On the Implications of Economic Borders Between Israel and Palestine

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Borders are viewed in the modern economic literature as another obstacle to the smooth functioning of ‘healthy’ economic forces. Since the famous debates concerning ‘free trade’ between Adam Smith and the Mercantilists, who wanted to restrict international trade, economists have been divided as to the pros and cons of abolishing economic borders. Interestingly, the Mercantilist rationale is one of the rare economic arguments on which there is a consensus: it was wrong. However, the broader issue of borders in economics remains, to a large extent, an open issue. Just last year, in the context of Globalization we saw a new round of the debate, this time between Prof. Stiglitz, the 2001 Nobel laureate in economics, who advocated more caution in eliminating economic borders world wide, and his very powerful opponents representing the conservative ‘Washington consensus’. In the context of the Israeli Palestinian conflict, and particularly throughout the 1990’s negotiations, the different positions on the pros and cons of economic borders played quite an important role.

The nature of the Oslo process, which was based on gradualism and transitory arrangements, postponed the issue of borders, including economic borders, to some later date. This was not an oversight, but rather part of what made Oslo possible in the eyes of its architects: *ambiguity*, which left a lot of room for different interpretations.

The Ben Shahar committee, nominated by Rabin's government in February 1993 to prepare the economic negotiations with the Palestinians, based its recommendations on the presupposition that a border, including an economic border, will not exist between the sides during the interim stage. This presupposition, motivated by political considerations and maybe also by a vision of permanent economic integration, dictated many of the committee's conclusions and led in April 1994 to the signing of *The Protocol on Economic Relations between the Government of the State of Israel and the PLO, Representing the Palestinian People,* better known as the Paris Protocol.

One of the surprising elements in the Paris Protocol is its similarity to the arrangements that Israel has dictated unilaterally in the occupied territories since 1967. The decision of the Israeli government in 1967-68 to integrate the territories economically with Israel, hence to abolish the economic borders, remained the corner stone also for the new arrangements.1 Thus, the Protocol did not radically change the then established economic regime between the two sides, although it did introduce some important modifications, which I shall discuss below.

The scheme presented in Table 1 distinguishes between two elements in the economic links between the Israeli and Palestinian economies: whether or not a border exists and whether a particular arrangement was imposed or agreed upon. Hence, in theory, though not necessarily in reality, there are four possibilities.

Table 1: A schematic description of economic regimes

	Economic Borders	**Economic Integration**
Agreed		**1994-2001** ***DE JURE:*** **The Paris Protocol**
Imposed	**1994-2001** ***DE FACTO:*** **Closures**	**1967-1993** ***DE JURE & DE FACTO:*** **Imposed (Partial) Integration**

The right column represents 'no economic borders', thus, economic integration. While the lower-right box represents an imposed integration regime, the upper-right represents an agreed integration. The 1967-1993 period falls clearly into the lower-right box; arrangements were imposed by Israel, an economic integration prevailed with the exceptions of some restrictions on free movements of goods and capital, and some negative effects of the occupation on economic development in the West Bank and

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1 On the debate in 1967-8 concerning the Israeli policy see Arnon et al (1997).

Gaza2. The upper-right box represents the Protocol's proposed regime. However, one should be very cautious in interpreting the word 'agreed': the nature of the Paris negotiations were such that one can argue that the Palestinians' acceptance of the terms of the Protocol had more to do with the balance of power between the two sides than with genuine, voluntary, acceptance. This reservation probably reflects other elements in the Oslo negotiations as well.

It might be a good reminder of different times to quote fully the preamble to the Protocol:

> "The two parties view the economic domain as one of their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace. Both parties shall cooperate in this field in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of mutual respect of each other's economic interests, reciprocity, equity and fairness.
>
> This protocol lays the groundwork for strengthening the economic base of the Palestinian side and for exercising its right of economic decision making in accordance with its own development plan and priorities. The two parties recognize each other's economic ties with other markets and the need to create a better economic environment for their peoples and individuals." [Protocol, 1994, p. 1]

Thus, the Protocol recognizes that there are two parties living in the same area, who may sometimes have different interests and priorities.

2 For a review of the economic conditions under occupation see World Bank (1993) and Arnon et al

The vision concerning the development of the Palestinian economy that the Protocol encapsulated emphasized free movements of goods and labor, hence no economic borders. Free trade with Israel was expected to enhance growth and the continuation of labor movements to Israel should have generated high employment. Several new elements were included in the Protocol. The new Palestinian Authority should have strengthened public sector activities to be financed by a new agreement on revenue sharing from import taxes and an efficient tax system. The investments of the public and private sectors within the Palestinian economy were the key to growth. Financial intermediation would be provided by the emerging banking system under the guidance of the Palestinian Monetary Authority, an embryo central bank. Funds originating in donor countries should have helped in financing the necessary infrastructure. Thus, the concept of no economic borders was the basis for the Protocol's economic strategy. Reality proved the architects of the Protocol to fail.

Whereas in the 1970s and 1980s there were only minor economic barriers between the Israeli and Palestinian economies, the situation began changing in the 1990s. After the 1991 Gulf War, Israel changed its policy and required every Palestinian seeking work in Israel to be equipped with a permit. The enforcement of this new rule became increasingly strict. Since 1993, after a series of terrorist attacks, Israel introduced a 'closure policy': roadblocks were set up on major transport arteries, denying entry into Israel from the Palestinian areas.[3] Closures were declared for different lengths of time and were imposed on various

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(1997)

[3] For a detailed analysis of the closures see World Bank and Mas (1999) and World Bank (2002).

categories of workers, according to sex, age and marital status. As long as a closure was in effect, all existing permits were suspended. In addition, internal closures between Palestinian areas were introduced. The closure policy had also a negative effect on trade between Israel and the Palestinians. According to World Bank estimates, imports to the Palestinian economy were cut by approximately 25% and exports were almost halved between 1992 and 1995. The impact on the Palestinian economy was devastating, since local employment depended on imports of raw materials from Israel and abroad, while most exports were sold in Israel.

Thus, in reality the new economic regime has been characterized not by integration but rather by unilaterally imposed separation and economic borders. The theoretical structure on which the Protocol was based fits the upper-right box of Table 1, but de facto the regime belongs to the lower-left box. Table 2 provides some basic data on closure days and growth. Clearly the high expectations of the first days of Oslo were not fulfilled.

Table 2: Border Closures and GNI (Gross National Income) per capita 1993-2001[4]

Year	Total Days of Border Closure	Lost Days as A Proportion Of Potential Work Days	Real GNI Per Capita
1993	26	6.1%	
1994	89	23.1%	-4.9%
1995	112	29.9%	-9.6%
1996	121	31.9%	-9.0%
1997	79	20.5%	3.4%
1998	26	5.2%	7.7%
1999	16	2.5%	3.3%
2000	75	18.8%	-11.7%
2001	210	70.6%	-18.7%

Sources: Unsco report and World Bank reports.

Although the closures policy is at the center of post-Oslo reality it has not been intensively debated. Clearly the protocol's vision was not implemented. Some observers simply call for implementation as a corrective measure. But why was the protocol not implemented? I believe that part of the answer lies with the illusions of the architects of the agreement, part can be explained by hidden agendas of both parties and part by economic 'incomplete contracts' theory.

4 UNSCO estimates based on information from the PA Ministry of Labor and the Palestinian border authorities. The border closures documented are those that impede the movement of Palestinian labor and commodities to Israel. The only Israel-Gaza commercial crossing point that has remained in operation since early October 2000 is at Karni/Muntar which itself has been completely closed on 20 days and partially closed on another 10 days during the reporting period. Effective border closure days exclude weekends (i.e. Saturdays and half the Fridays) and Jewish and Muslim holidays during which no Israeli-Palestinian business is transacted. Potential workdays between Israel and the OPT average about 277 each year, i.e. the western calendar days less weekends and Jewish and Muslim holidays.

The troubles started immediately after the political process began. One reason is obvious. Some Palestinians and some Israelis rejected the concept of reconciliation, of a political agreement that will lead to a final ‘two states’ agreement. Those who rejected the agreement started attacking it by attacking Israelis and Palestinians. Thus, both Palestinians and Israelis contributed much to the havoc. The security situation deteriorated immediately. Israel reacted by closures, arguing that these constituted a defensive measure. However, closures cannot stop such attacks as experience proves and the question of the real motive for the new closure policy remains open.

A common explanation is that Israel thought that economic measures would make the other side ‘behave better’. But who is the other side? Is it the Palestinian authority and its supporters or those who rejected the agreements and carried out most of the attacks? Clearly many support the argument that closures were used also as a form of pressure, partly on the general public and partly on the Palestinian authority. Closures also fit the ‘incomplete contracts’ approach.

The protocol was an ‘incomplete contract’ in terms of modern contract theory, consequently, it was time inconsistent. What does contract theory mean by this? When one has a contract, one knows that also tomorrow the contract will be binding and implemented because if it is breached one can go to court. Thus, the two sides have enough mutual leverage to implement the contract, whatever the conditions will be. In some economic contracts when one cannot go to court or to arbitration, it is very important to ensure that the two sides each have sufficient incentives to implement the contract even when conditions that have not been predicted, thus not covered in the contract, happen. Concerning the Protocol, which is such an incomplete contract since it did not address closure policy, the incentives structure did not insure continued functioning. When security deteriorated Israel used economic measures, some contradictory to the spirit of the Protocol. Thus, one can argue that there were structural weaknesses in the protocol that prevented its implementation.

Furthermore, I would like to argue that even if the protocol had been implemented it is not clear that it would necessarily be superior to other feasible arrangements. More specifically, I would like to argue as some of us have argued when Oslo began, that agreed economic borders between the two parties might be superior to integration, even under the assumption that integration could have been implemented. Why is that so? Investments in a Palestinian economy that has economic borders with Israel might be higher than under integration, since investors would face better economic environment including less risk.

What is an ‘agreed economic borders’ regime (upper left box in Table 1), sometimes referred to as agreed separation, and how can it provide such beneficial conditions?

An agreed separation is an agreement on a flexible border, an economic filter where passages will be built for goods, labor and other productive goods. This is an idea that has been in the air since 1995, but was never implemented. An Israeli committee was nominated to recommend an alternative to the Protocol’s integration under PM Rabin in 1995, but its findings were never published. According to this report the ‘agreed separation’ regime, the very simple architecture where you have borders and very efficient passages for laborers and goods, is feasible, so that people and goods can cross easily. Such an economic regime should make the flow of goods and labor relatively immune to the disturbances that the changing security arrangements create. Thus, as a result the Palestinian economy performance will improve.

The political compromise that is possible is clear to many on both sides. It is clear that it is a ‘two state’ solution. It is clear that we are talking about borders based on the green line, the 1967 border. It is clear that we are talking about Jerusalem as a capital of two states. It is clear that we are talking about solving the refugee problem, probably with only restricted number of returnees coming into Israel pre 1967 borders. It is clear that many settlers will be relocated into Israel’s pre 1967 borders.

Although the elements of the feasible agreement between the two sides are so clear, we experience two years of war and an agreement seems far from sight. The reason is to be found in the hegemonic position of the Israeli and Palestinian rejectionists in both societies.

And this brings me to my last point. Under the current situation, the Israeli public who wants withdrawal from the West Bank and Gaza or agrees to withdraw from the West Bank and Gaza, is very much attracted to a new concept, a very dangerous one. The Israeli public is drawn to what has been called imposed borders rather than the agreed ones. The 'agreed economic borders' concept is equivalent, in my view, to a 'two state solution' with flexible borders. However, a section of the Israeli public calls for the creation of walls, barriers that cannot be crossed. Such barriers will not be created only between Israel and Palestine, i.e. internal boarders, but will also be created along the external borders where they already exist. Thus, it will not establish a framework of 'a state alongside a state', but rather a non-sovereign 'state' within a state. From an economic point of view it will establish an economy within an economy, separated from Israel and the outside world by relatively closed borders where labor and trade flows will be restricted permanently. Furthermore, the 'state' would not embrace any possibility of implementing trade policy or other aspects of economic sovereignty. Under such political and economic arrangements one can predict the continuation of the disastrous economic conditions which prevail currently in the Palestinian economy. The traditional links with Israel and the Arab world will be cut and as a result one can expect sharp decline in standards of living that will turn the current horrible conditions into permanent ones. The Palestinian economy's dependency on labor and trade flows with Israel under the proposed 'separation' will complete the transformation of the Paris Protocol vision: A unilateral Israeli decision that ignores both the aspirations of the other side for sovereignty and its economic future. The fact that the proposed separation has only minor direct economic consequences for Israel is the mirror image of the asymmetrical relations.

Opposing to this unilateralist, imposed separation camp, a "back to negotiations" camp exists in Israel. The "negotiationists" are seeking a way out of the mud through the resumption of meaningful negotiations. Unfortunately, international forces which could have helped, like the U.S., are not willing to do it and in fact, support the Israeli rejectionists. The E.U., which could have played a major role, is waiting for the U.S. to change its' policy. Thus, it is up to the Israeli and Palestinian pragmatists to push back to meaningful negotiations and to pave the way to a renewed political "game of four". That is, to resume the reality of two people who are both divided into two camps: One who wants a political compromise and the other who rejects it. The fact that the extremists are taking center stage, and the agenda is theirs, is really what is between us, and a reasonable resolution to the political conflict and to some better economic conditions. A better understanding of the meaning of economic borders will make this new discourse different from the distorted one of the 1990's.

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