic ingredients are needed here:

- An unencumbered flow of goods across borders and within the West Bank and Gaza;

- An unencumbered flow of persons within the Palestinian Territories, coupled with a flows of workers to Israel which regains some stability and predictability;
- The continued uninterrupted flow of fiscal transfers from Israel to the Palestinian Authority[13] .

44. Phase II will require the re-establishment of a sound basis for economic development and growth, and requires attention to destroyed infrastructure and weakened institutions. Interim economic arrangements and preparatory steps that both parties need to take in expectation of final status will require early bilateral agreement. The meaning and operation of a Palestinian state with provisional borders needs thorough exploration, since this will be the precursor to full economic independence. Phase II arrangements must realistically be based on a "Paris Plus" formula – that is, the full implementation of the modified Paris Protocol. In particular, the fiscal arrangements in place since the implementation of the Paris Protocol have resulted in substantial leakage of import and purchase taxes. The group recommends that the Israeli and Palestinian authorities adjust the implementation of the Paris Protocol forthwith, so as to capture these revenue leakages. This can be done using a macro formula, or via tailored surveys.

45. Phase II arrangements should also encompass some additional steps to prepare for full statehood. These additional steps should include measures that ensure territorial viability, i.e. the creation of internal contiguity and the inception of economic control over external borders (flows and transit; customs/tax collection). They should include steps that denote emerging sovereignty, such as the right to issue currency and the granting of observer status in the IMF, the UN, the World Bank and the WTO. Attention should also be given to the development of institutions that will reinforce cooperation and resolve disputes.

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[13]These flows were withheld between December 2000 and November 2002, at which point they resumed without further hindrance. Some US$180 million in withheld revenues are still retained by Israel, however, as a result of their attachment to pending legal cases by Israeli citizens and individuals against the PA. The Government of Israel has been seeking, so far unsuccessfully, to argue with its court system that this attachment is unnecessary because the regular flow of transfers provides a potential future source of deductions against any successful claims.