Israeli Policy towards the Occupied Palestinian Territories: The Economic Dimension, 1967-2007

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This article focuses on the economic dimension of Israeli policy towards the Palestinian territories occupied in 1967. The article argues that since 1967, both before and after the Oslo process, Israeli policy was directed at preventing the "Two," i.e. the division of the land into two states and two economic (and political) sovereign entities, while also negating the "One," i.e. the establishment of a single political and economic entity. Although Israeli policy repudiated both the "Two" and the "One," it changed character and formulations from time to time. Thus, Israeli policies will be examined with all their twists, turns, and reversals, discussing their repercussions on Israel and especially on the Palestinian economy.

INTRODUCTION: THE DILEMMA OF THE OCCUPATION

> "Woe to me if I do, and woe to me if I don't."
> — Former Prime Minister Levi Eshkol, quoting the Talmud to Israeli Defense Force generals in 1967

Many Israelis, including those who shaped the country's policies after the June 1967 War, did not realize that Israel would continue to rule the West Bank of the Jordan River for so many years. At first, declarations and private meetings indicated that it was probably temporary, partly since there were serious doubts about Israel's ability to hold and continue to rule the newly occupied Territories.[1] A clear message came from the leading global powers against the future annexation of the Territories and there was also a major discrepancy between Israel's desire to expand its sovereign territory and international law. However, Israeli policy-makers, among them Prime Minister Levi Eshkol, had other doubts arising not from the country's political ability to expand geo-

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1. The terminology used in controversial issues, such as those with which we deal in this article, is never neutral and usually reflects the positions of the observers and participants; furthermore, terminology tends to change with time. Thus the word "occupied" was rarely used in Israeli discussions about the territories in the first years after l967; "administered" or "liberated" territories and other terms were more common.

graphically, but from the implications of such a decision. In a recent account of 1967, Tom Segev wrote:

> Once Eshkol shared his thoughts with IDF generals, there was no doubt as to what he wanted: A large country empty of Arabs. But not for the first time he relayed the feeling that Israel was a victim of various forces and historic processes beyond its control. Thus he used the Talmudic expression: Woe to me if I do, woe to me if I don't ... The effect of continuing conquest on Israel as a democratic, Jewish state disturbed Eshkol more than it did Moshe Dayan; this was the only real difference between them. All the rest were ego and politics.[2]

The far-reaching consequences of integrating the Territories into Israel were well-understood by some leaders. Annexing the Territories and erasing the pre-war economic and political borders — "the Green Line" — meant forming one geo-political unit. Forming one unit could bring about the integration of Palestinians into the Israeli polity and generate a new political reality. Conversely, preserving the border and not annexing the Territories could lead to the establishment of two political and economic units between the Mediterranean Sea and the Jordan River. The controversy between integration and separation, between erasing the Green Line and preserving it, between "One" and "Two," has haunted discussions from the very beginning.[3] Understanding the continued tension between integration and separation is an integral part of any analysis of the years since 1967.

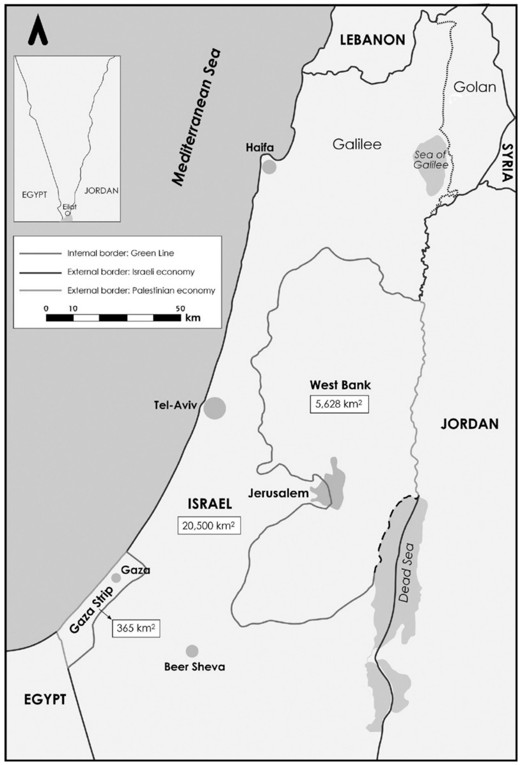
In this article I will focus on the economic dimensions of Israeli policy which refrained from deciding one way or the other, avoiding a decision on "Two" entities or "One." I will argue that since 1967 Israeli policy has been directed at preventing the "Two," i.e. the division of the land into two states and two economic (and political) sovereign entities while also negating the "One," i.e. the establishment of a single political and economic entity. Although since 1967 Israeli policy has repudiated both the "Two" and the "One," it changed character and formulations from time to time. Thus, I will examine Israeli policies in depth, with all their twists, turns, and reversals, discussing their repercussions on Israel and especially on the Palestinian economy.

In 1967 a new reality was born. Within a few days after the war, the borders demarcated by the Green Line, which had been closed to regular economic transactions, were opening while at the same time new economic borders were established. The *external* borders of the territory now under Israeli control were closed, while within a short time the *internal* borders practically disappeared as economic transactions crossed the Green Line. As we will see, the initial recommendations, including those of the Bruno Committee, comprised of leading economists appointed by then-Prime Minister Levi Eshkol, were different. However, after a bitter argument that lasted for two years, the Israeli government decided upon (limited) economic integration and practical

2. Tom Segev, *1967 ve-ha-Aretz Shintah Et Paneiha* [*1967: And the Land Changed its Face*] (Jerusalem: Keter, 2005), p. 581 (author's translation). For more on this period, see part four, entitled "They Thought They'd Won." Below we will examine Dayan's role in the debate.

3. See Jacob Metzer, *The Divided Economy of Mandatory Palestine* (Cambridge: Cambridge University Press, 1998). Metzer discusses economic developments between the Sea and the Jordan River during the Mandatory period, basing his analysis on the existence of two separate economies — Jewish and Arab — rather than one. We will not deal with the pre-1967 period in this article.

elimination of the Green Line.[4] Thus, economic borders between the Territories and Israel disappeared, shaping the links between the Israeli and Palestinian economies for many years.[5] The result was, in fact, only partial integration as a system of both visible and hidden restrictions played an important role in shaping the new economic regime in the area now under Israeli control.



Israel and the Occupied Territories
"Internal" and "External" Economic Borders

Israel implemented its own trade protocol on the new external borders and created a customs envelope.[6] The trade regime — a quasi-customs union — was established for the combined area of Israel and the Territories. We will discuss the arrangements in detail below, but it is important to note at the outset that in this case, unlike the norm for such arrangements, one side — Israel — dictated the terms of the customs union according to its own needs with no consultation and certainly no negotiations with the other side. There was also no agreement on sharing the revenues from import taxes. Thus, it was a unilaterally shaped trade arrangement, reflecting the nature of the occupation.

The unofficial leader of the integration camp in the Israeli Cabinet, Defense Minister Moshe Dayan, did not want to withdraw or disengage from the newly acquired lands. He expected that economic integration would bring a higher standard of living to the Territories and a decrease in opposition to Israeli rule, making it easier to continue holding the Territories. Other Israeli views reflected varying interests; concerns that

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4. On the discussions leading to the decision of relatively open borders see Shlomo Gazit, *Ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron* [*The Stick and the Carrot: The Israeli Administration in Judea and Samaria*] (Tel-Aviv: Zmora-Bitan, 1985). An English version appeared as *The Carrot and the Stick: Israel's Policy in the Administered Territories, 1967-1968* (Washington DC: B'nai B'rith Books, 1995); See also Arie Arnon, Israel Luski, Avia Spivak, and Jimmy Weinblatt, *The Palestinian Economy: Between Imposed Integration and Voluntary Separation* (Leiden: Brill, 1997).

5. The discussion below of "the Palestinian Economy" refers to the territories occupied in 1967, i.e. the West Bank and the Gaza Strip. Neither the Israeli units established in those areas ("settlements") nor the Palestinian units outside of those areas, either within Israel (the Green Line) or in what is called the Palestinian Diaspora (mainly refugees from 1948 living abroad) are included.

6. The Trade Protocol reflects customs, but also standards and health considerations, etc. The actual location of the external border with Egypt changed of course over the years; the map reflects post-1982 borders.

competition from Palestinian industries in the Territories might be a threat resulted in limiting the integration process. At first the movement of both agricultural and manufactured goods was controlled. Over time the Israeli government used other methods to preserve the advantage enjoyed by Israeli producers. Instead of limiting the passage of goods, the government placed limitations on competing activities within the Territories themselves.[7]

The public sector of the Palestinian economy, which deals with taxation, providing services, investment in infrastructure, etc. was under Israeli control from 1967 until the 1993 Oslo process. A macroeconomic policy aimed at serving the needs of the Palestinian economy was never implemented; additionally, since local currency did not exist, neither did any monetary policy. The local banking system had been ordered to close in 1967 and was not reopened until the 1980s, and even then in a very limited manner. During the first decades of the occupation a few Israeli banks very sparingly operated in the Territories. Financial institutions barely existed; minimal financial transactions were available through a relatively well-developed network of money changers that worked with the Jordanian banking system.

The Palestinian regions of the West Bank (including East Jerusalem) and the Gaza Strip were then, and remain today, very different and much less developed than Israel. In terms of Gross Domestic Product (GDP), which measures the productive capacity of an economy, the Palestinian economy's standing relative to Israel's did not change. In 1967 the Palestinian GDP in the West Bank (population 600,000) was 3.5% that of Israel; and the GDP in Gaza (population 380,000) was 1%. Measured together the Palestinian economy's GDP reached a peak of about 5% of Israel's GDP in the 1990s (see Tables 1 and 2). Palestinian living standards were much lower than those in Israel, and the large gap continued for the entire period.

The ratio between the Gross National Product (GNP) per person in the West Bank versus a similar measure in Israel was 15% during the first years after l967 (and in Gaza just 11%). In the 1970s and 1980s the ratio improved to more than 20% in the West Bank (and about 15% in Gaza), only to decline again in 2003, to lower than 10% in the West Bank (where the population had reached 2.2 million) and even less for Gaza (population 1.3 million).[8]

The structures of the two economies are extremely different in terms of indus-

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7. See Gazit, *Ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron*, and Ezra Sadan (the Sadan Committee) *Mediniyut Lepituach Kalkali Behevel Aza* [*Policy for Economic Development in the Gaza Area*] (MS, 1991). See also references in the World Bank, *Developing the Occupied Territories: An Investment in Peace,* six volumes (Washington DC: The World Bank, 1993) and Arnon et al., *The Palestinian Economy: Between Imposed Integration and Voluntary Separation*. We will return to this point later on.

8. Data for the period up to 1993/4 are from the Israeli Central Bureau of Statistics (ICBS), *National Accounts of Judea, Samaria and the Gaza Area 1968-1993,* Special Report #1012 (Jerusalem: ICBS, 1996); ICBS, *Judea, Samaria and the Gaza Area Statistics* (Jerusalem: ICBS, various issues); ICBS, *Statistical Abstract of Israel* (Jerusalem: ICBS, various years). Data for post-1994 years are from the Palestinian Central Bureau of Statistics (PCBS), *National Accounts* (Ramallah: PCBS, various years); PCBS, *Labor Force Surveys* (Ramallah: PCBS, various years). The question of Jerusalem will further confuse this discussion. Both data sources used a similar terminology which usually excluded East Jerusalem — captured in 1967 and annexed to Israel the next year — from most analyses. The data does not allow systematic comparisons of Purchasing Power Parity (PPP) measures.

Table 1: Basic Data on the West Bank: 1968-2005

	GDP Annual Average (million $ 1994 prices)	GDP Growth Rates (Average annual % change)	GNP Per Capita Growth Rates (Average annual % change)	Employed in Israel (% of total employment)	Factor Income from Abroad (% of GDP)	Imports (% of GDP)	Exports (% of GDP)	GDP as % of Israel's GDP
1968-1972	522	15	20	21*	20	67	22	2.6
1973-1979	904	6	4	30	32	73	25	3.1
1980-1987	1344	5	2	32	28	63	24	3.5
1989-1993	1951	8	5	31	30	--	--	3.7
1994-1996	2329	6 **	-9 **	18 **	17	76	22	2.9
1997-2000	2644	8	3	23	19	78	21	3.4
2001-2005	2588 ***	-1 ***	-6 ***	14	15	64	15	3.1

* For the years 1970-72 ** For the years 1995-96 *** For the years up to 2004

Sources: ICBS to 1993, PCBS and World Bank since 1994, and the author's calculations.

Data for the period up to 1993/4 is from the Israel Central Bureau of Statistics (ICBS), *National Accounts of Judea, Samaria and the Gaza Area 1968-1993,* Special Report #1012 (Jerusalem: ICBS, 1996); ICBS, *Judea, Samaria and the Gaza Area Statistics* (Jerusalem: ICBS, various issues); ICBS, *Statistical Abstract of Israel* (Jerusalem: ICBS, various years). Data for post 1994 years is from the Palestine Central Bureau of Statistics (PCBS), *National Accounts* (Ramallah: PCBS, various years); PCBS, *Labor Force Surveys* (Ramallah: PCBS, various years).

Table 2: Basic Data on the Gaza Strip: 1968-2005

	GDP Annual Average (million $ 1994 prices)	GDP Growth Rates (Average annual % change)	GNP Per Capita Growth Rates (Average annual % change)	Employed in Israel (% of total employment)	Factor Income from Abroad (% of GDP)	Imports (% of GDP)	Exports (% of GDP)	GDP as % of Israel's GDP
1968-1972	199	11	18	17*	9	64	21	1.0
1973-1979	306	7	6	37	28	109	36	1.1
1980-1987	379	3	2	45	57	123	43	1.0
1989-1993	574	7	5	34	46	79	14	1.1
1994-1996	1042	2 **	- 9 **	6 **	7	68	4	1.6
1997-2000	1258	4	3	14	15	65	6	1.7
2001-2005	1166 ***	- 1 ***	- 7 ***	2	--	66	5	1.4

* For the years 1970-72 ** For the years 1995-96 *** For the years up to 2004

Sources: ICBS to 1993, PCBS and World Bank since 1994, and the author's calculations.

Data for the period up to 1993/4 is from the Israel Central Bureau of Statistics (ICBS), *National Accounts of Judea, Samaria and the Gaza Area 1968-1993,* Special Report #1012 (Jerusalem: ICBS, 1996); ICBS, *Judea, Samaria and the Gaza Area Statistics* (Jerusalem: ICBS, various issues); ICBS, *Statistical Abstract of Israel* (Jerusalem: ICBS, various years). Data for post 1994 years is from the Palestine Central Bureau of Statistics (PCBS), *National Accounts* (Ramallah: PCBS, various years); PCBS, *Labor Force Surveys* (Ramallah: PCBS, various years).

trial composition, employment patterns, and economic development. There is no other example of such a large discrepancy between a developed economy and that of a "less developed country" (LDC) when the geographical distance between the two is negligible. Thus this article describes a unique economic interaction.

THE PERIOD OF ADJUSTMENT: 1968-1972

A short while after the June 1967 War Prime Minister Levi Eshkol called for professional expertise concerning policies in the areas over which Israel had taken control. The Committee for Developing the Administered Territories, headed by Professor Michael Bruno, included several leading Israeli economists. It presented its recommendations in an interim report in September 1967.[9]

The team offered a number of options. One was "Holding the Territories by conducting suitable economic activities;" and another "Holding the Territories with an emphasis on resolving the problem of the refugees in the Gaza Strip." The team dealt primarily with short-term issues, but also considered the long-term, including delineating the economic borders between the Administered Territories and Israel. The committee recommended that Palestinian labor not be permitted into the Israeli economy while allowing free passage for goods and services between the Territories and Israel. This was partly due to the high unemployment rate in Israel which had not yet recovered from the pre-war 1966-7 recession. Concerning the problem of employment in the West Bank and Gaza, the team recommended solving it by "government development activities," principally housing construction.

In terms of the discussions on economic integration, i.e. "Two" or "One" — the committee recommended erasing the trade border and preserving the labor border. But in the following two years the Israeli government adopted a completely different policy. The labor border between the Territories and Israel virtually disappeared, while the trade borders were delineated so that goods and services originating in the Territories could be sold in Israel, with certain limitations designed to protect Israeli producers, principally in agriculture.

Israeli economic policy relating to the Territories was drawn up after arguments between two camps: On one side was Defense Minister Moshe Dayan who favored economic integration between the Territories and Israel; the other side, headed by Finance Minister Pinhas Sapir, opposed economic integration and proposed economic borders between the Territories and Israel.

The argumentation of the two camps was revealing. The Dayan camp supported economic integration for both practical and principled reasons: relief of economic hardship in the Territories would lead to a decrease in opposition to Israeli rule. Economic deprivation would be relieved by permitting workers into Israel and opening Israeli and Jordanian markets to local goods. Dayan's reasoning was presented in his "Beer-Sheva Speech" in November l967. He argued that the Hebron/Beer-Sheva area, lying on both sides of the Green Line, should form a single organizational/economic entity in order to remove barriers and eliminate hatred. In Dayan's own words:

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9. Michael Bruno (the Bruno Committee), *Ha-Mediniyut Sheyesh Linkot be-Yachas Lashtahim* [*The Proper Policy for the Territories*] (MS, September 1967).

> In this southern part of the land, with its Jewish and Arab communities, we can weave our lives together. We can try to change two things: First, as far as it depends upon us, we can destroy barriers and prevail over hatred; secondly we can create economic integration — link the electric grid, the water system, set up a joint transportation system ... It's possible to organize this economically within one framework. Moreover, we can allow Arabs from Hebron to work in Beer-Sheva because in Hebron there is unemployment and in Beer-Sheva there is a need for workers ... *We should connect the two entities, if we, on our part and for ourselves, do not want to sever connections with these areas.*[10]

The economic integration Dayan recommended was not primarily based on short-term considerations of decreasing opposition to Israeli rule. He believed that integration was essential for maintaining Israeli access to the areas. Aspiring to integrate without formally annexing, Dayan believed that economic development and better living conditions would replace the Palestinian desire for political rights.

The events of 1968-9 supported the camp that championed economic integration.[11] Israel recovered from the recession that had begun before the 1967 War, and the demand for labor promptly increased. It should be noted that the Bruno Committee took this possibility into account as early as September 1967. The last chapter of its report, entitled "Alternative Hypotheses" reveals that the panel's members already understood the impossibility of completely preventing the passage of workers into Israel. Their principal concern was its negative influence on Israel at a time of high unemployment. Hence, the team recommended prohibiting employing workers from the Territories in Israel as long as the Israeli "labor market was vulnerable." However, under conditions of full employment it would be possible to permit the entrance of a "regulated number of Arab workers from the Territories."

Thus as economic conditions in Israel changed in 1968-9, the opposition to a closed labor border decreased, both among professional economists and government policy-makers. The decisive factor in opening labor and trade borders, while not entirely erasing them, was an Israeli consideration.

NO TO "TWO" AND NO TO "ONE:" 1972-93

The economic policy Israel adopted at the end of the 1960s shaped the development of the Palestinian economy for the next four decades. Within five years the pattern of employment changed and a significant number of people from the Territories worked in Israel (See Tables 1 and 2). Their salaries were lower than those of Israeli workers, but at first they were much higher than those of workers inside the Territories. With the passage of time the gap between wages paid to Palestinians working in Israel and the

10. Emphasis added. Quoted from the Defense Minister's answer to a question about his Beer-Sheva speech in the Knesset, November 17, 1968. See Gazit, *Ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron*, p. 350, translated from the Hebrew by the author; see also pp. 147-150 entitled "Integration to Israel."

11. A well-known economist, Abba Lerner, expressed in 1967 a cautious approach to integration. See Arie Arnon, "Professor A.P. Lerner on 'Israel and the Economic Development of Palestine': Twenty Years Later," *Research in the History of Economic Thought and Methodology*, Vol. 2 (1990), pp. 233-254.

Territories nearly disappeared. After about five years a stable pattern was established regarding economic relations between Israel and the Territories which continued until the 1990s.[12] Income generated from work in Israel covered a large part of the deficit in the balance of payments, while contributing to an increase in the standard of living. The growth in GNP per person in 1973-9 was 4% in the West Bank and 6% in the Gaza Strip; from 1980-7 the growth rate of GNP per person was 2% in both.

The large deficit in the balance of payments continued throughout the years; the excess in imports to the Territories was covered by income from work in Israel, unilateral transfers, and inflows of capital. Normally such a deficit would generate local production of traded manufactured goods, so that exports to Israel and the world would increase and cover part of the imports.[13] The slow growth of productive capacity was not only a result of the economy but perhaps principally due to politics. Israeli administration in the Territories put obstacles in the path of economic development by discouraging local initiatives that might compete with Israel. General (res) Shlomo Gazit, the first Coordinator of Activities in the Territories during Dayan's term as Defense Minister, writes in his important book *The Carrot and the Stick*:

> As regards the manufacturing sector, it was decided not to encourage Israeli investors to establish factories in the Territories or to become partners in existing ventures ... The desire to protect Israeli-made products was so great that Israel even attempted to prevent the establishment or reactivation of Arab-owned factories if there was any danger that their products might compete with Israeli products.[14]

Elsewhere he writes:

> Israeli policy in the administered territories led to a strange combination of relative economic prosperity accompanied by a rapid rise in the standard of living of the average Arab resident of the territories ... Economic prosperity was achieved by the simple expedient of importing labor services from the territories into the Israeli

12. See detailed description and analysis in George T. Abed, ed., *The Palestinian Economy: Studies in Development under Prolonged Occupation* (London: Routledge, 1988); World Bank, *Developing the Occupied Territories: An Investment in Peace*; Arie Arnon and Daniel Gottlieb, "A Macroeconomic Model of the Palestinian Economy: The West Bank and the Gaza Strip 1968-1991," *Bank of Israel Review*, Vol. 69 (1995), pp. 49-73; and Arnon et al., *The Palestinian Economy: Between Imposed Integration and Voluntary Separation*.

13. On the impact and uniqueness of trade and the monetary policy in the Palestinian economy see: Osama A. Hamed and Radwan A. Shaban, "One-Sided Customs and Monetary Union: The Case of the West Bank and Gaza Strip under Israeli Occupation," in Stanley Fischer, Dany Rodrik, and Elia Tuma, eds., *The Economics of Middle East Peace: Views from the Region* (Cambridge: MIT Press, 1993); Arie Arnon, Avia Spivak, and Jimmy Weinblatt, "The Potential for Trade between Israel, the Palestinians and Jordan," *The World Economy*, Vol. 19 (1996), pp. 113-34; Arie Arnon and Avia Spivak, "A Seigniorage Perspective on the Introduction of a Palestinian Currency," *Middle East Business and Economic Review*, Vol. 8 (1996), pp. 1-14; and Arie Arnon and Avia Spivak, "Monetary integration between the Israeli, Jordanian and Palestinian economies," *Weltwirtschaftliches Archiv*, Vol. 132 (1996), pp. 259-279. On the important labor flows see Radwan A. Shaban, "Palestinian Labor Mobility," *International Labour Review*, Vol. 132 (1993), pp. 655-672.

14. Gazit, *Ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron*, p. 251; see in the English version pp. 220-21.

> economy ... But at the same time, the Israeli authorities and the military government did little to develop the local economic infrastructure.[15]

In 1987 the first Intifada broke out; it caused a severe economic crisis in its first year, but it was limited to certain areas. The figures show that during the next few years, ties to Israel continued in the areas of employment, especially in the West Bank, and in trade. The main disruption to the economy was due to curfews imposed upon areas that were especially active in the uprising. However there were not yet severe limitations on the movement of workers and goods, so there was a rapid return to the conditions that had prevailed for the previous 20 years.

The Intifada and the Gulf War, with its ramifications on the balance of power in the region, contributed to the start of political negotiations. Those Arab leaders who supported the US in the 1991 Gulf War expected implementation of a "Territories for Peace" policy. The US signalled that it intended to support this policy at the 1991 peace conference in Madrid.

The new reality caused Israeli leaders to reassess the situation, including economic policy. The Defense Minister appointed the Sadan Committee to "examine methods of economic development in the Gaza Strip."[16] In its February 1991 report the committee confirmed Gazit's description of Israeli economic policies, and described the severe economic conditions in the Gaza Strip with uncharacteristic candor:

> All the governments of Israel recognized their obligation to care for the welfare of the residents of the Gaza Strip. However, in promoting the economic interests of the population, the focus was on wage-earners and on the short term. Regarding wage-earners, priority was given to increasing their income by employing them in the [Israeli] economy within the 'Green Line.' Only rarely did the policy opt for developing an infrastructure and encouraging the creation of factories and employment within the [Gaza Strip] itself (e.g. the creation of the Erez industrial zone.) No priority was given to promoting local entrepreneurship or the business sector in the Gaza Strip. Moreover, the authorities discouraged such initiatives whenever they threatened to compete with existing Israeli firms in the Israeli market. The Committee therefore recommends a change of policy to allow and encourage initiatives in the Gaza Strip, *including those that compete with Israeli products!*[17]

It took more than 20 years for Israel to consider changes in the strategies that had discouraged local production. Yet in 1991 as in 1968, Israeli policy-makers unilaterally continued to make policies that decisively affected Palestinian economic development. The Committee's recommendation to replace exporting labor services with exporting goods and locally produced substitutes for imports was long overdue.

One can analyze the various options concerning links between the Israeli and

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15. Gazit, *Ha-Makel ve-ha-Gezer: ha-Mimshal ha-Yisraeli be-Yehuda ve-Shomron*, p. 266; see in the English version p. 235.

16. Chaired by Professor Ezra Sadan, committee members included the then-Coordinator of Activities in the Territories, General Dan Rothschild, the Economic Advisor to the Prime Minister, Amos Rubin, and other experts.

17. The Sadan Committee, *Mediniyut LePituach Kalkali Behevel Aza*, p. 11; author's translation, emphasis in the original Hebrew.

Palestinian economies using a simple two dimensional scheme: One dimension relates to whether or not a border exists between the two economies; the second relates to whether the regime is unilaterally imposed as it was from 1967 to 1993, or is the result of a joint agreement (See Diagram 1). The alternative of no border, also called "imposed economic integration," since it is not the result of an agreement, characterizes the economic regime which Israel implemented in 1967 through 1993.

Diagram 1

A Schematic Description of Possible Economic Regimes

	Economic Borders	**Economic Integration**
Agreed	**Aix ERM 2004** Agreed Economic Borders Ben Bassat Committee, World Bank (2002)	1994-2005: **The Paris Protocol** Agreed (partial) integration *De Jure*
Imposed	1994-2005: **Closures** Imposed (partial) separation *De Facto*	1967-1993: **See Text** Imposed (partial) integration *De Jure & De Facto*

The negotiations that began in Madrid progressed slowly; at the beginning Israel sat opposite a joint Jordanian-Palestinian delegation and later faced Palestinian leaders from the Occupied Territories. But the most significant factor at negotiations — the one that pulled the strings — was the PLO, which did so from its headquarters in Tunis. With the election of a left-center government under Yitzhak Rabin in Israel in 1992, a new Israel-PLO channel opened; in 1993 it led to what became the Oslo Accords. Both sides devised political and economic arrangements; the latter took place in Paris between Israeli and PLO teams. They resulted in an economic agreement that nurtured great expectations. Both sides abandoned the "imposed" row in the scheme outlined in Diagram 1 and searched the "agreed" row for an arrangement that would either establish borders or be borderless (i.e., continue economic integration).

In February 1993, while the Oslo channel was still a secret, the Rabin government appointed an Israeli "Economic Consulting Team to the Political Negotiations." Headed by Professor Haim Ben-Shahar, the team presented its findings in July 1993, a short time before the signing of the Declaration of Principles (DoP) better known as the Oslo Accords.[18] Its recommendations were based on the assumption that during the

18. Haim Ben-Shahar (the Ben-Shahar Committee), *Doch Tzevet ha-Yiutz ha-Kakali Lamasa Umatan ha-Medini* [*Report of the Economic Consulting Team to the Political Negotiations*] (MS,
[Continued on next page]

interim agreement (for at most five years): "The principle of integration between the economies will be preserved, and no economic borders will be established."[19]

In September 1993, with the signing of the Oslo Accords between the Israeli government and the Palestine Liberation Organization, exclusive Israeli power over economic policy concerning the West Bank and the Gaza Strip ended. Paradoxically, just as the new economic regime with the declared objective of encouraging economic development was adopted, a serious economic crisis commenced which, in various ways, continues until today. The strategic decision not to choose between "One" and "Two" is partly responsible for the failure.

THE PARIS PROTOCOL AND CONTINUED INTEGRATION: 1994

Negotiations on the economic aspects of the Oslo Accords continued for six months after the Accords were signed. In April 1994, after agreeing to implement the DoP in Gaza and Jericho, "The Protocol on Economic Relations between the Government of Israel and the PLO Representing the Palestinian People" (briefly, the Paris Protocol) was signed in Paris.[20] The following important declaration appears in the Preamble to the agreement:

> The two parties view the economic domain as one of the cornerstone[s] in 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 ... 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.

After more than a quarter century the era of Israeli economic policy imposed on the Territories ended, at least according to the agreement. We may ask if the economic agreement represents the best interests of both sides, whose representatives signed the Protocol. Do the signatures represent willing agreement or was there still an aspect of coercion? We will examine this issue below.

The economic regime of the Paris Protocol is very similar to that designed at the

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1993).

19. See Haim Ben-Shahar, "*Hakdama le-Ekronot ha-Doch*" ["Introduction to the Principles of the Report"], *Economic Quarterly*, Vol. 95 (1995), pp. 135-154.

20. The full title: *Protocol on Economic Relations between the Government of the State of Israel and the P.L.O., Representing the Palestinian People*. The economic agreement known as "The Paris Protocol" was signed on April 29, 1994, in Paris. One week later it was one of the annexes to the Cairo Agreement that dealt with implementing the Oslo Accords first in Gaza and Jericho. See the English version in Arnon et al., *The Palestinian Economy: Between Imposed Integration and Voluntary Separation*; also the PLO, Negotiations Affairs Department, http://www.nad-plo.org/nego/permanent/economic/primary/ParisPro.pdf and on the Israel Ministry of Foreign Affairs website, http://www.israel-mfa.gov.il/MFA/Peace%20Process/Guide%20to%20the%20Peace%20Process/Gaza-Jericho%20Agreement%20Annex%20IV%20-%20Economic%20Protoco.

end of the 1960s, with few significant modifications. The Protocol assumed that no trade border will exist between the Israeli and Palestinian economies, as the Ben-Shahar committee recommended, and excepting some important differences, was agreed in 1994 to continue the existing trade regime.

The trade regime that existed between Israel and the Territories since 1967 corresponded to the conceptual framework of a customs union but it was implemented by Israel unilaterally — an "imposed customs union" rather than one achieved through agreement. Israel determined the trade arrangements according to its own interests. Additionally, in certain areas Israel protected itself in a manner not normally found in customs unions — for example in the area of agriculture. Another irregular and unusual feature of the imposed customs union: from 1967-1993 it provided no arrangement for sharing the proceeds from import taxes; the lion's share of the revenues was transferred to Israel.

The differences proposed in the Paris Protocol were meant to ease certain conditions for the Palestinians, i.e. the right to import certain goods in limited quantities at rates not regulated by Israeli customs (See Lists A and B in the agreement). It promised limited and temporary protection for Israeli agricultural products and more reasonable arrangements for dividing import duty revenues.

A bitter argument broke out during the Paris negotiations concerning the preferred customs regime. The Palestinians preferred a Free Trade Area (FTA) such as the 1994 NAFTA agreement between the USA, Canada, and Mexico. Members of a FTA do not share a single exterior border; each partner decides its own trade regime with the rest of the world. Rather, among the partners to the agreement there are trade borders, but goods manufactured within the joint area — in our case Israel and the Palestinian Territories — would not be subject to customs or other trade limitations when sold within the free trade area. When the Oslo Agreements and Paris Protocol were signed, Israel opposed any defined border, thus rejecting any system other than a customs union. The 'reward' that was offered to the Palestinians for agreeing to a customs union related to the labor links: allowing Palestinians to continue working in Israel. Thus, along with the carrot in the form of a customs union, appeared the stick, a threat to discontinue Palestinian entrance to the Israeli labor market. It was made clear to the Palestinians that the continuation of work in Israel depended upon accepting the continuation of the customs union.[21]

The threatening stick had been withdrawn, as can be seen in the section of the labor agreement:

21. The official exceptions to the customs union were lists of products A1, A2, and B (specified quantities of imports from Arab and non-Arab countries that were not subject to the Israeli trade protocol and investment goods for public development plans) as well as some exceptions applied temporarily to agriculture. See also Sharif S. Elmusa and Mahmud El-Jaafari, "Power and Trade: The Israeli-Palestinian Economic Protocol," *Journal of Palestine Studies*, Vol. 24 (1995), pp. 14-32; Arnon et al., *The Palestinian Economy: Between Imposed Integration and Voluntary Separation*, chapter 4; and Ephraim Kleiman, "Fiscal Separation without Economic Integration: Israel and the Palestinian Authority," in Assaf Razin and Ephraim Sadka, eds., *Economics of Globalization: Policy Perspectives from Public Economics* (Cambridge: Cambridge University Press, 1999), Chapter 11, pp. 246-263.

> Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and conditions of the labor movement into its area. If the normal movement *is suspended temporarily* by either side, it will give the other side immediate notification, and the other side may request that the matter be discussed in the Joint Economic Committee.
>
> The placement and employment of workers from one side in the area of the other side will be through the employment service of the other side and in accordance with the other side's legislation. The Palestinian side has the right to regulate the employment of Palestinian labor in Israel through the Palestinian employment service, and the Israeli Employment Service will cooperate and coordinate in this regard.[22]

Thus, the Economic Protocol states that movement of workers will be as "normal" as possible and permanent blockage on the movement of workers would not be permitted; there is, however, no clarification concerning the implications of frequent limits on movement.[23]

The agreements continued the strategy of avoiding a decision on "One" or "Two," seeking a provisional arrangement that would avoid establishing a border while not making the Territories and Israel into one economic (and political) unit. Although Israel formally accepted a legitimate partner, Dayan's vision had not been negated. Hence the Paris Protocol is represented in Diagram 1 as an "agreed economic integration," at least *de jure*. Yet, economic integration was far from perfect and the agreement was, as we have seen, just partially voluntary. However, the actual *de facto* developments led to the worst alternative: imposed separation. The latter is certainly not "One" but as we shall see it also does not serve the "Two."

THE CLOSURE REGIME — BACK TO UNILATERALISM: 1994-2000

Those who signed the Paris Protocol anticipated an increase in economic integration between the two economies, but the reality was a growing, unilaterally imposed, separation. After the agreement was signed many more restrictions were introduced on free movement, including on the flows of both goods and labor and even on free movement within the Territories. Many political and security reasons were given for the restrictions, created and enforced by Israel. Without elaborating on Israel's intentions, the result was "The Closure Regime" — both internal and external — very far from the openness espoused in the Paris Protocol.[24] Thus, the *de facto* economic regime was closer to an imposed separation.

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22. Article VII — Labor, Section 1. The emphasis is mine. The interpretation of this section was the subject of considerable debate, especially when Israel imposed an increasingly strict policy of closures.

23. The Paris Protocol is very similar to the conclusions of the Ben-Shahar committee, the Israeli team that prepared the economic negotiations on interim arrangements.

24. See discussion of the closures in Ishak Diwan and Radwan A. Shaban, eds., *Development under Adversity? The Palestinian Economy in Transition* (Washington: The World Bank, 1999) and World Bank, *Long Term Policy Options for the Palestinian Economy* (West Bank and Gaza office: The World Bank, 2002).

One important change in the economic reality concerned the public sector. The interim agreements led to establishing a public authority — first described as the Palestinian Interim Self-Governing Authority (PISGA) and then as the Palestinian Authority — which was responsible for virtually all civil and some security issues. Financing the Authority was to come from limited local taxation, transfers from Israel as described in the Paris Protocol, and on exceedingly generous foreign aid. Arrangements for international aid were made immediately after the signing of the Oslo Accords; the World Bank played a central role.[25]

The spirit of the agreement never materialized and energetic development on the West Bank and Gaza Strip dissipated. Violent hostilities between Israelis and Palestinians overshadowed ongoing bargaining between the sides and contributed to fading hopes for economic prosperity. The economy was supposed to sustain an end to the dispute, certainly according to advocates of "The New Middle East" like Shimon Peres. Reports from international organizations showed that the development strategy failed, especially in the two years immediately following the Paris Protocol, 1995 and 1996.[26]

The frequent closures and the replacement of Palestinians with foreign workers brought a dramatic change in the pattern of relations between the Israeli and Palestinian economies. The number of Palestinian workers in Israel dropped drastically: Before the 1994 interim agreements, 30% of the Palestinian labor force in the West Bank and more than 40% in Gaza worked in Israel. In 1995-6 the percentage of West Bank workers in Israel dropped to 18% and those from Gaza to only 6%. Thus salaries paid to workers from the Territories declined; remittances from work in Israel dropped from more than 30% of the GDP in the West Bank, to about 20%, while in Gaza remittances dropped from some 50% of the GDP in the 1980s to less than 10%. At the same time, the rate of unemployment in the Territories, which had been relatively low until 1993, rose to very high levels: around 20% in the West Bank and more than 30% in Gaza in 1996. These rates dropped a bit after a major closure ended in 1996 allowing more movement of workers during the late 1990s (See Tables 1, 2, and 3).

The characteristic deficit in the balance of payments continued and the Palestinians imported far more than they exported to Israel. The difference was covered by international aid, which, instead of creating conditions for sustainable development and productive growth, became a tool for preventing an even sharper drop in the standard of living. The private sector, expected to drive development in the Territories, failed to do so mainly because of the successive closures, political instability, and economic uncertainty that thwarted both local and foreign investors. The newly-formed public sector faced many difficulties, particularly the challenging process of transforming a stateless organization to a political body building national institutions. To some extent the public

25. World Bank, *Developing the Occupied Territories: An Investment in Peace*. It should be noted here that the World Bank Report published in August 1993 was both innovative and important. For the first time, a highly respected international team conducted extensive research on the economy of the Occupied Territories. That study made possible credible discussions on plans for aid that began immediately after the agreement was drawn up in 1993.

26. See Arie Arnon and Jimmy Weinblatt, "Sovereignty and Economic Development: the Case of Israel and Palestine," *Economic Journal,* Vol. 111 (2001), pp. F291-F308 and Diwan and Shaban, eds., *Development under Adversity? The Palestinian Economy in Transition*, chapters 1-4.

sector depended upon Israel's goodwill: According to the Paris Protocol, Israel was responsible for transferring various funds to the Authority including its revenue from import taxes and other payments. More than 60% of the revenues of the Palestinian Authority, excluding international aid, were transferred from Israel in the years 1995-2000. Thus dependency on Israel did not disappear, but changed from dependency on Israel's labor and goods markets to include financial support to the Palestinian public sector. After a wave of bombings by Palestinians in the summer of 1997, and against the terms of the agreement, the Israeli government voted not to transfer revenues it had collected for the Palestinians. It was not the last time that Israel would implement such measures.

Table 3: Basic Data on the West Bank and the Gaza Strip 1995-2005: Employment in Israel, Unemployment, and Under the Poverty Line (percentages)

	West Bank			Gaza		
	Employment in Israel (% of total employment)	Unemployment	Under the Poverty Line*	Employment in Israel (% of total employment)	Unemployment	Under the Poverty Line*
1995	20.2	13.9	--	3.3	29.4	--
1996	16.6	19.6	16	8.1	32.5	42
1997	19.5	17.3	16	11.0	26.8	38
1998	24.0	11.5	14	16.2	20.9	33
1999	25.9	9.5	13	15.7	16.9	32
2000	22.4	12.1	18	12.9	18.7	42
2001	18.0	21.5	27	1.9	34.2	54
2002	13.3	28.2	41	2.5	38.0	68
2003	12.5	23.8	37	3.3	29.2	64
2004	11.6	22.9	38	1.1	35.4	65
2005	13.8	20.3	46	0.4	30.3	63

*According to the World Bank, the poverty line is $ 2.1 per capita per day.

Sources: PCBS, *Labour Force Survey* (Ramallah: PCBS, 2006), http://www.pcbs.gov.ps/Portals/_pcbs/labor/Microsoft%20Word%20-%20Text-e.pdf; World Bank, various publications, available at http://go.worldbank.org/OM4QIEVVE0 and http://go.worldbank.org/2TW0J5F3L0.
For unemployment definitions see International Labour Organization (ILO), "The 20 Key Indicators of the Labour Market," December 9, 2005, http://www.ilo.org/public/english/employment/strat/kilm/indicators.htm#kilm8; and PCBS, http://www.pcbs.gov.ps/Portals/_pcbs/labor/

Optimistic expectations that trust building would pave the way to permanent agreement, political moderation would accompany a rising standard of living, and economic integration and assistance programs would be implemented, accompanied the signing of the Oslo Accords.[27] The actual disappointing economic reality was already evident in 1995. An early attempt to deal with the discrepancy and address the econom-

27. For two examples of the relatively optimistic discussions of integration in the mid-1990s see Mohamed A. El-Erian and Stanley Fischer, "Is MENA a region? The scope for regional integration," IMF Working Paper, pp. 96-30 (1996); and Hisham Awartani and Ephraim Kleiman, "Economic Integration Among Participants in the Middle East Peace Process," *The Middle East Journal*, Vol. 51 (1997), pp. 215-229.

ic difficulties was carried out by two Israeli committees appointed by Prime Minister Yitzhak Rabin in January 1995 to examine the security and economic issues of borders respectively.[28] The parallel committees worked on both tracks but neither completed nor published its findings. From drafts of the economics team's recommendations it is clear that while the security team supported the delineation of borders, the economists opposed borders and separation.[29]

The opposition to separation arose from opposition to Palestinian sovereignty and because economists naturally reject the very idea of borders. Thus, the economists rejected what we termed "Two." Although they did not rely on any historical precedents, their position was in line with that of Dayan and Israeli policy as implemented since 1967. A border is a decision in favor of "Two" and the economists remained committed to the strategy of indecision. The economic team's draft stated:

> Establishing a separation line adjacent to the Green Line (according to the understanding of the security team) ... is in clear opposition to the framework established for conducting negotiations with the Palestinians. At this stage there is no point in discussing the final status agreement — and certainly not borders.

Furthermore, from an economic point of view the draft said:

> The implications of separation ... on the Palestinian economy in the short term ... are severe. Separation ... will drastically affect the Palestinian demand for a change to the Cairo agreement [of which the Paris Protocol was an official element] and for opening the Palestinian economy to more countries.[30]

This basic dispute of whether or not to delineate political, legal, and economic borders between Israel and Palestine continued to affect Israeli politics. In 1995 the economic team had the upper hand. The draft of their report was leaked and used by those who supported economic integration.[31]

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28. Heading the committees were Cabinet Minister Moshe Shahal who chaired the security committee, and then-Director General of the Ministry of Finance David Brodet, who chaired the economic committee. The economic team was based upon "The Economic Committee to the Paris Peace Talks with the Palestinians" and its objectives were thus delineated in the draft report: "1.1 Examining the economic significance of separation between the population of the sovereign state of Israel and the Palestinian population in Gaza, Judea and Samaria. 1.2 Examining the impact of the separation on Israel's economy and on that of the Autonomy. 1.3 Drawing up recommendations for solving the problems that might arise in the Israeli and Palestinian economies as a result of this policy." Office of the Finance Minister, *Draft Report*, January 31, 1995.

29. Although the report was never officially published, the recommendations were leaked to the media for obvious political reasons. The author has a copy of that report. The Introduction states: "Upon thorough examination of the concept of separation, serious doubts arise regarding the concept itself and the possibility of implementing it …"

30. Office of the Finance Minister, *Draft Report*, January 31, 1995.

31. Thus, for example, a *Ha'aretz* editorial of March 19, 1995, under the headline: "[Separation] Has No Chance" stated: "The economic team ... will recommend that the Prime Minister not implement the separation plan, which he approved on the basis of security recommendations ... The economic team has presented to Yitzhak Rabin a great deal of material ... [he] should ... shelve the

[Continued on next page]

Plans allowing two nations and two economies to exist alongside each other — "Two" rather than "One" — required delineating borders which support economic development; these were rejected. The Paris Protocol, which assumes no borders and allows a continuation of Israeli rule, was the official economic agreement even though it was already evident that its implementation was problematic, if not impossible.

In the dispute between the security and economic teams, Shimon Peres, Foreign Minister at the time and Prime Minster for several months after Rabin's assassination, won the day. Along with the economics team, his vision of the "New Middle East" — a concept which excluded borders — won the 1995 debates. Peres' views were similar to those of Dayan and continued to be predominant in Israeli society in the coming years, although the security team's dissenting opinions began to be heard in official circles, as we shall see later on.

The decision not to decide, to continue to navigate between the "One" and the "Two" deepened the economic crisis in the Territories. The report of The Palestine Economic Policy Research Institute (MAS) and the World Bank, *Development Under Adversity* (prepared in 1996-7 and published in 1999) described the economic changes in the Territories — especially the negative effect of the closure regime.[32] Donations from international organizations and donor states were high, close to $300 per person per year at the height of the crisis, more than any other region in the world. Donor states expected the growth in aid would correspond to a process of economic revitalization in the Territories. They began to reassess their strategy in order to correct the failures that characterized economic relations between Israel and the Palestinians.[33]

The central economic question had been already mentioned in the 1967 report of the Bruno Committee: Is economic development in the Palestinian Territories possible without economic integration? If security and political borders were delineated, would economic borders allow both economies to prosper? Would the Palestinian economy come to rely less upon the export of labor and more on the export of goods? Economists naturally tend to favor integration and support dissolving borders, but many economists adopted a different approach: In certain periods and under certain conditions, the best arrangements might not be overall integration but rather an agreement which would include borders. Such an agreement might be the only possibility if the assurance of stability would mean higher investment.

A central issue in this context is the extent of economic sovereignty, especially regarding borders. Usually there are trade-offs between sovereignty and economic prosperity; that is, economies can give up some aspects of sovereignty in return for

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entire plan." The main points of the economic draft-report also appeared in *Yediot Ahronot* on March 21, 1995, pp. 6-7. The piece opposed Shahal and the idea of fixing borders, under the headline: "Separating from the Autonomy is an economic and political error that will cost Israel dearly."

32. Diwan and Shaban, eds., *Development under Adversity? The Palestinian Economy in Transition* and World Bank, *Long Term Policy Options for the Palestinian Economy*.

33. These questions were addressed at length in World Bank, *Long Term Policy Options for the Palestinian Economy*, which was dedicated to an economic analysis of long-term alternatives, i.e. not an interim agreement. The World Bank and other international organizations recommended less integrative alternatives. They came to the conclusion that post-1992 Europe was not the preferred model in this case, but rather Europe before the EU. They preferred a trade agreement similar to that of the Most Favored Nation (MFN).

more prosperity. This was basically the argument favoring the creation of the European Union. In our case, because of reasons unrelated to economics, there would be a definite need for more sovereignty and borders: Would that necessarily damage the potential for growth? Considering the continuing, hostile dispute, it would be realistic to assume that more sovereignty, especially regarding borders, would assure better chances for political stability, and would contribute to well-functioning economies.

Continuing discussions among concerned economists strengthen the view that not only political necessities but also economic considerations justify borders. There is not only a trade-off between sovereignty and prosperity but also a complimentary relationship which justifies borders for economic reasons. These arrangements are not what economists call "First Best," — but rather "Second Best." They do not reflect optimal, theoretical conditions that would bring maximum prosperity but reflect realistic conditions when it is impossible to attain the best. It is important to note that "Second Best" considerations often justify interventions in free market processes, i.e. arguments for protecting infant industries were raised. The debate emphasized short-term rather than long-term considerations.[34]

Avoiding the matter of borders in general, and their location in particular, prevented timely assessment of the advantages of "good" borders — where crossings are efficient. Of course borders disrupt the flow of goods and the means of production, but in some cases they are very disruptive, while in others they may be less so. Since until not long ago both sides believed that there would be no economic borders, there had been no thought given to the nature of borders. The present discussions about the barrier ignore the negative economic repercussions of a one-sided partition.

The conclusion that mutually agreed upon borders with specific, well-organized crossing-points could serve the interests of both sides was reached by the Committee to Discuss Principles of a Permanent Economic Agreement Between Israel and the Palestinian Authority, headed by Professor Avi Ben-Bassat. The committee was established in 1999 to prepare for economic negotiations parallel to the Camp David talks. Their conclusions were recently published and allow us to take a look at some considerations made by Israeli policy-makers before the second Intifada.

The Ben-Bassat Committee report reflects a new position among economists, even if its recommendations are neither official nor final. The material "has historical and research importance," as is stated in the report's preface.[35] The most basic conceptual changes were the preference for a defined, legal trade border and a rejection of the "customs union." The committee believed that Israeli and Palestinian interests would motivate both sides, even if for different reasons, to accept a Free Trade Area (FTA) resembling that which exists between the USA, Canada, and Mexico.

34. Arie Arnon and Jimmy Weinblatt, "Sovereignty and Economic Development: the Case of Israel and Palestine."

35. Avi Ben-Bassat (the Ben-Bassat Committee), *Doch Vaada le-Bhinat Ekronot Hesder ha-Keva ha-Kalkali Ben Yisrael ve-ha-Rashut ha-Phalestinit* [*Report of an Exploratory Committee to Assess the Principles of a Permanent Economic Agreement Between Israel and the Palestinian Authori*ty] (Avi Ben-Bassat, Committee Chairman and Director General of the Finance Ministry; Meir Kaputa, Secretary and author of draft report), in *Doch Minhal Hachnasot ha-Medina* [*The Annual Report of Israel's Revenue Administration*] (Jerusalem: Israel Revenue Administration, 2002-2003), pp. 489-627. Meir Kaputa was Deputy Director of IRA.

Regarding labor, the Ben-Bassat Committee recommended: "That Israel continues to protect its right to decide the number of Palestinian workers from the Territories."[36] The Committee based its decision upon what I believe is the questionable assumption that this was in accordance with the Paris Protocol, assuming that it protected Israel's right "to limit movement of labor of Palestinians in the Territories for security and economic considerations." It is most doubtful if that is an accurate interpretation of the Protocol which assured the normal movement of workers even if temporarily interrupted. It certainly was not in the spirit of the Paris Protocol, which aspired to clear the way for economic integration between the economies with minimal disturbances to economic linkages.

The idea that political and economic considerations gave preference to borders had begun to prevail among international experts concerned with the Israeli-Palestinian conflict. Particularly important was the World Bank's comprehensive 2002 research project *Long Term Policy Options for the Palestinian Economy*. Its authors concluded that an agreement even less integrative than a FTA would be preferable to the Palestinians on economic grounds. In research on economic alternatives for the long-term agreement, the World Bank and other international organizations recommended less integrative options. They came to the conclusion that post-1992 Europe is not the preferred model in this case, but Europe *before* the economic union. The trade arrangement they recommend is called "Most Favored Nation" (MFN — a trade regime in which the sovereign states adopt independent trade policies but do not discriminate among trade partners).

"THERE IS NO PARTNER" AND THE SECOND INTIFADA: 2000-2005

At Camp David in July 2000, the last chapter of the Israeli-Palestinian dispute was effectively shaped, at least as this article is written. Despondency at the failure of negotiations was as deep as aspirations were high at their outset. From "striving to put an end to the dispute" with a permanent two-state solution wherein both would live side-by-side in peace, there evolved a razor-sharp rhetoric where we "unmasked our enemies" who "spoke of peace but were actually trying to destroy us" as Israeli Prime Minister Ehud Barak argued. He made Israelis believe that "there is no partner." When Ariel Sharon, who had always held this to be true, came to power, he shut the door to the negotiating table, eliminating the possibility of repairing the failures of previous negotiations.[37]

The failure to reach a permanent agreement at Camp David along with the outbreak of the second Intifada ended efforts to implement an arrangement described in Diagram 1 as "agreed borders." The terms of such an alternative had never been specified or tested, neither in formal accords nor in actuality. Since 2000 the economy has become an inextricable part of the battlefield where, as in military strategy, both sides try to achieve a decisive victory. Economic policy became an accepted tool for applying

36. Avi Ben-Bassat (the Ben-Bassat Committee), *Doch Vaada le-Bhinat Ekronot Hesder ha-Keva ha-Kalkali Ben Yisrael ve-ha-Rashut ha-Phalestinit*, p. 517.

37. An analysis of the failure at Camp David is not within the realm of this paper. For more on the matter see Yoram Meital, *Peace in Tatters: Israel, Palestine, and the Middle East* (Boulder: Lynne Reinner Publishers, 2006).

pressure as each side does its best to hurt the other. Even for public relations purposes both sides no longer claim to be interested in the economic prosperity of the other.

The hostility dramatically affected the economy. Israel suffered a three-year recession and damaged its GNP by about 8%. The Palestinians suffered from an economic collapse on a different scale. In the first three years living standards dropped by about 30%. The unemployment rate rose to levels unknown in industrialized Western societies — about 30% in the West Bank and nearly 40% in Gaza (according to ILO definitions). The poverty rate, with a poverty line fixed by the World Bank at $2.1 per capita per day, rose from 13% before the collapse to a peak of 40% in the West Bank and from 32% to about 65% in Gaza. International aid from donor states rose to the unprecedented level of over one billion dollars a year, about one-third of the GDP. This assistance, rather than helping to build the Palestinian economy, became an emergency safety net.

Thus more than 30 years after devising a policy of imposed (partial) integration, when the time came to reshape economic relations between Israel and the Palestinians there was a continuing avoidance of the need to renegotiate "One" or "Two." While the Palestinian desire for sovereignty may conflict with aspirations for economic development, it is certainly possible to resolve the problem. The Palestinians have the right to design their own economic regime as they see fit. Since 1994 Israel has claimed that economic integration is good for the Palestinians. That claim has passed neither the test of time nor economic theory, and imposing economic integration has brought about most unfortunate results.

In the permanent agreement, both sides must choose paths that will solve contradictions between sovereignty and economic growth. The Israelis especially will be better off if they relinquish the impossible dream of erasing economic borders out of 'concern' for Palestinian living standards. Sovereignty means having the right to decide and implement policies, including economic policy, i.e. to designate economic borders and policies implemented within those borders. The Palestinians should do so according to their own best interests. Thus, we need a new agreement that includes "economic filters," i.e., borders for trade and labor flows that serve the interests of both sides. Agreement on economic borders does not mean total economic separation; these borders are meant to be relatively open to the movement of goods and people. It is important to invest in sophisticated, efficient crossing points where state-of-the-art security measures will prevent sporadic closures.

The search for an agreement in which each side would recognize the legitimacy of the other was continued in relatively limited circles.[38] For example the Aix Group, in which Israeli, Palestinian, and international economists participate, assumed that there would be two sovereign states that would negotiate mutually beneficial economic arrangements. The two nation-states would determine policies and make decisions, some independent and others coordinated. The Aix Group dealt with issues that require coordination in decision-making, and assessed the consequences of borders between

38. See a rare example for the continued attempts to discuss the economics of "two states" in David Cobham and Numan Kanafani, eds., *The Economics of Palestine: Economic Policy and Institutional Reform for a Viable Palestinian State* (London: Routledge, 2004). See in that volume an analysis of the Gaza port: Arie Arnon, Avia Spivak, and Oren Sussman, "Incomplete Contracts, the Port in Gaza and the Case for Economic Sovereignty," Chapter 11, pp. 281-290.

the two countries. Its *Economic Road Map,* published in January 2004, proposes a framework for the future economic relations between Israelis and Palestinians in the territory that lies between the Mediterranean Sea and the Jordan River.[39]

The Aix Group concluded that there was an advantage in starting from the end. The concept — "reverse engineering" — seeks to define the preferred final agreement, the third phase of the Road Map, and derive from it the arrangements for the present as well as for those phases leading to final status. This is of course exactly the opposite procedure and methodology of the Oslo process, where gradualism and vagueness concerning the end phase were the guiding principles.[40]

The economic rationale upon which the Aix Group based its recommendations differed from the regimes adopted in the past — those imposed by Israel after 1967 and of the 1994 Paris Protocol. The Group recommended establishing trade borders, an Israeli-Palestinian FTA, and regulated labor flows. There are specific recommendations on financial and monetary arrangements. The recommendations correspond to changes that occurred over time on both the political and economic horizons.

EPILOGUE 2006: DEAD END?

The rise of the Hamas government in January 2006, following its surprising achievement in the elections, seems to signify the beginning of a new era.[41] Although the framework describing the options for relations between the two peoples remained the same, the position of Hamas and the responses of the international community and Israel to their victory raised an important question: Is there any possibility of reaching an agreement? Moreover, under the current circumstances it is not even clear how normal economic life will continue.

The various options surveyed in this paper were presented in a simple, two dimensional scheme: one dimension related to the existence of a border versus no border; the second dimension distinguished between an imposed decision versus one that is mutually agreed upon (See Diagram 1). The economic policy Israel adopted in 1967 towards the Palestinian Territories — "imposed economic integration" — continued

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39. Aix Group "Economic Road Map: An Israeli-Palestinian Perspective on Permanent Status" [ERM], 2004, http://www.aixgroup.org/downloads.html (available in English, Arabic, Hebrew, and French), also in the *The Economic Quarterly*, Vol. 51, pp. 121-139 (Hebrew). There were about 30 Israeli, Palestinian, and international economists and observers in the Aix Group, some holding official positions and some not. They took part in the discussions as individuals — not as official representatives of their home institutions. The group met in 2002 in response to the initiative of Professor Gilbert Benhayoun of the Aix-en-Provence University, and thus its name. The group continues to deal with economic aspects of issues concerning a permanent agreement, including questions of the economic regime in Jerusalem, refugees, and shaping the nature of cooperation between the two countries. See also Aix Group, "Israel and Palestine: Between Disengagement and the Economic Road Map," (MS, 2005) http://www.aixgroup.org/downloads.html (English, Arabic, and Hebrew).

40. It is appropriate to note that I was the coordinator of the Israeli team at these discussions. However, the opinions in these pages are mine alone, and not necessarily those of other members and observers of the group.

41. It was the first election for members of the Palestinian Authority's Parliament in which Hamas took part as a movement. Hamas chose not to take part in the first Palestinian Authority elections in 1996.

until 1994 when the Paris Protocol was signed. "Agreed integration" based on no border characterizes the Paris Protocol. In reality, imposed economic borders — what we call "the closure policy" — has actually existed since 1994. The fourth alternative, which calls for mutually agreed upon borders, is an option that has never been tried. In this article we argue that a broad consensus over the last few years supports its advantages, both political and economic.

The rise of the Hamas government presents an unexpected challenge. According to its platform and declared beliefs, Hamas rejects a permanent agreement with Israel, specifically on dividing the land along an agreed border. Thus it seems that Hamas will not be a partner to any of the agreements, since they require two legitimate parties. Hamas does not accept the existence of two peoples sharing the territory between the Sea and the Jordan nor does it recognize the Israeli political entity as legitimate. All existing agreements assumed that the two states would recognize each other. The sides could decide on one economic unit without borders, i.e. a bi-national political entity whose economic agreements would resemble those of the EU since 1992, or they could establish separate economies with recognized, agreed-upon borders. However, denying the legitimacy of a partner, which characterizes the position of Palestinian politicians like those from Hamas and Israeli politicians who on principle deny Palestinian rights, will suit none of these options.

The Palestinian economy in the West Bank and the Gaza Strip, like all other economies, must have structured relations with the world. However, both the customs regime in effect since 1994 and the previously agreed financial policy are no longer recognized as obligatory — neither by the international community nor by Israel. In this regard the Palestinian economy in 2006 has no valid trade regime. Moreover, financing for the Palestinian Authority depends upon transfers from Israel as described in the Paris Protocol, and on outside assistance from the donor states. The decision taken in 2006 not to transfer funds to the Authority or to even discuss a trade regime, has turned the Palestinian economy into an entity unlike any other in the world, as it has no legal framework within which it can function. The complete collapse of the Palestinian economy has been prevented because the vacuum of "no economic regime" did not actually happen. In reality trade continues in a very limited manner and ways have been found to transfer funds to the public sector of the Authority. Even some workers from the West Bank continue to cross into Israel.[42] But its economic existence is under threat.

It is possible that the present chaos will become the birth pangs of a new agreement by both sides. If agreement is not reached but each side accepts the legitimacy of the other, we will find ourselves in the realm of imposed alternatives and, as has been the case over the last 40 years, only one side will decide for both.

But if the day comes when the two sides not only accept the legitimacy of the other, but agree that "Two exist and will continue to exist between the River and the Sea," they will have to examine the advantages and disadvantages of "One" or "Two." It is not a wild guess to expect that the first agreement, if ever reached, will establish an economic regime that will be close to an "Agreed Two."

42. About 55,000 workers from the West Bank continue to work in Israel. That number includes those who work in settlements in Jerusalem. The Israeli government policy of separation, made in June 2004, declares that by 2008 the number will be reduced to zero. This article was written before the changes in Gaza in June 2007 and hence does not address this development.